

CREDIT ACCEPTANCE CORP
Form 10-Q
July 30, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2013

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 000-20202
CREDIT ACCEPTANCE CORPORATION
(Exact name of registrant as specified in its charter)

MICHIGAN
(State or other jurisdiction of incorporation or
organization)

38-1999511
(I.R.S. Employer Identification No.)

25505 WEST TWELVE MILE ROAD
SOUTHFIELD, MICHIGAN
(Address of principal executive offices)

48034-8339
(Zip Code)

Registrant's telephone number, including area code: 248-353-2700

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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Large accelerated
filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller
reporting company)

Smaller reporting
company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of Common Stock, par value \$0.01, outstanding on July 19, 2013 was 23,280,737.

TABLE OF CONTENTS

PART I. — FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

<u>Consolidated Balance Sheets – As of June 30, 2013 and December 31, 2012</u>	<u>1</u>
<u>Consolidated Statements of Income – Three and six months ended June 30, 2013 and 2012</u>	<u>2</u>
<u>Consolidated Statements of Comprehensive Income – Three and six months ended June 30, 2013 and 2012</u>	<u>3</u>
<u>Consolidated Statements of Cash Flows – Six months ended June 30, 2013 and 2012</u>	<u>4</u>
<u>Notes to Consolidated Financial Statements</u>	<u>5</u>

<u>ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	<u>28</u>
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<u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	<u>40</u>
---	-----------

<u>ITEM 4. CONTROLS AND PROCEDURES</u>	<u>40</u>
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PART II. — OTHER INFORMATION

<u>ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	<u>41</u>
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<u>ITEM 6. EXHIBITS</u>	<u>41</u>
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<u>SIGNATURE</u>	<u>42</u>
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Table of Contents

PART I. - FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

CREDIT ACCEPTANCE CORPORATION
CONSOLIDATED BALANCE SHEETS

(In millions, except share and per share data)

	As of	
	June 30, 2013 (Unaudited)	December 31, 2012
ASSETS:		
Cash and cash equivalents	\$ 9.0	\$ 9.0
Restricted cash and cash equivalents	116.9	92.4
Restricted securities available for sale	47.5	46.1
Loans receivable (including \$7.3 and \$5.9 from affiliates as of June 30, 2013 and December 31, 2012, respectively)	2,278.5	2,109.9
Allowance for credit losses	(185.8)	(176.4)
Loans receivable, net	2,092.7	1,933.5
Property and equipment, net	22.4	22.2
Income taxes receivable	0.8	1.1
Other assets	26.0	28.9
Total Assets	\$ 2,315.3	\$ 2,133.2
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Liabilities:		
Accounts payable and accrued liabilities	\$ 112.3	\$ 105.8
Revolving secured line of credit	150.8	43.5
Secured financing	902.3	853.0
Mortgage note	3.9	4.0
Senior notes	350.2	350.3
Deferred income taxes, net	141.3	148.4
Income taxes payable	0.6	6.3
Total Liabilities	1,661.4	1,511.3
Commitments and Contingencies - See Note 14		
Shareholders' Equity:		
Preferred stock, \$.01 par value, 1,000,000 shares authorized, none issued	-	-
Common stock, \$.01 par value, 80,000,000 shares authorized, 23,280,737 and 24,114,896 shares issued and outstanding as of June 30, 2013 and December 31, 2012, respectively	0.2	0.2
Paid-in capital	58.7	53.4
Retained earnings	595.2	568.4

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Accumulated other comprehensive loss	(0.2)	(0.1)
Total Shareholders' Equity	653.9	621.9
Total Liabilities and Shareholders' Equity	\$ 2,315.3	\$ 2,133.2

See accompanying notes to consolidated financial statements.

Table of Contents

CREDIT ACCEPTANCE CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

(In millions, except share and per share data)	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
Revenue:				
Finance charges	\$ 147.5	\$ 134.0	\$ 290.4	\$ 260.1
Premiums earned	12.9	12.0	24.9	22.8
Other income	9.0	5.8	18.8	11.3
Total revenue	169.4	151.8	334.1	294.2
Costs and expenses:				
Salaries and wages	23.1	20.4	45.0	39.8
General and administrative	8.3	7.3	16.2	14.7
Sales and marketing	8.5	7.5	17.5	15.3
Provision for credit losses	5.4	2.8	11.2	8.0
Interest	16.2	15.6	32.2	30.8
Provision for claims	10.5	9.0	19.5	17.6
Total costs and expenses	72.0	62.6	141.6	126.2
Income before provision for income taxes	97.4	89.2	192.5	168.0
Provision for income taxes	35.9	32.6	70.4	61.1
Net income	\$ 61.5	\$ 56.6	\$ 122.1	\$ 106.9
Net income per share:				
Basic	\$ 2.57	\$ 2.18	\$ 5.06	\$ 4.11
Diluted	\$ 2.56	\$ 2.18	\$ 5.04	\$ 4.10
Weighted average shares outstanding:				
Basic	23,974,099	25,925,627	24,151,080	25,993,389
Diluted	24,017,273	25,979,872	24,220,403	26,083,112

See accompanying notes to consolidated financial statements.

