1995

Auto Dealership Engagement Manual, Volume 1

Tony L. Argiz

Marc S. Dickler

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AICPA

Auto Dealership Engagement Manual

INTEGRATED
PRACTICE
SYSTEM

VOLUME 1

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AICPA INTEGRATED PRACTICE SYSTEM

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INTEGRATED

PRACTICE

SYSTEM

This manual has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants or the Financial Accounting Standards Board and has no official or authoritative status.

The manual is issued as a nonauthoritative kit of practice aids and is not intended as a substitute for professional judgment or for authoritative technical literature.

The documentation in this manual is not a substitute for development and implementation by a firm of a system of quality control that is appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice.

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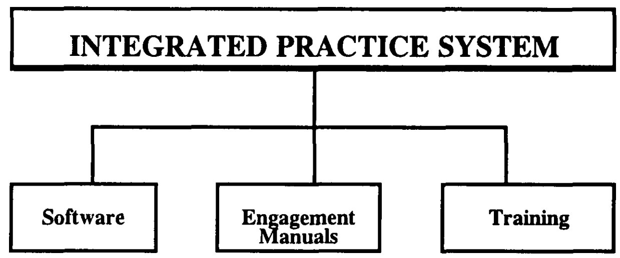
The AICPA Integrated Practice System:
For CPAs Concerned About Quality and Profitability



The Integrated Practice System gives practitioners the tools they need to conduct high-quality and cost-effective engagements. How? By enabling CPAs to anticipate engagement problems and by putting the solutions to these problems — integrated engagement manuals, software products, and training resources — within their grasp.

ONE SYSTEM, ONE SOLUTION

This innovative system is the *first* integrated system that is specifically designed to enhance the quality of your practice. It offers guidance on the day-to-day management of client engagements and provides practical discussions on the applicability of authoritative literature. Each element of the system — manuals, software, and training — was developed by CPAs who recognized the need to provide a comprehensive, hands-on approach to engagement planning and performance. Working alone or as a unified system, Integrated Practice System products provide the solutions needed for a firm to achieve top-quality performance and bottom-line profitability.

INTEGRATED PRACTICE SYSTEM — IN A CLASS BY ITSELF

Significant advantages distinguish these tools from other commercially available products. The Integrated Practice System tools —

- **Represent an integrated, synergistic system** that is state-of-the-art.

- **Include access to technical support hotlines** that put you in touch with professionals who can answer your technical questions. Just call the following numbers:

  Engagement Manuals 800-TO-AICPA (800-862-4272)

  Software Products 800-226-5800

  Training 201-938-3060

- **Receive ongoing field-testing and evaluation** from a task force of the AICPA's Private Companies Practice Section (PCPS) — CPAs who confront similar challenges in their practices and who represent the interests of local and regional firms.

- **Include a 60-day "no-questions-asked" return guarantee** that allows you the time to try the Integrated Practice System products and find out for yourself how your firm and staff can benefit from them.

ENGAGEMENT MANUALS: THE SMART KID ON THE BLOCK

Finally, there is a reliable, step-by-step approach for managing and performing your engagements. The Engagement Manuals point you in the right direction with the time-saving tools you need to conduct high-quality engagements with the greatest efficiency. Right from the start, the Engagement Manuals show you a direct route to protecting your bottom line. You can minimize on-site field work and put an end to "over-auditing" because our exclusive "ABC System" helps you evaluate risk in the critical planning stage. You'll find important guidelines to use in evaluating your client, so that you can adjust the level of testing to the internal controls employed by the client.

The Engagement Manuals feature a practical, "how-to" approach that enables you and your staff to cut through the clutter and focus on what's important. By eliminating time-consuming guesswork, they chart the course to the most cost-effective, efficient way of proceeding with your engagement. Plus, the manuals include ready-to-use forms, programs, checklists, and questionnaires — even sample correspondence to speed your work.

Each Engagement Manual includes —

- Guidance based on the most recent relevant authoritative and non-authoritative literature;
- Integrated work programs and checklists;
- Model letters ready for your use;
- Time-saving worksheets that capture important information and also help users identify opportunities for other services that can be provided to existing clients, such as consulting and tax services and the preparation of prospective financial information.
- Diskettes, in WordPerfect format, that include all the sample letters and accountant's/auditor's reports included in the manual.

What's more, the Engagement Manuals ease the process of quality review by helping you develop the documentation you need.

The Engagement Manuals can be easily used as stand-alone practice aids. Or, you can use them in conjunction with the full complement of software products — including the AICPA's very successful Accountant's Trial Balance (ATB) and Audit Program Generator (APG). It's the flexibility you need for a cost-efficient, high-quality engagement.

The AICPA recognizes your need to be up-to-date on issues that affect your clients — that's why subscribers automatically receive annual updates for the engagement manuals. Our goal, pure and simple: to provide the answers to your questions even before you ask them.

Because the AICPA has an ongoing commitment to developing the practice aids you need to serve your clients, it will continue to release new industry-specific manuals. These will contain the same kind of practical tools and how-to guidance that are the hallmarks of the Engagement Manuals.

Comprehensive Engagement Manual

The *Comprehensive Engagement Manual* can help practitioners manage most engagements. Designed to be the accountant's companion to audit, review, and compilation engagements, this manual includes checklists, forms, flowcharts, questionnaires, tables, and all the documentation necessary for any size client.

This four-volume set covers engagement performance, documentation and reporting, and helps you make key decisions, including —

- Assessing risk and establishing materiality limits;
- Selecting the most cost-beneficial audit approach;
- Designing the most economical auditing procedures; and
- Making sampling decisions that maximize efficiency.

The *Comprehensive Engagement Manual* features the unique and highly-popular "ABC System" that enables practitioners to identify the most cost-beneficial mix of tests of controls, substantive tests of balances, and analytical procedures for specific engagements. This manual is ideal for firms that want a system they can apply to the full spectrum of audit engagements — whether they plan to perform tests of controls or a totally substantive audit.

Small Business Audit Manual

The two-volume *Small Business Audit Manual*, an alternative to the *Comprehensive Engagement Manual*, walks you through each step of the audit of a small business client. Designed for firms that use a substantive testing approach on all of their audits, the *Small Business Audit Manual* helps you to:

- Plan a cost-effective and time-efficient engagement;
- Verify all financial statement assertions using substantive tests;
- Understand a client's internal control structure;
- Better understand how to apply authoritative standards to small business audits;
- Evaluate a small business' computer needs.

The *Small Business Audit Manual* also puts at your fingertips sample audit programs, questionnaires, model letters, time sheets, workpapers, and audit reports for a small business audit engagement — organized in the sequence they will be used. If your firm's audits rely totally on substantive testing, this is the manual for you.

Banks and Savings Institutions Audit Manual

The three-volume *Banks and Savings Institutions Audit Manual* can help you cope with the high risk generally associated with bank audits and the complexity of bank operations. It is designed to enable you to perform high-quality engagements with maximum time savings. Based on the unique "ABC System," this manual allows you to design the most efficient and cost-effective mix of tests of controls and substantive tests of balances, and analytical procedures. It does so by including:

- A framework to help practitioners design the most cost-effective audit strategy;
- Worksheets and forms to help auditors understand a bank's internal control structure and assess risk during engagement planning.
- Programs for interim work;
- Sampling documentation and discussions of professional standards that affect the sampling decision;
- Worksheets for various analytical procedures that can help to identify errors and irregularities.

Construction Contractors Audit Manual

You'll find this two-volume manual your most valuable practice aid when working on engagements for construction contractors. It contains:

- Two audit approaches—the "System's Walk-through Approach" for substantive audits and the "ABC System" — to help you design the most efficient and effective audit strategy for each engagement;
- Practical, how-to guidance for completing construction contractor audits;
- A chapter dedicated to the surety industry to help you understand what the surety wants and needs;
- All the necessary audit programs, forms, checklists, sample correspondence, and working papers to comply with today's quality control standards;
- A supplemental tax preparation checklist specific for construction contractors;
- The AICPA Audit and Accounting Guide, *Construction Contractors*, which contains discussions on the applicability of specific professional standards to engagements for construction contractors.

Compilation and Review Manual

This two-volume set gives you a step-by-step system to help you conduct high quality compilation and review engagements — profitably and in compliance with all current applicable professional standards. It contains:

- Programs, checklists, and sample correspondence for performing compilation and review engagements;
- Reporting guidance for OCBOA and personal financial statements;
- Guidance on performing and reporting on prospective financial information.

Credit Union Audit Manual

The two-volume set outlines the most efficient way to approach audits of credit unions and contains guidance on conducting them in compliance with current professional standards. This manual uses the "ABC System" and a newly designed audit strategy for small credit unions, which allows you to choose the best mix of tests of controls and substantive tests of balances, and analytical procedures for each engagement. This manual contains:

- Audit programs, forms, checklists, working papers, and illustrations necessary to perform credit union audits and supervisory examinations;
- The AICPA Audit and Accounting Guide, *Audits of Credit Unions*;
- The most recent checklists and illustrative financial statements for credit unions.

Quality Control Manual for CPA Firms

The *Quality Control Manual for CPA Firms* gives you a step-by-step practical approach to establishing and maintaining your quality control system. Written by CPAs who have extensive peer review experience, it provides all of the guidance and forms you will need, without overburdening you with unnecessary and complex documentation. This manual can be used by firms of all sizes, but its simple approach was designed with the small-to-medium-size firm in mind.

Not-for-Profit Organizations Audit Manual

The two-volume *Not-for-Profit Organizations Audit Manual* contains everything you need to conduct high-quality audits—audit programs, forms, checklists, and sample auditor's reports and financial statements developed especially for not-for-profit organization audits. Also discussed in this manual are two recently-released FASB Statements of Financial Accounting Standards on contributions and not-for-profit organizations' financial statements, as well as FASB's exposure draft on investments, the proposed AICPA Statement of Position on joint activities, and the AICPA's proposed Audit and Accounting Guide for not-for-profit organizations. The manual also helps you efficiently test the compliance requirements of the Yellow Book and OMB Circular A-133.

Auto Dealership Engagement Manual

The *Auto Dealership Engagement Manual* guides you through the twists and turns of an auto dealership audit. Developed to help you conduct effective and efficient engagements in this turbulent industry, it provides guidance that until now has been lacking. This manual includes:

- Two audit approaches — the All Substantive Approach for primarily substantive audits and the unique "ABC System" for audits in which it is efficient to test controls;
- An overview of the industry, including operating characteristics;
- Tailored audit programs and internal controls questionnaire;
- Discussion of auto dealership's unique accounting principles and practices;
- Sample auditor's reports and financial statements; and
- Tax information, including complex LIFO calculations and extended warranty service revenue recognition rules.

SOFTWARE — THE ELECTRONIC EDGE

The AICPA's software products — ATB Write-Up, Accountant's Trial Balance (ATB) and its modules, Audit Program Generator (APG), Engagement Manager (EM) and Depreciation, among others — put the solutions to daily practice problems at your fingertips. Together with the Engagement Manuals, they streamline engagement planning and performance, and enable you to more effectively monitor your staff and your budget. Most importantly, they prevent you from reinventing the wheel each time you plan and conduct an engagement.

It's easy to put these products to work for you. The software requires an IBM PC, XT, AT, PS/2 or IBM-compatible system and DOS version 3.1 or higher. A team of professionals is available to answer any of your questions; simply call the Software Support Hotline at 800-226-5800 or use the Software Express FAX service at 800-226-6868.

ATB Write-Up

ATB Write-Up features powerful options that let you analyze information and generate reports and financial statements quickly and easily. ATB Write-Up takes all of the power and flexibility of ATB, ATB Financial Statements, and ATB Consolidations and adds to it. ATB Write-Up offers:

- Period Reporting — Use up to 13 periods per year. This gives you the flexibility to generate annual, semiannual, quarterly or monthly reports.

- Departmental Reporting — Set up as many departments as you need. ATB Write-Up will print most workpapers and reports by department, in total for all departments, or for a selected range of departments.
- Financial Statements — Up to 16 columns, each custom-definable to include periods, departments, year-to-date, percentages, add columns together, and more.
- Consolidations — Link and combine accounts of related groups into one consolidated company.

Accountant's Trial Balance

ATB, the best-selling, most-used accounting software in the profession today, is an integral part of the IPS family. Designed ***by*** accountants ***for*** accountants and used by approximately 9,000 accounting firms, ATB automates much of the routine work associated with trial balance and financial statement preparation. Specifically, it:

- Generates picture-perfect working papers, including trial balances, journals, lead schedules, user-definable grouping schedules, and analytical review worksheets;
- Enables users to prepare trial balances based on GAAP, federal tax, state tax, or other user-selected accounting bases;
- Keeps up to five years of data on file for any one client, enabling you to generate a variety of comparative reports quickly and simply.

Modules for Use with ATB 3.0

- *ATB Financial Statements* — This powerful report writer enables you to produce final financial statements quickly and easily.
- *ATB Consolidations* — This module enables you to consolidate trial balances from up to nine individual companies into one ATB company trial balance — with ATB automatically keeping track of all activities.
- *ATB Conversion* — With ATB Conversion you can transfer any data electronically from a number of general ledger and working paper packages to ATB and from ATB to leading corporate tax preparation packages.

Audit Program Generator

The Audit Program Generator (APG) enables you to customize an audit program or a checklist to a particular client. Its unique features help you save time and unnecessary expense in conducting audits. Since its introduction in 1987, over 8,000 firms have used APG.

APG Version 2.0 enables you to —

- Create a variety of programs and checklists, including audit programs, disclosure checklists, and compliance checklists;
- Tailor the audit program to the needs of your specific client;
- Customize programs from a wide variety of sample AICPA work programs available in electronic format;
- Quickly link your audit procedures and financial statement assertions;
- Use a full-text editor to customize titles and footers and create appropriate tabular formats.

CHAPTER 1

INTRODUCTION

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Engagement Manager

The Engagement Manager (EM) software package can assist you in planning, analyzing, documenting, and correcting engagement management problems — and free up valuable staff time in the process. Most importantly, it handles the details of creating and modifying budgets, recording actual time and expenses, and comparing results so you can devote your energy to other aspects of your business. With EM's help, you can:

- Anticipate potential budget variances and delays through a variety of analytical reports;
- Spot potential problems while there is time to take action;
- Determine the effectiveness of individual staff members by analyzing their efficiency in assigned areas.

Depreciation

Depreciation provides a simple and efficient means of calculating and tracking how assets are depreciated. It calculates depreciation for six separate reporting bases: book, federal, state, AMT, ACE, and "other." What's more, it lets you apply various methods of depreciation to any of these reports and prints out complete worksheets showing changes in various property accounts and the necessary journal entries to record depreciation for the year. Now, with its pull-down menus, Depreciation is easier to use than ever.

Reports generated through AICPA Depreciation include:

- Depreciation schedules by category, G/L account number, system, or convention
- Summarized worksheet information for Forms 4255, 4562, 4626, 4797, 6252, and Schedule D
- AMT preference calculation
- ACE adjustment calculation
- Fully depreciated assets report
- Amortization report
- Section 179 deduction report
- ITC-taken report
- Basis comparison
- Depreciation account reconciliation
- Amortization account reconciliation
- Schedule M-1 information
- Overridden calculations

TRAINING RESOURCES: MAKING THE INTEGRATED PRACTICE SYSTEM WORK FOR YOU

Whether you're a user of one or more of the Integrated Practice System products or you're looking for ways to more effectively manage engagements, Training Resources can benefit you. You'll learn how the Engagement Manuals and Software can help your practice run more smoothly and how the system works to facilitate productivity, efficiency, and quality performance by you and your staff.

The Training Resources come in three formats: self-study or self-administered group study; customized in-house group study; and conferences. Here is what's available in each format:

Self-Study or Self-Administered Group Study

An *Orientation and Technical Update Seminar* is a formal group study-program designed to assist firms with initially implementing the Integrated Practice System Engagement Manuals. It also provides a monitored self-study orientation on the manuals for new staff. The seminar materials can help you to better understand and apply common SASs in the most efficient manner. You'll learn how to design tests, auditing procedures and sample sizes to collect the right amount of evidence needed for particular engagements.

Accountant's Trial Balance — CPE Edition is a self-study course that teaches you how to automate your working papers for all types of engagements. You'll earn eight hours of CPE credit as you become familiar with ATB and its most used features for audits, reviews, compilations, and tax working papers.

Accountants Trial Balance With Financial Statement Generator — CPE Edition is a self-study course that enables you to rapidly learn the basics of ATB and the Financial Statement Generator add-on module. The recommended CPE credit for this course is eight hours.

Customized In-House Group Study

Special in-firm training is available to demonstrate how your firm can put the Integrated Practice System products to use. And you'll see immediate results. That's because the training leader will use a current client engagement ***you select*** as the training model. Whether you select a one- or two-day training program, you'll learn how IPS products can help you address real client needs and resolve specific client problems.

AICPA Conferences

Training sessions focusing on the Engagement Manuals are part of many AICPA conferences designed for local and regional practitioners, including the highly rated PCPS Conference and the National Accounting and Auditing Advanced Technical Symposium.

To schedule in-firm training or to obtain more information about the Integrated Practice System Training Resources, including dates and locations of these conferences, call the AICPA Technical Information Division at (201) 938-3060.

AICPA INTEGRATED PRACTICE SYSTEM
AUTO DEALERSHIP ENGAGEMENT MANUAL

PREFACE

The AICPA *Auto Dealership Engagement Manual* is a complete guide to performing and reporting on audits of auto dealerships' financial statements. This Manual provides two approaches—the unique ABC System approach for engagemetns in which tests of controls will be performed to reduce substantive tests and the All-Substantive Approach, which is a primarily substantive audit approach. You select the approach that will be the most efficient and effective for each audit engagement.

The Manual is designed to comply with all applicable authoritative pronouncements. References are made throughout to AICPA Statements on Auditing Standards nd pronouncements of the Financial Accounting Standards Board. Discussed are accounting principles nd practices as they apply to auto dealerships.

This two-volume Manual contains all of the documentation, inlcuding quality control and engagement supervision documentation, needed to perform an audit of an auto dealership's financial statements. The following is a listing of some of the documentation included in this Manual, which has been tailored to meet the unique operations of auto dealerships.

- Client Acceptance and Continuance Form
- Audit Planning Memorandum
- Sample Engagement Letter
- Materiality Computation Form
- Risk of Potential Misstatements Evaluation Form
- Internal Controls Questionnaire
- Audit Programs for Tests of Controls and Substantive Tests
- Supervision and Review Form
- Sample Client Representation Letter
- Sample Auditor's Reports, including reports on reportable conditions
- Financial Statement Disclosure Checklist and Illustrative Financial Statements of Auto Dealerships

Also included in this Manual is guidance on Internal Revenue Service requirements relating to LIFO and extended warranty service revenue recognition rules.

ABOUT THE AUTHORS

ANTONIO L. ARGIZ, CPA is the Vice-President of Morrison, Brown, Argiz & Company, a regional CPA firm in Florida and Colorado. From 1986 to 1993, Mr. Argiz served on the Florida Board of Accountancy, which he chaired in 1989. Currently, he serves on the AICPA Council and the Technical Issues Committee of the AICPA's Private Company's Practice Section.

Mr. Argiz received his BBA from Florida International University in 1974 and was the recipient of the school's Beta Alpha Psi outstanding alumnus award in 1987, 1989 nd 1991.

MARC S. DICKLER, CPA is an audit manager with the CPA firm of Morrison, Brown, Argiz & Company in Miami, Florida. From 1984 through 1988, he was the Controller of several automobile dealerships.

Mr. Dickler received his Bachelor of Science in Commerce degree from Rider College (New Jersey).

DON M. PALLAIS, CPA has his own practice in Richmond, Virginia. A former member of the AICPA's Auditing Standards Board and the Accounting and Review Services Committee, he currently serves on the Virginia Society of CPAs Board of Directors and consults with the AICPA Special Committee on Assurance Swedrvices. Mr. Pallais was formerly AICPA Director of Audit and Accounting Guides. He has published numerous books, CPE courses, and articles on accounting and auditing topics.

Mr. Pallais received his MBA from the College of William and Mary nd his BBA from Baruch College. He has, over the years, served on several other AICPA and VSCPA committees.

ABOUT THE CONTRIBUTING AUTHOR

GERALD E. BOWERS, CPA, CMA, CIA is a tax manager with the CPA firm of Morrison, Brown, Argiz & Company in Miami, Florida. Mr. Bowers received his MBA from Harvard University, MS in Taxation from Florida International University and his BS in Engineering from Case Western Reserve University.

ABOUT THE CONSULTING EDITOR

JACOB J. COHEN, CPA, MBA, JD is director of the firm of Walpert, Smullian & Blumenthal, P.A., a regional accounting and consulting firm in Baltimore, Maryland.

Mr. Cohen heads the firm's division serving automobile dealers and is the technical director of the AutoCPA Group, a national network of accounting and consulting firms whose practices include a heavy concentration of automobile dealer clients.

Mr. Cohen received his MBA from Loyola College and his JD from the University of Baltimore. He has served on numerous professional and national task forces, including the AICPA's Auditing Standards Board as well as the Technical Issues Committee of the AICPA's Private Company's Practice Section. He has made numerous presentations to automobile dealer groups and professional associations, has written numerous articles on improving profitability of automobile dealerships and is on the editorial board of a number of national publications. Mr. Cohen, a Certified Fraud Auditor, handles numerous litigation support cases for auto dealerships and is currently the President of the Maryland Association of Certified Public Accountants.

PEER REVIEW OF THE AICPA INTEGRATED PRACTICE SYSTEM

AUTO DEALERSHIP ENGAGEMENT MANUAL

In keeping with our commitment to give you reliable practice aids, we engaged the CPA firm, Baird, Kurtz & Dobson, to perform a peer review of the *Auto Dealership Engagement Manual*. Using quality control materials that have been peer reviewed serves two purposes: (1) it provides reasonable assurance that the materials are reliable practice aids; and (2) it helps to minimize the cost of your firm's peer review.

A copy of Baird, Kurtz & Dobson's unqualified peer review report is included on the following page. This report has been accepted by the Private Companies Practice Section and the SEC Practice Section of the AICPA's Division for CPA Firms. Although the report addresses the 1994 edition of this Manual, it is valid for three years.

Baird,
Kurtz &
Dobson

Certified
Public
Accountants

January 24, 1995

The Board of Directors
American Institute of Certified
Public Accountants

We have reviewed the system of quality control for the development and maintenance of the 1994 edition of the *Auto Dealership Engagement Manual* (materials) of the **AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)** in effect for the year ended December 31, 1994 and the resultant materials in effect at December 31, 1994, in order to determine whether the materials are reliable aids to assist users in conforming with those professional standards the materials purport to encompass. Our review was conducted in accordance with the standards for reviews of quality control materials promulgated by the peer review committees of the Private Companies Practice Section and the SEC Practice Section of the AICPA Division for CPA Firms.

In performing our review, we have given consideration to the following general characteristics of a system of quality control. An organization's system for the development and maintenance of quality control materials encompasses its organizational structure and the policies and procedures established to provide the users of its materials with reasonable assurance that the quality control materials are reliable aids to assist them in conforming with professional standards in conducting their accounting and auditing practices. The extent of an organization's quality control policies and procedures for the development and maintenance of quality control materials and the manner in which they are implemented will depend upon a variety of factors, such as the size and organizational structure of the organization and the nature of the materials provided to users. Variance in individual performance and professional interpretation affects the degree of compliance with prescribed quality control policies and procedures. Therefore, adherence to all policies and procedures in every case may not be possible.

Our review and tests were limited to the system of quality control for the development and maintenance of the aforementioned materials of the AICPA and to the materials themselves and did not extend to the application of these materials by users of the materials nor to the policies and procedures of individual users.

In our opinion, the system of quality control for the development and maintenance of the quality control materials of the AICPA was suitably designed and was being complied with during the year ended December 31, 1994 to provide users of the materials with reasonable assurance that the materials are reliable aids to assist them in conforming with those professional standards the materials purport to encompass. Also, in our opinion, the quality control materials referred to above are reliable aids at December 31, 1994.

Baird, Kurtz & Dobson

With Offices in:
Arkansas
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Kansas
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Missouri
Nebraska
Oklahoma

Member of
Moores Rowland
International

SUGGESTED REVISIONS TO AUTO DEALERSHIP ENGAGEMENT MANUAL

Please submit all suggestions to improve the quality of the Auto Dealership Engagement Manual as they arise. We value users' input and will give all comments consideration when revising the manual.

To:
Susan Menelaides, CPA, Director
Technical Information Division
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

From:

____
(Name)

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(Firm)

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(Address)

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(Telephone No.)

Suggested Revisions:

Page No.	Comments

(Please attach additional sheets if necessary)

AUDIT MANUAL ADVISORY TASK FORCE

The manuals in the AICPA Integrated Practice System (IPS) are monitored by a special PCPS Audit Manual Advisory Task Force. Task force members use the manuals in their audit and accounting practices and continuously provide the AICPA staff with recommendations to enhance the manuals from the perspective of the small- and medium-sized firm.

MEMBERS OF THE AICPA PRIVATE COMPANIES PRACTICE SECTION (PCPS)
AUDIT MANUAL ADVISORY TASK FORCE

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AICPA INTEGRATED PRACTICE SYSTEM
AUTO DEALERSHIP ENGAGEMENT MANUAL

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CHAPTER 1

INTRODUCTION

1.000 PURPOSE OF THE MANUAL

1.001 There are over 20,000 auto dealerships in the United States. In recent years, the economic recession, foreign competition, and other factors have resulted in the demise of many dealerships. Generally, only those with the very best management teams and the ability to control costs or merge with others have survived. The auto dealership industry is large and pervasive, yet there has been no specific guidance on auditing dealerships until now.

1.002 The purpose of this Manual is to provide practitioners with information for use in auto dealership audit engagements. Included is engagement-oriented documentation designed to help you conduct effective and efficient engagements in this specialized industry. It is written for CPAs as an aid in conducting audits of auto dealerships, and for those who hold positions of responsibility in auto dealerships or who provide them with accounting or advisory services.

1.003 The information in this Manual is tailored to take into account the unique operating characteristics of auto dealerships. Included are many useful checklists and questionnaires to incorporate in dealership audits.

1.100 ORGANIZATION OF THE MANUAL

1.101 The following is a listing of the chapters in this Manual and a summary of the salient features of each:

1.102 Chapter 1 briefly discusses the auto dealership industry and some of the unique accounting, tax, and operational challenges dealerships face.

1.103 Chapter 2 explores the general aspects of the auto dealership industry. The discussion includes the current economic and regulatory environment, common dealership characteristics, how dealerships are established, and a description of the four dealership departments — new cars, used cars, parts and service.

1.104 Chapter 3 provides an overview of the operating characteristics of each dealership department. Included are discussions of the records and documentation found in a typical auto dealership, and some of the key control policies and procedures dealerships should establish. The chapter also provides illustrative flowcharts to assist practitioners in understanding the unique features of a dealership's internal controls and providing valuable recommendations to management.

1.105 Chapter 4 covers the considerations involved in deciding whether to accept or continue a relationship with an auto dealership client and audit planning requirements. Included are discussions of client acceptance and continuance, planning documentation, budgeting tools, and risk assessment.

1.106 Chapter 5 describes the two audit approaches presented in this Manual—the unique "ABC System," and the All-Substantive Approach. These two approaches are also followed in the AICPA's Integrated Practice System Comprehensive Engagement Manual, and in the other industry-specific manuals in the Integrated Practice System series. These two approaches may be summarized as follows:

- The ABC System provides a framework for obtaining an understanding of the internal control structure, assessing control risk and designing an audit strategy. Emphasis is placed on a flexible method of customizing audit procedures and documentation.
- The All-Substantive Approach applies many of the concepts on which the ABC System is based, but presumes a primarily substantive approach to the audit.

1.107 Chapter 6 discusses the internal control structure of the auto dealership. Included in this chapter are useful tools that will assist in documenting and evaluating the control structure and performing tests of controls.

1.108 Chapter 7 includes guidance on substantive testing for auto dealerships as well as substantive test audit programs designed for auto dealerships.

1.109 Chapter 8 deals with specific accounting principles for auto dealerships and provides related audit insights.

1.110 Chapter 9 discusses key federal income tax issues and certain other excise taxes and reporting requirements pertinent to the auto dealership. Among other things, this chapter illustrates the Alternative LIFO Method computations prescribed under Revenue Procedure 92-79 and the proper tax treatment for extended warranty and multi-year service contracts.

1.111 Chapter 10 contains information about the final phases of the audit. Covered in this section are a sample representation letter, and checklists documenting the supervision and review of the audit work performed.

1.112 Chapter 11 deals with financial statement presentation and disclosure requirements and also auditor's reporting requirements. This chapter includes illustrative financial statements, disclosure checklists and sample auditor's reports.

New Chapter for 1995

1.113 Chapter 13, added this year, provides guidance and practice aids for performing compilation and review engagements for auto dealerships. The chapter includes illustrative engagement letters, forms for documenting the understanding of the dealership's business and industry, and work programs for compilations and reviews.

1.114 The authors hope that you find this Manual useful and easy to use. We would appreciate your comments and suggestions.

1.200 THE AUTO DEALERSHIP INDUSTRY AT A GLANCE

1.201 As mentioned above, there are over 20,000 auto dealerships in the United States. The typical dealership is a complex enterprise comprised of four integrated departments — the new and used car departments and the parts and service departments. The primary function of the dealership, however, is to sell and service new automobiles under franchise agreements awarded by the manufacturer. Since the sale of new cars often involves accepting used car trade-ins which are later sold at wholesale or retail, the used car department also contributes to the overall profitability of the dealership.

1.202 The purchase of these new vehicles is generally financed through a "floor plan line of credit." Consequently, dealerships are usually highly leveraged.

1.203 The parts and service departments prepare the new and used vehicles for sale. The parts and service departments also contribute to the dealership's profitability by selling parts and performing repair and body work for customers.

1.204 Dealerships also earn a significant amount of income from their participation in the financing and leasing of new and used vehicles. In addition, dealerships may also earn insurance commissions from the sale of various insurance products.

The Need for an Audit

1.205 As part of the franchise agreement, dealerships are required to submit timely operating statements on the manufacturer's prescribed forms. Manufacturers generally do not require dealerships to have the operating statements audited, reviewed or compiled by independent accountants.

1.206 As mentioned above, however, auto dealerships generally finance the purchase of new vehicles through a "floor plan line of credit." The related floor plan agreements generally require the dealership to submit annual audited or reviewed financial statements.

1.300 UNIQUE ACCOUNTING PRINCIPLES AND PRACTICES OF AUTO DEALERSHIPS

1.301 Auto dealerships face a number of unique accounting challenges. Their auditors must understand these challenges in order to be able to design appropriate auditing procedures. Some of these challenges are summarized below.

Inventory Valuation

1.302 In order to reduce taxable income, dealerships often use the last-in, first-out (LIFO) inventory method in determining ending inventory and cost of goods sold. The most common application of LIFO inventory valuation by auto dealerships is for new vehicle inventories. The LIFO inventory valuation approach specified by IRS Revenue Procedure 92-79 and used by many dealerships is discussed and illustrated in Chapter 9 of this Manual.

1.303 New car and used car inventories are valued at the lower of cost or market. On the other hand, dealerships value their parts and accessories inventories at replacement cost. Because this method is a departure from Generally Accepted Accounting Principles, auditors of auto dealerships should consider the effect of this misstatement on the financial statements.

Repossession Losses

1.304 Dealerships occassionally finance a customer's purchase of new automobiles and in such instances, they usually sell the related notes to financial institutions. Repossession losses arise from customers' failure to pay notes taken to finance their vehicle purchases. In certain cases, the dealership must estimate the uncollectible loans and create a reserve.

Finance and Insurance Income

1.305 As mentioned earlier, dealerships earn a significant amount of income from their participation in the financing of new and used vehicles. When the dealership provides the customer with financing and the note is sold to a financial institution, that institution generally pays the dealership a fee. If a customer prepays or defaults on the note, the financial institution charges back a portion of the fee to the dealership.

1.306 Dealerships may also earn insurance commissions from the sale of various insurance policies, such as collision and extended warranty. When insurance policies are cancelled, the dealership is generally charged back a portion of the commission income.

1.307 Because of the potential for prepayments or defaults on notes sold to financial institutions and the possible cancellation of insurance policies, it may be necessary to establish a reserve for future chargebacks.

1.400 TAX ISSUES

1.401 The IRS has identified the auto dealership industry as one of those industries for which it has developed special industry expertise to assist its field agents during the conduct of audits. This Manual covers several topics given special emphasis by field agents in the course of their audits, including:

- LIFO Inventory Issues
- Uniform Capitalization Rules
- Used Car Inventory Rules
- Extended Warranty and Multi-Year Service Contracts
- Finance and Insurance Income
- Demonstrator Vehicles

- Luxury Vehicle Excise Tax
- Environmental Cleanup Costs

1.500 USE OF THIS MANUAL

1.501 This Manual is designed as a nonauthoritative practice aid. It is intended to provide users with practical how-to guidance in applying authoritative accounting and auditing literature in their auto dealership audit engagements.

1.502 The sample audit programs, forms, and checklists included in this Manual should be tailored to each engagement's circumstances, and also to the firm's quality control policies and procedures.

Updating of the Manual

1.503 This Manual will be updated annually to provide users the most current authoritative guidance. This second edition reflects the authoritative guidance issued through August 1995, including those issued up to:

- SAS No. 74
- FASB No. 122
- SOP 95-2
- FASB Interpretation No. 41
- FASB Technical Bulletin No. 94-1
- EITF Consensuses adopted up to and including the July 21, 1995 Emerging Issues Task Force meeting

1.504 Users should be alert for pronouncements issued subsequent to those listed above that could affect their engagements.

References to Authoritative Literature

1.505 Throughout this Manual, references to the publications containing authoritative literature have been included to help users in performing research. The explanation of these references follows:

AC = references to the sections in FASB *Accounting Standards — Current Text*

AU = references to the sections in the AICPA *Professional Standards* — Volume 1

ET = references to the Code of Professional Conduct in the AICPA *Professional Standards* — Volume 2

QC = references to the quality control standards in the AICPA *Professional Standards* — Volume 2

1.600 RECENTLY ISSUED AUTHORITATIVE PRONOUNCEMENTS

1.601 This section includes guidance and descriptions of pronouncements primarily issued or proposed in the past year that are relevant to auto dealerships. Those pronouncements not deemed to be relevant to an auto dealership are not identified herein. You may also need to refer to Exhibit 1 in Chapter 8, section 8.005, to identify the level of authority the pronouncement has within the GAAP heirarchy.

SFAS No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*

1.602 In an effort to improve the financial reporting of derivatives, the FASB issued SFAS No. 119, which is effective for calendar year 1994 financial statements, except for entities with less than $150 million in total assets, for which it is effective for calendar year 1995 financial statements. SFAS No. 119 expands and amends the requirements of SFAS No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*. First, it expands the disclosure requirements of SFAS No. 107 to include additional types of derivatives, such as options held. It also amends SFAS No. 107 as follows:

- If fair value information is located in more than one note, a summary table of fair value information should be included.
- Fair value and carrying amount should be disclosed together.
- Disclosures should clearly designate whether the derivatives are assets or liabilities.
- Information should clearly relate to balance sheet line items.
- Fair value information should not be combined or netted with non-derivatives (except if netting is permitted under FIN No. 39).

1.603 The Statement requires the following additional disclosures:

For derivatives held or issued for trading purposes (generally applies only to financial institutions that deal in derivatives):

- The average fair value balance of positions during the reporting period and ending fair value, and the net gains or losses resulting from trading activities.
- Identification of the derivative from which the gains or losses arose, and where those amounts are reported in the income statement.

For derivatives held or issued for purposes other than trading:

- The objectives of holding or issuing the derivatives.
- Recognition and measurement policies.

- How they are reported in the financial statements (balance sheet and income statement locations).
- If the derivatives are used to hedge anticipated transactions, a description and time period for the transactions, the classes of the derivatives, deferred gains and losses, and the events that would cause gains and losses to be recognized.

SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*

1.604 In March 1995, the FASB issued SFAS No. 121, which is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is prohibited. The Statement establishes accounting standards (including measurement and disclosure requirements) for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets for assets to be held and used and assets to be disposed of. SFAS No. 121 amends several existing pronouncements (see paragraphs 20-33 of the Statement).

1.605 **Assets to Be Held and Used.** According to the Statement, an entity is required to review its long-lived assets, such as buildings and equipment, for impairment whenever events or changes in circumstances relating to the assets ("triggering events") indicate that the carrying amount of an asset may not be recoverable. In other words, an event or change in circumstances, such as a significant decrease in the market value of an asset, a significant change in the extent or manner in which an asset is used, or a significant physical change in an asset, may indicate that an asset has been impaired.

1.606 If a triggering event has occurred, the entity then determines if an impairment loss should be recognized by measuring the expected future cash flows[1] (undiscounted and without interest charges) to be generated from the use of the asset and its eventual disposition. If the sum of the expected future cash flows is less than the carrying amount of the asset, then an impairment loss should be recognized.

1.607 The amount of the impairment loss to be recognized is measured by calculating the difference between the carrying amount and the fair value of the asset. The fair value is defined as the amount at which the asset could be bought or sold in a current transaction between willing parties. If quoted market prices in active markets are not available, SFAS No.121 discusses various methods of determining the fair value of the assets, including using estimates of expected future cash flows discounted at a rate commensurate with the risks involved.

1.608 Once an impairment is recognized, the reduced carrying amount of the asset is the new cost basis that should be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.

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[1] Future cash flows is defined as the future cash inflows expected to be generated by an asset less the future cash outflows expected to be necessary to obtain those inflows. When estimating expected future cash flows, assets should be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

1.609 Assets to Be Disposed Of. If management has committed to a plan to dispose of long-lived assets (whether by sale or abandonment), has the authority to approve the action, and this action is not considered a disposal of a segment under APB Opinion No. 30, the assets should be reported at the lower of carrying amount or fair value, less costs to sell. Fair value is measured the same as for assets to be held and used. The costs to sell an asset includes incremental direct costs, such as broker commissions, legal and title transfer fees, and closing costs. Assets to be disposed of should not be depreciated while they are held for disposal.

1.610 Subsequent revisions to the estimates of fair value should be reported as adjustments to the carrying amount of the assets, not to exceed the carrying amount (original basis less accumulated depreciation and amortization) of the assets before the adjustment was made.

1.611 Financial statement presentation and disclosure requirements of SFAS No. 121 are included in the Financial Statement Disclosure Checklist in Chapter 11, section 11.400.

SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*

1.612 In December 1994, the AICPA issued this SOP in response to a need for improved disclosure of significant risks and uncertainties brought about by a volatile business and economic environment. Many of the disclosure requirements of this SOP supplement or overlap the requirements of other authoritative pronouncements, primarily SFAS No. 5, *Accounting for Contingencies*. The SOP is effective for calendar year 1995 financial statements, and for interim periods in fiscal years subsequent to the year the SOP is first adopted. It applies to financial statements of all nongovernmental entities prepared in accordance with GAAP.

1.613 The disclosure requirements of SOP 94-6 fall into four categories:

All entities should report—

(1) Nature of operations

(2) Use of estimates in preparing financial statements

Only entities that meet certain conditions should report—

(3) Certain significant estimates

(4) Current vulnerability due to certain concentrations

Because the disclosure requirements of this SOP overlap with many other disclosure requirements, they may be combined or grouped with other related disclosures.

1.614 Nature of Operations. SOP 94-6 requires that an entity describe its major products or services and principal markets, including the location of those markets. If the entity operates more than one business, it should also disclose the relative importance of each business and the basis for determining the relative importance, such as assets, revenues, or earnings. It is not necessary to quantify the relative importance of different operations; instead, importance can be conveyed by terms such as "predominantly," "about equally," and "major."

1.615 Sample disclosures of nature of operations for a small business follows:

- Retail Franchisor of Sporting Goods

  Sporting Goods Headquarters, Inc. (the Company) was incorporated in Arizona in January 19X1. The Company operates retail sporting goods stores and grants franchises for the operation of retail sporting goods stores under the name of Sports Headquarters. At December 31, 19Y5, the Company had ten franchise locations and three company-owned stores.

- Manufacutirng Company

  Pipe Co., Inc. located in Houston, Texas, manufactures tubing and related products. The Company sells primarily to manufacturers of oil field equipment and leisure products that are located in the Southwestern United States.

1.616 Use of Estimates in the Preparation of Financial Statements. Disclosures should include a statement that financial statements prepared in accordance with GAAP require the use of management's estimates. The following disclosure, found in paragraph A-9 of the SOP, can generally be used verbatim to satisfy this requirement:

> The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

1.617 Certain Significant Estimates. Disclosure of information about estimates is required if two criteria are met: (1) it is reasonably possible that an estimate about a condition existing at the balance-sheet date will change in the near term (one year from the balance-sheet date) and (2) the effect of the change would be material to the financial statements. Examples of estimates that are often sensitive to material change are:

- Inventory and specialized equipment subject to technological obsolescence
- Valuation allowances for deferred tax assets based on future taxable income
- Valuation allowances for commercial and real estate loans
- Environmental cleanup-related liabilities
- Litigation-related obligations
- Contingent liabilities for obligations of other entities
- Amounts reported for pensions and postemployment benefits
- Amounts reported for long-term contracts.

1.618 The disclosures for certain significant estimates supplement those in SFAS No. 5, *Accounting for Contingencies*. However, the SOP applies not just to estimates related to contingencies, but also to other types of estimates, such as those related to the carrying value of assets and liabilities (e.g., long-term construction contracts). Also, the SOP introduces the concept of a "near term" change in the estimate, while SFAS No. 5 makes no distinction between "near term" and long-term changes in estimates.

1.619 As mentioned above, this disclosure need only be made if two criteria are met:

1) *It is at least reasonably possible that an estimate about a condition that existed at the balance-sheet date will change in the near term.* The SOP draws on the SFAS No. 5 definition of reasonably possible, which is "more than remote but less than likely." Therefore, the likelihood that an estimate will change in the near term should be at least "more than remote." In considering whether the estimate is sensitive to change in the near term, the entity should consider only facts and circumstances known to management before the financial statements are issued.

   To illustrate, consider a construction contractor's long-term contracts. Estimated costs to complete includes a particular material, and management is aware at year-end that a shortage and resulting price increase for this material may occur in the next few months. If the likelihood of the price increase in the near term is more than remote, then this disclosure criterion is met.

2) *The effect of the change would be material to the financial statements*. Determining whether the effect of a change in estimate would be material to the financial statements is a matter of judgment, and presumably involves the same judgment used to determine whether other items are material to the financial statements. Also, note that the SOP refers to materiality in relation to the effect of the change, not to the estimate. For example, consider an entity that has not recorded a valuation allowance for inventory subject to rapid technological obsolescence. Even though no estimate is recorded, the entity might need to disclose the fact that it is reasonably possible that a material change in the estimate is likely to occur in the near term.

1.620 If an estimate meets the disclosure requirements of SOP 94-6, the following matters should be disclosed:

- The nature of the uncertainty and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.
- If the estimate involves a loss contingency covered by SFAS No. 5, an estimate of the possible loss or range of loss, or a statement that such an estimate cannot be made. (Note that this requirement overlaps with SFAS No. 5 disclosure requirements for loss contingencies. In fact, for such items, the only disclosure added by SOP 94-6 is the statement that it is at least reasonably possible that a change in the estimate will occur in the near term.) Also, the SOP recommends, but does not require, disclosing the factors that cause the estimate to be sensitive to material change.

1.621 **Current Vulnerability Due to Certain Concentrations.** The SOP requires disclosure of certain concentrations if: (1) the concentration exists at the balance-sheet date, (2) the concentration makes the entity vulnerable to the risk of a near-term severe impact, and (3) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term. (As mentioned earlier near term is defined as a period not to exceed one year from the balance-sheet date.)

1.622 This disclosure is required only if all of the following criteria are met:

1. *The concentration existed at the balance-sheet date.* The SOP specifically identifies the types of concentrations that should be considered for this disclosure:

   - Concentrations in the volume of business transacted with a particular customer, supplier, or lender;
   - Concentrations in revenues from particular products or services;
   - Concentrations in the available sources of supplies of materials, labor or services (paragraph 24 of the SOP requires some specific disclosures for labor subject to collective bargaining agreements), or of licenses or other rights used in the entity's operations; and
   - Concentrations in the market or geographic area in which the entity operates (paragraph 24 of the SOP requires some specific disclosures for foreign operations).

2. *The concentration must make the entity vulnerable to the risk of a near-term severe impact.* The key concept (and probably the most difficult one) in applying this criterion is the concept of "severe impact." Paragraph 7 of the SOP defines severe impact as:

   > A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity...The concept of severe impact, however, includes matters that are less than catastrophic.

   As with materiality, determining whether something would constitute a severe impact requires judgment. For example, consider a manufacturer that buys all of its raw materials from one supplier. The loss of this supplier would cause significant production delays and greater than material losses of revenues, yet other suppliers can provide similar raw materials under similar terms. Thus, although losing this supplier could have a significant financially disruptive effect on the normal functioning of the entity, it would not cause bankruptcy because the entity could ultimately turn to other suppliers and resume normal operations.

3. *It is at least reasonably possible that the event that could cause the severe impact will occur in the near term.* As noted above, the SOP uses the SFAS No. 5 definition of reasonably possible of "more than remote but less than likely." Thus, the probability threshold for disclosure of a concentration is the same as that for disclosure of a loss contingency.

1.623 It is important to note that the SOP indicates that two types of concentrations are always considered to meet this "reasonably possible" criterion: (1) concentrations of customers, grantors, or contributors; and (2) concentrations of operations in foreign countries.

1.624 If any concentrations meet these criteria, paragraph 24 of the SOP states that disclosure "should include information that is adequate to inform users of the general nature of the risk associated with the concentration." An example of a disclosure for a concentration related to customers follows:

> At December 31, 19X5, receivables from three customers were about 45% of trade accounts receivable, and sales to these customers comprised 40% of total sales for the year then ended.

1.625 The Financial Statement Disclosure Checklist and Illustrative Financial Statements in Chapter 11 have been updated to include the disclosure requirements for SOP 94-6.

1.626 **Audit Considerations for SOP 94-6.** Since entities must adopt SOP 94-6 for their December 31, 1995 financial statements, auditors of those entities will need to ensure that the client has disclosed the nature of its operations, the use of estimates in preparing financial statements, certain significant estimates, and certain concentrations. The first two disclosures should be fairly straightforward. In fact, many companies already disclose information about the nature of their operations. The more difficult challenge for auditors will be to determine if circumstances that trigger the other two disclosures -- certain significant estimates and current vulnerability due to certain concentrations -- exist and, if they do, whether the disclosures are appropriate.

Generally, much of the information auditors obtain during the normal course of the audit provides a good foundation for determining whether the client has estimates and concentrations that require disclosure. Specific procedures directed towards SOP 94-6 may include:

Certain Significant Estimates:

- Obtain or prepare a listing of any estimates used in determining the carrying values of assets and liabilities and gain and loss contingencies that are sensitive to change. Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate.

  Examples of such estimates include:

  - inventory and specialized equipment subject to technological obsolescence
  - valuation allowances for deferred tax assets based on future taxable income
  - valuation allowances for commercial and real estate loans
  - environmental cleanup-related liabilities
  - litigation-related obligations
  - contingent liabilities for obligations of other entities
  - amounts reported for pensions and postemployment benefits
  - amounts reported for long-term contracts

- Consider whether it is at least reasonably possible that a material change in the estimate will occur in the near term.

- If such a situation is identified, review support for the calculation of the effect of the change.

Certain Concentrations

- Obtain or prepare a listing of the following types of concentrations, if any, that existed at the balance-sheet date and that make the entity vulnerable to risk of near-term severe impact (severe impact is a higher threshold than materiality, but less than catastrophic). Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate:
  - volume of business transacted with a particular customer, supplier, or lender
  - revenues from particular products or services
  - available sources of supply of materials, labor or services, or of licenses or other rights used in operations
  - market or geographic area in which the entity conducts its operations

- Determine whether it is at least reasonably possible that an event will occur in the near term that would cause the severe impact.

1.627 The Tests of Balances Audit Program in Chapter 7, section 7.500, includes steps for considering the completeness and accuracy of the SOP 94-6 disclosures.

SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*

1.628 On May 19, 1995, the AICPA's Accounting Standards Executive Committee issued SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*. This SOP applies to financial statements of investment partnerships exempt from SEC registration under the Investment Company Act of 1940 (with certain exceptions) when such statements are prepared in conformity with GAAP.

1.629 The SOP provides guidance on financial statement presentation and disclosure of investments, income, and partners' capital, including requirements to:

- Include a condensed schedule of investments in securities,

- Present a statement of operations in conformity with the requirements for statements of operations of management investment companies in the Audit and Accounting Guide, *Audits of Investment Companies*, and

- Disclose in the notes the method of computing payments or allocations to the general partner for management fees and present the amounts of such payments in either the statement of operations or the statement of changes in partners' capital.

1.630 The SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

Practice Bulletin (PB) No. 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships*

1.631 In April 1995, the AICPA's Accounting Standards Executive Committee issued PB No. 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships,* which requires that financial statements of a limited liability company (LLC) should:

- Be similar in presentation to those of a partnership,
- Be clearly identified as those of a limited liability company, and
- Disclose any limitations of members' liability, and different classes of members' interests and respective rights, preferences and privileges of each class.

1.632 The PB, which includes additional accounting, reporting, and disclosure requirements, is effective for financial statements issued after May 1995. Illustrative financial statements for a Limited Liability Company are included in Chapter 11, section 11.301.

Auditing Interpretation, *The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events* (AU 9411.11-.15)

1.633 This interpretation establishes guidance on what the auditor should consider when determining the appropriateness of an accounting principle adopted by management for material new types of transactions or events for which there are no established sources of accounting principles. The Interpretation states that when the auditor is evaluating the principle, he or she should assess the appropriateness of management's basis for selecting the principle by considering whether there are:

- Analogous transactions or events for which there are established accounting principles, or
- Other accounting literature.

Auditing Interpretation, *Audits of Financial Statements That Had Been Previously Audited by a Predecessor Auditor* (AU 9315.08-.18)

1.634 This interpretation of SAS No. 7, *Communication Between Prececessor and Successor Auditors* was issued in April 1995. The interpretation provides guidance to an auditor who is auditing and reporting on financial statements previously audited and reported on by a predecessor auditor (referred to as "reauditing"). The Interpretation states that:

- The auditor should request the predecessor auditor's workpapers for the year under audit and for the prior year.
- The review of these workpapers and inquiries of the predecessor auditor do not in themselves constitute sufficient competent evidential matter to provide a basis for expressing an opinion on the financial statements.

- The successor auditor should not divide responsibility for the work performed in his or her report.
- The successor may consider the information obtained from inquiries of the predecessor and any review of the predecessor's working papers and report in planning a reaudit.
- The successor auditor must become satisfied with the existence of beginning physical inventories by making or observing physical counts of inventories after the reaudit period and performing "roll back" procedures, test intervening transactions, such as testing prior transactions, reviewing prior count records, and performing analytical procedures. The auditor may not use the predecessor's inventory or other work for these purposes.

Auditing Interpretation, *Describing Tests of Operating Effectiveness and the Results of Such Tests* (AU 9324.31-.03) and *Service Organizations That Use the Services of the Service Organizations (Subservice Organizations)* (AU 9324.04-.18)

1.635 In April 1995, these two Auditing Interpretations of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* were issued:

a. *Describing Tests of Operating Effectiveness and the Results of Such Tests,* (AU 9324.31-.03) provides guidance to a service auditor as to how much detail and what information should be included in the description of "tests applied" and the "results of the tests."

b. *Service Organizations that Use the Services of Other Service Organizations (Subservice Organizations)* (AU 9324.04-.18) provides guidance for the user auditor and the service auditor when the service organization uses a subservice organization.

Auditing Interpretation, *Reporting on a Special-Purpose Financial Statement that Results in an Incomplete Presentation But Is Otherwise in Conformity with Generally Accepted Accounting Principles* (AU 9326.80-.87)

1.636 This interpretation defines what constitutes a contractual agreement under AU 623, *Special Reports*, and which guidance within the standards should be followed under different "special reporting" situations. This Interpretation also provides guidance when the auditor is to distribute the report to additional parties that were not part of the original contract or agreement.

Auditing Interpretation, *Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report* (AU 9341.01-.02)

1.637 This interpretation addresses the situation where auditors are asked to reissue reports that included a going-concern explanatory paragraph because the situation or condition that gave rise to substantial doubt about the entity's ability to continue as a going-concern has been resolved. This Interpretation provides guidance for auditors who agree to reissue their reports in such instances. It's important to note that the Interpretation does not *require* auditors to reissue their reports, however, if the auditor does agree to reissue his or her report, he or she should:

- Audit the event or transaction that prompted the request for reissuance,
- Perform procedures in paragraph 12 of AU 560, Subsequent Events, at or near the date of reissuance, and
- Consider factors described in paragraphs 6-11 of SAS No. 59, based on the conditions and circumstances at the date of issuance.

1.700 PROPOSED STATEMENTS

Proposed Amendment to SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*

1.701 In February 1995, the AICPA Auditing Standards Board issued this proposed amendment to SAS No. 55 that would incorporate the internal control concepts found in *Internal Control — Integrated Framework Report* (often referred to as the "COSO report"). Specifically, the amendment would change the current definition of internal control in SAS No. 55 from "control environment, accounting system, and control procedures" to the definition in the COSO report, "control environment, risk assessment, control activities, information and communications, and monitoring." The AICPA Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, will also be revised simultaneously. The final documents are expected to be issued in December 1995, and are expected to be effective for audits of entities with fiscal years beginning January 1, 1997. This amendment is not expected to have a significant impact on practical applications of SAS No. 55.

Proposed amendment to SAS No. 58, *Reports on Audited Financial Statements*

1.702 This proposed amendment was issued in July 1995 that would eliminate the requirement to add an explanatory paragraph to the auditor's report for certain uncertainties. This amendment would not affect the requirement in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to add such a paragraph for going-concern uncertainties. If approved, the final SAS is expected to be issued in December 1995, and would be effective for reports issued on or after June 30, 1996.

1.703 To determine the current status of these proposed amendments, call the AICPA's Technical Hotline at 800-862-4272, menu option 2.

Proposed Statement of Position, *Environmental Remediation Liabilities (Including Auditing Guidance)*

1.704 In June 1995, the AICPA Accounting Standards Executive Committee issued this proposed Statement of Position which provides guidance on the recognition, measurement, display and disclosure of certain environmental remediation liabilities. Among other things, the SOP requires that environmental remediation liabilities be accrued when the criteria of SFAS No. 5 are met, and it includes benchmarks to aid in determining when such liabilities should be recognized in accordance with SFAS No. 5.

1.705 Among the costs to be included in the measurement of the liability are:

a. Incremental direct costs of the cleanup effort,

b. Costs of compensation and benefits for employees to the extent they will devote time directly to the cleanup effort, and

c. Certain costs of legal work related to the cleanup effort.

The proposed SOP would be effective for financial statements beginning after December 15, 1995.

1.800 THE GAAP HIERARCHY AND EITF CONSENSUSES

1.801 In January 1992, the AICPA's Auditing Standards Board issued SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AU411). Statement on Standards for Accounting and Review Services (SSARS) No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992* (AR 100, footnote 3), clarifies that the hierarchy also applies to compilation and review engagements. SAS No. 69:

- Created two separate but parallel hierarchies—one for state and local governments and another for nongovernmental entities.
- Established a true GAAP hierarchy—unlike the old SAS, each successive category in the hierarchy is a different level of authority.
- Elevated the authority of Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) consensuses and AICPA Practice Bulletins from "other literature" to "established accounting principles."

1.802 Paragraph 16 of SAS No. 69 (AU 411.16) summarizes the pronouncements that are included in each of the five categories of GAAP for nongovernmental entities and for state and local governments.

1.803 SAS No. 69 is effective for reports on financial statements for periods ending after March 15, 1992. Generally, the revised levels of authority apply to pronouncements with effective dates after March 15, 1992. However, EITF consensuses issued before March 16, 1992 also are effective for initial application of an accounting principle after March 15, 1993.

Importance of EITF Consensuses

1.804 The one-year grace period assigned to the old EITF consensuses was designed to give accountants an opportunity to become acquainted with over 150 consensuses that were adopted before March 15, 1992. The consensuses listed in sections 1.505 ("Selected EITF Consensuses Adopted Before March 16, 1992") and 1.506 ("Selected EITF Consensuses Adopted Between March 15, 1992 and July 21, 1995") have the widest applicability and relevance to auto dealerships.

1.805 Selected EITF Consensuses Adopted Before March 16, 1992

Issue Number	Title and Issue

Balance-Sheet Classification

85-1 *Classifying Notes Received for Capital Stock*
Should notes received in exchange for capital stock be classified as an asset or as a reduction of equity?

86-30 *Classification of Obligations When a Violation is Waived by the Creditor*
How is the classification of long-term debt affected when the creditor waived existing debt covenant violations but retained future, periodic covenant requirements?

Contingencies

86-12 *Accounting by Insureds for Claims-Made Insurance Policies*
Should an enterprise record an incurred-but-not-reported (IBNR) liability for uninsured losses resulting from claims-made insurance policies?

Environmental Treatment Costs

89-13 *Accounting for the Cost of Asbestos Removal*
When may the costs of asbestos removal be capitalized, and, if expensed, may the costs be classified as an extraordinary item?

90-8 *Capitalization of Costs to Treat Environmental Contamination*
Should environmental contamination treatment costs be expensed or capitalized? Supplement to Issue No. 89-13.

Extinguishment of Debt

86-18 *Debtor's Accounting for a Modification of Debt Terms*
Should the exchange of a new noncallable debt instrument for an older callable debt instrument be accounted for as an extinguishment of the older debt issue?

89-15 *Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties*
Should the exchange of new debt for existing debt with the same creditor (at terms which are lower than the prevailing market rate) be considered an extinguishment of debt by the debtor?

Marketable Securities

86-40 *Investments in Open-End Mutual Funds That Invest in U.S. Government Securities*
Should investments in mutual funds that hold debt securities be accounted for at the lower of cost or market or amortized cost?

Income Taxes

87-8 *Tax Reform Act of 1986: Issues Related to the Alternative Minimum Tax*
How should the alternative minimum tax be accounted for under Accounting Principles Board (APB) Opinion No. 11 and SFAS Nos. 96 and 109?

88-4 *Classification of Payment Made to IRS to Retain Fiscal Year*
How should partnerships and Subchapter S corporations record payments made to the IRS to retain their fiscal year?

91-8 *Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax*
How should a state franchise tax that is partly based on an income tax be accounted for under SFAS Nos. 96 and 109?

Insurance

88-5 *Recognition of Insurance Death Benefits* (consensus reached on issue No. 1 only)
May income from death benefits on corporate-owned life insurance policies be recorded immediately on an actuarially expected basis rather than deferred until the insured's death?

Inventory

86-46 *Uniform Capitalization Rules for Inventory Under the Tax Reform Act of 1986*
Are the type of costs that must be allocated to inventory for tax purposes also capitalizable under GAAP?

Leases

88-10 *Costs Associated with Lease Modification or Termination* (consensuses reached on issue Nos. 2 and 3 only)
When should costs associated with lease modification or termination be expensed?

Nonmonetary Transactions

86-29 *Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value*
Should the magnitude of boot affect whether an exchange of nonmonetary assets is accounted for at the recorded amounts or fair value?

87-29 *Exchange of Real Estate Involving Boot*
Does SFAS No. 66 apply to exchanges of similar real estate involving boot that is at least 25% of the fair value of the exchange?

Real Estate

86-7 *Recognition by Homebuilders of Profit from Sales of Land and Related Construction Contracts*
How does SFAS No. 66 apply to the combined sale of land and building constructed by the seller under a construction contract?

88-24 *Effect of Various Forms of Financing under SFAS No. 66*
How should profit be recognized under SFAS No. 66 when a real estate transaction involves various forms of financing?

Revenue Recognition

88-18 *Sales of Future Revenues*
Should cash received in exchange for a promise to pay future revenues from a segment, product line, or other asset be classified as debt or deferred income? How should any foreign currency effects be recognized?

1.806 Selected EITF Consensuses Adopted Between March 15, 1992 and July 21, 1995

Business Combinations

93-7 *Uncertainties Related to Income Taxes in a Purchase Business Combination*
Is SFAS No. 38 on preacquisition contingencies applicable to income tax uncertainties and, if not, how should they be accounted for under SFAS No. 109?

95-3 *Recognition of Liabilities in Connection with a Purchase Business Combination*
In a purchase business combination, when should (1) costs to exit an activity of an acquired company, and (2) involuntary employee termination benefits and relocation costs be accrued as liabilities under APB Opinion no. 16, *Business Combinations*? What additional financial statement disclosures should the employer make related to these charges?

Environmental Liabilities

93-5 *Accounting for Environmental Liabilities*
When should recoveries be considered in measuring the amount of a contingent liability relating to environmental matters? Under what circumstances may an environmental liability be discounted?

Financial Instruments

93-18 *Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate*

What is the effect of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, on the measurement and recognition of impairment losses on certain mortgage-backed investments?

Foreign Exchange Translation

92-4 *Accounting for a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary*

When a foreign economy ceases to be highly inflationary, how should an entity account for the change in the foreign subsidiary's currency from the reporting currency to the local currency?

92-8 *Accounting for the Income Tax Effects Under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary*

Follow-up to Issue No. 92-4. Should the deferred taxes on the temporary differences arising from this type of change in functional currency be reflected as an adjustment to the cumulative translation adjustment component of stockholders' equity?

Income Taxes

93-12 *Recognition and Measurement of the Tax Benefit of Excess Tax-Deductible Goodwill Resulting from a Retroactive Change in Tax Law*

When an institution elects to retroactively amortize goodwill in accordance with the Omnibus Budget Reconciliation Act of 1993, how is the tax benefit related to tax-deductible goodwill in excess of "book" goodwill determined? How should that benefit be recognized under FASB Statement No. 109, *Accounting for Income Taxes*?

93-13 Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from *Continuing Operations*

Should the tax effect of a retroactive change in enacted tax rates for the period that includes the enactment date of the change be measured using temporary differences existing at the date of enactment or those existing at the effective date of the tax rate change?

94-10 Accounting by a Company for the Income Tax Effects of Transactions among or with its Shareholders under FASB Statement No. 109, *Accounting for Income Taxes*

Should tax effects caused by transactions among or with shareholders be included in the income statement or in equity in the separate financial statements of the company affected?

