KPMG Enterprise

KPMG Motor Industry Services Alert

April 2018

The downhill run to year-end

With the Easter holidays over, you are probably now focussed on how your dealerships will perform in the final three months of the financial year. While the dealerships operational results are key, it's just as important to focus on one of your largest expenses, your year-end tax bill.

It won't be long until 30 June comes and goes – but the one thing we do know is that your 30th June financial results will live with you for the next 12 months. Whether it's refinancing, selling or buying, how your 30th June accounts look will influence how people see your business.

Here are some key items that have a significant impact on your tax and financial year-end. Getting them right can have a major impact on your reporting season.

Preparing for your year-end audit and statutory accounts

1) Impact of pre-reported cars

The practice of pre-reporting vehicle registrations has long been used in the industry, assisting parties to achieve certain targets and in turn earn bonuses. Whilst there is the direct impact of the accounting mismatch of the timing of the bonus recognition, this practice has the potential for underlying and unintended consequences that can be easily forgotten but have a significant and unexpected impact on results – often not fully identified until late in the year-end process. It is the timing of these unintended impacts that can mean the issues have not been flagged and cannot be avoided resulting in a significant and negative effect on results. In the worst case the issue is not identified initially and compounds until found in a later period.

Practically, the act of pre-reporting vehicle registrations is where dealers register vehicles in a given period to get over the hump in respect of a periodic target from the OEM. Inherently this process may be seen as only creating a timing mismatch as ultimately the dealer is still required to sell the vehicle, and there is no duplication of sales volumes. However, pre-reporting kick starts the vehicle's life, starting the clock ticking on the manufacturers' warranty, and results in the vehicle moving to either demo or used stock classification which further reduces the expected selling price. These both result in the dealer needing to raise additional provisions against the stock value, and as stock ages further, and there is the potential for shifts in the market which only compounds these issues.

Potential impacts:

- Mismatch in tax and accounting treatment for bonuses.
- Drop-off in market significantly impacting the dealers' ability to move demo stock.
- Warranty period commences – impacting the benefit passed to the end customer.
- Dealer likely required to commence paying down floorplan if the stock isn't moved quickly, reducing the efficiency of working capital management.

What can you do to minimise the impact:

- Identify where this practice is being initiated at a level that may impact the dealership's operations,
- Quantify the number of vehicles impacted
- Calculate the impact per vehicle to ensure motor vehicle inventory is held at its net realisable value.
- Consider implementing an on-going amortisation process to smooth the recognition of the losses over the time the vehicles are held, avoiding the one-off impact of year-end recognition.

2) Maximising tax deductions on property developments

With tax expense being one of the largest expenses in your business, tax planning is something that should always be on your radar, typical issues include:

- Used and demonstrator vehicle valuations
- Spare parts valuation
- Treatment of holdback
- Treatment of bad debts

Your KPMG contact can assist with each of the above – navigating the different legislation and taxation requirements is imperative, however for this year we have decided to highlight the impact of one of, if not the biggest assets you hold – property.

For many dealerships, the property on which you operate will be the most significant asset you hold, and getting the related tax deductions right is critical. Many dealerships utilise a broad brush approach to depreciation for such assets, applying a standard rate across all components.

Dealerships can obtain a significant uplift in tax deductions by obtaining a **quantity surveyors** report. This report breaks down the relevant property assets into their individual components and applies a different useful life and therefore depreciation rate, to each component. This can result in bringing forward the deductions for tax depreciation to better reflect the pattern of use of such assets – and in many cases brings forward, and maximises the dealership tax deductions.

KPMG has significant expertise in this space and can provide assistance in pulling together the appropriate documentation as needed.

3) New lease accounting standard AASB 16…BE PREPARED!

The new leases standard, AASB 16 Leases, continues its march towards adoption and we are only seeing limited activity in respect of dealerships acting to assess and quantify the potential impacts.

Due for adoption financial years commencing after 1 January 2019, it is expected that many dealerships will experience a sharp increase in their EBITDA as their profit before tax plummets, all without a single change in how their business operates, but simply through the mandatory adoption of the new accounting standard.

