

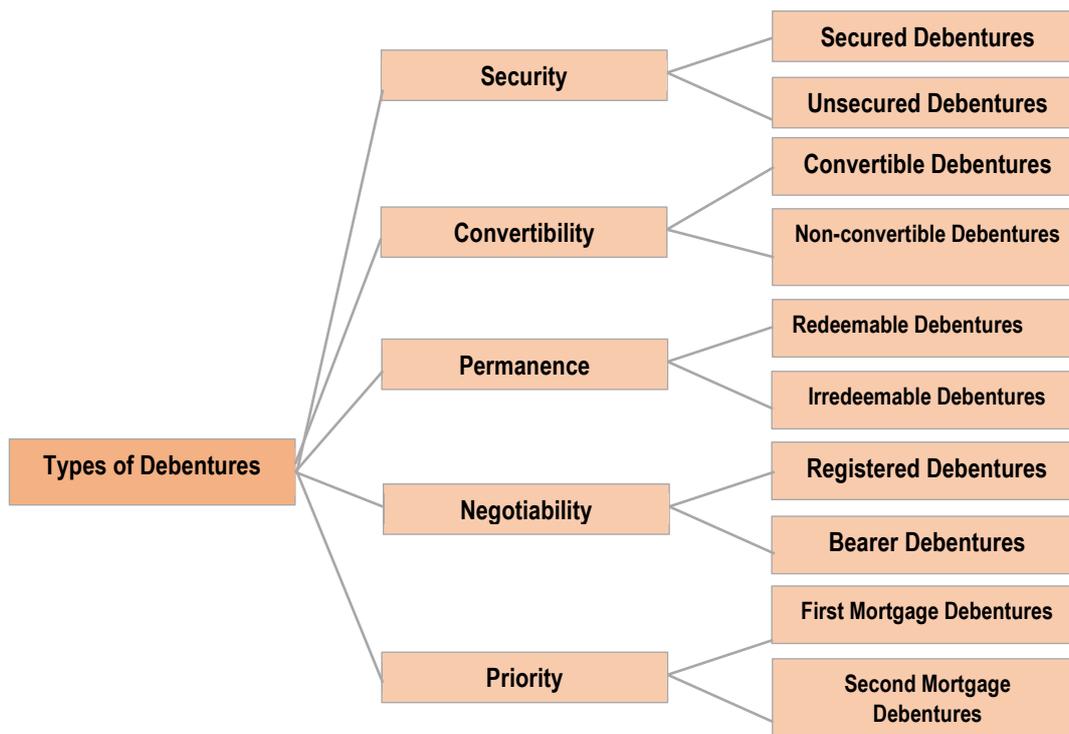
UNIT – 3: ISSUE OF DEBENTURES

LEARNING OUTCOMES

After studying this unit, you would be able to:

- ◆ Understand the meaning and basic purpose for raising debentures by the company
- ◆ Differentiate between shares and debentures of a company
- ◆ Understand various types of debentures
- ◆ Pass entries for issue of debentures payable in instalments
- ◆ Make entries for issue of debentures considering the conditions of redemption
- ◆ Pass entries for issue of debentures as collateral security
- ◆ Pass entries for debentures issued for consideration other than for cash
- ◆ Write off discount on issue of debentures
- ◆ Calculate interest on debentures.

UNIT OVERVIEW



3.1 INTRODUCTION

In the earlier units of this chapter, we have studied the issue of share capital as a means of raising funds for financing the business activities. But with increasing and ever growing needs of the corporate expansion and growth, equity source of financing is not sufficient. Hence corporates turn to debt financing through various means. Issuing debt instruments by offering the same for public subscription is one of the sources of financing the business activities. Debt financing does not only helps in reducing the cost of the capital but also helps in designing appropriate capital structure of the company. Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business.

3.2 MEANING

The most common method of supplementing the capital available to a company is to issue debentures which may either be simple or naked carrying no charge on assets, or mortgage debentures carrying either a fixed or a floating charge on some or all of the assets of the company.

A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest. If a charge* has been created on any or on the entire assets of the company, the nature of the charge and the assets charged are described therein. Since the charge is not valid unless registered with the Registrar, and the certificate registering the charge is printed on the bond. It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever way they think necessary to safeguard the interest of debenture holders.

Section 2 (30) of the Companies Act, 2013 defines debentures as “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.

Thus, It is clear from definition that debenture may be Secured Debenture or Unsecured Debenture.

Note: No company shall issue any debentures carrying any voting rights.

3.3 FEATURES OF DEBENTURES

1. It is a document which evidences a loan made to a company.
2. It is a fixed interest-bearing security where interest falls due on specific dates.
3. Interest is payable at a predetermined fixed rate, regardless of the level of profit.
4. The original sum is repaid at a specified future date or it is converted into shares or other debentures.
5. It may or may not create a charge on the assets of a company as security.
6. It can generally be bought or sold through the stock exchange at a price above or below its face value.

*Charge is an incumbrance to meet the obligation under the Trust Deed, whereby the company agrees to mortgage specific portion either by way of a first or second charge. Such charge implies right of lenders to secure their payment from such asset(s) or from the liquidator in the event of winding up or from the company when the charge becomes void.



3.4 DISTINCTION BETWEEN DEBENTURES AND SHARES

Debentures	Shares
1. Debenture holders are the creditors of the company.	1. Shareholders are the owners of the company.
2. Debenture holders have no voting rights and consequently do not pose any threat to the existing control of the company.	2. Shareholders have voting rights and consequently control the total affairs of the company.
3. Debenture interest is paid at a pre-determined fixed rate. It is payable, whether there is any profit or not. Debentures rank ahead of all types of shares for payment of the interest due on them.	3. Dividend on equity shares is paid at a variable rate which is vastly affected by the profits of the company (however, dividend on preference shares is paid at a fixed rate).
4. Interest on debentures are the charges against profits and they are deductible as an expense in determining taxable profit of the company.	4. Dividends are appropriation of profits and these are not deductible in determining taxable profit of the company.
5. There are different kinds of debentures, such as Secured/ Unsecured; Redeemable/ Irredeemable; Registered / Bearer; Convertible/ Non-convertible, etc.	5. There are only two kinds of shares—Equity Shares and Preference Shares.
6. In the Company's Balance Sheet, Debentures are shown under "Long Term Borrowings".	6. In the Company's Balance Sheet, shares are shown under "Shareholder's Fund" detailed in 'Share Capital' of Notes to Accounts.
7. Debentures can be converted into other debentures or shares as per the terms of issue of debentures.	7. Shares cannot be converted into other shares in any circumstances.
8. Debentures cannot be forfeited for non-payment of call moneys.	8. Shares can be forfeited for non-payment of allotment and call moneys.
9. At maturity, debenture holders get back their money as per the terms and conditions of redemption.	9. Equity shareholders cannot get back their money before the liquidation of the company (however, preference shareholders can get back their money before liquidation).
10. At the time of liquidation, debenture holders are paid-off before the shareholders.	10. At the time of liquidation shareholders are paid at last, after paying debenture holders, Trade payable, etc.



