# Preferred Stock: Usage and Characteristics

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**Abstract**

*This study was conducted to determine the purposes for which corporations issued preferred stock and the types of characteristics attached to those issues. One hundred sixty-eight currently outstanding industrial preferred stock issues were researched. The most frequently given reasons for issuing preferred stock were to finance acquisitions and mergers, to reduce corporate debt, and for employee stock option plans. The majority of the preferred stocks studied were nonparticipating, cumulative, preferred over common as to assets, callable, convertible, and had voting rights.*

## Introduction

Preferred stock was introduced as an instrument for financing corporate activities in the United States in 1836 (Evans 1929). The extent to which preferred stock has been issued has varied depending upon the economic needs of companies. The characteristics, or contractual provisions, of this class of stock have evolved as the economic environment has changed. Since its inception, preferred stock has developed into a complex security with a wide range of characteristics.

As part of its major agenda project on financial instruments and off-balance-sheet financing, the Financial Accounting Standards Board is currently considering "the financial accounting issues of distinguishing between liability and equity instruments and accounting for financial instruments that have characteristics of both liabilities and equity." (FASB 1990) Preferred stock, which has both characteristics, is one of the financial instruments being considered in this project. Regardless of its apparent significance as a financing instrument, preferred stock and its characteristics are generally accorded very little discussion in financial accounting textbooks or elsewhere.

The results of a study conducted to determine the purposes for which corporations issue preferred stock and the types of characteristics attached to stock issues are presented in this paper.

## The Research Sample

The research sample consists of 110 companies that have preferred stock in their equity structures. The population from which the sample was drawn is the 600 industrial and merchandising corporations surveyed in the Forty-Fourth Edition of *Accounting Trends and Techniques* (AICPA 1990). The characteristics of the preferred stocks reviewed were obtained from *Moody's Industrial Manual* (1990), which contains financial data covering fiscal periods ending between May 1, 1989, and April 30, 1990, for companies whose securities are listed on the New York, American, and regional stock exchanges.

The 110 companies surveyed had a total of 168 separate series of preferred stock outstanding. Sixty-two of the companies had only one issue of preferred stock outstanding; 48 had more than two outstanding issues.

Approximately fifty-eight percent of the stocks included in the survey were issued during the 1980s. The number of stocks issued during selected periods of time are shown in Table 1.

One hundred nine, 65 percent, of the issues had par values ranging from $.01 to $100 per share. The 59 remaining issues were no-par value stocks.

## Reasons for Issuing Preferred Stock

Sixty-five, 38.7 percent, of the preferred stock issues reviewed were issued for corporate mergers and acquisitions. Other reasons given for issuing preferred stock included: to reduce outstanding debt, for the company's employee stock ownership plan (ESOP), for general corporate purposes, and to retire other preferred issues. Table 2 shows the number of stocks issued for these and other purposes.

The purposes of preferred stock issuances for the time periods covered by this study are shown in Table 3. As indicated by this table, the vast majority of the stocks issued during the 1960s and 1970s were for acquisitions and mergers. Using preferred stock to finance acquisi-

**Table 1**
**Preferred Stock Issuances, by Time Periods**

| Time Periods | Number of Issues | Percent |
|---|---|---|
| 1930-1939 | 3 | 1.8 |
| 1940-1949 | 9 | 5.4 |
| 1950-1959 | 1 | 0.6 |
| 1960-1969 | 32 | 19.0 |
| 1970-1979 | 23 | 13.7 |
| 1980-1989 | 98 | 58.3 |
| 1990 | 2 | 1.2 |
| Total | 168 | 100.0 |

**Table 2**
**Purposes of Preferred Stock Issues**

| Purposes | Number of Issues | Percent |
|---|---|---|
| Acquisitions and mergers | 65 | 38.7 |
| Reduce debt | 32 | 19.0 |
| Employee stock ownership plans | 23 | 13.7 |
| General corporate | 9 | 5.4 |
| Retire other preferred issues | 6 | 3.6 |
| Pension contributions | 3 | 1.8 |
| Other | 13 | 7.7 |
| Not indicated | 17 | 10.1 |
| Total | 168 | 100.0 |

tions and mergers continued to be popular during the 1980s. However, during the 1980s the two most frequently cited reasons for issuing preferred stock were to reduce debt and for employee stock ownership plans.