95-10 *Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109,* Accounting for Income Taxes

Certain foreign jurisdicitons tax corporate income at different rates depending on whether that income is distributied to shareholders. Should a deferred tax asset be recognized (in the financial statements of a company that pays dividends subject to the tax credit to its shareholders) for the tax benefits of future tax credits that will be realized when income previously taxed at the undistributed rate is subsequently distributed?

Leases

93-8 *Accounting for the Sale and Leaseback of an Asset That Is Leased to Another Party*

How does a seller-lessee account for a sale/leaseback of personal property when the asset is subject to an operating lease at the time of sale or is subleased or intended to be subleased by the seller-lessee to a third party under an operating lease?

Nonmonetary Transactions

93-11 *Accounting for Barter Transactions Involving Barter Credits*

Does APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, apply to an exchange of a nonmonetary asset for barter credits?

Postretirement Benefits Other Than Pensions

93-3 *Plan Assets Under FASB Statement No. 106*

If a trust is established to pay postretirement benefits, must the trust assets be "bankruptcy-proof" to qualify as plan assets under SFAS No. 106?

Restructuring Charges

94-3 *Accounting for Restructuring Charges*

When should a liability be recognized for costs of termination benefits, as defined in the consensus, to be provided to involuntarily terminated employees? What related disclosures should be made for all periods until the termination plan is completed? (Note: At press time, the EITF had reached consensuses on only selected issues relating to restructuring charges. Remaining issues will be discussed and additional consensuses may be reached at future meetings. Therefore, practitioners should consult the looseleaf edition of *EITF Abstracts* or call the AICPA Technical Hotline to obtain current information on this issue.)

Debt Restructuring

94-8 *Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring*

In a debt restructuring, if there is a difference in the basis in the loan being restructured and the fair value of the debt security received, what should be the creditor's initial cost basis of a debt security received from the original debtor in a loan restructuring and how should the creditor account for any differences between the basis in the loan and the fair value of the security at the date of the restructuring?

Revenue Recognition

95-4 *Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease*

Is a manufacturer precluded from recognizing a sale of a product to a dealer if the customer subsequently enters into an operating lease with the manufacturer or its finance affiliate who acquires that product subject to a lease?

Transfer of Receivables With Recourse

92-2 *Measuring Loss Accruals by Transferors for Transfers of Receivables With Recourse*

When receivables are sold with recourse, should the transferor accrue all probable credit losses over the life of the transferred receivables at the sale date? May the recourse obligation be discounted if the timing of the cash flows can be reasonably estimated?

Stock Options

94-6 *Accounting for the Buyout of Compensatory Stock Options*

When compensatory stock options are repurchased by the issuing company, how should the total amount of compensation cost recognized as expense be determined?

1.807 Practitioners may obtain the *EITF Abstracts* by calling the FASB Order Department at (203) 847-0700.

1.900 USE OF FORMS IN ELECTRONIC FORMAT

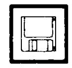
WordPerfect

1.901 Enclosed with this year's edition of the Manual is a complementary disk that contains the sample engagement letters, representation letters, sample auditor's reports, and other correspondence illustrated in this Manual. The documents in the disk are in WordPerfect format to allow you to easily customize them for each client.

Lotus 1-2-3

1.902 Also included on the complementary disk is the Summary of Possible Journal Entries Form in Lotus 1-2-3 (release 3.1 with WYSIWYG or release 3.4 and higher). This file allows you to easily post unrecorded misstatements and it contains formulas to calculate totals and percentages. If you do not have access to Lotus 1-2-3, you may copy the Form included in section 10.904 of Chapter 10 for inclusion in your workpapers.

1.903 These documents are identified in the manual by the following icon:

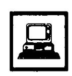


Audit Program Generator

1.904 Many subscribers to the Integrated Practice System Engagement Manuals are also users of the AICPA's Audit Program Generator (APG), a specially designed software program that allows you to customize a variety of AICPA work programs and checklists for each client.

1.905 If you are already an APG user, you may purchase the Library Volume containing the programs and checklists included in this Manual. To order APG and/or the APG Libraries for the Integrated Practice System Engagement Manuals, call the AICPA's Order Department at 1-800-862-4272, sub-menu #1. For APG product information, call the AICPA Software Connection at 1-800-226-5800.

1.906 The programs and checklists that are available in the APG Library Volume are identified by the following icon:



1.950 CONCLUSION

1.951 It is important to our overview of the auto dealership industry to realize that many factors affect the operations and management of a dealership, including manufacturer required operating statements, franchise and floor plan agreements, tax requirements, and federal, state, and local regulations. Accountants involved with auto dealerships need to understand all of these factors in order to conduct an efficient and effective dealership audit.

Auto Dealership Industry
General

CHAPTER 2

THE AUTO DEALERSHIP INDUSTRY — GENERAL

Table of Contents (Continued)

CHAPTER 2

THE AUTO DEALERSHIP INDUSTRY — GENERAL

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CHAPTER 2

THE AUTO DEALERSHIP INDUSTRY — GENERAL

2.000 WHAT IS AN AUTO DEALERSHIP?

2.001 An auto dealership is literally a combination of several separate, but integrated, enterprises managed as one company. These enterprises incorporate the new and used car departments as well as the parts and service departments.

2.002 Even though an automobile dealership may have all of these departments within its business structure, the primary function of the automobile dealership is to sell new automobiles to retail customers. These new automobiles are purchased from manufacturers with whom the dealership has existing franchise agreements. All of the other departments within the dealership are either directly or indirectly related to the sale of new vehicles. Though each department is a separate profit center, they all supplement the new car department.

2.003 Dealerships must be involved in the used car market, since used car trade-ins are often accepted in order to sell new cars. As a result, dealerships must also dispose of used cars either by selling them at wholesale (via auctions or to other used car lots) or at retail. The trade-in is a partial payment for some new cars.

2.004 Dealerships must maintain an adequate stock of parts and accessories and must furnish customer service. Not only do these departments contribute to the profitability of the dealership, but they also support the new and used car departments by preparing the vehicles for sale. Parts and service departments are generally required under the dealership's franchise agreement.

2.005 Dealerships usually earn a significant amount of income from their participation in the financing and leasing of new and used vehicles. In addition, dealerships may also earn insurance commissions from the sale of various insurance products (e.g., extended warranty, credit life insurance, etc.).

2.100 COMMON CHARACTERISTICS

2.101 The specific characteristics of automobile dealerships vary depending upon which franchise agreement the dealership operates. However, the following characteristics are generally common to all automobile dealerships:

- The dealership is franchised by a manufacturer (throughout this Manual, "manufacturer" will be used to denote domestic manufacturers as well as distributors of foreign-made vehicles). As a franchisee, the dealership is dependent upon the manufacturer in many ways, the most important being the available supply of a marketable product. The dealership also relies on the manufacturer to maintain, or even enhance, the image of the product.

- Dealerships are usually highly leveraged, generally because they must invest large amounts of money in vehicle inventory. Inventories are generally financed through a special type of credit facility, referred to as a "floor plan line of credit."
- The sale of automobiles is strongly correlated with certain economic factors such as the general inflation rate, consumer confidence, and the unemployment rate.
- Dealerships operate with narrow gross profit margins and high overhead costs resulting in a high sales break even point. High volume and fast turnover are key to a dealership's survival.
- Between 70 and 80 percent of operating expenses are fixed or semivariable. The only significant variable costs of operating a dealership are the costs of preparing cars for delivery and the commissions earned by sales personnel.
- Sales-related personnel, which include personnel involved in vehicle, parts, and service sales, are generally paid by commission. Salaried employees are generally involved in the administrative aspects of the dealership.

2.200 INDUSTRY TRENDS

Some Statistics

2.201 Automobile sales is big business in the United States. In 1994 alone, total dollar sales of all franchised new car dealerships rose to a record $434 billion and over 15.2 million new cars and light trucks were registered in the United States.[1] However, the automobile industry is vulnerable to economic swings and, therefore, is cyclical in nature. Illustration No. 2-1, "U.S. Car and Light Truck Sales," illustrates a complete industry cycle that took place between 1982 and 1994.

2.202 Total domestic car and light truck sales exploded during the mid-1980's, growing from a modest 10.05 million units in 1982 to a peak of 16.08 million units in 1986.[2] In contrast, the late 1980's was marked by substantial declines. Sales declined from 1988 through 1991, reaching an eight year low of 12.4 million units in 1991.[3]

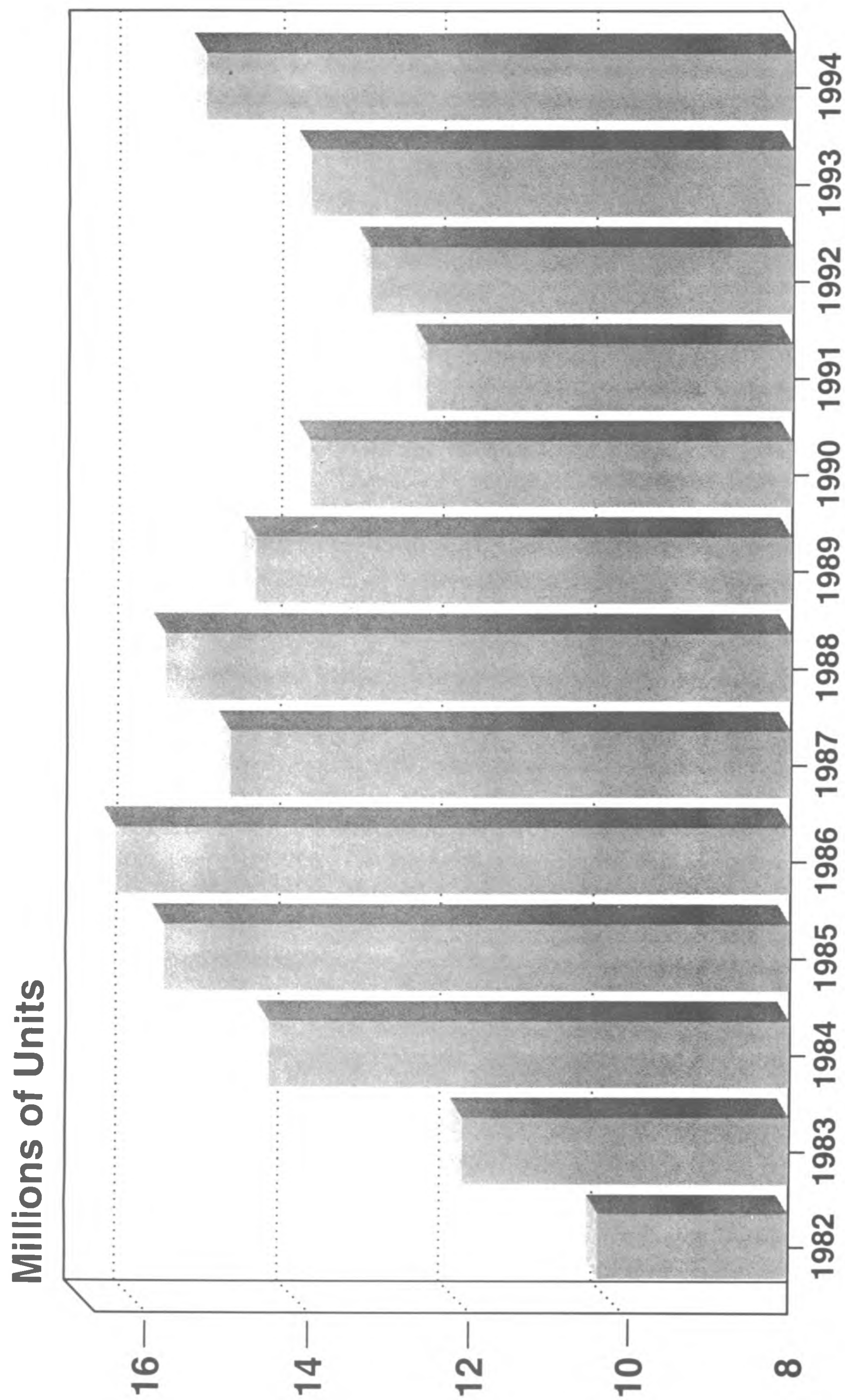
2.203 The industry began to rebound in 1992. The recovery in that year was relatively modest, which was consistent with the overall economy. However, vehicle sales in 1993 reached 1990 levels and 1994 was the best year since 1988. Illustration No. 2-1 illustrates these changes in sales through 1994.

[1] Automotive Executive Magazine, *1995 NADA Data Book*, August 1995, p. 30 and p. 47.

[2] Automotive News, *1995 Market Data Book*, May 24, 1995, p. 25; *1992 Market Data Book*, May 27, 1992, p.17.

[3] Ibid., *1992 Market Data Book*, May 27, 1992, p.17.

Illustration No. 2-1 **U.S. CAR AND LIGHT TRUCK SALES (1982–1994)**



Numerical Information From: Automotive News, 1995 and 1992 Market Data Books

2.204 During the lean years, many dealers struggled to survive. Faced with narrowing gross margins, these dealers reduced inventory, scaled back promotional expenses and laid off employees to reduce overall expenses. Despite these efforts, according to Automotive Executive Magazine, in 1990 and 1991 "...more than 20% of dealerships lost money, and nearly 1,500 went out of business."[4] With the recovery of the auto industry, which started in 1992 and 1993, finally taking hold in 1994, dealers had improved profit margins enabling them to add 57,000 people to their payrolls.[5]

2.205 Low dealer profitability has sparked a trend toward reducing the number of dealerships and consolidating several franchises under one roof. It was hoped that fewer dealerships could boost retail profits through higher volumes. As a result, the number of franchised car dealerships has decreased 25% between 1970 and 1993.[6] However, for the first time since the late 1980s, the decline has leveled out. Illustration No. 2-2 shows the change in the number of dealerships since 1970.

2.206 The decrease has come at the expense of small-volume dealerships. According to Automotive Executive Magazine, in 1985 there were more than 8,000 dealerships with fewer than 150 new vehicle sales per year; in 1995, there are fewer than 4,700 such dealerships. In contrast, there are more than 5,800 dealers in 1995 that sell greater than 750 vehicles per year versus less than 4,000 dealerships in 1985.[7]

2.207 During the 1980s the industry witnessed the growth of chain dealerships or "megadealers." In 1989, 20% of all dealerships were part of a chain, compared with only 13% in 1983. Chain affiliation grew even faster during the 1990–1993 recession, reaching 30% in 1993. This trend appears to reflect dealers' desire to achieve greater economies of scale. Furthermore, by offering a broad product line, dealers can reduce their dependence on the success of a particular make and increase their market penetration. Currently, the 100 largest U.S. megadealers (.6% of all dealers) generate more than 10% of U.S. new vehicle sales.[8]

2.208 Sales strength and dealer penetration may vary by geographic region. As shown in Illustrations Nos. 2-3 and 2-4, in 1994 the North Central states generated the highest total sales. However, this region also had the greatest number of dealer franchises and second lowest average sales per dealer. The Pacific states led the nation with average sales per dealer of $23.85 million, just slightly ahead of the second-place South Atlantic states. Dealers in the North Central states fared just slightly better than the Northeast in average sales.[9]

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[4] Automotive Executive Magazine, *1992 NADA Data Book*, August 1992, p.24.

[5] Ibid, *1995 NADA Data Book*, August 1995, p.23.

[6] Ibid, *1993 NADA Data Book*, August 1993, p.31.

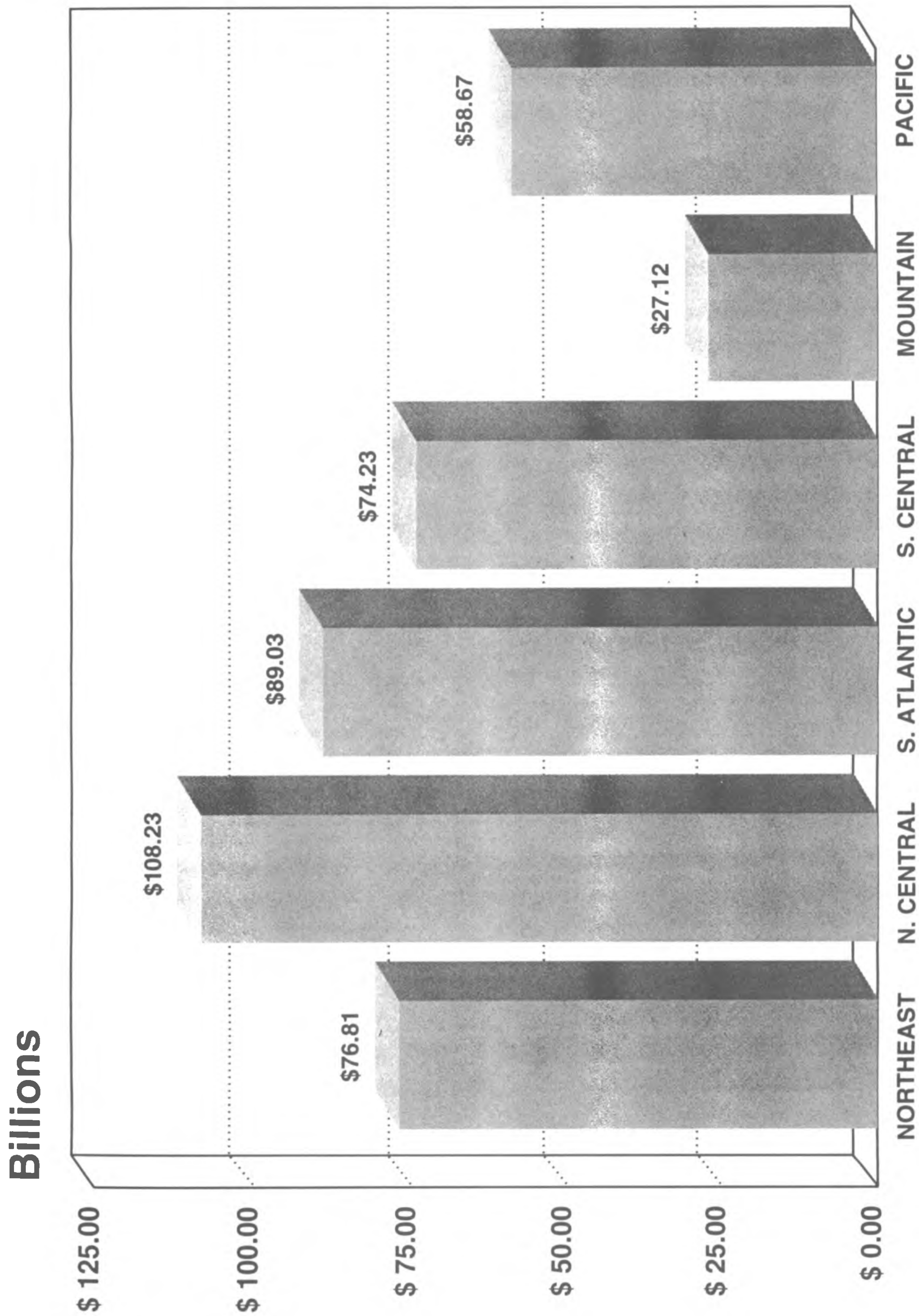
[7] Ibid, *1995 NADA Data Book*, August 1995, p.29.

[8] Automotive Executive, *Trendline*, May 1993, p.10.

[9] Automotive Executive Magazine, *1995 NADA Data Book*, August 1995, p.30.

Illustration No. 2-2 **U.S. NUMBER OF FRANCHISED CAR DEALERSHIPS**
(As of Beginning of Each Year)

Illustration No. 2-3 1994 TOTAL U.S. SALES — BY REGION



TOTAL SALES — $434.099 BILLION

Numerical Information From: Automotive Executive Magazine, 1995 NADA Data

Illustration No. 2-4 **1994 AVERAGE DOLLAR SALES PER DEALERSHIP (BY REGION)**

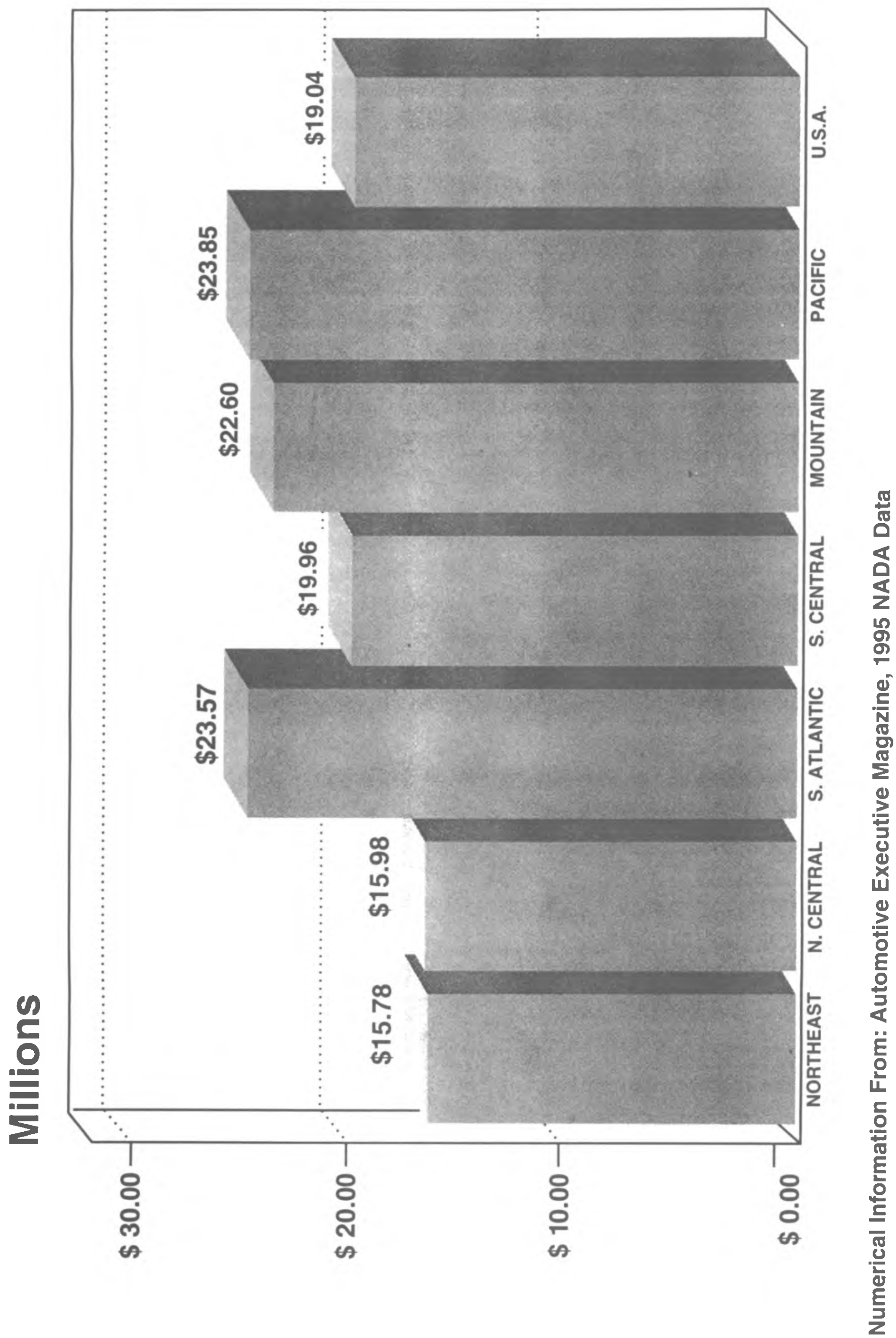
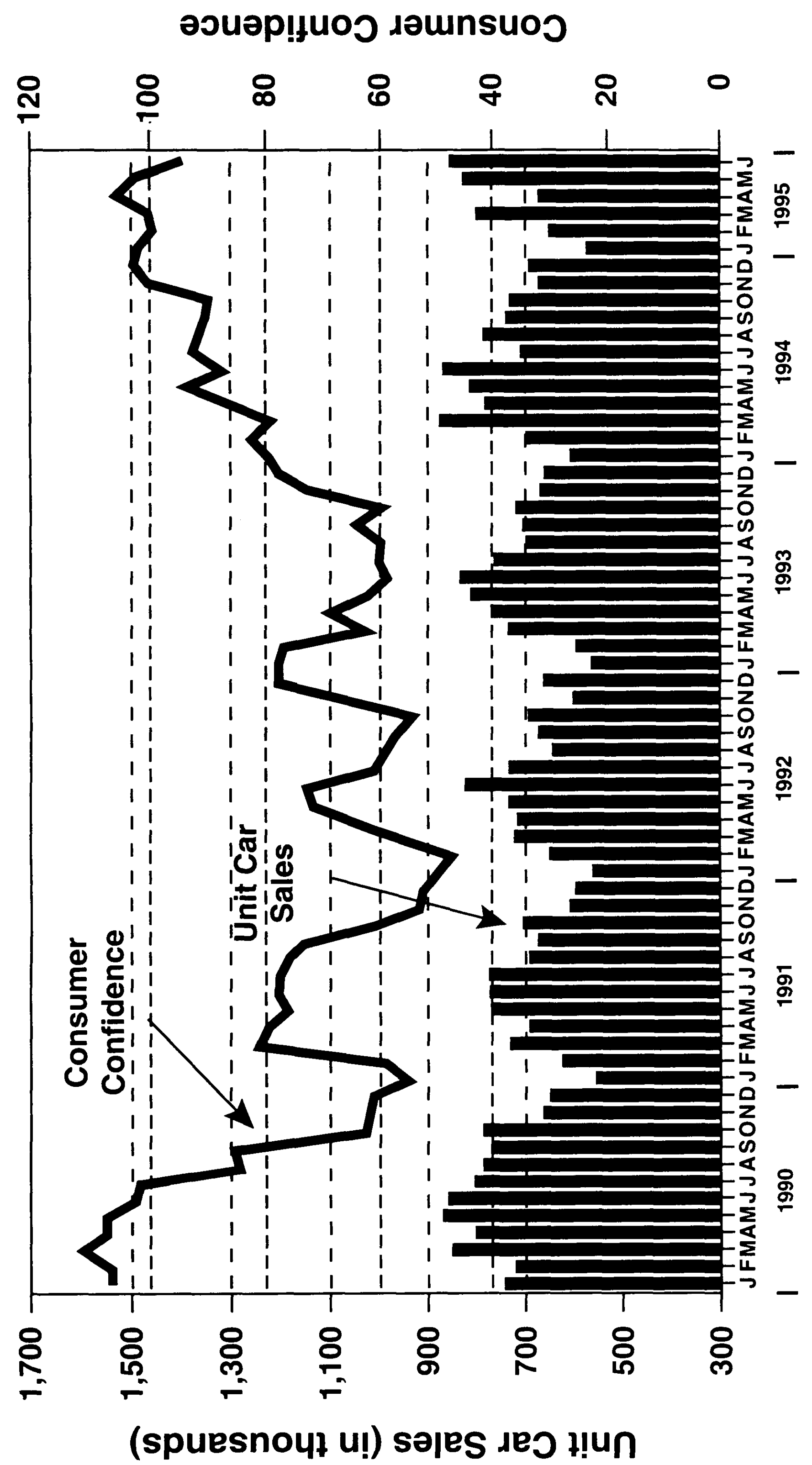


Illustration No. 2-5 **U.S. CAR SALES VS. CONSUMER CONFIDENCE**



Source of Consumer Confidence Index: The Conference Board, 1985 = 100.
Source of Car Sales Data: Automotive News, Market Data Books (1995, 1994, 1993, 1992 & 1991)
Automotive News (2/6, 3/6, 4/10, 5/8 & 7/10/95)

What Accounts for the Growth or Decline?

2.209 National Economic Pressures. Total retail automobile sales mirror the general ebb and flow of the economy. The buying decision is influenced by a multitude of economic factors including disposable personal income, consumer confidence, the relationship between car prices, the rate of inflation and real wage growth, and the availability, cost and average maturity of consumer credit. No single variable determines how the industry will perform over time. However, as noted in Illustration No. 2-5, there appears to be a strong historical relationship between consumer confidence and automobile sales. The chart also illustrates the seasonal nature of automobile sales. From January 1990 through April 1995, sales tended to be strongest during the second and third quarters.

2.210 The recovery, which began in 1992, has begun to take hold. The moderate gains achieved in 1992 and 1993 have accelerated into the best year since 1988. According to Bernstein Research, an investment research and management firm, three years of sub-par sales (1989–1991) created about 4.2 million units of pent-up demand and the average vehicle in operation was eight years old, making it increasingly likely that consumers would replace their cars.[10]

2.211 This growth has been fueled by several factors. First, there is a shortage of two- and three-year-old used cars, which has increased the value of buyers' trade-ins. This shortage is the result of the low sales in 1989–1991 along with many of those buyers financing their purchases with five-year loans. As a result, many potential purchasers have equity in their trade-ins that can be used to reduce monthly payments.[11]

2.212 Second, the manufacturers have adopted appealing leasing programs that enable consumers to drive away with monthly payments 20–40% below the amount that would otherwise be required under a five-year loan. The catalysts creating the attractive lease terms are high residual values for the cars (which is partially the result of the increased value of the two- and three-year-old cars) and favorable interest rates.[12]

2.213 According to Ferman Selz, Inc., an investment research and management firm, " ...it is difficult to predict what will happen in two or three years when millions of vehicles come off of leases and are recycled into the market. For now, leasing has become the preferred method of financing a car and the primary explanation for the acceleration in vehicle demand despite lackluster income and employment growth."[13]

2.214 Local Economic Pressures. Significant local developments also impact auto dealership performance.

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[10] Sanford C. Bernstein & Co., *The Automotive Industry*, September 1992, p.11.

[11] Ferman Selz, Inc., *Maryann N. Keller Automotive Studies, Auto Industry Observation #20, Vehicle Demand*, April 4, 1994.

[12] Ibid.

[13] Ibid.

2.215 Plant closings and layoffs by major employers can send local economies into a tailspin. Cutbacks on defense spending are likely to affect many communities that depend on military bases or defense-related production for economic prosperity.

2.216 Regions are also vulnerable to economic downturns in major local industries. Other regions may be susceptible to various natural disasters. Whenever a dealership operates in an area that is experiencing such economic pressures, new car sales are also negatively affected.

2.217 **Competition.** Industry competition continues to intensify. One reason for the heightened level of competition is the rapid rise of car prices. The average expenditure on a new car has risen over 120% since 1980, considerably faster than the consumer price index. As a result, consumers have become less brand loyal and increasingly value conscious, demanding better quality, improved features and distinctive styling.

2.218 Auto manufacturers have responded to these pressures through a series of technology improvements aimed at improving quality and reducing the time required to design and bring new models to market. Manufacturers that can reduce the number of defects and quickly introduce new, appealing models will enjoy the most success.

2.219 Price competition has also intensified as the price of foreign models has increased more rapidly than the price of domestics. In 1970, foreign car prices were 28% less, on average, than prices for American cars. Ten years later, the average consumer expenditure on new domestic models was only $127 more than the average expenditure on imports. In 1982, imports became more expensive than domestics. Since that time, the price gap has continued to widen in favor of domestics.[14]

2.220 Despite the favorable price swing, domestic manufacturers continued to lose market share to foreign producers throughout the 1980s. Apparently, consumers were willing to pay more in return for the higher quality offered by imports.

2.221 In the early 1990s, domestic manufacturers began closing the quality gap. A 1995 survey of new car and truck buyers reported an industry average of 103 defects per 100 cars in the first 90 days of ownership. Owners of domestic models reported 110 defects, down 22% from three years earlier.[15] As the quality of domestic makes continues to increase relative to imports, price will become a more prominent force driving competition.

2.222 Car prices are affected by a number of factors. Consumer tastes have shifted recently in favor of larger cars and bigger engines due, in part, to the relative stability of oil prices. New regulations and safety standards have created an upward pressure on prices. Car prices have also been affected by import tariffs and quotas. Also, the North American Free Trade Agreement (NAFTA) could, in the next few years, play a role in car prices.

2.223 Exchange rate fluctuations play a large role in determining the relative prices of domestic and foreign models. For example, Japanese vehicle prices have risen 51% since 1985, while the Big 3 have

[14] Ferman Selz, Inc., *Maryann N. Keller Automotive Studies, Auto Industry Observation #32, New Car Sales*, September 14, 1992, p.15.

[15] J.D. Power & Associates, *1995 Initial Quality Study*, May, 1995.

increased prices only 27% over the same period. The rapid rise of Japanese car prices is at least partially due to steady increases in the value of the yen relative to the dollar since 1985.[16] Japanese manufacturers have managed to avert some of the risk associated with tariffs, quotas, and exchange rate fluctuation by shifting production to the U.S. These same trends also apply to the European manufacturers.

2.224 Customer Financing. The variety of methods in which a customer can finance the purchase as well as the cost of the financing may influence car sales.

2.225 Since most customers finance their vehicle purchases, interest charges add to the cost of the vehicle. Even though interest rates have increased during 1994, they still remain relatively low. In addition, interest rates for other types of consumer debt are much higher than auto loans, giving consumers the perception that an auto loan is inexpensive.

2.226 The availability of credit is also important. According to the Consumer Bankers Association 1994 Automobile Finance Study, loan approvals have increased and banks are making quicker decisions on auto loans as a result of an easing in auto credit practices.[17]

2.227 Credit availability is not just restricted to banks and the captive finance companies of the manufacturers. In fact, credit unions' share of the auto loan business has increased from 16.5% of all auto credit outstanding in 1990 to 20% in 1993.[18]

2.228 As noted earlier, leasing is fast becoming the preferred method of financing a car. This shift in financing method is being encouraged by the car makers who are subsidizing leases by factoring high residual values into the lease. These high residual values coupled with low interest rates have made leasing extremely attractive to car buyers and have helped to stimulate sales.

2.229 Demographics. Lifestyle and demographic changes have had a significant impact on the automobile industry over the last 10 years. An increasing number of single-person and single-parent households means that incomes are being spread thinner. People that work and rely on a single vehicle will demand reliable cars and expect dealers to fix them fast and right the first time. Longer loan terms and favorable lease terms have enabled these segments to afford today's pricier cars. Quality improvements have allowed buyers to hold on to their cars longer.

2.230 Younger, working couples are becoming more affluent, waiting longer to have children, and having fewer children than their parents did. In this segment, the decision to buy is more likely to be influenced by distinctive styling than by low price or economy.

2.231 The "baby boomers" have matured into their late 40s. This has impacted the automotive industry in two ways. First, the boomers have reached their peak earning years, and increased the demand for high-end, luxury vehicles. Second, as their children matured into their teens, many boomers traded in their second sedans for mini-vans, sport utility vehicles, and other light duty trucks to meet the demands of

[16] Value Line, *Auto & Truck Industry*, June 18, 1993, p.101.

[17] Consumer Bankers Association 1994 Automobile Finance Study, cited in Automotive News, June 20, 1994, p.6.

[18] Ibid.

family life. The popularity of these vehicles has increased dramatically over the last 5 years, growing from 18.1% of total U.S. vehicle sales in 1980 to 40.4% in 1994.[19]

The Future

2.232 The automotive industry is shaped by a multitude of economic, demographic, and competitive forces, making predictions of the future difficult. The best one can do is to use the last 10 to 15 years as a guide for determining what will be the key indicators of dealer success in the future.

2.233 Economic uncertainty represents the greatest threat to the automobile industry. Durable goods, particularly cars, are sharply sensitive to economic contractions and slow to recover in expansionary times. Higher taxes, large defense cutbacks, a tighter monetary policy, rising inflation, or growing trade deficits could hamper economic growth and adversely impact the auto industry. The industry is likely to perform well under conditions of controlled economic expansion, interest rate stability, low unemployment, and moderate real wage growth.

2.234 Agreements between trading partners will also impact the industry. Lower U.S. import tariffs and quotas would cause the price of imports to decline relative to domestic car prices. The effect that NAFTA may have to car prices and the industry as a whole remains to be seen.

2.235 Safety concerns and environmental regulations will continue to pressure the industry. For example, under California's clean air rules, beginning in 1998, at least 2% of the cars sold in the state must emit no harmful exhaust emissions.[20] The minimum rises to 5% in 2001 and 10% in 2003. Unless there is a major technological breakthrough, most industry experts believe that these new vehicles will be battery-powered.[21] The California market is significant both because of its size (California accounted for more that 10% of all U.S. car sales in 1994) and because, historically, California has led the country in environmental reform. Other states have followed California's lead and have instituted their own environmental regulations.

2.236 The success of particular makes will depend on dealer and manufacturer responsiveness to changing American lifestyles. Consumers have become increasingly value conscious, demanding better quality, improved features, distinctive styling and improved service. The Big Three will depend on favorable exchange rates to keep foreign car prices high in the U.S. As the quality gap narrows, the price-performance tradeoff will begin to favor American manufacturers. Manufacturers and dealers will have to assign top priority to customer satisfaction to build brand image and foster customer loyalty.

Significance to Accountants

2.237 Automobile dealerships create a host of opportunities for accountants beyond the traditional audit, compilation, review, and tax services. The following is a partial list of business services that can be marketed to auto dealers:

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[19] Automotive News, *1995 Market Data Book* and *1991 Market Data Book*.

[20] Value Line, *Auto & Truck Industry*, June 18, 1993.

[21] Value Line, *Auto & Truck Industry*, June 17, 1994.

- Information systems evaluation and implementation
- Operational consulting to improve internal efficiency and tighten controls
- Business valuation
- Merger and acquisition support
- Lost profit projections related to business interruption

2.238 However, accountants also must ensure that they expand their client base (and services to existing clients) with clients that will benefit their practices. Dealership operating losses can accumulate quickly when sales decline, but dealership expenses remain relatively fixed. Extended declines can raise going-concern questions. Fee pressures intensify in tough economic times. Accountants are increasingly expected to justify their fees in terms of value-added services and to concede to partial write-downs at the conclusion of their work.

2.300 HOW AUTO DEALERSHIPS ARE ESTABLISHED

Franchise Agreements

2.301 Auto dealerships involve a close, direct relationship between the manufacturer and the dealership. Dealerships are independently owned retail outlets whose goals are aligned with those of the manufacturer in both operation and marketing objectives. The close cooperation and mutual dependence between the manufacturer and the dealership is established within the body of the franchise agreement, also known as the sales and service agreement.

2.302 The franchise agreement between the manufacturer and the dealer spells out the numerous sales and service responsibilities of each. Under auto dealership franchise agreements, the dealerships pay no fees to the manufacturer or distributor. Franchise agreements are nonassignable, personal services contracts awarded to qualified dealers who are generally required to take an active role in the operation of the dealership.

2.303 Franchise agreements are granted by the manufacturer to realize sales objectives in a certain geographical market. The franchise agreement does not restrict the dealership's sales solely to that site, but does limit the dealership somewhat in relocating within the market or to a different location. The franchise agreement also does not restrict the dealership from acquiring additional franchises; in fact, many dealers have more than one franchise in order to gain entry into several major market segments by providing models that appeal to many different types of car buyers.

2.304 The agreement requires dealers to provide adequate promotional activities, as well as service support by maintaining sufficient facilities, tools, equipment, parts, and trained personnel to service the vehicles they sell. Though stipulated in the agreement, the dealership's profitability is augmented by these requirements.

Financing Considerations

2.305 Floor Plan Line of Credit. The principal credit accommodation that lenders (banks, captive finance companies of the manufacturers, other finance companies, etc.) provide is inventory financing, referred to as the "floor plan line of credit." It is not unusual for a dealership's entire new vehicle inventory to be 100% financed. Some dealerships also have a portion of their used vehicle inventory financed, usually at 100% of cost. A sample floor plan agreement is included in section 2.901.

2.306 This type of financing is often regarded by lenders as having one of the highest degrees of risk of all credit facilities. Each floor plan note is secured by an individual vehicle. The lender's collateral remains in the possession of the dealership and turns rapidly as sales are generated.

2.307 A unique feature of floor plan lines of credit is the automatic drafting agreement, which gives the lender authority to pay the manufacturer directly as vehicles are shipped from the factory. These agreements specify the maximum credit line, the daily limit of drafts, and the conditions and procedures the lender follows to terminate the agreement.

2.308 Because each floor plan note is secured by a particular vehicle, the dealership must repay each note usually within three days after the sale of the vehicle. Most floor plan agreements, however, require the dealership to begin repaying notes on inventory that remains unsold for a specified period of time. Typically, the lenders require payment of 10% of the loan balance related to old model year vehicles that have been in inventory for over six months.

2.309 Borrowings under a floor plan line of credit are considered short-term debt because the dealer expects to sell the vehicles and pay off the related notes within a twelve-month period. Interest on floor plan debt is usually tied to the prime rate and is calculated monthly, based on the average daily outstanding balance.

2.310 Real Estate Financing. Dealerships often need real estate financing to purchase an existing facility from a third party, to expand existing facilities, or to relocate. Real estate financing is generally the result of the dealership acquiring the real estate and borrowing the funds. Alternatively, the owner of the dealership may personally, or through an affiliated real estate holding company, acquire the real estate in order to lease it to the dealership. In any case, the lender depends on the dealership to generate funds to liquidate the debt.

2.311 All of the above loan agreements may contain restrictive covenants and/or require the dealer principal to sign as guarantor.

Legal Considerations

2.312 Although the various states have their own specific requirements regarding the licensure of motor vehicle dealers, most states have the same basic licensing requirements, as discussed in sections 2.313-2.315.

2.313 Who Must be Licensed. Most states require any person engaged in the business of buying, selling, or dealing in motor vehicles, or offering or displaying for sale vehicles at wholesale or retail to be licensed. Any person who is required to have a dealer license, but who fails to obtain one, is subject to a number of different penalties including the issuance of an injunction by the filing of an unfair and deceptive trade practices complaint, or the filing of criminal charges for violation of the licensing requirements.

2.314 Types of Licenses. There may be separate designations for different types of dealers such as:

- Franchised motor vehicle dealer — allows the licensee to sell new motor vehicles under an established agreement with a manufacturer, importer, or distributor.
- Independent dealer in used cars only — permits the licensee to transact business either at retail or wholesale.

2.315 General Licensing Requirements. There are a number of general requirements that most states require as a prerequisite to receiving a license, including:

- Surety bond or irrevocable letter of credit — The assurance provided by the bond or irrevocable letter of credit must remain in force and effect until the statutes of limitations prohibit claims of any nature from being filed.
- Location and facility requirements — A dealership's proposed location and facilities must conform with statutory and rule requirements.
- Garage liability insurance — Insurance under a garage liability policy (insurance for bodily injury and/or property damage from a third party) may be required.
- Sales tax number — A state sales tax number (or proof that application has been made) is required on an application for a motor vehicle dealer license.
- Zoning and occupational license requirements — Generally, a state's Department of Motor Vehicles does not regulate zoning or issuance of occupational licenses. These are normally governed at the county or municipal level in the state. Refusal of a city or county to issue an occupational license may result in the denial of a dealer license.
- Retail installment sales license — A retail installment sales license may be required in order to engage in the business of a motor vehicle retail installment seller or to operate a branch of such a business.

2.400 DESCRIPTION OF DEALERSHIP DEPARTMENTS

New Car Department

2.401 A dealership may sell domestic and/or foreign models of vehicles. For domestic models, the dealerships generally have substantial control over the number of vehicles they can receive from the manufacturer, as well as the model mix and the amount of optional equipment. The dealer has the ability to contact the factory and order a vehicle with whatever options and colors are needed and have the vehicle on the lot in a relatively short period of time. Foreign model dealerships, have less control; the distributor usually allocates inventory to the various dealerships based on past sales performance.

2.402 A dealer may decide to have dual franchises. "Dualing" refers to the sale and service of more than one line of passenger cars in common physical facilities at the same location. Having more than one franchise is attractive when the combined franchises give a dealer entry into several major market segments by providing models that appeal to many different types of car buyers. Certain manufacturers may restrict the dealership from using one show room for two franchises; in that case, the dealer may have to add additional showroom facilities.

2.403 The general rule of thumb is that a dealership should carry a 45-day supply of new cars. This level of inventory allows the dealership to avert lost sales while keeping floor plan interest at a minimum.

2.404 New vehicles are received directly from the factory (for domestically built vehicles) or from the distributor. At the time the vehicle is shipped, the manufacturer passes title to the dealership by invoicing the dealership through the factory invoice and issuing an MSO (manufacturer's statement of origin).

2.405 The dealership's floor plan institution pays for the vehicles shipped when the manufacturer draws a draft on them. The invoice reflects the vehicle's base cost (important information if the dealership computes its inventory on the LIFO basis using the Alternative LIFO Method), the cost of any optional equipment, holdback (if applicable), advertising costs (if applicable), and destination charges.

2.406 "Holdback" is defined as an amount in addition to the vehicle's purchase price the manufacturer holds and later remits to the dealership. When the dealership is invoiced, the entire amount of the factory invoice is recorded as a floor plan liability (since the floor plan lender pays the entire invoice amount to the manufacturer), the holdback is recorded as a receivable, and the remainder is recorded as inventory. All domestic manufacturers and several foreign distributors use holdback when invoicing their dealers.

2.407 When the vehicle arrives at the dealership, it is not in immediate saleable condition. The dealership is required to perform certain tasks (such as attaching side mirrors, removing interior plastic covers, etc.) for which the manufacturer reimburses the dealership. These tasks are normally performed by the service department and charged to the new car department. Preparing the vehicle for sale is completed as soon as the vehicle arrives at the dealership.

2.408 Information that must be supplied to prospective purchasers of a new vehicle is included on the Monroney Sticker. Information found on the Monroney Sticker includes the manufacturer's suggested retail price ("MSRP") of the vehicle, the MSRP of factory-installed optional equipment included on the vehicle, and gas mileage. The Monroney Sticker is already on the car when it arrives at the dealership.

2.409 Also, the American Automobile Labeling Act, which became effective October 1, 1994, mandates that labels must go on every new car and light truck sold in the U.S. informing consumers of the following:

- Percentage of U.S.-Canadian parts
- Names of two countries that provided the most non-U.S.-Canadian parts
- Point of final assembly
- Country for source of engine
- Country for source of transmission

2.410 Within new car inventory, dealerships generally carry several vehicles designated as demonstrators, which are used to provide customers with test drives. Also, certain employees are furnished demonstrator vehicles to commute to and from work. These demonstrator vehicles are considered inventory because they are ultimately sold. Those that have a significant amount of accumulated mileage may or may not be considered new vehicles, depending on state regulations.

2.411 When the dealership sells a vehicle that is subject to floor plan debt, the lender usually requires payment within three days. Whether the dealership sells the car for cash or finances it through an installment sales plan, the funds belong to the lender and must be remitted promptly to prevent the dealer from being "out-of-trust." Since the dealer is a trustee for the units that are on the floor plan, the lender has a preferential position in its claim on the vehicle.

2.412 No discussion of car sales in today's market would be complete without mention of leasing activities. In recent years, leasing has become an important segment of new car sales, and that trend is expected to continue. From the dealership's perspective, leases are treated as sales because, in reality, the dealership sells the car to a leasing company, which in turn leases the car to the customer. The leasing companies involved in these transactions are generally the financing arms of the manufacturers, but may also be independent leasing companies.

2.413 Dealerships may be entitled to receive various incentives and rebates from the manufacturer. Incentive payments are generally based on the dealership reaching a predetermined sales goal. Rebates are tied to specific units of inventory — either a fixed amount paid for each sale of a particular model or rebates of floor plan interest. Rebates for sales of certain models are generally offered near the end of the model year as an inducement to sell the remaining inventory before the new model is introduced. Rebates of floor plan interest, often referred to as "floor plan assistance" or "floor plan allowance," reimburse the dealership for the interest paid during the period that the vehicle is in transit from the factory to the dealership.

2.414 Besides receiving vehicles directly from the manufacturer, the dealership can enter into "dealer trades" with other dealers. These transactions are not generally recorded as sales, but are recorded in much the same way as a vehicle received from the manufacturer. Generally, the dealership pays for these vehicles directly; however, it may finance the trade through the floor plan institution.

2.415 Salespersons' wages are generally earned on a commission basis which is calculated as a percentage of the gross profit of vehicles sold. Some dealerships pay higher percentages if the individual salesperson reaches certain sales plateaus. For example, if a salesperson sells five vehicles during the month, he or she may earn 15% of the gross profit of each vehicle sold. If he or she sells a sixth vehicle, the commission rate may increase to 20%, which would be applied retroactively to the first five vehicles sold.

2.416 Also, salespeople may be paid "spiffs," which are bonuses earned as an inducement for reaching a special sales goal (for example, most cars sold, highest gross profits earned, selling a specific older unit, etc.).

2.417 If any salesperson earns commissions that are computed to be less than minimum wage for the amount of hours they worked, the dealership is required to pay the minimum wage amount in order to be in compliance with the Fair Labor Standards Act.

Used Car Department

2.418 The used car department in a dealership may be handled as a necessary support for efficient new car retailing, or it may be operated as an important profit center in its own right. For some dealerships, the used car department merely provides the means for disposing of trade-ins; for others, the used car department provides a complete line for customers who consider a used car (i.e., a vehicle that has been previously owned or titled) as an alternative to a new car.

2.419 Dealers decide to develop their used car activities in different ways, and as a result, they differ in the extent to which they dispose of (either wholesale or retail) trade-ins, carry inventories of used cars, recondition used units, and extend warranties on used units.

2.420 At the time of trade-in, it is important that the used car be appraised correctly. An appraised value (also referred to as the "actual cash value" or ACV) that is greater than the true wholesale value of the used car inflates the new car gross profit and, at the same time, contributes to overstating the value of the used car. As a consequence, there may be significant future losses when these units are subsequently sold or revalued. Appraised values of used cars are determined internally, generally by the used car department manager.

2.421 Determining whether a traded-in vehicle should remain in inventory to be sold to retail customers or sold at wholesale or auction is based on a variety of factors. These factors include the estimated cost of reconditioning the vehicle to prepare it for retail sale and whether the vehicle, after reconditioning, is of the type the dealership normally carries in its inventory for retail sale (i.e., priced properly, no significant body damage, etc.).

2.422 Used cars generally lose their value through the passage of time. New cars generally do not depreciate in value over the short term if they remain untitled and do not accumulate any significant mileage. Therefore, used cars should be reconditioned quickly to reduce the likelihood of the vehicle declining in value. The reconditioning, which may include minor body work, is often done by the service department or, in some cases, by outside companies.

2.423 Dealerships that consider their used car departments as an important profit center generally do not rely solely on trade-ins as a source of used car inventory. To maintain a well balanced and sufficient stock of used cars, such dealerships also rely on the wholesale market. That is, they purchase the desired quantity and quality of vehicles either from other car dealers or from auctions.

2.424 If the traded-in vehicle does not meet the dealership's needs, it will sell the vehicle to a wholesaler or through an auction. If the vehicle has only scrap value, the dealership sells it to a scrap yard.

2.425 Salespeople in the used car department are generally compensated in the same manner as salespeople from the new car department.

Finance and Insurance (F&I) Department

2.426 The finance and insurance (F&I) department is responsible for providing financing and leasing options to customers, as well as selling various insurance products, such as credit life and disability insurance. In addition, the financing and insurance department sells extended warranty policies, which cover the future repairs of the vehicles once the factory warranty has expired.

2.427 This department often generates significant income to the dealership. Many dealerships require all customers to conclude the vehicle purchase within this department, even if the customer plans to pay for the purchase in cash, in the hope that the customer will finance the purchase through the dealership.

2.428 **Financing Arrangements.** To obtain financing for their customers, dealers will enter into arrangements with lenders, called "dealer agreements," which specify the terms under which the lender will finance the customer's new and used car purchases. These terms include, but are not limited to, the following:

- Documents and certificates to be forwarded to the lender with the contract
- Method of paying the dealership
- Method used to pay finance reserves (see section 2.435) to the dealership and the minimum amount to be retained by the lender

2.429 Dealerships generally limit the number of lenders they use to develop good working relationships with those lenders. A good relationship helps to ensure that the lender may occasionally purchase contracts with customers whose credit does not meet its usual criteria.

2.430 In order for the lender to approve the customer for financing, the dealership must send a copy of the customer's credit application, usually by facsimile machine. The lender reviews the credit application along with the customer's credit reports and notifies the dealership with either an unconditional or conditional approval or a rejection.

2.431 Conditional approvals may require that the customer remit an additional down payment, provide proof of home ownership and/or income, obtain a cosigner, etc. Conditional approvals may also require that the dealership assign the contract to the lender with full or limited recourse.

2.432 When the dealership assigns the contract to the lender with recourse, it is guaranteeing the customer's payment of the unpaid balance. Consequently, if the customer were to default on the loan, the dealership would be obligated to remit to the lender that portion of the unpaid balance for which they guaranteed payment. In return, when a vehicle is repossessed by the lender, it is returned to the dealership for subsequent sale.

2.433 Normally, dealerships sign few contracts with recourse. The lenders to whom these contracts are assigned should be able to provide the dealership with the outstanding balance information of the contracts to which the dealership has limited or full recourse. Using this information, past history, and the knowledge of the probable current value of the collateral, management provides a loss reserve for future repossessions.

2.434 Notwithstanding the above, contracts assigned to a lender with recourse should be recognized as a sale in accordance with Statement of Financial Accounting Standards (SFAS) No. 77, *Reporting by*

Transferors for Transfers of Receivables With Recourse, since the transfer meets all of the following conditions:

- The dealership surrenders control of the future economic benefits embodied in the contract,
- The dealership's obligation under the recourse provisions can be reasonably estimated, and
- The lender cannot require the dealership to repurchase the contract except pursuant to the recourse provisions.

2.435 Finance Income. As part of their arrangements with lenders, dealerships can earn a fee for each customer contract accepted by the lender. This fee is based on the difference between a minimum lending rate established with the lender (referred to as the "buy rate") and the interest rate actually charged to the customer. For example, if the dealership's buy rate is 8% and the rate charged to the customer is 10%, the dealership will receive a fee based on the difference of 2%. This fee, which is called a "finance reserve" is paid by the lender when the loan is paid off.

2.436 Because this fee is based on the contractual term of the loan, the dealership must return a portion of the fee if the customer pays off the loan early. These returns are referred to as "finance chargebacks." Using their historical experience with chargebacks, dealerships should record a liability for the amount of finance income received that they expect to have charged back in the future.

2.437 Insurance Income. Income earned from the sale of insurance products, such as credit life and disability, generally takes the form of commissions from the insurance company. If the customer were to cancel the policy early, the dealership would be charged for the commission not earned, referred to as an "insurance chargeback." Future insurance chargebacks are estimated based on the dealership's historical experience and recorded as a liability.

2.438 In practice, income earned from the sale of an extended warranty policy is treated the same as the sale of a credit life or disability policy. That is, the income is in the form of commissions that are recorded when the policy is sold. However, as discussed in section 2.440, this accounting treatment is not appropriate for certain extended warranty policies.

2.439 Extended warranty contracts are found in two forms: those in which the warranty company is the primary obligor and those in which the dealership is the primary obligor. In the former instance, the dealership merely acts as an agent on behalf of the warranty company. In other words, the dealership has no obligation to the customer to perform any warranty repairs. In this situation, the recording of the commissions at the point of sale of the policy is appropriate because the dealership has completed the revenue earning process.

2.440 In situations where the dealership is the primary obligor, the dealership may be required to bear the cost of the warranty repairs in certain situations, such as if the warranty company ceases to exist. These types of contracts are covered by FASB Technical Bulletin (FTB) No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*. FTB 90-1 states:

> Revenue from separately priced extended warranty and product maintenance contracts should be deferred and recognized in income on a straight-line basis over the contract period except in those circumstances in which sufficient historical evidence indicates that the costs of performing services under the contract are incurred on other than a straight-line basis. In those circumstances, revenue

should be recognized over the contract period in proportion to the costs expected to be incurred in performing services under the contract.

2.441 For income tax purposes, if the dealership is the obligor, the accounting treatment is governed either by Revenue Procedure 92-97 or Revenue Procedure 92-98. See sections 9.401 through 9.411 (Chapter 9) for a discussion of both Revenue Procedures.

2.442 F&I personnel are generally compensated on a commission basis whereby payment is calculated as a percentage of F&I income generated from the sale of the vehicle.

Service Department

2.443 The service department consists of a mechanical shop and a body shop, both of which contribute significantly to the profitability of the dealership. In fact, while the sales of new and used vehicles are cyclical, sales of service and parts provide a steady income stream. In addition, the mechanical and body shops within the dealership structure usually increase the dealership's parts department sales and gross profit.

2.444 **The Mechanical Shop.** The mechanical side of the service department, which is mandated in the franchise agreement, performs a number of essential functions. It prepares new vehicles for delivery to customers; it repairs and reconditions used vehicles in order to make them saleable; it services the dealership's own vehicles, such as demonstrator vehicles and parts trucks; and, for service customers, it provides repair and maintenance service both under the manufacturer's warranty and beyond the terms and period of the warranty.

2.445 Repair service covered under the manufacturer's warranty is paid to the dealership on a monthly basis. Because the manufacturer pays by repair order, the dealership must record the repair orders individually. The dealership must submit all relevant information to the manufacturer (usually through the computerized Dealer Communication System) for approval, and retain all parts removed for a period of time, usually 30 days, after which they are scrapped. The manufacturer may request that certain parts be sent to them for inspection.

2.446 A dealership may be audited by the manufacturer if the warranty repairs are consistently above the district average or if the dealership is about to be sold or closed. Upon audit, the manufacturer may charge the dealership back for previously paid claims if it determines that the support for the claim is incomplete or inconsistent with the repair performed.

2.447 Mechanics are usually not paid based on actual time spent on the job, but rather on time based on a standard guide published by the manufacturer or other company (e.g., Chilton's). These guides indicate the amount of time that each particular repair should take. Service writers (the salespeople who deal with the customer) are generally paid on a commission basis based on the amount of service sold.

2.448 **The Body Shop.** The body shop repairs and/or replaces the vehicle components that are neither mechanical nor electrical in nature. This department is generally not used to prepare vehicles for delivery or to provide repair service under the manufacturer's warranty (except for paint repairs). The majority of the work done in the body shop is paid by the customer's insurance company, which pays according to a detailed estimate prepared before work begins.

2.449 Body shop technicians, similar to mechanics, are not paid on actual time spent on the job. Rather, time is based on the original estimate and the technicians are paid accordingly. The mechanical and body shop managers are generally paid on the respective department's gross profit less certain controllable expenses, and service writers are paid on a commission basis.

Parts Department

2.450 The parts department purchases and stores parts used primarily by the service department. It also sells parts at retail (over the counter), and in many cases, wholesales parts to other dealerships, independent repair and body shops, as well as a variety of other qualified customers. The general rule of thumb is that a dealership should carry a 60-day supply of parts. This level of inventory allows the dealership to avert lost sales while not tying up too much capital and to keep potential obsolescence at a minimum.

2.451 Parts counter personnel are normally paid on a commission basis based on a percentage of either their respective sales generated or the department's sales, taken as a whole. The parts manager is generally paid based on the department's gross profit less certain controllable expenses.

2.500 MANAGEMENT ROLES

2.501 Most dealerships have similar organizational structures that include the following management positions and related responsibilities:

- The *General Manager* has overall responsibility for the successful operation of the entire dealership. These responsibilities include planning, motivating, controlling, and coordinating the activities of each department.
- The *Controller* is responsible with providing the General Manager and the respective department managers with current financial information. Besides the normal accounting functions that fall under the purview of this position, the Controller has the additional administrative responsibility of ensuring that each new and used car sold is properly registered with the state.
- The *General Sales Manager* is responsible for meeting the dealership's sales objectives on a daily, monthly, and annual basis for both new and used vehicle sales.
- The *Finance and Insurance Manager* is responsible for generating additional revenue for the dealership through the selling of finance and insurance programs to new and used car buyers. This person may also be responsible to complete the documentation necessary as part of leasing transactions.
- The *Service Manager* is responsible for operating the mechanical shop. This entails operating the shop at maximum efficiency while controlling costs, meeting sales and profit objectives, while building customer relationships and maintaining service records. This person is also responsible for the timely submission of factory warranty claims.
- The *Body Shop Manager* is responsible for operating the body shop. This entails developing business through customers, insurance adjusters, and other sources to ensure an adequate sales volume and profit.

- The *Parts Manager* is responsible for running a profitable and efficient parts department, including establishing proper purchasing procedures and maintaining control over the parts inventory. This person is generally the purchasing agent for the dealership's supplies.

2.600 REGULATORY ENVIRONMENT

Federal Regulations

2.601 Automobile dealerships are not specifically regulated at the federal government level. However, certain environmental and Occupational Safety and Health Administration (OSHA) regulations, as well as particular Internal Revenue Code sections, are of particular importance to the industry. The more significant regulations are as follows:

- *Resource Conservation and Recovery Act of 1976.* This is a comprehensive environmental protection law, which requires that underground storage tanks be monitored, tested, and insured against leaks as well as regulating the installation of new tanks. Also, the Act requires that dealerships that handle more than 220 pounds of hazardous substances per month have an Environmental Protection Agency (EPA) identification number and use EPA-certified haulers to remove these substances.
- *Comprehensive Environmental Response, Compensation, and Liability Act of 1980.* Also known as the "Superfund," this Act assigns responsibility to dealerships for hazardous wastes they generate. This responsibility includes the cost of cleaning up locations where hazardous wastes have been improperly disposed. Under a joint and several liability system, a dealership can be liable for the clean-up effort even if the dealership complied fully with every aspect of the law and was not negligent in any respect.
- *Safe Drinking Water Act of 1986.* This Act prohibits dealerships from discharging contaminants such as used oil, gasoline, diesel fuel, antifreeze, degreaser, brake fluids and other toxic wastes into septic systems, dry wells, cesspools or pits.
- *Clean Air Act (as amended).* This Act prohibits dealerships from tampering with, replacing or removing emission control equipment. In addition, an amendment to the Act requires that motor vehicle air conditioning coolants be recycled.
- *OSHA Regulations.* These regulations cover a variety of workplace safety issues designed to protect workers from injury. For example, because clutch and brake repairs can emit asbestos particles into the air, dealerships must train workers in the proper handling of asbestos emissions as well as avoiding inhaling asbestos particles. These regulations also require the dealership to inform its employees when they may be exposed to hazardous chemicals in the workplace.
- *Internal Revenue Code.* Section 6050I(a) of the Internal Revenue Code (the Code) requires all recipients of more than $10,000 cash (as defined) to file an information return (Form 8300) with the Internal Revenue Service within 15 days after receipt of the cash. This form must contain the name, address, and tax identification number of the person from whom the cash was received. The recipient must verify the identity of the payor by examining documents normally acceptable for identifying persons cashing or accepting checks (for example, driver's

license or credit card). A person who purports to be an alien must show his or her passport, alien registration card or other official document showing nationality or residence. The definition of cash includes cashiers checks, bank drafts, travelers checks, and money orders that are less than $10,000, but when used in combination with each other or cash, amounts to greater than $10,000. If a dealership does not comply with these reporting requirements, penalties of $25,000 to $100,000 may be assessed for each violation.