Table of Contents

CREDIT ACCEPTANCE CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

(In millions)	For the Three Months Ended June 30,	
	2013	2012
Net income	\$ 61.5	\$ 56.6
Other comprehensive income (loss), net of tax:		
Unrealized loss on securities, net of tax of \$0.1 for 2013	(0.2)	—
Other comprehensive income (loss)	(0.2)	—
Comprehensive income	\$ 61.3	\$ 56.6

(In millions)	For the Six Months Ended June 30,	
	2013	2012
Net income	\$ 122.1	\$ 106.9
Other comprehensive income (loss), net of tax:		
Unrealized loss on securities, net of tax of \$0.0 for 2013	(0.1)	—
Other comprehensive income (loss)	(0.1)	—
Comprehensive income	\$ 122.0	\$ 106.9

See accompanying notes to consolidated financial statements.

Table of Contents

CREDIT ACCEPTANCE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(In millions)	For the Six Months Ended June 30,	
	2013	2012
Cash Flows From Operating Activities:		
Net income	\$ 122.1	\$ 106.9
Adjustments to reconcile cash provided by operating activities:		
Provision for credit losses	11.2	8.0
Depreciation	2.7	2.5
Amortization	3.6	3.3
Loss on retirement of property and equipment	0.1	–
(Benefit) provision for deferred income taxes	(7.1)	11.0
Stock-based compensation	4.7	4.5
Change in operating assets and liabilities:		
Increase in accounts payable and accrued liabilities	6.5	9.9
Decrease in income taxes receivable	0.3	–
(Decrease) increase in income taxes payable	(5.7)	4.4
Decrease in other assets	2.3	1.1
Net cash provided by operating activities	140.7	151.6
Cash Flows From Investing Activities:		
Increase in restricted cash and cash equivalents	(24.5)	(23.7)
Purchases of restricted securities available for sale	(49.9)	(0.1)
Proceeds from sale of restricted securities available for sale	7.2	–
Maturities of restricted securities available for sale	41.0	–
Principal collected on Loans receivable	677.9	597.6
Advances to Dealers	(712.7)	(675.4)
Purchases of Consumer Loans	(56.3)	(60.7)
Accelerated payments of Dealer Holdback	(20.4)	(24.2)
Payments of Dealer Holdback	(58.5)	(62.6)
Net increase in other loans	(0.4)	–
Purchases of property and equipment	(3.0)	(6.0)
Net cash used in investing activities	(199.6)	(255.1)
Cash Flows From Financing Activities:		
Borrowings under revolving secured line of credit	1,559.8	1,262.6
Repayments under revolving secured line of credit	(1,452.5)	(1,293.4)
Proceeds from secured financing	646.5	922.6
Repayments of secured financing	(597.2)	(757.5)
Principal payments under mortgage note	(0.1)	(0.1)
Payments of debt issuance costs	(2.9)	(3.7)
Repurchase of common stock	(95.9)	(28.5)
Proceeds from stock options exercised	0.3	0.3
Tax benefits from stock-based compensation plans	0.9	1.6
Net cash provided by financing activities	58.9	103.9

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Net increase in cash and cash equivalents		–		0.4
Cash and cash equivalents, beginning of period		9.0		4.7
Cash and cash equivalents, end of period	\$	9.0	\$	5.1

Supplemental Disclosure of Cash Flow Information:

Cash paid during the period for interest	\$	28.9	\$	27.6
Cash paid during the period for income taxes	\$	81.2	\$	44.1

Supplemental Disclosure of Non-Cash Transactions:

Repurchase of common stock during the period and settled after June 30,	\$	–	\$	84.5
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See accompanying notes to consolidated financial statements.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“generally accepted accounting principles” or “GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for interim periods are not necessarily indicative of actual results achieved for full fiscal years. The consolidated balance sheet as of December 31, 2012 has been derived from the audited financial statements at that date but does not include all the information and footnotes required by GAAP for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K for the year ended December 31, 2012 for Credit Acceptance Corporation (the “Company”, “Credit Acceptance”, “we”, “our” or “us”).

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

We have evaluated events and transactions occurring subsequent to the consolidated balance sheet date of June 30, 2013 for items that could potentially be recognized or disclosed in these financial statements. We did not identify any items which would require disclosure in or adjustment to the financial statements.

2. DESCRIPTION OF BUSINESS

Since 1972, Credit Acceptance has offered automobile dealers financing programs that enable them to sell vehicles to consumers, regardless of their credit history. Our financing programs are offered through a nationwide network of automobile dealers who benefit from sales of vehicles to consumers who otherwise could not obtain financing; from repeat and referral sales generated by these same customers; and from sales to customers responding to advertisements for our product, but who actually end up qualifying for traditional financing.

We refer to automobile dealers who participate in our programs and who share our commitment to changing consumers’ lives as “Dealers”. Upon enrollment in our financing programs, the Dealer enters into a Dealer servicing agreement with us that defines the legal relationship between Credit Acceptance and the Dealer. The Dealer servicing agreement assigns the responsibilities for administering, servicing, and collecting the amounts due on retail installment contracts (referred to as “Consumer Loans”) from the Dealers to us. We are an indirect lender from a legal perspective, meaning the Consumer Loan is originated by the Dealer and assigned to us.

