

FVCPAs AUTO FOCUS

Summer 2011



Japan earthquake aftershock
Weathering inventory challenges

Can you expense your repairs?
Your answer might be at odds with the IRS

How to create an honest budget

**Get gassed up
to sell green cars**

 **Frankeberger Vausher + Company**
Certified Public Accountants

15325 Fairfield Ranch Road, Suite 180
Chino Hills, California 91709-8834

Phone: 909-597-1100
Fax: 909-597-1105
www.FVCPAs.com

Japan earthquake aftershock

Weathering inventory challenges

Both import and domestic dealerships are suffering an inventory crunch following Japan's March 11 earthquake, tsunami and subsequent nuclear crisis. This disaster highlights the downside to just-in-time (JIT) inventory practices. Here are some proactive ways to combat a summertime drought in the automotive supply chain.

JIT from a dealer's perspective

Ironically, Japan pioneered JIT manufacturing practices. The underlying idea is that manufacturers can minimize holding costs by keeping ultra-low quantities of inventory on hand. JIT inventory programs require speedy response, information sharing, and flexibility along the supply chain to respond to customer demand.

Buffer inventory levels are another key — but underappreciated — ingredient to effective JIT programs. Buffers minimize unexpected disruptions from, say, union strikes or natural disasters.

JIT manufacturing practices have spilled over to retailers, too. Lean dealerships have been taught to order as few parts, accessories, and used and new vehicles as possible to minimize pilferage, insurance expense, storage space, obsolescence and floor plan interest. The trick is to maintain sufficient inventory levels to spark interest among shoppers and prevent service delays.

Trickledown crisis

The crisis in Japan has thrown a wrench into the auto industry's efficient operating strategies. Thousands of parts go into every new vehicle, and many components are manufactured in Japan. If one part is missing — be it a brake

rotor, microprocessor or shock absorber — the entire production line halts.

The recovery has been slow and the full effect of the crisis remains uncertain. Automakers can't simply switch suppliers, and Japan tends to specialize in high-end, technical components that are subject to intense safety requirements.

Honda and Toyota were among those hardest hit by the production slowdowns and stoppages. Both reported a 30% decline in new vehicle inventory from March 1 to May 1, according to *Automotive News*. Just two weeks after the earthquake, Toyota began to ration more than 200 replacement parts, fearing dealers might start hoarding.



And the crisis has spread beyond Japanese automakers. For example, Chrysler and Ford have restricted vehicle orders in certain paint colors produced at Japanese factories. To conserve scarce parts, GM temporarily closed a Louisiana plant that makes the Chevy Colorado, a less popular product line.

Survival of the fittest

So, what's a dealer to do? First, stop discounting high demand, low supply models. If the demand for a vehicle exceeds your supply, you'll have the upper hand in sales negotiations. This is currently the case for hybrid cars, such as the Toyota Prius. The law of supply and demand means buyers may have to pay full sticker price this summer — a rarity in auto retailing.

Another strategy is to build up used car inventory, if you can't get your hands on new vehicles. Doing so will give you something to sell until your franchisor gets back on its feet. Moreover, price-conscious shoppers are likely to turn to used vehicles if the prices of new economy cars skyrocket due to inventory shortages.

Replacement parts remain a wild card. New vehicle inventory has been given the lion's share of attention, but many dealers fear summertime parts crunches could paralyze their service departments. To keep ahead of the game, review your current parts supply now, and identify and remedy potential weak spots.

If franchisors can't give you what you need, work with your Dealer 20 group, independent service shops, and other business contacts on ways to share inventory and refer customers. Consider using nonmanufacturer (generic) parts as an alternative to OEM parts, if necessary.

Lessons learned

Japan's crisis has taught the auto industry a valuable lesson: Reducing inventory has its limits; lean practices must include buffers and require ongoing evaluation. If you were one of the unlucky dealers who skimmed on inventory this winter, don't give up hope. Savvy pricing, networking and proactive ordering can pull you through the summer's temporary drought. ■

Can you expense your repairs?

Your answer might be at odds with the IRS

When you fix your fixed assets — that is, repair them — how should you account for them? Most business owners prefer to *expense* repairs and maintenance in the current period, because it saves taxes and simplifies the accounting.

But the IRS might argue that your simple fix qualifies as a separate, depreciable fixed asset and may launch an audit of your tax return. Here's some guidance to help you make

educated choices when accounting for repairs and maintenance spending.