Section 4001 of the Code relates to the tax imposed on the first retail sale or taxable use of passenger vehicles with an unloaded weight of 6,000 pounds or less and trucks and vans with a maximum loaded weight of 6,000 pounds or less. This tax, commonly referred to as the "luxury tax," is computed at 10% of the sales price that exceeds $32,000.

- *The Fair Labor Standards Act (as amended), also known as the Federal Wage-Hour Law.* This law encompasses the regulations governing minimum wage requirements. If any salesperson earns commissions that are computed to be less than minimum wage for the amount of hours they worked, the dealership is required to pay those employees the minimum wage. As a result, it is imperative that the dealership keep proper time records for all commissioned employees.

State and Local Regulations

2.602 State and local regulations generally fall under four categories: 1) environmental, 2) taxation, 3) vehicle registration, and 4) business practices.

- *Environmental.* State and local laws may mirror similar provisions in federal law or may further define and restrict dealerships more than the federal laws provided. For example, the majority of states have implemented a vehicle inspection and maintenance program as a measure for meeting requirements of the federal Clean Air Act.

- *Taxation.* It is generally the dealership's responsibility to collect the proper amount of sales tax due on any sales transaction. The applicable sales tax rules regarding unique situations, such as the sale of a vehicle to a nonresident who will title and register the vehicle in another state or foreign country, is obtainable from the state's department of revenue.

- *Vehicle Registration.* Under the laws of most states, the obligation is on every dealer who sells a motor vehicle to apply for transfer of title on behalf of the purchaser. An exception would exist if the purchaser intends to immediately remove a purchased vehicle from the state for the purpose of titling and registering it in another state. Many states require that the dealer actually apply for the transfer of title and registration within a specific time frame from the date of purchase or delivery.

- *Business Practices.* False, deceptive, or misleading statements regarding sales, financing, or advertising of vehicles may lead to both civil and criminal liabilities. Civil liability can result from the filing of an unfair and deceptive trade practices suit by the state attorney. In addition to possible fines, the dealer may be forced to rescind any sales contract stemming from the advertisement or to otherwise reimburse wronged consumers.

2.603 The dealer is required to keep certain records pertaining to the sale, purchase, or exchange of any motor vehicle. Depending on the state's requirements, these records may include the following:

- The number and date of issuance of a temporary tag.
- The date of a title transfer, the title number and state of issue.
- The owner from whom the motor vehicle was purchased or received.
- The name and address of the person to whom the motor vehicle was sold or delivered.
- A complete description of the vehicle including year, make, model, vehicle identification number, engine number, or such other numbers or identification marks as may be found on the vehicle, and a statement, if necessary, indicating that an identification number on a vehicle has been obliterated, defaced, or changed.
- An odometer disclosure statement.
- A sales contract.
- A purchase agreement.
- A finance contract.
- An insurance contract.
- A warranty agreement.
- Any other agreement relevant to the motor vehicle transaction.

2.700 COMMON USERS OF FINANCIAL STATEMENTS

Manufacturer/Franchisor

2.701 As part of the franchise agreement, the dealership is required to submit timely operating statements on the manufacturer's prescribed forms. The manufacturer uses these operating statements to ascertain that the dealership has complied with the financial aspects of the franchise agreement (e.g., minimum working capital) as well as to track the sales activity of each department of the dealership. The manufacturer uses this sales information for its own internal decision-making. There is generally no requirement for the dealership to have the operating statements audited, reviewed, or compiled by independent accountants. A sample "Ford Motor Company Dealer Financial Statement" is included in section 2.902.

2.702 Most manufacturers can provide the dealership with comparative sales and expense information using similar size dealerships and/or dealerships within the same regional sales area. Management can use this information to measure their performance and develop goals.

Management/Owner

2.703 Dealerships that have sophisticated, computerized accounting systems can provide management with daily financial information showing daily and month-to-date sales activity, gross profit, and expenses by department. This daily operating control report (the "DOC") is used by management to follow sales trends and highlight areas of concern, thus enabling management to react in a timely fashion.

2.704 Management uses the monthly operating statements submitted to the manufacturer for performance evaluation and analytical purposes.

Lenders

2.705 As part of loan covenants, many lenders require the dealership to submit annual audited or reviewed financial statements. Lenders generally perceive the internally prepared monthly operating statements as deficient since they usually reflect inventory at cost (rather than lower of cost or market) and often do not include substantial year-end adjustments. Lenders may use these annual statements to calculate certain ratios that enable them to determine the financial stability of the dealership.

Financial Information Presented in Prescribed Forms or Schedules

2.706 As mentioned in section 2.701, the dealership is required to submit timely operating statements to the manufacturer using its prescribed forms. Along with these prescribed operating statements, each manufacturer has a recommended chart of accounts. While account numbers may differ between manufacturers, generally, the charts of accounts are somewhat standard.

2.800 MEMBERSHIP ORGANIZATIONS, PUBLICATIONS, AND GLOSSARY OF SPECIAL TERMS

Membership Organizations

2.801 The following membership organizations can provide additional information about automobile dealerships:

- National Automobile Dealers Association, a not-for-profit organization promoting the interests of franchised new car and truck dealers in the United States, publishes economic newsletters, a monthly magazine, used car valuation guides, and other information on various aspects of dealerships. Information about its publications and seminars may be obtained by contacting:

  National Automobile Dealers Association
  8400 Westpark Drive
  McLean, Virginia 22102
  (703) 821-7000

- American International Auto Dealers Association is an organization promoting the interests of foreign franchises. Information about its publications may be obtained by contacting:

  American International Auto Dealers Association
  99 Canal Center Plaza
  Alexandria, VA 22314-1538
  (703) 519-7800

- State and regional not-for-profit organizations promoting the interests of automobile dealerships can be found in most states. These organizations generally stay abreast of state and local legislative issues and communicate these issues to their membership through newsletters. Information about these publications may be obtained by contacting the respective organizations as listed below:

ALABAMA
Automobile Dealers Assn. of Alabama
PO Box 1948
Montgomery, AL 36102-1948
(334) 834-6850
Fax: (334) 834-6852

ARIZONA
Arizona Automobile Dealers Assn.
4701 N. 24th Street
#B-3
PO Box 32717
Phoenix, AZ 85064-2717
(602) 468-0888

ARKANSAS
Arkansas Automobile Dealers Assn., Inc.
PO Box 9150
North Little Rock, AR 72119
(501) 372-2596
Fax: (501) 372-4389

CALIFORNIA (LONG BEACH)
Long Beach Motor Car Dealers Assn.
3520 Long Beach Blvd.
Suite 219
Long Beach, CA 90807
(310) 595-4326
Fax: (310) 988-1460

CALIFORNIA (NORTH)
California Motor Car Dealers Assn.
251 Marinda Drive
Fairfax, CA 94930
(800) 262-6232
Fax: (310) 822-6733

CALIFORNIA (ORANGE COUNTY)
Orange County Automobile Dealers Assn.
1200 Main St.
Suite H
Irvine, CA 92714
(714) 752-0459
Fax: (714) 752-0672

CALIFORNIA (SAN DIEGO)
New Car Dealers Assn. of San Diego County
10065 Mesa
San Diego, CA 92108
(619) 550-0080
Fax: (619) 550-9537

CALIFORNIA (SOUTH)
California Motor Car Dealers Assn.
420 Culver Blvd.
Playa del Rey, CA 90293
(310) 306-6232
Fax: (310) 306-2308

CANADA
Canadian Automobile Dealer Assn.
85 Renfrew Dr.
Markham, Ontario, Canada L3R ON9
(905) 940-4959
Fax: (905) 940-6870

CANADA (Ontario)
Ontario Automobile Dealer Assn.
85 Renfrew Drive, 2nd Floor
Markham, Ontario, Canada L3R ON9
(905) 940-6232
Fax: (905) 940-6235

COLORADO
Metro Denver Auto Dealers Assn. and Colorado Automobile Dealers Assn.
1601 Emerson Street
Denver, CO 80218
(303) 831-1691
(303) 831-1722
Fax: (303) 831-4205

CONNECTICUT
Connecticut Automotive Trades Assn., Inc.
91 Elm Street
Hartford, CT 06106
(203) 293-2500
Fax: (203) 527-2582

DELAWARE
Delaware Automobile and Truck Dealers Assn, Inc.
32 W. Lockerman
Suite 101C
Dover, DE 19901
(302) 734-3127
Fax: (302) 734-5402

FLORIDA
Florida Automobile Dealers Assn.
PO Box 531124
505 N. Mills Ave.
Orlando, FL 32853-1124
(407) 896-7371
Fax: (407) 896-7721

FLORIDA (CENTRAL)
Central Florida Auto Dealers Assn. Inc.
7380 Sand Lake Rd.
Suite 500
Orlando, FL 32819
(407) 352-5243
Fax: (407) 345-4797

FLORIDA (SOUTH)
South Florida Automobile Dealers Assn.
10185 NW 7 Avenue
Miami, FL 33150
(305) 758-2643
Fax: (305) 759-8996

GEORGIA
Georgia Automobile Dealers Assn
4000 Cumberland Pkwy
Bldg 900-A
Atlanta, GA 30339
(404) 432-1658
Fax: (404) 432-9100

IDAHO
Idaho Auto Dealers Assn.
1446 W. Bannock
Suite B
Boise, ID 83702
(208) 342-7779
Fax: (208) 345-4921

ILLINOIS
Illinois Automobile Dealers Assn.
300 W. Edwards
PO Box 3045
Springfield, IL 62708
(217) 753-0220
Fax: (217) 753-3424

ILLINOIS (CHICAGO)
Chicago Automobile Trade Assn.
One Tower Lane
Suite 1160
Oakbrook Terrace, IL 60181-4625
(708) 954-0600
Fax: (708) 954-0607

INDIANA
Automobile Dealers Assn. of Indiana Inc.
150 W. Market St.
Suite 812
Indianapolis, IN 46204
(317) 635-1441
Fax: (317) 685-1028

INDIANA (INDIANAPOLIS)
Indianapolis Automobile Trade Assn.
150 W. Market Street
Suite 810
Indianapolis, IN 46204
(317) 266-8455
Fax: (317) 685-1028

INDIANA (SOUTH BEND)
South Bend-Mishawaka New Car Dealers Assn.
15838 N. Lakeshore Drive
Granger, IN 46530-7846
(219) 272-7210
Fax: (219) 271-7021

IOWA
Iowa Automobile Dealers Assn.
1111 Office Park Road
West Des Moines, IA 50265
(515) 226-1900
Fax: (515) 225-9370

KANSAS
Kansas Automobile Dealers Assn.
800 Jackson
Suite 1110
Topeka, KS 66612
(913) 233-6456
Fax: (913) 233-1462

KENTUCKY
Kentucky Automobile Dealers Assn.
Box 498
Frankfort, KY 40602
(502) 695-3333
Fax: (502) 695-5790

KENTUCKY (LOUISVILLE)
Greater Louisville Automobile Dealers Assn., Inc.
901 Heyburn Bldg
332 W. Broadway
Louisville, KY 40202
(502) 583-0279
Fax: (502) 584-7326

LOUISIANA
Louisiana Automobile Dealers Assn.
7526 Picardy Avenue
Baton Rouge, LA 70808-9131
(504) 769-5500
(800) 375-LADA
Fax: (504) 769-2085

MAINE
Maine Automobile Dealers Assn.
180 Civic Center Dr.
PO Box 2667
Augusta, ME 04338-2667
(207) 623-3882
Fax: (207) 623-2318

MARYLAND
Maryland New Car & Truck Dealers Assn.
100 Cathedral St.
Suite 9
Annapolis, MD 21401
(410) 269-1710
Fax: (410) 269-5924

MASSACHUSETTS
Massachusetts State Automobile Dealers Assn.
59 Temple Place, Suite 505
Boston, MA 02111
(617) 451-1051
Fax: (617) 451-9309

MICHIGAN
Michigan Automobile Dealers Assn.
1500 Kendale Blvd.
PO Box 2525
East Lansing, MI 48826-2525
(517) 351-7800
Fax: (517) 351-3120

MICHIGAN (DETROIT)
Detroit Auto Dealers Assn.
1800 W. Big Beaver Rd.
Troy, MI 48084
(810) 643-0250
Fax: (810) 643-8788

MINNESOTA
Minnesota Automobile Dealers Assn.
277 University Ave.
St. Paul, MN 55103
(612) 291-2400
Fax: (612) 291-2894

MINNESOTA (TWIN CITIES)
Greater Metropolitan Automobile Dealers Assn. of Minnesota Inc.
7701 York Ave. S
Suite 230
Edina, MN 55435
(612) 831-8019
Fax: (612) 831-7687

MISSISSIPPI
Mississippi Automobile Dealers Assn.
800 Woodlands Parkway
Suite 100
Ridgeland, MS 39157
(601) 957-6868
Fax: (601) 956-1877

MISSOURI
Missouri Automobile Dealers Assn
PO Box 1158
205 E. Capitol
Jefferson City, MO 65102
(314) 634-3011
Fax: (314) 636-5834

MISSOURI (KANSAS CITY)
Motor Car Dealers Assn. of Greater Kansas City
7300 College Blvd
Suite 310
Overland Park, KS 62210
(913) 345-8970
Fax: (913) 345-8972

MISSOURI (ST. LOUIS)
Greater St. Louis Automotive Assn.
10730 Manchester Rd.
St. Louis, MO 63122
(314) 822-0333
Fax: (314) 822-3147

MONTANA
Montana Automobile Dealers Assn.
501 N. Sanders
Helena, MT. 59601
(406) 442-1233
Fax: (406) 449-0119

NEBRASKA
Nebraska New Car and Truck Dealers Assn.
PO Box 95023
Lincoln, NE 68509
(402) 475-1079
Fax: (402) 475-7422

NEVADA
Nevada Franchised Auto Dealers Assn.
PO Box 7320
Reno, NV 89510
(702) 331-6884
Fax: (702) 331-6887

NEW HAMPSHIRE
New Hampshire Automobile Dealers Assn.
507 South St.
PO Box 2337
Concord, NH 03302-2337
(603) 224-2369
Fax: (603) 225-4895

NEW JERSEY
New Jersey Coalition of Automotive Retailers
856 River Rd.
PO Box 7510
Trenton, NJ 08628
(609) 883-5056
Fax: (609) 883-1093

NEW MEXICO
New Mexico Automotive Dealers Assn.
3815 Hawkins, NE
Albuquerque, NM 87109
(505) 345-6060
Fax: (505) 345-1221

NEW YORK STATE
New York State Automobile Dealers
PO Box 7347
Capital Station
37 Elk St.
Albany, NY 12224
(518) 463-1148
Fax: (518) 432-1309

NEW YORK (ALBANY)
Capital Region Automobile Dealers Assn.
1 Pine West Plaza
Albany, NY 12205
(518) 452-0584
Fax: (518) 452-0810

NEW YORK (BUFFALO)
Niagara Frontier Automobile Dealers Assn., Inc.
1144 Wehrle Dr.
Williamsville, NY 14221
(716) 631-8510
Fax: (716) 631-0759

NEW YORK (CITY)
Greater New York Auto Dealers Assn.
18-10 Whitestone Expressway
Whitestone, NY 11357
(718) 746-5900
Fax: (718) 746-5557

NEW YORK (ROCHESTER)
Rochester Automobile Dealers Assn.
2024 W. Henrietta Rd.
Bldg. 4
Rochester, NY 14623-1389
(716) 272-7232
Fax: (716) 272-7375

NEW YORK (SYRACUSE)
Syracuse Automobile Dealers Assn. Inc.
770 James St.
Syracuse, NY 13203
(315) 474-1041
Fax: (315) 472-5839

NORTH CAROLINA
North Carolina Automobile Dealers Assn.
PO Box 12167
1029 Wade Ave.
Raleigh, NC 27605-2167
(919) 828-4421
Fax: (919) 829-9525

NORTH DAKOTA
Automobile Dealers Assn. of North Dakota
PO Box 2524
Fargo, ND 58108
(701) 293-6822
Fax: (701) 293-6824

OHIO
Ohio Automobile Dealers Assn.
655 Metro Place S
Suite 270
Dublin, OH 43017
(614) 766-9100
(800) 686-9100
Fax: (614) 766-9600

OHIO (AKRON)
Akron Automobile Dealers Assn.
688 Wolf Ledges Pkwy
PO Box 2244
Akron, OH 44309
(216) 434-3134
Fax: (216) 434-8310

OHIO (CLEVELAND)
Greater Cleveland Auto Dealers Assn.
6100 Rockside Woods Blvd.
Suite 235
Cleveland, OH 44131
(216) 328-1500
Fax: (216) 328-1504

OHIO (COLUMBUS)
Columbus Automobile Dealers Assn.
454 East Main Street
Suite 210
Columbus, OH 43215
(614) 464-1537
Fax: (614) 464-1540

OHIO (DAYTON)
Dayton Area Auto Dealers Assn.
2618 Needmore Rd.
Dayton, OH 45414
(513) 277-0999
Fax: (513) 277-0997

OHIO (EAST)
Automobile Dealers Assn. of Eastern Ohio
5353 Belmont Ave.
Youngstown, OH 44505
(216) 759-1111
Fax: (216) 759-1116

OHIO (TOLEDO)
Toledo Automobile Dealers Assn.
6641 Sylvania
Sylvania, OH 43560
(419) 843-2611
Fax: (419) 843-2622

OKLAHOMA
Oklahoma Automobile Dealers Assn.
101 N.E. 26th St.
PO Box 53305
Oklahoma City, OK 73152
(405) 521-1295
Fax: (405) 524-8377

OKLAHOMA (TULSA)
Tulsa Automobile Dealers Assn.
15 W. 16th St.
Suite1302
Tulsa, OK 74119
(918) 587-0141
Fax: (918) 592-5152

OREGON
Oregon Automobile Dealers Assn.
PO Box 14460
Portland, OR 97214
(503) 233-5044
Fax: (503) 231-4728

PENNSYLVANIA
Pennsylvania Automotive Assn.
1925 N. Front St.
PO Box 2955
Harrisburg, PA 17105
(717) 255-8311
Fax: (717) 255-8340

PENNSYLVANIA (PHILADELPHIA)
Automobile Dealers Assn. of Greater Philadelphia
Plymouth Greene Office Campus
805 E. Germantown Pike, Suite 120
Norristown, PA 19401-2450
(215) 279-5229
Fax: (215) 279-5240

PENNSYLVANIA (PITTSBURGH)
Pittsburgh Automobile Trade Assn.
4215 Northern Pike
Monroeville, PA 15146-2713
(412) 373-8380
Fax: (412) 373-0315

SOUTH CAROLINA
South Carolina Automobile Dealers Assn.
1517 Laurel St.
Columbia, SC 29201
(803) 252-0205
Fax: (803) 252-5965

SOUTH DAKOTA
South Dakota Automobile Dealers Assn.
PO Box 89008
Sioux Falls, SD 57105
(605) 336-2616
Fax: (605) 334-1938

TEXAS
Texas Automobile Dealers Assn.
1108 Lavaca
PO Box 1028
Austin, TX 78767-1028
(512) 476-2686
Fax: (512) 476-2179

TEXAS (DALLAS)
New Car Dealers Assn. of Metropolitan Dallas
2777 Stemmons Freeway
Suite 841
Dallas, TX 75207
(214) 637-0531
Fax: (214) 637-2630

TEXAS (HOUSTON)
Houston Automobile Dealers Assn.
PO Box 286
4645 Sweetwater Blvd.
Suite 500
Sugar Land, TX 77487-0286
(713) 980-3434
Fax: (713) 980-2608

TEXAS (SAN ANTONIO)
San Antonio Automobile Dealers Assn. Inc.
4414 Centerview
Suite 140
San Antonio, TX 78228
(210) 732-9647
Fax: (210) 732-3923

UTAH
Utah Automobile Dealers Assn.
1588 S. Main St.
Salt Lake City, UT 84115
(801) 484-8845
Fax: (801) 466-4824

VERMONT
Vermont Automobile Dealers Assn.
61 Elm St.
PO Box 561
Montpelier, VT 05601
(802) 223-6635
Fax: (802) 229-5696

VIRGINIA
Virginia Automobile Dealers Assn.
1800 W. Grace St.
Richmond, VA 23220
(804) 359-3578
Fax: (804) 358-8036

WASHINGTON, DC (METRO)
Automotive Trade Assn. National Capital Area
15873 Crabbs Branch Way
Rockville, MD 20855
(301) 670-1110
Fax: (301) 258-8320

WASHINGTON (STATE)
Washington State Auto Dealers Assn.
PO Box 58170
Seattle, WA 98138
(206) 251-9483
Fax: (206) 251-9485

WASHINGTON (PUGET SOUND)
Puget Sound Auto Dealers Assn.
16101 Greenwood Ave., N
Bldg 2700
Seattle, WA 98133
(206) 542-3551
Fax: (206) 542-7561

WEST VIRGINIA
West Virginia Auto & Truck Dealers Assn.
1618 Kanawha Blvd., E.
PO Box 2028
Charleston, WV 25311
(304) 343-4158
Fax: (304) 343-8474

WISCONSIN
Wisconsin Automobile & Truck Dealers Assn.
PO Box 5345
Madison, WI 53705
(608) 251-5577
Fax: (608) 251-4379

WISCONSIN (MILWAUKEE)
Automobile Dealers Association of Mega Milwaukee
3333 N. Mayfair Rd.
Suite 107
Milwaukee, WI 53222
(414) 259-6000
Fax: (414) 259-1371

WYOMING
Wyoming Automobile Dealers Assn.
PO Box 85
419 W. 18th St.
Cheyenne, WY 82001
(307) 638-4455
Fax: (307) 632-5254

Publications

2.802 The following publications can provide more information about automobile dealerships:

- **Dealer Business (Auto Age)**
  29 North Wacker Drive
  Chicago, IL 60606-3298
  (Monthly news magazine serving the new car and truck dealership industry, including manufacturers, distributors, finance and insurance companies, and repair and body shops.)
- **Automotive Executive**
  8400 Westpark Drive
  McLean, VA 22102
  (Monthly news magazine published by the National Automobile Dealers Association.)
- **Automotive News**
  1400 Woodbridge Avenue
  Detroit, MI 48207
  (Weekly newspaper covering all aspects of the automobile business from engineering and manufacturing to sales, marketing and servicing.)
- **Automotive News Market Data Book**
  1400 Woodbridge Avenue
  Detroit, MI 48207
  (Annual magazine encompassing annual data which includes vehicle production and sales and the top dealers by franchise.)
- **Black Book**
  National Auto Research
  Division of Hearst
  Business Media Corporation
  P.O. Box 758
  Gainesville, GA 30503
  (Weekly used car market guide published in regional editions which provides wholesale values for models five years old and newer.)
- **NADA Official Used Car Guide**
  National Automobile Dealers Association
  Used Car Guide Co.
  8400 Westpark Drive
  McLean, VA 22102
  (Weekly used car market guide published in nine regional editions which provides wholesale and retail values for models seven years old and newer.)

Glossary of Special Terms

2.803 The following are special terms used in the auto dealership industry:

ACV — The appraised value (actual cash value) of a used car trade-in that the dealership determines in order to record the vehicle into inventory.

Buy Here — Pay Here — Also referred to as a "note lot," this type of used car business is directed towards customers who purchase inexpensive, older model vehicles. The dealership generally provides its own financing.

Buy Rate — The minimum lending rate established by the lender for the financing of dealership customers. The difference between the buy rate and the actual interest rate charged to the customer is the major component in computing finance income.

Chargeback — See "Future F&I Chargebacks."

Contracts in Transit — Vehicle sales proceeds to be received by the dealership from finance or lease contracts that have been submitted to and approved by finance institutions.

Curtailment — The partial reduction of the amount of floor plan liability owed on a specific vehicle or vehicles. Usually lenders request a reduction in the dealership's liability on units not sold within a specified time period. Payment is made to the floor plan institution to reduce the amount owed on a specific vehicle. These payments are requested by the lender to reduce their exposure on vehicles that may have declined in market value.

Daily Operating Control Report (DOC) — A report that shows daily and month-to-date sales activity, gross profit, and expense information by department. Management uses this report to follow sales trends and highlight areas of concern in order to react in a timely fashion.

Dealer Communication System (DCS) — The computerized system with which the dealership communicates with the manufacturer for ordering of vehicles and parts, the submitting of warranty claims, etc.

Deal Jacket — A file in which all documentation related to the sold vehicle is kept.

Delivery Log — A document maintained by the new and used vehicle sales departments to account for vehicles delivered each day. Also referred to as the "desk log."

Dealer Trade — A dealership's purchase of a vehicle from another dealership of the same franchise. The transaction is not recorded as a sale since there is generally no income earned.

Dispatcher — The person within the service department who allocates specific jobs to the mechanics. Responsibilities include recording the flag time spent on each job by the mechanics.

Distributor — The company in the United States that distributes, regionally or nationally, vehicles built by a foreign manufacturer.

Dualing — The sale and service of more than one line of passenger cars in common physical facilities at the same location.

Extended Warranty — An insurance policy purchased by the customer to cover vehicle repairs after the original factory warranty expires. For income tax purposes, if the dealership is the obligor, the accounting treatment is governed either by Revenue Procedure 92-97 or Revenue Procedure 92-98.

Factory Invoice — Invoice used by the manufacturer to bill the dealership for vehicles purchased.

Factory Receivables — Receivables due from the manufacturer for programs such as holdback, warranty, floor plan allowance, incentives, etc.

Finance and Insurance Income (F&I Income) — Income earned as a result of retail sales of vehicles being financed and/or insured through the dealership. Finance income (also known as "finance reserves") is earned based on the percentage of the difference between the lender's buy rate (i.e., the minimum interest rate set by the bank) and the actual interest rate charged to the customer. Insurance income generally takes the form of commissions from the insurance company. The dealership is generally credited in advance for the interest and commissions earned and may be subject to future F&I chargebacks.

Finance Contract — The loan agreement between the customer and a lender that is used to fund the retail purchase of a vehicle. The lender becomes the lienholder of the vehicle (i.e., the vehicle is the collateral for the loan). The dealership can assign the contract to the lender with full, limited, or no recourse.

Flag — Document used to record time spent on a specific repair job by mechanics. This document is used to compute the cost of labor on the repair order and as support for compensating the mechanic.

Floor Plan Assistance (Floor Plan Allowance) — Reimbursement from the manufacturer for floor plan interest expense for the number of days the vehicle was in transit from the manufacturer to the dealership. In some cases, the manufacturer reimburses additional interest.

Floor Plan Line of Credit — An arrangement with a lender to finance purchases of inventory. Each floor plan note is secured by an individual vehicle. When the vehicle is sold, the related floor plan liability is usually due within three days.

Franchise (Sales and Service) Agreement — A nonassignable, personal services contract between a dealership and a manufacturer that spells out the numerous sales and service responsibilities of each.

Future F&I Chargebacks — The unearned portion of finance income to be repaid (returned) to the lender for past customers who defaulted on or prematurely paid off their loans. Also relates to the unearned portion of insurance commissions to be repaid to the insurance company for cancelled policies.

Holdback — An amount in addition to a new vehicle's purchase price that the manufacturer holds and later remits to the dealership.

Incentives — Payments from the manufacturer for the dealership's achieving specific pre-defined sales goals.

License and Title Fees — The charges for license plates and vehicle registration due on sold vehicles.

Lien Vehicle Payoffs — The payable due to a customer's lender for the amount remaining due on a traded-in vehicle. Once the lien payoff is made, the dealership receives the unencumbered title to the trade-in.

Manufacturer's Statement of Origin (MSO) — The document that assigns ownership of a new vehicle to the dealership from the manufacturer. Also referred to as an MCO (Manufacturer's Certificate of Ownership).

Monroney Sticker — Federally required information affixed to the new car by the manufacturer that discloses, among other things, the MSRP of the vehicle (including optional equipment) along with gas mileage comparison figures.

MSRP — Manufacturer's suggested retail price.

OSHA — Occupational Safety and Health Administration.

Out of Trust — The financial condition resulting from the dealership selling a vehicle but not paying the related floor plan obligation.

Parts Ticket — Invoice document used for parts sales to retail and wholesale customers.

Policy Adjustments — The expense of giving a customer parts or service as a goodwill gesture in order to keep the customer satisfied.

Reconditioning — Repairs and general refurbishing performed on used vehicles to place them in saleable condition.

Rebates — Inventory-related compensation received from the manufacturer. Examples include year-end model rebates and floor plan assistance.

Repair Order — Invoice document used for sales of mechanical or body shop repairs. These orders may be used for retail customers, warranty, or internal repairs.

Service Writer — The person within the service department who is the customer's contact person. Among other things, the service writer is responsible for documenting the customer's service request, determining whether the repair is covered under warranty, and ensuring proper completion of the repairs.

Spiff — Additional commission or bonus paid to a salesperson for a sales accomplishment.

Sublet Inventory — Cost of repairs or other related activity (e.g., towing) performed by outside vendors that has yet to be invoiced on a repair order.

Title — Legal document registered with the state that includes information regarding the ownership and lienholder of a specific vehicle.

Warranty Advance — An amount paid by the manufacturer at the start of each year as an advance for warranty claims.

Warranty Repairs — Repairs performed on vehicles for which the dealer is reimbursed by the manufacturer.

Washout Sheet — Document maintained in the accounting department that details the various costs associated with a vehicle in inventory.

Work in Process — Labor costs incurred on incomplete repair orders that have not been recorded as sales, but for which the mechanic has been compensated.

Year-end Model Rebate — A method used by certain manufacturers to compensate dealers at the end of a model year for the reduction in market value of those ending model year cars remaining unsold as of the new model date.

2.900 EXHIBITS

BILL OF SALE

Know All Men By These Presents, that the undersigned for valuable consideration does hereby grant, sell, transfer, and deliver unto the GENERAL MOTORS ACCEPTANCE CORPORATION, (Grantee) the products listed below.

To have and to hold all and singular the said goods and chattels to said grantee, its successors and assigns. The undersigned covenants with said grantee that undersigned is the lawful owner of said chattels; that they are free from all encumbrances; that undersigned has a good right to sell the same; that undersigned will warrant and defend same against the lawful claims and demands of all persons.

Witness the hand and seal of the undersigned, this .... day of .... 19......

Witness.. ....(Shipper)

By ....(Title)

GMAC Branch..........................

Invoice No. ....

Invoice Date..........................

Total Inv. Price $..........................

TRUST RECEIPT

TO GENERAL MOTORS ACCEPTANCE CORPORATION (hereinafter referred to as GMAC):

The undersigned (debtor), hereinafter referred to as the dealer, hereby acknowledges that GMAC has a security interest in said property and agrees that the dealer's possession thereof shall be on the terms and conditions set forth on the reverse side and herein incorporated by reference thereto.

Executed this________day of______________19____at ____________________
(CITY) (STATE)

____
WITNESS

____
(DISTRIBUTOR OR DEALER)

Appr. to Purchase	Date Purchased	Check No.

By____________________
(IF CORP. OR PART.) (TITLE)

No.	DESCRIPTION – SERIAL NUMBER	INTEREST			FLAT CHARGE		BALANCE	GMAC NOTE	DATE PAID
		Amt.	Date	Short	Paid	Short			
	TOTAL →→	X	X	X	X	X	X		X

DEALER'S NAME– ADDRESS–	Date of Note	IDENTIFICATION NO. 01285

PROMISSORY NOTE

IDENTIFICATION NO.
01285

...., 19..........
(City) (State) (Date)

ON DEMAND, for value received, I (we) promise to pay to the order of GENERAL MOTORS ACCEPTANCE CORPORATION at their office to be hereinafter designated

..../100 Dollars $ ....
with interest from the date hereof at the rate per annum herein incorporated by reference to the rate designated under the GMAC Wholesale Plan as the rate currently in force; however, if such rate is subsequently changed before payment is due, commencing on the effective date of each such change the rate per annum may, at the option of GMAC, be the rate designated under the GMAC Wholesale Plan for such period or periods.

I (we) agree, in the event this note is placed in the hands of an attorney for collection, to pay 15% of the amount due hereon as attorney's fees or, if prohibited, the amount permitted by law.

I (we) hereby waive all benefits of valuation, appraisement and exemption laws, and all rights of appeal and release all errors.

____
(Distributor or Dealer)

By..
(If Corp., or Part.) (Title)

TERMS AND CONDITIONS REFERRED TO IN TRUST RECEIPT

1. Title to said property shall remain in GMAC as security retained for and until the dealer's payment in cash of the amount payable under and according to his (its, their) promissory note of same identification number.

2. The dealer's possession of said property shall be for the purpose of storing and exhibiting same for retail sale in the ordinary course of business. The dealer shall keep said property brand new and subject to inspection and shall not use or operate same, for demonstration or otherwise, without express permission, and shall not in any event use said property illegally, improperly or for hire.

3. Said property shall be at the dealer's sole risk of any loss or damage of or to same during removal or transportation thereof from freight depot to dealer's place of business or at any other time during possession hereunder.

4. The dealer agrees to keep said property free of all taxes, liens and encumbrances, and any sum of money that may be paid by GMAC in release or discharge thereof shall be paid to GMAC on demand as an additional part of the obligation secured hereunder. The dealer shall not mortgage, pledge or loan said property, and shall not transfer or otherwise dispose of same except as next hereinafter more particularly provided.

5. The dealer may sell said property at retail in the ordinary course of business; provided, however, that any and all proceeds thereof shall be fully, faithfully and promptly accounted for by the dealer to the extent of the obligation hereby secured.

6. GMAC's security interest in said property hereunder shall attach, to the full extent provided or permitted by law, to the proceeds, in whatever form, of any retail sale thereof by the dealer until such proceeds are accounted for as aforesaid, and to the proceeds of any other disposition of said property or any part thereof by the dealer.

7. In the event of the dealer's default in payment under and according to said promissory note, or in the due performance of or compliance with any of the terms and conditions hereof, or in the event of a proceeding in bankruptcy, insolvency or receivership instituted by or against the dealer or the dealer's property, or in the event that GMAC deems itself insecure or said property or any part thereof in danger of misuse, loss, seizure or confiscation, GMAC may take immediate possession of said property, without demand or further notice and without legal process; for this purpose and in furtherance thereof, the dealer shall, if GMAC so requests, assemble said property and make it available to GMAC at a reasonably convenient place designated by it, and GMAC shall have the right, and the dealer does hereby authorize and empower GMAC, to enter upon the premises wherever said property may be and remove same.

   In the event of repossession of said property, then, (1) if the rights and remedies applicable to repossession hereunder are governed by the provisions concerning rights and remedies under Article 9 of, and relating to Secured Transactions under, the Uniform Commercial Code as a result of enactment thereof, GMAC shall have such rights and remedies as are thereunder provided and permitted, otherwise, (2) GMAC may, at its election, either (a) sell said property upon notice, at public or private sale, for the account of the dealer, or (b) declare this transaction and the dealer's obligation under the aforesaid promissory note to be terminated and cancelled, and retain any sums of money that may have been paid by the dealer hereunder.

8. Any provision hereof prohibited by law shall be ineffective to the extent of such prohibition without invalidating the remaining provisions hereof.

BILL OF SALE (DEALER'S COPY)

Know All Men By These Presents, that the undersigned for valuable consideration does hereby grant, sell, transfer, and deliver unto the GENERAL MOTORS ACCEPTANCE CORPORATION, (Grantee) the products listed below.

To have and to hold all and singular the said goods and chattels to said grantee, its successors and assigns. The undersigned covenants with said grantee that undersigned is the lawful owner of said chattels; that they are free from all encumbrances; that undersigned has a good right to sell the same; that undersigned will warrant and defend same against the lawful claims and demands of all persons.

Witness the hand and seal of the undersigned, this .... day of .... 19......

Witness .... (Shipper)

By .... (Title)

GMAC Branch ______________________

Invoice No. ______________________

Invoice Date ______________________

Total Inv. Price $ ______________________

TRUST RECEIPT

TO GENERAL MOTORS ACCEPTANCE CORPORATION (hereinafter referred to as GMAC):

The undersigned (debtor), hereinafter referred to as the dealer, hereby acknowledges that GMAC has a security interest in said property and agrees that the dealer's possession thereof shall be on the terms and conditions set forth on the reverse side and herein incorporated by reference thereto.

Executed this ________ day of ________________ 19 ____ at ________________ (CITY) ________ (STATE)

________________ WITNESS

________________ (DISTRIBUTOR OR DEALER)

Appr. to Purchase	Date Purchased	Check No.

By ________ (IF CORP. OR PART.) ________ (TITLE)

No.	DESCRIPTION – SERIAL NUMBER	INTEREST Amt.	INTEREST Date	INTEREST Short	FLAT CHARGE Paid	FLAT CHARGE Short	BALANCE	GMAC NOTE	DATE PAID
	TOTAL →	X	X	X	X	X	X		X

DEALER'S NAME– ADDRESS–	Date of Note	IDENTIFICATION NO. 01285

INSTRUCTIONS TO DEALER:

The principal amount necessary to send GMAC to release a product in full is shown in column "GMAC Note" opposite particular product you wish to release. To this amount add the interest due from date of promissory note to date of release, plus the GMAC Flat Charge as indicated on DF Wholesale Release Order–Form #4RDL. To your check for this combined amount, attach release order for products being paid and forward both to your GMAC branch.

Make a record of all payments on the above Record of Release.

Exhibit 2.901

TERMS AND CONDITIONS REFERRED TO IN TRUST RECEIPT

1. Title to said property shall remain in GMAC as security retained for and until the dealer's payment in cash of the amount payable under and according to his (its, their) promissory note of same identification number.

2. The dealer's possession of said property shall be for the purpose of storing and exhibiting same for retail sale in the ordinary course of business. The dealer shall keep said property brand new and subject to inspection and shall not use or operate same, for demonstration or otherwise, without express permission, and shall not in any event use said property illegally, improperly or for hire.

3. Said property shall be at the dealer's sole risk of any loss or damage of or to same during removal or transportation thereof from freight depot to dealer's place of business or at any other time during possession hereunder.

4. The dealer agrees to keep said property free of all taxes, liens and encumbrances, and any sum of money that may be paid by GMAC in release or discharge thereof shall be paid to GMAC on demand as an additional part of the obligation secured hereunder. The dealer shall not mortgage, pledge or loan said property, and shall not transfer or otherwise dispose of same except as next hereinafter more particularly provided.

5. The dealer may sell said property at retail in the ordinary course of business; provided, however, that any and all proceeds thereof shall be fully, faithfully and promptly accounted for by the dealer to the extent of the obligation hereby secured.

6. GMAC's security interest in said property hereunder shall attach, to the full extent provided or permitted by law, to the proceeds, in whatever form, of any retail sale thereof by the dealer until such proceeds are accounted for as aforesaid, and to the proceeds of any other disposition of said property or any part thereof by the dealer.

7. In the event of the dealer's default in payment under and according to said promissory note, or in the due performance of or compliance with any of the terms and conditions hereof, or in the event of a proceeding in bankruptcy, insolvency or receivership instituted by or against the dealer or the dealer's property, or in the event that GMAC deems itself insecure or said property or any part thereof in danger of misuse, loss, seizure or confiscation, GMAC may take immediate possession of said property, without demand or further notice and without legal process; for this purpose and in furtherance thereof, the dealer shall, if GMAC so requests, assemble said property and make it available to GMAC at a reasonably convenient place designated by it, and GMAC shall have the right, and the dealer does hereby authorize and empower GMAC, to enter upon the premises wherever said property may be and remove same.

   In the event of repossession of said property, then, (1) if the rights and remedies applicable to repossession hereunder are governed by the provisions concerning rights and remedies under Article 9 of, and relating to Secured Transactions under, the Uniform Commercial Code as a result of enactment thereof, GMAC shall have such rights and remedies as are thereunder provided and permitted, otherwise, (2) GMAC may, at its election, either (a) sell said property upon notice, at public or private sale, for the account of the dealer, or (b) declare this transaction and the dealer's obligation under the aforesaid promissory note to be terminated and cancelled, and retain any sums of money that may have been paid by the dealer hereunder.

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Witness the hand and seal of the undersigned, this .... day of .... 19......

Witness ....(Shipper)

By ....(Title)

GMAC Branch ....

Invoice No. ....

Invoice Date ....

Total Inv. Price $ ....

TRUST RECEIPT

TO GENERAL MOTORS ACCEPTANCE CORPORATION (hereinafter referred to as GMAC):

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Executed this________day of________________19____at ____________________
(CITY) (STATE)

____
WITNESS

____
(DISTRIBUTOR OR DEALER)

Appr. to Purchase	Date Purchased	Check No.

By____________________
(IF CORP. OR PART.) (TITLE)

No.	DESCRIPTION – SERIAL NUMBER	INTEREST			FLAT CHARGE		BALANCE	GMAC NOTE	DATE PAID
		Amt.	Date	Short	Paid	Short			
	TOTAL →	X	X	X	X	X	X		X

DEALER'S NAME– ADDRESS–	Date of Note	IDENTIFICATION NO. 01285

TERMS AND CONDITIONS REFERRED TO IN TRUST RECEIPT

1. Title to said property shall remain in GMAC as security retained for and until the dealer's payment in cash of the amount payable under and according to his (its, their) promissory note of same identification number.

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8. Any provision hereof prohibited by law shall be ineffective to the extent of such prohibition without invalidating the remaining provisions hereof.

FORD MOTOR COMPANY DEALER FINANCIAL STATEMENT

P & A CODE 1102	DEALER	REC'D 1103
PERIOD OF 1101	ADDRESS	SALES CODE
MONTH ENDED	CITY-STATE ZIP CODE	1104

BALANCE SHEET

ASSETS

1	CASH - ON HAND, IN BANK	● 1000 -1010	1105
2	CASH - MONEY MARKET / DEPOSIT	● 1015	1106
3	FINANCE CONTRACTS - NEW	● 1020	1107
4	FINANCE CONTRACTS - USED	● 1030	1121
5	MARKETABLE SECURITIES	1040	1122
6	NOTES RECEIVABLE — PAST DUE 1123	1100	1124
7	ACCOUNTS RECEIVABLE — VEHICLE — PAST DUE 1125	● 1110	1126
8	ACCOUNTS RECEIVABLE — PARTS SERVICE BODY — PAST DUE 1127	1120	1141
9	ACCOUNTS RECEIVABLE — OTHER — PAST DUE 1142	1130 1135	1143
10	FORD RECEIVABLES — W & P CLAIMS (LESS CREDIT ADV. 1144 ______)	1140	1145
11	FORD RECEIVABLES — VEHICLE HOLDBACK	1160	1146
12	FORD RECEIVABLES — INCENTIVES / CARRYOVER ALLOWANCE	1170 1175	1147
13	FORD RECEIVABLES — JOBBER INCENTIVES/ESP/FLOOR PLAN ASSISTANCE/OTHER	1180 -1200	1161
14	FORD RECEIVABLES — FLOOR PLAN ASSISTANCE (HDTC ONLY)	1177, 1230	1162
15	FORD RECEIVABLES — C.P.A. (HDTC ONLY)	1210	1163
16	FORD RECEIVABLES — PRICE PROTECTION (HDTC ONLY)	1220	1164
17	FORD RECEIVABLES — ALL OTHER (HDTC ONLY)	1240, 1265 -1271	1165
18	FINANCE RECEIVABLES - CURRENT	1280	1166
19	ALLOWANCE - DOUBTFUL RECEIVABLES	1290	(1167)
20	NEW — CARS — 1181 FORD — 1182 L-M — 1183	● 1300	1184
21	NEW — TRUCKS — 1185 FORD — 1191 L-M — 1186	● 1310	1201
22	NEW — DEMOS — 1202 FORD — 1192 L-M — 1193	● 1340	1205
23	USED — CARS — 1206 — 30 DAY — 1207	1350	1221
24	USED — TRUCKS — 1222 — 30 DAY — 1223	1360	1224
25	USED — RE-MARKETED VEHICLES — CARS — 1211 — 30 DAY — 1212	● 1355	1213
26	USED — RE-MARKETED VEHICLES — TRUCKS — 1214 — 30 DAY — 1215	● 1365	1216
27	PARTS INV. — 1321 FoMoCo 1400 — 1322	1410 -1421	1323
28	ALLOWANCE - PARTS INVENTORY ADJUSTMENT	1430	1324
29	OTHER INVENTORIES	1440 -1460	1325
30	LIFO INVENTORY RESERVE — 1326 NEW 1470 — 1327 USED	1480	(1341)
31	LIFO INVENTORY RESERVE — PARTS	1490	(1342)
32	PREPAID EXPENSES	1500 -1560	1343
33	**TOTAL CURRENT ASSETS**		1344
34	LEASED VEHICLES - NET	1610 -1640	1345
35	RENTAL VEHICLES - NET	1650 1660	1346
36	LAND AND IMPROVEMENTS - NET	1700 -1705	1347
37	BUILDINGS — COST	1710	1361
38	BUILDINGS — DEPRECIATION	1715	(1362)
39	EQUIPMENT — COST	1720 -1722	1363
40	EQUIPMENT — DEPRECIATION	1725 -1727	(1364)
41	LEASEHOLDS — COST	1730	1365
42	LEASEHOLDS — AMORTIZED	1735	(1366)
43	FINANCE RECEIVABLES DEFERRED - NET	1800 1805	1367
44	RECEIVABLES - OFFICERS & EMPLOYEES	1810	1381
45	CASH VALUE - LIFE INSURANCE	1820	1382
46	OTHER ASSETS - NET	1830 -1837	1383
47	**TOTAL ASSETS**		1384

48 Working Capital = Total Current Assets + LIFO Reserve LESS Total
49 Current Liabilities. (Should be 100% or more of Recommended Minimum,
50 as shown on FD 1984/LM 7191).

LIABILITIES

NOTES PAYABLE — NEW VEHICLES & DEMOS	● 2000	1421
NOTES PAYABLE — USED VEHICLES	● 2010	1422
NOTES PAYABLE — REMARKETED VEHICLES	● 2015	1431
NOTES PAYABLE — RECREATION VEHICLES INVENTORIES	2020	1423
NOTES PAYABLE — OTHER - SHORT TERM	2030	1424
NOTES PAYABLE — LONG TERM - CURRENT PORTION	2040	1425
NOTES PAYABLE — INSTALLMENT SALE BALANCE	● 2050	1426
BANK LOANS (AUTHORIZED LIMIT ______) (FOC ONLY)	2055	1441
ACCOUNTS PAYABLE	2100 -2190	1442
MEMO ACCOUNTS PAYABLE HDTC ONLY — TRADE	1443	
MEMO ACCOUNTS PAYABLE HDTC ONLY — NEW TRUCK BODIES EQUIP.	1444	
MEMO ACCOUNTS PAYABLE HDTC ONLY — USED TRUCKS	1445	
INCOME TAXES	2200 2205	1446
CUSTOMER — DEPOSITS	● 2300	1447
CUSTOMER — ACCOMODATIONS-SVC. CONTRACTS/REPO REFUND	2310 -2320	1461
ACCRUED — TAXES	2400 -2402	1462
ACCRUED — PAYROLL & BONUSES	2410 -2412	1463
ACCRUED — OTHER	2420 -2423	1464
TOTAL CURRENT LIABILITIES		1465

(●) Net Cash = Sum of Cash + Finance Contracts + Accounts Receivable New Vehicle + New Car, Truck, Demo & Remarketed Vehicle Inventories LESS Notes Payable New Vehicle & Demos, Notes Payable Used Vehicle (if any), Notes Payable Remarketed Vehicles, Installment Sale Balance & Customer Deposits. (Total should exceed an average month's total expense).

NET CASH ●		NET CASH
AVERAGE MONTH TOTAL EXPENSES		
NET CASH OVER (UNDER)		

LONG TERM LIABILITIES — MORTGAGES PAYABLE	2500	1483
LONG TERM LIABILITIES — NOTES PAYABLE — OFFICERS & OWNERS	2510	1484
LONG TERM LIABILITIES — NOTES PAYABLE — FORD	2515	1486
LONG TERM LIABILITIES — NOTES PAYABLE — OTHER	2520	1485
LONG TERM LIABILITIES — NOTES PAYABLE — LEASED VEHICLES	2530	1501
LONG TERM LIABILITIES — NOTES PAYABLE — RENTAL VEHICLES	2540	1502
ESTIMATED LIABILITY-REPOSSESSION PURCHASE LOSS	2600	1503
OTHER LIABILITIES	2700	1504
TOTAL LIABILITIES		1505
		NET WORTH
CORPORATION — CAPITAL STOCK	2800 -2803	1506
CORPORATION — RETAINED EARNINGS	2810	1507
SUB "S" — DIVIDENDS DECLARED	2820	(1521)
PARTNERS' OR PROPRIETOR'S — INVESTMENT	2830	1522
PARTNERS' OR PROPRIETOR'S — DRAWING	2840	(1523)
NET INVESTMENT		1524
NET PROFIT - AFTER INCOME TAX - YTD	2850	1525
NET WORTH		1526
TOTAL LIABILITIES & NET WORTH		1527

ACTUAL		WORKING CAPITAL
RECOMMENDED MINIMUM OR GUIDE		
ACTUAL OVER (UNDER)		

OPERATING ANALYSIS

		MONTH	YTD	MONTH	YTD
51					
52					
53		MONTH	YTD	% TOTAL SALES	
54	TOTAL SALES				
55	TOTAL GROSS				
56	TOTAL EXPENSE				
57	OPERATING PROFIT				
58	ADDIT. & DEDUCT. TO INCOME - BONUSES				
59	PROFIT BEFORE INCOME TAX				

ACCOUNTS RECEIVABLE AGING

	CURRENT	31 - 60	61 - 90	91 +
VEH. ACCOUNTS	5301	5302	5303	5304
PARTS ACCOUNTS	5311	5312	5313	5314
SERVICE ACCOUNTS	5315	5316	5317	5331
BODY ACCOUNTS	5332	5333	5334	5335
WARR. RECEIVABLES	5322	5323	5324	5325
FORD INCENTIVES	5326	5327	5341	5342

LINE NO	DEALER	P & A CODE	SALES CODE	MONTH	PG 2

OPERATING SUMMARY

LINE NO	OPERATING SUMMARY		DOLLARS MONTH	DOLLARS YTD	UNITS YTD CAR	UNITS YTD TRK
1	TOTAL SALES				N	N
2					U	U
3	TOTAL GROSS				% TOTAL GROSS	
4					MONTH	YTD
5	TOTAL SELLING EXPENSE					
6						
7	TOTAL SELLING/ ADJUSTED SELLING GROSS					
8						
9	TOTAL FIXED EXPENSE					
10						
11	DEALER SALARY					
12						
13	OPERATING PROFIT			1541		
14						
15	LEASED VEHICLE 5300	NET INCOME		1542		
16	RENTAL VEHICLE 5200			1543		
17	RECREATIONAL VEHICLE 9000			1544		
18	TRACTOR/ OTHER 9050			1545		
19	ADJ TO INCOME 9100 -9450			1546		
20	BONUS	DEALER 9500		1547		
21		EMPLOYE 9550		1561		
22	PROFIT BEFORE INCOME TAX			1562		
23				P N V S		
24	EST. INCOME TAX 9900				% TOTAL SALES	
25	NET PROFIT AFTER TAX					
26					PNVS	
27	TOTAL OVERHEAD EXP.					
28	TOTAL P. S, BS GROSS					
29	NET OPERATING COST					
30	TOTAL	VEHICLE GROSS				
31		VAR. SALES EXP.				
32		VARIABLE GROSS				
33	BREAKEVEN UNITS:				MONTH	YTD
34	N.O.C. ÷ VAR. GROSS PN/UVR					

DEPARTMENTAL OPERATING SUMMARY

	NEW	USED	PARTS *	SERVICE *	BODY *
M					
Y					
M					
Y					
M					
Y					
M					
Y					
M					
Y					
M					
Y					
M					
Y					

ADJUSTMENTS TO INCOME

		MONTH	YTD
ADDITIONS			
CASH DISC. EARNED	9100		5461
INTEREST INCOME	9150		5462
DIVIDEND INCOME	9200		5463
SALES FIXED ASSETS	9250		5464
OTHER	9300		5465
DEDUCTIONS			
CASH DISCOUNT	9400		5481
OTHER	9450		5482
TOTAL			5483

	MONTH	YTD
TOTAL PAYROLL		5365

Service Absorption: The Sum of Total Parts, Service & Body Shop Gross Profits DIVIDED By the Sum of Total Fixed Expense + Dealer Salary + Parts, Service & Body Shop Sales Expense.

	MONTH	YTD
(Benchmark is 85% – 100%)	%	%

OPERATING TREND ANALYSIS

LINE NO		NEW UNITS CAR	NEW UNITS TRUCK	USED UNITS RETAIL CAR	USED UNITS RETAIL TRUCK	TOTAL CAR/TRK (INCL. WHSL.)	SELLING/ADJUSTED * SELLING GROSS (000) NEW	USED	PARTS *	SERVICE *	BODY SHOP *	FIXED EXP. (000)	OPT. PROFIT B.I.T. (000)	NET PROFIT PNVS
35														
36														
37														
38	JANUARY													
39	FEBRUARY													
40	MARCH													
41	APRIL													
42	MAY													
43	JUNE													
44	JULY													
45	AUGUST													
46	SEPTEMBER													
47	OCTOBER													
48	NOVEMBER													
49	DECEMBER													
50	CURRENT YTD													
51	1993 YTD													

LINE NO	
52	NOTES:
53	
54	
55	
56	
57	
58	
59	
60	

Exhibit 2.902

LINE NO	DEALER				P & A CODE		SALES CODE	MONTH		PG 3

NEW VEHICLE DEPARTMENT

LINE NO	MONTH SALES	MONTH GROSS	MONTH UNITS	MONTH GR PVS				YEAR TO DATE UNITS	YEAR TO DATE GR PVS	YEAR TO DATE SALES	YEAR TO DATE GROSS
1					RETAIL	CROWN VICTORIA	3000 3001	2101		2102	2103
2						THUNDERBIRD	3010 3011	2104		2105	2106
3						TAURUS	3020 3021	2107		2121	2122
						TEMPO	3030 3031	2123		2124	2125
5						CONTOUR	3090 3091	2185		2186	2187
6						MUSTANG	3040 3041	2126		2127	2141
7						PROBE	3050 3051	2142		2143	2144
8						ESCORT	3060 3061	2145		2146	2147
9						FESTIVA / ASPIRE	3080 3081	2161		2162	2163
10						**TOTAL FORD RETAIL CARS**		2164		2165	2166
11						GRAND MARQUIS	3200 3201	2221		2222	2223
12						COUGAR	3210 3211	2224		2225	2226
13						SABLE	3220 3221	2227		2241	2242
14						TOPAZ	3230 3231	2243		2244	2245
15						MYSTIQUE	3270 3271	2341		2342	2343
16						TRACER	3250 3251	2246		2247	2261
17						CAPRI	3260 3261	2262		2263	2264
18						TOWN CAR	3280 3281	2265		2266	2267
19						MARK	3290 3291	2281		2282	2283
20						CONTINENTAL	3300 3301	2284		2285	2286
21						**TOTAL L/M RETAIL CARS**		2325		2326	2327
22						NON FoMoCo CARS	3340 3341	2364		2365	2366
23						**TOTAL RETAIL CARS**		2361		2362	2363
24						FORD MOTOR CO. FLEET CARS	3360	2337		2351	2352
25						NON FoMoCo FLEET CARS	3370	2353		2354	2355
26						**TOTAL FLEET CARS**		2367		2381	2382
27						CAR INCENTIVES	4380				2402
28						**TOTAL NEW CAR**		2403		2404	2405
2					RETAIL	BRONCO	3400 3401	2441		2442	2443
3						EXPLORER	3410 3411	2444		2445	2446
31						ECONOLINE	3420 3421	2447		2461	2462
32						RANGER	3430 3431	2463		2464	2465
33						F-150-350	3440 3441	2466		2467	2481
34						AEROSTAR	3450 3451	2482		2483	2484
35						VILLAGER	3480 3481	2322		2323	2324
36						WINDSTAR	3490 3491	2344		2345	2346
37						NON FoMoCo LIGHT TRUCK	3460 3461	2501		2502	2503
38						**TOTAL LIGHT TRUCK RETAIL**		2485		2486	2487
39						FLEET LIGHT TRUCKS	3470	2504		2505	2506
40						**TOTAL LIGHT TRUCK**		2507		2521	2522
41					RETAIL & FLEET	F-SUPER DUTY	3500 3501	2523		2524	2525
42						SERIES 600-800 (GAS)	3520 3521	2776		2777	2091
43						SERIES 600-800 (DIESEL)	3530 3531	2092		2093	2094
44						CARGO 6000-8000 (EXCL. TANDEMS)	3540 3541	2095		2096	2097
45						CARGO - TANDEM	3550 3551	2111		2112	2113
46						SERIES 7000-8000 (EXCL. CARGO)	3560 3561	2545		2546	2547
47						SERIES 9000 + TANDEMS (EXCL. CARGO)	3580 3581	2561		2562	2563
48						**TOTAL FORD HEAVY TRUCK**		2133		2134	2135
49						NON FoMoCo CLASS 4-7	3600 3601	2136		2137	2151
50						NON FoMoCo CLASS 8	3610 3611	2152		2153	2154
51						**TOTAL HEAVY TRUCKS**		2155		2156	2157
52						____ UNITS MO. / MEMO FLEET HEAVY / UNITS 2784 YTD ____					
53						TRUCK INCENTIVES	4620				2762
54						**TOTAL NEW TRUCK**		2763		2764	2765
						RESALE (850 & UP) 2184 (Units YTD ____)	4630				2761
56						DEALER TRANSFERS 2766 (Units YTD ____)	4640				2767
57						**TOTAL NEW VEHICLES**		2781		2782	2783

NEW VEHICLE DEPARTMENT

LINE NO	RETAIL LEASE ACTIVITY	CAR UNITS	CAR GROSS	CAR GR PVL	TRUCK UNITS	TRUCK GROSS	TRUCK GR PVL	NON FoMoCo UNITS	NON FoMoCo GROSS	NON FoMoCo GR PVL	TOTAL UNITS	TOTAL GROSS	TOTAL GR PVL
60	MONTH												
61	Y-T-D	5221	5222		5223	5224		5227	5241		5242	5243	

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DEALER | P & A CODE | SALES CODE | MONTH | PG 4

USED VEHICLE DEPARTMENT

LINE NO	MONTH SALES	MONTH GROSS	MONTH UNITS	MONTH GR PVS			YTD UNITS	YTD GR PVS	YTD SALES	YTD GROSS
1					USED CARS RETAIL	3700	2801		2811	2821
2					REMARKETED CARS RETAIL	3800	5721		5745	5722
3					USED LIGHT TRUCKS RETAIL	3750	2804		2814	2824
					USED M/H TRUCKS RETAIL	3850	2841		2842	2843
5					REMARKETED TRUCKS RETAIL	3950	5725		5746	5726
6					**TOTAL USED RETAIL**		5802		5803	5804
7					USED CARS WHOLESALE	3710	2802		2812	2822
8					REMARKETED CARS WHOLESALE	3805	5723		5747	5724
9					USED TRUCKS WHOLESALE	3760	2805		2815	2825
10					REMARKETED TRUCKS WHOLESALE	3955	5727		5801	5731
11					USED VEH. INVENTORY ADJUSTMENT	4702 4752 4880				2775
12					**TOTAL USED WHOLESALE**		5805		5806	5807
13					**TOTAL USED VEHICLES**		2807		2817	2827

LINE NO	RECONDITIONING ANALYSIS	UNITS MONTH	UNITS YTD	COST MONTH	COST YTD	COST PER UNIT MONTH	COST PER UNIT YTD
14							
15							
16	USED CAR		5244		5245		
17	USED TRUCK		5246		5247		

18 NEW VEHICLE — F & I DEPARTMENT — USED VEHICLE

LINE NO	NEW INCOME MONTH	NEW INCOME YTD	NEW UNITS MONTH	NEW UNITS YTD	NEW %PEN YTD	NEW PVR MONTH	NEW PVR YTD		USED UNITS MONTH	USED UNITS YTD	USED %PEN YTD	USED PVR MONTH	USED PVR YTD	USED INCOME MONTH	USED INCOME YTD
21		3101		3102				5000 5100 FINANCE CONTRACTS		3143					3144
22		3103						5010 5110 FIN. INC. ADJ.							3145
23		3104		3105				5020 5120 INSURANCE CONTRACTS		3146					3147
24		3106						5030 5130 INSUR. ADJ.							3161
25		3107		3121				5040 5140 EXT. SERVICE CONTR.		3162					3163
26		3122						5050 5150 EXT. SERV. CONTR. REF.							3164
27		3123						5060 5160 OTHER MERCHANDISE							3165
28		3124						6070,6080 6170,6180 REPO LOSS NET							3166
		3125						**F & I NET INCOME**							3167

NEW VEHICLE DEPARTMENT — USED VEHICLE DEPARTMENT

LINE NO	NEW MONTH	NEW YTD	PNVR MON	PNVR YTD		PUVR MON	PUVR YTD	USED MONTH	USED YTD
31		2871			CAR / TRUCK GROSS				2911
32		2872			F & I NET INCOME (LINE 29)				2912
33		2873	NEW GROSS % SALES	S	**TOTAL VEHICLE**	S	USED GROSS % SALES		2913
34		2874		G		G			2914
35	NEW VEHICLE SALES EXPENSE		% TOTAL NEW GROSS			% TOTAL USED GROSS		USED VEHICLE SALES EXPENSE	
36		2875			COMM & INCENT 7000 SALESPERSON 7200				2915
37		2876			7010 SALES MANAGERS 7210				2916
38		3127			7410 F & I 7460				3182
39		2877			7030 PRE-DELIVERY				
40	( )	(2881)			7040 PRE-DELIVERY ALLOWANCES				
41		2882			7050 FREE SERVICE / MAINTENANCE & POLICY 7230				2917
42		2883			**TOTAL VARIABLE EXPENSE**				2921
43		2884			**VARIABLE GROSS**				2922
44		2885			SALARIES 7070 SALESPERSONS 7270				2923
45		2886			7080 SALES MANAGERS 7280				2924
46		2887			7100 OTHER 7300				2925
47		3126			7400 F & I 7450				3181
48		2891			7110 ADVERTISING 7310				2926
49	( )	(2892)			7120 ADVERTISING REBATES 7320			( )	(2927)
50		2893			7130 PROMOTION 7330				2931
51		2894			7140 TRAINING 7340				2932
52		2895			7150 DEMO EXPENSE 7350				2933
53		2896			7160 7170 SERVICE LOANERS 7360 7370				2934
54		3141			7420 F & I OTHER 7470				3183
		2897			7180 INTEREST - FLOOR PLAN 7380				2935
56	( )	(2901)			7190 FLOOR PLAN ASSISTANCE				
57		2902			**TOTAL SEMI-FIXED EXPENSES**				2936
58		2903			**SELLING GROSS**				2937
59									
60									
61									

