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Re-Engineering Your Overhead Ratios

Part 2: The costs of doing business.

If I were Shakespearean, I'd have a soliloquy that began, "Ratio, Ratio, wherefore art thou, Ratio?" As I shared last month, I find ratios simply wonderful. In June, we covered operating ratios and those demonstrating revenue trends. This month, we'll focus on the costs of doing business.

The key operating costs of a funeral home are staffing, funeral supplies, livery, marketing, variable facility, fixed facility, and general and administrative. I didn't invent these categories. Years ago, Federated Funeral Directors of America (FFDA) divided operations into these key categories. Service Corporation International (SCI) also used a version of these. Since more people starting acquisition companies came from SCI or SCI spinoffs, or used FFDA as their bookkeeping firm, it made sense that I should focus my practice objectives around this common language as well.

STAFFING COSTS

The number-one expense in operating a funeral home is payroll. There are several ratios to look at for payroll. The easiest is the total payroll, payroll taxes and benefits ratio: *Payroll + Payroll Taxes + Benefits/Annual Sales.* Assume annual sales are $1 million and the total amount for payroll, payroll taxes and benefits is $350,000. The formula looks like this: *$300,000/$1,000,000.*

The result is 0.35. Another way to express this is 35 percent. So total payroll costs are 35 percent of annual sales. We like to see total payroll at 26 percent of annual sales or less. Therefore, in troubleshooting this scenario, my presumption would be that total payroll is too high. This is where, in our troubleshooting, we can use ratios to help figure out if the problem is salaries, benefits or payroll taxes. If it is partly or completely due to payroll, we can then ask, is it the owner's payroll or employees' payroll?

Of course, sometimes there are extenuating circumstances. For example, 26 percent might be great if there's one location. For two locations that are fully functioning, this could be about 28 percent to 30 percent. There may be some duplication of staff with multiple locations, such as non-licensed staff and variable location managers. There could also be redundancies for removal staff if the locations are not near each other. These costs add up.

FUNERAL SUPPLIES COSTS

There are costs for supplies such as fluids, surgical equipment, cosmetics and often the cost of a third-party retort. These are included in the category of funeral supplies costs and are not included in cost of goods sold. They are in this category because you do not mark these up and offer them for sale to consumers.

Assume again that annual sales are $1 million and the total amount of funeral supplies is $30,000. The formula is *$30,000/$1,000,000.* The result is 0.03 or 3 percent. So total funeral supplies costs are 3 percent of annual sales.

This category of cost has been increasing over the past three decades, going from about 1 percent to the current 3 percent, essentially because the cost of relying on retorts has increased. If you own a retort, the cost of operations is really the fuel cost of about $50 per cremation, and I don't think there are many cases where $50 worth of fluid is used to embalm a body. If you need to utilize a third-party retort, those costs are several hundred dollars. So, while your cost is increasing dramatically, at the same time, your revenue from that call is probably less than a burial call. Therefore, costs are increasing.

We like to see funeral supplies at 3 percent of annual sales or less. If you are relying on an outside crematory for more than 90 cremations a year, you can probably afford to purchase a retort and save some money.

LIVERY COSTS

These include the cost of cars and other equipment on wheels. If you're a wordsmith, it's clear that the category name goes back to the days of renting or owning horses and horse-drawn devices. I think it sounds classier than saying "cars and trucks." This includes the autos you own and rent on a per-call basis. When I first came into funeral service, the industry had the second-largest fleet of limousines and the second-largest number of vehicles of all industries, right behind the auto rental business. This category includes autos that are given to staff, including owners, and specialty vehicles such as hearses. It includes the cost of the lease, insurance, repair, gasoline and maintenance.

Assume annual sales are $1 million and the total amount of livery costs is $50,000. Thus, the formula is *$50,000/$1,000,000.* The result is 0.05 or 5 percent. So total livery costs are 5 percent of annual sales. We like to see livery costs at 4 percent to 5 percent of annual sales or less. If your expense is more than this and the auto is not usual and customary, be aware of the possible loss of deduction.

