UNDERWRITING OF SHARES AND DEBENTURES

(A) Write short notes on:
Question 1

"Firm" underwriting. Also give the accounting entries relating to firm underwriting in the books of: (i) the company, (ii) the underwriter

Answer

'Firm' underwriting signifies a definite commitment to take up a specified number of shares irrespective of the number of shares subscribed for by the public. In such a case, unless it has been otherwise agreed, the underwriter's liability is determined without taking into account the number of shares taken up 'firm' by him, i.e. the underwriter is obliged to take up :

1. the number of shares he has applied for 'firm'; and
2. the number of shares he is obliged to take up on the basis of the underwriting agreement.

For example, A underwrites 60% of an issue of 10,000 shares of Rs. 10 each of XY Co. Ltd. and also applies for 1,000 shares, 'firm'. The underwriting commission is agreed to at the rate of 2.5 percent. In case there are marked applications for 4,800 shares, he will have to take up 2,200 shares, i.e. 1,000 shares for which he applied 'firm' and 1,200 shares to meet his liability of underwriting contract. If, on the other hand, the underwriting contract has provided that an abatement would be allowed in respect of shares taken up 'firm', the liability of A in the above-mentioned case would only be for 1,200 shares in total. The accounting entries in relation to firm underwriting of 1,000 shares in the above example are given below :

Entries in the books of XY Co. Ltd. (Company)

			Dr.	*Cr.*
			Rs.	*Rs.*
1.	A's Account	Dr.	10,000	
	To Equity Share Capital Account			10,000
	(Being allotment of underwritten equity shares in pursuance of firm underwriting contract, vide Board's resolution)			
2.	Underwriting Commission on Issue of Shares Account	Dr.	250	
	To A's Account			250
	(Being underwriting commission due to the underwriter under the firm underwriting contract...)			
3.	Bank Account	Dr.	9,750	
	To A's Account			9,750
	(Being money received in full settlement of account from underwriter)			

Entries in the books of A (Underwriter)

			Dr.	*Cr.*
			Rs.	*Rs.*
1.	Underwriting Account	Dr.	10,000	
	To XY Co. Ltd. Account			10,000
	(Being the liability to take up necessary number of shares of the company in pursuance of firm underwriting contract recorded)			

2. XY Co. Ltd. Account	Dr.	250	
To Underwriting Account			250
(Being underwriting commission income credited to underwriting account)			
3. XY Co. Ltd. Account	Dr.	9,750	
To Bank Account			9,750
(Being balance money paid to the company in full settlement of account)			

Question 2

Write a short note on Firm underwriting and Partial underwriting along with firm underwriting.

Answer

In firm underwriting the underwriter agrees to subscribe upto a certain number of shares/debentures irrespective of the nature of public response to issue of securities. He gets these securities even if the issue is fully subscribed or over-subscribed. These securities are taken by the underwriter in addition to his liability for securities not subscribed by the public. Under partial underwriting along with firm underwriting, unless otherwise agreed, individual underwriter does not get the benefit of firm underwriting in determination of number of shares/debentures to be taken up by him.

Question 3

What are the terms used in under writing?

Ans: a. Marked Applications:

i. The application forms bearing the stamp of the underwriter are termed as "Marked Application forms.

ii. The benefit of marked applications is given to the concerned underwriters in whose favour application forms have been marked.

b. Unmarked Applications:

i. The application forms which do not bear the stamp of the underwriter are termed as 'Unmarked Application forms'.

ii. The benefit of unmarked applications is given first to the company to the extent of issue not underwritten by underwriters (in case any part of the issue is not underwritten).

iii. In case there is surplus, the benefit of surplus unmarked applications will be given to the underwriters in the ratio of their gross liability.

c. Full Underwriting:

i. When the entire issue is underwritten such underwriting is termed as 'full underwriting'. For example, X Ltd. decided to make a public issue of 1,00,000 Equity Shares of Rs. 10 each which is entirely underwritten by A,B,C and D in the ratio of 2:2:1:1.

ii. In such a case the benefit of unmarked applications is given to the underwriter in the ratio of their gross liability i.e., 2:2:1:1.

