FACT SHEET

Managing your Finances: Profit and Loss

Quick Summary

- Profit & loss accounts are a summary of 12 months of business transactions
- It provides a 'bottom line', clearly showing the profit – or loss – a business has created
- There are numerous benefits to creating profit and loss accounts – including making it quicker and easier to fill out VAT returns
- Profit & Loss and tax accounts have different rules and guidelines depending on if you're self employed or a limited company

Introduction: Profit & Loss Basics

First of all, what is a profit and loss account? Put simply, it's a summary of business transactions for a given period - normally over 12 months. By deducting total expenditure from total income, it shows on the 'bottom line' whether your business made a profit or loss at the end of that period.

A profit and loss account is produced primarily for business purposes - to show owners, shareholders or potential investors how the business is performing. But most of the information is also used by HM Revenue & Customs to check your tax calculations.

Are you a limited company?

By law, if your business is a limited company or a partnership whose members are limited companies, you must produce a profit and loss account for each financial year.

Are you self-employed?

Self-employed sole traders and most partnerships don't need to create a formal profit and loss account - but they do need to keep adequate records to complete their Self Assessment tax return fully and accurately.

The benefits of profit and loss accounts

Producing accurate records of profit and loss accounts has many benefits. For example it can:

- Give you the information you need to manage and grow your business
- Enable you to report on your profit or loss easily and quickly when required
- Improve your chances of getting a loan or mortgage
- Make filling in your tax return easier and quicker
- Make completing VAT Returns straightforward - if you are registered for VAT
- Help you or your business pay the right tax
- Provide back-up for claims for certain allowances
- Help you plan and budget for tax payments
- Reduce the risk of interest on late payments or late-filing penalties
- Help reduce fees if you use an accountant - your annual accounts will be far easier to produce.

Records required for producing a profit & loss account

It doesn't matter what type of business you own, you must keep accurate records of your income and expenditure.

Are you self-employed?

If you're self-employed, you need to keep your self-employment records for five years after the 31 January deadline - and you may need to keep them for longer if you file your return late or if HM Revenue & Customs starts a check.

Are you a limited company?

You need to keep limited company or partnership records for six years after the latest date your tax return is due.

What does the profit & loss account include?

The basic records you will need to keep should provide:

- Records of all your sales (turnover) and other income streams (such as, bank interest, sale of equipment, rental income, personal funds put into a limited company, etc.)
- Records of all your purchases and expenses - your expenditure – which can be split between 3 key areas: cost of sales - the base cost of obtaining or creating your product, business expenses, cost of equipment you have bought or leased for long-term use. (If your business is VAT-registered, you will need to record details of any VAT included in your expenditure).

You may also need to keep:

- A separate list for petty cash expenditure if relevant
- A record of goods taken for personal use and payments to the business for these
- A record of money taken out for personal use or paid in from personal funds - this applies to limited companies
- Back-up documents for all of the above

All of these documents will also be required for you to complete your tax returns.

Profit & loss accounting periods and tax

Account period

As mentioned briefly earlier on, businesses normally work out their profit and loss over a twelve-month period. This makes it easy to see how well your business is doing each year, and to compare one year with the next.

The way your accounts are taxed depends on what type of business you have.

Tax accounts for self-employed and partnerships

Self-employed sole traders and business partnerships are normally taxed on the profits for the 12 month accounting period ending during the tax year. The tax year runs from 6 April to 5 April the following year.
For example, if you make your annual accounts up to 31 December each year, your profits to 31 December 2018 are used in your 2018-19 tax return (for the year to 5 April 2019).

The simplest approach can be to make your annual accounts up to 31 March or 5 April, so that they match the tax year.

Starting or closing a business?

Special rules apply in this instance, or if you decide to change your accounting period to ensure that all your profits are fairly taxed.

To find out more about accounting periods for the self-employed and partnerships, download a help sheet on how to calculate your taxable profits from the HM Revenue & Customs (HMRC) website here.

Tax accounts for limited companies

Limited companies are required to submit annual accounts to Companies House, including a profit and loss account. When you start a new company, the financial year automatically runs to the end of the month a year after the company is incorporated.

For example, if a company is incorporated on 10 June, the first financial year runs from 10 June to 30 June the following year. But you can choose a different financial year end if you wish.

Your profit subject to Corporation Tax is normally based on an accounting period that matches this financial year. There are special rules if your accounting period is longer than twelve months (for example, if your new company makes up its accounts to a date more than a year away).
For more information, contact HM Revenue & Customs (HMRC) or see the government information website, **www.gov.uk**.

To continue reading on this topic area, please take a look at the Factsheet titled: Tools for Managing your Finances – Balance Sheet