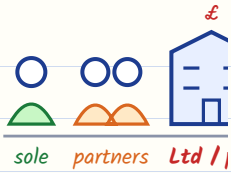
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Types of Business Entity



Syllabus topic 1.1 · AS Level: Paper 1 (Multiple Choice) and Paper 2 (Fundamentals of Accounting)

For the Cambridge International AS & A Level Accounting 9706 syllabus, exams in 2026, 2027 and 2028

Syllabus statements covered in this chapter

Syllabus ref.	What you must be able to do	Level
1.1.1	Describe sole traders, partnerships and limited companies (including plc): legal form, ownership, management and control	AS
1.1.1	Explain their advantages and disadvantages for the owners and for other stakeholders	AS
1.1.1	Explain sources of finance: secured and unsecured loans, bank overdrafts, payment by instalments, rental/leasing, trade credit, and the sources for limited companies (as in 1.5.4)	AS
1.1.1	Use your understanding of types of business entity to take relevant decisions	AS

Questions on Limited Liability Partnerships will not be set.

What is inside

1. Notes on the three entities and on sources of finance; how each entity shares its profit, with model layouts; 8 worked examples
2. Exam skills for Paper 2; common mistakes from the examiner report
3. 20 Paper 1 style multiple-choice questions, explained
4. Paper 2 style questions (30 and 15 marks) with full mark schemes; quick reference and "I can" checklist

How to read these notes

red = key term green = definition

1 = one mark in the mark scheme · OF = own-figure mark · AS = AS Level content

★ **Exam tip:** The type of entity decides **how profit is shared** and how the **capital or equity section** is set out. In "advise" questions always use the facts and figures of the business in the question. Money is shown in £.

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1.1 Types of business entity

A **business entity** is an organisation that carries on a business: it buys, sells, employs and borrows in its own name or in its owners' names. The syllabus compares three legal forms using four ideas:

- **Legal form**: **unincorporated** (no legal existence separate from the owners: sole traders and partnerships) or **incorporated** (registered as a company, a separate legal person that owns assets, makes contracts, and sues and is sued in its own name).
- **Ownership** (who provides the capital and owns the business), **management** (who runs it day to day) and **control** (who takes the big decisions and carries the risk). In a large company the owners (shareholders) are not the managers: **ownership is separated from control**.

sole trader → partnership → private limited company (Ltd) → public limited company (plc)

As a business grows it needs more capital, more owners and more protection from risk; in return it accepts more regulation, cost and disclosure.

Accounting entity and legal entity are not the same. The **business entity concept** (Chapter 2) keeps the accounts of *every* business separate from the owner's private affairs. But in **law** only a **company** is separate from its owners; a sole trader and partners are the same legal persons as their businesses, so they are liable for its debts.

Sole trader

A **sole trader** is a business owned by one person, who provides the capital, takes all the profit and is personally liable for all the debts of the business. The owner may employ staff; "sole" refers to ownership. Ownership, management and control are all in one person. Typical examples: shops, hairdressers, plumbers, tutors.

Unlimited liability: the owner is personally responsible for all the debts of the business, so private possessions (savings, house, car) can be taken to pay business creditors. There are no formalities beyond registering for tax, no duty to publish accounts, and no continuity: the business ends when the owner retires or dies.

advantages (to the owner)	*disadvantages (to the owner)*
easy and cheap to set up and to close; few legal formalities	unlimited liability: personal assets are at risk
all the profit belongs to the owner	capital limited to the owner's savings and what lenders will provide
full control, quick decisions, close contact with customers	long hours; no one to share work, losses or decisions; few specialist skills
financial affairs stay private	no continuity: illness, holidays or death can stop the business

Partnership

The Partnership Act 1890 defines a partnership as the relation which exists between persons carrying on a business in common with a view of profit. There are usually **2 to 20 partners** (some professional firms may have more): doctors, lawyers, accountants, family businesses. It is unincorporated, and each partner is an **agent** of the firm, so a contract made by one partner binds them all. Liability is **unlimited**: each partner is liable for **all** the debts of the firm, including those caused by another partner. Ownership, management and

control are shared as agreed; a **sleeping partner** provides capital but takes no part in running the business. A change of partner ends the old partnership (Chapter 15).

A **partnership agreement** (deed) is a written contract between the partners setting out how the partnership will be run and how profits and losses will be shared. It normally states: the capital each partner introduces; the **profit- and loss-sharing ratio**; rates of **interest on capital**, **interest on drawings** and **interest on partners' loans**; partners' **salaries**; limits on drawings; each partner's duties; how disputes are settled; and the rules for admission, retirement and dissolution. It **avoids disputes** because the rules are known in advance, but it costs legal fees and must be kept up to date.

Partnership Act 1890: the rules if there is no agreement: profits and losses are shared **equally**; **no interest on capital**, **no interest on drawings** and **no partners' salaries**; a partner's **loan** to the firm earns interest at **5% a year**.

★ ***Exam tip:*** Interest on a partner's **loan** is an **expense** (a finance cost), charged in the statement of profit or loss **before** the profit for the year is found. Interest on **capital**, salaries and interest on drawings are **appropriations** of the profit (Worked examples 3–5).

advantages of a partnership (compared with a sole trader)	*disadvantages*
more capital: each partner contributes, and lenders may lend more	unlimited liability, including for the actions of the other partners
more skills; partners can specialise; work and losses are shared	profits must be shared; disagreements and slower decisions
cover for illness and holidays	no continuity: a change of partner ends the old partnership
still easy to form; affairs stay private	capital still limited to what the partners have and can borrow

Limited company

A **limited company** is a business incorporated (registered) under company law, so it is a separate legal entity from its owners, the shareholders, whose liability for its debts is limited. Its capital is divided into **shares**; an **ordinary share** gives part-ownership, a vote and the right to any **dividends** (the part of the profit paid out to shareholders).

