

Auto Controllers' Roundtable

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Lecture by John Pico

A Controllers Duties and Obligations in Today's Economy

Introduction

My Background

Good morning ladies and gentlemen. Thank you for inviting me to speak today.

My name is John Pico and I have been advising automobile dealers for almost 40-years.

In 1972 I had a law firm in the San Francisco Bay Area and began by representing dealers in the capacity of an automotive attorney. In 1980, I decided I wanted to raise my family in the mountains, so I sold my firm and moved to Aspen, Colorado.

I did not want to practice law in Colorado, so I began consulting full time with dealers regarding buying and selling stores, refinancing, out-of-trust matters, valuations, and mediating disputes between partners and lenders. In those capacities I have probably completed in excess of 1,000 transactions.

You can get my full resume at www.advisingdealers.com.

I resided in Colorado until 2000, when I moved to Texas.

I did my first deals in Texas in 1986 when I sold Frontier GMC Truck and Century Chevrolet, both here in Fort Worth. GMC Trucks merged with Peterbilt and Century Chevrolet eventually sold again, was moved to Grapevine and is now called Classic Chevrolet.

Classic is now owned by Tom Durant who, along with one of his partners, Richard Allan, I have advised regarding the purchase of a couple of dealerships.

I recite this short summary to emphasize that the information I will share with you today came not only from books, but from practical experience.

With that introduction, let us get down to work.

DIFFICULT TIMES CREATE DIFFICULT CHOICES

In the good times, everybody feels good. The store is "humming," money is flowing and everyone thinks that **they** are the ones making it all happen.

Those are the times when the factories say: "Dealers don't sell cars, our name brand does." "Let's cutout the dealers and we will make a lot more money."

About every 15 or 20 years the factories forget the past and a new generation of executives think they can run stores better than dealers - and they just cannot resist trying their hand at it.

So they re-enter the retail sales arena, each time they do, they get their head handed to them.

The most recent example is FiCo - Ford Investment Company. FiCo probably set a record for the most money spent on dealerships without ever being profitable. It took them five years to figure out that maybe they couldn't do what dealers do.

Dealers, on the other hand, also get lulled into a "false sense of security." Their IQs fluctuate with their balance sheets and, after a few months of record profits, they feel bulletproof.

Then they start spending money on elaborate facilities and they don't pay as much attention to cost controls.

All of a sudden, "BAM" - Either the franchise, or the economy, or both get cold.

Cash flow shrinks and the dealership is in trouble. It's like running down the street at 50 miles per hour and stepping on a rake.

Floor-checks and flooring expenses increase, banks want business plans, inventory builds. Then, like a junkie, they need a "quick fix." The pressure is on.

How should the controller respond?

Today's Discussion

Before we can begin a discussion of today's economy, our role in today's economy and how to handle specific situations, we need to define things and get our priorities straight. We need a solid foundation upon which to build.

Without a foundation, you are a shell. It's the difference between going to school and having someone give you the answers and going to school, reading the books and understanding the answers.

A good anything (dealer, controller, lawyer, accountant) is a student of the industry. They are grounded and they do not get carried away with euphoria when fads and aberrations occur.

When I was a kid lawyer and was on about my 200th out-of-trust case, I went out and bought a set of those spice jars that you hang on the wall and label with the name of the spice: Oregano, Basil, and so forth.

Well, I was a real smart-ass and I used the jars to capture the air in the room of various out of trust deals I did: Jones, Smith, Hansen, and so forth. (Those are fictitious names by the way. The real names have been changed to protect the innocent.) I'd save them because each in its own right contained very rare air.

Even bankers would breathe that air. I was doing a deal in Colorado, where the dealer's over-draft at the bank was over \$30,000,000.

It still tickles me that the night we went to dinner with the bankers and their lawyers, the dealer and the banker were arguing over who would pay the dinner bill. Finally I whistled the banker's attention and said: "They guy is \$30,000,000 overdrawn. Who do you think is paying American Express anyway?"

What the heck were they all smoking?

So, before we start we need to progress in a building-block order and get us a foundation. We need to define:

- I. Who we are;
- II. To whom we owe our loyalties.
- III. Where we are today. And then -
- IV. How do we survive and prosper?

I. WHAT IS A CONTROLLER?

The book says that a **controller** or **comptroller** is a person who supervises accounting and financial reporting within an organization. In conjunction therewith, the controller oversees the implementation and monitoring of internal controls.

Well, in my experience I have found that a controller is more than that.

The controller is the keel on the ship. The dealer or GM steers the ship and you keep it in trim. You don't get caught up in fads and inflated markets.

