Finance

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Let's Talk Seriously About Accounting

This profession is largely made up of caregivers. As such, you focus on the needs of the families in your community more than the needs of your own family.

We get it. Profit margins have gone down since the 1980s. The average profit for a privately-owned business has fallen by almost 60 percent from about 14 percent of revenue to 6 percent of revenue. Our studies conclude that this is due to four factors:

1. The Federal Trade Commission's mandated Funeral Rule and the creation of an itemized General Price List.
2. The rise in cremation and the inability to determine how to price for it.
3. The rise in preneed with the limited crediting rate on accounts.
4. The lack of desire on the part of the 10,000 owners of the 14,000 privately-owned funeral homes to understand their financial situation and needs.

Can you guess which has played the largest role in the decline of profitability? We suspect it is reason number four.

If you take the time to understand your income statement, you can determine what prices should be. Regardless of a family's choice to bury or cremate, you are rendering services that have overhead. You can match overhead with family choices. If you understand the annual increase in your overhead, you can mandate to your preneed insurance and trust providers that they manage the money to provide for these increases.

We are convinced that declining profit is the result of funeral home owners/managers not focusing enough time on accounting results. Of course, the accountants for these clients should share in the blame as well.

The issue cannot be resolved until funeral home managers understand the reason for accounting. There are three reasons:

1. To compile the data for an accurate tax return.

2. To provide the data to your lenders to maintain your debt positions.

3. To manage the business.

In all cases, accountants provide the data to do all three, but most focus on the needs in the above order. The order should be reversed. So many of you employ accountants and bookkeepers that don't know funeral service. They don't know a casket from a vault. They don't understand the effect the numbers on your General Price List have on your profit and loss statement.

Most accountants provide financial statements about six to nine weeks after the end of the month or quarter. How does that data help you? Most don't assess your position year to date, and if you are having an off year, teach you how to fix the problem. Most do the bulk of tax planning after your year-end by adjusting bad debts and depreciation.

In this article, we are going to show you the top five mistakes funeral home accountants make that adversely affect the financial results to the business owner. We will also show you how to correct these failures.

1. Choosing the Wrong Business Entity to Operate Within

The first decision to make when starting your business is the form of entity. There are several questions you will need to answer before you can determine which form of business is the best for you:

- How many business owners will there be?
- How much liability is there in your line of business?
- How will you pay taxes on your profit?
- How will you get out of the business when it's time?

Sole Proprietor

A sole proprietorship is the simplest and easiest form of business to start and maintain. A person that conducts a business without formally organizing is a sole proprietor. Taxes are filed for the business as part of the personal tax return on the Schedule C and the business income is subject to self-employment tax of 15.3 percent.

While it is easy to be a sole proprietor, it does not offer any protection to the owner's assets from creditors of the business. It also only allows for very limited tax planning. So, while it provides simplicity, it puts the business assets at risk and has the owner paying the most in income taxes.

General Partnership

A business with more than one owner that does not want to be a corporation generally organizes as a partnership. A partnership allows the business income to flow through to the partners without being taxed at the entity level. However, the partners are jointly and severally liable for the partnership's debts. A partnership offers no protection to the personal assets of the partners. In addition, the income of the partnership that flows through to the partners is subject to the 15.3 percent self-employment tax. So, while it provides simplicity for two people, it puts the business assets at risk, and the owners pay the most in income taxes.

In a general partnership, both owners are equal in all regards of control. A slightly more complicated partnership is called a limited partnership. We do not see this often in small partnerships unless one partner is going to be a silent partner. In a limited partnership, there is a general partner that is actively managing the business and a limited partner who is passive in many decisions. Regardless, it is still a partnership and does not have protection for personal assets from business creditors.

Corporation

A corporation is a separate tax entity. It is intended to segregate the assets of the corporation from the assets of the owner. Corporations are composed of one or more stockholders. There are small, single-owner corporations, as well as large corporations with thousands of stockholders.

A C corporation is probably the most recognizable form of business. One of the disadvantages of a corporation is that the income of the business is subject to income tax and then taxed again when distributed to owners. However, owners of a corporation are typically only liable for debts of the business up to the amount of their investment in the shares they have purchased, thus protecting their personal assets from creditors of the corporation.

Taxation for a C corporation is a graduated tax. The corporation pays a tax of 15 percent on the first $50,000; then 25 percent on the next $25,000; then 34 percent on the next $25,000; and approximately 39 percent on anything over $100,000. Of course, with all tax rates, this is subject to change when new tax bills are passed by Congress.

Distribution of earnings is accomplished through dividends to stockholders, generally taxable as ordinary income to the stockholder. Additionally, transferring the ownership of a corporation is a fairly simple prospect of selling the shares either in part or all of the shares of the corporation.

S Corporation

In the mid-20th century, the U.S. Congress created the S corporation to combine the benefits of limited liability and pass-through income for small business owners. The S corporation was created to benefit small- and family-owned businesses. As part of the creation of the S corporation, there were limitations to ensure the election was open only to small businesses and became a preferred choice for many small business owners.

