Ideas to Improve Your Financials from NADA in New Orleans 2009

Jeffrey B. Forsberg, CPA PS

New Orleans was an interesting choice of venue for NADA in these unusual times because this town knows something about recovery. I am choosing my words carefully in the context of the economy, much in the same way that locals refer to Hurricane Katrina as "the Storm" in casual conversation there.

Although unbridled enthusiasm these days may be as hard to find as family entertainment on Bourbon Street, things will improve. It is important to remember that in every kind of economy, opportunities exist, and this is certainly true for the auto industry. Here are some ideas that may help.

An Idea to Increase Dealership Net Worth

The LIFO ("Last In, First Out") method for inventory has been, and should continue to be a valuable tax strategy to defer income tax. However, if your corporation has operating losses, particularly for "C" corporation with loss carryovers, LIFO benefits may not be available. Unhelpfully, banks effectively deduct 35% of your LIFO reserve balance from its add-back to tangible net worth, whether any LIFO tax is due or not!

If your operating results are not helped by current year LIFO adjustments, you might consider electing off LIFO and increase your equity position. The LIFO reserve is "recaptured," which increases dealership income in the year LIFO is terminated. This income could be offset by an operating loss. The following example illustrates the potential benefit:

	No Operating Losses	w/Operating Losses
LIFO Reserve	$1,000,000	$1,000,000
Operating Loss	0	-1,000,000
Subtotal	1,000,000	0
Income Tax (35%)	350,000	0
Equity Add-Back	$650,000	$1,000,000

In this simplified example, the losses absorb income from termination of LIFO. The real benefit is the additional $350,000 of net equity, without any check from the dealer! Even if no operating losses exist to absorb LIFO recapture, in full or part, income tax from LIFO recapture can be repaid over four years, interest-free.

Please consult your tax advisor to learn if any LIFO termination strategy makes sense for your dealership.

Grow your Financial Statements with Expense Control

At the time of this writing, banks are looking at your financial statements like never before. My recommendation is to do what it takes to "right-size" your dealership for profits by focusing on significant dealership expenses:

- **Personnel Cost:** Do you have the right mix and number of people? Dividing overall dealership gross profit by total number of all employees can help you assess that:

Franchise Group	Gross per Employee (per mo.)
Luxury	$10,302
Imports	$7,627
Domestic	$7,001
All Brands	$7,980

If your monthly gross profit per employee is not in line with averages above, target the various departments to learn where your focus belongs:

Franchise Group: Luxury	Gross per Employee (per mo.)
New	$15,479
Used	$13,442
Parts	$19,395
Service	$6,991

Franchise Group: Import	Gross per Employee (per mo.)
New	$10,289
Used	$11,658
Parts	$12,597
Service	$5,410

Franchise Group: Domestic	Gross per Employee (per mo.)
New	$10,555
Used	$11,492
Parts	$12,421
Service	$4,767

I recommend using the most recent three or six months of operations in your calculation in developing a monthly average. The results above were culled from 20 Group reporting for year 2008, courtesy of NCM Associates. Industry benchmarks®, not printed here, report even higher results among top tier performers –please call me if you're interested in these 2008 metrics.

A word of caution in using such statistics before you take action with head counts: Be sure your personnel summary data on the financial statements is accurate. Also, the counts should report "full time equivalents" for personnel. For example, if your financials report seven employees in the parts department and two individuals are half time, you have six full time employees. If your results fall below the averages above, personnel productivity may need improvement or it may be necessary to prune your fruit tree, so to speak, or both.

I also recommend that you cross-train your employees! If gives you operating flexibility and improves utilization of existing staff, reducing your personnel cost. Finally, pay plans should be reviewed (keep it simple and limit incentives to no more than 3 variables).

- **Insurance:** Often misunderstood, insurance is the cost of risk. Traditional insurance features low deductibles that effectively transfer most of that risk. Significantly, industry experts say you can save 50% of your annual premium if you retain more risk. Why? For every dollar you receive from an insurance company on a claim, you should expect to pay out as much as $2 in future premiums. In other words, you will always pay your own losses, and then some, except for catastrophic losses. Predictable losses with high frequency offer an especially good opportunity to make internal changes that allow more risk retention.

  The first step in lowering your insurance costs is getting control of your losses. Higher deductibles will likely drive down your overall cost of risk because policyholders become more proactive in reducing risks that give rise to the claims. There should be an attitudinal shift away from "don't worry, we have insurance coverage for that." Insurance should be used as a last resort, but industry experts say that too many dealers rely on costly "first dollar" policies. Retaining more risk confers both control and lower cost if changes are made to reduce risk hazards of the dealership.

- **Data Processing Expense ("DMS"):** A sign of changing times was the emergence of DealerTrack/Arkona. It expanded its floor space to rival ADP and R&R, the reliable titans of DMS vendors. More significantly, Arkona appeared to have better floor traffic.

  Clearly, dealers are seeking alternatives like never before, and cost-savings are the primary draw. Microsoft had presence, but I am maintaining my "hold" recommendation, as they likely won't be ready until 2010, if then.

  If you're considering a change, give yourself at least 6 months (12 months is better) to negotiate, plan and convert to a new system. Use a consultant in your negotiations for your DMS needs, such as The Paul Gillrie Institute to learn more about viable second-tier DMS options.

- **Flooring and Inventory Costs:** The cost of having excess new and used inventory, as well as the wrong mix, is both costly and risky in an environment of tight money and skittish banks.

  As I've written about before, software for the used vehicle department for purchase, mix and pricing decisions has never been better. The cost per month is nominal compared to the cost of making ill-informed decisions that arise from "gut instinct." NADA was flush with such tools, and I would start your research with vAuto and AAX first.

  Finally, if you haven't done so recently, please re-read your flooring agreement to ensure sold vehicles are paid within the time specified to steer clear of out-of-trust conditions.

Remember that it takes approximately $4,000,000* of annual sales to pay for every $5,000 of monthly expense, so cost controls can "cover" a lot of missing sales in this auto market.

** Net income on sales is assumed at 1.5%*

Estate Planning

This is the best time I can recall to do some estate planning. The basic estate plan is to transfer as much stock ownership for the greatest discount, and the earlier you do it the more you save. Whether by gift or sale, or a combination of both, your estate tax will be significantly reduced from transferring assets to your heirs or successors because of current dealership valuations and historically low interest rates. This economy offers both, offering a unique chance to maximize estate tax savings.

NADA in New Orleans, and the hardships found there, reminded everyone that decisions are rarely made easier by deferring them. Taking action that tunes-up your dealership today will position you to emerge stronger and more competitive tomorrow.