Chapter 1

Financial accounting of companies – concepts, unique ledger accounts and bookkeeping

By the end of this chapter, you will be able to:

- Define and explain accounting concepts unique to companies:
  - Companies – public and private
  - Companies Act
  - Registrar of Companies – Registration certificate
  - Memorandum of Incorporation
  - Income tax / provisional income tax
  - Dividends
  - Shares
  - Issue price
  - Earnings
  - Shareholders
  - Directors
  - Auditors
  - Limited liability
  - Separation of ownership from control
  - Retained income
  - Authorised share capital
  - Issued share capital
  - Johannesburg Stock Exchange (JSE)
- Bookkeeping of companies:
  - Journals
  - Ledger accounts
  - Trial Balances (dealt with in Chapter 2)
- Transactions include:
  - Issuing of shares at issue price
  - Buying back shares
  - Loans and interest capitalised
  - Income tax
  - Dividends
  - Directors' fees
  - Audit fees
- Analysis and indication of the effect of transactions on the accounting equation of a company
- Integration of ethical considerations relating to companies – roles of shareholders and directors, manipulation of share prices, corporate governance, etc.
- Application of GAAP principles and IFRS

Key concepts
• Companies Act • MOI • JSE • authorised shares • issued shares • issue price • provisional income tax • tax assessment • interim dividends • final dividends • limited liability • corporate governance • separation of ownership • retained income • directors' fees • audit fees • interest capitalised • buying back shares

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1. Introduction

Until now you have been dealing with two types of business: sole proprietor (Grade 10) and partnerships (Grade 11). Companies originated as a result of the shortcomings of these other types of business. The main differences between companies and sole proprietors or partnerships are listed in the table below.

Sole proprietor	Partnership	Company
One owner	Two or more partners	Shareholders
Not a separate legal entity	Not a separate legal entity	Separate legal entity
No legal regulations	A few legal regulations	Bound by Companies Act
Profits belong to owner	Profits are distributed in specific ratios to partners	Profits belong to the company and are paid out to the shareholders by way of dividends
Owner has unlimited liability – liable for all debts/losses	Partners have unlimited liability – liable for all debts/losses	Shareholders' liability is limited – the company as a legal entity is liable for debts/losses
Managed by owner	Managed by partners	Managed by board of directors
No foundation documents	Partnership agreement	Memorandum of Incorporation and Notice of Incorporation

Legal entity: Oil drum manufacturer

2. Legal entity

According to the business dictionary, a legal entity has legal capacity to enter into agreements or contracts, assume obligations, incur and pay debts, sue and be sued in its own right, and to be held responsible for its actions. In other words, a company as a **legal entity** implies the following:

- A company has its own rights and responsibilities and operates independent from its shareholders.
- The company owns the assets in its own right.
- The income generated belongs to the company and therefore the company as an entity is liable for tax.
- The company is liable for the company's obligations.

legal entity
has legal capacity to enter into agreements or contracts, assume obligations, incur and pay debts, sue and be sued in its own right, and to be held responsible for its actions

2.1 Advantages (benefits) of a company

- A legal existence separate from its management and shareholders – A company may own assets in its own right, may incur debt and perform **jural acts**.
- **Limited liability** to shareholders – Should a company's business fail, a shareholder's only loss is the value of their shares. The personal assets of the shareholder are protected. With a sole proprietor and partnership this is not the case. In other words, the personal assets of the proprietor or partners may be confiscated should the business fail.
- Continuity – Directors, managers and employees only act as agents of the company. If they leave, retire or die, the company remains in existence.

jural acts
enter into legal agreements and assume legal rights and obligations

limited liability
the concept whereby a person's financial liability is limited to the amount invested in the company. The investor is not personally responsible for the debts and obligations of the company.

2.2 Disadvantages of a company

- Companies are costly and complex to administer.
- Companies are regulated by complex Corporations Law, and comprehensive regulations of the Companies Act apply which protect the shareholders.
- Statutory audit of financial statements for companies with public liability are required.

