CHAPTER: ONE

REVIEW OF LITERATURE

1.1 Background Information of the Study

The purpose of dividends is to return wealth back to the shareholders of a company. There are two main types of dividends: cash and stock. A cash dividend is a payment made by a company out of its earnings to investors in the form of cash (check or electronic transfer). This transfers economic value from the company to the shareholders instead of the company using the money for operations. However, this does cause the company's share price to drop my roughly the same amount as the dividend. For example, if a company issues a cash dividend equal to 5% of the stock price, shareholders will see a resulting loss of 5% in the price of their shares. This is a result of the economic value transfer. Another consequence of cash dividends is that receivers of cash dividends must pay tax on the value of the distribution, lowering its final value. Cash dividends are beneficial, however, in that they provide shareholders with regular income on their investment along with exposure to capital appreciation.

A stock dividend, on the other hand, is an increase in the amount of shares of a company with the new shares being given to shareholders. For example, if a company was to issue a 5% stock dividend, it would increase the amount of shares by 5% (1 share for every 20 owned). If there are 1 million shares in a company, this would translate into an additional 50,000 shares. If you owned 100 shares in the company, you'd receive five additional shares.

This, however, like the cash dividend, does not increase the value of the company. If the company was priced at $10 per share, the value of the company would be $10 million. After the stock dividend, the value will remain the same, but the share price will decrease to $9.52 to adjust for the dividend payout. The benefit of a stock dividend is choice. The shareholder can either keep the shares or hope that the company will be able to use the money not paid out in a cash dividend to earn a better rate of return, or the shareholder could also sell some of the new shares to create his or her own cash dividend. The biggest benefit of a stock dividend is that shareholders do not generally have to pay taxes on the value. Taxes do need to be paid, however, if a stock dividend has an cash-dividend option, even if the shares are kept instead of the cash.

Stock dividends are thought to be superior to cash dividends as long as they are not accompanied with a cash option. This is due to the choice that stock dividends offer compared to cash dividends. But this does not mean that cash dividends are bad, they just lack choice; a shareholder could still reinvest the proceeds from the cash dividend back into the company through a dividend reinvestment plan.

There are different methods of financing or capitalizing an organization an organization. Bonus share issue is one of them, since bonus share is a form of dividend. First, the term dividend should be clearly understood to know the bonus share well. Shareholders' investment in common stock sacrifices the present opportunity in expectation of future increased income or returns in the form of dividends and capital gains, dividends one the major reason of investment in financial securities, it is the net earnings paid out to the shareholders. It is the distributed earnings to the shareholders of the corporate forms in return to their investment in firm's stocks. It is direct return to shareholders.

Divided policy refers to the guidelines that corporate management uses in establishing portion or retained earnings that are paid to the shareholders in dividends (*Mathur, 1979:297*). It involves the complex and controversial decisions between dividend payment and retention of earnings. It is affected by taxation and additional capital required in the corporate firm. There is no one universally acceptable dividend policy.

The commonly used dividend payment methods are cash dividends and stock dividend. In cash dividend direct cash or rupees is provided to the shareholders as a return to their share in the corporate. However, in stock dividend, additional stock is increased but the shareholders wealth remains the same. Some companies provide cash dividend together. Bonus shares are also understood synonymous to the stock dividend. No. of common stock is increased but the shareholders wealth remains the same. Since bonus shares are dividends, these are studied under the dividend policy of a corporate firm. Since the term 'bonus share' and ' stock dividend' cannot the same meaning and implication, only the term bonus share is used afterward in the subsequent paragraph, as it is the most commonly used term in Nepalese context.

An issue of bonus share represents a distribution of shares in addition to the cash dividend (known as stock dividend in the USA) to the existing shareholders. This has the effect of increasing the number of outstanding shares of the company. The shares are distributed proportionate ownership of the company, for example if a shareholder owns 100 shares at the time when a 10% (i.e. 1:10) bonus issue is made; he will receive 10 additional shares. The deceleration of the bonus shares will increase the paid-up share capital and reduce the reserves and surplus (retained earnings) of the company. The total net worth is not affected by the bonus issue. In fact, a bonus issue represents a capitalization of owner's equity portion i.e. the reserves and surplus. It is merely an accounting transfer form reserves and surplus to paid up capital (Pandey, 1999:782).

Stock Dividend implies a dispersment of additional shares of stocks to the firm's share shareholders. Thus, it can be understood as dividend paid in addition shares of stocks rather than in cash. It is simply involves a transfer of retained earnings to the capital stock account. According to the Company Act, Nepal (2053,B.S.) section 1, clause I and clause M bonus share is dividend as additional shares issued to the existing shareholders to capitalize the reserve mean conversion of partly paid up shares into fully paid by capitalizing its reserve and surplus.

The main objective of this chapter is to analyze and study the research work and clarify the need of the study rationally and systematically. It reviews literature on Stock Dividend and theoretical framework etc., including different views of experts and researches done by Master’s degree level students who had accomplished their researches on different companies of Nepal. This chapter covers the following aspects.

- Conceptual Framework
- Review of Master’s Thesis
- Review of Ph.D. Thesis
- Review of other Studies.

1.2 CONCEPTUAL FRAMEWORK

Stock dividends are shares issued to existing shareholders as a result of capitalization of the reserves (Chandra, 1994:540). It (known as bonus share) is a popular form of dividend in additional shares of stock rather than in cash (pandey, 1995:705). It is simply payment of additional stocks to share holders, which presented nothing more than a re-capitalization of corporate form's reserves and surplus created from the net profit (Van Horne, 1996:334). Corporate board (management) may decide to announce cash dividend and issue of bonus shares on the same data. Cash dividend involves actual paying of cash while bonus shares simply involve a transfer of retained earnings to the capital stock account. Therefore, an issue of bonus share represents a distribution of share in proportional in additional in addition to the cash dividend to the existing shareholders.

Since stock dividend is the form of dividend, first of all the term dividend should be clearly understood to know the stock dividend well. Shareholders` investment in common stock sacrifices the present opportunity in expectation of future increased income or return in the form of dividends and capital gains. Dividend is one of the major reasons of investment in financial securities. Dividend is the net earnings paid out to the shareholders. It is the distributed earnings to shareholders of the corporate firms in return to their investment in firm’s stocks. It is a direct return to the shareholders.

