

# **Study Unit 6**

## **Introduction to Companies**

Study Unit 6: Introduction to Companies

# **Introduction to Companies**

# Introduction

- Company is a form of business registered and operated under the Companies Act 71 of 2008
- Separate legal person
- Owners called shareholders who own a number of shares
- Main reason for Company as a form of business as compared to other types is the need to raise larger amounts of capital.
- Two Types of Companies
  - “Not for Profit” or
  - “For Profit” (four forms of For Profit Companies)

# Share Capital Structures

- Maximum number of shares (authorised):
  - MOI (Memorandum of Incorporation)
    - *Previously Memorandum and Articles*
- Authorised vs Issued
  - Company is not obliged to issue all its authorised shares (authorised share capital);
  - Issued share capital is what is shown in Statement of Financial Position
  - Authorised number of shares is disclosed in notes only
- No more par / nominal value shares (old companies act)
  - Therefore no more share premium
  - All shares = no par value
  - Often called the Stated Share Capital

# Equity in the SFP.....

Sole Proprietor	Partnership	Close Corporation	Company
Capital Account	Capital Account(s)	Members Contribution	Share Capital
	Current Account(s)	Retained income	Retained income
Reserves	Reserves	Reserves	Reserves

Note that in the Sole Proprietor and the Partnership we referred to Drawings when owners took cash out of the business.

For Close Corporations we refer to Distributions.

For Companies we refer to Dividends

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# **PROFIT COMPANIES**

# Profit Companies

- An association of persons who work together with the aim of making a profit.
- A profit company is established by registration and complying with legal requirements.
- Four types of companies if the aim is to make a profit
  1. Private Company
  2. Public Company
  3. State Owned Company
  4. Personal Liability Company

# Formation = Incorporation

- Apply to reserve proposed name with CIPC (Companies & Intellectual Property Commission) – if name is rejected then the registration number becomes the name of the company.
- Once the name is approved the MOI (CoR 15.1 Memorandum of Incorporation) and other prescribed forms (most notably CoR14.1 Notice of Incorporation) must be submitted and approved.
- Once approved:
  - Company name entered into the Companies Register
  - Certificate of Registration is issued to the company



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# **SHAREHOLDERS**

# Shareholders

- A share is one of the units of priority interest into which the proprietary (ownership) in a profit company is divided
  - ? What does this mean.....
  - For instance you may own 25 out of 100 shares in a company, shown on a share certificate
- Represents a share in the equity of the business (remember  $\text{equity} = \text{assets} - \text{liabilities}$ )
- Shareholders can be legal persons – ie a company may own shares in another company.

# Shareholders rights.....

1. Right to buy or sell shares in a company
2. Right to vote
3. Right to receive a share of the profits
4. Right to share in the net assets (assets – liabilities)

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# **SHARE TRANSACTIONS**

# Public Companies and the Prospectus

- Majority of a public company share capital is raised by inviting the public to buy shares
- A prospectus is the document used to invite public shareholders to invest in the shares of the company
- Upon purchase of the shares, the shareholder is issued a share (often referred to as securities) certificate which indicates:
  - Name of shareholder
  - Number of shares owned
  - Identification number of shares (eg shares 56 to 75)
  - If listed on the JSE, there are no share certificates as the details are recorded electronically on STRATE (Share Transfer Records All Transactions Electronic)

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# **TYPES OF SHARES**

# Types of shares

1. Ordinary shares
2. Preference shares
  - Cumulative preference shares
  - Participating preference shares
  - Convertible preference shares
  - Redeemable preference shares

# Ordinary Shares

- Do not have a fixed dividends
  - Only paid after Preference Shareholders have been paid their dividends
  - Dividends (sometimes called distributions) are paid out of available profits
    - If recommended by directors and approved by shareholders
    - No limits, but some restrictions in terms of regulation (Companies Act and Common Law)
    - Also consider the Framework concept of Capital Maintenance.



# Preference Dividends

- Normal preference dividends bear a fixed %
  - For example, XYZ Ltd issues 100, R15 000 preference shares that bear dividend at 10% per annum
    - Issued preference share capital in the SoFP will be 100 shares x R15 000 = R1 500 000
    - Every year XYZ will pay preference dividend of 100 shares x R15 000 x 10% = R150 000
    - Preference dividend will be paid before any dividend paid to ordinary shareholders
- ***CUMULATIVE preference dividend***
  - Different to normal preference shares in that any preference dividends that are not paid annually will accumulate and the company is obliged to make payment of outstanding preference dividends before paying any ordinary dividend.

# Redeemable preference shares

- Preference shares can be redeemable
  - This means that the company may have the choice or be required to buy the preference shares back (i.e. redeem).
  - The choice of redemption may be with the company itself, or the holder of the shares (the person who purchased the shares), this will depend on the individual preference shares and agreements.
  - Note that later on in your studies this choice will be very important as to the classification of the preference share as either equity or possibly a liability!

