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Dealer Insights

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Selden Fox

Accounting for your future

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Boost gross profits by improving inventory management

Smart inventory management is important for any retail business. However, it's crucial for auto dealerships when you consider the costs associated with stocking excess vehicle inventory.

From January through November 2018, the average dealership paid more than $53,000 a year in floorplan interest expense, according to NADA Dealership Financial Profiles. Carrying costs — such as keeping vehicles clean, well maintained, secure and insured — add even more to the expenses associated with poor vehicle inventory management.

Taking a comprehensive view

Managing inventory efficiently can help reduce interest expense and vehicle carrying costs, and thus boost dealership profitability. However, some owners place a higher priority on managing their *used* vehicle inventory than they do their *new* vehicle inventory. They may, for example, believe that new vehicles don't depreciate, or that factory floorplan assistance will cover the interest cost of carrying older-age vehicles.

Also, pay close attention to parts and accessories. Dealer reps may push you to buy more than you need, and some items, such as electronic sensors, speakers and DVD players, may be particularly susceptible to obsolescence or theft. And vendors oftentimes offer award programs for buying a certain quantity of a specific part or accessory to entice you to purchase more than you require.

Focusing on new inventory

Taking a proactive approach to the management of *new* vehicle inventory can help improve your dealership's financial performance and increase your gross profit. Here are a few ways to improve new vehicle inventory management:

Keep a close eye on key metrics. Compare your dealership "days' supply" to the market days' supply across all makes and models. To calculate days' supply, divide the number of vehicles in stock by the number of vehicles sold over the past month.

Achieving the right balance between these metrics minimizes the risk of aging, higher interest expense and lot upkeep that can eat into your profit margins. In general, larger gaps between these metrics suggest that you're stocking the wrong level or models of vehicles.

Give older vehicles fair treatment. The longer vehicles have been sitting around, the more money they're costing you. So, arrange older vehicles on your premises with the same enthusiasm as newer ones.

For example, park older vehicles up front where customers are more likely to see them and salespeople are more likely to show them. Also highlight older vehicles on your website and in online ads.

Only stock vehicles you can sell quickly. Which vehicles give you a competitive advantage over

other dealerships in your area? If you know that your competitors can sell certain makes or models at a lower price than you can, or are able to offer incentives that you can't, don't bother stocking these vehicles.

Carry a good mix of vehicles. Affordability has become a big issue with many customers as the average new vehicle price keeps rising. Thus, you should offer customers a wide range of choices in terms of price and features. This includes both fully loaded and base models.

In addition, you should predicate your inventory management decisions on hard sales data, not gut instinct. This requires generating accurate data from your dealership management system as well as outside sources such as DMV registrations and your manufacturer. Find out which vehicles are selling, how much they're selling for and how long they're taking to sell.

Asking others for input

Implementing efficient inventory management practices is a smart way to boost profits. But you don't need to go it alone. Your managers have frontline insight into effective strategies to improve how you control inventory at your dealership. And your CPA knows auto industry benchmarks and best practices to get your inventory management strategies up to speed.

Inventory accounting: LIFO or FIFO?

When accounting for new inventory, dealerships typically use one of two accounting methods: last-in, first-out (LIFO) or first-in, first-out (FIFO). The wrong choice costs you from an income tax perspective.

Dealerships can generally reduce income taxes by choosing LIFO instead of FIFO. Assuming that prices are rising, counting the last vehicles that arrived on your lot as the first ones sold will typically increase the cost of goods sold. And that, in turn, will presumably lower net income and taxes.

Since LIFO reduces net income, it's not always the right choice for a dealership. This is especially true if the owner plans to sell the store soon. Talk with your tax consultant about your decision.

Tried-and-true metrics are always of value

The use of metrics is an objective way to measure your dealership's performance. Well-devised, and accurately collected, analytics can reveal the realities of your business in black and white. The following are three established metrics that can be a useful record of your dealership's health.

1. Return on assets

A quick litmus test of performance is your dealership's return on assets (ROA). It's made up of two components. First, operating efficiency is measured with the profit margin ratio. This equals net income divided by sales. To improve profits — and, therefore, ROA — dealers can either increase sales or decrease costs.

Another way to try to improve ROA is to generate more sales for each dollar invested in assets without increasing expenses. Asset utilization is measured in terms of the total asset turnover ratio, which equals sales divided by total assets. For example, a total asset turnover of 1.3 means that, for each dollar invested in assets, the dealer generates $1.30 of sales. Assuming the additional sales are higher than the expenses needed to generate the sales, your ROA will increase.

In general, there's a tradeoff between operating efficiency and asset utilization. To illustrate, luxury dealers might earn a higher profit margin per vehicle, but they generally turn inventory slower than economy car dealers.

DuPont analysis, developed by the DuPont Corporation in the 1920s, provides a methodical approach to improving ROA. Dealers who think in these terms are better able to brainstorm specific action plans.

Cost cutting isn't the only way to make more money. Other options include selling more cars, carrying less parts and vehicle inventory, adding service hours, or divesting underused equipment and facilities.

