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The definitive guide to eCommerce accounting

Everything from financial software stack and inventory accounting.

Introduction

Ecommerce is a relatively new and growing industry segment of the economy.

Just 10 years ago, selling to customers outside of your postcode was unheard of. Platforms like Shopify, Amazon and BigCommerce have democratised retail, allowing small businesses to service customers across the globe.

Retailers who traditionally operated 'bricks and mortar' stores are shifting their focus to online channels to capture a larger market. This allows businesses to rapidly grow sales with no material increase in fixed costs.

But this opportunity comes with a new set of challenges.

Which platform do we choose? What are our digital marketing channels? Do we engage in 3PL or inhouse fulfillment?

I'm sure you're very familiar with all of these issues...

With front-end customer acquisition and branding often the focus of founders and operators, we often find that the tedious and sometimes 'boring' aspects of business are left to the bottom of the pile.

Yes, I'm referring to the accounting and finances...

As an accountant and financial advisor to ecommerce businesses, we've seen some horror stories.

From multi-million dollar turnover businesses still running their books on Google Sheets, to brands selling their products at negative gross profit margins because they were looking at the wrong reports...

We've seen it all.

Accounting and finance is already confusing subject matter for a lot of business owners. Unfortunately, the complexity is 10x'd in ecommerce accounting due to the number of moving parts and 'levers' that can quickly turn a profitable business to one that haemorrhages cash.

Every founder and ecommerce manager should understand at least the fundamentals of ecommerce accounting, so we've put together this playbook to get you started.

In our definitive guide to Ecommerce accounting playbook, we will cover:

1. How to design your inventory and accounting processes and software stack

- a. What is an inventory management system
- b. How does that interact with my ecommerce platform and fulfillment?
- c. How does it interact with my accounting system?
- d. How do I get sales data from my ecommerce platform to my accounting system?
- e. What does the best practice setup look like?

2. The top 5 accounting mistakes we see with ecommerce businesses, and how to avoid them

- a. Bank balance accounting
- b. Gross profit margins
 - i. Expensing cost of sales
 - ii. Not allocating variable costs to COGS
- c. Not grossing sales up for merchant fees, discounts and returns
- d. Not looking at financial reports

3. The 5 financial KPIs that every Ecommerce business should be monitoring and measuring

- a. Gross profit margin
- b. Returns and discounts rates
- c. CAC as a % of revenue
- d. Inventory days

4. How often you should engage with your finances and what services, information and advice you should expect from your accountant and bookkeeper.

1) How to design your inventory and accounting software stack

Efficient customer acquisition and conversion are the primary focus of most founders in Ecommerce.

But inventory management is the backbone of every retailer.

Indeed, you could have an amazing brand and vision - but if you have nothing to sell because you are stocked out, or if you sell your products at a loss: then you won't have a business for much longer.

Stock control therefore is one of the most important parts of an Ecommerce business. Knowing what you have in stock at all times allows you to make decisions around when to purchase more stock, how much is appropriate to carry in stock and even helps with pricing.

In your company's startup phase you can get away with managing stock in a spreadsheet. It's a frictionless, cheap process to get going - but it is a manual process!

Once you grow beyond \$300k of annual sales, you should explore implementing an Inventory Management System (IMS).

What is an IMS?

As the name suggests, an inventory management system (IMS) is a software tool that allows you to manage all things inventory related.

This software sits between your Sales and POS platform and accounting system. It also integrates to external partners like logistics and fulfilment providers (3PL) and external commerce platforms, such as Amazon.

How an IMS talks to your accounting system

An IMS feeds 2 types of financial data into your accounting system: your sales/revenue data, and COGS and inventory purchases data.

If your IMS is integrated to your accounting system, all of the sales, inventory purchases and Cost of Goods Sold (COGS) accounting will be automated. This is on the assumption it is set up correctly!

We advise this is best practice for every Ecommerce business as it saves a tonne of duplicate processes with automation.

If your IMS is not integrated to your accounting system (which is quite common), your accountant or bookkeeper will need to manually process COGS and inventory purchases. Inventory purchases should be entered into accounts payable, just like your ordinary bills.

COGS on the other hand will need to be recognised via a journal entry by taking up the opening and closing stock.



It's important that your bookkeeper and accountant understand how to technically account for inventory and COGS - considering deposits, pro-forma invoices and Inventory in Transit.

