How Does Pre-need Add Value to Your Funeral Home?

by Daniel M. Isard, MSFS

SPOILER ALERT! There is no Easter Bunny, Tooth Fairy, and please don't make me talk about Sasquatch. I am the person who has been saying for four decades, pre-need is not an asset. I am not reversing my stance on this. You can't argue against the existence of gravity and that pre-need is a liability. You can put cushions on the ground so when gravity takes your body from the tree limb you have a chance to walk away.

By the same token, you can make good decisions in the administration of your pre-need program to protect this liability from being too large of a liability. I will explain in this article. However, the theme of this article is that pre-need can add value to your business. I will explain that as well.

Imagine that funeral home had been aggressively marketing pre-need for many years and had $3,000,000 in pre-need. The risk of a transfer failing is going to be much less, so a buyer would be willing to pay more on the higher side of FMV.

Math Doesn't Lie

In the worlds of accounting and valuation, pre-need is a simple analysis. At the end of the day the formula for pre-need is, "The Present Value of the Assets must be equal to or greater than the Present Value of the Liability." The Present Value of the Liability is easily determined. At the day a funeral home writes a pre-need contract with a consumer, that Liability is the face value of the contract. If that consumer signs a contract for a $10,000 funeral, the Liability is $10,000. Simple. If that day the consumer gives you $10,000 in cash or a life insurance policy for that value, the formula is $10,000 Liability equal to $10,000 of Assets. This is the optimum result.

Let's take this contract out three years. Assume the cash that is invested in a trust at 100% and that cash yields a Total Return of 3% per year, now you will have $10,927. That is the amount of your Assets. But how much is the Liability at the end of three years? Well, what is the price of that funeral if someone came in At Need? If you raised prices 3% per year, we would have a Liability of $10,927. Therefore, we are still at the optimum result.

The Guarantee

Somewhere in the evolution of pre-need funerals, someone thought it was a good idea to tell a consumer that the price they pay for a funeral, once funded, will not increase. This entire tangent of thought is abbreviated by the phrase, "The Guarantee." The Guarantee seemed like a nice idea, but in my research on the feasibility of The Guarantee, it is a terrible idea. Once again, math proves the idea doesn't work.

When a funeral home offers The Guarantee, they are now introducing the risk of Inflation out performing Investment Yield. Inflation is not the Consumer Price Inflation (CPI). Inflation is inflationary costs of running a funeral home. I label this Funeral Service Inflation (FSI). While some points of FSI and CPI are the same, most are either different or they are amplified in FSI. For example, the cost of health insurance, automobiles, gasoline, heating and housing is figured in both CPI and FSI. However, when CPI factors health insurance, it is for one family. FSI figures three families because that is the average number of families covered by a funeral home's health insurance.

If health insurance goes up 3% in a year, that is equal to a 9% increase in FSI! CPI figures the increase in automobiles, but funeral homes do not have removal cars that are Toyotas; and again the average funeral home has more autos than the average consumer. Of course, CPI doesn't factor things like caskets and vaults in their market basket of consumer purchases each year, but you purchase many of these indigenous merchandise items.

The net result is, in every year I studied burial cases, FSI was almost 200% or more of CPI! As I have seen cremation resulting in the majority of dispositions, the FSI is not as high but it is still higher than CPI. I have seen the cost of staffing alone go from 26% of Total Revenue to 36%–40% of Total Revenue for cremation cases.

If I take you back to the analysis of "Present Value of Liabilities must be equal or less than the Present Value of the Assets," if casket prices went up more than the Return on Investment, suddenly we have less Assets than Liability. If we see, as we have seen in the last several decades, the Return on Investment at 1% of salaries, benefits and casket costs going up at a greater amount, then the Liability is growing faster than the Assets. Suddenly this simple concept is growing out of your control because of The Guarantee.

The Trusting

Another way funeral service has screwed up pre-need is the trusting percentage of the deposits. Not all states are 100%

trusting. Assume a family makes a $10,000 funeral arrangement and pays $10,000 to the funeral home, but that funeral home is in a 90% trusting state. If you were to buy that funeral home, you now have a bunch of pre-needs that have 10% less in Assets than the Liability!

I am sure that some pre-need insurance company sales people are feeling mighty confident after reading this last paragraph. However, the comparison is not fair. Insurance companies ask a few questions to prescreen early claims from happening. These prescreening questions only affect those who are more likely to die before the insurance company can recover their costs of acquisition.

While I am comparing insurance to trust funding, insurance has a great advantage over trusts because it is self-completing for those paying via installments. Not all families can afford to pay a lump sum. If they have to pay via installments, insurance can compute what that amount needs to be to fully fund and if death occurs before the account is fully funded, insurance provides the difference on the initial amount.

As I stated above, not everyone can afford to pay a lump sum when they arrange. If you have a $10,000 funeral but the family can only afford to pay $2,000 a year for five years, that is not the same as investing $10,000 as a lump sum. $10,000 invested at 3% at the end of five years equal $11,590 but $2,000 a year invested at 3% at the end of five years equals $10,940. This is a difference of almost $650 or about 6% of the total funeral bill!

Installment payments with an insurance company have a premium to make up that difference. Trust billing typically does not, so the trust is going to be funded to a lesser degree when a family pays into a funeral pre-need trust in installments. Of course, there are other costs that are not taken into account by a trust billing, such as the cost of producing and accounting for those deposits. This could be about $25 per bill, making the net received on a trust that is paid via installments a greater shortfall than the lump sum deposit.

Preneed accounts that have been well invested don't necessarily increase value if the excess of those accounts is given back to the consumers, their heirs, or the state (in the case of SSI). While it is good for the Present Value of the Assets to be greater than the Present Value of the Liabilities, if you refund the excess, that makes the equation of the Assets equal to the Liabilities. Funeral homes that have the option to retain the excess and give it back, yet when there are shortfalls from The Guarantee are absorbing them, are again making the Assets less than the Liabilities.

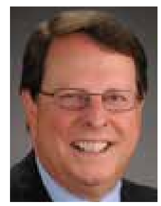
How Does This Work?

So, with all this negativity, how does pre-need add value? Imagine that a valuation of a funeral home results in Fair Market Value (FMV). FMV is expressed as one number but it is really a range. That range usually is narrow, within 5% to 10% of the value. When a funeral home has a large amount in their pre-need coffers, that is going to reduce risk on a transfer. That reduced risk results in a higher conclusion of value, within the range.

The typical funeral home has about 140% of its annual Revenue as pre-need balance. So, a business doing $1,000,000 of Revenue is typically going to have about $1,400,000 in pre-need account balances. That puts the risk at an average rate. Imagine that funeral home had been aggressively marketing pre-need for many years and had $3,000,000 in pre-need. The risk of a transfer failing is going to be much less, so a buyer would be willing to pay more on the higher side of FMV.

Is pre-need necessary? Yes! Is the guarantee necessary? No! If there are shortfalls and the family has no assets to make up the shortfall, then the funeral home should have the latitude to provide a lower priced casket or other merchandise to equalize the shortfall.

The very first article I ever had published in the 1980s was entitled, "Pre-need; Meal Ticket To The Future or Will It Eat Your Lunch?" I am sorry to say, in four decades, that question is still not universally answered. M



Dan Isard, MSFS, is founder of The Foresight Companies LLC, a Phoenix-based business and management consulting firm specializing in mergers and acquisitions, valuations, accounting, financing HR services and family surveys. He is the author of several books and hundreds of published articles in industry magazines, including "The Director's Finance 201" column. He can be reached at 800.426.0165 or danisard@theforesightcompanies.com.