- **Limited liability**: a shareholder can lose no more than the amount paid, or still to be paid, for his or her shares; personal assets are safe if the company fails.
- **Continuity**: the company continues when shareholders sell their shares or die. **Regulation**: it must keep proper records, file financial statements in a set format where the public can see them and, above a size limit, have them **audited** (Chapter 19).
- **Management and control**: shareholders elect **directors** to run the company. In a small private company the shareholders are often the directors; in a large company **ownership is separated from control**, so directors report to the shareholders through the annual financial statements.

	private limited company (Ltd)	public limited company (plc)
shares	cannot be offered to the general public; usually held by family and friends and transferred only with the other shareholders' agreement	can be offered to the public and traded on a stock exchange; a legal minimum share capital (in the UK, £50 000)
control	owners usually also run it; easy to keep control	many shareholders; ownership separated from control; risk of a takeover
disclosure	files financial statements; small companies may file shorter versions	full annual report published; strict stock-exchange rules; always audited

advantages of a limited company (to the owners)	disadvantages
limited liability, so people are more willing to invest	cost and formalities of setting up; rules on records, filing and audit
more capital from share issues (a plc from the public)	financial statements can be seen by anyone, including competitors
continuity; shares can be sold without closing the business	in a plc, shareholders may lose control to directors or a takeover bidder
status: suppliers and lenders may trust a company more	banks often want personal guarantees from directors of small companies

The three types compared

	sole trader	partnership	limited company
legal form	unincorporated	unincorporated; Partnership Act 1890	incorporated: separate legal entity
owners	one	usually 2–20 partners	shareholders
management and control	the owner	the partners (as agreed)	directors elected by shareholders
liability of owners	unlimited	unlimited	limited to their shares
continuity	ends with the owner	ends with a change of partner	continues
long-term finance	owner's savings, loans	partners' capital, loans	shares, debentures, retained earnings, loans
profit	all to the owner; added to capital; owner takes drawings	shared in the appropriation account, credited to current accounts; partners take drawings	dividends to shareholders; the rest kept as retained earnings; directors' pay is an expense
owners' interest in the statement of financial position	capital: opening + profit – drawings	capital accounts and current accounts	equity: share capital, share premium, reserves
publication of accounts	private	private	filed publicly; audited above a size limit

The view of other stakeholders

A **stakeholder** is any person or group with an interest in the business and its performance (users of accounts: Chapter 11). The syllabus asks for advantages and disadvantages from their point of view too.

stakeholder	how the type of entity affects them
lenders	An unincorporated business offers the owners' **personal** wealth as well as business assets; a company's creditors can claim only against **company** assets, so banks ask for **security** or personal guarantees. Audited company accounts help lending decisions.
suppliers	Credit to a small limited company is riskier because shareholders have limited liability, but its filed accounts can be checked before a credit limit is set.
employees and customers	Larger companies usually offer more job security and after-sales continuity; a sole trader gives a personal service but may close when the owner retires.
investors	Shares in a plc are easy to buy and sell; joining a partnership means unlimited liability and taking part in management.
government	Companies are more regulated and pay tax on company profits; sole traders and partners pay income tax on their share of profit.

Worked example 1: which type of business entity?

Identify the type of entity in each case and give the reason. (a) Ama's dental practice is owned by three dentists who share the profits 2:2:1. (b) Shares in Horizon Foods are bought and sold on the stock exchange. (c) Raúl repairs computers on his own; his house was sold to pay the debts of his failed business. (d) Five members of the Okafor family own all the shares in Okafor Builders and cannot sell them to the public. (e) A business continued trading unchanged after its largest shareholder died.

(a) **partnership**: several owners sharing profits by agreement; (b) **public limited company**: only a plc can offer shares to the public and be listed; (c) **sole trader**: one owner with unlimited liability; (d) **private limited company**: shares held privately and not offered to the public; (e) **limited company**: continuity, because the company is a separate legal entity.

Worked example 2: what unlimited liability means in figures

Omar Siddiqui, a sole trader, closed his sports shop on 30 June 2026. The business assets were turned into cash and the business liabilities were settled. Omar has personal savings of £20 000. (a) Calculate how much Omar must pay from his personal savings. (b) Explain what the position would have been if the business had been Siddiqui Sports Limited, with Omar holding all 25 000 £1 ordinary shares.

Omar Siddiqui
settlement on closure of the business, 30 June 2026

	£	£
business assets turned into cash		
equipment	9 500	
inventory	12 800	
trade receivables collected	6 200	
bank	10 000	
		38 500
less business liabilities		
trade payables	17 300	
bank loan (unsecured)	30 000	
other payables	5 000	
		52 300
shortfall: liabilities exceed assets		13 800

(a) The business owes £52 300 but its assets raise only £38 500. Because Omar has **unlimited liability**, the shortfall of **£13 800** must come from his private savings, leaving him £6 200.

(b) As a **limited company**, the company (not Omar) owes the debts. Omar would lose the £25 000 paid for his shares, but his savings would be safe. The creditors (suppliers, the bank) would share the loss of £13 800, unless Omar had given the bank a **personal guarantee** for the loan.