If the accounting is incorrect, you will find that your Gross Profit margins in the profit and loss will be very lumpy on a month-to-month basis - and wrong.

What IMS and software tools do you recommend?

There are a myriad of IMS in the market. All of them have slightly different functionality and integrations, but they fundamentally do the same thing - manage your inventory.

We recommend you check out (in no particular order):

- Cin7
- Unleashed
- DEAR Inventory
- TradeGecko

You should consider speaking with a specialist integration and business systems consultant to implement this in your business.

If you don't have an IMS, or you have one that is not integrated to your accounting system, you will need to consider other tools to automate the sales income directly from your Ecommerce platforms.

Most traditional accountants and bookkeepers will 'cash code' these cash deposits as they are paid into your bank account. This methodology is ok, but it's important to ensure they "gross up" the merchant fees associated with the deposits so you are reporting on gross sales. This little nuance can skew the reporting of your gross profit margins.

You can automate the accounting of this revenue from your sales platforms to your accounting system via intermediary software tools. Popular ones in the market include:

- A2X
- Reconcile.ly

Do we need an ERP?

A question we get a lot is about Enterprise Resource Planning (ERP) systems. At what point does it make sense to upgrade your finance systems to an ERP, such as Netsuite?

We have clients with revenues doing over \$50M of annual sales that still use off the shelf accounting software packages, such as Xero, in conjunction with a dedicated IMS.

As long as the structure of your data is warehoused in the right systems, your accounting and finance systems can effectively scale using off the shelf, cloud based accounting systems and IMS outlined above.

The most extreme example we have found is Australian e-commerce company Kogan. It used Xero and Unleashed, an inventory management app, to push through \$170 million in annual revenue.

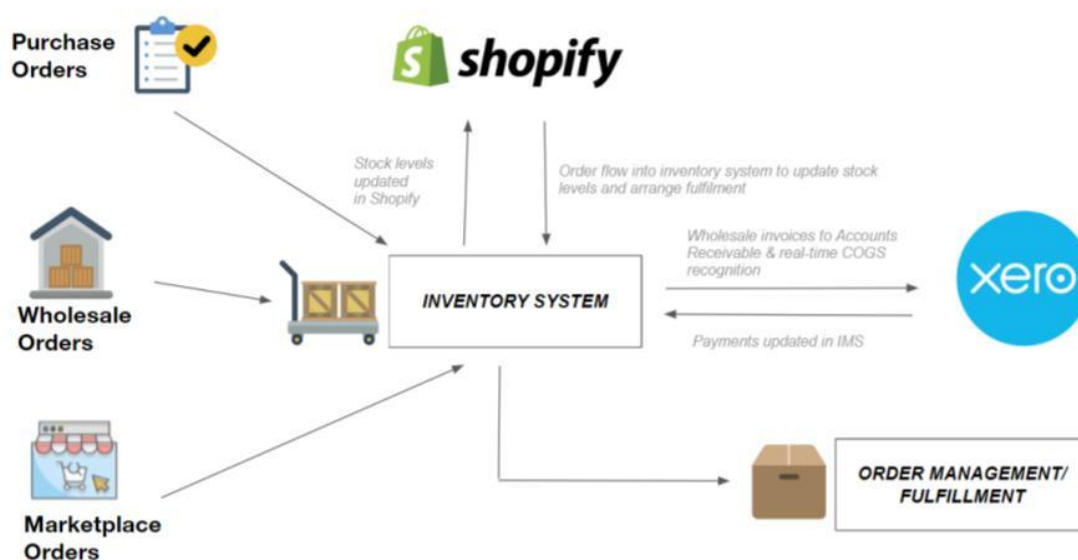
“Kogan CFO David Shafer revealed that his company was making about 10,000 transactions a day through Unleashed. Unleashed rolled up the transactions into one daily transaction before pushing it into Xero.”

This is why it's important to understand how your systems are warehousing data, as that is often the limiting factor.

What does the best practice setup look like?

The 'best practice' accounting software / IMS setup looks like the following:

Omnichannel Ecommerce Accounting setup



In summary, laying the foundations of your Ecommerce accounting software stack is important to help you run your business and accurately understand your company's financial position.

The last thing you want to do is scale problems!