We have two programs: the Portfolio Program and the Purchase Program. Under the Portfolio Program, we advance money to Dealers (referred to as a “Dealer Loan”) in exchange for the right to service the underlying Consumer Loans. Under the Purchase Program, we buy the Consumer Loans from the Dealers (referred to as a “Purchased Loan”) and keep all amounts collected from the consumer. Dealer Loans and Purchased Loans are collectively referred to as “Loans”. The following table shows the percentage of Consumer Loans assigned to us based on unit volumes under each of the programs for each of the last six quarters:

Quarter Ended

	Portfolio Program	Purchase Program
March 31, 2012	93.3	% 6.7 %
June 30, 2012	93.6	% 6.4 %
September 30, 2012	93.8	% 6.2 %
December 31, 2012	94.0	% 6.0 %
March 31, 2013	94.4	% 5.6 %
June 30, 2013	93.9	% 6.1 %

Portfolio Program

As payment for the vehicle, the Dealer generally receives the following:

- a down payment from the consumer;
- a non-recourse cash payment (“advance”) from us; and
- after the advance has been recovered by us, the cash from payments made on the Consumer Loan, net of certain collection costs and our servicing fee (“Dealer Holdback”).

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)
(UNAUDITED)

2. DESCRIPTION OF BUSINESS – (Concluded)

We record the amount advanced to the Dealer as a Dealer Loan, which is classified within Loans receivable in our consolidated balance sheets. Cash advanced to the Dealer is automatically assigned to the Dealer's open pool of advances. We generally require Dealers to group advances into pools of at least 100 Consumer Loans. At the Dealer's option, a pool containing at least 100 Consumer Loans can be closed and subsequent advances assigned to a new pool. All advances within a Dealer's pool are secured by the future collections on the related Consumer Loans assigned to the pool. For Dealers with more than one pool, the pools are cross-collateralized so the performance of other pools is considered in determining eligibility for Dealer Holdback. We perfect our security interest in the Dealer Loans by taking possession of the Consumer Loans, which list us as lien holder on the vehicle title.

The Dealer servicing agreement provides that collections received by us during a calendar month on Consumer Loans assigned by a Dealer are applied on a pool-by-pool basis as follows:

- First, to reimburse us for certain collection costs;
- Second, to pay us our servicing fee, which generally equals 20% of collections;
- Third, to reduce the aggregate advance balance and to pay any other amounts due from the Dealer to us; and
- Fourth, to the Dealer as payment of Dealer Holdback.

If the collections on Consumer Loans from a Dealer's pool are not sufficient to repay the advance balance and any other amounts due to us, the Dealer will not receive Dealer Holdback.

Dealers have an opportunity to receive an accelerated Dealer Holdback payment each time 100 Consumer Loans have been assigned to us. The amount paid to the Dealer is calculated using a formula that considers the forecasted collections and the advance balance on the related Consumer Loans.

Since typically the combination of the advance and the consumer's down payment provides the Dealer with a cash profit at the time of sale, the Dealer's risk in the Consumer Loan is limited. We cannot demand repayment of the advance from the Dealer except in the event the Dealer is in default of the Dealer servicing agreement. Advances are made only after the consumer and Dealer have signed a Consumer Loan contract, we have received the original Consumer Loan contract and supporting documentation, and we have approved all of the related stipulations for funding. The Dealer can also opt to repurchase Consumer Loans that have been assigned to us under the Portfolio Program, at their discretion, for a fee.

For accounting purposes, the transactions described under the Portfolio Program are not considered to be loans to consumers. Instead, our accounting reflects that of a lender to the Dealer. The classification as a Dealer Loan for accounting purposes is primarily a result of (1) the Dealer's financial interest in the Consumer Loan and (2) certain elements of our legal relationship with the Dealer.

Purchase Program

The Purchase Program differs from our Portfolio Program in that the Dealer receives a one-time payment from us at the time of assignment to purchase the Consumer Loan instead of a cash advance at the time of assignment and future Dealer Holdback payments. For accounting purposes, the transactions described under the Purchase Program are considered to be originated by the Dealer and then purchased by us.

Program Enrollment

Dealers may enroll in our program by (1) paying an up-front, one-time fee of \$9,850, or (2) agreeing to allow us to retain 50% of their first accelerated Dealer Holdback payment. Dealers are granted access to the Portfolio Program upon enrollment. Access to the Purchase Program is limited and is typically only granted to Dealers that either have received their first accelerated Dealer Holdback payment under the Portfolio Program or are franchise dealerships.

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business Segment Information

We currently operate in one reportable segment which represents our core business of offering Dealers financing programs and related products and services that enable them to sell vehicles to consumers, regardless of their credit history. The consolidated financial statements reflect the financial results of our one reportable operating segment.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)
(UNAUDITED)

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (Continued)

Loans Receivable and Allowance for Credit Losses

Consumer Loan Assignment. For accounting and financial reporting purposes, a Consumer Loan is considered to have been assigned to us after all of the following has occurred:

- the consumer and Dealer have signed a Consumer Loan contract;
- we have received the original Consumer Loan contract and supporting documentation;
 - we have approved all of the related stipulations for funding; and
- we have provided funding to the Dealer in the form of either an advance under the Portfolio Program or one-time purchase payment under the Purchase Program.