How each type of entity deals with its profit

The type of entity changes the **last part** of the statement of profit or loss and the **capital section** of the statement of financial position. To compare, take one business, owned first by **Leila Haddad** alone, then by Leila and **Marco Rossi** as partners, and then as **Haddad Rossi Limited**. In each case £85 000 has been invested and the **profit for the year** to 31 December 2026 is **£72 000** (for the company, after the directors' salaries, which are expenses). As a **sole trader**, Leila adds all £72 000 to her capital and deducts her drawings of £30 000 (drawings are not an expense). As a **company**, dividends paid of £24 000 (£0.40 a share on 60 000 shares) are deducted from **retained earnings** in the statement of changes in equity and the other £48 000 stays in the company. As a **partnership**, the profit is divided in the appropriation account and credited to the partners' current accounts (Worked examples 3 and 4).

Leila Haddad (sole trader)
statement of financial position at 31 December 2026 (extract)

	£	£
Capital		
opening balance	85 000	
add profit for the year	72 000	
	157 000	
less drawings	30 000	
closing capital	127 000	

Haddad Rossi Limited
statement of financial position at 31 December 2026 (extract)

	£	£
Equity		
ordinary shares of £1 each	60 000	
share premium	15 000	
retained earnings (10 000 + 72 000 − 24 000)	58 000	
Total equity		133 000

The partnership's capital section is in Worked example 4. Notice the different words: **capital** and **drawings** for a sole trader; **capital accounts** and **current accounts** for partners; **equity**, **share capital**, **reserves** and **dividends** for a company. In Paper 2 the correct label earns the mark, so never mix them (for example, "drawings" in a company, or "dividends" in a partnership).

Worked example 3: the partnership appropriation account

Leila Haddad and Marco Rossi's partnership agreement provides: interest on capital at 6% a year on capital account balances (Leila £50 000, Marco £35 000); a salary for Marco of £12 000 a year; interest on drawings (Leila £450, Marco £300 for the year); residual profit shared Leila 3/5, Marco 2/5. The profit for the year ended 31 December 2026 was £72 000. Prepare the appropriation account.

Leila Haddad and Marco Rossi
appropriation account for the year ended 31 December 2026

	£	£	£
profit for the year			72 000
add interest on drawings			
Leila Haddad		450	
Marco Rossi		300	
			750
			72 750
less			
interest on capital			
Leila Haddad	3 000		
Marco Rossi	2 100		
		5 100	
salary: Marco Rossi		12 000	
			17 100
residual profit			55 650
share of residual profit			
Leila Haddad (3/5)		33 390	
Marco Rossi (2/5)		22 260	
			55 650

- Start with the **profit for the year** from the statement of profit or loss.
- **Add** interest on drawings: it is charged **to** the partners, so more profit is left to share: 72 750.
- **Deduct** interest on capital (6% × 50 000 = 3 000; 6% × 35 000 = 2 100) and salaries.
- The **residual profit** 55 650 is shared in the profit-sharing ratio; the shares must add back to it.
- Check: Leila 3 000 + 33 390 – 450 = £35 940; Marco 2 100 + 12 000 + 22 260 – 300 = £36 060; together £72 000 ✓.

Worked example 4: partners' current accounts and the capital section

At 1 January 2026 the current accounts had credit balances: Leila £2 400, Marco £1 100. Drawings for the year were Leila £28 000 and Marco £30 000. Prepare the current accounts in columnar form and the capital section of the statement of financial position at 31 December 2026.

Leila Haddad and Marco Rossi
current accounts

date	*details*	*Leila £*	*Marco £*	*date*	*details*	*Leila £*	*Marco £*
Dec 31	drawings	28 000	30 000	Jan 1	balance b/d	2 400	1 100
Dec 31	interest on drawings	450	300	Dec 31	interest on capital	3 000	2 100
Dec 31	balance c/d	10 340	7 160	Dec 31	salary		12 000
				Dec 31	share of profit	33 390	22 260
		38 790	37 460			38 790	37 460
				Jan 1	balance b/d	10 340	7 160

Leila Haddad and Marco Rossi
statement of financial position at 31 December 2026 (extract)

	£	£
Capital accounts		
Leila Haddad	50 000	
Marco Rossi	35 000	
		85 000
Current accounts		
Leila Haddad	10 340	
Marco Rossi	7 160	
		17 500
total capital		102 500

- The **capital account** shows the fixed capital each partner has invested: it changes only if capital is introduced or withdrawn.
- The **current account** takes every appropriation: credit interest on capital, salary and share of profit; debit drawings and interest on drawings.
- A **credit** balance on a current account is owed **to** the partner (part of capital); a **debit** balance means the partner has drawn more than his or her share and is shown as a deduction.

Worked example 5: with and without a partnership agreement

Tara Mensah (capital £80 000) and Dev Kapoor (capital £20 000) have no partnership agreement. Tara has also lent the firm £10 000. Dev works full time in the business; Tara works one day a week. The profit for the year before charging interest on Tara's loan was £46 500. (a) Calculate how much each partner receives under the Partnership Act 1890. (b) Dev proposes an agreement: interest on the loan at 6%, interest on capital at 5%, a salary of £15 000 for Dev, residual profit shared equally. Calculate how much each would receive.

	no agreement (Partnership Act 1890)	*proposed agreement*
interest on Tara's loan of £10 000 (an expense, charged before appropriation)	5% = £500	6% = £600
profit for the year available to share	46 500 − 500 = £46 000	46 500 − 600 = £45 900
interest on capital	none	5%: Tara £4 000, Dev £1 000
salary	none	Dev £15 000
residual profit, shared equally	£46 000 → £23 000 each	45 900 − 5 000 − 15 000 = £25 900 → £12 950 each
Tara receives in total	**£23 500** (500 + 23 000)	**£17 550** (600 + 4 000 + 12 950)
Dev receives in total	**£23 000**	**£28 950** (1 000 + 15 000 + 12 950)

Comment: without an agreement Dev receives almost the same as Tara although he does most of the work; Tara receives no reward for providing four times as much capital. An agreement lets the partners reward **capital** (interest on capital), **work** (salaries) and **risk** (the sharing ratio) fairly, which is why a written agreement helps to avoid disputes.