2) The top 5 Ecommerce accounting mistakes, and how to avoid them

When we meet ecommerce founders and business owners for the first time, the first question we ask is what numbers do they look at.

The typical responses are:

- Their sales dashboard from Shopify
- Their bank account balance

These are not the best pieces of business intelligence to run your business.

Firstly - revenue is a vanity metric. Just because you have sales, it doesn't mean you have a profitable and cash flow generating business.

Your sales dashboards telling you nothing about:

- Your gross profit dollars
- Efficiency of customer acquisition costs
- Payroll, rent...you get the picture.

And so, many founders look at their bank account balance as well. Because cash is king, right?

Yes, cash is definitely king - but running your business based on your bank balance is also flawed. The money in your bank account is not all yours to spend - it's money that's owed to suppliers, money owed to the Government for taxes.

Equally, your bank account balance doesn't tell you if you have a profit and cash producing business.

Everyone knows they should be using their accounts as the financial 'source of truth' for their business.

Yet, many business owners still make decisions based on their bank balance and sales reports.

So why is that?

From our experience, it's typically because:

- Many founders don't understand how to read their financials to help them make decisions;
- They don't trust their accounts because the bookkeeping and accounting looks wrong and doesn't make sense.

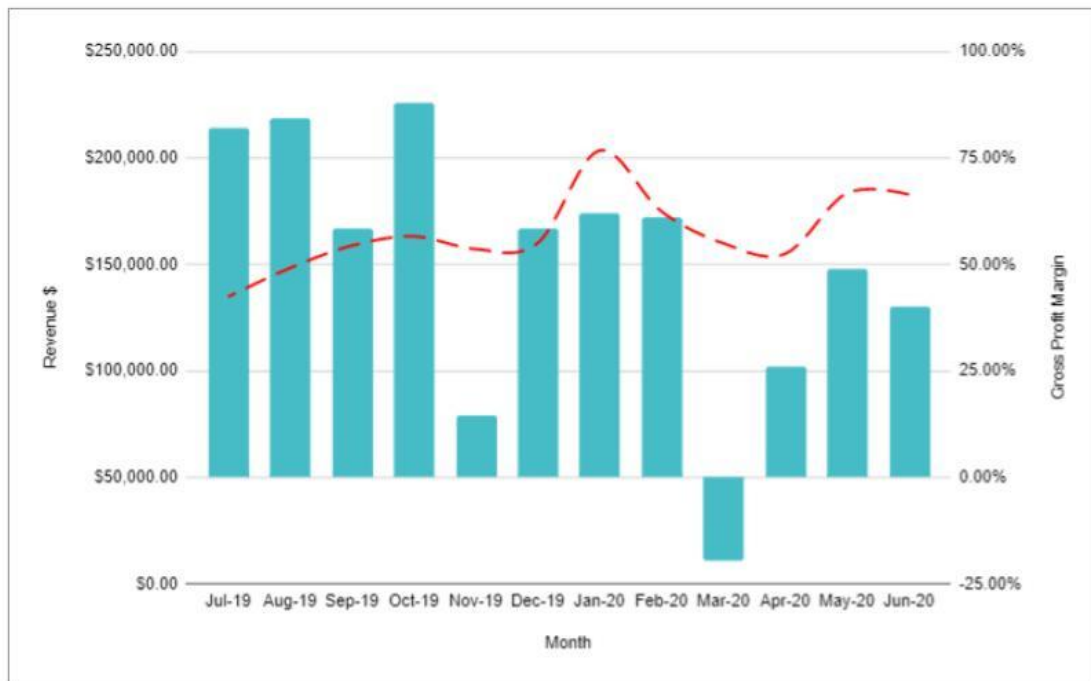
In this section, we'll be unpacking the top 5 accounting mistakes for Ecommerce businesses.

1) Incorrect inventory accounting

In our experience, incorrect inventory accounting is the most common issue with Ecommerce businesses.

We see it in 95% of cases.

You will know immediately if your inventory accounting is incorrect if your monthly Gross Profit margins are lumpy, and jumps around a lot.

