



RAMA UNIVERSITY

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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: B.COM V SEM.

SUBJECT: INTRODUCTION TO FINANCIAL MANAGEMENT

SUBJECT CODE: BCH 505

LECTURE: 21

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LECTURE-21



2. Cost of Preference Capital:

A fixed rate of dividend is payable on preference shares. Though dividend is payable at the discretion of the Board of Directors and there is no legal binding to pay dividends yet it does not mean that preference capital is cost free. The cost of preference capital is the function of the dividend expected by its investors.

Formula:

$$K_p = \frac{I}{P \text{ or } NP}$$

Where, K_p = Cost of preference Capital

D = Dividend

P = Preference Share

Capital NP = Net Proceedings

Cost of Redeemable Preference Capital:

Sometimes redeemable preference Capital Shares is issued which can be redeemed or cancelled on maturity date. The cost of such capital can be computed as follows:-

$$K_{db} = \frac{\frac{D + \frac{1}{N} (MV - NP)}{\frac{I}{2} (MV + NP)}}$$

Where, K_{pr} = Cost of redeemable Preference Capital

D = Annual Preference Dividend

MV = Maturity value of preference shares

NP = Net proceeds Preference shares

Illustration13. A company issues 1,000 7% preference shares of Rs. 100 each at a premium of 10% redeemable after 5years at par. Compute the cost of preference Capital. Solution:

$$\begin{aligned} K_{db} &= \frac{\frac{D + \frac{1}{N} (MV - NP)}{\frac{I}{2} (MV + NP)}}{7,000 + \frac{1}{5} (1,00,000 - 1,10,000)} \\ &= \frac{\frac{1}{2} (1,00,000 + 1,10,000)}{4.76\%} \end{aligned}$$