TUTOR MARKED ASSIGNMENT

Course Code	**:**	**ECO - 14**
Course Title	**:**	**Accountancy - II**
Assignment Code	**:**	**ECO – 14/TMA/2016-17**
Coverage	**:**	**All Blocks**

Maximum Marks: 100

Attempt all the questions.

1. What are the objectives of keeping branch accounts? Explain how Branch Stock Account helps in keeping effective control over the branch stock.

   (8+12)

2. What are the characteristics of a hire purchase agreement? Describe the rights of a hire under hire purchase agreement.

   (10+10)

3. Explain how is good will brought in by an incoming partner treated in the books of account? How will you deal with the existing goodwill in the books, if any.

   (10+10)

4. XYZ Ltd. Issued 1,50,000 equity shares of Rs. 10 each at a premium of Rs. 2 per share payable Rs. 3 on application , Rs. 5 on allotment (including premium) and balance in two calls of equal amount. Applications were received for 200000 shares and pro-rata allotment was made to all the applicants. The excess application money was adjusted towards allotment. Mahesh who was allotted 400 shares failed to pay 1st and 2nd call and his shares were forfeited after the second call. Pass the necessary journal entries in the books of XYZ Ltd. And also show the Balance Sheet.

   (20)

5. “Return on investment (ROI) is considered to be the master ratio which reflects the overall performance of the firm.” Elucidate.

   (20)

ASSIGNMENT SOLUTIONS GUIDE (2016-2017)

E.C.O.-14

Accountancy-II

Disclaimer/Special Note: These are just the sample of the Answers/Solutions to some of the Questions given in the Assignments. These Sample Answers/Solutions are prepared by Private Teacher/Tutors/Authors for the help and guidance of the student to get an idea of how he/she can answer the Questions given the Assignments. We do not claim 100% accuracy of these sample answers as these are based on the knowledge and capability of Private Teacher/Tutor. Sample answers may be seen as the Guide/Help for the reference to prepare the answers of the Questions given in the assignment. As these solutions and answers are prepared by the private teacher/tutor so the chances of error or mistake cannot be denied. Any Omission or Error is highly regretted though every care has been taken while preparing these Sample Answers/Solutions. Please consult your own Teacher/Tutor before you prepare a Particular Answer and for up-to-date and exact information, data and solution. Student should must read and refer the official study material provided by the university.

Attempt all the questions.

Q. 1. What are the objectives of keeping branch accounts? Explain how Branch Stock Account helps in keeping effective control over the branch stock.

Ans. A business organisation, with a view to increase its sales, may run different units at different places either in the same town or in different towns and also in foreign countries. The different units so run are called 'branches' and the main office under which various units are operating is called Head Office.

Branch Stock Account: The Branch Stock Account is opened with the opening value of stock at branch and in transit (at invoice price) and debited with the invoice value of goods sent to branch and goods returned by the customers. This account is credited with the sales (cash and credit) and goods returned to the head office (at invoice price). Ultimately, this account is credited with the closing stock of the branch at invoice price. Sometimes, it is also credited with goods in transit at the end of the year (at invoice price). Since this account is a statement showing the reconciliation of stock, both the sides should tally and, in effect, this account cannot have any balance. But, in practice, there are often slight differences for example, it is practically impossible to weigh up exactly 100 separate kg of butter from one quintal butter slab. In some cases, there may be a surplus for different reasons such as, sale of goods above invoice price and absorption of moisture (in case of sugar, fertiliser, etc.) Thus these differences are adjusted by making small allowances. If there is shortage/deficiency then it is recorded on the credit side and surplus is recorded on the debit side.

Important features of Branch Stock Account are as under:

(i) It controls branch stock.

(ii) It is maintained at invoice price.

(iii) Actual stock with the branch is shown as the balance in this account.

The following are the main objectives of maintaining branch accounts:

(i) Actual financial position of the business can be found out on the basis of head office and branch accounting periods.

(ii) Profit or loss of each branch can be found out.

(iii) They help in controlling branches.

(iv) Suggestions for increasing the efficiency of the branch can be sent on the basis of branch accounts.

