Lesson 5

Related Aspects of Company Accounts

Key Concepts One Should Know

- Buy back
- Escrow account
- Collateral security
- ESOP
- ESOS
- Underwriting
- Under subscription

Learning Objectives

To understand the:

- Share capital structure in the balance sheet of a company.
- Methods and accounting procedure of issue of shares.
- Accounting procedure of buy-back of shares.
- Accounting treatment for ESOPs and ESPS.
- Meaning and types of Underwriting
- Difference between marked application and unmarked applications.
- Liability of underwriters.
- Meaning of debenture and bonds;
- Methods for the issue of debenture for cash and for consideration Other than cash;
- Issue of debenture as a collateral security;
- Sources and record transaction relating to redemption of Debenture;
- Methods of redemption of debenture;
- Sinking Fund Investment
- Cum-interest and Ex-interest, open market operations

Lesson Outline

- Buy-Back of Shares
- Modes of Buy-Back
- Debentures-Issue & Redemption
- Accounting for Debentures
- Accounting Aspects of Issue
- Redemption of Debentures
- Different Methods of Redemption of Debentures
- Issue of Employee Stock Options
- Explanatory Statement Annexed to Notice
- Disclosure in Board's Reports
- General Rights available
- Entry in Register of Members
- Underwriting of Shares
- Underwriting Agreement
- Sub-Underwriters
- Underwriting Commission
- Full and Partial Underwriting
- Accounting Entries
- LESSON ROUND UP
- TEST YOURSELF

BUY-BACK OF SHARES

When a company has substantial cash resources, it may like to buy its own shares from the market particularly when the prevailing rate of its shares in the market is much lower than the book value; or what the company perceives to be its true value. Buy-back of shares enables the company to go back to its shareholders and offers to purchase from them the shares they hold. Buy-back of Securities is a very important tool for companies that wants to reduce their Share Capital.

Conditions for buy-back:

According to Section 68(2), following conditions must be satisfied in order to buy-back the shares:

(a) must be authorized by its articles;

(a) a special resolution has been passed at a general meeting of the company authorizing the buy-back, but the same is not required when:

- (i) the buy-back is 10% or less of the total paid up equity capital and free reserves of the company; and
- (ii) such buy-back has been authorized by the Board by means of a resolution passed at its meeting;

(b) the buy-back is twenty-five per cent or less of the aggregate of paid up capital and free reserves of the company. But in case of Equity Shares, the same shall be taken as 25% of paid up equity capital only.

(c) Debt Equity ratio should be 2:1, where: Debt is aggregate of secured and unsecured debts owed by the company after buy-back, and Equity: is the aggregate of the paid up capital and its free reserves;

(d) all the shares or other specified securities for buy-back are fully paid up;

(e) If shares or securities are listed, buy-back will be in accordance with the regulations made by the Securities and Exchange Board in this behalf; and

(f) the buy-back in respect of unlisted shares or other specified securities will be in accordance with Share Capital and Debentures Rules, 2014.

(g) no offer of buy-back shall be made within a period of one year from the date of the closure of the preceding offer of buy-back, if any.

Explanatory Statement – Section 68(3):

The notice of the meeting at which the special resolution is proposed to be passed shall be accompanied by an explanatory statement stating –

(a) a full and complete disclosure of all material facts;

(b) the necessity for the buy-back;

(c) the class of shares or securities intended to be purchased under the buy-back;

(d) the amount to be invested under the buy-back; and

(e) the time-limit for the completion of buy-back.

As per the rules, following more details is to be included in the Explanatory Statement:

(f) the date of the board meeting at which the proposal for buy-back was approved by the Board of Directors of the company;

(g) the number of securities that the company proposes to buy-back;

(h) the method to be adopted for the buy-back;

(i) the price at which the buy-back of shares or other securities shall be made;

(j) the basis of arriving at the buy-back price;

(k) the maximum amount to be paid for the buy-back and the sources of funds from which the buy-back would be financed;

(l) Shareholding:

(a) it is the aggregate shareholding of the promoters and of the directors of the promoter, where the promoter is a company, of the directors and key managerial personnel, as on the date of the notice convening the general meeting;

(b) the aggregate number of equity shares purchased or sold by persons mentioned in sub-clause (a) during a period of twelve months preceding the date of the board meeting at which the buy-back was approved and from that date till the date of notice convening the general meeting;

(c) the maximum and minimum price at which purchases and sales referred to in sub-clause (b) were made along with the relevant date;

(m) if the persons mentioned in l (a) intend to tender their shares for buy-back –

(a) the quantum of shares proposed to be tendered;

(b) the details of their transactions and their holdings in the last twelve months, prior to the date of the board meeting at which the buy-back was approved including information of number of shares acquired, the price and the date of acquisition;

(n) a confirmation that there are no defaults subsisting in repayment of deposits, interest payment thereon, redemption of debentures or payment of interest thereon, or redemption of preference shares, or payment of dividend due to any shareholder, or repayment of any term loans, or interest payable thereon to any financial institution or banking company;

(o) a confirmation:

(a) that the Board of Directors have made a full enquiry into the affairs and prospects of the company and that they have formed the opinion- general meeting is convened there shall be no grounds on which the company could be found unable to pay its debts;

(b) about the company's prospect for the year immediately following that date, its management character and initiations, its financial resources that will be available during that year so that the company shall he able to meet its liabilities as and when they fall due and shall not be rendered insolvent within a period of 1 year from that date; and

(c) the directors have taken into account the liabilities(including prospective and contingent liabilities), as if the company were being wound up under the provisions of the Companies Act, 2013.

(p) a report addressed to the Board of Directors by the company's auditors stating that-

(i) they have inquired into the company's state of affairs;

(ii) the amount of the permissible capital payment for the securities in question is in their view properly determined;

(iii) that the audited accounts on the basis of which calculation with reference to buy-back is done is not more than six months old from the date of offer document; and

(iv) the Board of Directors have formed the opinion as specified in point 'o' on reasonable grounds and that the company, with regard to its state of affairs, shall not be rendered insolvent within a period of one year from that date.

Other Conditions for Buy back

- Every buy-back shall be completed within a period of one year from the date of the resolution or special resolution, as the case may be, passed by the Board. [Section 68(4)]
- The buy-back can be :

(a) from the existing shareholders or security holders on a proportionate basis;

(b) from the open market;

(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity. [Section 68(5)]

- Before making such buy-back, file with the Registrar, a declaration of solvency signed by at least two directors of the company, one of whom shall be the managing director, if any, Form No. SH.9 may be prescribed and verified by an affidavit to the effect that the Board of Directors has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year from the date of declaration adopted by the Board. [Section 68(6)]
- Company shall extinguish and physically destroy the shares or securities so bought back within seven days of the last date of completion of buy-back. [Section 68(7)]
- Where a company completes a buy-back of its shares or other specified securities, it shall not make a further issue of the same kind of shares or other securities including allotment of new shares or other specified securities within a period of six months except by way of:
  (a) bonus issue, or
  (b) in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.
- Company shall maintain a register in Form No. SH.10 of the shares or securities so bought, the consideration paid for the shares or securities bought back, the date of cancellation of shares or securities, the date of extinguishing and physically destroying the shares or securities. The register of shares or securities bought back shall be maintained at the registered office of the company and shall be kept in the custody of the secretary of the company or any other person authorized by the board in this behalf. The entries in the register shall be authenticated by the secretary of the company or by any other person authorized by the Board for the purpose.
- A company shall, after the completion of the buy-back under this section, shall file with the Registrar a return in Form No. SH.11 containing such particulars relating to the buy-back within thirty days of such completion. There shall be annexed to the return, a certificate in Form No. SH.15 signed by two directors of the company including the managing director, if any, certifying that the buy-back of securities has been made in compliance with the provisions of the Act and the rules made thereunder.
- If a company makes any default in complying with the provisions of this section or any regulation made by the Securities and Exchange Board, for the purposes of clause (f) of sub-section (2), the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees.

