

# Re-Engineering Your Operating Ratios

Nothing is sexier to a finance geek than ratio analysis – the relationship of numbers to other numbers. If you think one set of data points rocks, you can't imagine how much my blood pressure rises when I get to look at two sets of data points intersecting with each other! The only thing more erotic is when I can compare those intersecting data points with the data points of others.

Congratulations on reading this far. No one in the history of *The Director* has used the words “sexier” and “erotic” in the opening of an article. Nevertheless, I shall live up to this hype!

There are many financial questions that can only be answered by ratio analysis. As people manage their businesses,

they like to compare themselves to others, asking, “Am I better than my peer group?” That's natural. We have been raised to judge our height, weight, income and other factors in comparison to others. We compare our case count to others. When I first came into funeral service in 1984, funeral home owners would compare how many bronze caskets they had sold. If one guy heard that his competitor had sold five, he started telling his buddies he'd sold six. Unfortunately, braggadocio is the only byproduct of these comparisons.

In this month's re-engineering column, I'm going to define numerous operating ratios (more to come next month). You can compute your results, analyze

whether you're on target and, most importantly, learn how to correct your ratio if you're off target.

Before I go any further, I need to explain what a ratio is. A ratio is nothing more than a fraction. Like any fraction, you have a numerator (the number on top of the line) and a denominator (the number below the line). When you divide the numerator into the denominator, you get a number. It is this number we compare with others and from which we create national averages.

Now that you know how a ratio is formed, you can figure out whether the ratio has an error and what the cause of that error might be. There are just three things that could cause a ratio to be wrong. The denominator could be too large or too small, the numerator could be too large or too small or (this is getting really hot now!) both the numerator and denominator could be wrong.

Take, for example, an analysis that shows whether your receivables are in line. The denominator is annual sales; the numerator is the value of account receivables (A/R): *Account Receivables/Annual Sales*. Let's assume, for the sake of example, that annual sales are \$1,000,000 and account receivables are \$200,000. The formula would look like this:  $\$200,000/\$1,000,000$ .

The result of the calculation is 0.20. Another way to express this is 20 percent. In this example, A/R is 20 percent of annual sales. We like to see A/R at 11 percent of annual sales or less. In troubleshooting this, therefore, my presumption at the start would be that the A/R is too high.

There are ratios that are balance sheet oriented, others that are income statement oriented and a few that take information from each. Many ratios even take information from operating data, which is not a part of the accounting figures.

## Income Statement Ratios

*Average Revenue per Call* is the most

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common analysis of all funeral home operational statistics. The key points of analysis require that you understand the following:

*What is revenue?* Revenue is all income to the business that is earned from current operations from consumers. It does not include cash advances. It also does not include discounts from casket rebates, interest on receivables, income from written-off accounts or preneed commissions. So if it shows up on a statement of goods and services (other than cash advances), it is revenue.

*What is a call?* A call is any effort to serve a family or another funeral service professional. We categorize them in four categories:

1. *Casketed call:* any call in which you are serving a family directly in which the body is casketed in any "casket."
2. *Non-casketed call:* any call in which you are serving a family directly in which a body is not casketed or in a ship-out container.
3. *Trade or shipping call:* any call for another funeral home, local or distant.
4. *Indigent, contract or child call:* any

call for which you are not attempting to make a usual profit.

So the formula would look like this: *Total Revenue/Total Calls*.

There is no national average, despite what anyone tells you. We can compute one by adding up all of the money spent on funerals and dividing it by all 2.3 million deaths, but that would be weighted by the effect of states with the highest numbers of deaths. There is a much more effective way to assume the average revenue per call by state or even within a region, as the casketed/non-casketed rate is more regionally accurate. Every time you don't sell a casket, you probably don't sell a vault and you almost certainly won't sell a memorial marker. Therefore, revenue is going to be less in those regions with higher non-casketed rates.

*Average Wholesale per Call:* This ratio is another part of a simple but necessary analysis – the total amount of merchandise costs for the materials you purchase for resale divided by total calls. When performing this calculation, keep in mind the definition of merchandise, which is only the stuff you buy for resale

and only the cost of that stuff. It doesn't include payroll or other costs. The formula: *Total Cost of Goods Sold/Total Calls*.

