Chapter - 2

Issue and Redemption of Debentures

Accounting For Debentures

Debenture : It is a document issued by a company under its common seal acknowledging the debt and it also contains the terms of repayment of debt and payment of interest at a specified rate.

Section 2 (30) of Companies Act, 2013 defines debenture as “Debenture includes debenture stock, bonds or any other instrument of a company evidencing a debt, whether constituting a charge on the company’s assets or not.”

Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company’s general meetings of shareholders. The interest paid to them is a charge against profit in the company’s financial statements.

TYPES OF DEBENTURES

Convertibility point of view : There are two types of debentures :

Convertible debentures, which can be converted into equity shares of the issuing company after a predetermined period of time.

These may be **Partly Convertible Debentures (PCD) :** A part of these instruments are converted into Equity shares in the future at notice of the issuer. The issuer decides the ratio for conversion. This is normally decided at the time of subscription.

Fully convertible Debentures (FCD) : These are fully convertible into Equity shares at the issuer’s notice. The ratio of conversion is decided by the issuer. Upon conversion the investors enjoy the same status as ordinary shareholders of the company.

Non-convertible Debentures, which are simply regular debentures, cannot be converted into equity shares. These are debentures without the convertibility feature, these usually carry higher interest rates than their convertible counterparts.

On basis of Security, debentures are classified into:

Secured Debentures : These instruments are secured by a charge on the fixed assets of the issuer company. So if issuer fails to pay of either the principal or interest amount, its assets can be sold to repay the liability towards debenture holders.

Unsecured Debentures : These instrument are unsecured in the sense that if the issuer defaults on payment of the interest or principal amount, the investor is treated like other unsecured creditors of the company.

From Redemption point of view

Redeemable Debentures : Redeemable debentures are those which are redeemed or paid off after the termination of fixed term. The amount paid off includes the principal amount and the current year's interest. The company always has the option of either to redeem a specific number of debentures each year or redeem all the debentures at specified date.

Irredeemable or Perpetual Debentures : Irredeemable debentures are those debentures which do not have any fixed date of redemption. They are redeemed either in the event of winding up or at a very remote period of time. Irredeemable or perpetual debenture holders can never force the company to redeem their debentures.

Distinguish Between a Share and Debenture

Basis	**Share**	**Debenture**
Ownership	Shareholders are the owners of company	Debenture holders are the lenders of company
Form of return	Dividend	Interest
Security	Not secured	Secured by a charge on assets
Voting right	Equity shareholders have the voting right	No voting right in normal course of business
Risk	More risk as compared to	Risk Free due to secured

	Debentures	Debentures

Issue of Debentures:

Debentures can be issued in following ways:

1. for cash
2. for consideration other than cash
3. As collateral security

Terms of Issue

Debentures can be issued in following ways:

1. Issue of Debentures at Par
2. Issue of Debenture at Premium
3. Issue of Debentures at Discount.

Debenture Payable in Installments

1. First instalment paid along with application is called as application money.
2. Second instalment paid on allotment is called as allotment money.
3. Subsequent instalments paid are called as call money calls can be more than one and called First call, second call or as the case may be.

Issue of Debentures for Cash

(a) When Debentures amount received in lump sum with the application

On receipt of application money	Bank A/c Dr. To Debenture Application and Allotment A/c	With the application money received
On acceptance of application money	Debenture Application and Allotment A/c Dr. To X% Debentures A/c To Bank A/c	With Amount of application money on allotted debentures, and Excess amount refunded.

(B) When Debentures amount received in installments.

In this case accounting entries will be same as at the time of issue of shares in instalments with small change in the name of term like-the share capital word replaced with the X% Debentures A/c, and Share word replaced with Debentures e.g. Equity share capital into 8% Debentures, Equity share application into Debentures Application and follows on.

AT Par : means debentures are issued at face value.