Dividend is also interrupted as left over earnings paid to the stockholders after financing all acceptable investment opportunities *(Van Horne, 1981:448).* Dividends refer to the signal of the sustainable income of the corporate firms *(Watts, 1973:91)*. Dividends convey the management’s expectation of future profitability and prosperity to the shareholders *(Archer and D’Ambrosio, 1976:410)*. It is a tangible evidence of the firm’s ability to generate liquidity *(Martin, Pretty, Keown and Scott, 1979:484)*. Dividend can be distributed only from net profits and retained earnings. Dividend should meet the normal expectations of average shareholders.

Stock dividends are a form of dividend that a company provides to its stockholder. A company can provide dividend to its stockholders in the form of cash dividend, stock dividend (bonus share), bond dividend, scrip dividend and property dividend. For our convenience, stock dividend may be written as bonus share in further paragraphs.

Corporate firms, generally, announce stock dividend rather than cash dividend or cash dividend plus bonus shares in proportion to reward to their shareholders. Although the recipients may feel psychologically better of after receiving the bonus shares (stock dividend), they are actually no better off then they were prior to its payment. It is also generally believed that the stockholders are actually worse off as result of the payment of bonus shares since issuing the new shares creates no value and the firm must pay for printing up and issuing the new shares. Technically an issue of bonus share is nothing more than an accounting transfer from retrained earnings to the capital stocks accounts. A bonus share simply splits the 'ownership pie' into more pieces but does not affect the size of the pie.

A second alternative to the payment of cash dividends involves the purchase of a portion of the firm's outstanding common stock should a corporation decide to engage in the repurchase of its outstanding common shares? Resources of share result (i) reducing the number of shares outstanding, and (ii) transferring cash from the corporate coffers to those shareholders who tender their shares (Bowlin, et al, 1990:372) Repurchase of shares is not allowed to exercise in Nepal yet. So this aspect is not studied in this study.

Corporate firms in Nepal also have been practicing the stock dividends and bonus shares as a means of rewarding to the shareholders. In 1992/93, Nepal Arab Bank Ltd in its fifth annual General Meeting declared in principle 60% cash dividend which included 20% actual cash dividend and 40% cash dividend which was capitalized from profits which correspond of Rs. 12 million transferred from profit and loss account to equity capital resulting no affect in financial position (Shreshta,M , 1992:35). Since then bank increased its equity capital from time to time by issuing bonus shares. Likewise, Nepal Bank Ltd. Nepal Bank Ltd, Nepal Grindlays Bank Ltd., Nepal Indosuez Bank Ltd., Nepal Insurance Company, Bishal Bazar Company Ltd have also been found increased in equity capital many times by way of issuing bonus shares. The study of practice of stock dividends or bonus shares issue and its effect on price of listed stocks of Nepalese corporate firms are presented in subsequent paragraph.

1.2.1 Advantage of Stock Dividend

Corporate forms can conserve cash pay dividends under financial difficulty and contractual restriction and lower share prices to the active trading range by issuing bonus share. Similarly, shareholders gain tax benefit on bonus share over cash dividend, bonus share has favorable psychological value to the shareholders and they interpret it as an indication of higher profitability. The advantages of bonus share issue to shareholders and the company can be explained as follows:

To the shareholders:

a) Tax benefit: Cash dividend is included as ordinary income and taxed at ordinary income tax rate. But the receipt of bonus shares by the shareholders is not taxable as income. Further, the shareholders can sell the new shares received by the way of the bonus issue to satisfy his desire for income and pay capital gain taxes, which are usually less that the income taxes on the cash dividends. The shareholders could sell a few shares of his original holding to desire capital gains. But selling the original shares considered as a sale of principal by some shareholders. They do not mind selling the shares received by way of the bonus shares as they consider as they consider it a windfall gain not a part of the principal.

b) Indication of higher future profits: The issue of bonus shares is normally interpreted by shareholders as an indication of higher profitably. When the profits of a company do not rise and it declares a bonus issue, the company will experience a dilution of earnings as a result of the additional shares outstanding. Since a dilution of earnings is not desirable, the directors usually declare bonus shares only when they expect rise in earnings to offset the additional outstanding shares. Bonus shares thus may convey some information, which may have a favorable impact on value of the shares. But it should be noticed that the impact on value is that of the growth expectation and not the bonus shares, which simply conveys in information.

c) Future dividend may increase: If a company has been following a policy of paying a fixed amount of dividend per share and continues it after the declaration of the bonus issue, the total cash dividends of the shareholders will increase in future. The increase in the shareholder's cash dividend may have a favorable effect on the value of the share. It should be however, realized that the bonus issue per share has no effect on the value of the share.

d) Psychological value: The declaration of the bonus issue may have a favorable psychological effect on shareholders. The receipt of bonus shares gives them a chance to sell the shares to make capital gains without imparting their principal investment. They also associated it with the prosperity of the company. Because of these positive aspects of the bonus issue, it is usually received positively by the marked. The shale of the shares, received by the way of the bonus shares, by some shareholders widens the distribution of the company shares. This tends to increase the market interest in the company shares; thus supporting of raising its market price.

To the company:

a) Conservation of cash: The declaration of a bonus issue allows the company to declare a dividend without using up cash that may be needed to finance the profitable investment opportunities within the company. The company is, thus, able to retain earnings and at the same time satisfy the desires of shareholders to receive dividend. Directors of a company must consider the financial needs of the company and the desires of shareholders while making dividend decision. These two objectives are often in conflict the use of bonus issue represents a compromise, which enables directors to achieve both these objectives of a dividend policy. The company could retain earnings without declaring bonus share issue. But the receipt bonus shares satisfies shareholder psychologically. Also their total cash dividend can increase in future when cash dividend per share remains the same.

b) Only means to pay dividend under financial difficulty and contractual restrictions: In some situation, even if the company's intention is not to retain earnings, the bonus issue is the only means to pay dividend and satisfy the desires of shareholders. When a company is facing a stringent cash situation, the only way to replace the cash dividend is the issue of bonus shares. The declaration of bonus issue under such as situation would not convey a message of the company profitability, but financial difficulty. The declaration of the bonus share issue is necessitated when the restrictions to pay the cash dividend are put under loan agreements. Thus under the situation of financial stringency or contractual constrain in paying cash dividend, the bonus issue is meant to maintain the confidence of shareholders in the company.

c) More attractive share price: sometimes the intension of a company is issuing bonus shares is reduce the market price of the share and make it more attractive to investors. If the market price could be brought down to a desired range, the trading activity would increase. Therefore, the bonus issue is used as a means to keep the market price of the share within a desired trading range.

