FALL 2012

INSIGHT

BY AXIOM ADVISORS

IN THIS ISSUE

Excerpt from page 2

Year End recommendations:

- **Cash:** Are the bank statements reconciled? The Controller should ensure that the cash balances are fully reconciled
- **Customer Accounts:** Have we overstated our revenues with uncollected accounts? The Controller should review the receivable balances with Management in detail.
- **Vehicle Inventory:** Is a surprise LIFO recapture or phantom vehicle lurking in the inventory? Several year-end considerations should be made for vehicle inventories.
- **Parts Inventory:** How much parts inventory do we really own? The parts physical inventory should be scheduled as close to year-end as possible.
- **Prepaid Expenses and Accruals**: What secrets are accumulating in these accounts? The Controller should review the schedule of prepaid expenses and ensure nothing is "hung-up" on the balance sheet that should be expensed in the current year.
- **Open Repair Order's:** Has that vehicle really been in the shop for 180 days? The Service Manager and Controller should take extra time review the open RO list at year end and ensure RO's are closed if the repairs have been completed.
- **Open Counter Tickets:** Are these parts still on the shelf? The same situation as open RO's applies to open counter tickets.
- **Retained Earnings:** What happened to this balance during the year? The Controller should keep an accurate record of what is being recorded in this account throughout the year.
- **Taxes:** Are the tax tables correct? No one likes to pay taxes, especially more than necessary.
- **Personnel:** Are we properly staffed for our business needs? The year is coming to a close and it's time to look at the return on personnel investment.

Now's the Time to Sell Dealership

We don't need to get too deep into statistics or demographics to know we will see some dramatic changes to the dealership body profile over the next five years.

As featured in WARD'S Dealer Business *By Phil Villegas*

I'm not referring to changes in laws or regulations or in how we retail vehicles, but rather the characteristics of dealers themselves. We are surrounded by an aging dealer body. While the aging itself is not the issue, it's the inevitable volume of ownership transfers we expect to see in the coming years that may present valuation and succession issues for dealers looking forward to selling and retiring.

What we are seeing in the dealership buy-sell markets is that many dealers are waiting to wrap up 2012 before offering their store for sale. I can understand why a dealer would opt to wait until the end of the year; after all, 2012 is the best year most dealers have had since 2007. That would allow them to command a higher sale price for their stores because most dealerships sell based on a multiple of their earnings.

While most dealership brokers tend to rationalize that no matter what the current or foreseeable market conditions, "today" is always the best time to sell, the fact is that now may indeed be the best time to bring your store to market if you were planning on selling.

Our recommendation to dealers planning to sell in the next few years is to bring their store to market now or, at a minimum, get the process started. Doing so will minimize the potential downside value risk of buyers having too many options, a trend we anticipate seeing toward the second quarter of next year.

Imagine there are 25 houses in a neighborhood and three or four focused people with an eye to buy. Say two houses are for sale, and they have been on the market for a while. One house, while nice, is priced so unreasonably high that no one is interested. The other is such a mess, it may as well be sitting on toxic radioactive ground.

continued on page 2

continued from page 1

You know from neighbors that you're not the only one planning to sell next year so that you can retire and move somewhere warmer. By your own estimates, you figure there are at least five people, including yourself, who plan to sell in the next year.

Knowing all of this, do you wait until other neighbors list their properties or do you try to come to market first? Coming to market now gives you the best shot at the best buyers.

Waiting can risk diluting these buyers over more properties, which can have a negative impact on your pricing. Besides the pricing impact, when buyers have too many options, you no longer have the undivided attention of your buyer, causing the sale process to drag along.

Every part or your house gets nitpicked and contrasted against others. While you may be asking for a reasonable and fair price, one or more of your retirement-minded neighbors may just decide to sell below that in order to get on the golf course as soon as possible.

As consultants and not brokers, we have the freedom to be objective without affecting our bottomline. Our advice is that if you plan to sell by 2014, it would be both safe and advisable to place your store on the market sooner.

There is enough traction on 2012 earnings and sales that a buyer will allow you to annualize your results. You won't have to wait for the ball to drop on 2012 to be able to use current-year performance. So you might as well snag that early tee time while it's still available and before the course gets crowded.

Don't wait until the New Year to get your financials in shape

– *What Managers should be doing NOW to get ready.*

By Marilou Vroman

As the holidays approach and concentration may drift to turkey, holiday parties, and gift giving; now is the time to get dealership ready for a successful year-end and a clean, lean New Year.

Year-end, quarter-end and month-end are all happening at the same time. The pressure is on to deliver as many units as possible and close out the year with a strong finish. For some, it's just another date, but for the dealer, it's a time when final earnings and performance reports are generated, bonuses are calculated, and dealer can finally see the results of the year's efforts.