It is important that dealership groups allocate sufficient time to preparing this change in order to identify and quantify the impact of the new standard on the information they provide to key stakeholders, such as financiers, shareholders and also their external advisors. Identifying the potential impact of the standard BEFORE entering into new contracts may reduce the risk of any unintended consequences.

What are the implications?

- 'Grossing up' of assets and liabilities relating to operating leases
- Change in profit and amortization profile (more finance expense, early expense recognition profile)
- Change to key financial ratios and balances
- EBITDA
- Total assets; and
- Total Indebtedness
- Changes to debt covenant calculations and compliance
- Executive remuneration calculations for listed entities and private equity
- Tax balances (i.e. Thin Capitalisation for foreign owned entities)
- Dividend payment in early years of the lease term

When do you need to act?

NOW!

- The first June year-end the standard is effective for is 2020 (2019 for December year-ends)
- Comparatives are required, depending on your transition option, for periods beginning 1 July 2018 (1 January 2018 for December year-ends)
- Dealership groups, however, already need to consider the impacts of the new standard when
    - Renegotiating or entering into new lease contracts
    - Refinancing or entering into new borrowing arrangements
    - Disclosing the impact of the new standard in their current financial statements
    - Budgeting for profit and loss results for future years
    - When considering new acquisitions

What key actions must Dealership Groups take?

- Prepare a complete listing of all leases held (including service contracts that may contain elements that meet the definition of a lease (for leases))
- Quantify impact of the change in the new lease standard on key financial metrics, including EBITDA, Total Assets and Debt Covenants

- Determine which transition option is more beneficial to apply to your dealership group
- Inform key stakeholders (banks and shareholders) of the impact of the change
- Renegotiate existing contracts to consider the impacts of the change in the leasing standard (e.g. debt covenants)
- Prepare disclosure for financial statements identifying the impacts of the change

The key is being prepared and to assess the GAP and IMPACT of the changes in the new leases standard. The summary of the changes and potential impacts must be shared and discussed with the owners/directors and executive management of the dealership group.

If you need a hand, we can help with the impact assessment, implementation process, systems support and calculations, assurance over the compliance with the standard through accounting advice and training your finance team and key personnel.

What is the impact of doing nothing?

- Dealers may breach financial covenants
- Senior management will lose time having to investigate and explain variances to relevant stakeholders
- Delays, and inaccuracy in reporting
- Mismatch between internally and externally reported results
- Increased compliance costs
- Entering into unfavourable contracts

4) Sale / exit readiness

Over the past 12 months we have continued to see increasing transaction activity in the Motor Industry sector. Understanding where your dealership group is heading, the expectations of the varying stakeholders, and the relevant market trends, is imperative to directing the business to maximise shareholder value.

Those groups that have been able to maximise value, have demonstrated a willingness to treat this process as an on-going one, noting that planning for an exit cannot start early enough and being divestment ready for when the IPO or sale window is open is critical.

Planning for such an event in many regards is maintaining an appropriate level of corporate hygiene.

What things should you consider?

- Corporate governance
- Risk management and internal control
- Financial reporting
- Organisational structuring
- Tax planning
- Debt structuring
- A stable IT environment
- Management structure and incentive programs

If you need a hand, we can help KPMG provides a broad range of services tailored to the Motor Industry, including:

- Divestment readiness workshops
- Vendor / buyer due diligence
- Data room preparation
- Ownership and tax structuring
- Operational reviews
- Valuation / financial models
- Succession planning

We are here to help, if you need a hand feel free to contact any member of the KPMG MIS team.

5) Don't let the 13th month surprise you

Lastly, but potentially, most importantly, as you move toward year-end **"don't let the 13 month surprise you".**

Consider the following:

- Getting monthly reconciliations up to date – start recognising the impact of year-end adjustments now to minimise the one-off nature of their impact
- Review clearing and holding accounts
- Review of aged accounts receivable balance
- Review of aged stock for recoverability – consider the impact of pre-reporting (as discussed above)
- Consider factory support programs and ensure all have been accounted for appropriately and up to date
- Schedule year-end stocktakes
- Ensure floorplan reconciliations are up to date
- Review all accruals and prepayments for any errors or adjustments
- Update annual leave and long service leave in line with payroll reports.

Contact us

If you would like more information contact:

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