

MAY/JUNE 2010

# DEALER INSIGHTS



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Dealer Digest

# Drawing an effective budget

Knowing what to financially expect for your dealership in the short term — say, the next 12 months — is more important than ever. With sales down and store financing harder to come by, you need to maintain a tight grip on your finances. And while you can't predict your income and expenditures to the dollar, you can budget for them.

If you're like some dealers, you may live without a budget, putting all your emphasis on sales goals and projections. But setting your sights on sales alone is wearing blinders. You need to see 360 degrees. Realistic budgeting allows you to pay bills, fund your commitments and invest in new opportunities when the timing is right.

## Put it in writing

To help ensure that your budget is right for your dealership today, write a short description of your business and its market as they are now. Are vehicle sales hot, cold or lukewarm? What about service department activity? How is the local economy affecting customer buying habits? These are factors you likely know well, but giving your budget a context will help ensure that your budget is on target.

Your budget also should reflect your business plan and, thus, potential changes to your



market, customers and competition; changes you want to make at your dealership; and your goals for the year. It also should reflect any problems you're facing as well as any operational challenges, such as the meshing of two stores into one. So also write up a list of these key issues so you can factor them in as you draft your budget.

## Include the right elements

To paint a full financial picture, your budget must include realistic projections of all expenses and revenue. Expenses can be broken down into:

- ❑ Fixed costs, such as lease payments, utilities, financing, property taxes, insurance, and maintenance and repairs,
- ❑ Variable costs, such as employee pay and benefits (including overtime) and advertising, and
- ❑ Capital costs, such as for new diagnostic equipment.

Revenue will consist of new and used vehicle sales, service and repairs, finance and insurance and, if your dealership offers it, body work.

## Use history only as a guide

If you're drafting a budget for the first time, collect recent historical information on sales and costs — these could give you a starting point for projecting future sales and costs. Look at 20 Group averages and NADA benchmarks to determine areas of focus. Evaluate current economic conditions in your area to project variations in sales volumes, and then use your best estimate of the next 12 months' operations.

If you already work with a budget, compare last year's *actual results* with last year's *projections*. What you learn will help you to reassess your budget for the coming year and adjust line items accordingly. For example, let's say that last year you projected \$10 million in new car sales, but instead came in at \$7.5 million. If you don't expect the economy to change drastically from last year, you'll probably want to keep the coming year's projections closer to last year's actual results.

Bottom line? Base your forecasts on a combination of history and how effective you expect your future sales and cost-control efforts to be. Most important, don't over-project on the sales side. Take into account your sales plans and how your sales resources will be used, and use this to predict a monthly breakeven point for sales.

## Involve key people

Budgeting works best when you involve the employees who have financial responsibilities. Ask them to provide figures for the budget, such as sales forecasts, advertising cost estimates and parts purchasing projections. Not only does this potentially provide you with more accurate information, but it also helps ensure that the employees who have the most impact will buy into the plan.

Compare their estimates against your own, and adjust as appropriate. These employees may have noted trends you're unaware of that could affect sales or expenses. At the same time, they may not yet be aware of strategic decisions that could affect the dealership's finances. So balance those factors to determine the most realistic numbers.

## Get some help

The accounting software you already own likely has budgeting capabilities. If not, buying new

## Budget watching

A budget is only as good as it reflects reality, which means it needs to be reviewed and updated regularly. If your income and expenses aren't projected as accurately as possible, your budget will be an ineffective map of where you're going.

So, as your budget year progresses, compare your store's actual income and expenses to its budgeted projections. Do this on a monthly basis and reforecast your projections accordingly. Your financial advisor can help you with budget analysis and reforecasting.

software to fit your needs can be a relatively modest investment that usually pays for itself in time and accuracy. Some software can perform "what-if" analyses, for example, projecting results under different economic conditions — or with the closure of a competitor store.

A financial advisor, with experience in the auto dealership niche, also can assist you in developing a solid budget. He or she can provide additional insight that a software program can't.

## Wrap it up

Once you've drawn your budget, add an executive summary. It can serve as a "take-away" for employees and be useful when applying for a loan. You may want to attach supporting information to your budget, such as sales-results analysis, historical costs, and tables and graphs depicting market and cost trends. Budget planning can help you manage your business's money more effectively, improve decision-making, avoid cash shortages and identify challenges before they become crises. ■

# LIFO lessons learned

Many auto dealerships use the last-in, first-out (LIFO) method of valuing their inventories of new and used vehicles, parts, and accessories. Typically, this costing method can save some dealerships a pile of greenbacks on their tax bills. But in some situations, LIFO can be costly.

