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INSIGHT

BY AXIOM ADVISORS

IN THIS ISSUE

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Fraud patterns and indicators which should be a constant reminder for all dealers:

- **Occupational fraud is a significant threat to small businesses.**
- **Perpetrators with higher levels of authority tend to cause much larger losses.**
- **The longer a perpetrator has worked for an organization, the higher fraud losses tend to be.**
- **The frauds reported lasted a median of 18 months before being detected.**
- **Most occupational fraudsters are first-time offenders with clean employment histories.**
- **In 81% of fraud cases, the fraudster displayed one or more behavioral red flags.**

In the Service Department, Small Changes Can Lead to Big Profits

By Marilou C. Vroman, CPA

As dealerships press for profitability in a challenging economic climate, now is the time to look for hidden opportunities and greater efficiencies – all while maintaining a dedicated focus on eliminating roadblocks to success. One area that certainly merits a closer look is the service department.

Dealers have a tendency to look at high level indicators of store performance. The questions often heard at month end are: "How many cars did we deliver?" or "Where is fixed gross going to end up this month?" But rather than focusing on performance from an altitude of 10,000 feet, perhaps more specific questions should also be asked such as: "How did our fixed operations performance compare to our facility potential?" or "Why did we fall short of expectations?" or "How productive and efficient are our technicians and what opportunities do we have to make improvement?"

In order to ask these questions, it is important to understand the underlying factors that drive the service department's profitability. While there are many variables that work together to generate profits, a closer look at key performance indicators can reveal the truth behind the results appearing on the financial statement.

First, the facility utilization should be evaluated. The dealership has a maximum realizable service capacity which should be compared to actual labor sales on a monthly basis. The maximum capacity is referred to as facility potential. Facility potential is calculated via the following formula: The number of bays multiplied by the number of days in the period multiplied by hours per day multiplied by the effective labor rate. This calculation assumes that the service department is open for 24 hours, with a working technician at every bay. While this calculation may seem unrealistic at first glance, in reality the facility can, in fact, be generating revenue 24 hours per day, seven days per week, by scheduling technicians in shifts. Facility utilization is calculated by dividing actual labor sales revenue by the facility potential for the same period. Some dealers may be surprised to find that the service department is actually operating at less than 50% of its maximum potential. When millions are spent to build a state of the art service facility with countless bays, this indicator can be quite revealing.

Second, the dealership's labor sales potential should be compared to actual labor sales. Calculating the labor sales potential for a dealership for a given month is done according to the following formula: The number of technicians multiplied by working hours per day multiplied by service days per month multiplied by the effective labor rate. The difference between the sales potential and actual labor dollars sold is the missed revenue opportunity for the month. Take for example a dealership with 20 technicians, 23 service days per month, a posted labor rate of $100, and 9 hours of operation per day. The potential labor sales dollars for this facility is $414,000. If the technicians actually bill 8 hours per day - just one hour less - and the effective labor rate is $99 - just one dollar less than the posted rate - the missed opportunity is $49,680 in revenue. At 72% gross profit margin, that lost revenue equates to $35,769 of missed gross profit opportunity. While there are many variables that affect the actual labor sales, it is not uncommon for a dealership to perform below potential. Simply understanding what the potential amount is provides a basis to further evaluate the variables that may be falling short of expectations.

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With the effective labor rate driving both the labor potential and facility potential, examination of this indicator is essential. The effective labor rate, or "ELR," is calculated by taking total labor sales dollars and dividing by the total labor hours billed (flat rate hours) for the period. The effective labor rate is the true labor rate being charged after considering discounts and other adjustments. Ideally, the dealership's effective labor rate should be the same, or higher, than the posted labor rate. If the ELR is less than the posted rate, revenue opportunity has been lost. One recommendation is to review exception reports to look for labor rate discounts. Proper job pricing and training of service advisors are critical to maintaining a high ELR. For services where pricing must remain competitive, such as lube oil and filter, labor discounts may be appropriate. In some cases, charging an account for promotional discounts, rather than reducing the labor rate, can help protect the dealership's ELR. It is important to note also that many manufacturers will base their decision to increase a dealer's warranty labor rates on the effective labor rate realized by the dealership for customer pay repairs. If the ELR is too low, increases in warranty labor rates may be compromised.