Expensing is simple

The easiest way to account for repairs or maintenance on depreciable property — such as a service lift, garage door or showroom flooring — is to expense it right away. In simple accounting terms, you debit repairs and maintenance expense and credit cash (or a loan account if the repair is financed).

When you expense a repair or maintenance item, the accounting treatment lowers your profit in the current accounting period. While expensing a repair makes your dealership appear less profitable to lenders and any investors, the upside is that it lowers your taxable income and, therefore, your tax bill.

IRC Sec. 162 allows dealerships to deduct routine repairs and maintenance expenses that keep their business property in good, efficient operating condition.

The IRS backs capital improvement

The IRS has another, more complicated plan for repairs and maintenance spending: You must capitalize them under Internal Revenue Code (IRC) Section 263(a). The IRS recently added treatment of repairs and maintenance spending to its list of Tier 1 issues — the items that garner the most attention during an audit.

Capitalized costs increase fixed assets on your balance sheet. IRS rules allow you to deduct a portion of the capitalized cost over the improvement's useful life. This deduction is called "depreciation expense."

Ultimately, the sum of the depreciation deductions will be the same as if you immediately subtracted the expenditure as a repair and maintenance expense, but there's a timing difference. A capital improvement also affects your property's tax basis, thereby lowering capital gains if you sell the property before the improvement has been fully depreciated.

To complicate matters further, capitalized repair costs may create deferred tax liabilities on your balance sheet. These liabilities occur when dealerships use different depreciation methods for

book and tax purposes. IRS rules permit companies to use accelerated depreciation methods, but Generally Accepted Accounting Principles (GAAP) lean toward straight-line depreciation methods to avoid artificial fluctuations in profits.

It all depends

To illustrate, suppose some wooden roof shingles over the showroom are damaged in a summer thunderstorm. Reshingling the roof with wooden shingles to match the existing color or using another type of shingle (if wood shingles aren't available) qualifies as repairs and maintenance, according to the IRS. But redoing the roof with a maintenance-free composite material that has a 50-year useful life would need to be capitalized as a long-term improvement.


The recovery period for nonresidential real property — such as a roof — is 39 years. Depreciation is straight line using the midmonth convention, which presumes an asset is put into service at the middle of the month it was acquired. So, a roof installed in June is allowed 6½ months' depreciation in the first year.



Tax Court weighs in

When deciding what to do with your repairs and maintenance spending, it may help to know what factors the Tax Court considers, according to the IRS *Capitalization v Repairs Audit Technique Guide*. Here they are:

Capital improvement	Repair expense
<ul style="list-style-type: none">■ Improves the property's operating condition■ Restores the property to "like new" condition■ Adds new or replacement components or material subcomponents to the property■ Upgrades or modifies the property■ Enhances property value as a betterment■ Extends the property's useful life■ Improves the property's efficiency, quality, strength or capacity■ Ameliorates a material condition or defect■ Adapts the property to a new use	<ul style="list-style-type: none">■ Keeps the property in efficient operating condition■ Restores the property to its previous condition■ Protects the property through routine maintenance■ Provides incidental repair to the property



Under the IRS's "plan of rehabilitation" doctrine, the Service also considers whether a taxpayer has made a general plan to rehabilitate, modernize or improve the property. An auto dealer, for example, should capitalize incidental repairs or painting costs incurred as part of a showroom remodel. The phases of an overall remodeling job can't be separated simply to avoid capitalizing costs.

If you spent \$50,000 in June on a new composite roof, you could deduct only \$695.50 in year 1, \$1,282 in years 2 to 38 and \$588.50 in year 39. This contrasts sharply with an immediate year 1 deduction for wood shingles. Bottom line? When fixing your fixed assets, it's important to consider how your repairs will be classified under IRS guidelines.

Routine repairs can be expensed

IRC Sec. 162 allows dealerships to deduct routine repairs and maintenance expenses that keep their business property in good, efficient operating condition. Routine inspection and testing of service tools and equipment, for example, can be expensed in the current period.

Conversely, the IRS considers repairs and maintenance spending a *capital improvement* if it adds to an asset's value, lengthens the duration that you can use an asset, or adapts an asset to a

different use. As a rule of thumb, consider capitalizing any repair or improvement that will benefit your dealership beyond the next 12 months.

A pro can help

It's not always easy to decide whether repairs and maintenance should be capitalized or expensed. But the IRS will definitely scrutinize this line item on your dealership tax return. And you'll bear the burden of proving your repairs and maintenance deductions. So, it makes sense to consult an accounting professional if you have questions.