Portfolio Segments and Classes. We are considered to be a lender to our Dealers for Consumer Loans assigned under our Portfolio Program and a purchaser of Consumer Loans assigned under our Purchase Program. As a result, our Loan portfolio consists of two portfolio segments: Dealer Loans and Purchased Loans. Each portfolio segment is comprised of one class of Consumer Loan assignments, which is Consumer Loans with deteriorated credit quality that were originated by Dealers to finance consumer purchases of vehicles and related ancillary products.

Dealer Loans. Amounts advanced to Dealers for Consumer Loans assigned under the Portfolio Program are recorded as Dealer Loans and are aggregated by Dealer for purposes of recognizing revenue and evaluating impairment. We account for Dealer Loans in a manner consistent with loans acquired with deteriorated credit quality. The outstanding balance of each Dealer Loan included in Loans receivable is comprised of the following:

- the aggregate amount of all cash advances paid;
 - finance charges;
 - Dealer Holdback payments;
- accelerated Dealer Holdback payments; and
 - recoveries.

Less:

- collections (net of certain collection costs); and
 - write-offs.

An allowance for credit losses is maintained at an amount that reduces the net asset value (Dealer Loan balance less the allowance) to the value of forecasted future cash flows discounted at the yield established at the time of assignment. This allowance calculation is completed for each individual Dealer. The discounted value of future cash flows is comprised of estimated future collections on the Consumer Loans, less any estimated Dealer Holdback payments. We write off Dealer Loans once there are no forecasted future cash flows on any of the associated Consumer Loans, which generally occurs 120 months after the last Consumer Loan assignment.

Future collections on Dealer Loans are forecasted based on the historical performance of Consumer Loans with similar characteristics, adjusted for recent trends in payment patterns. Dealer Holdback is forecasted based on the expected future collections and current advance balance of each Dealer Loan. Cash flows from any individual Dealer Loan are often different than estimated cash flows at the time of assignment. If such difference is favorable, the

difference is recognized prospectively into income over the remaining life of the Dealer Loan through a yield adjustment. If such difference is unfavorable, a provision for credit losses is recorded immediately as a current period expense and a corresponding allowance for credit losses is established. Because differences between estimated cash flows at the time of assignment and actual cash flows occur often, an allowance is required for a significant portion of our Dealer Loan portfolio. An allowance for credit losses does not necessarily indicate that a Dealer Loan is unprofitable, and seldom are cash flows from a Dealer Loan insufficient to repay the initial amounts advanced to the Dealer.

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)
(UNAUDITED)

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (Continued)

Purchased Loans. Amounts paid to Dealers for Consumer Loans assigned under the Purchase Program are recorded as Purchased Loans and are aggregated into pools based on the month of purchase for purposes of recognizing revenue and evaluating impairment. We account for Purchased Loans as loans acquired with deteriorated credit quality. The outstanding balance of each Purchased Loan pool included in Loans receivable is comprised of the following:

- the aggregate amount of all amounts paid during the month of purchase to purchase Consumer Loans from Dealers;
 - finance charges; and
 - recoveries.

Less:

- collections (net of certain collection costs); and
- write-offs.

An allowance for credit losses is maintained at an amount that reduces the net asset value (Purchased Loan pool balance less the allowance) to the value of forecasted future cash flows discounted at the yield established at the time of assignment. This allowance calculation is completed for each individual monthly pool of Purchased Loans. The discounted value of future cash flows is comprised of estimated future collections on the pool of Purchased Loans. We write off pools of Purchased Loans once there are no forecasted future cash flows on any of the Purchased Loans included in the pool, which generally occurs 120 months after the month of purchase.

Future collections on Purchased Loans are forecasted based on the historical performance of Consumer Loans with similar characteristics, adjusted for recent trends in payment patterns. Cash flows from any individual pool of Purchased Loans are often different than estimated cash flows at the time of assignment. If such difference is favorable, the difference is recognized prospectively into income over the remaining life of the pool of Purchased Loans through a yield adjustment. If such difference is unfavorable, a provision for credit losses is recorded immediately as a current period expense and a corresponding allowance for credit losses is established.

Credit Quality. Substantially all of the Consumer Loans assigned to us are made to individuals with impaired or limited credit histories or higher debt-to-income ratios than are permitted by traditional lenders. Consumer Loans made to these individuals generally entail a higher risk of delinquency, default and repossession and higher losses than loans made to consumers with better credit. Since most of our revenue and cash flows are generated from these Consumer Loans, our ability to accurately forecast Consumer Loan performance is critical to our business and financial results. At the time the Consumer Loan is submitted to us for assignment, we forecast future expected cash flows from the Consumer Loan. Based on these forecasts, an advance or one-time purchase payment is made to the related Dealer at a price designed to achieve an acceptable return on capital.

