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HEADLIGHTS

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DEALERSHIP REAL ESTATE AND "BLUE SKY"

We are routinely asked to assist clients evaluating potential dealership transactions. Among the first two questions we ask are:

- ✔ Has the real estate been appraised?
- ✔ Is the facility image compliant?

If the answer to either of these questions is no, it is difficult to properly assess the amount of "blue sky" inherent in the deal. Blue sky is a function of the annual profits a store is expected to produce. Consequently, the multiple is the number of years a buyer is willing to work for a seller. The investment in image-compliant real estate translates into the future rent factor, which of course is the largest fixed expense a dealership will incur and will have a direct impact on potential profitability.

Jay Goldman, Boyer & Ritter, LLC, Harrisburg, PA

It is not unusual for a dealer to think that the rent factor is not that important because it is self-charged and can therefore be whatever a dealer wants—provided the mortgage is covered. We think that approach is short sighted. Dealers are in multiple lines of business simultaneously, at a minimum: the dealership and the real estate (frequently, insurance, as well).

Each of these lines of business should be evaluated on a stand-alone basis. The proper return on an investment in real estate changes with interest rates and geography, but recently we have been using 7.5% as the benchmark when working with clients. So, if you pay $10m for the real estate, the rent would be $750,000. That rent factor should then be built into your projection for the profitability of the dealership, which relates to blue sky based on assumed multiples.

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WINTER 2023

WHAT DEALERSHIPS AND THEIR LENDERS NEED TO KNOW ABOUT THE NEW GAAP LEASING STANDARDS

BACK TO THE BASICS: TIME FOR GROSS AND EXPENSE MANAGEMENT CONSIDERATION

Let's assume a prospective buyer enters a Letter of Intent (LOI) indicating they will pay appraised value for the real estate. Let's further assume that they expect the real estate to appraise for $10m and believe the facility is image compliant. Now, let's assume the appraisal comes back at $12m *OR* an additional investment of $2m in improvements is required to satisfy manufacturer facility requirements. Now, the rent should be $900,000 annually ($12m × 7.5%). The dealership is now $150,000 ($900,000 – $750,000) less profitable. Assuming a multiple of 5, the computed blue sky would have been $750,000 less.

In many ways, the relationship between the real estate and the goodwill is like that of the car being purchased and the car being traded in. Neither exists in a vacuum, and the value of one has a direct impact on the other. The greater the investment in real estate, the greater the downward pressure on the value of the franchise.

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

WHAT DEALERSHIPS AND THEIR LENDERS NEED TO KNOW ABOUT THE NEW GAAP LEASING STANDARDS

Scott Woodward, CPA
Woodward & Associates, Inc.

In February 2016, the Financial Accounting Standards Board (FASB) issued rules on capitalizing operating leases. After many years of delay, the rules are now required to be in effect for financial statements issued in 2022. This new standard typically applies to rent paid on buildings and leased equipment. This standard could affect monthly dealer statements, as well as compilations, reviews and audits. Generally, this change would have a negative result on these various statements.

An over-generalization of these rules requires companies to capitalize operating leases longer than 12 months. This would include rent paid for the dealership facility. The requirement is that the company will capitalize the lease (asset) and set up a long-term liability (debt) on the balance sheet. As the payments, or rent, are paid, depreciation expense, interest expense and reduction of long-term debt will all be recorded.

Some might think a work-around would be to institute a verbal month-to-month lease. The rules require you to look at both the written lease and the intent. Most dealers own their own real estate and have no intention of stopping the rent; thus, the intent is a lease in perpetuity.

By following this lease standard, the adjustments to the financial statement could cause dealers to default on various loan covenants. The most likely covenants that would be affected are any related to debt since a new debt for the lease would be recorded on the balance sheet. These covenants include many common lending ratios, such as debt-to-equity ratios and return on assets or investment. Many lenders are unaware of these rules. The borrowers and lenders have not begun discussing the implications to the financial statements, and many might be surprised to see the

negative impact from following the new rules. While the financial strength of the company has not changed, these new rules make the business appear much weaker than under previous accounting standard requirements.