With the service department potential now identified, the dealer should drill down to more detailed indicators such as technician performance. Three key indicators of a technician's performance are efficiency, productivity, and proficiency.

Technician efficiency is a measure of the technician's overall skill level versus the job that has been performed. In the case of warranty work, technician efficiency can also be an indicator of how realistic the manufacturer's expectations are with respect to flat rate hours necessary to complete a job. Technician efficiency is calculated by dividing sold (billed) hours by actual hours per technician for a period. Actual hours in this context are actual hours spent repairing vehicles, rather than hours on the clock. Technician efficiency for an experienced technician typically should fall in the area of 115% or more. At less than 100%, there may be a need for training, or redistribution of work to more skilled technicians.

The second indicator - technician productivity - measures how productive a technician is with his time during the work day. Technician productivity is calculated by dividing the actual hours a technician is dedicated to repairing vehicles by the number of hours the technician is available. Available hours are those where the technician is physically present and available to work, even if the technician is less than accurate with the time clock. Technician productivity should be as close to 100% as possible to maximize the opportunity for billed hours. Factors that can adversely affect technician productivity include: excess breaks, chatting at the parts counter, morale, work ethic, and shop layout, to name a few.

The third indicator is technician proficiency. This indicator is a combination of efficiency and productivity. Technician proficiency is measured by dividing the billed flat rate hours by the available hours per technician. Proficiency is a broad spectrum indicator of fixed operations performance since it is not only driven by the technician, but also service advisors, management, and the parts department.

In addition to analyzing the service department indicators above, dealers should investigate roadblocks to maximizing labor sales. They should ask questions of department management such as:

- ***What is causing technicians to spend time away from their bays?***
- ***Are parts fill rates at optimal levels?***
- ***Is the distribution of work to technicians appropriate for their skill level?***
- ***Is the facility designed to promote efficiency of work flow and information?***
- ***Are technicians properly trained?***
- ***Do technicians have the correct tools and are the tools in good working order?***
- ***Are staffing levels appropriate to meet customer demand?***
- ***Are the technicians paid fairly and rewarded for a job well done?***

Another very important consideration not to be overlooked is the dealership culture. Studies have shown time and again that positive employee morale drives increases in productivity. It is important to ensure that the dealership management promotes a culture of recognition and reward for a job well done, especially in the service department. Consider evaluating pay plans and implementing a pay or bonus structure that rewards employee efforts to improve efficiency and productivity. Eliminate "cancer" in the shop by evaluating personnel and either counseling or removing employees who create a negative influence or distraction to others.

In summary, dealers should evaluate their facility potential as a whole, look at the total revenue potential that can be generated by the technicians, and remove roadblocks to efficiency, productivity and proficiency. With pressures mounting on dealerships to remain profitable, it is critical to take the time to focus on the great opportunities that lie within the service department. Pushing the needle just a little can yield significant dividends to the bottom line.

Violation of Trust:

Watching the Watchers Can Reduce Your Risk

By Lamar J. Lewis-Sutton, CPA, CFE, CDFA

Trust at its core is a charge or duty imposed in faith or confidence to an individual to be used or cared for in the interest of another. Therefore, since most dealerships are either family owned, or there's a family environment within the dealership, it's easy for dealers to instill excessive trust in certain employees. Longevity and daily interaction with employees makes it hard not to trust dedicated employees in which a dealer has developed professional, and in some cases, personal relationships. It's a natural desire for dealers to trust key employees in an effort to free up time from toiling over every aspect of the dealership's operations and focus on the big picture.

In fact, no dealership can thrive without trusting employees, but some dealerships are financially impacted because they have trusted employees too much. For instance, allowing a Controller to sign checks without a second authorized check signer paired with processing payroll, and reconciling the monthly bank statement can be an invitation for inappropriate activities to occur and go undetected for a while before being discovered, if at all. The key is to "trust, but verify" via a combination of well-designed internal controls and surprise tests (e.g. reviewing a random sample of transactions processed or approved by a specific employee).

