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ARE YOU GETTING THE MOST OUT OF YOUR SERVICE CONTRACT COMPANY?

Because dealers have made sizeable profits over the last several years, many have ignored potential profitability opportunities related to their service contract position. Dealers generally have their own position on the profits of the service contracts they sell. The types of these positions vary based on their dealership(s) size, age of the dealer and economic goals of the dealer. There are basically 3 types of service contract companies that dealers might have a position in:

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Woodward and Associates, Inc.

1. RETRO (retrospective rating program) money

2. CFC (controlled foreign corporation)/NCFC (noncontrolled foreign corporation)

3. DOWC (dealer-owned warranty company)

What are the basics of these types of programs?

A RETRO is where a dealer sells someone else's service contract (i.e., it is common for Ford dealerships to sell Ford Motor Company service contracts) and then the dealer participates in the profit, like a commission, for selling those contracts. Typically, there is no risk, and the dealer is limited on the amount of profit they can make. This income is usually taxed as ordinary income.

In a CFC or NCFC, dealers, through an administrator, create an offshore reinsurance company that sells the dealer's own service contracts. The difference between a CFC and NCFC is dependent on the dealer's size. Generally, large dealer groups cannot have a CFC. This income is typically taxed as capital gains.

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WINTER 2024

PARTS INVENTORY MANAGEMENT   PAY PLAN DESIGN

A DOWC has many of the benefits of a CFC or NCFC but is located onshore and provides an opportunity to invest the unearned premiums. This company is taxed as a C corporation in the state where the dealer is located. The income is typically taxed as capital gains but could also include some corporate income taxes, as well.

What should dealers be looking for?

1. Training. Regardless of the vendor or program you select, it is irrelevant if the vendor you selected does not physically come to your dealership to train your F&I (Finance and Insurance) employees. With this training, you should be able to review performance on your monthly dealership financial statement by looking at the profit per service contract and your penetration (service contracts sold compared to total retail units sold).

2. Administrative Fee. How much administrative fees you pay per service contract (and any additional costs you might have) to a third party? Many providers, whether intentionally or through ignorance, don't provide an accurate breakdown of their administrative fee. Many different types of names for fees or charges can make it difficult to provide an accurate number. If your representative cannot quickly show you these fees, you should investigate for yourself to determine what the actual fee is.

3. Loss Ratios. I would suspect many dealers have not recently, or ever, requested their administrator to show them their loss ratios. Recently, we have looked at a few for clients and have found that their monthly losses have increased significantly compared to a few years ago. These losses are usually generated from selling more and older used vehicles, along with a rise on the price of parts and labor. Some dealers might be required to invest their own money in their reinsurance company to have enough liquidity to cover their loss ratio reserves as required by being regulated as an insurance company.

An AutoCPAGroup member could be a valuable resource to help analyze your position and even help compare the various vendors that exist in this area. ✍

PARTS INVENTORY MANAGEMENT

Carl Jensen
Larson & Company, PC

As the end of the year approaches, dealerships review checklist items to make sure they take advantage of the best tax strategies. Typical checklists include such items as pass-through entity state tax payments, used-vehicle write downs, etc. In addition, I would recommend that an annual parts inventory be included on the year-end checklist.

A NADA white paper, "Managing Your Parts Inventory for High Performance," by parts consultant Kevin Ellington, notes several metrics essential to maintaining an effective and efficient parts department. Several of these address inventory performance metrics which include days' supply, level of service, obsolescence, etc. The white paper also addresses the need to manage lost sales as well as level of service. These metrics are important tools to help maintain a proper inventory makeup. Mr. Ellington also addresses asset management and how to know the true value of your inventory using bin checks, reconciliations and a physical inventory. All these tools assist management in overseeing the parts or, as we say, "the dollar bills sitting on the shelves."