Transfer of certain sums to capital redemption reserves account (Section 69)

Where a company purchases its own shares out of free reserves or securities premium account, a sum equal to the nominal value of the shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such transfer shall be disclosed in the balance sheet. The Capital Redemption Reserve Account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Prohibition on buy-back in following circumstances (Section 70)

No company shall directly or indirectly purchase its own shares or other specified securities –

(a) through any subsidiary company including its own subsidiary companies;

(b) through any investment company or group of investment companies; or

(c) if a default, is made by the company, in the repayment of deposits accepted either before or after the commencement of this Act, interest payment thereon, redemption of debentures or preference shares or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company. Provided that the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist.

No company shall, directly or indirectly, purchase its own shares or other specified securities in case such company has not complied with the provisions of:

(a) Sections 92: Annual Return

(b) Section 123: Declaration and Payment of Dividend

(c) Section 127: Failure to pay Dividend

(d) Section 129: Failure to give True and Fair Statement

SEBI (Buy-back of Securities) Regulations, 2018

The Securities and Exchange Board of India, has issued the SEBI (Buy-back of Securities) Regulations, 2018 with regard to buy-back of shares or other specified securities by companies.

Modes of buy-back

A company may buy-back its shares or other specified securities by any one of the following methods:

a) from the existing share holders or other specified securities holders on a proportionate basis through the tender offer;

b) from the open market through—

  i) book-building process,

  ii) stock exchange;

c) from odd-lot holders, provided that no offer of buy-back for fifteen per cent or more of the paid up capital and free reserves of the company shall be made from the open market.

Disclosures, filing requirements and timelines for public announcement and draft letter of offer

When a company proposes to buy-back its own shares, and it has been authorised by a special resolution or a resolution passed by the board of directors, as the case may be, shall make a public announcement within two working days from the date of declaration of results of the postal ballot for special resolution/board of directors resolution in at least one English National Daily, one Hindi National Daily and one Regional language daily, all with wide circulation at the place where the Registered Office of the company is situated and the said public announcement shall contain all the material information as specific in these Regulations. A copy of the public announcement along with the soft copy, shall also be submitted to SEBI, simultaneously, through a merchant banker.

The company shall within five working days of the public announcement file the following :

a) A draft letter of offer, along with a soft copy, containing disclosures as specified in these regulations through a merchant banker who is not associated with the company.

b) A declaration of solvency in specified form and in a manner provided in Section 68(8) of the Companies Act, 2013.

c) Prescribed fees as specified in these regulations.

SEBI may provide its comments on the draft letter of offer within seven working days of the receipt of the draft letter of offer. Letter of Offer shall be dispatch to the Shareholders

The company shall dispatch the letter of offer along with the tender form to all securities holders which are eligible to participate in the buy-back offer not later than five working days from the receipt of communication of comments from SEBI.

Note:

- Letter of Offer may also be dispatched through electronic mode in accordance with the provisions of the Companies Act, 2013.
- On receipt of a request from any shareholder to receive a copy of the letter of offer in physical form, the same shall be provided.

If in case an eligible public shareholder does not receive the tender offer/offer form, even though he can participate in the buy-back offer and tender shares in the manner as provided by SEBI.

The date of the opening of the offer shall be not later than five working days from the date of dispatch of the letter of offer. It shall be remain opened for a period of ten working days.

The company shall provide the facilities for tendering of shares by the shareholders and settlement of the same, through the stock exchange mechanism in the manner as provided by SEBI.

Additional Conditions for Buyback of Shares or Other Securities

A company shall not buy-back its shares or other specified securities :

a) so as to delist its shares or other specified securities from the stock exchange.

b) from any person through negotiated deals, whether on or off the stock exchange or through spot transactions or through any private arrangement.

A company shall not make any offer of buy-back within a period of one year reckoned from the date of expiry of buyback period of the preceding offer of buy-back, if any.

A company shall not allow buy-back of its shares unless the consequent reduction of its share capital is affected.

Escrow account

Regulation 9(xi) of SEBI (Buy back of Securities) Regulations, 2018 provides that a company shall, as and by way of security for performance of its obligations under the regulations, on or before the opening of the offer, deposit in an escrow account such sum as specified below:

The escrow amount shall be payable in the following manner:

a) if the consideration payable does not exceed Rupees 100 crores; 25 per cent of the consideration payable;

b) if the consideration payable exceeds Rupees 100 crores; 25 per cent upto Rupees 100 crores and 10 per cent thereafter.

The escrow account referred to in this regulation shall consist of,

(i) cash deposited with a scheduled commercial bank, or

(ii) bank guarantee in favour of the merchant banker, or

(iii) deposit of acceptable securities with appropriate margin, with the merchant banker, or

(iv) a combination of (i), (ii) and (iii) above.

Advantages of Buy-Back

Buy-back have the following advantages:

(i) A company with capital, which cannot be profitably employed, may get rid of it by resorting to buy-back, and restructuring its capital.

(ii) Free reserves which are utilized for buy-back instead of paying dividend enhance the value of the company's shares and improve its earnings per share.

(iii) Surplus cash may be utilized by the company for buy-back and avoid the payment of dividend tax.

(iv) Buy-back may be used as a weapon to frustrate any hostile takeover of the company by undesirable persons.

Accounting for Buy-Back

Buy-back of shares is just the opposite of issue of shares. Just as shares may be issued at par, at a premium, even buy-back may be at par, at a premium or at a discount. The basis of accounting for buy-back is Section 68 of the Companies Act, 2013. This Section not only permits a company to buy-back or redeem its equity shares, but also specifies the sources from out of which repurchase is to be effected.

According to Section 68(1), a company may buy-back its shares or other specified securities from out of:

1. Its free reserves, or
2. The securities premium account, or
3. The proceeds of any shares or other specified securities.

However, no buy-back of shares shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities. This Section also lays down that all the shares or other specified securities for buy-back are fully paid up.

As per Section 69, when a company purchases its own shares out of free reserves. Then a sum equal to the nominal value of the shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such transfer should be disclosed in the balance sheet.

The Capital Redemption reserve account may be applied by the company, in paying up unissued share of the company to be issued to members of the company as fully paid bonus shares.

DEBENTURES-ISSUE AND REDEMPTION

Introduction

"Debenture" includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the assets of the company or not.

A commercial definition of the debenture is an acknowledgement of a debt in writing, given under the seal of the company, containing a contract for the repayment of the principal sum at a specified date, and for the payment of interest (usually half yearly) at a fixed rate until the principal sum is repaid. It may or may not give a charge on the assets of the company as a security for the loan.

A debenture like a share is also a movable property transferable in the manner provided in the Articles of the company.

Requirement

The long-term requirements of capital are raised by any company primarily through issue of shares and debentures. The shareholders are essentially the owners of the enterprise, those who buy debentures are creditors for long-term funds and do not enjoy voting rights. In brief all securities other than shares issued by a company come under the term debentures.