Worked example 6: a limited company's equity

On 1 January 2026 Nuvola Limited had 200 000 ordinary shares of £0.50 each, share premium £20 000, general reserve £15 000 and retained earnings £41 300. During 2026: 40 000 ordinary shares were issued at £0.80 each, fully paid; the final dividend for 2025 of £0.05 a share and an interim dividend for

2026 of £0.03 a share (on all 240 000 shares) were paid; £5 000 was transferred to the general reserve. The profit for the year was £38 600. Prepare the statement of changes in equity and the statement of financial position at 31 December 2026 from the balances given.

Workings: new shares 40 000 × £0.50 = £20 000 share capital and 40 000 × £0.30 = £12 000 share premium (cash received £32 000); final dividend 200 000 × £0.05 = £10 000; interim dividend 240 000 × £0.03 = £7 200.

Nuvola Limited

statement of changes in equity for the year ended 31 December 2026

	share capital £	share premium £	general reserve £	retained earnings £	total £
at 1 January 2026	100 000	20 000	15 000	41 300	176 300
issue of ordinary shares	20 000	12 000			32 000
profit for the year				38 600	38 600
final dividend 2025 paid				(10 000)	(10 000)
interim dividend 2026 paid				(7 200)	(7 200)
transfer to general reserve			5 000	(5 000)	-
at 31 December 2026	120 000	32 000	20 000	57 700	229 700

Nuvola Limited

statement of financial position at 31 December 2026

	£	£
Assets		
Non-current assets		
property	150 000	
machinery	64 500	
		214 500
Current assets		
inventory	18 400	
trade receivables	14 200	
cash and cash equivalents	9 750	
		42 350
Total assets		256 850
Equity and liabilities		
Equity		
ordinary shares of £0.50 each	120 000	
share premium	32 000	
general reserve	20 000	
retained earnings	57 700	
Total equity		229 700
Non-current liabilities		
6% debentures (2032)		15 000
Current liabilities		
trade payables	10 950	
other payables	1 200	
		12 150
Total liabilities		27 150
Total equity and liabilities		256 850

- Balances: property £150 000, machinery £64 500 (both at carrying amount), inventory £18 400, trade receivables £14 200, cash and cash equivalents £9 750, 6% debentures (2032) £15 000, trade payables £10 950, other payables £1 200.
- **Equity** = share capital + reserves = £229 700, the closing total of the statement of changes in equity.
- **Debentures** are long-term **loans**, so they are a non-current liability, not equity.
- Headings "Equity and liabilities", "Total equity", "Total liabilities" and "Total equity and liabilities" are written in full.

Sources of finance and methods of funding

Every entity needs finance to start, to buy non-current assets, to pay for inventory and expenses while waiting for customers to pay (**working capital**), and to expand. Sources are classified as:

- **internal** (from within the business: owner's capital, profits kept in the business, selling unwanted assets) or **external** (from outside: banks, suppliers, finance companies, new shareholders);
- **short term** (repayable within a year: overdraft, trade credit) or **long term** (several years: loans, debentures, share capital);
- **debt** (must be repaid, with interest) or **equity** (owners' capital, which is not repaid while the business continues).

Matching rule: finance **long-term** needs (premises, machinery, vehicles) with **long-term** sources, and **short-term** needs (inventory, a temporary cash shortage) with **short-term** sources. Using an overdraft to buy a machine risks the bank asking for repayment before the machine has earned the money.

source	what it is · points for an evaluation
secured loan	a loan where the lender has a legal claim (a charge) over specified assets of the borrower, which it can sell if the loan is not repaid, e.g. a mortgage on premises · lower interest and larger amounts because the lender's risk is lower; the asset can be lost
unsecured loan	a loan with no claim over specified assets · quicker, no asset at risk; higher interest, smaller amounts, shorter terms
bank overdraft	permission to pay out more than is in the current account, up to an agreed limit; interest only on the amount overdrawn, day by day · flexible for short gaps; high rate; repayable on demand, so a **current** liability
payment by instalments	a deposit and regular instalments over an agreed period (e.g. hire purchase: ownership passes with the last instalment) · use of the asset now, cost spread; total paid exceeds the cash price; the asset may be repossessed
rental / leasing	paying a regular rent to use an asset owned by someone else (the lessor) for an agreed period · no large outlay; servicing often included; can upgrade; never owned, so no resale value
trade credit	buying goods or services now and paying the supplier later, e.g. after 30 or 60 days · "free" short-term finance, but any cash discount is lost and late payment harms the supplier relationship
owners' capital, retained profits	savings introduced by the owners, or profits kept in the business · no interest and nothing to repay, but limited in amount

Examples in figures. An overdraft of £3 000 for two months at 12% a year costs 3 000 × 12% × 2/12 = £60. A supplier offering a 2% cash discount on a £15 000 invoice paid within 10 days would accept £14 700; taking the full 30 days of credit "costs" the £300 discount lost.