(v) Branch requirements of goods and cash can be estimated.

(vi) They help in complying with the requirements of law because according to companies' act 1956.

Branch Stock Account is a practical means of controlling stock at branch. This account records the transactions in regard to the stock in the branch at invoice price. The debit side of this account records the inflow of stock into the branch and credit side records its outflow from the branch. This account is a statement showing the reconciliation of stock, both the sides should tally and, in effect, this account cannot have any balance. But, this is only a theoretical

view. In practice, there are often slight differences, usually deficiencies. In practice, it is usual to make certain allowances in respect of such unavoidable differences. If it is more than normal allowance, enquiries should be made as to the causes of the difference. Shortage/deficiency is recorded on the credit side and surplus is recorded on the debit side.

Q. 2. What are the characteristics of a hire purchase agreement? Describe the rights of a hire under hire purchase agreement.

Ans. Nature of Hire Purchase Agreement: Hire-Purchase System is a special system of purchase and sale of goods. Under this system purchaser pays the price of the goods in instalments. Under the Hire Purchase System the customer (called the Hire Purchaser) obtains possession of the goods at the outset and can use it, while paying for it by instalments over an agreed period of time. However, the ownership of the goods remains with the seller (called the Hire Vendor) until the hire purchaser has made all the payments. Each instalment paid by the hire purchaser is treated as hire charges for using the asset. In case he fails to pay any of the instalments (even the last one) the hire vendor will take back his goods without compensating the buyer. i.e., the hire vendor is not going to pay back a part or whole of the amount received through instalments from the buyer.

The instalments may be annual, six monthly, quarterly, monthly fortnightly etc. Under this system the goods are delivered to the purchaser at the time of agreement before the payment of instalments but the title on the goods is transferred after the payment of all instalments as per the hire-purchase agreement. The special feature of a hire-purchase transaction is that the payment of every instalment is treated as the payment of hire charges by the purchaser to the hire vendor till the payment of the last instalment. After the payment of the last instalment, the amount of various instalments paid is appropriated towards the payment of the price of the goods sold and the ownership or the goods is transferred to the purchaser. Thus hire-purchase means a transaction where the goods are sold by vendor to the purchaser under the following conditions:

(1) The goods will be delivered to the purchaser at the time of agreement.

(2) The purchaser has a right to use the goods delivered.

(3) The price of the goods will be paid in instalments.

(4) Every instalment will be treated to be the hire charges of the goods which is being used by the purchaser.

(5) If all instalments are paid as per the terms of agreement , the title of the goods is transferred by vendor to the purchaser.

(6) If there is a default in the payment of any of the instalments, the vendor will take away the goods from the possession of the purchaser without refunding him any amount received earlier in the form of various instalments.

Characteristics of Hire Purchase Agreement: The characteristics of the hire purchase agreement are:

(1) The hire vendor transfers only possession of the goods to the hire purchaser immediately after the contract for hire purchase is made.

(2) The goods should be delivered by the hire vendor on the condition that a hire purchaser should pay the agreed amount in periodical instalments.

(3) The hire purchaser generally makes a down payment (initial payment) on signing the agreement and the balance of the amount along with interest is paid in instalments at regular intervals for a specified period.

(4) Each instalment including down-payment (if any) is treated as hire charges by the seller.

(5) Each instalment consists partly of a finance charge (interest) and partly of a capital payment.

(6) The hire purchaser should be given power to exercise the option to purchase the hired goods.

(7) The property in goods is to pass to the hire purchaser on the payment of the last instalment and exercising the option conferred upon him under the agreement.

(8) The hire purchaser has the right to terminate the agreement at any time before the properly so passes.

(9) In case of default in respect of payment of even the last instalment, the hire vendor has the right to take the goods back without making any compensation.

Rights of Hirers: The hirer usually has the following rights:

(1) To buy the goods at any time by giving notice to the owner and paying the balance of the HP price less a rebate (each jurisdiction has a different formula for calculating the amount of this rebate).