We monitor and evaluate the credit quality of Consumer Loans on a monthly basis by comparing our current forecasted collection rates to our initial expectations. We use a statistical model that considers a number of credit quality indicators to estimate the expected collection rate for each Consumer Loan at the time of assignment. The credit quality indicators considered in our model include attributes contained in the consumer's credit bureau report, data contained in the consumer's credit application, the structure of the proposed transaction, vehicle information and other factors. We continue to evaluate the expected collection rate of each Consumer Loan subsequent to assignment primarily through the monitoring of consumer payment behavior. Our evaluation becomes more accurate as the

Consumer Loans age, as we use actual performance data in our forecast. Since all known, significant credit quality indicators have already been factored into our forecasts and pricing, we are not able to use any specific credit quality indicators to predict or explain variances in actual performance from our initial expectations. Any variances in performance from our initial expectations are the result of Consumer Loans performing differently than historical Consumer Loans with similar characteristics. We periodically adjust our statistical pricing model for new trends that we identify through our evaluation of these forecasted collection rate variances.

When overall forecasted collection rates underperform our initial expectations, the decline in forecasted collections has a more adverse impact on the profitability of the Purchased Loans than on the profitability of the Dealer Loans. For Purchased Loans, the decline in forecasted collections is absorbed entirely by us. For Dealer Loans, the decline in the forecasted collections is substantially offset by a decline in forecasted payments of Dealer Holdback.

Methodology Changes. During the second quarter of 2013, we enhanced our methodology for forecasting future collections on Loans, which is described more fully in Note 5 to the consolidated financial statements. For the three and six months ended June 30, 2013 and 2012, we did not make any other methodology changes for Loans that had a material impact on our financial results.

Table of ContentsNOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)
(UNAUDITED)

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (Continued)

Reinsurance

VSC Re Company (“VSC Re”), our wholly-owned subsidiary, is engaged in the business of reinsuring coverage under vehicle service contracts sold to consumers by Dealers on vehicles financed by us. VSC Re currently reinsures vehicle service contracts that are underwritten by one of our third party insurers. Vehicle service contract premiums, which represent the selling price of the vehicle service contract to the consumer, less fees and certain administrative costs, are contributed to trust accounts controlled by VSC Re. These premiums are used to fund claims covered under the vehicle service contracts. VSC Re is a bankruptcy remote entity. As such, our exposure to fund claims is limited to the trust assets controlled by VSC Re and our net investment in VSC Re.

Premiums from the reinsurance of vehicle service contracts are recognized over the life of the policy in proportion to expected costs of servicing those contracts. Expected costs are determined based on our historical claims experience. Claims are expensed through a provision for claims in the period the claim was incurred. Capitalized acquisition costs are comprised of premium taxes and are amortized as general and administrative expense over the life of the contracts in proportion to premiums earned. A summary of reinsurance activity is as follows:

(In millions)	For the Three Months Ended		For the Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Net assumed written premiums	\$ 14.1	\$ 12.0	\$ 30.4	\$ 28.3
Net premiums earned	12.9	12.0	24.9	22.8
Provision for claims	10.5	9.0	19.5	17.6
Amortization of capitalized acquisition costs	0.3	0.3	0.6	0.6

We are considered the primary beneficiary of the trusts and as a result, the trusts have been consolidated on our balance sheet. The trust assets and related reinsurance liabilities are as follows:

(In millions)	Balance Sheet location	As of	
		June 30, 2013	December 31, 2012
Trust assets	Restricted cash and cash equivalents	\$ 5.1	\$ 2.2
Trust assets	Restricted securities available for sale	47.5	46.1
Unearned premium	Accounts payable and accrued liabilities	41.2	35.7
Claims reserve (1)	Accounts payable and accrued liabilities	1.7	1.4

(1) The claims reserve is estimated based on historical claims experience.

Our determination to consolidate the VSC Re trusts was based on the following:

- First, we determined that the trusts qualified as variable interest entities. The trusts have insufficient equity at risk as no parties to the trusts were required to contribute assets that provide them with any ownership interest.
- Next, we determined that we have variable interests in the trusts. We have a residual interest in the assets of the trusts, which is variable in nature, given that it increases or decreases based upon the actual loss experience of the related service contracts. In addition, VSC Re is required to absorb any losses in excess of the trusts' assets.
- Next, we evaluated the purpose and design of the trusts. The primary purpose of the trusts is to provide third party product providers ("TPPPs") with funds to pay claims on vehicle service contracts and to accumulate and provide us with proceeds from investment income and residual funds.
- Finally, we determined that we are the primary beneficiary of the trusts. We control the amount of premium written and placed in the trusts through Consumer Loan assignments under our Programs, which is the activity that most significantly impacts the economic performance of the trusts. We have the right to receive benefits from the trusts that could potentially be significant. In addition, VSC Re has the obligation to absorb losses of the trusts that could potentially be significant.