3.5 TYPES OF DEBENTURES

The following are the types of debentures issued by a company. They can be classified on the basis of:

(1) Security; (2) Convertibility; (3) Permanence; (4) Negotiability; and (5) Priority.

1. Security

- (a) *Secured Debentures*: These debentures are secured by a charge upon some or all assets of the company. There are two types of charges: (i) Fixed charge; and (ii) Floating charge. A fixed charge is a mortgage on specific assets. These assets cannot be sold without the consent of the debenture holders. The sale proceeds of these assets are utilized first for repaying debenture holders. A floating charge generally covers all the assets of the company including future one.
- (b) *Unsecured or "Naked" Debentures*: These debentures are not secured by any charge upon any assets. A company merely promises to pay interest on due dates and to repay the amount due on maturity date. These types of debentures are very risky from the view point of investors.

2. Convertibility

- (a) *Convertible Debentures*: These are debentures which will be converted into equity shares (either at par or premium or discount) after a certain period of time from the date of its issue. These debentures may be fully or partly convertible. In future, these debenture holders get a chance to become the shareholders of the company.
- (b) *Non-Convertible Debentures*: These are debentures which cannot be converted into shares in future. As per the terms of issue, these debentures are repaid.

3. Permanence

- (a) *Redeemable Debentures*: These debentures are repayable as per the terms of issue, for example, after 8 years from the date of issue.
- (b) *Irredeemable Debentures*: These debentures are not repayable during the life time of the company. These are also called perpetual debentures. These are repaid only at the time of liquidation.

4. Negotiability

- (a) *Registered Debentures*: These debentures are payable to a registered holder whose name, address and particulars of holding is recorded in the Register of Debenture holders. They are not easily transferable. The provisions of the Companies Act, 2013 are to be complied with for effecting transfer of these debentures. Debenture interest is paid either to the order of registered holder as expressed in the warrant issued by the company or the bearer of the interest coupons.
- (b) *Bearer Debentures*: These debentures are transferable by delivery. These are negotiable instruments payable to the bearer. No kind of record is kept by the company in respect of the holders of such debentures. Therefore, the interest on it is paid to the holder irrespective of any identity. No transfer deed is required for transfer of such debentures.

5. Priority

- (a) *First Mortgage Debentures*: These debentures are payable first out of the property charged.
- (b) *Second Mortgage Debentures*: These debentures are payable after satisfying the first mortgage debentures.

3.6 ISSUE OF DEBENTURES

3.6.1 Accounting entries for issue of redeemable debentures

The issue of redeemable debentures can be categorized into the following:

1. Debentures issued at a par and redeemable at par or at a discount;
2. Debentures issued at a discount and redeemable at par or at discount;
3. Debentures issued at premium and redeemable at par or at discount;
4. Debentures issued at par and redeemable at premium;
5. Debentures issued at a discount and redeemable at premium.
6. Debentures issued at premium and redeemable at premium.

Note: Redemption at a discount may be a rare circumstance in practical life.

Journal entries in each of the above cases are discussed below:

1. **Debentures issued at par redeemable at par:** When debenture are issued at par, the issue price is equal to par value, in this regard the following entries are recorded:

- (a) For receipt of application money :

Bank A/c	Dr.
To Debenture Application A/c	

- (b) For transfer of application money to debentures account :

Debenture Application A/c	Dr.
To ...% Debenture A/c	

ILLUSTRATION 1

Amol Ltd. issued 40,00,000, 9% debentures of ₹ 50 each, payable on application as per term mentioned in the prospectus and redeemable at par any time after 3 years from the date of issue. Record necessary entries for issue of debentures in the books of Amol Ltd.

SOLUTION

Books of Amol Ltd.

Journal

Date	Particulars	L.F	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c Dr.		20,00,00,000	
	To Debenture Application A/c (Debenture application money received)			20,00,00,000

Debenture Application A/c	Dr.	20,00,00,000	
To 9% Debentures A/c			20,00,00,000
(Application money transferred to 9% debentures account consequent upon allotment)			

2. **Debentures issued at Discount and Redeemable at par or at discount** : When debentures are issued at discount, issue price will be less than par value. The difference between the two is considered as loss on issue on debentures and is to be written-off over the life of debentures. The entries with regards to issue are given below :

(a) For receipt of application money

Bank A/c	Dr.
To Debenture Application A/c	

(b) At the time of making allotment

(i) Debenture Application A/c	Dr.
Discount on issue of debentures A/c	Dr.
To ...% Debentures A/c	

ILLUSTRATION 2

Atul Ltd. issued 1,00,00,000, 8% debenture of ₹100 each at a discount of 10% redeemable at par at the end of 10th year. Money was payable as follows :

₹ 30 on application

₹ 60 on allotment

Record necessary journal entries regarding issue of debenture.

SOLUTION

Books of Atul Ltd.

