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(b) Preference Shares

The capital raised by issue of preference shares is called preference share capital. The preference shareholders enjoy a preferential position over equity shareholders in two ways:

(i) receiving a fixed rate of dividend, out of the net profits of the company, before any dividend is declared for equity shareholders; and

(ii) receiving their capital after the claims of the company's creditors have been settled, at the time of liquidation. In other words, as compared to the equity shareholders, the preference shareholders have a preferential claim over dividend and repayment of capital. Preference shares resemble debentures as they bear fixed rate of return. Also as the dividend is payable only at the discretion of the directors and only out of profit after tax, to that extent, these resemble equity shares. Thus, preference shares have some characteristics of both equity shares and debentures. Preference shareholders generally do not enjoy any voting rights. A company can issue different types of preference shares (see Box B).

Merits

The merits of preference shares are given as follows:

(i) Preference shares provide reasonably steady income in the form of fixed rate of return and safety of investment;

(ii) Preference shares are useful for those investors who want fixed rate of return with comparatively low risk;

(iii) It does not affect the control of equity shareholders over the management as preference shareholders don't have voting rights;

(iv) Payment of fixed rate of dividend to preference shares may enable a company to declare higher rates of dividend for the equity shareholders in good times;

(v) Preference shareholders have a preferential right of repayment over equity shareholders in the event of liquidation of a company;

(vi) Preference capital does not create any sort of charge against the assets of a company.

Limitations

The major limitations of preference shares as source of business finance are as follows:

(i) Preference shares are not suitable for those investors who are willing to take risk and are interested in higher returns;

(ii) Preference capital dilutes the claims of equity shareholders over assets of the company;

(iii) The rate of dividend on preference shares is generally higher than the rate of interest on debentures;

(iv) As the dividend on these shares is to be paid only when the company earns profit, there is no assured return for the investors. Thus, these shares may not be very attractive to the investors;

(v) The dividend paid is not deductible from profits as expense. Thus, there is no tax saving as in the case of interest on loans.