Cash and Cash Equivalents

Cash equivalents consist of readily marketable securities with original maturities at the date of acquisition of three months or less. As of June 30, 2013 and December 31, 2012, we had \$8.5 million and \$4.8 million, respectively, in cash and cash equivalents that were not insured by the Federal Deposit Insurance Corporation ("FDIC"). As of January 1, 2013, the temporary unlimited coverage for noninterest-bearing transaction accounts expired, which increased the amount of cash and cash equivalents not insured by the FDIC.

Table of ContentsNOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)
(UNAUDITED)

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (Concluded)

Restricted Cash and Cash Equivalents

Restricted cash and cash equivalents increased to \$116.9 million as of June 30, 2013 from \$92.4 million as of December 31, 2012. The following table summarizes restricted cash and cash equivalents:

(In millions)	As of	
	June 30, 2013	December 31, 2012
Cash related to secured financings	\$ 111.8	\$ 90.2
Cash held in VSC Re trusts for future vehicle service contract claims (1)	5.1	2.2
Total restricted cash and cash equivalents	\$ 116.9	\$ 92.4

(1) The unearned premium and claims reserve associated with the trusts are included in accounts payable and accrued liabilities in the consolidated balance sheets.

As of June 30, 2013 and December 31, 2012, we had \$114.9 million and \$82.0 million, respectively, in restricted cash and cash equivalents that was not insured by the FDIC. As of January 1, 2013, the temporary unlimited coverage for noninterest-bearing transaction accounts expired, which increased the amount of restricted cash and cash equivalents not insured by the FDIC.

New Accounting Updates

Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. In February 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2013-2 which requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. The new guidance requires an entity to disaggregate the total change of each component of other comprehensive income either on the face of the income statement or as a separate disclosure in the notes to the financial statements. The amendments in ASU 2013-02 do not change the current requirements for reporting net income or other comprehensive income in financial statements. ASU 2013-02 is effective for fiscal years beginning after December 15, 2012. The adoption of ASU No. 2013-2 on January 1, 2013 did not have a material impact on our consolidated financial statements.

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts. In October 2010, the FASB issued ASU No. 2010-26, which amends Topic 944 (Financial Services – Insurance). ASU No. 2010-26 is intended to address diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral. The amendments specify which costs incurred in the acquisition of new and renewal contracts should be capitalized. ASU No. 2010-26 is effective for fiscal years beginning after December 15, 2011. While the guidance in this ASU is required to be applied prospectively upon adoption, retrospective application is also permitted (to all prior periods presented). Early adoption is also permitted, but only at the beginning of an entity’s annual reporting period. The adoption of ASU No. 2010-26 on January 1, 2012 did not have a material impact on our consolidated financial statements.

Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. In May 2011, the FASB issued ASU No. 2011-04 which amends Topic 820 (Fair Value Measurement). ASU No. 2011-04 is intended to provide a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between U.S. GAAP and IFRS. The amendments in ASU No. 2011-04 include changes regarding how and when the valuation premise of highest and best use applies, the application of premiums and discounts, and new required disclosures. ASU No. 2011-04 is to be applied prospectively upon adoption and is effective for interim and annual periods beginning after December 15, 2011 with early adoption prohibited. The adoption of ASU No. 2011-04 on January 1, 2012 did not have a material impact on our consolidated financial statements, but expanded our disclosures related to fair value measurements.

4. RESTRICTED SECURITIES AVAILABLE FOR SALE

Restricted securities available for sale consist of amounts held in trusts related to VSC Re. We determine the appropriate classification of our investments in debt securities at the time of purchase and reevaluate such determinations at each balance sheet date. Debt securities for which we do not have the intent or ability to hold to maturity are classified as available for sale, and stated at fair value with unrealized gains and losses, net of income taxes included in the determination of comprehensive income and reported as a component of shareholders' equity.

Table of ContentsNOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (CONTINUED)
(UNAUDITED)

4. RESTRICTED SECURITIES AVAILABLE FOR SALE – (Continued)

Restricted securities available for sale consist of the following:

	Cost	As of June 30, 2013		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
US Government and agency securities	\$ 25.3	\$ –	\$ (0.2)	\$ 25.1
Commercial paper	15.4	–	–	15.4
Corporate bonds	3.3	–	(0.1)	3.2
Certificates of deposit	3.8	–	–	3.8
Total restricted securities available for sale	\$ 47.8	\$ –	\$ (0.3)	\$ 47.5

	Cost	As of December 31, 2012		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
US Government and agency securities	\$ 20.6	\$ –	\$ (0.1)	\$ 20.5
Commercial paper	18.9	–	(0.1)	18.8
Corporate bonds	3.3	–	–	3.3
Certificates of deposit	3.3	–	–	3.3
Foreign Government bonds	0.2	–	–	0.2
Total restricted securities available for sale	\$ 46.3	\$ –	\$ (0.2)	\$ 46.1

The fair value and gross unrealized losses for restricted securities available for sale, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

	(In millions)	Securities Available for Sale with Gross Unrealized Losses as of June 30, 2013					
		Less than 12 Months			12 Months or More		
		Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Total Estimated Fair Value	Total Gross Unrealized Losses
US Government and agency securities	\$	12.9	\$ (0.2)	\$ –	\$ –	\$ 12.9	\$ (0.2)
Commercial paper		4.6	–	–	–	4.6	–
Corporate bonds		3.1	100%				
Graco do Brasil Limitada	Brazil	100%*					
Graco Fluid Equipment (Shanghai) Co. Ltd.	China (PRC)	100%					