1.2.2 Limitation of Stock Dividend

Issue of stock dividend is not free to limitations although it has many advantages. It has the following limitations:

a) Shareholders' wealth remain unaffected: Bonus shares are considered valuable by most shareholders. But they fail to realize that the bonus shares do not affect their wealth and therefore, in itself it has no value for them. The declaration of bonus shares is a method of capitalizing the past earnings of the shareholders. In fact the bonus issue does not give any extra or special benefit to a shareholder. His proportional ownership in the company does not change. The chief advantage of the bonus share issue is that it has a favorable psychological impact on shareholders. The issue of bonus share gives an indication of the company growth to shareholders. Shareholders welcome the distribution of bonus share since it has informational value.

b) Costly to administer: The disadvantage of bonus issues from the company's point of view is that they are more costly to administer then cash dividend. The company has to print new certificates and post them to thousands of shareholders.

c) Problem of adjustment EPS and P/E ratio: The bonus issue can be disadvantageous if the company declares periodic small bonus shares. The investment analysis does not adjust the earnings per share for small issues of bonus shares. Only the significant issues of bonus shares are adjusted by them. When the earnings per share are not adjusted, the measured growth in the earnings per share will be less than the true growth based on the adjusted earnings downwards.

1.2.3 Condition for the issue of Stock Dividend

In India, stock dividends are issued in addition to and not in lieu of cash dividends. A company is not allowed to declare bonus shares unless partly paid up shares have been converted into fully paid up shares. Bonus shares are made out of share premium and free reserve, which includes investment, allowance reserve but exclude capital reserve on account of assets revaluation. In no time, the amount of bonus issue should exceed the paid up capital. A company can declare bonus shares once in a year. A resolution approving the proposal of the bonus issue, clearly indicting the rate of dividend payable on the increased capital should be passed by company's shareholders. Company intending to issue bonus share should no be in default of payments of statutory dues to employees and term loans to financial institutions (Pandey, 1999:786)

1.2.4 Regulation of Stock Dividend issues and Determining Bonus Ratio

The key regulatory provisions governing the issue of stock dividends are as follows:

a) The bonus issue is made out of free reserves built out the genuine profits or share premium collected in cash only.
b) The residual reserves after the proposed capitalization shall be at least 40% of the increased paid up capital.
c) 30% of the average profits before tax of the company for the previous three years should yield a rate of dividend on the expanded capital base of the company of 10% (Chandra, 2001:503).

Looking at the regulation on bonus issue, we find that the restriction that are likely to be critical in most situation are the residual reserve requirement (the reserve after proposed capitalization should be at least 40% of the increased paid of capital) and the profitability requirement (30% of the average amount of pre-tax profit of the company in the previous 3 years should yield a return of at-least 10% on the increased capital). Hence the maximum ratio of bonus that a company can declare is the value of b which satisfies the following constraints (Chandra, 2001:504):
Residual reserve requirement: $(R\text{-}S\ b) \geq 0.4\ (1+b)$
Profitability requirement: $0.3\ PBT \geq 0.1\ S\ (1+b)$

Where,

R= Reserve before bonus declaration

S= Paid-up capital before bonus declaration

b= Bonus ratio

PBT= Average profit before tax of the company in the previous 3 years.

After computation of the both profitability and residual reserve requirement, lesser bonus ratio will be allowed to declare bonus issue to the company.

1.2.5 Causes of Stock Dividend Issue

The cause of stock dividend issue can be categorized in two types.

General Causes: General causes why corporate firms issue of bonus share may be as follows:

(1) For increasing the capitalization for the increased scale of operation.

(2) For compensating to the existing shareholders for the decrease yield.

A large number of corporate firms announce an disuse bonus shares to increase the capital base if the corporate management felt such need of to comply with the policy directives given by concerned authority to increase the capital base from time to time. In our country, NRB issues the policy directives to the commercial banks to control and for the supervision of the establishment and operation of commercial banks in Nepal. NRB had already issued the policy directives regarding the requirement of increasing minimum paid up capital in old commercial banks (NRB, circular, 25Nov 1996), which significantly affected the bonus issuing practice of commercial banks in Nepal. Corporate firms, other than in banking sector can issue the bonus shares to their shareholders by the corporate management as per the rules and provisions in Company Act 1997

Some or the corporate firms issue bonus shares to their existing shareholders in order to compensate for the decrease in dividend Yield decrease because of rapid increase in the market price of the shares compared to increase in nominal rate of dividend. Cash dividend divided by paid up price of share gives nominal rate of dividend. Because of the fast growth rate and partly because of under capitalization, the market price of the stock of such firms increases in fast rate continuously. The value of existing shareholders' stock rises. As a result, even if normal dividend rate seems attractive, dividend yield decrease and continues to be lowered. Thus to compensate to the existing shareholders for their increased value of investment and also to correct the effect of under capitalization, bonus shares are issued to them by corporate management which help to raise up the dividend yield in future because of the effect of decrease in market price of shares.

Specific Causes: The specific causes why corporate firms issue bonus shares may be as follows (Chandra, 1994:540-541):

- To bring the market price of the stock in most popular range
- To increase the number of shares and to promote active trading in the stock market
- To minimize the adverse effect of high nominal dividend rate and to minimize the effect of profiteering in the market.
- To increase the share capital base.
- Tom improve the prospects of rising additional found.
- To gain the confidence of stockholders in the prospects of the corporate firm and increasing the total dividends

1.2.6 Effect of stock dividend issue

There is different thinking about the effects of bonus share issue. Somebody think that bonus issue leads to increase the market value of the firm by increasing the equity capital base without effecting the dilution of share ownership. Others think bonus share issue only conserve the cash consistent with the corporate firms motives to finance its growth and expansion from internal sources thereby enhancing the future market value. Generally, bonus share issue does not change the ownership pattern. The shareholder proportional ownership remains unchanged. But it affects the book value per share, the earnings per share and the market price per share because of increase in number of share as a result of issue of bonus shares. It is an inexpensive way to raise the additional capital for growth and expansion. That is why bonus share issue has become an important and prevalent practice to increase the equity base internally.