Your CPA can review past and current classifications of repairs and maintenance costs, document your expense deductions with repair cost studies, and identify weak spots in existing documentation. He or she also can handle the mechanics of depreciating capital improvements, freeing up your time for daily operating tasks. ■

How to create an honest budget

What's your dealership's 2012 budget going to look like? U.S. vehicle sales looked rosy earlier this year — statistics keeper Autodata Corp. reported that for the first four months of 2011 new car sales were up 19% over the same period in 2010, and SUVs and crossovers were up 21.1%. But new car and truck sales declined 3.7% in May, which was the first significant setback in more than 18 months.

Analysts can conjecture how U.S. new- and used-car markets will perform in 2012, but no one knows for sure — particularly in *local* markets. So, with the future uncertain, the somewhat daunting challenge is to create a realistic annual budget that's based on fact, not optimism.

Making sure you're current

An effective way to start the budget process is to 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 buying patterns? These are factors you likely know well, but giving your budget a context will help ensure that it's 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, and your goals for the year. It also should reflect any problems you're facing as well as any operational challenges, such as adding another store.

Getting employees to buy in

Budgeting works best when you involve employees who have financial responsibilities, because they're closest to having their pulse on the trends. 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 your plan. Compare their estimates against your own, and adjust as you see fit.

Breaking down costs and revenues

To paint a complete picture, your budget must include realistic projections of all expenses and revenue. Break down your expenses as follows: *Fixed costs* include lease payments, utilities, financing, property taxes, insurance, maintenance and repairs. *Variable costs* cover employee pay and benefits (including overtime) and advertising. And *capital costs* include outlays such as new computer equipment, facility upgrades and 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.

Projecting — based on facts


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 reassess your budget for the coming year and adjust line items accordingly. If last year's budget included a pay freeze for noncommission employees, for example, you'll likely want to factor wage increases into the current budget.

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 overproject 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.

Enlist a professional

Consult with your accounting professional during the budgeting process. He or she can help you moderate your instinctive optimism about the future and solidify the reasonableness of your budget, which is an attribute that computer software doesn't possess. ■



Get gassed up to sell green cars

With gas prices what they are today, it can be tough for dealerships and their customers. But you can use today's record-high gas prices as a selling tool. Appealing to buyers' green sides may require your salespeople to retool their sales tactics, however.

Reach out

Anyone who's been driving a gas hog represents a potential sale. Start with direct mail and e-blast campaigns that target customers who've previously purchased a gas guzzler from you. If the service department does repairs and maintenance on one, share that customer's information with the sales department. Proactively reaching out to this market can give you a leg up on your competitor.

Do the math

In the store, ask salespeople to educate customers on your product line's fuel economies. Identify which vehicles offer the best gas mileage. Customers may be surprised to learn that a 4-cylinder turbo crossover sometimes gets better gas mileage than a midsize V-6 sedan.

Suppose a family drives 15,000 miles each year, mostly in city traffic. By trading in a vehicle that gets 12 miles per gallon for a fuel-efficient minivan that achieves 20 miles per gallon, the family can save 500 gallons of gas each year. At \$4.25 a gallon, that's \$2,125 a year.

By comparing the cost savings to the monthly payment, this simple math can be effective at justifying a new car purchase.

Seal the deal

With gas prices exceeding \$4 per gallon this summer, many people driving gas hogs will contemplate a trade-in. You need a way to bring in these customers, educate them on the merits of fuel-efficient vehicles, and then close the deal.

Dealership Consulting Services

- Audits & Financial Statement Reviews
- Accounting and Operational Reviews
- Interim Review of Internal Controls
- Tax Planning, Compliance and Preparation
- LIFO Computations and Compliance
- Used Vehicle Valuation
- Management Advisory Services
- Dealership Mergers & Acquisitions
- Due Diligence
- Litigation Support and Arbitration
- Dealership Business Valuations
- Forensic Accounting
- Fraud & Embezzlement Investigations
- Business Damages and Lost Earnings

The Partners of Frankeberger Vausher + Company, CPAs have in excess of 50 years professional dealership experience. We consult with clients, their advisors, and other professional relationships to maximize their results, protect their assets and minimize their risk. We are considered "Automotive Specialist" not only from an accounting perspective but to include taxation matters and Litigation Support activities.

"Any Accountant Can Count – It's The One You Count On That Matters"

For more information, please contact:

Dennis Frankeberger, CPA/CFF, CFE
909-597-1100
FV@FVCPAs.com
www.FVCPAs.com