SINKING FUNDS FOR BOND REDEMPTION

Should They Be Charged Against Profit and Loss?—Views of David S. Kerr, C.A.

In the published annual reports of large corporations there frequently appears as a charge against profit and loss account an item for sinking fund payable to the trustee under the bond issue.

Bearing in mind that the sinking fund is an amount payable at stipulated periods under the terms of the trust deed securing the bond issue, and that the fund is to be used by the trustee in the redemption of the bonds, it is plain that the amount thus allocated is for the purpose of reducing the liability on the bond issue, writes Mr. D. S. Kerr, C.A., in the Canadian Chartered Accountant. The mere payment of a liability is not, of itself, sufficient grounds for a charge against profit and loss account. A company loaning five thousand dollars merely substitutes a debtor for a cash item for that amount. Similarly a sum of money received by a company on loan is credited to the lender and charged to cash; when it is repaid it is simply a credit to cash and a debit to the borrower. Nor does it make any difference if the loan be secured by collateral of any kind. A bond issue is nothing more nor less than a secured loan. When the cash for the bonds is received, cash is charged and bond issue credited. When the bonds are redeemed, the bond issue is debited and cash credited. The fact that the bond issue is paid off by instalments will not alter the treatment of the various payments.

The question of premiums or discounts on the bonds redeemed through the operations of the sinking fund will not be taken into account in these remarks.

Why is there the practice of charging against profit and loss and crediting a so-called "sinking fund reserve account" with the amount of the periodical allocation? This entry, of course, is in addition to the entry crediting cash and debiting the sinking fund trustee.

Treatment of Sinking Fund.

These are the most frequently used arguments: (1) The cash is to be supplied out of the profits of the concern; (2) the available balance of the profit and loss account is reduced, and therefore, dividends are not paid to the same extent as otherwise they would be.

Sinking fund payments are payable as a rule whether a company is making profits or running at a loss. As to the dividend question, the balance at the credit of the profit and loss account or surplus account does not necessarily indicate whether or not a dividend should be paid, as the amount of cash available for the payment of the dividend must surely guide the directors of a company. A cursory glance at the published balance sheets of large corporations discloses large balances being accumulated at the credit of the surplus account, which is, of course, only right. It is likely to be suicidal on the part of a company to divide up all of its profits. Another point is that it often happens in practice that companies require to borrow from their bankers sufficient cash to make the sinking fund payments.

Another viewpoint is this. Suppose a company charges the profit and loss account with the sinking fund, and borrows the necessary cash from the bank. Cash is required in due course to repay the bank. No one would ever think of passing any entry in connection therewith through the profit and loss account. Yet the cash has to be provided. If, then, there be any argument in favor of the view that an entry should appear through the profit and loss account for the sinking fund, it would also be necessary to take a similar view in connection with the repayment of a bank loan or any other indebtedness, such as short-term notes, etc. The manner in which the money was used at the time of its being secured has nothing whatever to do with profit and loss transactions. There is some inclination to discuss this treatment of the sinking fund upon the basis that the money was used for investment in the fixed assets.

Bond Issue Secured by Fixed Assets.

Some corporations charge to the profit and loss account an amount equal to the sinking fund payment, but do not set up the usual depreciation reserve, as they consider the sinking fund offsets the depreciation. Other corporations will set aside the usual depreciation and in addition charge the sinking fund to profit and loss. Still other companies charge the sinking fund and a smaller depreciation reserve, as they consider the aggregate amount sufficient to offset the depreciation.

There is no relation whatever between the sinking fund and the necessary depreciation allowance. A company may have several bond issues outstanding for various periods, such as ten, twenty, thirty or forty years. As a rule, the depreciation reserve is not based upon such a varying number of years. The depreciation reserve is usually based upon only certain of the fixed assets, while the bond issue is usually secured by all of the fixed assets. For instance, land is not a depreciable asset, nor is a perpetual franchise. Yet these form good security for bond issues. Further, bond issues are seldom over seventy per cent. of the value of the assets mortgaged.

It seems to be bad practice to show in an account a charge against profit and loss under the heading "sinking fund," and then to explain that this charge is "in lieu of depreciation," or is supplementary to the depreciation specifically shown. If the sinking fund be "in lieu of" all or part of the depreciation, the corresponding credit should not be to a sinking fund reserve, but to a depreciation reserve, as it is to offset a reduction in the value of the fixed assets. If the amount in such instances be left at the credit of a sinking fund reserve, then the accounts do not disclose the real situation, as the net value of the fixed assets (cost less depreciation) is overstated to the extent of the sinking fund reserve. Again, if instead of crediting the sinking fund reserve, these items be credited to a general reserve, the same erroneous impression is conveyed.

Must Not Overlook Stockholders.

The position of the stockholders must not be overlooked. Suppose a bond issue of $1,000,000 for twenty years. At the end of the nineteenth year there has been accumulated a sinking fund of $950,000, and the balance of the profit and loss account is $100,000. After the lapse of the bond issue the balance sheet will be changed to show either a balance at the credit of profit and loss account of, say, $1,100,000, or $100,000 and a credit at a reserve account (previously sinking fund reserve) of $1,000,000, eliminating the last year's earnings, except the $50,000 sinking fund. Ordinarily, stockholders do not understand the effect of this method of dealing with the sinking fund. It is most desirable to have all statements relate, as plainly as possible, the real situation. If a reserve has been accumulated it ought to be distinctly shown as such and not confused with depreciation.

Another point in connection with the charging to the profit and loss account of the sinking fund, in lieu of depreciation, is that it may sometimes cause confusion in dealing with insurance companies in the event of it being necessary to arrive at the net book value of assets.

Take the case of a company with a bond issue outstanding, but no provision for periodical sinking fund payments to the trustee, the bonds being payable at maturity. A comparison between the accounts of such a company and a similarly situated concern which treats its sinking fund in the method discussed would not be of any avail.

After Deducting Instalments.

In the event of a company treating its sinking fund in the manner discussed, it would be well to note in parenthesis after the surplus account, a memo to the effect that the surplus has been arrived at after deducting the sinking fund instalments paid to the trustee, aggregating so much. This is on the assumption that the sinking fund payments were not thus treated in lieu of depreciation.

It is unfortunate that the word "fund" is so frequently used in designating an account with a credit balance. The term "fund" always conveys an idea of something in hand.

Have patience and courage, work hard, fight or pay.

The facts are often better than the sentiment. Analyse them carefully.

Mayor Hocken, of Toronto, has revived his plan for the rearrangement of the duties of the city treasurer and the appointment of a finance commissioner. The mayor thinks that the statutory duties of the city treasurer are sufficiently arduous without the added responsibilities of the bond business. "The new commissioner, if appointed, would sell bonds, look after the sinking funds, advise as to sources of revenue, and generally supervise the accounting system." No definite action was taken by the controllers regarding the suggestion.