Journal

Date	Particulars	L.F.	Debit (₹)	Credit (₹)
	Bank A/c	Dr.	30,00,00,000	
	To Debenture Application A/c			30,00,00,000
	(Debenture application money received)			
	Debenture Application A/c	Dr.	30,00,00,000	
	To 8% Debentures A/c			30,00,00,000
	(Application money transferred to 8% debentures account consequent upon allotment)			
	Debenture allotment A/c	Dr.	60,00,00,000	

Discount on issue of debentures A/c	Dr.	10,00,00,000	
To 8% Debentures A/c (Amount due on allotment)			70,00,00,000
Bank A/c	Dr.	60,00,00,000	
To Debenture Allotment A/c (Money received consequent upon allotment)			60,00,00,000

3. Debentures Issued at Premium and Redeemable at par or at discount

When debenture are issued at premium, the issue price is more than the par value. The premium is transferred to securities premium account. In this regard, the following journal entries are recorded:

When premium amount is received at the time of application;

- (a) For receipt of application money

Bank A/c	Dr.
To Debenture Application A/c	

- (b) For transfer of application of money at the time of allotment

Debenture application A/c	Dr.
To ...% Debentures A/c	
To Securities Premium A/c	

When debentures are issued at par or premium value but redeemed at discount, then it means that the company will gain by paying less. This gain will not be recognised in the books at the time of issue of debentures as per the conservatism concept.



ILLUSTRATION 3

Koinal Chemicals Ltd. issued 15,00,000, 10% debenture of ₹50 each at premium of 10%, payable as ₹20 on application and balance on allotment. Debentures are redeemable at par after 6 years. All the money due on allotment was called up and received. Record necessary entries when premium money is included in application money.



SOLUTION

Books of Koinal Chemicals Ltd.

Journal

When premium money is received along with application money :

Date	Particulars	L.F.	Debit Amount (₹)	Credit Amount (₹)
	Bank A/c	Dr.	3,00,00,000	
	To Debenture Application A/c (Debenture application money received)			3,00,00,000

Debtures Application A/c	Dr.	3,00,00,000	
To 10% Debtures A/c			2,25,00,000
To Securities Premium A/c			75,00,000
(Application money transferred to 10% debtures account and securities premium account consequent upon allotment)			
Debture Allotment A/c	Dr.	5,25,00,000	
To 10% Debtures A/c			5,25,00,000
(Call made consequent upon allotment)			
Bank A/c	Dr.	5,25,00,000	
To Debture Allotment A/c			5,25,00,000
(Call made consequent upon allotment money received)			

4. Debtures issued at par and redeemable at a premium

Where debtures are to be redeemed at premium, an extra entry is to be made at the time of issue and allotment of debtures. This extra entry is to be passed for providing premium payable on redemption. Debture Redemption Premium Account is a personal account which represents a liability of the company in respect of premium payable on redemption.

In this case, the issue price is same as par value but the redemption value is more than the par value, therefore redemption premium is recorded as a loss on issue of debtures at the time of allotment of debtures. Following journal entries are recorded in this regard:

- (a) For receipt of application money

Bank A/c	Dr.	
To Debture application A/c		

- (b) At the time of making allotment

- (i) Transfer of application money to debture account

Debture Application A/c	Dr.	
To ...% Debture A/c		

- (ii) Call made consequent upon allotment

Debture Allotment A/c	Dr.	
Loss on issue of debture A/c	Dr.	[Equal to Debture Redemption Premium]

 To ...% Debture A/c

 To Debture redemption premium A/c

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c	Dr.	
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5. Debentures Issued at discount and redeemable at premium

In this situation the issue price is less than par value but redemption value is more than par value. The difference between the redemption price and the issue price is treated as discount/loss on issue of debentures. Suppose, a 10% debentures of ₹ 1,000 is issued at a discount of ₹ 100 and redeemable at a premium of ₹5 per debenture, the amount of loss will be equal to ₹ 1,005 – ₹ 900 = ₹ 105. This is to be treated as loss on issue. It is to be noted that premium on redemption of debentures is also credited by ₹ 5.

(a) For the receipt of application money

Bank A/c	Dr.
To Debenture Application A/c	

(b) At the time of making allotment

(i) Transfer of application money to debenture account

Debenture Application A/c	Dr.
To % Debentures A/c	

(ii) Call made consequent upon allotment of debentures at discount and redeemable at premium

Debenture Allotment A/c	Dr.
Discount/Loss on issue of debenture A/c	Dr.
To ...% Debenture A/c	[Amount equal to the discount on issue of debenture plus Premium on redemption]

(c) For receipt of call made on allotment

Bank A/c	Dr.
To Debenture Allotment A/c	

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c	Dr.
Discount/Loss on issue of debentures A/c	Dr.
To ...% Debentures A/c	
To Debenture redemption premium A/c	

ILLUSTRATION 5

Agrotech Ltd. issued 150 lakh 9% debentures of ₹100 each at a discount of 6%, redeemable at a premium of 5% after 3 years payable as : ₹50 on application and ₹ 44 on allotment. Record necessary journal entries for issue of debentures.

SOLUTION

Books of Agrotech Ltd.

Journal

Date	Particulars	L.F.	Debit Amount (₹ Lakhs)	Credit Amount (₹ Lakhs)
	Bank A/c To Debenture Application A/c (Debentures application money received)	Dr.	7,500	7,500
	Debenture Application A/c To 9% Debentures A/c (Application money transferred to 9% debentures account)	Dr.	7,500	7,500
	Debenture Allotment A/c Loss on issue of debenture A/c To 9% Debentures A/c To Debenture redemption premium A/c (Call made consequent upon allotment of debentures issued at discount and redeemable at premium)	Dr. Dr.	6,600 1,650	7,500 7,50
	Bank A/c To Debenture Allotment A/c (Allotment amount received)	Dr.	6,600	6,600

Working Notes :

Loss on issue of debentures =

(Amount of discount on issue + Premium payable on redemption) x No. of Debentures

$$= (6\% \text{ of } ₹100 + 5\% \text{ of } ₹100) \times 150 \text{ lakh}$$

$$= (₹ 6 + ₹ 5) \times 150 \text{ lakh}$$

$$= ₹ 1,650 \text{ lakh}$$

6. Debentures Issued at premium and redeemable at premium

In this situation, the issue price is more than par value and also redemption value is more than par value. The premium received at the time of issue of debentures is credited to Securities premium account and premium paid at the time of redemption is a loss to be provided at the time of issue of debentures. Suppose, a 10% debenture of ₹1,000 is issued at a premium of ₹100 and redeemable at a premium of

₹50 per debenture. In the given case ₹100 is to be credited to Securities premium account and ₹50 will be the loss to be provided at the time of issue of debentures. It is to be noted that premium on redemption of debentures is also credited by ₹ 50.

