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IMPROVING PROFITABILITY THROUGH STANDARD PROFIT FORMULATION, A CASE STUDY OF INDONESIAN SMALL CONTRACTOR SERVICE COMPANY

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Abstract

This paper is based on quantitative research with a case study at a small-scale contractor service company engaged in civil, mechanical and electrical work in Indonesia. The owner, who also served as a director of the company, stated that his company faced a stagnant condition in the last three years, even though projects from customers were always there, internal audit found that there were problems with internal factors in the company, such as invalid financial reports, lack of working capital and unserved potential orders. The problem stems from a lack of competent resources in the administrative and finance sections. Because the owner serves as the finance and administration staff at the same time in order to save money on the company's expenses, decisions, financial records, and administration are not carried out properly, and the company does not know whether the project undertaken by the company makes a profit.This double hat role also raises another serious problem for the company, since the director neglects aspects of business development, due to leadership time being mostly spent on things that can be resolved at lower levels. In this study, a vicious circle pattern was discovered, which causes financial problems for the company despite the fact that it is working on many projects. Improvements in the organizational structure and the determination of profit standards are made so that the company can escape the vicious circle and finally be able to improve its profitability.

Keywords: contractor; profitability; small business

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Introduction

According to (Zaridis & Mousiolis, 2014), small-medium business has not been seen as an important part of the economy, but it is more seen in terms of its contribution to the achievement of employment opportunities for the community. Indonesia's population is expected to reach 269,6 million by 2020 (Supas, 2015), which can be a double-edged sword. On the one hand, this figure represents a great opportunity for the micro, small, and medium enterprise market, but it can also be a burden on the government if not managed properly (Peterson, 2017), similar to other small-medium business sectors, PT.XYZ, a small scale company engaged in civil-mechanical-electrical contractors which was founded in 2014, is the place where the author conducted this

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case study. When this study was conducted, the company had been established for more than 6 years, based on the small business lifecycle that was introduced by (Lewis & Churchill, 1983). There are five stages of the business lifecycle, and currently the company is in the survival stage, which means that the business has proven feasible to run, and already has loyal customers who regularly use the services or products offered. The company’s customer segment is large scale manufacturing firms. There were 30.115 large and medium manufacturing companies in Indonesia (BPS, 2018). This number is a potential market for PT.XYZ

Despite the number of projects completed, the owner stated that his business had not developed in the last 3 years, because the company often experienced a lack of working capital, did not feel any benefits that could be enjoyed from the projects obtained, the assets did not increase, and the owner also did not feel his increase in wealth. This condition is slightly different from the company's turnover record collected by the author during the internal audit. When compared to the initial position in 2018, there was a turnover growth of 90.24% in 2019 and it grew 23.11% in 2020. This phenomenon is very interesting, because behind the big growth in the last 3 years, the owner actually complains about the condition of the company that is not growing. The situation shows that the owner does not have a detailed view of the condition of his company as well as problems with managing the company. If left unchecked, it will certainly be dangerous for the company and it is not impossible that it will cause the company to fail.

(Gaskill, Van Auken, & Manning, 1993) describe four factors that lead to the failure of small businesses: Ineffective leadership, poor financial management, not competitive in the market, unable to grow and expand. At least two of the four things mentioned by Gaskill exist in the company. This research will look for existing problems and find solutions to overcome these problems based on PT. XYZ’s case.

Profit is the financial benefit obtained from business activities when income is greater than total expenses, costs and taxes, while profitability is defined as the company's ability to generate positive operating income or profit using its resources (Kenton, 2019). Three types of profit are commonly known, namely gross profit, operating profit and net profit. Gross profit is a profit that is calculated based on the selling price of the product or service minus the expenses incurred directly by the activities that produce the goods or services. More easily stated, gross profit is total sales minus the Cost of Goods Sold (COGS). Meanwhile, operating profit is gross profit minus supporting operating expenses. The last one is net profit, which is operating profit minus tax and interest expense (Ross, Jaffe, & Kakani, 2016).

