



Question 6. Differentiate between redemption of debentures out of capital and out of profits.

Answer: Debentures can be redeemed out of capital and out of profits. The following are the difference between these two methods.

Redemption of Debentures Out of Capital: This is the situation where debentures are redeemed out of capital and no profits are utilised for redemption of the debentures, such redemption is termed as redemption out of capital. In this situation, no profits are required to be transferred to the Debenture Redemption Reserve (DRR).

Here it is to be remembered that no company can redeem its debenture purely out of capital because as per the guideline laid down by Securities and Exchange Board of India (SEBI) and the Section 117C of Company Act of 1956, before starting any redemption process a company is required to create a DRR equal to 50% of the debentures issued).

Therefore, it is not possible to redeem debentures purely out of capital, as it reduces the value of assets. There are exceptions in the following case

- (i) Infrastructure companies (i.e., those companies that are engaged in the business of developing, maintaining and operating infrastructure facilities)
- (ii) A Company that issues debentures with a maturity up to 18 months.
- (iii) In case of convertible debentures and convertible portion of partly convertible debentures.

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. As transfer of amount (profits) to the DRR from Profit and Loss Appropriation Account reduces the amount of profit available for distribution of dividend, so this redemption process is known as redemption out of profit.

DRR is shown under the head of Reserves and Surpluses on the Liabilities side of the Balance Sheet. DRR account is closed by transferring it to General Reserve only when all the debentures are redeemed.

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