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Proven expertise in helping dealerships build success

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Paul A. Cerrone, CPA, MST, CVA, managing partner, is an ADP Certified CPA with more than 30 years of experience in serving automotive dealers. He specializes in helping clients minimize taxes, maximize profits and achieve their business and personal financial goals. Paul can be reached at 508-845-7600 or pcerrone@cgscpas.com.

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AUTOFOCUS

SPRING 2016

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Should you add a BDC to your operation?

Where to look when you need a loan

Buyer beware
Realize the importance of an environmental site assessment

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Internal controls are vital in guarding against fraud

Many dealerships are riding the wave of an improved economy and the booming automobile industry, which experienced a record sales year in 2015. In the midst of these positive developments, however, there's one potential risk dealerships should be aware of: internal fraud.

Traditionally, many stores have been susceptible to fraud due to their relatively small financial and accounting staffs, the large sums of cash kept on hand, a high volume of transactions, and their highly marketable inventories. Growing sales and revenue can present even more opportunities for dishonest employees to embezzle funds.

MAKING FINANCIAL INFORMATION TIMELY

One of the best ways to mitigate fraud and embezzlement is to implement a system of strong internal controls. For most dealerships, this starts with making sure that accurate financial information is generated on a timely basis.

All dealership transactions — including vehicle sales, invoice payments, repair orders and cash receipts — should be posted daily by the accounting department. This will make it easier to detect fraudulent activity early and take steps to stop fraud in its tracks before too much damage is done.

SEGREGATING DUTIES

Another crucial internal control is segregating financial and accounting duties among multiple employees. In other words, the same employee shouldn't make deposits and also reconcile the bank account, or both collect and deposit cash. Without this control, a financial employee could steal cash by voiding vehicle service orders and falsifying deposit slips, for example.

If your accounting staff isn't large enough to segregate financial tasks, have your CPA firm complete some of these tasks, such as account reconciliation. Also make sure the owner is keeping a close eye on finances by periodically spot-checking the bank statements and other financial records. Even better, send bank statements to the owner's home instead of to the dealership.

INSTALLING OTHER INTERNAL CONTROLS

Here are a few more internal controls that can help your dealership mitigate fraud and embezzlement:

Keep an eye on electronic funds transfers (EFTs). Thieves are increasingly using wire transfers and ACH transactions to commit fraud, since EFTs can make it easier to hide their tracks. So review these transactions regularly and make sure all EFTs are supported by an invoice or other supporting vendor documentation.

Review adjusting journal entries. These are used by accounting employees to correct original posts.

Buyer beware

Realize the importance of an environmental site assessment

As they sell and repair vehicles, automobile dealerships may release hazardous materials into the surrounding soil, such as gasoline, solvents, used motor oil and antifreeze. This makes environmental liability one of the biggest risks dealerships face.

Thus, it's critical to ensure that you're properly disposing of hazardous materials to reduce your risk exposure. But that's not all: If you're considering buying or leasing another dealership, make sure you won't be held liable for environmental contamination that may *already* exist on the property.

WHAT'S YOUR LIABILITY?

That's right: You could be liable for the cost to clean up environmental waste that was improperly disposed of by a previous site owner. This is according to two separate federal statutes: the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and the Resource Conservation and Recovery Act (RCRA).

The best protection from such liability is to have an environmental site assessment of the property as part of your due diligence during the acquisition process. This is especially important if the dealership was operating before current regulations governing the use and disposal of hazardous materials went into effect in the late 1980s.

The most common type of assessment for auto dealerships is a Phase I Environmental Site Assessment (ESA). The assessment should be performed by a trained environmental professional, and follow ASTM International standards and "all-important inquiries" rules. The assessment consists of:

- A review of the property's records,
- A physical site inspection, and
- Interviews with current property owners and occupants, neighbors and local government officials.

WHAT IF AN ENVIRONMENTAL PROBLEM IS FOUND?

If your Phase I ESA identifies "recognized environmental conditions" (RECs), you may need to proceed to Phase II ESA. This will include soil and groundwater sampling and a laboratory analysis to confirm or deny the presence of hazardous materials and contamination on the property.

A Phase II ESA could result in remedial actions required to clean up the property and an estimate of the potential environmental cleanup costs. This information might prove helpful in deciding whether or not to proceed with the dealership acquisition. Other options: You could require the current owner to clean up the property prior to the sale, or factor the potential cost of cleanup into your offer price.