d. Partial Underwriting:

i. When only a part of issue is underwritten, such underwriting is termed as 'Partial Underwriting'. For example, X Ltd., decided to make a public issue of 1,00,000 Equity Shares of Rs. 10 each out of which 90,000 shares are underwritten by A, B, C and D in the ratio of 2:2:1:1. It means 10,000 shares are underwritten by the company itself.

ii. In such a case, the benefit of unmarked applications will first be given to the company.

iii. In case there is surplus, such surplus will be distributed among other underwriters in the ratio of their gross liability.

e. Sole Underwriting:

i. When the issue is underwritten only by one underwriter, such underwriting is termed as 'Sole Underwriting'. For example, if an issue of 1,00,000 shares of Rs. 10 each of X Ltd., is underwritten by A, it is a case of sole underwriting.

ii. In such a case, the distinction between marked and unmarked applications is not of such significance.

f. Joint Underwriting:

i. When the issue is underwritten by two or more underwriters, such underwriting is termed as 'Joint Underwriting'. For Example, if an issue of 1,00,000 shares of Rs. 10 each of X Ltd., is underwritten by A, B, C and D in the ratio 2:2:1:1, it is a case of joint underwriting.

ii. In such a case the benefit of unmarked applications is given to the underwriters in the ratio of their gross liability.

iii. The benefit of marked applications is given to the concerned underwriters in whose favour applications have been marked.

g. Firm Underwriting:

i. Meaning: Firm underwriting refers to a definite commitment by the underwriter to take up a specified number of securities irrespective of the number of securities subscribed by the public.

For example, the entire issue of X Ltd., is underwritten as follows:

A. 1,60,000 shares (firm underwriting 3,600 shares)

B. 1,60,000 shares (firm underwriting 2,000 shares)

C. 80,000 shares (firm underwriting 1,200 shares)

D. 80,000 shares (firm underwriting 10,000 shares)

In this case only 4,63,200 shares (i.e., 4,80,000 shares – firm underwriting of 16,800 shares) will be offered to public and 16,800 shares will be taken up by the underwriters even if the issue is oversubscribed.

ii. Treatment: The benefit of firm underwriting may be given either.

Ø To an individual underwriter on the basis of his individual firm underwriting, or

Ø To all the underwriters in the ratio of their gross liability

In other words, firm underwriting shares may be treated at par with either 'Marked Applications' or 'Unmarked Applications'.

(B) Practical Questions:

Question 1

Noman Ltd. issued 80,000 Equity Shares which were underwritten as follows:

Mr. A	*48,000 Equity Shares*
Messrs B & Co.	*20,000 Equity Shares*
Messrs C Corp.	*12,000 Eqiuty Shares*

The above mentioned underwriters made applications for 'firm' underwritings as follows:

Mr. A	*6,400 Equity Shares*
Messrs B & Co.	*8,000 Equity Shares*
Messrs C Corp.	*2,400 Equity Shares*

The total applications excluding 'firm' underwriting, but including marked applications were for 40,000 Equity Shares.

The marked Applications were as under:

Mr. A	*8,000 Equity Shares*
Messrs B & Co.	*10,000 Equity Shares*
Messrs C Corp.	*4,000 Equity Shares*

(The underwriting contracts provide that underwriters be given credit for 'firm' applications and that credit for unmarked applications be given in proportion to the shares underwritten)

You are required to show the allocation of liability. Workings will be considered as a part of your answer.

Answer

Noman Ltd.
Statement showing Liability of Underwriters

	Mr. A	*M/s. B & Co.*	*C Corpn.*	*Total*
Gross Liability (No. of shares)	48,000	20,000	12,000	80,000
Unmarked Applications* (Ratio 48:20:12)	10,800	4,500	2,700	18,000
	37,200	15,500	9,300	62,000
Marked Applications	8,000	10,000	4,000	22,000
	29,200	5,500	5,300	40,000
Firm underwriting	6,400	8,000	2,400	16,800
Balance to be taken under the contract	22,800	-2,500	2,900	23,200
Credit for excess of B & Co. (ratio 48 : 12)	2,000	2,500	500	
Net Liability	20,800		2,400	
Add: Firm Underwriting	6,400	8,000	2,400	16,800
Total Liability	27,200	8,000	4,800	40,000

Working Note :

* Total Applications	40,000	Shares
Marked Applications	22,000	Shares
Unmarked applications	18,000	Shares

Question 2

A joint stock company resolved to issue 10 lakh equity shares of Rs. 10 each at a premium of Re. 1 per share. One lakh of these shares were taken up by the directors of the company, their relatives, associates and friends, the entire amount being received forthwith. The remaining shares were offered to the public, the entire amount being asked for with applications.

