S G C Certified Public Accountants

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COMMON ACCOUNTING MISTAKES TO AVOID!

Each and every day, we receive calls from dealers around the country calling because they've just discovered they've been handling their accounting and taxes wrong and now they are in trouble with the IRS and their Bank. These sorts of messes can take months to correct and can often cripple a dealership if they end up owing big money to the IRS.

Here are the most common mistakes we see dealers making (hopefully none of these apply to you!):

MISTAKE #1: **Filing your dealership's tax return on the cash basis of accounting.**
In accordance with IRS rules, any entity that has inventory *must* file on the accrual basis of accounting.

MISTAKE #2: **Setting up a related finance company while your dealership and/or RFC are set-up as partnerships (or LLCs filing as partnerships).**
IRS regulations that allow the sale of finance receivables from a dealership to an RFC apply *only to corporations*. Therefore both the dealership and the RFC *must* be corporations (C-Corporations, S-Corporations, or LLCs filing as corporations).

MISTAKE #3: **Selecting a Dealer Management Software that is not widely used.**
The Dealer Management Software is used to track everything from inventory to sales, to collections and charge offs. Items like interest amortization, sales tax calculations and proper contract printing are quite complex and it is highly recommended that you select one of the 3 or 4 most popular software systems because these software systems have probably been thoroughly tested in the state in which you do business.

MISTAKE #4: **Selecting an overly expensive and complicated accounting package.**
Far too often we see dealers using accounting packages that were probably intended for use in Fortune 500 companies. Dealers then end up wasting far too much time just trying to manage the accounting software. Don't underestimate QuickBooks and Peachtree; they are very capable accounting packages.

MISTAKE #5: **Being overly aggressive when selecting the discount rate for selling receivables to the RFC.**
IRS rules require that notes be sold to your RFC at fair market value. We therefore recommend you obtain a written bid from a third party to substantiate your discount. In addition, you may not have a discount rate higher than your gross profit in the deal, as dealers may not sell receivables to the RFC for less than they have in the deal.

MISTAKE #6: **The RFC failing to pay for the receivables it purchases from the dealership.**
Because the sale of the receivables between the dealership and the RFC must be completed as though the RFC were a third party finance company, the RFC must pay in-full for the receivables it purchases in a *reasonable* amount of time (generally 90 days or less). Failure to pay for the receivables purchased by the RFC could lead to the IRS's argument that the sale of the receivables was never completed and therefore the RFC should be collapsed…leading to a potentially very large tax bill.

MISTAKE #7: **Failing to properly document the sale of receivables between the dealership and the RFC.**
You must have proper legal documentation, which details and supports the sales of the receivables from the dealership to the RFC. Without the supporting legal documents, the IRS could argue that the sale of receivables never took place.

MISTAKE #8: **Selling receivables to the RFC with full recourse.**
When the RFC buys the receivables, it must assume full risk of loss if the receivable turns out to be a bad debt. If you give the bad loans back to the dealership, the IRS can argue that the receivables were never truly sold to the finance company because the finance company does not have the risk of loss. In most circumstances, selling notes to your RFC with recourse will be treated as a loan (not a sale of receivables) by the IRS.

MISTAKE #9: **Improperly operating or improperly capitalizing your RFC.**
IRS rules require that the RFC be a full-fledged company. It should have its own employees, its own expenses, and it should be properly capitalized. Being properly capitalized means that the owners of the RFC put real money into the company to start it up and it should also have access to a line of credit. After all, it does have to pay for the receivables its going to buy and that seed money has to come from somewhere.

MISTAKE #10: **Setting-up the accounting integration between your DMS and accounting software, and then assuming the financial statements are always accurate.**
This is one of the most common problems we see. A lot of the top DMS programs allow for accounting integration, where the day's activity from the DMS are automatically posted to the general ledger of the accounting software. While this is great, it does not mean your financial statements are accurate. You are still required to reconcile your bank accounts, note payable accounts, as well as maintain your accounts payable and expenses. Accounting integration is *just one small piece* of assembling accurate financial statements. In fact, we generally recommend to new clients that they *not* turn on accounting integration in the beginning. This way they can learn to use the DMS month-end reports and learn how to manually close their books, which helps them to spot problems in the event the accounting integration posts incorrectly (which happens more often than you might think!).

MISTAKE #11: **Charging off an account and restocking the repossessed vehicle into inventory at the balance owed on the charged off contract.**
Dealers often think that as long as they got the car back, they really didn't lose any money when the account was charged off. They just stock the repo inventory back in at the balance of the old account and re-retail the unit. This is *unacceptable*. Accounting rules require that inventory be carried at market value (wholesale value to a dealer) and you should not rob the gross profit of the next deal to cover your losses on the last deal. Each deal must stand on its own.

MISTAKE #12: **Commingling funds between the dealership and the RFC.**
Dealers often only have one cashier and all of the money collected during the day just gets deposited into the bank account of the dealership. If you have an RFC, a lot of the money you collected will be payments from customers currently owned by the RFC. IRS rules require the you separate collections belonging to the RFC and deposit them directly into the RFC's bank account. Reconcile your cash receipts on a *daily* basis and don't use handwritten receipts; always print electronic receipts for customers directly from the DMS which ensures all collections are properly documented in the DMS.

MISTAKE #13: **Thinking the *Allowance for Bad Debts* and the *Reserve for Warranty Claims* are deductible for tax purposes.**
WRONG! IRS regulations do *not* allow you to deduct any amount that is considered an estimate (which is exactly what the Allowance for Bad Debts and Reserve for Warranty Claims are). Charge offs and warranty claims may only be deducted on your tax return *when they occur*.

MISTAKE #14: **Owners failing to directly monitor portfolio performance and operations.**
Far too often we hear of non-active owners discovering that an employee has committed fraud. This business handles vast amounts of cash and fraud is a common problem. As an owner, do not rely on your employees to feed you information (as your employees might be the ones committing fraud). Learn to use the DMS system yourself and monitor certain critical items like delinquency, recency, daily cash collections, and daily deposits.