While it is a requirement to follow new accounting standards, it is common for compilation and reviewed financial statements to depart from generally accepted accounting principles (GAAP). To avoid this issue, the report could disclose the accounting departures in the financial statement, similar to variable interest entity (VIE) notes or revenue recognition standards. For those that choose not to follow this new rule, it would be very likely that lenders will not realize there is a departure from GAAP as the financial statement will look identical to how the statements have been reported to them in the past Please note that, for GAAP purposes, you are still required to determine the effect of the departure.

This issue will also extend to the dealer financial statements. Certain automotive factories have added a lease liability spot in long-term debt to dealers' monthly statements. Toyota and Lexus, for example, added spots to their 2022 financial statements. Most dealers were completely unaware of this addition, and very few, if any, have inserted any numbers into this spot on the statement.

Dealers should be discussing this new lease standard with their legal professionals and various lenders, along with their **AutoCPAGroup** member, to determine the most appropriate course of action for each business. ✍

BACK TO THE BASICS: TIME FOR GROSS AND EXPENSE MANAGEMENT CONSIDERATION

Wayne Zimmerman, CPA
Pomares & Co., LLP

With record profitability and cash flow, the last five or six years have been astonishing for dealerships. Yet, things change, and dealers have to accept that there might be a likely impending correction on the foreseeable horizon. Historically low interest rates are creeping upward, as is inflation, and consumer confidence is trending downward. It is hard to imagine that these factors will not have an adverse impact on dealership profitability. With this cloud of impending change looming, I cannot recommend more the need to get back to the basics in regard to expense and gross management.

During the difficult "not so long ago" years, dealership managements were gross and expense hawks, drilling down deeply into every minute detail of the gross and expense accounts. I now notice with many dealerships that the trend toward this management is, unfortunately, more lackadaisical than it was in those challenging periods. Dealership expense and gross management is not something that can be corrected overnight. It takes a coordinated effort from all dealership team members to develop a system that adequately details gross and expense issues and identifies the issues that warrant consideration and potential correction.

If you are not already doing so, it's now time to develop a system

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that provides timely and relevant information to those with the responsibility for the management of gross and expenses. The sooner this is accomplished, the quicker your team will be in a position to adapt if, and when, things start to slow down. Some components of your gross and expense management system should include:

New- and Used-Vehicle Gross

A detailed reconciliation of new- and used-vehicle gross, as posted by accounting, should include all adjustments made outside of the deal and should be provided to the new- and used-vehicle managers for review, at a minimum, monthly. Best practices suggest doing this on a daily basis, so the respective managers have an opportunity to adequately evaluate any gross changes and make corrections as needed.

Finance and Insurance Gross

In addition to the reconciliation of new- and used-vehicle gross described above, a detail of all finance and insurance chargebacks should be provided for evaluation by responsible management.

Parts and Service Gross

Exception reports should be developed and provided to the parts and service managers on a daily basis. The current dealer nanagement system (DMS) allows for a myriad of exception reports. At a minimum, these reports should include repair orders or parts tickets that are below predetermined margins.

Expense and Gross Forecasting

Develop departmental gross and expense forecasts and regularly compare the results to actual.

Expense and Gross Benchmark Comparisons

Regularly compare departmental gross and expense detail to factory, 20 group or other identifying detail. This should be a regular part of the monthly review process.

Expense Detail

Develop a system that details all expense accounts, per month, by vendor. This detail should be accumulated in a manner that allows for easy comparison to identified prior periods, preferably monthly.

With adequate planning and the development of system of management information that is both timely and relevant, dealerships will position themselves to make changes quickly and efficiently based on any changing economic condition.

An **AutoCPAGroup** member could be a helpful link in assisting in the development of such a system. ✍

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