Issue of Debentures for Consideration other than Cash

When Debentures are issued for purchased of asset

When Debentures Issued for purchases Asset at par	**Sundry Asset A/c Dr. To Vendor**	**With the purchases consideration**
Vendor Dr. To Debenture Account		
When Debentures are issued for purchases of asset at premium	Sundry Assets A/c Dr. To Vendor Vendor Dr. To Debenture A/c To Security Premium Reserve A/c	With the purchases Consideration No. of debentures par value No. of debentures x premium
When business is Purchased	When Purchase consideration is equal to net value of assets Sundry Assets A/c Dr. To Sundry Liabilities A/c To Vendor When Purchases consideration more than net value of assets Goodwill Account Dr.	Value of asset Value of liabilities Purchases consideration Excess of Purchase Value (B/F) Value of Liabilities Purchases Consideration

	To Sundry Liabilities A/c To Vendor	
	When Purchase Consideration is less than net value of asset Sundry Assets Account Dr. To Sundry Liabilities A/c To Capital Reserve To Vendor	Value of Asset Value of liabilities Difference (B/F Purchases Consideration

Collateral Security : Collateral security means security provided to lender in addition to the principal security. It is a subsidiary or secondary security. Whenever a company takes loan from bank or from any financial institution it may issue its debentures as secondary security which is in addition to the principal security. Such an issue of debentures is known as 'issue of debentures as collateral security'. The lender will have a right over such debentures only when company fails to pay the loan amount and the principal security is exhausted. In case the need to exercise the right does not arise debentures will be returned back to the company. No interest is paid on the debentures issued as collateral security because company pays interest on loan.

In the accounting books of the company issue of debentures as collateral security can be credited in two ways :

i. **First method :** No Journal entry to be made in the books of accounts of the company for debentures issued as collateral security. A note of this fact is given in this case.
ii. **Second method :** Entry to be made in the books of accounts of the company.

A journal entry is made on the issue of debentures as a collateral security, Debentures Suspense Account is debited because no cash is received for such issue.

Following journal entry will be made

Journal

			Debit	Credit

Date	Particulars	LF.	(Rs.)	(Rs.)
	Debenture Suspense A/c Dr. To % Debentures A/c (Being the issue of Debentures of Rs.... each issued as collateral security)			

INTEREST ON DEBENTURES
Interest on Debentures is calculated at a fixed rate on its face value and is usually payable half yearly & is paid even company is suffering from loss because it is charge on profit.

Income Tax is deducted from interest before payment to debenture holders. It is called T.D.S. (Tax deducted at source).

JOURNAL ENTRIES

1.	**When interest is Due**	
	Debentures Interest A/c Dr.	(Gross Interest)
	To Debentures holder A/c	(Net Interest)
	To Income Tax Payable A/c	(Income Tax Deducted)
2.	When Interest is paid	
	Debentures Holder A/c Dr.	(With Interest)
	To Bank A/c	
3.	On payment of Income Tax to Government	
	Income Tax Payable A/c Dr.	(Amount of Income)
4.	On Transfer of Interest on Debenture to statement of profit and Loss A/c	(Tax deducted at source)
	Statement of Profit and Loss Dr.	
	To Debenture Interest A/c	(Amount of Interest)

Company Accounts – Redemption of Debentures

Meaning : Redemption of debentures means repayment of the due amount of debentures holders. Its may be at par or at premium.

Time of Redemption

a. **At maturity :** When repayment is made at the date of maturity of debentures which is determined at the time of issue of debentures.
b. **Before maturity :** If articles of association and terms of issue mentioned in prospectus allows, then a company can redeem its debentures before maturity date.

Redemption Methods

1. **Redemption in Lump-sum :** When redemption is made at the expiry of a specific period, as per the terms of issue.
2. **Redemption by draw of lots :** In this method a certain proportion of debentures are redeem each, year, the debenture for which repayment is to be made is selected by draw of lots.
3. **Redemption by purchases in open market :** If articles of association of a company authorize, it may purchases its own debentures from open market i.e. stock exchange

Advantages of this Method

1. When market price of own debentures is low than the redeemable value is less then the amount payable on maturity.
2. Decrease the amount of interest payable to outsiders.
3. If term of issue is provided that debentures are to be redeemed at premium then such premium can be reduced.

Sometimes company can purchases the debentures at more than the redeemable value due to the following reasons:

1. To maintain the solvency ratio.
2. To utilize the surplus money or funds which are lying idle with the company.
3. When rate of interest on debentures is more than the current market rate of interest on debentures in the industry.

