100 Introduction

100.1 When the word *dealership* is mentioned, most people think of automobile dealerships. With the number of automobiles on the road today, that is understandable. However, there are other dealerships that sell heavy trucks, farming machinery, boats, and recreational vehicles. While this *Guide* concentrates on vehicle dealerships (those selling automobiles and light trucks), the accounting principles and tax requirements for other types of dealerships are, for the most part, identical.

100.2 Even though there is a vast market for their products, dealerships are in fierce competition with each other to sell new and used vehicles. Consequently, profit margins are low.

100.3 Most dealerships make a slightly higher gross profit on used vehicles than on new ones. Used vehicle demand has increased as higher prices for new vehicles have made them unaffordable for many people. However, due to continued low financing rates for new vehicles and other aggressive incentives offered by many manufacturers, the difference between the number of new and used vehicles sold by franchised dealers has been declining.

100.4 In addition to the competition for buyers among new and used vehicle dealerships, there is competition among new vehicle dealerships. Steeper prices and sky-high insurance payments are driving away buyers in their late teens and early twenties. Also, aging baby boomers continue to favor more functional transportation, such as family sedans, minivans, and sport utility vehicles.

100.5 The National Automobile Dealers Association publishes *NADA Data* annually. *NADA Data* is a comprehensive statistical analysis of the franchised new vehicle dealership industry and is available on the Internet at **www.nada.org**.

100.6 It is important to understand today's dealership industry and anticipated changes. This chapter is designed to facilitate that understanding.

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101 Forms of Organization

101.1 Like other businesses, dealerships may be organized in one of several different forms. That decision is often based on the dealership's overall objectives, such as minimizing income taxes or limiting liability. Significant factors to consider include:

- The required financing.
- Whether income or a loss is expected in the near term.
- The risk of significant liabilities resulting from the business.
- Whether capital will be needed.
- The tax consequences.
- The personal wealth of the owners.

101.2 While a detailed discussion of the various organization forms is outside the scope of this *Guide*, the following paragraphs describe the advantages and disadvantages of several organization forms that may be used by dealerships.

Proprietorships

101.3 Proprietorships are the most basic and usually the simplest form of business organization. In a proprietorship, the owner holds title to property, conducts business for profit, and is directly and personally liable for all obligations of that business. In most cases, the owner's personal assets can be seized to satisfy debts of the proprietorship. Some of the advantages and disadvantages of this legal form are as follows:

- Advantages:

  •• *Easy Formation.* Fewer filings, elections, and registrations.

  •• *Simple Operations.* The owner manages his or her business.

  •• *Easy Asset Sales.*

  •• *Fewer Administrative Complexities.*

  •• *No Double Taxation.* The proprietorship's taxable income, losses, and credits pass through to the owner. This avoids double

taxation of business income and allows current deduction of business losses.

• Disadvantages:

•• *Difficult to Sell.* The assets of the business are transferable, but the business entity is not. When a proprietorship is *sold*, the business assumes a new identity.

•• *Limited Capital.* A proprietorship's primary sources of capital are equity contributions from the proprietor and loans obtained by the proprietor.

•• *Unlimited Liability.* This is especially important in businesses that are susceptible to personal injury and product liability.

•• *Limited Management Resources.* Because ownership cannot be shared, the skills and experience of others who have vested interests in the successful operation of the enterprise may be lacking.

General Partnerships

101.4 General partnerships are composed of two or more partners who join together to carry on a trade or business. Some of the advantages and disadvantages of the general partnership form include:

• Advantages:

•• *No Double Taxation.* The partnership's taxable income, losses, and credits generally pass through to the partners.

•• *Fewer Administrative Requirements.* For example, general partnerships often have no formal state registration requirements.

•• *More Management Resources.* Partnerships have multiple owners who bring more skills, expertise, and different perspectives to the business. This is especially important when the partners' skills and expertise are complementary.

•• *More Sources of Capital.* Although general partnerships are normally limited to the same sources of capital as proprietorships, their potential pool of capital is normally greater because they have multiple owners.

• Disadvantages:

•• *Personal Liability.* In most states, general partners are liable for all the partnership liabilities (not just a share of the liabilities based on their ownership percentage). Normally, they are also liable for wrongful acts committed by their partners. Furthermore, any partner may be able to bind the partnership in a contract within the scope of the business operations.

•• *Limited Life.* A general partnership dissolves whenever a majority of the partners die, become disabled, or withdraw from the partnership. However, provisions can be made in a partnership agreement to keep the business in operation.

•• *Less Management Control.* Partners enjoy less management control than sole proprietors. The existence of multiple owners may lead to disagreement about management and control issues, resulting in inaction.

•• *Difficult to Transfer.* Partnership interests can be difficult to transfer. Doing so requires finding a willing buyer and obtaining the approval of the other partners.

Limited Partnerships

101.5 Limited partnerships have two types of partners—general partners and limited partners. General partners manage the daily operations. They are personally liable for the partnership's obligations. Limited partners are passive investors whose liability is normally limited to the amount of their investment.

101.6 Limited partnerships have many of the same advantages and disadvantages as general partnerships. The following are some of the differences between the two types of partnerships:

• *Administrative Burden.* State laws generally establish certain requirements for forming limited partnerships. For example, limited partnerships often must file a certificate of limited partnership with the secretary of state or other state or county offices.

• *Many Investors.* Limited partnerships can have a large number of limited partners. These partnerships can raise capital from a large number of investors.

• *Management Control.* Limited partnerships are controlled primarily by the general partner(s).

• *Longer Life and Transferability.* Limited partnerships may endure upon the death, disability, or withdrawal of a limited partner. In theory, limited partner shares can be transferred more easily, but it may be unlikely that a market for limited partnership interests will exist.

• *Passive Activity Losses.* The deductibility of partnership losses by limited partners might be restricted under the passive activity loss rules if the limited partners do not meet the tests for material participation.

• *Limited Liability.* Limited partners' liability is normally limited to the amount of their investment. (However, if the limited partnership does business outside the state of its creation, these limitations may not be effective in the other states.)

Corporations

101.7 Corporations are business entities created under state law. Legally, they are considered artificial persons created to conduct business. Thus, they can hire employees, enter into contracts, acquire assets, and incur liabilities. The following are some of the key advantages and disadvantages of the corporate form of business:

• Advantages:

•• *Limited Liability.* Generally, stockholders are not personally liable for a corporation's obligations. However, stockholders are often required to personally guarantee bank debt as a condition of obtaining a loan.

•• *Continuity of Life.* The corporation continues indefinitely, even after the death, bankruptcy, or retirement of a stockholder. Dissolution requires a resolution of the directors and approval of the stockholders (voluntary) or judicial action (involuntary). Although indefinite life is usually an advantage, it causes dissolution to be a potentially expensive process.

•• *Transferability* . Theoretically, transferability of ownership is easier for a corporation than for other forms. In reality, two factors reduce this advantage:

— Closely held stock is not very marketable.

— Many stockholders are more interested in limiting transferability than promoting it.

•• *Management Resources and Control.* When there is a single stockholder, the corporation generally offers the same flexibility and control as a sole proprietorship. Multiple owners provide a greater pool of management resources for the business.

• Disadvantages:

•• *Corporate Level Taxation.* The taxable income of C corporations is subject to a separate corporate income tax. Dividends distributed to shareholders are taxable to the shareholders but not deductible by the corporation. This results in double taxation of corporate profits. Also, losses of C corporations are not passed through to stockholders but can be carried back or carried forward to other tax years by the corporation.

