Audit Practices for Automobile Dealerships

Paul C. Schauer

Abstract

One of the most important factors in a successful audit is a well-designed audit plan. The audit plan is a comprehensive process determining how the audit will be executed. One of the significant products of the audit plan is the audit program. It describes in detail the control and substantive tests the auditors will perform during the course of the audit. Audit programs are often designed by selecting specific steps from a standardized audit program that address the risk tolerance for the audit of the current client. When that is not plausible, audit programs have to be developed that address the unique accounting systems of the client. This case study uses automobile dealerships, an industry with which almost everyone is familiar, to provide examples of accounting systems that require unique methods to perform an efficient and effective audit.

Introduction

Automobile dealerships have five distinct business functions – new vehicle sales, used vehicle sales, finance, service, and parts. Some may have a sixth function, an auto body shop. This case study provides the background for any unique features of the financial accounts used to record the operation of these functions, and then asks the students how they would plan to audit each of those accounts. It is designed to broaden the student's understanding of the audit process and to provide a method for them to apply the audit methodologies they have learned to unique situations.

The unique features of an automobile dealership's financial accounts are focused in the revenue, inventory, and payment cycles. This case study focuses on the portions of those cycles that are unique. Those unique features provide the opportunity for a lively discussion among the students as to how they should be addressed in an audit environment.

I. The Revenue Cycle

Most businesses that extend credit to their customers have one accounts receivable which is quite similar in characteristics to most other business' accounts receivable. The primary function of the audit tests of accounts receivable is to determine existence and collectability. Automobile dealers have multiple accounts receivable whose characteristics associated with their existence and collectability vary significantly. Below, each type of account and their origin and characteristics are identified. The auditor can fully expect to get no response from any automobile manufacturer for requests for confirmation details or the gross amount of any account balances.

A. Vehicle Accounts Receivable

Once the documents for the sale of a vehicle are signed by the customer, the transaction is recorded in the financial accounts of the dealership. Since there is generally a time lag between the signing of the agreement and the delivery of the vehicle, the amount the customer will pay in cash is recorded in the vehicle accounts receivable. Good internal control procedures at a dealership would require that the receivable is collected prior to the actual delivery of the vehicle.

B. Contracts in Transit

Although most customers obtain any required financing of the vehicle they purchased through the dealership, very few dealerships actually finance the vehicles. Instead they sell the finance contract to the financing arm of their manufacturer or other financial institutions (collectively financial institutions). Payment for the sale of the finance contract is generally received within a few days.

C. Finance Receivables, Net

When a dealership sells a finance contract to financial institutions they receive a commission on the sale of the contract. The commission is determined by the value of the difference between the interest rate charged to the customer and the interest rate charged by the financial institution over the life of the finance contract. Payment of the commission is made within a few days. If the customer pays off the finance contract in advance, a chargeback for the finance income received and not earned is charged against the dealership account.

D. Rebates Receivable

There are two kinds of manufacturer rebates paid to the dealer for vehicles. The first is a customer rebate. The customer is eligible to receive the rebate in cash but customer rebates are almost exclusively used to reduce the cost of the vehicle. The second is a dealer rebate. This is an amount given to the dealer as a sales incentive for a particular type of vehicle or model year. If the dealer complies with the terms of the rebate, a payment will be made in the next monthly dealer statement. Valid rebates are 100 percent collectable.

E. Holdback

For all domestic and many foreign vehicle manufacturers, included in the invoice price of a new vehicle is the cost of the vehicle and a holdback amount. Usually the holdback amount is three percent of the invoice price. Holdback is recorded when the vehicle is placed in inventory. Quarterly, the dealership is reimbursed for the amount of the holdback for all vehicles shipped during that quarter. (This practice may seem strange, but it is believed that the reason for this practice was to provide the dealership with money to pay their quarterly income tax installment).

The timing of when holdback is paid is not consistent across manufacturers or even different dealers of the same manufacturer. For this case, assume that holdback is paid on March 10th, a date after the audit firm's fieldwork, for vehicles shipped in December of the year under audit and January and February of the subsequent year. The balance at December 31st consists of the holdback for eighty five vehicles that were received in December of the year under audit and six that were received in the following January.

F. Service and Parts Receivables

These receivables generally result from providing service on fleet vehicles or other commercial accounts or from the sale of parts to other repair shops. Rarely do dealerships offer credit to individuals, their transactions are paid for in cash or with a credit card. Thus these receivables have the characteristics of a typical wholesale establishment.

G. Warranty Receivables

Payments for service provided under the manufacturer's warranty are reimbursed to the dealership at rates established by the manufacturer. If the dealership complies with the procedures established by the manufacturer for the reimbursement for service covered by the manufacturer's warranty, payment will be received in the next dealership statement. (Note that existence requires that the warranty claim was made properly and the service for which the dealership is requesting reimbursement is covered by the manufacturer's warranty. If this is the case the amount is 100 percent collectable.)