Typically when an employee is given full access or too much control over transactions or processes at a dealership, an opportunity for inappropriate activities may exist. For example, a sales person who's given both sales and F&I functions could have the ability to manipulate deals and misappropriate customer down payments prior to a deal being posted in the accounting department. Dishonest employees have a better opportunity to embezzle or misappropriate a dealership's assets and resources when its operations are more profitable. Greater profit makes it easier to mask inappropriate activities.

As the economy continues to improve, so will the profitability of dealers which may be a welcome sign for potential embezzlers that may have been waiting for the dealership's cookie jar to be refilled. One difficulty in trying to determine which trusted employee will commit fraud is that given the right opportunities, pressures, and rationalizations, a large percentage of trusted employees are capable of committing some type of fraud. As a result, efforts to create employee fraud prevention programs at a dealership may not be sufficient to deter a trusted employee from crossing the line, especially in a dealership environment which typically has a large volume of transactions processed on a monthly basis (Some ideas for addressing this concern are listed further in this column).

As reported in the Association of Certified Fraud Examiners' 2012 Report to the Nations on Occupational Fraud and Abuse, there are well known patterns and indicators which should be a constant reminder for all dealers, such as:

- *Occupational fraud is a significant threat to small businesses (which includes dealerships);*
- *Perpetrators with higher levels of authority tend to cause much larger losses (prime example of why cameras over the cashier may deter some losses from occurring, but greater risk lies in other areas of the dealership where cameras are seldom hovering - such as the accounting office, sales desk, and parts department);*
- *The longer a perpetrator has worked for an organization, the higher fraud losses tend to be (yes, keep watching those new employees and do a good job screening them before they're hired, but the employees that know the internal operations and weaknesses of a dealership pose a greater threat);*
- *The frauds reported lasted a median of 18 months before being detected (this is a simple reminder to remain vigilant in an effort to deter or at least shorten the amount of time it takes to identify inappropriate activities within the dealership before the losses incurred become jaw dropping);*
- *Most occupational fraudsters are first-time offenders with clean employment histories (hence, don't let your guard down just because a background check comes back clean);*
- *In 81% of fraud cases, the fraudster displayed one or more behavioral red flags that are often associated with fraudulent conduct, such as:*

  - Living beyond their means

  - Experiencing financial difficulties

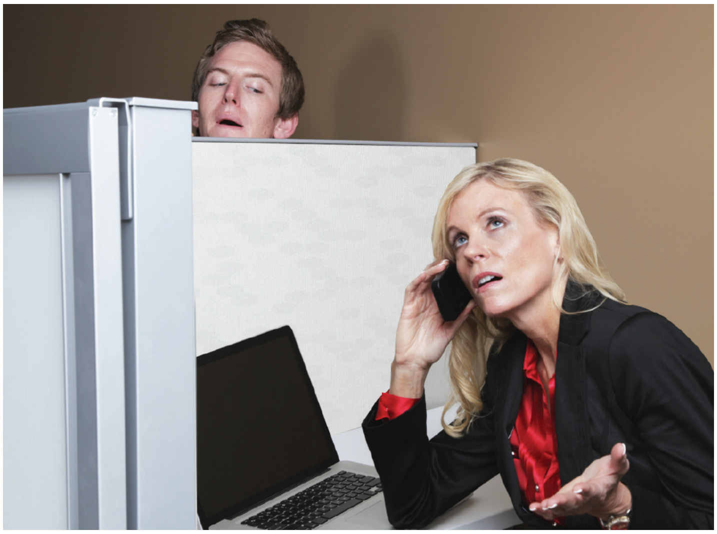
  - Unusually close association with vendors or customers

  - Displayed excessive control issues

These behavioral red flags may not be easily identified; however, in some cases they're very obvious based on casual conversations revealing an employee's recent purchase of a $250,000 vehicle and a vacation home in Hawaii, all on a $75,000 per year salary. If no actions are taken to investigate potential threats to the dealership, then a dealer may be vulnerable to being impacted by a trusted employee's inappropriate activities.