3. Companies Act

South Africa has a well-developed and formally regulated Companies Law regime. The Companies Act 61 of 1973 used to regulate all matters relating to companies. In April 2011, a new Companies Act 71 of 2008 became law. The aims of the new Act are to simplify the procedure for forming companies, and to reduce the cost of forming and running a company. Smaller companies could not afford the high audit fees and the new Act brings relief to these companies. The **Companies Act** is administered by the Registrar of Companies and covers aspects such as the procedures for forming a company, how capital may be raised, how they should be run and what information should be disclosed in financial statements.

Companies Act (1)

Companies Act (2)

3.1 Registrar of Companies

The Minister of Finance shall, subject to the laws governing the public service, appoint a Registrar of Companies, who shall exercise the powers and perform the duties assigned to the Registrar by this Act. The Registrar of Companies will issue a registration certificate as evidence of the incorporation and registration of a company.

Companies Act

regulates many aspects of a company's existence and conduct

3.2 Types of companies

Profit companies				Non-profit companies
Private company (Pty) Ltd.	**Personal liabilities company Inc.**	**State-owned company SOC Ltd.**	**Public company Ltd.**	**NPC**
Its MOI prevents it from offering securities to the public and restricts the transferability of securities.	MOI states that the directors and past directors are jointly liable, together with the company, for any debts and liabilities that were contracted during their periods of office.	They are defined in terms of the Public Finance Management Act or are owned by a municipality.	The public is invited to buy shares and these shares can be transferred freely.	Certain aspects of the Companies Act do not apply to these companies.

In Grade 12, we will only look at the difference between public and private companies and we will only discuss the bookkeeping process of public companies.

Companies and Intellectual Property Commission

all companies must be registered with this organisation

3.3 Public and private companies

The following table compares the differences between the two types of companies.

Public company	Private company
One person may incorporate a public company.	One person may incorporate a private company.
The company name ends in "Limited", abbreviated to Ltd.	The company name ends in "Proprietary Limited", abbreviated to (Pty) Ltd.
The minimum number of directors is three.	The minimum number of directors is one.
The public is invited to buy shares.	The public is not invited to buy shares.
Shares can be transferred freely.	Shares can only be transferred after approval by the Board of Directors.
Public companies must appoint an auditor, audit committee and **company secretary**.	Private companies appoint an audit committee only to the extent provided for in the MOI.
All public companies must have audited financial statements that should be presented to shareholders at the AGM within six months after financial year-end.	Private companies only need to be audited if: • It has assets exceeding a value of R5 million. • Their public interest score exceeds 750 points. • Public interest score is between 300 and 750. • The financial statements were internally compiled.
Public companies must appoint a Social and Ethics Committee.	Private companies only need to appoint a Social and Ethics Committee if their public interest score exceeds 750 points.
They raise capital by issuing shares to the public.	They raise capital by issuing shares to the owners.

i The public interest score for each financial year is calculated as the sum of the following:

- Number of points equal to the number of employees
- One point for every R1 million in outstanding unsecured debt (e.g. loans, creditors)
- One point for every R1 million in turnover during the financial year
- One point for every security holder

company secretary

ensures the Board remains aware of its duties and responsibilities and attends all meetings of the Board and its sub-committees

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Excerpt
More Information

Memorandum of Incorporation (MOI)
a document that sets out rights, duties and responsibilities of shareholders, directors and others within and relation to a company

Notice of Incorporation
a formal announcement to the public, indicating the formation of a new legal entity

prospectus
a document describing the main features of a business for prospective buyers

3.4 Formation of a company

A company is founded in terms of the regulations of the Companies Act 71 of 2008. When registering and founding a company, the Companies Act stipulates the following:

- A **Memorandum of Incorporation** (**MOI**) and **Notice of Incorporation** must be drawn up and submitted to the Registrar of Companies (Companies and Intellectual Property Commission or CIPC).
- The Registrar will then:
  - approve the name of the company
  - enter the prescribed information concerning the company in the Companies Register
  - endorse the Notice of Incorporation and Memorandum of Incorporation.
- A **registration certificate** will then be issued to the company so that it can commence business.
- A **prospectus** has to be compiled. The prospectus should contain, among others, the name and address of the company, details of the directors, particulars of share capital, etc.