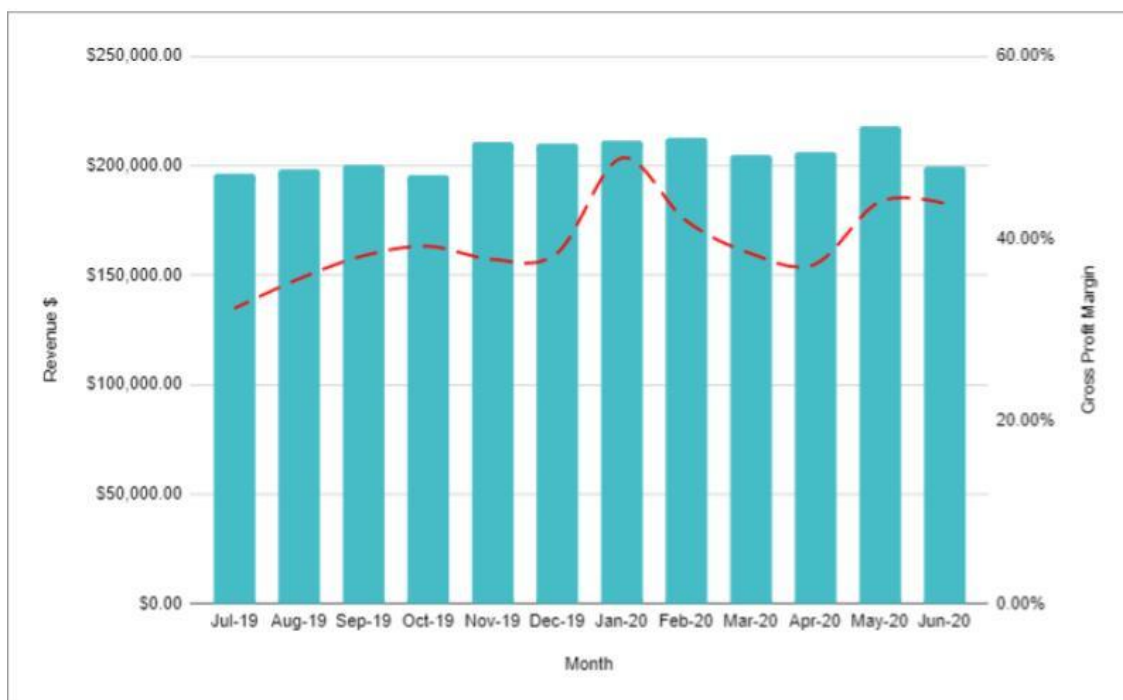


Take a look at the graph above to demonstrate my point: A business with lumpy gross profit margins due to incorrect inventory accounting.

This fluctuating gross profit margin is not due to the product mix - it's because the inventory is not being accounted for correctly.

As you can see in this diagram, the gross profit margins, represented in the teal bar graph are fluctuating significantly on a month-to-month basis.

After fixing up this businesses inventory accounting, the result is this:



As you can see the gross profit margins are now consistent on a monthly basis - which makes a lot more sense.

Your gross profit margins should not significantly fluctuate on a month-to-month basis.

Yes, it will subtly change due to product mix, assuming you sell products with different gross margins, but overall it should be consistent.

In our experience, incorrect inventory accounting is the most common issue with Ecommerce businesses. It is a common frustration for founders who can't understand why their P&L doesn't make sense.

This is important because every business owner and founder must have an intimate understanding of their gross profit. It is one of the most important financial metrics in your business - more important than sales.

How to fix it

It's important that your bookkeeper and accountant understand how to correctly account for inventory and COGS. Your bookkeeping needs to consider the correct accounting treatment and timing of inventory purchases, including:

- Deposits
- Balance payments on pro-forma invoices
- Inventory in Transit
- Closing stock

If any of these are not accounted for correctly, there's a good chance your P&L will be inaccurate, and potentially misleading.

2) Incorrectly calculating Gross Profit

Gross profit is one of the most important financial metrics in your business because it tells you how much profit you're generating from your sales.

I think Gross Profit is more important than your sales because it shows the quality of your revenue. It does so by considering all of the 'direct costs' associated with generating that revenue.

It's calculated as your Revenue, less Direct costs, also known as 'Cost of Sales'. In our experience, the Cost of Sales is not very well understood, and incorrectly accounted for.

Despite being a pretty fundamental concept of business, there's a lot of confusion around how to accurately calculate it.

It typically comes down to - what expenses are considered a 'cost of sale.'

What is considered a 'cost of sale'

It's pretty obvious that your Cost of Goods Sold is considered a cost of sale.

