What Is a Debenture?

A debenture is a kind of bond or other debt instrument that does not have any assets backing it up as collateral. Since debentures lack collateral as security, they depend on the credit profile and reputation of the issuer for support. Both companies often issue debentures as a way to raise money or capital.
A debenture is a debt instrument that does not have collateral backing it up and usually has a term of more than 10 years. Debentures rely solely on the financial strength and reputation of the issuer. Corporations frequently use debentures to raise funds or capital. Some debentures can be converted into equity shares while others cannot.

Types of Debentures

Registered vs. Bearer

When debts are issued as debentures, they can be registered to the issuer. In that case, the transfer or trading of these securities needs to go through a clearing facility that notifies the issuer of ownership changes so they can pay interest to the correct bondholder. A bearer debenture, on the other hand, is not registered with the issuer. The owner (bearer) of the debenture is entitled to interest just by possessing the bond.

Redeemable vs. Irredeemable

Redeemable debentures clearly specify the exact terms and date by which the issuer of the bond must repay their debt in full. Irredeemable (non-redeemable) debentures, in contrast, do not hold the issuer liable to repay in full by a certain date. Because of this, irredeemable debentures are also known as perpetual debentures.

Convertible vs. Nonconvertible

Convertible debentures are bonds that can be converted into equity shares of the issuing corporation after a specific period. Convertible debentures are hybrid financial products with the benefits of both debt and equity. Companies use debentures as fixed-rate loans and pay fixed interest payments. However, the holders of the debenture have the option of holding the loan until maturity and receiving the interest payments or converting the loan into equity shares.

Convertible debentures are attractive to investors that want to convert to equity if they believe the company's stock will rise in the long term. However, the ability to convert to equity comes at a price since convertible debentures pay a lower interest rate compared to other fixed-rate investments.

Nonconvertible debentures are traditional debentures that cannot be converted into equity of the issuing corporation. To make up for the lack of convertibility, investors are compensated with a higher interest rate compared to convertible debentures.

Features of a Debenture

When a company issues a debenture, the first step is to draft a trust indenture. A trust indenture is an agreement between the company issuing the debenture and the trustee who will manage the interests of the investors.

The next step is to determine the coupon rate, which is the interest rate the company will pay to the debenture holder or investor. The coupon rate can be fixed or floating. A floating rate may be tied to a benchmark like the 10-year Treasury bond yield, so it will change when the benchmark changes.

The company's credit rating, and consequently the debenture's credit rating, impacts the interest rate investors will get. Credit rating agencies assess the creditworthiness of corporate and government debt issues, providing investors with an overview of the investment risks involved.

Agencies like Standard and Poor's assign letter grades reflecting the underlying creditworthiness. The S&P system ranges from AAA for excellent to C and D for the lowest ratings. Any debt getting a rating below BB is considered speculative grade, also known as junk bonds. Essentially, the lower the rating, the more likely the issuer is to default.

For non-convertible debentures, the date of maturity is also a key feature. This date determines when the company must repay the debenture holders. The company has choices regarding how the repayment will occur. Typically, it is as redemption from the capital, where the issuer pays a lump sum at the maturity date of the debt. As another option, the payment may utilize a redemption reserve, where the company makes set payments annually until full payment at the maturity date.

Pros and Cons of Debentures

Debentures are long-term debt instruments that companies issue to raise money for growth and operations. Investors who buy debentures receive regular interest payments, which are relatively safer than returns from owning a company's stock shares. Unlike bonds backed by collateral, debentures are unsecured corporate bonds and thus riskier for investors. To compensate for the lack of collateral, debentures offer higher interest rates than comparable secured bonds. Therefore, investors should carefully evaluate the financial strength of companies issuing debentures due to the increased risk.

Advantages of debentures:

- They provide regular interest income to investors.
- Some are convertible into company stock shares after a period, making them more enticing to investors.
- In bankruptcy, debentures are paid before common stockholders.

Drawbacks of debentures:

- Fixed-rate debentures may lose value if market interest rates rise.
- An issuer's creditworthiness is key given the risk of default.
- Debentures can lose purchasing power to inflation if interest payments don't keep pace.

Issue of Debentures for Cash

Debentures are said to be issued at par when their issue price is equal to the face value. The journal entries recorded for such issue are as under:

(a) If whole amount is received in one instalment:

(i) On receipt of the application money

Bank A/c Dr.

To Debenture Application & Allotment A/c

(ii) On Allotment of debentures

Debenture Application & Allotment A/c Dr.

To Debentures A/c

(b) If debenture amount is received in two instalments:

(i) On receipt of application money

Bank A/c Dr.

To Debenture Application A/c

(ii) For adjustment of applications money on allotment

Debenture Application A/c Dr.

To Debentures A/c

(iii) For allotment money due

Debenture Allotment A/c Dr.

To Debentures A/c

(iv) On receipt of allotment money

Bank A/c Dr.

To Debenture Allotment A/c

(c) If debenture money is received in more than two instalments

Additional entries:

(i) On making the first call

Debenture First Call A/c   Dr.

To Debentures A/c

(ii) On the receipt of the first call

Bank A/c   Dr.

To Debenture First Call A/c

Note:

Similar entries may be made for the second call and final call. However, normally the whole amount is collected on application or in two instalments, i.e., on application and allotment.