

Re-Engineering Your Overhead

Overhead, a simple component of the profit and loss statement (P&L), comprises every cost your business incurs. In fact, as you will discover, it comprises *all* costs, whether deductible or non-deductible. In fact, it is really more than the deductible and non-deductible items that represent every cost you incur to operate your business.

Of course, overhead doesn't really include such things as cash advances, which are "exchange items" that funeral homes account for as an accommodation to consumers. Cash advance items typically provide no profit to a funeral home; occasionally, they may have a small profit, but they are not intended to have such. For example, sometimes a newspaper will bill you a slightly lesser amount for an obituary than its published rate due to a discount you're awarded based on large purchases over the course of a year. This amount cannot be reasonably computed to consumers. I will tell you that in the more than 2,200 valuations I have performed in my career, fewer than 20 funeral homes have had an exact computation of "cash advances in" equaling "cash advances out."

Overhead can be a flat amount, essentially irrespective of how many calls you perform, or it can be a variable amount. For example, your cost of goods sold is a variable cost. Each family you serve has a cost, which is added upon the other costs. Full-time staffing is a fixed cost. Certainly there is some variable cost in staffing, but most funeral homes have a high fixed cost and a low variable cost associated with staffing and employee benefits. Funeral homes are tough businesses to run due to the high fixed cost you have.

Now let me introduce you to overhead in its three classifications.

1. Deductible Overhead

When establishing overhead, you have to look at a profit and loss statement and the line items of these costs. The key points

to the overhead are contained in your chart of accounts (COA), which is akin to a small paragraph for an accountant. For example, you might have the COA for cost of goods sold, but if that is the title of the paragraph, within the body, you are going to have (in no particular order) caskets, urns, vaults, clothing, cremation containers, shipping containers, temporary urns, register books, flowers and more.

The problem with a chart of accounts for funeral service is that there is no uniform COA for funeral service. If you eliminate the national companies from the approximately 20,000 funeral homes in the country, you're left with about 14,000 privately owned firms, which shakes down to about 10,000 owners. If you have 2,000 of these owners being served by a national accounting firm, that leaves about 8,000 other accountants who have at least one client who is the owner of a funeral home. As if the accounting world were a modern-day Babylon, we see many different languages spoken and entries noted in the oddest ways.

Deductible overhead consists of:

- *Cost of Goods Sold* This is the merchandise you buy for reselling to families at a profit and includes all of the items listed previously. It differs from funeral costs in that embalming fluid is not marked up and resold. The cost of formaldehyde is part of the embalming service you provide.

- *Staff Costs, Benefits and Taxes* This is the largest single cost of operations. This includes reasonable compensation for the owner/manager(s) and all full-time and part-time staff. If you use contractors for removal in lieu of staff, that cost would be in here also. The cost of benefits for health insurance, retirement plans, suits and other perquisites would be in this category. Payroll taxes, FICA, FUTA and SUTA are also included here.

- *Variable Facility Costs* As the name implies, these are the costs of your facility that are variable. This typically includes

utilities for heating, air conditioning and electricity and also covers repairs that are routine to maintain the property.

- *Advertising Costs* Advertising is the public marketing of your business. It would include any media purchases for ads promoting your business and website costs. This is also where the church bulletins and calendars would be lumped.

- *Other Funeral Costs* This is one of those COA that is getting more powerful each year. This is where you would place the cost of your professional service needs for embalming, surgical needs, and universal precautions. While these items are nominal, we include the cost of crematory expenses in this category also. These crematory expenses are increasing.

- *Automobiles* All of the costs of your livery go in this category, including auto leases, insurance, maintenance, fuel and even cleaning. If you are buying the autos with a note, this is where the auto interest expense would go, as well as auto depreciation.

- *Fixed Facility Costs* If you own the building in your operating company, the costs of rent would be zero, but the interest and depreciation (if any) on the property would go here. If you own the building via another enterprise or it is owned by an unrelated third party, you would pay rent and that rent is computed here.

- *General and Administrative* This is a giant catch-all category for several smaller charts of accounts, including bad debt, travel, promotion and public relations, legal and audit, telephone, office expense, other taxes and licenses, and miscellaneous.

- *Bad Debt:* your write-off of unpaid accounts.

- *Travel:* business travel for you and your staff needed for attending continuing education events or to accompany bodies.

- *Promotion and Public Relations:* the incidentals of influencing patronage. This

is where you would deduct the cost of tickets to take centers of influence to events and other such items.

- *Office Expense*: costs for your copier and other office equipment and supplies.

- *Other Taxes and Licenses*: a category for permits and taxes that are often issued on a local basis. This could include the cost of licensure for funeral directors, insurance licenses and crematory operator licenses.

- *Miscellaneous*: a category that is the sponge of the chart of accounts, absorbing everything that doesn't seem to have a place. Usually, this is where the general insurance expense is recorded, along with laundry or sundry expenses for your lounge.

There is one other deductible overhead expense: the "other expense (income)." Since we are recording expenses here, expenses are positive numbers. Income is actually a negative expense, which is why in the heading it is shown in parentheses. This is not necessarily operational income. It could include as expense any covenant payments, non-operation-

al consulting payments, preneed expenses for commission and preneed income from commissions.

Casket rebates can be shown in the cost of goods sold but I like to see it in

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the "other expense (income)" category as it often shows up at the end of the year. If you have a contract with monthly payments or credits against your new purchases, put those into cost of goods sold.

So if we add up all of the above items, we arrive at the total deductible overhead. It is not, by a long shot, the total overhead. That is still 479 words away!

2. Non-Deductible Overhead

Not all overhead is deductible. If you have debt on the purchase of the business, shares of the business, real estate or autos, that debt is split into two items. Within each payment you make to the bank are interest and principal. Interest, in most cases, is deductible. I say "most cases" because there are some situations in which it is not deductible. For the sake of brevity, if you are buying shares in a C corporation and are not materially participating in the operation of the business, it is deductible only up to the amount of the dividends paid out. If you are working actively in the business, it would be "trade or business" interest and thus deductible. However, regardless of your activity level, principal on any note is not deductible. This could be a large overhead item.

There are other overhead items that may not be deductible. The biggest risk to owners of a C corporation is that the salary you pay yourself or rents you pay yourself may not be deductible. If the amount is deemed excessive, that amount deemed to be above the fair market cost would not be deductible. Therefore, your business paid it out, but it is a dividend. Dividends are not deductible to the company. Also, meals you participate in are not deductible in full, and some portion of your auto expense may not be deductible either.

"There But You Don't Know It" Overhead

I rant constantly that this business can't compute its overhead with two hands at the same time (well, something akin to this). You don't include certain items that clearly need to be factored into your overhead that are really overhead. Large corporations build these in and so should you. They include:

- *Capital Expenditures* Yes, you take depreciation, but that is a tax-motivated matter. It is a return on the investment you made. You need to start putting money away for things for the future. If a new roof is \$25,000 and you need to put one on every 25 years, then \$1,000 a year should go into a savings account to pay for this. That \$1,000 is part of your current overhead.

- *Taxes* Yes, federal income taxes should be part of your overhead. If you have a profit, then you will have federal income taxes.

- *Profit* This is a big part of your overhead. In previous re-engineering articles, I talked about making sure you have a profit by building it into overhead. I will not restate it here, but profit must be built into your overhead or you won't have one!

Adding up all three categories and the components within each gives you the sum of your total overhead. Next month, I will take you through target percentages for each expense and some other operating ratios. ✦

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