Management Dynamics: International Journal of Management and Digital Sciences
Volume. 2 Nomor. 1 Tahun 2025
e-ISSN : e-ISSN : 3048-4162, p-ISSN : 3048-4154, Page. 104-114
DOI: https://doi.org/10.70062/managementdynamics.v2i1.62
*Available online at:* https://management.ifrel.org/index.php/ManagementDynamics

# Analysis Understanding Financial Risk in Debt Instruments: The Role of Debt Repayment Provisions in Preferred and Common Stock

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***Abstract :*** *Debt instruments, particularly those related to preferred and common stocks, play an important role in capital markets and corporate finance. One of the crucial elements that influence investment decisions and corporate policies is debt repayment provisions. Preferred stocks, with higher priority in terms of debt repayment, provide a sense of security for investors because they provide greater protection against the risk of loss. In contrast, common stocks, which have lower priority in debt repayment, offer higher potential returns but with greater risks. This article aims to explore the role of debt repayment provisions in common stocks through an in-depth literature review. The methodology used is a thematic and comparative analysis approach to the existing literature, focusing on the differences in debt repayment rights and their impact on investment decisions and corporate policies. The results show that debt repayment provisions have a significant impact on investment stability, where preferred stocks are more beneficial for conservative investors who prioritize security, while common stocks are more suitable for investors seeking potential returns for conservative investors who prioritize security, while common stocks are more suitable for investors seeking potential high returns despite greater risks. This conclusion provides an important contribution to understanding the dynamics of the capital market and helps investors and companies in designing better financial strategies. Further research is needed to explore the direct effect of debt repayment provisions on capital market performance and stock value in companies.*

***Keywords:*** *Debt, Stocks, Investment, Returns*

## 1. INTRODUCTION

### Research Background

The capital market is one of the main pillars of the modern economy, allowing companies to access the capital needed for expansion and development. One of the main ways companies raise funds is by issuing debt and equity instruments, both of which have different characteristics and impacts on the company's financial structure and investment decisions. These financial instruments play a very important role in risk management, company growth, and financial stability for both the company itself and the shareholders and creditors involved (Fery Fadly, 2024) . In this context, preferred stock and common stock appear as two very different instruments, each of which has advantages and disadvantages in terms of debt management, debt repayment, and profit sharing for investors.

Debt policy repayment is an important aspect in corporate financial management, which includes strategic decisions regarding the duration and proportion of debt financing use in the company's capital structure. According to (Setyani, 2018) , debt policy is a

*Received: Desember 17, 2024; Revised: Desember 27, 2024; Accepted: Januari 13, 2025; Pubhlished : Januari 15, 2025*

strategic step taken by company management to support business operations and expansion through the use of foreign capital. However, this policy requires careful management, considering that excessive use of debt can increase interest expenses, thereby reducing the net profit available to shareholders. In addition, high dependence on debt can increase the company's financial risk, especially in unstable economic conditions.

In measuring debt policy, *Debt to Asset Ratio* (DAR) is one of the commonly used indicators. DAR calculates the proportion of total debt to total assets of the company, thus providing an overview of how much the company relies on debt to finance its assets (Sunaryo, 2019; Sunaryo, Lestari, et al., 2024) . This ratio is important in evaluating the company's capital structure, because a ratio that is too high can indicate significant financial risk, while a ratio that is too low can indicate a lack of optimization of financing from external sources. Thus, debt policy focuses not only on short-term management, but also on the company's long-term financial sustainability.

According to (Deni Sunaryo, Hamdan, Alfina Anggriani, Cecilia Winata, 2024; Maulana et al., 2024) , most industrial companies where most of their capital is invested in fixed assets, will prioritize the fulfillment of their capital from permanent capital, namely equity, while debt is complementary. This can be related to the existence of horizontal conservative financial structure rules which state that the amount of equity should at least be able to cover the amount of fixed assets plus other assets that are permanent in nature , and companies whose assets consist mostly of current assets will prioritize their funding needs with debt.