The issue was underwritten by X, Y and Z for a commission @2% of the issue price, 65% of the issue was underwritten by X, while Y's and Z's shares were 25% and 10% respectively. Their firm underwriting was as follows :

X 30,000 shares, Y 20,000 shares and Z 10,000 shares. The underwriters were to submit unmarked applications for shares underwritten firm with full application money along with members of the general public.

Marked applications were as follows:

X 1,19,500 shares, Y 57,500 shares and Z 10,500 shares.

Unmarked applications totalled 7,00,000 shares.

Accounts with the underwriters were promptly settled.

You are required to :

(i) Prepare a statements calculating underwriters' liability for shares other than shares underwritten firm.
(ii) Pass journal entries for all the transactions including cash transactions.

Answer

(i) Statement showing underwriters' liability for shares other than shares underwritten firm

	X	*Y*	*Z*	*Total*
Gross liability (9,00,000 shares in the ratio of 65 : 25 : 10)	5,85,000	2,25,000	90,000	9,00,000
	1,19,500	57,500	10,500	1,87,500
	4,65,500	1,67,500	79,500	7,12,000
Less : Allocation of unmarked applications (including firm underwriting i.e. 7,00,000) in the				

ratio 65 : 25 : 10	4,55,000	1,75,000	70,000	7,00,000			
	10,500	(7,500)	9,500	12,500			
Surplus of Y allocated to X and Z in the ratio 65 : 10 12,500	(6,500)	7,500	(1,000)	–	4,000	–	8,500

	Rs.	Rs.	Rs.
Liability amount @ Rs. 11	44,000	–	93,500
Underwriting commission payable			
(Gross liability × Rs. 11 × 2%)	1,28,700	49,500	19,800
Net Amount payable	84,700	49,500	
Net Amount receivable			73,700

(ii) Journal Entries

		Dr.	*Cr.*
Bank A/c	Dr.	11,00,000	
To Equity Shares Application A/c			11,00,000
(Being application money received on 1 lakh equity shares @ Rs. 11 per share)			
Bank A/c	Dr.	97,62,500	
To Equity Share Application A/c			97,62,500
(Application money received on 8,87,500 equity shares @ Rs. 11 per share from general public and underwriters for shares underwritten firm)			
Equity Share Application A/c	Dr.	1,08,62,500	
X' s A/c	Dr.	44,000	
Z' s A/c	Dr.	93,500	
To Equity Share Capital A/c			1,00,00,000
To Securities Premium A/c			10,00,000
(Allotment of 10 lakh equity shares of Rs. 10 each at a premium of Re. 1 per share)			
Underwriting commission A/c	Dr.	1,98,000	
To X's A/c			1,28,700
To Y's A/c			49,500
To Z's A/c			19,800
(Amount of underwriting commission payable to X, Y and Z @2% on the amount of shares underwritten)			
Bank A/c	Dr.	73,700	
To Z's A/c			73,700
(Amount received from Z in final settlement)			
X's A/c	Dr.	84,700	
Y's A/c	Dr.	49,500	
To Bank A/c			1,34,200
(Amount paid to X and Y in final settlement)			

Question 3

Scorpio Ltd. came out with an issue of 45,00,000 equity shares of Rs. 10 each at a premium of Rs. 2 per share. The promoters took 20% of the issue and the balance was offered to the public. The issue was equally underwritten by A & Co; B & Co. and C & Co.

Each underwriter took firm underwriting of 1,00,000 shares each. Subscriptions for 31,00,000 equity shares were received with marked forms for the underwriters as given below:

A & Co.	*7,25,000 shares*
B & Co.	*8,40,000 shares*
C & Co.	*13,10,000 shares*
Total	*28,75,000 shares*

The underwriters are eligible for a commission of 5% on face value of shares. The entire amount towards shares subscription has to be paid alongwith application. You are required to:

(a) Compute the underwriters liability (number of shares)

(b) Compute the amounts payable or due to underwriters; and

(c) Pass necessary journal entries in the books of Scorpio Ltd. relating to underwriting.