According to the guidelines issued by the Controller of Capital Issues, the objects of the issue can be among other things:

(1) Setting up of new projects;

(2) Expansion or diversification of existing projects;

(3) Normal capital expenditure for modernization;

(4) To augment long-term resources of the company for working capital requirements;

(5) Merger /Amalgamation of companies in pursuance of schemes approved by banks, financial institutions and/or any legal authority;

Differences between Shares and Debentures

	Shares	**Debentures**
Definition	An instrument to acknowledge the ownership of the company	An instrument to acknowledge thecreditors of the company.
Status	A shareholder is the owner and a member of the company.	A debenture holder is not a member but a creditor.
Return	A shareholder may receive dividend only when a company makes a profit.	A debenture holder has a right to interest even if the company does not make profit.
Rate of return	Dividend rate can vary depending on the profit position.	Debenture carries a fixed rate of interest.
Accounting treatment	Dividend is given out of appropriable profit and not chargeable to Profit and Loss account.	Debenture interest is chargeable to Profit and Loss account.

Redemption	In the case of shares, the concept of redemption does not apply. However, a company can buy-back shares in accordance with the provisions in the Companies Act.	Debentures are normally redeemable although a company can issue perpetual debentures.
Voting rights	A shareholder has voting rights.	A debentureholder cannot have voting rights.
Status at the time of winding up	At the time of winding up shareholders have the least priority regarding the return of amount due to them.	At the time of winding up debenture holders have a priority over the share holders regarding the return of amount due to them.

ACCOUNTING FOR DEBENTURES

There are three stages of accounting for debentures:

(i) When debentures are issued;

(ii) When provision for their redemption is made; and

(iii) When ultimately debentures are redeemed. A detailed study of each stage is made in the following pages.

1. ISSUE OF DEBENTURES

Debenture [Section 71]

(1) A company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. Provided that the issue of such debentures, shall be approved by a special resolution passed at a general meeting.

(2) No company shall issue any debentures carrying any voting rights.

(3) Secured Debentures may be issued by a company subject to such terms and conditions as may be prescribed.

(4) Where debentures are issued by a company under this section, the company shall create a Debenture Redemption Reserve Account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilized by the company except for the redemption of debentures.

(5) No company shall issue a prospectus, or make an offer, or give an invitation to the public or to its members exceeding five hundred for the subscription of its debentures, unless the company has, before such issue or offer, appointed one or more debenture trustees, and the conditions governing the appointment of such trustees shall be such as may be prescribed.

(6) A debenture trustee shall take steps to protect the interests of the debenture holders and redress their grievances in accordance with such rules as may be prescribed.

(7) Any provision contained in a trust deed for securing the issue of debentures, or in any contract with the debenture holders secured by a trust deed, shall be void in so far as it would have the effect of exempting a trustee thereof from, or indemnifying him against, any liability for breach of trust, where he fails to show the degree of care and due diligence required of him as a trustee, with regard to the provisions of the trust deed conferring on him any power, authority or discretion; provided that the liability of the debenture trustee shall be subject to such exemptions as may be agreed upon by a majority of debenture holders holding not less than three-fourths in value of the total debentures at a meeting held for the purpose.

(8) A company shall pay interest and redeem the debentures in accordance with the terms and conditions of their issue.

(9) When at any time the debenture trustee comes to a conclusion that the assets of the company are insufficient or are likely to become insufficient to discharge the principal amount as and when it becomes due, the debenture trustee may file a petition before the Tribunal and the Tribunal may, after hearing the company and any other person interested in the matter, by order, impose such restrictions on the

incurring of any further liabilities by the company as the Tribunal may consider necessary in the interests of the debenture holders.

(10) When a company fails to redeem the debentures on the date of their maturity or fails to pay interest on the debentures when it is due, the Tribunal may, on the application of any or all of the debenture holders, or debenture trustee and, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith on payment of principal and interest due thereon.

(11) If any default is made in complying with the order of the Tribunal under this section, every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to three years, or with a fine which shall not be less than two lakh rupees and which may he extended to five lakh rupees, or with both.

(12) A contract with the company to take up and pay for any debentures of the company may be enforced by a decree for specific performance.

(13) The Central Government may prescribe the procedure, for securing the issue of debentures, the form of debenture trust deed, the procedure for the debenture holders to inspect the trust deed and to obtain copies thereof, quantum of debenture redemption reserve required to be created and such other matters.

Issue of Secured Debenture

The company shall not issue Secured Debentures, unless it complies with the following conditions, namely:-

a) an issue of Secured Debentures may be made provided the date of its redemption shall not exceed ten years from the date of issue.

Provided that the following classes of companies may issue secured debentures for a period exceeding ten years but not exceeding thirty years,

(i) Companies engaged in setting up of infrastructure projects;

(ii) 'Infrastructure Finance Companies' as defined in clause (vii-a) of sub-direction (1) of direction 2 of Non-Banking Financial (Non-deposit accepting or holding) Companies Prudential Norms (Reserve Bank) Directions, 2007;

(iii) 'Infrastructure Debt Fund Non-Banking Financial companies' as defined in clause (b) of direction 3 of Infrastructure Debt Fund Non-Banking Financial Companies (Reserve Bank) Directions, 2011.

(iv) Companies permitted by a Ministry or Department of the Central Government or by Reserve Bank of India or by the National Housing Bank or by any other statutory authority to issue debenture for a period exceeding ten years.

(b) such an issue of debentures shall be secured by the creation of a charge, on the properties or assets of the company, having a value which is sufficient for the due repayment of the amount of debentures and interest thereon;

(c) the company shall appoint a debenture trustee before the issue of prospectus or letter of offer for subscription of its debentures and not later than sixty days after the allotment of the debentures, execute a debenture trust deed to protect the interest of the debenture holders ; and

(d) the security for the debentures by way of a charge or mortgage shall be created in favour of the debenture trustee on –

(i) any specific movable property of the company (not being in the nature of pledge); or

(ii) any specific immovable property wherever situate, or any interest therein.

ACCOUNTING ASPECTS OF ISSUE DEBENTURES

Accounting aspects of issue of debenture may be studied from three different sides.

(1) What would be the consideration?

(a) Issued for cash

(b) Issued for consideration other than cash

(c) Issued as collateral security

(2) What would be the issue price?

(a) Issued at par

(b) Issued at a premium

(c) Issued at a discount

(3) How the redemption be made.

(a) Redeemed at par

(b) Redeemed at a premium

(c) Redeemed at a discount

Combining (2) and (3), the following are the options of issue.

(a) Issued at par and redeemable at par

(b) Issued at a discount and redeemable at par

(c) Issued at a premium and redeemable at par

(d) Issued at a premium and redeemable at a premium

(e) Issued at par and redeemable at a premium

(f) Issued at a discount and redeemable at a premium

The accounting entries for the above six combinations are given in the table below.

	Transaction	**Account**	
		Debited	**Credited**
A.	Issued at par and redeemable at par	Bank	Debentures
B.	Issued at a discount and redeemable at par	Bank Discount on issue of debentures	Debentures
C.	Issued at a premium and redeemable at par	Bank	Debentures Security Premium
D.	Issued at a premium and redeemable at premium	Bank Loss on the issue of debenture	Debentures A/c Security Premium Prem. on redemption of debentures.
E.	Issued at par and redeemable at a premium	Bank Loss on the issue of debentures	Debentures Prem. on redemption of debentures
F.	Issued at discount and redeemable at a premium	Bank Loss on the issue of Debentures **	Debentures Prem. on redemption of debentures

** Loss on the issue of debentures includes discount on issue and a premium on redemption.

Issue for Consideration other than Cash

In this case debentures are issued for consideration other than cash. Examples are allotment of debentures for assets purchased or technical services received. There is no receipt of cash in these transactions for the allotment of debentures.