MARKETING COSTS

These include advertising and promotion of the business, as well as preneed marketing. In today's world, it also includes a funeral home's Internet and social media budgets. Once again, assume annual sales are $1 million and the total amount of advertising, donations to be included in church bulletins, Internet costs and preneed soliciting are $40,000. The formula is *$40,000/$1,000,000.* The result is 0.04 or 4 percent. So total marketing costs are 4 percent of annual sales. We like to see marketing at 4 percent to 6 percent of annual sales or less. If marketing costs are higher, you need to analyze the results and determine whether the amount spent is effective. We see a great deal of funeral marketing money wasted on ineffective promotions.

VARIABLE FACILITY COSTS

Included in the variable facility costs category are the repairs for and maintenance of a business property. This includes routine maintenance, such as snow removal and lawn services, as well as repairs on anything that breaks in a funeral home. It does not include planned capital expenditures; those are capitalized, which means they are depreciated. So if a roof needs to be repaired, that is a variable facility cost. If the roof needs to be replaced, it's a capital expenditure. As money is spent to promote or protect the investment of the business, it can be a deductible expense, and it's just a matter of how quickly it is written off. Also within this category are utilities: heat, water and natural gas to maintain the building. (Natural gas to fuel the retort would be a funeral supplies cost.)

Note that this category is called "variable," as opposed to the next category, named "fixed." A business can have expenses that are known and essentially set before the accounting year even begins and other expenses that are unknown. This past year was the year snow removal service owners bought new cars and took trips to Hawaii! However, no one knows in advance what this cost is going to be. If you are renting your building, that expense is easy to compute in advance.

Once again, let's assume annual sales of $1 million and total amount of variable facility expenses of $30,000. The formula looks like: *$30,000/$1,000,000.* The result is 0.03 or 3 percent. So, total variable facility costs are 3 percent of annual sales. We like to see this category at 3 percent of annual sales or less.

FIXED FACILITY COSTS

This includes the rental cost of the building, including real estate taxes and business realty insurance. If the corporation owns the building, there is no rent. In my example, I will present this in two ways.

Assume the corporation owns the real estate and annual sales are $1 million and the total amount of real estate taxes and insurance is $30,000. The formula: *$30,000/$1,000,000.* So the result, in this example in which the real estate is owned by the operating company, is 0.03 or 3 percent. We like to see fixed facility costs at 3 percent of annual sales or less.

Suppose the real estate is owned by an entity other than the operating entity. This could be another entity owned by the owners, former owners or an unrelated party. Assume this property owner rents the real estate to you. If annual sales are $1 million and the total amount of lease payment plus real estate tax and insurance is $120,000, the formula would be *$120,000/$1,000,000.*

So the result when real estate is owned by an entity other than the operating company is 0.12 or 12 percent. So total fixed facility costs are 12 percent of annual sales. When realty is owned by another, we like to see fixed facility costs at 11 percent to 12 percent of annual sales or less. When the ratio is greater, it means that the profit of the business is accruing to the landlord. If the operating company owner is the landlord, the IRS could deny a deduction for some amount of the expense.

In a frequently occurring matter, we have found that when real estate is owned inside the operating company, revenue per call is often lower than comparable businesses in which the real estate is owned by another enterprise. We think this is because there is no rent showing in the former company's overhead. The absence of this rent leads the people who set the prices to think their overhead is lower, and they set their fees lower. Nothing can be less true. The lack of an expense is not an argument for a lower overhead. All that happens then is that you wind up getting a lower return on your investment!

GENERAL AND ADMINISTRATIVE

This is a wide-ranging category that includes bad debt, office expenses, dues, subscriptions, general insurance, accounting and legal. Before reaching a number for the entire category, we need to focus on a ratio for bad debt. Bad debt should not exceed 1.5 percent of revenue. If it does, it's too high, meaning that your arrangement proceedings need to be adjusted.

Assume annual sales are $1 million and the total amount of general and administrative costs, including bad debt, is $100,000. The formula: *$100,000/$1,000,000.* The result is 0.10 or 10 percent. So total general and administrative costs are 10 percent of annual sales. We like to see General and Administrative costs somewhere between 8 percent and 11 percent of annual sales or less.

We can therefore reach some conclusions on operating ratios. I will lead you to the balcony for a soliloquy of ratios next month, but I'm still debating whether my prose will appear in iambic pentameter, as Shakespeare would write, or in a Seussean style of rhyme, with respect to *The Cat in the Hat.* The Profit in the Pocket, perhaps? ✶

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