Sources of Redemption of Debentures

1. Proceeds from fresh issue of Share Capital or Debenture holder.
2. From accumulated profit.
3. Proceeds from sale of fixed assets.
4. A company may purchases its own debentures out of its surplus funds.

Two terms which are used in the redemption of debentures :

1. **Redemption out of capital :** When a company has not used its reserve or accumulated profit for redemption of its debentures, it is called redemption out of capital, So company using this method have not transferred its profit to DRR A/c. But as per SEBI guidelines it is necessary for a company to transfer 50% amount of nominal value of debentures to be redeemed in DRR A/c before redemption of debentures commence.
2. **Redemption out of profit :** Redemption out of profit means that adequate amount of profits are transferred to DRR A/c from Statement of Profit & Loss before the redemption of debenture commences. This reduces the amount available for dividends to shareholders.
3. **Debenture Redemption Reserve (DRR) :** Section 71 (4) of the companies Act, 2013 requires the company to create DRR out of the profits available for dividend and the amount created in DRR shall not be utilized for any purpose except redemption. Rule 18 (7) of Companies (share capital and Debentures) Rules, 2014 requires the following companies to create DRR of an amount equal to 25% of the value of Debentures:–

i. NBFCs registered with RBI
ii. Financial institutions other than all India Financial Institutions regulated by RBI.
iii. Housing finance companies registered with National Housing Bank. DRR is required for publicly three classes of companies, not for privately placed.
iv. Any other company (whether listed or unlisted), DRR to be created for both public and private placed debenture.

As per rule 18 (7) (c), every company required to create / Maintain DRR shall invest or deposit before 30th April specified. Securities a sum which shall not be less than 15% of the amount of debentures, maturing for payment during the year ending 31st March of the next year.

Exemption to create DRR:–

i. All India Financial Institutions regulated by RBI.
ii. Banking Companies.

Note: 1. It is assumed that company has invested 15% of redeemable amount an April 30 and incashed it as per Companies Act, 2013.

2. It is assumed that company has created debenture Redemption Reserve @25% of the redeemable debenture and transferred it to General Reserve after redemption of all the debentures.

Redemption Method 3 : Redemption of debentures by the purchase of own debentures in the open market. According to the Companies Act, a company can redeem its debentures in full or in part by purchasing its own debentures in the open market (Stock exchange) provided the company is authorised to do so by its Articles of Association.

Suitability of this Method

1. When interest rate on own debentures is higher than the market interest rate.
2. When own debentures are quoted at a discount in the open market, a company can earn profit on redemption as debentures are available at below its nominal value in the market, otherwise normal redemption may be at par or at premium.

Debenture Redemption Reserve : Creation of Debenture Redemption Reserve (DRR) is necessary if debentures have been purchased for cancellation. Unless otherwise stated in question, it is assumed that the company has adequate balance in DRR before initiating the process of purchase of debentures for cancellation.

Accounting Treatment

(A) When Debentures are purchased from the open market for immediate cancellation :

(i) When own debentures are purchased : e.g. if a company purchase 1,000 of its own debentures of 50 each at 49 (including all purchase exp.) in the open market for immediate cancellation.

Journal

Date	Particulars	L.F	Debit(Rs.)	Credit(Rs.)
	Own Debentures A/c		49,000	
	To Bank A/c			49,000
	(Being the purchased of 1000 own debentures @ 49 each)			

(ii) For Cancellation of own Debentures:

There may be three case – (a) when own debentures are purchased at nominal price – the entry passed is for cancellation :

X% Debentures	Dr. (Nominal Face Value of Deb.)
To Own Debentures A/c(Purchase Cost)	

(B) When own debentures are purchased at price below Nominal value of Debentures : the entry pass is for cancellation:

(i) X% Debentures A/c	Dr. (Nominal/Face Value Debentures)
To Own Debentures A/c	(Purchase cost of own Deb.)
To Profit on cancellation of own Debentures of own Debentures A/c	

Hint: (Profit on Cancellation is the Excess of nominal value over purchase cost of own debentures cancelled)

Profit on cancellation of own Debentures is a capital profit and therefore, is transferred to capital Reserve (or it may be used to write off discount / Loss on issue of debentures) the entry is:

To writing off Capital losses.]

