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Going Beyond Accounting, Taking Business Forward

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Why Forming a Company for Your Start-up Could be Your Worse Mistake

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As accountants involved with start-ups, a common mistake we see business owners make is to form a company without consulting with a good accountant for strategic advice before doing so, and instead, citing affordability of professional fees as a barrier. And here's the thing … what many start-up business owners are oblivious to is that by forming a company in itself has invited far higher professional fees for the duration of the existence of the company due to the legalities surrounding the compliance with both the Company's Act and accountants' international professional standards.

The truth is that the cost of a first consultation with a professional accountant is dirt cheap in most cases and comparing this cost to the long term ongoing compliance costs of being in the wrong structure from the start is a no-brainer.

To clarify, accountants consider a "start-up" as being any business operating within its first 5 years. There are 2 main structure options available to start-ups:

- Sole proprietor or partnership
- Company or Incorporated

The structure best suited for you is dependent on a number of factors, such as the industry you will operate in, your future plans for the business, your own personal circumstances, your potential customers and tax law.

Companies cost more to set-up and run than the simple business structure of a sole proprietorship or partnership, yet many business newbies end up paying far more for being in a company structure than their type of business and circumstances warrants, and here is why:

1. **A company is a separate legal entity**
   Whereas there is no legal distinction between the business and its owner in a sole proprietor structure or partners in a partnership structure, a company is a separate legal entity and governed by the Companies Act. The Income Tax act and the Tax Administration Act apply to both companies and sole proprietors, amongst several other legislations.

2. It's a complex structure

It is important for newbie business owners to gain knowledge and understanding of the Companies Act before deciding on what structure is best.

The Companies Act is a daunting piece of legislation as it carries some significant consequences for non-compliance and reckless or negligent trading with even some basic offences being subject to criminal prosecution.

Instead, sole proprietors are not governed by these arduous laws, regulations and its related "prescribed standards"; it is easy to start-up and an uncomplicated structure.

3. High level of qualification and experience required

It is rarely that a company owner has a current 3 year accounting degree behind them and an expert knowledge of the Companies Act, its Regulations and "prescribed standards" and as a result, necessitates having to outsource these skills when requiring company secretarial services or when preparing accounting records and annual financial statements to comply with the Companies Act without falling foul of the law and some of its dire consequences.

4. Accounting records

If you thought that your unqualified wife, boyfriend or other cut-price resource can prepare the books of account for your company because you're convinced that "it cannot be difficult, it's not rocket science", or, "my business is small", then consider this. Regulation 25 of the Companies Act lays down the minimum requirements that the accounting records must comprise of, and for any layman, it is formidable!

And to crown it, here is the first of several bombshells that many company owners don't know! Section 28(3) of the Companies Act renders it "an offence" (yes … a criminal offence) if the company fails to keep accurate or complete accounting records. Worse still, the Act even makes it a criminal offence if your company does keep accounting records, but not in accordance with the "prescribed manner and form"!

Reading between the lines, what you are actually saying is that "it's too small to afford professional fees". If that were true, then it's time to reassess this basic view and consider getting out of trading in a company structure.

In contrast, sole proprietors are required to keep accounting records in terms of the Income Tax Act and the VAT act, if applicable. Other than the VAT act, these are really basic records which do not have to comply with the "prescribed manner and form".

5. Annual financial statements

Granted, many company owners draw the line when contemplating drafting their own annual financial statements and prefer to outsource this task to their accountant. Nevertheless, for accountants this is often a catch-22 situation if the accounting records have been prepared by an untrained person as it often results in the accounting records not being prepared according to the "prescribed standards". Consequently, the accountant first has to fix the accounting records, creating higher costs for the company. The Companies Act requirement related to the compilation of the annual financial statements is complex and onerous hence the professional accountant's fee is costly.

And to top it all, another bombshell that many company owners don't know! Section 29(6) of the Companies Act renders it another criminal offence if the financial statements fail, in a material way, to comply with the financial reporting standards or does not present fairly the state of affairs and business of the company or is materially false or misleading.

Sole proprietors, on the other hand, are not required by law to prepare a balance sheet, let alone a full set of financial statements. They do however, like directors of a company, need to prepare a statement of assets and liabilities for their income tax return. Sole proprietors only need to prepare an income statement using the accrual method of accounting for the sole purposes of filing their personal income tax return.

6. Prescribed standards

These are standards prescribed by IFAC (International Federation of Accountants) and have a direct bearing on the requirements of the SA Companies Act. Accountants have to prescribe, but not limited to, the following international standards for SME's:

- **IFRS for SME's**
  IFRS for SME's is a self-contained international financial reporting standard designed to meet the needs and capabilities of small and medium sized companies. In essence, it elevates simple bookkeeping methods to more complex accounting records and is reliant on certain business judgements made by the company's management.

- **ISRS 4410** -International Standards on Related Services (compilations)

- **ISRS 4400** -International Standards on Agreed-Upon-Services

- **ISRE 2400** -International Standards on (independent) Review Engagements

- **ISQC 1**-International Standards on Quality Control (as it relates to ISRS 4410, ISRS 4400 and ISRE 2400)

7. **Quality control**
Accountants preparing compilation of annual financial statements, agreed-upon-services or independent review engagements for companies are subject to quality control in terms of the international professional standards of quality control governing accountants, adding to the cost of preparing annual financial statements for companies.

8. **Company secretarial compliance and annual returns**
Another reason for higher costs of maintaining a company are due to company and securities registers that need to be maintained by the company in terms of the Act as well as the payment of annual duties to ensure the company is not deregistered by CIPC. One of the most significant aspects of the new Companies Act was the introduction of section 25 whereby the location of all company accounting and other records must be registered at CIPC if not located at the company's premises. This means that there is yet another cost every time a company changes its accountant.

These costs do not apply to sole proprietors. What is more, a sole proprietor's business cannot be "de-registered" by a government institution as is the case with companies. It's easy to close the business.

9. **Income tax administration**
A company is a separate legal entity and therefore has to register for income tax. The shareholders have to also be registered for tax in their personal capacities. This means that owners of companies who outsource their tax affairs have to pay double the amount for fees on preparing income tax returns than sole proprietors do.

10. **Employees tax (PAYE)**
Every company must have at least one director at all times. In terms of the income tax act, a director is an employee and subject to PAYE. This means that the company has to register as an employer with SARS on formation of the company and submit a monthly EMP201 return together with a payment of taxes for the director. To avoid penalties and interest, the director or his or her accountant must accurately determine the remuneration payable to the director every month in order to calculate the PAYE, adding to the cost of maintaining a company.

11. **Deemed dividend tax at 20% under certain circumstances**
If a director decides to try get around having to pay over PAYE monthly by not disclosing any remuneration but continues to draw monies for personal use, this could result in a "deemed dividend" for the company.

The implication for the company could be tax at a straight 42.4%. If your personal drawings and tax rate thereon is lower, then ouch! SARS scores!

In contrast, a sole proprietor is not subject to dividend withholding tax as all profits are taxed in the personal hands of the sole proprietor, so this precarious and costly position that some companies find themselves in does not apply.

The bottom line

Importantly, costs of running a company should never be the single factor when deciding on the most suitable structure for your business. Unlike companies where the owner's personal assets are protected under certain circumstances, this protection is not afforded to sole proprietors, whose personal assets are at risk, unless your assets are in a trust.

However, picking the wrong structure could see you paying higher fees to professionals, paying more tax or increasing your personal liability risk.

It is important early on to identify whether the wrong structure is being used so your accountant can put a plan in place to change to something more suitable with limited or no tax implication.

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