Debentures issued as Collateral Security

(a) This is the third type of consideration for which company issues debentures. The issue of debentures as a collateral security means issue of debentures as a subsidiary or secondary security, that is, a security in addition to the prime security. Secondary security is to be realized only when the prime security fails to pay the amount of loan. Debentures issued as a collateral security can be dealt within two ways in the books:

a. First Method

No entry is made in the books. On the liability side of the balance sheet below the item of loan a note that it has been secured by the issue of debentures is to be given. This is shown in the balance sheet as follows:

b. Second method

Sometimes the issue of debentures as collateral security is recorded by making a journal entry as follows:

Debenture suspense account	Dr.	(This appears on the assets side)
To Debenture account		(This appears on the liabilities side)

When the loan is paid the above entry is cancelled by means of a reverse entry.

Discount on the issue of Debenture

When debentures are issued at a discount, it is prudent to write off the loss during the life of debentures.

REDEMPTION OF DEBENTURES

Redemption of debentures is the process of discharging the liability on account of debentures in accordance with the terms of redemption stated in the debenture trust deed. Discharge of debenture liability is usually by paying cash to the debenture holders. But this can take other forms, such as conversion or rollover. In the case of conversion debentures are converted into preference shares or equity shares. Rollover refers to the issue of new debentures, in exchange for the old ones. Both conversion and rollover are subject to detailed SEBI guidelines.

When a company issues debentures it must also plan the resources required for such redemption. This can be done by setting aside profits every year and investing them wisely in investments outside, so that there will be no liquidity problem at the time of redemption. Alternatively, the company can take an insurance policy by paying regular premium, so that the policy matures coinciding with the time of redemption. With the amount received on the maturity of policy the company faces no problem in carrying out the redemption. These are the two ways in which a company can make provisioning for redemption of debentures.

CREATION OF DEBENTURE REDEMPTION RESERVE (DRR) ACCOUNT

According to Sub rule 7 of Rule 18 of The Companies (Share Capital and Debentures) Rules, 2014, The company shall create a Debenture Redemption Reserve for the purpose of redemption of debentures, in accordance with the conditions given below-

(a) the Debenture Redemption Reserve shall be created out of the profits of the company available for payment of dividend;

(b) the company shall create Debenture Redemption Reserve (DRR) in accordance with following conditions:-

  (i) No DRR is required for debentures issued by All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures. For other Financial Institutions (FIs) within the meaning of clause (72) of section 2 of the Companies Act, 2013, DRR will be as applicable to NBFCs registered with RBI.

  (ii) For NBFCs registered with the RBI under Section 45-IA of the RBI (Amendment) Act, 1997, and for housing finance companies registered with the national housing bank] 'the adequacy' of DRR will be 25% of the value of outstanding debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities) Regulations, 2008, and no DRR is required in the case of privately placed debentures.

  (iii) For other companies including manufacturing and infrastructure companies, the adequacy of DRR will be 25% of the value of outstanding debentures issued through public issue as per present SEBI (Issue and Listing of Debt Securities), Regulations 2008 and also 25% DRR is required in the case of privately placed debentures by listed companies. For unlisted companies issuing debentures on private placement basis, the DRR will be 25% of the value of outstanding debentures.

Provided that where a company intends to redeem its debentures prematurely, it may provide for transfer of such amount in Debenture Redemption Reserve as is necessary for redemption of such debentures even if it exceeds the limits specified in this sub-rule.

(c) every company required to create Debenture Redemption Reserve shall on or before the 30th day of April in each year, invest or deposit, as the case may be, a sum which shall not be less than fifteen percent, of the amount of its debentures maturing during the year ending on the 31st day of March of the next year, in any one or more of the following methods, namely:-

(i) in deposits with any scheduled bank, free from any charge or lien;

(ii) in unencumbered securities of the Central Government or of any State Government;

(iii) in unencumbered securities mentioned in sub-clauses (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882;

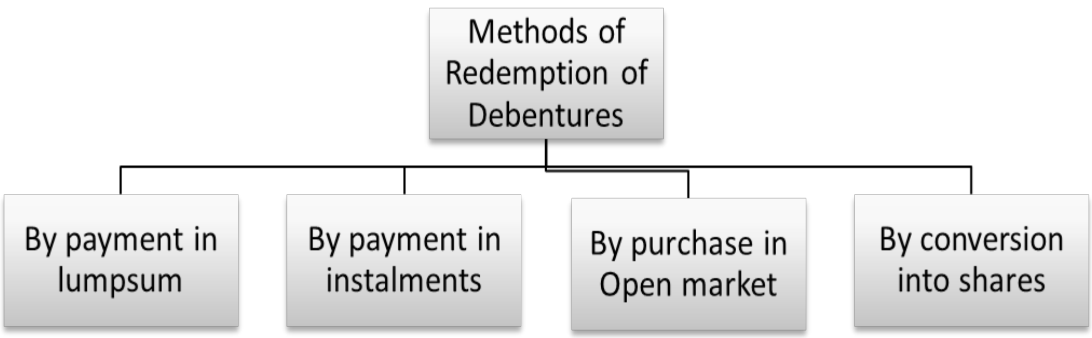
(iv) in unencumbered bonds issued by any other company w hich is notified under sub-clause (f) of section 20 of the Indian Trusts Act, 1882;

(v) the amount invested or deposited as above shall not be used for any purpose other than for redemption of debentures maturing during the year referred above: Provided that the amount remaining invested or deposited, as the case may be, shall not at any time fall below fifteen per cent of the amount of the debentures maturing during the year ending on the 31st day of March of that year;

(d) in case of partly convertible debentures, Debenture Redemption Reserve shall be created in respect of non-convertible portion of debenture issue in accordance with this sub-rule.

(e) the amount credited to the Debenture Redemption Reserve shall not be utilised by the company except for the purpose of redemption of debentures

METHODS OF REDEMPTION OF DEBENTURES



Redemption of debentures must be done according to the terms of issue of debentures and any deviation there from will be treated as a default by the company. Redemption by paying off the debt on account of debentures issued can be done in one of the following methods:

1. **By payment in lumpsum**

   Under payment in lumpsum method, at maturity or at the expiry of a specified period of debenture the payment of entire debenture is made in one lot or even before the expiry of the specified period.

2. **By payment in Instalments**

   Under payment in installments method, the payment of specified portion of debenture is made in installments at specified intervals.

3. **Purchase of Debentures in Open Market**

   Debentures sometimes are purchased in open market; where there is a Debenture Redemption Reserve out of the reserve and, if there is none, as a general investment; the Debenture Investment Account or Own Debenture Account is debited.

4. Conversion into Shares

A company may issue convertible debentures, giving options to the debenture holders to exchange their debentures for equity shares or preference shares in the company.

EMPLOYEE STOCK OPTION PLAN (ESOP), EMPLOYEES STOCK OPTION SCHEME (ESOS)

Issue of Employee Stock Options

A company, other than a listed company, which is not required to comply with Securities and Exchange Board of India Employee Stock Option Scheme Guidelines shall not offer shares to its employees under a scheme of employees' stock option (hereinafter referred to as "Employees Stock Option Scheme"), unless it complies with the following requirements, namely:-

(1) the issue of Employees Stock Option Scheme has been approved by the shareholders of the company by passing a special resolution.

Explanation: For the purposes of clause (b) of Sub-section (1) of Section 62 and this rule "Employee" means-

(a) a permanent employee of the company who has been working in India or outside India; or

(b) a director of the company, whether a whole time director or not, but excluding an independent director; or

(c) an employee as defined in clauses (a) or (b) of a subsidiary, in India or outside India, or of a holding company of the main company, or of an associate company.

Employees Stock Option Scheme does not include –

(i) an employee who is a promoter or a person belonging to the promoter group; or

(ii) a director who either himself or through his relative or through anybody in the corporate, directly or indirectly, holds more than ten percent of the outstanding equity shares of the company.