•• *Double Taxation on Liquidation.* When a C corporation liquidates, double taxation may also occur. The corporation is taxed on the gain from the sale or disposition of assets (when the distribution is deemed a sale at the fair market value of the assets). Stockholders are taxed on the distributions received from the corporation. The double tax detriment of C corporations was amplified in 2013 and after, given the increase in the maximum long-term capital gain and qualifying dividend rate in 2013 and after from 15% to 20%.

101.8 **C Corporations and S Corporations** Federal tax law recognizes two types of corporations—

• *C Corporations.* C corporations are separate taxpaying entities.

• *S Corporations.* S corporations generally do not pay federal income taxes. Their income, losses, deductions, and credits pass through to stockholders. Corporations must file elections and meet certain eligibility requirements to qualify as S corporations.

101.9 To qualify for S status, the following requirements must be met:

• The corporation must be a domestic corporation.

• The corporation must be an eligible corporation. (For example, it cannot take the Puerto Rico and possessions tax credit for doing business in a United States possession.)

• The corporation cannot have more than 100 stockholders.

• The corporation's stockholders must be U.S. citizens or residents, estates, charitable organizations, or certain qualifying trusts. (S corporation stockholders cannot be corporations, foreign entities, or nonqualifying trusts.)

- The corporation can have only one class of stock.

101.10 The corporation must file an election (Form 2553) on or before the 15th day of the third month of the year for which the election is made (or, in the case of a newly formed corporation, the activation date).[1] All stockholders at the time of the election must consent to the election on Form 2553 or on a separate statement attached to Form 2553. Also, if the election is made during the taxable year for which it is to be effective, all persons who were stockholders during the year prior to the election must consent.

101.11 New C corporations and S corporations should both consider qualifying their stock for treatment under IRC Section 1244. Basically, Section 1244 allows a loss on the disposition of qualifying stock to be treated as an ordinary loss rather than as a capital loss for tax purposes. Ordinary loss treatment is also available if the stock becomes worthless. As an added benefit, any loss that qualifies as an ordinary loss under IRC Section 1244 is also treated as a trade or business loss in computing a shareholder's net operating loss (NOL). Consequently, Section 1244 losses are allowed for NOL purposes without being limited by nonbusiness income.

Limited Liability Companies

101.12 Limited liability companies (LLCs) are entities, owned by members, that combine many of the tax advantages of a partnership with the liability protection of a corporation. Each state establishes its own LLC rules and characteristics.

101.13 The advantages and disadvantages of LLCs include:

- Advantages:

  - Members are not personally liable for LLC obligations. (However, members are personally liable for their own actions and the actions of people they supervise.)

  - The number of members is not limited, and members can be corporations, trusts, partnerships, other LLCs, or others.

  - Double taxation is avoided. (Taxable income is passed through to the members.)

  - Members can participate in managing the LLC.

  - Distributions to members do not have to be directly proportional to the member's ownership percentage as they do for S corporations.

  - LLCs can have two or more classes of ownership.

  - Assets flow in and out of the LLC at tax basis, not fair market value.

- Disadvantages:

  - LLCs may have a limited life depending on state law. (In some states, affirmative votes are required of all members to continue operations if a member dies or withdraws.)

  - Transfer of interests is more difficult. (Although a member may transfer an equity interest in an LLC, the new owner does not necessarily acquire all the rights and attributes of a member.)

  - In some states, LLCs must have at least two members.

•• Some states do not provide special tax status for LLCs.

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[1] *PPC's 1120 Deskbook* discusses possible ways to overcome missed filing deadlines.

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102 Franchise Relationships

Franchise Agreements

102.1 New vehicle dealerships have a different relationship with their suppliers (i.e., the manufacturers) than most commercial businesses have. They must enter into franchise agreements (also known as sales and service agreements) with manufacturers to obtain the vehicles they sell and to perform warranty work. Those agreements are personal service contracts that may not be assigned to others.

102.2 Franchise *agreement* may be a misnomer because an agreement assumes that the affected parties have negotiated and compromised before reaching the agreement. In most cases, the terms of a franchise agreement are unilaterally set by the manufacturer. Most states have laws to protect the dealer from abuse by the manufacturer. However, it is unclear whether, or how, federal bankruptcy of manufacturers will affect state protection.

Common Requirements of a Franchise Agreement

102.3 Most dealership franchise agreements include requirements such as the following:

- Timely submission of monthly financial statements to the manufacturer.

- The sales and service performance or responsibilities the dealership has to meet.

- The necessity for the dealership to advertise and provide activities that promote the sale of new vehicles.

- The manufacturer's right to approve a dealership's change of location or addition of another franchise. In contrast, the manufacturer may establish additional dealerships without approval of an existing dealership since franchise rights ordinarily are not exclusive to territories. Most states have motor vehicle commissions to regulate the manufacturers and provide a forum for dealer complaints.

- A prohibition on the dealership's knowingly exporting vehicles for sale or use outside of the United States.

- The manufacturer's right of first refusal if the dealership is to be sold. Changes in ownership must be approved by the manufacturer, and the manufacturer generally has the right to substitute another buyer for the one the dealership has selected. That right may be detrimental to the dealership because qualified buyers may be reluctant to bid if they feel the manufacturer will substitute another buyer. Manufacturers may use the right of first refusal to control the makeup of the dealership's governing body.

All franchise agreements are subject to state franchise laws.

Term of the Agreement

102.4 A franchise agreement may be perpetual but is generally for a specific time period.

Termination of the Agreement

102.5 Each failure to meet a requirement of a franchise agreement does not warrant termination. If a dealership is in violation of the agreement, the remedies are termination, specific performance, or other civil action. An agreement in the process of being terminated remains in effect until that

process is completed. If an agreement is terminated, the dealership cannot sell vehicles or perform warranty work. However, terminations involved with manufacturer bankruptcy may provide for a more orderly wind-down.

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103 Industry Trends

103.1 The dealership industry has been forced to react rapidly to changing economic, regulatory, and technological factors that affect vehicle sales and service, as well as dealership continuity. For example, for a continuing dealership, a depressed economy will generally increase the sale of used vehicles while decreasing the sale of new vehicles. However, aggressive manufacturing incentives may counteract this trend. Service departments are becoming more profitable because buyers are keeping their vehicles longer and having them repaired rather than trading vehicles every two or three years. Customers may lease vehicles rather than buying them in order to get better vehicles for their money. Those leased vehicles are returned to the used vehicle market, resulting in increased availability of quality late model used vehicles.

New Car Prices

103.2 The average price of a new car, including accessories and options, has generally been decreasing but many still believe it is too high for the average consumer. Manufacturers may need to consider additional ways to keep from pricing individuals out of the market, for example, by establishing standardized specifications for automatic transmissions and parts, such as alternators, seat tracks, batteries, and electrical connectors. This could result in substantial cost savings.

Used Vehicle Superstores

103.3 The demand for quality used vehicles has resulted in a differing marketing concept, the used vehicle superstore. An example is CarMax (which is publicly traded). Those stores typically differ from the usual used vehicle operation in the following ways:

- A larger selection is offered. Each lot carries an average of 300 to 450 used vehicles. Their focus generally is on cars one to six years old with less than 60,000 miles.

- No-haggle pricing is used instead of negotiated sales. Generally, the sales staff is paid an identical, fixed-dollar commission on every vehicle sold, not commissions based on a particular make, model, or price of a vehicle.

