Sinking Fund, Sinking Fund Assets, Sinking Fund Bonds and Sinking Fund Redemption Notice
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SINKING FUND

A fund created by setting aside out of earnings at stated intervals monies sufficient to provide for the payment of all, or part, of a long-term debt, such as an issue of bonds, or of a senior stock, such as preferred stock. The creation of a sinking fund is a method of amortization or extinguishment of a debt not yet matured, and is as binding on the debtor organization (obligor) as any other provision of the contract.

A sinking fund is usually placed in the hands of a sinking fund trustee named under the terms of a mortgage deed. It may be invested in three ways: deposited in a bank to bear interest, invested in bonds of other organizations, and invested in bonds of the issuing organization. Since there is the opportunity for mismanagement of sinking fund investments, it is usually considered safer to apply sinking fund payments to the purchase of the company's own bonds being amortized, thus extinguishing the very debt for which the sinking fund was created.

There are three ways in which a sinking fund may be invested in a company's own bonds: purchasing and keeping alive parts of other issued, purchasing and keeping alive parts of the issue being amortized, and purchasing and cancelling parts of the issue being amortized. The latter method is usually considered the best since it not only decreases fixed charges, but increases the equity of the owners and strengthens the security of the bondholders. It also prevents mismanagement of the sinking fund and tends to stabilize the price by making a market for the bonds.

The purchase of the bonds being amortized may be accomplished by open market transactions, or else the mortgage deed may provide for the purchase on certain interest dates of a certain number of bonds to be called by lot, usually at a premium. In the latter case, notice is given by the sinking fund agent that in accordance with the provisions of the mortgage and deed of trust it has designated by lot, for redemption on a certain date out of monies paid to the trustee by the issuing company, a certain sum of money for the redemption of bonds bearing the numbers stated in the notice.

"Mandatory" Sinking Fund on Preferred Stock.

Preferred stock with a "mandatory" sinking fund of a specific dollar amount per year for retirement of the preferred stock at a specific sinking fund price(s) has led to the new classification of "term" preferred stock. Since the sinking fund provision will retire all of the preferred stock in a given number of future years, such preferred stock has been loosely referred to as having a future "maturity" and as being in the nature of "debt," to be included on the balance sheet as part of the long-term debt of the company.

Preferred stock, with or without a mandatory sinking fund, is stock, and preferred stock holders are not creditors as they would be in the case of debt. Moreover, examination of the provisions for a mandatory sinking fund indicates that default in providing the “mandatory” sinking fund does not create an act of default for failure to pay money owed, as in the case of debt. In case of failure to provide the mandatory sinking fund as agreed by the company in the preferred stock’s provisions, typical provisions for such mandatory sinking fund preferred stock call for a penalty, for prohibition of the use of cash for common stock dividends, and for the repurchase by the company of its stock – serious consequences of course for the common stock holders, but not an act of default on debt, as in the case of a defaulted sinking fund called for in covenants of bonds and/or debentures.

The SECURITIES AND EXCHANGE COMMISSION (SEC) in its accounting release on the subject did not concur in including mandatory sinking fund preferred stock in the long-term debt of a company; but the SEC did provide for the listing of such preferred stock ahead of other preferred stock without such provision, in the preferred stock component of shareholders’ equity.

SINKING FUND ASSETS

An account that represents cash or securities in which the SINKING FUND is invested. From an accounting and credit standpoint, these assets should be considered as applicable to the reduction of the relative liabilities.
SINKING FUND BONDS

Bonds issued under a SINKING FUND agreement, which requires the debtor organization (obligor) to periodically set aside out of earnings a sum which, with interest, will be sufficient to redeem the issue in whole or part of maturity. The purpose of sinking fund bonds is to give assurance to investors that systematic provision is to be made for the repayment of the loan, and sinking fund payments become obligatory as part of the contract. Sinking fund payments are usually made to a trust company or sinking fund trustee and are just as binding on the issuer as interest payments, e.g., failure to make sinking fund payments entitles the bondholders to the same legal rights as default in payments of interest.

Sinking fund bonds occur among both civil and corporate issues, but are more common among the latter. Sinking fund bonds are essential for the protection of the investor in the case of extractive industries, such as coal mining, oil and the like, since the assets of those industries are of a wasting character. Among railroad and public utility corporations where the fixed assets must be kept intact in order that operations may continue, sinking funds are nevertheless quite common.

Among civil issues, the serial method of debt repayment has tended to replace the sinking fund method in recent years.

SINKING FUND REDEMPTION NOTICE

A notice, published in accordance with the requirements of the bond indenture notifying holders of bonds that are callable for redemption before maturity that certain bonds have been drawn by lot for current sinking fund redemption on a specified date and should be presented for payment, as interest will cease after the redemption date.

One of the continuing functions of custodianship and administration of securities is to be aware of and act promptly on such sinking fund notices, so as to minimize the loss of investment income from the called principal. Individual sinking fund notices are mailed to holders of registered bonds, but coupon (bearer) holders can only be reached through sinking fund advertisements published in the financial press, such as the appended example. One of the services of the statistical services is the collection and dissemination of financial notices of this type.