Sources of finance for limited companies (developed in Chapter 10, topic 1.5.4)

source	features
issue of ordinary shares	permanent capital, never repaid while the company exists; no interest, dividends only when the directors decide and profits allow; but new shareholders get votes, so control is **diluted**; issue costs. Shares issued above their nominal value create **share premium**.

rights issue	new shares offered to existing shareholders in proportion to their holdings, usually at a discount to the market price: cheaper to arrange, and control stays with existing shareholders if they take up their rights.
debentures	long-term loans to a company, usually secured on its assets, at a fixed rate of interest and repayable on a stated date; interest must be paid even in a loss-making year, but it is an expense for tax and no control is given away. A non-current liability, not equity.
retained earnings	profits not paid out as dividends: no cost of issue and no loss of control, but shareholders may want higher dividends.

A **bonus issue** raises no cash at all: it turns reserves into share capital (Chapter 10). Sole traders and partnerships cannot issue shares or debentures.

Worked example 7: buy with a loan, pay by instalments, or lease?

Ana Costa, a sole trader caterer, needs a van with a cash price of £24 000. (1) Secured bank loan of £24 000 at 7.5% a year, interest paid yearly, repaid in one sum after three years. (2) Instalments: deposit £4 800 and 36 monthly instalments of £620; Ana owns the van after the last instalment. (3) Lease for 36 months at £560 a month, servicing included; the van is returned at the end. If Ana buys, servicing costs £600 a year and the van will be worth £9 000 after three years. Calculate the net cost of each option over three years.

Ana Costa
cost of the van over three years

	secured bank loan £	*payment by instalments* £	*leasing* £
loan interest (24 000 × 7.5% × 3 years)	5 400		
loan repaid at the end of year 3	24 000		
deposit		4 800	
instalments (36 × 620)		22 320	
lease rentals (36 × 560)			20 160
servicing (3 × 600; included in the lease)	1 800	1 800	included
total payments	31 200	28 920	20 160
less value of the van at the end of year 3	9 000	9 000	-
net cost over three years	22 200	19 920	20 160

- Count **every** payment Ana makes, including servicing for the options where she owns the van.
- If she owns the van, **deduct** its value at the end: she can sell it.
- Instalments are cheapest (£19 920), leasing is only £240 more and needs no deposit; the loan is dearest (£22 200) because of the interest.

Worked example 8: advise (model answer)

Leila Haddad (sole trader) wants £40 000 to open a second shop. She forecasts a profit next year of £72 000 before any interest. Option 1: Marco Rossi joins her as a partner, introducing £40 000 capital, with a salary of £12 000 and 2/5 of the remaining profit. Option 2: a five-year bank loan of £40 000 at 8% a year, secured on her first shop. Advise Leila which option she should choose. Justify your answer by considering both options. [7]

Option 1 (partnership). Marco brings capital that never has to be repaid and no interest is payable ✓, so there is no fixed cash outflow if the new shop has a slow start ✓. He also brings skills and can run the second shop while she runs the first. **But** Leila must share the profit: she would receive (72 000 − 12 000) × 3/5 = £36 000, about half of what she would keep as a sole trader ✓; she gives up full control and is liable for debts caused by Marco's decisions, and they may disagree ✓.

Option 2 (secured loan). Leila keeps full control and all the profit: 72 000 − interest 3 200 = £68 800 ✓. Because the loan is secured, the interest rate is lower ✓. **But** interest and repayments must be paid even if the forecast is not met, and she could lose her first shop if she cannot repay; she would also still have to run two shops on her own.

Recommendation: Leila should choose the **loan**: the interest of £3 200 a year is small compared with the £32 800 a year of profit she would give up to a partner, provided her forecast is realistic and she can employ a manager for the second shop ✓.

Paper 2 "advise" questions are usually marked as: 1 mark for each valid point for or against (identify) and 1 for developing it (so what?), up to a maximum on each, and 1 for a recommendation supported by a reason. Points must refer to **both** options and to the business in the question. Either recommendation can earn full marks if justified.

Exam skills for Paper 2

Layouts and labels

- Every account and statement needs a **heading**: the name of the business or partners, then "appropriation account **for the year ended** 31 December 2026", "current accounts", "statement of changes in equity for the year ended …", "statement of financial position **at** …".
- Use the label that belongs to the entity: **capital**/**drawings** (sole trader), **capital accounts**/**current accounts**/**share of profit** (partnership), **share capital**/**share premium**/**retained earnings**/**dividends paid**/**Total equity** (company). Write every label in full: "profit for the year", not "net profit" or "NP".
- Columnar current accounts: one amount column per partner on each side; balance each column separately and bring the balances down on the correct side.

Workings and own figures

- Show each working with its **net value**: "6% × 50 000 = 3 000". A bracket of figures with no answer earns no calculation mark.
- The marks for residual profit, shares of profit and closing balances are **own-figure (OF)** marks: a correct method on a wrong earlier figure still scores. So always finish the layout.
- Check that the partners' totals (interest on capital + salary + share − interest on drawings) add back to the profit for the year.

Explain, discuss, advise

- **Explain**: make the point and develop it with "so ..." or "because ..."; one- or two-word answers seldom score.
- **Advise** between two options: give advantages **and** disadvantages of **both** options, use the figures in the question (profit shares, interest, net cost), then give a clear recommendation with a reason. Do not simply repeat the information given.
- Stay with the entity in the question: shareholders, dividends and "dilution of control" are not relevant to a sole trader or a club taking a loan.

Common mistakes that lose marks

- **Explanations without development**: "limited liability" alone is a point; add "so the shareholders can lose only the amount they paid for their shares, not their personal assets".
- **Generic advice**: listing the pros and cons of a sole trader in general instead of addressing the business and figures given, or commenting on only the option chosen.
- **Interest on a partner's loan** treated as an appropriation: it has already been deducted as an expense in arriving at the profit for the year, so it is not deducted again in the appropriation account.
- **Current account balances**: forgetting that a credit balance on a partner's current account is an amount owed **to** the partner, or entering a debit balance b/d on the wrong side.
- **Wrong terms**: "net profit", "total capital" for a company, abbreviations such as "IOC", "P&L" or "RE"; drawings shown in a company or dividends in a partnership.
- **Share issue versus debentures**: the key difference is that share capital is **permanent** finance with no compulsory return, while debentures must be repaid and carry interest every year.
- **Calculations** with no net value shown, so no method marks can be given when the final answer is wrong.