The controller doesn't just amass information.

The controller is the one who should know the health and direction of the organization.

By the direction, I mean that the controller should be aware of the inventory and days' supply. The controller must not only know where we are and where we have been, but where we are going.

If you are building a new facility that is projected to have a rent factor of \$1,500 per new unit retail, it is up to the controller to know: "That dog don't hunt." The store is going to go broke."

The controller must then relate that information accurately to the dealer, the general manager and the owner.

Although sometimes they may be the same person, they are often three or more distinct individuals and **you cannot forget that.**

"The items you monitor" and "How you monitor them" we will get to in a moment. Right now it is important to emphasize to whom you owe a duty.

WHERE ARE YOUR LOYALTIES?

It sounds like a simple question, but generally it is not.

The reason it is not simple is because:

- (1) Owners/investors do not usually take the time to set the foundation for and to emphasize the answer to that question.
 - Factories are an exception. If you have ever worked for a DD, Motors Holdings, or an MID store, you know that the factory is specific about to whom the controller owes his or her loyalty. Only the factory can hire, fire or give a raise to the controller. The GM has no authority in that regard and must discuss any complaints about the controller with the factory.
 - The rest of the investors (outside the factory) usually ignore the discipline required to define the controller's responsibilities and authority.

- (2) The daily interaction between the General Manager [GM] and the controller creates a relationship that inhibits an open and honest relationship between them and the owner.

This is an important topic, - especially in a struggling economy, so let me be clear on the subject.

The dealership is having a bad month and the GM tells the controller to book certain expenses into "prepaid" and to pick them later, in a month when the store is doing better.

Or the controller sees an RO from the service department for a non-existent add-on to a vehicle.

So, what have we got and who do we have to tell?

#1 - We have the makings of a fraudulent financial statement.

- A. The statement is going to be given to a lender and that statement will portray an inaccurate net worth, inaccurate working capital and inaccurate statement of assets.
- B. And, the dealership will be asking the lender to lend money, such as flooring or a cap loan, based upon that inaccurate statement.
- C. The lenders and the government call that "fraud", which I will get back to in a moment.

#2 - We have a problem with the dealer and the owner.

- A. For all the same reasons we stated about the bank, because if we go along with the program, we are knowingly supplying them with an inaccurate financial statement concerning their investment; and
- B. If we go along with the program, we are denying the dealer and the owner the opportunity to correct problems before they exacerbate to a degree that they cannot be corrected.

I have seen this movie hundreds of times and only the names, franchises and towns are different. The script and the theme is the same.

The assets are overstated and the liabilities are understated.

Contracts-in-Transit are "packed."

Vehicle Receivables are "packed."

Prepaid Expenses are "packed."

All payables are not reported.

Accrued vacation is not accurate.

Then one day the bank finds the dealership out of trust and when they ask what happened, the GM says: "We had a bad weekend."

What was bad was the management - and the controller.

In the Enron case they called them co-conspirators.

Beware of this: a car dealership is like a dinosaur. You put a bullet in its brain and it walks 5-miles before it falls over dead. There is so much cash flow in a dealership that I have seen dealerships that went for over five years before anyone figured out they were broke.

So where do your duties lie?

First, "Be true to thyself."

Your first duty is to you and your family, if you have one.

In Tampa Bay a few months ago the controller got off easy. He pled guilty to the felony of "conspiracy to commit bank fraud" and agreed to testify against the dealer.

The charge of "conspiracy to commit bank fraud carries a maximum penalty of five years in prison, a \$250,000 fine, three years' probation and a special assessment of \$100.

The controller was lucky because the 53-year old General Motors dealer (who was the father of 2 and well-known for his community contributions) was convicted of wire and bank fraud.

The dealer was sentenced to 11 years and 3 months in federal prison (not probation), restitution of \$1,066,851 to the bank, and a \$2,300 special assessment. (Following his release from prison, he is to be placed on 5-years supervisory release.)

As a result of his guilty plea and his testifying against his old boss, the controller was only given a fine equal to his total salary for 2004.

In Texas, two controllers were sentenced to prison and ordered to pay restitution of over a million dollars for a scheme a dealer concocted to keep the dealerships afloat until they sold.

The controllers, Perry P. and Donna F. argued to the 5th Circuit Court of Appeals that they were just following the orders of the dealer and had no specific intent to deceive or cheat the bank and that they thought the dealer, who was a wealthy man, could cover the float. The dealer even testified on their behalf and accepted personal responsibility for the scheme.