(2) To return the goods to the owner which is subject to the payment of a penalty to reflect the owner's loss of profit but subject to a maximum specified in each jurisdiction's law to strike a balance between the need for the buyer to minimize liability and the fact that the owner now has possession of an obsolescent asset of reduced value.

(3) With the consent of the owner, to assign both the benefit and the burden of the contract to a third person. The owner cannot unreasonably refuse consent where the nominated third party has good credit rating.

(4) Where the owner wrongfully repossesses the goods, either to recover the goods plus damages for loss of quiet possession or to damages representing the value of the goods lost.

The hirer usually has the following obligations:

(a) to pay the hire instalments.

(b) to take reasonable care of the goods (if the hirer damages the goods by using them in a non-standard way, he or she must continue to pay the instalments and, if appropriate, compensate the owner for any loss in asset value)

(c) to inform the owner where the goods will be kept.

Q. 3. Explain how is good will brought in by an incoming partner treated in the books of account? How will you deal with the existing goodwill in the books, if any.

Ans. Meaning of Goodwill: A well-established business over a period of time develops an advantage of good name, reputation and wide business connections. This helps the business to earn more profits as compared to a newly set-up business. In accounting, the monetary value of such advantage is known as 'goodwill'. It is regarded as an intangible asset. In other words, goodwill is the value of the reputation of a firm in respect of the profits expected in future over and above the normal profits. It is generally observed that when a person pays for goodwill, he/she pays for something, which places him in the position of being able to earn super profits as compared to the profit earned by other firms in the same industry. Goodwill is the attracting force, which attracts the customers towards products of the firm. It is the value of customers' confidence in the business. It is really the reputation and honour attached to the business by its consumers and other related parties, caused by its efficient working and other business and human qualities.

In the words of **Eric L Kohler** "Goodwill is the excess of the price paid for a business as a whole over the book values or over the computed value of all intangible assets purchased. Normally, goodwill thus acquired is only one type appearing on books of account and in financial statements."

According to **Professor Dicksee** "when a man pays for goodwill he pays for something which places him in a position of being able to earn more money than he would be able to do by his own unaided efforts. Thus, the capacity of a business to earn profits in future is basically what is meant by term goodwill."

In simple words, goodwill can be defined as ''the present value of a firm's anticipated excess earnings" or as "the capitalized value attached to the differential profit capacity of a business". Thus, goodwill exists only when the firm earns super profits. Any firm that earns normal profits or is incurring losses has no goodwill. According to accounting point of view goodwill may be termed as the average profit, super profit and capilalised value of super or average profit.

Goodwill originates with the customers' confidence in the partnership firm. If the firm wins over the confidence, there is an extra-ordinary increase in the profits of the business. It enables the firm to earn profit more than other firms in the industry. The excess, super and extra-ordinary profit earned is termed as goodwill.

Treatment Of Goodwill On Admission Of A Partner: Accounting treatment of goodwill at the time of admission of a partner can be classified into four parts:

(1) When new partner pays amount of goodwill privately: In this case no entry will be passed in the books of the firm.

(2) When new partner brings his share of goodwill in cash or kind. In this case the following entries are passed: For amount of Capital + Goodwill brought in by new partner

Cash/Bank/ Assets A/c Dr.
  To New Partner's Capital A/c (for amount of capital)
  To Premium A/c (for amount of goodwill)

For amount of goodwill brought in by new partner credited to Old Partner's Capital A/cs in their Sacrificing Ratio.

Premium A/c Dr.
  To Old Partner's Capital A/cs

When old partners withdraw the amount of goodwill.

Old Partner's Capital A/c Dr.
  To Cash/Bank A/c

Condition: When new partner brings his share of goodwill in cash, in this case no goodwill should already appear in the books. In case goodwill already appears in the books it should be written off in old ratio. Entry will be:

Old Partner's Capital A/cs Dr.

To Goodwill A/c

Example 2: A and B are partners sharing profit and losses in the ratio of 5:3. C is admitted as a new partner for 1/5th share. C brings Rs. 15,000 as his Capital and necessary amount of his share of goodwill in cash. Total goodwill of the firm is Rs. 60,000. Goodwill already appears in the Balance Sheet of A and B is Rs. 20,000. Pass necessary journal entries.