Paper 1 style multiple-choice questions

20 questions, 1 mark each. Choose one answer, A, B, C or D. Answers with explanations follow the questions.

1. Which feature applies to a sole trader but **not** to a private limited company?

   A the owner has unlimited liability
   B the business is a separate legal entity
   C the owners receive dividends
   D the financial statements must be filed publicly

2. There is no partnership agreement. How are the partners' profits shared?

   A in the ratio of their capitals
   B 5% interest on capital, then equally
   C equally
   D in the ratio of the hours each partner works

3. A partner lent £20 000 to the partnership. There is no partnership agreement. How much loan interest is the partner entitled to for a year?

   A nil **B** £1 000 **C** £1 200 **D** £2 000

4. Which is a disadvantage of a limited company compared with a partnership?

   A the owners have limited liability
   B the business continues when an owner dies
   C it is easier to raise large amounts of capital
   D its financial statements are available for the public, including competitors, to see

5. Which statement about a public limited company is correct?

A its shares may only be transferred with the agreement of the other shareholders

B its shares may be offered to the general public and traded on a stock exchange

C its shareholders are liable for all the debts of the company

D it is not required to have its financial statements audited

6. Consider these statements.

1 Ownership is separated from control. 2 The business has unlimited liability. 3 The business continues if an owner sells his or her share.

Which statements usually apply to a public limited company?

A 1 and 3 only B 1 and 2 only C 2 and 3 only D 1, 2 and 3

7. What is a secured loan?

A a loan at a fixed rate of interest

B a loan that must be repaid within one year

C an agreement to overdraw the bank account up to a limit

D a loan where the lender has a legal claim over specified assets if it is not repaid

8. X and Y are partners sharing residual profit 3:2. X receives a salary of £10 000. Interest on capital is X £4 000 and Y £3 000. The profit for the year is £52 000. What is Y's total share of the profit?

A £14 000 B £20 800 C £17 000 D £21 000

9. Why might a business lease a machine rather than buy it?

A there is no large payment of cash at the start

B the business becomes the owner of the machine

C the total of the lease payments is always less than the cash price

D the machine can be sold at the end of the lease

10. For which purpose is a bank overdraft most suitable?

A buying new premises

B paying suppliers while waiting for credit customers to pay

C buying another business

D repaying a ten-year loan

11. A machine has a cash price of £12 000. It can be bought by a deposit of £2 400 and 24 monthly instalments of £450. By how much does the total paid exceed the cash price?

A £10 800 B £13 200 C £1 200 D £600

12. Which source of finance is available to a limited company but **not** to a sole trader?

A bank loan

B bank overdraft

C trade credit

D issue of debentures

13. A supplier offers a cash discount of 2.5% for payment within 14 days. An invoice for £8 400 is paid within 14 days. How much is paid?

A £8 190 B £8 400 C £210 D £8 610

14. From a supplier's point of view, what is the main risk of selling goods on credit to a small private limited company rather than to a sole trader?

A the company cannot be taken to court

B the shareholders have limited liability, so the supplier may not be paid in full if the company fails

C the company must publish its financial statements

D the company continues if a shareholder dies

15. Which item in a limited company's statement of financial position is a liability and **not** part of equity?

A share premium B retained earnings C share capital D debentures

16. A sole trader closed her business. Its assets raised £41 000 and its liabilities were £55 000. She has personal savings of £30 000. How much of the business liabilities must she pay from her savings?

A nil B £30 000 C £14 000 D £55 000

17. An investor bought 5 000 ordinary shares of £1 each in a limited company at £1.60 each, fully paid. The company then failed, owing more than the value of its assets. What is the most the investor can lose?

A £8 000 B £5 000

C £3 000 D an unlimited amount

18. Which would **not** normally be included in a partnership agreement?

A the ratio in which profits and losses are shared B the rate of interest on capital

C the salaries to be paid to partners D the selling prices of the firm's products

19. A company has: share capital £100 000; share premium £25 000; retained earnings £40 000; 7% debentures £30 000. What is its total equity?

A £195 000 B £165 000 C £125 000 D £140 000

20. Which statement about trade credit is correct?

A it is a long-term source of finance

B interest is always charged on it

C it allows a business to use goods before paying for them

D it appears as trade receivables in the statement of financial position

Answers and explanations

1 A · 2 C · 3 B · 4 D · 5 B · 6 A · 7 D · 8 C · 9 A · 10 B · 11 C · 12 D · 13 A · 14 B · 15 D · 16 C · 17 A · 18 D · 19 B · 20 C

1. **A.** B, C and D describe companies; a sole trader is personally liable for all debts.
2. **C.** Partnership Act 1890: equal shares; no interest on capital or salaries.
3. **B.** 5% × 20 000 = 1 000 under the Act; C uses 6%.
4. **D.** Loss of privacy; A, B and C are advantages of a company.
5. **B.** A describes a private company; C and D are false for a plc.
6. **A.** Shareholders have limited liability, so statement 2 is false.
7. **D.** Security is a claim over assets; C is an overdraft.
8. **C.** Residual 52 000 − 10 000 − 7 000 = 35 000; Y 2/5 = 14 000 + 3 000 = 17 000. A omits interest on capital.
9. **A.** Leasing avoids a large outlay; the lessor keeps ownership, so B and D are wrong.
10. **B.** Short-term working capital need; A, C and D need long-term finance.
11. **C.** 2 400 + 24 × 450 = 13 200; 13 200 − 12 000 = 1 200. B is the total paid.
12. **D.** Only companies can issue debentures or shares; A–C are open to all.