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LINE NO.	PARTS DEPARTMENT MONTH	PARTS YTD	PARTS GROSS % SALES MON	PARTS GROSS % SALES YTD			SERVICE DEPARTMENT MONTH	SERVICE YTD	SERVICE GROSS % SALES MON	SERVICE GROSS % SALES YTD	BODY SHOP DEPARTMENT MONTH	BODY SHOP YTD	BODY SHOP GROSS % SALES MON	BODY SHOP GROSS % SALES YTD
1		3401			5400 WHOLESALE	S								
2		3402				G								
3		3403			6410 WHOLESALE JOB INCENTIVE	G								
4		3404			TOTAL WHOLESALE	G								
5		3405			5420 COUNTER RETAIL	S								
6		3406				G								
7		3407			5430 5700 REPAIR SHOP	S		3525						
8		3421				G		3526						
9		3422			5440 5710 ESP REPAIR SHOP	S		3527						
10		3423				G		3541						
11		3424			6450 JOB INCENTIVE	G								
12		3425			5460 5720 WARRANTY & POLICY CLAIMS (SERVICE)	S		3543						
13		3426				G		3544						
14		3427			5470 5730 INTERNAL (SERVICE)	S		3545						
15		3441				G		3546						
16					UNAPPLIED TIME 6740 6845	G		3547				3667		
17		3443			5480 5750 SUBLET REPAIRS	S		3561				3625		
18		3444			5800	G		3562				3626		
19		3445			5490.5491 5760 OTHER MERCHANDISE	S		3563						
20		3446				G		3564						
21														
22														
23		3447			TOTAL PARTS SALES-SERV.	S								
24		3461				G								
25		3462			5500 BODY SHOP (METAL)	S						3627		
26		3463			5810	G						3641		
27		3464			5510 BODY SHOP (PAINT)	S						3642		
28		3465			5820	G						3643		
29		3466			5520 WARRANTY & POLICY CLAIMS (BODY SHOP)	S						3644		
30		3467			5830	G						3645		
31		3481			5530 INTERNAL (BODY SHOP)	S						3646		
32		3482			5840	G						3647		
33		3483			5540 5770,5780 MATERIALS	S		3566				3661		
34		3484			5850	G		3567				3662		
35		3485			TOTAL PARTS SALES-BODY	S								
36		3486				G								
37		3487			6550 6560 DISCOUNTS EARNED	G								
38		3501			6570 6580 INVENTORY ADJ	G								
39		3502			TOTAL DEPARTMENTS	S		3581				3683		
40		3503				G		3582				3684		

LABOR RATES

REPAIR	BODY	W & P	INTERNAL
3521	3522	3523	3524

R.O. ANALYSIS		TRAFFIC R.O. COUNT	SALES PER R.O. PARTS	SALES PER R.O. LABOR
REPAIR SHOP	M			
	Y	3621		
BODY SHOP	M			
	Y	3622		
W & P CLAIMS	M			
	Y	3623		
ESP REPAIR	M			
	Y	3587		
INTERNAL	M			
	Y	3624		

NON-FOMOCO DUALS ONLY
MEMO: OTHER FRANCHISE PARTS PURCHASES

MONTH	YTD
	3565

LINE NO.	76 PARTS SALES EXPENSE MONTH	76 PARTS SALES EXPENSE YTD	% PARTS GROSS MON	% PARTS GROSS YTD		77 SERVICE SALES EXPENSE MONTH	77 SERVICE SALES EXPENSE YTD	% SERV. GROSS MON	% SERV. GROSS YTD	78 BODY SHOP SALES EXPENSE MONTH	78 BODY SHOP SALES EXPENSE YTD	% BDY GROSS MON	% BDY GROSS YTD
42		3701			COMPENSATION-MANAGERS 00 05		3761				3821		
43		3702			SAL.-OTHER 10		3762				3822		
44		3703			COMM. & INCENT OTHER 20		3763				3823		
45		3704			ADVERTISING/ PROMOTION 30 31		3764				3824		
46		3705			TRAINING 40		3765				3825		
47		3706			POLICY ADJ 50		3766				3826		
48		3707			SERV LOANER 60 61		3767				3827		
49		3721			TOOLS & SUPP.-FRT 70 71		3781				3841		
50		3722			EQ. & VEH. MAINT 80		3782				3842		
51		3723			INVTY CONTROL 90								
52		3507			95 VACATION & 90 TIME OFF PAY-TECH		3783				3843		
53		3724			TOT. SALES EXP.		3784				3844		
54		3725			SELLING GROSS		3785				3845		
55	( )	(3726)			SHOP PARTS GROSS TRANS		3786				3846		
56		3727			ADJ. SELLING GROSS		3787				3847		

57 NOTES:
58
59
60
61

Exhibit 2.902

DEALER	P & A CODE	SALES CODE	MONTH	PG 6

LINE NO			MONTH	YTD	MON	YTD	NEW	USED	PARTS *	SERVICE *	BODY *	UNAPPLIED
	SELLING/ADJUSTED * SELLING GROSS ALL DEPTS			4101			4102	4103	4104	4105	4106	
	FIXED EXPENSE				% GROSS		DEPARTMENTAL FIXED EXPENSE ALLOCATION - YTD					
1	SAL.-GEN. MGR.	8000		4121			4122	4123	4124	4125	4126	4127
2	SALARIES-ADM.	8020		4141			4142	4143	4144	4145	4146	4147
	EMPLOYEE BENEFIT	8040		4161			4162	4163	4164	4165	4166	4167
4	PAYROLL TAXES	8100		4181			4182	4183	4184	4185	4186	4187
5	PENSIONS	8200		4201			4202	4203	4204	4205	4206	4207
6	INST'L. ADV & PROMO.	8220 8240		4221			4222	4223	4224	4225	4226	4227
7	RENT & EQUIVALENT *	8300 -8420		4241			4242	4243	4244	4245	4246	4247
8	UTILITIES	8500		4361			4362	4363	4364	4365	4366	4367
9	TELEPHONE	8520		4381			4382	4383	4384	4385	4386	4387
10	TAXES	8540		4401	•		4402	4403	4404	4405	4406	4407
11	INSURANCE	8600 8620		4501			4502	4503	4504	4505	4506	4507
12	OFFICE SUPPLIES	8640		4521			4522	4523	4524	4525	4526	4527
13	PROFESSIONAL & SERVICE FEES	8660		4541			4542	4543	4544	4545	4546	4547
14	DATA PROCESSING	8680		4561			4562	4563	4564	4565	4566	4567
15	BAD DEBTS	8700		4581			4582	4583	4584	4585	4586	4587
16	CONTRIBUTIONS	8720		4601			4602	4603	4604	4605	4606	4607
17	INTEREST	8740		4621			4622	4623	4624	4625	4626	4627
18	DEPREC. EQUIP.	8760		4641			4642	4643	4644	4645	4646	4647
19	EQ. & VEH. MAINT. GEN'L.	8780		4661			4662	4663	4664	4665	4666	4667
20	TRAVEL & ENTERTAINMENT	8800		4681			4682	4683	4684	4685	4686	4687
21	MISCL. EXPENSE	8820		4701			4702	4703	4704	4705	4706	4707
22			ALLOCATION OF UNAPPLIED EXPENSE ◆				4722	4723	4724	4725	4726	4727
23	TOTAL FIXED			4801			4802	4803	4804	4805	4806	TOTAL APPLIED ◆
24	DEALER SALARY	8900		4821			4822	4823	4824	4825	4826	
25	OPERATING PROFIT			4841			4842	4843	4844	4845	4846	

LINE NO	VEHICLE AND F&I SELLING GROSS ANALYSIS				
26	NEW VEHICLE				
27	MONTH	YTD		MONTH	YTD
28			CAR & TRUCK GROSS		
29			VAR. SELLING EXP.		
30			SEMI-FIXED SELLING EXP.		
31			SELLING GROSS		
32			TOTAL F & I NET INCOME		
33			F & I SELLING EXPENSES		
34			F & I SELLING GROSS		
35			TOTAL SELLING GROSS		

USED VEHICLE — RENTAL DEPARTMENT	MONTH	YTD
INCOME		3221
SALARIES		3224
COMMISSIONS/INCENTIVES		3225
OTHER EXPENSES		3226
TOTAL NET 5200		3227
AGREEMENTS		3222

INVENTORY ANALYSIS	RENTAL CAR	RENTAL TRUCK	RENTAL RV	SERVICE LOANERS
TOT UNITS @ EOM	5101	5122	5143	5164
TOT UNIT-DAYS AVAIL. / MO.	5102	5123	5144	5165
CUST.-ESP.-PAID DAYS / MO.	5103	5124	5145	5166
SERVICE LOANER-PAID DAYS / MO.	5104	5125	5146	5167
DEALER-PAID DAYS / MO.	5105	5126	5147	5181
NON-UTILIZED DAYS / MO.	5106	5127	5161	5182
% UTILIZATION	5107	5141	5162	5183
% CUSTOMER / ESP. PAID	5121	5142	5163	5184
VEHICLE EQUITY	1481 NEW		1482 USED	

LINE NO	*RENT & EQUIVALENT		MONTH	YTD
36				
37	NET RENT OR EQUIV.	8300 8320		5421
38	DEPREC. & AMORT.	8340 8360		5422
39	INSURANCE-BUILDING	8380		5423
40	TAX-REAL ESTATE	8400		5424
41	MAINT.-BUILDING	8420		5425
42	TOTAL			5426

LINE NO	PERSONNEL SUMMARY		ADMIN	N & U	F & I	REN/LSE	PARTS	SERVICE	BODY
44	DEALERS		5501						
45	MANAGEMENT		5761	5762	5763	5764	5765	5766	5767
46	SALESPERSONS			5704	5584	5585	5586	5587	5601
47	TECH-NICIANS	REPAIR						5602	5603
48		INTERNAL		5705				5624	5625
49	CLERICAL		5681	5706	5663	5664	5665	5666	5667
50	OTHER		5781	5782	5783	5784	5785	5786	5787
51	TOTAL	5703	5702	5707	5684	5685	5686	5687	5791

LINE NO						
52	SALESPERSON TENURE (IN MONTHS)	LESS THAN 12 MOS.	5811	SERVICE ADVISOR TENURE (IN MONTHS)	LESS THAN 12 MOS.	5815
53		12-36 MOS.	5812		12-36 MOS.	5816
54		37-60 MOS.	5813		37-60 MOS.	5817
55		61 + MOS.	5814		61 + MOS.	5821
56	SALESPERSON TURNOVER	HIRED-YTD	5822	SERVICE ADVISOR TURNOVER	HIRED-YTD	5824
57		TERM.-YTD	5823		TERM.-YTD	5825

LINE NO	MEMO: SPLIT SLS FORCE	NEW ONLY	USED ONLY	COMB. N. & U.	TOTAL	STALL COUNT REPAIR	INTERNAL	BODY
59	MANAGERS	5841	5842	5843	5844	REPAIR	INTERNAL	BODY
60	SALESPERSONS	5845	5846	5847	5861	5604	5626	5484

NEW TRUCK INVENTORY & UNFILLED ORDERS

HDTC ONLY	(MEMO) 120 DAYS	INVENTORY PURE	INVENTORY TOTAL	ORDERS WRITTEN	ORDERS UNFILLED
LIGHT	2941	2942	2943	2944	2945
F-SUPER DUTY	6101	6102	6103	6104	6105
SERIES 600-800 (GAS)	2946	2947	2951	2952	2953
SERIES 600-800 (DIESEL)	6106	6107	6111	6112	6113
CARGO 6000-8000 (EXCL TANDEMS)	2954	2955	2956	2957	2971
CARGO-TANDEM	6114	6115	6116	6117	6121
SERIES 7000-8000 (EXCL CARGO)	2972	2973	2974	2975	2976
SERIES 9000 & TANDEM (EXCL CARGO)	2977	2981	2982	2983	2984
NON FoMoCo CLASS 4-7	2985	2986	2987	2991	2992
NON FoMoCo CLASS 8	6122	6123	6124	6125	6126
RESALE	2993			2994	2995
TOTAL	2996	2997	2851	2852	2853

GROSS (INCLUDING HOLDBACK & RESALE) ORDERS WRITTEN $ 2854 UNFILLED ORDERS $ 2855

Exhibit 2.902

Auto Dealership Industry
Operating Characteristics

CHAPTER 3

THE AUTO DEALERSHIP INDUSTRY — OPERATING CHARACTERISTICS

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CHAPTER 3

THE AUTO DEALERSHIP INDUSTRY — OPERATING CHARACTERISTICS

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CHAPTER 3

THE AUTO DEALERSHIP INDUSTRY — OPERATING CHARACTERISTICS

3.000 INTRODUCTION

3.001 As part of the requirement to obtain an understanding of the entity's control structure under Statement on Auditing Standards (SAS) No. 55, *Obtaining an Understanding of the Entity's Internal Control Structure*, auditors should have a basic understanding of the entity's accounting system, including how transactions are initiated, processed, and ultimately reported in the financial statements.

3.002 This chapter provides a overview of the operating characteristics of the four major operating departments of a dealership, New Car, Used Car, Parts, and Service, including how transactions are initiated and processed through the dealership's accounting system. Also included are discussions of the records and documentation found in a typical auto dealership, and some of the key control policies and procedures dealerships should establish.

3.003 Section 3.500 of this chapter contains brief descriptions of various software packages used by dealerships. Section 3.600 provides illustrative flowcharts depicting the major internal control structure policies and procedures discussed in this chapter. These flowcharts are designed to assist practitioners in understanding the unique features of a dealership's internal controls and providing valuable recommendations to management. A time-saving feature, they may be modified to efficiently document the required understanding of your dealership clients' internal controls.

3.100 NEW CAR DEPARTMENT

Purchases

3.101 Management must always be cognizant as to which models are selling and be able to predict the peak and slow selling times of the year. This knowledge enables management to determine the appropriate models and quantities that should be ordered from the manufacturer. Management communicates this information to the manufacturer through the Dealer Communication System ("DCS"). See section 3.500 for further information regarding DCS.

3.102 When the vehicle is shipped to the dealership, the manufacturer draws a draft on the dealership's floor plan line of credit to obtain payment for those vehicles. Concurrently, the manufacturer sends the vehicle invoice and Manufacturer's Statement of Origin (MSO) to the dealership. In practice, the dealership records the purchase of the vehicle in the vehicle purchases journal when the invoice is received. Because the terms from the manufacturer are usually FOB shipping point, the dealership usually must make a year-end adjustment to record any vehicles in transit at the end of the year. The following accounts are affected based on the particular factory invoice to record the vehicle into inventory:

	Dr	Cr
New car inventory	XXXX	
Holdback receivable (if applicable)	XXXX	
Floor plan notes payable		XXXX

3.103 The dealership can also "dealer trade" with another dealership of the same franchise generally for the purpose of obtaining a specific model for an impending sale. The accounting for this type of transaction is as follows:

	Dr	Cr
New car inventory	XXXX	
Vehicle payable		XXXX

3.104 Entries to record new vehicle purchases are simultaneously recorded into the general ledger and the new car inventory schedule. Also, the computerized vehicle management system, which gives the sales department up-to-date information on inventory in stock, as well as the cost and Manufacturer's Suggested Retail Price (MSRP) of each vehicle, is updated. Many dealerships use washout sheets to track the vehicle's original manufacturer cost and the cost of any dealer-installed optional equipment.

3.105 When the vehicle arrives at the dealership, it is inspected for damage. Damage is usually repaired at the dealership's service department and a claim is made against the carrier.

3.106 In order to prepare the vehicle for sale, certain tasks, such as removing interior plastic covers, attaching side mirrors, etc., are performed by the dealership and paid for by the manufacturer at a pre-determined amount. These tasks are normally done by the dealership's service department and are recorded as internal sales on a repair order (see section 3.408).

Inventory Control

3.107 An important aspect of good inventory control is conducting a physical count of new car inventory every month, and reconciling the results to the general ledger and the new car inventory schedule. The new car inventory schedule, which is the dealership's perpetual inventory record, lists every new vehicle in inventory, usually in stock number order, along with the original factory invoice cost, and the cost of all repair orders charged to the vehicle for dealer-installed options. Dealerships should also reconcile their inventory records to the monthly statements received from the floor plan institution, which shows the detail of vehicles on the floor plan.

3.108 In addition to the dealership's physical counts, the floor plan institution will also conduct monthly counts to ensure that all vehicles subject to floor plan financing are, in fact, in inventory. If the floor plan institution cannot locate a vehicle during a physical count or cannot determine that the vehicle has been recently sold, it will usually request payment for that vehicle immediately. This situation, referred to as "out-of-trust," can result in termination of the floor plan line of credit. Well-run dealerships will perform their own periodic reviews of inventories subject to floor plan financing to promptly identify and correct any out-of-trust situations.

3.109 As part of good cash management, the dealership should also monitor its investment in inventory not subject to floor plan financing.

3.110 Because of their susceptibility to theft, car inventories must be kept in a well-secured lot that safeguards the vehicles both during and after the dealership's operating hours. Control of the vehicles' keys and MSO's should be maintained by persons who do not have access to the inventory records.

Sales

3.111 The purchaser of the vehicle can use any of the following methods to pay the dealership:

- Cash and/or a trade-in.
- Cash downpayment and/or a trade-in, with the balance financed through the lenders with whom there is a dealer agreement.
- Lease arranged by the dealership. Generally cash is remitted for first month's lease payment and security deposit; however, the customer may make an additional cash advance to reduce the monthly leasing payments.
- Financed through the customer's bank or credit union (in which case the customer delivers a draft made out to the dealership).

3.112 The customer may also buy an extended warranty policy for the car and, if the dealership arranges for financing, credit life and disability insurance may also be purchased.

3.113 Once the dealer and the customer agree on the sales price, the dealer prepares a "buyer's order," which states the agreed-upon price and method of payment, and which is signed by both parties. If the dealership arranges for the financing, either through a lender with which there is a dealer agreement or with the manufacturer's credit arm, the dealer will ask the customer to complete a credit application. If it appears that the customer can easily qualify for financing, the sales manager or F&I manager may send the credit application, along with the buyer's order, to the financing company immediately, often by facsimile machine.

3.114 In some cases, if the customer's credit application is extremely strong, the sales manager or F&I manager will authorize release of the vehicle to the customer before the lender has approved the credit application. This is referred to as a "spot delivery." In the event the lender subsequently denies the loan, the customer must, of course, return the vehicle and the dealership must reverse the sale in its accounting records.

3.115 For each vehicle sold, the dealership maintains a "deal jacket" which includes information such as the buyer's order, billing invoice, factory invoice, and any repair orders for options added to the vehicle. In addition, a copy of the customer's drivers license, insurance verification, and signed powers of attorney, which are used to title the vehicle, are included.

3.116 When the vehicle is delivered to the customer, the new car sales manager (or other designated person) records the customer's name and certain vehicle information (including the type of vehicle and its identification number) in the delivery log. The delivery log is maintained by the sales department and shows the vehicles delivered each day. A copy of the delivery log is forwarded to the accounting department the following day.

3.117 The sales transaction (which is recorded in the new car sales journal) may affect many accounts including sales and cost of sales, as the chart below illustrates:

Dr	Cr
New car cost of sales	New car inventory
Vehicle receivables	New car sales
Contracts in transit	Sales tax payable
Used car inventory (trade-in)	Lien payable
Due from finance company	Finance reserve income
Commission expense (salesman)	Commission payable
Extended warranty cost of sales	Tag and/or registration payable
	Insurance income
	Insurance premium payable
	Extended warranty sales
	Extended warranty payable
	Owed to customer ("we owe")

Those accounts that involve somewhat unique accounting or recording treatment are discussed in the following sections.

3.118 The *vehicle receivables* account is used for several purposes. If the customer remits a deposit prior to purchasing a vehicle and/or pays cash (including personal checks, cashier checks, etc.) for the vehicle the cash amount is credited to *vehicle receivables* under an original customer number. When the billing invoice is completed and the vehicle is delivered to the customer, *vehicle receivables* is debited for the amount previously received.

3.119 The cashier is responsible for collecting all customer payments. Generally, a three-part receipt is completed, which reflects the date, customer name, amount, and method of payment (i.e., cash, personal check, cashier's check, credit card, etc.). One part is given to the customer, the second to the deal jacket, and the third is used as support for the daily deposit. The method of payment is important due to the IRS rules governing cash transactions in excess of $10,000 (see section 2.601 of Chapter 2).

3.120 In addition, if the customer finances the purchase through his or her own bank or credit union, *vehicle receivables* is used to record the draft receivable from the customer's lender.

3.121 *Contracts in transit* represents the proceeds from the sale of a vehicle to be received by the dealership for finance or lease contracts that have been submitted to and approved by financial institutions with whom the dealership has a dealer agreement.

3.122 Generally, the dealership receives the proceeds within a few days from delivery of the contract to the lender. Lenders will not accept the contract if the required attachments are incomplete. For example, the lender may require proof of income (e.g., a pay stub) before approving the contract. If the finance contract arrives without the proof of income, the lender may return the contract to the dealership. This would obviously delay the dealership's receipt of the proceeds for the sale. Ensuring that all finance contracts submitted to lenders are complete is an important control in a dealership.

3.123 The *used car inventory* (trade-in) value is determined by a knowledgeable person (usually the used car manager) who bases the valuation on a variety of factors including the condition of the car, past experience with resales, and published information (e.g., Black Book or the NADA Official Used Car Guide). The used car value is important because it affects the new car gross profit.

3.124 *Due from finance company* is the receivable set up for the *finance reserve income* earned on the difference between the lender's buy rate and the actual interest rate charged to the customer (see Chapter 2, section 2.434).

3.125 Depending on the specific state sales tax regulations, sales tax is collected, recorded in the *sales tax payable* account, and ultimately remitted to the state taxing authority. Export sales generally are not subject to sales tax. Instead, the dealership would be required to document the exporting of the vehicle by retaining copies of the shipping documents (bill of lading, dock receipt, etc.).

3.126 When a customer trades in a vehicle subject to a lien, the dealership generally assumes the balance due, and as a result, records the liability in the *lien payable* account.

3.127 *Insurance income* is generated when credit life and when disability insurance policies are sold to the customer. Generally, the customer pays the entire premium to the dealership, and dealership retains a percentage of the premium as its commission. The difference is remitted to the insurance company. Any amounts due to the insurance company are recorded in *insurance premium payable*.

3.128 The sale of an extended warranty policy is generally recorded as *extended warranty sales* and *extended warranty cost of sales*, as opposed to the accounting for insurance income as described in section 3.127. Similar to an insurance transaction, however, the customer pays the entire premium to the dealership. The amount due to the warranty company is recorded in *extended warranty payable*.

3.129 As discussed in Chapter 2, sections 2.438 and 2.439, there are two basic types of extended warranty contracts: those in which the dealership is the primary obligor and those in which the warranty company is the primary obligor. Most dealerships record sales of both types of extended warranty policies in the same manner: a debit to *extended warranty cost of sales* for the premium remitted to the warranty company and a credit to *extended warranty sale* for the premium collected from the customer. As mentioned in Chapter 2, section 2.439, this accounting treatment in not in accordance with GAAP for contracts in which the dealership is the primary obligor. Accounting for contracts in which the dealership is the primary obligor is discussed in sections 8.619 through 8.620.

3.130 Occasionally, the customer will accept delivery of the vehicle before all of the optional equipment purchased has been installed. In such cases, the dealership records a liability for the cost of installing the equipment it owes the customer. The account used to record these liabilities is often referred to as the *we owe* account.

3.131 Sales of certain vehicles may provide additional income to the dealership through factory incentives. The timing of the recognition of income from incentive programs depends on the terms of each program. For example, if an incentive program is designed so that an incentive is earned for every vehicle of a particular model sold, the dealership would recognize income as each qualifying vehicle is sold. On the other hand, many incentive programs are based on reaching a certain sales quota of a particular model within a specified time period. In these cases, the dealership should not record incentive income until the specified quota is reached. In any event, management should ensure that incentive income recognized reflects sales that qualify under the terms of the related incentive programs.

3.132 Once all of the necessary information has been included in the deal jacket and the vehicle is delivered, the deal jacket is forwarded to the accounting department. Each completed deal should be matched by accounting against the delivery log. This procedure serves to highlight those vehicles delivered for which the respective deal jackets have yet to reach accounting.

3.133 The accounting department is responsible for ensuring that the deal jacket is complete and for recording the transaction. If applicable, accounting forwards the finance or lease contract to the lender, along with all necessary attachments, and remits payment to the floor plan institution. Accounting is also responsible for registering the vehicle and obtaining new (or transferring) the customer's tags (license plate).

3.134 The salesperson's commission on the vehicle sale is calculated by accounting, and the documentation sent to the salesperson and the payroll department. The payroll department maintains a commission sheet on which each commission earned is recorded. At the end of the pay period, the commissions earned are tallied and the salesperson is paid.

3.200 USED CAR DEPARTMENT

Purchases

3.201 As noted above, most of the vehicles the used car department "acquires" are through customer trade-ins. The used car manager decides whether these vehicles should be placed on the lot for sale on the retail market or whether the vehicle should be sold to a wholesaler, either directly or through an auction.

3.202 If the car is to be sold through the retail market, management will have the vehicle safety-inspected and, if necessary, reconditioned (i.e., detailed, minor repairs, etc.). These tasks are normally performed by the service department and are recorded as internal sales on a repair order (see section 3.408).

3.203 Used cars may also be purchased from other dealers or through auctions in order to provide better balance to the used car inventory, both in quantity and quality. Payment of these vehicles is generally accomplished with an "envelope draft." The seller deposits the envelope draft in his or her bank after enclosing all necessary documentation, including the title to the vehicle and an odometer statement. The seller's bank presents the draft to the dealership's bank which notifies the dealership that a draft is being held for payment. Management reviews the documentation contained in the draft, pays for the draft, and retrieves the documentation.

3.204 When the vehicle is recorded in inventory in the general ledger, it is also recorded in the vehicle management system, which tracks each specific unit and any repair or reconditioning costs. This procedure takes place whether the used car has been acquired through trade-in, from another dealer, or through the auction.

Inventory Control

3.205 As with new car inventory, physical counts of the used car inventory should be conducted every month and the results reconciled to the used car inventory schedule.

3.206 In addition, if the used car inventory is subject to floor plan financing, the dealership's floor plan institution will take a physical inventory count, generally once a month. The institution will demand immediate payment for any vehicle that is on floor plan, but not counted.

3.207 The physical lot should be constructed so that vehicles are safeguarded during closing hours. Vehicles sent to auction for disposition in the wholesale market must be controlled to ensure that if they remain unsold, they are returned to the dealership. Management should also have adequate safeguards over the vehicle's keys and titles.

3.208 Most dealerships try to maintain a 30-day supply of used vehicles since the value of a used car declines relatively quickly. Often dealerships will have a policy to dispose of all vehicles in the wholesale market that remain unsold over a certain amount of time (usually 60 days).

Sales

3.209 Procedures for selling used vehicles on the retail market are generally the same as for new vehicles as discussed in sections 3.111–3.134.

3.210 The sale of a used vehicle to a wholesaler or through an auction is accomplished through the envelope draft system discussed in section 3.203. If the dealership sells directly to wholesalers, the dealer should be aware that the used car manager could have personal "side" agreements with the other dealer that may reduce the dealership's profits on the sale of these vehicles. Therefore, the dealer should require that all wholesale sales be through the auction or with approved wholesalers.

3.300 PARTS DEPARTMENT

3.301 Parts departments exist primarily to support the body and mechanical work performed in the dealership's service department. However, it also sells parts to outsiders, such as do-it-yourselfers, body shops, gas stations, other dealerships, etc. The parts department is supervised by the parts manager, who is responsible for purchasing parts and accessories from the manufacturer, as well as other dealerships and vendors, safeguarding the parts inventory, and supervising the parts department personnel.

Purchases

3.302 The parts department purchases parts and accessories mainly from the factory through weekly stock orders. The parts manager reviews a computer-generated printout called a "stock order" showing which parts need to be ordered. It is generated by a program that computes the optimal stocking level based on sales and quantities on hand. It is reviewed by the parts manager and transmitted to the factory by computer.

3.303 Most dealerships have a shipping and receiving clerk responsible for ensuring that the dealership receives the parts ordered, that the shipment is complete, and that no damage occurred during shipment. When a shipment arrives, the shipping and receiving clerk compares the packing slip with the original stock order report (which serves as the purchase order) to determine that all parts requested were shipped, compares the parts received with the packing slip to determine that the shipment is complete, and inspects the parts for damage. The clerk's signature on the packing slip indicates that these steps have been performed and the shipment has been accepted. The signed packing slips are then given to the parts department manager for his or her review, and the items are recorded in the perpetual inventory record (the parts counter pad) and placed in their respective locations (bins).

3.304 Parts may also be purchased from other dealerships. These parts are generally purchased on an as-needed basis because they cost more than if the dealership were to purchase the parts directly from the manufacturer. These purchases require a purchase order.

3.305 Parts and accessories not supplied by the manufacturer may be purchased from other vendors. These purchases also require a purchase order. Even though most of these vendors are reputable, management needs to be aware that some vendors may supply incentives to the parts manager to buy excess quantities.

3.306 All parts purchases are recorded at current manufacturer costs. Any discount received or premium paid is recorded to an account entitled "stock order allowance," which is a cost of sale account. This practice is in keeping with the industry practice of maintaining parts inventory at current replacement cost, as discussed in section 3.307.

Inventory Control

3.307 The entire parts and accessories inventory are maintained on a perpetual inventory system and controlled by the parts counter pad, which is generated through the computer system. The parts counter pad shows the part number, quantity on hand, and unit cost. The unit cost is updated at the beginning of each month (through information received from the manufacturer) to reflect current replacement costs. The monthly cost updating to current replacement cost presents an interesting dilemma to the auditor. However, while this is not in keeping with the concept of valuing inventory at the lower of cost or market, the effect on the financial statements is generally immaterial and approximates the FIFO basis, because the parts inventory turns over several times a year. See section 3.316 for additional discussion.

3.308 Access to the parts department should be limited to authorized personnel, and all doors to the parts department should be locked.

3.309 Parts department personnel should perform periodic physical inventory counts and should compare the results to the counter pad to ensure that the perpetual inventory record (i.e., the counter pad) is accurate. In addition, accounting department personnel should conduct surprise test counts. Every month, the total parts inventory as reflected on the counter pad should be reconciled to the general ledger since the parts counter pad is not integrated with the general ledger.

3.310 At least once a year, a physical count of the entire inventory should be taken by persons who do not have access to the parts inventory. Prior to the count, the counter pad should be printed. Once the count has been completed, the counter pad is updated to reflect the actual unit count. This "after inventory" counter pad is compared to the "before inventory" counter pad to highlight any discrepancies. Once the discrepancies have been corrected, the updated counter pad should be reconciled to the general ledger.

3.311 The controls and procedures over the dealership's parts driver should include independent verification of the parts being given to and taken from the driver.

3.312 Every manufacturer allows each dealership to return parts under certain conditions. First, based on the dealership's volume of purchases from the manufacturer, a certain allowance builds up whereby the dealership will receive the full amount of the part's cost upon return. In circumstances when the dealership wants to return parts in excess of this allowance, the manufacturer will refund a reduced amount (e.g., 70% of the cost).

3.313 Further, the parts must be returned in their original, unopened packages. If the packages are damaged, the manufacturer generally will not accept the return.

3.314 Finally, the manufacturer has specific times during the year in which these returns may take place.

3.315 At the end of every month, the parts manager uses the computer to print month-end reports that show a variety of information in addition to sales and purchase information. One of these reports shows the units and dollar amount of parts that have not been sold for specified periods of time. These time periods are divided into three-month segments; that is, the report shows the total amount of parts sold in the last three months, parts that were last sold between three and six months ago, parts that were last sold between six and nine months ago, etc. Using this report, management can track obsolescence problems. Generally, the rule of thumb is that no more than 10% of the parts inventory over six months old is acceptable.

Sales and Cost of Sales

3.316 As noted in section 3.307, the parts counter pad is updated monthly to reflect current replacement cost. This monthly updating is done primarily to establish the selling prices, which are generally a function of replacement cost multiplied by a fixed gross profit percentage. As a result, the part's cost of sale, which originates from the parts counter pad, is the same as its replacement cost. The difference created by updating the parts counter pad to replacement cost is defined in the industry as appreciation or depreciation, depending on whether prices have increased or decreased. The general ledger should be adjusted each month for any appreciation or depreciation and the income effect recorded in an inventory adjustment account.

3.317 The parts department's customers include the dealership's service department, as well as other dealerships, do-it-yourselfers, body shops, gas stations, etc. Parts are charged to the service department via the repair order, which is discussed in sections 3.410–3.417. Over-the-counter sales to customers other than the dealership's service department are recorded on numerically sequenced parts tickets. Depending on the customer type, the sale would be recorded as a retail, wholesale, or internal sale in the parts sales journal.

3.318 Retail sales originate at the parts department's retail (front) counter. The counterman uses the computer system or a current counter pad to determine whether the parts are in stock and if so, retrieves the part and prints a parts ticket reflecting the sale. The printing of the parts ticket automatically relieves inventory from the counter pad. The parts ticket is given to the customer who takes it to the cashier in order to make payment. The paid receipt is returned to the counterman who then releases the part to the customer. Retail sales are generally subject to sales tax.

3.319 The wholesale sale, which is normally not subject to sales tax, is made to customers who are in the business of reselling parts, typically via repairs of vehicles. Wholesale sales, which may be over-the-counter or delivery sales, are recorded on a parts ticket. For delivery sales, the parts ticket or a delivery log is kept by the parts manager or cashier for control purposes, and a copy is given to the dealership's parts driver. The method of payment, COD or charge, is noted on the parts ticket or delivery log. Upon delivery, the wholesale customer signs the parts ticket or delivery log, which is returned by the driver, along with the cash payment if applicable, to the parts manager or cashier for comparison to the control copies.

3.320 If the delivery is charged to the customer's account, the related customer receivable is automatically recorded when the parts ticket is recorded. Otherwise, the customer pays the dealership when the parts are purchased, and the cash is recorded in a cash sales account when the parts ticket is posted to the general ledger. This account is used to ensure that all cash that should be received is actually received and deposited. The account is offset by the cash deposit that takes place the following business day. If a balance exists in this account after the deposit is recorded, it generally means that a cash parts ticket was generated but the cash was not received.

3.321 The parts department also sells parts to the service department (mechanical and body shops), usually over the parts shop's back counter. Although the service department opens repair orders (see section 3.407), only the parts department can apply (or remove) parts to a repair order. In a manual system, this control is maintained by the parts department keeping the "accounting" copy of the repair order. In a computer system, only the parts department has access to the program that applies parts to a repair order.

3.322 In order for a mechanic to be issued a part, he must bring the work order (which indicates the repair order number) to the back counter, and the parts counterman records the issuance of the part on the repair order or in the computer. The parts department must give its final approval before the repair order can be closed.

3.323 Parts countermen are normally paid a monthly commission based on a percentage of either the department's total sales, or their individual sales. Individual sales information is printed in the parts department and reviewed by the parts manager before forwarding to accounting. The accounting department reviews and recomputes the commissions prior to submitting the information to payroll for payment.

3.324 Because parts tickets are numerically sequenced, accounting can generate a missing document report that discloses any missing parts tickets. Management should review the report every month to ensure that all parts tickets are accounted for.

3.400 SERVICE DEPARTMENT

3.401 The service department, also called the mechanical and body shop, supports the new and used car departments by preparing new cars for sale, reconditioning used car trade-ins, and performing warranty repairs. It also provides services to retail customers for repair and body work not covered by warranty. The service department personnel consists of mechanics, service writers who are the customer's contact person, and a dispatcher who assigns mechanics to the jobs. (The dispatcher's functions may be handled by the service writer if the service writer has certain mechanics assigned to handle all of his jobs.) A service department manager oversees the service department's operations.

Costs

3.402 The primary cost of operating the service department is the mechanic's time. The costs of a particular job are accumulated on a repair order, which is the document on which all labor, parts, and supplies charged to the job are accumulated. Although time clocks are used to track the mechanic's time charged to each repair order, the labor costs actually charged to a job are based on standard guidelines for the type of work performed. These guidelines may be obtained from the manufacturer or other publisher such as Chilton's. The service department manager will compare the mechanic's actual time to the job versus the standard time to identify inefficiencies.

3.403 Supplies and parts used on a repair job are requisitioned from the parts department, as discussed in section 3.321.

3.404 Vehicle repairs may also involve using an outside company, such as using a glass company to replace windshields. Such outside repairs are known as "sublet repairs." The purchase of sublet repairs requires a purchase order, generally issued by the parts department as part of its purchasing function.

Inventory Control

3.405 The service department does not typically carry inventory for resale, other than gas, oil, grease, and body shop materials; however, these items are generally controlled by the parts department. Inventory items that are under the service department control include sublet repairs inventory and work in process — labor inventory.

3.406 Sublet repairs inventory originates when the dealership pays an outside company for providing sublet repair work (as discussed in paragraph 3.404). The service department must ensure that each sublet repair is recorded on a repair order so the customer can be charged. Also, work in process — labor inventory is charged when the dealership pays the mechanic for work performed on vehicles (as discussed in paragraphs 3.411–3.413).

Sales

3.407 **Mechanical Shop Sales.** Sales of mechanical work generally originate on the dealership's service drive. The service writer, who is the customer's contact person, is responsible for documenting the customer's service request (maintenance or repair items), determining whether the repair is covered under manufacturer warranty or under an extended warranty contract (in which case the service writer is required to get approval from the extended warranty company), preparing the work order (the repair order may double as a work order), and, after the repairs have begun, ensuring the proper completion of the job. The customer signs the work order, and the vehicle is given to the mechanic so the work can begin.

3.408 The service department also reconditions trade-ins and prepares new vehicles for sale. The new and used car managers must authorize any work to be performed on these vehicles. One or more designated service writers may have the responsibility of handling all internal work. Labor and parts are recorded as internal sales and added to the inventoried cost of the respective vehicles. Significant inter-department sales and gross profit in inventory should be eliminated in the dealership's financial statements.

3.409 Even though many of the dealership's departments may be computerized, service department records are often maintained on a manual system. Sections 3.410–3.414 discuss manual repair order systems, while sections 3.415–3.422 discuss computerized systems.

3.410 Manual Repair Order. Most manual repair order systems use prenumbered, four-part repair order forms. The four parts of the form are designated for the accounting department, the customer, the service department, and the mechanics. The first three copies are given to the parts department in order to control and document the parts requisitioned for the job. Parts department personnel record all parts requisitioned on these three copies when the related parts are given to the mechanic.

3.411 The fourth ("hard") copy is given to the mechanic who will be performing the service on the vehicle. On this copy, the mechanic documents the diagnosis and the resolution of the vehicle problem for all repairs. This documentation is significant, especially when the repairs are covered under factory warranty. In fact, the manufacturer has the option of auditing past warranty repairs to determine whether the repairs were necessary, whether the repairs actually took place, and whether the manufacturer's payment of those repairs were appropriate based on the standard guide published by the manufacturer.

3.412 The dispatcher maintains a three-part document called a "flag sheet" for each mechanic. This three-part document is used not only to calculate each mechanic's wages, but also to allocate labor charges to each job the mechanic works on. Because mechanics will work on several repair jobs during a pay period, two parts of the flag sheet contain the time spent on each job the mechanic worked on during the pay period: one part is kept by the dispatcher and the other is sent to the payroll department for purposes of calculating the mechanic's wages. The third copy of the flag sheet consists of ten or more perforated "flags." As the mechanic completes work on a particular job, the time spent is noted on one of the flags, and the flag is attached to the respective repair order. Also noted on the flag are the mechanic's employee number and the repair order number.

3.413 When the job is completed, all copies of the repair order are forwarded to the cashier who completes the repair order by calculating the labor charges (flag hours multiplied by the mechanics' hourly rate), in addition to the parts and sublet repair sales and cost amounts. The accounting and customer copies are stamped "paid" indicating method of payment.

3.414 The accounting copy of the manual repair order is routed to the accounting department for posting to the general ledger.

3.415 Computerized Repair Order. In a computer system, mechanical and body shop work begins with the preparation of a "work order" (as opposed to a repair order in a manual system). The work order is generated (and a copy given to the customer) indicated that work is authorized to begin. The same basic procedures for accumulating parts and labor charges to a job are the same: the difference being that the parts department enters parts and the dispatcher logs the mechanic's time into the computer.

3.416 When the job is completed, the cashier prints the numerically sequenced four-part repair order (which shows the amount to be remitted by the customer), matches it to the work order, and gives a copy of the repair order to the customer upon payment.

3.417 One copy of the repair order is sent to the accounting department as support for the entry into the general ledger. The entry is posted automatically through the computer after being approved by accounting.

3.418 The sales transaction (which is recorded in the service sales journal) may affect many accounts including sales and cost of sales, as illustrated below:

Dr	Cr
Parts cost of sales	Parts inventory
Mechanical labor cost of sales	Work in process — labor inventory
Sublet repairs cost of sales	Sublet repairs inventory
Gas, oil, and grease cost of sales	Gas, oil, and grease inventory
Cash sales	Parts sales
Accounts receivable-parts and service	Mechanical labor sales
New/used car inventory	Sublet repairs sales
Warranty receivables	Gas, oil, and grease sales
Pre-delivery service receivable	

3.419 The *mechanical labor sales* and *mechanical labor cost of sales* accounts are further segregated in the general ledger. If the repair work performed was covered under manufacturer warranty, the sale and cost of sales are recorded as mechanical labor — warranty sales and mechanical labor — warranty cost of sales, respectively. The amount due from the manufacturer is recorded in the warranty receivables account.

3.420 If the service work was for another department of the dealership, the sale and cost of sales are recorded as *mechanical labor — internal sales* and *mechanical labor — internal cost of sales*, respectively. The new or used car inventory account is charged if the service work was to install an option or repair a new vehicle in inventory or recondition a used vehicle in inventory. If the work performed is to prepare the new car for sale, the *pre-delivery service receivable* account is charged for the amount to be paid by the manufacturer, with any excess charged to new vehicle inventory.

3.421 Similarly, sales to retail customers are recorded as *mechanical labor — customer sales* and *mechanical labor — customer cost of sales*, respectively.

3.422 If the customer has a charge account, *accounts receivable — parts and service* is automatically charged when the repair order is recorded into the general ledger. Otherwise, the customer pays the dealership when the vehicle is delivered, and the cash is charged to the *cash sales* account. This account is used to ensure that all cash that should be received is actually received and deposited. The account is offset by the actual cash deposit, which takes place the following business day. If a balance exists in this account after the deposit is recorded, it generally means that a cash repair order was closed but the cash was not received.

3.423 Body Shop Sales. Orders for body shop work generally originate at the body shop. The damaged vehicle is first given an estimate that must be approved by the customer (if the customer is paying directly) or by the customer's insurance company. The parts requisition and the recording of time is handled in the same manner as a mechanical repair order, except that the time is governed by the estimate and not by a standard manual. Also, comparable to the mechanical labor sales, body shop labor sales are segregated in the general ledger as warranty, customer, and internal sales.

3.424 Service writers are normally paid on a commission basis as a percentage of their respective sales generated. A record of sales orders generated by each repair order is reviewed by the service manager before being forwarded to accounting. Finally, accounting reviews and recomputes the commissions prior to submitting the information to payroll for payment.

3.425 Since all of the repair orders are numerically sequenced, the accounting department can generate a missing document report which discloses any missing repair orders. Management should review the report every month to ensure that all repair orders are accounted for.

3.500 VENDOR SOFTWARE

3.501 There are several companies, both subsidiaries of the manufacturers and independent companies, that provide fully-integrated computer packages to automobile dealerships. These packages, which generally run on a mini-computer, link the entire dealership together and include all or some of the following applications:

3.502 Accounting and Administration

- *Integrated general ledger.* All of the dealership's sales functions may be fully integrated with the general ledger. This is generally organized so that all entries must be approved by the accounting department before the general ledger is updated. Also, most systems can provide schedules for any account, such as new car inventory, accounts payable, etc.
- *On-demand checking.* Rather than keying manually prepared checks into the general ledger, the computer system enables the user to create checks that are automatically recorded.
- *Payroll.* Most dealership computer systems include a complete payroll system. These systems also enable the dealership to prepare all payroll tax returns.
- *Daily operating control (DOC).* This system is capable of printing a document that shows daily and month-to-date sales activity, gross profit, and expense information by department. Management uses this report to follow sales trends and highlight areas of concern in order to react in a timely fashion.
- *Dealer Communication System (DCS).* This is the computerized system with which the dealership communicates with the manufacturer for the ordering of vehicles and parts, the submission of warranty claims, etc. Having a DCS system is generally required by the manufacturer and may be a stand-alone computer system if not offered by the computer vendor as part of the standard computer system.

3.503 Vehicle Sales

- *Follow up.* This program allows management to follow up on customers who visited the dealership but did not purchase a vehicle. This system generally interfaces with a processing program for preparing letters to these prospective customers.
- *Vehicle management.* This gives the sales department up-to-date information on inventory in stock as well as the cost and MSRP of each vehicle. It may also provide information on the location of each vehicle on the dealership grounds.
- *F&I and leasing.* Primarily used as a sales and administrative tool, this application enables the F&I and leasing departments to calculate customer payment schedules for installment contracts and leases and to print all forms connected with the vehicle sale (billing invoice, power of attorney, odometer statement, finance or lease contract, etc.). Other features may include full integration with the general ledger so that sales information is updated quickly, and connections to credit bureaus through a modem.

3.504 Parts Department

- *Inventory.* This system maintains a perpetual inventory of several thousand part numbers which are updated monthly to current replacement cost (see section 3.316). This parts counter pad is the source used for costing parts on parts tickets.
- *Sales.* The sale of parts to retail and wholesale customers is recorded on a computerized parts ticket which automatically decreases the inventory count on the counter pad. At the end of each business day, the day's sales can be automatically posted to the general ledger by the accounting department. Another characteristic is the complete integration with the service department whereby parts are recorded directly onto the automated repair order (see section 3.415).
- *Automated parts cataloging.* This feature eliminates the catalog books and/or microfiche that parts departments have used in the past to determine parts needed for specific repairs. The automated parts catalog, which can use a touch screen monitor, may be integrated with the parts counter pad.

3.505 Service Department

- *Merchandising.* The merchandising system maintains a data base of service customers that can be accessed several ways, including vehicle identification number, customer name, and license plate number. This data base may include the complete history of vehicle maintenance and repairs for each customer. After keying in the mileage of the vehicle when it arrives at the dealership for service, the system provides suggestions as to additional maintenance items that can be provided. This data base can be integrated with vehicle follow up (section 3.602) so that vehicles delivered by the sales department are automatically set up in the service merchandising data base. This system is generally integrated with a word processing system so that letters can be sent to customers as service reminders or for upcoming sales.
- *Invoicing/Sales.* The entire sales function is initiated on the service drive when the work order is printed and the customer authorizes the work to be performed. The dispatcher can

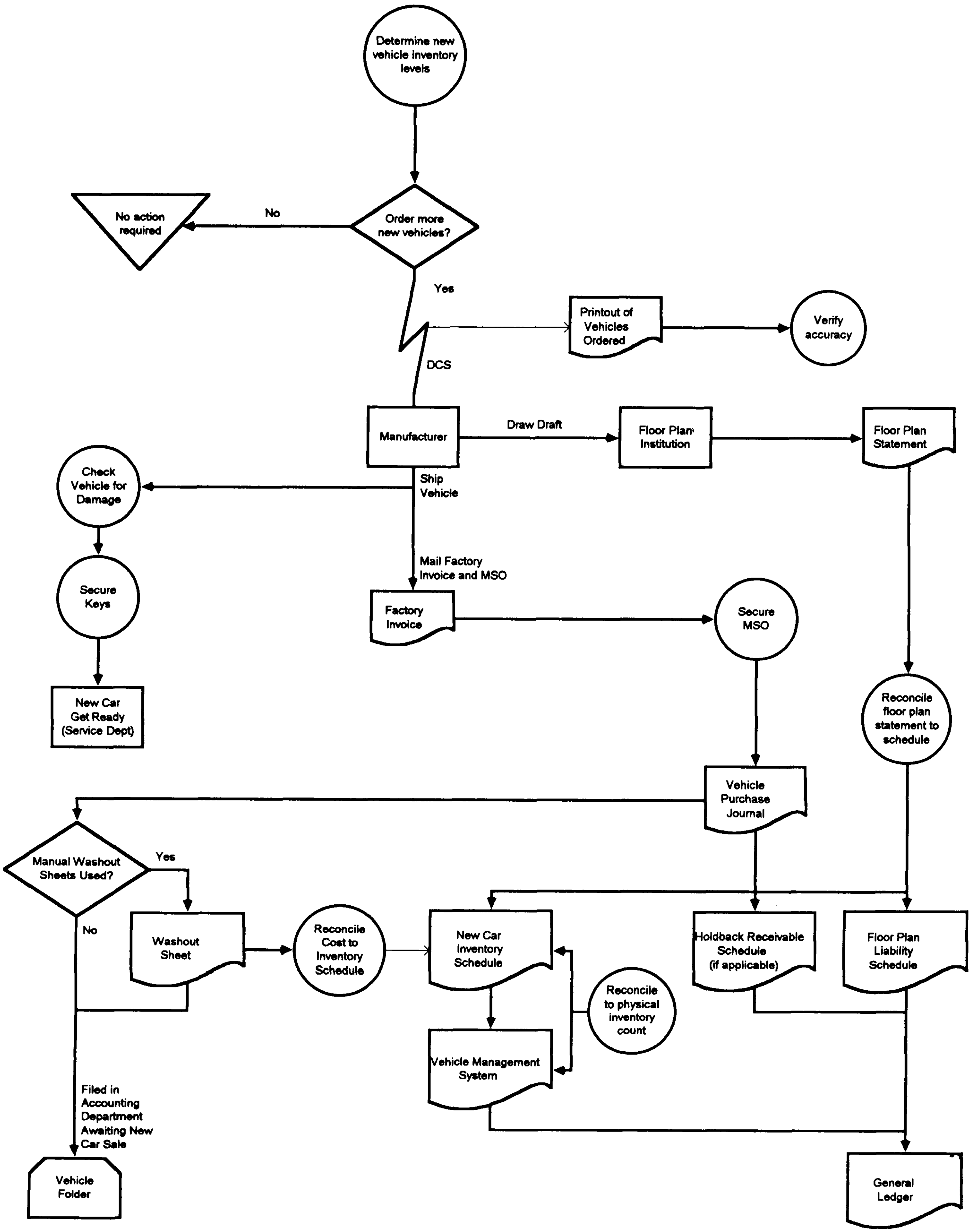
electronically post the technicians' time to the work order and the parts department can do the same with the parts. The dispatcher can also assign work to each mechanic. Using a terminal in the shop, the mechanic can determine the next job and, after inspecting the vehicle, input findings and conclusions automatically. The cashier is then able to print a completed repair order, which includes all of the above information. The program computes the sale and cost of sales amounts and indicates the amount due from the customer. At the end of each business day, the day's sales can be automatically posted to the general ledger by the accounting department.

3.600 ILLUSTRATIVE FLOWCHARTS

Section	Description
3.601	New Vehicle Purchases
3.602	New Vehicle Sales
3.603	Service Department

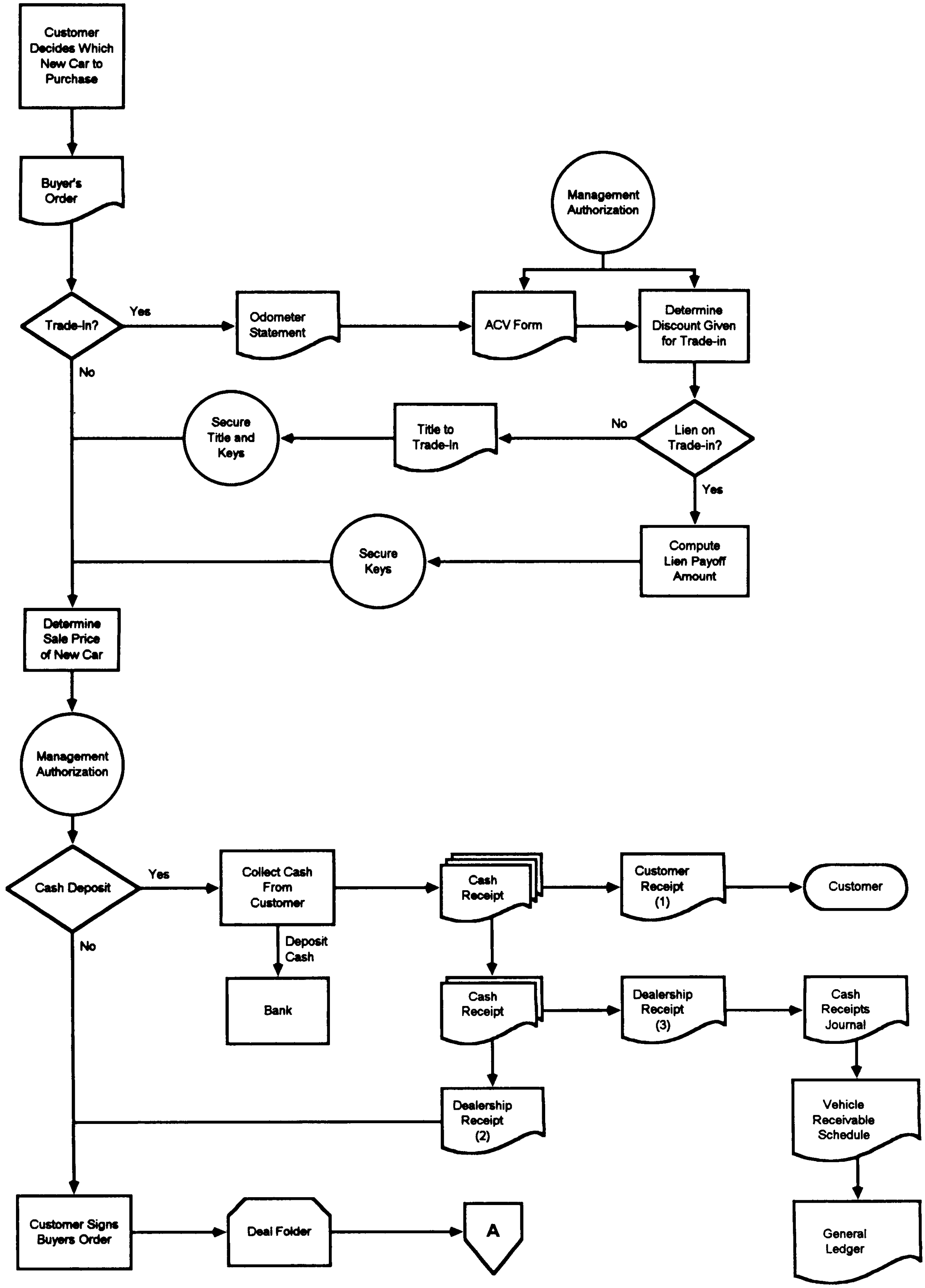
New Vehicle Purchases

Illustration 3.601



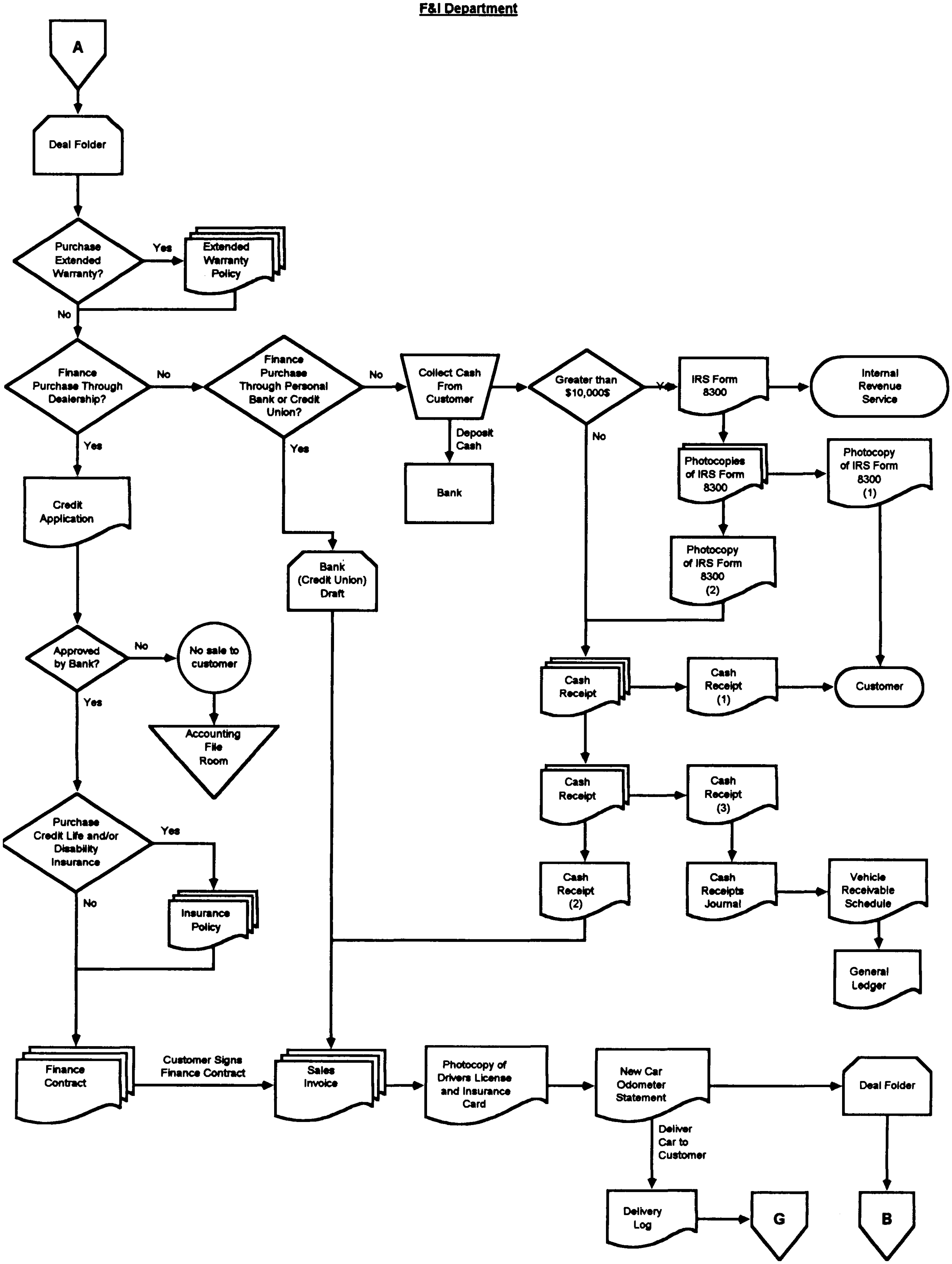
New Vehicle Sales

Illustration 3.602



New Vehicle Sales

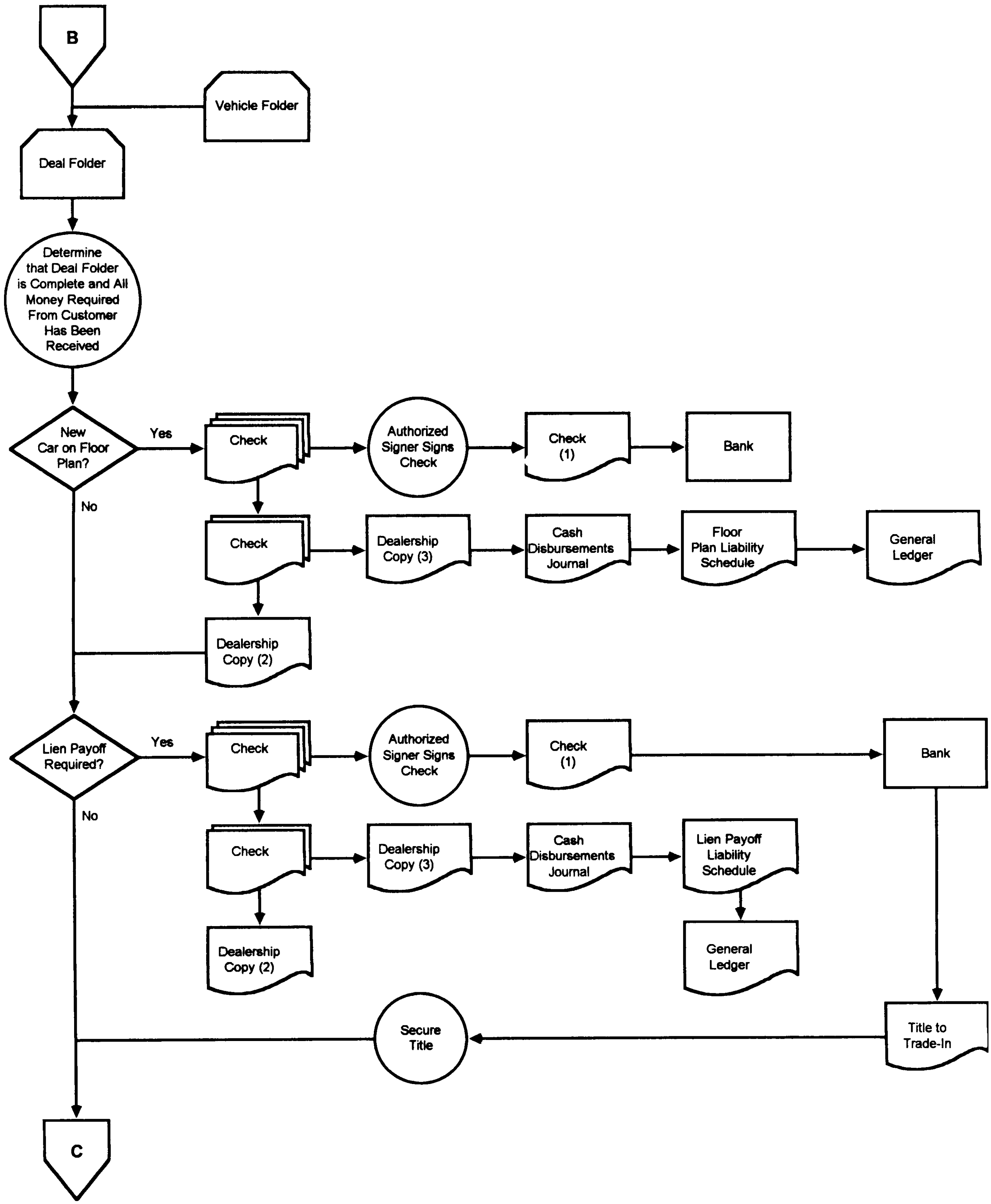
F&I Department



New Vehicle Sales

Accounting Department

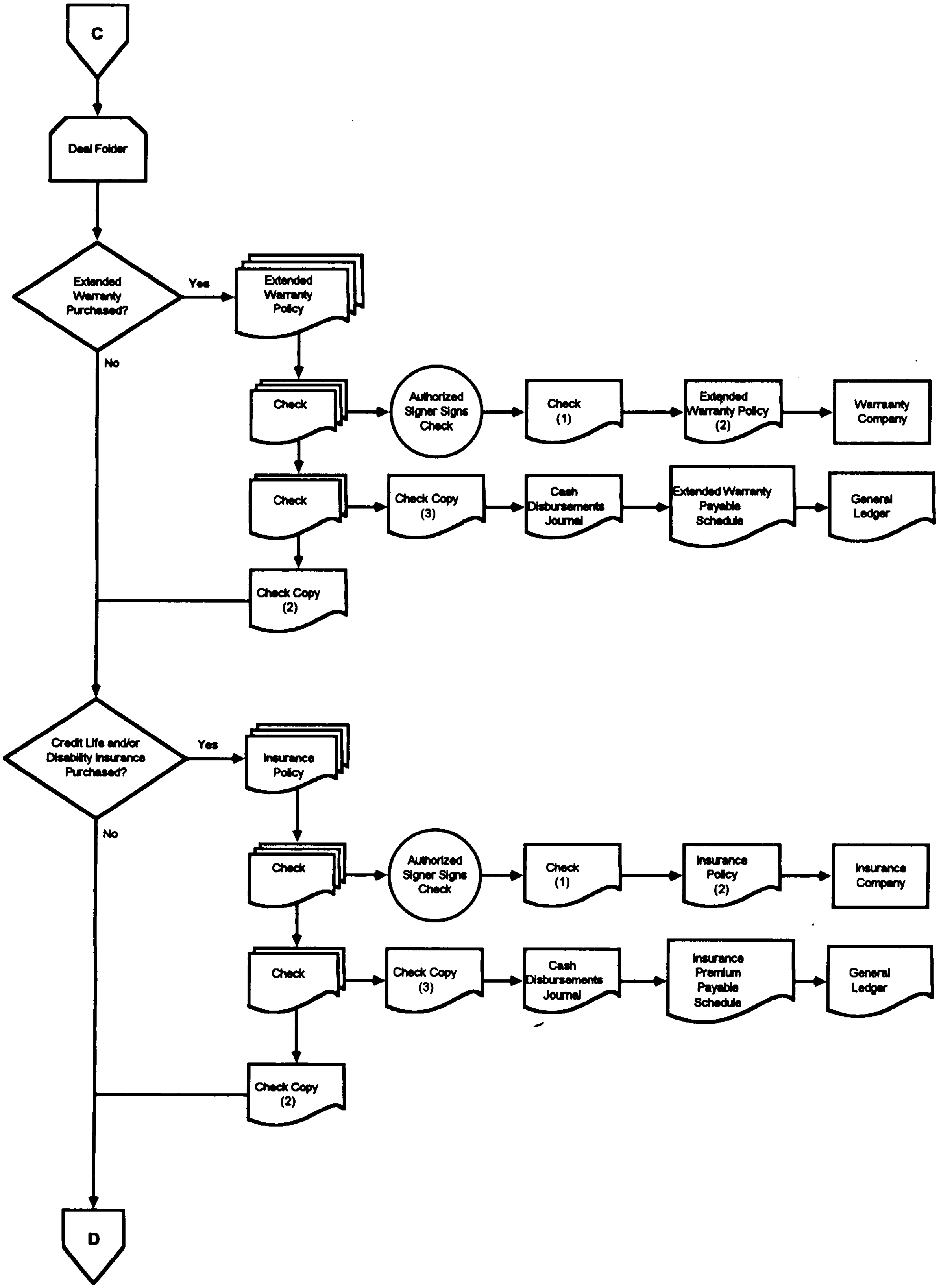
(Cash Disbursements)