Theoretically stock dividend or bonus share issue is not a thinking of value to the investors *(Van Home, 1963:335)*. Normally it does not affect the wealth of the shareholders *(pandey, 1995:707)*. In efficient market, stock dividend or bonus share issue, because of decrease in market price per share proportionately to bonus issue ratio shareholders` wealth would not be affected. However, if market is inefficient, corporate management decision to issue bonus share in any ratio as expected by shareholders may have psychological effects on existing shareholders that may have favorable impact in the share prices. Share price is expected to increase normally because shareholders interpret the issue of bonus shares as an indication of higher profitability and expectation of increased total cash dividend.

The announcement of bonus share issue by the corporate firms creates a great deal of uncertainty as regards to the future dividend, bring chances and thus the dividend behavior in future. Besides it has a significant impact on market price of share, which ultimately affects the wealth of the stockholders. But it is also true that announcement of bonus share in itself creates no wealth since it produces no future stream of income (*Sherman and Young, 1971:370).* Bonus share issue results in maximization of wealth only it there is increased dividend payment after bonus issue which is possible only if increased capital raised internally through the bonus issue is profitably and effectively utilized. Thus bonus issue is desirable to that extent only that the corporate firms need additional financing for increased profitable investment *(Manandhar, 2002:193).*

Bonus shares are shares issued to existing shareholders as a result of capitalization of reserve. In the wake of bonus shares issues:

a) The par value of the share is unchanged.

b) A part of reserves is capitalized.

c) The shareholders` proportional ownership remains unchanged.

d) The book value per share, the earning per share and the market price per share decline.

e) The market price per share is brought within a popular trading range.

A stock dividend is paid in additional shares of stock instead of cash and simply involves a bookkeeping transfer from retained earnings to the capital stock account. The transfer from retained earning to the capital stock account must be based on market value. Stock dividends are limited by the size of retained earnings. The rule was put into effect to prevent the declaration of stock dividend unless the firm has had earnings *(Weston and Copeland, 1992:680)*. But in Nepal, bonus share issue is being practiced by transferring the retained earnings to the capital stock account on the basis of par value of stock.

1.2.7 Shareholders' Equity Before and After Stock Dividend

Theoretically, stock dividend issue does not give value to the shareholders. Shareholders' wealth remains same after bonus share issue as before bonus share issue. It can be illustrate by a hypothetical example. Suppose a company had a total shareholders' equity before issuing a stock dividend as bonus. The market price of the stock is Rs. 150 per share. The company issued 40% (2:5) stock dividend and no cash dividend. Each shareholder having 5 shares got two additional shares.

The amount of stock dividend is calculated on market value of stock i.e. Rs. 4,200,000 (Rs. 150×28,000 shares). The amount of the stock dividend is transferred from retained earning to the common stock on the basis of par value of the stock and remaining to the share premium. Therefore, the amount transferred from retained earning to the common stock account is Rs. 2,800,000 (Rs. 100×28,000). The residual 1,400,000 (Rs. 50×28,000) is transferred to the share premium account. Shareholders total equity before and after stock dividend is same i.e. Rs. 14,000,000. EPS of the company is reduced proportionately as increment of common stock. MPS of the company is reduced. Theoretically, it is Rs. 107 (150/1.40).

Shareholders have more share of stock after stock dividend but lower EPS. In reality every shareholder's proportionate ownership claim against total earnings available to common shareholder (No. of share × EPS) remains same.

1.2.8 Stock dividend vs. new share

Bonus share differ from an issue of a new equity share. If a firm needs to finance, it can also obtain fund by selling new shares. To sell new shares in market, a company must bear flotation costs are high; it might be reluctant to sell new common stock. Therefore to save the flotation cost and to avoid the difficulties in raising external equity a company practices raising the additional capital from internal sources. A company can use bonus share as a less expensive alternative source of capital.

1.2.9 Stock dividend vs. Cash Dividend

The distribution of stock dividend in various circumstances becomes an effective method of concerning to the shareholders and assurance about the profitable reinvestment of the retained profits. The stock dividend represents a certificate indicating the amount of reinvestment made on behalf of each shareholder (Williams, 1965: 55). But there is no obligation on the management to ensure that reinvestment of past-accumulated profits and reserves (retained income) via issue of bonus share yield a reasonable return for shareholders. Therefore most investors express serious doubt about the retained profits being taken at their face value or being invested in sufficiently remunerative schemes.

Moreover, unless there are special tax consideration (e.g. an exceptionally high proportion of the shareholders are surtax payers hence making retained earning specially advantageous) shareholders may be justifiably suspicious of companies, which retain and exceptionally high proportion of earnings and thus decline to submit to the financial scrutiny and discipline involved in raising external equity (Merrect, A.J. and Allen Sykes, 1966: 46). One seems to be left with the conclusion that there (companies) which retain a relatively high proportion of profit select relatively unprofitable investments. The present result, therefore, seem to lend some weak support to the view that institutional or fiscal arrangement which limit dividends are relatively inefficient method of increasing investment (Little, 1962: 412).

These are the reasons that the market assigns several times more weight to dividends than to retained income. But if the management is able to assure or convey to the shareholders about the profitable reinvestment of the retained profit via increase in the quantum of dividend or retained income may be preferable. There are some other conflicting reasons between bonus share and cash dividend. They are,

a) Liquidity position,

b) Degree of accumulated retained earning,

c) Legal requirement or desire to increase paid up capital.

Bonus share in any ratio as expected by the shareholders may have psychological effects on existing shareholders that may have favorable impact in the share price; share price is expected to increase normally because shareholders interpret the issue of bonus shares as an indication of corporate firm's prospect of higher profitability and expectation of increased total cash dividends.

Bonus share issue increases the outstanding number of shares but does not change the shareholders' proportional ownership pattern. Shareholders retain the proportional ownership in the corporate firm and total net worth remains same. There is only readjustment of the paid up share capital. Bonus share issue has a definite advantage to the corporate firm also. Generally bonus share may be accompanied by an increased cash dividend, which may have positive effect in shareholders wealth in future period of time.