Solution:

Journal

Date	Particulars	L.F.	Dr. Rs.	Cr Rs.
(i)	Cash A/c Dr.		27,000	
	To C's Capital A/c			15,000
	To Premium A/c			12,000
	(Being the amount of Capital and Goodwill brought in by C)			
(ii)	Premium A/c Dr.		12,000	
	To A's Capital A/c			7,500
	To B's Capital A/c			4,500
	(Being the amount of goodwill brought in by C credited to A and B in their Sacrificing Ratio, which is 5:3)			
(iii)	A's Capital A/c Dr.		12,500	
	B's Capital A/c Dr.		7,500	
	To Goodwill A/c			20,000
	(Being existing goodwill written off in Old Ratio)			

Workings Note: C's Share of Goodwill = 1/5 × Rs. 60,000 = Rs. 12,000

(3) When new partner does not bring his share of goodwill in cash: In this case new partner's share of goodwill is charged to his capital account and transferred to old partner's capital accounts in their sacrificing ratio. Entries for this will be:

(i) For amount of capital brought in by new partner

Cash/Bank/ Assets A/c Dr.

To New Partner's Capital A/c

(ii) For new partner's share of goodwill credited to old partner's capital accounts in their sacrificing ratio

New Partner's Capital A/c Dr.

To Old Partner's Capital A/cs

(iii) When old partners withdraw the amount of goodwill.

Old Partner's Capital A/c Dr.

To Cash/Bank A/c

Condition: No goodwill should already appear in the books. In case goodwill already appears in the books it should be written off in old ratio. Entry will be:

Old Partner's Capital A/cs Dr.

To Goodwill A/c

Example 3: A and B are partners sharing profits and losses in the ratio of 5:3. C is admitted as a new partner for 1/5th share. C brings Rs. 50,000 as his capital but he is not able to bring his share of Goodwill in cash. Total Goodwill of the firm is Rs. 60,000. In the books of A and B (i)No Goodwill already appears and (ii)Goodwill already appears at Rs. 24,000.

Pass necessary journal entries.

Solution:

Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
(a)	Bank A/c Dr.		50,000	
	To C's Capital A/c			50,000
	(Being the amount of capital brought in by C)			
	C's Capital A/c Dr.		12,000	
	To A's Capital A/c			7,500
	To B's Capital A/c			4,500
	(Being C's share of goodwill credited to A's and B's Capital A/cs in their sacrificing ratio.)			
(b)	Bank A/c Dr.		50,000	
	To C's Capital A/c			50,000
	(Being amount of capital brought in by C)			
	C's Capital A/c Dr.		12,000	
	To A's Capital A/c			7,500
	To B's Capital A/c			4,500
	(Being the C's share of goodwill credited to A's and B's Capital A/cs in their sacrificing ratio.)			
	A's Capital A/c Dr.		15,000	
	B's Capital A/c Dr.		9,000	
	To Goodwill A/c			24,000
	(Being the existing goodwill in the books written off in old ratio)			

(4) When new partner brings only a part of his share of goodwill in cash or kind: In this case amount brought in by new partner as his share of goodwill transferred to old partner's capital accounts in their sacrificing ratio and the amount that is not brought in by him is charged to his capital account and is also transferred to old partner's capital accounts in their sacrificing ratio. Entries will be in following manner:

For amount of Capital + Goodwill brought in by new partner

Cash/Bank/Assets A/c Dr.

To New Partner's Capital A/c (Amount of Capital)

To Premium A/c (Amount of Goodwill brought in by new partner)

For amount of goodwill brought in by new partner credited to old partner's capital accounts in their sacrificing ratio.

Premium A/c Dr.

To Old Partner's Capital A/cs

For amount of goodwill not brought in by new partner charged to his capital account and credited to old partner's capital accounts in their sacrificing ratio.

New Partner's Capital A/c Dr.

To Old Partner's Capital A/cs

Condition: No goodwill should already appear in the books. In case goodwill already appears in the books it should be written off in old ratio. Entry will be:

Old Partner's Capital A/cs Dr.