- (a) For the receipt of application money

Bank A/c		Dr.
	To Debenture Application A/c	

- (b) At the time of making allotment

- (i) Transfer of application money to debenture account

Debenture Application A/c		Dr.
	To % Debentures A/c	

- (ii) Call made consequent upon allotment of debenture at premium and Redeemable at premium

Debenture Allotment A/c		Dr.
Loss on issue of debenture A/c		Dr. [Amount equal to the premium on redemption]
	To ...% Debenture A/c	
	To Securities Premium A/c	[Amount equal to premium on issue]
	To Premium on Redemption of	[Amount equal to premium on Debentures A/c redemption]

Students can note that instead of passing the separate entries, a compound entry can be passed:

Bank A/c		Dr.
Loss on issue of Debentures A/c		Dr.
	To ...% Debentures A/c	
	To Securities Premium A/c	
	To Premium on redemption of debentures A/c	

3.6.2 Accounting for issue of debentures payable in instalments

Just like shares, money payable on debentures may be paid either in full with application or by instalments. Accounting entries will differ to some extent in either case.

3.6.2.1 Debentures Payable in Full on Application

Where the amount due on debentures are payable in full on application, it is usual to open a separate Debentures Application Account for each class of debentures, such as 10% Debentures Application Account or 12% Debentures Application Account. These accounts record moneys received from the applicants of debentures. If an issue is over-subscribed, these accounts can be used to record the refund of moneys to the unsuccessful applicants. At the time of allotment of debentures, the amount in Debentures Application Account is transferred to the respective Debentures Account.

As discussed above, debentures may be issued at par, at a premium, or at a discount.

3.6.2.2 Debentures Issued at Par

The debentures which are issued at par are issued at the same price as their nominal value; that is, if a debenture with a nominal value of ₹ 100 is issued at par, the company receives ₹ 100.

The accounting entries would be as follows:

- (a) When cash is received

Bank Account	Dr.
To Debentures Application Account	

(Being money received on.... debentures @₹each)

- (b) When excess money is refunded or adjusted for future calls

Debentures Application Account	Dr.
To Bank Account (Amount refunded)	

To Debenture Allotment A/c (Amount adjusted for allotment)

(Being excess money...debentures adjusted as per Board's Resolution

No....dated.....)

- (c) When the debentures are allotted

Debentures Application Account	Dr.
To % Debentures Account	

(Being the allotment of...debentures of ₹each as per Board's Resolution

No....dated.....)

- (d) On Allotment money being called

Debenture Allotment A/c	Dr.
To % Debentures Account	

(Being Allotment Money Called)

- (e) On Allotment money being received

Bank A/c	Dr.
To Debenture Allotment A/c	

(Being Allotment money received)

- (f) On Debenture Call money being called

Debenture Calls A/c	Dr.
To % Debentures A/c	

(Being Call money made due)

(g) On Debenture Call money being called

Bank A/c	Dr.
To Debenture Calls A/c	
(Being Call money received)	

ILLUSTRATION 6

Simmons Ltd. issued 1,00,000, 12% Debentures of ₹100 each at par payable in full on application by 1st April, Application were received for 1,10,000 Debentures. Debentures were allotted on 7th April. Excess money refunded on the same date.

You are required to pass necessary Journal Entries (including cash transactions) in the books of the company.

SOLUTION

In the books of Simmons Limited

Date	Particulars	₹ 000	₹ 000
April 1	Bank A/c Dr. To Debentures Application A/c (Being money received on 1,10,000 debentures)	11,000	11,000
April 7	Debentures Application A/c Dr. To Bank A/c (Being money on 10,000 debentures refunded as per Board's Resolution No.....dated...)	1,000	1,000
April 7	Debentures Application A/c Dr. To Debentures A/c (Being the allotment of 1,00,000 debentures of ₹ 100 each at par, as per Board's Resolution No.....dated...)	10,000	10,000

3.6.2.3 Debentures Issued at a Premium

A company issues debentures at a premium when the market rate of interest is lower than the debentures interest rate. The debentures, which are issued at a premium, are issued at a higher price than their nominal value; that is, if a debenture with a nominal value of ₹ 100 is issued at 10% premium, the company receives at ₹110 where the investor gets slightly less interest than stated in the debenture. For example, 12% Debentures of ₹100 issued at a premium of 10%. The investor will get ₹12 p.a. for his investment of 110. Therefore, the effective rate of interest on investment is $(12/110 \times 100) = 10.91\%$.

The premium on debentures is credited to 'Securities Premium Account' as 'Debentures' are covered in the definition of 'securities' specified in the clause (h) of section 2 of the Securities Contracts (Regulation) Act. Therefore, restriction of utilization of debentures (securities) premium will also be governed by Section 52 of the Companies Act, 2013.

The accounting entries would be as follows:

- (a) When cash is received
- | | | |
|-----------------------------------|-----|------------------------------|
| Bank Account | Dr. | [Nominal value plus premium] |
| To Debentures Application Account | | |
- (Being money received on....debentures @ ₹ each including premium of ₹)
- (b) When excess money is refunded
- | | | |
|--------------------------------|-----|--|
| Debentures Application Account | Dr. | |
| To Bank Account | | |
- (Being refund of money on....debentures @ ₹ each, as per Board's Resolution No.....dated....)
- (c) When the debentures are allotted
- | | | |
|--------------------------------|-----|--|
| Debentures Application Account | Dr. | |
| To % Debentures Account | | |
| To Securities Premium Account | | |
- (Being the allotment of....debentures, premium transferred to Securities Premium Account, as per Board's Resolution No....dated....)

3.6.2.4 Debentures Issued at a Discount

The Companies Act does not impose any restriction on the price at which debentures can be issued. Unlike shares, there is no limit for discount on issue of debentures. This is why it is very common for debentures to be issued at a discount. The debentures which are issued at a discount are issued at a lower price than nominal value, that is, if a debenture with a nominal value of ₹100 is issued at 10% discount, the company receives ₹90 only. The issue of debentures at a discount slightly increases the true rate of interest payable. For example, 12% Debentures of ₹100 issued at a discount of 10%. The Company will have to pay ₹12 for a loan of ₹90. Therefore, the true rate of interest is $(12/90 \times 100) = 13.33\%$.