- Technology is used to match customers with vehicles. Shoppers enter information such as the type of vehicle they are seeking into computer terminals and find vehicles on the lot that meet their criteria. In addition, the inventory of vehicles at all sites is listed on the company website, allowing customers to shop for vehicles at home and order cars not at their regional superstore.

- A positive shopping experience is being sold instead of price because their prices tend to be higher than other used car lots.

- If they want to trade in a vehicle, buyers get an appraisal that they can take in cash if they do not find what they want to buy.

- They generally get their inventory from vehicle auctions, financial institutions, manufacturers selling leased vehicles, companies disposing of fleet vehicles, and direct purchase from consumers.

103.4 To more effectively compete with used vehicle superstores, factory-sponsored used vehicle dealerships may band together to have a larger inventory. Manufacturers recognize that used vehicle superstores are pushing traditional dealerships to focus more on serving used vehicle customers and that certifying used vehicles and offering manufacturer-based warranties for used vehicles is necessary.

103.5 The superstore marketing concept is not limited to used vehicles. For example, CarMax is selling new cars from Chevrolet, Chrysler, Dodge, Jeep, Scion, Nissan, and Toyota at certain locations.

Fewer Dealerships in the Future

103.6 The U.S. auto market has been in a transition. Consolidation, spin-offs, restructurings, and closings have reduced the number of new car dealerships in the U.S. This decline is expected to continue as more franchised dealerships are consolidated or closed and as major manufacturers make concerted efforts to reduce competition among their own dealerships and restructure their own operations.

103.7 Prior to the economic contraction that began in 2008, the “Big Three” automakers, Ford, GM, and Chrysler, had begun taking steps to weed out unprofitable dealers in the bigger market areas. Because they were manufacturing fewer vehicles each year, they needed fewer dealerships to sell them. When there are too many dealers, owners cannot afford to reinvest in their dealerships. Sales suffer when facilities are not maintained, especially when a dealership is competing with a megastore that has bright, modern facilities. And, as discussed in paragraph 103.15, more and more buyers are turning to the Internet to either begin the purchasing process or to actually complete a vehicle purchase, another factor contributing to the need for fewer dealerships. The 2008 economic contraction exacerbated that situation as both GM and Chrysler filed for bankruptcy.

103.8 Chrysler had consolidated numerous dealerships into dealerships carrying all three Chrysler brands under one roof. GM had also combined Pontiac, GMC, and Buick dealerships into one channel before discontinuing the Pontiac brand in 2009. As part of their 2009 restructurings, GM shut another 1,100 dealerships and Chrysler closed approximately 800.

Megadealerships

103.9 When the automobile industry was born over a century ago, buggy and wagon makers such as Buick and Studebaker had networks of local businessmen who sold their vehicles across the country. As carriage makers started building cars, their networks of buggy shops turned into networks of car dealerships. Through those networks, manufacturers control how their vehicles are sold without the costs of maintaining their own retailing networks.

103.10 Big dealerships bought out smaller low-performing dealerships, creating megadealerships that own more than one facility and often sell different brands. Even though most megadealerships are still family owned and operated, they are not small businesses. For example, they generate millions of dollars in annual revenues, support large sales staffs, and, in many cases, own prime real estate.

103.11 Many of those owners are nearing retirement age, and their children may not be interested in continuing the business. The megadealerships may not be easy to sell because potential buyers need substantial amounts of capital. Some dealerships are being sold to investment companies, as discussed beginning at paragraph 103.12.

Retail Chains

103.12 Investment bankers and venture capitalists have the capital to buy dealerships and consolidate them into retail chains. And, the aging of the owners of some megadealerships affords investment companies the opportunity to acquire whole groups of dealerships at once.

103.13 Several companies, including Lithia Motors, Sonic Automotive, United Auto Group, AutoNation, and Asbury Automotive Group, actively acquired dealerships and instituted cost saving measures. They entered the dealership industry with its inefficient marketing and distribution system and seized a competitive advantage by reducing those costs. For example, they can buy advertising in bulk, consolidate parts and service operations, and install centralized management information systems to reduce the clerical staff required.

103.14 **Publicly Held Retail Chains** Another trend has emerged that affects retail chains. During 1996, Cross-Continent Auto Retailers became the nation's first automobile dealership to go public. AutoNation has purchased hundreds of new vehicle dealerships. Other publicly held dealership groups include United Auto Group, Sonic Automotive, Hometown Auto Retailers, Lithia Motors, Penske Automotive Group, and CarMax.

Online Marketplaces

103.15 The newest way to purchase a car might be to skip the retail dealership altogether and buy online, or at least get a connection to a dealership's Internet sales department. Since a dealership's Internet sales department makes its commissions on volume, not price, it can often offer a better price to an online customer than a traditional salesperson can offer at a dealership. Buyers can save time and money and overall may have a more pleasant buying experience. Both new and used vehicles are sold online. Online retailers carry no inventory but are able to find the exact car, options, color, etc., that the buyer wants by searching nationwide inventories. Financing and smaller details, like extended warranties and rust proofing, can also be arranged online. Some Internet sites email free dealership quotes to customers while others act more like brokers. In some cases, even when a purchase is made through a dealer, the buyer feels like he or she is dealing directly with the Internet seller, and the car is delivered right to the customer's front door.

Demand for Lease Vehicles

103.16 As mentioned in paragraph 103.1, leasing grew in popularity because a customer can buy a more luxurious vehicle at a lower initial cost and lower payments. Some dealerships have started leasing used vehicles. Leasing programs have advantages and disadvantages for the dealership. A leasing program flattens out the business cycle by having contract renewals or replacements year round, but it cuts down on F&I (finance and insurance) and extended service contract income. Dealerships that have strong lease programs have a constant source of good used vehicles. However, customers who lease often have no brand loyalty, and they often do not use the dealership's service department unless there is a warranty problem.

103.17 The average lease terms have increased, with many exceeding 36 months. As lease terms lengthen, there is concern that there may be fewer *off-lease* customers to purchase new vehicles and that there will be fewer quality, low-mileage off-lease vehicles available for sale as used vehicles.

Direct Repair Programs

103.18 Insurance companies, eager to repeat the way managed care has controlled health care costs, have been applying similar concepts to fixing vehicles in programs called *direct repair*. Customers are encouraged to use one of a prescribed list of collision repair shops, thereby streamlining costs and improving service. They usually get their vehicles back faster (thus saving on rental fees) and often get a lifetime guarantee on the repairs. Dealerships may affiliate with multiple insurance companies.

103.19 While direct repair programs are not new for some insurance companies, increased competition in past years has prompted other insurers to offer them as a way to lower expenses and improve service. Repair shops videotape or digitally photograph the damage and transmit the tape or photos immediately to a claims adjuster's office, allowing damage to be assessed and repaired faster than before. In effect, the repair shops have taken over some of the duties of the insurance companies, such as administrative work and some claims functions.

Other Trends

103.20 A list of some other trends affecting the dealership industry follows:

• *Internet Sites Where a Buyer Can Obtain Information about a New Vehicle.* Kelley Blue Book (**www.kbb.com**) provides new vehicle sticker and invoice prices and manufacturer rebates as well as used car prices. Microsoft's MSN Autos (**http://home.autos.msn.com**) provides new vehicle sticker and invoice prices, dealer Internet links, online purchasing and quotes, and used car classifieds. Currently, the information at those websites is free. The Fighting Chance Information Service (**www.fightingchance.com**) costs $39.95 for one vehicle with additional orders at the same time costing $15 each. The buyer is furnished the sticker price and dealer invoice price; the latest issue of *CarDeals*, a biweekly report on the manufacturer's cash incentive programs; an analysis of how the manufacturer and vehicle model have been doing in the marketplace; several articles to help interpret the information and provide additional insight into the nuances of purchasing a vehicle; and a telephone number to call to discuss the purchasing process.

