March 2018

Weighing the Risks and Benefits of Service Loaner Programs

An article by Jodi L. Kippe, CPA, and Michael D. Perry, CPA

Audit / Tax / Advisory / Risk / Performance
Smart decisions. Lasting value.™

Service loaner programs are experiencing a surge in popularity. Manufacturers like these programs, which allow them to sell more cars. Dealers like the programs because they provide a convenience to customers and offer customers a chance to drive new car models. As service loaner programs become more popular, their associated expenses are becoming a greater area of concern for dealers.

As dealers today continue to face flat or declining gross profits and increasing expenses, they should take care to fully understand the benefits and risks of service loaner programs, including their associated costs, which can be significant, and tax implications.

Benefits and Risks

What makes service loaner programs so attractive to today's dealers? These programs are known to raise customer satisfaction and customer retention, which has the added benefit of potentially increasing fixed operations revenue. In addition, service loaner programs allow dealers to promote new models, which can lead to increased vehicle revenue. Despite these benefits, service loaner programs are associated with substantial risks and costs, including:

- Lease payments
- Finance costs
- Insurance costs
- Service capacity issues (when customers refuse service without a loaner)
- Depreciation (can be high for rentals)
- Incidental costs (such as fuel, parking tickets, and tolls)
- Sales and use tax

Quantifiable Costs

When managing a service loaner program, dealers should implement a tracking system to make sure they capture associated costs. Obvious expenses include lease payments, floor plan costs, insurance costs, taxes, depreciation, and incidental costs such as those associated with fuel, parking tickets, and tolls. Management also should analyze the gains or losses resulting from the transfer of a loaner into used vehicle (UV) inventory, which should be at fair market wholesale value, and the gross amount earned when the loaner subsequently is retailed.

These amounts should be compared to rental income and incentives provided by manufacturers to help dealers determine the real costs of the service loaner program. In addition, when recording the gains and losses associated with loaners, management should make sure the appropriate departments within the dealership are being allocated their fair share of service loaner program profits or losses. For example, if the loaners are being retailed at unusually high grosses, this may suggest they are being transferred at an undervalued amount, which could benefit the sales department and increase their compensation.

Management also should be collecting and monitoring cost data about the mileage, age, and makes of the models being transferred from the loaner program to UV inventory. Manufacturers' program guidelines typically dictate the parameters regarding how long a loaner is to remain in service. However, management still needs to closely monitor loaner inventory to make sure the right vehicles – in the right condition – are placed in the dealership's UV lot at the right time. Having a wrong mix of vehicles could lead to the dealer being stuck with aged vehicles, which potentially can result in lower grosses.

This risk becomes even more prevalent in instances where manufacturers pressure their franchises to use more vehicles as service loaners to boost vehicle sales. Closely monitoring trends related to loaner costs and their subsequent sales will assist dealers in this area. Many manufacturers require dealerships to purchase service loaner management software. If used to its full capabilities, this software can help dealers find savings opportunities related to service loaner use. Software capabilities include metric reporting of valuable data points such as:

- In-service time (average length of time vehicle is in the loaner fleet)
- Length of loan (total agreement days/total agreements closed)
- Turn rate (business days in the month/ computed length of loan)
- Utilization rate (number of days a vehicle was on loan versus the number of days a vehicle was available)

Unquantifiable Costs and Benefits

Unlike those already discussed, some of the benefits associated with service loaner programs can be difficult to calculate or measure. However, dealers still should be aware of them. One of the primary goals of a service loaner program is to increase customer satisfaction in the service department, which often can result in customer retention and revenue growth. Having loaner vehicles available for service customers is a great customer perk – and is often an expected one.

Customer satisfaction, however, can be difficult to measure other than by analyzing customer satisfaction index scores before and after implementation of a loaner program. At the same time, the expectation of a service loaner can create capacity issues if customers are postponing services until a loaner is available. This backlog can lead to delayed, or even lost, service revenues. Subletting rentals can help mitigate this issue, but a customer may become accustomed to a certain type of vehicle that cannot be provided by the dealership's local rental car company. Therefore, when implementing a loaner program, dealers should make sure they have an appropriate number of vehicles in service to meet customer demand.