The court held that the controllers knew their activities would have the effect of artificially inflating the bank balances. The court held:

To find a conspiracy violation under 18 U.S.C. §371, [conspiracy to commit bank fraud] a jury need only find an agreement between two or more persons to violate the law and an overt act by one member of the conspiracy in furtherance of the conspiracy. A specific agreement need not be shown, but may be inferred from concert of action.

Your second duty is to be true to the owners that put up the money. They are the people that trusted you to monitor the deal and to tell them how they were doing.

If you lie by them by fudging the books and not disclosing to them what the GM asked you to do, you are then putting their families at risk because the bank will look to them for any short-fall.

If you lie to them by fudging the books than you deprive them of the opportunity to accurately evaluate their investment and decide whether they want to stay in, or get out.

If you lie to them by fudging the books, then you deprive them of the opportunity to correct a situation before it gets out of hand.

If you tell them the truth and they also tell you to fudge the books - it's "show and tell" time for your character.

As Troy Aikman said after Sunday's Dallas loss to St. Louis: Tough times don't build character, they emphasize the character (or lack of it) already built into you.

WHAT DO YOU NEED TO DO?



First of all, you need to keep the books correctly. If someone tells you differently, you need to explain to them the ramifications both with respect to losing control of their own "horizon indicator" and with respect to the potential liability.

For those of you who don't fly, a horizon indicator is an instrument used in an aircraft to inform the pilot of the orientation of the aircraft relative to earth. It indicates pitch (fore and aft tilt), bank (side to side tilt) and yaw

(left to right and right to left. It is displayed like a ball, colored blue on top, dark on the bottom - with a centering line going across it. If the centering line is in the blue, you are climbing. If it is in the dark, you are descending.

You can pray. You can tilt your body like some people do when they go bowling. But, the fact is: if the indicator indicates descent, you will eventually hit the ground unless you correct the plane.

A dealership financial statement is the business' horizon indicator. It tells you if you are climbing, falling, tilting, or about to take a turn.

Put inaccurate information in, and you will get inaccurate information back.

The company's accountant should be able to tell you if your prepaid expenses are overstated, if your contracts in transit are high, and if you are properly accounting for accrued vacations and other liabilities.

There are also factory accounting websites to help you properly categorize your expenses, pro-rate your rent and calculate your working capital. Ford, for example, has: <http://www.fordacctg.com/>; General Motors has: http://gm.acctmanual.com/gm_acct_manual.htm and the other factories have theirs.

What the CPA cannot know is:

Were the aftermarket items added to the vehicles legitimate? I have seen phony RO'S and phony aftermarket invoices adding value to vehicles in stock.

Were the add-ons all booked timely? - I have seen aftermarket items added to vehicles, but not booked before the vehicle was sold, thus causing the sales department to appear to make a big gross selling the vehicle when in fact the vehicle was sold for a loss.

Were the contracts properly cashed at the bank? - I have seen misrepresentations made ranging from misstated income to non-existent sunroofs in order to get a vehicle financed.

It is the controller's job to know those things and to report them to the owner.

WHERE ARE WE TODAY?

In a word: "CHALLENGED."

There is a crisis in the business and that crisis is not going to pass soon. It began with the sub-prime mortgage crisis in 2007 and has continued to the credit crunch of today.

Lenders have tightened credit requirements for car buyers, reduced flooring lines, raised interest rates, required additional curtailments, shortened the time frame for curtailments and some have even placed a moratorium on new accounts.

As a result of both the economy and the tighter credit requirements US Auto sales have dropped to a 15-year low and are expected to stay there for the foreseeable future.

The good news is that with gas prices dropping and the appearance of the drop being more permanent, vehicle values should stabilize and truck and SUV desirability should increase. Also, lower demand worldwide and the repeal of the moratorium against offshore drilling should help keep oil prices depressed.

The other good news is that there are a lot of banks stepping up to buy retail paper:

Chase

Wachovia

Key Bank

Also, while GMAC Financial Services has raised its "buy rate" to 7.69%, Automotive News reported that lenders such as Quantum Auto Group (5.29%), Citizen's Auto Financial (5.69%) and TD Bank (5.4%) are all competitive.

How do we Survive and Prosper?

First of all, the entrepreneur has to have the ability to accurately assess his or her position. You can't do that with personalities involved, so you have to divorce yourself from personalities when (1) evaluating your position and (2) creating your business plan.

That doesn't mean that you have to be heartless. It means you cannot get an accurate assessment of where you are and what you must do if you are thinking of Harry's wife, or Donna's children. Once you find out where you are and what you need to do, you can address Harry's or Donna's problems, but you cannot let them influence you in your initial diagnosis or business plan.