There's an old saying that's long been accepted in fraud prevention circles called the 10-10-80 rule: which is broken down as follows:

- *10 percent of individuals will never steal no matter what;*
- *10 percent of individuals will steal every opportunity they have;*
- *And the remaining 80 percent of individuals will go either way depending on how they rationalize a particular opportunity.*



The good news for dealers is that there are steps a dealership can do to sway the 80 percent to their side or at least reduce the length of time to discover inappropriate activities. Some approaches consist of:

- ***Hotline:*** Most incidents of employee theft or inappropriate activities are revealed by coworkers, but many are hesitant to report these incidents to the dealer. Set up a system whereby employees may report inappropriate activities and alleged thefts anonymously. If a dealership has 100 employees, then you have 100 sets of eyes watching over the dealership. If someone is seeing something – that they have a gut feeling about – give them an avenue to report it, especially since some employees fear retaliation and prefer to report potential frauds or inappropriate activities anonymously. For instance, subordinates of a key manager may be fearful or unwilling to question actions taken by their supervisor; but they may call an 800 number in a heartbeat.

- ***Mandatory Vacations:*** Require all employees (especially management personnel and accounting) to take at least a full week off per year. More importantly, don't allow paperwork to pile up during their scheduled vacation. Have someone else perform ALL of the regular duties of the vacationing employee. Employees that refuse to take vacations or are unwilling to share duties should be monitored closely and be required to take off immediately.

- ***Perception:*** Employees are less likely to take part in inappropriate or unethical activities, if they believe they will be caught. Hence, let the bells ring loud within the dealership by being very clear with employees that your dealership has zero tolerance for employee theft of any sort, including non-transparent relationships with vendors, customers, or even family members. In addition, ensure that your company policies are written and distributed to all employees which outlines exactly what constitutes violations of trust, conflicts of interest, and theft.

- ***Separation of Duties:*** Avoid at all costs allowing a single individual the capability and power to have full control over transactions and processes from start to finish. For smaller dealerships, this is easier said than done, but some form of separation of duties is necessary. Furthermore, when separation of duties cannot be accomplished, internal audit tests should be performed to ensure employees are being monitored. For instance, an employee responsible for authorizing wire transfers should not be responsible for posting the payment and reconciling the monthly bank statement.

- ***Address Verifications:*** Employees' home and all known addresses should be compared with vendor addresses at least annually to determine if any potential conflicts of interest exist and have not been properly disclosed. Also, if your CFO or Controller is responsible for handling the administrative aspects of dealing with State or regulatory agencies, then the addresses for all dealership entities should be verified within a dealership's State website to confirm that mailing addresses have not been changed to an employee's home address as a means of diverting correspondence in an effort to conceal inappropriate activities conducted by trusted employees.

- ***System Access:*** System users accessing the dealership's Dealer Management System ("DMS") should be closely monitored on a monthly basis to identify who has access to the DMS and more importantly to determine what types of transactions are being processed by these individuals. Reports can be generated from the DMS which can assist dealers in obtaining the appropriate system users access information. In addition, unknown system users and employees with unnecessary system access should be prohibited from the DMS.

- ***Price Comparisons:*** Kickback schemes are very difficult to identify, but it's easy to compare vendor prices and in most cases dealers typically pay more for services and products when kickbacks are involved. Hence, a dealer should obtain competitive bids for services and products when inappropriate activities are suspected and at least annually in an effort to keep trusted employees and vendors honest.

Violations of trust directly affect a dealership's bottom line and can cost a dealer hundreds of thousands of dollars if it goes undetected for many years. Anyone is capable of breaking the bonds of trust, if the opportunity presents itself; therefore, dealers should be more attentive and verify the activities of trusted employees.

Does Fiat Really Need Stand-Alone Stores?

By Phil Villegas

As featured in

WARD'S Dealer Business

While Suzuki exiting the U.S. market does not shock me, what does surprise me is the value of the dealer network that Suzuki disregarded.

Almost all emerging or existing international brands want to enter the U.S. market. The challenge of establishing a strong dealer network keeps many of them away.

I would have thought Suzuki, in exiting the U.S. market, would have attempted to maximize the value of its dealer network. I would have thought Chinese auto brands eyeing the market would want to partner with Suzuki's retail network.

I even advised a dealer who was considering dropping or selling his Mitsubishi franchise to keep it because it seemed inevitable a Chinese brand ultimately would partner with Mitsubishi for its dealer network. Seeing Suzuki exit, I now realize how I had miscalculated the situation.

