Daniel M. Isard

Re-Engineering Your Overhead Ratios: The Conclusion

For the past two months in this column, we've focused on operating ratios in the running of your business. As a reminder to readers, last month I promised that in the August column I would be writing in rhyme à la Dr. Seuss since I live my life following the basic storyline of the creation of this man (by the way, my favorite is *If I Ran the Zoo*). So, we are going Seussical! I'll call this column Horatio Sees Ratio.

Horatio sees a ratio. He sees ratios high and low. But before reading my last two columns, Horatio didn't know a ratio from radicchio.

Last month, I gave you the operating ratios of a well-run funeral home. But the numbers tell only a small part of the story. We have to review these ratios with operating data as well. The cost of goods sold is operating data and is a function of the casketed/non-casketed rate.

Expense	Recommended Ratio as a Percent of Revenue
Cost of Goods Sold	Varies based on casketing rate
Staffing	26%-30%
Funeral Supplies	2%-3%
Marketing	4%-6%
Livery	3%
Variable Facility	3%
Fixed Facility	3% if property is in operating company; 11%-12% if owned outside operating company
General and Administrative	8%-11%, with bad debt not to exceed 1.5%

In summary, we can compute the EBITDA (earnings before interest, tax, depreciation and amortization) of a funeral home. The outright variables are the casketed/non-casketed rate and whether the real estate is owned within the operating company or outside of the operating company. EBITDA could be in the range of 41 percent to 51 percent, less the cost of goods sold, with real estate in the operating company up to as much as 33 percent and up to 43 percent if the real estate is owned outside of operating company.

If this is the case, however, why is it that according to Federated Funeral Directors of America, the average profit margin this year is only 7 percent? My conclusion is simple: Most funeral homes are not well run.

Horatio didn't scream "Hooray" when looking at his ratios today. His profit wasn't fit, Monday to Friday.

Ratios are things that pencil-sucking geeks seek. They seek them day and night. They seek them here, there and everywhere. But bad ratios are indeed a fright all right!

The first thing you must understand in dealing with expense ratios is that the expenses might be fixed or variable. Remember, by definition, fixed expenses really don't change during the course of the year. The amount of the expense is set on January 1 regardless of how many families are served. A variable expense might be the same cost for each funeral, but it can vary in the total amount and in the percentage of revenue based on case count. Fixed expenses are very difficult to manage. Variable expenses are easy to manage. For example, in the chart above, different expenses are predictably either fixed or variable.

Expense	Fixed	Variable	Recommended Ratio as a Percent of Revenue
Cost of Goods Sold		X	Varies based on casketing rate
Staffing	X		26%-30%
Funeral Supplies		X	2%-3%
Marketing	X		4%-6%
Livery	X		3%
Variable Facility		X	3%
Fixed Facility	X		3% if property is in operating company; 11%-12% if owned outside operating company
General and Administrative	X		8%-11%, with bad debt not to exceed 1.5%

Horatio knew ratios are fractions. He knew the numerator even though he was a number hater. He dealt with the demon denominator that seemed to be his profit evaporator. If only he knew what the means to the ratio means.

Running a funeral business is difficult. Most of your expenses are fixed, yet you cannot control your market or demand. Usually, you run difficult businesses with more variable expenses. Variable expenses are only about 5 percent to 6 percent, plus the cost of goods sold. It's easy to manage a business with high variable costs as opposed to managing a business with high fixed costs.

If I were to use the now defunct Loewen Group as an example, this company had staffing costs that were high and grew higher year after year. Its staffing costs increased even though in many locations, the company was losing calls year after year. This was one of the key problems that led to Loewen Group's bankruptcy.

As an example of staffing correctly, look at most funeral businesses that would be described as "direct disposal companies." Their overhead is almost totally a variable cost. They hire contractors to supplement their small fixed staffing as needed. They use low-cost vehicles. Their building needs are minimal. So they take the fixed costs and drive them down while making most of the operating costs variable expenses. When you do that, you can be very profitable.

What Horatio didn't know was that when dividing fractions, you take certain actions and magically the number becomes unencumbered from itself. He discovered you invert the fraction and multiply, even though he didn't quite know why. He just did it this way each day until the day he died.

The result of this entire discussion on operating ratios is this: Revenue minus cost of goods sold minus operating expenses equals profit. Profit is a variable result! It is a result of your management of fixed and variable expenses. It is not a given. Over the course of the past 30 years, the average profit of a Federated Funeral Directors of America funeral home customer dropped from about 13.5 percent to 7 percent. 2013 was the first major increase in profit in more than a decade!

Profit schmofit, Horatio would hear, from funeral home managers at conventions drinking beer. Just give me calls and I'll be okay he would hear them say just before the bankruptcy attorney walked their way.

So profit is about half of what it was 30 years ago, and there are only three possible explanations for this: A) Consumers are spending less, B) costs are going up by more than consumers are spending or C) it's a combination of the two.

The correct answer is B! Consumers are not spending less. Yes, with cremation, many consumers are spending less, but by and large, the average revenue per call is increasing. Some years, it is increasing more than 5 percent! Operational costs are going up by more than consumers are spending. Casket costs are going up, health insurance costs are going up, salaries are going up.

