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FOUNDATION LEVEL PAPER 1: PRINCIPLES AND PRATICE OF ACCOUNTING

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CHAPTER 10-Company Accounts- Unit 3

- This unit deals with the issue and redemption of the debentures
- While raising the loan from different external sources by a company, one of the convenient methods is to issue the debentures, which is debt instrument.
- It is simple debt instrument, which acknowledges the debt against the company, carrying the terms of redemption (repayment) and interest to be charged.
- Section 2(30) of the Companies Act debenture includes debenture stock, bonds or any other instrument which are in the nature of the debt, whether they are constituting a charge on the assets or not.
- Generally when a bank loan is taken, security has to be given by the company in the same way when the money is taken from the debenture holders- then the charge on the assets of the company y to be created so that in case of any default, the debenture holders get the rights on the assets.



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- The features of debentures are as follows-
 - It is loan against the company
 - It is a fixed income bearing security where the interest is charge against the profit and has to be paid periodically.
 - The repayment of the principal value to the debenture holders to be done after a specific period.
 - It can be secured (charge against the company's assets) or unsecured (no charge on the assets of co)
 - It can be bought and sold through the stock exchange at value more or below the face value.



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Debentures	Shares
1. They are the creditors of the company as it is a debt instrument	1. They are the owners of the company
2. They do not have voting rights in the company	2. They have voting right through which they take part in the management of the co
3. Interest is payable on debentures at specified intervals irrespective of whether profit or loss is earned. Rate of interest is fixed	3. The dividend is paid only if there is profit and all the other expenses have been first. Rate of dividend is varying.
4. In Balance sheet they are shown under the Liabilities- Long term borrowings	4. They are shown under the shareholders funds in the liabilities of the Balance sheet
5. Debentures cannot be forfeited for the non payment of any installment	5. Shares can be forfeited and re- issued in case of non-payment upto two calls.
6. The repayment of the amount given by debenture holders is done first.	6. The remaining amount after all the payments is repaid to the shareholders



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- The Types of debentures which can be issued can be classified on the basis of the following-
 - Security
 - Convertibility
 - Permanence
 - Negotiability
 - Priority
- **Security-** we have **secured debentures** which refer to the creation of charge on the assets of the company and **unsecured debentures** or **naked debentures** which are not secured against the assets of the company.
- The **charges** can be **fixed or floating**. Fixed charge is created against specific assets which cannot be sold unless debenture holders are consulted. Floating charge is created on all the assets of the company.



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- **Convertibility- Convertible debentures** are those which can be converted into equity shares after certain period of time from the issue. Debentures can be partly or fully convertible into shares.
- **Non-convertible debentures** cannot be converted into shares and they have to be paid in cash.
- **Permanence-** From the permanence point of view- we have redeemable and irredeemable debentures. **Redeemable debentures** are those which are repaid after certain period of time from issue. **Irredeemable or perpetual** are those which are not repaid in the life time of the company except on winding up.
- **Negotiability-** from this point the debentures are called **registered** and **bearer debentures**. **Registered debentures** are those whose name is entered in the register of the debenture holders and to whom the interest and the principal is paid. They are not easily transferable except with rules and procedures to be complied as per Co Act 2013. They are paid to the registered holder or their order



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- **Negotiability-** from this point the debentures are called **registered** and **bearer debentures**. **Bearer debentures** are those which are transferable by delivery. They are negotiable instruments just payable to the holder. Interest is paid to the holder irrespective of the identity.
- **Priority-** Based on the priority there are **first and second mortgage debentures**. Out of the property charged- the first mortgage debentures are paid first and then the second mortgage debentures is paid.
- **Accounting treatment of the issue of debentures-** The main difference between the issue of shares and debentures is that in case of shares- we journalize only the issue of shares and we don't have the terms of redemption. Here in debentures while passing the issue entries, we shall also provide for the terms of redemption.
- The debentures can be repaid as par and at premium (such a premium is taken to Premium on redemption account). This is not securities premium amount- but it a loss or expense on repayment of debentures which shall be treated as expense and debited.



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- **Accounting treatment of the issue of debentures-** Like the shares, even the debentures can be issued at par, premium as well as discount (this is not possible in case of shares). Hence the following situations can arise as a result of the issue and redemption of debentures-
- Case 1- Issue at par and redemption at par
- Case 2- Issue at par and redemption at premium
- Case 3- Issue at premium and redemption at par
- Case 4- Issue at premium and redemption at premium
- Case 5- Issue at discount and redemption at par
- Case 6- Issue at discount and redemption at premium.

The journal entries will be passed for each case- with regard to the terms of redemption they will be recorded in the transfer entry of the debenture application or allotment as given in the question.



