Q1. What do you mean by Ratio Analysis?
Solution: Ratio analysis is a method of financial analysis. It explains the relationship between various items of the Balance Sheet and Income Statements. It helps in determining profitability, operational efficiency, solvency etc. of a firm. It may be expressed as a fraction, proportion, percentage or in times. Ratio analysis provides vital information to various accounting users regarding the financial position and feasibility and performance of a firm. It also helps to lay down the framework for decision making and policy designing by the management.

Q2. What are the various types of ratios?
Solution: Accounting ratios are classified in the following two ways:

I. Traditional Classification
II. Functional Classification

I. Traditional Classification: This classification is based on financial statements, i.e. Profit and Loss Account and Balance Sheet. Traditional classification further segregates accounting ratios on the basis of the accounts to which the elements of a ratio belong. On the basis of accounts of financial statements, traditional classification segregates accounting ratios as

a. Income Statement Ratios: These are ratios whose elements belong only to the Trading and Profit and Loss Account such as Gross Profit Ratio etc.

b. Balance Sheet Ratios: These are ratios whose elements belong only to the Balance Sheet such as Current Ratio, Debt Equity Ratio etc.

c. Composite Ratios: These are ratios whose elements belong to the Trading and Profit and Loss Account as well as to the Balance Sheet such as Debtors Turnover Ratio etc.

II. Functional Classification: This classification shows the functional need and purpose of calculating ratio. The basic grounds to compute ratio is to ascertain liquidity, solvency, financial performance and profitability of a business. Therefore, functional classification classifies various accounting ratios as

a. Liquidity Ratio: These ratios are calculated to find short-term solvency.

b. Solvency Ratio: These ratios are calculated to find long-term solvency.

c. Activity Ratio: These ratios are calculated for measuring operational efficiency and efficacy of operations. These ratios relate to sales or cost of goods sold.

d. Profitability Ratio: These ratios are calculated to evaluate the financial performance and financial viability of the business.

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