To Goodwill A/c

Example 4: A and B are partners sharing profits and losses in the ratio of 5:3. C is admitted as a new partner for $1/5^{th}$ share. C brings Rs. 50,000 as his capital and brings only 60% of his share of Goodwill in cash. Total Goodwill of the firm is Rs. 60,000. Pass necessary journal entries when A and B withdraw 50% of the amount brought in by C as his share of goodwill in cash. Goodwill already appears in the books at Rs. 16,000.

Solution:

Journal

Date	Particulars	L.F.	Debit (Rs.)	Credit (Rs.)
	Bank A/c Dr Dr To C's Capital A/c To Premium A/c (For amount of capital and goodwill brought in by C)		57,200	 50,000 7,200
	Premium A/c Dr. To A's Capital A/c To B's Capital A/c (For amount of goodwill brought in by credited to old partner's capital account in their sacrificing ratio)		7,200	 4,500 2,700
	C's Capital A/c Dr. To A's Capital A/c To B's Capital A/c (For amount of goodwill not brought in by C charged to his capital A/c and credited to old partner in their sacrificing ratio)		4,800	 3,000 1,800
	A's Capital A/c Dr. B's Capital A/c Dr. To Bank A/c (Being the amount of goodwill withdrawn by old partners)		2,250 1,350	 3,600
	A's Capital A/c Dr. B's Capital A/c Dr. To Goodwill A/c (Being the goodwill in the books written off in old ratio)		10,000 6,000	 16,000

Workings:

C's Share of Goodwill = 1/5 × Rs. 60,000 =
Rs. 12,000.

But C brings only 60% of his share of goodwill in cash i.e. Rs. 12,000 × 60/100 = Rs. 7,200.

C does not bring 40% of his share of goodwill in cash i.e. Rs. 12,000 × 40/100 = Rs. 4,800.

Note: *Recommendation of Accounting Standard 10 (AS-10) – Issued by The Institute of Chartered Accountants of India. According to AS – 10 goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Thus, in case of admission or retirement/death of a partner or in case of change in profit sharing ratio among partners, goodwill, following the accounting standard should not be raised in the books of the firm because no consideration in or money worth is paid for it. If any partner brings any premium over and above his capital should be distributed to other existing partners. If goodwill is evaluated at the time of change in the constitution of the firm (by way of admission/ retirement/death/change in profit sharing ratio), goodwill should not be brought in books since it is inherent goodwill. If it is raised then it should be immediately written off.*

Q. 4. XYZ Ltd. Issued 1,50,000 equity shares of Rs. 10 each at a premium of Rs. 2 per share payable Rs. 3 on application Rs. 5 on allotment (including premium) and balance in two calls of equal amount. Applications were received for 200000 shares and pro-rata allotment was made to all the applicants. The excess application money was adjusted towards allotment. Mahesh who was allotted 400 shares failed to pay 1st and 2nd call and his shares were forfeited after the second call. Pass the necessary journal entries in the books of XYZ Ltd. Ans also show the Balance sheet.

Solution

Date	Particulars	L.F.	Debit Amount	Credit Amount
	Bank A/c or		6,00,000	6,00,000
	To equity share application A/c			
	(Being share application money received on 2,00,000 shares)			
	Equity			
	Share application A/c and		6,00,000	
	Equity			
	To Share capital A/c			
	equity			4,50,000
	To share Allotment A/c			1,50,000
	(Being share application money is transferred to share capital and share allotment A/c)			
	Equity			
	Share allotment A/c-or		7,50,000	
	To Equity Share capital A/c			4,50,000
	To Share Premium A/c			
	Being share allotment money due			3,00,000
	Bank A/c or		6,00,000	
	To equity Share allotment			6,00,000
	Being share attoment money recived			
	Equity			
	Share 1st call A/c or		3,00,000	
	To equity share capital A/c			3,00,000
	(Being first call money back)			
	Bank A/c or		2,99,200	
	Calls in Area A/c or		800	3,00,000
	To equity share ISFW calls A/c			
	(Being Ist call money reccived except 400 shares)			
	Equity share IInd and Final call A/c-or		3,00,000	
	To equity share capital A/c			3,00,000
	Being IInd ad final call money due			
	Bank			
	Bank A/c or		2,99,200	
	Calls in Awears A/c or		800	
	To equity share IInd and final calls A/c (Being IInd and final call money received except 400 shares.			3,00000
	equity share capital A/c or			
	To share for fixed A/c			2400
	To calls in Awears A/c			1600
	(Being 400 shares are for faited because of non payment of 1st and IInd call money			

