The ultimate guide to accounting for startups

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Starting a new business can be exciting but also comes with extra responsibilities. If you want your startup to succeed, you'll need a firm grip on your finances from day one — and that's why accounting for startups is so important.

That said, it's hard to know where to begin, especially if you're a first-time entrepreneur and you've never balanced your books or filed a tax return before. Which accounting method should you use for your new startup? Should you incorporate your business? Why are balance sheets and profit and loss statements so important?

As expert accountants for startups, we're here to put your mind at ease. In this guide, we cover the essential accounting tasks and skills you need to get your business off the ground and on the path to success. Here's what you need to know.

Why is accounting for startups so important?

Meet your legal obligations

When you set up a business, you must follow various regulations and meet UK financial reporting standards to stay compliant. While specific rules can vary depending on the size and nature of your startup, keeping accurate business records is non-negotiable.

By implementing good bookkeeping practices early on, you can easily meet these requirements, reducing any risk of non-compliance fines from HMRC and cutting down time spent filing your tax returns.

Take control of your finances

No two successful businesses are the same, but they all have one thing in common: sound financial management. Staying on top of your accounting tasks can give you a clear, accurate picture of your business finances, helping you make informed decisions that move your startup forward.

Build a brighter future

Remember, good financial management isn't just about staying compliant; it's about securing a brighter future for your business.

The better you understand your finances, the easier it'll be to move your business forward. Regular in-depth financial analysis can help you flag risks and opportunities before they arise, so you can be proactive instead of reactive in your decision-making.

Taking your first steps

You'll need to register your new business before you start tracking your sales and calculating your tax liabilities.

If you're setting up shop by yourself, you'll usually need to sign up as either a sole trader or a limited company.

Setting up as a sole trader

As a sole trader, you run your business as a self-employed individual and pay income tax on your earnings.

There's no legal distinction between yourself and your business, which means you call all the shots and take home 100% of the profits after tax. However, this also means you're personally liable for any debts your business incurs.

To set up as a sole trader in the UK, you must register for self-assessment on the HMRC website. This process is relatively easy and usually involves less paperwork on your part.

Starting a limited company

Setting up a limited company, meanwhile, is more complicated. Firstly, you'll need to register with Companies House and pay an initial startup fee. You'll also need to register with HMRC for corporation tax – this can usually be done as part of the Companies House registration. You'll then pay corporation tax on your taxable profits.

Once you've incorporated your business, you'll need to file annual tax returns and company accounts each year. If you take a salary or dividends from your company, you're also required to run payroll and report your earnings in a self-assessment tax return.

However, limited companies are generally taxed at a lower rate and have more tax-planning opportunities than sole traders. There's also a legal distinction between yourself and the company – which means that, in most cases, you'll have less personal liability if something goes wrong.

Your accounting method

There's more than one way to keep track of your finances, so one of the first decisions you'll need to make as a new business owner is which accounting method to use for your startup.

There are two main methods: accruals basis accounting and cash basis accounting.

The accruals basis

With accruals basis accounting (also known as traditional accounting), you record all your revenue and expenses as soon as a transaction occurs — even if money hasn't changed hands.

This method also helps ensure that the receipts and expenses that apply to the accountancy year are recorded in that period.

The cash basis

When using cash basis accounting, you only recognise revenue and expenses after funds enter or leave your business accounts. This accounting technique was designed to make accounting more accessible for smaller businesses.

Only unincorporated businesses (sole traders and partnerships) with an annual turnover of £150,000 or less can use the cash basis to prepare their accounts. This method isn't an option for limited companies, regardless of turnover.

In cases where your business grows during a tax year, you can still stay in the scheme — unless your total turnover exceeds £300,000.

Which scheme should I choose?

While there's no one-size-fits-all solution, there are a few specific things you should keep in mind when accounting for startups.

Firstly, the accruals basis can usually provide a more accurate overview of your business's fiscal health – particularly in the longer term. To gain this insight, however, you need to use more advanced accounts, meaning this method is often more complex and time-consuming.

By comparison, using the cash basis of accounting is simple, as you only need to account for funds received or paid.

This method can also make it easier to see how much cash you have at any given time — which is particularly useful in the early stages of a new business. And in some circumstances, it may be more cost-effective to use the cash basis.

Generally speaking, smaller firms often prefer the simplicity the cash basis brings, while larger businesses and those with more complicated finances are more likely to use the accruals basis.

Many of our new business clients use the cash basis when they start but later switch to the accruals basis once their business reaches a specific size. If you're unsure which scheme to choose, we can help you find a solution that works best for your business.

Your business records

Keeping accurate, up-to-date business records is essential if you want to stay in HMRC's good books.

While the records you need to hold on to will vary depending on the nature of your startup, most businesses are required to keep details of all:

- income the business receives (including from sales, loans and grants)
- business expenses
- business assets
- debts owed by or to the business
- stock and inventory
- goods bought and sold and who they were sold to or bought from (excluding retail businesses)
- bank statements.

It's worth noting that while this list may be long, it's far from exhaustive. You'll have additional recordkeeping requirements, for example, if you're an employer, you run a limited company, or you're registered for VAT.

How long should I keep business records for?

If you're a sole trader or in a business partnership, you must retain these details for at least five years after the self-assessment submission deadline. Limited companies, meanwhile, must keep these records for a minimum of six years after the end of the financial year.

Why do I need to keep these records?