3.5 Board of Directors

The shareholders, as the "owners" of a company, elect a Board to act as the co-ordinating and policy-making body of the company. The Board must consist of at least three directors. The MOI may allow for a higher number of directors if required. Most boards of public companies have between eight and twelve directors.

The directors of a company are elected by the holders of voting rights in the company, but the Act does allow for the direct appointment of a director by a person specified in the MOI. However, at least 50% of directors must be elected by the shareholders.

A person acting in the capacity of a director must exercise his powers and perform his functions:

- in good faith and for a proper purpose
- in the best interest of the company
- with the degree of skill, care and diligence that may reasonably be expected of someone with the same knowledge and skills.

jointly and severally
both together and separately

fiduciary
being responsible for property and power entrusted to you

Directors of a company may be held **jointly and severally** liable for any loss, damage or costs sustained by the company as a result of a breach of the director's **fiduciary** duty or the duty to act with care, skill and diligence.

Directors can be executive, non-executive or independent. The King III Report defines these as follows:

- **Executive directors** are involved in the day-to-day management of the company and/or in full-time salaried employment of the company.
- **Non-executive directors** are independent of management on all issues including strategy, performance, sustainability resources, transformation, employment equity etc.
- **Independent directors** have not been employed by the company in any way during the previous three years and should be totally independent from any business relationship (supplier/customer) with the company, since their role is to bring to the Board independent judgment and broad business experience.

King IV and the JSE listing requirements recommend that the positions of **chairperson** and **chief executive officer** (**CEO**) of the company should be separated, or that the Board appoint a lead independent director who will bring some independence to board discussions.

chairperson
someone who presides over a meeting, committee, board etc.

Chief Executive Officer (CEO)
the managing director who controls the work of the other directors

KING CODE

Some of the Board's roles and functions are to:

- provide strategic direction to the company and approve strategic plans
- retain full and effective control of the company
- ensure that the company complies with all laws and regulations
- delegate appropriate powers to management and to monitor them on an ongoing basis
- identify and monitor key risks and ensure that the company has effective internal control measures to manage all risks
- identify and monitor key performance areas for the Board and management.

3.6 Management of the company

Not all Board members are involved in daily routine activities. A management team is usually appointed to do this. Management consists of a managing director and officials, who are responsible for controlling and managing the company's activities. There may be a manager each for sales, purchases, assets, human resources, marketing etc.

King IV: a document that sets out rights, duties and responsibilities of shareholders, directors and others within and in relation to a company

JSE listing requirements: rules and regulations to which all listed companies and directors must comply

Management is extremely important and is described as "the process of working with and through others to achieve organisational objectives in an efficient and ethical manner" (Kreitner-Kinicki: 2006).

The main role of management in a company is to meet their company's objectives. A good manager will be able to:

- define strategies and goals for the company
- apply financial, budgetary, personnel, policy and security judgments
- do strategic planning by setting targets and to ensure that benchmarks are reached in time
- lead, motivate, do teambuilding and have good relationships with employees
- have good communication skills externally and internally in their organisation.

3.7 Independent auditors

All public companies must appoint a registered independent auditor (in terms of the Auditing Professional Act) at every **Annual General Meeting** (**AGM**). When a firm is appointed as auditor, the audit committee must also verify the independence of the individual that will be responsible for the audit. The Act provides for the regular rotation of auditors, so the appointed auditor must be rotated every five years. The independent auditor expresses an opinion on the financial statements and indicates whether the user can rely on the financial statements.

Annual General Meeting
usually referred to as an **AGM**; a formal meeting which is held once a year

3.8 Audit and Risk Committee

The shareholders of all public companies must appoint an audit committee at every AGM. The audit committee should consist of at least three members who must be directors of the company and:

- NOT be involved in the day-to-day management of the company
- NOT be a full time executive employee for the company for the past three financial years
- NOT be a material supplier or customer of the company so that outside parties think that person's judgement would be affected by that relationship
- NOT be related to anybody who falls within the above criteria.