Many dealers state that the parts department fulfills the demand for an annual parts inventory by performing perpetual inventory counts throughout the year. Some dealers also perform a soft reconciliation at month's end for the parts inventory. Perpetual inventory counts, or systematic bin checks throughout the year, coupled with monthly reconciliations, are key tools in maintaining the parts inventory. The perpetual counts assist in keeping order, cleanliness and accountability within the parts department. These processes keep the parts department running at optimal efficiency.

If performed correctly, a yearly parts inventory has the ability to give the stakeholders of the parts department—and the dealership as a whole—a clear understanding of the status of the parts inventory. We have seen, over the years, the most efficient way to perform a parts inventory is as follows:

✔ Count teams of no fewer than two (at least one person with parts department experience)

✔ Count sheets without on-hand quantities

✔ Count from the bin to the count sheets, top to bottom, left to right

✔ Verifications done via the plus/minus report

✔ Parts managers do not participate in count, other than to assist (and bring the food)

Most importantly, the year-end inventory should be a joint operation between the parts and accounting departments to make sure there is a clean cut-off to ensure an understanding of what is and is not included in the inventory, and what are reconciling items. If there is no clean cut-off, there is no way to know the true value of the inventory. The inventory does not need to be performed at the end of year; however, it is recommended to be performed as close to a month end as possible, to assist in a proper cut-off.

All the previously mentioned procedures (perpetual inventory counts, bin checks, monthly reconciliations), coupled with a well-performed inventory coupled with a clean cut-off, will provide the best understanding of where a parts inventory stands.

If you would like to discuss this further, please contact a member of the AutoCPAGroup. ✍

PAY PLAN DESIGN

Wayne Zimmerman, CPA
Pomares and Company, LLP

We are regularly asked about pay plan design, and while we are not in a position to offer advice specific to a client, we can share some common design considerations based on ideas we see in the industry. Pay plan design requires an intimate knowledge of the dealership team and can be a stressful and unrelenting task that wears out the designer. The design is a balancing act that must satisfy both the goals of the dealership while also satisfying the dealership staff.

Too many dealerships fail to take pay plan design seriously. Some common problems we see in pay plan design are old pay plans carried forward without any consideration of impact on the dealership in its current state, new pay plans haphazardly designed without sufficient consideration of their impact, overly complicated pay plans and pay plans that do not sufficiently award superior production.

With that said, some of the better designed plans share the following features:

Simplicity—I have seen pay plans so complicated that it would take a mathematics professor to understand them. How can an employee

please turn the page ☞

manage his or her production if he or she cannot understand the compensation based on that production? A general design rule is to keep it simple. An individual should be able to have a strong idea of their pay plan long before the compensation is detailed and ultimately paid.

Specificity—A pay plan should be specific in its communication. Interpretive components can lead to disputes and disgruntlement. Components of the pay plan need to be clear and concise—with no room for interpretive consideration.

Consistency—A play plan should be as consistent as possible based on the dealership status. If it is constantly changing, it will have limited effectiveness because the dealership team will have no confidence in its application. This is not to say pay plans shouldn't change periodically; rather, a change should result from a specific event that is communicated to and understood by the dealership staff.

Design to Meet Specific Goals—Pay plans should have components in their design that are focused on specific dealership goals. If there are things the dealership wants or needs to improve, a component of the pay plan should be specifically based on those wants or needs. Pay incentive is a powerful tool to reach even the most specific and difficult dealership goals.

Reward for the Producers—Pay plans should sufficiently reward the true producers. Too many pay plans fail to adequately reward superior production. If there is not enough of a gap between the compensation for someone performing in a superior manner from one performing in an average manner, the superior performer could, and typically will, take their effort somewhere else. Getting someone who performs routinely at a high level takes a lot of effort, so why let that individual go because they are treated as though their effort is seen as not more than average?

No pay plan is perfect. There are always going to be components that may be more skewed to the dealer and some that may be more skewed to the employee. But with careful and precise consideration to the components of a pay plan, a balance agreeable to all parties can be realized, resulting in effective results for all involved.

For assistance in setting up design and application of an effective pay plan, consult your AutoCPAGroup member. ✍

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