Balance Sheet of M/s XYZ Ltd as on

Liabilities	Amount	Liabilities	Amount
Share capital A/c	14,96,000	Bank A/c	17,98,400
Share forfeiled A/c	2400		
Share Premium A/c	3,00,000		
	17,98,400		17,98,400

Q. 5. "Return on inveestment (ROI) is considered to be the master ratio which reflects the overall performance of the firm." Elucidate.

Ans. Meaning Of Ratio Analysis: A relationship between various accounting figures, which are connected with each other, expressed in mathematical terms, is called accounting ratios. According to **Kennedy and Macmillan**, "The relationship of one item to another expressed in simple mathematical form is known as ratio. **Robert Anthony** defines a ratio as – simply one number expressed in terms of another." Accounting ratios are very useful as they briefly summarise the result of detailed and complicated computations. Absolute figures are useful but they do not convey much meaning. In terms of accounting ratios, comparison of these related figures makes them meaningful. For example, profit shown by two-business concern is Rs. 50,000 and Rs. 1,00,000. It is difficult to say which business concern is more efficient unless figures of capital investment or sales are also available. Analysis and interpretation of various accounting ratio gives a better understanding of the financial condition and performance of a business concern.

The technique of analyzing and interpreting financial statements with the help of accounting ratios is called Ratio Analysis. In the words of **J. Batty**-Management Accounting "Primarily, the object of ratio analysis is to help management in analyzing and interpreting the financial statements, to get adequate information useful for the performance of various functions like planning, co-ordination, control, communication and forecasting etc." However, the utility of ratio analysis is not confined to management alone. Ratio analysis serves the purpose of all those who are interested in a concern in one way or the other. In view of the various users of ratios, there are many types of ratios which can be calculated from the information obtained from the financial statements. The particular purpose of the user shall determine the particular ratios that might be used for analysis. It is a tool used by individuals to conduct a quantitative analysis of information in a company's financial statements. Ratios are calculated from current year numbers and are then compared to previous years, other companies, the industry, or even the economy to judge the performance of the company. Ratio analysis is predominately used by proponents of fundamental analysis. There are many ratios that can be calculated from the financial statements pertaining to a company's performance, activity, financing and liquidity. Some common ratios include the price-earnings ratio, debt-equity ratio, earnings per share, asset turnover and working capital.

Objectives of Ratio Analysis

In valuing and assessing the financial health of any company, various types of analyses are necessary to develop a competent report and conclusion, whether it is digging into the qualitative aspects of a company, or the quantitative. With the quantitative, it considers examining the measurable dynamics of a company. How we pull out the quantitative aspect will come largely from calculations using the items on a company's financial statements (i.e. income statement, balance sheet, statement of cash flows). As you probably know, the majority of the ratios calculated in this tutorial will be looking at items from a financial statement and understanding the relationship between them. Like any research, quantitative analysis will produce excellent results when combined with other methods and techniques in studying a company. While ratios can tell us much about a company, it is important to note that ratios are most effective when analyzing a ratio's trend or when comparing a ratio against its competitors. Understanding the company's history and environment is the key element in determining its health, value, and future potential. It is also important to note how the ratio is changing.

Classification of Ratios

The ratios can be classified in various ways. They are:

- Liquidity ratios

- Solvency ratios
- Activity ratios
- Profitability ratios.