The duties of the audit committee include:
- nominating an independent auditor
- determining the audit fee
- ensuring the appointment of the auditor complies with the Companies Act and other relevant legislation
- determining the nature and extend of non-audit services
- preparing a report to be included in the annual financial statements describing how the committee carried out to its functions, stating whether the auditor was independent, and commenting on the financial statements, accounting practices and internal control measures of the company
- receiving and dealing with relevant complaints
- making submissions to the board regarding the company's accounting principles, financial controls, recording and reporting
- evaluating the company's exposure and responses to significant business, strategic, statutory and financial risks
- ensuring effective communication between directors, management and internal and external auditors
- reviewing compliance with JSE listing requirements and King IV.

3.9 Summary of company committees

Committee	Appointed by	Composition	Main functions and roles
Audit committee (required by Companies Act)	Elected by the shareholders at the AGM	At least three members, all of whom must be independent non-executive directors (NEDs)	• Nominate and appoint the auditor. • Oversee the financial reporting. • Report on integrated reporting, risk management, sustainability and IT governance.
Risk committee (recommended by King Code)	Appointed by the board	Recommended that members be executive and non-executive directors with a majority being NEDs	• Oversee the risk management function. • Advise on risk strategy and policy to ensure that risks are adequately managed, monitored and controlled.
Remuneration committee (recommended by King Code)	Appointed by the board	Recommended that all members be NEDs, with the majority being independent	• Assist the board with setting and implementing remuneration policies so that directors and executives are remunerated fairly, responsibly and transparently. • Establish an appropriate reward policy that attracts and motivates executives to achieve the long-term interests of shareholders.
Social and ethics committee (required by Companies Act)	Appointed by the board	At least three directors or prescribed officers of the company, at least one must be a NED	• Monitor the company's activities with regard to matters relating to: • social and economic development • good corporate citizenship • environmental, health and safety concerns • consumer relationships • labour and employment.
Nominations committee (recommended by King Code)	Appointed by the board	Recommended that all members be NEDs, with the majority being independent	• Assist with appointments to the board and the audit committee. • Ensure that the nomination and appointment of directors are transparent and fair. • Ensure that the board comprises the necessary skill, knowledge and expertise to ensure the long-term sustainability of the company.

3.10 Shareholders

A shareholder has the following rights:
- Voting power on major issues such as electing directors and fundamental changes. This takes place at the AGMs. Usually a shareholder gets one vote for every share they own.

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More Information

- An entitlement to dividends – they share in the profits of the company.
- Ownership in a portion of the company. They will share in the final distribution of net assets upon liquidation.
- Opportunity to inspect the company's books and records.

The following should be transacted during the AGM:
- Presentation of the directors' report, audited financial statements and report of the audit committee
- Election of directors
- Appointment of an auditor and an audit committee
- Any matters raised by shareholders.

Promoters: are the initial group of people who decide to start the company.

4. Separation of ownership from control (corporate governance)

To **separate ownership** from control means that owners have delegated part of their control and rights to the managers of the company. However, they do keep the right to take away the delegated control and rights from the managers if they are dissatisfied with how the business is managed. In companies, the shareholders elect directors, who appoint managers. Directors must represent shareholders' interest and determine the broad policies that the managers will carry out.

In a company, in contrast to a partnership, ownership is separated from operational control. This separation creates the need for independent monitoring and control. The Companies Act provides rules and regulations for the directors to follow to safeguard the company's shareholders.