Meanwhile, preferred stock is an equity instrument that gives its holders the right to receive dividends before common stock, as well as priority rights in capital repayment if the company is liquidated. Although it does not provide voting rights, preferred stock provides benefits in the form of fixed dividends that are safer than common stock. However, preferred stockholders will only be paid after all company debts, including bonds, are paid off. Preferred stock repayment usually occurs after long-term debts such as bonds are paid, but earlier than common stock. ( Irgie Ramadhan et al., 2024)

The main difference between bond and preferred stock repayment lies in their priority structure. Bonds as debt instruments have a higher priority in terms of repayment, meaning that the company must first fulfill its obligations to bondholders before paying preferred stockholders. Meanwhile, preferred stock, although having a higher priority than common stock, remains below the more pressing debt repayment obligations. ( Rodríguez , Velastequí, 2019)

In many cases, the decision to issue preferred or common stock is also influenced by a company's policies regarding social and environmental responsibility. Companies that focus on sustainability and social impact tend to prefer issuing common stock, which provides more flexibility in capital allocation and profit management. On the other hand, companies that focus more on financial stability and investment security may be more inclined to choose preferred stock.

Debt repayment provisions in preferred and common shares also play an important role in managing the relationship between the company, investors, and creditors (Sunaryo & Lestari, 2023) . A healthy relationship between these three parties is essential to ensure the smooth operation and growth of the company. Ambiguity or uncertainty in debt repayment provisions can damage this relationship and cause tensions that can harm the company in the long run. In this context, companies that have transparent and fair debt repayment policies will find it easier to get support from investors and creditors. Conversely, companies that do not have clear policies may face difficulties in attracting capital and obtaining loans from creditors. Therefore, it is important for companies to develop debt repayment policies.

## 2. METHODOLOGY

This study uses a literature review approach to examine the role of debt repayment provisions in preferred and common stocks. A literature review is a method used to collect, evaluate, and synthesize published research results on a particular topic. By using this method, the study aims to provide a deeper understanding of the dynamics of debt repayment in both types of stocks and how it affects investment decisions and corporate policies.

In this study, the literature search process began with the identification of relevant sources in international academic databases, such as Google Scholar, JSTOR, ScienceDirect, and Scopus. The articles were selected based on two main criteria: relevance to the topic of debt repayment provisions on preferred and common shares, and the quality of the methodology used in the article. The selection of relevant articles was carried out by considering the year of publication, with a focus on literature published in the last five years to ensure that the findings retrieved were the most up-to-date.

In addition to the thematic approach, this study also uses a comparative approach to compare various aspects of debt repayment provisions between preferred and common shares. This comparative approach is carried out by comparing existing studies on both types of shares in the context of debt repayment, with the aim of understanding the differences and similarities in their impact on shareholders and creditors. The results of this comparative approach are expected to provide clearer insight into the advantages and disadvantages of each type of share in terms of debt management.

The main data sources in this study are articles published in leading finance, economics, and management journals. The researcher also considers including literature published in textbooks or research reports from financial institutions that are relevant to the topic being studied. Each article analyzed is evaluated based on the quality of the research conducted, the methodology used , and its contribution to the understanding of debt repayment provisions on preferred and common shares.

One of the limitations of this study is the inability to collect primary data through surveys or interviews with investors and companies. However, this study attempts to overcome this limitation by relying on high-quality secondary data sources, which have been tested and accepted by the academic community. This allows the researcher to provide a broader and more objective view of the role of debt service provisions in preferred and common stocks.

