FEATURE

Contracting is a Great Small Business

Best methods in how to set up and layout a contracting business

By Dr. Perry Daneshgari

Unlike other small business construction contracting, the electrical contracting industry requires more than a few "good guys" to start. Every way you look at it, small business has as many challenges as any other larger business. The difference is that contracting has a more fluid income and the contractor is only as good as "their last job." Just like any restaurant, they can only make your food or service bad once. The customers have a choice.

Small business is defined many different ways. The U.S. government has its own definition when it comes to qualifications for doing business with the government. If you would like to know about it, see this link: https://www.sba.gov/contracting/getting-started-contractor/make-sure-you-meet-sba-size-standards/table-small-business-size-standards.

In MCA's studies for IEC and NECA, we found out that 57% of electrical contractors are smaller than $5,000,000 in annual sales and 82% are smaller than $10,000,000 (See Figure 1 for breakdown of contractor sizes). So, the next time you give a few hundred thousand dollars job to a foreman to "run it" for you, you are actually giving him or her a company to run. What is even scarier is that they most likely have zero education, training, or experience in running a company, including money management, people management, and work management. The irony is that many of these foremen end up figuring it out by the school of hard knocks; and those are the ones that often go into business for themselves. The challenge becomes that as the "small business" moves from field to office, the "foreman" – who is now the owner – needs to know a few key things to be as successful at running his shop as he was at running his jobs. The common theme is: transfer value to the customer and they will vote with their dollars.

Build a Business Model

So, what should you do to start or improve your contracting company? First and foremost, realize that you are a business and not just an electrical shop. You may ask what does that mean? Here is what it means:

- A business is there to help the economy of the country to run by turning the money and employing people
- A business has to treat the money as "a means of commerce" and not just a means of wealth
- A business can depreciate its investment in properties of any kind
- A business is taxed based on its organization and selection of its type of business
- A business has to be active for it to benefit the society and the owner

Why are all these important to know? Because if you don't know the legal environment of your business you could easily lose it or be put away for violation of laws governing:

- Money
- People
- Environment
- Safety
- Material

All businesses should start off with a good lawyer and accountant. These two social professions are not something you want to fool with. Then you can start building or improving your business based on the markets you are in and based on engagement with your customers.

Your customers are the ones that pay your bills, send your kids to school, pay for your vacations, buy your next truck, and get you your next job. So be nice to them and arrange your company's operations based on their and your employees' needs. You could say, "I am taking all the risks," and you are correct. However, if you do it right you will also take all the rewards and then some – like being your own boss and everyone (sort of) following your commands and wishes. It makes you feel like "the Man" or "the Woman."

Now you are prepared to be in business, regardless of what business that is. So let's start understanding the contracting business. There are two basic business financial models. One is called "Variable Cost Model" and the other is called "Fixed Cost Model," (see Figure 2 and Figure 3 for the financial model schematics). As a construction contractor, you are operating under a "Variable Cost" financial model and most of the rest of the world operates under a "Fixed Cost" financial model. This simply means that your costs and your profits are driven by the amount of sales you have per year. In other words, if you

FIGURE 1 - Size of Electrical Contractors

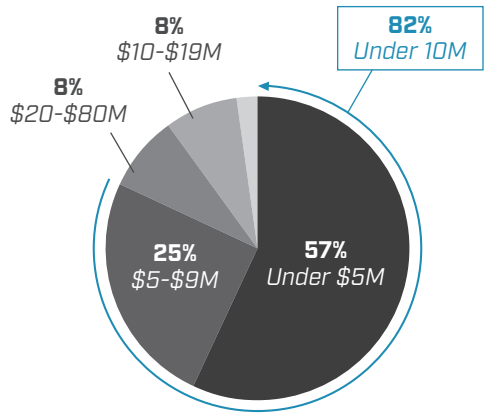
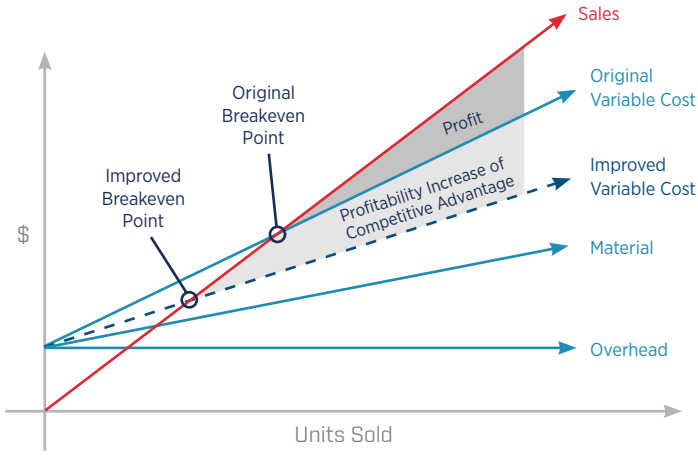


FIGURE 2 - Financial Model: Variable Cost Drivers



As the "small business" moves from field to office, the owner needs to know a few key things to be as successful at running his shop as he was at running his jobs. The common theme is: transfer value to the customer and they will vote with their dollars.