The company issues debentures at a discount when the market rate of interest is higher than the debenture interest rate. Like shares, Debentures Account is credited with the nominal value. The difference between the nominal value of debentures and cash received is transferred to "Discount on Issue of Debentures Account. In the subsequent years, Discount on Issue of Debentures is written-off proportionately by charging to the Statement of Profit and Loss. It is considered a normal practice to amortize discount on issue of debentures over the period of benefit, i.e., normally 3 to 5 years.

The accounting entries would be as follows :

- (a) When Cash is received
- | | | |
|-----------------------------------|-----|------------------------|
| Bank Account | Dr. | [Actual cash received] |
| To Debentures Application Account | | |
- (Being money received on....debentures @ ₹each)

- (b) When excess money is refunded
- | | | |
|-------------------------------|-----|--|
| Debitures Application Account | Dr. | |
| To Bank Account | | |
- (Being excess money on...debtures refunded as per Board's Resolution No.....dated....)
- (c) When the debtures are allotted
- | | | |
|---------------------------------------|-----|-----------------------------|
| Debitures Application Account | Dr. | [Actual cash received] |
| Discount on Issue of Debtures Account | Dr. | [Discount on debtures] |
| To % Debtures Account | | [Nominal value of debtures] |
- (Being the allotment of...debtures of ₹each @ ₹each as per Board's Resolution No.....dated...)

In fact, the discount on issue of debtures is considered as incremental interest expense. The true expense (net borrowing cost) for a particular accounting period is, therefore, the total interest payment plus the discount written off.

ILLUSTRATION 7

X Ltd. issued 1,00,000 12% Debtures of ₹ 100 each at a discount of 10% payable in full on application by 31st May, 2020. Applications were received for 1,20,000 debtures. Debtures were allotted on 9th June, 2020. Excess money was refunded on the same date. Pass necessary Journal Entries. Also show necessary ledger accounts.

SOLUTION

In the books of X Limited Journal Entries

Date	Particulars		₹ '000	₹ '000
May 31	Bank A/c Dr. To Debtures Application A/c (Being money received for 1,20,000 debtures @ ₹ 90 each)		10,800	10,800
June 9	Debtures Application A/c Dr. To Bank A/c (Being excess money on 20,000 debtures @ ₹ 90 refunded as per Board's Resolution No.....dated....)		1,800	1,800
June 9	Debtures Application A/c Dr. Discount on Issue of Debtures A/c Dr. To 12% Debtures A/c (Being the allotment of 1,00,000 debtures of ₹ 100 each at a discount of ₹ 10 per debture as per Board's Resolution No.....dated...)		9,000 1,000	10,000

Bank Account

Date	Particulars	₹	Date	Particulars	₹
31.5.2020	To 12% Debentures Application A/c	10,800	9.6.2020	By 12% Debentures Application A/c	1,800
		10,800	9.6.2020	By Balance c/d	9,000
					10,800

12% Debentures Account

Date	Particulars	₹	Date	Particulars	₹
30.6.2020	To Balance c/d	10,000	9.6.2020	By 12% Debentures Application A/c	9,000
		10,000	9.6.2020	By Discount on Issue of Debentures A/c	1,000
					10,000

Debentures Application Account

Date	Particulars	₹	Date	Particulars	₹
9.6.2020	To Bank A/c	1,800	31.5.2020	By Bank A/c	10,800
9.6.2020	To 12% Debentures A/c	9,000			
		10,800			10,800

Discount on Issue of Debentures Account

Date	Particulars	₹	Date	Particulars	₹
9.6.2020	To 12% Debentures A/c	1,000	30.6.2020	By Balance c/d	1,000
		1,000			1,000



3.7 ISSUE OF DEBENTURES AS COLLATERAL SECURITY

Collateral security means secondary or supporting security for a loan, which can be realised by the lender in the event of the original loan not being repaid on the due date. Under this arrangement, the borrower agrees that a particular asset or a group of assets will be realized and the proceeds there from will be applied to repay the loan in the event that the amount due, cannot be paid.

Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft. When the loan is repaid on the due date, these debentures are at once released with the main security. In case, the company cannot repay its loan and the interest thereon on the due date, the lender becomes the debenture holder who can exercise all the rights of a debenture holder.

The holder of such debentures is entitled to interest only on the amount of loan, but not on the debentures.

Accounting Entries

There are two methods of showing these types of debentures in the accounts of a company.

- To Vendors Account [Purchase consideration]
(Being the assets and liabilities taken over)
- (b) Vendors Account Dr.
- To Debentures Account
(Being the issue of....debentures to satisfy purchase consideration)

Further it should be noted that these debentures can be issued at par, premium and at discount. In each case the second entry for issue of debentures would be done accordingly. Number of debentures to be issued is calculated as follows:-

1. When debentures are issued at par

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value}}$$
2. When debentures are issued at premium

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value} + \text{Premium}}$$
3. When debentures are issued at discount

$$\text{No. of Shares} = \frac{\text{Purchase Consideration}}{\text{Par Value} - \text{Discount}}$$

ILLUSTRATION 10

X Company Limited issued 10,000 14% Debentures of the nominal value of ₹50,00,000 as follows:

- (a) To sundry persons for cash at 90% of nominal value of ₹25,00,000.
- (b) To a vendor for purchase of fixed assets worth ₹10,00,000 – ₹12,50,000 nominal value.
- (c) To the banker as collateral security for a loan of ₹10,00,000 – ₹12,50,000 nominal value.

Pass necessary Journal Entries.