(O’Mara, 2015) emphasizes the importance of gross margin management in company profitability. In a construction project, the estimated project cost which is translated into an offer to the customer should include all costs that need to be incurred in order to complete the project, both direct and indirect costs, according to (Kusnadi & Yudoko, 2016). These costs are illustrated in the image below:

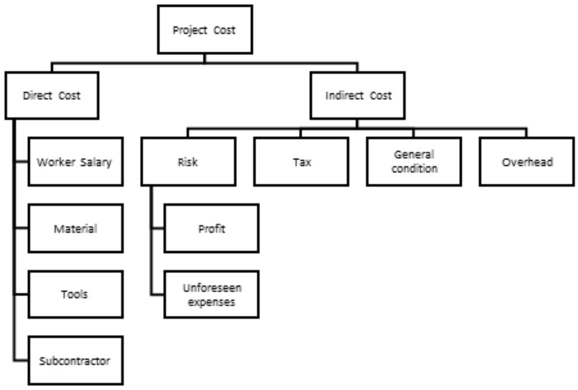

Figure 1
Project Cost Structure

Increasing a company's profitability can be accomplished in a variety of ways, including raising prices to increase the difference between the capital price and the selling price; lowering costs by negotiating material prices, finding new suppliers who are more competitive, re-discussing profit-sharing schemes for investors, or looking for financial institutions with lower loan interest rates; and increasing a company's revenue (O'Mara, 2015).

Construction service companies must be able to identify the costs required for a job before sending offers to customers. The recommended gross margin for construction is 34 to 42 percent for renovations, 26 to 34 percent for special jobs, and 21 to 25 percent for new building construction (Stefan, 2018). The main components of costs that are calculated as project overhead costs are office staff salaries, equipment costs, building rent, communication, transportation, electricity, field coordination, project administration costs and security. According to a survey conducted by Magaline et al. (2015), the amount of overhead costs for construction companies in Indonesia ranges from 0.1 to 24%, which includes project and office overheads.

Table 1
Overhead cost of contractor in Indonesia
(Magaline,2015)

Contractor size	0,1 - 6%	6,1 - 12%	12,1 - 18%	18,1 - 24%	24,1 - 30%
Medium-Small	40,63%	26,56%	25,01%	7,8%	0
Big	13,05%	52,17%	30,44%	4,35%	0

High overhead costs will be an additional burden for the company, making it less competitive in price with competitors who have lower overhead, but this does not always mean that overhead costs are always detrimental, because the components of the overhead costs are required to support the company's operations. ratio of overhead to direct costs will decrease along with the increase in company revenue.

The small business lifecycle is the stage of a business that starts from its inception until it becomes very large or even fails and dies. According to (Lewis & Churchill, 1983), the small business lifecycle consists of five stages. 1. Existence, the beginning of the establishment of a business. Cash flow planning is very important at this stage to keep the business running. The main problem that arises in the early stages is getting customers. Small business owners at this stage do almost anything that is necessary for operations. 2. Survival, If the business is able to enter the survival stage, it means that the business has proven feasible to run and already has loyal customers who regularly use the services or products offered. The problem that arises at this stage is to determine the profit that is not only to keep the business but also accommodate obsolete assets replacement and financing business growth to make it bigger. In the survival stage, the owner begins to delegate several important functions to employees. If they are able to pass this stage, the business will enter the third stage, but many businesses are held back for a long time in the survival stage because they are only able to generate marginal profits which are limited to keeping the company alive and can not accommodate asset rejuvenation. 3. Success. At this stage, the company is financially sound, reaching a size sufficient to be able to continue to exist indefinitely. Because of its stable position, the company can achieve profits above the company's basic needs. The organization began to be developed more broadly.

