North country auto case

Business

Chapter 5 Profit Centers 201 Country Auto, Inc.

{Liddy, part owner of North Country Auto, Inc. , was feeling pretty the new control systems recently put in place for his five departtiers (new and used car sales, service, body, and parts departments) . . escrioes eacn aepartment. Mr.

Liddy strongly believed in the concept ” geach department individually as a profit center. But he also recoghl3. llengeof getting his managers to “ buy in” to the system by work’::. : ffotthe good of the dealership. Untty Auto, Inc.

, was a franchised dealer and factory-authorized llter forFord, Saab, andVolkswagen. Multiple franchises were beore common in the 1980s. But the value of multiple franchises. did f guidebook, published monthly, was, at best, a near estimate of liquidata; value.

Actual values varied daily with the supply-demand balance at auto . ~”” tions. These variances could be as much as 25 percent of the book value,’. . .

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. •. Ms. Robbins believed that she could sell the trade-in quickly at $5, 000 a.! :’ earn a good margin, so she chose to carry it in inventory instead of wholes . 1::; Chapter 5 Profit Centers 205 206 Part OneThe Management Control Environment “ Fmance fees consist of income that the dealer earns on dealer-sourced extended warranties sold through the dealership.

auto loans. It also includes the dealer’s commission on service contracts and it for a value estimated to be $3, 500. Mr. Walker, in turn, used the $3, 500 value in calculating his actual profit on the new car sale. In performing the routine maintenance check on the trade-in, the service department reported that the front wheels would need new brake pads and rotors and that the rear door lock assembly was jammed. The retail estimates for repair would be $300 for the brakes ($125 in parts, $175 in labor) and $75 to fix the lock assembly ($30 in parts, $45 in labor).

Cleaning and touch-up (performed by service department as a part of the service order for lock and brake) would cost $75. The service department also recommended that a full tune-up be performed for a retail price of $255 ($80 in parts, $175 in labor). The repair and tune-up work was completed and capitalized at retail cost into used car inventory at $705. These mechanical repairs would not necessarily increase wholesale value if the car subsequently were sold at the auction. The transfer price for internal work recently had changed from cost to full retail equivalent. The retail markup for labor was 3.

5 tim. es the direct hourly rate and about 1. 4 times for parts. George Liddy was concerned that the retail transfer price of the repairs in conjunction with his plan to eventually allocate full costs to each department (as illustrated in Exhibit 3) might encourage the used car sales manager to avoid the possibility of losses in her department by wholesaling trade-in cars that could be resold at a profit for the dealership. This might also hurt the dealership by making its deals less attractive for new car customers. Knowing how important it was to maintain credibility with each of the departments, Liddy called a meeting with the three department managers.

He decided to use the recently completed new car sale to illustrate the effect that transaction would have on departments' profits. In his presentation, Mr. Liddy laid out the transaction and allocation of profits and costs. After this presentation, Mr. Liddy asked for the reactions of his department managers.

Chapter 5 Profit Centers 207Alex Walker was the first to chime in, " 1 understand that the allowance above book value on the trade-in cannot be accounted for as profit. However, the real issue is how to set the price between me and Amy when we transfer the trade-in. 1 refuse to be responsible for any loss that might arise if the trade-in vehicle is liquidated at auction for an amount less than the wholesale guidebook value. Her department should be accountable for its valuation errors. " Amy Robbins vehemently disagreed.

" My department should not have to subsidize the profits ofthe new car sales division. Liddy quickly jumped into this deteriorating argument, " Obviously, we need to carefully consider how to set the price between the new and used car departments and who should be responsible for unexpected losses. " " Another item that concerns me," Robbins went on, " is using full retail price for parts and labor used in the repairs of trade-ins. Given underutilized capacity in service, I do not understand why 1 am charged full price. It doesn't make sense for the service department to mark up on projects undertaken for new and used car departments within our own dealership. can't see how we can make profits when one part of our company sells to another.

” Robbins added, “ When I am unsure of the actual retail value, 1 tend to wholesale rather than take a risk of a negative margin at retail. However, when I do this, we may be losing as an organization as a whole. ” “ I agree with Amy on this,” stated Walker, “ and I have the same problem with dealer-installed options. When 1 am charged full price for options, I have no incentive to try to sell these items. ” .

“ Hold on,” said the service department manager. 1 make my profit by selling service, and these are the prices I would charge for outside work. To sell service for a lower price inside defeats the purpose of this profit center idea. But 1 do have a problem with getting full price for parts. The demand for parts is derived almost completely from service, and we are dependent on parts for quick delivery for repairs. ” Liddy jumped back in.

“ Obviously, we are dependent on each other for quality and prompt service. We need to make sure that, as each of you maximizes profits in your departments, you do not negatively affect other departments. Liddy continued, “ I am also concerned about the impact of capitalizing trade-in repairs rather than expensing immediately. We all know that wholesale values drop with each publication of the new guidebook. I am afraid that, when a car is slow to sell, we might be reluctant to sell the car at a loss, even though we should.

Car inventory ties up cash, and a key measure of departmental success is our inventory turnover [average industry inventory turnover was 75 days for new cars and 45 days for used cars]. In conclusion, while I think the profit center concept makes good sense for this business, I am concerned about the frictions that are taking place between the departments. ” Questions 1. Using the data in the transaction, compute the profitability of this one transaction to the new, used, parts, and service departments. Assume a sales commission of $250 for the trade-in on a selling price of $5, 000.

(Note: Use the following allocations [new, $835; used, $665; parts, $32; service, $114] for overhead expenses while computing the profitability of this