

UNDERWRITING OF SHARES AND DEBENTURES ✓

MEANING OF UNDERWRITING

Underwriting is a contract whereby a responsibility is taken or a guarantee is given that the shares or debentures of the company will be subscribed for. Some individuals, firms or companies give a guarantee that so many shares of the company will be taken up by the public. In case these shares are not taken up by the public, they are taken up by the guarantors themselves. Those who give such guarantee are called Underwriters and the shares are said to be Underwritten. The underwriting of securities can be done by an individual, firm or company.

Underwriter and their financial position. An individual, firm or company can be appointed as an underwriter, however, their financial conditions should be very sound enough. Those company who appoint underwriters for underwriting their shares and debentures have to make a declaration in their prospectus that the financial position of the underwriters as sound enough. In this regard care should be taken when making such declaration otherwise the company will be held liable.

Underwriting Commission. A commission is given to the underwriters for underwriting work, this commission is known as Underwriting Commission. This commission is found out on the issue price of the shares or debentures underwritten. Commission to the underwriters is paid on the whole of issue underwritten irrespective of the fact that whole of the issue has been taken over by the public or not, but underwriting Commission can be paid only when it is authorised by Articles of Association.

ADVANTAGES AND OBJECTS OF UNDERWRITING

- (1) Subscription of Capital of the company becomes certain. In the absence of an underwriting agreement there is always uncertainty regarding its subscription by the public. Due to the guarantee of the underwriters this uncertainty is removed.
- (2) The company which has underwriters, commands more confidence amongst the public because subscribers feel that had the company been bad, underwriters would have never entered in underwriting agreement.
- (3) It increases the goodwill of the company. Normally, underwriters underwrite the shares and debentures of only those companies which are sound concerns and whose future is bright. They know that if shares will not be taken up by the public they will have to take up these shares, hence ultimate burden will be on them. This is why underwriting creates an impression regarding sound status of a company.

PAYMENT OF REMUNERATION TO UNDERWRITERS

The underwriters may be remunerated either in cash or by issue of fully paid shares. The remuneration can be paid out of the following funds : (i) Undistributed profits of the company (ii) Future profits (if underwriter agree) If the shares are issued to premium, then Clause 78 should be followed in this regard.

UNDERWRITING AGREEMENTS

If company has been formed underwriting agreements are made with the company and if it has not been formed underwriting agreements are made with the promoters of the company.

Responsibility of the Underwriter's Representatives. If an underwriter dies, his representative becomes liable for complying the provisions of underwriting contract.

Statutory Report. The statutory report shall set out the extent, if any, to which each underwriting contract, if any, has been carried out, and the reasons therefore.

COMMISSION

A company may pay a commission to any person in consideration of :

(a) his subscribing or agreeing to subscribe, whether absolutely or conditionally, for any shares in, or debentures of, the company, or (b) his procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in, or debentures of the company, if the following conditions are fulfilled namely :

- (i) The payment of commission is authorised by the Articles;
- (ii) The commission paid or agreed to be paid does not exceed in the case of shares, *five percent* of the price at which the shares are issued or the amount or rate authorised by the Articles, whichever is less and in the case of debentures *two and half per cent* of the price at which the debentures are issued or the amount or rate authorised by the Articles, whichever is less;
- (iii) The amount or rate percent of the commission paid or agreed to be paid is—in the case of shares or debentures offered to the public for subscription disclosed in the Prospectus, and in the case of shares or debentures not offered to the public for subscription, disclosed in the statement in lieu of Prospectus, or in a statement in the prescribed form signed in the like manner as a statement in lieu of Prospectus and filed with the registrar before the payment of the commission;
- (iv) The number of shares or debentures which persons have agreed for a commission to subscribe absolutely or conditionally is disclosed in the manner aforesaid; and
- (v) A copy of the contract for the payment of the commission is delivered to the registrar at the time of delivery of the Prospectus or the statement in lieu of Prospectus for registration.

BROKERAGE

Broker is a person who helps in subscribing the shares, but he himself does not take up those shares which are not taken up by the public. Whatever commission is paid for such subscription of shares is called Brokerage. The commission which is paid to Stock Brokers and Bankers is called Brokerage.

Accounting record in the Books of Company for Commission and Balance Sheet

Illustration 1

Swadeshi Mills Ltd., Kanpur issues 550, 6% debentures of ₹ 100 each and 4,000 equity shares of ₹ 10 each to the public. Ramesh & Company has entered into an underwriting agreement with Swadeshi Mills for the subscription of whole of the issue of the public at a Commission of 2% on equity shares and 1% on debentures. Cash was received for all the equity shares and debentures from the public except that of 50 debentures. These were taken up by the underwriters. Underwriters paid the balance due. Pass the necessary Journal entries and also prepare the Balance Sheet in the books of Swadeshi Mills Ltd.