Most people get this right. But what many founders don't consider is all the on-costs of selling and delivering your product to customers.

From an ecommerce accounting perspective, these are referred to as 'other direct costs' and include:

- Merchant fees (Stripe fees, Paypal, Amazon, Afterpay etc.)
- Shipping and postage fees to customer
- Inbound shipping costs

As a rule of thumb, any expenses that are variable in nature, (costs that increase as your sales volume increases) are typically a cost of sale.

This is important so we can accurately determine your gross profit margin.

3) Looking at profit, but not cash flow

My accountant said I made a profit this year. But where is the cash?

This would have to be the number 1 question I get asked by every business owner and entrepreneur. Where is my cash flow?

When assessing the financial performance of a business, most people always refer to profit.

I mean, accountants and business gurus always tell us that profit is the indicator of financial success, right?

Well, the problem with looking at profit is that it's not the best indicator of financial performance. In fact it can be very misleading.

Why is that?

Well, it's because Profit is not the same as your cash flow!

The difference between profit and cash flow can be explained by the movements in your balance sheet. Your profit is skewed by accounting adjustments for the treatment of certain types of expenses (like capitalising assets), as well as changes in working capital.

This is particularly true for Ecommerce businesses because most of your cash is tied up in inventory.

The challenge with inventory based business models is that it's easy to be 'overstocked'. In other words, your business is holding too much inventory and not converting it to sales very quickly.

Bloated inventory balances are a key culprit for retailers experiencing cash flow issues.

The profit per your accounts can be a deceiving indicator of success as it can be manipulated by accounting adjustments.

We recommend that all business owners look at cash flow reports in addition to just your Profit and loss statement.

Ultimately, a cash flow statement is the truest measure of your financial performance.

Surplus cash is the only thing that matters.

4) Not grossing sales up for merchant fees, discounts and returns

There are 2 hidden factors that kill the profitability of an eCommerce business as they grow.

They are:

1. Discounts - the most destructive financial lever in your business.
2. Customer Returns - consider the direct cost of dealing with double shipping and indirect costs of handling and labour.

We find that many founders and managers don't understand the true costs of these to their business. It's because they are not often quantified in their financials.

The problem with traditional P&Ls for Ecommerce businesses is that the typical bookkeeper/accountant accounts for the revenue NET of discounts and returns.

In other words, they only account for the cash deposited from your merchant facilities and often completely ignore the discount and returns altogether.

Our recommendation is that you should quantify these costs on your profit and loss statement (example below).

5) Not looking at Financial KPIs

Your P&L reports tell you how much profit (or loss) your business made - but that's about it.

It doesn't help you understand:

- Whether that is good, or bad
- How you should improve your financial performance

This is why it's important to quantify and measure the relevant Key Performance Indicators (KPIs) of your business.

In our next section, we will deep dive into the relevant KPIs for Ecommerce businesses - and how you can measure them in your business.

Profit & Loss Ecommerce Business P/L

	31 Jan 20	% of gross revenue
Income		
Online Sales	\$168,410	
Offline Sales	\$287,540	
Customer returns and refunds	(\$62,958)	13.81%
Discounts	(\$137,540)	30.17%
Net Sales	\$255,452	

A little bit of extra work in your accounting tells you a more complete story of the financial health of your business.

As you can see, these little devils can have a massive impact on your bottom line...

3) The 4 financial KPIs that every Ecommerce business measure

In a world where we can literally quantify everything, numbers and data can be overwhelming.

The thing is, generating and capturing your business data is not the problem. The hard part is determining which numbers are actually relevant to your business goals.

In other words, what are numbers critical to your success?

In this section, we will unpack 4 financial KPIs your Ecommerce business should be measuring and monitoring.

1) Gross Profit

A dollar is a dollar, right? 1 dollar of sales is the same in comparison to another?

Not quite.

Not all revenue dollars are created equal. But all gross profit dollars are!

Gross profit is more important than measuring sales, because it shows the quality of your sales. Looking purely at your topline doesn't give you visibility on whether you are growing profitability.

Anyone can make sales, my point is are you making a profit from those sales?

Your Gross profit margin will vary depending on what you sell. If you sell commoditized goods or a reseller of other brands, your gross profit margins could be as low as 25%.

If you sell your own products, classic DTC – you should be achieving margins between 40% – to upwards of 60%.