Objectively decide where you stand (your pluses and minuses - how strong or weak you are - what your strong and weak points are).

Then decide what is best for the business. If you base your business plan on what is best for the business, you will automatically be doing what is best for Harry, Donna and you.

The Plan

So what is the plan to get through these hard times of today?

These are different times than the oil crunches of the 1970s, or the inflation and 21% interest rates of the 1980's and they require different solutions.

#1 - Protect Yourself with your Main Lender

Protecting your banking relationship is the most important thing you can do. Without a bank, it doesn't matter how many cars your store sells, or how many costs you cut.

The bank is the heart of the store and cash is the blood. If the heart isn't pumping blood, the game is over.

The question here is: "Where does the lender stand today?"

1. Much of the decision making today is out of the hands of the lender, because of the crisis and the FDIC playing a more active role in monitoring the banks.
2. Today, the lenders do not care how "strong" the owner is financially. They want loans on the books that will be paid by the business and not by the guarantor.
3. The lender will use your statement to re-calculate your working capital and net worth.

- (a) By now the lenders are getting sophisticated and cautious enough to sort out inflated receivables and prepaids. They will ask the dealer to write them down and the guarantor to make a contribution in capital to correlate with the inflation.
- (b) The lenders will add back LIFO (GM already does it on its statement) and Shareholder loans (because the loans will be subordinated) and then ask the dealer to make up any shortage in working capital.
- (c) New vehicles and carry-overs will be curtailed.
- (d) If after analyzing your inventory the lender determines you will have continued losses, it will ask you to obtain another wholesale source. Lenders are getting beat-up by Wall Street and the Feds and they do not want bad loans on their books. - Again, a bad loan to them is one that they anticipate they will have to ask the guarantor to pay, instead of the business.

4. If you are strong enough, or lucky enough to maintain your wholesale source, you now have to work-out a plan to make it through these times.

For what it is worth, it is not only the independent lenders that are asking dealers to find other sources, but unlike slowdowns of the 1970s and 1980s, the factory finance companies are also giving their dealers such notices.

For you General Motors dealers, do not forget the rules of QLTD - Qualified Long Term Debt.

In most dealerships Working Capital is determined by subtracting from "Current Assets" the dealerships "Current Liabilities" and adding back LIFO.

In a General Motors dealership Working Capital is determined by subtracting from "Current Assets" ALL DEBT, BOTH CURRENT AND LONG TERM.

GM, however, allows the dealer to add back to Working Capital that portion of Long Term Debt that meets the following three criteria:

1. The note must be payable to the owner of a substantial equity interest.
PLUS

2. Principal payments must be restricted to profits. PLUS
3. The amount to be excluded is limited to 50% of the Working Capital Standard.

Number 3 is the kicker because many controllers try to exclude the entire amount of the owner's loan and that's not correct.

EXAMPLE from GM'S ACCOUNTING MANUAL

Net Working Capital - Dealer

Total Current and Working Assets	\$5,000,000
Minus: Total Liabilities	\$4,500,000
Plus: Qualified Long Term Debt	\$30,000
Plus: Deferred Taxes (Account 333, Deferred Taxes)	\$20,000
Plus: Total LIFO Reserve (O.R. Page 7)	\$500,000
Plus: Mortgages Payable - Real Estate	\$550,000
Dealer Net Working Capital	\$1,600,000

Note: All dollar amounts are found on the Balance Sheet (O.R. Page 1) except for the Total LIFO Reserve. However, the dollar amount shown in LIFO RESERVE (O.R. Page 1) in the Asset Column as a NEGATIVE (which is the same amount as the TOTAL LIFO RESERVE on the O.R. Page 7) can be used in the computation by ignoring the negative sign in the calculation.

Let's talk about working capital for a minute.

The net working capital standard represents the minimum amount of net working capital that the factory has determined is needed to sustain satisfactory operation of the business.

This net working capital standard is part of the contractual agreement between the dealership and the manufacturer and is established annually based on the dealer's method of operation and data shown on the operating reports for a 12-month period.

The determinants are:

- An average month's expenses excluding depreciation and amortization
- An average month's parts and service customer receivables

- An average month's cost of used vehicles sold retail (Note: If any used vehicles are on floorplan, the amount of the note payable ([Notes Payable - Used Vehicles](#)) will be subtracted from the used vehicle component, but only up to a maximum of 30% of the average's monthly cost.)
- An average 2.4 months' cost of sales for parts and accessories sold
- An average month's balance for factory receivables
- An average month's cost of warranty claim sales

That brings us to the next item.