**The Characteristics**

The characteristics of the 168 preferred stock issues researched are classified in this study as to: dividend provisions, asset preferences, voting rights, call provisions, exchangeable provisions, conversion provisions, redemption provisions, and the preemptive right. The characteristics found and the frequency with which they appeared are summarized in Table 4 and discussed in the following pages of this paper.

*Dividend Provisions*

One hundred sixty-seven of the stocks had dividend provisions. One paid no dividend. The characteristics of the dividend provisions are discussed in the following paragraphs.

Nonparticipating. One hundred sixty-five, 98.2 percent, of the stock issues had nonparticipating dividend provisions. Approximately ninety percent of these stocks paid cash dividends which were fixed in amount by contract. Seventeen of the issues had variable or adjustable cash dividend rates. According to Van Horne and Wachowicz, this characteristic originated in 1982. (1992) Stocks with these features were generally referred to as money market or auction preferreds. For example, Weyerhaeuser Corporation's market auction cumulative preferred dividend provisions read:

"*Dividends . . . are cumulative and are generally set every 49 days by auction procedures, unless the Company does not pay timely the full amount of any dividends or the redemption price of shares called for redemption, in which case the dividend rate for all succeeding dividend periods will be 150% of the 60-day 'AA' Composite Commercial Paper Rate. The maximum dividend rate in any auction, depending upon the prevailing rating of the shares of the series, will be within a range of 110-150% of the 60-day 'AA' Composite Commercial Paper Rate.*" (Moody's 1990, p. 6455)

**Table 3**
**Purposes of Preferred Stock Issues, by Time Periods**

| | Time Periods | | | | | |
|---|---|---|---|---|---|---|
| | Prior to 1960 | 1960-1969 | 1970-1979 | 1980-1989 | 1990 | Total |
| Purposes | | | | | | |
| Acquisitions/mergers | 1 | 30 | 17 | 17 | 0 | 65 |
| Reduce debt | 2 | 1 | 3 | 26 | 0 | 32 |
| ESOP | 0 | 0 | 1 | 20 | 2 | 23 |
| General corporate | 3 | 0 | 2 | 4 | 0 | 9 |
| Retire preferred | 4 | 0 | 0 | 2 | 0 | 6 |
| Pension contributions | 0 | 0 | 0 | 3 | 0 | 3 |
| Other | 1 | 1 | 0 | 11 | 0 | 13 |
| Not indicated | 2 | 0 | 0 | 15 | 0 | 17 |
| Total | 13 | 32 | 23 | 98 | 2 | 168 |

Dividends were payable in the form of cash or additional shares of preferred stock on three of the nonparticipating issues.

All of the stocks in this category were preferred over the common stock as to dividends. Usually, when more than one issue of preferred stock was outstanding, all of the stocks in the series shared equal dividend preferences. In a few cases, however, some of the issues in a series had dividend preferences over junior issues.

Participating. Only one of the preferred stocks was termed participating; however, four additional issues were, in effect, participating because of their dividend provisions. These four stocks were entitled to the higher of a specified fixed amount or an amount equal to the dividend paid on common stock. Specifically, the no-par preference stock of the Colgate-Palmolive Company is:

"*Entitled to semi-annual dividends of the higher of $4.88 per annum or the current dividend paid on common shares for comparable six-month period.*" (Moody's 1990, p. 2771)

Cumulative/Noncumulative. One hundred sixty-five, 98.2 percent, of the stocks had cumulative dividend provisions. One of these was cumulative only if the dividend was earned. Dividends were in arrears on 15 of these issues. Three of the issues were noncumulative.

*Asset Preferences*

One hundred thirty-four, 79.8 percent, of the preferred issues were preferred over common as to assets in case of voluntary or involuntary liquidation. One issue was not preferred in this respect. There was no indication of asset preferences on the remaining issues.

Some of the stocks were preferred due to their redemption values, but the majority had asset preferences expressed in the form of liquidation values. Although there were exceptions, the voluntary liquidation values of most of the stocks exceeded their involuntary liquidation values. The contractual provisions of The May Department Stores Company's $3.40 preferred, no-par, stock provide a general indication of the types of liquidation terms found. These provisions are:

"*In liquidation, entitled to redemption price if voluntary and to $100 per share if involuntary plus accrued dividends in each case.*" (Moody's 1990, p. 4083)

As was the case with dividend preferences, some preferred issues had prior rights over other issues. The general rule, however, was for all stocks within a series to have equal asset preferences.