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13. **A.** 8 400 × 97.5% = 8 190; C is the discount itself.
14. **B.** The supplier can claim only against company assets; C actually helps the supplier.
15. **D.** Debentures are long-term loans; A, B and C make up equity.
16. **C.** 55 000 − 41 000 = 14 000 shortfall, paid because of unlimited liability.
17. **A.** 5 000 × £1.60 = £8 000 paid: limited liability caps the loss there.
18. **D.** Prices are a business decision, not a term of the agreement.
19. **B.** 100 000 + 25 000 + 40 000 = 165 000; debentures are a liability (A adds them).
20. **C.** Buy now, pay later: short-term and usually interest-free; it is shown as trade payables.

Paper 2 style questions

Total: 45 marks. Full mark schemes and answer layouts follow each question.

Question 1 *[30 marks]*

Mei Tan and Kwame Asante are in partnership, repairing and hiring out bicycles. Their financial year ends on 31 December.

(a) State **two** items, other than the profit-sharing ratio, that are usually included in a partnership agreement. *[2]*

Additional information

1. Balances at 1 January 2026: capital accounts Mei £70 000, Kwame £40 000; current accounts Mei £3 200 credit, Kwame £900 debit.
2. The partnership agreement provides for: interest on capital at 5% a year on the capital account balances; a salary for Kwame of £14 000 a year; residual profits and losses shared Mei 3/5, Kwame 2/5.
3. Interest on drawings for the year was Mei £520, Kwame £360. Drawings were Mei £26 000, Kwame £29 500.
4. Kwame has also lent the partnership £10 000 at 6% a year. The interest for the year has been paid by bank and is included in the expenses.
5. The profit for the year ended 31 December 2026 was £61 360.

(b) Prepare the appropriation account for the year ended 31 December 2026. *[8]*

(c) Prepare the partners' current accounts in columnar form for the year ended 31 December 2026. Balance the accounts and bring down the balances on 1 January 2027. *[7]*

Mei Tan and Kwame Asante
current accounts

date	details	Mei £	Kwame £	date	details	Mei £	Kwame £

(d) Explain what is meant by **unlimited liability** and why it is a particular risk for Mei. *[3]*

(e) Calculate the share of the profit for the year that each partner would have received if there had been **no** partnership agreement. *[3]*

(f) The partners are considering converting the business into a private limited company, Tan Asante Cycles Limited, in which they would be the only shareholders and directors. Advise the partners whether they should do this. Justify your answer by considering both the advantages and the disadvantages. [7]

Question 1: mark scheme

Mark scheme

- (a) any two 1 1: the rate of interest on capital; partners' salaries; the rate of interest on drawings; the rate of interest on partners' loans; the capital each partner must introduce; limits on drawings; the duties of each partner; how disputes are settled; procedures for admission, retirement or dissolution (accept other valid items)

Mark scheme

(b) one mark per badge; the interest on Kwame's loan is **not** deducted (it is already an expense). Interest on drawings: one mark for both partners.

Mei Tan and Kwame Asante
appropriation account for the year ended 31 December 2026

	£	£	£	
profit for the year			61 360	1
add interest on drawings				
Mei Tan		520		
Kwame Asante		360		1
			880	
			62 240	1 OF
less				
interest on capital				
Mei Tan	3 500			
Kwame Asante	2 000			1
		5 500		
salary: Kwame Asante		14 000		1
			19 500	
residual profit			42 740	1 OF
share of residual profit				
Mei Tan (3/5)		25 644		1 OF
Kwame Asante (2/5)		17 096		1 OF
			42 740	

- interest on capital 5% × 70 000 = 3 500 and 5% × 40 000 = 2 000
- residual 62 240 – 5 500 – 14 000 = 42 740
- Mei 3/5 = 25 644; Kwame 2/5 = 17 096

Mark scheme

(c) both opening balances on the correct sides (1); drawings (1); interest on drawings (1 OF); interest on capital (1 OF); salary (1 OF); share of profit (1 OF); both balances b/d on 1 January 2027 (1 OF)

Mei Tan and Kwame Asante
current accounts

date	*details*	*Mei £*	*Kwame £*		*date*	*details*	*Mei £*	*Kwame £*	
Jan 1	balance b/d		900	1	Jan 1	balance b/d	3 200		
Dec 31	drawings	26 000	29 500	1	Dec 31	interest on capital	3 500	2 000	1 OF
Dec 31	interest on drawings	520	360	1 OF	Dec 31	salary		14 000	1 OF
Dec 31	balance c/d	5 824	2 336		Dec 31	share of profit	25 644	17 096	1 OF
		32 344	33 096				32 344	33 096	
					Jan 1	balance b/d	5 824	2 336	1 OF

Mark scheme

- (d) the owners are personally responsible for all the debts of the business 1; if the business cannot pay, creditors can claim the partners' private assets such as savings or homes 1; each partner is liable for debts caused by the other partner's decisions, and Mei has more capital (70 000) and probably more private wealth at risk / she is bound by Kwame's contracts 1

Mark scheme

- (e) profit before loan interest 61 360 + 600 = 61 960 1; less loan interest at 5% under the Partnership Act 1890: 500 1; 61 460 shared equally = £30 730 each 1 OF (no interest on capital, salary or interest on drawings)