Separation of ownership

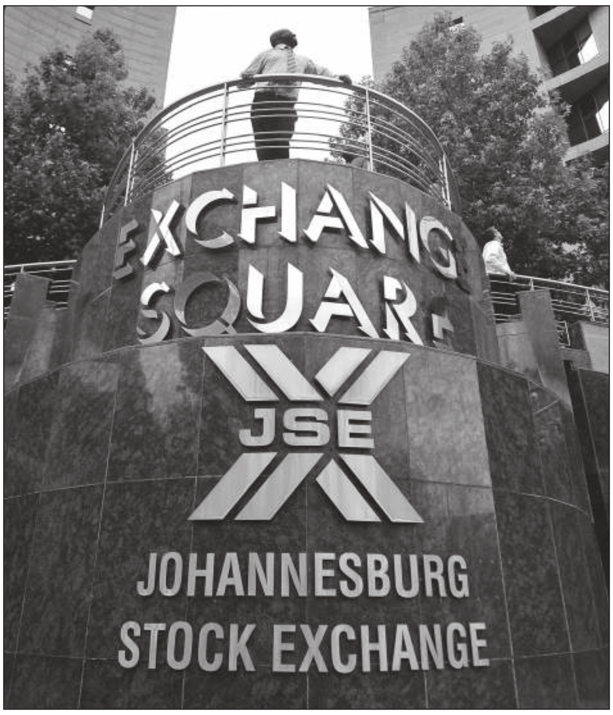
one group of people, the directors, is responsible to manage the money contributed by another group of people, the shareholders

5. Johannesburg Stock Exchange Limited (JSE)

The **JSE** Limited, previously the JSE Stock Exchange, is the largest stock exchange in Africa. The JSE provides a market where shares can be traded freely under a regulated procedure.

The JSE is bound by the provisions of the Stock Exchange Control Act 1 of 1985 (SECA), and all actions taken and requirements issued must be in terms of this Act. The JSE is required by SECA to look after the interests of both the investing public and its members.

It is the duty of the JSE to prescribe the rules and regulations, in the form of the Listing Requirements, with which all member companies and directors must comply, including that companies should adopt **IFRS** in financial statements, requirements in respect of auditors, requirements regarding corporate governance, etc.



JSE

a place where shareholders can buy and sell shares according to certain rules

IFRS

International Financial Reporting Standards

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Excerpt
More Information

Activity 1.1

Match the persons or institutions listed in Column A, with their description in Column B.

Write out these descriptions in your Exercise Book, so that you a have a summary of all the people and institutions connected to companies.

Column A: Person / Institution		Column B: Description	
1.	promoters	A.	provides a market where shares can be traded freely under a regulated procedure
2.	shareholders	B.	the initial group of people who decided to start a company
3.	Registrar of Companies	C.	involved in the day-to-day management of the company and a member of the Board
4.	independent auditor	D.	a member of the Board not involved in the day-to-day management of the company; brings independent judgment to the Board
5.	Chief Executive Officer (CEO)	E.	the owners of a company and who have voting rights
6.	SARS	F.	expresses an opinion on the financial statements and indicates whether the reader can rely on the financial statements
7.	company secretary	G.	the institution to which a company must pay tax on the profit earned
8.	JSE	H.	the managing director who controls the work of the other directors
9.	executive director	I.	attends all Board and sub-committee meetings and ensures that all the legal matters relating to a company are attended to
10.	Non-executive director	J.	a group that monitors the impact of the company's activities on the environment and public health and reports to shareholders
11.	Social and Ethics Committee	K.	issues a registration certificate so that a company can start doing business

6. Shares

A company needs funds to start and then run a business. They can get these funds in the following ways:

- raising funds from the shareholders (selling shares)
- generating profit (internal source)
- borrowing through loans (external source).

There are two basic classes of shares that a company may issue:

- ordinary shares
- preference shares.

Preference shareholders have preference over the ordinary shareholders in the event where a company is liquidated. Ordinary shares are therefore riskier from an investor's point of view, but they usually outperform preference shares on the stock markets.

Ordinary shareholders are not guaranteed to receive dividends because ordinary dividends depend on the profitability of a company and its cash flow. Preference shareholders generally receive a fixed percentage dividend annually.

In Grade 12, however, we are only going to deal with ordinary shares, not preference shares.