• *Comparative Marketing.* Marketing campaigns that feature a direct comparison with competing vehicles have gone to a new level.

• *Longer Extended Warranties.* With longer factory warranties on engines and transmissions, extended warranties are also expanding.

• *New Dealership Architecture.* Many manufacturers are emphasizing brand image through their dealerships and are implementing redesigned showrooms. Manufacturers often state that standardized dealerships help to differentiate their brands from the competition. [2]

• *Fuel-saving Hybrid Automobiles.* Higher gasoline prices have created increased consumer demand for more fuel efficient automobiles, spurring automakers to accelerate plans of hybrid vehicles. Currently, most of the major vehicle manufacturers offer hybrid electric vehicles, which use both batteries and fuel-burning engines to provide power. That combination of power sources increases gas mileage and reduces pollution while meeting consumers' desires for vehicles that can be driven anywhere. The growth in the hybrid market is expected to continue, especially now that hybrids have been around long enough for buyers to trust the technology, more options are available, and there is a much wider selection of brands and models.

• *Non-combustion Fuel Cell Automobiles.* Most of the large car manufacturers are developing cars and/or trucks that will run on fuel cells. The new, non-combustion engine runs on hydrogen and produces neither smog nor emissions, except water vapor. Plus, the mileage capacity is expected to be much more than electric cars.

• *Bi-fuel and Alternative Fuel Automobiles.* Natural gas is relatively inexpensive, clean-burning, and readily available in North America. Honda touted its natural gas-powered Civic Natural Gas as the cleanest vehicle ever built with an internal combustion engine. Ethanol-based automobiles have been well-publicized as a viable alternative fuel, specifically those that use E85 ethanol fuel (85 percent ethanol and 15 percent gasoline).

• *Consignment Sales.* Some dealerships are selling used vehicles on consignment. The vehicles do not have floor plan expense and generally sell for more than other used vehicles. The dealerships retain a percentage of the sales price or a flat sum based on the vehicle's estimated value.

• *Competition for Service Work*. Service providers, like Wal-Mart and discount parts stores, are proving to be strong competitors with dealership service departments.

• *Expanding Accessories Market.* The market for accessories like running boards, mud flaps, bug screens, etc. is growing. Those accessories are even selling well at car washes. Some dealerships are focusing on selling accessory packages for used vehicles and vehicles purchased at other dealerships.

• *No-haggle Pricing.* Industry analysts predict that it may increase modestly but not take over the industry.

• *Salaried Salespeople.* Paying salespeople a salary or a salary plus a bonus instead of a commission may become more prevalent. Longevity bonuses may reduce turnover, which historically has been very high for dealerships.

• *Scrutiny of Lending Practices*. Highly visible lawsuits and regulatory scrutiny against automotive dealerships for potential lending violations against the federal Truth-in-Lending Act (TILA) and the Uniform Deceptive Trade Practices Act (UDTPA) have raised dealers' concerns about their lending practices. Common complaints include incomplete disclosure in the contract of after-market products and inconsistent collection of certain fees. Many dealerships are now emphasizing increased communication and disclosure with the consumer.

• *Increased Customer Privacy.* The Federal Trade Commission's Safeguard Rule requires that dealerships provide administrative, technical, and physical safeguards to protect customer information. Dealerships have had to ensure that reasonable policies and procedures exist to protect the security and confidentiality of information collected from (and about) customers, including information obtained from the dealership's internet website.

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[2] In May 2014, the IRS Office of Chief Counsel released a memorandum which states that automobile manufacturer payments to dealerships, in order to encourage the dealerships to comply with the latest brand image program through performing upgrades to their facility, should be included in the dealerships' gross income for tax purposes. A copy of the memorandum can be found at **www.irs.gov/pub/irs-utl/AM2014-004.pdf**.

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104 Dealership Consolidations

104.1 As discussed beginning at paragraph 103.6, many manufacturers have had programs to reduce the number of dealerships. Essentially, the consolidation programs try to align franchises and physical facilities in terms of (a) location (i.e., obtaining *right* or *better* locations), (b) improved facilities and image, and (c) product availability and product mix in terms of make and model of brands. One benefit of such a reduction is significant savings in distribution and marketing costs. This section discusses reduction programs and steps accountants can take to assist their dealership clients in preparing for the effects of those programs.

104.2 Although there is no standard consolidation program for all manufacturers, the following generalizations seem to apply:

• Each manufacturer has its own plans for realigning its franchise network. Over the past few years, Ford, without fanfare or publicity, implemented an aggressive consolidation program.

• If most manufacturers could start all over again today, many of their dealerships would not be found to be in the right locations with the right product mix.

• Some dealerships are protected from having their selling agreements terminated for arbitrary reasons by state law to some degree, but that degree of protection varies from state to state.

• The specifics of consolidation programs and activities are constantly changing in shape and impact. Some of the factors influencing a manufacturer's activities at any given time include:

•• Local circumstances in the dealership's primary market area.

•• The degree of resistance or passivity dealerships offer, either individually or collectively.

•• The strength or weakness of state dealership protection laws and the willingness of manufacturers to test them.

• Dealerships are not treated consistently by manufacturers under consolidation programs, so it is reasonable to expect some degree of confusion and inefficiency to accompany their implementation.

• Complex decisions with major tax consequences may have to be made under critical time pressures. Dealerships and their accountants should reevaluate buy-sell agreements, estate and succession planning, dealership valuations, and corporate and individual income tax strategies. More than ever before, dealerships need competent accountants, attorneys, brokers, and advisors who understand the dealership industry and the rapidly changing environment in which dealerships operate. Paragraph 104.4 discusses actions accountants can take to minimize the consequences of consolidation programs to their dealership clients.

• Dealers who do not have realistic valuations of their dealerships stand to lose even more. Every valuation should address the question, “What is the dealership's status with respect to possible consolidation?” The answer to that question must consider, among other things, the effect of the consolidation programs of other manufacturers on their dealerships in the same market area.

• It is critical that dealerships fighting to survive or planning to expand have adequate capitalization. Significant funds may be necessary to finance facilities that comply with new image standards and other program requirements. Factory incentives, cash payments, loans, and lower financing costs are often available, but dealerships must aggressively seek them out and bargain for them.

• There is no specific cutoff date on which the manufacturers' attempts at consolidation and managed attrition will cease. Many believe consolidation will continue well into the future. It is expected that those dealerships that survive will be better off and more profitable in the long run.

Terminating Franchises

104.3 Some manufacturers may attempt to terminate franchises for cause without compensation. There are several reasons a manufacturer may give for the termination. For example, the dealership may have:

• Produced insufficient sales according to the manufacturer's criteria.

• Received a poor customer satisfaction rating. Those dealerships will not add any new lines and may lose the ones they have.

• Failed to maintain adequate working capital (resulting in out of trust problems), or there may be other *going concern* considerations.

• Reported transactions dishonestly to the manufacturer, especially those transactions involving warranty claims and sales incentive programs.

• Occupied inadequate or deteriorating facilities that have not been upgraded or repaired.

• Formulated an inadequate succession plan.

• Initiated a transaction that is not permitted in the franchise agreement.

The manufacturer may also try to terminate a dealership's franchise if the dealer is convicted of a criminal activity or if there is adverse publicity brought on by the behavior of the dealer or another key employee.

