UNDERSTANDING COMPANIES

Grade 12 Accounting

Companies and Financial Statements

CHAPTER OUTCOMES

After studying this chapter, you should be able to:

✓ Explain what a company is

✓ Identify the characteristics of a company

✓ Differentiate between shareholders and directors

✓ Explain the concept of limited liability

✓ Explain the role of auditors

✓ Understand IFRS and CIPC

✓ Answer theory questions relating to companies

✓ Apply company concepts in examination questions

1. INTRODUCTION TO COMPANIES

Imagine that three entrepreneurs decide to open a national clothing business.

The business grows rapidly and opens stores in Johannesburg, Cape Town, Durban and Polokwane.

The owners now need:

- More money to expand
- Better management structures
- Legal protection

- Investors

A sole trader or partnership may no longer be suitable.

The owners therefore register a company.

A company is one of the most important forms of business ownership in South Africa.

Most large businesses such as banks, retailers, mining houses and telecommunications companies operate as companies.

Examples include:

- Shoprite
- Pick n Pay
- MTN
- Vodacom
- Standard Bank

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2. WHAT IS A COMPANY?

Definition

A company is a business organisation that is registered according to the Companies Act and exists as a separate legal entity from its owners.

This means:

The company has its own identity.

The company can:

✓ Own property

✓ Borrow money

✓ Sue another party

✓ Be sued

✓ Enter into contracts

STUDYPACK EXAM TIP

Many learners simply memorise the definition.

The examiner may ask:

Why is a company regarded as a separate legal entity?

Answer:

Because the company exists independently from its shareholders and has its own legal identity.

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3. CHARACTERISTICS OF A COMPANY

There are several characteristics that make companies unique.

These are frequently tested in Grade 12 examinations.

3.1 Separate Legal Entity

This is the most important characteristic.

The company and the owners are not the same person.

Example:

Suppose StudyPack (Pty) Ltd buys a building.

The building belongs to the company.

It does not belong personally to the shareholders.

3.2 Limited Liability

One of the greatest advantages of a company.

What does it mean?

Shareholders can only lose the amount they invested.

Their personal possessions are protected.

Example:

John buys shares worth R50 000.

The company later fails.

John loses his investment of R50 000.

The company's creditors cannot take:

✗ John's house

✗ John's vehicle

✗ John's personal savings

REMEMBER THIS

Limited Liability = Limited Risk

Shareholders are not personally responsible for company debts.

3.3 Continuity

A company has an unlimited lifespan.

The company continues to exist even if:

- A shareholder dies
- A shareholder sells shares
- Directors resign

Example

If a shareholder owning 10 000 shares dies, the company continues operating normally.

This differs from a sole trader where the business often ends when the owner dies.

3.4 Ownership Transfer

Ownership is transferred through shares.

Shares can be bought and sold.

This makes it easier to attract investors.

3.5 Separation of Ownership and Management

This is another favourite examination concept.

Shareholders own the company.

Directors manage the company.

Many learners confuse these roles.

SHAREHOLDERS VS DIRECTORS

Shareholders	Directors
Owners of company	Managers of company
Invest money	Make decisions
Receive dividends	Receive directors' fees
Vote at AGM	Run daily operations
Elect directors	Accountable to shareholders

EXAM TRAP

Question:

Who owns the company?

Many learners answer:

"Directors"

WRONG.

Directors manage.

Shareholders own.

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4. TYPES OF COMPANIES

For Grade 12, you should know:

Private Company (Pty) Ltd

Shares are not traded publicly.

Example:

StudyPack (Pty) Ltd

Public Company Ltd

Shares may be traded on the Johannesburg Stock Exchange (JSE).

Example:

MTN Group Ltd

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5. SHARE CAPITAL

One of the most important Grade 12 topics.

Before learning financial statements, learners must understand shares.

What is a Share?

A share represents ownership in a company.

If a company has:

1 000 000 shares

and you own:

100 000 shares

then you own:

10%

of the company.

SHARE CAPITAL EXPLAINED

When a company sells shares to investors, it receives money.

This money is called Share Capital.

Example:

StudyPack issues:

100 000 shares

at R10 each

Money received:

R1 000 000

This becomes Share Capital.

EXAM TIP

Do not confuse:

Share Capital

with

Retained Income

Share Capital comes from shareholders.