(2) The company shall make the following disclosures in the explanatory statement annexed to the notice for passing of the resolution-

(a) the total number of stock options to be granted;

(b) identification of classes of employees entitled to participate in the Employees Stock Option Scheme;

(c) the appraisal process for determining the eligibility of employees to the Employees Stock Option Scheme;

(d) the requirements of vesting and period of vesting;

(e) the maximum period within which the options shall be vested;

(f) the exercise price or the formula for arriving at the same;

(g) the exercise period and process of exercise;

(h) the lock-in period, if any ;

(i) the maximum number of options to be granted per employee and in aggregate;

(j) the method which the company shall use to value its options;

(k) the conditions under which option vested in employees may lapse, e.g., in case of termination of employment for misconduct;

(l) the specified time period within which the employee shall exercise the vested options in the event of a proposed termination of employment or resignation of employee; and

(m) a statement to the effect that the company shall comply with the applicable accounting standards.

(3) The companies granting option to their employees pursuant to Employees Stock Option Scheme will have the freedom to determine the exercise price in conformity with the applicable accounting policies, if any.

(4) The approval of shareholders by way of separate resolution shall be obtained by the company in case of-

(a) grant of option to employees of subsidiary or holding company; or

(b) grant of option to identified employees, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant of option.

(5) (a) The company may by special resolution vary the terms of Employees Stock Option Scheme not yet exercised by the employees, provided such variation is not prejudicial to the interests of the option holders.

(b) The notice for passing special resolution for variation of terms of Employees Stock Option Scheme shall disclose complete variation, the rationale of it, and the details of the employees who are beneficiaries of such variation.

(6) (a) There shall be a minimum period of one year between the grant of options and vesting of option:

In a case where options are granted by a company under its Employees Stock Option Scheme, in lieu of options held by the same person under an Employees Stock Option Scheme in another company, which has merged or amalgamated with the first-mentioned company, the period during which the options granted by the merging or amalgamating company were held by him shall be adjusted against the minimum vesting period required under this clause;

(b) The company shall have the freedom to specify the lock-in period for the shares issued pursuant to exercise of option.

(c) The Employees shall not have right to receive any dividend, or to vote, or in any manner enjoy the benefits of a shareholder in respect of option granted to them, till shares are issued on exercise of option.

(7) The amount, if any, payable by the employees, at the time of grant of option-

(a) may be forfeited by the company if the option is not exercised by the employees within the exercise period; or

(b) the amount may be refunded to the employees if the options are not vested due to non-fulfillment of conditions relating to vesting of option as per the Employees Stock Option Scheme.

(8) (a) The option granted to employees shall not be transferable to any other person.

(b) The option granted to the employees shall not be pledged, hypothecated, mortgaged or otherwise encumbered or alienated in any other manner.

(c) Subject to clause (d), no person other than the employees to whom the option is granted shall be entitled to exercise the option.

(d) In the event of the death of employee, while in employment, all the options granted to him till such date shall vest in the legal heirs or nominees of the deceased employee.

(e) In case the employee suffers a permanent incapacity while in employment, all the options granted to him as on the date of permanent incapacitation, shall vest in him on that day.

(f) In the event of resignation or termination of employment, all options not vested in the employee as on that day shall expire. However, the employee can exercise the options granted to him which are vested within the period specified in this behalf, subject to the terms and conditions under the scheme granting such options as approved by the Board.

(9) The Board of Directors shall, inter alia, disclose in the Directors' Report for the year, the following details of the Employees Stock Option Scheme:

(a) options granted;

(b) options vested;

(c) options exercised;

(d) the total number of shares arising as a result of exercise of option;

(e) options lapsed;

(f) the exercise price;

(g) variation of terms of options;

(h) money realized by exercise of options;

(i) total number of options in force;

(j) employee-wise details of options granted to;-

(i) key managerial personnel;

(ii) any other employee who receives a grant of options in any one year of option amounting to five percent or more of options granted during that year.

(iii) identified employees who were granted the option, during any one year, equal to or exceeding one percent of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

(10) (a) The company shall maintain a Register of Employee Stock Options in Form No. SH.6 and shall enter therein the particulars of option granted under clause (b) of Sub-section (1) of Section 62.

(b) The Register of Employee Stock Options shall be maintained at the registered office of the company or such other place as the Board may decide.

(c) The entries in the register shall be authenticated by the company secretary of the company or by any other person authorized by the Board for the purpose.

(11) Where the equity shares of the company are listed on a recognized stock exchange, the Employees Stock Option Scheme shall be issued, in accordance with the regulations made by the Securities and Exchange Board of India in this behalf.

The Institute of Chartered Accountants of India has issued guidance note on Accounting for Employee Share-based payments. The Guidance Note has suggested the following guidelines for accounting of ESOPs:

Some employers use share-based payments as a part of remuneration package for their employees. Such payments generally take the terms of Employee Stock Option Plans (ESOPs). The guidance not recognizes that there are two methods of accounting for employee share-based payments viz. the fair value method and the intrinsic value method and permits as an alternative the intrinsic value method with fair value disclosures.

An enterprise should recognize as an expense (except where service received qualifies to be included as part of the cost of an asses) the services received in an equity-settled employee share-based payments plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Option Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in the Guidance Note.

If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employees as a consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognize services received in full with a corresponding credit to equity account.

- If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments would be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time-proportion basis, with a corresponding credit to the equity account.
- An enterprise should measure the fair value of shares, or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted. If market prices are not available, the enterprise should estimate the fair value of the

instruments granted using a valuation technique to estimate what the price of those instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, wiling parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock option) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price.

Employees Stock Option Scheme (ESOS)

ESOP means a scheme under which the company grants option (a right but not an obligation) to an employee to apply for shares of the company at a predetermined price. This right is exercisable by the employee, during the specified period. Section 2(37) of the Companies Act, 2013 states that the "employee stock option" means the option given to the whole time director, officers or employees of a company which gives such directors, officers or employees the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a predetermined price. The SEBI has issued guidelines for ESOS of listed companies. These guidelines are also applicable for Employee Stock Purchase Scheme (ESPS), which implies a scheme under which the company offers shares to employee as part of public issue or otherwise.

Accounting for ESOP – The option discount (which is also known as fair value or accounting value of options) granted to employees during the accounting period should be treated as compensation to employees. Option discount means the excess of the market value of the share at the date of grant of the option under ESOS over the exercised price of the option (including upfront payment, if any). The option discount should be amortized on a straight-line basis over the vesting period, i.e., the period over which option is exercisable.

Disclosure in the Director's Report – The Board of Directors shall inter alia disclosure either in the Director's Report or in the annexure to the Director's Report the following details of the ESOS:

(a) Options granted;

(b) The pricing formula;

(c) Options vested;

(d) Options exercised;

(e) The total number of shares arising as a result of exercise of option;

(f) Options lapsed;

(g) Variation of terms of options;

(h) Money realized by exercise of options;

(i) Total number of options in force;

(j) Employee wise details of options granted to:

   (i) Senior managerial personnel;

   (ii) Any other employee who receives a grant in any one year of option amounting to 5% or more of option granted during that year;

   (iii) Identified employees who were granted option, during any one year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

(k) 'diluted earnings per share' pursuant to the issue of shares on exercise of option calculated in accordance.

Equity Shares with Differential Rights

According to Section 43 of the Companies Act, 2013, Equity share capital may be Equity Share Capital with voting right or Equity Share Capital with differential right as to dividend, voting or otherwise.

Rule 4 of the Companies (Share Capital and Debentures) Rules 2014 deals with equity shares with differential rights.

Which Company may issue:

A company limited by shares shall issue equity shares with differential rights as to dividend, voting or otherwise, when it complies with the following conditions, namely:-

(a) The articles of association of the company authorize the issue of shares with differential rights.