Issue of bonus share does not make a cash drain from the bank balance of the corporate firm as payment of cash dividend does. It conserves cash, as it is a popular means to pay dividend under financial difficulty and at the same time helps in bringing the market price of share in most popular range (Pandey, 1995:708). Thus in order to avoid the borrowing in case of cash shortage for payment of cast dividend, corporate firm is reduced. As such the market price of the share, in most of the cases in efficient market, decreases by the amount of cash dividend distributed.

It is believed that neither the firm nor its shareholders' are better of worse off after a issue of bonus shares unless there is an increase in the dividend payout ratio and or stock price earning ratio. Shareholders also generally expect increase in DPR in the future years as a result of bonus share issue. In another word, if increase in total amount of cash dividend -and increase in earnings do no accompany bonus share issue; such issue does not benefit shareholders in term of value of stocks. There is thought that shareholders get increased cash dividend because of increased DPR only and thus it seems increased cash dividend not because of bonus share.

Bonus share is expected to project an image of growth hopefully and create a favorable impression of existing and prospective shareholders and also more protection for shareholders in the event of financial difficulty by capitalizing some of the retained earnings into common stock and! or additional paid in capital; issue of bonus share may have favorable impact on market price of stock in subsequent years (Gitman, et at. 1985:875).

1.2.10 Stock dividend Vs. Share Splits

In an economic sense bonus shares and stock splits are very similar although used for different purposes. There is significant difference only from accounting standpoints. In stock splits the numb of shares is increased through a proportional reduction in the par value of the stock. While in issuing bonus shares par value is not reduced. Thus from a practical standpoint there is little difference between a bonus share and a stock split. Stock split may convey the same information about the future earnings to investors and favorable prospect of corporate firm as stock dividend. Both affect the market price in the same direction. The New York Stock Exchange considers any distribution of stock totaling less than 25 percent or more a stock split (Weston, and Copeland, 1990:680-81). But we consider both are similar, the discussion below equally applies to both.

1.2.11 Stock dividend vs. Right Offering

When new shares of common stocks are offered to the general public, the proportionate ownership of existing shareholders is likely to be reduced. However, if a preemptive right is contained in the firm's articles of incorporation, the firm must first offer any new issue of common stock to existing shareholders. This assures each owner his or her proportionate owner's share. An issue of common stock to existing shareholders is called a right offering. Here, each shareholder is issued an option to buy a specified number of new shares from the firm at a specified price within a specified time after which the rights expire.

Therefore, a public issue of equity can be sold directly to the public with the help of underwriters; this is called a general cash offer. Alternatively, a public equity issue can be sold to the existing shareholders by what is called rights offer.

1.2.12 Legal and Procedural Aspects of Stock Dividend

The bonus share that can be legally issued to the existing shareholders is governed by Company Act, 1997 (2053 B.S.), and in case of commercial banks by the commercial Banks Act, 1974 (2031 B.S.), and subsequent amendment thereon in addition.

Company Act, 1997 section 21-clause'd' required the corporate firm to state the point Relating to the bonus share issue in the prospectus. Section 42 subsections 3 of the act Stated that in case of need of issuing bonus shares corporate firm is not required publishing the prospectus. Sub section 4 of the same section is concerned with the issue of bonus share to the corporate employees. The sub section restricted the issue of bonus shares if corporate management thinks necessary to appropriate not more than 5 percent of the increased capital to the employees of the corporation.

Sections 68 required the corporate management to table on and pass the special resolution as regards to the issue of bonus share in the annual general matting. Corporate management must give notice of bonus share before its issue to the concerned authority, SEBON (Company Act, 1997, section 137)

Section 42 sub-sections 5 debarred the corporate firm in increasing share capital or issuing the bonus shares from reserves and surplus created by any other source created by revaluation of corporate firms' assets except earned profits.

Besides, regarding the share capital and distribution of dividend, Commercial Bank Act, 1947 and subsequent amendments there on also govern commercial banks. Section 14, subsection 5 stated that commercial banks have to increase their authorized, issued and paid up capital as per directives given by NRB from time to time (4th Amendment.1989) section 18 restricted the commercial banks to announce the dividend unless it has recovered the preliminary expenses, debit balance of profit and loss account and build capital reserve, risk bearing reserve and general reserve as required by policy provisions (4th Amendment, 1989). The government's budget speeches and policy directives by NRB changed these provisions later on from time. In this regard, effective from Aug. 31, 1995 NRB made necessary changed relating to paid up capital of commercial banks to be newly established afterwards. NRB issued a circular to raise their paid up capital of old commercial banks already in operation with their head office in Katmandu up to Rs. 500 million by the end of 2000/01 (NRB, circular, 25 Nov. 1996).

These new provisions relating to the paid up capital of commercial banks have directly affected the dividend policy and practices of old commercial banks. Most of the commercial banks are bound to review and change their dividend practice in terms of dividend rate and amount. Even if they have capacity to pay higher rate of dividend, commercial banks are induced to maintain higher reserves and surpluses by retaining more earning so that corporate management can attain to minimum level of paid up capital as directed by NRB.

1.2.13 Factors Affecting Stock Price

Investment is the sacrifice of current amount of Rs. For future amount of Rs. Shareholders' investment in common stock sacrifices the present opportunities in expectation of future increased income or return in the form of dividends and capital gains. Stock price per share is the amount of Rs. Determined by market processes for buying and selling. A number of factors affect the stock price. Broadly, they can be classified as external factors and internal factors. External factors are located outside the firms. They are not under the control of firm. Condition of country's economy, political stability, opportunities of investment, inflation, investors' expectations, technological changes etc the external factors affecting stock prices.

Internal factors are located within the firm. They are divided policy, performance of firm, earning of the firm, image of the firm etc. Dividend policy may be fixed dividend, earning based dividend, increasing dividend, stock dividend, cash and stock dividend together. Firms paying higher dividend to its shareholders are priced higher than the firms paying lower dividend. Theoretically, stock price lowers after cash dividend by the amount of cash dividend. In cases of stock dividend, stock prices lower in the proportion of stock dividend. But previous studies show that their actual market prices are above the intrinsic value after bonus issue. Firm with good image is also priced higher than its intrinsic value. For example, Nepal Bank Limited, its intrinsic value is below than its par value but its stocks are trading above the par value.

According to another thinking, stock price of a firm is determined by demand and supply of its stocks in stock exchange market. If demand of stock of a firm is higher than the supply, its price bids up and vice versa.