Similar to Suzuki, Mitsubishi internationally is a successful Japanese auto maker with a great reputation for providing reliable and economical vehicles that are in high demand in emerging markets. Unlike the U.S., those are markets where model refreshes, design and innovations are not as essential for maintaining high sales volumes.

With the exception of luxury and exotic segments, the only path to profitability in the U.S. is through volume. Suzuki and Mitsubishi can divert their U.S. resources to make larger profits in lower-volume markets elsewhere because they do not have to invest as much in ongoing product development. They don't have a financial need to partner with a Chinese brand in the U.S.

Neither Suzuki nor Mitsubishi has found much success in America. So, what should a Mitsubishi dealer do? What happened with Suzuki dealers helps answer that. If you are a Mitsubishi dealer, I hope you have another franchise or are one heck of a used-car guy. If neither, I would consider an exit strategy before one is handed to you.

We now know what the end of the movie may look like for some franchises with limited models, resources and commitments in the U.S.

But why do dealers make what appears to be a limitless commitment to these brands? Dealers invest millions of dollars in single-purpose facilities, dedicate hundreds of thousands of dollars in advertising and brand-building and commit tremendous personnel resources to promoting a brand in exchange for potential profitability.

Dealers do not need to look too far to see that many of these auto makers lack the product or management depth to position their brands as anything more than speculative.

Yet time and time again, dealers expect these brands to be the industry's Rocky Balboa that somehow, despite limitations, can take all the hits that the U.S. market can give and still compete with the heavyweights.

They hope those brands become the next Toyota or BMW. But it took those winners decades to establish their foothold in the U.S., and only after establishing trust with both customers and dealers and developing a reputation for product excellence.

One of the strongest stances the National Automobile Dealers Assn. has taken lately is its opposition to auto makers' facility-upgrade programs. The trade group has tried to show that some of the imposed new-facility requirements hurt dealers more than help them. There is validity to NADA's claims that auto makers are overreaching.

There is no better current example of the dealer-facility divide than Fiat. I have a lot of respect for what Sergio Marchionne has done for Chrysler and Detroit. But the manner in which Fiat was launched is self-serving and doesn't benefit dealers.

Instead of selling Fiats in carved-out areas of Chrysler stores, similar to what Toyota did with Scion and Hyundai did with the upscale Genesis models, Marchionne insisted on Fiat stand-alone stores.

That requirement additionally burdens cash-strapped Chrysler dealers who must invest a lot for minimal returns.

This comes at a time when other brands are seeing strength in melding their dealer networks. For instance, Land Rover and Jaguar are moving to consolidate all points. Ford is looking to pair the Ford and Lincoln brands where feasible.

General Motors allowed significant consolidation among its dealers. Audi allows dualed franchises in smaller markets. Yet, Fiat feels it is stronger on its own.

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About 150 dealers have built exclusive facilities to essentially sell one model, the Fiat 500. Margins are thin. Not enough units are in operation to adequately support a dealership's service department. When Hummer had separate stand-alone dealerships, it already had two models and a third on the way. Hummer dealers earned high profit margins. Sales volumes were decent. Despite all this, the business model failed.

Exclusive sales points for low-volume models only work for luxury and exotic brands. Even then, much of the dealership profits come from used-vehicle sales and service operations.

Many Fiat dealers agreed to build exclusive facilities based on the prospect of possibly attaining an Alfa Romeo franchise down the road. But to cite another movie, this "Field of Dreams" mentality can be costly.

Dealers can fall into a trap when investing in emerging brands. They think that because the franchise carries no blue-sky payments it is somehow free. This is far from the truth.

Even new points for Toyota, Mercedes-Benz, BMW and Honda are not without risk or significant capital requirements. Dealers who make those outlets work usually have extensive personnel and financial resources to weather the first few years of business.
With the growth of Chinese auto brands and the development of alternative-fuel technologies, we are seeing new ventures at home and abroad.

We may ultimately see the next great auto maker of the century. But dealers need to stop some of the irrational behavior they display when a new brand comes along. It not only can hurt them, but also the industry as a whole. That is because the bar for facility requirements will continue to be raised by every auto maker entering the market.

New brands entering the U.S. will continue to need a strong dealership network. That always has been the case. But they all don't need exclusive facilities. Dealers need to exercise due diligence when it comes to deciding which auto maker to partner with.