✓ UNDERWRITING ACCOUNT

Underwriters open an account called Underwriting Account to know profit or loss on underwriting. This account is practically like Statement of Profit and Loss. This account is debited with the expenses of the underwriters in connection with underwriting and it is also debited with that amount at which underwriters have to take up those shares which were not taken up by the public, following items are recorded in its credit side :

(i) Commission receivable by the underwriters; (ii) Sale of shares by underwriters; (iii) Value of unsold shares. When the underwriters take the unsold shares then they are treated like purchase of goods, hence underwriting account is debited by the value at which these shares are taken up.

Closing Stock. While closing the underwriting account, the shares which are not sold by the underwriters which were underwritten, these are treated as closing stock. The valuation of these shares is made either at cost price or at market price, whichever is lower.

Profit or Loss on Underwriting : The difference in the underwriting account is treated as profit or loss. If the total of the debit side more than the credit side it is treated as profit and vice-versa loss.

SUB-UNDERWRITING

If an underwriter has more work of underwriting, he may keep a number of underwriters under him. All such underwriters work under him. They have normally no contract with the company; they are responsible to the underwriter only, hence they are called sub-underwriters.

Overall Commission or Over-riding Commission

When a broker enters in an agreement with the company that he will appoint sub-underwriters who will assist in underwriting work, he gets an additional commission from the company for the subscription procured by the sub-underwriters. This commission is known as overall commission or over-riding commission.

Underwriting Account

The commission paid to sub-underwriters is recorded in the debit side of underwriting account. Whatever shares are taken up by the sub-underwriters, are recorded in the credit side of underwriting account. If a sub-underwriter sells his shares, this sale is not recorded in underwriting account.

FIRM UNDERWRITING

If an underwriter enters into an agreement with the company that he will purchase a certain number of shares or debentures of the company without caring as to the number of shares which will be taken up by the public on the basis of the Prospectus. It is known as Firm Underwriting. Suppose a company has issued 3,00,000 shares of ₹ 10 each out of which firm underwriting is 15,000 shares. Public has subscribed for 3,00,000 shares. As 15,000 shares are reserved for underwriters, only 3,00,000 – 15,000, i.e., 2,85,000 shares will be issued to the public and application money of remaining (3,00,000 – 2,85,000) or 15,000 shares will be returned to the public. Normally, an underwriter cannot set off his firm underwriting liability, but if the contract provides setting off firm underwriting out of underwriting liability, it may be done.

Calculation of Underwriting Commission : In case of firm underwriting, the commission will be calculated on all those shares which were contracted for underwriting. For example, if 20,000 shares of ₹ 10 each were underwritten and out of these 3,000 shares were of firm underwriting, even then commission for all $20,000 \times 10 = ₹ 2,00,000$ will be determined.

Illustration 7

A Ltd. issued 20,000 shares of ₹ 10 each and B agreed to underwrite them at a commission of 4 per cent. This commission was payable 40 per cent in cash and 60 per cent in fully paid shares. B also made a firm application for a further 3,000 shares. All the shares of A company were not taken up by the public and B has to take up 10 per cent of the shares underwritten. The market price of the shares of A company was ₹ 8 per share. Prepare the Underwriting Commission Account and Shares in A Ltd. Account in the books of B.

Solution 7

Underwriting Commission Account

To Shares in A Ltd.	₹ 8,000 ¹	By Bank A/c	₹ 3,200 ²
		By Shares in A Ltd. (480 Shares)	₹ 4,800 ³
	₹ 8,000		₹ 8,000

✓ MARKED APPLICATIONS OR FORMS

When shares and debentures of the company are issued to the public, whatever shares and debentures are issued by the underwriters to the public, they place a seal of their name and address on the application form; and when the form bearing seal of the underwriters is received by the company, it becomes clear to the company as to how many forms are due to the efforts of a particular underwriter. Such applications which bear the seal of the name and address of the underwriter are called marked applications or forms. This is necessary in the case of such companies whose shares are underwritten by a number of underwriters.

✓ UNMARKED APPLICATIONS

There is no such motivation to the applicants by the underwriter and these share applications are received directly from the company and are sent to them. However, the benefit of these shares are given to all the underwriters. In absence of any information the benefit of unmarked application is given to all the underwriters in the proportion of gross liability. If any specific information is provided then such information will be taken into consideration for providing the benefit. Those applications are called unmarked which do not bear the seal of any underwriter.

DETERMINATION OF LIABILITY IN RESPECT OF AN UNDERWRITING CONTRACT

If the whole of the issue has been underwritten by one person, he is responsible to subscribe for all the shares or debentures that have not been subscribed by the public. In such a case, it is not necessary to know the number of applications which had originated through the underwriter and those which had flowed directly to the company.

✓ In the case in which only part of an issue has been underwritten, or where there are a number of underwriters, a certain amount of difficulty may arise in determining the liability of each of the underwriters; such a difficulty may arise in deciding the basis on which the unmarked applications, *i.e.*, the applications which have directly flowed to the company should be allocated among the different underwriters.

This can be done in two ways. According to one method, the unmarked applications are allotted in the proportion of gross amount of capital underwritten. Alternatively these are