It goes without saying – the higher the gross profit margin, the better. The best businesses in the world have strong Gross Profit margins.

So what's a good gross profit?

If you're an FMCG business that does less than \$10M of sales every year and your goal is to build a profitable business, our recommendation is that you should target gross profit margins of 40%+.

This gross profit is net of shipping fees, merchant fees and the cost of goods.

2) Returns and Discounts

It goes without saying that increasing prices is the most effective way to maximise the profitability of your business.

This is because raising prices doesn't impact the unit cost of sales. All the additional dollars you make in price increases go directly to your bottom line profit.

Now, the same thing happens in the reverse when you offer discounts.

For every percentage that you discount, that is a percentage of profit coming off your bottom line.

Customer returns are equally destructive.

Consider all of the direct costs of dealing with returns and exchanges. Double shipping absorbed by you (depending on the generosity of your returns policy) and all the additional costs of handling the product.

Most businesses can "resell" returned items, however there are products that you just can't. Casper, the DTC mattress retailer for example, can't resell its mattresses. Why? Well, It's hard to jam a mattress back into a box.

But more importantly, sleeping on a mattress, soiled with a stranger's back sweat is just gross.

Accordingly, all the returns are sunk costs - with the mattress ending up in charity bins and landfill.

My point is, discounting and return rates can erode your profitability. It's therefore important to measure and monitor these.

The best way to achieve this is to quantify these costs on your profit and loss statement.

A little bit of extra work in your accounting tells you a more complete story of the financial health of your business.

3) Customer Acquisition Costs as a % of revenue

Many growth marketers focus on Return on Ad Spend ("ROAS") as a metric to understand the effectiveness of direct marketing and broader customer acquisition costs.

Whilst it is a good proxy, it has flaws.

Firstly, true attribution is elusive. Just because a customer saw an ad on Instagram, it doesn't mean they bought your product just because of that ad. They could have been reading your blogs for a while now. Maybe they saw (but didn't click) a banner ad displayed on Google. Perhaps their friend was talking about your brand but it was the ad that prompted the 'buy' trigger.

The buyer's journey is long and complex, so how do you practically assign budget to each touch point? Equally, how much can you spend to ensure profitable growth and acquisition?

We take a macro perspective to understand how much is being spent on Customer Acquisition as a cost bucket, as a percentage of revenue.

How much to budget for customer acquisition costs.

If you're aiming for sustainable, profitable growth, we recommend that your total customer acquisition costs as a percentage of net sales should be between 10% and 15% of revenue.

Your customer acquisition costs include:

- Advertising costs
- Fees paid to marketing consultants / agencies
- The wages and salaries of your in house marketing team
- General marketing costs

Again, this is a general guide on the assumption that your business is aiming for sustainable, profitable growth. I.e - you're not deliberately burning cash for the sake of top-line growth.

4) Inventory Days

Inventory management is by far the most critical aspect of running a successful Ecommerce business.

Inventory management is a science. It takes data and an acute understanding of the market to get the balancing act of inventory purchases just right. If you carry too much stock, your cash becomes tied up.

These funds could otherwise be used to fund the rest of your business. This cash flow problem can be compounded if your product is perishable or depreciates quickly—as it loses value each day you hold on to it.

In a worst-case scenario, you could be left with no cash and no product.

On the flipside, if you carry too little stock, you might run out and have nothing to sell to your customers. This can cripple your future sales, as your revenue is hamstrung until you can be restocked.

Measuring metrics like *inventory days* is an approach to help you manage this fine balancing act.

You can calculate your inventory days with the following formula:

$$\text{Inventory on hand \$} / \text{Monthly Cost of Goods Sold \$} \times 30$$

What are benchmark inventory days?

Average inventory days vary between industries and depends on the product type and business model. For example, companies that sell perishable or fast-moving products, like food, will have a lower inventory days benchmark than businesses selling non-perishable or slower-moving products, like cars.

Below is a guideline of inventory benchmark days for key industries from the 2010 issue of Supply Chain Digest.

Industry	Average Inventory Days
Internet and Catalog Retail	30
Restaurants and Cafes	3 to 5
Apparel and Luxury Goods	60
Consumer Technology	30

Every business is unique, so these inventory days benchmarks should be used only as a guide.

For example, in 2017, Apple's average inventory days was a mere 11.18—an enviable figure, given that the benchmark for consumer tech is 30 days.