#2 - Have the Factory recalculate your working capital.

If your working capital was determined last year, it was probably based on your old sales goals. If the factory recalculates it at today's sales, it could be as much as a million dollars lower. That million dollars is a cushion that could allow you to curtail vehicles with less financial strain because you freed-up a bunch of capital.

Without exception, all of the deals I have seen lately have been overcapitalized based upon today's sales.

3 - Review your wholesale flooring and capital loan agreements.

Without a doubt, your bank has reviewed your agreements. Can you tell me all of the conditions under which the bank can call your loans, other than missing payments? You need to know them.

#4 - Review your sales and service agreement.

The factory slips in new items from time to time and you need to know them. For example, GM'S new agreements state that if a dealer terminates, the factory only has to buy-back new vehicles that have been on the lot for less than 120 days. That clause makes termination a different animal in different states because many states have their own laws regarding the buy-back of vehicles upon termination.

#5 - Set-up a "slush fund." [Hold on to your cash.]

This isn't the time to be a star and spend the dealerships cash on early payments or capital improvements.

If you have a line of credit, draw down on it.

Lenders are freezing both unsecured lines of credit and floorlines.

For example, lenders have recently told a number of dealers that they would not floor used vehicles any more. Consequently, the bank froze the floor line at what it was on the date of the notice and, as the dealer paid-off the vehicles, the bank lowered the floorline to correspond to the lower outstanding debt.

They are doing the same things with unsecured lines of credit - Lowering the lines as they are paid down.

#6 - Consolidate and eliminate positions.

How many title clerks do you have? Can one clerk do the job for 2 dealerships?

Do you need a dispatcher in service, or can the job be handled by the service writers or service manager?

Are your guarantees too high?'

Are you following-up on draws, or writing them off if the salesperson doesn't make the minimum.

Cut to the bone and build back only when there is a trend of increased business.

#7 - Determine what outside maintenance work you can bring inside.

Washing vehicles, cleaning windows, sweeping floors, dumping garbage - When you are selling a lot of vehicles and have zero unapplied time in service, it pays to outsource.

For now, if you are really a team, then everyone should kick-in and contribute to lowering overhead.

#8 - Is the Advertising Necessary?

How much advertising do you really need?

What did you sell last weekend? Extra advertising for a weekend or holiday sale doesn't pencil if you sold 10 new vehicles last weekend and you pay \$25,000 for an ad that sells 13 vehicles this weekend.

Take a look at the ads you did and compare the sale days to the non sale days to determine if the ad even paid for itself.

#9 - Review your payables.

I have one client that saved \$18,000 per month by not filling the gas tank located at the dealership. No matter how many controls he put on gas distribution, employees and relatives still used it. Even padlocks did not stop the usage. But, keeping the tank empty and filling up at the local station did.

Are there phone functions that the phone company is billing for that you can get from your Computer Company, or vice-versa?

#10 - When you are finished analyzing, be realistic about your chances of weathering the storm.

Like it or not, this economy is going to be with us for a while and we have to realistically assess our chances of surviving.

There is a good book called "The Zurich Axioms." It was written by a Swiss Banker's son (Max Gunther) who wondered why Swiss Bankers never went broke.

He interviewed his dad and all of his dad's competitors and then put together a set of axioms they followed the, in his opinion, made them "bullet-proof."

One of the axioms is: "When the ship is sinking, don't pray - jump."

There is a lot to go through to get to that point, - but you have to be able to recognize if and when it is reached.

One additional word of advice is: Either you make decisions, or time makes them for you - and you generally won't like the decisions time makes.

Thank you for your time and attention, and I hope I helped make you better controllers.

Mr. Pico has served as a court appointed "Consultant to Debtor" in bankruptcy cases, a "Court Appointed Mediator" in automotive disputes, the "Court Appointed Arbitrator / Appraiser" in partnership disputes, a "Court Approved Consultant to Receiver" in a check-kiting case, as a "Superior Court Mediator" in dealership/lender litigation and has been recognized as an expert witness on both State and Federal levels. He has consulted on upside-down positions of over \$50 Million, out of trust position of over \$4 Million and a bank overdraft of \$30 Million. Since 1972, Mr. Pico has completed over 1,000 automobile dealership transactions, whose combined values exceed One Billion Dollars. In 1986, he authored and National Legal Publishing Company published the nation's first book on Buying and Selling Automobile Dealerships. You can view his biography at <http://www.advisingdealers.com>.

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