As part of the methodology, the researcher also evaluates potential bias in the existing literature. This bias can arise due to methodological factors used by previous researchers or due to limited data available. By evaluating this potential bias, this study attempts to provide a more objective view and is not influenced by a narrow perspective. Finally, this study not only aims to answer questions about the role of debt repayment provisions in preferred and common stocks, but also to provide deeper insight into the effect of debt repayment policies on corporate financial stability and capital market dynamics. By using this comprehensive literature review method, this study hopes to make a significant contribution to the development of science in the fields of finance and capital markets.

## 3. RESULTS

In this analysis, the researcher compiles findings related to the comparison of debt repayment provisions on preferred and common shares based on various existing literature studies. In general, the main difference between these two financial instruments lies in the rights granted to shareholders in terms of debt repayment, as well as how this impacts investment decisions and corporate stability. Preferred shares tend to provide more benefits in terms of risk reduction, especially related to priority in debt repayment if the company faces bankruptcy or financial difficulties. Conversely, common shares offer greater profit potential but also carry higher risks.

According to (Irgie Ramadhan et al., 2024) From the results of the discussion above, it can be concluded that there is a significant influence of the share ownership structure on the dividend policy of PT. FKS Food Sejahtera Tbk. The presence of preferred shares, with their fixed dividend obligations, encourages the company to implement a more conservative dividend policy . On the other hand, common shares play an important and diverse role in determining dividend policy. Common shareholders, through their voting rights at the GMS, have a direct influence on dividend decisions. The structure of common share ownership, which includes institutional and managerial ownership. The dividend policy of PT. FKS Food Sejahtera Tbk is significantly influenced by the structure of common share ownership. The company carefully balances dividend distribution with retained earnings to support sustainable growth and maintain investor confidence.

According to (Sari et al., 2020) the results of this study indicate that debt repayment policy has a significant impact on the company's financial stability and stock performance, both for common and preferred shares. In preferred shares, effective debt repayment contributes to reducing interest expenses and other financial obligations, which has a positive impact on the company's liquidity. Companies that are able to pay off debts well will be more trusted by investors, because they feel safer with the priority of debt repayment given to preferred shareholders. This results in increased market confidence and creates a good reputation in the eyes of creditors.

According to (Dwik Suryacahyani Gunadi & Widyatama, 2021) Profits from stock investments can be obtained from capital gains or increases in stock prices or from dividends or company profits distributed to shareholders in a certain period of time. Article 1 paragraph (2) letter a of PP 14/1997 regulates the amount of PPh as referred to in Article 1 paragraph (1) for stock sales transactions, namely 0.1% of the gross amount of the sales transaction value. This means that final PPh for stock sales transactions is required to pay tax regardless of whether the seller (trader/investor) makes a profit or experiences a loss.

According to (Epi Meyorga, Pujo Gunarso, 2024) said that this policy must also be implemented carefully, because overly aggressive debt repayment can limit the company's space to invest in expansion or innovation. On the other hand, timely repayment allows companies to allocate resources better, maintain financial stability, and create opportunities for better dividend distribution or funding for new projects.

According to (Andani, 2021) said that Overall, the right debt repayment policy on both types of shares contributes to reducing financial risk, increasing the company's stability and liquidity, and increasing investor confidence in the shares. Preferred shareholders benefit from payment priority, while common shareholders can benefit from policies that lead to greater growth and profit sharing.

As a conclusion of these results and analysis, it is clear that debt repayment provisions on preferred and common shares have a significant impact on investment decisions and corporate policies. Preferred shares provide advantages in terms of risk reduction and debt repayment priority, making them a safer choice for investors who prioritize stability. On the other hand, common shares provide the opportunity for greater returns, albeit with higher risks. The decision to choose between preferred and common shares largely depends on the financial goals and risk profile of the investor as well as the financial strategy adopted by the company.

## 4. DISCUSSION

One of the findings from this discussion is that preferred stock provides benefits for investors who prioritize risk reduction. When a company faces financial difficulties or even bankruptcy, preferred stockholders will be prioritized in receiving debt payments. In other words, preferred stock provides a kind of guarantee or security for investors because they have a higher right to receive payments compared to common stockholders. This finding confirms that preferred stock is more suitable for conservative and more risk-sensitive investors.