If your inventory days are higher than the benchmarks, consider ways you can reduce them. Lower inventory days result in more cash. It's one more goal as you strive for operational excellence.

Tactics to reduce inventory days?

Obsolete and slow-moving stock are the culprits behind bloated inventory balances. These are the products that have become dated because a newer, shinier version has been launched in the market. This is especially real for if you're a business subject to trends and seasonality, like fashion.

There are a number of methods to identify obsolete stock. You probably already have a feel for what needs to be written-off. For a data-driven approach, generate a stock report from your inventory management system and filter the data to identify the last sale date.

If the time period from your sale date to today's date is greater than your Inventory Days metric, assess whether it can be sold at a discount price, or at worst case, written off completely. In order to manage your inventory, we recommend using an inventory management system that integrates to your accounting system. This will take a lot of the guesswork out of inventory control.

Selling obsolete stock may have an impact on short-term profit. But they will be offset by the long-term benefit as your carrying costs are eliminated, and immediate cash flow is realized. Ignore sunk costs.

4) How you should work with an Ecommerce Accountant

Chances are you already work with an accountant. She is already handling your tax affairs and her involvement is mostly focused on corporate structuring, tax compliance and tax minimisation.

When it comes down to the bookkeeping (data-entry), typically this is resourced by an external contractor, an internal administration officer, or yourself!

The question then arises - who is responsible for the activities that happen in between, like the management reporting, looking at KPIs, Cashflow management and budgeting?

Traditionally, this is the realm of CFOs.

Getting what you need

Medium and large businesses engage with more than one accountant in their business. Yes, they still have an accountant to manage tax compliance, but they also have other forms of accountants – ranging from financial accountants, financial manager, management accountants and CFOs.

The role of these accountants are focused on the future growth and financial operations of the company. They do business financial planning, developing and reporting on KPIs, cash flow management and forecasting and providing insights to the owners and managers on what the numbers are saying. Ultimately, the goal is to leverage these insights to improve profit, cash and financial value of your business.

Overall, there is a big difference between a commercially minded financial manager/CFO and a tax accountant.

Indeed, they are both technically accountants. But your tax accountant's focus is tax compliance.

The financial manager's focus is on driving financial performance. These are completely different frames and capabilities.

The chart below breaks down the roles and responsibilities of a tax accountant vs a management accountant/CFO.

It's rare to find this type of strategic financial accountant in the small business space. Why? Well firstly, they cost a lot. Many small businesses can't justify the costs of a full-stack finance team, costing upwards of \$300k of fixed annual salary costs in their business.

But secondly, it's quite a narrow field of expertise. It takes a different approach to accounting to blend commercial and financial strategy and apply that to fast-growing eCommerce business.

That’s why we started SBO.Financial – a different type of accounting firm to provide the full stack of financial services – from CFO, management accounting and bookkeeping, for a fraction of the cost.

The information flow and timing

The chart below summarises the activities and timeframes of how a well-governed finance function should run.

Function	Responsibility
Complete accounts and accounting reconciliations by the 15th day of end of month	Bookkeeper
Monthly financial report and KPI dashboard generated on the same day	Financial Management accountant
Update cash flow budget, maintaining short range cash flow forecasts and undertaking analysis on your target financial performance compared to your actual activity.	Financial Management accountant
Lodge tax compliance (sales tax filings, income tax returns)	Tax accountant

In Summary

As a founder and small business owner: you are responsible for your company's finances.

Everything from cash flow management, your P&L, and even a fundamental understanding of how your business makes money. It's a critical skill that every business leader must have.

The good news is that you knowing your numbers is not rocket science.

You don't need a degree in accounting. You don't need to be good at math or spreadsheets.

You just need to know the basics.

This eCommerce accounting guide will equip you with the financial fundamentals of how to run a profitable, cash flow producing business that will be operating for the long term.

If you need assistance from an Ecommerce accounting expert - feel free to reach out.



Jason Andrew

Jason is a chartered accountant, founder, and business advisor to high-growth businesses. His accounting firm, SBO.Financial, focuses on helping high-growth businesses with their numbers, ranging from bookkeeping and financial control to profit and cash flow maximization strategies. He is the author of Stark Naked Numbers—an entrepreneurial accounting book written to improve the financial literacy of business owners.