UNIT 11 - Sinking Fund- Types, Advantages & Disadvantages

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Introduction

- A sinking fund is created by the company to revoke the debt.
- This sinking fund is used to make payments to the investors when a company redeems the debt securities or a preferred stock.
- A sinking is used to pay the liability of a company that will come in future.
- A sinking is used to redeem burden of a company, to replace fixed assets, a redemption of stock etc.
- In sinking fund, money is regularly added constantly to assure the investor's confidence.
- A sinking fund is a collection of money done by the company to write off the debt.
- A sinking fund is kept aside by setting a revenue over a certain period of time for the future expense like capital expense repayment of debt etc.
- A sinking fund is generally used when company issue a bond.
- A company has to pay an interest on the issued bonds to the bondholders.
- A company anyhow manage to pay interest from the profit but the time comes when a company has to pay back the principal amount, at that time company use a sinking fund.
- So, the main purpose of a sinking fund is to pay the debt in time.

For Example:

If a company has issued a bond with a maturity of 10 years, so to pay the bond amount after 10 years a company starts putting some money from the starting on a regular basis into a sinking fund so at the end of 10 years company is able to pay on time.

Types of sinking fund

There are four types of sinking fund

1) Specific purpose sinking fund

In the specific sinking fund, a company uses this specific purpose sinking fund just to do that particular purpose and nothing else. So it is called specific purpose sinking fund.

2) Callable bond sinking fund

As the name describes a callable bond sinking fund means a sinking fund in which a company has a specific call price. So, a callable sinking fund is when needed.

3) Purchase back sinking fund.

A purchase back sinking fund is used when a company wants to purchase a bond back. A bond can be purchased from the bondholders at two prices, one is market price and the other one is at the sinking fund price.

4) Regular payment sinking fund

A regular payment sinking fund is used to make payment regularly to the trustee and many other.

Advantages:

- A sinking fund helps the company to pay its liability well in advance.
- A company is able to pay the debt in time because a company has already pulled a money well before.
- A sinking fund is also used to redeem the bond or any other liability in a mid-way also.
- A sinking fund also increases the goodwill of the company by paying the debt in time, and this will increase the faith of investors and attract more investment.

Disadvantages:

- When a company uses the sinking fund to buy bonds before maturity, investor losses the interest on that particular time.
- When a company uses this fund to purchase bonds at a discount or par value, so this will lose to the investors.
- When a company has sufficient fund to buy back, the investors cannot take advantage of the company and that will make uncertainty to the investors.