Involvement by Accountants

104.4 There are several steps accountants can take to minimize the consequences of consolidation programs to their dealership clients. For example, accountants can:

• Review the franchise agreement to determine the answers to the following questions:

•• When does the current agreement terminate?

•• Under what circumstances can it be terminated?

•• To which termination conditions is the dealership most vulnerable?

• Obtain a copy of any state laws that provide protection to the dealership. A written summary may be available from the state dealership association.

• Review any recent valuations of the dealership that were completed in light of the manufacturer's consolidation program. Accountants can determine how significantly the value of the dealership affects the dealer's post-retirement cash needs and other goals. They can also review buy-sell agreements and other estate planning documents.

• Prepare a valuation by vehicle line or franchise if pressure is expected from the manufacturer in connection with dualing or stand-alone status.

• Prepare supporting financial and other information in response to claims or statements made by the manufacturer (in correspondence, telephone calls, and seemingly informal conversations) to the dealership. Correspondence from the manufacturer should always be truthfully answered. Responses should be directed to the letter's originator, but copies should be sent to other interested parties at the factory.

• Conduct a survey or compliance check to determine the dealership's exposure, if any, to manufacturer warranty claim or incentive program audits initiated in conjunction with consolidation programs.

With that information, accountants can discuss either proactive or defensive strategies with dealership management and legal advisors.

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105 Independence and the Performance of Nonattest Services for Dealerships

105.1 Independence is an important issue for many small practitioners because, as discussed more fully in Chapter 9, the only type of report a CPA can issue on financial statements when he or she is not independent is a compilation report. However, independence is much easier to define than to apply. An infinite variety of situations can occur that raise questions regarding independence issues but are not necessarily independence problems. Therefore, it is important for CPAs to understand the various rules that govern independence. The following paragraphs discuss the authoritative literature relating to independence, the conceptual framework for independence, and the impact of performing nonattest services for dealership attest clients. Throughout the discussion, the authors generally use the terms *practitioner*, *accountant*, *member*, and *auditor* interchangeably.

105.2 The primary rules governing independence are found in the AICPA *Code of Professional Conduct* (Code). [3] The authors recommend that the CPA read ET 1.200 of the AICPA *Code of Professional Conduct* for guidance concerning independence. [4] Independence requirements also can be found in the SSARS, SASs, SSAEs, and AICPA Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control*. Not having independence when required can have significant negative ramifications for the firm and the nonindependent practitioner. Complying with the independence requirements of the Code of Conduct ensures that the related independence requirements of SQCS No. 8, SSARS, SASs, and SSAEs are met. While the authoritative literature governing the various types of engagements contains a great deal of discussion about the concepts of independence, identifying independence problems, and resolving nonindependence situations, the basic concept of independence is the same regardless of the level of service or the type of engagement. [5] Basically, accountants are independent if they are free from obligation to or interest in their clients.

105.3 Quality Control Standards (QC 10.25) require that the firm obtain written confirmation, at least annually, regarding compliance with the firm's independence policies and procedures from all personnel required to be independent. The representations should indicate whether the employee is complying with all of the requirements of ET 1.200 of the Code, as well as the rules of the state boards of accountancy and regulatory agencies. It also requires the firm to accumulate and communicate relevant information to its personnel to enable them to readily determine whether they are independent. Additional guidance regarding QC 10 can be found in *PPC's Guide to Quality Control*.

105.4 Many threats to independence are specifically addressed in ET 1.200 of the AICPA *Code of Professional Conduct*. For independence-related matters that are not explicitly addressed in the Code of Conduct, AICPA members are required to apply the risk-based approach found in the Conceptual Framework for AICPA Independence Standards (the Framework) (ET 1.210.010).

Conceptual Framework for Independence

105.5 The Framework (ET 1.210.010) describes the risk-based approach used by PEEC to analyze independence matters when it develops standards. Applying the Framework is discussed in the following paragraphs.

105.6 **No Independence Interpretations or Rulings** In situations where there are no independence interpretations or rulings that address a practitioner's particular independence circumstance, ET 1.210.010.01 requires the practitioner to evaluate whether his or her particular independence situation would lead a reasonable person who is aware of all of the facts to conclude that the practitioner is not independent. When making that determination, practitioners must refer to the risk-based approach described in the Framework.

105.7 **Unacceptable Risk** The Introduction to the Conceptual Framework indicates that under a risk-based approach to analyzing independence, a member's relationship with a client is evaluated to determine whether it poses an unacceptable risk to the member's independence. Risk is unacceptable if the relationship would compromise (or would be perceived as compromising by an informed third party having knowledge of all relevant information) the member's professional judgment when rendering an attest service to the client.

105.8 **Threats** Threats to independence are circumstances that could impair independence. Many different circumstances (or combinations of circumstances) can create threats to independence. Some examples include the following:

- *Self-review Threat.* Reviewing your own nonattest work, or that of your team, as part of the attest engagement.

- *Adverse Interest Threat.* Actions or interests between the accountant and the client that are in opposition, such as a threat of litigation by

either party.

• *Familiarity Threat.* Practitioners who have close or longstanding relationships with attest clients.

• *Undue Influence Threat.* Attempts by an attest client's management to exercise influence over the practitioner, such as pressure to reduce audit procedures for the purpose of reducing audit fees.

• *Financial Self-interest Threat.* Potential benefit to an accountant from a financial relationship with an attest client, such as excessive reliance on revenue from a single attest client.

• *Management Participation Threat.* Performing management functions on behalf of an attest client, such as making hiring decisions.

105.9 **Safeguards** Safeguards are controls that mitigate or eliminate threats to independence. To be effective, safeguards must eliminate the threat or reduce to an acceptable level the threat's potential to impair independence. Safeguards are generally created or implemented by one of the following three sources:

• *Profession, Legislation, or Regulation.* Examples include continuing education requirements on independence and ethics, and external review of a firm's quality control system.

• *Attest Client.* Examples include a tone at the top that emphasizes the attest client's commitment to fair financial reporting and policies and procedures that are designed to achieve fair financial reporting.

• *CPA Firm.* Examples include rotation of senior personnel who are part of the attest engagement team, and the involvement of another firm to perform part of an engagement.

105.10 **Required Documentation** If threats to independence are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. In instances where threats to independence are not at an acceptable level, thereby requiring safeguards, the following should be documented:

• The threats identified.

• The safeguards applied to eliminate the threats or reduce them to an acceptable level.

Nonattest Services

105.11 CPAs who perform attest services for dealership clients (i.e., audits, reviews, and compilations) may also perform, or be requested to perform, consulting or other nonattest services for the dealership. An independence issue may arise when practitioners provide any nonattest service, such as financial statement preparation, accounting, bookkeeping, or data processing services for a dealership attest client. According to ET 1.295.010.01, before CPAs perform nonattest services for an attest client, they should determine that the requirements of the Code have been met.

105.12 If the requirements of ET 1.295.010.03 have not been met during the period of the attest engagement or the period covered by the financial statements, independence is considered impaired *unless, for nonattest services performed during the period covered by the financial statements—*

a. the nonattest services were provided prior to being engaged to perform the attest engagement (period of engagement),

b. the nonattest service related to periods prior to the period covered by the financial statements, and

c. the financial statements for the period to which the nonattest service relate were audited by another firm (or in the case of a review engagement, reviewed or audited by another firm).

105.13 During an attest engagement, the CPA will often communicate with management about issues related to the engagement. The following discussions are considered a normal part of an attest engagement and would not be subject to ET 1.295.010.04:

- The client's selection and application of accounting standards or policies and financial statement disclosure requirements.