At year end, the most important manufacturer financial statement is printed and the "perceived" true results of operations are etched in stone. A key pitfall with dealers' financial statements that contain many prepaid balances and balances to be written-off or adjusted, is that in some stores where there is an absentee owner, or the store is part of a dealer group, the General Manager will use the lack of purely accurate financials to their pay plan advantage. Since most GMs are paid a percentage of the bottom-line, many will try to influence the Controller to adjust certain balances as part of the 13th month clean-up, in turn artificially boosting their compensation. This is a key consideration in ensuring that operating costs and expenses are identified before the year end, and not "cleaned up" in the 13th month.

Following are some questions to ask your management team and recommendations of what they should be doing NOW to get ready for the approaching year-end, to ensure the last statement is a true record of the dealership's financial performance and to be ready for a fresh start in the New Year:

Cash

Are the bank statements reconciled? The Controller should ensure that the cash balances are fully reconciled. "Fully reconciled" means positively identifying reconciling items and posting an entry to correct those lingering aged items. In addition, are there large outstanding checks that need to be reissued or voided? Year-end is a good time to clean up aged items on the bank reconciliation since not only the cash balance is affected, but expenses or assets may be misstated as well. Furthermore, certain dealerships reconcile cash daily – which is highly recommended. However, if bank reconciliations are not performed daily, the Controller should review the activity in the bank as the year end approaches to determine if any payments have been made that may affect inventories or expenses but have not yet been recorded in order to ensure these items are recorded in the current year.

Customer Accounts

Have we overstated our revenues with uncollected accounts? The Controller should review the receivable balances with Management in detail. Year-end is the time to determine whether balances are collectible or not. Uncollectable balances represent excess unearned income on the books that should be written-off rather than held until the next year. The dealer will not want to pay tax on this income, so evaluate collectability of these items carefully. In addition, in some states, the sales tax collected on the related sale may also be reversed since the write-off is in essence the reversal of a sale, or a portion thereof. Be sure to check with your state sales tax laws to be in compliance.

Vehicle Inventory

Is a surprise LIFO recapture or phantom vehicle lurking in the inventory? Several year-end considerations should be made for vehicle inventories. First and foremost, while many dealers perform physical inventories on a weekly or monthly basis, they do not go through the trouble of fully reconciling the results to the General Ledger. The reconciliation process will assure the dealer that all of the vehicle inve6ntory has been accounted for and will confirm if a vehicle is missing. A physical inventory should be taken by individuals who do not have control or record keeping abilities in relation to the vehicle inventory. The physical inventory should be taken as close to the year-end as possible and reconciled to the final inventory balance in the general ledger.

For those dealers on LIFO, inventory changes from one year to the next should be closely monitored. If the ending inventory balance of the current year declines compared to the ending balance of the prior year, there is a risk of a LIFO recapture, which equates to additional taxable income to the Dealer. In advance of the year end, Management should discuss status of the inventory and forecasted purchases and sales so year-end LIFO surprises can be avoided. In addition, the dealer's CPA may request copies of new vehicle invoices, used vehicle valuations, and LIFO reports for year-end inventories. Keep these items readily available to ensure an accurate LIFO calculation.

Parts Inventory

How much parts inventory do we really own? The parts physical inventory should be scheduled as close to year-end as possible. This will help ensure the final balance is as accurate as possible. A third party inventory service is typically recommended to obtain an unbiased and fair valuation of the inventory and a report of the condition of the departmental operations. Internal inventories may save money in the short run, but are much like writing your own report card. Don't just take someone's word for it – verify whether there is inventory that is obsolete, missing, or needs to be written-down. These are potential losses that should be recorded in the year incurred and not carried forward. Keep a good record of items that are written-off and adjust the PAD accordingly. In addition, parts cost adjustments such as appreciation and depreciation should also be recorded prior to the year-end. Verify that the latest parts pricing has been updated in the DMS before closing out the year.

Prepaid Expenses and Accruals

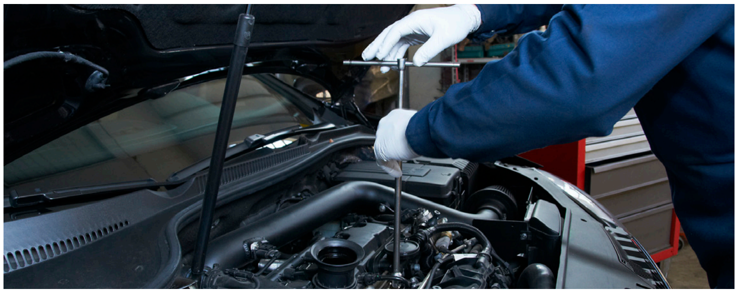
What secrets are accumulating in these accounts? The Controller should review the schedule of prepaid expenses and ensure nothing is "hung-up" on the balance sheet that should be expensed in the current year. The schedule should contain only those items that should legitimately be expensed in future periods.