IS AN ESA WORTH IT?

The cost of a Phase I ESA often can range between \$3,000 and \$4,000. When you consider that hazardous waste cleanup can cost tens of thousands of dollars or more, this could turn out to be a very worthwhile investment.

Specifically, you can inquire about *term loans*. These are amortizing fixed-rate loans typically used to finance the purchase of fixed assets such as furniture, fixtures and equipment. They also are sometimes used to finance smaller reimaging projects. The loan's term should be structured to match the depreciable or useful life of the asset being purchased.

> *If a bank loan doesn't look inviting or doable, there are other financing options to explore.*

You also might be eligible for a *commercial mortgage* or *construction loan*. These are generally used to finance the construction or purchase of new or existing buildings (including a new showroom) or the purchase of commercial real estate. They also are used to finance larger, significant reimaging or remodeling projects, and are typically amortized for a period of up to 15 or 20 years.

EXPLORE OTHER SOURCES

If a bank loan doesn't look inviting or doable, there are other financing options to explore. The Small Business Administration (SBA) offers several types of loans designed for dealerships that meet the SBA's definition of a small business. For example, *SBA 504* loans can be used to finance the purchase of equipment, buildings and commercial real estate. The SBA guarantees a portion of the loan, which gives banks more lending flexibility.

You also could explore *manufacturer financing,* which typically offers certain advantages over bank financing. Bank loans usually include strict conditions, such as minimum monthly payment amounts and covenants that require borrowers to meet certain performance levels and that restrict their business activities. Banks also typically require borrowers to submit detailed financial information along with their loan request, and they might require owners to pledge personal assets as collateral — including a personal residence. Manufacturers usually don't demand any of these things.

For this reason, many dealerships consider automobile manufacturers' financing arms for loans to finance an expansion. In addition to providing consumer credit, manufacturers' financing arms, such as Ford Credit, GM Financial and BMW Financial Services, can provide business loans to help dealers finance their growth and expansion plans.

Another plus: Manufacturers already have a relationship with their franchises and know their financial conditions. Thus, dealerships may have to jump through fewer hoops to obtain financing than if they were trying to obtain a bank loan. On the down side, financing through the manufacturer will typically involve a higher finance charge or interest rate.

SHOP AROUND

An established dealership has some good options these days for securing a loan. Shop around to make sure you are getting a competitive rate and attractive terms.

The general manager or owner should approve and sign off on all adjusting journal entries.

Monitor parts inventory. Conduct periodic random counts of vehicle parts throughout the year, rather than just conducting a year-end parts inventory. Also consider setting up cameras in your parts storage area to make it harder for employees to steal items they can then turn around and sell or use themselves.

> *Once you have implemented internal controls, it's important that you test them periodically.*

Create a formal "approved vendor" list. All dealership vendors, from your paintless dent removal specialist to your wholesaler, should be documented on an official vendor list. Then check all disbursements (both paper checks and EFTs) against this list.

Watch out for payroll fraud. Segregate payroll duties (such as preparation, authorization and disbursement) among multiple employees, and have the controller or general manager review final payroll before it's disbursed. Also require the payroll clerk to take an annual vacation in which he or she is gone for at least one full payroll cycle.

Kickbacks are another fraud risk that dealerships should be aware of. Here, a used car manager might buy or sell vehicles at a price that's unfavorable to the dealership and then receive a kickback from the wholesaler. In one instance, a manager was selling used cars wholesale at a loss to the dealership because he was a part owner of the wholesaler!

TESTING YOUR CONTROLS

Once you have implemented internal controls, it's important that you test them periodically to make sure they're working as intended. For example, when reviewing bank statements, trace a few transactions all the way back to their origin, and ask the bank for electronic debit and credit memos. If you own multiple stores, have controllers from different locations test the internal controls of one another's stores.

Also consider establishing a fraud hotline that employees can use to anonymously report suspicions of fraud. Employee tips are one of the most common ways that fraud schemes are uncovered.

DO IT NOW

Don't wait until your dealership is victimized to take action. Implement strong internal controls now to help protect against fraud and embezzlement.

50 WAYS TO STEAL FROM A DEALERSHIP

In its *Dealership Internal Control Manual*, the National Independent Automobile Dealers Association has published a list of what it calls "50 ways to steal from the dealership." Among these 50 dealership embezzlement schemes are:

- Stealing body shop and service department supplies to use for off-site repairs or sell for cash,
- Inserting fictitious journal entries into dealership records,
- Granting business to favored suppliers in exchange for kickbacks,
- Not recording repair orders or other sales and pocketing the cash, and
- Paying fake (self-prepared) invoices with dealership funds and pocketing the money.