- Whether the client's accounting and financial reporting methods are appropriate.

- Adjusting journal entries proposed by the practitioner.

- The form or content of the financial statements.

The CPA is cautioned to consider whether the level of involvement is so extensive (i.e., due to the number or frequency of such routine activities) that it constitutes performing a separate nonattest service.

105.14 ET 1.295 of the AICPA *Code of Professional Conduct* requires the following with respect to the performance of nonattest services:

- The CPA should not assume any management responsibilities.

- The client must agree to perform certain specific functions in connection with the nonattest services.

- The CPA should establish and document in writing the understanding with the client regarding the nonattest services.

Chapters 9-10 discuss attest and nonattest engagements for dealerships. Note that the ability to perform those engagements may be affected by the discussion in the following paragraphs.

105.15 Independence is considered to be impaired if a member (or his or her firm) assumes management responsibilities for an attest client. However, the member may assist management in those responsibilities. For the member to remain independent, before the start of the nonattest engagement, the client should agree to perform all of the following functions in connection with the nonattest services (ET 1.295.040.01a of the AICPA *Code of Professional Conduct*):

- Assume all management responsibilities.

- Oversee the services by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience.

- Evaluate the adequacy and results of the services performed.

- Accept responsibility for the results of the services.

105.16 In addition, before the start of the nonattest engagement, the member should be satisfied that the client will be able to meet all of these criteria, make an informed judgment on the results of the nonattest services, and make the significant judgments and decisions that are management's responsibility. In cases where the client is unable or unwilling to assume its responsibilities, the member's performance of the nonattest services would impair independence.

105.17 The Code also requires the member to *establish* and *document in writing* his or her understanding with the client regarding the following (ET 1.295.040.01c of the AICPA *Code of Professional Conduct*):

- Objectives of the engagement (i.e., the nonattest services).

- Services to be performed.

- Client's acceptance of its responsibilities.

- Member's responsibilities.

- Any limitations of the engagement.

105.18 The Code of Conduct does not specify how the understanding is to be documented, so the practitioner has flexibility. For example, the understanding might be documented in a separate engagement letter, in the workpapers, in an internal memo, or in the engagement letter obtained in conjunction with an attest engagement. The authors believe it is common in many dealership attest engagements to also provide nonattest services, such as tax return preparation or bookkeeping services. The practitioner may choose to document the understanding with the client about the performance of nonattest services in the checklist at DLR-CX-1.2, “Engagement Independence Compliance and Nonattest Services Documentation Form.”

105.19 Certain activities performed as part of a nonattest service are considered to be management responsibilities and, therefore, create a management participation threat that would be so significant that no safeguards could reduce the threat to an acceptable level. Performance of those activities for an attest client would impair independence regardless of whether the practitioner complies with the other requirements of ET 1.295 of the AICPA *Code of Professional Conduct*. In addition, if an accountant assumes a management responsibility for an attest client, the management participation threat created would be so significant that no safeguard could reduce the threat to an acceptable level. The Interpretation lists common nonattest service activities and notes whether they are or are not considered to impair independence. ET 1.295.030.02 provides the following examples of activities that are considered management responsibilities and would impair independence (that is, they would preclude the practitioner from being independent):

- Setting policies or strategic direction for the client.

- Directing or accepting responsibility for the actions of the client's employees except as permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards.

- Exercising authority on behalf of a client, such as authorizing, executing, or consummating transactions, or having the authority to do so.

- Preparing source documents, in electronic or other form, that evidence the occurrence of a transaction.

- Having custody of client assets.

- Deciding which of the auditor's, or other third parties', recommendations should be implemented or prioritizing those recommendations.

- Reporting to those in charge of governance on behalf of management.

- Serving as a client's stock transfer or escrow agent, registrar, general counsel, or its equivalent.

- Accepting responsibility for the management of a client's project.

- Accepting responsibility for the preparation and fair presentation of the client's financial statements.

- Accepting responsibility for designing, implementing, or maintaining internal control.

- Performing ongoing evaluations of the client's internal control as part of its monitoring activities.

105.20 ET 1.295.160 of the Code also addresses tax compliance services. Preparing a tax return and transmitting the tax return and related payment, either electronically or in paper form, to a taxing authority does not impair independence as long as the practitioner does not have custody or control of the client's funds and the individual overseeing the tax services (a) reviews and approves the return and payment and (b) signs the return prior to transmittal, if required for the filing. Signing and filing a tax return impairs independence unless the practitioner has legal authority to do so and—

- the taxing authority has prescribed procedures, allowing the taxpayer to permit the practitioner to sign and file a return on their behalf, that meet the standards for electronic return originators and officers outlined in IRS Form 8879, or

- an individual in client management who is authorized to sign and file the tax return provides the practitioner with a signed statement that indicates—

  - the return being filed.

  - that the individual is authorized to sign and file the return.

  - that the individual has reviewed the return, including accompanying schedules, and it is true, correct, and complete to the best of the individual's knowledge and belief.

  - that the individual authorizes the practitioner to sign and file the return on behalf of the client.

The practitioner's representation of the client in an administrative proceeding before a taxing authority does not impair independence providing the practitioner obtains the client's agreement prior to committing the client to a specific resolution with the taxing authority. Independence is impaired if the practitioner represents the client in court to resolve a tax dispute.

105.21 In addition, under ET 1.295.110 of the Code, certain appraisal, valuation, or actuarial services are considered to impair independence. Performing appraisal, valuation, or actuarial services impairs independence if the results are material to the financial statements and the service involves significant subjectivity. For example, a material asset appraisal or business valuation generally involves significant subjectivity, and therefore would impair independence if performed for financial statement purposes. However, an actuarial valuation of a client's pension liabilities ordinarily does not require significant subjectivity and, therefore, would not impair independence even if the amount was material.

105.22 Under ET 1.295.040 of the Code, certain types of forensic accounting services may impair independence. Independence is impaired if a practitioner conditionally or unconditionally agrees to provide expert witness testimony for a client. However, under certain defined conditions, independence is not impaired if the practitioner provides expert witness testimony for a large group of plaintiffs or defendants that includes the practitioner's client. If the practitioner provides litigation services where he or she is a trier of fact, special master, court-appointed expert, or arbitrator in a matter involving a client, independence is impaired.

105.23 In some cases, the auditor may perform extended audit services for a client. Extended audit services may include assistance with the client's internal audit function or an extension of audit services beyond the requirements of generally accepted auditing standards. ET 1.295.150 of the AICPA *Code of Professional Conduct* also addresses the impact of those services on the auditor's independence. Performance of internal audit assistance services does not impair the auditor's independence as long as the auditor is not an employee of the client or does not act in the capacity of management (for example, determining the scope, risk, and frequency of internal audit activities). The auditor should be satisfied that the client understands its responsibility for directing the internal audit function. The general requirements of the Interpretation discussed previously (such as documenting the understanding with the client) also must be met. With respect to providing assistance with the internal audit function, the

auditor should be satisfied that the board of directors and/or audit committee (if one exists) is fully informed of the engagement. Generally, performing procedures that are merely an extension of the auditor's scope applied in the audit of the client's financial statements (such as confirming accounts receivable) would not impair the auditor's independence even if the extent of testing exceeds the requirements of generally accepted auditing standards.