New Vehicle Sales

Accounting Department

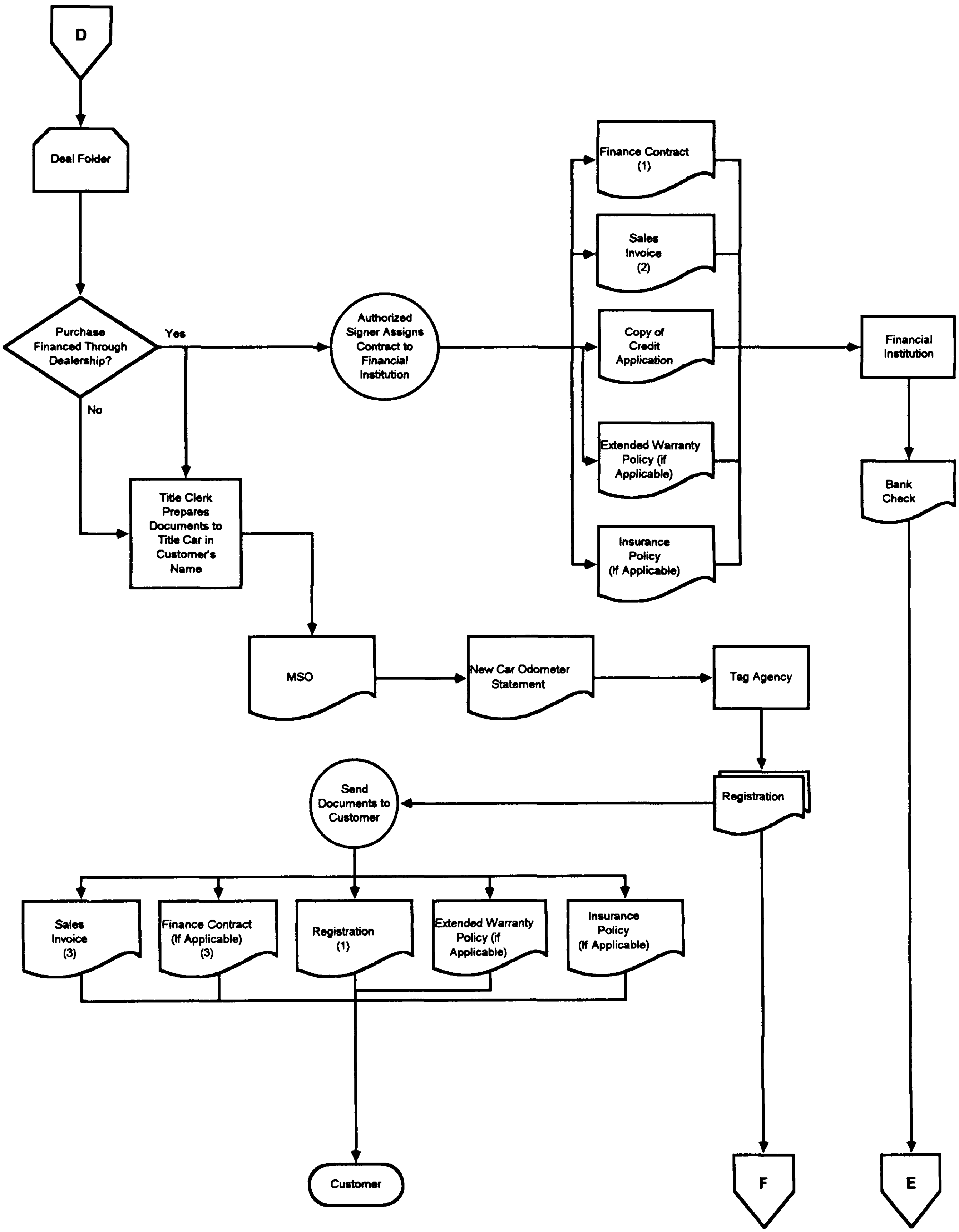
(Cash Disbursements)



New Vehicle Sales

Accounting Department

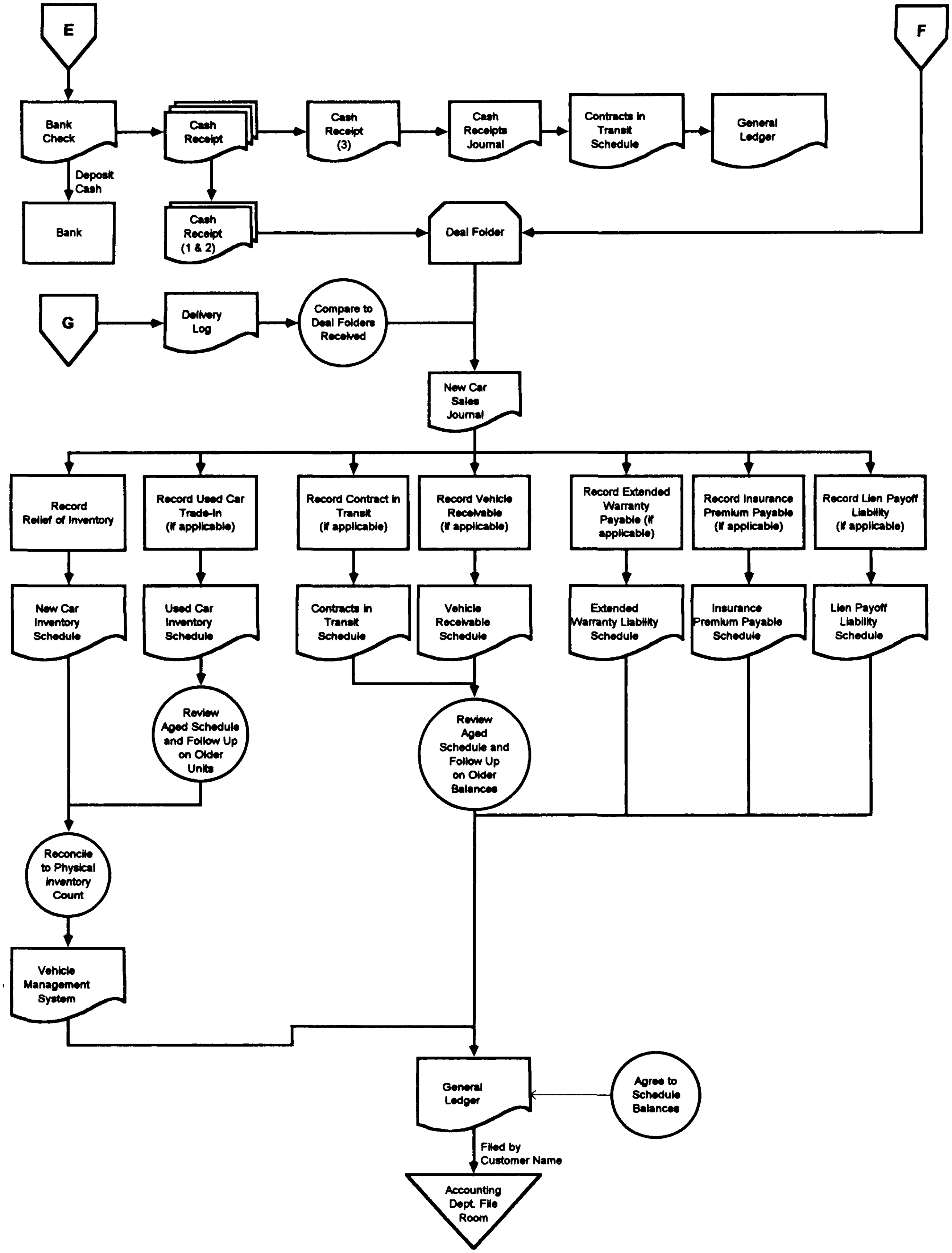
(Contract in Transit and Documents to Customer)



New Vehicle Sales

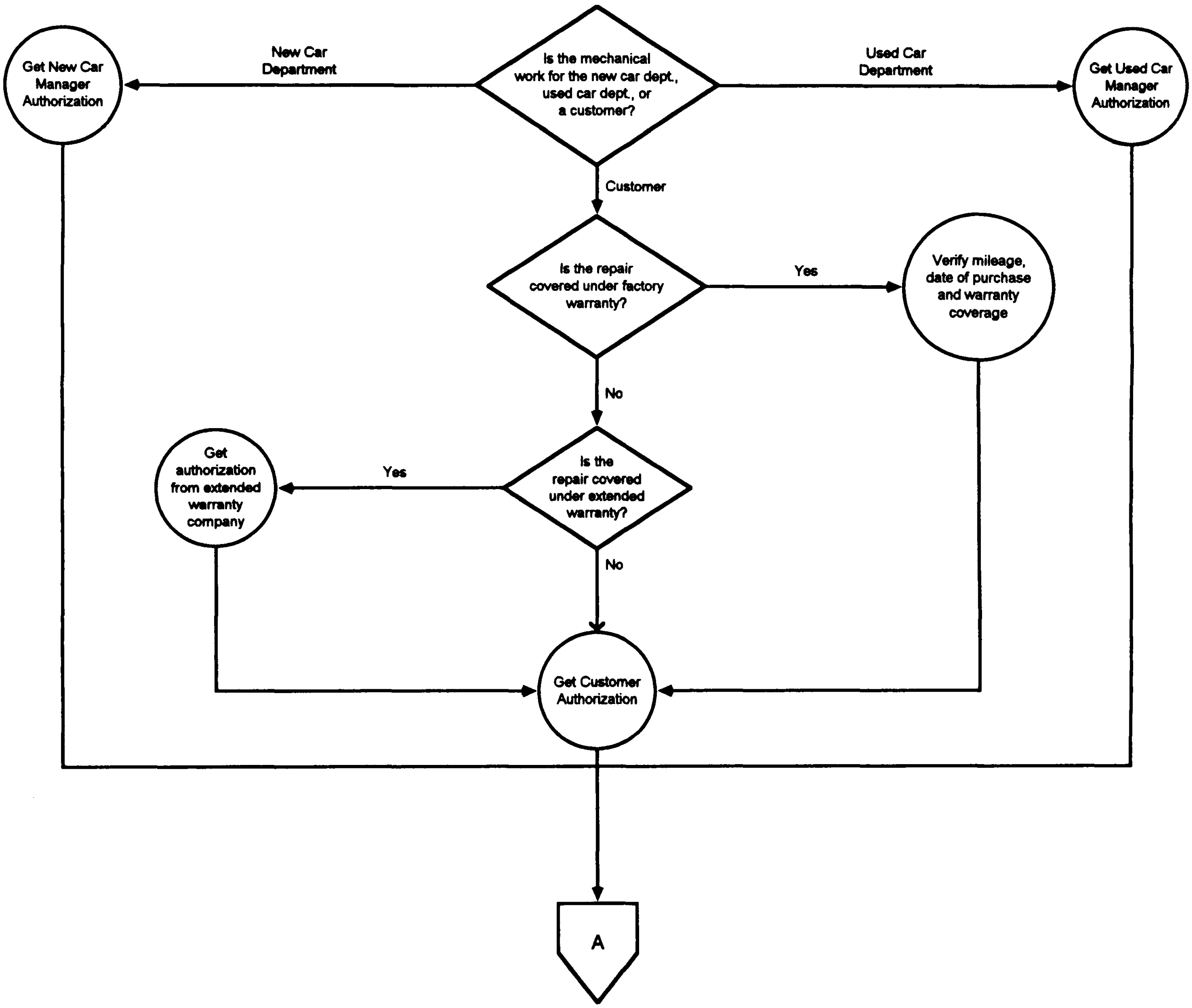
Accounting Department

(Receipt of CIT Proceeds and Recording Sale)

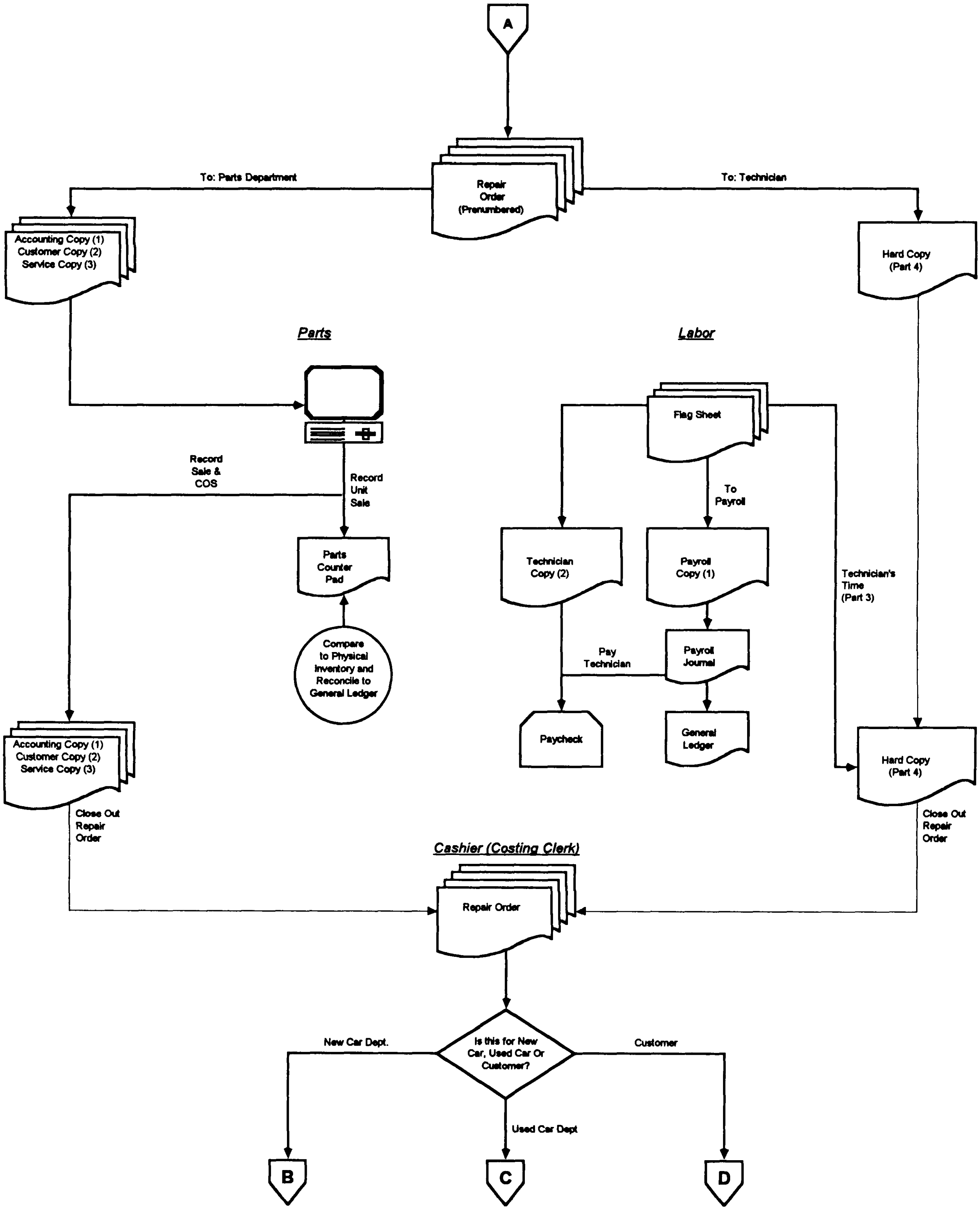


Service Department

Illustration 3.603

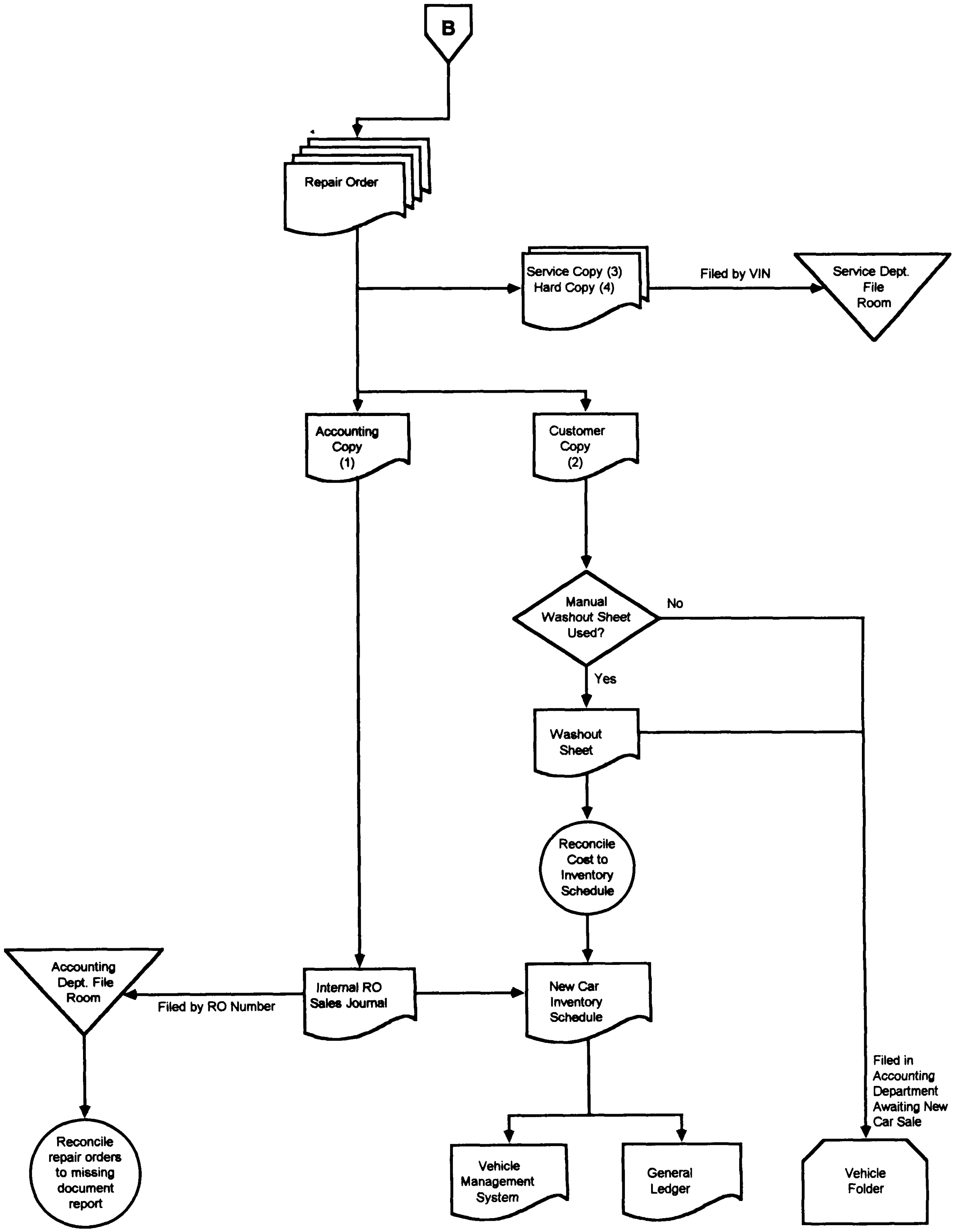


Service Department



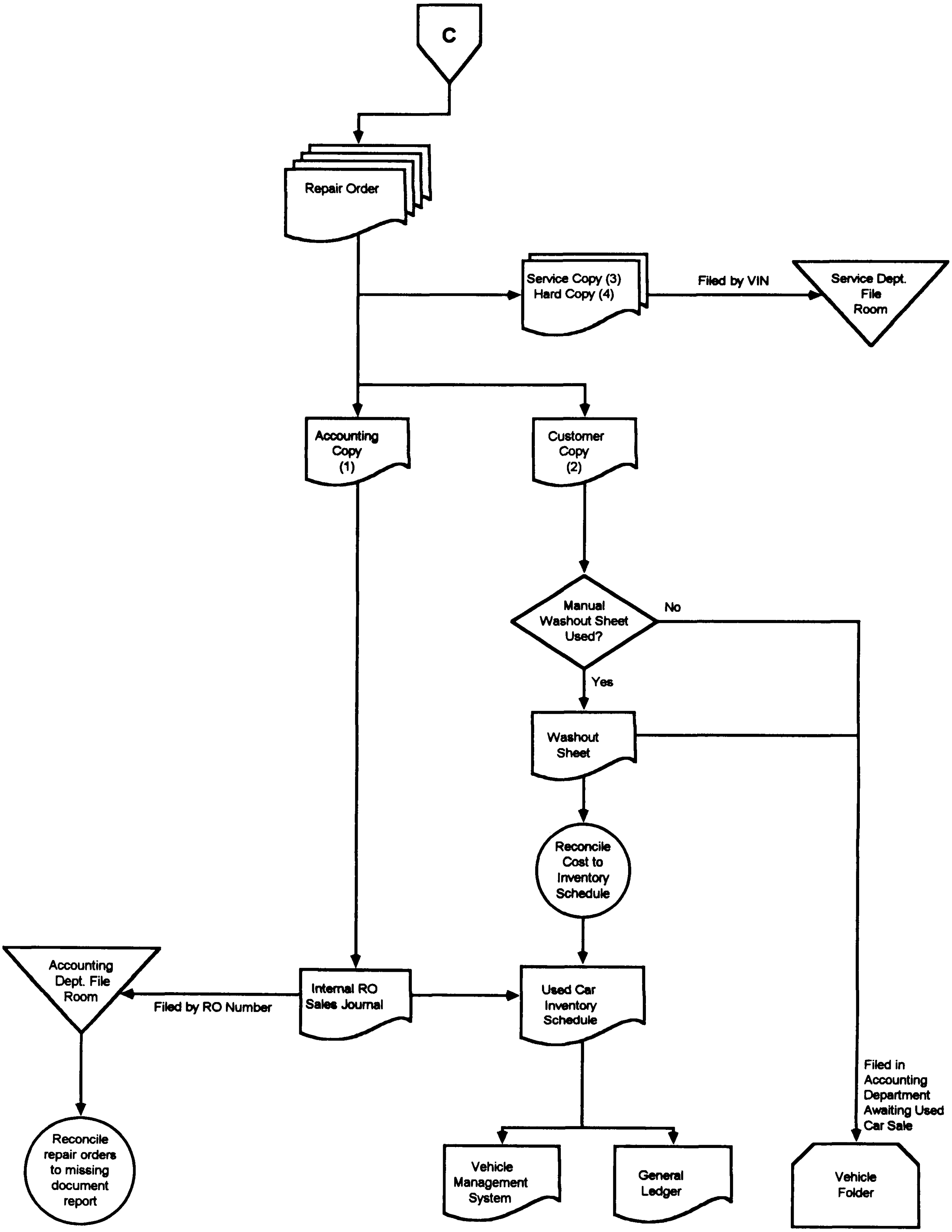
Service Department

New Car Get Ready



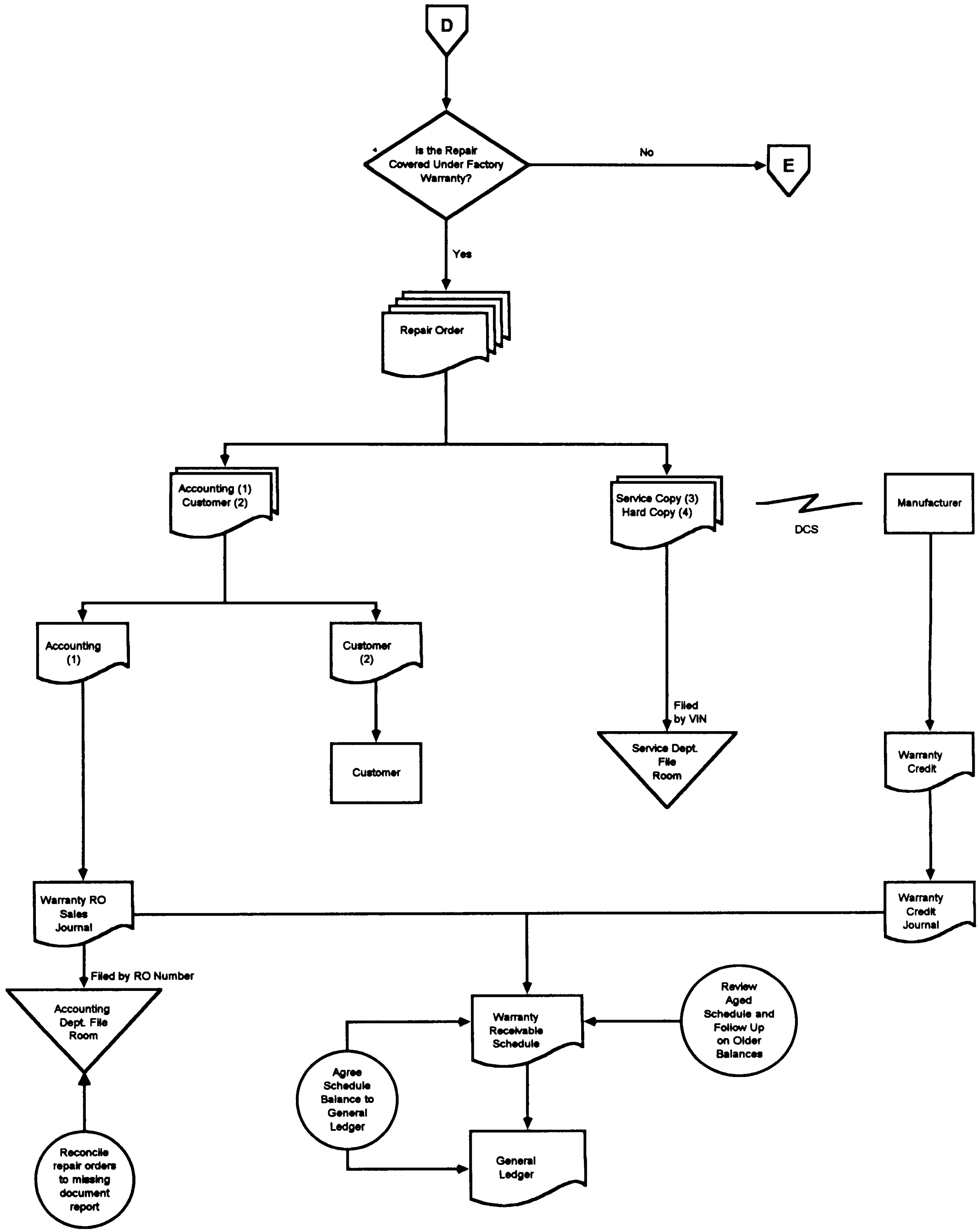
Service Department

Used Car Reconditioning



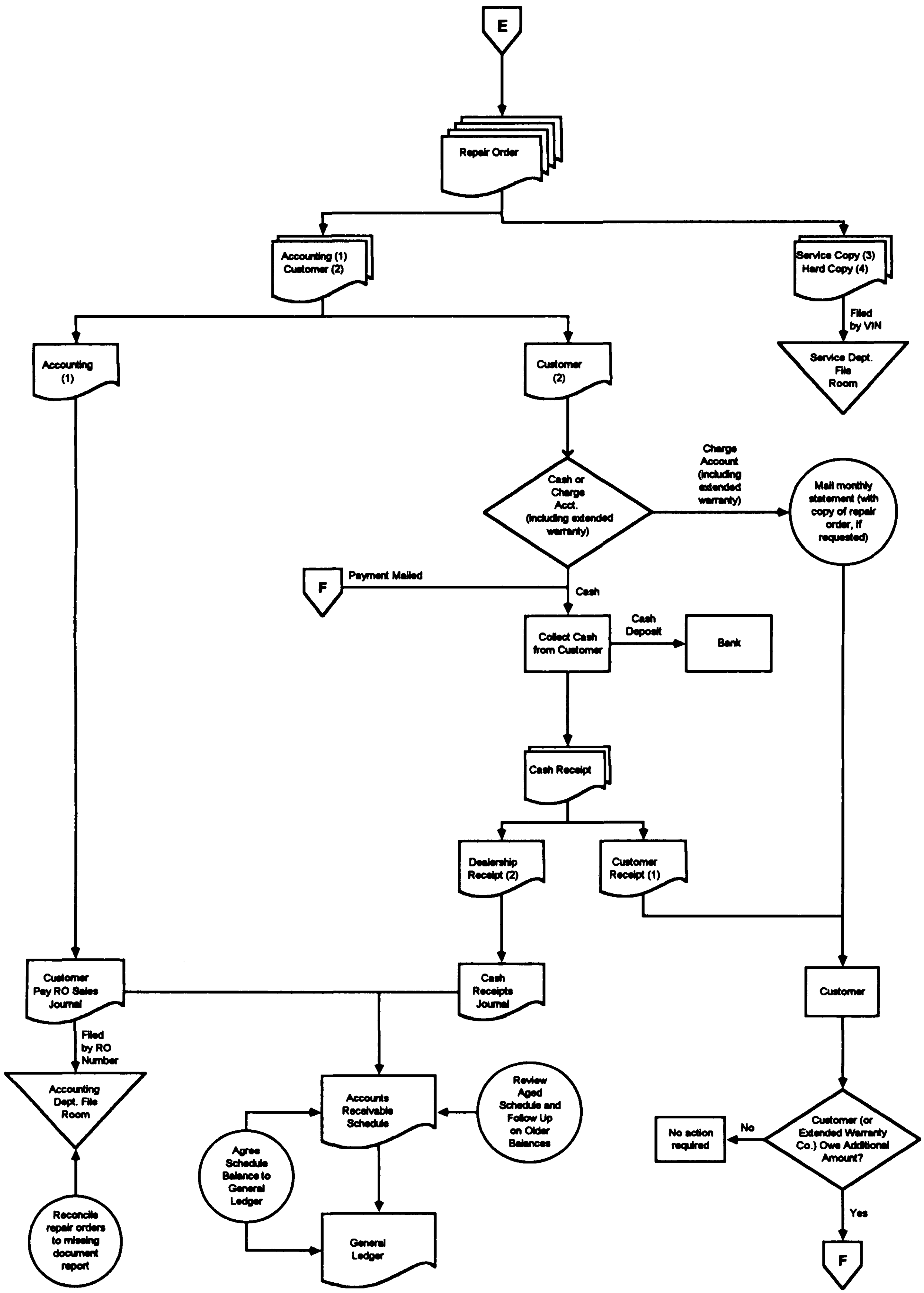
Service Department

Customer



Service Department

Customer



Pre-Engagement
& Audit Planning

CHAPTER 4

PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING

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CHAPTER 4

PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING

Table of Contents (Continued)

CHAPTER 4

PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING

4.000 INTRODUCTION

4.001 In recent years, accountants who provide auditing, compilation, and review services have become increasingly aware of the importance of evaluating their relationships with prospective and continuing clients and the need to perform adequate planning in their audit engagements. This chapter discusses the requirements to perform client acceptance and continuance procedures and to adequately plan engagements to audit auto dealerships' financial statements. Also discussed are other pre-engagement considerations.

4.100 CLIENT ACCEPTANCE AND CONTINUANCE

4.101 Although most firms want to expand their client base, this expansion should be carefully monitored to ensure that accepting a prospective client and continuing a relationship with an existing client will not harm the firm's reputation and standing in the community.

4.102 The AICPA Statement on Quality Control Standards (SQCS) No. 1, *System of Quality Control for a CPA Firm*, requires that firms establish policies and procedures for accepting and continuing clients. Specifically, paragraph 7 of SQCS No. 1 (QC 10.07) states:

> Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity.

4.103 Firms should develop, preferably in writing, quality control policies and procedures for evaluating new and existing client relationships. These policies should specify:

For prospective clients

- The procedures to be followed for evaluating a prospective client, including:
  - obtaining and reviewing the prospective client's available financial statements or information.
  - inquiring of third parties, such as the prospective client's attorneys, bankers, etc. about the dealership and its management.
  - communicating with the predecessor auditor or accountant.

- considering circumstances that would require special attention or that present special risks in the engagement.
- evaluating the firm's independence and ability to serve the prospective client.
- determining whether accepting the client would violate any applicable regulatory agency requirements or the codes of conduct of the AICPA or state CPA society.

- The individuals responsible for evaluating prospective clients and making acceptance decisions, and for approving such decisions.
- How appropriate firm personnel are informed of the policies and procedures for accepting clients.
- The individuals responsible for administering and monitoring compliance with the firm's policies and procedures.

For continuing clients

- The procedures followed for evaluating relationships with continuing clients, such as:
  - considering whether significant changes have occurred since the last engagement, such as changes in management, the board of directors, legal counsel, financial condition, or scope of the engagement.
  - considering whether any conditions exist that would have caused the firm to reject the client had they been known at the time of initial acceptance.
- The frequency of such evaluations.
- The individuals responsible for evaluating continuing clients, for deciding whether to continue relationships with existing clients, and for approving such decisions.
- How firm personnel are informed of the firm's continuance policies and procedures.
- The individuals responsible for administering and monitoring compliance with the policies and procedures.

Each firm should design quality control policies and procedures that meet its unique organizational and operating characteristics.

4.104 The Client Acceptance and Continuance Form at section 4.501 is designed to help firms evaluate prospective and existing clients. It provides documentation of the evaluation process for new and existing clients, the decision to accept and continue clients, and approval of the decision to accept and continue clients. This Form should be modified as necessary to interface with the firm's quality control policies and procedures for acceptance and continuance of clients.

4.105 For prospective clients, Part I of the Client Acceptance and Continuance Form should be completed by the in-charge and approved by the engagement partner. Part II should be completed by the engagement partner and approved by the partner responsible for approving new clients.

4.106 For existing clients, the in-charge should update and revise the form, as necessary, to evaluate the desirability of continuing the relationship with the client. Multi-year sign-off space is provided to document an annual evaluation and the engagement partner's approval of the continuance (or discontinuance) decision.

4.107 Two critical factors in the acceptance and continuance decision are considering the possibility of going-concern problems and identifying potential independence impairments. These factors are discussed in the following sections.

Potential for Going-Concern Problems

4.108 Financial reporting is based on the assumption that the entity will continue as a going concern, unless there is significant information to the contrary. Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU 341), requires the auditor to evaluate the client's ability to continue as a going concern for a period not to exceed one year beyond the balance-sheet date. To perform this evaluation, the auditor is not required to design audit procedures to detect going-concern problems; rather, the evaluation should be based on information obtained during the course of the audit about conditions or events that indicate that there is substantial doubt about the entity's ability to continue as a going concern. Examples of such conditions or events are negative cash flows, defaults on loan agreements, contraction of service levels, franchise termination by a manufacturer, legal proceedings, and operating difficulties.

4.109 If the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, he or she should:

- Consider management's plan to mitigate the effects of the condition or event, and
- Assess the likelihood that the plans can be effectively implemented.

4.110 If substantial doubt remains after evaluating management's plans, the auditor should:

- Consider the adequacy of financial statement disclosures about the going concern problem, and
- Include an explanatory paragraph in the auditor's report to reflect his or her conclusion that there is substantial doubt about the entity's ability to continue as a going concern.

4.111 Whenever the auditor becomes aware of conditions or events that cause him or her to believe that there may be substantial doubt about an entity's ability to continue as a going concern, he or she should document the condition or event, the procedures followed to reach a conclusion about whether substantial doubt exists and, if applicable, the effect on the auditor's report and financial statements. If questions about an entity's ability to continue as a going concern arise in performing pre-engagement and audit planning procedures, they should be documented in the Client Acceptance and Continuance Form and the Audit Planning Memorandum. Questions identified during engagement performance should be documented in a special memorandum that includes a discussion of:

1. The nature of the condition or event that raises a going-concern question.

2. The evaluation of management's plans and other factors, and related audit evidence, that might either mitigate or aggravate the condition or event.
3. The assessment of whether substantial doubt exists about the dealership's ability to continue as a going concern.
4. The evaluation of the adequacy of financial statement disclosures of the matters giving rise to the information indicating a going-concern problem and management's plans to mitigate the problem.
5. Any modifications to the auditor's report considered necessary for the uncertainty.

4.112 The following are some conditions and events that may raise a question about an auto dealership's ability to continue as a going concern:

- Recurring operating losses
- Working capital deficiencies
- Default on loans or similar agreements, including an "out of trust" situation
- Restructuring of debt
- Substantial dependence on the success of a particular project
- Legal proceedings, legislation or similar matters that might jeopardize a dealership's ability to operate
- Loss of a key franchise, license, principal customer or supplier

4.113 As mentioned above, if the auditor becomes aware of any of these conditions during the course of the audit, he or she should inquire about management's plans to mitigate the effect of the conditions or events, and should assess the likelihood that such plans can be effectively implemented.

Independence

4.114 Auditors must be independent of a client in order to be able to express an opinion on the financial statements. SQCS No. 1 contains a requirement that firms establish quality control policies and procedures that ensure that they comply with the professional requirements concerning independence. Specifically, paragraph 7 of this Statement states:

> Policies and procedures should be established to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the rules of conduct of the AICPA. Rule 101 of the rules of conduct [ET section 101] contains examples of instances wherein a firm's independence will be considered impaired.

Also, the AICPA's *Code of Professional Conduct* "Objectivity and Independence" (ET section 55), states:

> A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

4.115 In addition to the basic independence rule found in the *Code of Professional Conduct*, there are independence interpretations and rulings that address specific situations encountered by accountants. The following apply especially to auditors of small businesses. However, accountants should be familiar with all of the independence rules, interpretations, and rulings.

- Interpretation 101-3, "Accounting Services" (ET 101.05), sets forth criteria for independence when the member is asked to provide manual or automated bookkeeping or data processing services (including systems design and programming assistance and renting computer time) to a client.
- Ethics Ruling 191-1, "Acceptance of a Gift" (ET 191.001-.002), indicates that a member may not accept more than a token gift from a client.
- Ethics Ruling 191-3, "Members as Signer or Cosigner of Checks" (ET 191.005-.006), indicates that a member may not accept responsibility of signing or cosigning checks.
- Ethics Ruling 191-4, "Payroll Preparation Services" (ET 191.007-.008), indicates that a member may not perform payroll preparation services for a client if the member is a signer or cosigner of the checks and the member's bank account is used.

4.116 These independence requirements apply not only to AICPA members, but their spouses and dependents as well. Independence is generally not impaired solely because the member's spouse or dependent is employed by the client, as long as the employment is in a position that does not allow significant influence over the dealership's operating, financial, or accounting policies. However, if the employment is in a position in which the person's activities are audit-sensitive (normally an element of or subject to significant internal accounting controls, such as cashier, internal auditor, or accounting supervisor), the auditor's independence would be impaired.

4.117 In addition to establishing policies and procedures to ensure that firms have adequate procedures to determine that their personnel are independent with respect to their clients, the authors believe it is advisable to also ensure that potential independence impairments have been identified and resolved before each engagement begins. As a result, the Client Acceptance and Continuance Form in section 4.501 requires that this determination be made on each engagement before deciding to accept a new client or continue a relationship with an existing client.

> **Practice Tip:**
>
> All practitioners, and the members of their professional staffs, must be thoroughly familiar with the Code of Professional Conduct, the interpretations of ET section 55 that appear in ET section 101, and the related individual rulings that appear at ET section 191 ("Ethics Rulings on Independence, Integrity, and Objectivity").

4.200 ENGAGEMENT LETTERS

4.201 Adequate engagement planning includes establishing an understanding with the client regarding the nature of the firm's services, timing of field work, report deadlines, responsibilities of the client, and methods of fee determination and payment. The engagement partner should confirm, at least annually, an understanding of the nature of the engagement and the extent of the reporting responsibilities before beginning field work. Such communication will normally include an appropriate engagement letter and a pre-engagement client conference.

4.202 Currently, there are no authoritative pronouncements requiring a written engagement letter for an audit, although most firms regard its completion as good business practice. An engagement letter helps to prevent misunderstandings between the client and the auditor regarding the services to be provided, including the limitations. The engagement letter also sets forth the responsibilities of the client, and in most states it becomes a legally binding contract on both parties. There are other good reasons to obtain an engagement letter, including the following:

- *Reduce the risk of litigation.* Misunderstandings with clients regarding the nature and limitations of the services provided can result in litigation.
- *Avoid misunderstandings by the staff.* The staff performing the work can review the engagement letter to obtain a clear understanding of the services to be provided and the required timing of issuance of the report.

> **Practice Tip:**
>
> Be careful when using a proposal or preliminary engagement letter for a client. If the letter describes additional services that are not finally agreed upon, it may be used in litigation as an indication of inadequate performance by you on the engagement. You should make sure that a final engagement letter is always issued in such circumstances.

4.203 The letter should be prepared by the in-charge or the engagement partner before any significant work takes place on the engagement. The partner should personally present the letter to the client to ensure that a complete understanding has been achieved. The signed copy should be filed with the current engagement's working papers.

4.204 Should the nature of an engagement change during its progress, or should the firm be engaged for additional services during the year, a new engagement letter should be prepared. A step up from a compilation to an audit engagement and a special engagement for preparing a budget and cash flow forecast are examples of changes that would require a new engagement letter.

4.205 Section 4.502 provides an example of an engagement letter appropriate for the audit of an auto dealership.

4.300 AUDIT PLANNING

4.301 Professional standards include many general and specific planning requirements. The two basic requirements to plan engagements are:

(1) The third General Standard of Rule 201 of the AICPA *Code of Professional Conduct* states, "A member shall adequately plan and supervise the performance of professional services."

(2) The first standard of generally accepted auditing standards (GAAS) requires that "the work is to be adequately planned and assistants, if any, are to be properly supervised."

4.302 SAS No. 22, *Planning and Supervision* (AU 311), provides specific guidance to the independent auditor performing an audit in accordance with GAAS, including developing an audit program and obtaining an understanding of the client's operations. Many other SASs also require consideration of matters such as potential misstatements, continued existence of the entity, accounting estimates, obtaining an understanding of the internal control structure, and preliminary materiality.

4.303 Audit planning is also affected by the following AICPA auditing standards:

1. SAS No. 22, *Planning and Supervision*
2. SAS No. 31, *Evidential Matter*
3. SAS No. 39, *Audit Sampling*
4. SAS No. 41, *Working Papers*
5. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*
6. SAS No. 48, *The Effects of Computer Processing on the Audit of Financial Statements*
7. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
8. SAS No. 54, *Illegal Acts by Clients*
9. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*
10. SAS No. 56, *Analytical Procedures*
11. SAS No. 57, *Auditing Accounting Estimates*
12. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
13. SAS No. 67, *The Confirmation Process*

14. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*
15. SAS No. 73, *Using the Work of a Specialist*

4.304 Achieving both engagement quality and profitability requires extensive planning. Engagement planning should begin well before field work begins and continue until completion of the engagement. The engagement partner should be involved at strategic times during the planning, performance, and completion of an engagement. Early and frequent partner involvement in program design and in related judgment decisions will help develop the in-charge and other staff personnel, will identify problems timely, and will contribute to a high-quality, profitable engagement.

4.305 Effective planning for audits of auto dealerships generally involves the following five basic audit planning activities:

1. Obtain an understanding of the client's internal control structure.

2. Determine the level of overall engagement risk, the risk of potential misstatements, and the overall materiality limit.

3. Make judgments about the staffing of the engagement, the extent of supervision and the degree of professional skepticism.

4. Decide on the most cost-beneficial audit approach based on the risk assessment and materiality decisions.

5. Determine the nature of the service to be rendered (for example, an audit, the preparation of tax returns, etc.).

Obtain an Understanding of the Internal Control Structure

4.306 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, requires that auditors obtain an understanding of the client's internal control structure sufficient to plan the audit. Paragraph 16 of SAS No. 55 (AU 319.16) states:

> The auditor should obtain a sufficient understanding of each of the three elements of the entity's internal control structure [the control environment, accounting system, and control procedures] to plan the audit of the financial statements. The understanding should include knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to —
>
> - Identify types of potential misstatements.
> - Consider factors that affect the risk of material misstatements.
> - Design substantive tests.

Completion of the Internal Controls Questionnaire in Chapter 6, section 6.100, or the All-Substantive Approach Questionnaire in Chapter 5, section 5.603, provides a basis for obtaining an understanding of the client's internal control structure sufficient to plan the audit.

Assess Risk

4.307 Overall Engagement Risk. Overall engagement risk has the following primary components:

- Integrity of management.
- Use of financial statements.
- Auditability of the entity.
- Business environment.

4.308 Overall engagement risk will subjectively affect the desired level of assurance in the financial statements taken as a whole. Specifically, it will affect the acceptable levels of risk of incorrect acceptance and risk of assessing control risk too low in the substantive tests of balances and tests of controls sample size determinations.

4.309 Evaluating overall engagement risk as high or low will result from considering each component. The rationale behind the evaluation should be documented in the Audit Planning Memorandum illustrated in section 4.506.

4.310 Integrity of Management. SAS No. 58, *Reports on Audited Financial Statements,* states, "The financial statements are the responsibility of management." SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, states, "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty." SAS No. 53 also states, "Management integrity is important because management can direct subordinates to record transactions or conceal information that can materially misstate financial statements."

4.311 The integrity of management should be evaluated as part of the client acceptance or continuance decision and noted on the Client Acceptance and Continuance Form, section 4.501. Approval of this Form by designated partners is an indication that the integrity of management is considered adequate and that no circumstances have come to their attention that would require special auditing procedures to detect and report errors and irregularities or illegal acts.

4.312 Any significant matters related to management's integrity that arise during the planning or performance of the audit should be documented in a special memorandum containing a description of:

1. The matters designated for further consideration.
2. The risk of material misstatement in the financial statements.
3. The additional or changed auditing procedures considered necessary to mitigate such risks.
4. The results of performing such procedures and their effect on the auditor's reports.

4.313 Use of Financial Statements. The risk associated with the use of audited financial statements is usually high because the auditor cannot control their ultimate distribution or the purposes for which users rely on them. The risk is even higher in circumstances such as the following:

- Statements are used in legal proceedings.
- Statements are used to demonstrate compliance with restrictions in notes or other debt.
- Statements are used for obtaining credit.
- Statements are used for price-setting in purchases, sales or mergers.

4.314 The expected use of financial statements should be documented annually on the Client Acceptance and Continuance Form.

4.315 Auditability of the Entity. A firm should consider the auditability of the entity prior to deciding whether to accept or retain a client. Although a potential client may request an audit and users of the financial statements may require an audit, certain factors may preclude an auditor from being able to express an opinion on the financial statements.

4.316 If a client's accounting system does not provide sufficient evidence to support the recorded transactions, or if the client's accounting records have been destroyed or lost, the entity may be unauditable.

4.317 For a new client, auditability can usually be determined through discussions with management and the predecessor auditor or accountant. The auditor should inquire as to the accounting system and how management determines that the policies and procedures for processing financial information are followed. For a continuing client, auditability is determined by discussions with management as well as through prior experience.

4.318 Business Environment. The auditor should also consider the business environment in which the client operates. For example, is the dealership operating in a depressed local economy or facing increased competition? All of these concerns should be addressed when an auditor decides to accept or retain a client.

Risk of Potential Misstatements

4.319 The risk that potential misstatements will occur results primarily from weaknesses in the internal control structure, inherent risks in certain transactions or account balances, material and unusual account balances, and the dealership's history of misstatements. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* refers to these risks as inherent and control risks. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* refers to errors and irregularities as unintentional and intentional misstatements of financial statements, respectively. These risks are evaluated and documented on the following forms, which are included in Chapters 5 and 6 of this Manual:

- ABC System: Internal Controls Questionnaire, Planning Matrix, Risk of Potential Misstatements Evaluation Form, and Tests of Controls Programs.

- All-Substantive Approach: All-Substantive Approach Questionnaire and Tests of Controls Programs (System C).

4.320 The level of risk of potential misstatements will directly affect the desired level of assurance in the affected transaction or balance. High risk requires a higher level of assurance which requires more evidence. Low risk means less evidence is necessary.

4.321 Errors and Irregularities. SAS No. 53 (AU 316) requires auditors to assess the risk that errors and irregularities that have a material effect on the financial statements could occur, and to design and perform the audit to obtain reasonable assurance that such errors and irregularities will be detected during the audit. It also discusses the impact of errors and irregularities on the auditor's report, and the auditor's requirement to communicate errors and irregularities to the audit committee or its equivalent.

4.322 Paragraph 2 of SAS No. 53 (AU 316.02) defines errors as "*unintentional* misstatements or omissions of amounts or disclosures in financial statements." In paragraph 3 (AU 316.03), irregularities are defined as "*intentional* misstatements or omissions of amounts or disclosures in financial statements." Because irregularities are intentional (and, as a result, may involve forgery or collusion), they are usually more difficult to detect than errors.

4.323 Because auditors' opinions are based on the concept of reasonable assurance, they cannot guarantee that financial statements are free from material misstatements due to errors and irregularities. However, they must exercise due care in planning, performing, and evaluating the results of the audit and must apply the appropriate level of professional skepticism to achieve reasonable assurance that the material errors and irregularities will be detected.

4.324 As part of audit planning, auditors should assess the risk that errors and irregularities may cause the financial statements to be materially misstated. The auditor's concern about the risk of material misstatements is either heightened or mitigated by the auditor's understanding of the internal control structure.

4.325 SAS No. 53 (AU 316.10) cites a number of management, operational, industry, and engagement characteristics that might cause the auditor to believe that there is an increased risk that material errors and irregularities could occur. Several of these characteristics, as they apply to auto dealerships, are listed below:

- Operating and financing decisions are dominated by a single person.
- The auto industry in general is declining, with many dealerships failing.
- The dealership operates in a declining geographical area where developmental, traffic pattern, and safety considerations contribute to declines in sales volume and gross profit.
- Many contentious or difficult accounting issues are present.
- Significant and unusual related-party transactions or balances are present.
- A large number of complex laws and regulations have a direct and material effect on the financial statements. (Examples would include a sudden increase in luxury tax, import tax, or "gas guzzler" tax.)

- Internal or external matters exist that raise substantial doubt about the dealership's ability to continue as a going concern.
- Profitability of dealership relative to the industry is inadequate or inconsistent.

4.326 Completing or updating the Client Acceptance and Continuance Form (section 4.501), the Audit Planning Memorandum (section 4.506), the Internal Controls Questionnaire (Chapter 6, section 6.100), the Risk of Potential Misstatements Evaluation Form (Chapter 5, section 5.601), and the All-Substantive Approach Questionnaire (Chapter 5, section 5.603) provide a basis for assessing the risk that material errors and irregularities could occur.

4.327 Design of the Audit. Based on this assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that could have a material effect on the financial statements. This strategy might involve placing more experienced staff on the engagement, increasing supervision and review of assistants' work, testing more items, performing procedures on year-end rather than on interim balances, or modifying the nature of auditing procedures to obtain more reliable evidential matter.

4.328 Evaluating the Audit Test Results. Auditors are accustomed to evaluating the impact of differences between the client's accounting records and the auditor's findings. This evaluation is emphasized in SAS No. 53 because irregularities have implications beyond their direct monetary effects.

4.329 SAS No. 53 requires that when the auditor concludes that a potential audit adjustment is related to an irregularity, but is not material to the financial statements, he or she should refer the matter to at least one level of management above those involved in the irregularity, and should be satisfied that the irregularity has no implications on other aspects of the audit. An example of an irregularity that would generally not be material to the financial statements is a misappropriation of petty cash.

4.330 If the auditor believes that the irregularity is or could be material to the financial statements, he or she should:

1. Consider the implications for other aspects of the audit.
2. Discuss the matter and the approach to further investigation with an appropriate level of management at least one level above those involved.
3. Attempt to obtain sufficient competent evidential matter to determine whether, in fact, material irregularities exist and, if so, their effect.
4. If appropriate, suggest that the client consult with legal counsel on matters concerning questions of law.

4.331 Effect of Irregularities on the Auditor's Report. If financial statements affected by a material irregularity are not revised, the auditor should express either a qualified or adverse opinion, explaining all substantive reasons for the opinion. If the auditor is unable to perform necessary auditing procedures related to the irregularity, or if the auditor is unable to reach a conclusion about the financial statement effect of the irregularity, he or she should issue a disclaimer of opinion, or a qualified opinion due to a scope limitation. If management refuses to accept a modified auditor's opinion due to an irregularity, the auditor should withdraw from the audit. In any event, the auditor should ensure that matters involving errors and irregularities are communicated to the audit committee or its equivalent.

Illegal Acts

4.332 SAS No. 54, *Illegal Acts by Clients* (AU 317), prescribes the nature and extent of consideration an auditor should give to the possibility that the client has committed illegal acts, and also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

4.333 Paragraph 2 of SAS No. 54 (AU 317.02) defines illegal acts as "violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity." Determining whether an act is illegal is normally beyond the auditor's professional competence and would generally be based on an attorney's advice or on the findings of a court of law.

4.334 Of key importance to applying SAS No. 54 is an understanding of the difference between direct and indirect effects of laws and regulations. Direct-effect laws and regulations are those that affect financial statement line items (e.g., tax laws). Indirect-effect laws and regulations are those that relate more to the dealership's operations than to its financial statements, such as occupational safety and health and equal employment. While violations of these laws do not directly affect financial statement line items, they can result in monetary fines, penalties, and damages that could require adjustment to or disclosure in the financial statements. Understanding these two concepts is important because the auditor's responsibilities to detect and report direct-effect laws and regulations in a GAAS audit are different from the responsibilities to detect indirect-effect laws and regulations. Specifically, the auditor's responsibility to detect misstatements from illegal acts that have a direct and material effect on the financial statements is governed by SAS No. 53. SAS No. 54 specifies the auditor's responsibilities regarding illegal acts related to indirect-effect laws and regulations (hereinafter called simply "illegal acts"). Section 2.600 of Chapter 2 provides a summary of the types of federal, state, and local regulations that auto dealerships must be aware of.

4.335 SAS No. 54 does not require the auditor to design tests to detect illegal acts; however, the auditor must be aware that illegal acts may have occurred and must perform certain audit procedures to confirm the existence of illegal acts if such specific evidence is discovered. The Statement indicates that the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. If information provided by management is insufficient to determine whether an illegal act has occurred, the auditor should:

- Consult with the client's attorneys or other specialists about the application of laws and regulations relevant to the circumstances, and the possible effects on the financial statements.
- Apply additional procedures, if necessary, to obtain further understanding of the nature of the act.

4.336 If the auditor concludes that an illegal act has occurred, he or she must consider the implications (both qualitative and quantitative) of the illegal act on the auditor's report and the financial statements. Improper accounting or inadequate disclosure of a material illegal act could result in a qualified or adverse opinion. If the auditor is unable to obtain sufficient competent evidential matter about a possible illegal act, he or she would generally disclaim an opinion on the financial statements. If the client refuses to accept a modified auditor's report in these situations, the auditor should consider withdrawing from the engagement, and should communicate the reasons for withdrawal to the audit committee or its equivalent.

Make Preliminary Judgment About Materiality Levels

4.337 Overall Materiality. Under SAS No. 22, auditors are required to plan their audits to provide reasonable assurance that material misstatements will be detected. In meeting this requirement, auditors should establish a preliminary materiality threshold for the purpose of planning the appropriate auditing procedures to detect material misstatements in the financial statements.

4.338 Materiality Table. Obviously, quantifying the materiality level is a matter of professional judgment. Most auditors of auto dealerships base the preliminary materiality level on a percentage of some component of the client's financial statements, generally the greater of total assets or total revenues. The following is a suggested scale that may be used in making a preliminary judgment about materiality.

Materiality Base — Greater of Total Assets or Total Revenues		Percentage of the base
Over	**But Not Over**	
$ 0	$ 30,000	6.00%
30,000	100,000	$ 1,800 + 5.00% in excess of $ 30,000
100,000	300,000	$ 5,300 + 3.00% in excess of $ 100,000
300,000	1,000,000	$ 11,300 + 2.00% in excess of $ 300,000
1,000,000	3,000,000	$ 25,300 + 1.50% in excess of $ 1,000,000
3,000,000	10,000,000	$ 55,300 + 1.00% in excess of $ 3,000,000
10,000,000	30,000,000	$125,300 + 0.50% in excess of $ 10,000,000
30,000,000	100,000,000	$225,300 + 0.25% in excess of $ 30,000,000
100,000,000	300,000,000	$400,300 + 0.20% in excess of $100,000,000
300,000,000	—	$800,300 + 0.15% in excess of $300,000,000

4.339 As an illustration of the application of the table,[1] assume that an auto dealership has total assets of $5,642,000 and total revenues of $18,442,000. Using the larger materiality for planning purposes would be calculated as follows:

$$\$125{,}300 + [(18{,}442{,}000 - 10{,}000{,}000) \times .0050] = \$167{,}510$$

[1] Subscribers to the 1994 edition of this Manual will notice that changes have been made to this table. These changes were made to better reflect the amounts and percentages used in current practice, and will result in lower materiality thresholds.

4.340 Because many audits are begun prior to year end, it is often necessary to estimate the financial statement bases (total assets and total revenue) for use in calculating planning materiality. Usually these estimates are made based on the dealership's year-to-date results, and considering any audit adjustments that are likely to be made. Audit adjustments from the prior period are often good predictors of adjustments that will be necessary in the current year.

4.341 Considering Adjustments to the Financial Statement Base. The materiality percentages presented above are those some firms use for audits of commercial businesses. Because of the unique aspects of the financial statements of auto dealerships, the authors recommend that the auditor consider some adjustments to these bases. For example, revenues in an auto dealership can be very large, while gross margin and pre-tax income are normally very low in comparison. In such circumstances the auditor may consider judgmentally reducing the base.

4.342 Some auto dealerships report much smaller amounts of one financial statement base than another. Such a dealership might have total assets of $10,000,000, and total revenue of $80,000,000. Use of total revenues in the sliding scale above would result in a preliminary materiality judgment of $350,300, which might lead to the conclusion that few things on the balance sheet are material. On the other hand, a materiality calculated on the total assets base would be $62,300.

4.343 In these cases, the authors believe that using the larger of total assets or total revenue may still be appropriate. However, the auditor may want to consider reducing overall materiality somewhat to reflect the extreme difference between the two financial statement bases. As a matter of judgment, the auditor may consider adjusting the materiality to an amount that a creditor or other financial statement user would consider material. For instance, in a situation like that noted above (in which total assets are considerably less than total revenues), a reduction in the calculated overall materiality may be appropriate if there are significant assets that are used as collateral on loans.

