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Class 12 commerce   Sub. ACT Date 03.01.2021

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Issue and Redemption of Debentures (H.W)

Question 6:

Differentiate between redemption of debentures out of capital and out of profits.

ANSWER:

Redemption of Debentures Out of Capital

When debentures are redeemed out of capital and no profits are utilised for redemption, then such redemption is termed as redemption out of capital. In such a situation, no profits are transferred to the Debenture Redemption Reserve (DRR).

As per the guideline laid down by Securities and Exchange Board of India (SEBI) and the Section 117C of Company Act of 1956, the creation of DRR is mandatory (DRR). Therefore, it is not possible to redeem debentures purely out of capital, as it reduces the value of assets. The following companies are exempted from the creation of DRR.

1. Infrastructure companies (i.e. those companies that are engaged in the business of developing, maintaining and operating infrastructure facilities)

2. A Company that issues debentures with a maturity up to 18 months

Redemption of Debenture Out of Profits

When debentures are redeemed out of profit then no capital is utilised for redemption. Before redeeming the debentures profits are transferred to DRR from Profit and Loss Appropriation Account. The creation of DRR is mandatory as per the guidelines laid down by Securities and Exchange Board of India (SEBI). SEBI mandates transferring amount equal to 50% of debentures issued to DRR before redeeming debentures. In this method, as profits are transferred to the DRR Account, thereby reducing the total amount of profits, therefore this method is termed as Redemption of Debentures Out of Profits. In this method, first of all, the required profits are transferred from Statement of Profit and Loss to the DRR Account. The working of which is shown in the Notes to Accounts of Reserves and Surplus (as prescribed in Revised Schedule VI). The final balance (after considering DRR) is shown as the sub-head 'Reserves and Surplus' under the main head of Shareholders' Funds on the Equity and Liabilities side of the Company's Balance Sheet. Lastly, when all the debentures are redeemed, then DRR account is closed by transferring its amount to the General Reserve.

Question 7:

Explain the guidelines of SEBI for creating Debenture Redemption Reserve.

ANSWER:

The following are the main points of SEBI's guidelines for creation of Debenture Redemption Reserve (DRR).

1. Every company that issues debentures with a maturity of more than 18 months shall create DRR.

2. An amount equal to 50% of debenture issued shall be transferred to DRR before starting redemption of debentures.

3. Creation of DRR is applicable only for Non-Convertible Debentures and for non-convertible part of Partly Convertible Debentures.

4. Any withdrawal from DRR is allowed only after 10% of debentures are redeemed.

Thus, as per the SEBI's guidelines, 50% of the debentures issued should be redeemed out of the profits that are transferred to DRR and the remaining 50% of the debentures issued can be redeemed either out of profits or out of capital. Hence, no company can redeem all the debentures issued purely out of the capital.

As per the SEBI's guidelines the following companies are exempted from the creation of DRR.

1. Infrastructure companies (i.e. those companies that are engaged in the business of developing, maintaining and operating infrastructure facilities)

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Question 8:

Describe the steps for creating Sinking Fund for redemption of debentures.

ANSWER:

The various steps involved in the creation of Sinking Fund for redemption of debentures can be better understood by the help of the example explained below.

A Company issued 10% Debentures of Rs 5,00,000 for 3 years. The investment is expected to earn 6% p.a. The Sinking Fund table shows that 0.31411 invested annually at 6% amount to Rs 1 in 3 years.

Step 1: Calculate the amount of instalment to be required every year for investment with the help of the Sinking Fund table. Like in the example Rs 1,57,055 (i.e. 0.31411 × 5,00,000) is required every year.

Step 2: The amount of instalment calculated in the above step is transferred to the Debenture Redemption Fund (Sinking Fund) by debiting from Profit and Loss Appropriation Account.

Step 3: In the first year, the above instalment is invested to yield amount required for redemption of debenture by debiting Debenture Redemption Fund Investment Account.

Step 4: The interest on investment is received on half yearly or annual basis. In the example, the interest of Rs 9,423 is received on annual basis. $\left(1{,}57{,}055 \times \frac{6}{100} = \text{Rs } 9{,}423\right)$

Step 5: The total amount of investment, i.e. interest plus instalment is invested in the subsequent year. In the example, Rs 1,66,478 (i.e. Rs 1,57,055 + Rs 9,423) is invested in the next year.

Step 6: Repeat the Step 2, 3, 4 for each subsequent years up to the end of the life of the debenture. In the year of redemption, the instalment (i.e. the last instalment) will be debited to the Profit and Loss Appropriation Account but will not be invested.

Step 7: In the year of redemption, the investment is sold off.

Step 8: The profit (loss) on the sale of the investment is transferred by debiting (crediting) Debenture Redemption Fund Investment Account to the Debenture Redemption Fund Account.

Step 9: The payment to the debenture holder is made.

Step 10: The balance of Debenture Redemption Fund Account *if any*, is transferred to the General Reserve.