Bonus issues / Stock Splits

A balancing act

Smart investors buy cum-bonus shares and sell at ex-bonus prices to offset capital gain earned in other share transactions

Bonus shares have always excited retail investors as they are issued free of cost to the shareholders. If an investor holds 100 shares of a company and a 2:1 bonus issue is announced, then the shareholder gets 200 shares free. His total shareholding in the company stands increased to 300 shares instead of the original 100 shares. It sounds amazing. But should it amuse us so much is a million-dollar question.

After the bonus issue, the total number of shares outstanding on the balance sheet of a company increases. With this, the equity share capital also increases. But the free reserves decrease. Thus, the net worth of the company remains unchanged. Though there is a rise in the absolute number of shares, there is no change in the shareholding pattern in percentage terms. Hence, the aggregate stake of the promoter group and the non-promoter shareholders remains the same.

A company can use its business profit either to pay dividend to its shareholders or to plough it back into the business for funding modernisation, expansion or diversification projects. The part of profit that is not distributed to the shareholders as dividend is known as retained earning, which is shown as reserves and surplus on the liabilities side of the balance sheet. Profitable companies are able to credit substantial amounts every year to their reserves. These reserves can be capitalised or used to issue bonus shares. Thus, a part of the reserves gets converted into equity share capital of the company. A company's reserves also belong to the shareholders. Capitalisation of reserves, through issue of bonus shares, merely gives that ownership a more tangible form. It does not at all affect the assets side of the balance sheet. Thus, the issue of bonus shares is just an accounting entry followed by a corporate action through which the shares are credited in the demat accounts of the shareholders.

After the announcement of a bonus issue, the company fixes a record date or cut-off date to ascertain the names of the shareholders who will be allotted bonus shares. After the announcement of the bonus but before the record date, the shares trade on the stock exchanges at cum-bonus price. After the record date, the shares trade at ex-bonus price.

When the shares become ex-bonus, the market price of each share generally falls in proportion to the new shares being issued so that the market value of an investor's total shareholding and the market capitalisation of the company as a whole remains more or less the same. For instance, if the bonus ratio is 1:1, the share price will halve. If the bonus ratio is 2:1 (two bonus shares for every equity share held), the share price will become one-third. In many cases, the stock market reacts positively to a bonus announcement due to which the ex-bonus price of the total shares is usually higher than the price of the original shares before the bonus announcement.

A bonus issue is considered as a sign of strength and good financial health of the company. Investors think that a company issuing bonus shares is capable of servicing its enhanced equity base. Otherwise, why will the management allot additional equity shares to its shareholders? Some investors perceive that companies announcing bonus shares have ample growth potential, which may or may not hold good in all the cases. Consequently, the mad scramble for the company's shares in the market and the resulting demand-supply mismatch gives an impetus to the share price. In view of this, information relating to bonus issue is

considered price-sensitive. Therefore, the securities market regulator, Securities and Exchange Board of India (Sebi), has kept bonus issues in the list of price sensitive information under the Sebi (Prohibition of Insider Trading) Regulations, 1992. Any corporate insider who buys a company's shares based on inside information of forthcoming bonus issue is deemed to have violated Sebi regulations.

It is a healthy trend that many companies are issuing bonus shares. However, before investing at cum-bonus price, long-term investors should ensure that the company is fundamentally strong. A major benefit of a bonus issue to investors is improvement in liquidity and, thereby, lowering of the impact cost, which is defined as the difference between the ideal price and the price at which the trade is actually executed. Thus, the investors feel the share price has become affordable. Moreover, equity-heavy balance sheets are desirable as they provide more comfort to creditors.

Some companies, with insufficient reserves and surplus, resort to the technique of stock-split. Stock-split is a relatively new phenomenon in the Indian market. A common example is a 2-for-1 stock-split, where every equity share with face value of Rs 10 is split into two equity shares of Rs 5 face value. This means that after the stock-split an investor would own twice the number of shares that he originally owned and the company, in turn, has twice the number of shares outstanding. But the share capital remains the same. With effect from the record date for the stock-split in the 2:1 ratio, the company's shares start trading at almost half the price compared with the previous day's closing price.

