Bonus Shares

Definition:

"Bonus shares are additional shares given to the current shareholders without any additional cost, based upon the number of shares that a shareholder owns. These are company's accumulated earnings which are not given out in the form of dividends, but are converted into free shares".

Why Are Bonus Shares Issued.?

Let me try & simplify this for you…

- Let's say a company makes Rs 1000 as profit, Now suppose the company has 100 shares, Then earning per share is:-

$$\frac{\textit{Profit}}{\textit{no.of shares}} = \frac{\text{Rs. } 1000}{100} = \text{Rs. } 10.$$

- Suppose there is a surge in the demand for company's product causing its profits to go up from Rs 1,000 to Rs 10,000.

- One should observe is that while the profit went up from Rs 1000 to Rs 10,000 the number of shares remains the same at 100.Hence, by definition, earnings per share would be 100. .

- Now, as we know that Market Price = EPS x$\frac{P}{E}$ .If we were to assume a P/E of 10, the price per share would become Rs 1000…

Here :- P = Market vale per share.

E= Earning per share.

- At a price of Rs 1000, it would be very difficult to expect retail participation because any investor would need a minimum of Rs 1000 to purchase a single stock.
- But that's quite a large amount. Say, an investor has only Rs 500 but wants to invest in this company. What does he do??
- Despite having the desire to buy the stock, he will not be able to participate for want of money.

- It, therefore, becomes essential for the company to increase the number of shares, so that the price per share is within the reach of retail participants.
- Let's say the company declares a 1:4 bonus which essentially means that for every 1 share you get an additional 4 shares. So, in effect, you get a total of 5 shares…
- This would increase the total number of shares from 100 to 500.
- The earnings per share would now become EPS = $\frac{\text{Total Earnings}}{\text{No. of Shares}}$ (or) Rs ($\frac{10,000}{500}$ = Rs 20)

- And that would bring down the price per share from an unaffordable Rs 1000 to a more amenable Rs 200 (EPS x *P/E* = 20 x 10)

- So in other words 100 shares x 1000 = Rs 10,000 is reconfigured as 500 shares x 200 = Rs 10,000.

- This division of shares thus increases retail participation and hence liquidity to the stock, making it easily tradable as more buyers and sellers are able to participate because of a lower unit value per share.

- And our friend is also in a better position & can buy at least two shares with his Rs 500 (2 x 200 = 400) & he will be left with Rs 100.

Thus we have seen how and why ‘Bonus Shares’ are issued in the stock market.

What can be used for issue of bonus shares ?

- Balance in the Profit and Loss Account;
- General Reserves or other Reserves created out of the profits;
- Realized capital profits and reserves;
- Securities Premium Account;
- Capital Redemption Reserve Account

METHODS OF ISSUING BONUS SHARES

- Aletrnative-1

Capitalization of Profit by Issuing Bonus Shares by Issuing of FREE Fully Paid Shares as Bonus Shares.

- AIternative-2

Capitalization of Profit by Without Issuing Bonus Shares by making Partly Paid Shares as Fully Paid without getting Cash from the shareholders.

ACCOUNTING TREATEMENT OF BONUS SHARES

- On Issue of Bonus Shares at PAR :-

Bonus to Shareholders A/C ….. dr To Equity Share Capital A/C

- On Issue of Bonus Shares at PREMIUM

:- Bonus to Shareholders A/C …… dr

To Equity Share Capital A/C To Securities Premium A/C

LEGAL REQUIREMENT'S

Bonus shares to existing

SHARE HOLDER'S :-

Specific prior permission from RBI.

ADVANTAGES

- Remedy for under capitalization .
- Marketability of share increases .
- Maintenance of liquidity position of the company .
- Increase in shareholders holdings and increased investor confidence .
- Retained profits can be used for development and expansion.

Disadvantage's

- More costly to administer.
- EPS, MPS, declines
- Rate of dividend in future may reduce
- It may encourage speculation in shares
- Increases in capitalization which cannot be justified until and unless there is proportionate increase in earning capacity of the company


THANK
YOU