Key Financial & Accounting Metrics Small Business Owners Need to Master

Jim Ashley / jim.ashley@forvis.com

Small business owners never run short on tasks needing their attention. There are some days in which these tasks are accomplished with ease, yet there are other days these tasks can seem overwhelming. Without the experience of perspective and learning the ability to prioritize, you'll be at risk of stagnation and ultimately burnout. Accomplishing tasks is a critical component of day-to-day operations, but to drive long-term success, small business owners must prioritize time for goals and strategy development. Operational strategy is measured by the language of business, finance, and accounting; there are some key financial and accounting metrics small business owners must master to help drive success for the long term.

Cash Flow Cycle

There's no doubt that cash is king, but managing your business by your bank account balance is only one (albeit critical) metric to consider. Positive cash flow and a growing bank account are the ultimate outcomes of success in the business cycle, but like everything on your balance sheet, those are merely that day's snapshot. Small business owners must understand their business's cash flow cycle so they can learn to better manage and grow this king of all assets.

Cash flow from operations starts with sales, and the company's ability to effectively collect on its sales is a driver for success. Unless your cash collection occurs at the time of sale, the accounts receivable days on hand (also commonly known as Days Sales Outstanding or DSO) metric must be mastered. This metric measures the average number of days it takes to collect on billed invoices and is calculated by dividing your account receivable balance by annual revenue and then multiplying that outcome by 365.

$$\text{Accounts Receivable Days on Hand} = \frac{\text{Account Receivable Balance}}{\text{Annual Revenue}} \times 365$$

Performing periodic analysis of this ratio will prove out the small business's increase or decrease in its ability to ultimately collect on its sales. We suggest identifying and comparing this metric to your industry's average as a benchmark; you can then set management's goals and implement the related strategy.

As your small business collects cash, it must then schedule and pay its bills that were previously incurred. The inverse to the receivables metric noted above is the accounts payable days on hand ratio. This will measure the average number of days that a company takes to pay its bills and is calculated by dividing the company's accounts payable balance by annual cost of sales (or cost of goods sold) and multiplying the outcome by 365.

$$\text{Accounts Payable Days on Hand} = \frac{\text{Accounts Payable Balance}}{\text{Annual Cost of Sales or Cost of Goods Sold}} \times 365$$

Like the receivable metric, a small business should identify its industry average and then develop goals and implement strategies to more effectively manage cash outflows—we encourage analysis with respect to taking advantage of vendor discounts for early or timely payment.

Inventory-driven business owners must understand the cash cycle relationship of producing inventory, converting the sale, and ultimately collecting the cash. The average age of inventory (sometimes called days inventory outstanding or days in inventory) is another great metric to measure your small business cash flow cycle. Calculate this metric by dividing the company's average inventory by annual cost of goods sold and multiplying this outcome by 365.

$$\text{Average Age of Inventory} = \frac{\text{Average Inventory}}{\text{Cost of Goods Sold}} \times 365$$

The average age of inventory will measure the liquidity of the small business's inventory—in other words, how many days its takes to convert inventory into cash. Investigating your industry's average is the critical first step to understanding how well the small business manages its stock. This metric is another important indicator to measure and ultimately master for the cash flow cycle. However, the most strategic outcome will be driven when management focuses on improving and mastering all three of these cash flow cycle metrics.

Gross Profit Margin

If cash is the gas in your small business's tank, then profits are how you refill it. Small business owners should be careful to not confuse the correlation of revenue growth leading to profit growth. The first step in better understanding this concept is shifting your mindset from a model of "all-out" sales generation to one of margin-based growth. To do that, you need to understand and distinguish your business's direct or variable costs versus overhead costs. Once you have isolated your direct costs, you can measure your gross profit margin and calculate the gross profit percentage. To determine this, subtract your direct costs from your gross revenue and divide this result by total revenue. Gross profit percentages can vary over the short term but must be monitored and adjusted over the long term. Small businesses should first determine their industry's average gross profit percentage before developing a strategy. Depending on your industry, labor will play a varying role in your company's gross profit. For service-based businesses, much of the labor expense is the true direct cost, but for product-based businesses, labor is more of a hybrid cost requiring analysis and allocation of overhead labor versus direct labor. The key to success with this metric is knowing and understanding your company's and industry's sales cycle, direct costs, and labor interplay.

$$\textit{Gross Profit Margin} = \frac{\textit{Gross Revenue-Direct Costs}}{\textit{Total Revenue}}$$

Employee-Based Metrics

This article has touched on various accounting terms (cash, accounts receivable, accounts payable, and inventory), and these are all measurable and reportable on your small business's balance sheet—but what about employees? You're probably familiar with the phrase "Employees are a company's most valuable asset," yet you don't see this listed on the balance sheet of your small business. So what's the disconnect? Rightly or wrongly, employees aren't an "accounting" asset, but they're clearly a critical component of success in your small business. As noted above, labor costs directly interplay with profitability and can sometimes be the direct cost driver for your small business's margin. A key employee-based metric is revenue per full-time employee, which can be calculated by simply taking your annual revenue divided by average full-time employees. However, similar to the concept of gross profit, product-based small businesses should measure gross profit per employee by dividing your annual gross profits by average full-time employees. The ability to measure, monitor, and eventually forecast the labor needs in your small business is an essential component of long-term success.

$$\textit{Revenue per Full-Time Employee} = \frac{\textit{Annual Revenue}}{\textit{Average Full-Time Employees}}$$

$$\textit{Gross Profit per Employee} = \frac{\textit{Annual Gross Profit}}{\textit{Average Full-Time Employees}}$$

Recap & Next Steps

Small business owners should learn to master cash flow, margin, and employee-based metrics applicable to their industries. Long-term success involves the development and pursuit of goals as monitored and measured by these key metrics. Learning your industry's metrics, understanding the success drivers in your small business, and investing the time to implement financial-based strategies will help set the stage for growth and attaining your goals.

Do you need help getting started or help with accountability? Visit our Outsourced Accounting Services page to learn how we can assist your small business with mastering these metrics and connect with a **FORVIS** professional today.