1.3 REVIEW OF RELATED STUDIES

1.3.1 Review of Master's Thesis

Padam Gharti (2001) conducted a study on "Bonus Share Announcement and its Impact on stock price of Nepalese corporate firms".
The main objectives of the study were:

- To examine the relation of dividend quantum change and stock price.
- To examine the relation between share price rise and bonus ratio.
- To evaluate the relation of bonus share announcement and stock price.

This study is limited to mainly five years data. The study had covered the period of
1995/96 to 1999/2000. The study had used only secondary data. The study had included 16 numbers of bonus shares issue in the sample. 9 commercial banks, 2 insurance companies, 2 finance companies, 2 trading companies and lather were taken in sample organization.

Gharti found that the immediate share price rise after bonus share announcement is significant. The share price, in most of the cases, does not decease after distribution of bonus share according to bonus ratio as theory says. The reason behind the situation may be that the investors cannot interpret the information and data. There is a great misconception about bonus share that the general investors think that they receive extra/additional share with same value. According to Gharti's findings, long-term effect of bonus share issue as well as immediate is significantly positive. In most of the case, the aggregate market valuation of the corporate firm's equity capital increased as the result of bonus share issue. The companies announce bonus share without frequently cash dividend distribution ultimately faces drastic fan in their share prices. The Nepalese capital market did not show any response that whether the company was intended to increase future dividend (return) or not. The immediate response of the market was not sufficiently rational. The public in most of the cases was provided with very little information about real motive behind an issue of bonus share. Nepalese capital market was speculative-oriented; therefore it takes more consciously bonus share announcement than the cash dividend announcement. Whatever the dividend policy of the company, the immediate impact and a year later are significantly positive. (Gharti, 2001)

Bishnu Kumar Thapa (2003) studied the "Comparative study of dividend policy and valuation of listed companies". The objectives of the study were;

- To highlight the dividend policy and practices of the companies.
- To access the impact of dividend on market price of share.
- To analyze the variable such of profit, retained earning, dividend, growth rate and other relevant variables to share the relationship between the value and other ingredient affecting it.

The study had taken 4 commercial banks, 4 finance and insurance companies and 4 trading and manufacturing listed in NEPSE in the sample. The study had used only secondary data. The statistical tools to analyze the data were graphic presentation, trend analyzed, and cross-section, analyzed, co-efficient of correlation and regression analysis. Similarly, the study had also med price determination as financial tools,

Thapa (2003) found that the shareholders have high expectation, which is partly accepted.
Dividend paid only in profitable years. He concluded that there was no stability of dividend. He found that there was positive impact of earnings per share on valuation of share, market price considerably higher than net worth. The researcher concluded the calculated price did not match with quoted price and stock price had been fluctuating. (Thapa, 2003)

Dinesh Dhakal (2007) conducted the study of "Rights and Bonus share issue Practices in Nepalese Corporate Sectors". The main objectives of the study are:

- To identify and evaluate the characteristics of rights and bonus share issue,
- To study and analyze the regularity and frequency of rights and bonus share issue in Nepalese corporate firms
- To study the rights and bonus share issue from corporate firms
- To study and analyze the relation to rights and bonus share issue to size and age of the corporate firms,

The study had taken 23 listed companies including commercial banks, manufacturing companies, finance and insurance companies and others. The study used only secondary data available from NEPSE. The statistical tools used by the researcher are very simple in manner like simple average, percentage and simple graphical methods.

He found that corporate firms especially commercial banks in Nepal have the practice of issuing bonus shares to increase the total capital fund.(capitalization) as required by policy directives issued by NRB. There is more frequent issue of bonus share after the policy directives by NRB in fiscal year 1996/97 to commercial banks to increase their capital fund with a view to increase the liquidity position of the commercial banks, safeguard the depositors interest and help mobilize resources for large projects through the banking sector within the country, the commercial banks under operations and having a low capital base have been directed to raise their capital fund at a minimum level.

From the sample bonus share study the overall trend are going positively practice of issuing the bonus share by Nepalese corporate firms. According to the findings of the study, bonus share issue practice is being increased among the Nepalese corporate firms. Shareholders' perception towards bonus share is positive. They are optimistic to the firms who have issue bonus share. They get tax benefit over cash dividend and capital gain in future. They also hope mare dividends in future. Bonus share is one of the important causes of buying, selling and holding the stock. However, there seemed to have been no regular and consistent policy regarding bonus issue in terms of bonus ratios and time interval between one bonus issue and another. From the study Nepalese corporate firms followed a wide variety of bonus share ratio ranging form 1:1 to 1:10. However, it was found that out of many bonus ratios in practice 1:1, 1:2, 1:10, 1:4 and 3:5 are more popular among the corporate firms. It is found that from the analysis, large corporate firms in general tend to issue bonus share in higher ratio as compared to the small corporate firms. But there was more bonus share issuing by corporate firms of moderate age than the high or low age of the corporate firms.

1.3.2 Review of Ph D Thesis

K.D. Manandhar (2002) conducted a study on "Corporate Dividend Policy arid practice in Nepal". Since bonus share is a form of dividend, the study had included 36 number of bonus share issue from fiscal year 1999/94 to 1997/98. Both primary and secondary data were used. Some of the major findings of the study were;

- It is found that increase in dividend rate is common with the lower bonus share ratio and decrease with higher ratio. Corporate firms announcing the higher bonus share ratio would likely to decrease the post bonus dividend rate.
- Dividend behavior after bonus share is not clear at the time of its announcement.
- There is not immediate price rise significantly after bonus share announcement as expected. Market price starts rising after six month from the announcement month.
- Majority of the investors invest in common stocks in expectation of capital gain resulting from increase in market price of the 65% of the respondents are found interested in investing in stock to realize capital gain and 35% in expectation of receiving bonus share.
- Expectation of bonus. share is ranked first (86%), expectation of higher return ranked second (70%) and expectation of regular dividend is ranked third

(65%) by the shareholders as the causes of interest in investing in stocks of the corporate firms,

- Shareholders are not found satisfied with the dividend paying culture of the corporate management.
- Shareholders in Nepal want the corporate firms to follow stable and gradually increasing dividend payout policy, rather than earning based dividend payou policy.
- 88% of the respondents are of the opinion that issue of bonus shares must be accompanied by higher dividend rate.
- The most practical form of dividend in Nepal is cash dividend.
- Corporate firms are found to have issued bonus shares in order to increase the capital base and achieve the most respectable size of the corporate firms.(*Manandhar*, *2002*)

1.3.3 Review of Other Studies

Barker (1958) studied the effect of stock dividend and stock split on common stock ownership daring four years period from 1950-53. On the basis of the empirical work, he concluded that stock dividend and stock split result larger increase in stock ownership. He found that percentage increase was highest of 30% because of stock split of 5 for 4 or above, sock dividend of 5% to 25% resulted 17% increase in common stockowners. The increase in common stock ownership was only 5% in case of the corporate firms, which did not announce the stock dividend or split. His work revealed the fact that the use of stock dividend and split effectively increases the stock ownership.