# Participating preference shares

- Participating preference shares have two components for dividend:
  - a fixed % dividend (usually lower than a normal preference share)
  - A share of the ordinary dividends (called a participation in the ordinary dividend)

# Convertible preference shares

- Convertible preference shares will (or may be) converted into ordinary shares:
  - Not always a compulsory conversion, sometimes it may be optional (either by issue or holder)
  - Needs a ratio of ordinary shares to preference shares for conversion, for example 3 preference shares will be converted into one ordinary share.

# Combination of the above

- Preference shares may have a large number of variations – and most of the variations refer to the types of dividends linked to the preference share;
- All of the types of preference shares listed above may be combined
  - For example:
  - Cumulative, redeemable preference shares; or
  - Non cumulative, convertible participating preference shares

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# **ISSUE OF SHARES**

# Issue of Shares

- First issue of shares is always to the “incorporators” of the company
- Procedure for issuing shares:
  - Investor wishing to subscribe for shares must complete an application form (usually included in prospectus)
  - Application form submitted to company along with payment for full amount of shares being subscribed for by investor
  - Applications and payments received after closing date will be returned
  - When applications have been accepted, shares are allotted to the new shareholders
  - Shareholders are issued with securities certificates (if listed on JSE STRATE used) and their names are entered into the securities register.
  - If oversubscribed – ie more applications for shares than that being offered as available for issue – money from unsuccessful applicants must be refunded
  - If under subscribed – ie not enough applications for shares to raise the required capital – the company would normally make use of an underwriter to overcome this risk.
- Note, the company cannot issue shares that are not fully paid up and is also prohibited from issuing more shares than were originally offered to the public.

# Recording the issue of shares

- Three basic transactions:
  1. Record the receipt of monies from application to subscribe for shares
  2. Allot shares
  3. Refund money to unsuccessful applicants



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# **RECORDING ISSUE OF SHARES INCORPORATORS (FOUNDERS)**

# Journals - Incorporators

Bank Incorporators: Ordinary Shares Incorporators: x% Preference shares		
<i>Receipt of application money from incorporators</i>		

Incorporators: Ordinary Shares Incorporators: x% Preference shares Share Capital: Ordinary Shares Share Capital: x% Preference shares		
<i>Allotment of shares to incorporators of the company</i> <i>NOTE: Highly unlikely to be a different amount from application money for incorporators</i>		

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**ISSUE OF SHARES TO THE PUBLIC**  
**APPLICATION = ALLOTMENT**

# Illustration 1

## Application equal to allotment

- ABC Ltd offered 100 shares at R1 each to the public in a prospectus
- Exactly R100 was received along with matching application forms.
- Underwriters commission is calculated at 5% of the shares offered and underwritten.

# Underwriters Commission

Underwriters Commission		
Creditor – Name of Underwriter		
<i>Underwriters commission raised as a creditor</i>		
<i>Note: Often calculated as a percentage of the total shares to be underwritten</i>		

# Receive cash for applications and allot successful applicants shares

Bank		
Application and allotment: Ordinary Shares Application and allotment: x% Preference shares		
<i>Receipt of application money from public</i>		

Application and allotment: Ordinary Shares Application and allotment: x% Preference shares Share Capital: Ordinary Shares Share Capital: x% Preference shares		
<i>Allotment of shares to successful applicants</i>		

# Pay Underwriters Commission

Creditor – Name of Underwriter		
Bank		
<i>Underwriters commission paid</i>		

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# **ISSUE OF SHARES TO THE PUBLIC APPLICATION GREATER THAN ALLOTMENT**



**IF MORE SHARES WERE APPLIED  
FOR BY THE PUBLIC THAN THE  
NUMBER OF SHARES OFFERED  
TO THE PUBLIC**

**NO PAYMENT BY UNDERWRITERS,  
JUST REFUND UNSUCCESSFUL  
APPLICANTS**

## Illustration 2

### Application greater than allotment

- ABC Ltd offered 100 shares at R1 each to the public in a prospectus (R100 worth of shares offered to the public)
- R120 was received along with matching application forms.
- Underwriters commission is calculated at 5% of the shares offered and underwritten.