Just as there is no national average for average revenue per call, there is no national average for average wholesale per call. We could compute one by adding up all of the money spent on caskets, vaults and markers and again divide that by all 2.3 million deaths, but it wouldn't mean anything to you unless you were in an area that replicated the national average. This is even more obvious when I see two funeral homes within miles of each other whose results differ by as much as 25 percent!

Average wholesale can be expressed as a dollar amount from the above expression. It is more telling, however, when compared as a percentage of revenue!

The *Wholesale as a Percent of Total Revenue* ratio represents the result of any choice of spending the consuming public is making. I can see if my dollar amount is changing due to an error of the staff or if my pricing for services is ineffective. So the formula looks like: *Total Cost of Goods Sold/Total Revenue*.

Look at the following example:

	2011	2012	2013
<b>Calls</b>	110	112	108
<b>Total Revenue</b>	\$720,000	\$735,000	\$742,000
<b>Total Cost of Goods Sold</b>	\$140,000	\$138,000	\$135,000

If I apply the previously stated formulas, I can see three things clearly:

	2011	2012	2013
<b>Average Revenue/Call</b>	\$6,545	\$6,563	\$6,870

I can observe that consumer spending increased slightly in 2012 over 2011, to a greater extent in 2013 over 2012 and over the three years studied:

	2012 over 2011	2013 over 2012	2013 over 2011
<b>Average Revenue/Call</b>	100 %	105 %	105 %

So the average revenue per call is increasing over the three years about 2.5 percent per year, with no measurable increase 2012 over 2011. This leads me to ask questions. Did you not raise prices in 2012? If you did, how could spending not increase to a measurable amount on average? If you did not raise prices, then what was the reason?

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When I look at the merchandise result, I make two very important observations:

	2011	2012	2013
<b>Average Wholesale/Call</b>	\$1,273	\$1,232	\$1,250
<b>Average Wholesale/Call</b>	19 %	19 %	18 %

The dollar amount of spending actually went down in 2012 when compared to 2011. While it decreased \$41 per call during that time period, my average wholesale/call went up a total of \$18. Since average wholesale/call went down \$41, that tells me that service fees, on average, went up about \$59 per call. I know instinctively that the price of caskets and other merchandise in 2012 went up 4 percent to 6 percent over 2011. So my conclusion is that families were choosing less merchandise. Merchandise that cost \$1,273 in 2011 should have cost about \$1,330 in 2012. So in real dollars, merchandise spending went down.

The same can be concluded about 2013, when spending went up \$18 on merchandise over the previous year but was still

under where it was in 2011. That same \$1,273 spent on merchandise in 2011, which would have been about \$1,330 in 2012, should have gone up another 4 percent to 6 percent in 2013. So for spending to remain the same in 2013 as it was in 2011, the average wholesale per call should have gone up to about \$1,395 in 2013. It didn't. While the average revenue per call did increase, it didn't increase sufficiently over the three-year period.

When looking at the average wholesale per call percentage, we look at relative spending – relative to actual revenue. As this spending goes from 19 percent to 18 percent, you might deduce that that's only a 1 percent decrease. But it's actually a 5.5 percent decrease (18 is 94.5 percent of 19)! People have lost presidential elections by less than 5.5 percent and were deemed political failures.

To make all of this more obvious, we should probably look at the case count for the three-year period (chart, top right).

It's clear in this example that the non-casketed component is increasing in number. As "casketed" declines and "non-casketed" increases, we are faced with

	2011	2012	2013
<b>Casketed</b>	88	87	86
<b>Non-Casketed</b>	19	22	22
<b>Trade Shipping</b>	2	1	0
<b>Indigent, Contract, Children</b>	1	1	0

a compounding problem. Another way to look at this is the percentage mix, as shown below. As the mix of cases is filled with more non-casketed cases, the result is affecting revenue. Since overhead (to be discussed next month) is probably increasing, there is only one part of the income statement that can change – profit.

	2011	2012	2013
<b>Casketed</b>	80%	78%	80%
<b>Non-Casketed</b>	17%	20%	20%
<b>Trade Shipping</b>	2%	1%	0%
<b>Indigent, Contract, Children</b>	1%	1%	0%

Businesses don't plan to fail and most of you don't fail to plan. You fail to observe. Next month, we'll look at ratios to preserve profit.

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