Fama, Fisher, Jenson and Roll (1969) studied that exact effect of stock splits on shareholders' wealth extensively. Their pioneering study measured unexpected stock price changes around split ex-dates. They studied monthly data fro 940 splits between 1927and 1959 and revealed no significant changes in shareholders' wealth in split month. However, for a sub sample of firms that split and increased their dividend that found an increase in shareholders' wealth in the months following the split. For a dividend decreased, they found decrease in the shareholders' wealth. Researchers concluded that stock split could be interpreted as messages about dividend increase or about higher future cash flows (Fama, et al., 1969: 1-21).

There is nevertheless a widespread belief in financial circles that an optimal or psychological price range exists for stocks due to stock dividend. Optimal means that if the price is within this range, P/E ratio and hence the value of the firm will be maximized (Weston, Beasley and Brigham, 1996:660). Thus it is believed that there is an optimal price range due to stock split and hence there is more trading liquidity which causes the rise in price of stock. Copeland (1979) tested this assumption but found little empirical evidences. Contrary to the belief, he found another empirical result that market liquidity actually decreased following a stock split. He argued that the volume of trade proportionately decreases because of increase in brokerage charges and transaction cost because of increases in number of outstanding shares. The empirical work of Copeland revealed that stock split lowers the post split liquidity (Copeland, 1979: 115-141).

Many other scholars also studied extensively the effect of stock dividend on shareholders' return. Foster and Vickery (1978) and Woolridge (1983a, 1983b) found that stock dividend effect on shareholders' return was larger than stock splits.

Grinblatt, Masulis and Titman (1984) studied the effect of stock splits on shareholders' return. They examined a special sub sample of splits where no other announcement were made in the 3-day period around the split announcement and where no cash dividends had been declared in the previous three years. On the basis if 125 pure stock splits, they found a statistically significant announcement was considered as favorable signal about the firm's future cash flows. They also confirmed the work of Foster, Vickrey, and Woolridge and found that the announcement effect of stock dividends was larger compared to pure stock split. Their study showed that the increase in shareholders' return due the stock dividend announcement was 4.9% based on 382 sample and it was even more 5.89% in a sub sample of 84 stock dividend announcement cases. McNicholes and Dravid(1990) in their study found the significant increase in earnings after stock split (McNcholes and Dravid, 1990:877).

The effect of stock dividend and stock split is widely studied by many researchers. Most of the researchers attempted to isolate the abnormal return associated with a particular event of stock dividend or stock split, and found that there was a stock prices increase owing to the favorable information effect. From the various empirical studies it seems that stock dividends and stock splits are best explained as signals about better future prospects for the firms.

Rrennan and Copeland (1988) studied the signaling effect of stock splits. They are of the view that transaction cost is higher for low price stock than high price stock. The signaling effect is positive in the future if the cash flow exceeds the cost of lower liquidity. There will be more favorable response to lower stock split compared to high stock split. There is also said to be a statistically significant and positive stock price reaction around the announcement of stock dividend (Van Horne, 1996:337-38).

In stock dividend, the retained earnings must be reduced by the rupee amounts of stock dividend. As stock dividends are limited by the size of retained earnings, only those corporate firms willingly announce the stock dividend maintaining the minimum required level of retained earnings. As stock dividend is looked as a positive signal of improved performance and increased profitable investment it is natural that existing and prospective shareholders expect return to rise following the stock dividend announcement and hence the increase in he value to the stocks.

However, there are also studies that revealed the insignificant influence of stock dividend on stock prices. They argued that if risk adjusted market movement is considered there is no uniform conclusion in this regard.

Barker (1958) and Fama, and others (1969) remarked that investors see stock split and stock dividend for what they are simply additional pieces of paper called share certificates. They are of the view that only if stock dividend is accompanied by higher earnings and cash dividends, then investors will bid up the price of the stock, if not the dilution of earnings and dividend per share causes share price to fall by the same percentage as the stock dividend. Stock dividend itself is not the cause of market price change in the market. The empirical study by Barker, revealed that when stock dividend was associated with cash dividend increase, the value of the company's stock 6 month after stock dividend were not accompanied by cash dividend increase, stock values fell by 12% during the subsequent 6 month period. Therefore, researcher concluded that stock dividend is simply a piece of paper, not representing true income unless accompanied by dividend increase (Barker, 1958:99-114). Thus, it makes the fact clear that the fundamental determinants of stock prices are earning per share and dividend per share and dividend per share rather than stock dividend and stock split (Weston, et al., 1996:664),

Dr. M.K. Shrestha and K.D. Manandhar jointly conducted a study on **“Bonus share issue practices in Nepalese corporate firms.”**

The specified objectives of the study were:-

- To study and analyze the frequency of bonus share issue;
- To study and analyze he regularity of bonus share issue;
- To identify the most popular bonus share issue ratio;
- To study and analyze the relation to bonus share issue to the size and age of the corporate firms.

The study was based as only secondary data before the fiscal year 1997/98. 12 firms were taken as samples, which was issued bonus share at least once during the period of1987/88 to1997/98. Samples from manufacturing sector were not included. Only simple statistical tools such as percentage, frequency distribution and average were used to study, understand and analyze the collected data.

Some of the findings of the study were:-

- The most popular bonus ratios prevalent in Nepalese corporate practices are 1:1, 1:2 and 1:5.
- The number of bonus issue tended to rise from 1992/93.
- There is a trend of raise the additional equity capital by capitalizing the reserve and net profit by issuing bonus shares or stock dividend.
- No consistency in bonus issue ratio is observed.
- Large corporate firms are found to issue bonus shares more times than the small size corporate firms.
- Corporate firms over than20 years are found to have issued bonus shares more times (Shrestha & Manadhar; 1999:47-67).