(b) The issue of shares is authorized by an ordinary resolution passed at a general meeting of the shareholders. Where the equity shares of a company are listed on a recognized stock exchange, the issue of such shares shall be approved by the shareholders through postal ballot.

(c) The voting power in respect of shares with differential rights of the company shall not exceed seventy four per cent. of total voting power including voting power in respect of equity shares with differential rights issued at any point of time

(d) The company has not defaulted in filing financial statements and annual returns for three financial years immediately preceding the financial year in which it is decided to issue such shares.

(e) The company has no subsisting default in the payment of a declared dividend to its shareholders or repayment of its matured deposits, or redemption of its preference shares, or debentures that have become due for redemption, or payment of interest on such deposits, or debentures or payment of dividend.

(f) The company has not defaulted in payment of the dividend on preference shares or repayment of any term loan from a public financial institution, or State level financial institution, or scheduled Bank that has become repayable or interest payable thereon, or dues with respect to statutory payments relating to its employees to any authority or default in crediting the amount in Investor Education and Protection Fund to the Central Government. Provided that a company may issue equity shares with differential rights upon expiry of five years from the end of the financial Year in which such default was made good

(g) the company has not been penalized by Court or Tribunal during the last three years of any offence under the Reserve Bank of India Act, 1934, the Securities and Exchange Board of India Act, 1992, the Securities Contracts Regulation Act, 1956, the Foreign Exchange Management Act, 1999 or any other special Act, under which such companies being regulated by sectoral regulators.

This may be noted here that the, penalty by regulators itself causes no disqualification.

EXPLANATORY STATEMENT ANNEXED TO NOTICE

The explanatory statement to be annexed to the notice of the general meeting or of a postal ballot shall contain the following particulars, namely:-

(a) The total number of shares to be issued with differential rights;

(b) The details of the differential rights;

(c) The percentage of the shares with differential rights to the total post-issue paid up equity share capital, including equity shares with differential rights issued at any point of time;

(d) The reasons or justification for the issue;

(e) The price at which such shares are proposed to be issued either at par or at a premium;

(f) The basis on which the price has been arrived at;

(g) In case of:

  (i) Private placement or preferential issue-

    (a) details of total number of shares proposed to be allotted to promoters, directors and key managerial personnel;

    (b) details of total number of shares proposed to be allotted to persons other than the promoters, directors and key managerial personnel, and their relationship, if any, with any of the promoters, director or key managerial personnel;

  (ii) Public issue-

  Reservation, if any, for different classes of applicants including promoters, directors or key managerial personnel;

(h) The percentage of voting right which the equity share capital with differential voting right shall carry to the total voting right of the aggregate equity share capital;

(i) The scale or proportion in which the voting rights of such class or type of shares shall vary;

(j) The change in control, if any, in the company that may occur consequent to the issue of equity shares with differential voting rights;

(k) The diluted Earning per Share (EPS) pursuant to the issue of such shares, calculated in accordance with the applicable accounting standards;

(l) The pre- and post-issue shareholding pattern along with voting rights as per clause 35 of the listing agreement issued by Security Exchange Board of India from time to time.

Please note here, Clause 35 is specially made applicable to the company issuing equity shares with differential rights for the purpose of these subrules.

No Conversion:

The company shall not convert its existing equity share capital with voting rights into equity share capital carrying differential voting rights and vice versa.

Disclosure in Board's Reports:

The Board of Directors shall, inter alia, disclose in the Board's Report for the financial year in which the issue of equity shares with differential rights was completed the following are the details :

(a) The total number of shares allotted with differential rights;

(b) The details of the differential rights relating to voting rights and dividends;

(c) The percentage of the shares with differential rights to the total post-issue equity share capital with differential rights issued at any point of time and percentage of voting rights which the equity share capital with differential voting right shall carry to the total voting right of the aggregate equity share capital;

(d) The price at which such shares have been issued;

(e) The particulars of promoters, directors or key managerial personnel to whom such shares are issued;

(f) The change in control, if any, in the company resolution from the issue of equity shares with differential voting rights;

(g) The diluted Earning per Share (EPS) pursuant to the issue of each class of shares, calculated in accordance with the applicable accounting standards;

(h) The pre and post issue shareholdings pattern along with voting rights in the format specified under sub-rule (2) of rule 4.

General Rights available:

The holders of the equity shares with differential rights shall enjoy all other rights such as bonus shares, and rights shares etc., which the holders of equity shares are entitled to, subject to the differential rights with which such shares have been issued.

Entry in Register of Members:

Where a company issues equity shares with differential rights, the Register of Members maintained under Section 88 shall contain all the relevant particulars of the shares so issued along with details of the shareholders.

However, according to the Companies (Share Capital and Debentures) Amendment Rules, 2014 of 18th June 2014, it is hereby clarified that equity shares with differential rights issued by any company under the provisions of the Companies Act, 1956 (1 of 1956) and the rules made thereunder, shall continue to be regulated under such provisions and rules. This means provisions of earlier Act shall continue to apply.

UNDERWRITING OF SHARES

Underwriting is an agreement, with or without conditions, to subscribe to the securities of a body corporate when existing shareholders of the corporate or the public do not subscribe to the securities offered to them.

When a company goes in for an Initial Public Offer (IPO), it may face certain uncertainty about whether its Offer of shares or other securities will be subscribed in full or not. If the public issue does not get fully subscribed, the project for which the funds are being raised cannot be implemented. As per law, it is required that if the company is not able to collect 90% of the offer amount, then it needs to compulsorily return the money to those who have subscribed to the shares.

To avoid the risk of undersubscription companies may seek the help of a specialized group of risk redeemers called underwriters. The function of the Underwriters is to arrange subscription of floated shares.

If the whole or a certain portion of the shares or debentures of the company are not applied for by the public, the underwriters themselves apply or persuade others to apply for those shares or debentures. The underwriters, as risk takers, and are entitled to get commission at prescribed rates.

It can be easily comprehended that when the floated shares are likely to be undersubscribed, the underwriters come to the forefront. In other cases they remain in the background, acting as catalysts arranger of sale to the investing public.

Before entering into an agreement with the company, the underwriters assess the following:

(a) worth of the public issue;

(b) market response to the issue; and

(c) their own ability to get the issue fully subscribed.

Depending upon the risk assessment of the issue, the underwriters decide on their amount of commission. Owing to under subscription, if the issue is devalues, the underwriters pay up the required amount and deduct their commission from that.

From the viewpoint of the issuer company, the following are generally observed:

(a) While selecting underwriters and finalizing underwriting arrangements, lead merchant bankers shall ensure that the underwriters do not overexpose themselves so that it may become difficult to fulfill underwriting commitments.

(b) The overall exposure of underwriter(s) belonging to the same group or management in an issue shall be assessed carefully by the lead merchant banker.

(c) The lead merchant banker shall satisfy themselves about the ability of the underwriters to discharge their underwriting obligations satisfactorily.

(d) The lead merchant banker shall:

   (i) incorporate a statement in the offer document to the effect that in the opinion of the lead merchant banker, the underwriters' assets are adequate to meet their underwriting obligations;

   (ii) Obtain underwriters' written consent before including their names as underwriters in the final offer document.

(e) In order to ascertain the underwriters' worth, the lead merchant banker(s) shall undertake a minimum

(f) underwriting obligation of 5% of the total underwriting commitment, or Rs. 25 lacs whichever is less.

(g) The outstanding underwriting commitments of a merchant banker shall not exceed 20 times its net

(h) worth, any point of time.

(i) With respect to an underwritten issue, the lead merchant banker shall ensure that the relevant details are included in the offer document underwriters.

It should be noted that as per the latest SEBI Guidelines underwriting is not mandatory.