## Facing an unusual tax year

2009 was not a typical year. New and used vehicle sales were sluggish in the first two quarters, and many dealerships cut back on inventories. Later, with the Cash for Clunkers program starting in late July, auto sales heated up and supplies diminished.

Thus, some dealers who used LIFO to value their new and used vehicle invento-

ries are facing an unwelcome surprise: much larger 2009 tax bills — in some cases as much as \$100,000 more than in 2008 — if they ended the year with these inventories far below their normal levels.

## Understanding LIFO's quirks

To avoid such a tax hit, make sure you understand when you should use LIFO and when you should forgo it. LIFO, which is most beneficial in inflationary times, treats the vehicles purchased latest — and usually at a higher cost than older inventory — as selling first. Higher purchase costs yield less taxable income and lower taxes.

Although most dealers experienced inflation last year, a large decrease in inventory resulted in a decrease in LIFO reserves and a large increase to income. Your tax advisor can suggest a strategy for avoiding this scenario in the future. One might be that you stock up on year-end inventory or revise your LIFO pools — perhaps combining cars and light trucks into a single pool.

## Other inventory methods

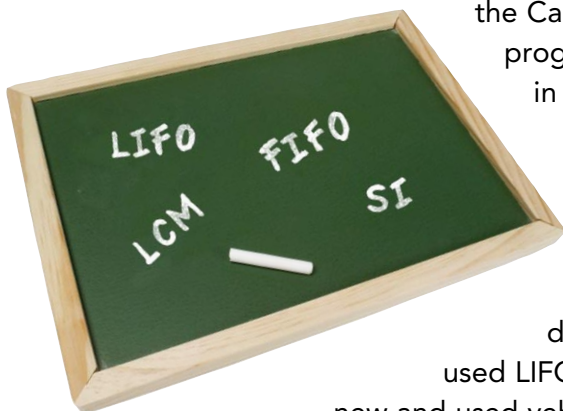
You have a great deal of discretion in what accounting method you can use for inventory, as long as you clearly reflect your income. In addition to LIFO, the most common inventory accounting methods are:

### Specific identification (SI) method.

Under this method each inventory item is individually traced and identified. Costs charged to cost of sales are tied to the actual vehicle sold. SI is generally used to value all vehicles in day-to-day operations because vehicles can be separately identified by their VINs. For tax purposes, you can then apply lower of cost or market (LCM) valuation (see below), which allows you to more accurately know your actual monthly profit. Also, SI is used to account for certain items for tax purposes due to rarity, such as repossessions.

### Lower of cost or market (LCM) method.

This method is typically used to value used cars. To apply the method, a valuation guide, such as *Kelley Blue Book* or *Black Book*, is used at year end. Vehicles are valued on an individual basis using 100% of the average wholesale valuation quote.



If you're like most dealers, you likely value your inventories in monthly statements at factory replacement cost. But at year end, be sure to use a costing method that will reduce your income tax bill. Once you use one costing method, you'll need to file an application with the IRS to change to another method.

### **Making a wise decision**

Choosing which inventory method to use for your inventory pools should be done in tandem with a tax advisor who has ample

experience working with auto dealerships. Your advisor can generate tax projections using more than one costing method and determine which method or methods are best for your business. ■



## **Dealerships in distress**

Out-of-court workouts are among their options

U.S. business bankruptcies rose 38% in 2009, according to Automated Access to Court Electronic Records, a database of U.S. bankruptcy statistics used by attorneys and lenders. While the worst ramifications of the recession may be over, many dealerships continue to fight for their survival in a frail economy.

Lackluster sales and an inability to refinance heavy debt obligations will cause some of them to lose the battle — and perhaps the war. How do dealerships know if they're on the road to bankruptcy? And, if they are, what are their options?

### **Telltale signs**

There are telltale signs that a dealership may be headed toward bankruptcy. The most obvious is that inventory isn't moving, even with manufacturer rebates, discounts or other incentives. And this is having a big impact on finances: For example, Bite the Bullet Auto

Sales has skipped a floor plan payment, filed its financial statements late, and been dodging calls from its lender. Its showroom is showing its age, but the owners can't afford to update.

Moreover, there isn't enough cash to cover utility bills or payroll. They've begun handing out pink slips. And, seeing the writing on the wall, employees are voluntarily jumping the fence for greener pastures.

