6 Accounting Concepts E-Commerce Business Owners Need to Know

E-commerce business owners face unique challenges when it comes to pricing and delivering their products. Familiarize yourself with these six concepts to run your e-commerce business successfully.

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E-commerce business owners have a degree of flexibility not afforded those with physical storefronts. More appealing than avoiding rent on a storefront, being able to fulfill orders from home while wearing sweatpants would lead me to opt for an e-commerce model.

Setting up your accounting system can be one of the most stressful parts of opening a new business. As you establish your online enterprise, familiarize yourself with the most common accounting issues for e-commerce business owners.

How does e-commerce accounting differ from standard accounting?

An e-commerce business faces different tax and accounting situations than a brick-and-mortar store, but it’s nothing you can’t handle.

- **Sales tax:** A brick-and-mortar store charges sales tax according to laws in the state where the store is located. On the other hand, customers of e-commerce businesses only pay sales tax when the business has a significant business connection, called a sales tax nexus, in the customer’s state. Check out our guide on [e-commerce sales tax](#) to learn when you’re required to charge and remit sales tax. Most point-of-sale
(POS) platforms, like Shopify POS, put the onus on business owners to charge sales tax when required.

- **International duties and taxes:** E-commerce businesses that ship overseas must ensure compliance with international regulations. Communicate to your customers the duties and taxes applicable to their orders.

- **Shipping:** Unlike brick-and-mortar business owners, shipping can account for a high proportion of your total expenses. You need a system to estimate and track these expenses in your accounting software. Also, decide whether to pass on these costs to your customers.

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### The 6 accounting principles you should be familiar with to run a successful e-commerce business

You don’t need to be an accounting expert to open an e-commerce business. Once you familiarize yourself with a few accounting concepts, you’ll be ready to set up an impeccably organized small business bookkeeping system to help you run a profitable e-commerce business.

#### 1. Startup accounting

Brush up on the bookkeeping basics as you create your e-commerce business. Accounting software can generate journal entries and financial statements, but setting it up correctly requires a working understanding of these foundational concepts.

Startup accounting encompasses more than just bookkeeping procedures. For example, you need to choose an inventory accounting method and either the cash or accrual basis of accounting.

Because of all the costs associated with starting a business, pay special attention to cash flow in the early stages. Monitor the cash flow statement in your accounting software and regularly complete bank reconciliations to keep your business afloat before sales start rolling in.
Once you’ve mastered the basics of accounting, you can move onto more complex topics, like financial forecasting, to help you devise a realistic growth plan.

2. Cost of goods sold

The cost of goods sold (COGS) refers to the three product costs: direct material, direct labor, and manufacturing overhead.

- **Direct material** includes the cost of your products’ raw materials. If your company makes coffee mugs, your raw materials are ceramic and paint. Include taxes and shipping from the supplier to your factory in the direct materials cost.

- **Direct labor** refers to labor costs for workers to turn the product into a finished good.

- **Manufacturing overhead** adds factory rent, utilities, and supervisory staff costs to your product costs. It has **fixed and variable** elements.

The cost of shipping products to your customers isn’t part of the **COGS calculation**. Shipping to customers must be accounted for separately, which we’ll explore next.

3. Shipping to customers

E-commerce order fulfillment should be one of the first processes you perfect. When your sales rely on shipping products, you need to be fast and efficient.

The cost of shipping to customers isn’t part of the cost of goods sold — because it’s distinct from the product itself — but it does play a role in the total cost of sales. Tracking these costs accurately allows you to decide how much to charge for shipping.

Say I open Book Me, a purveyor of books long and short, heavy and light. Customers pay a flat $10 shipping fee for every order, regardless of weight or number of books.

You should immediately record a sale when someone places an order. Imagine that a college student orders two heavy textbooks for $250. Ignoring sales tax and credit card processing fees, the sales journal entry is:
You may remember from bookkeeping 101 that you debit expenses and credit revenues, with very few exceptions. We’re about to break that rule: Credit shipping expenses for the amount your business charges customers. It creates a negative balance in your shipping expenses account, to be offset by the actual shipping costs in the following journal entry.