A stock-split or a bonus issue does not affect the net worth of a company. There is no cash inflow or outflow due to bonus issue or stock split. To compute earning per share (EPS), net profit has to be divided by the number of outstanding shares [EPS = Net profit / Number of shares]. As the net profit remains same but the number of outstanding shares increase after the stock-split or bonus issue, EPS declines. Although EPS drops in proportion to the new shares issued, it does not affect the shareholders due to the fact that post such issues the investor owns more number of shares, which compensates for the fall in EPS. The price to earning multiple (share price divided by EPS) remains the same despite the reduction in EPS because the stock price also reduces after the record date for the bonus issue or stock-split.

The issue of bonus shares means actual capitalisation of reserves, whereas stock-split does not have any impact on the balance sheet. Stock-split is beneficial to short-term investors, while a bonus issue is beneficial for the long-term investors.

An obvious question is that if there is no value addition for the shareholders, why do companies announce stock-splits? The primary reason is to infuse additional liquidity by making shares look apparently more affordable. The shares only appear to be cheaper as practically it makes no difference whether an investor buys one share with face value of Rs 10 per share at the market price of Rs 1000 or five shares of Rs 2 face value each at the market price of Rs 200 per share. The dividend is also paid on the basis of the amount paid-up per share. Thus, if a company announces dividend of 20%, then the pre-split shares would have

Gearing up

Bonus issue has to be implemented within two months from the board of directors' decision, subject to shareholders' approval

Bonus shares can be issued by a company only if its articles of association authorise a bonus issue. In case there is no provision in the articles, they must be amended by passing a special resolution at a general meeting of the company.

The bonus issue must be sanctioned by the shareholders in the general meeting on recommendation of the board of directors. The company should not have defaulted in payment of interest or principal of fixed deposits or debt securities issued by it and it has sufficient reason to believe that it has not defaulted in the payment of statutory dues of the employees such as contribution to provident fund, gratuity and bonus

Partly paid shares, if any, outstanding on the date of allotment are made fully paid-up. If the company's shares are listed the stock exchange(s) must be informed of the decision of the board to issue bonus shares immediately after the board meeting. If the bonus shares are to be issued to non-resident members, necessary documents have to be submitted to the Reserve Bank of India.

No issuer can make a bonus issue of equity shares if it has outstanding fully or partly convertible debt instruments at the time of making the bonus issue unless it has made reservation of equity shares of the same class in favour of the holders of such outstanding convertible debt instruments in proportion to the convertible part. The equity shares reserved for the holders of fully or partly convertible debt instruments have to issued at the time of conversion

No bonus shares in lieu of dividend

of such convertible debt instruments on the same terms or same proportion on the basis of which the bonus shares were issued.

Bonus issue is to made out of free reserves built out of the genuine profit or securities premium collected in cash only. Reserves created by revaluation of fixed assets cannot be capitalised for issuing bonus shares.

Bonus shares cannot be issued in lieu of dividend. An issuer, announcing a bonus issue after the approval of its board of directors and not requiring shareholders' approval for capitalisation of profit or reserves for making the bonus issue, has to issue bonus shares within 15 days from the date of approval of the issue by the board of directors: Bonus issue has to be implemented within two months from the date of the meeting of its board of directors where the decision to announce the bonus issue was taken subject to shareholders' approval. Once the decision to make a bonus issue is announced, it cannot be withdrawn.

entitled a dividend of Rs 2 per share on face value Rs 10, whereas after split each share would entitle the investor to a dividend of 40 paisa (face value Rs 2 per share), which aggregates to Rs 2 for every five equity shares. Thus, the dividend yield ratio does not change with the stock-split.

Stock-splits are completely tax neutral for the shareholders as the total cost of the shares remains unchanged. For instance, if the total cost of 1,000 shares purchased at Rs 200 per share was Rs 2 lakh, then after the stock-split in the ratio of 5:1 the investor would hold 5,000 shares costing Rs 2 lakh. Thus, the cost to be taken per share for the purpose of computation of capital gain tax will be Rs 40 per share instead of Rs 200 per share and the market price will also be approximately Rs 40 per share resulting in no gain or loss for the shareholder from taxation perspective.

Since money is not paid for acquiring bonus shares, they have to be valued at nil cost while computing capital gain tax to be paid at the time of sale of bonus shares. The originally acquired shares continue to be valued at the same price at which they were acquired by the investor. Bonus shares have to be held for one year to qualify for long-term capital gain. The one year period starts from the date of allotment of bonus shares, whereas for stock-splits, the one-year period has to be reckoned from the date of original investment in the shares and not from the date of the stock-split.