For Bite the Bullet and dealerships like it, it's time to assemble a team of professionals. Together, an attorney and a financial expert can help navigate the tough road ahead. In addition to selling the business, there are several relief methods available to distressed dealerships.

### **Out-of-court workouts**

Formal bankruptcy proceedings are costly and regimented, so distressed dealerships

often try out-of-court turnarounds, known as “workouts,” before filing for bankruptcy. Communication with creditors is imperative to a successful workout. Their buy-in on the reorganization plan reduces the likelihood of an involuntary bankruptcy.

Workouts start by taking charge of disbursements with daily cash budgets. A dealer may save cash by renegotiating debt terms, cutting service hours or combining administrative positions, for example.

## **Chapter 7 bankruptcy (liquidation) is the method of last resort.**

Once the immediate bleeding stops, management can focus on mid- and long-term improvements. A dealer might, say, brainstorm about marketing strategies, upgrade accounting systems for more timely information, or retrain employees on sales tactics and improved customer service. A financial professional who specializes in bankruptcy can help devise and implement a realistic plan.

## **Chapter 11 bankruptcy (reorganization)**

Here the dealership retains its assets as a “debtor in possession” and remains open. Meanwhile, the owners work with creditors and the bankruptcy court to come up with a turnaround plan.

Specifically, the court appoints a turnaround specialist to look over the dealership’s shoulder and help implement the reorganization plan, which creditors have the right to vote on. The good news is that a court-imposed

reorganization protects the dealership’s assets from creditors until the plan is devised and approved. Under Chapter 11 filings, the dealership has a right to renegotiate existing debts and contracts (such as leases), including union contracts.

## **Chapter 7 bankruptcy (liquidation)**

This is the method of last resort. Two types of liquidation exist: voluntary and involuntary. While most commercial bankruptcies are voluntary, creditors have the right under both Chapters 7 and 11 to initiate an involuntary bankruptcy filing.

In Chapter 7 liquidations, a court-appointed trustee sells the dealership’s assets and distributes the funds to creditors in a specific order set forth in the bankruptcy code. Businesses that file under Chapter 7 are closing their doors, and usually owners are left with nothing.

## **Survivor advantage**

As the economy slowly recovers, some additional dealership casualties are probably yet to come. But those dealerships that survive — with leaner expenses and perhaps a new business plan — are likely to be in better shape than they were before the recession. ■



# DEALER DIGEST

## Do early distributions hurt?

Early distributions from qualified retirement plans — such as 401(k)s and SIMPLEs — and IRAs can have some negative tax consequences that you and your employees (if you sponsor a retirement plan) should be aware of:



- ❑ Payments from these plans before age 59½ are generally considered early distributions, and
- ❑ Early distributions are usually subject to a 10% penalty (on top of any ordinary income tax due).

Distributions rolled over to another qualified retirement plan or an IRA aren't subject to the additional 10% penalty as long as the rollover is completed within 60 days of the distribution. For more, contact your tax advisor. ■

## Moving used-car inventory

Managing used-vehicle inventory can be challenging, participants at a recent best practices meeting of the newly formed Pre-Owned Automobile Dealers Alliance recently noted. Here are some of the attendees' suggestions:

- ❑ Use inventory-management software to assess the retail and wholesale markets in your area and make inventory stocking decisions.
- ❑ Let human judgment supplement the software in your decision-making.

- ❑ Keep the original pricing on your used vehicles after price reductions to entice customers.
- ❑ Keep an eye out for trade-ins, which tend to sell fastest.

Also, use a marketing message that hits customers where it counts. The message should reverberate, "This vehicle is a good value." ■

## Repos up, leasing down

Total pre-owned vehicle repossessions reached a record high of 1.9 million units last year, according to the *2009 Used Car Market Report* by Manheim Consulting. And the rise in repossessions is not because of bad loans, but because of "good loans that went bad," according to Manheim's chief economist.

Also last year, new lease originations fell to 1.1 million units, according to the report — the lowest number since leasing first began in the 1980s. The top year for leasing was 1999, with 3.7 million deliveries. ■

## Truck donations to Haiti

U.S. auto dealers have donated at least 100 trucks to relief efforts in Haiti, according to the National Automobile Dealers Association (NADA). And efforts to donate another 100 trucks were underway as of this writing. The donated vehicles are mostly new and used light pickup and cargo trucks capable of traversing rough terrain to deliver critical supplies. For more information about these tax-deductible donations, e-mail [trucks@clintonfoundation.org](mailto:trucks@clintonfoundation.org). ■