4.344 Using the Materiality Computation Form. A Materiality Computation Form is in section 4.507. This schedule should be used to compute the overall materiality limit, the basic allowance for unknown misstatements to be used in substantive tests of balances sampling, and the lower limit for individually significant items. The lower limit for individually significant items can be used to determine immaterial sampling populations and account balances for which no auditing procedures are necessary.

4.345 The overall materiality limit should be entered on the Summary of Possible Journal Entries Form (Chapter 10, section 10.904) during engagement planning. It is general guidance, rather than absolute and represents the allowance for both known and unknown misstatements. Known and unknown misstatements are considered to comprise 100% of the overall materiality limit; known misstatements being 1/3 and unknown misstatements being 2/3. The rationale used to establish engagement materiality limits should be documented on the Materiality Computation Form (section 4.507) and in the Audit Planning Memorandum (section 4.506).

Staff the Engagement and Plan for Supervision

4.346 As part of the planning process, the auditor should ensure that persons who work on an auto dealership audit possess the appropriate technical training and proficiency. SQCS No. 1 states the basic quality control requirement for assigning personnel to engagements:

> Policies and procedures for assigning personnel to engagements should be established to provide the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. In making assignments, the nature and extent of supervision to be provided should be taken into account. Generally, the more able and experienced the personnel assigned to a particular engagement, the less is the need for direct supervision.

4.347 The following should be considered in making assignments of individuals to auto dealership engagements:

- Staffing and timing requirements of the specific dealership engagement.
- Evaluation of qualifications of personnel regarding experience, position, background, and special expertise.
- The planned supervision and involvement by supervisory personnel.
- Projected time availability of individuals to be assigned.
- Situations where independence problems and conflicts of interest may exist or may appear to exist, such as assignment of personnel to engagements for clients who are former employers or are employers of certain kin.
- Continuity of personnel to provide an efficient audit, balanced against rotation of staff to provide other personnel with different experience.

4.348 Supervising personnel on an engagement is an ongoing process. However, at the initial planning stage of the engagement, supervision of personnel requires developing realistic estimates of the time that will be needed to perform and review the staff's work. Use of budgeting and time control documents facilitate effective engagement supervision and management. Although not required by professional standards, budget and time control analyses can help improve engagement profitability by identifying problems and inefficiencies early. Staff time should be recorded weekly on the Time Accumulation Sheet (section 4.503), with total engagement time summarized on the Time Summary Form (section 4.504) and compared to budget. These documents have been designed for use in all auto dealership audit engagements in excess of 40 hours. Used consistently, they can make staff more conscious of the efficient use of time and improve their performance.

4.349 For budgets to benefit the firm and engagement personnel, they must first be realistically prepared. Budgets must be based on engagement circumstances, not on fees. All time spent on engagements must be charged to the client and entered on the Time Accumulation Sheet in section 4.503. At the completion of the engagement, the Time Accumulation Sheet should be reconciled to the Time Summary Form in section 4.504 and to the firm's billing records. If the staff becomes aware of ways to reduce audit time in the future, the suggestions should be noted on the Summary of Time Savings for Next Year Form found in section 4.505.

Decide on the Most Cost-Beneficial Audit Approach

4.350 Two audit approaches are presented in this Manual: the ABC System and the All-Substantive Approach. The ABC System should be used if the dealership has a good accounting system and strong control procedures. This system allows the auditor to assess control risk at below the maximum for each major audit area, and to design an audit strategy that achieves the appropriate mix of tests of controls, analytical procedures, and tests of details. It also provides for testing at interim dates.

4.351 Under the ABC System, completion of the following documents helps the auditor develop a cost-beneficial audit approach:

- The Client Acceptance and Continuance Form and the Audit Planning Memorandum, which require the auditor to inquire about situations that could affect the audit approach.
- The Internal Controls Questionnaire, which provides an understanding of the dealership's control structure and a preliminary decision about the assessed level of control risk.
- The Risk of Potential Misstatements Evaluation Form, which is used to assess the risk that errors and irregularities could occur.
- The Planning Matrix, which combines the findings from the above forms and results in an audit strategy (that is, nature, timing, and extent of tests) for each major audit area.

4.352 The All-Substantive Approach should be used on engagements for which a substantive approach is the most cost-beneficial. Under this approach, control risk is assessed at the maximum (or slightly below the maximum) and no or little reliance is placed on tests of controls. This approach requires that all testing be done as of the balance-sheet date.

4.353 Completion of the following forms will help the auditor plan the most cost-beneficial approach under the All-Substantive Approach:

- The Client Acceptance and Continuance Form and the Audit Planning Memorandum, which require the auditor to obtain information about situations that could affect the audit approach.
- The All-Substantive Approach Questionnaire, which provides an understanding of the dealership's control structure and an evaluation of the risk of potential misstatements.

Perform Analytical Procedures

4.354 SAS No. 56, *Analytical Procedures* (AU 329), provides that analytical procedures be used for the following three purposes:

- In the planning stage, to plan the nature, timing, and extent of other auditing procedures.
- As a substantive test, to obtain evidential matter about financial statement assertions.
- In the final review stage, as an overall review of the financial information.

4.355 The purpose of analytical procedures performed during the planning stage of an audit is to identify unusual transactions or events and any areas that represent specific risks, so that the auditor can plan an appropriate audit strategy, i.e., the appropriate nature, timing, and extent of tests.

4.356 Analytical procedures performed during planning are often very simple. For example, they may include few or all of the following:

- Review of fluctuations in account balances using the current and prior year's trial balances.
- Review of trends or other information contained in interim or manufacturers statements such as sales volume in units of new and used cars, repair orders, body shop volume, etc.
- Scan of ledgers and journals noting large or unusual appearing items.
- Identify unusual or unexpected balances or relationships.

The auditor should customize analytical procedures to suit the specific engagement being performed.

4.357 The auditor should document the procedures and results of the planning analytical procedures performed in the Audit Planning Memorandum in section 4.506, and communicate his or her observations to the audit team. Further audit testing should be modified based on the results of the analytical procedures performed. The auditor should also document any modification of audit testing as a result of planning analytical procedures. Analytical procedures performed as a substantive test and at the final review stage are discussed in Chapters 7 and 10, respectively.

4.400 DOCUMENTING AUDIT PLANNING DECISIONS

4.401 The Audit Planning Memorandum in section 4.506 is the culmination of the planning process and should be prepared for all audit engagements for auto dealerships. It is critical to achieving both engagement quality and profitability. The Memorandum should be prepared by the engagement in-charge and approved by the engagement partner before engagement personnel begin field work. It can be prepared using the form in section 4.506 or in a handwritten or typed narrative.

4.402 The Audit Planning Memorandum is comprised of Section I, Engagement Administration, and Section II, Technical Audit Planning Decisions. A few words about section subheadings follow:

I. A. Presentation of Engagement Letter

The engagement letter is a primary tool for obtaining client understanding of the firm's and client's responsibilities. A good understanding before the engagement begins can prevent misunderstandings later. To gain a good understanding, the engagement partner should deliver the letter and discuss its contents with the dealership's owner, manager, or audit committee (or persons of equivalent authority, such as the board of directors).

I. B. Use of Client Assistance or Paraprofessionals

The schedule attached to the Client Acceptance and Continuance Form lists possible areas of client assistance. Client assistance should be used to the maximum extent possible on every engagement. When client personnel are unavailable, the use of firm paraprofessionals to perform any necessary accounting services and clerical work in connection with the engagement should be considered.

I. C. Planning for Proper Work Space and Equipment

The engagement in-charge has responsibility for arranging adequate work space before the field work begins. Poor lighting, lack of adequate heat or air conditioning, desks or tables that are too small, or work locations that are not near client accounting personnel are examples of situations that hinder the efficient completion of an engagement.

I. D. Assignment of Staff

A basic element of a good quality control system is assigning personnel to engagements and to tasks that are commensurate with their capabilities. Assigning the right people to engagements also helps complete the engagements in the minimum amount of time.

Whenever possible, the prior year's engagement personnel should be reassigned and rotated to new positions on the engagement each year. When reassignment is not possible, an attempt should be made to assign new staff with experience with auto dealerships. When inexperienced personnel, or personnel unfamiliar with auto dealerships, are assigned to an engagement, the in-charge or partner is responsible for providing appropriate training.

I. E. Target Dates

Setting target dates during planning is the first step to achieving timely engagement completion. These target dates should also become the input to the firm's staff scheduling system.

I. F. Use of Specialists

The firm should consider using outside specialists whenever audit procedures require knowledge or skills beyond the auditing firm's expertise. Such areas may include actuarial computations for pension funds, questions of law, or audits designed using clients' EDP systems. Guidance on using the work of a specialist is included in Chapter 7.

I. G. Use of Audit Software

Audit software should be used to the maximum extent practical on all engagements. This section should list the specific, planned applications.

I. H. Audit Budget

The audit budget should be prepared, at least tentatively, prior to beginning field work. The budget should be based on circumstances, not on fees. The budget documents should be summarized in this section for discussion with the partner.

I. I. Other Special Considerations

This section is provided to document any significant engagement administration circumstances or problems not covered above.

II. A.-F. Technical Audit Planning Decisions

Each section should present the results of the decisions, as well as the rationale, or judgments, behind them. Detailed computations or explanations should be either included or incorporated by reference to other working papers or forms. Section II. E. must include documentation about the assessed level of control risk if control risk is assessed at below the maximum.

II. G. Planning Analytical Procedures

Analytical procedures used in planning the audit should focus on enhancing the auditor's understanding of the client's operations and transactions and events that have occurred since the last audit, and on identifying areas that may present significant audit risks. Such procedures range from reviewing changes from the prior year to the current year's working trial balances, to more extensive analyses using monthly manufacturer statements, and other industry data that may be available.

II. H. Other Special Considerations

Special risks of misstatements, irregularities, illegal acts, or any other accounting or auditing problems discovered during planning, should be discussed in this section. The situation, its possible impact on financial statements, and the planned modification of auditing procedures should be detailed for consideration and approval by the partner.

4.500 DOCUMENTATION ASSISTANCE

4.501

Client Acceptance and Continuance Form—Part I
Auto Dealerships

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

Part I: Part I of this form should be completed for all prospective clients for which an audit is to be performed. This Form should be completed by the in-charge and approved by the engagement partner as a basis for initially accepting the client. Part I should be updated and reviewed annually as a basis for deciding to retain the client.

Part II: Part II of this Form should be completed by the engagement partner and concurring partner to document the firm's decision to accept or reject the client.

CLIENT'S LEGAL NAME:

ADDRESS:

PHONE:

FEDERAL I.D. NO.:	STATE I.D. NO.:

1. Describe the nature of the client's business (and locations, if other than above address):

2. Circle the type of entity (corporation, proprietorship, partnership, LLC, or S corporation).

3. List key owners, officers, and directors of the client:

Name	Percent Owned	Position	Family Relationship

4. Identify any related businesses or individuals:

Name	Nature of Relationship

5. Identify the client's predecessor accountants:

Name:
Address:
Phone:
Contact Person:

6. Indicate the results of our inquiries of the predecessor accountant regarding the following:

a. Reasons for change of accountant: ______________________

____

b. Integrity of management and owners: ______________________

____

c. Disagreements on accounting principles and auditing procedures: ______________________

____

____

d. Fee disputes: ____

____

7. Describe the client's relationships with financial institutions: ____________________

____

____

Institution	Type of A/C's or Loans	Account Executive & Phone

Results of inquiries: ____

____

8. Describe the services to be provided: ____

____

____

Service	How Often? Monthly	Quarterly	Annually	Report Deadlines

9. Will the financial statements and reports be used for high-risk purposes, e.g., reports to financial institutions, to obtain or renew significant amounts of credit, or for sale of the business? If so, describe the use of the financial statements: ____

10. Read the latest financial statements and tax returns and indicate findings:

11. Does the client have potential going-concern problems? If so, describe them: ____________________

12. Identify the client's legal counsel:

Name:
Address:
Phone:
Contact Person:

Results of inquiries: ____________________

13. State name(s) of other third parties contacted concerning management's and owners' reputation, attitude, ability, integrity, and results of inquiries:

14. Describe any significant engagement performance, accounting, or tax problems with which we should be concerned:

15. Describe any pending litigation against the client or its principals:

16. Describe the fee/billing arrangements:

17. Describe any potential independence problems with respect to the client:

18. Describe any other major changes not mentioned above since our last evaluation of this client. Also describe any other matters that have come to our attention that would have caused us to reject the client had we been aware of them at the time of our initial acceptance of this client:

	19____	19____	19____	19____	19____
Prepared or updated by: In-Charge	______	______	______	______	______
Reviewed by: Engagement Partner	______	______	______	______	______

Client Acceptance and Continuance Form—Part II
Auto Dealerships

Client: ______________________________

Financial Statement Date: ______________________________

	Yes	No
1. Is there any reason to doubt the integrity of management (owners)?	☐	☐
2. Are we aware of any significant disagreements between management or owners and the predecessor accountant?	☐	☐
3. Does there appear to be any potential fee collection problems?	☐	☐
4. Are the client's needs beyond our capabilities or staffing abilities?	☐	☐
5. Are we aware of any independence problems that may affect our ability to meet the client's needs?	☐	☐
6. Are there high-risk factors related to the engagement that may affect our decision to accept the client?	☐	☐
7. Is there a potential problem with management or owners not fully understanding the limitations of the services to be provided (e.g., for the detection of fraud)?	☐	☐

For any "Yes" answers, explain how we plan to mitigate the problem (for example, by assigning more experienced personnel to the engagement, using outside consultants, obtaining a retainer from the client, etc.):

Acceptance Decision:

Yes ______ No ______

Engagement Partner: ______________________________ Date: ______________

Concurring Partner: ______________________________ Date: ______________

4.502 SAMPLE ENGAGEMENT LETTER — AUDIT OF FINANCIAL STATEMENTS

[CPA Firm Letterhead]

[Date]

____
____
____

This will confirm our understanding of the arrangements for our audit of the financial statements of ________________________ [name of dealership], for the year ended ________ [financial statement date].

We will audit the dealership's balance sheet at _________ [financial statement date], and the related statements of income, retained earnings and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the dealership's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit in order to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventories, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations or other irregularities. However, we will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to our attention.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

As part of our engagement for the year ending ________ [financial statement date], we will also prepare the following federal and state income tax returns for _________ [name of dealership]:

____

____

____

____

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fees for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

We are pleased to have this opportunity to serve you.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

[Partner's Name]
[Firm's Name]

Acknowledged:

____

[Client Representative's Name]

____

[Title]

____

[Date]

4.503

Time Accumulation Sheet

Client: ______________________

Financial Statement Date: ______________________

ACTUAL HOURS AND DATE

WORK AREAS	Budget						Sub-total						Sub-total						Total
Planning & administration																			
Internal control structure																			
Cash																			
Investments																			
Receivables																			
Inventories																			
Other assets																			
Property & equipment																			
Notes & loans payable																			
Payables & accruals																			
Income taxes																			
Other liabilities																			
Equity																			
Revenues																			
Expenses																			
Commitments, contingencies, & subsequent events																			
Related parties																			
Trial balance & adjustments																			
Supervision & review																			
Management letter																			
Report preparation																			
TOTAL																			

4.504

Time Summary Form

Client: ______________________

Financial Statement Date: ______________________

	Budgeted Hours					Actual Hours					Actual Over
	Asst.	I/C	Mngr.	Ptnr.	Tot.	Assist.	I/C	Mngr.	Ptnr.	Tot.	(Under)*
Planning & administration											
Internal control structure											
Cash											
Investments											
Receivables											
Inventories											
Other assets											
Property & equipment											
Notes & loans payable											
Payables & accruals											
Income taxes											
Other liabilities											
Equity											
Revenues											
Expenses											
Commitments, contingencies, & subsequent events											
Related parties											
Trial balance & adjustments											
Supervision & review											
Management letter											
Report preparation											
TOTAL											

* Attach memorandum explaining significant variances.

4.505

Summary of Time Savings for Next Year

Client: ______________________________

Financial Statement Date: ______________________________

SAVINGS SUGGESTIONS

4.506

Audit Planning Memorandum

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This memorandum should be completed for all audit engagements by the in-charge and reviewed by the engagement partner, before engagement personnel begin field work.

I. ENGAGEMENT ADMINISTRATION

A. Presentation of Engagement Letter

____
____
____
____
____

B. Use of Client Assistance or Paraprofessionals

____
____
____
____
____

C. Planning for Proper Work Space and Equipment

____
____
____
____
____

D. Assignment of Staff

____
____
____
____

E. Target Dates

Audit report	__________
Management letter	__________
Tax returns	__________
Start of interim field work	__________
Start of year-end field work	__________
Other	__________

F. Use of Specialists

____

____

____

____

G. Use of Audit Software

____

____

____

____

H. Audit Budget

____

____

____

____

I. Other Special Considerations

____

____

____

____

____

II. TECHNICAL AUDIT PLANNING DECISIONS

A. Overall Engagement Risk

____

____

____

____

____

B. Understanding of Internal Control Structure

C. Overall Materiality Limit

D. Sampling

E. Audit Approach

F. Key Engagement Area(s)

G. Planning Analytical Procedures

H. Other Special Considerations

Prepared by: ______________________ Date: ______________
(In-Charge)

Reviewed by: ______________________ Date: ______________
(Partner)

4.507

Materiality Computation Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be completed by the in-charge during planning and approved by the partner before field work is started.

I. Overall Materiality Limit Computation:

Approximate balances at or near financial statement date:

A. (Total Assets - A) × C + B = D ______________

B. (Total Revenue - A) × C + B = E ______________

Overall Materiality Limit = Greater of D or E ______________

Materiality Base — Greater of Total Assets or Total Revenues		Percentage of the base		
Over	**But Not Over**			
A		**B**	**C**	
$ 0	$ 30,000		6.00%	
30,000	100,000	$ 1,800	+ 5.00% in excess of	$ 30,000
100,000	300,000	$ 5,300	+ 3.00% in excess of	$ 100,000
300,000	1,000,000	$ 11,300	+ 2.00% in excess of	$ 300,000
1,000,000	3,000,000	$ 25,300	+ 1.50% in excess of	$ 1,000,000
3,000,000	10,000,000	$ 55,300	+ 1.00% in excess of	$ 3,000,000
10,000,000	30,000,000	$125,300	+ 0.50% in excess of	$ 10,000,000
30,000,000	100,000,000	$225,300	+ 0.25% in excess of	$ 30,000,000
100,000,000	300,000,000	$400,300	+ 0.20% in excess of	$100,000,000
300,000,000	—	$800,300	+ 0.15% in excess of	$300,000,000

Rationale for overall materiality limit (if other than the larger of above computations):

____

____

____

____

____

II. Basic Allowance for Unknown Misstatement Computation:

For nonstatistical sampling applications, the basic allowance can be used in place of tolerable misstatement amount. If used in the table approach or model approach, it should also be considered when comparing total actual, projected and estimated misstatement to the final financial statement amounts.

Overall materiality limit from above	$ ________
Less estimated known misstatement from sampling and nonsampling tests (e.g., 1/3 of overall materiality)	________
Basic allowance for unknown misstatement	$ ________

III. Individually Significant Items — Computation of Lower Limit:

The lower limit for individually significant items will usually be set at 1/3 of the basic allowance. Individually significant items may also be determined judgmentally for each sampling application. The rationale for such judgmentally determined limits should be explained at the bottom of the page.

Lower limit for individually significant items $ ________

Rationale for lower limit:

____

____

____

____

____

____

This uniform lower limit will normally be used for determining individually significant items to derive sampling populations and for determining sampling populations and account balances that are not material which can be excluded from testing.

If different lower limits are used for certain accounts, or for such procedures as sales and purchases cutoff tests and search for unrecorded liabilities, the reasons for their use should be documented below:

____

____

____

____

____

____

____

Audit Approach

CHAPTER 5

THE AUDIT APPROACH: THE ABC SYSTEM OR THE ALL-SUBSTANTIVE APPROACH

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THE AUDIT APPROACH: THE ABC SYSTEM OR THE ALL-SUBSTANTIVE APPROACH

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THE AUDIT APPROACH: THE ABC SYSTEM OR THE ALL-SUBSTANTIVE APPROACH

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CHAPTER 5

THE AUDIT APPROACH: THE ABC SYSTEM OR THE ALL-SUBSTANTIVE APPROACH

5.000 INTRODUCTION AND OVERVIEW OF AUDIT APPROACHES

5.001 This Manual presents practical assistance to all auditors of auto dealerships, whether the auditors develop their own forms, questionnaires, programs, and workpapers, or whether they use those provided throughout this Manual.

5.002 This chapter, however, presents a unique approach (the ABC System) to audit planning and performance—an approach designed specifically to minimize substantive testing and thereby maximize engagement profits. It also provides an alternative approach (the All-Substantive Approach) which is used when performing all substantive testing is more efficient than performing tests of controls.

5.003 Also included in this chapter is sampling guidance for performing tests of controls and tests of details.

Overview of ABC System

5.004 The ABC System is a unique approach to planning and performing the audit, in that it is designed to allow the auditor to assess the control risk for each of the major audit areas of a dealership, and to provide the auditor with the tests of details, tests of details, and analytical procedures most likely to be relevant to each major audit area.

5.005 The ABC System is based on the assumption that the auditor will desire to place as much reliance on the client's internal control structure as possible in order to minimize substantive testing while maintaining high audit quality and complying fully with generally accepted auditing standards.

5.006 The ABC System's Internal Controls Questionnaire (Chapter 6, section 6.100) is organized into three levels of priorities (for each major audit area):

- Those controls necessary to provide the client with an effective basic accounting system (level C),
- Those controls necessary to provide the client with both an effective accounting system and good primary controls (levels B and C acting together), and
- Those controls necessary to provide the client with good secondary controls, as well as good primary controls and an effective accounting system (levels A, B, and C acting together).

5.007 By completing the entire Internal Controls Questionnaire, the auditor can assess the controls for each major audit area. The auditor can then exercise judgment to determine that:

- A major audit area for which all (or substantially all) controls in the A, B, and C levels are present would qualify as an "A System," for which the auditor could assess control risk as low or moderate (which would justify minimizing substantive tests once the controls themselves are tested),
- A major audit area for which all (or substantially all) controls in the B and C (but not the A) levels are present would qualify as a "B System," for which the auditor could assess control risk as moderate to slightly below the maximum (which would justify reducing some substantive tests once the controls are tested), or
- A major audit area for which all (or substantially all) controls in the C level (but not the A and B levels) are present would qualify as a "C System," for which the auditor could assess control risk as maximum to slightly below maximum (which would cause the auditor to perform primarily substantive tests in most cases, even after the controls are tested).

5.008 Illustration 5-1 portrays the interrelationship of control risk and degree of reliance on controls for systems classified as A, B, or C.

5.009 The Manual's programs for tests of controls (Chapter 6, section 6.300) and tests of balances (Chapter 7, section 7.500) are organized according to whether controls over a major audit area are determined to constitute an A System, a B System, or a C System. Each major audit area must be assessed and classified independently from other major audit areas; thus, the payroll cycle may be classified as an A system, the payments and acquisitions cycle may be classified as a B System, and the collections and sales cycle may be a C System. Of course, an auditor must use his or her understanding of the client and the client's industry to customize the precise audit program for an engagement, but the ABC System gives the auditor assistance with determining appropriate and justifiable levels of substantive testing without "overauditing" or "underauditing."

5.010 The ABC System incorporates analytical procedures to the maximum extent possible, whether a system is rated as A, B, or C, in order to obtain the optimal mix of audit evidence for quality and efficiency. The ABC System is discussed further in section 5.100.

Reliance Matrix

5.011 The following Reliance Matrix illustrates the alternative approaches to auto dealership audits outlined in this manual. The approaches can be applied separately by transaction cycle and assume analytical procedures will be applied and relied on to the maximum extent practical.

ILLUSTRATION NO. 5-1

RELIANCE MATRIX

Reliance on Types of Tests Based on Control Risk Assessment

Audit Approach	Control Risk	Tests of Controls	Analytical Procedures	Tests of Details
ABC System:				
System A: Good Internal Control Procedures	Low to Moderate	High Reliance	Maximum Extent Possible	Low Reliance
System B: Good Accounting System and Primary Controls	Moderate to Slightly Below the Maximum	Moderate Reliance	Maximum Extent Possible	Medium Reliance
System C: Good Accounting System	Slightly Below the Maximum to Maximum	Low or No Reliance	Maximum Extent Possible	Slightly less than High to High Reliance
All-Substantive Approach:				
Weak Accounting System or More Efficient Substantive Tests	Slightly Below the Maximum to Maximum	Low or No Reliance	Maximum Extent Possible	Slightly less than High to High Reliance

5.012 There are two ways in which an auditor may come to the decision to assess control risk at the maximum for all major audit areas: elective and forced.

5.013 **Elective Use of the Approach.** If the client's operations and financial statements are noncomplex, an auditor may decide that substantive testing can easily provide all the evidential matter needed to express an opinion on the financial statements. An example might be a used car dealership that does not maintain a parts or service department.

5.014 For this type of client, the auditor may decide to "artificially" assess control risk at the maximum for all major audit areas in order to avoid the inefficient use of audit time to make a detailed evaluation of and to test the internal control structure on which the auditor does not intend to rely.

5.015 This Manual provides an All-Substantive Approach Questionnaire (section 5.403) for the auditor to document his or her understanding of the client's internal control structure. By using this questionnaire, an auditor may bypass the two ABC System steps of completing the entire Internal Controls Questionnaire and performing extensive tests of controls. However, performing limited tests of controls is recommended in order to enhance the auditor's understanding of the internal control structure and the flow of transactions through the accounting system. Completing some or all of the System C Tests of Controls Programs can satisfy these objectives.

5.016 **Forced Use of the Approach.** The auditor does consider controls over each major audit area and determines that control risk in fact should be assessed at maximum, due to absent or faulty controls or due to inadequate compliance with the controls that ostensibly are in place. Such situations would call for the forced use of the All-Substantive Approach, unless or until the auditor determines that the client records are not auditable, which would require a scope limitation or withdrawal from the engagement.

5.017 The All-Substantive Approach is discussed further in section 5.200.

Types of Tests

5.018 In developing an audit strategy, the auditor must consider, among other things, the relative efficiency and effectiveness of the three types of audit procedures—tests of controls, tests of details, and analytical procedures. To help in this determination (which influences the auditor's selection of the ABC System or the All-Substantive Approach), the following sections briefly describe these three types of tests.

Tests of Controls

5.019 When the auditor assesses control risk at below the maximum (such as in a System A or B approach), he or she must perform tests of controls to support the lower assessed level of control risk. Appendix B of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319.67), defines tests of controls as:

> Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial statement assertion.

Examples of tests of controls include inquiries of client personnel, inspection of documents and reports, reperformance and observation of the application of a control policy or procedure. Performing tests of controls to support a lower assessed level of control risk allows the auditor to reduce substantive tests. As a result, before performing tests of controls, the auditor should weigh the relative effort needed to perform the tests of controls against the effort saved by reducing substantive tests. Tests of Controls Programs are included in Chapter 6, section 6.300.

Substantive Tests

5.020 Paragraph 4.11 of the AICPA's Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, states:

> The auditor makes judgments about the nature of substantive tests based on an assessment of the effectiveness and efficiency of the available alternative procedures in detecting material misstatements. The procedures may include substantive analytical procedures, substantive tests of details, or a combination of both. Judgments about the nature, timing, and extent of audit procedures are influenced by the—
>
> - Assessment of the inherent risk of material misstatement.
> - Materiality of transactions and balances.
> - Assessed level of control risk.
> - Amount, volume, and variability of transactions and balances.
> - The effectiveness of other available audit procedures.

5.021 As a result, the assurance an auditor needs from substantive tests (which is based on the assessed level of control risk and tests of controls) is obtained by performing tests of details, analytical procedures, or a combination of both.

5.022 Depending on the nature and extent of the analytical procedures, it may be possible to *substantially* reduce the related tests of details. For example, a reasonableness test of depreciation expense may eliminate detail tests of a client's depreciation schedule. As another example, calculation of units sold times average sales price to predict sales revenues may eliminate the need for further analysis of that account. In both of these cases, a simple analytical procedure may be used to adequately verify all the financial statement assertions for a general ledger account balance. Further tests of those balances may not be necessary.

5.023 Substantive Tests of Details. Whenever control risk is assessed at the maximum level (a substantive audit approach), the auditor will place high reliance on tests of details. Characteristics of highly reliable tests of details are that they are performed at year end rather than at interim dates, the evidence provided by the tests is highly reliable (such as examining supporting documents prepared by a third party rather than internally-prepared documents), and larger sample sizes are selected.

5.024 When the auditor assesses control risk at a moderate or low level and therefore performs tests of controls, the nature, timing, and extent of substantive tests may be changed. The Evidence Matrix in Illustration No. 5-2 shows the impact of the auditor's control risk assessment on the substantive tests of details evidence.

5.025 The Tests of Balances Audit Programs for auto dealerships are included in Chapter 7.

5.026 Analytical Procedures. In most cases, analytical procedures should be performed to the maximum extent possible, because they are often more efficient to perform than tests of details. The results of the analytical procedures should be documented on supporting working papers.

5.027 Analytical procedures should at least be performed as work is completed and adjustments are prepared for each audit area. Performing analytical procedures as work is completed will provide corroborating evidence that will help achieve the desired level of assurance. In such cases, the results of analytical procedures are high-reliance evidence. When modifying the tests of details procedures, the contribution of analytical procedures to verification of the financial statement assertions should be considered.

ILLUSTRATION NO. 5-2

EVIDENCE MATRIX

Audit Approach	Control Risk for Most Financial Statement Assertions	Tests of Details Evidence: Nature	Extent	Timing
ABC Approach:				
System A: Good Internal Control Procedures	Low	Least Reliable	Small Samples	Most Precede Year End
System B: Good Accounting System and Primary Controls	Moderate	More Reliable	Medium Samples	Some Precede Year End
System C: Good Accounting System	Slightly Below the Maximum to Maximum	Most Reliable	Large Samples	Most at Year End
All-Substantive Approach:				
Weak Accounting System or More Efficient Substantive Tests	Slightly Below the Maximum to Maximum	Most Reliable	Large Samples	Most at Year End

5.100 THE ABC SYSTEM

5.101 As mentioned in section 5.005, the ABC System should be used for engagements in which the auditor plans to rely on the client's internal control structure in order to minimize substantive tests. The following are the basic steps involved in designing an audit approach using the ABC System, and the forms and documents contained in this Manual related to those steps:

Procedure	Documentation
1. Understand the dealership's operations and industry.	1. Client Acceptance and Continuance Form
2. Perform audit planning procedures.	2. Audit Planning Memorandum
3. Perform analytical procedures sufficient to plan the audit.	3. Audit Planning Memorandum
4. Obtain an understanding of the dealership's internal control structure.	4. Internal Controls Questionnaire and Computer Controls Questionnaires
5. Assess the risk that misstatements in the financial statements could occur.	5. Risk of Potential Misstatements Evaluation Form
6. Assess control risk for each financial statement assertion and determine the tests of controls and the level of substantive tests to be performed.	6. Internal Controls Questionnaire and Planning Matrix

5.102 Procedures 1, 2, and 3 are discussed in Chapter 4 of this Manual. The following sections discuss procedures 4, 5, and 6 and the related documentation.

Internal Control Structure

5.103 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319), requires the auditor to obtain a sufficient understanding of an entity's control structure (control environment, control policies and procedures, and accounting system) to adequately plan the audit and to determine the nature, timing, and extent of audit procedures. As discussed in Chapter 1, section 1.701, the AICPA's Auditing Standards Board has released a proposed amendment to SAS No. 55, which is expected to be effective in the fourth quarter of 1995. This amendment would incorporate the definition and description of internal control found in the Committee on Sponsoring Organizations report, *Internal Control-Integrated Framework*, (the "COSO Report") into SAS No. 55. It is not expected to result in a significant change in practice. The description of the three elements of the control structure contained in SAS No. 55 is shown in Illustration No. 5-3.

ILLUSTRATION NO. 5-3

ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

For a financial statement audit, an entity's internal control structure comprises the following:

Control Environment: The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies or procedures. The control environment includes such factors as—

- Management's philosophy and operating style.
- The entity's organizational structure.
- The functioning of the board of directors and its committees, particularly the audit committee.
- Methods of assigning authority and responsibility.
- Management's control methods for monitoring and following up on performance, including internal auditing.
- Personnel policies and practices.
- Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies.

The control environment reflects the overall attitude, awareness, and action of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity.

Accounting System: The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system will give appropriate consideration to establishing methods and records that will—

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

ILLUSTRATION NO. 5-3 (Continued)

ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

Control Procedures: Those policies and procedures, in addition to the control environment and the accounting system, that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparisons of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

5.104 Completion of the Internal Controls Questionnaire (Chapter 6, section 6.100) satisfies the SAS No. 55 requirement to obtain and document the understanding of the three elements of the control structure. The authors encourage the use of additional narratives and flowcharts on larger, more complex engagements. However, they should supplement rather than replace the Internal Controls Questionnaire.

5.105 The Questionnaire is divided into the following major audit areas:

I. Accounts receivable, contracts in transit, and sales. (existence, valuation, and completeness)
II. Acquisitions of inventory and fixed assets (existence and valuation), and related liabilities (completeness), and expenses. (completeness, valuation, and presentation)
III. Payroll expenses. (valuation)
IV. Safeguarding of inventory. (existence, completeness, and valuation)
V. All areas.

5.106 The Internal Controls Questionnaire, Tests of Controls Programs, and Tests of Balances Programs are designed by audit areas and are based on transaction cycles. Strengths and weaknesses in the internal control structure for each transaction cycle must, therefore, be reflected in the auditor's planned assessed level of control risk.

5.107 Within each of the five sections of the Internal Controls Questionnaire listed in section 5.105 are three categories of controls: the accounting system controls, primary controls, and secondary controls. As described below, the "yes" and "no" responses within the three categories will help the auditor select the proper system for that section. System C is the weakest system and is characterized by good accounting system controls, but weak primary and secondary controls; System A is the strongest and is characterized by good accounting system and good primary and secondary controls. Even if the auditor anticipates that some major audit areas will be C Systems, all questions should be answered so that the auditor's requirement to understand the control structure is met. The following describes how to select the appropriate system (A, B, or C) after completing the Internal Controls Questionnaire.

1. Within each of the five sections of the Questionnaire, identify the most advanced system classification, A, B or C, with a majority of "yes" answers in each section of the Questionnaire. Because tests of controls often require less time than tests of details, the objective should be to perform tests of controls to the maximum extent practical.

2. Consult with the engagement partner to determine if tests of controls for the system classification selected are practical in light of past experience with the client. Prior years' unacceptable results from tests of controls, and the resulting high reliance on substantive tests, may cause the selection of a lower system classification, i.e., B or C, and a reduction in controls testing. In other words, this decision may prevent overauditing.

3. For all "no" answers, i.e., potential weaknesses, up to and including the system selected in each section, complete the following process:

   a. Determine if the "no" answer is, in fact, a weakness.

   b. For the potential weakness, review any "yes" answers to other controls for possible offsetting strengths. Such strengths could be included within the system classification selected or in a more advanced system. For example, a weakness in a System B (a "no" answer) could be offset by another control within System B (a "yes" answer) or by a control in System A.

   c. The Tests of Controls Programs have been designed to test the controls that exist in each system, as evidenced by the Internal Controls Questionnaire. For example, the control in a System A that may offset a weakness in System B would not be tested when the System B Tests of Controls Program is used. To rely on the offsetting System A control, a modifying test of that control must be added to the System B program.

   d. Select the Tests of Controls Programs for each section of the Questionnaire that corresponds with the selected system classification, A, B, or C.

5.108 The in-charge's selection of the type of internal control system should be recorded on the Planning Matrix, section 5.402, and reviewed by the engagement partner before the in-charge selects the corresponding Tests of Controls Programs. The complete Internal Controls Questionnaire is included in Chapter 6, section 6.100.

5.109 Illustration No. 5-4 is a sample section of the Internal Controls Questionnaire.

5.110 EDP Controls. SAS No. 55 and SAS No. 48, *The Effects of Computer Processing on the Examination of Financial Statements,* require the auditor to understand the client's methods used to process significant accounting information, e.g., computer processing, because such methods influence the design of the accounting system and the nature of the internal control procedures. SAS No. 48 summarizes the aspects of computer processing that may have an effect on planning an audit of financial statements. Completion of the EDP Questionnaire provides the auditor with the minimum understanding of the internal controls structure required to design an all-substantive audit approach. If the audit is designed to test controls (thereby reducing substantive testing) the questionnaires guide the auditor in identifying key EDP controls. The auditor would then incorporate these controls into the Internal Controls Questionnaires and the Tests of Controls Programs. Significant applications may include general ledger or payroll processing on a microcomputer. These forms are included in Chapter 6, sections 6.215–6.217.

5.111 For entities using microcomputers for various accounting applications, certain basic internal control weaknesses may also exist. Any weaknesses resulting from microcomputer applications should also be considered during the evidence design process.

Risk of Potential Misstatements Evaluation

5.112 As discussed in sections 4.319–4.336 of Chapter 4, an important consideration in designing an audit strategy is considering the risk that errors, irregularities, and illegal acts that have a material effect on the financial statements could occur. The assessment of this risk, combined with information obtained in completing the Client Acceptance and Continuance Form, the Audit Planning Memorandum, and the Internal Controls Questionnaire affects the nature, timing, and extent of tests required to reduce that risk to an acceptable level. For example, if the auditor determines that there is a high risk that a material error could occur in a particular area (such as an asset subject to misappropriation or an account that involves very complex accounting methods), he or she would increase the amount of evidence required from tests of controls, analytical procedures, and/or tests of details for that area. The purpose of the risk evaluation is to direct the auditor's efforts toward the audit areas that are most likely to contain misstatements. Most importantly, this assessment occurs before the evidence collection process begins.

5.113 This early assessment allows the auditor to modify the design of tests before the engagement is completed and overauditing has occurred. For example, the auditor may have planned to test a client's parts inventory by relying heavily on tests of controls, in order to reduce year-end inventory count observations, pricing, and clerical tests. A review of the client's prior year's error history, however, revealed that significant counting, pricing, and clerical testing errors had occurred, resulting in a significant extension of the year-end tests. In this case, both extensive tests of controls and substantive tests were required. Had the prior year's errors been identified at the beginning of the engagement, the auditor would have planned to rely primarily on substantive tests, rather than waste time and effort on tests of controls that produced unsatisfactory results.

ILLUSTRATION NO. 5-4

Internal Controls Questionnaire — Auto Dealerships

Section III

Client: Greenhill Autos, Inc.

Financial Statement Date: December 31, 1995

MAJOR AUDIT AREA: Payroll expenses. (valuation)

TRANSACTION CYCLES: Payroll and personnel.

ACCOUNTING CONTROLS (SYSTEM C)	Personnel	Yes	No	N/A
1. A payroll journal is prepared and balanced.	Pat	✓		
2. Payroll disbursements are made by check.	Barbara	✓		
3. Labor is classified by department.	Marc	✓		
4. Employees' time records are maintained.	Doris	✓		
5. W-4 forms are maintained.	Doris	✓		
6. Employees' earnings records are maintained.	John	✓		
7. A payroll bank account reconciliation is prepared.	John	✓		
8. Wage rates, commission levels, and sales contests are authorized by the dealer or manager.	Marc	✓		

PRIMARY CONTROLS (SYSTEM B)

	Personnel	Yes	No	N/A
1. Time sheets, commission sheets, and payroll copies of repair orders (for service department mechanics) are prepared by employees.	Marc	✓		

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
Section III (Continued)

	Personnel	Yes	No	N/A
2. The dealer or manager approves:				
a. Rates of pay.	Marc	✓		
b. Commission levels.	Marc	✓		
c. Sales contests.	Marc	✓		
d. Withholdings.	Marc	✓		
e. Changes in above.	Marc	✓		
3. The payroll bank account reconciliation is prepared by someone independent of payroll preparation, approvals and check signing functions or by the dealer or manager.	Barbara		✓	
4. Payroll checks are prenumbered and accounted for.	Pat	✓		
5. Checks are recorded in the payroll journal timely.	Barbara	✓		
6. Payroll journals are posted at least monthly to employees' earnings records.	Pat	✓		
7. Payroll checks are signed by the dealer or manager.	Marc	✓		
8. Time sheets, commission sheets, and payroll copies of repair orders (for service department mechanics) are approved by the dealer or manager.	Marc	✓		

SECONDARY CONTROLS (SYSTEM A)

General

	Personnel	Yes	No	N/A
1. A time clock is used to record time or time is logged by someone independent of payroll preparation, check-signing, and distribution functions.	—		✓	

INTERNAL CONTROLS QUESTIONNAIRE— AUTO DEALERSHIPS
Section III (Continued)

	Personnel	Yes	No	N/A
2. Commission sheets are prepared by someone independent of payroll preparation, check-signing, and distribution functions.	—		✓	
3. All-payroll calculations are checked by a person other than the payroll clerk.	—		✓	
4. Employees' earnings records are periodically reconciled to the general ledger by persons independent of payroll preparation and distribution.	Marc	✓		
5. Account codings are reviewed by someone other than preparer.	—		✓	
6. Adequate personnel files are maintained.	Pat	✓		
7. The numerical sequence of payroll checks is accounted for by a person independent of the preparation function.	—		✓	
8. Payroll is prepared by persons independent of time card approval, check signing, and check distribution.	—		✓	
9. Payroll bank account reconciliation is reviewed by the dealer or manager.	Marc	✓		
10. Unclaimed payroll checks are followed up on by the dealer or manager.	Marc	✓		
11. Periodically, all payroll checks are handed out to employees by the dealer or manager.	Marc	✓		
12. The dealer or another appropriate official ensures payments to commissioned personnel are at least equal to minimum wage requirements.	—		✓	
Service Department				
13. The service department manager or dispatcher affixes "flags" to the payroll copies of repair orders.	Joe	✓		

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS

Section III (Continued)

	Personnel	Yes	No	N/A
14. Balances in the WIP-labor account are periodically examined for propriety.	—		✓	

Other comments:

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

	1995	19	19	19	19
Prepared by: Client					
In-charge					
Reviewed by: Engagement Partner					

(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

(3) Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

5.114 The Risk of Potential Misstatements Evaluation Form in section 5.401 is designed to help the auditor assess the likelihood that material misstatements in the financial statements could occur, and if so, to develop an appropriate audit strategy. It should be completed during the pre-engagement audit planning by the in-charge and reviewed by the partner.

5.115 The Form is comprised of two parts. Part I, "Special Considerations," is a series of questions about the client and the audit engagement circumstances that could indicate a high risk of potential misstatements. "Yes" answers to the questions in Part I should be explained. Part II, "Potential Misstatements Matrix," involves assessing the risk of misstatements for each audit area. This assessment is made by considering: (1) the responses to Part I, "Special Considerations," (2) whether the accounts are unusual and material or high risk due to the client's industry and operations, and (3) information from prior years' engagements about high exposure areas and any significant adjustments, made or passed. After considering these three risk categories, the auditor arrives at a conclusion, based on his or her professional judgment as to whether risk is high or low for each area. This conclusion is transferred to the Planning Matrix, section 5.402, where it will be considered in developing an audit strategy. Any situations that indicate a high risk of potential misstatement should be described, along with the planned modification to the tests of controls and substantive tests.

The Planning Matrix

5.116 Completion of the Client Acceptance and Continuance Form, the Audit Planning Memorandum, the Internal Controls Questionnaire, and the Risk of Potential Misstatements Evaluation Form provides the auditor with the information needed to plan the nature, timing, and extent of tests. The Planning Matrix in section 5.402 is designed to bring this information into one form.

5.117 The Planning Matrix contains the following major audit areas:

- Cash
- Accounts receivable, including contracts in transit
- New vehicle inventory
- Used vehicle inventory
- Parts inventory
- Property and equipment
- Wholesale finance liability
- Income and expense, including payroll expense

5.118 These are the areas most likely to be tested under a System A or B in an auto dealership. In other words, they are areas in which tests of controls may be an efficient and effective means of reducing substantive tests. The Matrix should be modified on each engagement to include any other accounts or audit areas for which the System A or B would be more efficient and effective.

5.119 Completion of the Planning Matrix involves the following steps for each audit area:

1. Indicate the preliminary System classification (A, B, or C) from the Internal Controls Questionnaire.

2. Based on the system classification in step 1, select the planned assessed level of control risk. Because a System C lacks good primary and secondary controls, control risk should be assessed at the maximum or slightly below the maximum for these classifications. Control risk for System B classifications can be assessed at a moderate level, and for System A, at a moderate or low level. Also, the auditor may elect to use the System C even though the system is evaluated as an A or B, if he or she believes it will be more efficient and effective to test those assertions under System C.

3. From the Risk of Potential Misstatements Matrix, indicate whether the risk of potential misstatements is high or low.

4. Determine whether analytical procedures can be relied on to detect material misstatements and indicate whether the risk that they will **not** detect a material misstatement is maximum, moderate, or low.

5. Indicate briefly, the planned reliance on tests of details for the audit area, including the nature, timing, and extent of these tests.

5.120 Illustration No. 5-5 shows some ways that substantive tests may be reduced in an auto dealership audit when the ABC System is used.

ILLUSTRATION NO. 5-5

REDUCTIONS IN SUBSTANTIVE TESTS

Audit Areas	Possible Reductions in Tests
1. Cash	1. Prove fewer bank reconciliations. Prove some reconciliations at dates other than balance-sheet date. Trace fewer reconciling items to support. Use client's subsequent bank statement instead of cutoff statement.
2. Sales cutoff	2. Limit the extent of cutoff tests.

ILLUSTRATION NO. 5-5 (Continued)

REDUCTIONS IN SUBSTANTIVE TESTS

Audit Areas	Possible Reductions in Tests
3. Physical inventory observation	3. Fewer test counts taken and recorded. More time spent determining client is following instructions. Less time spent on observation. Observe cycle counts for perpetual systems.
4. Tests of details of inventory pricing and clerical tests	4. Limit the extent of the tests.
5. Vouching and inspecting fixed assets	5. Less physical inspection of assets. Limit the extent of vouching tests for additions, repairs, supplies, etc., especially when numerous, low value assets have been capitalized.
6. Search for unrecorded liabilities	6. Higher dollar limits for review of journals, open invoices, receiving reports and purchase order files. Few, if any, vendor confirmations would be sent.
7. Purchases cutoff	7. Limit the extent of cutoff tests.
8. Payroll tests	8. Eliminate monthly or periodic comparison of payroll. Eliminate reconciliation of payroll-to-payroll tax returns.
9. Expense account analysis and vouching	9. Limit extent of account analysis and vouching.

5.200 THE ALL-SUBSTANTIVE APPROACH

5.201 The All-Substantive Approach (formerly the Small, Noncomplex Engagement Approach) should be used on engagements that have some or all of the following characteristics:

1. Concentration of operational control in the hands of one or a few individuals.

2. Management personnel or employees have limited accounting knowledge.

3. Management believes that it cannot or need not hire employees having extensive accounting knowledge.

4. The potential for management override of internal accounting controls is high.

5. Internal control deficiencies result from:

   a. Limited segregation of functions within the accounting system because of the small number of employees.

   b. Easy access to physical assets by clerical and administrative personnel.

   c. Informally designed procedures for planning, budgeting, accounting, and reporting depend on management style.

6. The dealership has an inactive or ineffective policy making body.

5.202 The majority of small- and medium-sized dealerships possess some or all of these characteristics, making it necessary for the auditor to perform extensive substantive tests to compensate for inability to rely on tests of controls.

5.203 As mentioned in section 5.015, an auditor may elect to use the All-Substantive Approach on an engagement, if he or she decides that a substantive audit approach would be the most efficient approach. In other words, the nature of the organization's control structure may make performing substantive tests more cost effective than tests of controls. For example, for a used car dealership that does not maintain a parts or service department, it may be more cost effective to perform extensive tests of inventory details (a substantive approach) than to perform tests of controls in order to limit those tests.

5.204 In such circumstances, the engagement partner may approve the All-Substantive Approach discussed below. This approach involves assessing control risk at the maximum or slightly below the maximum for all major audit areas. Under this approach, little or no reliance is placed on tests of controls and high reliance is placed on tests of details and analytical procedures. Even though tests of controls are not required whenever control risk is assessed at the maximum, this approach provides for minimum controls tests through completion of the System C Tests of Controls Programs. Performing these minimum tests of controls is recommended because they can enhance the auditor's understanding of the control structure and flow of transactions through the accounting system, and also allow the auditor to slightly reduce substantive tests.

5.205 Illustration No. 5-6 shows the primary planning and procedural forms that should be completed when using the All-Substantive Approach, along with the corresponding forms used in the ABC System.

ILLUSTRATION NO. 5-6

DOCUMENTATION REQUIREMENTS FOR THE ALL-SUBSTANTIVE APPROACH AND THE ABC SYSTEM

All-Substantive Approach	ABC System
Client Acceptance and Continuance Form	Same.
Audit Planning Memorandum	Same.
All-Substantive Approach Questionnaire	Internal Controls Questionnaire, Risk of Potential Misstatements Evaluation Form, and Planning Matrix.
Materiality Computation Schedule and Summary of Possible Journal Entries Form	Same.
System C Test of Controls Programs (optional)	System A, B, and C Tests of Controls Programs, as evaluated for each audit area.
Internal Control Structure Reportable Conditions Form, based on completion of the All-Substantive Approach Questionnaire	Same, but based on Internal Controls Questionnaire.
Tests of Balances Program, highly reliable procedures and maximum sample sizes.	Same, with less reliance if related audit areas are evaluated as Systems A or B.

All-Substantive Approach Questionnaire

5.206 The All-Substantive Approach Questionnaire—Auto Dealerships, included in section 5.403, should be completed on small, noncomplex engagements if it is the most cost-beneficial approach. Section I of the Questionnaire is designed to provide the auditor with an understanding of the dealership's internal control structure as required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. It also helps the auditor identify material control environment and accounting system weaknesses that might impact the design of the audit. "No" answers should be recorded on the Internal Control Structure Reportable Conditions Form in Chapter 6, Section 6.400.

5.207 Section II should be used to evaluate the risk of potential misstatements on the engagement. Areas containing high risk should be described and considered when designing analytical procedures and tests of details and selecting sample sizes. A high risk of potential misstatements may increase the evidence requirements in certain audit areas.

5.208 Completion of the Internal Controls Questionnaire, the Planning Matrix, and the Risk of Potential Misstatements Evaluation Form is **not** necessary for All-Substantive Approach engagements.

Tests of Controls

5.209 Even though tests of controls are not required whenever control risk is assessed at the maximum, the All-Substantive Approach provides for minimum controls testing, using the System C Tests of Controls Programs, to enhance the auditor's understanding of the control structure and flow of transactions. Performing the System C tests of controls may also support an assessment of control risk at slightly below the maximum, allowing the auditor to achieve a slight reduction in tests of details. The System C Tests of Controls Programs should be selected for all audit areas. Minimum sample sizes may be selected, since minimum reliance is being placed on the tests of controls.

Analytical Procedures

5.210 As for all audit engagements, analytical procedures should be performed on All-Substantive Approach engagements to the maximum extent practical and should be performed as early in the engagement as possible. On engagements where significant adjustments are required, analytical procedures should be performed after all significant adjustments have been recorded. In each circumstance, the evidence provided by analytical procedures should be considered in modifying the Tests of Balances Program.

Tests of Details

5.211 Because minimum or no reliance is placed on tests of controls in a System C, substantive tests become the primary source of evidence. The nature, timing, and extent of the tests of details and analytical procedures selected should be those that are the most reliable, e.g., positive rather than negative confirmations, larger sample sizes, and tests should be performed at year end rather than at interim dates. Illustration No. 5-7 presents some suggestions that should be considered in designing high-reliance substantive tests for major audit areas.

ILLUSTRATION NO. 5-7

ALL-SUBSTANTIVE APPROACH
SUGGESTED SUBSTANTIVE TESTS

Major Audit Area	Program Design Consideration
1. Cash	1. Prove all major bank reconciliations at the balance-sheet date. Trace most reconciling items to cutoff statements. Search extensively for unrecorded bank transfers.
2. Sales cutoff	2. Perform extensive cutoff tests by reference to sales documents for a large period before and after the balance-sheet date.
3. Physical inventory observation	3. Consider observing inventory from start to finish. Make extensive test counts at all locations.
4. Inventory pricing and clerical tests	4. Perform extensive, representative tests. A significant portion of the inventory items should be subjected to tests.
5. Vouching and inspecting fixed assets	5. Perform extensive vouching and inspections. A significant portion of the fixed assets, repairs, supplies, etc., accounts balances should be subjected to tests.
6. Search for unrecorded liabilities	6. Perform an extensive search for unrecorded liabilities including subsequently recorded transactions, open invoices, receiving report and purchase order files. Low dollar limits should be used. Consider confirming major suppliers, including zero balances.
7. Purchases cutoff	7. Perform extensive cutoff tests by reference to vendor invoices for a large period before and after the balance-sheet date.

ILLUSTRATION NO. 5-7 (Continued)

ALL-SUBSTANTIVE APPROACH
SUGGESTED SUBSTANTIVE TESTS

Major Audit Area	Program Design Consideration
8. Payroll tests	8. Compare monthly payroll by labor category and follow up on transactions by reference to underlying records. Consider predictive analytical procedure or reconciling gross wages to payroll tax returns. Consider observation of payroll distribution.
9. Expense account analysis and vouching	9. Perform extensive vouching tests for all significant account balances by examining canceled checks and supporting documents.

5.300 SAMPLING DECISIONS

Audit Procedure Study and Changes to "Sampling Decisions"

5.301 As this Manual goes to print, the Auditing Standards Division of the AICPA is developing an Audit Procedure Study (APS) to replace the AICPA Audit and Accounting Guide, *Audit Sampling*. The APS is expected to be issued by the fourth quarter of 1995.[1]

5.302 The guidance contained in this section is consistent with the guidance in the Audit and Accounting Guide except that the "assurance factors" used in the Model Approach (see section 5.336) conform with those used in the draft APS. The authors believe that these factors better reflect current practice.

5.303 This section has been revised to make it easier to comply with the requirements of SAS No. 39, *Audit Sampling*. To simplify our coverage of audit sampling for substantive tests, the Table Approach to nonstatistical sampling has been removed from this edition of the Manual because the approach is in substance equivalent to the Model Approach. Practitioners who wish to use the Table Approach should refer to the AICPA Audit Sampling Guide. In this regard, the following forms have been deleted:

- Sampling Decision Working Paper

[1] When the APS is issued, it may be obtained by calling the AICPA's Order Department at 1-800-862-4272.

- Sample Size Selection and Evaluation Form
- Attributes Sampling Summary Form
- Nonstatistical Sample Size Selection Matrix — Tests of Controls

5.304 The requirements for audit sampling are included in SAS No. 39, *Audit Sampling* (AU 350), and the AICPA Audit and Accounting Guide, *Audit Sampling* (AAG-SAM).

5.305 According to SAS No. 39, *Audit Sampling* (AU 350), sampling occurs when the auditor tests less than 100% of a population to make some conclusion about the population. SAS No. 39 applies to tests of controls when such tests are performed and to tests of balances when sampling populations are material. The extent to which sampling is used in an audit depends on the size of the client and the nature of the client's internal control structure. If the All Substantive Approach is being used, the auditor will not perform tests of controls using audit sampling. Also, if the sampling populations are small, it is usually more efficient to audit individually significant items and obtain audit assurance about the remaining balance through analytical procedures than to perform audit sampling. As the size and sophistication of the client's internal control structure increases, the auditor is more likely to use audit sampling to perform tests of controls and tests of balances.

Audit Sampling for Tests of Controls

5.306 SAS No. 39 indicates that an auditor may use nonstatistical or statistical sampling in performing tests of controls. This Manual provides guidance for both approaches. Regardless of whether nonstatistical or statistical sampling is being used, audit sampling for tests of controls involves the following steps:

1. **Determine the objective of the test** — The objective of a test of control is to determine whether a particular internal control policy or procedure is being applied as prescribed. Audit sampling for tests of controls is generally appropriate when application of the internal control policy procedure leaves documentary evidence of performance. Normally, audit sampling for tests of controls will involve selecting a sample of documents and examining them for evidence that the relevant internal control policy or procedure was applied. Tests of controls involving observation of performance of procedures or inquiries of the client are not normally subject to audit sampling.

2. **Define the deviation conditions** — A deviation condition is a situation that indicates that the policy or procedure was not performed. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (e.g., the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. Adequate performance of a policy or procedure consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed procedure requires that support for every disbursement should include an invoice, a voucher, a receiving report, and a purchase order, all stamped "Paid." The auditor believes that the existence of an invoice and a receiving report, both stamped "Paid," is necessary to indicate adequate performance of the procedure for purposes of supporting the assessed level of control risk. Therefore, a deviation may be defined as " a disbursement not supported by an invoice and a receiving report that have been stamped 'Paid.'"

3. **Define the population** — The population selected must be appropriate for the objective being tested. For example, if the auditor is testing the operating effectiveness of an internal control procedure designed to determine if all shipments were billed, the auditor would not detect deviations by sampling from billed items. An appropriate population for detecting such deviations usually includes the record of all items shipped.

   For samples to be representative of the period under audit, the population generally should include all transactions processed during the period. However, sometimes the results of tests performed at an interim date may be sufficient to generalize about the population for the entire period. In determining whether interim tests are sufficient, the auditor should consider the results of the tests, responses to inquiries concerning the remaining period, the length of the remaining period, the nature and amounts of the transactions or balances involved, and related evidence obtained from the tests of balances. If a control policy or procedure has been changed during the year, the auditor will often decide that it is efficient to only test the new policy or procedure.

   For sample results to be reliable, the sample must be selected from the complete population. Completeness of the population can be determined by either physical or numerical control. Normally, the auditor can establish the completeness of the population by inspecting the documents to see that it appears that they have all been accounted for.

4. **Determine the method of selecting the sample** — Any sample that is selected should be representative of the population and all items should have an opportunity to be selected. Random-number selection should generally be used when statistical sampling is being applied. When nonstatistical sampling is applied, random-number sampling, systematic sampling, and haphazard sampling are methods that might be used to obtain a representative sample. Methods of selecting samples are discussed beginning at section 5.343.

5. **Determine the sample size** — Sample sizes for tests of controls are affected by (1) the risk of assessing control risk too low, (2) the tolerable deviation rate, (3) the expected population deviation rate, and (4) any effects of small population sizes.

   Guidance for determining sample size when performing nonstatistical sampling begins with section 5.309. A description of statistical sampling begins with section 5.312.

6. **Perform the sampling plan** — Once the sample has been selected, the auditor should examine each item for evidence of performance of the internal control policy or procedure. If the auditor selects an item that is unused (e.g., a voided document), the auditor should select another item, at random. However, the auditor should make sure that the item really represents an unused item. If the document is valid, but cannot be found, the item should be treated as a deviation in evaluating the sample results.

7. **Evaluate the sample results** — Guidance for evaluating nonstatistical sampling results begins with section 5.310 and guidance for evaluating statistical sampling results begins with section 5.313.

8. **Document the sampling procedure** — The audit working papers should document the following matters:

   - The objectives of the test.

- A description of the deviation conditions.
- The acceptable risk of assessing control risk too low.
- The tolerable deviation rate.
- The expected deviation rate.
- The sample results, including the disposition of any deviations found.
- The effect of the results on the auditors assessed level of control risk.

5.307 Factors Affecting Sample Sizes for Tests of Controls. Sample sizes for tests of controls are affected by the following factors:

1. *Acceptable risk of assessing control risk too low.* The risk of assessing control risk too low is the risk that the sample supports a lower level of control risk than is in fact the case. Decreasing the risk of assessing control risk too low will increase the sample size.

2. *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. As the expected population deviation rate increases, the sample size will increase.

3. *Tolerable deviation rate.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure that the auditor is willing to accept without increasing the assessed level of control risk. Higher tolerable deviation rates will permit smaller sample sizes.

4. *Population size.* Populations over 500 items have little or no effect on sample size. For populations under 500 in size, the auditor may slightly reduce the size of the sample.

5.308 The effects of these factors may be summarized as follows:

Factor	Effect on Sample Size
Acceptable risk of assessing control risk too low — increase (decrease)	Smaller (larger)
Tolerable deviation rate — increase (decrease)	Smaller (larger)
Expected population deviation rate — increase (decrease)	Larger (smaller)
Population size	Populations less than 500 items should be adjusted to slightly smaller sample sizes

5.309 Sample Sizes Using Nonstatistical Sampling. Nonstatistical sample sizes for tests of controls may be determined using the sample size selection tables in section 5.310, or they may be selected on a purely judgmental basis. Sample sizes should be entered directly on the appropriate Tests of Controls Program. For each method of selection, the auditor should document consideration of the relevant factors. For example, the rationale for selecting tests of controls sample sizes of 30 from the first table in section 5.310 for an internal control system that is classified as a System B may be:

1. Control risk will be assessed at a moderate level, and

2. The expected population deviation rate is at or near zero.

5.310 The following tables should be used for a nonstatistical approach to determine sample sizes for tests of controls:

CONTROLS TESTING NONSTATISTICAL
SAMPLE SIZE SELECTION TABLE

Assessed Level of Control Risk	Sample Size
Maximum	0
Slightly below the maximum	15
Moderate	30
Low	40

The numbers in the table were determined using a risk of assessing control risk too low of 10% and an expected population deviation rate of 0%. When deviations are expected or found in a sample, the following table may be used to determine the sample size or evaluate the sample results:

Deviations (Expected or Actual)	Assessment of Control Risk		
	Slightly Below Maximum	Moderate	Low
0	15	30	40
1	25	50	65
2	34	67	90
3	43	85	115

5.311 In evaluating the results of the sample, the auditor should consider the number of deviations found and the nature of the deviations. If the auditor uses the first table in section 5.310 to determine sample size, the discovery of one or more deviations will require the auditor to reassess the planned level of control risk. In these cases, the second table in section 5.310 may be used to evaluate the assessed level of control risk that is supported by the sample results. When looking at the nature of the deviations, the auditor is concerned with the following questions:

- Was the cause of the deviation an error or does it indicate an intentional violation of the control?
- Are there implications for other audit areas?

5.312 Sample Sizes Using Statistical Sampling. The appropriate statistical method for tests of controls is attributes sampling, which is a technique designed to estimate qualitative characteristics of a population. Attributes sampling results may be used to estimate the frequency of deviations from performance of an internal control policy or procedure.