SOLUTION

In the books of X Company Ltd. Journal Entries

Date	Particulars		₹	₹
(a)	Bank A/c Dr.		22,50,000	
	To Debentures Application A/c (Being the application money received on 5,000 debentures @ ₹ 450 each)			22,50,000
	Debentures Application A/c Dr.		22,50,000	
	Discount on issue of Debentures A/c Dr.		2,50,000	

	To 14% Debentures A/c (Being the issue of 5,000 14% Debentures @ 90% as per Board's Resolution No....dated....)		25,00,000
(b)	Fixed Assets A/c To Vendor A/c (Being the purchase of fixed assets from vendor)	Dr.	10,00,000 10,00,000
	Vendor A/c Discount on Issue of Debentures A/c To 14% Debentures A/c (Being the issue of debentures of ₹ 12,50,000 to vendor to satisfy his claim)	Dr.	10,00,000 2,50,000 12,50,000
(c)	Bank A/c To Bank Loan A/c (See Note) (Being a loan of ₹10,00,000 taken from bank by issuing debentures of ₹12,50,000 as collateral security)	Dr.	10,00,000 10,00,000

Note : No entry is made in the books of account of the company at the time of making issue of such debentures. In the Balance Sheet the fact that the debentures being issued as collateral security and outstanding are shown under the respective liability.



3.9 TREATMENT OF DISCOUNT/LOSS ON ISSUE OF DEBENTURES

The discount on issue of debentures is amortised over a period between the issuance date and redemption date. It should be written-off in the following manner depending upon the terms of redemption:

- If the debentures are redeemable after a certain period of time, say at the end of 5 years, the total amount of discount should be written-off equally throughout the life of the debentures (applying the straight line method). The main advantage of this method is that it spreads the burden of discount equally over the years.
- If the debentures are redeemable at different dates, the total amount of discount should be written-off in the ratio of benefit derived from debenture loan in any particular year (applying the sum of the year's digit method). This method is suitable when debentures are redeemed by unequal instalments.

The accounting entries would be as follows :

Profit and Loss Account	Dr.
To Discount on Issue of Debentures Account	
(Being the amount of discount on issue of debentures written-off)	

Loss on issue of debentures is also a capital loss and should be written off in a similar manner as discount on debentures issued. In the balance sheet both the items (Discount and Loss) are shown as Non-current/current assets depending upon the period for which it has to be written off.

ILLUSTRATION 11

HDC Ltd issues 1,00,000, 12% Debentures of ₹100 each at ₹94 on 1st January, 2020. Under the terms of issue, the debentures are redeemable at the end of 5 years from the date of the issue. Calculate the amount of discount to be written-off in each of the 5 years.

SOLUTION

Total amount of discount comes to ₹ 6,00,000 (₹6 X 1,00,000). The amount of discount to be written-off in each year is calculated as under :

Year end	Debentures outstanding	Ratio in which discount to be written-off	Amount of discount to be written-off
1 st	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
2 nd	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
3 rd	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
4 th	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000
5 th	₹ 1,00,00,000	1/5	1/5th of ₹ 6,00,000 = ₹ 1,20,000

ILLUSTRATION 12

HDC Ltd. issues 2,00,000, 12% Debentures of ₹10 each at ₹9.40 on 1st January, 2020. Under the terms of issue, 1/5th of the debentures are annually redeemable by drawings, the first redemption occurring on 31st December, 2020. Calculate the amount of discount to be written-off from 2020 to 2024.

SOLUTION

Calculation of amount of discount to be written-off

At the Year end	Debentures Outstanding before redemption	Ratio of benefit Derived	Amount of discount to be written-off
2020	₹ 20,00,000	5	5/15th of ₹ 1,20,000 = ₹ 40,000
2021	₹ 16,00,000	4	4/15th of ₹ 1,20,000 = ₹ 32,000
2022	₹ 12,00,000	3	3/15th of ₹ 1,20,000 = ₹ 24,000
2023	₹ 8,00,000	2	2/15th of ₹ 1,20,000 = ₹ 16,000
2024	₹ 4,00,000	<u>1</u>	1/15th of ₹ 1,20,000 = <u>₹ 8,000</u>
	TOTAL	15	₹ 1,20,000

3.10 INTEREST ON DEBENTURES

Interest payable on coupon debenture is treated as a charge against the profits of the company. Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures. The company will pay interest net of tax to the debenture holders because the company is under obligation to deduct tax at

source at the rates applicable under tax rules from time to time. The companies will deposit the tax so deducted with income tax authorities. Following accounting entries are to be recorded in this regard:

1. *For making interest due*

Interest A/c	Dr.
To Debenture holders' A/c	

2. *For making payment of interest and deduction of tax at source (TDS)*

Debenture holders A/c	Dr.
To TDS Payable A/c	
To Bank A/c	

3. *For making payment of tax deducted at source*

TDS payable A/c	Dr.
To Bank A/c	

4. *For transferring interest to profit and loss account*

Profit and Loss A/c	Dr.
To Interest A/c	



ILLUSTRATION 13

A company issued 12% debentures of the face value of ₹10,00,000 at 10% discount on 1-1-2017. Debenture interest after deducting tax at source @ 10% was payable on 30th June and 31st of December every year. All the debentures were to be redeemed after the expiry of five year period at 5% premium.

Pass journal entries for the accounting year 2020.



SOLUTION

Journal Entries

			(₹)	(₹)
1-1-2020	Bank A/c	Dr.	9,00,000	
	Discount/Loss on Issue of Debentures A/c	Dr.	1,50,000	
	To 12% Debentures A/c	Dr.		10,00,000
	To Premium on Redemption of Debentures A/c			50,000
	(For issue of debentures at discount redeemable at premium)			
30-6-2020	Debenture Interest A/c	Dr.	60,000	
	To Debenture holders A/c			54,000
	To Tax Deducted at Source A/c			6,000
	(For interest payable)			
	Debenture holders A/c	Dr.	54,000	

31-12-2020	Tax Deducted at Source A/c To Bank A/c (For payment of interest and TDS)	Dr.	6,000	60,000
	Debenture Interest A/c To Debenture holders A/c To Tax Deducted at Source A/c (For interest payable)	Dr.	60,000	54,000 6,000
	Debenture holders A/c Tax Deducted at Source A/c To Bank A/c (For payment of interest and tax)	Dr. Dr.	54,000 6,000	60,000
	Profit and Loss A/c To Debenture Interest A/c (For transfer of debenture interest to profit and loss account at the end of the year)	Dr.	1,20,000	1,20,000
	Profit and Loss A/c To Discount/Loss on issue of debenture A/c (For proportionate debenture discount and premium on redemption written off, i.e., 1,50,000 x 1/5)	Dr.	30,000	30,000

SUMMARY

- ◆ Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business. A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest. Money payable on debentures may be paid either in full with application or in instalments.
- ◆ Debenture holders are the creditors of the company whereas shareholders are the owners of the company. Debenture holders have no voting rights and consequently do not pose any threat to the existing control of the company. Shareholders have voting rights and consequently control the total affairs of the company.
- ◆ Debentures can be classified on the basis of: (1) Security; (2) Convertibility; (3) Permanence; (4) Negotiability; and (5) Priority.
- ◆ Issue of redeemable debentures can be categorized into the following:
 1. Debenture issued at par and redeemable at par or at a discount;
 2. Debenture issued at a discount and redeemable at par or at discount;
 3. Debenture issued at premium and redeemable at par or at discount;
 4. Debenture issued at par and redeemable at premium;
 5. Debenture issued at a discount and redeemable at premium.