2. Customer service index

No dealership's self-evaluation would be complete without addressing the customer service index (CSI). Successful dealers value their customers. High service ratings equate with goodwill and repeat business.

Industry analysts evaluate customer satisfaction. For example, J.D. Power and Associates computes CSI by surveying five measures during the first three years of vehicle ownership: service quality, service initiation, service advisor, service facility and vehicle pick-up. Scores are reported on a 1,000-point scale (the higher the score, the better).

Manufacturers pay close attention to CSI — and will let you know if you receive an unfavorable survey. Find out where your dealership stands. If you're not an industry leader, train your staff on ways to cater to customer needs. Make customer satisfaction a top priority.

3. Employee productivity levels

If employees are an asset, what's your return on hiring and retaining them? You invest a lot of money on each employee — salaries, benefits and training — and everyone should contribute to the bottom line.

For example, each salesperson should have a minimum monthly sales goal, and every technician should achieve a certain number of chargeable hours. Even the F&I manager should have, say, an extended warranty sales goal each week. And these goals should be monitored.

Communicate your expectations and help rookies learn the ropes. Those who fail to carry their weight after sufficient training and performance feedback may not be worth their expense. No one wants to hand out pink slips, but it's an unavoidable part of running a successful business.

Making the grade

Here's an idea to spotlight your dealership's performance. After you collect the above metrics at three-month intervals, distribute quarterly "report cards" to your management team. These reports can serve as the springboard for continuous-improvement discussions.

Have each department set and monitor specific goals aimed at improving ROA, customer satisfaction and productivity. Include both short- and long-term expectations in your action plan. Reward strong performance and encourage teamwork.

Share the news

Traditional metrics can let your managers, and all employees, know how their departments, and your dealership in general, have performed. Spread that information and act accordingly.

Valuing your dealership

The importance of EBITDAM and earnings quality

Many terms are used in the world of accounting that don't make much sense anywhere else. One of these is the acronym EBITDA (earnings before interest, taxes, depreciation and amortization). Calculating EBITDA makes it easier to compare profitability between dealerships.

There's another accounting acronym that's important when valuing a business: EBITDAM, with the "M" referring to "management excesses." Calculating EBITDAM can significantly impact your dealership's value and potential selling price.

Normalize your earnings

All earnings are *not* the same from a valuation perspective, so a business valuation expert will attempt to "normalize" earnings by adding and subtracting different items. EBITDAM eliminates certain discretionary management expenses from the EBITDA equation to give a better picture of your dealership's true profitability. These expenses often include:

- Rent that's above (or below) fair market value,
- Owner salaries above (or below) what would be considered normal,
- Family members on the payroll who don't provide services to the dealership, and
- Overremits in the F&I department going outside the dealership.

EBITDAM is calculated by adjusting EBITDA for such discretionary expenses. Here's an example that shows the impact of calculating EBITDAM on valuation.

ABC Dealership has an EBITDA of $1.5 million. The business is valued at $7.5 million, using a multiple of five times earnings that was derived from sales of comparable dealerships. However, the owner is running $350,000 of discretionary expenses through the business, which includes paying himself and several family members above-market salaries.

The owner wants to have a business valuation performed, because he's considering selling the dealership in the next year. Adding these discretionary expenses back to EBITDA would result in EBITDAM of $1.85 million. Assuming the same multiple of five times earnings, the dealership's value would rise from $7.5 million to $9.25 million — an increase of $1.75 million, or more than 23%.

Determine earnings quality

Another adjustment to earnings to consider when performing a business valuation is one-time and nonoperational items. Examples include:

- Inventory valuation methods and used inventory negative equity,
- One-time items of income or expense, such as gains or losses on sales of assets,
- Unrecorded or underrecorded liabilities, and
- Debt and debt-like items, such as deferred compensation plans and pending legal disputes.

When making these kinds of adjustments, it's crucial to understand the accounting methods being used in the dealership.

It's also important to consider the quality of earnings. In other words, how much income is generated from a dealership's core operating activities, such as selling and servicing vehicles and selling F&I products?

If your main sources of earnings are a strong sales team and strategic cost-cutting initiatives, you generally have high-quality earnings. However, if earnings come mainly from aggressive accounting practices, the sale of assets for gain or ever-changing economic factors, you generally have low-quality earnings.

High-quality earnings are readily repeatable. They aren't caused by temporary, unsustainable events or external factors, such as low interest rates or strong economic growth.

It's important to be aware of the relative strength of your dealership's earnings. One way to shed light on earnings quality is to have a "quality of earnings" study performed by an accounting professional. This study will make appropriate earnings adjustments to give buyers and sellers greater assurance that the stated earnings are viable and sustainable in the future.

What's your true profitability?

Before putting your dealership on the market, it's important to consult a business valuation professional to understand how to normalize and assess the quality of your earnings. These steps will help reveal your dealership's true profitability, which will result in a more accurate valuation and possibly a higher selling price.