5.313 Applying attributes sampling involves performing the following steps:

1. **Decide on the attributes to test.** The Tests of Controls Program may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.
2. **Define the population from which the sample items should be selected.** The auditor should make sure that the population is appropriate for the audit objective as described in 5.306.
3. **Specify the following factors:**

   - *Acceptable Risk of assessing control risk too low.* The risk of assessing control risk too low is the risk the sample supports a lower level of control risk than is the case. Since sample evidence represents the only evidence typically obtained about the operating effectiveness of a particular control, the risk of assessing control risk too low is usually set at 5% or 10%.
   - *Tolerable deviation risk.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure the auditor is willing to accept without increasing the assessed level of control risk. Higher assessments of control risk will permit higher tolerable deviation rates as shown in the following table:

Planned Assessed Level of Control Risk	Tolerable Rate
Low	2% - 7%
Moderate	6% - 12%
Slightly below the maximum	11% - 20%
Maximum	Omit test

   - *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. The auditor's expectations may be based on prior years' experience with the client, or experience with similar clients. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor's planned assessed level of control risk.

4. **Determine the appropriate sample size.** Sample sizes are found in the tables in sections 5.314 through 5.315. The table in section 5.314 is designed for a risk of assessing control risk too low of 5%, and the table in section 5.315 is designed for a 10% risk of assessing control risk too low. With the tolerable deviation rate and the expected deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor's planned assessed level of control risk.

5. **Randomly select the sample from the population.** The section beginning at 5.343 describes the methods that may be used to select a random sample.

6. **Perform the audit procedures to identify deviations in the sample.**

7. **Calculate the statistical results.** Using the tables in sections 5.316–5.317 for the appropriate risk of assessing control risk too low, determine the actual tolerable deviation rate from the sample size and the actual number of deviations found in the sample.

8. **Reassess the level of control risk.** If the actual deviation rate in the sample is higher than that specified in determining the sample, the sample results will not support the auditor's planned assessed level of control risk. In these situations, the auditor should increase the assessed level of control risk. The auditor should also consider the causes of the deviations found, and whether they have implications for other audit areas.

9. **Document the Sampling Procedures.** The audit working papers should document the matters set forth in 5.306 (Item No. 8).

5.314

Statistical Sample Sizes for Testing Controls
Five Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Expected Population Deviation Rate	Tolerable Rate 2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*	*	146(6)	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*	*	*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*	*	*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*	*	*	*	*	68(5)	37(3)

* Sample Size is too large to be cost effective for most audit applications.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table assumes a large population.

5.315

Statistical Sample Sizes for Testing Controls
Ten Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Expected Population Deviation Rate	Tolerable Rate 2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	144(0)	76(0)	57(0)	45(0)	38(0)	32(0)	28(0)	25(0)	22(0)	15(0)	11(0)
.25	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.50	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.75	265(2)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.00	*	176(2)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.25	*	221(3)	132(2)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.50	*	*	132(2)	105(2)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.75	*	*	166(3)	105(2)	88(2)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
2.00	*	*	198(4)	132(3)	88(2)	75(2)	48(1)	42(1)	38(1)	25(1)	18(1)
2.25	*	*	*	132(3)	88(2)	75(2)	65(2)	42(1)	38(1)	25(1)	18(1)
2.50	*	*	*	158(4)	110(3)	75(2)	65(2)	58(2)	38(1)	25(1)	18(1)
2.75	*	*	*	209(6)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.00	*	*	*	*	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.25	*	*	*	*	153(5)	113(4)	82(3)	58(2)	52(2)	25(1)	18(1)
3.50	*	*	*	*	194(7)	113(4)	82(3)	73(3)	52(2)	25(1)	18(1)
3.75	*	*	*	*	*	131(5)	98(4)	73(3)	52(2)	25(1)	18(1)
4.00	*	*	*	*	*	149(6)	98(4)	73(3)	65(3)	25(1)	18(1)
5.00	*	*	*	*	*	*	160(8)	115(6)	78(4)	34(2)	18(1)
6.00	*	*	*	*	*	*	*	182(11)	116(7)	43(3)	25(2)
7.00	*	*	*	*	*	*	*	*	199(14)	52(4)	25(2)

* Sample Size is too large to be cost effective for most audit applications.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table assumes a large population.

5.316

Statistical Sample Results Evaluation
Table for Tests of Controls
Tolerable Deviation Rate at Five Percent Risk of Assessing Control Risk Too Low

Actual Number of Deviations Found

Sample Size	0	1	2	3	4	5	6	7	8	9	10
25	11.3	17.6	*	*	*	*	*	*	*	*	*
30	9.5	14.9	19.6	*	*	*	*	*	*	*	*
35	8.3	12.9	17.0	*	*	*	*	*	*	*	*
40	7.3	11.4	15.0	18.8	*	*	*	*	*	*	*
45	6.5	10.2	5.4	16.4	19.2	*	*	*	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*	*	*	*
55	5.4	8.4	11.1	5.5	15.9	18.2	*	*	*	*	*
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	*	*	*	*
65	4.6	7.1	9.4	11.5	5.6	15.5	17.4	19.3	*	*	*
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0	19.7	*	*
75	4.0	6.2	8.2	10.1	11.8	5.6	15.2	16.9	18.5	20.0	*
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	*
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.8	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	5.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4

* Over 20 percent.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table presents upper limits as percentages. This table assumes a large population.

5.317

Statistical Sample Results Evaluation
Table for Tests of Controls
Tolerable Deviation Rate at Ten Percent Risk of Assessing Control Risk Too Low

Actual Number of Deviations Found

Sample Size	0	1	2	3	4	5	6	7	8	9	10
20	10.9	18.1	*	*	*	*	*	*	*	*	*
25	8.8	14.7	19.9	*	*	*	*	*	*	*	*
30	7.4	12.4	16.8	*	*	*	*	*	*	*	*
35	6.4	10.7	14.5	18.1	*	*	*	*	*	*	*
40	5.6	9.4	12.8	16.0	19.0	*	*	*	*	*	*
45	5.0	8.4	11.4	14.3	17.0	19.7	*	*	*	*	*
50	4.6	7.6	10.3	12.9	15.4	17.8	*	*	*	*	*
55	4.1	6.9	9.4	11.8	14.1	16.3	18.4	*	*	*	*
60	3.8	6.4	8.7	10.8	12.9	15.0	16.9	18.9	*	*	*
70	3.3	5.5	7.5	9.3	11.1	12.9	14.6	16.3	17.9	19.6	*
80	2.9	4.8	6.6	8.2	9.8	11.3	12.8	14.3	15.8	17.2	18.6
90	2.6	4.3	5.9	7.3	8.7	10.1	11.5	12.8	14.1	15.4	16.6
100	2.3	3.9	5.3	6.6	7.9	9.1	10.3	11.5	12.7	5.9	15.0
120	2.0	3.3	4.4	5.5	6.6	7.6	8.7	9.7	10.7	11.6	12.6
160	1.5	2.5	3.3	4.2	5.0	5.8	6.5	7.3	8.0	8.8	9.5
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6

* Over 20 percent.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table presents upper limits as percentages. This table assumes a large population.

Audit Sampling for Tests of Balances

5.318 In planning tests of balances, the auditor should decide on the most efficient approach to performing the tests. For some recorded populations, instead of sampling, it may be more efficient to examine individually significant items comprising a majority, or near majority, of the recorded population. Audit assurance about the remaining balance may then be obtained by (1) performing analytical procedures, or (2) concluding that the risk of material misstatement of the remaining balance is low. For example, confirmation of 50% to 80% of the dollar amount of accounts receivable may be necessary when risk is high; 40% to 60% may be sufficient when risk is low.

5.319 Obviously, when the remaining balance, after auditing the individually significantly items, is immaterial, no testing of the remaining balance is necessary.

5.320 The decision to sample, or not to sample, should be documented in the Audit Planning Memorandum (Chapter 4, section 4.506).

5.321 Selecting all individually significant items is not considered a sampling application. Items such as large receivables are usually examined individually. Procedures used for examining such items should ordinarily be the most reliable under the circumstances, such as positive confirmation requests.

5.322 When planning a sampling application for tests of balances, the in-charge should consider the financial statement assertions and audit objectives and their relationship to populations selected. For example, understatements cannot be detected by sampling recorded amounts; instead, units from populations of all existing transactions must be selected. The populations, and the appropriate sampling units, are described in the Tests of Balances Program — Audit Dealerships (Chapter 7, section 7.500).

5.323 The following is an approach to nonstatistical sampling for tests of balances.

1. Determine the sampling population by identifying and deducting the individually significant items.

2. Determine the sample size by considering the following factors:

    - The amount of tolerable misstatement.
    - The assessed level of inherent and control risk for the assertions being tested.
    - The risk that other substantive procedures (e.g., analytical procedures) will fail to detect a material misstatement.
    - Variations within the population.

3. Select the sample.

4. Perform the test procedure.

5. Evaluate the results.
   - Project the misstatement.
   - Consider sampling risk.
   - Consider qualitative aspects of the test results.

6. Document the sample procedure when using the Model Approach described in sections 5.331-5.332, the Model Approach Working Paper — Tests of Details Sampling (see section 5.406) and the Audit Sampling Evaluation Form — Tests of Details Sampling (see section 5.407) may be used for this purpose.

5.324 Sample selection methods should produce representative samples and may include random selection, systematic selection, or haphazard selection methods. Care should be taken to avoid bias, however, when a haphazard selection method is used. Section 5.343 describes these sample selection methods.

5.325 Determine the Sample Size for Tests of Balances. Sample sizes for tests of balances are affected by the following factors:

- *Tolerable misstatement.* As the amount of tolerable misstatement increases, the sample size decreases. Conversely, larger sample sizes are required to compensate for a smaller amount of tolerable misstatement. The tolerable misstatement for a sampling application may be taken from the Materiality Computation Form in Chapter 4, section 4.507

- *Assessed level of inherent and control risk.* As the combined level of inherent and control risk increases, the sample size increases. Assessments of inherent and control risk may be obtained by reviewing the Planning Matrix (see section 5.402).

- *The risk that other substantive procedures will fail to detect a material misstatement.* As the risk that other substantive procedures will fail to detect a material misstatement increases, the sample size increases. This risk is determined by considering the effectiveness of these procedures.

- *Variations within the population.* Sample sizes are smaller when the sampling population is stratified into homogeneous groups. Larger sample sizes are usually required to obtain a representative sample from sampling populations with high variations.

5.326 Illustration No. 5-8 summarizes the impact of the factors above on sample size planning.

ILLUSTRATION NO. 5-8

FACTORS INFLUENCING SAMPLE SIZES FOR SUBSTANTIVE TESTS OF BALANCES

	Conditions Leading to:	
Factor	Smaller Sample Size	Larger Sample Size
a. Tolerable misstatement.	Larger amount	Smaller amount.
b. Assessed level of inherent and control risk.	Lower.	Higher.
c. Risk that other procedures will fail to detect a material misstatement.	Lower.	Higher.
d. Variation within the population.	Less variation.	More variation.

5.327 Nonstatistical Sampling Approaches. At the direction of the engagement partner, either of the following nonstatistical approaches can be used for selecting tests of balances sample sizes:

1. Judgmental method.
2. Model approach.

5.328 Judgmental Method. Sample sizes can be selected judgmentally after considering the influence of the factors described above. The in-charge should describe, in the Audit Planning Memorandum, the factors that influence the sample sizes selected for substantive tests of balances. The engagement partner should approve the planned sample sizes before the substantive tests of balances work is begun. See Chapter 4, section 4.506 for an illustrative Audit Planning Memorandum.

5.329 Judgmentally selected samples are considered in terms of audit coverage of a total population. Large dollar coverage generally includes individually significant items, and units from the sampling population that cover more than 50% of the dollar amount of the total population.

5.330 The coverage of the total population will also be affected by the nature of the population and the degree of the engagement risks. For example, a large coverage of accounts receivable for confirmation in high-risk circumstances may be from 50% to 80% of the total dollar population. A large coverage for an inventory price test in the same circumstances may only be 30% to 40% of total inventory because the risk of inventory price misstatement is generally less. In low-risk circumstances, a large coverage of accounts receivable may be 40% to 60%, a large inventory coverage may be 20% to 30%. These percentages are not presented as specific guidelines for decision making, but as illustrations of the factors influencing nonsampling decisions. Since the auditor's opinion is expressed on the financial statements taken as a whole, evidence should be designed to include tests of a majority of the dollars in the financial statements, but should also be, overall, the most efficient in the circumstances.

5.331 **The Model Approach.** The model approach is a nonstatistical sampling method that is based on Probability Proportional To-Size (PPS) Sampling. Because the approach is based on PPS theory, the overall materiality limit does not have to be allocated to each account to determine tolerable misstatements. Instead, the basic allowance for unknown misstatement, i.e., overall materiality limit minus estimates for unadjusted misstatement from nonsampling tests, expected projected misstatement from sampling tests and related allowances for imprecision, may be used in place of tolerable misstatement for each sampling application. An acceptable approach would be to use 66⅔%, or a smaller percentage, of the overall materiality limit for the basic allowance. (See the Materiality Computation Form in Chapter 4, section 4.507.) Under PPS theory, the overall materiality limit does not have to be allocated to accounts because the financial statements may be viewed as one population and the basic allowance for unknown error applies to the financial statements taken as a whole. The basic allowance must also be considered, however, when measuring misstatements on the Summary of Possible Journal Entries Form.

5.332 It is important to recognize that when sample sizes are selected nonstatistically based on some statistical theory such as PPS, it is assumed that the population will be stratified. A simple method of stratification is as follows:

- Determine the mean of the population to be sampled.
- Select 2/3 of the sample items from those items equal to or greater than the mean.
- Select 1/3 of the sample items from those items less than the mean.

5.333 If it is not practical to stratify the sampling population, the sample size should be increased by a factor of 20%, or multiplied by 1.2.

5.334 A more time consuming, yet more accurate method would, of course, be a PPS statistical selection method. For the sake of time, however, this statistical method ordinarily is not used. When populations are unusually large and engagement risks are high, however, a PPS statistical method may be appropriate. Guidance for PPS statistical sampling may be found in the AICPA Audit Sampling Guide.

5.335 Developed from the model in the AICPA Audit Sampling Guide (paragraphs 4.57 to 4.60), the Model Approach follows:

Sampling Population Tolerable Misstatement	×	Assurance Factor	=	Preliminary Sample Size (units)
Preliminary Sample Size (Units)	×	Marginal Risk Factors (1.2 to 1.5)	=	Adjusted Sample Size (units)

5.336 The assurance factors, also based on PPS statistical theory, are as follows:

Assessment of inherent and control risk	Risk that other substantive procedures (e.g. analytical procedures) will fail to detect a material misstatement		
	Maximum	Moderate	Low
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

5.337 The steps to be taken in determining the sample size using the Model Approach Working Paper — Tests of Details Sampling Form (see section 5.406) are as follows:

A. Assess the combination of inherent and control risk:

1. Maximum — Control and inherent risk are assessed at the maximum for the particular assertions. No tests of controls are required to support this assessment.

2. Slightly below the maximum — Control and inherent risk are assessed at slightly below the maximum for the particular assertions. Minimal tests of controls are required for this assessment.

3. Moderate — Control and inherent risk are assessed at a moderate level for this particular assertion. Moderately effective tests of controls are required for this assessment.

4. Low — Control and inherent risk are assessed at a low level for the particular assertions. Very effective tests of controls are required for this assessment.

B. Determine the basic allowance for unknown misstatements (tolerable misstatement). This is related to preliminary estimates of materiality for the engagement.

C. Assess the risk that other substantive procedures (such as analytical procedures) designed to test the same assertions will fail to detect a material misstatement in a particular assertion as follows:

1. Maximum — No other substantive procedures are performed that are designed to test the same assertions.

2. Moderate — Other substantive procedures to test the assertions are expected to be moderately effective in detecting material misstatements.

3. Low — Other substantive procedures to test the assertions are expected to be highly effective in detecting material misstatements.

D. Determine the population's recorded amount after deducting any items that will be audited 100% (all items that are more than 1/3 of tolerable misstatement).

E. Use the appropriate assurance factor and the formula to determine the initial sample size.

5.338 Depending on the amount of the basic allowance for unknown misstatements, sample sizes computed with this model may approximate those sizes selected judgmentally. Because the model is based on a highly stratified approach, and this approach usually will include minimal or no stratification, the sample should be somewhat larger than the preliminary size if there are significant variations in the population. If stratification is necessary and is not practical, an acceptable approach would be to multiply the preliminary sample size by a marginal risk factor of 1.2 to compensate for the sampling risk associated with not stratifying. The marginal risk factor should *not* be used when the population is stratified or when stratification is not necessary.

5.339 **Evaluating the Sample Results.** The misstatement in the sample must be projected to the population. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement by the fraction of total dollars in the population to total dollars included in the sample. For example, if a $1,000 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $10,000 ($1,000/.10).

5.340 A second method for projecting the misstatement uses the average difference between the audited and the recorded amounts of each item included in the sample. For example, if $200 of misstatement is found in a sample of 100 items, the average difference between audited and recorded amounts for items in the sample is $2 ($200/100). An estimate of the amount of misstatement in the population may be calculated by multiplying the total number of items in the population (in this case 25,000 items) by the average difference of $2 for each sample item. The estimate of misstatement in the population is $50,000 (25,000 × $2).

5.341 If the projected misstatement is less than tolerable misstatement for the account balance, consideration must be given to the risk that actual misstatement exceeds the amount of tolerable misstatement. If the projected misstatement is less than 1/3 of tolerable misstatement, it is generally safe to conclude that sampling risk is sufficiently low. If it is greater than 1/3, consideration should be given to performing additional tests of the account.

5.342 The Audit Sample Evaluation Form — Tests of Details (section 5.407) is designed to project the misstatement in the sample to the population, and to evaluate sampling risk. The form should be completed by the in-charge and reviewed by the engagement partner. Remember that any projected misstatement should be posted to the Summary of Possible Journal Entries Form.

Selecting Samples

5.343 SAS No. 39 permits random number selection, systematic selection with or without random starts and haphazard selection methods for nonstatistical sampling. Block sampling is not acceptable. A random number selection method should be used for statistical sampling.

5.344 Random-based selection methods can be applied using random number tables or computer or calculator programs. The Random Selection With a Random Table Form (see section 5.404) may be used to document sample size selections using a random number table.

5.345 To use a random number table:

1. Assign each element in the population a unique address that corresponds to the random number table.
2. Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.
3. Place a pencil on a page to determine a random starting point.
4. Modify the population numbers to the smallest possible number of digits to reduce discards.

5.346 The procedure for using a program or calculator to generate random numbers varies with the programs. However, these techniques generally require the auditor to provide the smallest and largest item numbers, and the number of sample items needed.

5.347 Systematic sampling requires the calculation of an interval. An interval is determined by dividing the population size by the number of sample units desired. For example:

$$N = \text{Sample Size} = 4{,}000$$
$$n = \text{Desired Units} = 50$$
$$I = \text{Interval}$$

$$I = \frac{N}{n} = \frac{4{,}000}{50} = 80$$

5.348 After selecting a random number within the interval as a starting point, each 80th unit would be selected. A Random Selection With a Systematic Sample Form in section 5.709 may be used to document systematic selection methods with random starts.

5.349 Haphazard sampling involves selecting items on a purely judgmental basis, without any bias towards the selection of particular items.

5.400 DOCUMENTATION ASSISTANCE

5.401

Risk of Potential Misstatements Evaluation Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be used on audit engagements under the ABC approach to evaluate and document the risk of potential errors and irregularities. Answers should be based on inquiries of client personnel, an understanding of the client's business and industry, experience from prior years' engagements, the current year's internal control structure assessment and other special considerations. The impact of the risk of potential misstatements should be documented in the Planning Matrix.

	Yes	No
I. Special Considerations. ("yes" answers, i.e., high risk, should be checked on accompanying Potential Misstatements Matrix)		
1. Are there client-imposed limitations on the scope of the engagement? (Describe below.)	____	____
2. Is this an initial engagement?	____	____
3. Do discussions with prior engagement personnel or predecessor accountants indicate a high risk of potential misstatements? (Describe below.)	____	____
4. Are the client's accounting policies, methods or estimates unusual or difficult to apply, or have they been changed recently? (Describe below.)	____	____
5. Are there significant related-party or other unusual transactions? (Describe below.)	____	____
6. Is the overall engagement risk evaluation high?	____	____

Describe the circumstances surrounding "yes" answers and record effects on Potential Misstatements Matrix:

II. Potential Misstatements Matrix:

Complete the accompanying Potential Misstatements Matrix and transfer the summary of risk by audit area to the Planning Matrix. In addition to classifying the risk of potential misstatements from special considerations above by engagement area, the Potential Misstatements Matrix includes similar classifications for:

1. High Risk or Material *and* Unusual Account Balances:

   The nature of the client's industry or operations may typically cause certain account balances and the relative risk of misstatements to be high. Material account balances must also be unusual in the client's circumstances to be considered high risk. Sales of fixed assets, for example, would not be considered high risk unless increases or decreases were unusual in nature or account.

2. Significant Prior-Year Adjustments and Exposure Areas:

   Significant prior-year adjustments, made or passed, and exposure areas that may recur and affect the current period should also be noted on the Potential Misstatements Matrix.

3. Reportable Conditions in the Internal Control Structure:

   Reportable conditions are derived from the Internal Controls Questionnaire. The effects of reportable conditions on major engagement areas should be evidenced on the Potential Misstatements Matrix.

POTENTIAL MISSTATEMENTS MATRIX — AUTO DEALERSHIPS

Engagement Area	Special Considerations	High Risk/Unusual and Material Account Balances	Prior-Year Adjustments or Exposure Areas	Risk Summary (Low or High)
Cash				
Contracts in transit				
Manufacturer receivables				
Accounts receivable				
Inventories				
Property and equipment				
Accounts payable				
Wholesale finance (floor plan) liability				
Income				
Payroll tests				
Expense account analysis and vouching				

The risk categories on the Potential Misstatements Matrix for each engagement area should contain a check mark (✓) where the risk of potential misstatements is high. Low risk is otherwise assumed. After considering the number and significance of misstatements in each engagement area, the in-charge should use professional judgment to summarize the risk of potential misstatements as low or high. The summary should be transferred to the Planning Matrix. Describe below the modifications to the Tests of Balances Audit Program that will be made to compensate for the high risks of potential misstatements (low risks require no modification).

Prepared by: ______________________ Date: ______________________
(In-charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

EXPLANATION OF HIGH RISK POTENTIAL MISSTATEMENTS

Engagement Area	Explanation

5.402

Planning Matrix — Auto Dealerships

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

The Planning Matrix should be prepared by the in-charge for audit engagements under the ABC Approach. The matrix coordinates the evaluation of the risk of potential misstatements and the internal control structure to guide the selection of tests of controls, and tests of balances, and analytical procedures and sample sizes. The Matrix should be completed after the following documents have been finalized:

1. Client Acceptance and Continuance Form.

2. Audit Planning Memorandum.

3. Internal Controls Questionnaire and any supplementary narrative and flowcharts.

4. Risk of Potential Misstatements Evaluation Form.

The Matrix and related documentation should be reviewed by the engagement partner before the tests of controls are started.

PLANNING MATRIX — AUTO DEALERSHIPS

(1) Major Audit Areas	(2) Related Tests of Controls	(3) System Classification (Circle One)	(4) Assessed Level of Control Risk	(5) Risk of Potential Misstatement (High or Low)	(6) Risk That Analytical Procedures Will Not Detect Material Misstatement	(7) Resulting Evidence Required from Tests of Details
I. Cash					M Md L	________
	I. Accounts Receivable, Contracts in Transit and Sales (Collections)	A B C	M S Md L	________		
	II. Inventory, Fixed Assets, Related Liabilities, and Expenses (Payments)	A B C	M S Md L	________		
III. Accounts Receivable					M Md L	________
	I. Accounts Receivable, Contracts in Transit and Sales (Collections and Sales)	A B C	M S Md L	________		
IV. New Vehicle Inventory					M Md L	________
	II. Inventory, Fixed Assets, Related Liabilities, and Expenses (Acquisitions)	A B C	M S Md L	________		
	IV. Physical Inventory	A B C	M S Md L	________		

PLANNING MATRIX — AUTO DEALERSHIPS (Continued)

(1) Major Audit Areas	(2) Related Tests of Controls	(3) System Classification (Circle One)	(4) Assessed Level of Control Risk	(5) Risk of Potential Misstatement (High or Low)	(6) Risk That Analytical Procedures Will Not Detect Material Misstatement	(7) Resulting Evidence Required from Tests of Details
V. Used Vehicle Inventory					M Md L	________
	II. Inventory, Fixed Assets, Related Liabilities, and Expenses (Acquisitions)	A B C	M S Md L	________		
	IV. Physical Inventory	A B C	M S Md L	________		
VI. Parts Inventory					M Md L	________
	II. Inventory, Fixed Assets, Related Liabilities, and Expenses (Acquisitions)	A B C	M S Md L	________		
	IV. Physical Inventory	A B C	M S Md L	________		
IX. Property and Equipment					M Md L	________
	II. Inventory, Fixed Assets, Related Liabilities, and Expenses (Acquisitions)	A B C	M S Md L	________		

PLANNING MATRIX — AUTO DEALERSHIPS (Continued)

(1) Major Audit Areas	(2) Related Tests of Controls	(3) System Classification (Circle One)	(4) Assessed Level of Control Risk	(5) Risk of Potential Misstatement (High or Low)	(6) Risk That Analytical Procedures Will Not Detect Material Misstatement	(7) Resulting Evidence Required from Tests of Details
XII. Accounts Payable					M Md L	________
	II. Inventory, Fixed Assets, Related Liabilities, and Expenses (Payments and Acquisitions)	A B C	M S Md L	________		
XIV. Wholesale Finance Liability					M Md L	________
	II. Inventory, Fixed Assets, Related Liabilities, and Expenses (Payments and Acquisitions)	A B C	M S Md L	________		
XVII. Income and Expense					M Md L	________
	I. Accounts Receivable, Contracts in Transit and Sales (Collections and Sales)	A B C	M S Md L	________		

PLANNING MATRIX — AUTO DEALERSHIPS (Continued)

(1) Major Audit Areas	(2) Related Tests of Controls	(3) System Classification (Circle One)	(4) Assessed Level of Control Risk	(5) Risk of Potential Misstatement (High or Low)	(6) Risk That Analytical Procedures Will Not Detect Material Misstatement	(7) Resulting Evidence Required from Tests of Details
XVII. Income and Expense (Cont.)					M Md L	________
	II. Inventory, Fixed Assets, Related Liabilities, and Expenses (Payments and Acquisitions)	A B C	M S Md L	________		
	III. Payroll Expenses	A B C	M S Md L	________		

Other: ____

____

____

____

Note: The accounts contained on this Form are those for which control risk is often assessed at a moderate or low level. It is assumed that control risk is assessed at a maximum for accounts not listed above. Any items not listed for which control risk will be assessed at a moderate or low level should be added to this Form.

Prepared by: ____________________ Date: ____________

Approved by: ____________________ Date: ____________

Planning Matrix Legend

(1) The major audit areas included in the matrix represent those areas in which it is likely that tests of controls would be performed. These audit areas correspond to sections in the Auto Dealership Tests of Balances Audit Program (Chapter 7, section 7.500).

(2) The Related Tests of Controls column refers to the sections in the Tests of Controls Programs that support the major audit area in Column 1.

(3) The system classification is obtained from the Internal Controls Questionnaire. The systems selected should be supported by the Tests of Controls performed in section 6.300 (Column 2).

(4) Assessing control risk at less than the maximum will decrease the amount of evidence required from substantive tests. Control risk may be assessed at the Maximum (M), Slightly below the Maximum (S), Moderate (Md), or Low (L). Tests of controls must be performed in situations where control risk is assessed at slightly below the maximum or at a moderate or low level.

(5) From the Risk of Potential Misstatements Evaluation Form, the risk of potential misstatements (low or high) may vary for different financial statement assertions. These risk factors may increase or decrease the needed evidence from substantive tests. The risk may be assessed as high or low.

(6) Evidence from analytical procedures can reduce the extent of the evidence required from tests of details. The Planning Matrix rates this evidence in terms of the risk that the analytical procedures will fail to detect a material misstatement in the account or the assertions about the account. For example, maximum risk means no evidence is obtained from analytical procedures.

(7) The required evidence from tests of details is a result of the assessed level of control risk, the risk of potential misstatements, and the evidence obtained from analytical procedures. The examples below illustrate this relationship.

The Planning Matrix contains assessments for assertions about those accounts where audit efficiencies are usually obtained. Assertions about other accounts not contained on the form can be added when we decide to assess control risk for those assertions at less than the maximum. For assertions about accounts not included or added to the Planning Matrix, our approach is assess control risk at the maximum and place maximum reliance on analytical procedures and tests of details.

These guidelines presume account balances are material. If balances are immaterial, so state in the Final Resulting Required Evidence from Tests of Details. No evidence is required for immaterial account balances.

High degree of evidence from tests of details will require procedures with high reliability, e.g., large sample sizes with tests performed primarily at the balance-sheet date. Low degree of evidence from tests of details will allow less reliable tests, e.g., small sample sizes and performing tests at interim dates.

Page 2 of 3

System Classification	Control Risk	Risk of Potential Misstatements	Risk That Analytical Procedures Will Not Detect a Material Misstatement	Resulting Required Evidence from Tests of Details
A	M S Md L	Low	M Md L	None
A	M S Md L	High	M Md L	Low
A	M S Md L	Low	M Md L	Low
A	M S Md L	Low	M Md L	Moderate
B	M S Md L	Low	M Md L	None
B	M S Md L	High	M Md L	Moderate
B	M S Md L	Low	M Md L	Moderate
C	M S Md L	Low	M Md L	Low
C	M S Md L	High	M Md L	Moderate
C	M S Md L	Low	M Md L	Slightly Below High
C	M S Md L	Low	M Md L	Moderate
C	M S Md L	Low	M Md L	High

The ABC approach presumes high reliance on analytical procedures for all engagements to the maximum extent practical.

Final modification of the Tests of Balances Audit Program will be made based on the results of performing the tests of controls on the internal control structure policies and procedures.

(8) Nonstatistical sample size ranges for tests of controls may be determined using the following table unless otherwise directed by the engagement partner. Sample sizes so selected should be entered directly on the appropriate Tests of Controls Program. The in-charge should document in the Planning Memorandum consideration of the factors that affect the sample sizes selected. The partner should approve the Planning Memorandum *before* the tests of controls are begun.

Page 3 of 3

TESTS OF CONTROLS
SAMPLE SIZE SELECTION TABLE

Assessed Level of Control Risk	Sample Size*
Maximum	0
Slightly below the maximum	15
Moderate	30
Low	40

* The numbers in the table were determined using a risk of assessing control risk too low of 10% and an expected population deviation rate of 0%. If one or more deviations are found in the sample, the sample size should be increased or the assessed level of control risk should be increased.

(9) When deviations are expected or found in a sample the following table may be used to determine the sample size or evaluate the sample results:

Deviations (Expected or Actual)	Assessment of Control Risk		
	Slightly Below Maximum	Moderate	Low
0	15	30	40
1	25	50	65
2	34	67	90
3	43	85	115

Tests of controls consisting of observation of performance and inquiries are not normally subject to audit sampling.

5.403 ALL-SUBSTANTIVE APPROACH QUESTIONNAIRE — AUTO DEALERSHIPS

Use of the Questionnaire

This Questionnaire is designed to be used on small, noncomplex audit engagements. It consists of two sections: Section I contains questions about the dealership's control structure and Section II deals with the risk of potential misstatements. Completion of Section I provides the auditor with the basic understanding of the control structure. It requires the auditor to document any special internal control matters that would affect substantive testing. Section II requires the auditor to consider the risk of potential misstatements in the financial statements, and consider their impact on the design of the audit.

This Questionnaire replaces the Internal Controls Questionnaire, the Planning Matrix, and the Risk of Potential Misstatements Evaluation Form, required under the ABC System. The decision to use this Questionnaire should be made during planning and should be based on engagement circumstances and economic considerations. For example, tests of controls may have produced unacceptable results in prior years, or the nature of the client's operations may cause substantive tests to be the most efficient evidence collection methods. Use of this Questionnaire presumes that maximum substantive tests will be performed and that they will be performed as of the balance-sheet date. Minimum tests of controls through completion of the System C Tests of Controls Programs are recommended.

INSTRUCTIONS:

When appropriate, client personnel should complete the Questionnaire for review by the in-charge. In the "Personnel" column insert the name and title of the individual that performs the control procedure. If more than one individual is listed because the question relates to segregation of duties, briefly describe the procedure performed by each.

"No" answers to the control environment and accounting systems questions (Section I) represent potential weaknesses. Material weaknesses and reportable conditions should be posted to the Internal Control Structure Reportable Conditions Form. Most dealerships' control environments include dealer or manager controls. The term "manager," as used in this Questionnaire, describes a person performing internal verification functions. That person may be the general manager, controller, bookkeeper or other employee.

The risks of potential misstatements, and the resulting program modification, should be summarized in Section II by the in-charge. Both sections should be reviewed by the engagement partner before field work is started.

All-Substantive Approach Questionnaire — Auto Dealerships — Section I

Client: ____________________

Financial Statement Date: ____________________

	Personnel	Yes	No	N/A
General Control Environment and Accounting System				
1. A general ledger is posted and balanced.				
2. A general journal is prepared and balanced.				
3. Journal entries have adequate support.				
4. An adequate chart of accounts is in use.				
5. The dealer or manager participates in the day-to-day activities of the dealership.				
6. All-employees in a position of trust are bonded adequately.				
7. All-employees in a position of trust are required to take vacations.				
8. Hazard insurance coverage is periodically reviewed to determine adequacy.				
9. Management receives financial statements on a regular basis.				
10. The dealer's attitudes about income taxes and business risks are conservative.				
11. The dealer/manager understands the importance of control procedures.				
12. The dealer/manager understands and uses financial statements and reports prepared by accounting personnel.				
13. Accounting personnel have experience and training appropriate for their jobs and understand their responsibilities.				

ALL-SUBSTANTIVE APPROACH QUESTIONNAIRE—AUTO DEALERSHIPS
Section I (Continued)

	Personnel	Yes	No	N/A
14. The dealer/manager and accounting personnel are competent, possess high integrity and are concerned about the quality of their work.	______	___	___	___
15. Documents, records, and assets are physically controlled to prevent their destruction or unauthorized use.	______	___	___	___
16. The financial condition of the dealership is sound.	______	___	___	___

17. Describe the following features of the control environment:

a. Describe the personnel structure of management, accounting, and operations personnel below, or attach an organization chart.

____

____

____

____

b. Describe the dealer's attitudes and practices that may affect the risk of errors or irregularities in the financial statements. Consider such factors as deteriorating operations creating a need for working capital, financial statement ratios influencing lenders' decisions, motivation of dealer/manager to reduce income taxes, and dealer's history of taking unnecessary business risks.

____

____

____

____

____

c. In case of an absentee owner, describe the general manager's compensation method and whether it is reasonable.

____

____

____

____

ALL-SUBSTANTIVE APPROACH QUESTIONNAIRE— AUTO DEALERSHIPS

Section I (Continued)

d. Describe the dealer's awareness of the importance of a good accounting system, performing board/manager controls and understanding and use of related financial information.

e. List the accounting personnel, their positions and length of employment, describe briefly their education and experience and evaluate their job performance based on firm experience with the client.

f. Describe how the client achieves an adequate cut-off of transactions when the financial statements are prepared.

g. Describe how the client's financial statements are prepared, including the way in which major accounting estimates are made.

ALL-SUBSTANTIVE APPROACH QUESTIONNAIRE— AUTO DEALERSHIPS
Section I (Continued)

	Personnel	Yes	No	N/A
Sales and Collections Transaction Cycle				
1. A cash receipts journal is prepared and balanced.	______	___	___	___
2. A sales journal is prepared and balanced.	______	___	___	___
3. Cash receipts are recorded as received.	______	___	___	___
4. Sales are recorded in the appropriate period.	______	___	___	___
5. Records of customer payments of accounts receivable are maintained (remittance advice or duplicate deposit slip).	______	___	___	___
6. Collections are deposited intact.				
7. Over-the-counter receipts are controlled such as by a cash register or prenumbered receipts tickets, parts tickets, or repair orders.	______	___	___	___
8. Sales invoices evidencing delivery date are prepared for sales of new and used cars.	______	___	___	___
9. Dated repair orders and parts tickets are prepared.	______	___	___	___
10. Customers' statements are mailed periodically.	______	___	___	___
11. The dealer or manager reviews copies of sales invoices or customers' statements and resolves customer disputes.	______	___	___	___
12. Receivables are aged regularly and reviewed by the board or manager.	______	___	___	___
13. The person who opens the mail maintains a log of mail receipts.	______	___	___	___
Acquisitions and Payments Transaction Cycle				
1. A cash disbursements journal is prepared and balanced.	______	___	___	___

ALL-SUBSTANTIVE APPROACH QUESTIONNAIRE— AUTO DEALERSHIPS
Section I (Continued)

	Personnel	Yes	No	N/A
2. A detailed depreciation schedule is prepared and balanced to the general ledger.				
3. All-checks are signed by the dealer or manager.				
4. Checks are signed only when disbursement is made (not in advance).				
5. The check signer compares data on supporting documents to checks.				
6. Vendor invoices are canceled when checks are signed.				
7. Checks are recorded in the disbursements journal as prepared.				
8. Checks are prenumbered.				
9. Vendor invoices support purchases.				
10. Vendor invoices or receiving reports contain the date goods were received.				
11. Unpaid vendor invoices are filed separately from paid invoices.				
12. Purchases are approved by the dealer or manager.				
13. The bank reconciliation is reviewed by the dealer or manager.				
Payroll and Personnel Transaction Cycle				
1. A cash disbursements journal is prepared and balanced.				
2. Payroll disbursements are made by check.				
3. Checks are prenumbered.				

ALL-SUBSTANTIVE APPROACH QUESTIONNAIRE— AUTO DEALERSHIPS
Section I (Continued)

	Personnel	Yes	No	N/A
4. Payroll checks are recorded in the payroll journal as prepared.				
5. Employees' time records are maintained.				
6. W-4 forms are maintained.				
7. Employees' earnings records are maintained.				
8. The payroll bank reconciliation is reviewed by the dealer or manager.				
9. Wage rates are authorized by the dealer or manager.				
10. Payroll checks are signed by the dealer or manager.				
11. Payroll checks are periodically distributed by the dealer or manager.				

Inventory and Warehousing Transaction Cycle

	Personnel	Yes	No	N/A
1. An annual physical inventory is taken and adequate count records (tags or sheets) are maintained.				
2. Adequate records of inventory pricing and summary are maintained.				
3. The inventory count is taken, checked or supervised by the dealer or manager.				
4. Obsolete and consigned goods are excluded from the count.				
5. Good physical cutoff procedures are utilized to insure an accurate count and recording of inventory.				

ALL-SUBSTANTIVE APPROACH QUESTIONNAIRE—AUTO DEALERSHIPS
Section I (Continued)

Modification of standard tests for special internal control risks:

____
____
____
____
____
____
____
____
____
____
____
____
____

Unless indicated otherwise, control risk is assessed at the maximum level for all financial statement assertions.

	19____	19____	19____	19____	19____
Prepared by:					
Client	______	______	______	______	______
In-charge	______	______	______	______	______
Reviewed by:					
Engagement Partner	______	______	______	______	______

All-Substantive Approach Questionnaire — Auto Dealerships — Risk of Potential Misstatements and Impact on Substantive Tests — Section II

Client: ______________________________

Financial Statement Date: ______________________________

I. Describe any special considerations such as scope limitations, first engagement circumstances, unusual or difficult accounting principles, methods or estimates, related parties or other unusual circumstances causing risk. Identify engagement areas affected.

____
____
____
____
____
____
____
____

II. Describe high risk or unusual and material account balances.

____
____
____
____
____
____
____
____

III. Describe prior-year adjustments or exposure areas with potential impact on this year's engagement.

____
____
____
____

ALL-SUBSTANTIVE APPROACH QUESTIONNAIRE— AUTO DEALERSHIPS—RISK OF POTENTIAL MISSTATEMENTS AND IMPACT ON SUBSTANTIVE TESTS

Section II (Continued)

IV. Describe the impact of the risks of potential misstatements on the substantive tests, i.e., the resulting program modifications.

Prepared by: ____________________ Date: __________
(In-charge)

Reviewed by: ____________________ Date: __________
(Partner)

5.404

Random Selection With a Random Table Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

To use the random selection method with a random number table:

- Assign each element of the population a unique address that corresponds to the random number table.
- Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.
- Place a pencil on a page to determine a random starting point.
- Modify the population numbers to the smallest possible number of digits to reduce discards.
- Pure random sampling should be applied to the entire population; stratified random sampling would separate the population according to some characteristic such as size of elements or features of the underlying transaction. This form should be used to document random selection with a random table or calculator. If a computer is used, a copy of the computer printout should be retained as documentation.

POPULATION DESCRIPTION

1. Type of document designated as the sampling unit. ______________________________

   a. Largest document number plus 1 ______________________________

   b. Smallest document number ______________________________

   c. Population size ______________________________

2. Nature of the sampling unit if not a document. ______________________________

3. Description of the population if No. 2. is applicable (including population size and numbering of population). ______________________________

RANDOM SELECTION WITH A RANDOM TABLE FORM
(Continued)

RANDOM NUMBER TABLE

Name of table. ______________________

Page(s) used. ______________________

Correspondence between the table and sampling units (normally document number). ______________________

Number of digits used. ______________________

Starting point in table. ______________________

First usable sample number. ______________________

Last usable sample number. ______________________

Stopping point in table. ______________________

Number of sample items selected. ______________________

Modifications to reduce discards. ______________________

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

5.405

Random Selection With a Systematic Sample Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form is used to document systematic selection methods with random starts.

POPULATION DESCRIPTION

1. Type of document designated as the sampling unit. ______________
   a. Largest document number plus 1 ______________
   b. Smallest document number ______________
   c. Population size ______________
2. Nature of the sampling unit if not a document. ______________
3. Description of the population if No. 2. is applicable (including population size and numbering of population). ______________

$$\frac{\text{Population Size}}{\text{Sample Size}} = \text{initial interval}$$

Initial interval × number of desired starts =

adjusted interval

Rounded interval.

Random number(s) from the table.

First sample item(s).

Last sample item(s).

Prepared by: ______________________________ Date: ______________
(In-Charge)

Reviewed by: ______________________________ Date: ______________
(Engagement Partner)

5.406

Model Approach[1] Working Paper — Tests of Details Sampling

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be completed by the in-charge during planning and approved by the engagement partner before field work is started.

1. Check the financial statement assertion(s) being tested:

a. Existence and occurrence	______	c. Completeness	______
b. Rights and obligations	______	d. Valuation or allocation	______

2. Description of sampling application: ______________________________

____

____

3. Total recorded population for ______________________ $__________

   Less amount of individually significant items (Usually all items equal to or greater than 1/3 of tolerable misstatement) (__________)

   Sample population $__________

4. Describe what will be considered to be a misstatement for testing purposes:

____

____

____

(1) The model approach generally will not be used for populations containing less than 500 units or large populations of small-dollar units.

Assessment of inherent and control risk	Risk that other substantive procedures (such as analytical procedures) will fail to detect a material misstatement		
	Maximum	Moderate	Low
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

5. Calculate the initial sample size with the following formula:

Sampling Population		Basic Allowance (Tolerable Misstatement)[2]		Assurance Factor		Initial Sample Size
$ ________	÷	$ ________	×	________	=	________

6. Allocate the sample items:

	Population Items	Population Dollars	Sample Items	Sample Dollars
a. Stratum 1—Items above the mean of the sampling population (select 2/3 of the sample items from this subpopulation)	____	$____	____	$____
b. Stratum 2—Items less than the mean of the sampling population (select 1/3 of the sample items from this subpopulation)	____	$____	____	$____
c. Total	____	$____	____	$____

Prepared by: ______________________________ Date: ____________________
(In-charge)

Reviewed by: ______________________________ Date: ____________________
(Engagement Partner)

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(2) Amount should be two-thirds of overall materiality limit.

5.407

Audit Sample Evaluation Form — Tests of Details Sampling

Client: ______________________________

Financial Statement Date: ______________________________

1. Project the misstatement (use only one column if the sample population was not stratified):

	Stratum 1	Stratum 2
a. Misstatement in the sample	$ ________	$ ________
b. Dollar value of the sample	$ ________	$ ________
c. Dollar value of the strata	$ ________	$ ________
d. Projected misstatement in the sample stratum (c. ÷ b. × a.)	$ ________	$ ________
e. Total projected misstatement in the sample population (d.1. + d.2.)	$ ________	

2. Evaluate sample risk:
   a. Misstatements found in the group audited 100% $ ________
   b. Projected misstatement in the sample population (1.e.) $ ________
   c. Total projected and known misstatement (2.a. + 2.b.) $ ________
   d. Amount of above misstatement corrected $ ________
   e. Remaining known and projected misstatement (2.c.-2.d.) $ ________*
   f. Tolerable misstatement for the account (From the Model Approach Working Paper—Tests of Balances) $ ________
   g. Is the remaining known and projected misstatement (e.) less than 1/3 of the amount of tolerable misstatement (f.)? Yes ___ No ___

   If the answer to (g.) is "No", sampling risk may be unacceptably high and additional testing should be considered.

Prepared by: ______________________________ Date: ______________
(In-charge)

Reviewed by: ______________________________ Date: ______________
(Engagement Partner)

* This amount should be posted to the Summary of Possible Journal Entries Form (section ______).

Internal Controls

CHAPTER 6

INTERNAL CONTROLS

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CHAPTER 6

INTERNAL CONTROLS

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CHAPTER 6

INTERNAL CONTROLS

6.000 CONSIDERATION OF INTERNAL CONTROLS IN AUTO DEALERSHIP AUDITS

Introduction

6.001 This chapter covers the auditor's consideration of the internal control structure in audits of auto dealerships' financial statements in accordance with generally accepted auditing standards (GAAS). As discussed in Chapter 5, the auditor's consideration of the internal control structure plays a vital role on the nature, timing, and extent of the audit procedures performed. This chapter provides guidance on the assessment, documentation, and testing of the internal controls used by auto dealerships.

6.002 Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319), indicates that an entity's internal control structure consists of the following three elements:

- The control environment.
- The accounting system.
- Control procedures.

6.003 **Control Environment.** Most auditors think of internal controls in terms of policies and procedures over the recording, processing, and reporting of financial data. While these specific internal control policies and procedures are certainly the backbone of good internal controls, SAS No. 55 emphasizes the need to consider other factors (referred to as the "control environment") that can greatly impact, both positively and negatively, a dealership's internal controls. The following are examples of factors that should be considered in obtaining an understanding of a dealership's control environment, as listed in paragraph 9 of SAS No. 55 (AU 319.09):

- Owner and/or general manager's philosophy and operating style.
- The organizational structure.
- The functioning of the board of directors and its committees, particularly the audit committee.
- Methods of assigning authority and responsibility.
- Owner and/or general manager's control methods for monitoring and following up on performance, such as daily operating control reports.

- Personnel policies and practices.
- External influences that affect the dealership's operations and practices, including manufacturer-required operating statements.

6.004 As mentioned above, these factors can positively or negatively impact a dealership's internal controls. For example, if the dealership has established strong internal controls, but the general manager's attitude toward maintaining the controls is lax, then internal controls could easily be bypassed or overridden. Conversely, if internal controls are weak due to a lack of segregation of duties, active oversight by top management of the accounting and financial reporting process can mitigate the weakness. In most cases, considering the above factors gives the auditor a sufficient understanding of the control environment to understand the owner's and general manager's attitude, awareness, and actions towards the control environment.

6.005 **Accounting System.** The accounting system consists primarily of the dealership's methods to identify, assemble, analyze, and record financial information. These methods are crucial to providing accountability of the dealership's assets and liabilities. Effective accounting systems will:

- Identify and record all valid transactions.
- Classify financial transactions on a timely basis.
- Value these financial transactions in an appropriate manner.
- Identify the time period in which these financial transactions occurred.
- Adequately disclose these transactions in the financial statements.

6.006 **Control Procedures.** Control procedures are those policies and procedures, in addition to the control environment and accounting system, that have been established to provide reasonable assurance that specific organizational objectives will be achieved. Control procedures include:

- Proper authorization of transactions.
- Adequate segregation of duties.
- Providing a documented audit trail.
- Safeguarding of assets.
- Independent review of other procedures performed.

6.007 In all audits, the auditor is required to obtain and document his or her understanding of the three elements of the control structure in order to plan and perform an audit.

Documentation of Internal Control Structure

6.008 The Internal Controls Questionnaire, section 6.100, and the EDP Questionnaires in this chapter, section 6.200, can assist the auditor in accomplishing these objectives for an engagement in which the ABC System is selected. For audits using the All-Substantive Approach, the All-Substantive Approach Questionnaire in Chapter 5, section 5.403, along with the EDP Questionnaires in this chapter, documents the auditor's understanding of the control structure. The Internal Controls Questionnaire has been customized to reflect the controls typically required for an auto dealership. For example, the questions address controls over new and used car inventory, parts inventory, repair orders, parts tickets, and other areas unique to auto dealerships. The EDP Questionnaires aid the auditor in documenting his or her understanding of the EDP controls.

6.009 As discussed in sections 5.103–5.109 of Chapter 5, completing the Internal Controls Questionnaire helps the auditor select the appropriate system (A, B, or C) for each major audit area. The system selected should be noted on the Planning Matrix in section 5.402 in Chapter 5 for use in determining the nature, timing, and extent of tests.

6.010 The following describes the process for selecting a system:

1. Within each of the five sections of the Internal Controls Questionnaire, identify the most advanced system classification, A, B, or C, with a majority of "yes" answers. Because tests of controls often require less time than tests of balances, the objective should be to perform tests of controls to the maximum extent practical.

2. Consult with the partner to determine if tests of controls for the system classification selected are practical in light of past experience with the client. Prior years' unacceptable results from tests of controls, and the resulting high reliance on substantive tests, may lead to a decision to select a lower system classification, i.e., B or C, and minimize controls testing. In other words, this decision may prevent inefficient auditing.

3. For all "no" answers, i.e., potential weaknesses, up to and including the system selected in each section, perform the following:

   a. Determine if the "no" answer is, in fact, a weakness.

   b. For the potential weakness, review any "yes" answers to other controls for possible offsetting strengths. Such strengths could be included within the system classification selected or in a more advanced system. For example, a weakness in a System B (a "no" answer) could be offset by another control within System B (a "yes" answer) or by a control in System A.

6.011 The Internal Controls Questionnaire may be completed by the client's employees or by engagement personnel. If the client's employees are used, their work should be reviewed by the in-charge to ensure that questions are answered correctly.

6.012 Rather than complete a new Questionnaire every year, many firms merely update the prior year's questionnaire and any supplementary narratives and flowcharts. As mentioned above, client personnel may be used to perform the updates.

Testing the Internal Control Structure

6.013 An inverse relationship exists between the amount of tests of controls and the substantive testing performed in an audit. For engagements using the ABC System (see section 5.100, Chapter 5), the auditor will generally perform tests of controls.

6.014 Similar to the Internal Controls·Questionnaire, the Tests of Controls Programs contain three levels of controls: System C (accounting system), System B (primary controls), and System A (secondary controls). As a result, the auditor should complete the Tests of Controls Programs that correspond to the systems selected in the Internal Controls Questionnaire. (See discussion in sections 6.008-6.012.)

6.015 Because the Tests of Controls procedures within a system correspond directly to that system's control procedures in the Internal Controls Questionnaire, the auditor may need to modify the Tests of Controls Programs for any compensating controls considered in the Internal Controls Questionnaire. For example, if a control in a System A offsets a weakness in System B, that control would not otherwise be tested under the System B Tests of Controls Program. To rely on the offsetting System A control, a modifying test of that control must be added to the System B program.

6.016 Standard Tests of Controls Programs, section 6.300, have been coordinated with the Internal Controls Questionnaire with particular attention paid to the special needs of auto dealerships. Completing and evaluating the results of these tests may reduce substantive procedures. Guidance on selecting sample sizes for tests of controls is included in Chapter 5, section 5.300.

Documenting Internal Control Structure Weaknesses

6.017 In completing the Internal Controls Questionnaire and the EDP Questionnaires and in performing the tests of controls, the auditor may become aware of deficiencies in the design or operation of the control that could adversely affect the entity's ability to properly record, summarize, and process financial data. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU 325), defines such matters as "reportable conditions" and requires that they be communicated to the entity's audit committee or its equivalent. As the auditor becomes aware of reportable conditions during the course of the audit, he or she should record them on the Internal Control Structure Reportable Conditions Form in section 6.400 for inclusion in the communication to the audit committee. Chapter 10, sections 10.610-10.617, contains examples of such communications.

6.100 INTERNAL CONTROLS QUESTIONNAIRE

Use of Questionnaire

This Questionnaire is divided into the following major audit areas:

I. Accounts receivable, contracts in transit, and sales (existence, valuation, and completeness).
II. Acquisitions of inventory and fixed assets (existence and valuation), and related liabilities (completeness) and expenses (valuation and presentation).
III. Payroll expenses (valuation).
IV. Safeguarding of inventory (existence, completeness, and valuation).
V. All areas.

Each of the five sections is further divided into three levels: Accounting System (System C); Primary Controls (System B); and Secondary Controls (System A). In addition, to the extent that controls under these levels differ among a dealership's departments, they are categorized by department.

System C will result in control risk being assessed at the maximum or slightly below the maximum for most financial statement assertions. The absence of significant aspects of an effective accounting system may mean the client's system is not auditable or that significant reconstruction of records must take place before the audit begins.

System B includes an adequate accounting system and significant primary control procedures, which allows control risk to be assessed at a moderate level for some financial statement assertions.

System A has a well-designed control environment, accounting system, and primary and secondary control policies and procedures. This system allows control risk to be assessed at a moderate or low level.

Instructions:

When appropriate, client personnel should complete the Questionnaire for review by the in-charge. This questionnaire should be used to select the standard system classification and the related Tests of Controls Programs for each major audit area.

In the "Personnel" column insert the name and title of the individual who performs the control procedure. If more than one individual is listed because the queston relates to segregation of duties, briefly describe the procedure performed by each. "No" answers represent potential weaknesses. Material weaknesses and reportable conditions should be posted to the Internal Control Structure Reportable Conditions Form.

The client's systems may contain dealer or manager controls. The term "manager," as used in this questionnaire, describes a person performing internal verification functions. That person may be the general manager, controller, bookkeeper, or other employee.

The systems selected in this Questionnaire should be transferred to the Planning Matrix.

Internal Controls Questionnaire — Auto Dealerships Section I

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Accounts receivable, contracts in transit, and sales (existence and valuation).
2. Sales (completeness).

TRANSACTION CYCLES: Collections and sales.

	Personnel	Yes	No	N/A
ACCOUNTING SYSTEM (SYSTEM C)				
Collections				
1. A cash receipts journal is prepared and footed.	______	___	___	___
2. Records of payments on accounts receivable and contracts in transit by customer are maintained (e.g., remittance advices or duplicate deposit slips).	______	___	___	___
3. Over-the-counter receipts are controlled by repair orders, parts tickets, or receipts tickets.	______	___	___	___
4. Cash receipts are deposited intact.	______	___	___	___
5. Bank accounts are reconciled monthly.	______	___	___	___
Sales				
General				
1. Customers' statements are mailed periodically.	______	___	___	___
New and Used Car Departments				
2. Sales invoices evidencing delivery date are included in deal folders.	______	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION I (Continued)

	Personnel	Yes	No	N/A
Parts and Service Departments				
3. Dated repair orders and parts tickets are prepared.	________	___	___	___
PRIMARY CONTROLS (SYSTEM B)				
Collections				
General				
1. Collections are deposited intact, daily.	________	___	___	___
2. Over-the-counter receipts are controlled by a cash register or prenumbered repair orders, parts tickets, or receipts tickets.	________	___	___	___
3. Cash receipts are recorded in the receipts journal as received.	________	___	___	___
4. The bank reconciliation is prepared by someone independent of all cash receipts functions.	________	___	___	___
5. Cash receipts are posted to an accounts receivable subsidiary ledger.	________	___	___	___
6. The accounts receivable subsidiary ledger is posted, balanced, and reconciled to the general ledger monthly.	________	___	___	___
7. Prenumbered credit memos, repair orders, parts tickets, and receipts tickets are safeguarded and accounted for.	________	___	___	___
8. Cash discounts are approved by the dealer or manager.	________	___	___	___
New and Used Car Departments				
9. A schedule of contracts in transit is maintained and reconciled to the general ledger monthly.	________	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION I (Continued)

	Personnel	Yes	No	N/A
Sales				
General				
1. Monthly statements are sent to customers.				
2. The dealer or manager approves all credit sales.				
3. Sales are posted to an accounts receivable subsidiary ledger.				
4. The dealer or manager approves all discounts, allowances, and bad-debt write-offs.				
New and Used Car Departments				
5. Recording of sales is supported by invoices and complete documentation in deal folders.				
6. The desk log ("shipping report") is compared to deal folders to insure all folders are received.				
Parts and Service Departments				
7. Recording of sales is supported by prenumbered parts tickets or repair orders.				
8. Sales are recorded in a sales journal in the period materials are delivered to the customer (for parts) or repair orders are closed (for services).				
SECONDARY CONTROLS (SYSTEM A)				
Collections				
General				
1. Incoming mail is received, opened, and logged by a person independent of the over-the-counter cash collections, cash receipts journal, general journal entry, and accounts receivable functions.				

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS SECTION I (Continued)

	Personnel	Yes	No	N/A
2. The log of mail receipts is reconciled to deposits by someone who is independent of the functions of handling or recording cash.	______	___	___	___
3. Persons receiving cash over-the-counter are independent of the mail opening, deposits, and general ledger, cash receipts journal, and accounts receivable subsidiary ledger posting functions.	______	___	___	___
4. A person independent of cash receipts and posting functions reconciles over-the-counter receipts to accompanying detail such as cash register tapes, receipts tickets, etc.	______	___	___	___
5. Account codings are reviewed by someone other than the preparer.	______	___	___	___
6. The bank reconciliation is reviewed by the dealer or manager.	______	___	___	___
7. A restrictive endorsement is placed on all checks when received.	______	___	___	___
8. Deposits are prepared by a person independent of the mail opening and listing function.	______	___	___	___
9. Items returned by the bank are received unopened by a person independent of the functions of handling or recording cash receipts.	______	___	___	___
10. Prenumbered credit memos, repair orders, parts tickets, and receipts tickets are accounted for by someone independent of their preparation.	______	___	___	___
11. The accounts receivable subsidiary ledger is reconciled to the general ledger by persons who do not maintain the subsidiary ledger.	______	___	___	___
<u>Parts and Service Departments</u>				
12. The "cash sales" account is examined to insure it returns to a zero balance daily.	______	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION I (Continued)

	Personnel	Yes	No	N/A
Sales				
General				
1. The dealer or manager reviews customer statements or invoices.				
2. A monthly aged analysis of manufacturer and accounts receivable is reviewed by the dealer or manager.				
3. Bad debts written off are controlled by a person who is independent of the functions of handling or recording cash receipts.				
4. Account codings are reviewed by a person independent of the preparer.				
5. The dealer or manager follows up on customer complaints.				
6. Credit memo prices and calculations are double checked and approved by a person independent of the preparer.				
New and Used Car Departments				
7. The dealer or manager approves final vehicle sales prices.				
8. Used car trade-in allowances are approved by the dealer or manager.				
9. Sales invoices and calculations are double checked by a person independent of the preparer.				
10. A monthly aged analysis of manufacturer and customer accounts receivable and contracts in transit is reviewed by the dealer or manager.				
11. Procedures exist to insure that cash receipts of $10,000 or more are identified and reported to the IRS, as appropriate. (Note that "cash" includes bank checks and money orders for under $10,000.)				

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION I (Continued)

	Personnel	Yes	No	N/A
Parts and Service Departments				
12. A sales price list approved by the dealer or manager is used.	______	___	___	___
13. The dealer or manager ensures that all warranty repairs are covered by the warranty contract before work begins.	______	___	___	___

Other comments:

____

____

____

System selection (circle one):

System A[1]   System B[2]   System C[3]

Modification of standard tests:

____

____

____

	19____	19____	19____	19____	19____
Prepared by:					
Client	____	____	____	____	____
In-Charge	____	____	____	____	____
Reviewed by:					
Engagement Partner	____	____	____	____	____

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(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

(3) Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Internal Controls Questionnaire — Auto Dealerships

Section II

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Acquisitions of inventory and fixed assets (existence and valuation).
2. Liabilities and expenses (completeness).
3. Expenses (valuation and presentation).

TRANSACTION CYCLE:
1. Acquisitions and payments.

	Personnel	Yes	No	N/A
ACCOUNTING SYSTEM (SYSTEM C)				
Acquisitions				
1. Vendor invoices, or other documents, indicate the date that goods or services were received.				
2. Unpaid vendor invoices are filed separately from paid invoices.				
Payments				
1. A balancing cash disbursements journal is maintained for each bank account.				
2. Cash disbursements are made by check (except for petty cash).				
3. Cash disbursements are supported by vendors' invoices or other external documents.				
4. Bank reconciliations are prepared timely for all accounts.				
5. Cash disbursements are authorized by a responsible official.				

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION II (Continued)

	Personnel	Yes	No	N/A
PRIMARY CONTROLS (SYSTEM B)				
Acquisitions				
General				
1. Vendors are approved by a responsible official.				
2. All purchases are approved by a responsible official.				
3. Purchases journals are maintained, as appropriate.				
Used Car and Parts Departments				
4. An accounts payable subsidiary ledger is maintained and is reconciled to the general ledger monthly.				
New Car Department				
5. A schedule of new cars on floor plan is maintained and is reconciled to the general ledger monthly.				
Payments				
1. An imprest petty cash fund is used.				
2. The dealer authorizes all bank accounts and check signers.				
3. The bank is immediately notified of all changes of authorized check signers.				
4. All invoices are approved for payment by a responsible official.				
5. Vendor invoices are recalculated prior to checks being prepared.				
6. Checks are prepared by an individual independent of persons who approve vendor invoices.				