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Graco Fluid Equipment (Suzhou) Co. Ltd.	China (PRC)	100%*****
Graco GmbH	Germany	100%
	Hong Kong	
Graco Hong Kong Ltd.	Kong	100%
Graco K.K.	Japan	100%
Graco Korea Inc.	Korea	100%
Graco Ltd.	England	100%
	United States	
Graco Minnesota Inc.	States	100%
Graco N.V.	Belgium	100%*
Graco S.A.S.	France	100%
	United States	
Gusmer Corporation	States	100%
Gusmer Canada Ltd.	Canada	100%****
Gusmer Europe, S.L.	Spain	100%****
Gusmer Sudamerica S.A.	Argentina	100%****
	United States	
Liquid Control Corporation ¹	States	100%
Liquid Control Ltd.	England	100%**
	United States	
Lubriquip, Inc.	States	100%

* Includes shares held by selected directors and/or executive officers of the Company or the relevant subsidiary to satisfy the requirements of local law.

** Shares 100% held by Liquid Control Corporation.

*** Shares 100% held by Graco Hong Kong Limited.

**** Shares 100% held by Gusmer Corporation.

***** Shares 100% owned by Graco Minnesota Inc.

¹ Effective January 1, 2007, the name was changed to Graco Ohio Inc.

Exhibit 23

Consent Of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in Registration Statements No. 333-17691, No. 333-17787, No. 333-03459, No. 333-75307, No. 333-63128, No. 333-123813 and No. 333-134162 on Form S-8 of our reports dated February 19, 2007, relating to the financial statements and financial statement schedule of Graco Inc. (which report expresses an unqualified opinion and includes an explanatory paragraph relating to the Company's change in the method of accounting for share-based compensation in 2006 described in Note A) and management's report on the effectiveness of internal control over financial reporting, appearing in this Annual Report on Form 10-K of Graco Inc. for the year ended December 29, 2006.

DELOITTE & TOUCHE LLP

Minneapolis, Minnesota
February 19, 2007

Exhibit 24

Power of Attorney

Know all by these presents, that each person whose signature appears below hereby constitutes and appoints David A. Roberts or James A. Graner, that person's true and lawful attorney-in-fact and agent, with full power of substitution and re-substitution for that person and in that person's name, place and stead, in any and all capacities, to sign the Report on Form 10-K for the year ended December 29, 2006, of Graco Inc. (and any and all amendments thereto) and to file the same with the Securities and Exchange Commission, granting unto said attorney-in-fact and agent, full power and authority to do and perform each and every act and thing requisite or necessary to be done in and about the premises, as fully to all intents and purposes as that person might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, or his substitutes, may lawfully do or cause to be done by virtue hereof.

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In witness whereof, the following persons have signed this Power of Attorney on the date indicated.

	<u>Date</u>
<u>/s/R. G. Bohn</u> W. J. Carroll	<u>February 16, 2007</u>
<u>/s/W. J. Carroll</u> W. J. Carroll	<u>February 16, 2007</u>
<u>/s/J. W. Eugster</u> J. W. Eugster	<u>February 16, 2007</u>
<u>/s/J. K. Gilligan</u> J. K. Gilligan	<u>February 16, 2007</u>
<u>/s/L. R. Mitau</u> L. R. Mitau	<u>February 16, 2007</u>
<u>/s/M. A. Morfitt</u> M. A. Morfitt	<u>February 16, 2007</u>
<u>/s/M. H. Rauenhorst</u> M. H. Rauenhorst	<u>February 16, 2007</u>
<u>/s/D. A. Roberts</u> D. A. Roberts	<u>February 16, 2007</u>
<u>/s/W. G. Van Dyke</u> W. G. Van Dyke	<u>February 16, 2007</u>
<u>/s/R. W. Van Sant</u> R. W. Van Sant	<u>February 16, 2007</u>

Exhibit 31.1

Certification

I, David A. Roberts, certify that:

1. I have reviewed this annual report on Form 10-K of Graco Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of

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financial statements for external purposes in accordance with generally accepted accounting principles;

- c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:
- a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 19, 2007

/s/David A. Roberts

David A. Roberts

Chairman, President and Chief Executive Officer

Exhibit 31.2

Certification

I, James A. Graner, certify that:

1. I have reviewed this annual report on Form 10-K of Graco Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5.

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The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:

- a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 19, 2007

/s/James A. Graner

James A. Graner

Chief Financial Officer and Treasurer

Exhibit 32

Certification Under Section 1350

Pursuant to Section 1350 of Title 18 of the United States Code, each of the undersigned certifies that this periodic report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in this periodic report fairly presents, in all material respects, the financial condition and results of operations of Graco Inc.