Profitability in Relation to Capital Employed (Investment)

1. Return on Investment or Return on Capital Employed: This ratio shows the relationship between the profit earned before interest and tax and the capital employed to earn such profit. Return on capital employed measures the profit, which a firm earns on investing a unit of capital. The profit being the net result of all operations, the return on capital expresses all efficiencies and inefficiencies of a business. This ratio has a great importance to the shareholders and investors and also to management. To shareholders it indicates how much their capital is earning and to the management as to how efficiently it has been working. This ratio influences the market price of the shares. The higher the ratio, the better it is.

$$\text{Return on Capital Employed} = \frac{\text{Net Profit before Interest, Tax and Dividend}}{\text{Capital Employed}} \times 100$$

where Capital Employed = Share Capital (Equity + Preference) + Reserves and Surplus + Long-term Loans – Fictitious Assets

Or

Capital Employed = Fixed Assets + Current Assets– Current Liabilities.

2. Return on Equity: Return on equity is also known as return on shareholders' investment. The ratio establishes relationship between profit available to equity shareholders with equity shareholders' funds. Return on Equity judges the profitability from the point of view of equity shareholders. This ratio has great interest to equity share-holders. The return on equity measures the profitability of equity funds invested in the firm. The investors favour the company with higher ROE.

$$\text{Return on Equity} = \frac{\text{Net Profit before Interest, Tax and Preference Dividend}}{\text{Equity Shareholders' Funds}} \times 100$$

Where Equity Shareholders' Funds = Equity Share Capital + Reserves and Surplus – Fictitious Assets

The ratio of return on owners' equity is a valuable measure for judging the profitability of an organisation. This ratio helps the shareholders of a firm to know the return on investment in terms of profits. Shareholders are always interested in knowing as to what return they earned on their invested capital since they bear all the risk, participate in management and are entitled to all the profits remaining after all outside claims including preference dividend are met in full. This is the single most important ratio to judge whether the firm has earned a satisfactory return for its equity-shareholders or not. A higher ratio indicates the better utilisation of owners' fund and higher productivity. A low ratio may indicate that the business is not very successful because of inefficient and ineffective management and over investment in assets.

3. Earning Per Share: Earning per share is calculated by dividing the net profit (after interest, tax and preference dividend) by the number of equity shares. Earning per share helps in determining the market price of the equity share of the company. It also helps to know whether the company is able to use its equity share capital effectively with compare to other companies. It also tells about the capacity of the company to pay dividends to its equity shareholders

$$\text{Earning Per Share} = \frac{\text{Net Profit after Interest, Tax and Preference Dividend}}{\text{No. of Equity Shares}}$$

4. Dividend Pay out Ratio: This ratio measures the relationship between the earnings belonging to the ordinary shareholders and the dividend paid to them. In other words, the dividend pay out ratio shows what percentage share of the net profits after taxes and preference dividend is paid out as dividend to the equity shareholders. It can be calculated by dividing the total dividend paid to the owners by the earnings available to them. The formula for computing this ratio is:

$$\text{Dividend payout ratio} = \frac{\text{Dividend per equity share}}{\text{Earnings per share}}$$

This ratio is very important from shareholder's point of view as its tells him that if a firm has used whole, or substantially the whole of its earnings for paying dividend and retained nothing for future growth and expansion

purposes, then there will be very dim chances of capital appreciation in the price of shares of such firms. In other words, an investor who is more interested in capital appreciation must look for a firm having low payout ratio.

The operating ratio does not show the profitability on investment while, capital turnover ratio, doesn't show the profitability on sales. However, ROI being the product of the aforesaid two ratios reflects the overall profitability. It is used as a basis for various managerial decisions like expansion and diversification of activities. It is very important in capital budgeting. Thus return on investment is considered as the master ratio due to the following reasons:

- It measures the overall efficiency of management and profitability of the business. It is also used to measure the profitability of a division or department of the business.
- It is highly useful in interfirm comparison of performance.
- It is often used for planning an ideal capital structure.
- It enables the management to make efficient capital budgeting decisions.
- It may be used as an instrument of control by comparing the relative profitability of different products.
- It can be used for determining the selling price of products. The price must cover cost of manufacturing, selling and administration as well as desirable rate of return on investment.