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Video Transcription: What is a Share?

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Hello there, my name is Jacqui and in this video we are going to be answering some common questions that students often have about shares.

Let's start by looking at a sole trader. Remember that in this form of business entity, there is no legal separation between the business and the owner. So, a single owner contributes all of the owner funding, referred to as capital. When the funding is contributed, and we will assume that the funding is in the form of cash, the business processes the following journal entry: Debit Bank (Assets), Credit Capital (Equity). Another way of looking at this transaction is that the owner's claim on the net assets of the business is held by a single person. In other words, the sole trader owns 100% of the net assets of the business.

This is relatively straight-forward. But what about a company? Remember that a company is a separate legal entity. There is a legal separation between the company's net assets and owners of the company, and there can be many owners. Let's say a company needs to raise funding and receives cash from its owners who are investing in the business, as opposed to lending the business money that would be repayable with interest. When the funding is contributed to the business, the net effect of the journal entries processed by the business will result in a Debit Bank (Assets) and Credit Share Capital (Equity). However, unlike the sole trader there may be lots of different parties contributing to the owner funds or capital.

So, what does the company do? It issues shares. These shares are units of ownership – they reflect the right that the holders of the shares have in the company. A share could be said to represent part-ownership of an entity. In other words, where the ownership of the business is divided into a large number of separate units, with each unit or share entitling the holder, also known as the shareholder, to share or participate in the benefits of the company. So anyone that holds or we could say owns a share, is therefore a shareholder.

For example, if a company has 1 000 shares, a single shareholder may own all 1 000 shares or 1 000 shareholders may each own 1 share, or anything in between. As you know, the word 'share' means that more than one person, and potentially many, are able to benefit from the resource, for example, sharing a cake, or in the case of shares, the net assets of the business. Share capital is therefore a mechanism to ensure that each shareholder is treated fairly and in proportion to the actual ownership that they have in the business – the company.

If you own 10 times more shares than someone else, you should benefit 10 times as much. Dividing the capital contributions into shares makes it possible to track who owns what proportion of the business, and therefore who should be rewarded and by how much when the company makes a profit.

Let's look at a few common questions that students ask about shares. So, what is authorised share capital, what is issued share capital and how do both of these impact on the financial statements of the company?

Think about going to a bank and making arrangements to get a loan – if the bank agrees, they will also agree on how much they would be willing to lend you, this is the authorised amount and this is the amount that is possible to get as permission has been granted for it to be issued. However, it is only when you actually receive the cash, the amount that you have borrowed is issued and should be recognised as a loan liability. You would not recognise the amount of your authorised borrowing facility as a liability, but you would recognise the amount that was issued to you as a liability.

However, it is useful information to disclose the amount that has been authorised to you. In other words, the maximum amount that you could borrow should you need the funds. Let's think of this in relation to shares.

When a company comes into existence, one of the legal requirements is that the individuals starting the company draft a Memorandum of Incorporation (MOI). The MOI is a document that sets out the rules of the company. One item that appears in the MOI is the authorised share capital. The authorised share capital is the amount that we can issue as shares – like your loan facility. However, only when cash or others assets are received for the shares will these shares be treated as being issued. At that date the assets received will be debited and share capital, credited.

So when a company invites owners to contribute funding to the business, receives the funding and acknowledges that they are part-owners by issuing shares, the business will recognise an increase in assets and an increase in share capital. Authorised shares are therefore the maximum number of shares that the company can issue, whereas issued shares are the number that have actually been issued to the shareholders.

So, we've looked at what a share is to the company that issues the shares. Now, what about the shareholder? In the hands of shareholders the share represents part ownership of the business. From the shareholder's perspective, the shares are an investment. In other words, they will be considered an asset in the hands of the shareholders. The shareholder can benefit from the increase in the share price, any distribution of profits, or can sell some or all of their shares and give up their rights, and the shareholder takes the risk that the share price may decrease.

So, what happens if a shareholder wishes to dispose of their shares? Can they insist that the company buys the shares? No. Unless the company itself has indicated that there will be a share buy-back, the company has decided to buy back some of its own shares from existing shareholders, they will need to find other people that wish to purchase these shares and sell them to these individuals. For a public company, this sale could occur via a stock exchange, assuming, of course, the company is listed.

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The existing owner would sell their shares to other interested individuals. The cash generated by this transaction goes to the existing shareholder, the seller, who is giving up their shares, and the buyer receives the shares and becomes a shareholder. In other words, replaces the seller as a shareholder in the company. The only direct impact on the company is a change in the name of the shareholders. Remember that no new shares are being issued by the company, these are existing shares that are being bought and sold by individuals and no cash is being received by the company.

A share is a means of representing part ownership of a business. A company will issue shares when they start up, or at any other time that the company needs additional funding and intends to raise the funds from owners.

Thank you for watching.