Likewise, accruals should be reasonable. Excess reserves should be evaluated for reasonableness and if excessive, certain reserves should be taken into income. Reserves present an opportunity to "bury" certain expenses or write-offs in future periods. Reserve balances should serve a specific purpose and should be reasonable. Review key expenses and ensure payroll, insurance, advertising are properly accrued as well.

Open Repair Orders

Has that vehicle really been in the shop for 180 days? The Service Manager and Controller should take extra time review the open RO list at year end and ensure RO's are closed if the repairs have been completed. This typically isn't an issue since the Service Manager would like as much revenue to be reported in the period as possible. However, at times, the open RO list is used as an alternative to setting up a receivable from a customer. The repairs are complete, the vehicle is burning gas, yet the RO is still open pending payment from the customer. An inventory of open RO's compared to vehicles in the shop should be taken to confirm that any open RO isn't just a place holder waiting on customer payment. In addition, internals repairs are important to validate as well. Be sure internals are closed in a timely manner so the vehicle inventory reflects the correct cost including reconditioning, and, if there is any policy work that has been performed, the related expense is recorded before year end.

Open Counter Tickets



Are these parts still on the shelf? The same situation as open RO's applies to open counter tickets. The Parts Manager and Controller should confirm the sales are truly pending, and the parts have not left the dealership. If the part has left the premises, the counter ticket should be closed. In addition, open tickets should be evaluated prior to the parts physical inventory since open tickets with parts dollars charged out affect the reconciliation between the parts PAD and the GL.

Retained Earnings

What happened to this balance during the year? The Controller should keep an accurate record of what is being recorded in this account throughout the year. This is an area where certain expenses and write-offs may be recorded but may go undetected if someone is not watching. Be certain to understand any changes in this account, especially at year-end.

Taxes

Are the tax tables correct? No one likes to pay taxes, especially more than necessary. Federal, state and local tax rate changes are typically effective at the beginning of the New Year. Check the Dealer Management System ("DMS") to be sure that sales, use tax, federal withholding tables, FICA, SUTA and FUTA rates and other taxes and fees have been updated for the upcoming year. Sometimes these changes are not automatically updated in the system by the DMS provider, so it's the dealership's responsibility to ensure the tax tables are up to date.

Personnel

Are we properly staffed for our business needs? The year is coming to a close and it's time to look at the return on personnel investment. Perhaps certain positions of luxury have accumulated in the dealership, yet they do not provide a good return on investment. Alternatively, perhaps a department has been understaffed and sales, customer experience, or CSI scores have been adversely affected? Year-end is a good time to evaluate how the operation is running as a whole and to determine if staffing changes should be made. Year-end is a time when individuals often re-evaluate their personal situations as well. Employee's may make New Year's resolutions and decide it's time for a career change. The dealership should take advantage of the new faces that have decided to enter the talent pool beginning in January. The pendulum swings both ways however, and the dealership should also be mindful of its own employees and communicate often with key talent to ensure they are not contemplating a career change as well. Invest in key employees, offer new incentives, promote from within, raise the bar, compensate fairly, and expect outstanding results.

In closing, the New Year is perfect a time to go on a diet, get in shape, get ready for a better year ahead. For dealerships, the New Year's resolutions start early. Trim the fat and clean up the financials NOW, and get ready or a happy, healthy and PROSPEROUS New Year.

Accounting for the Controller

Can you trust your controller not to steal from you? Can you trust that your controller will catch someone else if they're stealing from you? If you answered yes to both questions, congratulations! You are in a very exclusive group of dealers, one that will likely become more elite in years to come.

By Phil Villegas

Whether you're at the store from bell to bell or on the golf course most of the week, dealers have varying levels of trust with their controllers. Few controllers have earned unconditional trust, and rightly so.

Let's face it, no one in a dealership can cause more harm to the business than a bad controller. Unlike other key managers, whose positions are based on the performance of their respective departments, performance standards typically do not exist for accounting offices. And, if they do, they are extremely limited.

Just because everything appears to be running smoothly in the accounting office, that doesn't mean it is. Appearances can be deceiving. Ask anyone who's had a stroke or heart attack, or better still, a dealer who has been the victim of fraud. Most couldn't believe it. They felt like it could never happen to them.

