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## When is overhead too high?

**Raleigh, N.C., January 22, 2014** – Selling, general and administrative (SGA) expenses, on average, represent about 25 percent of sales for a privately held company with more than $10 million in annual revenue, according to data from Sageworks, a financial information company. But SGA expenses, which are those that cannot readily be allocated to the cost of producing a specific good or providing a specific service, represent nearly 48 percent of sales, on average, for a private company with less than $1 million in annual sales.

With sales growth slowing among private U.S. companies, businesses need to preserve or grow the bottom line, and one way is to control or cut SGA, or overhead, expenses. In fact, sometimes it can pay more to cut overhead than to boost sales, because typically, more of the cut to overhead will fall directly through to profits than will a similar boost in sales.

How do you detect out-of-whack overhead? Overhead ratios can vary dramatically not just by size of business but also by industry, so one way is to use industry data to benchmark your overhead expense ratio to peers'. Overhead at privately held retailers, for example, in 2013 averaged 22 percent, but private firms offering professional, scientific and technical services (a category that includes consultants and lawyers) had average overhead representing 51 percent of sales, according to a financial statement analysis.

Industries with higher overhead rates aren't necessarily poorly run, said Sageworks analyst Libby Bierman. "Industries, like the retail sector, that depend on inventories and physical goods can more easily attribute product costs to a particular stream of revenue and therefore account for more in their gross expenses," she said. That, in turn, leaves fewer expenses to be lumped in with overhead, which can be something of a catch-all for businesses, especially those that don't have great cost accounting systems.

Even within a certain sector, such as construction, overhead rates vary. For example, overhead expenses for plumbing and heating, ventilation and air conditioning (HVAC) contractors have been running at about 25 percent of sales the last two years, while new home builders' overhead has averaged around 20 percent of sales, Sageworks' data show. These variations may reflect new home builders' higher relative percentage of expenses tied to direct costs (such as land and sub-contractor-provided services such as plumbing, framing and electrical) rather than to general administrative and marketing costs, said Michael Bohinc, owner of Keeping Score Inc., an accounting, tax and business management advisory services firm specializing in working with plumbers and HVAC companies.

HVAC or plumbing contractors, on the other hand, "primarily sell their services, i.e., labor," Bohinc said. "It's been my experience that labor generates significantly higher overhead amounts than materials in the construction industry." A lot of this is tied to "unproductive" labor costs, or labor that can't be directly billed to customers. This could include labor for providing estimates, if estimates are provided for free, for example.

It's not just private companies that may be looking to reduce overhead. Macy's (NYSE: M) and Target (NYSE: TGT) are among companies that have announced cuts in back-office jobs such as merchandise-planning and administrative positions. But controlling or trimming overhead can have an outsized impact on smaller businesses, because they spend a higher percentage of their sales on overhead, on average, than do larger firms, according to data from Sageworks.

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If you determine you are lagging peers in controlling overhead, how can you trim these expenses?

"A good starting point is reviewing the expenses that have historically gone into that number and setting up subaccounts to track those over time," Bierman said. "That practice will help the business owner identify directional trends and head off even small increases, which can be significant when you realize the connection to profit. Since 2011, the professional, scientific and technical services sector has been able to reduce average overhead by 3 percent, and in the same period saw average net profit margin rise between 2 and 3 percent."

Other suggestions for reducing overhead costs:

- Use web-based technologies to reduce costs tied to buying software and providing IT support.
- Shop around for commercial and workers' compensation insurance to seek a lower rate.
- Monitor unbilled labor carefully, as it is one of the major overhead expenses for contractors and some other labor-intensive firms.
- Trim fuel costs. "Proper scheduling of jobs and routing of the vehicles using tracking systems can bring significant fuel cost savings," Bohinc said.
- Evaluate your office space and its use. Greg Mertz, managing director of medical practice consulting firm Physician Strategies Group LLC, recently suggested that doctors consider moving billing, accounting and transcription staff to a nearby office that costs much less per square foot than does medical practice space. The medical practice can then turn the vacated space into exam rooms or modify them to support offering a revenue-generating ancillary service.

**About the Data**

Sageworks possesses a proprietary database of privately held company financial statements aggregated by industry. Each day, approximately 1,000 of these financial statements are collected by Sageworks from accounting firms, banks, and credit unions through a cooperative data model with Sageworks' clients. The data is segmented and can be queried by 1,400 industry codes, 70 financial metrics, company size, and geographic location.

**About Sageworks**

Raleigh, NC-based Sageworks is a financial information company. Sageworks' data and applications are used by thousands of financial professionals across North America to analyze privately held companies.

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