HEADLIGHTS

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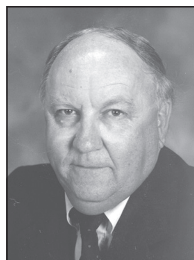
PARTS AND SERVICE DEPARTMENTS PROFITABILITY

It is not an easy or quick process for many dealers to determine the "profitability" of their parts and service departments. Judgment is required, and some dealers attempt to allocate fixed and semifixed expenses to determine profitability. This allocation can be arbitrary as well as misleading. I have found that taking only certain "direct" expenses can be a quick and reasonable computation method to better measure departmental profitability. This also helps determine whether the direct parts and service expenses are reasonable. Direct expenses mean "controllable" expenses. Below I have provided what I use in making this computation. Listed are the types of "direct" expenses to use and the percentage of gross profit from that department that would be expected for each direct expense.



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Parts Department

Parts employee compensation—25% (works in parts department, not office clerical); parts advertising—2%; parts training expense—1%; parts policy work—2%; parts service loaners expense—2%; parts tools and supplies—2%; parts freight—2%; parts equipment and vehicle supplies—2%; and parts inventory control—2%. The total of these "direct" parts expenses equals 40% of the parts department's gross profit. This means that 60% of the total parts gross profit remains after direct parts expenses. The median dealer, the middle dealer in my sample of more than 50 dealers, had a 63% retention of gross profit, which means 37% of parts gross profit was consumed by "direct" parts expenses.

Service Department

Service employee compensation—33% (works in service department, not office clerical); service advertising—5%; service training—2%; service

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SUMMER 2017

MONITORING FINANCIAL COVENANTS WITH FLOOR PLAN LENDERS

INCOME AND ESTATE TAX THOUGHTS

policy work—2%; service loaners—3%; service tools and supplies—4%; service equipment and vehicle supplies—2%; and service vacation time-off pay—4%. The total of these "direct" service expenses equals 55%. This means that 45% of the total service gross profit remains after direct service expenses. The median dealer, the middle dealer in my sample of more than 50 dealers, had a 45% retention of gross profit, which means 55% of service gross profit was consumed by "direct" service expenses.

If you take 10 minutes, you can find out whether you meet these two metrics. Oftentimes, we find that the compensation for parts exceeds 25% by a large amount or compensation for service exceeds 33% by a large amount. When this is the case, you either have too many service administrative employees, are paying them too much or both. Recently, for a poorly performing dealer that had a 35% retention of parts gross profit, we found an adequate number of parts employees, but the manager and almost all the parts employees were overpaid.

In summary, you can have your staff compute the above for an ideal parts gross retention of 60% and a service gross retention of 45%. ✍

MONITORING FINANCIAL COVENANTS WITH FLOOR PLAN LENDERS

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Dealerships maintain various fiduciary-type relationships with outside third parties. One of the most important of these relationships is with their floor plan lender.

As a condition of receiving advances from a floor plan lender, financial covenants within the vehicle flooring and security agreement require that a dealership maintain a minimum inventory trust percentage, a formalized benchmark based on a dealer's net cash position. If this is not complied with, a borrower can be considered "out of trust." A common net cash calculation lenders use is computed by adding together cash, contracts in transit, vehicle receivables and new vehicle inventory, while subtracting the new vehicle floor plan payable and customer deposits. Often, financed used vehicle inventory and the corresponding floor plan payable are included in the calculation. The net cash position is then divided by total floor plan payable to calculate a dealer's inventory trust percentage, which is then compared with the lender's benchmark.

One can't overemphasize the importance of maintaining an in trust position with the lender. When the lender detects an out of trust position, this can lead to various forms of pressure on the dealership, including:

✔an escalation in the frequency of floor plan audits. In addition to requiring the dealership to apply available cash to pay off vehicles due on audit, floor plan audits lead to unnecessary time spent by dealership personnel who are diverted from ongoing dealership operations.

✔pushing the dealer to make some choices from a less-than-optimal bargaining position, such as having to quickly secure financing to inject money into the business and/or search for a new source of floor plan financing.

The ramifications of being out of trust can be severe. In a worst-case scenario, the dealer may be forced out of business.

Dealers often use the phrase "out of trust" to indicate that a given dealer is late in paying off sold

vehicles within the time period prescribed in the floor plan agreement. While late payments may be a symptom of being out of trust, the inaction of not paying off vehicles when due does not create an out of trust position. A dealer may have funds available to pay off vehicles, but for various reasons, such as inattention, poor accounting procedures or deliberate fraud by responsible persons within the organization, may be late in paying off vehicles. An actual out of trust position is linked to a deficiency in a dealership's net cash position and is a fundamental problem that needs to be addressed.

Lenders use various tools to determine trust compliance. Tools at their disposal include:

✔monitoring the dealership's net cash position from financial statements submitted to the lender on a monthly basis.

✔performing periodic audits of floor plan inventory.

✔tracking payment history for sold vehicles—a poor payment history can indicate underlying problems with a dealer's net cash position.

Maintaining a good working relationship with a dealership's floor plan lender is an important part of running an efficient operation focused on generating net profit. Dealers should consider working with their AutoCPAGroup member to monitor their net cash position and avoid being blindsided by noncompliance issues. ✍

INCOME AND ESTATE TAX THOUGHTS

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Tax professionals follow proposals to change tax law as they work their way through Congress and eventually to the president's desk. We are trying to determine how this will affect our clients in order to provide feedback to our representatives in Congress or to trade groups we have contact with, including NADA. At the same time, we have learned the way that a proposed law starts out typically changes, in many instances by a lot, before actually being signed into law. As these laws work their way through Congress, clients ask me what I think. My response is usually a two-part answer: First, I say here is what the proposed law says. Second, don't count on it being the same once it gets to the president's desk.

Many times, decisions made by businesses and individuals include the income tax effect of the choices they are contemplating. When tax law changes are being considered, this affects the decisions individuals and businesses are trying to make and can slow down that process. The uncertainty in what the actual tax law will be has an impact on the overall economy.

Currently, discussions are underway about eliminating the estate tax; however, this is not the first time this has been proposed in Congress. While there has been support in prior years from both sides of the aisle, other forces have prevented the proposals from being passed into law. Today's hyperpartisan Congress could make it harder to eliminate the estate tax this time.

The estate tax provides a small percentage of total U.S. tax collections. Per IRS statistics for the fiscal year ending September 30, 2015, the estate tax provided 0.5% of total U.S. tax collections.

One proposal would allow a certain amount of assets (up to $10 million) to be valued at their fair market value at the date of death. This would become the new income tax basis for the beneficiaries who receive these assets, and when the assets are sold, the taxable gain would be the difference between the sales price and the fair market value at death. No estate tax would be paid at death.

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INCOME AND ESTATE TAX THOUGHTS

(continued from page 3)

All remaining assets would be valued at the decedent's income tax basis with no increase in the tax basis to fair market value. When these assets are sold, income tax will be paid on the difference between the sales price and the decedent's income tax basis. This will offset some or all of the decrease in federal tax revenue caused by eliminating the estate tax. One result would be to make the estate tax law simpler to administer and would assist the transfer of family-owned businesses. Would other issues come up due to this change? I am sure there would be some.

Feel free to discuss any of these matters with your **AutoCPAGroup** member. ✍

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