# Underwriters Commission

Underwriters Commission		
Creditor – Name of Underwriter		
<i>Underwriters commission raised as a creditor</i>		
<i>Note: Often calculated as a percentage of the total shares to be underwritten</i>		

# Receive cash for applications and allot successful applicants shares

Bank		
Application and allotment: Ordinary Shares Application and allotment: x% Preference shares		
<i>Receipt of application money from public</i>		

Application and allotment: Ordinary Shares Application and allotment: x% Preference shares Share Capital: Ordinary Shares Share Capital: x% Preference shares		
<i>Allotment of shares to successful applicants</i>		

# Refund unsuccessful applicants

Application and allotment: Ordinary Shares Application and allotment: x% Preference shares Bank		
<i>Cash refund to unsuccessful applicants</i>		

# Pay Underwriters Commission

Creditor – Name of Underwriter		
Bank		
<i>Underwriters commission paid</i>		

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# **ISSUE OF SHARES TO THE PUBLIC APPLICATION LESS THAN ALLOTMENT**

**IF LESS SHARES WERE APPLIED  
FOR BY THE PUBLIC THAN THE  
NUMBER OF SHARES OFFERED  
TO THE PUBLIC**

**UNDERWRITERS TAKE UP  
REMAINING SHARES – BUT DO  
NOT PAY IMMEDIATELY**



# Illustration 3

## Application less than allotment

- ABC Ltd offered 100 shares at R1 each to the public in a prospectus (R100 worth of shares offered to the public)
- R90 was received along with matching application forms.
- Underwriters commission is calculated at 5% of the shares offered and underwritten.

# Underwriters Commission

Underwriters Commission		
Creditor – Name of Underwriter		
<i>Underwriters commission raised as a creditor</i>		
<i>Note: Often calculated as a percentage of the total shares to be underwritten</i>		

# Receive cash for applications and allot successful applicants shares

Bank Application and allotment: Ordinary Shares Application and allotment: x% Preference shares		
<i>Receipt of application money from public</i>		

Application and allotment: Ordinary Shares Application and allotment: x% Preference shares Share Capital: Ordinary Shares Share Capital: x% Preference shares		
<i>Allotment of shares to successful applicants</i>		

# Underwriters take up shortfall

Debtor – name of Underwriter  Share Capital: Ordinary Shares Share Capital: x% Preference shares		
<i>Allotment of shares to the underwriter</i>		

# Final settlement or receipt with underwriter

Creditor – Name of Underwriter		
Debtor – Name of Underwriter		
Bank (balancing figure)		
<i>Underwriters commission paid – if the Creditor &gt; Debtor amount</i>		

OR

Creditor – Name of Underwriter		
Debtor – Name of Underwriter		
Bank (balancing figure)		
<i>Underwriters commission paid – if the Creditor &lt; Debtor amount</i>		

**SHARE ISSUE EXPENSES TO BE  
WRITTEN OFF AGAINST RETAINED  
INCOME**

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# **WRITE OFF SHARE ISSUE EXPENSES TO RETAINED EARNINGS**

# Share issue expenses

Share issue expenses		
Bank		
<i>Pay share issue expenses</i>		

Retained Earnings		
Share issue expenses		
Underwriters commission		
<i>Write off all share issue expenses to Retained Earnings in Equity</i>		
<i>NOTE: Don't forget about the underwriters commission expense from the first journal</i>		



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**HOMEWORK – Exercise 6.3 page 100 SG**

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# **ISSUE OF CAPITALISATION SHARES**

# Capitalisation shares

- No cash is paid out
- Shareholders receive shares
  - Usually done instead of dividends
- Also referred to as a Bonus Issue
- No real benefit if issued to all shareholders in proportion to current shares held
  - Just a book entry to convert reserves into share capital
- If shares not issued in proportion to current shareholding then there is economic substance

**Changing the number of pieces in  
the pie?**

# Accounting entry?

	<b>Debit</b>	<b>Credit</b>
Dr Retained Earnings*	RXX	
Cr Issued Share Capital		RXX

\* This may be any distributable reserves account not just Retained Earnings.

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# **HOMEWORK – Exercise 6.2 page 99 SG**

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# **DIVIDENDS**

# Dividend Overview

- Dividends are paid out of profits to shareholders (owners)
- Preference dividends paid first before ordinary dividends
- Dividends are paid equally per share (proportionate)
  - can be paid via assets (in specie) or as capitalisation (bonus) share issue
- Process:
  - Directors recommend the amount of dividends to be paid
  - Companies Act requirement – liquid and solvent after dividend paid
  - Dividend approved and therefore declared at the Annual General Meeting (AGM)
  - At AGM shareholders can declare a dividend lower than that recommended by Directors
- May NOT be paid from Capital



# Two Kinds of Dividends

- Interim Dividends
  - Declared before the end of the year
  - Declared by directors, but ratified at AGM by shareholders
  - CanNOT be declared until all outstanding dividends are paid in full
- Final (Annual) Dividends
  - Declared at year end
  - Recommended by directors, approved and declared by shareholders
  - Reduce available profit / reserves by any interim dividends declared during the year

# Accounting Journals