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION II (Continued)

	Personnel	Yes	No	N/A
7. Check signers are independent of the functions of approving vendors' invoices and maintaining cash disbursement records.	______	___	___	___
8. Checks are signed only when supported by approved invoices (not signed in advance).	______	___	___	___
9. Check signers compare data on supporting documents to checks.	______	___	___	___
10. Check signers examine appropriate approval on supporting documents before signing checks.	______	___	___	___
11. Checks are recorded in the disbursements journal, and when appropriate in the accounts payable subsidiary ledger.	______	___	___	___
12. Checks are prenumbered and accounted for.	______	___	___	___
13. Voided checks are adequately defaced and are easily accessible for review.	______	___	___	___
14. The practice of cashing checks out of cash receipts is prohibited.	______	___	___	___
15. Bank transfers are scheduled, and investigated to ascertain that both sides of the transaction are recorded.	______	___	___	___
16. Bank reconciliations are prepared by someone independent of all cash disbursements functions or reviewed by an independent official.	______	___	___	___

SECONDARY CONTROLS (SYSTEM A)

Acquisitions

General

	Personnel	Yes	No	N/A
1. All supporting documents are matched by a person independent of the ordering function, or the dealer or manager, before entry in the purchases journals.	______	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE – AUTO DEALERSHIPS
SECTION II (Continued)

	Personnel	Yes	No	N/A
2. Account codings are reviewed by someone other than the preparer.				
Parts Department				
3. Approved vendor price lists are in use.				
4. Prenumbered purchase requisitions and/or purchase orders are prepared as authorization for purchases.				
5. The numerical sequence of purchase orders and/or requisitions is accounted for by a person independent of the preparation function.				
6. The receiving department inspects the quantity and quality of materials on receipt.				
7. Prenumbered receiving reports are prepared as support for purchases.				
8. The numerical sequence of receiving reports is accounted for by a person independent of the preparation function.				
Used Car and Parts Departments				
9. The person who reconciles the accounts payable subsidiary ledger to the general ledger is independent of the function of maintaining the subsidiary ledger.				
10. Accounts payable subsidiary balances are periodically reconciled to vendors' statements by a person independent of the ordering and payments functions.				
New Car Department				
11. New cars are inspected upon receipt and damage claims are promptly filed with the carrier.				
12. The person who reconciles the list of new cars on floor plan to the general ledger is independent of the function of maintaining the list.				

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION II (Continued)

	Personnel	Yes	No	N/A
13. The list of new cars on floor plan is reconciled to statements from the floor plan institution by a person independent of the ordering and payments functions.				
14. The list of new cars on floor plan is compared to the monthly physical inventory to identify potential out of trust situations. Follow-up is performed and resolved promptly.				
Payments				
1. The numerical sequence of checks issued is accounted for by someone independent of the preparation function.				
2. Checks are mailed by a person independent of the function of recording cash disbursements.				
3. The bank reconciliation is prepared by a person independent of the check signing or recording functions.				
4. Bank reconciliations are reviewed by the dealer or manager.				
5. Items returned by the bank are received unopened by a person independent of the functions of approving, preparing, or recording cash disbursements.				
6. The check preparation function is independent of purchases journal, general ledger, and accounts payable subsidiary ledger posting functions.				
7. Account codings are reviewed by someone other than the preparer.				
8. Access to blank checks is limited to persons authorized to prepare checks, and check sequences are accounted for.				
9. Dual authorization is required for large disbursements.				
10. At the time of check signing, all supporting documents are approved and canceled to prevent duplicate payment.				
11. A check protector is used.				

INTERNAL CONTROLS QUESTIONNAIRE—
AUTO DEALERSHIPS
SECTION II (Continued)

Other comments:

____

____

____

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

____

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____

____

	19___	19___	19___	19___	19___
Prepared by:					
Client	___	___	___	___	___
In-Charge	___	___	___	___	___
Reviewed by:					
Engagement Partner	___	___	___	___	___

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(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

(3) Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Internal Controls Questionnaire — Auto Dealerships

Section III

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREA: Payroll expenses (valuation).

TRANSACTION CYCLE: Payroll and personnel.

	Personnel	Yes	No	N/A
ACCOUNTING CONTROLS (SYSTEM C)				
1. A payroll journal is prepared and balanced.				
2. Payroll disbursements are made by check.				
3. Labor is classified by department.				
4. Employees' time records are maintained.				
5. W-4 forms are maintained.				
6. Employees' earnings records are maintained.				
7. A payroll bank account reconciliation is prepared.				
8. Wage rates, commission levels, and sales contests are authorized by the dealer or manager.				
PRIMARY CONTROLS (SYSTEM B)				
1. Time sheets, commission sheets, and payroll copies of repair orders (for service department mechanics) are prepared by employees.				
2. The dealer or manager approves:				
a. Rates of pay.				
b. Commission levels.				

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS SECTION III (Continued)

	Personnel	Yes	No	N/A
c. Sales contests.				
d. Withholdings.				
e. Changes in above.				
3. The payroll bank account reconciliation is prepared by someone independent of payroll preparation, approvals, and check signing or by the dealer or manager.				
4. Payroll checks are prenumbered and accounted for.				
5. Checks are recorded in the payroll journal timely.				
6. Payroll journals are posted at least monthly to employees' earnings records.				
7. Payroll checks are signed by the dealer or manager.				
8. Time sheets, commission sheets, and payroll copies of repair orders (for service department mechanics) are approved by the dealer or manager.				

SECONDARY CONTROLS (SYSTEM A)

General

	Personnel	Yes	No	N/A
1. A time clock is used to record time or time is logged by someone independent of payroll preparation, check-signing, and distribution functions.				
2. Commission sheets are prepared by someone independent of payroll preparation, check-signing, and distribution functions.				
3. All payroll calculations are checked by a person other than the payroll clerk.				

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION III (Continued)

	Personnel	Yes	No	N/A
4. Employees' earnings records are periodically reconciled to the general ledger by persons independent of payroll preparation and distribution.				
5. Account codings are reviewed by someone other than preparer.				
6. Adequate personnel files are maintained.				
7. The numerical sequence of payroll checks is accounted for by a person independent of the preparation function.				
8. Payroll is prepared by persons independent of time card approval, check signing, and check distribution.				
9. Payroll bank account reconciliation is reviewed by the dealer or manager.				
10. Unclaimed payroll checks are followed up on by the dealer or manager.				
11. Periodically, all payroll checks are handed out to employees by the dealer or manager.				
12. The dealer or another appropriate official ensures payments to commissioned personnel are at least equal to minimum wage requirements.				
Service Department				
13. The service department manager affixes "flags" to the payroll copies of repair orders.				
14. Balances in the WIP-labor account are periodically examined for propriety.				

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION III (Continued)

Other comments:

____

____

____

System selection (circle one):

System A[1]   System B[2]   System C[3]

Modification of standard tests:

____

____

____

____

____

	19____	19____	19____	19____	19____
Prepared by:					
Client	______	______	______	______	______
In-Charge	______	______	______	______	______
Reviewed by:					
Engagement Partner	______	______	______	______	______

(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

(3) Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Internal Controls Questionnaire — Auto Dealerships

Section IV

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Safeguarding of inventory (existence and completeness).
2. Inventory (valuation).

TRANSACTION CYCLE:
1. Inventory and warehousing (perpetual inventory records maintained).

	Personnel	Yes	No	N/A
PRIMARY CONTROLS (SYSTEM B—THERE IS NO SYSTEM C)				
General				
1. All inventory purchases and sales are recorded in the perpetual records and the general ledger.				
2. Repair orders are prepared for all internal service work.				
3. Perpetual records are periodically reconciled to the general ledger.				
4. All perpetual records are reconciled to physical inventories at least quarterly.				
5. Physical inventory counters are given adequate instructions.				
6. Perpetual inventory records are posted to date of count to obtain a good cutoff.				
Used Car Department				
7. Excess quantities of used cars in inventory are periodically evaluated and the records adjusted as appropriate.				

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION IV (Continued)

	Personnel	Yes	No	N/A
Parts Department				
8. Excess, obsolete, and slow-moving inventory is periodically identified and returned to manufacturer for appropriate credit.				
9. Withdrawals from inventory are based on prenumbered parts tickets or repair orders.				
10. All inventory write-offs are approved by a manager.				

SECONDARY CONTROLS (SYSTEM A)

	Personnel	Yes	No	N/A
General				
1. All classes of inventory are stored under good physical safeguards.				
2. Materials costs, labor charges, and overhead costs relating to internal work are recorded in the perpetual records and the general ledger.				
3. All internal service work is based on prenumbered repair orders approved by the appropriate manager.				
4. Periodic physical counts are made and agreed to perpetual records by persons independent of the inventory and warehousing functions or by a manager.				
5. Written instructions are prepared and used for periodic physical counts.				
6. The numerical sequence of internal service repair orders is periodically accounted for by someone independent of their preparation.				
7. Material and labor costs charged to inventory are controlled by bills of materials and charges approved by management.				

INTERNAL CONTROLS QUESTIONNAIRE—
AUTO DEALERSHIPS
SECTION IV (Continued)

	Personnel	Yes	No	N/A
8. Perpetual records are periodically reconciled to the general ledger by an independent person.	________	___	___	___
New and Used Car Departments				
9. Title documents are maintained in a fire-proof safe and car keys are kept in a secure place.	________	___	___	___
Parts Department				
10. Warranty parts are segregated and maintained for periods mandated by the manufacturer.	________	___	___	___

Other comments:

____

____

____

____

____

System selection (circle one):

System A[1] System B[2]

[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION IV (Continued)

Modification of standard tests:

	19___	19___	19___	19___	19___
Prepared by:					
Client	___	___	___	___	___
In-Charge	___	___	___	___	___
Reviewed by:					
Engagement Partner	___	___	___	___	___

Internal Controls Questionnaire — Auto Dealerships

Section V

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS: All areas.

TRANSACTION CYCLES: All cycles.

	Personnel	Yes	No	N/A
General Control Environment and Accounting System				
1. The financial condition of the dealership is sound.	______	___	___	___
2. Financing sources other than the dealer are available.	______	___	___	___
3. The dealer's attitudes about income taxes and business risks are conservative.	______	___	___	___
4. The dealer understands the importance of control procedures.	______	___	___	___
5. The dealer understands and uses financial statements and reports prepared by accounting personnel.	______	___	___	___
6. Accounting personnel have experience and training appropriate for their jobs and understand their responsibilities.	______	___	___	___
7. The dealer and accounting personnel are competent, possess requisite integrity, and are concerned about the quality of their work.	______	___	___	___
8. Documents, records, and assets are physically controlled to prevent their destruction or unauthorized use.	______	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION V (Continued)

9. Describe the following features of the control environment:

   a. Describe the organization of management, accounting, and operations personnel below or attach an organization chart.

   ____
   ____
   ____
   ____

   b. Describe the dealer's attitudes and practices that may affect the risk of errors or irregularities in the financial statements. Consider such factors as deteriorating operations creating a need for working capital, financial statement ratios influencing lenders' decisions, motivation of owner to reduce income taxes, dealer's history of taking unnecessary business risks.

   ____
   ____
   ____
   ____

   c. In the case of an absentee dealer, describe the general manager's compensation method and whether it is reasonable.

   ____
   ____
   ____
   ____

   d. Describe the dealer's awareness of the importance of a good accounting system, performing owner/manager controls, and understanding and use of related financial information.

   ____
   ____
   ____
   ____

   e. List the key accounting personnel, their positions and length of employment, describe briefly their education and experience and evaluate their job performance based on firm experience with the client.

   ____
   ____
   ____
   ____

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS SECTION V (Continued)

f. How does the client achieve an adequate cut-off of transactions when the financial statements are prepared?

____

____

____

____

g. Describe how the dealership's financial statements are prepared, including the way in which major accounting estimates are made.

____

____

____

____

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION V (Continued)

10. How are transactions processed?

Transactions	Describe how transactions are initiated, including the documents used	Describe how transactions are recorded and summarized
Sales		
Collections		
Purchases		

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION V (Continued)

Transactions	Describe how transactions are initiated, including the documents used	Describe how transactions are recorded and summarized
Payments		
Payroll		
Other		

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION V (Continued)

11. What is the form of the dealership's accounting records?

Record	Form of the Records Manual/Computer		Personnel Responsible
Journals and schedules:			
Cash receipts	M	C	______
Cash disbursements	M	C	______
New car sales	M	C	______
Used car sales	M	C	______
Parts sales	M	C	______
Service	M	C	______
Internal work	M	C	______
Purchases/voucher	M	C	______
New car purchases/voucher	M	C	______
Payroll	M	C	______
General	M	C	______
______	M	C	______
______	M	C	______
Ledgers:			
General	M	C	______
Accounts receivable	M	C	______
Accounts payable	M	C	______
List of new cars on floor plan	M	C	______
New car inventory schedule	M	C	______
Used car inventory schedule	M	C	______
Parts counter pad	M	C	______
______	M	C	______

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION V (Continued)

Accounting System (System C)

1. A general ledger is posted and balanced. ____________ ____ ____ ____
2. A general journal is prepared and balanced. ____________ ____ ____ ____
3. General journal entries are adequately supported. ____________ ____ ____ ____
4. An adequate chart of accounts is in use. ____________ ____ ____ ____
5. All employees in a position of trust are adequately bonded. ____________ ____ ____ ____
6. All employees in a position of trust are required to take vacations. ____________ ____ ____ ____
7. The owner's personal income and expenses are segregated from the business. ____________ ____ ____ ____

Primary Controls (System B)

1. The dealer or manager participates in the day-to-day operations of the business. ____________ ____ ____ ____
2. Adequate reports and financial information are available to and reviewed by the dealer or manager. ____________ ____ ____ ____
3. All journal entries are approved by the dealer or manager. ____________ ____ ____ ____

Secondary Controls (System A)

1. Budgets are prepared and used to control operations. ____________ ____ ____ ____
2. Property and equipment records are maintained, periodically reviewed and checked to assets, and reconciled to the general ledger. ____________ ____ ____ ____
3. Hazard insurance coverage is periodically reviewed to determine adequacy. ____________ ____ ____ ____

INTERNAL CONTROLS QUESTIONNAIRE — AUTO DEALERSHIPS
SECTION V (Continued)

4. All accounting records, securities, and other valuable papers and records are adequately safeguarded. ________ ____ ____ ____

Other comments:

____
____
____
____
____

Modification of standard tests:

____
____
____
____
____

	19____	19____	19____	19____	19____
Prepared by:					
Client	____	____	____	____	____
In-Charge	____	____	____	____	____
Reviewed by:					
Engagement Partner	____	____	____	____	____

6.200 INTERNAL CONTROLS OVER COMPUTER PROCESSING

6.201 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* requires the auditor to obtain an understanding of a dealership's internal control structure, including the controls over computer processing. This understanding of computer processing controls, which is required even when an all substantive approach to the audit is taken, enables the auditor to design effective substantive tests. This section describes how the auditor can obtain this required understanding, and how it may be documented in the working papers. It also describes typical tests of computer processing controls.

6.202 Today's computer environment is very diverse. Many dealerships use microcomputer systems to maintain all of their accounting records. Some "megadealers" use mainframe computers that are often linked to microcomputer work stations. This section may be used to evaluate the computer controls for dealerships that have a sophisticated computer system, as well as those that use microcomputers and purchased software products.

6.203 Paragraphs 6.204 through 6.206 explain the various types of computer controls that may be established by a client. Tests of computer controls are addressed in paragraphs 6.218 through 6.226. Paragraphs 6.227 through 6.237 describe the auditor's consideration of computer controls when a client has a significant accounting application that is processed by a service organization (e.g., a data processing service center or benefit plan servicer). The following elements of documentation assistance are included in this section:

- The Microcomputer Questionnaire (section 6.215) — is designed to document the required understanding of computer processing controls in audit engagements in which the dealership's computer system is comprised of only microcomputers and purchased software products. If the computer system has some of the controls included in the Questionnaire, the procedures used to obtain an understanding of the computer processing controls will usually provide evidence that will support a lower assessed level of control risk.
- The General Computer Controls Questionnaire and the Application Computer Controls Questionnaire (sections 6.216 and 6.217) — designed to document the auditor's understanding of computer systems that are more sophisticated (e.g., when the dealership develops its own software).
- Service Organization Application Controls Questionnaire (section 6.233) — designed to document the auditor's understanding of the controls at a service organization when it is necessary to obtain and understand those controls and a service auditor's report is not available.
- The Service Auditor Report Evaluation Form (section 6.234) — designed to document the auditor's evaluation of the report of a service auditor when it is necessary to obtain an understanding of the controls applied at a service organization.

Computer System Controls

6.204 To evaluate a dealership's internal control structure, the auditor should have a general understanding of the different computer system controls. In this section the two major types of computer controls — general controls and application controls — are briefly described.

6.205 General controls affect all applications and include:

a. Adequate segregation of computer-related duties, e.g., computer operation, programming, and data input,

b. Controls over the development and testing of programs and systems,

c. Procedures to prevent unauthorized changes to existing programs and systems,

d. Controls over access to programs and data, and

e. Controls over computer operations.

6.206 Application computer controls are those that relate only to a specific accounting application, such as payroll. Application controls include those that relate to input, processing, and output of specific information. For example, application controls for payroll would include:

- Controls to ensure the accuracy of the input of hours and wage rates, such as reviews of credit reports.
- Controls over the accuracy of payroll checks and reports, such as reconciliation of control totals, or supervisory review of checks and reports.

> **Practice Tip:**
>
> General controls affect all computer applications. If a dealership has weak general controls, the auditor generally cannot place any reliance on application controls.

Obtaining an Understanding of Computer System Controls

6.207 As a part of planning the audit, the auditor should identify those account balances, transaction classes, and disclosure components of the financial statements that involve significant computer processing. This will define the scope of the auditor's review of computer system controls. If the systems are very complex, it may be useful to prepare flowcharts documenting significant computer applications. The information in these flowcharts may be obtained from prior knowledge of the dealership's business, discussions with client personnel, and reference to prior year's workpapers.

> **Practice Tip:**
>
> Flowcharts generally should be prepared only when the computer system is very complex and the auditor is planning to assess control risk at a moderate or low level.

6.208 **Procedures to Obtain Understanding.** The auditor obtains an understanding of computer-related controls through procedures such as inquiry, observation, and inspection of documents. For example, to obtain an understanding of the design of the computer system used to generate the general ledger, the auditor may make inquiries of appropriate personnel about input, processing, and output control procedures, and inspect application software documentation. The auditor may inquire about data security and database backup procedures, and inspect any control reports or logs. The auditor also may observe users of the system in actual performance of their duties and review the resultant documents and records.

6.209 The nature and extent of the auditor's understanding will vary from client to client, and is influenced by the size and complexity of the dealership's computer system and procedures. The auditor's prior experience with the client and assessments of inherent risk and materiality of the various account balances and transaction classes may also effect the nature and extent of the audit procedures performed to obtain an understanding of the computer controls.

6.210 Documenting Computer System Controls. The Microcomputer Questionnaire (section 6.215) may be used to document the dealership's controls when the computer system consists of microcomputers and purchased software products. This is the only computer questionnaire that should be completed for such clients.

6.211 For clients with more sophisticated computer systems, the auditor may complete:

- The General Computer Controls Questionnaire (section 6.216)
- The Application Computer Controls Questionnaire (section 6.217)

6.212 The General Computer Controls Questionnaire documents controls over the dealerships's computer system environment. The areas addressed include data processing management issues, systems development practices, and policies regarding end-user developed systems. If the client does not develop any application software internally, many of the questions in this questionnaire will not apply.

6.213 The Application Computer Controls Questionnaire is used to document the nature of each major computer application. The information prepared to document the understanding of the internal control structure elements will vary depending on the size and complexity of the client and its computer systems.

6.214 In some cases, the auditor may find it necessary to prepare additional materials to adequately document complex applications. Block diagrams, flowcharts, database structure listings, video display layouts (screen shots), and narratives are sometimes used to document the flow of transactions through a complex system. Copies of key input forms, computer prepared documents, and reports also may help to describe the nature of the computer processing. For very complex computer systems, the auditor should consider getting a computer specialist to participate in the review.

6.215

Microcomputer Questionnaire

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This questionnaire should be used to document controls when a client uses microcomputers and one or more purchased, standard, UNMODIFIED accounting packages to process accounting information.

1. Names and models of computers: ______________________________

2. Name of operating system: ______________________________

3. Name and version of software:

   Package 1 ______________________________
   Package 2 ______________________________
   Package 3 ______________________________
   Package 4 ______________________________

4. Major reports generated from software:

   Package 1 ______________________________
   Package 2 ______________________________
   Package 3 ______________________________
   Package 4 ______________________________

5. Key operators and their responsibilities:

Key Operator	Responsibilities

MICROCOMPUTER QUESTIONNAIRE (Continued)

Are any of their duties incompatible?_____ Explain. ____

____

____

6. Describe any controls, such as user ID numbers, passwords and locking on/off switches that are used to prevent unauthorized access to programs and accounting data. ____________________

____

____

____

7. Describe controls that insure that all transactions are processed and that the same data is not processed twice.

____

____

____

____

____

____

8. Are users adequately trained and provided with adequate instructions on how to use the computer system? Yes ________ No ________

9. Who is responsible for reviewing the reports generated from the microcomputer?

Report	Reviewer
________________________	____________
________________________	____________
________________________	____________
________________________	____________

10. Have procedures been developed for periodic back-up of files? ____________________

____

11. Are backup files stored in a secure location? ______________________________

____

12. Has management considered developing a disaster plan, including arrangements for emergency equipment, facilities, insurance, etc.? Yes ____ No ____

MICROCOMPUTER QUESTIONNAIRE (Continued)

13. Tests of Controls

    The inquiry, observation, and inspection procedures used to obtain an understanding of the computer system are usually sufficient to support an assessment of control risk at less than the maximum.

    Describe any *additional* tests of microcomputer controls performed (e.g., inspection of evidence of review of computer output):

    ____
    ____
    ____
    ____
    ____

14. Summary of Findings

    Describe the major control strengths noted:

    ____
    ____
    ____
    ____

    Describe the major control weaknesses noted:

    ____
    ____
    ____
    ____

15. The auditor's understanding of computer controls, and the results of the tests of controls should be considered in the auditor's assessment of control risk for all financial statement assertions that are affected by computer processing.

Practice Tip:

Computer processing controls usually have an impact on the existence, completeness, and dollar value of related transactions and balances. For example, if the client has good internal controls over processing of sales and cash receipts, the auditor may reduce the extent of the tests of existence, completeness and gross dollar value of accounts receivable (e.g., the number of confirmations mailed may be reduced).

MICROCOMPUTER QUESTIONNAIRE (Continued)

	19____	19____	19____	19____	19____
Prepared or updated by:					
Client	________	________	________	________	________
In-Charge	________	________	________	________	________
Reviewed by:					
Engagement Partner	________	________	________	________	________

6.216

General Computer Controls Questionnaire

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This questionnaire should be completed and updated annually to document controls that are global to the dealership's computer system environment. For each item, place a "✓" in the "Yes" or "No" column to indicate whether the procedure is performed or in the "N/A" column if the procedure is not applicable to the client's control system. When you've completed the questionnaire, review your "Yes" and "No" responses and determine how they impact your assessment of control risk. The effects of any "No" answers should be considered and documented in the space provided. Also, "No" answers should be considered for required communication of internal control structure related matters as material weaknesses and reportable conditions. (See Chapter 10, section 10.610.) **(If the client's computer system uses only unmodified software products and the system is not complex, this questionnaire should not be completed. See section 6.215 for the Microcomputer Questionnaire.)**

Organizational Controls

	Yes	No	N/A
1. If available, attach a copy of the management information systems (MIS) department organization chart.	______	______	______
2. Does the MIS department have adequate organizational status to be independent of the other organizational groups that it serves?	______	______	______
3. Have written job descriptions been prepared for all key positions in the MIS department?	______	______	______
4. Have procedures been established to ensure that MIS department employee qualifications are matched to the specific requirements for each employee's position?	______	______	______
5. Are system operations, input, database control functions, and system development activities performed by separate individuals?	______	______	______

GENERAL COMPUTER CONTROLS QUESTIONNAIRE (Continued)

6. Are operations personnel periodically rotated between jobs or applications? ______ ______ ______

7. Are operations personnel required to take vacations? ______ ______ ______

8. Are operations personnel prohibited from initiating transactions or making master file (table) changes? ______ ______ ______

9. Are departments (groups) that initiate changes to database master information provided a report showing changes actually made? ______ ______ ______

Application Development Controls (includes standard spreadsheets, databases used for computer applications, Lotus programs, etc.)

10. Have formal documentation standards and procedures been established? ______ ______ ______

11. Have standards for systems development and programming been developed? ______ ______ ______

12. Have formal operator and user instructions been developed? ______ ______ ______

13. Have formal program testing procedures been established for new applications and revisions to existing applications? ______ ______ ______

14. Are programs tested by persons independent of the programmer(s) who developed the software? ______ ______ ______

15. Are the data used for testing and the results of testing maintained for supervisory review and historical purposes? ______ ______ ______

16. Are personnel that test programs prohibited from testing new or revised programs on live data files? ______ ______ ______

17. Have procedures been developed for the documentation of requests for program changes? ______ ______ ______

18. Are program change requests approved in writing by a supervisory level person? ______ ______ ______

GENERAL COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Operations Controls

19. Have procedures been established to monitor operator/user adherence to prescribed instructions? _____ _____ _____

20. Are adequate computer operation logs maintained for batch processing of transactions? _____ _____ _____

21. Are adequate computer controls (transaction logging, etc.) established over interactive processing of transactions? _____ _____ _____

22. Is a schedule prepared of applications to be processed, and reports and documents to be produced? _____ _____ _____

23. Are control procedures over report distribution adequate? _____ _____ _____

24. Have procedures been established to prohibit computer operators or users from having access to system or program logic documentation? _____ _____ _____

Data, Program and Facilities Backup Controls

25. Have procedures been established for the periodic backup of critical data and programs from all centralized computers and file servers? _____ _____ _____

26. Is the backup media (diskettes, tapes, tape cartridges, etc.) stored at a secure location? _____ _____ _____

27. Have procedures been established for the restoring of backed up data and programs in the event of a system failure? _____ _____ _____

28. Has the client's ability to restore critical data and programs been tested? _____ _____ _____

29. Has a written disaster recovery plan been developed and have arrangements for emergency equipment and facilities been made? _____ _____ _____

30. If necessary, are virus tests performed on a regular basis? _____ _____ _____

GENERAL COMPUTER CONTROLS QUESTIONNAIRE (Continued)

31. Tests of Controls:

Inquiry, observation, and inspection procedures are typically the only procedures that are used to test general controls. Therefore, the procedures used to obtain an understanding of the general controls are usually sufficient to support an assessment of control risk at less than the maximum.

Describe any additional procedures designed to test general computer controls:

____

____

____

____

____

32. Summary of Findings:

Describe the major control strengths in the general controls:

____

____

____

____

____

Describe the major control weaknesses in the general controls:

____

____

____

____

____

33. This evaluation of general computer controls and the evaluations of application computer controls should be considered in the assessment of control risk for the financial statement assertions that are affected by computer processing.

	19____	19____	19____	19____	19____
Prepared or updated by:					
In-Charge	______	______	______	______	______
Reviewed by:					
Engagement Partner	______	______	______	______	______

6.217

Application Computer Controls Questionnaire

Client: ______________________

Financial Statement Date: ______________________

INSTRUCTIONS:

This form should be completed and updated annually for each significant accounting application by the in-charge or a computer specialist, and reviewed by the engagement partner. Additional documentation obtained from the client, vendors, and others should be included in the workpapers with this form. **(If the client's computer system uses only unmodified software products and the system is not complex, this form should not be completed. See section 6.215 for the Microcomputer Questionnaire.)**

Attach copies of any computer input screens, input documents, and reports that are considered necessary to document the internal controls.

Application Name: ______________________
System Name: ______________________

Application Narrative: (describe in non-technical terms what the application does)

____
____
____
____

Describe how critical this application is to the operations of the dealership. Discuss the impact on the client of not having this application operational.

____
____
____
____

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Section 1 — Technology Employed by the Application

Computer Hardware

Mainframe (centralized) Computer: ______________________________

File server(s): ______________________________

Stand Alone Workstations: ______________________________

Other Significant Hardware Devices (e.g. point of sale terminals, bar code readers, image scanners, etc.): ______________________________

Systems Software

Mainframe (centralized) computer: ______________________________

File server(s): ______________________________

Stand Alone Workstations: ______________________________

Application and Utility Software

Name (including version #): ______________________________
Vendor: ______________________________

Name (including version #): ______________________________
Vendor: ______________________________

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Name (including version #): ______________________
Vendor: ______________________

Name (including version #): ______________________
Vendor: ______________________

Section 2 — Application Database/File Structure

List the major master files/tables in the application and a brief description of their contents: ______

List the key transaction files/tables in the application and a brief description of their contents: ______

ATTACH COPIES OF EACH FILE OR TABLE STRUCTURE LISTING

Section 3 — Master File/Table and Transaction Entry

Describe the nature of the transaction including:

Significant Source Documents and Contents

Input Screens

Retention Policy

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Who is responsible for reviewing the completeness and accuracy of the input?

Describe forms, logs, reconciliations, etc. used to control input.

Form	Description

Describe the controls established to insure that all transactions are processed and that the same data is not processed more than once.

Section 4 — Report, Query and Other Output

Describe the nature of computer output including:

Printed documents

Listings, journals, subsidiary ledgers, ledgers, summaries, etc.

Control reports and listings

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Describe the tests made by accounting or user personnel to verify the accuracy of the information processed.

Describe the procedures for error correction and reprocessing.

Describe the retention policy.

Section 5 — Personnel

Identify all persons performing any computer or accounting function related to the application.

Name and Job Title	Related Duties

Do any of the above persons have other duties that are incompatible?

Is segregation of duties adequate for the application?

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Is cross-training of personnel adequate to provide for vacations, emergency leaves and unplanned terminations?

Section 6 — Custody of Assets and Authorization of Transactions

Do computer operations, programming or other computer systems personnel have access to client assets or the ability to authorize transactions?

Section 7 — Security

Describe how the following security features of the operating system and/or network operating system are implemented for this application.

Software:

User numbers and password protection

File and subdirectory user and group rights assignment

Hardware/Operating System:

Disk mirroring, duplexing, transaction tracking and other data protection and error recovery features.

Describe any other security features

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Section 8 — Tests of Controls:

The inquiry, observation, and inspection procedures used to obtain an understanding of the application controls are usually sufficient to support an assessment of control risk at less than the maximum.

Describe any additional procedures designed to test application computer controls:

____
____
____
____
____
____

Section 9 — Summary of Findings

The application computer controls analyzed in this questionnaire (in conjunction with your evaluation of general computer controls) should be considered determining the assessed level of control risk for the related financial statement assertions.

Describe the effect of your understanding and the tests of controls performed on your assessment of control risk for the related financial statement assertions:

____
____
____
____

	19____	19____	19____	19____	19____
Prepared or updated by:					
Client	________	________	________	________	________
In-Charge	________	________	________	________	________
Reviewed by:					
Engagement Partner	________	________	________	________	________

Tests of Controls

6.218 In addition to obtaining an understanding of the internal control structure, the auditor may perform tests of controls. These tests provide evidential matter to support an assessed level of control risk below the maximum. Tests of controls may be directed toward the effectiveness of the design of internal control structure policies and procedures, or they may be directed toward the effectiveness of operation of the policies and procedures during the period under audit.

6.219 Microcomputer Systems. Tests of controls in a microcomputer environment are not significantly different from those in a manual accounting environment. Control over a microcomputer can be achieved in one of two ways:

- Adequate segregation of duties exists, and access to the computer system is controlled to prevent changes in programs and data by unauthorized employees, or
- Adequate segregation of duties does not exist or access to the computer system is not adequately controlled, but these weaknesses are mitigated by the fact that appropriate personnel (e.g., the dealer/manager) perform a detailed review of the computer reports.

6.220 These controls can generally be tested with observation, inquiry, and inspection of computer reports. The Microcomputer Questionnaire (section 6.215) may be used to document the auditor's tests of controls in a microcomputer environment.

6.221 Sophisticated Computer Systems. In more sophisticated computer systems, the auditor will generally begin by testing general controls. If these controls are weak, no reliance can be placed on application controls.

6.222 General controls over computer systems are generally tested by observation, inquiry, and inspection of documents and control logs. Controls that are most significant include:

- Segregation of duties within the MIS department, so that individuals with knowledge of programs and programming language cannot make unauthorized changes in programs or data,
- Procedures for developing and testing, and implementing new programs, and
- Security controls to prevent unauthorized changes to data by users, e.g., passwords and control logs.

6.223 The procedures used to obtain an understanding of the general controls generally are sufficient to obtain evidence about their operating effectiveness.

6.224 Applications controls are designed to assure the accuracy and completeness of specific data. The controls that are most significant to the auditor include:

- Controls that prevent unauthorized changes to data, such as passwords, user numbers, and control reports,

- Controls that insure the accuracy of data input, such as validity tests of data as it is entered into the system, review of edit reports that summarize changes to data, and control totals,
- Procedures for correcting and reprocessing data that was entered incorrectly, such as follow-up procedures on computer error reports,
- Training of user personnel about how to input data, and
- Adequate user instructions (i.e., in user manuals).

6.225 Application controls in sophisticated computer systems can be tested in a number of ways. The most common approach to testing application controls is described below:

- Observation and inquiry about the use of passwords and the application of validity tests as actual data is entered,
- Inspection of computer output, including error reports and related follow-up,
- Inspection of documents that evidence the review of computer output by appropriate personnel, and
- Inquiry about the training of user personnel and inspection of user instructions.

6.226 The procedures performed in obtaining an understanding of application controls generally are sufficient to allow control risk to be assessed at a level below the maximum. If the client's general and application controls are very effective, these procedures may be sufficient to justify a moderate level of control risk for the related assertions. If the auditor wishes to further reduce the level of control risk, he or she may add tests of controls to the General and Application Computer Controls Questionnaires.

Processing of Transactions by Service Organizations

6.227 SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* provides guidance to the auditor when his or her client uses a service organization to process a significant application. The Statement also provides guidance for auditors who issue reports on the processing of transactions by service organizations for use by other auditors, but for purposes of this discussion, we will focus on the guidance for auditors whose clients use the service organization.

6.228 When auditing a dealership that uses a service organization, the auditor should consider the significance that the service organization's policies, procedures, and records have on the client's financial statements. Factors the auditor considers include:

- The financial statement assertions affected by the service organization's processing,
- The nature of the services provided by the service organization,
- The client's internal control policies and procedures that are applied to the transactions processed by the service organization and the availability of auditable data in the client's possession,
- The terms of the contract between the client and the service organization, and

- The service organization's capabilities, including its —
  - Record of performance
  - Insurance coverage
  - Financial stability.

6.229 In many situations the dealership will have adequate controls over the data processed by the service organization. In these circumstances, there is no need to obtain an understanding of the controls at the service organization. As an example, a client that uses a service bureau to process payroll will usually have adequate controls to provide reasonable assurance that the service bureau is processing the payroll transactions accurately. These controls might consist of a review and testing of the payroll records that are received from the bureau.

6.230 An understanding of the controls at the service organization is generally needed only when the service organization both authorizes and processes transactions. An example of this organization would be a trust (e.g., a pension trust), in which the servicing financial institution makes investment decisions and maintains records of the transactions.

6.231 When the auditor decides that an understanding of the service organization's controls is necessary, this understanding may be obtained by:

- Reviewing manual or system documentation held by the client that describes the service organization's controls over the client's transactions, or
- Obtaining a report from a service auditor who performed procedures at the service organization for the benefit of multiple users.

6.232 In rare circumstances, the auditor may decide that it is necessary to perform procedures at the service organization to gain the required understanding of internal control.

6.233 If the auditor decides that an understanding of the controls at the service organization is necessary and a report by the service auditor is not available, he or she may complete the Service Organization Application Controls Documentation Form, shown in section 6.238.

6.234 If a service auditor report is available, it will be of one of the following two types:

- a report on policies and procedures placed in operation, or
- a report on policies and procedures placed in operation and tests of operating effectiveness.

6.235 **Report on Policies and Procedures Placed in Operation.** This report addresses the policies and procedures that the service organization has put into effect in the processing of the dealership's transactions. More specifically, it addresses (1) whether the policies and procedures were suitably designed to achieve specified control objectives, and (2) whether they have been placed in operation as of a specified date. This type of report is useful for obtaining an understanding of the controls at the service organization, but it does not provide evidence to reduce the assessed level of control risk.

6.236 Report on Policies and Procedures Placed in Operation and Tests of Operating Effectiveness. In addition to describing the service organization's controls over the client's transactions, this report addresses the effectiveness of the related controls during the period specified. Therefore, this type of report provides evidence that may allow the user auditor to reduce the assessed level of control risk.

6.237 Evaluating the Service Auditor Report. The Service Auditor Report Evaluation Form, shown in section 6.239, may be used to evaluate a service auditor report.

6.238

Service Organization Application Controls Questionnaire

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be used when (1) the service organization both authorizes and maintains records of significant transactions, and (2) there is no service auditor's report available. The information should be used to evaluate the need to visit the service center to perform a detailed evaluation of the center's internal controls, to document information obtained during the visit and to identify any material weaknesses for follow-up.

This form should be completed by the in-charge, or computer specialist and reviewed by the engagement partner.

Any weaknesses or strengths noted should be evaluated by the auditor in assessing control risk.

Section 1 — General Information

Name of service center: ______________________________

____

Address: ______________________________

____

Name of individual(s) in dealership responsible for service center application:

____

____

____

____

Is there a formal agreement? _____ If so, obtain copy.

Is there insurance protection for the following:

1. Program or software destruction? _____

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

2. Loss of data? _____

3. Business interruption? ______

4. Errors and omissions? _____

Application Narrative: (describe in non-technical terms what the application does) ________________

Describe how critical this application is to the dealership. Discuss the impact on the dealership of not having this application operational. ________________

Section 2 — Technology Employed by the Application

Computer Hardware

Provide a general description of the service organization's hardware that is used to process dealership transactions: ________________

Systems and Application Software

Provide a general description of the service organization's systems and application software that is used to process dealership transactions: ________________

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Section 3 — Transaction Entry

Describe the nature of the transaction including:

Significant Source Documents and Contents

Input Screens

Retention Policy

Who is responsible for reviewing the completeness and accuracy of the input?

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Describe any forms, logs, reconciliations, etc. used to control input.

Form	Description

Describe the controls established to insure that all transactions are processed and that the same data is not processed more than once.

Describe how information is submitted to the service organization.

Section 4 — Report, Query, and Other Output Received From the Service Organization

Describe the nature of computer output including:

Printed Documents

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Listings, journals, subsidiary ledgers, ledgers, summaries, etc.

Describe any tests made by service organization personnel to verify the completeness and the accuracy of the information processed.

Describe any tests made by dealership accounting or other dealership personnel to verify the completeness and the accuracy of the information processed.

Describe the procedures for error correction and reprocessing.

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Section 5 — Information Retained by the Service Organization

Describe significant documents, transaction files, master tables/files, etc. retained by the service organization and the security and retention procedures employed.

Section 6 — Custody of Assets and Authorization of Transactions by the Service Organization

Describe the nature of service organization personnel's access to dealership assets and ability to authorize transactions.

Section 7 — Security

Describe the segregation of duties related to the processing of the dealership's transactions.

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Describe how the following security features of the operating system and/or network operating system are implemented for this application.

User numbers and password protection

Describe any other security features.

Section 8 — Summary of Findings

Describe the major control strengths noted.

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Describe the major control weaknesses noted.

____
____
____
____
____
____
____

Describe the effect of your understanding and the tests of controls performed on your assessment of control risk for the related financial statement assertions.

____
____
____
____
____
____
____

	19____	19____	19____	19____	19____
Prepared or updated by: In-Charge	________	________	________	________	________
Reviewed by: Engagement Partner	________	________	________	________	________

6.239

Service Auditor Report Evaluation Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be used when (1) the service organization both authorizes and maintains records of significant transactions, and (2) there is a service auditor's report available.

This form should be completed by the in-charge or computer specialist and reviewed by the engagement partner.

Include a copy of the service auditor's report in the workpapers.

Section 1 — General Information

Name of service center: ______________________________

____

Address: ______________________________

____

Name of individual(s) in dealership responsible for service center application:

____

____

____

____

____

Is there a formal agreement? _____ If so, obtain copy.

Is there insurance protection for the following:

1. Program or software destruction? _____

2. Loss of data? _____

SERVICE AUDITOR REPORT EVALUATION FORM (Continued)

3. Business interruption? _____

4. Errors and omissions? _____

Application Narrative: (describe in non-technical terms what the application does) ______________

Describe how critical this application is to the dealership. Discuss the impact on the dealership of not having this application operational: ______________

Section 2 — Service Auditor

Name of the service auditor: ______________

Does the Service Auditor have a good reputation? _______

Section 3 — The Service Auditor's Report

A. Describe the type of report issued by the service auditor. ______________

B. Describe the major control strengths in the service organization's processing.

C. Describe the major control weaknesses in the service organization's processing.

SERVICE AUDITOR REPORT EVALUATION FORM (Continued)

D. If the service auditor performed tests of the operating effectiveness of controls, identify those tests that will be relied upon in assessing control risk for the client.

____
____
____
____

Section 4 — Client Involvement

A. Describe any control procedures performed by dealership personnel to test the accuracy of service organization processing.

____
____
____
____

Section 5 — Summary of Findings:

Describe the effect of your understanding and the tests of controls performed on your assessment of control risk for the related financial statement assertions:

____
____
____
____

	19____	19____	19____	19____	19____
Prepared or updated by: In-Charge	______	______	______	______	______
Reviewed by: Engagement Partner	______	______	______	______	______

6.300

Tests of Controls Programs — Auto Dealerships

Section I: System A

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Accounts receivable, contracts in transit, and sales (existence and valuation).
2. Sales (completeness).

TRANSACTION CYCLE:
1. Collections and sales.

Procedure	Done By	Date	W/P Ref.
Collections			
General			
1. Determine by inquiry, observation, or inspection that the incoming mail is received, opened, and logged by a person independent of over-the-counter cash collections, cash receipts journal, general journal entry, and accounts receivable functions.	______	______	______
2. Determine by observation or inspection that a restrictive endorsement is placed on all checks.	______	______	______
3. Determine by observation or inquiry that persons receiving cash over-the-counter are independent of the mail opening, deposits, cash receipts journal, and the general ledger and accounts receivable subsidiary ledger posting functions.	______	______	______
4. Determine by observation or inquiry that a person independent of cash receipts and posting functions reconciles over-the-counter receipts to accompanying detail such as cash register tapes, receipts forms, etc.	______	______	______
5. Determine by inquiry, observation, or inspection that collections made by sales personnel are adequately controlled, such as by cash register tapes or receipts tickets.	______	______	______

TESTS OF CONTROLS PROGRAMS —AUTO DEALERSHIPS
SECTION I: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
6. Examine evidence that account codings for receipts are reviewed by an individual other than the preparer.	______	______	______
7. Examine evidence and observe that persons reconciling bank accounts are independent of cash receipts and cash disbursement functions or that the reconciliation is reviewed by the dealer or manager.	______	______	______
8. Examine evidence that a person independent of cash receipts and posting functions reconciles the log of mail receipts to deposits.	______	______	______
9. Determine by inquiry, observation, or inspection that items returned by the bank are received unopened by a person independent of the functions of handling or recording cash receipts.	______	______	______
10. Examine evidence that prenumbered credit memos, repair orders, parts tickets, and receipts tickets are safeguarded and accounted for.	______	______	______
11. Select a sample of _____ entries in the cash receipts journal and trace amounts and dates to supporting logs of mail receipts.	______	______	______
12. Select a sample of ______ daily logs of mail receipts and perform the following steps:			
a. Trace to posting in cash receipts journal.	______	______	______
b. Determine proper account coding.	______	______	______
c. Obtain supporting authenticated detailed deposit slips and remittance advices and:			
(1) Trace deposit slip total to bank statement noting agreement of date and amount.	______	______	______
(2) Compare total and individual amounts on deposit slips and remittance advices to daily cash receipts.	______	______	______

TESTS OF CONTROLS PROGRAMS —AUTO DEALERSHIPS
SECTION I: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
d. Trace individual amounts to postings in the accounts receivable subsidiary ledger noting agreement of names, dates, and amounts.	_____	_____	_____
13. Select a sample of _____ daily cash register reports and/or daily over-the-counter receipt tickets, and trace to duplicate deposit slips.	_____	_____	_____
14. Examine evidence of monthly reconciling of the accounts receivable subsidiary ledger to the general ledger by persons who do not also maintain the subsidiary ledger.	_____	_____	_____
<u>Parts and Service Departments</u>			
15. Determine by inquiry and observation whether the "cash sales" account is examined by a responsible official.	_____	_____	_____
Sales			
1. Examine evidence of review of the monthly analysis of aged manufacturer and accounts receivables by a responsible person independent of the functions of handling or recording cash receipts, and that this person investigates as necessary.	_____	_____	_____
2. For new car sales, used car sales, parts sales, and service sales journals, select a sample of _____ entries in each of the sales journals, obtain sales invoices, parts tickets, repair orders and/or credit memos and examine for evidence of:			
a. Approval of account codings.	_____	_____	_____
b. Doublechecking of calculations and prices.	_____	_____	_____
3. Examine evidence and/or observe that the dealer or manager investigates customer complaints.	_____	_____	_____
4. Observe that an approved sales price list is in use.	_____	_____	_____
5. Select a sample of _____ new car invoices, _____ used car invoices, _____ parts tickets, and _____ repair orders issued during the year and compare to entries in each of the sales journals for name, date, and amount.	_____	_____	_____

TESTS OF CONTROLS PROGRAMS —AUTO DEALERSHIPS
SECTION I: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
6. For car sales, used car sales, parts sales, and service sales journals, select a sample of _____ entries in each of the sales journals and perform the following:			
a. Trace to sales invoices, parts tickets and repair orders and compare similarity of name, date, and amount.	_____	_____	_____
b. Verify prices and recalculate amounts.	_____	_____	_____
c. Trace postings to accounts receivable subsidiary ledger and compare name, date, and amount.	_____	_____	_____
d. Check propriety of account codings.	_____	_____	_____
7. Examine evidence of the investigation of significant variances from budgeted revenue amounts.	_____	_____	_____
8. Examine evidence that a responsible official independent of the functions of handling and recording cash receipts approves bad-debt write-offs.	_____	_____	_____
9. Examine evidence or observe that a responsible official approves all credit sales, purchase discounts, and allowances.	_____	_____	_____
10. Other procedures: ______________________ ______________________ ______________________ ______________________	_____	_____	_____

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Auto Dealerships

Section I: System B

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Accounts receivable, contracts in transit, and sales (existence and valuation).
2. Sales (completeness).

TRANSACTION CYCLE:
1. Collections and sales.

Procedure	Done By	Date	W/P Ref.
Collections			
General			
1. Examine evidence or observe that the person reconciling bank accounts is independent of all cash receipts functions or that the reconciliation is reviewed by an independent official.	______	______	______
2. Observe that over-the-counter receipts are controlled, such as by a cash register or prenumbered repair orders, parts tickets, or receipts tickets.	______	______	______
3. Examine evidence of monthly balancing of the accounts receivable subsidiary ledger to the general ledger.	______	______	______
4. Examine evidence that prenumbered cash receipts tickets, repair orders, credit memos, and parts tickets are safeguarded and accounted for.	______	______	______
5. Observe and inquire about the timely deposit of cash receipts.	______	______	______
New and Used Car Departments			
6. Examine evidence of monthly balancing of the schedule of contracts in transit to the general ledger.	______	______	______

TESTS OF CONTROLS PROGRAMS — AUTO DEALERSHIPS
SECTION I: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
Sales			
General			
1. Examine evidence that monthly statements are sent to customers.	______	______	______
2. Examine evidence that a responsible official approves all credit sales, sales discounts, allowances, and bad-debt write-offs.	______	______	______
New and Used Car Departments			
3. Determine by inquiry and observation whether a desk log ("shipping report") is used and compared to deal folders received.	______	______	______
4. Other procedures: ______	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Auto Dealerships

Section I: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Accounts receivable, contracts in transit, and sales (existence and valuation).
2. Sales (completeness).

TRANSACTION CYCLES:
1. Collections and sales.

Procedure	Done By	Date	W/P Ref.
Collections			
1. Examine evidence that over-the-counter sales are controlled by repair orders, parts tickets, or receipts tickets.	______	______	______
2. Observe and inquire about the timely deposit of cash receipts.	______	______	______
Sales			
1. Observe and inquire about the preparation and mailing of customers' statements.	______	______	______
2. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

TESTS OF CONTROLS PROGRAMS — AUTO DEALERSHIPS
SECTION I: SYSTEM C (Continued)

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Auto Dealerships

Section II: System A

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Acquisitions of inventory and fixed assets (existence and valuation).
2. Liabilities and expenses (completeness).
3. Expenses (valuation and presentation).

TRANSACTION CYCLES:
1. Acquisitions and payments.

Procedure	Done By	Date	W/P Ref.
Acquisitions			
General			
1. Determine by inquiry, observation, or by examining evidence that all supporting documents are matched by a person independent of the ordering function before entry in the purchases journals.	______	______	______
2. Examine evidence of an independent second-person review of purchases account codings.	______	______	______
3. Select a sample of _____ entries in the purchases journals and perform the following:			
a. If paid, trace check number to entry in cash disbursements journal. If unpaid, investigate reasons.	______	______	______
b. Obtain vendor invoice and where applicable, the receiving report, and the purchase order and/or purchase requisition and perform the following:			
(1) Compare name, dates, and amounts.	______	______	______
(2) Review invoice for approval of purchase by the dealer or manager or another appropriate official.	______	______	______

TESTS OF CONTROLS PROGRAMS — AUTO DEALERSHIPS
SECTION II: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
(3) Review receiving report for proper approval.	______	______	______
(4) Review purchase order and/or purchase requisition for proper approval.	______	______	______
(5) Verify prices and recalculate footings and extensions on invoices.	______	______	______
(6) Compare quantities and descriptions.	______	______	______
(7) Check propriety of account codings.	______	______	______
(8) Determine that supporting documents are canceled to prevent re-use.	______	______	______
Parts Department			
4. Examine evidence, or observe, that approved vendors' price lists are in use.	______	______	______
5. Examine evidence, or observe, that the numerical sequence of purchase orders and/or requisitions is being accounted for.	______	______	______
6. Examine evidence, or observe, that the receiving department inspects the quantity and quality of materials when receiving reports are prepared.	______	______	______
7. Examine evidence, or observe, that the numerical sequence of receiving reports is being accounted for.	______	______	______
8. Select a sample of _____ receiving reports issued during the year and trace to vendor invoices and entries in the purchases journal. Compare:			
a. Type of merchandise.	______	______	______
b. Name of vendor.	______	______	______
c. Dates received.	______	______	______
d. Quantities.	______	______	______
e. Amounts.	______	______	______

TESTS OF CONTROLS PROGRAMS —AUTO DEALERSHIPS
SECTION II: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
Used Car and Parts Departments			
9. Examine evidence, or observe, that accounts payable subsidiary ledger balances are periodically reconciled to vendors' invoices by a person independent of the ordering and payment functions.	______	______	______
New Car Department			
10. Determine by inquiry and observation that new cars are inspected upon receipt.	______	______	______
11. Examine evidence, or observe, that the list of new cars on floor plan is reconciled to statements from the floor plan institution by a person independent of the ordering and payments functions.	______	______	______
12. Examine evidence, or observe, that the list of new cars on floor plan are compared to the monthly physical inventory.	______	______	______
Payments			
1. Examine evidence that supporting documents are approved and canceled at time of check signing.	______	______	______
2. Examine evidence or observe that the numerical sequence of checks is accounted for by someone independent of the preparation function.	______	______	______
3. Inquire or observe that checks are mailed by an individual independent of the functions of maintaining cash disbursement records and preparing checks.	______	______	______
4. Examine evidence, inquire, or observe that the bank reconciliation is prepared by an individual independent of the check-signing or recording functions and that the reconciliation is reviewed by an independent official.	______	______	______
5. Determine by inquiry, observation, or inspection that the check preparation function is independent of the purchases journal, general ledger, and accounts payable subsidiary ledger posting functions.	______	______	______

TESTS OF CONTROLS PROGRAMS — AUTO DEALERSHIPS
SECTION II: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
6. Determine by inquiry, observation, or inspection that items returned by the bank are received unopened by a person independent of the functions of approving, preparing, or recording cash disbursements.	______	______	______
7. Select a sample of _____ entries in the cash disbursements journal and perform the following procedures:			
a. Obtain paid check and:			
(1) Examine signature and endorsement.	______	______	______
(2) Compare to entry for payee, date, and amount.	______	______	______
b. Obtain supporting documents and:			
(1) Determine that documents agree with disbursement and that the vendor and nature of purchase are proper.	______	______	______
(2) Examine approval for payment by the dealer or manager or another appropriate official.	______	______	______
(3) Compare vendor name and amount to entry.	______	______	______
(4) Determine if discount was taken where appropriate.	______	______	______
(5) Examine approval of disbursement account coding.	______	______	______
(6) Determine if supporting documents are canceled to prevent duplicate payment.	______	______	______
(7) Trace postings to the accounts payable subsidiary ledger.	______	______	______

TESTS OF CONTROLS PROGRAMS —AUTO DEALERSHIPS
SECTION II: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
8. Other procedures:			
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Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Auto Dealerships

Section II: System B

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:	1.	Acquisitions of inventory and fixed assets (existence and valuation).
	2.	Liabilities and expenses (completeness).
	3.	Expenses (valuation and presentation).
TRANSACTION CYCLE:	1.	Acquisitions and payments.

Procedure	Done By	Date	W/P Ref.
Acquisitions			
General			
1. Examine evidence that a responsible official approves purchases.	______	______	______
2. Examine evidence that vendors are approved by a responsible official.	______	______	______
Used Car and Parts Departments			
3. Determine by inspection and inquiry that the accounts payable subsidiary ledger is reconciled to the general ledger monthly.	______	______	______
New Car Department			
4. Determine by inspection and inquiry that the schedule of new cars on floor plan is reconciled to the general ledger monthly.	______	______	______
Payments			
1. Test by observation and inquiry that the check signer reviews supporting documents.	______	______	______

TESTS OF CONTROLS PROGRAMS —AUTO DEALERSHIPS
SECTION II: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
2. Examine evidence that checks are prenumbered and accounted for.	______	______	______
3. Test by observation and inquiry that checks are prepared by an individual independent of those approving vendors' invoices.	______	______	______
4. Examine evidence that a responsible official approves invoices for payment.	______	______	______
5. Examine evidence, inquire, or observe that bank reconciliations are prepared by someone independent of all cash disbursements functions or that the reconciliation is reviewed by an independent official.	______	______	______
6. Examine evidence that vendor invoices are recalculated prior to the preparation of checks.	______	______	______
7. Other procedures: ______ ______ ______ ______	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Auto Dealerships

Section II: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Acquisitions of inventory and fixed assets (existence and valuation).
2. Liabilities and expenses (completeness).
3. Expenses (valuation and presentation).

TRANSACTION CYCLE:
1. Acquisitions and payments.

Procedure	Done By	Date	W/P Ref.
Acquisitions			
1. Examine evidence that payments are approved by the dealer or manager.	____	____	____
Payments			
1. Examine evidence that cash disbursements are supported by vendors' invoices or other external documents.	____	____	____
2. Examine evidence that bank accounts are reconciled.	____	____	____
3. Other procedures: ____________ ____________ ____________ ____________	____	____	____

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________ Date: ______________
(In-Charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs — Auto Dealerships

Section III: System A

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREA: Payroll expenses (valuation).

TRANSACTION CYCLE: Payroll and personnel.

Procedure	Done By	Date	W/P Ref.
General			
1. Observe that a time clock is used to record time or that time is logged by persons independent of the payroll preparation, check signing, or distribution functions.	______	______	______
2. Observe that commission sheets are prepared by persons independent of payroll preparation, check-signing, or distribution functions.	______	______	______
3. Examine evidence of doublechecking of payroll rates and calculations by an independent person.	______	______	______
4. Examine evidence of periodic reconciliations of employees' earnings records to the general ledger by persons independent of payroll preparation and distribution.	______	______	______
5. Select ______ payroll labor distributions and examine evidence that account codings are reviewed by someone other than the preparer.	______	______	______
6. Select ______ personnel files and examine written evidence of the following:			
a. Wage rate authorization.	______	______	______
b. W-4 form signed by the employee.	______	______	______
c. Withholdings authorizations signed by employees and approved by the dealer or manager or another appropriate official.	______	______	______

TESTS OF CONTROLS PROGRAMS — AUTO DEALERSHIPS
SECTION III: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
7. Examine evidence or observe that payroll checks are accounted for by a person independent of the preparation function.	_______	_______	_______
8. Examine evidence that the payroll bank account reconciliation is performed by a person independent of the preparation and distribution functions and reviewed by a responsible official.	_______	_______	_______
9. Select a sample of _______ series of _______ duplicate payroll checks and:			
a. Account for the numerical sequence.	_______	_______	_______
b. Trace to payroll journal entries for name, date, and amounts.	_______	_______	_______
10. Select a sample of _______ entries in the payroll journal, obtain canceled checks, time sheets, commission sheets, payroll copies of repair orders (for mechanics), and personnel files and:			
a. Recompute gross pay.	_______	_______	_______
b. Scan withholdings and other deductions for reasonableness.	_______	_______	_______
c. Examine time sheets, commission sheets, and payroll copies of repair orders for approval by the dealer, manager, or another appropriate official.	_______	_______	_______
d. Examine check for signature of dealer or manager.	_______	_______	_______
e. Examine evidence of the dealer's or manager's approval of rates of pay and withholdings.	_______	_______	_______
f. Trace postings to employees' earnings records.	_______	_______	_______
g. Review for proper account classification.	_______	_______	_______

TESTS OF CONTROLS PROGRAMS —AUTO DEALERSHIPS
SECTION III: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
h. Determine whether gross pay for commissioned personnel is at least equal to minimum wage requirements.	______	______	______
Service Department			
11. Determine by inquiry and observation whether balances in the WIP-labor account are periodically examined for propriety.	______	______	______
12. Other procedures: ______ ______ ______ ______	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________ Date: ______________
(In-Charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs — Auto Dealerships

Section III: System B

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREA: Payroll expenses (valuation).

TRANSACTION CYCLE: Payroll and personnel.

Procedure	Done By	Date	W/P Ref.
1. Test by observation and inquiry that time sheets, commission sheets, and payroll copies of repair orders (for mechanics) are prepared by employees.	______	______	______
2. Test by observation and inquiry that the items in Step 1 are approved by the dealer or manager.	______	______	______
3. Test by observation, inquiry or inspection that the dealer or manager or another appropriate official approves rates of pay, commission levels, sales contests and withholding and changes thereto.	______	______	______
4. Examine evidence that the payroll bank account is reconciled by someone independent of payroll preparation, approval and check signing functions.	______	______	______
5. Examine evidence that payroll checks are prenumbered and accounted for.	______	______	______
6. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

TESTS OF CONTROLS PROGRAMS —AUTO DEALERSHIPS
SECTION III: SYSTEM B (Continued)

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Auto Dealerships

Section III: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREA: Payroll expenses (valuation).

TRANSACTION CYCLE: Payroll and personnel.

Procedure	Done By	Date	W/P Ref.
1. Review selected payroll journals and personnel records.	______	______	______
2. Other procedures:			
______________________________			
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Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Auto Dealerships

Section IV: System A

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Safeguarding of inventory (existence and completeness).
2. Inventory (valuation).

TRANSACTION CYCLE:
1. Inventory and warehousing (perpetual inventory records maintained).

Procedure	Done By	Date	W/P Ref.
1. Observe that all inventory is stored under good physical safeguards.	______	______	______
2. Examine evidence or observe that physical counts are made and agreed with perpetual records by persons independent of the inventory and warehousing cycle.	______	______	______
3. Examine copies of instructions for periodic physical counts.	______	______	______
4. Examine evidence, or observe, that:			
a. Internal service repair orders are approved.	______	______	______
b. The numerical sequence of internal service repair orders is accounted for by someone independent of their preparation.	______	______	______
5. Examine evidence of reconciliation of perpetual records with the general ledger by an independent person.	______	______	______
6. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

TESTS OF CONTROLS PROGRAMS — AUTO DEALERSHIPS
SECTION IV: SYSTEM A (Continued)

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Auto Dealerships

Section IV: System B

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Inventory (existence and completeness).
2. Inventory (valuation).

TRANSACTION CYCLE:
1. Inventory and warehousing (perpetual inventory records maintained).

Procedure	Done By	Date	W/P Ref.
1. Test by observation and inquiry that inventory counters are given adequate instructions.	______	______	______
2. Test by observation and inquiry that adequate cutoff procedures are used to insure an accurate count.	______	______	______
3. Test by observation and inquiry that obsolete and consigned goods are excluded from the count.	______	______	______
4. Other procedures: ______________________	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________ (In-Charge) Date: ______________________

Reviewed by: ______________________ (Engagement Partner) Date: ______________________

Tests of Controls Programs — Auto Dealerships

Section V: System A

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS: All areas.*

TRANSACTION CYCLES: All cycles.

Procedure	Done By	Date	W/P Ref.
1. Obtain and review operations budgets.	____	____	____
2. Observe adequate safeguards over the following:			
a. Accounting records.	____	____	____
b. Securities and other valuable papers.	____	____	____
c. Other records.	____	____	____
3. Examine evidence that fixed assets records are periodically reviewed, checked to assets, and reconciled to the general ledger.	____	____	____
4. Other procedures: ____________________	____	____	____

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ____________________ (In-Charge) Date: ____________________

Reviewed by: ____________________ (Engagement Partner) Date: ____________________

***Note:** There are no System B and C Tests of Controls Programs for these areas.

6.400

Internal Control Structure Reportable Conditions Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be completed by the in-charge or supervised staff, and reviewed by the engagement partner for all audit engagements. The information should be used to complete the required communication of internal control structure related matters and other matters.

The Internal Controls Questionnaire — Auto Dealerships, the All-Substantive Approach Questionnaire, the EDP Questionnaires, any internal control narratives, and the results of tests of controls are the primary sources for identifying reportable conditions. Reportable conditions are significant deficiencies in the design or operation of the control structure, including the control environment, the accounting system, and primary and secondary controls, that could adversely affect the dealership's ability to record, process, and summarize financial data consistent with management's assertions in the financial statements. Weaknesses should be classified as material or immaterial. Other operations or management suggestions may also be included on this form.

The form is designed to include the documentation source of the conditions, the audit areas affected by the conditions, and a format for writing comments.

Prepared by: ______________________________ Date: ______________
(In-Charge)

Reviewed by: ______________________________ Date: ______________
(Engagement Partner)

REPORTABLE CONDITIONS

Documentation Source	Audit Areas Affected by Condition	Situation	Problem	Recommendation	Discussed With	Disposition

Index

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References are to section numbers.

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Compilation and Review Manual	*(2 Volumes)*
Comprehensive Engagement Manual	*(4 Volumes)*
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