6.1 Authorised and issued share capital

Initial Public Offering (IPO)

When Shares are offered on a public stock exchange for the first time.

Authorised shares are the maximum number of shares a company's Memorandum of Incorporation permits it to issue.

Issued shares are the number of shares the company has actually sold.

Issue price is the price for which the shares are sold.

The difference between the authorised share capital and the issued share capital is known as the reserve or **unissued share capital**.

6.2 Issuing shares: Bookkeeping

Example

Issuing ordinary shares

According to the Memorandum of Incorporation (MOI) of Danjo Traders Ltd., they are authorised to issue 100 000 ordinary shares. On 1 March 2018, Danjo Traders Ltd. issued 60 000 shares at an issue price of R16,50 per share. On 31 March 2018, applications for all 60 000 shares together with their payments were received.

Required

1. Show the entries in the journals
2. Post to the General Ledger
3. Show the effect on the accounting equation and how it will be reflected in the notes to the financial statements.

Solution

1. **Journal entry**

The entry for this transaction can be done either in the General Journal or the Cash Receipts Journal.

Cash Receipts Journal of Danjo Traders Ltd. for March 2018 **CRJ**

Doc. no.	Day	Details	Fol.	Analysis of receipts	Bank	Sundry accounts	
						Amount	Details
65	31	Shareholders	B1	990 000	990 000	990 000	Ordinary share capital
					B6		

OR

General Journal of Danjo Traders Ltd. for March 2018 **GJ**

Doc. no.	Day	Details	Fol.	Debit	Credit
	31	Bank	B6	990 000	
		Ordinary share capital	B1		990 000
		(Issue 60 000 shares @ R16,50)			

2.

General Ledger of Danjo Traders Ltd.
Balance Sheet accounts

Dr Ordinary Share Capital B1 Cr

Date		Details	Fol.	Amount	Date		Details	Fol.	Amount
					2018 Mar	31	Bank	CRJ	990 000

Example continued

Dr — Bank — B6 — Cr

Date		Details	Fol.	Amount	Date		Details	Fol.	Amount
2018 Mar	31	Ordinary share capital	CRJ	990 000					

3.

Assets		Owner's Equity		Liabilities	
Effect	**Reason**	**Effect**	**Reason**	**Effect**	**Reason**
+ 990 000	Cash increase	+ 990 000	Increase in ordinary share capital		

Danjo Traders Ltd.
NOTES TO THE FINANCIAL STATEMENTS
7. ORDINARY SHARE CAPITAL

AUTHORISED	
Number of ordinary authorised shares: 100 000 shares	
ISSUED	
0 ordinary shares in issue at 1 March 2018	
60 000 additional shares issued during the financial year at issue price R16,50 each	990 000
60 000 ordinary shares in issue at 28 February 2019	**990 000**

Activity 1.2

According to the Memorandum of Incorporation of Xoseka Traders Ltd., they are authorised to issue 110 000 shares. On 1 July 2019 Xoseka Traders Ltd. offered 60 000 ordinary shares for sale to the public at R7 per share.

By 31 July 2019 the company had received applications and full payment for all these shares.

The financial year of Xoseka Traders Ltd. ends on 30 June.

Required

1. Show the entry for this transaction in the Cash Receipts Journal for July 2019.
2. Show the entry in the General Ledger.
3. Show the effect on the accounting equation.
4. Prepare the note for Share Capital to the financial statements.

Activity 1.3

Activity 1.3

Francken Ltd. are registered to issue 140 000 ordinary shares. The following entry appeared in their books on 1 March 2018, the beginning of their financial year:

Ordinary share capital R200 000 (50 000 shares)

On 1 May 2018 the company offered a further 70 000 ordinary shares to the public at R4,30 each. By 31 May 2018 the company had received applications and full payment for all these shares.

Required

1. Show the entry for this transaction in the General Journal for May 2018.
2. Show the entry in the Ordinary Share Capital account in the General Ledger.
3. Show the effect on the accounting equation.
4. Prepare the note for Share Capital to the financial statements.