The controller has the unique ability of disguising and prolonging their illicit or incompetent activities for months without raising any red flags. It's not difficult for a controller to either misappropriate company assets or simply fail to prevent others from doing so.

The latest publicized occurrence was in January 2012, where an ex-Controller of a Pennsylvania dealership was sentenced to 72 months in prison for embezzling more than $10 million from 2004 to 2011. The Defendant used her position to carry out wire transfers in large amounts from the dealerships' bank account to her personal bank accounts and altered the bank statements and general ledger when being audited by outside accounting firms.

Here are some of the most common frauds that have occurred at dealerships either by the controller or where the controller failed to catch a perpetrator:

- **Payment to fake vendor**
- **Overpayment to actual vendor, refund or credit misappropriated**
- **Payment to actual vendor for services not provided to the dealership**
- **Payment or wire for payoff of car loans or credit card**
- **Unauthorized use of company credit or fuel cards**
- **Cashing of customer refund checks in collusion with an outside person**
- **Refunds processed through credit card machines**
- **Replacing cash on service tickets with discounts or coupons**
- **Wires out of bank accounts**
- **Skimming or shorting deposits to the bank**
- **Ghost employee on payroll**
- **Collusion and overpayment of wages to actual employee**
- **Over-withholding of federal taxes and recovering funds through tax return refund**
- **Manipulating financials to benefit pay plans**

While this list is by no means all-inclusive, as many other methods of fraud exist, we wanted to emphasize the various avenues that are available for a dishonest employee. Fortunately the vast majority of employees and controllers are honest by nature. Very few set out to defraud a dealer from the onset of employment. However, studies have shown that most employees who commit fraud have been employed for more than five years and do not have any previous criminal record.

Most employees who commit fraud do so when the opportunity presents itself. They may find weaknesses in the system and think no one will notice the difference. These employees typically rationalize their behavior by the feeling that they are being under-compensated. They build such a strong belief of entitlement, however misplaced, that when they are caught, many have convinced themselves that they have done nothing wrong.

Associating a certain percentage of entitlement to the store's overall profitability can be particularly strong among controllers,

continued on page 6

continued from page 5

especially if they are feeling over-worked, under-paid, and especially under-appreciated. This sense of entitlement does not always translate into fraud, but it can become costly if a growing sense of apathy develops. A controller's lack of focus or concern will undoubtedly lead to decreases in profitability by both intentional and unintentional means.

While there is no simple litmus test to determine if a controller or other employee is committing fraud, there are several steps a dealer can take to minimize exposure.

- *Complete a background check on all new hires.*
- *The duty of handling and receiving cash should be segregated from the responsibility of recording cash on the dealership's books.*
- *All checks received should be endorsed for deposit immediately with the dealership endorsement stamp.*
- *Make sure all checks are signed by two individuals, one of which is independent of the accounting office.*
- *Have all bank statements and copies of cancelled checks mailed to the dealer's house for review.*
  - *-Review cancelled checks for unusual payees, endorsements or only having one signature.*
  - *-Review bank statements for unusual transactions, such as wires, ACHs, EFTs, deposit corrections, and other debits.*
  - *-Review and test reconciling items on bank reconciliations.*
- *Review credit card merchant account statements for unusual credit activity.*
- *Review master payroll registers periodically for unusual payees, withholding amounts, and/or total compensation. (Just signing the payroll is not enough of a control.)*
- *Implement an approved vendor list that includes wholesalers.*
- *Ensure that a purchase order (PO) system is used on all expenses.*
- *Be mindful of payments made out to the dealership's owner that are personal in nature and mailed to the dealership instead of the owner's home. These may go unrecorded and be substituted for cash in the deposit.*
- *Review the general journal on a monthly basis for possible write-offs or unusual reclassifications. Journal entries are a primary means by which fraud is covered-up and continued over extended periods of time.*
- *Make sure the controller and office employees take vacations that are long enough for other employees to complete the employees' core job functions.*
- *Adopt an open door/zero tolerance policy. Employees need to have a form of communicating unusual activity and should also know that any inappropriate activity will not be tolerated.*
- *Evaluate the behavior of dealership employees.*
- *Foster a culture of honesty within management and staff.*
- *Document losses and the reasons for the losses, while taking strong corrective actions.*

As you can see, internal auditing can be a full-time job. While many dealers take it upon themselves to complete all these steps on a periodic basis, many feel that their time and efforts are better served elsewhere and delegate these responsibilities to a trusted family member or an outside firm.

Every day as a dealer principal you are put in a position to weigh the risks and rewards of varying operational decisions. While internal audits are often viewed as an expenditure that a dealer can go without, that leaves us with only one thing to ask: "What will the cost be to not answering the questions at the beginning of this article honestly?"