Managerial positions were held by employees who were recruited professionally. 4. Take-off. At this stage, the company is required to grow rapidly and be able to finance this growth and the owner is ready to fully delegate the business to professionals to increase the effectiveness of a complex organization. Failure in the take-off stage will make the business return to stage three, or even the business be sold because the cost of expansion paid for by revenue growth; 5. Resource Maturity. At the resource maturity stage, the company must be able to consolidate and control the financial benefits generated by business growth. On the other hand, the company must not forget its flexibility, speed of response to change and entrepreneurial spirit. At stage five, the company has been decentralized, has an independent leader in each division and is able to manage business units independently. If the company is not fast enough to respond to the demands of change, a phenomenon of ossification will emerge, characterized by slow decision making, less innovation and risk aversion. Then another company that moves more flexibly will emerge, which will replace the domination of this company in the market.

Method

A. Data Collection

A qualitative approach is utilized for data collection in the business coaching of PT. XYZ. Interviews are conducted to produce descriptive data in the form of written or spoken words from people and observed behavior (Basrowi dan Suwandi, 2008). Group discussions were conducted to find out the problems faced by the company, business processes and some technical details (Miles, Huberman, &

Saldaña, 2018). To get initial data about the company's income, the author recaps the purchase orders received for projects that have been undertaken by the company. Questioning frameworks and coaching models are utilized to help owners find solutions to problems facing the organization (Stout-Rostron, van Rensburg, & Sampaio, 2018).

Primary and secondary data related to the business of PT. XYZ obtained from the previous process was analyzed to identify problems that occurred and then obtain a solution to the problem (Miles & Huberman, 1994). Reduced data is displayed in the form of charts, text, matrices, or diagrams to aid analysis using the business process analysis method, Business Model Canvas, VRIO, Porter's 5 Forces, and STP, before moving on to the SWOT and TOWS analysis methods.Research conclusions are the result of two series of previous stages, where, since the beginning of data collection, regularity, patterns, possible configurations, cause and effect of the data have been recorded (Miles & Huberman, 1994).

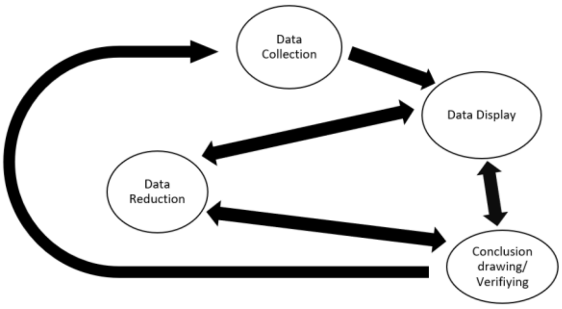

Figure 2
Data Analysis Component and its interaction (Miles & Huberman, 1994)

Furthermore, a cross-check is carried out to ensure the validity of the results and conclusions obtained, in action research such as business coaching, the coach stimulates the coachee to think about developing the potential around the client, which can affect organizational performance (Stout-Rostron, van Rensburg, & Sampaio, 2018). Methods that used in calculating the cost of services that are customized are Standard Costing, which is a estimated cost to produce one unit of a finished product or service. The standard used can be either a physical standard or a price standard. This method can also be a tool in evaluating the efficiency of the costs incurred in the project, by comparing the standard project price with its realization. In the standard costing method, costs are calculated based on standard quantities and standard prices for material costs, labor costs and overhead costs.