1.4 Concluding Remarks

This study enquires upon the Stock Dividends and its effects on market price of the common stock of selected listed companies of Nepal. It covers the period of nine years from fiscal year 1998/99 to 2006/07. It included the data of the selected listed companies with Nepal Stock Exchange Ltd. Kathmandu, Nepal (NEPSE).

A concluding remark is drawn after having gone through the theoretical framework and review of related studies. From the above studies, it is clear that studies were concerned with stock dividend (Bonus Share) and its impact on market price of common stocks. The findings of the studies are not unanimous across industry sectors. The reason behind this is difference in methodology, sample size and time. However, studies proved that stock dividends play vital role in dividend policy uses by most of the companies.

The study attempted to review the stock dividend issue by the companies. Barker (1958) studied the effect of stock dividend and stock split on common stock ownership daring four years period from 1950-53. On the basis of the empirical work, he concluded that stock dividend and stock split result larger increase in stock ownership. He found that percentage increase was highest of 30% because of stock split of 5 for 4 or above, sock dividend of 5% to 25% resulted 17% increase in common stockowners. The increase in common stock ownership was only 5% in case of the corporate firms, which did not announce the stock dividend or split. His work revealed the fact that the use of stock dividend and split effectively increases the stock ownership.

In stock dividend, the retained earnings must be reduced by the rupee amounts of stock dividend. As stock dividends are limited by the size of retained earnings, only those corporate firms willingly announce the stock dividend maintaining the minimum required level of retained earnings. As stock dividend is looked as a positive signal of improved performance and increased profitable investment it is natural that existing and prospective shareholders expect return to rise following the stock dividend announcement and hence the increase in he value to the stocks.

Barker (1958) and Fama, and others (1969) remarked that investors see stock split and stock dividend for what they are simply additional pieces of paper called share certificates. They are of the view that only if stock dividend is accompanied by higher earnings and cash dividends, then investors will bid up the price of the stock, if not the dilution of earnings and dividend per share causes share price to fall by the same percentage as the stock dividend. Stock dividend itself is not the cause of market price change in the market. The empirical study by Barker, revealed that when stock dividend was associated with cash dividend increase, the value of the company's stock 6 month after stock dividend were not accompanied by cash dividend increase, stock values fell by 12% during the subsequent 6 month period. Therefore, researcher concluded that stock dividend is simply a piece of paper, not representing true income unless accompanied by dividend increase. Thus, it makes the fact clear that the fundamental determinants of stock prices are earning per share and dividend per share and dividend per share rather than stock dividend and stock split.

This study is concentrated on dividend, specially, stock dividend (Bonus Share), it is in the shareholders' mind, its issuance and its effect on market price of the common stock. Now, stock dividend is a popular form of dividend among the shareholders and its issuance is being increased. It solves the complex and controversial decision about retention of earning and payment of dividend. So, it has been emerged as a popular method of capitalizing earnings and rewarding shareholders.

From the review of previous studies, it has been cleared that most of the Nepalese corporate firms has started to issue the stock dividend as dividend to reward their shareholders. And it is shown that stock dividend is the one of the most important financing factor that effects the shareholders mind whether they should to buy the stocks of the companies or not.

1.5 Major Finding & Recommendation

Major Findings

The study is concentrated on dividend, especially stock dividend (bonus share); it is in the shareholders' mind, its issuance and its effect on market price of common stock. Now, stock dividend is a popular form of dividend among the shareholders and its issuance is being increased. It solves the complex and controversial decision about retention of earning and payment of dividend. So, it has been emerged as a popular method of capitalizing earnings and rewarding shareholders. Its perception on shareholders is found positive and they liked it for capital gain the future and tax benefit over cash dividend.

From the sample stock dividend study, the overall effect of stock dividend issue on market price of common stock found positive which is above the theoretical price after stock dividend issue. Shareholders are optimistic to the firms who have issue bonus share. They expect more dividends in future.

According to the findings from the study, the following points are concluded:

a) Stock dividend issue practice is being increased among the Nepalese corporate firms.
b) The effect of stock dividend on market price of common stock is found positive which is above the theoretical price after bonus share issue.
c) Shareholders' perception towards bonus share is positive. They are optimistic to the firms who have issue stock dividend. They get tax benefit over cash dividend and capital gain in future. They also hope more dividends in future. Bonus share is one of the important causes of buying selling and holding the stocks.
d) While pricing the stock, shareholder focus their attention to the DPS rather than EPS. They are ready to pay higher price for the firms paying higher dividend, not thinking earning of the firms. In such a environment, stock dividend is a good form of dividend for the growing firms having good investment opportunities.
e) Shareholders like bonus share accompanying higher dividend in future.
f) The statement corporate management issue stock dividend not only to increase base capital but also reduce the market price within the most popular trading range is accepted.

Recommendations

The study concentrates on dividend, specifically stock dividend or bonus share in Nepalese corporate firms. So, recommendations on dividend and dividend policy are made here:

a) Some of the corporate firms are found not considering the stock market conditions, shareholders' expectation while formulating dividend policy. So, it is recommended to them to consider the stock market conditions, shareholders' expectation while formulating dividend policy to increase the market value of the firm.
b) Shareholders pay higher price for the firms paying higher dividend. So, it is recommended to the corporate management

not hold unnecessary or excess reserve or retained earnings. It usage as dividend increases the market value of the firms.

c) The proposition that shareholders' interests are protected less if issue of stock dividend is not accompanied by higher dividend rate in future is accepted. So, corporate management should declare stock dividend accompanying higher dividend in future. The additional fund capitalized must be effectively and profitable utilized.
d) Stock dividend issue is found as one the important factor of buying, selling and holding the stocks by shareholders. So, corporate firm should have correct dividend policy balance the current dividend with future growth. So, they should have not only the policy of paying cash dividend but also the policy of issuing stock dividends in certain time interval to meet firm's growth and shareholders' expectation.
e) Bonus share issue and investment requirement or growth prospect must be matched so that post bonus dividend rate could be increased or remained same. If old dividend rate cannot be maintained, shareholders' interest protected less.
f) The study found that the objective of stock dividend issue is focused to increase base capital. So, it is recommended that stock dividend issue should address the objective of maximizing the welfare of the shareholders.

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