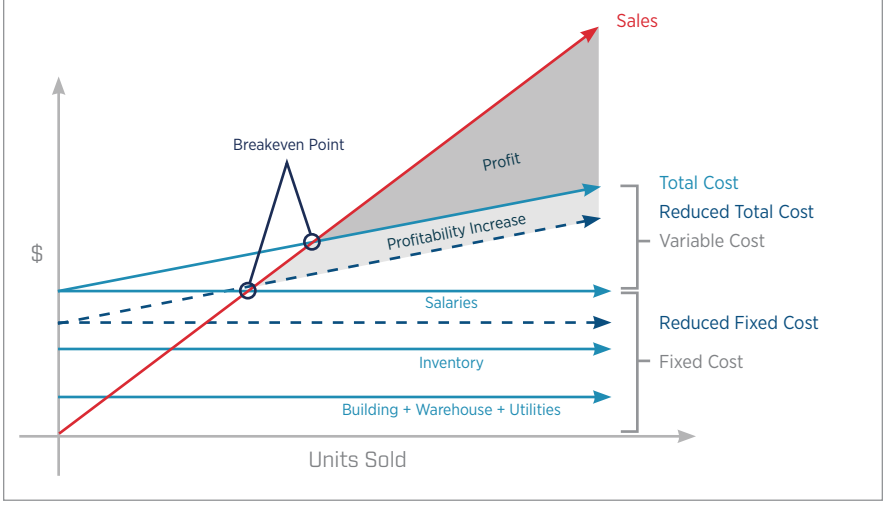
don't get any projects, then a majority of your costs go away, except the overhead, which should be between 9-18% of your sales volume, depending on the kind of work you do. If you perform with better margins, then this good for you. On the other hand, the fixed cost operators, like your general contractors, owners, manufacturers, and vendors have to sell enough to cover all their overhead, which is normally 80% of their annual sales.

Let's take another look at Figure 2, which is your operational financial model. On the y-axis, you have dollars. On the x-axis, you have the units sold. The units sold can be labor hours – which is the most common – or the number of dollars on the projects. The first vertical line corresponds to your annual overhead cost. If your overhead is a certain amount, just draw a straight line representing the dollars you have to spend if you don't have any project costs. This includes:

- Rent
- Gas
- Office personnel, including yourself and the employees you don't want to lay off
- Internet
- Utilities
- Etc.

Then on top of that line, draw your material cost per dollar sold. Don't worry about the exactness of it. Just take your material cost for the last three years and divide it by your project sales income, and then divide it by three or however many years you want to calculate it for. You can see as your sales dollars go up and as projects hours accumulate, your material cost will go up. Now do the same for the labor cost and draw a line on top of the overhead and material cost. If you now add your average sales dollars per labor hours sold from the base of the two axes you will get your "Break Even Point" (BEP), which simply means when you will make enough money to cover your overhead. That BEP is your magic number for making money.

FIGURE 3 - Financial Model: Fixed Cost Drivers



Let's assume you do everything right and you actually make more money – more than your annual costs. Now what? Now you have to find a way to deal with taxes and how it will impact your cash flow next year in March or April, when your accountant will tell you how much cash you have to fork out to cover those taxes. There are many different ways the government will help you to reduce the impact of this, which your accountant may not tell you because they have to worry about their own business. For instance, you can depreciate most, if not all, of your expenditure on capital goods or a lease, which simply means anything you spent more than $500 on. Let's say you bought a truck last year. Depending if it was new or used, there are different tax sections that would allow you to depreciate the entire, or a portion of, your cost. Depreciation means you don't pay as much taxes on your income as you would if you didn't have the depreciation. See, the government wants you to buy things to do your business. In case you're asking why, it's because if you are buying things other businesses are doing their work and you are keeping them employed. So to reward you, if for example you bought a truck for $50,000, they will allow you to take this amount off your annual income, which means you don't pay income tax on $50,000 of your sales, depending on how you will depreciate it.

I know this amount of information may be much to consider, which is why we will be writing more about the "Small Business" topic in future articles. Look for those to come as we want to help you run your business better. You can always call or contact me for more information.

Dr. Perry Daneshgari is the president/ CEO of MCA Inc. MCA Inc. is a research and implementation company that focuses on implementing process and product development; waste reduction; and productivity improvement of labor, project management, estimation, accounting, and customer care. He has also published four books and an ASTM Standard for Job Productivity Measurement.