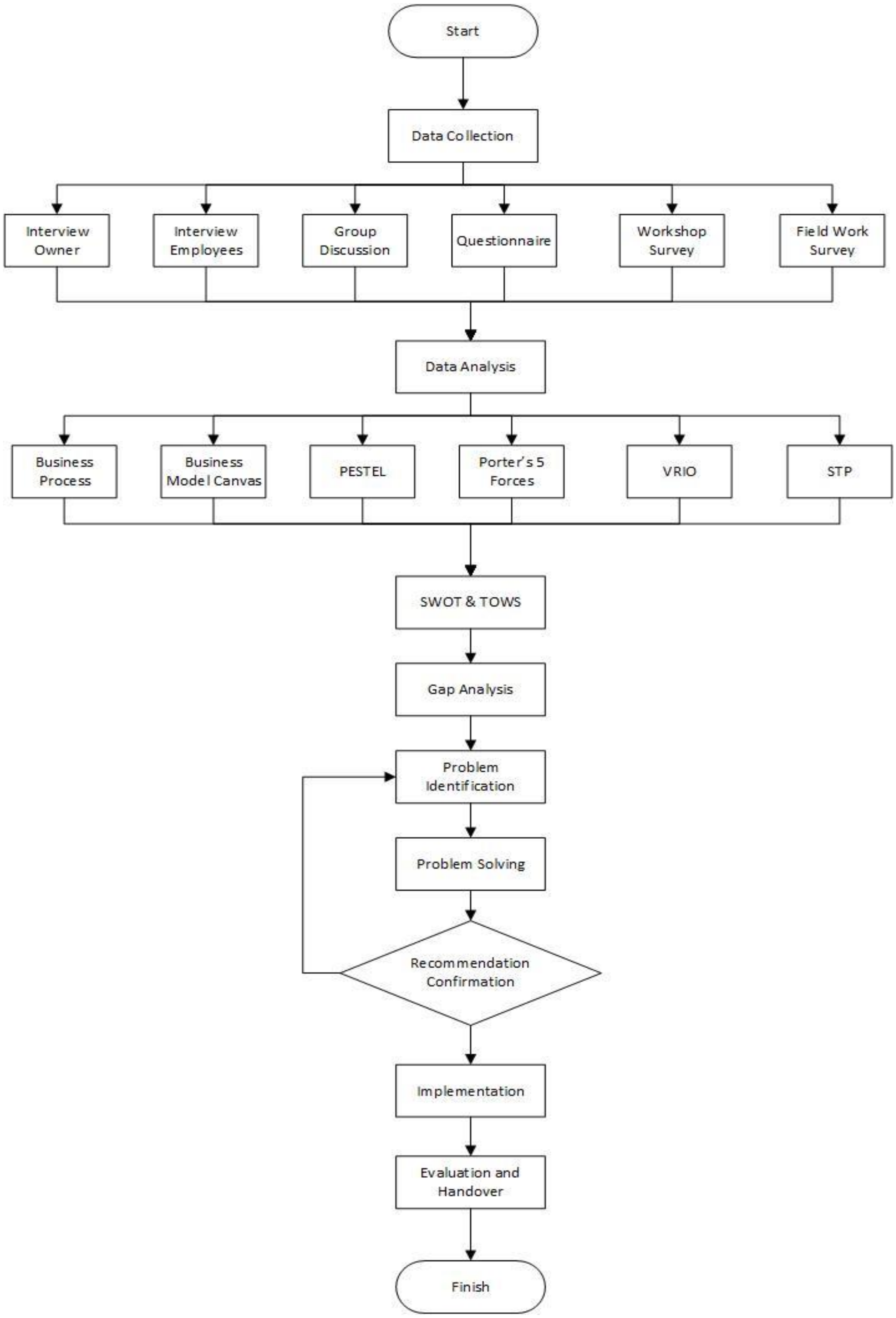

Figure 3
Action research process

B. Measures and Analysis

SWOT analysis is used to determine the state of a company's strengths and weaknesses, and the strengths, weaknesses, opportunities, and threats are mapped based on findings from the business process, business model canvas, PESTEL, Porter's Five Forces, VRIO, and STP.After identifying these four factors, the company can focus more on its own strengths, improve its weaknesses, pursue existing opportunities, and avoid threats that could jeopardize the company's business continuity. While TOWS matrix is created to continue the information obtained by SWOT. The TOWS matrix is used to analyze, compare, and select business strategies to achieve company targets. Four kinds of strategies can be developed in the TOWS matrix, namely SO (Strengths - Opportunities), ST (Strengths - Threats), WO (Weaknesses - Opportunities), and WT (Weaknesses - Threats). The results are then subjected to gap analysis. Through gap analysis, several important findings need to be resolved, including the fact that the directors do not receive regular salaries and can take company cash according to their needs, so it is necessary to decide on the director's salary and separate their personal finances from the company's finances. In addition, most project expenses are not recorded accurately because a double-roled director has no sufficient time allocated to handling them. Company fixed costs and unexpected costs in the field are not counted in the quotation. It is necessary to distribute a company's fixed costs for each and every project completed, as well as the costs that frequently occur unexpectedly in the field of bid prices. Another problem is that, unable to send price quotes due to limited working capital, outside investors are willing to collaborate with a profitsharing scheme if the financial reporting is carried out accurately and transparently.