How to manage employees of different ages with insight

Your dealership's employees likely represent a mix of age groups. Successfully managing employees across generations requires understanding these generational trends while avoiding broad stereotypes.

Four generations co-exist

Definitions vary slightly, but the U.S. Chamber of Commerce Foundation defines today's generations as follows: Members of the Baby Boomer generation were born from 1946 to 1964. Members of Generation X were born from 1965 to 1979. Members of the Millennial generation were born from 1980 to 1999. And members of Generation Z were born after 1999.

Adapt your management style

Broadly speaking, Millennial and Generation Z employees can't be handled effectively in the same way that Baby Boomers and Generation X

employees are. This means that you and your managers must learn how to adapt your management style to fit employees of these generations.

For example, many Millennials and Gen Z employees like, or even expect, to receive regular *feedback* about their performance, as well as public recognition and praise when they've done well. While most Baby Boomers and Gen Xers also enjoy positive performance feedback, they may also derive personal satisfaction from a job well done.

Employees from different generations also tend to have their own views of *company loyalty*. Many younger employees, for example, are more loyal to their principles and their co-workers than they are to an organization, while many older employees feel a greater sense of company loyalty. Keep these and other differences in mind when managing employees across generations.

> *Millennial and Generation Z employees simply can't be handled effectively in the same way that Baby Boomers and Generation X employees are.*

Recognize the generations' diverse *views toward compensation*. While money is valued to some degree by employees across generations, younger employees tend to prioritize salary less than older workers. For example, according to a study conducted by the National Association of Colleges and Employers, a high salary ranks just fifth on the list of motivating factors for Millennial employees.

Different strokes for different folks

Misunderstandings and conflicts often arise due to *value differences* between managers and employees of different generations. For example, many older managers expect employees to be willing to do "whatever it takes" to get the job done, including working long hours. However,

many younger employees place a high value on achieving work-life balance.

When possible, Baby Boomers and Gen Xers who are managing younger employees should try to be flexible when it comes to scheduling. But this doesn't mean young employees shouldn't be required to work hard. The key is to find the right balance so that work is accomplished satisfactorily and on time, and young employees feel like their values are being respected.

Different generations tend to bring *different strengths* to the workplace. For example, many younger employees have strong computer and technical skills, while many older employees have valuable industry experience, wisdom and insight.

Try to create situations where employees from diverse generations can work together on teams and share their knowledge and strengths with each other. In doing so, encourage them to communicate openly and honestly and to be willing to learn from — instead of compete with — each other.

Get to know them

Good managers understand the demographic trends that affect the workforce, but avoid making sweeping generalizations about their own staffs. Instead, they try to get to know each employee individually to better determine "what makes them tick" and adapt their management strategies accordingly.

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Selden Fox

Accounting for your future

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Selden Fox is a mid-size firm with 60 employees, including 35 CPAs, and another dozen professional staff. Tom DeSimone and Garth Reimel, previously owners of Richard T. DeSimone & Co., lead the firm's auto dealership practice. Selden Fox has the industry expertise and a significant base of tax and audit resources for automobile dealers and their related businesses.

At Selden Fox, family-owned, closely held businesses like yours is our forte. Selden Fox services many types of privately held businesses, nonprofit organizations, and governmental entities. Services include financial statement reporting, audit and assurance, tax, accounting solutions, and general consulting services. With the addition of Tom and Garth, Selden Fox now boasts a new and significant expertise in working with the automobile industry. We would be happy to meet you and discuss any business concerns, strategies, ideas, or questions.

What do Tom and Garth bring to the table? Throughout their many years in business together, Tom and Garth have had a very personable hand-shake approach to business. They treat your business as if it was their own family's business. However, they have a very intense and experienced knowledge of the automobile business, the means, methods, and protocols of the dealership operations; internal controls; factory protocols and methods; and specific dealership tax laws.

Selden Fox's commitment is to build and preserve your trust and confidence, to foster long-lasting valuable partnerships and relationships. As with all of our clients, this is accomplished, first with our devotion to maintaining quality professional standards within the firm, continually studying new accounting, generally accepted accounting principles, and tax laws, and to seek to have a well-deserved pride in our reputation.

Our specific dealership services include (but not all encompassing):

- Financial Statement Reporting for
  - Certified Audits
  - Reviewed Financials
  - Compiled Financials
- Development of Internal Controls and Expense Analysis
- Assistance and Recommendations of Account Reconciliations
- Consulting in Banking Matters (i.e., Financial Reporting, Working Capital, Referrals)
- Year over Year Comparison of Operations
- Estate Planning and Wealth Preservation
- Income, Business, Trusts & Estate Tax Returns
- IRS Representation of Various Types
- LIFO Calculations/Compliance and Consulting (IRC 263A Calculations if Required)
- 401(k) and Pension Audits
- Other Consulting as Requested

We appreciate the opportunity to serve you. A special thanks to those of you who referred your family, friends and associates. We appreciate your confidence and always welcome your referrals.