Under the SEBI rules, no person other than a share broker or merchant banker can act as an underwriter unless he holds a certificate granted by SEBI.

Regarding underwriting, the following disclosures should be made in the Offer Document:

(a) Names and addresses of the underwriters and the amount underwritten by them.

(b) Declaration by the Board of Directors of the issuing company that the underwriters have sufficient resources to discharge their respective obligations.

Underwriting Agreement

An underwriting agreement is a contract between a group of investment bankers who form an underwriting group or syndicate and the issuing corporation of a new securities issue. The purpose of the underwriting agreement is to ensure that all of the players understand their responsibility in the process, thus minimizing potential conflict. The underwriting agreement is also called an underwriting contract.

Sub-Underwriters

In order to spread the risk of under subscription, the principal underwriters may enter into subsidiary agreements with sub-underwriters. Such agreements are made between the underwriters alone, with the company not being a party thereto. As per agreement, the company pays commission at a prescribed rate to the principal underwriters, who in turn, disburse commission to the sub-underwriters. Sometimes an additional commission is paid to the principal underwriters to encourage sub-underwriting. This is known as over-riding commission. The payment of an over-riding commission enables the company to deal with first one or two underwriters instead of a number of them.

Underwriting Commission

It may be paid in cash or in fully paid up shares or debentures or a combination of all these. It is paid on the issue price of the shares or debentures so underwritten. As per the provision of Section 40 of the Companies Act, 2013, commission is payable, if the following conditions are satisfied:

(a) The payment of the commission is authorized by the articles;

(b) the commission may be paid out of proceedings of the issue or the profit of the company or both.

(c) The commission paid or agreed to be paid does not exceed in the case of shares, five per cent of the price at which the shares are issued or the amount or rate authorized by the articles, whichever is less, and in the case of debentures, two and a half per cent of the price at which the debentures are issued or the amount or rate authorized by the articles, whichever is less;

(d) the prospectus of the company shall disclose -

   (i) the name of the underwriters;

   (ii) the rate and amount of the commission payable to the underwriter; and

   (iii) the number of securities which is to be underwritten or subscribed by the underwriter absolutely or conditionally.

(e) there shall not be paid commission to any underwriter on securities which are not offered to the public for subscription;

(f) 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.

Full and Partial Underwriting

When the whole issue is underwritten by the underwriter(s) it is called full underwriting. When a part (say 75%) of the whole issue is underwritten by the underwriter(s) it is called partial underwriting. In this case the company is treated as having underwritten the balance of shares.

Accounting Entries

1. For Commission/brokerage due:

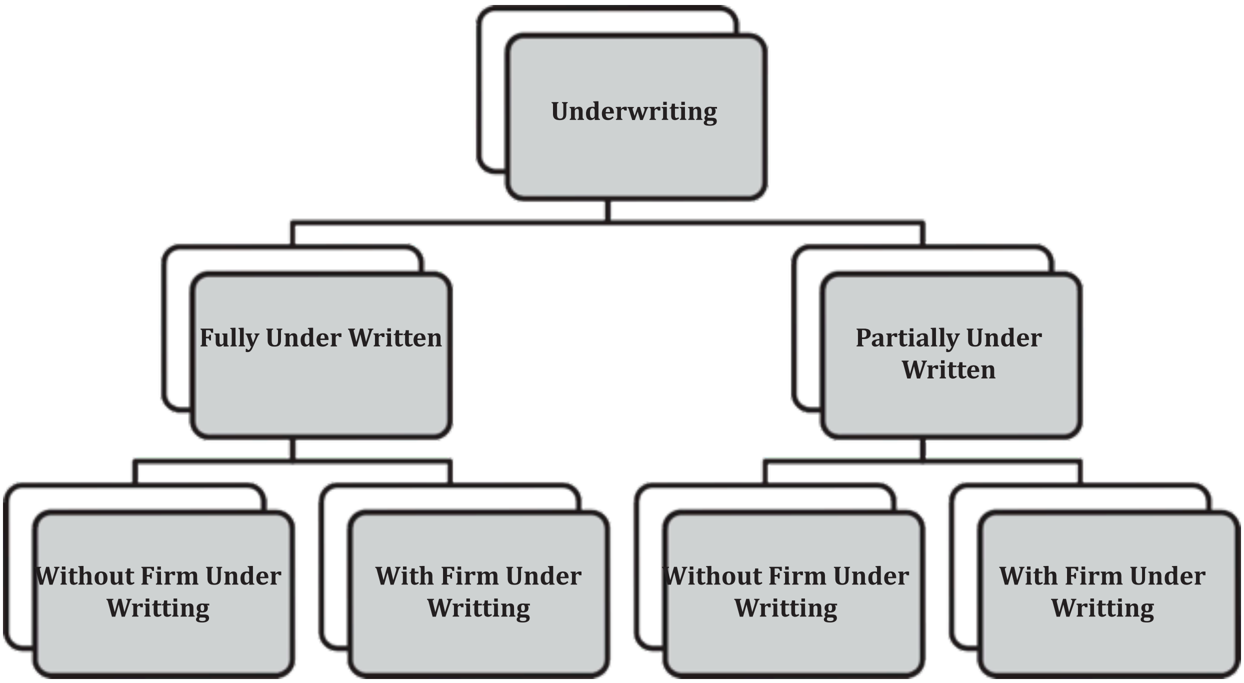
Commission/Brokerage A/c	Dr.
To Underwriter Account	
To Broker Account	

2. For payment of Commission/brokerage

Underwriter Account	Dr.
Broker Account	Dr.
To Bank Account [Cheque]	
To Share Capital Account [Shares]	
To Debentures Account [Debentures]	

Determination of Liability in respect of Underwriting Contract

The nature of underwriting contract determines the liability of the underwriter. The different types of underwriting contract with their subdivisions can be shown with the help of the following diagram:



1(a) When the Issue is Fully Underwritten [without Firm Underwriting]

If the entire issue has been underwritten by one underwriter, the determination of his liability is very simple. The total number of applications (both marked and unmarked) are deducted from the number of shares underwritten and the resultant figure is treated as a liability of the underwriter. For example, X Ltd. issued 1,00,000 equity shares of Rs. 10 each. The issue was fully underwritten by A. However, the company received applications for 80,000 shares which includes marked applications for 60,000 shares.

Here, A's liability will be 1,00,000- 60,000- 20,000 = 20,000 shares. A would get full credit for the unmarked 20,000 applications.

If the entire issue has been underwritten by a number of underwriters, certain difficulties may arise in respect of division of unmarked applications.

The unmarked applications can be divided between the underwriters in the following two ways.

Method 1

Under this method, all unmarked applications are divided between the underwriters in the ratio of gross liability of individual underwriter. For determining the liability of individual underwriter, the following steps are followed:

Step 1 Compute gross liability (if it has not been given) of individual underwriter on the basis of agreed ratio. For example, X Ltd. issued 1,00,000 Equity shares of Rs. 10 each. The issue was underwritten as : A-30%; B -40% and C-30%. Here the gross liability will be: A-30% of 1,00,000 = 30,000 Shares; B-40% of 1,00,000 = 40,000 shares C-30% of 1,00,000 = 30,000 shares.

Step 2 Subtract marked applications from gross liability of respective underwriters.

Step 3 Determine the number of unmarked applications. (Unmarked application = Total applications received less marked applications). Divide unmarked applications between different underw1iters in the ratio of gross liability, as per our example, in the ratio of 3:4:3. If the resultant figures are all positive or zero, then stop here. Now these figures represent the net liability of each underwriter. If some of the resultant figures are negative, then continue to Step 4.

Step 4 Add all negative figures and divide the resultant ones between the underwriters having positive figures in the ratio of gross liability inter se (for details see Illustration 3). Repeat Step 4 unless all figures are non-negative. Now these figures represent the net liability of each underwriter.

