Preference Share Meaning

preference shares also known as preference stock, the preference shares are the type of shares whose shareholders are given preference in comparison to the other common stockholders when it is the time to pay dividends.

Similarly, when it is the time for sharing profits derived from the financial year, those individuals who own preferred shares are given the returns first and the dividends handed out are fixed in nature.

The returns that can be earned from these types of shares is exponentially more than the other commonly given out shares.

The features of preference shares are

Preference shares are endowed with a lot of features. While some of the features are specially designed for only a few types of preferred shares, the rest of the features are common for all varieties of preference shares. Some of them include:

- Maturity - In terms of maturity, the preference shares have the outcome similar to that of equity shares. The preference shares are not redeemable and the company is not liable to pay the equivalent amount as long as the company is running. Only when the company is on the verge of closure, the company needs to pay the preference shareholders after the amount has been mutually decided by the management.

- Claims on income - The rate of dividend that is to be paid to the preference stockholders is fixed and it is decided by the management that the individuals who own preference shares have the right to claim dividend before it is given out to the owners of equity shares. However, the ultimate decision of whether to invest the dividend or pay it in the form of dividend rests with the company.

- Claims on assets - When the company is about to shut down, the repayment of the funds is first done to the individuals who own preference shares than the shareholders of the equity shares. But the preference shareholders do not have any legitimate claim on the surplus assets of the business entity.

- Control - Because the owners of preference shares do not have any legal say during voting, they are not considered to have a say in the decisions taken by the company. However, in the rare case when their dues have been left unpaid even after repeated reminders, the preference shareholders can vote on the resolution that can be put forward for addressing their grievances.

- Hybrid form of security - The preference shares have features of both equity shares as well as other forms of debt financing, hence they are known as hybrid forms of security.

Preference shares are similar to equity shares in the fact that the payment of funds is not mandatory, the dividend that is paid is only from the share of distributable profits and the dividend paid is not considered as an expense while calculating the tax liability of the business.

Types of preference shares

Cumulative preference shares

The individuals who are owners of preference shares have the legal right to put forward their claim returns for even the financial years that have not recorded any profits. When the company does make substantial profits, the cumulative preference shareholders are given the dividend by computing for all the years to date for which the dividend has not been paid.

Non-cumulative preference shares

The individuals who are shareholders of the non-cumulative preferred shares types have no right to demand the returns of the previous years. They are given out dividends only in the financial year where profits have been recorded.

Redeemable preference shares

The main rule that governs the process of holding the shares is that the company need not pay a dividend until the company is on the verge of liquidation. The company can redeem the shares that come under the category of redeemable preference shares and they should be fully paid off either out of the profits or from the freshly invested funds.

Irredeemable preference shares

Irredeemable preference shares refer to those shares that can be redeemed only when the company is on the verge of closure.

Participating preference shares

The owners who have a stake in the participating preference shares have a right to get dividend when there are sustainable profits to the company. Firstly, a dividend at a fixed rate is issued to them. Thereafter the rate of returns is equal to that of the equity shares.

Non-participating preference shares

Non-participating preference shares are eligible to get only a fixed rate of returns and they do not have a right on the extra profits made by the company.

Convertible preference shares

After a predetermined period, the owners of the convertible preference shares can change their shares into holdings in equity shares.

Non-convertible preference shares

The preference shares that cannot be converted into equity shares are termed as non-convertible preference shares.

Advantages of preference shares

- The company is not legally bound by rights to pay for returns in the case of preference shares until the company filed for liquidation. By the mutual decision of the management of the company, the amount to be paid as the dividend is decided and it is paid from the profits obtained.
- Preference shares are a source of funds for the company in the long run.
- The company is not responsible for redeeming the shares that come under the category of preference shares till the time the company is in operation.
- When the share of the sustainable profits increases, the amount of dividends that are doled out to the preference share stakeholders also varies.
- The owners of the preference shares do not have any voting rights in the managerial decisions.

Disadvantages of preference shares

- The preference shares are more costly than other types of shares declared by the company as the expectation of the preference shareholder is more than other shares owners.
- The rate of returns on the preference shares is lesser in comparison to the other types of shares such as equity shares.
- Preference shares are considered to be riskier to when compared to other shares as they are subject to the fluctuations in the market.
- Preference shareholders do not have any rights to vote or take part in the company's decision-making process.

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