Answer

(a) Computation of liabilities of underwriters (No. of shares):

	A & Co.	B & Co.	C & Co.
Gross liability	12,00,000	12,00,000	12,00,000
Less: Firm underwriting	1,00,000	1,00,000	1,00,000
	11,00,000	11,00,000	11,00,000
Less: Marked applications	7,25,000	8,40,000	13,10,000
	3,75,000	2,60,000	(2,10,000)
Less: Unmarked applications distributed to A & Co. and B & Co. in equal ratio	1,12,500	1,12,500	Nil
	2,62,500	1,47,500	(2,10,000)
Less: Surplus of C & Co. distributed to A & Co. and B & Co. in equal ratio	1,05,000	1,05,000	2,10,000
Net liability (excluding firm underwriting)	1,57,500	42,500	Nil
Add: Firm underwriting	1,00,000	1,00,000	1,00,000
Total liability (No. of shares)	2,57,500	1,42,500	1,00,000

(b) Computation of amounts payable by underwriters:

Liability towards shares to be subscribed @ 12 per share	30,90,000	17,10,000	12,00,000
Less: Commission (5% on 12 lakhs shares @ 10 each)	6,00,000	6,00,000	6,00,000
Net amount to be paid by underwriters	24,90,000	11,10,000	6,00,000

(c) In the Books of Scorpio Ltd.

Journal Entries

Particulars		*Dr.* *Rs.*	*Cr.* *Rs.*
Underwriting commission A/c	Dr.	18,00,000	
To A & Co. A/c			6,00,000
To B & Co. A/c			6,00,000
To C & Co. A/c			6,00,000
(Being underwriting commission on the shares underwritten)			
A & Co. A/c	Dr.	30,90,000	

B & Co. A/c	Dr. 17,10,000	
C & Co. A/c	Dr. 12,00,000	
To Equity share capital A/c		50,00,000
To Share premium A/c		10,00,000
(Being shares including firm underwritten shares allotted to underwriters)		
Bank A/c	Dr. 42,00,000	
To A & Co. A/c		24,90,000
To B & Co. A/c		11,10,000
To C & Co. A/c		6,00,000
(Being the amount received towards shares allotted to underwriters less underwriting commission due to them)		

Question 4

Gemini Ltd. came up with public issue of 30,00,000 Equity shares of Rs. 10 each at Rs. 15 per share. A, B and C took underwriting of the issue in 3 : 2 : 1 ratio.

Applications were received for 27,00,000 shares.

The marked applications were received as under:

A	8,00,000 shares
B	7,00,000 shares
C	6,00,000 shares

Commission payable to underwriters is at 5% on the face value of shares.

(i) Compute the liability of each underwriter as regards the number of shares to be taken up.

(ii) Pass journal entries in the books of Gemini Ltd. to record the transactions relating to underwriters.

Answer

(i) **Computation of liability of underwriters in respect of shares**

(In shares)

	A	*B*	*C*
Gross liability	15,00,000	10,00,000	5,00,000
Less: Unmarked applications	3,00,000	2,00,000	1,00,000
	12,00,000	8,00,000	4,00,000
Less: Marked applications	8,00,000	7,00,000	6,00,000
	4,00,000	1,00,000	(2,00,000)
Surplus of C distributed to A & B in 3:2 ratio	1,20,000	80,000	2,00,000
Net liability	2,80,000	20,000	Nil

(ii) Journal Entries in the books of Gemini Ltd.

		Rs.	*Rs.*
A's Account	Dr.	42,00,000	
B's Account	Dr.	3,00,000	
To Share Capital Account			30,00,000
To Securities Premium Account			15,00,000
(Being the shares to be taken up by the underwriters)			

Underwriting Commission Account	Dr.	15,00,000	
To A's Account			7,50,000
To B's Account			5,00,000
To C's Account			2,50,000
(Being the underwriting commission due to the underwriters)			
Bank Account	Dr.	34,50,000	
To A's Account			34,50,000
(Being the amount received from underwriter A for the shares taken up by him after adjustment of his commission)			
B's Account	Dr.	2,00,000	
To Bank Account			2,00,000
(Being the amount paid to underwriter B after adjustment of the shares taken by him against underwriting commission due to him)			
C's Account	Dr.	2,50,000	
To Bank Account			2,50,000
(Being the underwriting commission paid to C)			