HEADLIGHTS

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USED-VEHICLE FRAUD

Because dealers are busy with the day-to-day operations of their business and want to trust their employees, they sometimes think that scams only happen to other dealerships ... until it happens to them. A dealer's best defense is knowing and watching for the latest trends in scamming. According to the Winter 2013 edition of "Auto Focus" by Thomson Reuters, some of the most frequent scams include

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✔ **Falsified loan requirements and documentation:** Buyers with weak credit scores can be the best targets. These consumers are told that, because of their poor credit, the lender requires an extended warranty to secure the loan, thus fraudulently boosting the profit on the sale. Other buyers may be told that online financial institution lending (which the consumer secured before entering the dealership) cannot be accepted, because these lenders take too long to pay the dealerships. This scam often persuades the consumer to use the dealership's financing instead, for fear of losing the ability to purchase the vehicle. This also gives the finance person the opportunity to charge a much higher interest rate.

✔ **Misrepresented history and condition:** Unscrupulous salespeople will try to close the deal at all costs, including lying about mileage, previous ownership and condition. Educated consumers will take the car to a mechanic to have it inspected or obtain a vehicle history report from a third party before buying the vehicle. But other consumers are at the dealership's mercy. Offer to provide a car history check as part of the sales process; that not only creates consumer confidence but also reinforces the dealership's high ethical standards to its employees.

✔ **Excessive administrative fees:** Dealer prep and handling fees can be bumped up by simply misleading the customer about the standard charge.

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Scams like these can lead your state attorney general to bring charges against your dealership for odometer tampering and for securities fraud related to fraudulent motor vehicle titles. On top of that, you are paying out excessive commissions on boosted "fraudulently obtained" profits.

You may never realize how valuable your dealership's good reputation is until it is ruined by an unscrupulous employee. Be proactive by reviewing your used-car department's practices. One method involves hiring an investigator to pose as a new employee specifically to learn what is happening in the sales department. Hold fraud awareness training sessions, and conduct periodic audits of deal documentation. For more information, contact your AutoCPAGroup member. ✍

BLUE SKY/GOODWILL AND MULTIPLE OF EARNINGS

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Some people in the industry use multiples of earnings to determine "blue sky"/goodwill. This method, however, can be simplistic and inaccurate unless other factors are considered in the analysis. For example, blue sky calculated at eight times reported pretax earnings results in a 12.5% pretax return on investment (ROI) based on the blue sky amount alone. The average dealer over the last 20 years has made a much better ROI than this.

Questions for dealers to consider: What is the multiple for blue sky if the earnings are zero? What is the multiple for blue sky if the earnings in the most recent year are higher than they have ever been? What is the multiple for blue sky if the franchise is at the high end of desirability today? Definitions for earnings and multiples vary.

Earnings definitions can include (a) most recent year reported pretax profits, (b) average/weighted average pretax profits for the most recent 3 to 5 years, (c) average/weighted average normalized pretax profits for the last 3 to 5 years or (d) expected future annual pretax profits.

In all cases, earnings need to be normalized by considering such items as

✔ LIFO (last-in, first-out) adjustments

✔ reasonable dealer/general manager compensation

✔ rent paid, to determine if a fair value is being paid for the facilities being used

✔ diverted income, which is income generated by the dealership, such as overbills and retroactive service contract income, but not run through the dealership accounting records

✔ depreciation and amortization expense and whether the amounts are reasonable based on assets utilized by the dealership (amortization of intangible assets should be added back)

✔ non–arm's length expenses that could include excess compensation to relatives or other employees of the dealership

✔ necessary or required facility upgrades: most needed facility upgrades will not facilitate increased sales, but the increased occupancy costs will reduce the expected pretax profits

The second component is the multiple used. Many times, the multiples we hear about (five to 10) are high because the seller is underperforming, and the buyer expects to materially increase the normalized pretax profits. That means this multiple is based on current earnings and not on the buyer's expected earnings. In reality, the multiple is in the range of one to four on expected profits, plus the investment needed to capitalize the dealership.

For example: Take a BMW and Ford dealership of the same size and in the same town with reported profits of $2,000,000. Assume a multiple of eight for BMW and four for Ford. Why would someone pay $16,000,000 blue sky for BMW and only $8,000,000 for Ford? The pretax ROI is quite different. While some brands do carry a premium, paying twice as much for one dealership over another where expected operational profits are the same is a large risk.

To summarize, you need to normalize earnings to compute what a reasonable pretax ROI would be to confirm that your multiple is reasonable and makes business, not merely emotional, sense. ✍

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New-vehicle leasing as a financing alternative for consumers has been a customary business practice for years, although its popularity has varied based on interest rates and expected residual values of the vehicles at the end of the respective leases. Leasing typically offers the customer lower monthly payments and provides the dealers with a predictable opportunity to return those customers to the dealerships to purchase or lease another vehicle.

Used-vehicle leasing has also been an alternative for a number of years, but it has not been as popular with customers as new-vehicle leasing. A growing trend among independent dealers who provide "buy-here, pay-here" services for customers is a switch to "lease-here, pay-here" services. Dealers are making this transition for a number of reasons, which can include

1. the ability to reduce and/or defer both state and federal taxes
2. cost savings with respect to customer bankruptcy and vehicle repossession
3. exemption from certain regulatory compliance required for financing transactions

A significant potential benefit to leasing vs. financing relates to sales tax. Many states apply sales taxes to each lease payment received rather than requiring the collection of sales tax on the entire taxable amount at the time of the sale. Not only does leasing defer payment of the sales tax over time but it potentially eliminates the loss of the sales tax deduction on repossessions when the related finance contract has been sold to a finance company. However, since some customers may move to other states, sales tax filings could be required in the states where customers register their vehicles.

Federal and applicable state income tax savings may be obtained as well, through the deferral of the gross profit that would be realized on a traditional sale and finance transaction. The vehicles remain the property of the dealership and are depreciated over time, using accelerated methods for tax purposes. The use of a related finance company is eliminated, as is the need to book a tax loss on the sale of the lease.

Because the vehicles' titles remain with the dealership, the dealership can be in a better position when a customer files for bankruptcy or when a vehicle is repossessed. Federal and state regulatory requirements are generally less onerous for leasing transactions than for financing transactions.

Are there any drawbacks? Lease-here dealers can be exposed to lessor vicarious liability. While federal law has now virtually eliminated this risk, some states may still require minimum insurance coverage, and dealers should consider the potential exposure, as well as the cost of the insurance coverage. Dealers should also consider the need for liability coverage to cover product liability lawsuits and claims in the event a lessee fails to maintain the vehicle in proper working order.

Many dealers rely on lines of credit with financial institutions to finance both buy-here and

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lease-here operations. Lease accounting will significantly change the dealership's financial statements and tax returns; dealers should ensure that financial covenants are not violated when considering the addition of lease-here to buy-here.

Compared with buy-here operations, lease-here operations can offer benefits; however, dealers should seek advice from knowledgeable CPAs, attorneys and financial advisers before changing from financing to leasing, to determine which operations model works best for them, the applicable sales tax laws and the tax implications of these transactions. ✍