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EBOOK

A guide to small business finance

Understanding small business financial management



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Understanding Financial Statements

With so many things to juggle in a small business, it is all too easy to be immersed in your day-to-day operations and neglect the big picture. As you plan for one year, five years, or even a decade from now, it is important to keep up with your finances.

Most small business owners are not accountants. And many small businesses don't know which product or service makes the most profit. As a small business owner, it is crucial to understand your financials so you're aware of how your business is doing at any given time.

At a high level, your financials refer to reports and statements that offer insights into the financial health of your small business. In this guide, we will cover the Income Statement, Balance Sheet, and Cash Flow Statement as well as the key accounting formulas to help you evaluate your key performance indicators (KPIs).

What is an Income Statement?

A business's performance is reflected in the **Income Statement**, also known as a **profit and loss (P&L) statement**. The statement includes business income, operating costs, and expenses used to calculate total business profit or loss for a specified financial period.

P&L statements help you manage your business better and keep your financials on track. A monthly statement monitors the performance of your business against stated projections—reflecting a profit, loss, or break-even situation. If the P&L identifies problems, you will have a chance to correct them before anything gets out of hand.

What is a Balance Sheet?

While producing positive net income is a critical first step, it doesn't tell the full story. The **Balance Sheet**, sometimes referred to as a statement of financial position, essentially identifies your company's net worth.

On a Balance Sheet you will list out what your business owns (assets) and how much it owes (liabilities) to determine your Return on Assets (ROA). Your ROA is a key indicator of your company's ability to generate future revenues.

What is a Cash Flow Statement?

To have enough cash available to run the day-to-day business operations and cover any unexpected expenses, you will need to forecast and plan for cash coming in and going out of your business as accurately as possible.

The **Cash Flow Statement** summarizes the amount of cash your business takes in, the sources of cash, the amount of cash that goes out, and how cash is used. Think of the Cash Flow Statement as the bridge between the Income Statement and the Balance Sheet.

In addition to these three main financial statements, other reports – such as a sales report or an accounts receivable aging report – can add tremendous value and help you better understand the financial health of your business. It's important to have accurate and timely financial statements that are customized to suit your business so you can spot problems early and enhance your decision making.

Accounting Formulas You Should Know

The data that goes into your financial statements are calculated from your business metrics, such as total sales and monthly expenses. To understand if those numbers are healthy, there are several accounting formulas that analyze your business performance. Below are the ones to become familiar with.

Formula	Calculation	Explanation
AR Days Sales Outstanding	Days Sales Outstanding = (Avg. Accounts Receivable Balance / Sales) * 365	This is a measure that indicates how much a given period's sales are uncollected at a given point in time. This measure should be as small as possible for a successfully growing business.
Break-even point	Break-even point = Sales – Costs = $0 profit	Your break-even point for your goods or services lets you know when a sale covers the full cost, both fixed and variable, to deliver a good or service. This calculation can help you manage costs and determine a sales price that will ensure a profit.
Current Ratio	Current Ratio = Current Assets/Current Liabilities	This is a balance sheet measurement that also seeks to measure your ability to cover current obligations with current assets. It includes inventory that generally takes longer to convert to cash. A strong ratio is 2 or above.
Debt-to-Equity Ratio	Debt-to-Equity Ratio = Debt / Owner's Equity	This is an indicator of a company's ability to borrow. It tells a bank how much external debt a business has in relation to the owner's own investment (represented by balance sheet equity or net worth). For most industries, a banker will not loan funds to a business with a Debt-to-Equity ratio that is higher than 2.
Gross Margin	Gross Margin = Gross Profit / Sales	This is a critical first measure of success and indicates the percentage of direct profit you are generating on sales of goods or services. Your Gross Margin enables you to see if you are generating sufficient returns on your goods and services.

