THE CPA TUNEUP®

Summary 2015

Accounting for Chargebacks

By Brian Campbell, CPA

Selling financing, insurance and extended warranty products are part of the vehicle selling process. As dealership sales of vehicles have increased, so has the income generated from the sales of financing and insurance (F&I) products and extended warranty contracts. Typically, the sales of these products account for a large portion of the overall income of a dealership. I have seen over the past few years as sales have increased, so have chargebacks related to these products. Chargebacks are typically recorded as a contra revenue item in the period in which the actual chargeback occurs. For accounting purposes, an estimate of future chargebacks should be evaluated and recorded, if deemed to be significant. As sales increase, chargebacks increase and the corresponding reserve for future chargebacks should also increase.

With financing agreements, if a customer defaults on the loan or pays it off early, the financing institution adjusts the dealership's commission. This adjustment is the chargeback that is recorded as contra revenue. In some situations, the financing institution may retain a portion of the commissions as an advance on chargebacks, or the dealership may negotiate special arrangements to avoid chargebacks in exchange for a lower commission being paid.

With extended warranty contracts, the dealers can act as either a broker for a warrantor or act as the warrantor. Those that act as brokers retain no warranty responsibility and receive commissions from the warrantors. If the customer cancels the extended warranty contract at some point during the life of the contract, the dealership’s commission earned from the sale of the extended warranty contract is adjusted as a chargeback.

If a dealership is subject to chargebacks, the dealership should consider whether material future chargebacks are probable under contracts sold through the balance sheet date. If they are, the dealership should record a reserve to recognize the estimated chargebacks that will be incurred on F&I and warranty contracts previously sold. The reserves should be recorded as a liability if the dealership has received the commission income. If some of the commission income is recorded as a receivable, then there should be an allowance recorded against the receivable.

One approach to estimate the reserve to record is for a dealership to review the historical chargebacks as a percentage of gross commissions earned and calculate an average chargeback percentage. If a typical contract sold has a life of three years, then take the gross sales commissions for the past three years and apply the percentage factor to each year to determine what the current reserve should be. See below for an example.

To Calculate Average Chargeback Percentage

- Year 1 chargebacks/gross commissions 100,000/1,000,000 = 10%
- Year 2 chargebacks/gross commissions 200,000/1,500,000 = 13%
- Year 3 chargebacks/gross commissions 300,000/2,000,000 = 15%
- Average chargebacks = (10%+13%+15%)/3 = 12.66%

To Calculate Year End Reserve

- Year 1 gross commissions = 1,000,000 x (1/3)12.66% = 42,200
- Year 2 gross commissions = 1,500,000 x (2/3)12.66% = 126,600
- Year 3 gross commissions = 2,000,000 x (3/3)12.66% = 253,200
- Total year end reserve = 421,800

As you can see above, with sales increasing, there is a chance that chargebacks are increasing also. With the substantial increase in sales that dealerships have been experiencing over the past few years, there is a good chance that the reserve for chargebacks is a material amount and should be recorded as a liability at the end of each period. If you have any questions on how to analyze your dealership’s chargebacks, do not hesitate to contact one of Henry & Horne, LLP’s dealership professionals.

If you have any questions, Brian can be reached at (480) 839-4900 or BrianC@hhcpa.com.

ABOUT US

Henry & Horne, LLP is one of the leading accounting firms in Arizona with offices in Tempe, Scottsdale and Casa Grande. We combine the knowledge and expertise of a premier consulting firm with the personal attention of a local CPA, meaning unmatched service to you. Our services include: daily, monthly and annual bookkeeping and accounting; audit, review and compilation of company financial statements; audits of 401(k) plans; tax planning and compliance; CPA Tuneup®; cost segregation studies; internal control reviews; estate, gift & trust services; real estate appraisal and consulting; and valuation and litigation support services.

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extra parts

Marty McFly's hoverboard in Back to the Future is becoming reality thanks to Lexus. According to Autoweek, the hoverboard reportedly achieves magnetic levitation through the use of liquid nitrogen-cooled superconductors as well as permanent magnets. The technology is apparently a very miniaturized form of what maglev trains use.

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When consumers are shopping for cars using their smartphones, apparently Toyota is king. A new Edmunds.com survey finds that Toyota is the most popular auto brand with iOS and Android users. It also appears that smartphone shoppers are just as likely – if not more likely – to engage in serious shopping behaviors than people using desktops, laptops and tablets.

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If you have a vehicle with OnStar, your car will soon be contacting you via phone call, text or email when the alarm sounds, alerting you that your vehicle may be in the process of getting stolen. According to Car and Driver, it will alert only the subscriber. Calling the cops would be up to you.

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Must Do's During Buy-Sell Agreements

By Kane Lavin, CPA

Over the past several years, I have encountered numerous issues with buy-sell agreements during the purchase of a dealership or its assets. Generally, the buy-sell is a purchase of the assets out of one entity and recording them into another entity. Buy-sell agreements can also be structured to just purchasing all of the outstanding stock of the company.

Following is a list of things that should be done during the buy-sell.

Make sure the new entity is setup in advance of the buy-sell date and properly capitalized. That means the shareholders' investments are properly documented and a bank account has been established in the new company's name. I recommend paying all expenses involved with the new company through the new company's bank account. It is a lot easier to track and document the expenses this way instead of an owner's personal account. These same rules apply in the real estate entity if there is property being purchased and put into a separate entity.

Make sure the new entity applies for a federal identification number and the entity properly elects its tax status, such as electing to be an S corporation. Also make sure all needed licenses are acquired such as dealer license, MVD license, sales tax, and state withholding number for payroll.

All parts and used vehicles should be properly valued as of the buy-sell date. I recommend a parts physical be done by an outside service. This is generally arranged by and paid for by the buyer. All used vehicles being purchased should be valued properly and agreed upon by the buyer and seller.

The amount being paid for new vehicles must be agreed upon and clearly stated. The cost of new vehicles can be affected by holdback, advertising and dealer add-ons. If the vehicles are floored, make sure it is clear how the sold units are being paid for. If the vehicles are being purchased at invoice less holdback, you don't want to simply transfer the floor plan amount as a form of payment for the new vehicles.

Fixed assets being purchased should be valued by an outside company. The outside company should provide the value of each asset. Some assets may be financed and an agreement to assume the loan may be needed as part of the agreement. Dealerships generally do not do consistent inventories on fixed assets. A lot of fixed assets are on the books but no longer at the dealership.

Customer deposits and we-owes should be accounted for properly as well. Other items in this area are prepaid oil changes by customers. Some dealerships let customers pay for oil changes in advance at a discount in order to make sure they retain them as a service customer. You don't want unexpected customer problems if these items are not properly accounted for.

Make sure the new computer system is ready to go and the employees are properly trained or proper support is available for the transition period.

These items are not an all-inclusive list, but are important items to consider and areas I've seen cause problems with buy-sell agreements.

If you have any questions regarding buy-sell agreements, please contact one of Henry & Horne, LLP's dealership professionals.

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