While having all the formal requirements and limited liability of a corporation, owners gain the benefit of pass-through taxation status. The elimination of the double taxation on profits of the company is attractive to small business owners.

An existing corporation has the option of making an S election within 60 days of the close of any fiscal year. However, C corporations looking to make the S election should discuss this with their tax adviser as there could be significant tax consequences at the time of the election.

The difference is the tax consequences.

Limited Liability Company

Limited liability companies are probably the most versatile form of business available today. An LLC can be used to combine all of the most desirable traits of the other forms of business. An LLC enjoys the benefit of pass-through taxation (depending on tax election), and it also limits the liability of the owner to their investment in the business, shielding their personal assets.

Not only can an LLC elect to be treated as a corporation for tax purposes – it can also make an S election. This is beneficial for a company that is starting out small but wants to plan for significant growth in the future. You never know – you could be the next big thing in the funeral business. Everyone has to start somewhere.

	C Corporation	S Corporation
Revenue	**$720,000**	**$720,000**
Deductible Expenses	**$648,000**	**$648,000**
Taxable Profit	**$72,000**	**$72,000**
Tax Rate	**15% on the first $50,000 and 25% up to the next $25,000**	**Taxed as additional income on the individual tax return probably at a 34% or up to 39% rate**
Tax	**$13,000**	**$24,480**

This chart shows that the C corporation has a lower tax on an equal amount of revenue. However, the remaining earnings are locked inside the C corporation. To get earnings out of the C corporation a distribution of a dividend or salary is required, and that is taxed as ordinary income. That equates to a double tax rather than the single tax on the S corporation.

So, which should you be? While there are many considerations, most small funeral homes should own their real estate in an LLC and lease it to the operating company. The operating company should probably be an S corporation or LLC.

2. Cash versus Accrual Accounting Errors

There are two types of accounting methods: cash basis and accrual basis. The cash-basis method records revenue when it is received, and expenses are deducted when they are paid. The cash method is what all individuals use when computing their personal tax returns. The accrual method records revenue when you have the right to receive it, and expenses are deducted when they are incurred, not when they are paid. Almost all funeral homes file their business taxes on the accrual basis.

An accountant that does not know funeral service does not see the folly in filing taxes on the accrual basis. In fact, for almost 30 years funeral homes were required to file on the accrual basis. There is a long-faded tax court case on this issue as a business wanted to file on the cash basis. The business, which happened to be a funeral home, lost the case. It was crystal clear after that day that businesses selling merchandise as a component to their overall services had to be on the accrual tax filing, especially funeral homes. That is, until the early 2000s when a homebuilder fought the case and won.

Upon reading this case, we wrote the Internal Revenue Service and proposed several scenarios of funeral home operations. The IRS concurred that in each case the funeral home was eligible to file on either the cash or accrual basis. We shared this communication with one of our competitors in a holistic effort to help many funeral homes. The competitor declared that they were going to keep filing on the accrual basis as there wasn't enough benefit for the taxpayer. To us, that is lazy and selfish. It is akin to a funeral director not selling a family a bronze casket because it is too heavy.

Just as our tax laws were being formed, Judge Learned Hand wrote in a 1930s opinion on individual taxation: *Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes* *as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands.*

This doesn't mean that you cheat on your taxes. This doesn't mean that you deduct the cost of your child's wedding as a preneed seminar. This means the tax laws are written and available for all of us to read. We can all follow them and use them to our best advantage.

The issue with funeral home operations is simple. Most funeral homes allow clients to make payments over time for at-need arrangements. At the same time, they typically pay their bills on a timely basis. Look at the following scenario of an accrual tax basis funeral home *(see chart at right)*:

Case Count	120
Revenue	$720,000
Accounts Receivable This Year	$70,000
Deductible Expenses	$648,000
Taxable Profit	$72,000
Tax Rate	34%
Tax	$24,480
Net After Tax	$47,520
Net After Tax Cash Flow	$(22,480)

In this case, we have a 120-call business on the accrual basis with $720,000 of revenue of which about $70,000 is still uncollected. After paying bills, there is a taxable profit of about $72,000. Assuming they are a Sub S or LLC, these earnings are taxed on top of the owner's salary, so it will probably be at a 34 percent tax rate. The tax is $24,480. After paying all expenses and the tax, this business has negative cash flow of $22,480 since there is $70,000 not received. How can a business have both a $72,000 profit and negative earnings of $22,480? Does this sound familiar? Is this what your year-end statement looks like?