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- **Case 1- Issue at par and redemption at par**

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

% Debenture application A/c Dr
 To % Debenture A/c

- **Case 2- Issue at par redemption at premium**

Bank A/c Dr
 To % debenture application A/c

% Debenture application A/c Dr
 To % debenture A/c



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- **Case 2- Issue at par redemption at premium**

in the transfer entry of the allotment we shall bring the adjustment with regard to redemption at premium

Debenture Allotment A/c	Dr	
Loss on issue of debenture A/c	Dr	
To %Debenture		
To Premium on redemption A/c		(with the amount of the premium on redemption)



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- **Case 3- Issue at premium redemption at par**

Bank A/c Dr
 To % debenture application A/c

% Debenture application A/c Dr
 To % debenture A/c

To securities premium A/c (if the SP is collected with application else it has to be taken with allotment instalment- depending on the question)



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- Case 4- Issue at premium and redemption at premium

Bank A/c Dr
 To % debenture application A/c

% Debenture application A/c Dr
 Loss on issue of debentures A/c
 To % Debenture A/c

To securities premium A/c (if the SP is collected with application else it has to be taken with allotment instalment- depending on the question)

To premium on redemption A/c (with the amount of premium on redemption)



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- **Case 5- Issue at discount and redemption at par**

Bank A/c Dr
 To % debenture application A/c

% Debenture application A/c Dr

Discount on issue of debentures A/c Dr (with the amount of discount in ques)
 To % debenture A/c

Case 6- Issue at discount and redemption at premium- change only in the transfer entry

% Debenture application A/c Dr

Discount on issue of debentures A/c Dr (with the amount of discount in ques)

Loss on issue of debenture A/c Dr

 To % Debenture A/c

 To Premium on redemption A/c (with the premium on redemption amount)



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- **Issue of debentures as collateral security-** Under this concept- where a loan is taken from a bank- in order to have additional security apart from the primary security- the debentures of a company can be issued as collateral security.
- Once after the repayment of the original loan, these debentures are release with main security. If there is default in the loan repayment, then the bank becomes our debenture holders.
- The main point to be noted here is that debentures issued as collateral security does not entitle them to interest on debentures, the bankers still receive only the interest on the main loan. Only upon default they become the actual debenture holders and get right for interest on such debentures.
- In the books of the company- there are **two methods** in which this can be accounted.
- **Method 1-** Not to pass any entry, but to show the collateral in the notes to accounts that the debentures have been issued as collateral to the main loan.



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- **Issue of debentures as collateral security-** Under this concept- where a loan is taken from a bank- in order to have additional security apart from the primary security- the debentures of a company can be issued as collateral security.
- **Method 2-** To pass the following entry in the books-

Debentures Suspense A/c	Dr	(will be shown under the assets in BS)
To % Debentures A/c		(will be shown under the liabilities in BS)
- Out of both the methods- it is logical to follow the method 1 since the bankers are not yet the debenture holders, hence passing an entry means that debentures have been issued.
- **Issue of debentures for consideration other than cash-** As in the case of issue of equity shares, even the debentures can be issued as consideration instead of cash in case of purchase of any assets or any running business consisting of both assets and liabilities..
- The debentures can be issued at par, premium and discount against the consideration for the purchase.



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- **Issue of debentures for consideration other than cash-** hence it becomes very important to find out the no. of debentures which is calculated as below-

$$\text{No of debentures} = \frac{\text{Purchase consideration}}{\text{Issue price of debentures}}$$

- **Issue price of the debentures** is as follows-
 - At Par- Issue price = face value
 - At Premium- Issue price = Face value + premium
 - At discount- Issue price= Face value- discount
- The entry to be passed in the above case is as follows-

Assets A/c Dr
 To liabilities A/c
 To Purchase consideration

(This amount from entry shall be substituted in the formula as above)



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- **Issue of debentures for consideration other than cash-** The next entry to be passed in the above case is as follows-

Purchase consideration A/c Dr (This amount from entry shall be substituted in the formula as above)

Discount on issue of debentures A/c Dr* (only if the deb are issued at discount)

To % Debenture A/c

To Securities premium A/c (only if deb are issued at premium)

- **Treatment of loss/ discount on issue of debentures-** The loss concerned with issue of debentures is of two types- The discount on debentures issued, and the premium to be paid on redemption.
- Both these amount shall be computed from the question and the total amount to be written off to the Profit and loss account in a particular ratio.



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- **Treatment of loss/ discount on issue of debentures-** The amount to be written off to the Profit and loss account shall be in two ways.
- **One** – In equal proportion over the tenure of the debentures. For ex if debentures are issued for 5 years and the total loss is 20,000. Then Rs. 4,000 ($20,000/5$), shall be written off for the next 5 years to the profit and loss A/c.
- **Two-** when the debentures are redeemed in a particular way- then based on the ratio of the outstanding value of the debentures- the amount of total loss will be written off to the profit and loss ac.
- **Interest on debentures-** The interest is always calculated on the face /nominal value of the debentures and the coupon rate . The company will pay the interest to the debenture holders after deducting the TDS.



THANK YOU