6. Debenture issued at premium and redeemable at premium.

Note: In practical life redemption at a discount is rare,

- ◆ Collateral security means secondary or supporting security for a loan, which can be realised by the lender in the event of the original loan not being repaid on the due date. Under this arrangement, the borrower agrees that a particular asset or a group of assets will be realized and the proceeds there from will be applied to repay the loan in the event that the amount due, cannot be paid. Sometimes companies issue their own debentures as collateral security for a loan or a fluctuating overdraft.
- ◆ Debentures can also be issued for consideration other than for cash, such as for purchase of land, machinery, etc.
- ◆ The discount on issue of debentures is amortised over a period between the issuance date and redemption date. Loss on issue of debentures is also a capital loss and should be written off in a similar manner as discount on debentures issued. In the balance sheet both the items (Discount and Loss) are shown as Non-current/current assets depending upon the period for which it has to be written off.
- ◆ Interest payable on debentures is treated as a charge against the profits of the company. Interest on debenture is paid periodically and is calculated at coupon rate on the nominal value of debentures.

TEST YOUR KNOWLEDGE

True and False

1. Debenture holder are the owners of the company.
2. Perpetual debentures are payable at the time of liquidation of the company.
3. Registered debentures are transferable by delivery.
4. When companies issue their own debentures as collateral security for a loan, the holder of such debenture is entitled to interest only on the amount of loan and not on the debentures
5. Debentures suspense account appears on liability side of balance sheet.
6. If a company incurs loss, then it does not pay interest to the debenture holders.
7. At the time of liquidation, debenture holders are paid off after the shareholders.
8. Convertible debentures can be converted into equity shares.
9. Redeemable debentures are not payable during the life time of the company.
10. Debentures can be issued for a consideration other than for cash, such as for purchasing land, machinery etc.

Multiple Choice Questions

1. Premium on redemption of debentures account appearing in the balance sheet is _____.
(a) A nominal account – expenditure

- (b) A nominal account - income
(c) A personal account _____.
2. Debenture interest
- (a) Is payable before the payment of any dividend on shares
(b) Accumulates in case of losses or inadequate profits
(c) Is payable after the payment of preference dividend but before the payment of equity dividend_____.
3. F Ltd. purchased Machinery from G Company for a book value of ₹ 4,00,000. The consideration was paid by issue of 10% debentures of ₹ 100 each at a premium of 25%. The debenture account was credited with _____.
- (a) ₹ 4,00,000 (b) ₹ 5,00,000 (c) ₹ 3,20,000
4. Which of the following is not a characteristic of Bearer Debentures?
- (a) They are treated as negotiable instruments
(b) Their transfer requires a deed of transfer
(c) They are transferable by mere delivery
5. When debentures are issued as collateral security, the final entry for recording the collateral debentures in the books is _____.
- (a) Credit Debentures A/c and debit Cash A/c.
(b) Debit Debenture suspense A/c and credit Cash A/c.
(c) Debit Debenture suspense A/c and credit Debentures A/c.
6. When debentures are redeemable at different dates, the total amount of discount on issue of debentures should be written off
- (a) Every year by applying the sum of the year's digit method
(b) Every year by applying the straight line method
(c) To profit and loss account in full in the year of final or last redemption

Theoretical questions

1. Distinguish between debentures and shares.
2. Explain the purpose for raising of debenture by the company. Also give the main features of debentures.

Practical questions

1. Country Crafts Ltd. issued 1,00,000, 8% debentures of ₹ 100 each at premium of 5% payable fully on application and redeemable at premium of ₹ 10 Pass necessary journal entries at the time of issue.

2. Koinal Chemicals Ltd. issued 20,00,000, 10% debentures of ₹50 each at premium of 10%, payable as ₹ 20 on application and balance on allotment. Debentures are redeemable at par after 6 years. All the money due on allotment was called up and received. Record necessary entries when premium money is included in allotment money.
3. Kapil Ltd. issued 50,000, 12% Debentures of ₹100 each at a premium of 10% payable in full on application by 1st March, 2020. The issue was fully subscribed and debentures were allotted on 9th March, 2020.
Pass necessary Journal Entries (including cash transactions).
4. On 1st April 2020 Sheru Ltd. issued 1,00,000 12% debentures of ₹100 each at a discount of 5%, redeemable on 31 March 2025. Issue was oversubscribed by 20,000 debentures, who were refunded their money. Interest is paid annually on 31 March. You are required to prepare:
 - (i) Journal Entries at the time of issue of debentures.
 - (ii) Discount on issue of Debenture Account
 - (iii) Interest account and Debenture holder Account assuming TDS is deducted @ 10%.

ANSWERS/HINTS

True and False

1. False: Debenture holder are the creditors of the company.
2. True: Perpetual debentures, also known as irredeemable debentures are not repayable during the life time of the company.
3. False: Registered debentures are not easily transferable by delivery. Bearer debentures are transferrable by delivery.
4. True: In case the company cannot repay its loan & the interest thereon on the due date, the lender becomes debenture holder & then only he is entitled to interest on debentures.
5. False: Debentures suspense account appears on asset side of balance sheet under non-current asset.
6. False: Even if the company incurs loss or earns profit, it has to pay the interest on debentures.
7. False: At the time of liquidation, debenture holders are paid off before shareholders on priority basis.
8. True: Convertible debentures can be converted into equity share after a certain period of time from the date of its issue.
9. False: These debentures are repayable as per the terms of issue, for example, after 8 years from the date of issue.