Required:

Determine for each account the control or substantive tests which could be used to determine the existence and collectability of the accounts receivable. Include in your answer the impact of receivables older than their normal collection cycle.

II. Revenue Recognition

A. Recognition of Revenue, Vehicle Sales

The typical vehicle purchasing process at an automobile dealership is the customer is met by a salesman, a vehicle is identified, the customer takes a test drive, the customer and the salesman come to agreement on a price, and the deal is signed by the customer. Based on contract law, the offer and acceptance has been completed. Subsequent to that point, typically financing arrangements must be finalized, the actual sales agreement is drafted, and final preparation of the vehicle occurs.

Required:

Determine whether to recognize revenue upon offer and acceptance, or in dealer speak, when the vehicle crosses the curb, i.e. The customer drives the vehicle off the dealer's lot.

B. Amount of Revenue Recognized, Vehicle Sales

The majority of vehicle sales involve a trade-in, the customer's current vehicle is surrendered to the dealer and the value of that vehicle is used to offset a portion of the purchase price of the vehicle the customer is buying. Typically, any discount the dealer offers on the cost of the vehicle the customer is purchasing is included in the trade-in value of the vehicle being surrendered. This is good for the customer for they feel they are getting top dollar for their trade-in. It has no impact on the dealer for they are merely re-characterizing the sales price. It is bad for the auditor, for any difference between the stated trade-in value for the vehicle being surrendered in the sale and the actual value of that vehicle results in excess revenue on the vehicle being sold and an overstatement of the inventory value of the trade-in. The dealer may adjust the value of the trade-in to its proper value when the transaction is recorded or they may not.

Required:

How would you as the auditor determine whether excess revenue is being recognized on vehicle sales where part of the purchase price is paid with a trade-in?

C. Recognition of Revenue, Finance Income

Finance income results from the sale of a finance contract to a financial institution. The amount of the income is the difference between the amount of interest expected to be received by the financial institution based on the interest rate in the finance contract and the amount of interest based on the interest rate implicit in the sale of the contract.

Required:

Since the finance contract is for a loan of many years and the amount is not certain, should the dealership recognize all of the income at the time of the sale of the contract or over the life of the contract? If you believe the revenue should be recognized over the life of the contract and the dealership recognizes it immediately, how would you convince the dealer your accounting method is preferable?

III. Inventory Cycle

The primary function of the audit tests of the inventory cycle is to determine existence and valuation. Automobile dealerships generally have three types of inventory, new vehicles, used vehicles, and parts. They may also have small amounts of work in process in the auto repair and body shops. Since vehicles can be identified by the vehicle identification number (VIN), for new and used vehicles, the specific identification method is used for costing these inventories. Parts are generally use replacement cost for inventory valuation. Work in process is recorded at cost.

A. New Vehicles

All vehicles have vehicle identification numbers assigned by the manufacturer. These numbers are engraved on the dashboard and the engine block. However, most dealerships identify vehicles by a dealer assigned number which is not derived from the vehicle identification number. Valuation is based on invoice price plus the cost of any dealer installed options.

B. Used Vehicles

Vehicle identification is the same as for new vehicles. Valuation is based on the price paid for the vehicle. If the vehicle was purchased at auction or from a wholesale dealer, an invoice will indicate the price paid. If the vehicle was obtained from a trade-in on the purchase of another vehicle, valuation is more difficult. As described under revenue recognition above, alternative methods for determining the true value of the used vehicle may be required.

C. Parts

Identification of a part can be determined by a part number contained either in the packaging or as a label for the part bin. Dealers maintain their parts inventory at replacement cost rather than cost because the sales price for parts is determined by a standard markup on current replacement cost. Updated replacement costs are provided to the dealership by the manufacturer on a regular basis. The total impact of the difference between carrying cost and replacement cost is recorded in a cost of goods sold account as a credit balance.

Required:

Based on the characteristics of each class of inventory, identify the audit procedures that should be used to determine existence and valuation of inventory.

IV. Payment Cycle

A. Line of Credit, Floorplan

Almost all automobile dealerships finance their new vehicle inventory and some also finance their used vehicle inventory using a line of credit known as floorplan. Each vehicle financed is treated as an individual note. The collateral for the note is the vehicle itself. A dealership can finance as many vehicles using these notes until they reach their credit limit under the line of credit. Upon the sale of a vehicle, the amount of the note for that vehicle must be paid to the lender. The lender provides monthly statements of all vehicle notes where each vehicle financed is identified by their vehicle identification number. Dealer inventory listings include all vehicles, their recorded cost, their vehicle identification number, and the amount of the floorplan note for each vehicle.

Required:
Identify the audit procedures that should be used to determine the completeness and accuracy of the dealership's floorplan debt.

Author

Paul C. Schauer
Professor, Bowling Green State University, Bowling Green, Ohio, USA, schauer@bgsu.edu