105.24 Although performing an individual nonattest service might not impair independence, the cumulative effect of multiple nonattest services can increase the significance of threats to independence. As discussed in ET 1.295.020 of the AICPA *Code of Professional Conduct*, before agreeing to perform the services, the member should evaluate whether the aggregate effect of performing multiple nonattest services results is a significant threat to independence that cannot be reduced to an acceptable level by the application of safeguards. If there are no safeguards that eliminate the threat or reduce it to an acceptable level, the member's independence would be impaired. It is not necessary to consider threats that might be created when other network firms within the member's firm's network provide nonattest services.

105.25 **Should Proposing Journal Entries and Preparing Financial Statements in Connection with an Attest Engagement Be Viewed as Bookkeeping and, Therefore, Nonattest Services?** ET 1.295.120.02 of the Code includes bookkeeping as an example of a nonattest service. Rather than define bookkeeping, the Code provides several examples of services that would be considered bookkeeping. Those examples include proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client. The AICPA's Professional Ethics Executive Committee (PEEC) issued a revision to ET 1.295.010.06 of the Code that considers financial statement preparation and cash-to-accrual conversions performed by the member as nonattest services, even if the services are performed as part of an attest engagement. This revision is effective for periods beginning on or after December 15, 2014.

105.26 **Additional Questions in Applying ET 1.295 of the AICPA *Code of Professional Conduct*** The following additional questions are likely to arise as practitioners apply the requirements of the Code. The responses reflect the authors' views on such matters based on the requirements of ET 1.295.

a. *Providing Routine Advice to Clients.*

Question—If a client calls the auditor and asks a technical question, would this be considered a nonattest service for which ET 1.295 would apply?

Response—No, routine activities performed by the auditor, such as providing advice and responding to clients' technical questions as part of the normal client relationship, are not considered nonattest services for which ET 1.295 would apply. (See discussion at paragraph 105.13.)

b. *Inadvertent Noncompliance.*

Question—What if the practitioner inadvertently fails to comply with the requirement to document in writing the practitioner's understanding with the client?

Response—A failure to document the understanding with the client is not considered to impair a member's independence provided such understanding has been established. Rather, such a failure, regardless of whether it was isolated or inadvertent, would be considered a failure to comply with an ethics standard under ET 1.310 of the AICPA *Code of Professional Conduct*.

c. *Assessing Whether an Individual Possesses Suitable Skill, Knowledge, or Experience.*

Question—How does an auditor assess whether a client's designated employee possesses suitable skill, knowledge, or experience as required by the Interpretation?

Response—It is not intended that the client employee possess a level of technical expertise equal to the auditor's (that is, sufficient to perform or reperform the auditor's services). The client employee need only understand the nonattest services enough to be able to provide general direction for the services; understand the key issues the auditor identifies; make any required management decisions; and evaluate the adequacy of, and accept responsibility for, the results of the auditor's work. The designated individual fulfills the competency requirement by possessing suitable skills, knowledge, and/or experience based on factors such as his or her understanding of the service, knowledge of the client's business and industry, general business knowledge and education, and position at the client. When assessing the employee's competency, the relative importance of those factors is considered in relation to the service being performed. The auditor may educate his or her client in order for them to assume their responsibilities. For example, if the auditor performs routine bookkeeping services for an attest client, he or she could ensure compliance with the requirements of the Interpretation by reviewing the proposed journal entries with the client and explaining in general terms how each entry affects the financial statements. The client should then be in a position to approve the journal entries and accept responsibility for the financial statements.

d. *Nonattest Services Performed before the Client Becomes an Attest Client.*

Question—The practitioner accepts an audit engagement for a client for whom he or she has previously provided only bookkeeping services. Prior to accepting the audit engagement, the practitioner does not have a written understanding with the client under ET 1.295 of the AICPA *Code of Professional Conduct*). Has the practitioner violated the documentation requirement of the Interpretation? Is the practitioner's independence impaired?

Response—The ET 1.295 documentation requirement does not apply to nonattest services performed before the client becomes an attest client. The auditor would be permitted to prepare the required documentation upon acceptance of an audit engagement, provided the auditor is able to demonstrate his or her compliance with the other general requirements during the period covered by the financial statements, including the requirement to *establish* an understanding with the client.

The practitioner's independence would not be impaired when the practitioner performed nonattest services that would have impaired independence during the period covered by the financial statements, provided that the nonattest services were provided prior to accepting the attest engagement, the nonattest services were for a period prior to the financial statement period, and the financial statements for the period to which the nonattest services relate were reviewed or audited by another firm.

As a practical matter, practitioners who are initially engaged to only provide nonattest services but expect to subsequently be engaged to also provide attest services may consider structuring the engagement so that performance of the nonattest services will not impair independence for the attest services.

105.27 **Illustrative Examples** The following paragraphs provide several scenarios relating to accounting services in which auditors' independence might be impaired. Also included with each scenario are the authors' views (considering the guidance in ET 1.295 of the AICPA *Code of Professional Conduct*) about whether or not the services are permitted under ET 1.295 (that is, whether or not the services impair independence).

Example 1-1: Auditor has authority to sign or co-sign checks.

Scenario: Auditors accept the responsibility of signing or co-signing a client's checks in emergency situations.

Is Independence Impaired? Yes, independence would be impaired because such activities are considered management responsibilities. Having the authorization to sign or co-sign checks on a client's bank account, even if such activity is never performed, impairs independence.

Example 1-2: Auditor provides payroll services that include co-signing payroll checks.

Scenario: The auditor provides payroll services for a client that consist of calculating the payroll amounts, preparing journal entries to record those amounts, preparing and co-signing payroll checks, making electronic payroll tax payments, and preparing quarterly and annual payroll tax returns.

Is Independence Impaired? Yes, independence would be impaired because signing checks, or having the authority to sign or co-sign checks, is a management responsibility. Preparation of payroll tax returns also impairs independence unless the requirements outlined in paragraph 105.20 are met.

Example 1-3: Auditor codes check stubs based on information provided by the client.

Scenario: When performing monthly accounting services for a client, the auditor codes the check stubs (that is, determines the general ledger accounts to which the disbursements should be recorded and writes the appropriate account numbers on each check stub) based on the description provided by the client on the check stubs.

Is Independence Impaired? No, independence is not impaired. Normally, coding check stubs will not impair the auditor's independence as long as the client provides sufficient detail to clearly identify the nature of each transaction. Note that, in some cases, the auditor can determine the nature of a transaction based on the payee (for example, the electric company, office supply company, etc.). However, the auditor needs to be careful not to assume the role of management, thereby losing independence with respect to the client.

Example 1-4: Auditor records journal entries in the client's accounting system.

Scenario: An auditor records journal entries in the client's accounting system.

Is Independence Impaired? No, the auditor's independence would not be impaired provided that the client understands the nature and impact of the journal entries. For example, the auditor could provide the client with a printout of proposed journal entries accompanied by clear explanations, ask the client to review the printout, and then ask whether the client has any questions about the entries.

Although not required, some auditors obtain the client's written approval of the proposed journal entries by, for example, signing or initialing the journal entries or on a separate journal entry approval form, such as the one included in this *Guide* at DLR-CX-12.1.

Example 1-5: Auditor installs pre-packaged accounting software.

Scenario: An auditor installs pre-packaged accounting software, such as *QuickBooks*, for his or her client and sets up the chart of accounts and financial statement format defaults.

Is Independence Impaired? No, the auditor's independence is not impaired. In its *Background and Basis for Conclusions*, the Professional Ethics Executive Committee stated that independence is not considered impaired, as this type of service does not constitute *designing* a system, provided the auditor does not create or change the source code(s) underlying the pre-packaged software.