Mark scheme

(f) 1 mark for each advantage or disadvantage identified (max 3) and 1 mark for its development (max 3), referring to the partners' situation; 1 mark for a recommendation supported by a reason.

advantages of becoming a limited company	disadvantages
limited liability 1: Mei and Kwame would lose only the 110 000 invested, not their homes or savings, if the business failed 1	formation costs and legal duties 1: annual financial statements in a set format must be filed (and possibly audited), adding accountancy fees 1
separate legal entity with continuity 1: the business would survive if one of them retired or died; easier to bring in new investors by selling shares 1	loss of privacy: competitors could see the accounts / profits; a bank may still ask them for personal guarantees, so limited liability gives less protection than expected
may find it easier to raise finance or win larger hire contracts because of company status	profit can only be taken as dividends or directors' pay; Kwame's salary and the current-account system would end

Recommendation supported by a reason, e.g. "they should convert, because the hire business carries a risk of large claims and limited liability protects their personal assets, which outweighs the extra cost" 1. Accept other valid responses.

Question 2 [15 marks]

Kaveh Rahimi owns a bakery as a sole trader. He needs a new oven with a cash price of £18 000, but has little spare cash. The oven is expected to be worth £7 000 after two years. He is considering three options.

- **Option A**: an unsecured bank loan of £18 000 at 10% a year, interest paid at the end of each year, the loan repaid in full after two years. Kaveh buys the oven and pays for servicing at £400 a year.
- **Option B**: payment by instalments: a deposit of £3 000 and 24 monthly instalments of £720. Kaveh owns the oven after the last instalment. Servicing costs £400 a year.
- **Option C**: leasing the oven for 24 months at £690 a month, servicing included. The oven is returned at the end of the lease.

(a) Explain the difference between a **secured** loan and an **unsecured** loan. [2]

(b) Calculate the net cost to Kaveh of each option over the two years. [6]

(c) Explain why a bank overdraft would **not** be a suitable way to finance the oven. [2]

(d) Advise Kaveh which option he should choose. Justify your answer. [5]

Question 2: mark scheme

Mark scheme

- (a) a secured loan gives the lender a legal claim over specified assets of the borrower (e.g. premises) which can be sold if the loan is not repaid 1; an unsecured loan has no such claim, so the lender's risk is higher and the interest rate is usually higher / the amount smaller 1

Mark scheme

(b) one mark per badge; the two net-cost marks are own-figure marks.

Kaveh Rahimi
net cost of the oven over two years

	option A bank loan £	option B instalments £	option C leasing £	
loan repaid at the end of year 2	18 000			
loan interest (18 000 × 10% × 2)	3 600			1
deposit + instalments (3 000 + 24 × 720)		20 280		1
servicing (2 × 400)	800	800	included	1
lease rentals (24 × 690)			16 560	1
total payments	22 400	21 080	16 560	
less value of the oven after two years	7 000	7 000	–	
net cost	15 400	14 080	16 560	1 OF 1 OF

Net cost A = 22 400 – 7 000 = 15 400; B = 21 080 – 7 000 = 14 080; C has no resale value and servicing is included.

Mark scheme

- (c) an overdraft is short-term finance that the bank can ask to be repaid at any time 1, but the oven is a non-current asset used for many years, so Kaveh might have to repay before the oven has earned the money / overdraft interest rates are high 1

Mark scheme

- (d) up to 4 marks for points referring to the options and the figures, e.g.: B has the lowest net cost, £14 080 ✓, and Kaveh owns the oven, but he needs a £3 000 deposit that he may not have / instalments are a fixed monthly outflow ✓; C needs no deposit and includes servicing, so cash flow is smooth and there is no risk of repair bills ✓, but it is the dearest at £16 560 and he never owns the oven ✓; A is unsecured, so no assets are at risk, but £18 000 must be repaid in one sum after two years, a large risk for a business with little cash; the £7 000 resale value is only an estimate
- recommendation supported by a reason, e.g. "choose B because it is £2 480 cheaper than leasing and he will own the oven, provided he can find the deposit" ✓

Quick-reference table

Item	Key point
sole trader	one owner; unincorporated; unlimited liability; all profit to the owner; capital + profit – drawings
partnership	usually 2–20 partners; Partnership Act 1890; unlimited liability; each partner an agent of the firm
Partnership Act 1890 (no agreement)	profits shared equally; no interest on capital or drawings; no salaries; 5% a year on partners' loans
appropriation account	profit for the year + interest on drawings – interest on capital – salaries = residual profit, shared in the agreed ratio
capital and current accounts	capital = fixed investment; current = appropriations less drawings; credit balance owed to the partner
company equity	share capital + share premium + general reserve + retained earnings; dividends and profit in the statement of changes in equity
instalments / leasing	instalments: own the asset at the end, total cost above cash price; leasing: never own, no deposit, often serviced
company sources	ordinary shares and rights issues (permanent, dilute control), debentures (loan, interest, repayable), retained earnings

"I can" checklist

- ☐ describe the legal form, ownership, management and control of each entity
- ☐ explain unlimited and limited liability, with figures
- ☐ give advantages and disadvantages for owners and other stakeholders
- ☐ distinguish a private and a public limited company
- ☐ list the contents of a partnership agreement and the Act's rules
- ☐ prepare an appropriation account and columnar current accounts
- ☐ set out the capital or equity section for each entity, incl. a simple statement of changes in equity
- ☐ explain each source of finance and match it to a need
- ☐ calculate and compare the cost of loan, instalments and leasing
- ☐ advise on the choice of entity or finance, with a justified recommendation