As one way to help alleviate capacity issues, some dealerships use employees or a valet service to drop off the service loaner, take the customer's vehicle to the dealership for service, and then return the vehicle to the customer when service is complete.

In addition, dealers should implement incentives for customers to return loaners in good shape upon the availability of their serviced vehicles.

This will help protect future sales inventory mix. Unfortunately, loaner vehicles sometimes are returned to the dealership late, with an empty gas tank, or in poor condition. Service loaner rental agreements between the dealership and customers, therefore, should include provisions that hold customers accountable for additional rental fees, fuel, vehicle damages, and any other incidental costs. These provisions should be communicated upfront to customers to prevent confusion and customer dissatisfaction.

Tax and GAAP Considerations

The proper approaches to tax treatment for service loaner programs are complex and sometimes uncertain, including a lack of IRS guidance on dual-use property. Depending on various circumstances, including the loaner program's guidelines and when vehicles are made available for sale, a dealership's loaner fleet may be deemed inventory or fixed assets. Shorter service periods may indicate the loaner fleet should be treated as inventory; longer service periods may indicate treatment as fixed assets. For tax purposes, depreciation is not allowed on a fixed asset acquired and disposed of in the same tax year.

Other depreciation limits may apply as well. In certain states, regulatory requirements, along with sales and use tax requirements, are the most important factors that determine inventory versus fixed asset treatment. If the dealership follows the last-in, first-out (LIFO) accounting method for inventory that includes loaners, the loaners would need to be included in the LIFO calculation. Dealerships should fully disclose all details regarding their service loaner programs to their accountants to make sure the correct tax method is applied.

Dealerships that prepare their financial statements in accordance with generally accepted accounting principles (GAAP) also should consider the effect a service loaner program may have on their balance sheets. Often, loaners are funded through a dealership's floor plan or a manufacturer's captive agreement. These liabilities are presented as current on the balance sheet because they typically require curtailment payments, renew on an annual basis, and are due when the loaner is taken out of service. The vehicles may be presented as current assets (for example, loaner inventory) or as noncurrent assets (such as property and equipment), depending on whether the vehicles are expected to be disposed of within one year. A program that requires loaners to be in service for greater than one year may experience a detrimental effect on the current ratio, as a portion of the liability would be current and the asset non-current.

In addition, while some manufacturers provide loaners through leases, the leases normally require the dealership to acquire the loaners when taken out of service. When this occurs, the lease would meet the definition of a capital lease because ownership transfers at the end of the lease term. Accordingly, the service loaners and the corresponding lease liability would be recorded on the balance sheet. This would again affect certain balance sheet performance measures, such as the current ratio and debt-to-equity ratio. These changes to the balance sheet need to be considered, particularly if a dealership's lender requires GAAP-based financial covenants.

Weighing Benefits and Risks

Running a service loaner program at a dealership is a challenging undertaking. Today's manufacturers provide dealers attractive loaner incentives to help offset the cost of these programs, but a dealership still needs to meticulously track its program to make effective decisions. Most likely, the popularity of service loaner programs will continue for the foreseeable future, making them a "must" for dealers to please both manufacturers and customers.

To make sure they are getting the biggest bang for their buck, dealers must remember to take into account all the costs and benefits of service loaner programs.

Learn More

Jodi Kippe
Partner
+1 954 489 4742
jodi.kippe@crowe.com

Mike Perry
+1 954 202 8638
mike.perry@crowe.com

This article was originally published by Digital Dealer on March 30, 2018.

crowe.com

Text created in and current as of March 2018; Cover and artwork updated in May 2018.

The information in this document is not – and is not intended to be – audit, tax, accounting, advisory, risk, performance, consulting, business, financial, investment, legal, or other professional advice. Some firm services may not be available to attest clients. The information is general in nature, based on existing authorities, and is subject to change. The information is not a substitute for professional advice or services, and you should consult a qualified professional adviser before taking any action based on the information. Crowe is not responsible for any loss incurred by any person who relies on the information discussed in this document. Visit www.crowe.com/disclosure for more information about Crowe LLP, its subsidiaries, and Crowe Global. © 2018 Crowe LLP.