As if all of this were not difficult enough, we have the preneed effect as well. I've written a logical and cogent argument about the complete dynamic of preneed in a 520-page book. When you set your GPL each year, for 70 percent of all funeral homes that accept the preneed account as payment in full, that preneed account does not react to the change in the price. You get as payment in full what the account bears. If you are located in states that have had massive preneed funding glitches, it is even worse. Today, by my estimate, almost 30 percent of all funerals are prefunded. Therefore, only 70 percent of your price adjustments are applicable to consumer spending, as 30 percent are paying whatever the value of the preneed account might be.

The guarantee you make is a loser's bet. I know, the insurance or trust companies tell you to do it, but remember, they are not governed by any form of guarantee themselves (except in some very limited states). The casket companies tell you to do it, yet they won't limit their price to you. Your staff wants you to be price sensitive while at the same time wanting fair and reasonable raises.

Let me summarize what we've learned so far:

- Consumers are spending more.
- Your prices are going up slightly.
- Overhead is going up more than your prices.
- The cost of merchandise is going up more than any inflation rate.

Defining profit is something left for theologians and philosophers. The brave accountants who walk in this midst do so at risk to their right brain. In my work, I have looked for a means to be consistent – a means to compare businesses, one to the other, even though many funeral homes have different models. Some have the real estate within the company and others have it owned through a related or unrelated company. Some are newly acquired and some are in the hands of owners for many years. Some have debt and some have none. Some are C corporations and some are pass-through tax entities, such as Sub S corporations. So defining profit cannot be done the way most accountants define profit, which is earnings after tax.

I have worked to define profit so that each of these differences doesn't misrepresent one business over or under another. First, we must measure profit before tax. Then we must eliminate the issues of depreciation or amortization, which are Congress-given tax incentives. Then I decided we must measure profit without regard to any debt service. This yielded a measurement of profit called EBITDA: earnings before tax, interest, depreciation and amortization.

EBITDA is an important comparative measure. However, there is another very common factor: rents. Some funeral homes have the real estate within their corporation and some outside, so rent is paid. Therefore, another comparative measure eliminates rent from the equation and now we have an acronym that sounds as if a pirate created it: EBITDAR!

So Horatio struggled and tussled and twisted and turned to understand earnings and his learnings went far. Searching for answers to increase EBITDA and EBITDAR, he sat in seats in seminars. Horatio discussed EBITDAR in the funeral home and in his car, on his boat and from afar.

Allow me to restate the initial chart with EBITDA as a part of the conclusion (below).

As you can see, the EBITDAR spread between a well-run company and a good company is about 10 percent. That means

Expense	Low	High
Cost of Goods Sold	Varies	Varies
Staffing	26%	30%
Funeral Supplies	2%	3%
Marketing	4%	6%
Livery	3%	3%
Variable Facility	3%	3%
Fixed Facility	3% if property is within the company	12% if there is rent
General and Administrative	8%	11%
EBITDA	51% less cost of goods sold	32% less cost of goods sold
EBITDAR	51% less cost of goods sold	41% less cost of goods sold

a company grossing $1 million of revenue can make $100,000 more if it is run well. If you use EBITDA, a well-run company will produce about 19 percent more profit, which, on that same revenue, is about $190,000!

That is only part of the equation. Since the value of companies is commercialized at a multiple of EBITDA, a well-run company will be valued higher than an average company. For example, if the multiple is five (the multiple changes based on many factors), the value of a well-run company is almost $1 million more than an average company! As Sen. Everett Dirksen said to his colleagues when discussing an appropriations bill years ago, "Gentlemen, a million here and a million there [and] pretty soon we are talking some real money!"

There is an imperative to running your company well. Sometimes it's making sure revenue is at its maximum. Sometimes it's making certain you are merchandising properly. In all cases, if we know our operating ratios, we can determine if operating overhead is the right amount or too much. If it's too much, we can alter the expense, but we must have the knowledge to be able to compare. The bottom line is that we can choose our profit. We must start, however, with the lowly fraction. We must know our ratios.

Horatio spent all of his time with meek geeks and tall geeks hoping to seek and find what would work in his mind to comprehend the end of ratios. He took humorous and numerous actions to perfect his fractions. He didn't question why, he just inverted and multiplied until he cried. He wasn't a geek, as much as he tried. Alas, he wound up getting no traction on the reaction between what would increase his EBITDAR. So after three articles on the subject of ratios, he chose to hire a geek. His next book will be called Horatio Hires a Geek. ✶

Dan Isard, MSFS, is president of The Foresight Companies LLC, a Phoenix-based business and management consulting firm specializing in mergers and acquisitions, valuations, accounting, financing and customer surveys. He is the author of several books and host of The Dan Isard Show at www.funeralradio.com. *He can be reached at 800-426-0165 or danisard@f4sight.com. For copies of this article and other educational information, visit* www.f4sight.com. *Connect with Isard and The Foresight Companies by following them on Twitter at @f4sight or on Facebook.*

The financial and tax advice contained in this article is for informational purposes only and may or may not apply to your individual position. Readers are strongly encouraged to seek the counsel of qualified advisors before undertaking any action based on this information.

Editor's Note: NFDA members can review past 2014 Finance 101 columns on re-engineering your business; digital copies of *The Director* are available at *www.nfda.org/nfda-publications/the-director.* Non-member subscribers can call an NFDA member services representative at 800-228-6332.