Result and Discussions

A. Discussion

One of the problems that causes the owner not to know whether the project being carried out makes a profit or a loss is because there is no definite profit formula, so that, in sending a price quote, the owner only adds a nominal amount on an estimated basis after taking into account the material and labor costs that are directly related to the project. After going through a series of discussions, the owner finally realized that having a profit formula is what a company needs, so that the bids submitted do not cause losses due to incorrect estimation of margins.

The field entered by PT. XYZ is not price sensitive, because consumers prioritize service quality and safety in doing work, since the work is carried out in dangerous areas such as working at heights, working in explosive and flammable areas or working in confined spaces, so that reasonable margin adjustments relatively does not influence the consumer's decision to use the service, on the other hand profit margin after adjustment using the standard profit formula is still within the range recommended by (Stefan, 2018) for contractor service companies.

B. Results

Starting with identifying and separating company-personal assets, the company also identifies the fixed costs that need to be incurred by the company regardless of how much work is being done. The table below shows the details of the overhead costs that must be incurred by PT. XYZ in 2021. This amount includes new workshop rentals, additional employees for finance and administration, as well as the rejuvenation of work tools. Based on the costs identified, it is determined that the company must issue a fixed cost of Rp. 1,801,611,267, equivalent to 17.3%, with the company's revenue target for 2021 being IDR 2.5 billion, which is then charged to the quotation on a prorated basis as a mark-up on direct materials and direct labor, after which the margin is entered. Standard costing formulation is carried out in the following stages: Determining the variable cost components in the project, Determining the cost driver for variable costs, determining standard usage for variable cost components and multiplying them by the standard price, Add all variable costs and overhead costs to determine the standard unit cost. Prior to the business coaching process, the calculation as the basis for the quotation did not include overhead costs as a cost component. At that time, profit margins were immediately given according to the owner's estimate of 25% to 30%. So, at this stage, what is done is to include overhead costs of 17.3% from direct materials and direct labor before being given a margin, where the gross margin for renovation work, according to Stefan (2018), is recommended in the range of 34 to 42%. In addition, it is necessary to include a PPh 23 fee of 0.5%.

Table 2
Calculation for 1m^2 Brick wall quotation

Component	Standard Price	Standard Usage		Standard Cost	Amount
Direct Material					
Brick	Rp950	70	pcs	Rp66,500	
Sand	Rp200,000	0.05	m3	Rp10,000	
Portland Cement	Rp1,350	8.32	kg	Rp11,232	
Total Direct Material					**Rp87,732**
Direct Labor					
Workman	Rp240,000	0.1	OH	Rp24,000	
Helper	Rp150,000	0.3	OH	Rp45,000	
Foreman	Rp320,000	0.025	OH	Rp8,000	
Total Direct Labor					**Rp77,000**
Total Overhead					**Rp28,499**
Total Standard Unit Cost					**Rp193,231**
Margin 25%					**Rp48,308**
PPh 23 UMKM 0,5%					Rp1,208
Quotation Price to Customer					**Rp242,746**

In this study, we discovered that the company has been submitting price quotations that are too low because they do not account for overhead costs, which unconsciously affects the company's profit. Furthermore, the profit sharing scheme prior to the study adheres to gross profit, so the company's portion becomes very small because the company must bear the hidden overhead costs. Significant differences can be seen between the two profit calculation methods. With the old calculation based on the owner's estimates, it turns out that the net profit obtained is Rp. 5,024, while if the price quote is calculated using the standard profit formula, the company can get a net profit of Rp. 34,661 at a price that is still in the competitive price range. From this phenomenon, it is revealed that the statement of the owner of the company stating that his company has not developed in the last three years is quite valid, because the company apparently does not enjoy a reasonable amount of profit, because the offer price sent to customers only includes direct materials and direct labor, while indirect costs become a deduction from company profits, as well as profit sharing that is carried out on gross profit, so that at the end of the calculation, the net profit enjoyed by the company is only 2.34% of the project value.