10. True: Debentures can be issued for a consideration other than for cash, such as for purchasing land, machinery etc.

Multiple Choice Questions

1. (c) 2. (a) 3. (c) 4. (b)
5. (c) 6. (a)

Theoretical Questions

- Refer para 3.4 for the distinction between Shares and Debentures.
- Debenture is one of the most commonly used debt instrument issued by the company to raise funds for the business. The most common method of supplementing the capital available to a company is to issue debentures which may either be simple or naked carrying no charge on assets, or mortgage debentures carrying either a fixed or a floating charge on some or all of the assets of the company.

For features of debentures refer para 3.3.

Practical Questions

1. **Journal Entries in the Books of Country Crafts Ltd.**

Date	Particulars	L.F.	Debit Amount (₹'000)	Credit Amount (₹'000)
(a)	Bank A/c To Debenture Application A/c (Debenture application money received)	Dr.	10,500	10,500
(b)	Debenture Application A/c Loss on Issue of Debenture A/c To Securities Premium A/c To 8% Debentures A/c To Premium on Redemption A/c (Debenture application money transferred to debenture account)	Dr. Dr.	10,500 1,000	500 10,000 1,000

2. **Journal Entries in the Books of Koinal Chemicals Ltd.**

Particulars		Debit Amount (₹ lakhs)	Credit Amount (₹ lakhs)
Bank A/c To Debenture Application A/c (Debenture application money received)	Dr.	400	400

Debtures Application A/c To 10% Debtures A/c (Debenture application money transferred to 10% debenture account consequent upon allotment)	Dr.	400	400
Debenture allotment A/c To 10% Debtures A/c To Securities Premium A/c (Call made on allotment of debenture including premium)	Dr.	700	600 100
Bank A/c To Debenture Allotment A/c (Money received consequent upon allotment)	Dr.	700	700

3. **Journal Entries in the books of Kapil Limited**

Date	Particulars		₹	₹
2020 March 1	Bank A/c To Debtures Application A/c (Being the money received on 50,000 debentures @ ₹ 110 each including premium of ₹ 10 each)	Dr.	55,00,000	55,00,000
March 9	Debtures Application A/c To 12% Debtures A/c To Securities Premium A/c (Being the allotment of 50,000 debentures of ₹ 100 each, premium @ ₹ 10 each transferred to Securities Premium Account as per Board's Resolution No....dated....)	Dr.	55,00,000	50,00,000 5,00,000

4. (i) **Journal in the Books of Sheru Ltd.**

Date	Particulars	LF	(₹ 00)	(₹ 00)
2020 Apr 1	Bank A/c To Debenture Application A/c (Being debenture application money received for 1,20,000 debentures)		1,14,000	1,14,000
	Debenture Application A/c Discount on Issue of Debenture A/c To 12% Debenture A/c To Bank A/c (Being application money transferred to debenture account and excess refunded)	Dr. Dr.	1,14,000 5,000	1,00,000 19,000

(ii)

Discount on Issue of Debenture A/c

Date	Particulars	₹'00	Date	Particulars	₹'00
1.4.20	To 12% Debentures A/c	5,000	31.3.21	By Profit & Loss A/c	1,000
		<u>5,000</u>	31.3.21	By Balance c/d	<u>4,000</u>
					<u>5,000</u>
1.4.21	To Balance b/d	4,000	31.3.22	By Profit & Loss A/c	1,000
		<u>4,000</u>	31.3.22	By Balance c/d	<u>3,000</u>
					<u>4,000</u>
1.4.22	To Balance b/d	3,000	31.3.23	By Profit & Loss A/c	1,000
		<u>3,000</u>	31.3.23	By Balance c/d	<u>2,000</u>
					<u>3,000</u>
1.4.23	To Balance b/d	2,000	31.3.24	By Profit & Loss A/c	1,000
		<u>2,000</u>	31.3.24	By Balance c/d	<u>1,000</u>
					<u>2,000</u>
1.4.24	To Balance b/d	1,000	31.3.25	By Profit & Loss A/c	1,000
		<u>1,000</u>			<u>1,000</u>
					1,000

(iii)

Interest A/c

Date	Particulars	₹'00	Date	Particulars	₹'00
31.3.21	To Debentureholder A/c	<u>12,000</u>	31.3.21	By Profit & Loss A/c	<u>12,000</u>
		12,000			12,000
31.3.22	To Debentureholder A/c	<u>12,000</u>	31.3.22	By Profit & Loss A/c	<u>12,000</u>
		12,000			12,000
31.3.23	To Debentureholder A/c	<u>12,000</u>	31.3.23	By Profit & Loss A/c	<u>12,000</u>
		12,000			12,000
31.3.24	To Debentureholder A/c	<u>12,000</u>	31.3.24	By Profit & Loss A/c	<u>12,000</u>
		12,000			12,000
31.3.25	To Debentureholder A/c	<u>12,000</u>	31.3.25	By Profit & Loss A/c	<u>12,000</u>
		12,000			12,000

Debentureholder A/c

Date	Particulars	₹'00	Date	Particulars	₹'00
31.3.21	To Bank A/c	10,800	31.3.21	By Interest A/c	12,000
31.3.21	To TDS A/c	<u>1,200</u>			<u>12,000</u>
		12,000			
31.3.22	To Bank A/c	10,800	31.3.22	By Interest A/c	12,000
31.3.22	To TDS A/c	<u>1,200</u>			<u>12,000</u>
		12,000			

31.3.23	To Bank A/c	10,800	31.3.23	By Interest A/c	12,000
31.3.23	To TDS A/c	<u>1,200</u>			<u>12,000</u>
		<u>12,000</u>			<u>12,000</u>
31.3.24	To Bank A/c	10,800	31.3.24	By Interest A/c	12,000
31.3.24	To TDS A/c	<u>1,200</u>			<u>12,000</u>
		<u>12,000</u>			<u>12,000</u>
31.3.25	To Bank A/c	10,800	31.3.25	By Interest A/c	12,000
31.3.25	To TDS A/c	<u>1,200</u>			<u>12,000</u>
		<u>12,000</u>			<u>12,000</u>