The AICPA website has an Ethics Hotline where members of the AICPA's Professional Ethics Team answer questions about independence and other behavioral issues. The toll-free number for the Ethics Hotline is (888) 777-7077.

105.28 **Staff Members on Loan** An independence problem that often arises concerns participation in the audit by staff members on loan from another firm who have some prior involvement with the client, e.g., providing accounting or other nonattest services. ET 0.400.12 of the AICPA *Code of Professional Conduct* defines the term *covered member*. The definition makes clear that the independence requirements apply to all employees and all contractors participating on the engagement team. (Specialists such as actuaries, appraisers, engineers, and environmental consultants who do not directly participate in the audit, and persons performing only clerical functions, such as typing, are not considered members of the engagement team.) This means that staff on loan from another firm become covered members for purposes of determining independence, and if they have any relationship to the client that impairs their independence, the firm engaged to perform the audit is not independent.

105.29 A related question is whether staff on loan from another firm are not independent of the client simply because a partner of that other firm is not independent of the client. In other words, do the individual staff members of the other firm carry a taint of nonindependence that arises solely from their regular employment by a firm that is not independent? ET 1.220.030 of the Code clarifies that the use of the staff will impair independence, but that the “use of the work of such individuals in a manner similar to internal auditors is permissible provided that there is compliance with the Statements on Auditing Standards.” An auditor may make use of internal auditors to provide direct assistance in performing an audit as long as the auditor (a) supervises, reviews, evaluates, and tests their work appropriately and (b) exercises his own judgment on matters such as sufficiency of tests and materiality of misstatements. To be in conformity with ET 1.220.030, the authors recommend that staff members on loan from a nonindependent firm be treated analogously to internal auditors. As long as there is proper supervision of their work, their participation in the engagement generally will not create an independence problem.

105.30 **Unpaid Fees** An auditor's independence can be impaired by unpaid fees. Specifically, ET 1.230.010.02-.03 of the AICPA *Code of Professional Conduct* states that independence will be considered impaired if fees (billed or unbilled) or a note receivable arising from such fees for professional services rendered more than one year prior to the date of the current year's report remain unpaid when that report is issued. (While ET 1.230.010.02-.03 does not indicate that the unpaid fee needs to be of a certain amount before it impairs independence, the authors believe that amounts that are clearly inconsequential would not impair independence.) An accounts receivable aging may be reviewed periodically to monitor past due accounts. Auditors need to ensure that all prior year's fees are collected before the current year's report is issued. In addition, if prior year fees are unpaid, auditors need to consider the reasons why the fees might remain unpaid. Chances are that if past fees have not been paid, future fees will also not be paid. Consequently, auditors ought to seriously consider not accepting a new client or continuing an existing engagement if prior year fees are unpaid.

105.31 **Client Employee** When an individual in the immediate family of an engagement team member is employed by the client, independence violations can occur. However, ET 1.270.020.02 of the AICPA *Code of Professional Conduct* includes an exception specifically allowing individuals in a covered member's immediate family (spouse or dependent) to be employed by a client in a position *other than* a *key position*. A *key position* includes one involving—

- primary responsibility for significant accounting functions that support material financial statement components,
- primary responsibility for financial statement preparation, or
- the ability to exercise influence over financial statement content (such as by being a client's president; controller; or chief executive, financial, operating, or accounting officer).

105.32 There are also independence concerns when a former partner or professional employee becomes an employee of a client. The primary concerns are that partners or professional employees who leave the CPA firm to work for a client have close relationships with the engagement team, know the engagement approach, and could potentially circumvent procedures. In addition, junior engagement team members might have great respect for the person and might not be able to objectively question him or her. According to ET 1.279.020.02 of the AICPA *Code of*

Professional Conduct, “Employment or Association with Attest Clients,” a firm's independence will be considered to be impaired when a former partner or professional employee becomes a key employee of a client unless *all* of the following conditions are met:

- Amounts due the former partner or professional employee for his or her previous interest in the firm and for unfunded, vested retirement benefits are not material to the firm, and the formula used to calculate the payout benefits is not variable.

- The former partner or professional employee is not in a position to influence the firm's operations or financial policies.

- The former partner or professional employee does not participate or appear to participate in the firm once employment with the client has commenced.

- The engagement team considers the appropriateness of modifying the engagement procedures to compensate for the risk that engagement effectiveness could be reduced by the former partner or professional employee's knowledge of the engagement plan.

- The firm assesses whether the engagement team members have the appropriate experience and status to effectively deal with the former partner or professional employee, if he or she will significantly interact with the engagement team.

- The engagement workpapers are reviewed to ensure the engagement team maintained an appropriate level of skepticism when evaluating the representations and work of the former partner or professional employee.

105.33 **Financial Interests** A practitioner who has a direct or material indirect financial interest in a client is not considered to be independent. Similarly, practitioners who have a material financial interest in nonclients related to clients through common control or joint ventures are not considered to be independent.

105.34 **Other Independence Requirements** Regulatory agencies, certain state CPA societies, and state boards of accountancy may have established independence requirements applicable to CPAs under their jurisdiction that are more restrictive than those of the AICPA. A practitioner should, therefore, be aware of applicable requirements before accepting an engagement.

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[3] See the discussion of the Code beginning in paragraph 600.6.

[4] In addition to the AICPA's *Code of Professional Conduct*, a variety of independence-related resources are available. The AICPA, through its website at **www.aicpa.org**, provides resources, publications, and recent developments on the topic of professional ethics. The AICPA also issues an Independence and Ethics Developments Audit Risk Alert that addresses recent developments in independence and ethics, and provides information that assists with the understanding of independence rules. The AICPA has provided an Independence Toolkit at **www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/Pages/PCPSIndependenceToolkit.aspx** that includes the *AICPA Plain English Guide to Independence*, FAQs, and other resources.

[5] The independence requirements of state boards of accountancy, state CPA societies, the PCAOB, the SEC, the DOL, the GAO, and other regulatory organizations may be different from and more restrictive than those of the AICPA and should be consulted as applicable. AICPA members are required to also follow other regulatory organization independence requirements when performing applicable services.

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106 Scope of *PPC's Guide to Dealerships*

106.1 Accountants who are familiar with *PPC's Guide to Audits of Nonpublic Companies* will see similarities between it and this *Guide*. This *Guide* tailors the guidance in *PPC's Guide to Audits of Nonpublic Companies* to a typical dealership engagement. It also adapts the engagement approach in *PPC's Guide to Compilation and Review Engagements* to be easily applied when providing compilation and review services to dealerships. These two *Guides* can be consulted when unusual situations are encountered.

106.2 While the audit and compilation and review chapters are helpful on dealership engagements, this *Guide* also may be consulted by financial managers and general managers of dealerships when questions arise. It comprehensively discusses dealership accounting considerations, taxation issues, financial reporting, and valuation concerns.

106.3 *PPC's Guide to Dealerships* is divided into 10 chapters. These chapters (a) discuss authoritative accounting literature that applies to dealerships; (b) provide practical guidance on how to apply auditing, review, and compilation standards to engagements to report on dealership financial statements; (c) explain the complex income tax rules that dealerships must follow; and (d) discuss consulting services and related standards relevant to dealerships.

106.4 This *Guide* also includes practice aids specifically tailored to dealership engagements, such as engagement programs (audit, review, and compilation), confirmation letters, and checklists.

106.5 The authors believe that this *Guide* will familiarize users with the accounting and tax rules that apply to dealerships and provide guidance for auditing, reviewing, or compiling dealership financial statements efficiently and effectively. It will also help users in providing management consulting services to their dealership clients.

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