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Class 12 commerce Sub. ACT Date 20.01.2021

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Accounting *Ratios*

Types of Ratios

There is a two way classification of ratios:

(1) traditional classification, and

(2) functional classification. The traditional classification has been on the basis of financial statements to which the determinants of ratios belong. On this basis

the ratios are classified as follows:

1. Income Statement Ratios: A ratio of two variables from the income statement is known as Income Statement Ratio. For example, ratio of gross profit to sales known as gross profit ratio is calculated using both figures from the income statement.

2. Balance Sheet Ratios: In case both variables are from balance sheet, it is classified as Balance Sheet Ratios. For example, ratio of current assets to current liabilities known as current ratio is calculated using both figures from balance sheet.

3. Composite Ratios: If a ratio is computed with one variable from income statement and another variable from balance sheet, it is called Composite Ratio. For example, ratio of credit sales to debtors and bills receivable known as debtor turnover ratio is calculated using one figure from income statement (credit sales) and another figure from balance sheet (debtors and bills receivable). Although accounting ratios are calculated by taking data from financial statements but classification of ratios on the basis of financial statements is rarely used in practice. It must be recalled that basic purpose of accounting is to throw useful light on the financial performance (profitability) and financial position (its capacity to raise money and invest them wisely) as well as changes occurring in financial position (possible explanation of changes in the activity level). As such, the alternative classification (functional classification) based on the purpose for which a ratio is computed, is the most commonly used classification which reach as follows:

1. Liquidity Ratios: To meet its commitments, business needs liquid funds. The ability of the business to pay the amount due to stakeholders as and when it is due is known as liquidity, and the ratios calculated to measure it are known as 'Liquidity Ratios'. They are essentially short-term in nature.

2. Solvency Ratios: Solvency of business is determined by its ability to meet its contractual obligations towards stakeholders, particularly towards external stakeholders, and the ratios calculated to measure solvency position are known as 'Solvency Ratios'. They are essentially long-term in nature, and

3. Activity (or Turnover) Ratios: This refers to the ratios that are calculated for measuring the efficiency of operation of business based on effective utilisation of resources. Hence, these are also known as 'efficiency ratios'.

4. Profitability Ratios: It refers to the analysis of profits in relation to sales or funds (or assets) employed in the business and the ratios calculated to meet this objective are known as 'Profitability Ratios'.