*Voting Rights*

Voting rights are discussed under three classifications. These classifications are unqualified, contingent, and none or not indicated.

Unqualified Voting Rights. Eighty-five, 50.6 percent, of the preferred stock contracts provided the holders with the right to vote on general corporate matters and on the election of members of the board of directors. Generally, each share of stock carried one vote per share. Some of the convertible issues had voting rights

**Table 4**
**Characteristics of 168 Preferred Stock Issues**

| | Number of Issues | Percent |
|---|---|---|
| Dividend Provisions | | |
| Nonparticipating | 162 | 96.4 |
| Participating | 5 | 3.0 |
| No Dividend | 1 | 0.6 |
| Cumulative | 165 | 98.2 |
| Noncumulative | 3 | 1.8 |
| Asset Preferences | | |
| Preferred over Common | 134 | 79.8 |
| Equal to Common | 1 | 0.6 |
| Not Indicated | 33 | 19.6 |
| Voting Rights | | |
| Unqualified | 85 | 50.6 |
| Contingent | 52 | 31.0 |
| None | 5 | 3.0 |
| Not Indicated | 26 | 15.4 |
| Call Provisions | | |
| Callable | 144 | 85.7 |
| Noncallable | 24 | 14.3 |
| Exchangeable Provisions | | |
| Exchangeable | 19 | 11.3 |
| Nonexchangeable | 149 | 88.7 |
| Conversion Provisions | | |
| Convertible | 109 | 64.9 |
| Nonconvertible | 59 | 35.1 |
| Redemption Provisions | | |
| Sinking Funds | 17 | 10.1 |
| Mandatory Redemption | 15 | 8.9 |
| Redeemable at Owner's Option | 9 | 5.4 |
| Nonredeemable at Owner's Option | 127 | 75.6 |
| Preemptive Right | | |
| No Preemptive Right | 73 | 43.5 |
| Not Indicated | 95 | 56.5 |

equal to the number of shares into which their preferred shares were convertible. The number of votes per share ranged from a low of 0.1 to a high of 160. Atlantic Richfield's $3 cumulative convertible preferred's voting provisions are typical of those found on the majority of the stocks surveyed. These provisions are:

"*Has eight votes per share, . . . votes as one class with common except that, on default of 6 quarterly dividends, the number of directors shall be increased by 2 and preferred shall have right, voting as a class, so long as such default continues, to elect such two additional directors . . . .*" (Moody's 1990, p. 103)

In addition, most of the preferred stocks with voting rights required the consent of the majority, frequently, two-thirds, of the preferred stockholders voting as one class to change the terms of the preferred stock contract adversely.

Contingent Voting Rights. In addition to the 85 stocks that were characterized by unqualified voting rights, 52 empowered their holders with special voting rights if the corporation defaulted on dividend, sinking fund, or mandatory redemption provisions. Usually the contingent voting rights enabled the preferred stockholders to elect a specified number of members to the board of directors.

None or Not Indicated. Approximately eighteen percent of the preferred stocks surveyed were either nonvoting or their voting rights were not specified. Many of the nonvoting stocks had special provisions that required the consent of the majority, normally two-thirds, of the preferred stockholders votes before the corporation could issue stock with prior rights or change the terms of the existing preferred contract adversely.

*Call Provisions*

One hundred forty-four, 85.7 percent, of the issues were callable (or redeemable) at the option of the company. Twenty-four were noncallable. Generally, the call provisions required that the stockholders be given at least 30 days' notice prior to the effective call date. Approximately one-half of these stocks had call prices that were fixed throughout the call period. The remainder had call prices that decreased at specified dates throughout the call period.

While some of these stocks were callable at any time subsequent to their issuance, many had protective features attached to the call provision in the form of a limited call period. Most frequently, the stocks were not callable until after a designated waiting period had expired. Occasionally, the call provision expired after a specified period of time had elapsed.