Method 2

Under this method, all unmarked applications are divided between the underwriters in the ratio of gross liability less marked applications. For determining the liability of individual underwriter following steps are followed:

Step 1 Compute gross liability in the usual manner (if it has not been given).

Step 2 Subtract marked applications from gross liability of respective underwriters. If some of the resultant figures are negative, add all negative figures and divide their sum in the ratio of gross liability inter se.

Step 3 Determine the number of unmarked applications. Divide unmarked applications between different underwriters in the ratio of gross liability less marked applications, i.e., the resultant figures of Step 2. If the resultant figures of Step 3 are all positive or zero, stop here. Now these figures represent the net liability of each underwriter.

If some of the resultant figures are negative, then continue to Step 4.

Step 4 Add all negative figures and divide their sum between the underwriters having positive figures in the same ratio of Step 3. Repeat Step 4 unless all figures are non-negative. Now these figures represent the net liability.

LESSON ROUND-UP

- When a company has substantial cash resources, it may like to buy its own shares from the market particularly when the prevailing rate of its shares in the market is much lower than the book value or what the company perceives to be its true value.
- As per Section 68, 69, 70 of the Companies Act, 2013 states that a company may purchase its own shares or other specified securities out of its free reserves, and the proceeds of any other shares or other specified securities.
- Buy-back is permissible: (a) from the existing security holders on a proportionate basis through the tender offer; or (b) from the open market.
- Regulation 10(1) of the Securities and Exchange Board of India provides that a company shall, as and by way of security for performance of its obligations on or before the opening of the offer of re- purchase, deposit in an escrow account such sum as is specified in 10(2).
- A company, other than a listed company, which is not required to comply with Securities and Exchange Board of India Employee Stock Option Scheme Guidelines shall not offer shares to its employees under a scheme of employees' stock option (hereinafter referred to as "Employees Stock Option Scheme")
- ESOP means a scheme under which the company grants option (a right but not an obligation) to an employee to apply for shares of the company at a predetermined price. This right is exercisable by the employee, during the specified period.
- Section 2(37) of the Companies Act, 2013 states that the "employee stock option" means the option given to the whole time director, officers or employees of a company which gives such directors, officers of employees the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a predetermined price
- According to Section 43 of the Companies Act, 2013, Equity share capital may be Equity Share Capital
- with the voting right or Equity Share Capital with differential right as to dividend, voting or otherwise.
- Rule 4 of the Companies (Share Capital and Debentures) Rules 2014 deals with equity shares with differential rights.
- The company shall not convert its existing equity share capital with voting rights into equity share
- capital carrying differential voting rights and vice versa.
- The holders of the equity shares with differential rights shall enjoy all other rights, such as bonus shares, rights shares etc., which the holders of equity shares are entitled to, subject to the differential rights with which such shares have been issued
- Where a company issues equity shares with differential rights, the Register of Members maintained under section 88 shall contain all the relevant particulars of the shares so issued along with details of the shareholders.
- Underwriting is an undertaking or guarantee given by the underwriters to the company that the shares or debentures offered to the public will be subscribed for in full.
- An underwriting agreement may be: Complete Underwriting, Partial Underwriting and Firm Underwriting.
- Applications bearing the stamp of the respective underwriters are called marked applications and the applications received directly by the company which do not bear any stamp of the underwriters are known as unmarked applications.

- Debentures may be issued at par, or at a premium, or at a discount.
- Debentures may be issued by a company for cash, for consideration other than cash, and as collateral security.
- The issue of debentures to vendors is known as issue of debentures for consideration other than cash.
- The term 'Collateral Security' implies additional security given for a loan. When a company takes a loan from bank or insurance company, it may issue its own debentures to the lender as collateral security against the loan in addition to any other security that may be offered such an issue of debentures is known as "Debentures Issued as Collateral Security.
- A company may issue debentures on any specific condition as to its redemption, such as: issued at par and redeemable at par, issued at a discount redeemable at par, issued at a premium redeemable at par, issued at par redeemable at a premium, issued at discount, but redeemable at premium.
- When a company issues debentures it undertakes to pay interest thereon at a fixed percentage. The payment of interest on the debt is obligatory on the part of the company issuing them irrespective of the fact whether the company earns profit or not and the interest payable on debentures is a charge against the profits of the company.
- Discount on issue of debentures is a capital loss to the company and it is required to be shown on the assets side of the Balance Sheet under the heading "Other Current or Non-Current Asset" until it is written off.
- When a company issues debentures at par or at a discount which are redeemable at a premium, the premium payable on redemption of the debentures is treated as capital loss.
- Redemption of debentures refers to the discharge of the liability in respect of the debentures issued by a company. Debentures can be redeemed at any time either at par or at a premium or at a discount.
- Debentures may be redeemed by way of: annual drawings, payment in one lump sum at the expiry of a specified period or at the option of the company at a date within such specified period, purchase of debentures in the open market and conversion into shares.
- Interest on debentures is generally paid half-yearly to the holders on certain specified dates. If the purchase price for the debentures includes interest for the expired period, the quotation is said to be "Cum-interest", on the other hand, the purchase price for the debentures excludes the interest for the expired period, the quotation is said to be "Ex-interest".

TEST YOURSELF

1. In April 2009, a company issues 13% Rs 20, 00,000 debentures at Rs 96 but redeemable at Rs 103. Redemption will be carried out by annual drawings of Rs 4 lacs (face value) commencing at the end of March 2014. What do you recommend as the amount to be charged to the profit and loss account, apart from that of interest?

[Ans.: Rs 20,000 p.a. from March 2010 to March 2014,

Rs. 16,000 in March 2015, Rs 12,000 in March 2016,

Rs. 8,000 in March 2017, Rs 4,000 March in 2018].

2. Calculate the amount of discount to be written off each year on the debentures of Rs 60,00,000 issued on 1.1.2014 at a discount of 5% repayable in annual drawings of Rs 10,00,000 each year. Accounting period ends on 31st December.

[Ans.: Ratio - 6 : 5 : 4 : 3 : 2 : 1; Discount Amount : I - Rs 85,714; II - Rs 71,429; III - Rs 57,143; IV - Rs 42,857; V - Rs 28,571 and VI - Rs 14,286].

3. (a) A company issues 11% Rs 10,00,000 debentures, repayable at the end of 10 years at a premium of 5%. It decides to establish a sinking fund to take care of the redemption. Investments in readily marketable securities yield 6% per annum. Sinking Fund Table shows that Rs 0.075868 annually is required to produce Rs 1 at the end of 10 years @ 6%. What is the annual amount that has to be set aside and what account will be debited for credit to the Sinking Fund (Debenture Redemption Fund) A/c?

   (b) If investments are made to the nearest Rs 100, how much will be invested at the end of the 3rd year in the above case?

[Ans.: (a) Rs 79,661.40, debit Profit & Loss Appropriation A/c; (b) Rs 89,500].

4. P. Ltd. issued Rs.10,00,000 13.5% debentures at a discount of 5%; the debentureholders have an option of converting the amount into Rs. 10 equity shares at a premium of 10%. A debentureholder holding Rs 40,000 debentures wishes to exercise the option. How many shares will he get?

[Ans.: 3,454].

5. In 2010 Gee Ltd. issued 10% Rs. 20,00,000 debentures at a discount of 10%; the debentures were redeemable in 2014. In 2014 the company gave the debentureholders the option of converting the debentures into equity shares at a premium of 25%. One debentureholder, holding Rs. 1,00,000 debentures, wants to exercise the option. What is the face value of the shares that he will get?

[Ans.: Rs 80,000].