Table 3
Previous method vs Standard Profit formula

	Without Profit Formula	**With Profit Formula**
Price Quotation	214,152	242,746
Direct Material	87,732	87,732
Direct Labor	77,000	77,000
Overhead	not determined	28,499
Markup	30%	25%
PPh 23	not included	1,208
Gross Profit	49,420	78,014
Gross Margin	23.08%	32.14%
Operating Profit	**20,921**	**49,515**
Investor Profit Sharing	14,826	14,855
Net Profit	**5,024**	**34,661**

With a turnover target of Rp. 2.5 billion per year in 2021, PT. XYZ's overhead costs will be 17.3%. According to Magaline (2015), 25.01% of medium-sized contractors charge overhead costs ranging from 12.1% to 18%, implying that PT. XYZ's overhead costs are still competitive when compared to other contracting companies. With this research, the company is aware of a minimum turnover limit that will make the company uncompetitive. This minimum volume of Rp. 1,801,611,267 per annum is calculated with an overhead cost scenario of 24%, a figure that based on Magaline's Survey (2015) exceeds the overhead costs of most of its competitors.

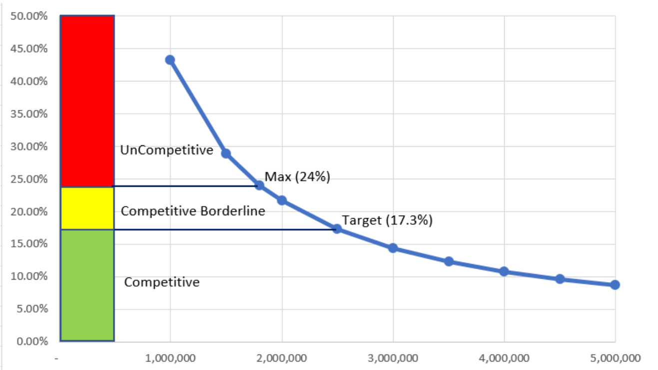

Figure 4
Company Revenue and Competitiveness (Author, 2021)

Along with the presence of employees who work full time in finance and administration, the company's financial records can be traced to conformity and then new financial statements are made. Once financial and administrative records are well managed, companies can break the company's vicious cycle. with improved financial records and report accuracy, the director has a dashboard to see indicators of the company's financial condition and performance that helps him to make business decisions, on the other hand it is easier for companies to get access to capital either through cooperation with investors or access to banking, cooperation with investors through profit sharing schemes is also easier to do because of precise profit calculations and transparency of reporting.

Figure 5
PT.XYZ's Vicious Circle (Author, 2021)

Conclusion

The question that arose at the beginning of the research was finally answered, because the owner did not feel that his company was growing, even though the revenue was always growing, because the profit margin obtained by the company was too small. As well as the problem of why companies experience financial difficulties with project funding, this is caused by poor financial management due to the absence of competent resources for handling financial and administrative aspects.

With this research, the company's profitability increased by 11.93 percent through synergy between the author and company owners, with the aim of formulating a standard profit formula to help the company Identify the profit they make from each project they work on by identifying fixed and variable costs incurred by the company in each project, as well as costs issued to keep the company running. The calculation of price offers prior to the business coaching process, which only takes into account direct costs, results in relatively small profits obtained by the company, plus a profit-sharing arrangement. In this research, we identified a vicious circle that makes it difficult for the company to develop a reluctance to recruit employees in the finance and administration department with the assumption that the position will burden the company and have no added value that can increase the company's profit, so the director chooses to work on aspects of his own. This prevents the company from growing because it is unable to identify the benefits obtained, perform accurate financial reporting, and accurately identify the true costs incurred on each project. This vicious circle can finally be broken with the recruitment of finance and administration employees.

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