Formula	Calculation	Explanation
Inventory Days Outstanding	Inventory Days Outstanding= (Inventory / Cost of Goods Sold)*365	This is a measure of the amount of inventory (in dollars) you have accumulated in relation to the cost of items sold during a period. You want this number to be as low as possible, indicating your ability to produce maximum sales from minimal inventory investments.
Inventory Turnover	Inventory Turnover = Cost of Goods Sold/Inventory on Hand	Inventory Turnover is another way to measure operational efficiency in managing inventory. This is the inverse of the previous inventory measure and can be calculated for individual items on hand. It is designed to indicate which items are moving most rapidly, helping you determine which items to re-stock. You want this number to be as high as possible for each item in inventory.
Net profit	Net profit = Sales – Expenses	Net profit, sometimes referred to as the bottom line or net income, is the amount left over after all expenses, including the cost of goods sold, operating expenses, and debt, have been accounted for.
Net profit margin	Net profit margin = Net profit / Sales	While knowing you net profit is important, your net profit margin is a stronger indicator of your business's financial health. If you profit margin is slim or doesn't improve over time, it may be time to re-evaluate your pricing or change your service or product offerings.
Return on Assets	Return on Assets = Net Income/ Total Assets	The ratio gives you an indication of how efficiently your assets are being used to generate profits.

Benefits of Accounting Software vs Spreadsheets

It is not uncommon for a small business owner to start tracking their business finances with a spreadsheet. Or perhaps more accurately, a series of spreadsheets.

However, as your finances become more complex, you'll quickly discover spreadsheets don't grow well with your business. In a spreadsheet every financial transaction, such as a payment arriving in your bank account, must be manually updated. This not only takes up time, it also increases the likelihood of data errors. Manual data entry also means you lack a real-time view of your business finances.

Fortunately, you can mitigate these challenges by automating your finances with accounting software like Sage 50cloud Accounting. Here are some key benefits to using accounting software in your business.

1. Simple to use and get started

If you can use a spreadsheet you can use accounting software. Modern small business accounting software is quick to set-up and offers a user-friendly design. Accounting software is more than just a tool to record transactions, it lets you visually see how much money is coming in and out of your business each month with automated dashboards. In addition, with accounting software like Sage 50cloud Accounting, you can generate your financial statements with a few easy clicks.

2. Save time with automation

Accounting software lets you reduce the time you spend on paperwork by automating common accounting tasks. You can connect to your bank account, for example, so incoming payments can be matched to invoices in minutes. You can also save time by setting up your invoices to recur automatically.

3. Get paid faster

Speaking of invoices, approximately 30% of small businesses experience problems from past due invoices, resulting in businesses spending an average of 130 hours chasing late payments[1]. That's valuable time you could be spending on growing your business.

Accounting software helps you speed up your invoicing process by enabling you to create, edit, send, and track your invoices. Your customers can even pay you online, directly from a "Pay now" button.

4. Cloud connected software

Not ready to commit to inputting your data with a cloud-based solution? Sage 50cloud Accounting installs onto your desktop or laptop computer and all of your data is saved to your hard drive. With cloud-connected features like Bank Feeds and Invoice Payments, you still get the benefit of connecting to the cloud with all of the reliability of an on-premise software.

5. Conquer year-end

As a small business owner, it's likely the two times of year that you will talk to your accountant or bookkeeper the most are tax season and year-end. Using accounting software helps to ensure all your invoices, receipts, and statements are neatly filed and easily accessible to your accountant or bookkeeper.

1 The Domino Effect: The impact of late payments: https://www.sage.com/en-us/blog/wp-content/uploads/sites/2/2017/12/Domino-Effect-Late-Payments-Research-Sage.pdf

Ready to automate your small business finances with Sage?

Discover the solutions that will help you automate your finances so you can reduce admin, get paid faster, and spend more time on your business.

Sage 50cloud Accounting

You're a small business with big goals. Sage 50cloud Accounting can help you reach them with time-saving automation for invoicing, expense and payment tracking, and data entry. With your data stored on your computer, you can monitor, manage, and grow your business.

AutoEntry

As a small business owner, your time is valuable. AutoEntry alleviates hours of work, automating burdensome tasks and cutting down on manual data entry mistakes, so you have more time to focus on your business. Easily capture receipts using your mobile device and sync the data automatically to your Sage 50cloud Accounting solution.

Stripe

No more chasing late payments. Sage 50cloud Accounting works effortlessly with Stripe to give your customers a simple and secure way to pay you directly from a "Pay now" button. From invoicing to payment processing – it's all taken care of automatically so you can better manage your cash flow and focus on your valuable customer relationships.

Visit **sage50accounting.com** to start a free test drive.

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