Shipping two hefty textbooks isn’t cheap, and it ends up costing $25 to ship them. Record shipping costs as incurred.

<table>
<thead>
<tr>
<th>ACCOUNT</th>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$260</td>
<td></td>
</tr>
<tr>
<td>Shipping expense</td>
<td></td>
<td>$10</td>
</tr>
<tr>
<td>Revenue</td>
<td>250</td>
<td></td>
</tr>
</tbody>
</table>

Your general ledger shipping expense balance reads $15, the net cost of shipping ($25 actual shipping cost - $10 cost passed on to the customer).

Sometimes a customer-paid shipping fee exceeds actual shipping costs, earning you extra income. Say the actual shipping cost is just $7. You’d record the actual shipping expense first:
Then, recognize the additional income:

<table>
<thead>
<tr>
<th>ACCOUNT</th>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shipping expense</td>
<td>$3</td>
<td></td>
</tr>
<tr>
<td>Other income</td>
<td></td>
<td>$3</td>
</tr>
</tbody>
</table>

4. Sales discounts, returns, and allowances

Any retail business should be familiar with accounting for sales discounts, returns, and allowances.

To record adjustments to sales, you should add two accounts to the chart of accounts in your accounting software: “sales discounts” and “sales returns and allowances.”

When you subtract these two accounts from your total sales number, you get net sales. Net sales reflect your total sales revenue after subtracting returns, discounts, and allowances, which are discounts made for defective merchandise that customers keep.

You should track all discounts in your accounting software. Say my online bookstore runs a sale with 15% off and free shipping, and a customer buys a book that usually sells for $10. Ignoring sales tax and credit card processing fees, the sales journal entry is:
The net sale is $8.50 ($10 original price - $1.50 discount).

E-commerce businesses, especially ones that sell clothes, should expect a fair amount of returns. Make an explicit returns policy that lists the return window.

Record returns and discounts on defective merchandise using the “sales returns and allowances“ account. Say a customer returns a book for which she paid $20. The journal entry reads:

<table>
<thead>
<tr>
<th>ACCOUNT</th>
<th>DEBIT</th>
<th>CREDIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales returns and allowances</td>
<td>$20</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>$20</td>
</tr>
</tbody>
</table>

Notice in all of these examples we never reduce the “sales“ account balance. Instead, discounts, returns, and allowances are tracked separately and subtracted from the sales account, making it easier to track sales activity.

5. Profitability

E-commerce businesses are operating in an international marketplace, bringing about fierce competition for customers. Sales and price slashing can increase your edge in the
market, but you need to measure your profitability before offering a deal or price cut on your products.

Use the following metrics to measure your business’s profitability:

- **Break-even point** tells you how many products your business needs to sell to neutralize costs.
- **Contribution margin** measures the profitability of your products after subtracting variable costs. The main variable costs are direct materials, direct labor, the variable portion of manufacturing overhead, and shipping to customers.
- **Gross profit margin** assesses profitability of your products after subtracting all product costs. This metric includes the fixed portion of manufacturing overhead, the only difference between contribution margin and gross profit margin for e-commerce businesses.
- **Operating margin** refers to your company's earnings after deducting expenses of your primary business activities.
- **Net profit margin**, more often called net income, is your business’s bottom-line earnings. When you subtract non-business expenses and income tax from operating margin, you get net profit margin. Net profit margin is the final determinant in whether your business is in the black or red.

Profitability metrics can inform your business budget and help you create a pricing structure that yields maximum profits.

### 6. Business tax deductions

New business owners might not be familiar with the business tax deductions they can take on their business tax return. Unlike personal tax deductions, businesses can deduct most ordinary and necessary business expenses.

Peruse our guide to small business tax deductions for a sizable list of expenses you should deduct on your tax return.

You can run an e-commerce business from anywhere. Those who dedicate a portion of their home to an e-commerce business can take advantage of the home office deduction.
Add these 6 concepts to your shopping cart

Don’t let the dread of accounting keep you from building a thriving e-commerce business. Once you master these six concepts, you can turn your attention to the creative side of running a business, like designing products and building an e-commerce marketing strategy.