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Detect Car Dealership Red Flags

Knowing where to look, what to watch for and what questions to ask can help prevent unpleasant surprises

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As the auto industry responds to changing market conditions such as ebbing vehicle sales, dealership group chief financial officers, lenders and investors sharpen their focus on dealer profitability and overall financial performance.

That's particularly true for those dealerships that are highly leveraged due to rapid expansion in recent years.

Knowing where to look, what to watch for and what questions to ask can help prevent unpleasant surprises.

Start with basics

Curiosity, common sense and general business judgment are essential when evaluating dealership performance.

A review should begin with verifying key financial information, how it is recorded and how it is reported.

The review should include verifying inventory existence and valuation, as well as accounts receivable, floor plan balances and proper recording of dealership accruals.

Potential warning signs of existing problems include:

- Significantly aging inventory.
- Inventory that is not regularly adjusted to market value.
- Floorplan balances without inventory costs.
- A recent history of aggressive, highly leveraged acquisitions.
- New or expanded facilities that are based on planning volumes and projections rather than historical performance.
- Significant prepaid and other receivable balances.
- High levels of employee turnover in the accounting department.
- Accounting staff with only minimal industry experience or formal training.
- Delays in final closing entries and annual internal financial statements.
- An unusually large number of year-end adjusted journal entries, especially those that go beyond the expected adjustments. That includes inventory adjustments, depreciation and provision for chargeback.

None of these indicators is necessarily proof of financial problems, but each one should be viewed as a sign that some additional scrutiny is warranted.

Dig into details

Careful review of financial statements is essential, but one should never assume the financial statements dealers submit to their manufacturers are complete or accurate.

Factory statements are designed to track certain financial and performance indicators that are of importance to the manufacturer. These indicators are not necessarily those that matter most to dealership group owners, CFOs, lenders or investors.

In addition, factory statements are not designed to comply with generally accepted accounting principles (GAAP). Factory statements typically classify certain income and expense items differently from how a GAAP-compliant statement would classify those items. That means some commonly used ratios and metrics will differ.

Most users will have several critical indicators they rely on to get a general picture of a dealership's overall condition.

Among these are inventory-to-floor plan ratio, days aging on contracts in transit, days aging on used inventory and floor plan without costs.

Regardless of the specific data points a user tracks, they should be compared against recognized industry benchmarks and – above all – tracked over time to spot critical trends.

It is important to look past the numbers and dig into the details in order to identify the underlying financial and operational factors that drive the numbers. That means examining the supporting schedules and interim reports from which the financial statement data was derived.

Ask the right questions

An accurate evaluation of a dealership's performance and financial position often comes down to asking the right questions. For example:

- Are cash reconciliations being completed and reviewed, and are all items reasonable and current in nature?
- Are used-vehicle values being recorded properly?
- Are goodwill balances supported with revenue and growth in line with projections at the time of creation?
- Are chargeback provisions recorded accurately?
- Is service department profitability improving to offset margin pressures on new-vehicle sales?
- Are owner distributions consistent with current-year earnings?
- Are prepaid balances or "other assets" consistent with historical averages or expectations, or could they be hiding expenses?
- Are receivables growing while sales are decreasing?

- Are loans from owners or related parties larger than expected? Are they growing? Do collection issues exist?
- Are long-term assets such as owner's notes incorrectly recorded as current assets such as parts or service receivables – thus distorting working capital?
- Are company vehicles recorded as inventory rather than as long-term assets – thus distorting the current ratio?
- Are year-end audit adjustments and write-offs properly posted to the income statement or retained earnings?

These questions are a starting point, not a complete list. But they represent the inquisitive mindset necessary to evaluate a dealership's financial position accurately.

As the industry adapts to changing economic trends and buyer demographics, it becomes even more important for owners, CFOs, lenders and investors to dig into the details behind the financial statements.

Learn more

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