However, although preferred shares provide a greater sense of security, common shares remain a more desirable instrument for many investors seeking higher potential returns. Common shares give their holders voting rights at general shareholder meetings, allowing them to influence company policy. In addition, common shares have greater growth potential, especially if the company is successful in expanding its business and increasing the market value of its shares. This explains why common shares are more attractive to investors who have a higher risk tolerance and prioritize long-term return potential (Sunaryo et al., 2022) .

On the other hand, many companies choose to issue preferred stock in order to raise capital without having to give voting rights to investors. Preferred stock allows companies to raise capital by providing greater incentives to investors, while still maintaining control over corporate decisions. Therefore, companies that rely more on preferred stock tend to be more focused on stability and reducing the potential for volatility that can occur in the stock market. On the other hand, companies that rely on common stock often have more flexibility in managing dividend policies and other decisions, because they are not tied to the fixed dividend payment obligations that are usually associated with preferred stock.

One of the main disadvantages of preferred stock is that while they provide priority in debt repayment, they often do not provide voting rights in corporate decisions. This can reduce the appeal of preferred stock to investors who want to have an influence on the direction of corporate policy. For example, while preferred stockholders have priority in receiving debt payments, they do not have the right to elect the board of directors or influence corporate policies on investment and development. On the other hand, common stockholders have voting rights, which gives them more control over the management of the company, albeit with greater risk in terms of debt payments and dividends (Deni Sunaryo, Hamdan, Alfina Anggriani, Cecilia Winata, 2024; Hascika et al., 2024; Lestari et al., 2024; Sunaryo, Adiyanto, et al., 2024; Wahyuni et al., 2024) .

However, it is important to note that these debt repayment provisions can also affect the company's reputation in the capital market. Companies that have clear and transparent debt repayment policies tend to be more trusted by investors and creditors. Uncertainty about how debt will be repaid or how dividends will be paid can lead to a decrease in market confidence and lower the value of the company's shares. Therefore, companies must be careful in choosing the type of shares issued and ensure that the debt repayment provisions applied can provide confidence to investors and creditors. From a corporate policy perspective, clear debt repayment provisions are very important to avoid conflicts between shareholders and creditors (Lestari et al., 2024; Wahyuni et al., 2024) . Such conflicts can damage the company's relationship with investors and creditors.

## 5. IMPLICATIONS

The managerial implications of this analysis emphasize the importance of companies in strategically managing their shareholding structure to achieve a balance between financial stability and growth potential. By understanding the characteristics of preferred and common shares, management can design a stock issuance strategy that suits the company's capital needs. Preferred shares can be used to attract investors who prioritize security and stability, while common shares are more effective in attracting investors who focus on long-term growth.

In the context of debt repayment, companies need to optimize policies that support financial stability without sacrificing investment opportunities. Aggressive debt repayment must be accompanied by careful planning so as not to limit the space for innovation or business expansion. Timely repayment of preferred stock debt is also a priority to maintain investor and creditor confidence, while improving the company's reputation in the capital market.

In addition, dividend policy must be managed by considering the needs and expectations of both preferred and common shareholders. The fixed dividend obligation on preferred shares requires a conservative approach, while common shares provide greater flexibility in distributing profits. Management needs to ensure that retained earnings are sufficient to support long-term growth, while maintaining investor confidence through a transparent dividend policy.

Furthermore, corporate risk management must consider the priority of debt payments based on the type of stock issued. In this case, preferred stock requires careful liquidity management to meet priority obligations, especially in unstable economic conditions. Meanwhile, common stock presents volatility risks that must be managed to protect the company's value in the stock market.

On the other hand, issuing common stock provides flexibility in funding new, innovative projects, while preferred stock can be used to invest in more conservative projects, such as infrastructure or low-risk assets. Therefore, management needs to be careful in choosing a funding strategy that suits the company's risk profile and long-term goals.