However, if this business were on the cash basis, that same result would be *(see chart below)*:

Case Count	120
Revenue	$650,000
Accounts Receivable This Year	$ -
Deductible Expenses	$648,000
Taxable Profit	$2,000
Tax Rate	34%
Tax	$680
Net After Tax	$1,320
Net After Tax Cash Flow	$1,320

In this case, we have a 120-call business on the cash basis. It has about $720,000 of revenue of which about $70,000 is still uncollected, so for cash-basis reporting, it shows revenue of $650,000. After paying bills, the result is a taxable profit of about $2,000 on the cash basis. Assuming it is a Sub S or LLC, these earnings are taxed on top of its salary at a 34 percent tax rate. The tax is $680. After paying all expenses and the tax, this business has positive cash flow of $1,320. Which outcome would you rather have? Positive cash flow or negative?

Don't get us wrong, accounts receivable must be collected, but you are only taxed when you collect them.

If you show this article to one of the old-fashioned accountants, they will smugly point out that if you collect all of the receivables next year, you will only have this benefit for the first year. They are wrong. It is more akin to having an interest-free loan from the government for about $24,000 for as long as you own the business. I would rather have that than owe the government.

3. Failure to Help You Set Prices Accurately

If your accountant is focused on tax, you probably don't get any management information from them until May, if ever. You need to make a new GPL effective January. If the CPA claims to know funeral service, they are giving you this data almost midway through the year. That is far too late to do anything beneficial with it.

Furthermore, if your accountant doesn't know funeral service, they don't know how to apply this data to help set your prices. You are probably just adding some false factor to last year's made up number and praying you will be somewhere near the result you need.

Think back to the good old days of accounting. The accountant would work with the business owner to get everything set up right. They would help with budgets and results. Today that knowledge is vacant from your advisory team.

Prior to 1984, before the FTC required itemized pricing, you took the casket price and multiplied by four or five and your prices were set. Since 1984, we have had to allocate the service fees to 16 different categories of charges and hope you were right.

It is impossible to have a high probability of meeting your revenue goals when you are guessing at your service fees. With a 50 percent national cremation rate, how can you rely upon the sale of caskets and vaults to provide for your overhead?

We need to gather the right data, make good assumptions and establish a pricing schematic for your business. Then each quarter, we determine if we made good assumptions. If the assumptions were flawed, then we make adjustments throughout the year. While you stay focused on your families, it is the purview of your accountant to do this number work for you.

4. Failure to Handle the Real Estate Properly

The single most expensive component to your business is the investment you make in your real estate. This asset is not just where you work and serve families – it is an advertising statement for your business every day of the year.

Since the real estate is such a large financial asset, you need to get the most finance leverage out of it. Many business owners make mistakes when it comes to their real estate. These mistakes are:

- Spend too much for it.
- Don't own it properly.
- Fail to take the right amount of rent out of the business.

Too often, a funeral home builds or purchases real estate to fulfill its ego and not its wallet. Funeral homes should not spend more than 80 percent of the revenue of the operating company (net of cash advances) for real estate. If you are planning a new business, that is 80 percent of the anticipated revenue 10 years from the startup date. Otherwise, you will be in the real estate business and not the funeral business.

As stated previously, we like to see the real estate owned in a separate LLC. We want to see the operating business pay rents to the real estate LLC. The rents provide a return on investment and pay any mortgage for the acquisition.

Rent should be 8 percent of funeral service revenue (net of cash advances). In the analysis, we have been working with, a 120-call business *(please see chart at right)*:

Revenue	$720,000
Rent % of Funeral Service Revenue	8%
Rent $	$57,600
Fair Market Value of Real Estate	$576,000
There should be a written lease for multiple years.	

5. The Proper Chart of Accounts

We have performed more than 2,500 business valuations, so we see the work of many other accountants. If someone works with many funeral homes, they may have figured out the chart of accounts.

The chart of accounts is a listing of all accounts used in the general ledger of an organization. The chart is used by the accounting software to aggregate information into an entity's balance sheet and income statement. The chart is usually sorted by account number to ease the task of locating specific accounts. This is as basic as accounting gets. If one accountant dies and is replaced with another, all the same entries are coded the same way.

The problem is three-fold. First, most accountants don't know the business so they put items into categories that don't make sense. For example, cost of goods sold is just what the name implies. It is the cost for goods and merchandise that you sell on a retail basis. Should embalming fluids be in this category? No, not unless you are selling them on a retail basis to families. Should payroll be in this category? No. Your staffing is not like a commercial store. Your staffing is used to provide service.

The second problem is the lack of accounts. For example, revenue. You have revenue from about 16 or more service items, probably five different types of merchandise and then exchange items called "cash advances." Most accountants do not have enough rows of categories for revenue. Almost half that we see in our valuation practice list everything as "revenue" and lump it all into one line. If you look at that, you cannot decipher if cash advances are increasing or if profitable revenue is increasing. You could have more revenue and less profit due to this laziness.

Lastly, you cannot look at your chart of accounts without interpreting it with your operating information. For example, staff cost. To say you have $200,000 in staffing cost means very little by and of itself. You have to contrast this to last year and the previous years. You must contrast this to revenue, so you know the percentage this is to revenue. You must also align this with the number of funeral directors you employ. You should also look at this based upon the type of calls (casketed and noncasketed) you are servicing. •