Implementing sound internal controls is the best protection against these and other fraud schemes. Ask your CPA for help developing controls, if you need assistance.

Should you add a BDC to your operation?

Business Development Centers (BDCs) aren't new. They've been used for years as a tool for managing incoming leads. But there's renewed interest in BDCs today as a way to better handle the high volume of leads coming in from new technology sources like PCs, tablets and smartphones.

So how do you determine whether your dealership should add a BDC? Consider these factors:

BDC USES VARY

The specific role of the BDC varies by dealership. In general, BDC employees (often referred to as *business development representatives* or *BDRs*) are responsible for fielding all incoming leads, regardless of their source. BDRs also are usually responsible for qualifying those leads, gathering pertinent information from prospects, and setting appointments with salespeople.

A big benefit of creating and staffing a BDC is that specially trained employees will handle the all-important first contact with prospects and schedule sales appointments. But different skills are required for different tasks: for example, responding to leads vs. guiding customers through the sales process. Having a BDC is meant to ensure that the best-qualified employees perform each of these key functions.

BDRs aren't customer service representatives *per se*. The latter generally handles customer questions and complaints. Conversely, BDRs are specially trained in persuading prospects to make an appointment to visit the dealership and meet with a sales representative.

They do this by conveying a sense of trust, excitement, comfort or urgency with potential customers that validates their selection of the dealership. This recognizes that cars are seldom sold over the phone or the Internet. Instead, the phone or Internet is the instrument used to get a prospect

into the dealership, where a trained salesperson can take the reins.

PRICING ALTERNATIVES EXIST

Of course, there's a cost to building and staffing a BDC — mainly the hiring and training of good BDRs. So dealerships must weigh this cost against the potential benefits that can be derived from a BDC. In general, BDCs tend to be more cost-effective for midsize and larger dealerships than they are for smaller dealerships.

Here's a cost-saving alternative if you don't want to completely jump into the pond: Outsource BDC functions to a service provider that specializes in handling leads and setting up dealership appointments. This is often a more cost-efficient option for smaller dealerships than creating and running their own in-house BDC.

Another option is to run a "hybrid BDC." With this model, Internet leads are usually segregated from phone and text leads due to the unique nature of online sales. Internet BDRs keep their leads and try to close the sales, while salespeople receive phone and text leads themselves and are responsible for setting their own appointments.

ESTABLISHING GOALS IS CRUCIAL

Once you decide to create a BDC, create processes for managing the leads that come into your dealership from a variety of sources. Determine specifically what you hope your BDC will accomplish for your dealership, and then frame this in the form of measurable goals. For example, one of your objectives might be to bump up the percentage of incoming leads that are converted into sales appointments from 40% to 60%.

Another essential step is to hire the right BDRs. They don't necessarily need to have auto dealership experience — you can train them. It's more important that these representatives have strong communication and persuasive skills, both verbal and written.

You also should properly incentivize your BDRs. Compensation for BDRs can be on a straight-salary basis or salary plus commission. If you only pay a salary, periodically hold contests to give BDRs additional financial incentives to set more appointments.

Sometimes, friction can develop between BDRs and salespeople if one feels the other is encroaching on his or her territory. So it's important to carefully define the responsibilities of BDRs and your sales team, and make sure the lines of communication between them remain open.

Determine what you hope your BDC will accomplish for your dealership, and then frame this in the form of measurable goals.

IS IT WORTH IT?

Launching a BDC represents a major change in the day-to-day operations of your auto dealership. Your CPA can perform a cost analysis to make sure that the benefits are worth the expense, and that you're choosing an appropriate option.

Where to look when you need a loan

With interest rates poised to rise, it's probably a good time to apply for a loan if you're planning to invest big dollars into your dealership and need to borrow cash. Dealership owners have a number of borrowing options.

TURN TO YOUR BANK

Their bank is the first place many dealerships look for growth financing. Commercial banks offer a range of loans that can help dealerships fund their growth plans. Or you can turn to the commercial lending department at a bank in your community.

Banks typically offer their own types of equipment loans, which provide money to businesses for machinery, tools and office equipment, such as computers and copy machines. Equipment loans are often easier to obtain, because the equipment serves as collateral for the loan.