Transparency in debt repayment and dividend policies is also an important aspect to maintain market confidence. By ensuring consistent and clear policies, companies can build a positive reputation in the eyes of investors and creditors, while mitigating potential conflicts between preferred shareholders, common shareholders, and creditors. In the long term, this implication provides a basis for companies to design financial policies that are integrated with business strategies, so as to create sustainable added value for all stakeholders.

## 6. CONCLUSION

Debt repayment policy has a significant impact on the financial stability of the company and the attractiveness of the shares of both common and preferred stocks. Proper debt repayment can improve the financial position by reducing interest expenses and other long-term liabilities, which in turn increases the company's liquidity and provides more room for investment or dividend distribution. For preferred stockholders, this policy provides a higher sense of security because of the priority in debt repayment, while for common stockholders, efficient debt repayment can open up opportunities for growth and higher returns.

However, although debt repayment policy can improve the stability and liquidity of the company, it should be remembered that the company must also consider the balance between paying debt and maintaining financial flexibility for long-term expansion and investment. Paying off debt too quickly without considering the need for new investment can limit the company's growth potential, which can ultimately affect the performance of shares, both common and preferred shares. Therefore, companies need to design a wise debt repayment policy, which not only considering reducing financial obligations but also maintaining a balance with the need to fund expansion projects.

In this case, companies that issue preferred stock should focus on careful debt management to maintain financial stability without sacrificing growth potential. Meanwhile, companies with common stock should be more careful in managing debt repayment policies so as not to reduce investment capacity that can drive stock price increases in the future. Healthy debt repayment can improve a company's reputation in the eyes of investors and creditors, allowing them to access financing at lower interest rates and reduce the risk of bankruptcy.

**Suggestion**

Companies are re-evaluating their capital structure and ensuring that the debt repayment policy implemented supports the company's long-term goals without sacrificing growth opportunities. Companies should consider maintaining a balance between paying off debt and using funds for development projects that have the potential to increase the company's value. In addition, companies need to communicate debt repayment policies transparently to investors and creditors in order to create better relationships and increase market confidence in the company.

Going forward, further research is needed to analyze the impact of debt repayment policies across different industry sectors and market conditions. This research can help deepen the understanding of how appropriate debt repayment policies can affect corporate performance and how companies can adjust their financing strategies in the face of changing market dynamics. Thus, companies will be better prepared to design policies that not only reduce financial risk but also increase their long-term growth potential and value.

**Research Limitations**

This study only focuses on examining debt repayment policies on common stock and preferred stock in companies listed on the capital market, without covering unlisted companies or companies in the informal sector. This limits the generalizability of the results of this study only to companies operating in open and structured markets, where available data is more transparent and easily accessible. This study does not discuss sectors or types of companies that may have different financing models, such as state-owned companies or companies that rely heavily on external financing.

In addition, this study focuses on qualitative analysis and literature review, without conducting primary data collection or empirical case studies. In other words, this study does not involve interviews with shareholders, company managers, or creditors, which could provide a deeper perspective on the debt repayment policies implemented. Therefore, the analysis conducted is more theoretical and relies on data available in the literature, which may have limitations in describing more actual and dynamic situations in the field.

This study is also limited by time, as it only covers literature published in the last five years. This limits the analysis to recent developments in debt repayment policy and may not fully capture older studies or historical views on the topic. Therefore, some aspects of debt repayment policies implemented in the past may not be fully captured in this analysis.

Another limitation that needs to be noted is that this study does not discuss in detail external factors that can affect debt repayment policies, such as macroeconomic conditions, government policies, or regulatory changes that can affect companies' decisions in managing their debt. Although these factors can have a significant impact on company policies, the focus of this study is more on the internal aspects and financial decisions of companies related to their debt structure.

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