Retained Income comes from profits.

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6. AUTHORISED SHARES VS ISSUED SHARES

This is frequently examined.

Authorised Shares

Maximum number of shares that may be issued.

Example:

5 000 000 shares

Issued Shares

Actual shares sold to shareholders.

Example:

3 200 000 shares

EASY MEMORY TRICK

Authorised = Allowed

Issued = Sold

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7. DIVIDENDS

Why do people buy shares?

To earn dividends.

What is a Dividend?

A dividend is a distribution of profits to shareholders.

Example:

Company profit:

R10 000 000

Dividend declared:

R3 000 000

Shareholders receive:

R3 000 000

TYPES OF DIVIDENDS

Interim Dividend

Paid during the year.

Final Dividend

Declared at year-end.

Usually appears in examination adjustments.

EXAM TRAP

Declared - Paid

A final dividend may be declared but not yet paid.

In this case it becomes:

Shareholders for Dividends

(Current Liability)

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8. RETAINED INCOME

Not all profit is distributed.

Some profit remains in the business.

This is called Retained Income.

Example

Profit after tax:

R1 000 000

Dividends:

R300 000

Retained Income:

R700 000

WHY RETAIN PROFITS?

Companies retain profits to:

✓ Expand operations

✓ Buy assets

✓ Open branches

✓ Reduce borrowing

✓ Improve cash flow

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9. ROLE OF DIRECTORS

Directors manage the company.

Responsibilities include:

- Strategic decisions
- Hiring executives
- Approving budgets
- Declaring dividends
- Protecting shareholder interests

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10. ROLE OF AUDITORS

Auditors provide assurance that financial statements are reliable.

They are independent.

Their job is not to run the company.

Their job is to examine financial records.

WHY ARE AUDITORS IMPORTANT?

They:

✓ Improve trust

✓ Detect irregularities

✓ Protect shareholders

✓ Promote accountability

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11. IFRS

IFRS stands for:

International Financial Reporting Standards

These are accounting rules used worldwide.

Their purpose is:

- Consistency
- Comparability
- Transparency

EXAM QUESTION

What is IFRS?

Answer:

International Financial Reporting Standards used to ensure consistency in the preparation and presentation of financial statements.

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12. CIPC

CIPC stands for:

Companies and Intellectual Property Commission

FUNCTIONS OF CIPC

✓ Registers companies

✓ Maintains company records

✓ Protects intellectual property

✓ Ensures legal compliance

REMEMBER

IFRS = Accounting Standards

CIPC = Company Registration

Many learners confuse the two.

COMMON EXAM MISTAKES

❌ Shareholders manage the company

✓ Directors manage the company

❌ Directors own the company

✓ Shareholders own the company

❌ Share capital comes from profit

✓ Share capital comes from investors

❌ Declared dividend equals paid dividend

✓ Declared dividends may still be payable

CHAPTER SUMMARY

A company:

- Is a separate legal entity
- Has limited liability
- Has continuity
- Is owned by shareholders
- Is managed by directors
- May issue shares
- Pays dividends
- Retains profits
- Uses IFRS
- Registers through CIPC

PRACTICE QUESTIONS

QUESTION 1

Define a company.

(2)

QUESTION 2

Explain the concept of limited liability.

(2)

QUESTION 3

Differentiate between shareholders and directors.

(4)

QUESTION 4

What is the difference between authorised shares and issued shares?

(4)

QUESTION 5

State TWO functions of the CIPC.

(2)

QUESTION 6

Explain why retained income is important.

(4)

MEMORANDUM

QUESTION 1

A company is a registered business entity that exists separately from its owners.

(2)

QUESTION 2

Shareholders are only liable for the amount invested and are not personally responsible for company debts.

(2)

QUESTION 3

Shareholders own the company while directors manage the company.

Shareholders receive dividends while directors receive directors' fees.

(4)

QUESTION 4

Authorised shares are the maximum number of shares that may be issued.

Issued shares are shares that have actually been sold.

(4)

QUESTION 5

Any TWO:

- Register companies
- Maintain company records
- Protect intellectual property
- Monitor compliance

(2)

QUESTION 6

Retained income provides funds for growth, expansion, purchasing assets and reducing borrowing.

(4)