You don't need to include all your business records when filing your annual tax return, but you are required to provide them at HMRC's request. Failing to do so could result in a hefty non-compliance fine – or you may even be disqualified as a company director.

Understanding your financial statements

Unless you're a chartered accountant, you probably didn't go into business to crunch numbers and generate financial reports. But if you want to give your startup the best chance of success, you'll need a basic grasp of the three primary financial statements:

- profit & loss statement
- balance sheet
- cashflow statement.

The good news is you don't need to be fluent in accounting jargon to understand these reports. With the power of cloud platforms like Xero and an accountant by your side, you'll easily draw up and navigate your core financial statements.

Here's what you need to know.

1. Profit and loss statement

Your profit and loss (P&L) statement looks at your business transactions to give you an overview of your startup's profitability over a particular period (usually monthly, quarterly or annually).

This report records your startup's **income**, **expenses** and the **cost of goods sold** during that period. Using this data, you can work out your business's gross profit and net income (also known as your "bottom line").

Your **gross profit** is the total revenue generated from selling goods or services. Once you have this figure, you then need to subtract all your expenses (including the cost of goods sold, utility bills and other operational costs) to find your **net income**.

Why do I need a P&L statement?

Technically, you're only required to produce an annual P&L statement if you run a limited company – but that doesn't mean unincorporated businesses should skip it altogether.

An awareness of your startup's bottom line is essential if you want to make well-informed business decisions. Your income statement can provide valuable insight into what you're doing right and where there's room for improvement.

You can also look at statements from businesses similar to yours to compare your performance against competitors. And once you've been in business for a while, you can even use past and present income statements to measure your progress.

2. Balance sheet

A balance sheet offers a snapshot of a business's financial position at a specific time.

The left side of your balance sheet records your business **assets**. This is everything that your startup owns and controls, such as cash, inventory, buildings and investments.

You'll find your startup's **liabilities** on the right side of your balance sheet. These range from short-term debts and obligations, such as money you owe suppliers, to longer-term bank loans and bonds.

Finally, your **equity** is what's left when you subtract your liabilities from your assets.

The main thing to remember is that your balance sheet must always balance. That means that the **value of your assets** always equals the **combined value of your liabilities and equity**. If things don't add up, that means something's gone wrong.

Why do I need a balance sheet?

Again, balance sheets are only mandatory for some businesses, but there are benefits outside of compliance.

Think of your balance sheet as a financial healthcheck or MOT. Giving yourself a clear view of your startup's finances can allow you to make better-informed financial decisions.

3. Cashflow statement

Last but not least is your cashflow statement. This report tracks how cash moves in and out of your startup over a particular period of time.

The key sections of a cashflow statement are:

- **Operating activities:** Cash generated or used in your core business operations, including money from sales, payments made to suppliers, and operating costs.
- **Investing activities:** Cash generated or used in buying or selling long-term assets, such as equipment or investments.
- **Financing activities:** Cash generated or used in financing activities, such as borrowing/repaying loans and paying dividends.

Why do I need a cashflow statement?

In the early stages of a new business, overheads are often high and funds limited. As a result, keeping a close eye on cashflow is essential.

The better you understand how your operations and other business activities impact your cash position, the easier it is to pay your bills on time and stay in business.

Analysing past cashflow statements can also help you develop more accurate budgets and forecasts in the future.

How to get accounting for startups right

1. Set up a dedicated bank account

Setting up a business bank account is one of the very first things you should do as a new business owner. Regardless of the size or nature of your startup, you need to keep your business and personal finances separate if you want to stay on top of your books.

Using a dedicated account for your business transactions can make accounting for startups much easier to manage. Perhaps most importantly, it can also save you time and stress when meeting your compliance requirements.

2. Use cloud accounting software

Cloud accounting platforms like Xero, QuickBooks and Sage can automate many time-consuming accounting tasks for you, freeing up more space for you to focus on building your business from the ground up.

Making the most of different cloud accounting tools can also give you deeper insight into your startup's performance. Depending on your chosen provider, you can even connect your software to your business bank account or other business processes for seamless integration.

3. Keep detailed records

Knowing which records you need to keep as a new business owner is only half the battle; you also need to know how to maintain good bookkeeping practices.

Meticulously recording all your income and expenses throughout the year is essential for meeting your obligations on time – but that's far from the only benefit. With all your financial data organised, accurate and up to date, you'll be able to maximise business expenses more easily.

4. Monitor your cashflow

Cashflow is the lifeblood of your business and tracking it is the cornerstone of accounting for startups. By carefully monitoring your cash position, you'll always know where your money is. This can help you ensure you have enough liquidity to cover your expenses or even invest money back into the business.

Meanwhile, cashflow forecasting can help you plan for potential shortfalls or surpluses.

5. Work with an accountant

Many first-time entrepreneurs choose to manage their accounting tasks by themselves to cut costs, but that isn't always the best choice.

As your business grows, your finances and your accounting responsibilities grow more complicated. Moving your startup forward can be challenging if you're spending most of your time attending to your administrative burden.

That's why you should consider outsourcing accounting for startups to a professional. Experienced accountants for startups won't just manage your basic bookkeeping for you; they'll offer expert advice, maximise savings on your tax returns and keep you up to date with the latest business news.

Having a trusted adviser to turn to can also give you some valuable peace of mind. If you have any questions or concerns about your business or want to discuss your tax strategy, your accountant is only an email or phone call away.

Get in touch with our friendly team today to find out how we can help your new business thrive.

Ready to find out more?

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