(ii) Profit on Cancellation of own Debentures A/c or

To Capital Losses (if any) A/c

To Capital Reserve A/c

In above example the entries for cancellation of debentures will be:

Journal

Date	Particulars	L.F	Debit(Rs.)	Credit(Rs.)
	X% Debentures A/c Dr.		50,000	
	To Own Debentures A/c			49,000
	To Profit on Cancellation of own debentures A/c			1,000
	(Cancellation of own Debentures)			
	Profit on Cancellation of own Debentures A/c Dr.		1,000	
	To Capital Reserve			1,000
	(Profits on conciliation of own Den. Is transferred to capital Reserve)			

(C) When own debentures are purchased at a price above its face value. E.g. Debentures of the face value of Rs. 40,000 ate purchased in the open market at Rs. 42,000, the entry will be

Journal

Date	Particulars	L.F	Debit (Rs.)	Credit(Rs.)
	Own Debentures A/c Dr.		42,000	
	To Bank A/c			42,000
	(Purchased of own Debentures for Rs. 42,000)			

	X% Debentures A/c Dr.		40,000	
	Loss on Redemption of Debenture A/c Dr.		2,000	
	To own Debenture A/c			42,000
	(Cancellation of own Debentures)			

'Loss on Redemption of Debentures' is a capital loss and is therefore written off against capital profit or in the absence of capital profit is written off from statement of profit and loss.

(B) Purchase of own Debentures from open market for investment purpose : e.g. if a company purchase it 9% debentures of 50,000 at 49,000 as investment the entry will be:

Date	Particulars	L.F	Debit (Rs.)	Credit(Rs.)
	Investment in own Debentures A/c Dr.		49,000	
	To Bank A/c			49,000
	(Being Purchases of own debentures as investment)			

It should be noted that in the above entry an account named "Investment in own debentures A/c" is debited with purchase cost instead of "own debentures A/c" because own debentures have been purchased as an assets. "Investment in own debenture" will appear on the assets side under Non-Current Investment or current investment depending upon the time of Cancellation/Redemption or resell time.

Advantages : Reasons for Purchase of own Debentures as Investment :

i. Debentures are available in open market at a price below its nominal value.
ii. These debentures can be resold at profit in the market OR can be cancelled if the market price of such debentures further goes down.
iii. Interest payment on such debentures is saved which would otherwise be paid to debenture holders.

Resell these debenture in the market : the journal entries will be :

Bank A/c Dr.

(Net amount realised from own Deb.)

Loss on sale of own Debentures A/c*Dr. (Excess of cost over sale price)

To Investment in own Debentures A/c (cost of own debentures)

To Profit on sale of own Debentures A/c*(Excess of sale price over cost)

Note : *There will be one entries from two above Profit or Loss as the case. Loss or Profit on sale of own debentures will be transferred to Statement of profit and loss at the end of accounting year.

Profit on sale of own Debentures A/c Dr.

To Statement of Profit and Loss

B (II) On Cancellation of Debentures at a later date :

(a) X% Debentures A/c Dr.

Loss on cancellation of own Debentures A/c Dr..

To Investment in own Debentures A/c

To Profit on cancellation of own Debentures A/c

(b) Profit on cancellation of own Debentures A/c Dr.

To Capital Reserve A/c

Treatment of Interest on Own Debentures : when a Company purchase it own debentures for investment and has not cancelled them upto the interest payment due date. The company will pay interest only to outside debentures holders and interest on own debentures held by the company is retained by the company entries will be:

(i) When interest becomes due on Debentures :

Debentures interest A/c	Dr. (Total interest)

To Debentures holders A/c	(int. for outsides)
To Int. on own Debentures A/c	(Interest on Own Debentures)

(ii) On Payment of interest to outsider debentures holders:

Debentures holders A/c Dr.

To Bank A/c

(iii) Transfer of Int. to statement of P/L at the end of accounting year:

(a) Statement of Profit & Loss	Dr. (Total Int. of accounting year transferred)
To Debentures interest A/c	

Transfer of Interest on Own debentures to statement of Profit & Loss

Interest on own debentures A/c Dr.

To Statement of Profit & Loss