*Exchangeable Provisions*

The exchangeable provision, a provision that permits the issuing corporation to convert preferred stock into debt at its option, appears to have originated in the 1980s. Nineteen, 11.3 percent, of the preferred stock issues were exchangeable. One of these issues was also exchangeable at the option of the stockholders. The other 149 stocks had no exchangeable provisions. The convertible exchangeable preferred shares of National Semiconductor Corporation, which were issued in 1985, provide an example of the provisions found on exchangeable stocks. National Semiconductor's preferred shares:

"*. . . are exchangeable at the option of the Company, in whole but not in part on any dividend payment date commencing September 1, 1987, for Company's 8% convertible subordinated debentures due 2010 at the rate of $500 principal amount of debentures for each preferred share.*" (Moody's 1990, p. 6001)

*Conversion Provisions*

One hundred nine, 64.9 percent, of the issues were convertible into common stock at the option of the preferred shareholders. Fifty-nine were nonconvertible. Time limits, similar to those attached to the call provisions, were frequently placed on the conversion privileges.

The values of the conversion rights were expressed on either a dollar or share equivalency basis, with the latter being the most prevalent. As a general rule, conversion privileges were protected against dilution. The conversion provision on Atlantic Richfield's $3 cumulative convertible preferred is representative of those found on other issues. This stock is convertible:

"*Into common at any time (if called, on or before 5th business day prior to redemption date) at rate of 6.80 common shares for each preferred share. No adjustment for interest or dividends. Cash paid in lieu of fractional shares. . . . Conversion privilege protected against dilution.*" (Moody's 1990, p. 103)

*Redemption Provisions*

Approximately twenty-four percent of the preferred stock issues had contractual provisions related to their redemption. The redemption provisions found on these issues fall under three classifications--sinking funds, mandatory redemption, and redeemable at the option of the stockholder.

Sinking Funds. Seventeen of the stock contracts required the redemption of preferred shares through the operation of a sinking fund. Sinking funds are designed to redeem a specified or determinable number of shares of the stock annually. Normally, redemption occurs gradually over a period of several years as is illustrated by one of The May Department Stores Company's preferred sinking funds which requires that:

"*During each year ending July 1 . . . Company shall retire at least 1% of total shares of preferred previously issued, any deficiency to be made good before payment of dividends on junior stock. Credit may be taken for any preferred acquired or retired and any shares retired for sinking fund are not to be reissued.*" (Moody's 1990, p. 4083)

Mandatory Redemption Provisions, Other than Sinking Funds. Fifteen, approximately nine percent, of the stock issues contained mandatory redemption provisions. These provisions require redemption of the stock directly from the holders over specified, frequently short, periods of time. For example, the mandatory redemption provisions of Hills Stores Company's 10% cumulative preferred, Series C stock are:

"*Redeemable at 100% of liquidation preference. Mandatory redemption, 25% each year beginning on December 10, 2000. Mandatory redemption value, $22,805,000.*" (Moody's 1990, p. 3091)

Redeemable at the Option of the Stockholder. Nine of the preferred issues were redeemable at the option of the holders. Three of these issues were redeemable, however, only if there was a change in ownership or control of the corporation.

*Preemptive Right*

Seventy-three, 43.5 percent, of the issues were designated as not having the preemptive right in case additional preferred shares were issued. There was no indication as to whether or not the majority, 56.5 percent, of the issues had this right.

**Summary**

Preferred stock has been used as an instrument for financing corporate activities in the United States for more than 150 years. Since its inception, preferred stock has evolved, as the economic environment has changed, into a complex security with numerous characteristics. One hundred sixty-eight contemporary industrial preferred stocks were researched to determine the purposes for their issuances and their characteristics. The most frequently given reason for issuing preferred stock was to finance acquisitions and mergers. All but one of the stocks issued for acquisitions and mergers were issued between 1960 and 1989. During the 1980s, the most common reasons for issuing preferred stock were to reduce corporate debt and for employee stock option plans.

As to characteristics, the majority of the preferred stocks researched were: nonparticipating, cumulative, preferred over common as to assets, callable, convertible into common stock, and had voting rights. Slightly more than 11 percent had exchangeable provisions enabling the issuing company to convert the stock into debt securities if it so desired. Finally, 19 percent of the stock contracts contained either sinking fund or mandatory redemption requirements, but only about five percent were redeemable at the option of the stockholders.

**Suggestions for Future Research**

As indicated by this research, two new characteristics or types of preferred stock--money market (auction) preferreds and the exchangeable provision--originated during the 1980s. The reasons for the creation of these new characteristics could be researched.

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