BUSINESS FINANCE

3 FINANCIAL METRICS EVERY SMALL BUSINESS OWNER SHOULD MONITOR

As a small business owner, it's essential that you have a firm grasp of your financial metrics. Your business's success (or failure) depends on more than just sales – understanding key metrics ensures you're making informed decisions and avoiding potential pitfalls. Here are three crucial financial metrics that every business owner should track regularly:

1. CASH FLOW

Cash flow is the lifeblood of your business. Cash flow measures the money flowing in and out of your company over a specific period of time. Without cash flowing into your business, your options for your business are seriously limited and this will impact everything you do (or attempt to accomplish). Even if your business is profitable on paper, insufficient cash flow can lead to significant operational challenges that will hamper your ability to run your business.

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Why It Matters:

- A positive cash flow means that the money coming into your business exceeds the amount that is going out which enables you to cover expenses and invest in your future growth.
- Negative cash flow is an indicator of potential upcoming trouble that could include delayed payments from customers or overspending on inventory or other costs.

Example: A retailer experiencing seasonality in their business may generate significant sales during the holiday season but struggle to pay suppliers in January if customers delay their payments. Managing cash flow ensures you have liquidity to meet obligations and avoid future problems.

Pro Tip: Regularly review your cash flow statement. Shorten payment terms for clients or offer early payment discounts. Negotiate extended payment terms with vendors to ease cash constraints.

Additional Insights:

- Use cash flow forecasts to anticipate potential shortfalls and plan accordingly.
- Monitor cash reserves to ensure you have a buffer for unexpected expenses, such as equipment repairs or market downturns.

2. NET PROFIT MARGIN

Quite simply, net profit margin is your bottom line. It is a ratio that represents how much profit remains after all expenses, including taxes and overhead, are deducted. It's calculated as:

Net Profit / Revenue x 100

Why It Matters:

- This metric shows how effectively your business turns revenue into profit.

- Declining net margins might indicate rising overhead costs, excessive spending, or inefficient operations.

Example: A service business with $100,000 in revenue and $80,000 in total expenses has a net profit margin of $20,000 or 20%. If expenses increase to $85,000, the margin drops to 15,000 or 15%.

Pro Tip: Conduct regular expense reviews to identify areas for cost reductions. Eliminate unnecessary subscriptions or explore energy-saving initiatives to lower utility bills.

Additional Insights:

- Analyze trends over time to identify potential red flags, such as steadily increasing costs.
- Compare your net profit margin to industry benchmarks to gauge performance.
- Use net profit margin to determine the viability of new projects or investments.

3. ACCOUNTS RECEIVABLE TURNOVER

This metric measures how efficiently your business collects payments from customers which is very important for a small business. It's calculated as: **Net Credit Sales / Average Accounts Receivable**

Why It Matters:

- A low turnover rate indicates customers are taking too long to pay, which can strain cash flow.

- A high turnover rate suggests efficient collections, ensuring steady cash inflows.

Example: If your business generates $120,000 in credit sales and has an average accounts receivable of $20,000, your turnover rate is 6. This means customers pay, on average, every two months.

Pro Tip: Use invoicing software to send automated reminders and offer small discounts for early payments. Be consistent with follow-ups on overdue accounts (something I have written about previously).

Additional Insights:

- Establish clear payment terms in contracts to avoid confusion with clients.
- Consider implementing late payment fees to encourage on-time payments.
- Regularly review your accounts receivable aging report to identify and address overdue accounts promptly.

Why These Metrics Matter

By monitoring these financial metrics, you can:

- Spot potential financial challenges early which could be vital in the on-going success or your business and positively/negatively impact your ability to implement your growth plans.
- Set realistic revenue and expense goals through a regimen of creating annual budgets and reviewing your performance to that budget each month. This will force you to regularly monitor your company's performance.
- Make data-driven decisions to improve profitability and operational efficiency as the last thing you want to do is make uninformed decisions which could turn into mistakes.

Additional Benefits:

- Consistent monitoring enables you to adapt quickly to market changes. In today's fast-changing business environment, this could be the difference between growth and success versus stagnation or loss.
- Strong financial metrics can make your business more attractive to potential investors or buyers. You should be running your company as if you are preparing to sell your business regardless of whether you have any intention of selling (ever).
- Better financial visibility helps you secure funding or lines of credit more easily. This is part of being prepared and managing your business for the future as you never know when you may need financing to manage a short-term downturn or take advantage of an opportunity that may require cash.

Financial clarity is the foundation of a successful business. Keeping an eye on these metrics ensures you're not just surviving but thriving in today's competitive market. If you're unsure where to start or want expert guidance to improve your financial management, let's have a conversation. I'd love to help you gain insights and take your business to the next level.

Jeff Solomon is the founder and owner of CFO On The Go, a fractional CFO practice. CFO On The Go provides affordable, part-time CFO services to multiple companies allowing business owners and decision makers access to high level, financial leadership.