If both the original shares and the bonus shares are sold together within 12 months from the date of purchase of original shares, the notional loss on the original shares (as the ex-bonus market price of shares would be less than the cost) can be set off against the gain made on the sale of bonus shares because the cost of acquisition of bonus shares is assumed to be nil. Thus, the transaction would be tax-neutral for the investor. However, if both the original and the bonus shares are sold together within 12 months of the bonus issue and the original shares have been held for at least 12 months, the investor would end up paying short-term capital gain tax on the sale of bonus shares, which cannot be set off against the loss on original shares as the long-term capital gain on shares held for more than 12 months are exempt from tax. Therefore, investors should avoid selling the bonus shares within 12 months from the date of allotment.

The most effective strategy is to sell the original shares after 12 months from the date of purchase and, thereafter, sell the bonus shares when the 12-month period from the date of allotment of bonus shares is complete. In demat form, it is not possible to distinguish shares from each other. As demat shares do not bear any distinctive numbers, there is a presumption that the shares acquired earlier are regarded as having been sold first, i.e, the first-in first-out (FIFO) method is applicable for computation of capital gains.

Stock-split has not impact on balance sheet

A major reason for the movement in share prices immediately after the announcement of bonus issue is that shrewd investors use bonus issues to reduce their income-tax liability. The practice of buying shares after announcement of bonus at cum-bonus price and selling the original shares at ex-bonus price and booking short-term losses in the process is called bonus stripping. It is somewhat similar to dividend stripping.

While dividend stripping, which is prohibited under Section 94(7) of the Income Tax (IT) Act, 1961, covers shares as well as mutual fund units, bonus stripping under Section 94(8) of the IT Act includes only mutual fund units. Thus, bonus stripping of company shares is still in practice though in not allowed for mutual fund units.

Suppose an investor has booked short-term capital gain of Rs 10 lakh by selling equity shares of various companies within one year from the date of their respective purchases. Hence, he would have to pay capital gain tax of 15% or Rs 1.50 lakh. Instead of paying the capital gain tax, if the investor buys, say, 10,000 shares of a company, which has announced 1:1 bonus, trading at cum-bonus price of Rs 200 per share, then his aggregate investment will be Rs 20 lakh.

Immediately after the record date, the share price would most likely fall down to one-half, i.e,, Rs 100 per share. Now the investor owns 20,000 shares. Out of these, he can sell the original 10,000 shares. The cost of the original 10,000 shares will still be taken at Rs 200 per share or Rs. 20 lakh and the cost of bonus shares would be taken as zero. When these original 10,000 shares are sold in the market, they can fetch only Rs 100 per share or Rs 10 lakh. In other words, the investor incurs a loss of Rs 10 lakh, which can be set off against the short-term capital gain of Rs 10 lakh that he has already booked before entering into this fictitious transaction. The balance 10,000 shares can continue to be held for at least one year from the date of their allotment so that they would qualify for long-term capital gain, fully exempt from tax.

Bonus stripping for mutual fund units was quite prevalent. To plug the loophole, the government amended Section 94(8) of the IT Act, 1961. The amended section provides that for mutual fund units purchased within three months prior to the record date for entitlement of bonus and sold within nine months after the record date, the loss arising on sale of original units will be ignored for computing the income chargeable to tax. The loss so ignored shall be treated as the cost of acquisition of such bonus units and, accordingly, the tax liability would be adjusted if the bonus units are sold within one year from the date of allotment.

Investors should not forget that a company's net worth and profit margin have no co-relation with a bonus issue or stock-split. Increase in the number of shares in the demat account of an investor through bonus issue or stock-split can not assure capital appreciation. After the bonus issue, most of the companies proportionately reduce the dividend per share. Thus, there is no assurance of increase in annual income through dividend receipts.

Quite often, bonus and stock-splits are announced by small companies to lure gullible retail investors so that the operators can offload their accumulated shares to such investors. Investors are better off investing in shares based on their inherent strengths and not on the notion that they can make a quick buck by investing in companies that have announced bonus issues or stock-splits.

—Rajesh Relan