Date: February 19, 2007

/s/David A. Roberts

David A. Roberts

Chairman, President and Chief Executive Officer

Date: February 19, 2007

/s/James A. Graner

James A. Graner

Chief Financial Officer and Treasurer

Exhibit 99

Cautionary Statement Regarding Forward-Looking Statements

Graco Inc. (our Company) wishes to take advantage of the safe harbor provisions regarding forward-looking statements of the Private Securities Litigation Reform Act of 1995 and is filing this Cautionary Statement in order to do so.

From time to time various forms filed by our Company with the Securities and Exchange Commission, including our Company's Form 10-K, Form 10-Q and Form 8-K, its Annual Report to Shareholders, and press releases, other written documents or oral statements released by our Company, may contain forward-looking statements. Forward-looking statements generally use words such as expect, foresee, anticipate, believe, project, should, estimate, will, and similar expressions, and reflect our Company's expectations concerning the future. Such statements are based upon currently available information, but various risks and uncertainties may cause our Company's actual results to differ materially from those expressed in these statements. Among the factors which management believes could affect our Company's operating results are the following:

With respect to our Company's business as a whole, our Company's prospects and operating results may be affected by:

changes in world economies, including expansions, downturns or recessions and fluctuations in gross domestic product, capital goods investment activity, interest rates, and foreign currency exchange rates;

the ability of our Company to successfully integrate acquisitions, in particular the recent acquisitions of Liquid Control Corporation, Gusmer Corporation and Lubriquip, Inc.;

the ability of our Company to successfully divest or discontinue incompatible or unprofitable lines of business;

the ability of our Company to successfully maintain quality, customer service and inventory levels in light of the longer lead times created by the establishment of assembly operations in Suzhou, People's Republic of China and the expanding use of foreign sources for materials and components, especially in Asia;

the ability of our Company to successfully recruit and employ employees with required skills, training and education, such as machinists and engineers;

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international trade factors, including changes in international trade policy, such as export controls, trade sanctions, increased tariff barriers and other restrictions; weaker protection of our Company's proprietary technology in certain foreign countries; the burden of complying with foreign laws and standards; and potentially burdensome taxes;

the ability of our Company to develop new products and technologies; maintain and enhance its market position relative to its competitors; maintain and enhance its distribution channels; identify and enter into new markets; realize productivity and product quality improvements; react expeditiously to fluctuations in demand; offset cost pressures from labor, materials and overhead with price increases; and control expenses;

disruption in operations, transportation, communication, customer operations, distribution, payment or sources of supply, including the cost and availability of skilled labor, materials and energy, caused by political or economic instability, acts of God, labor disputes, war, embargo, weather, flood, fire, infectious disease, or other cause beyond its reasonable control, including military conflict in the Middle East or on the Korean peninsula, and terrorist activity throughout the world;

cost pressure and lack of availability of key materials and materials used in the manufacture of products;

worldwide competition from low-cost manufacturers, including those that copy our Company's products;

security breaches, breakdown, interruption in or inadequate upgrading or maintenance of our Company's information processing software, hardware or networks;

successful implementation of an enterprise resource planning ("ERP") software system throughout our Company;

changes in the markets in which our Company participates, including consolidation of competitors and major customers, price competition, and products demanded;

changes in accounting standards or in the application by our Company of critical accounting policies;

compliance with corporate governance requirements;

growth in either the severity or magnitude of the products liability claims against our Company, particularly with respect to asbestos or silica claims; and

changes in the return on investments in the Company's retirement plan.

The prospects and operating results of our Company's Contractor Equipment segment may be affected by: variations in the level of residential, commercial and institutional building and remodeling activity; the loss of, or significant reduction in sales to large customers; the pricing power of large customers; the availability and cost of construction financing; changes in the environmental regulation of coatings; consolidation in the paint equipment manufacturing industry and paint manufacturing industry; changes in the technology of paint and coating applications; changes in the buying and channel preferences of the end user; the Company's success in converting painters outside North America from brush and roller to spray equipment; changes in the business practices (including inventory management) of the major distributors of contractor equipment; changes in construction materials and techniques; changes in the cost of labor in foreign markets; the regional market strength of certain competitors; the level of government spending on infrastructure development and road construction, maintenance and repair; and the nature and extent of highway safety regulation.

The prospects and operating results of our Company's Industrial Equipment segment may be affected by: the capital equipment spending levels of customers; the availability and cost of financing; changes in the environmental regulation of coatings; changes in the technical and performance characteristics of materials, including powder coatings; changes in application technology; the ability of our Company to meet changing customer requirements; consolidation or other change in the channels of distribution; the pricing strategies of competitors; consolidation in the fluid handling equipment manufacturing industry; changes in the worldwide procurement practices of the major automobile manufacturers; changes in automotive manufacturing processes; and consolidation in the automobile manufacturing industry worldwide.

The prospects and operating results of our Company's Lubrication Equipment segment may be affected by: consolidation in the oil production industry; the development of extended life lubricants for vehicles; the reduction in the need for changing vehicle lubricants; consumer trends in do-it-yourself versus do-it-for-me oil changes; the successful development of vehicles that use power sources other than the internal combustion engine; consolidation of automotive dealerships; trends in spending by state and

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local governments; variations in the equipment spending levels of the major oil companies; and the ability to profitably grow our newly acquired industrial lubrication business (Lubriquip).