Ratio Analysis—Limitations

Specification requirement— Limitations of ratio analysis and the importance of inter-business and historical comparisons.

Limitations of Ratios

We have seen that there are a number of ratios that we can use to help us examine and comment upon both Profit and Loss Accounts and Balance Sheets. Unfortunately though, these ratios do have weaknesses, making them imperfect tools for the job. Below we look at some of the main reasons for the existence of these weaknesses.

1. Firms can use different accounting policies

The choices of accounting policies may distort inter-company comparisons. Accounting law allows firms to use some discretion when preparing accounts. Firms should be consistent with their own policies, not changing how they prepare their accounts each year, but this does not mean that will use the same policies, as competitor firms. This difference makes inter firm comparisons potentially very difficult.

2. Outdated information in financial statement

The figures in a set of accounts are likely to be at least several months out of date, and so might not give a proper indication of the company's current financial position, and since the Balance Sheet is only a "snapshot" of the business at a particular time, any ratio based on the figures contained in the Balance Sheet may not be representative of the financial position of the company for the year as a whole. For example, it is common for a seasonal business to have a year-end which coincides with a low point of business activity. Thus stocks and debtors may be low in the Balance Sheet as a result of this.

3. Use of Creative Accounting

The businesses apply creative accounting in trying to show the better financial performance or position which can be misleading to the users of financial accounting. An extension of creative accounting is Window Dressing. These are techniques applied by a firm in order to show a strong financial position (see Chapter on Window Dressing).

4. Summarised information in accounts.

Ratios are based on financial statements which are summaries of the accounting records. Through the summarisation some important information may be left out which could have been of relevance to the users of accounts. Most sets of accounts have a section called 'Notes to Accounts', and it is not unusually to find the P and L Account and Balance Sheets taking up two pages at the front of the published accounts, whilst the 'Notes' occupy 20 pages at the back. Careful ratio analysis must take into account the content of these 'notes'.

5. Interpretation of the ratios is not a science.

As we have seen it is difficult to generalise about whether a particular ratio is 'good' or 'bad'. For example a high Acid Test Ratio may indicate a strong liquidity position, which is good or alternatively excessive cash which is

bad. Similarly a high gearing ratio may denote either a firm that uses its borrowings for growth efficiently or alternatively one that is up to its neck in debt and cannot afford to repay its loans.

6. Inflation

Comparison of performance over time can be distorted by inflation which leads to price increases. Inflation makes comparisons of results over time misleading as financial figures will not be directly comparable. Changes in results one year to the next, such as increases in revenue and net profit may indicate that the business has improved its performance when in fact increases may have resulted from inflation not improved sales.

7. Impact of seasonality on trading

Financial statements are based on year end results which my disguise fluctuations that occur on a seasonal basis. Businesses which are affected by seasons can choose the best time to produce financial statements so as to show better results. For example, a maize growing company will be able to show good results if accounts are produced in the selling season. At this time the business will have good stock levels and bank balances will be at their highest. If results had been produced six months earlier the company will have a lot more liabilities, much lower cash balances and fewer debtors about to pay.

8.Different market, and financial risk profiles

No two companies are the same, and they can be very different. One major cause of the difference is the type of market the firm operates in. Is it a monopoly, is there a great deal of competition, does the government limit competition or interfere with price? All of these will influence profit margins and prices,

Even when examining competitors in the same industry or market, using ratios to compare one company with another could provide misleading information. Two firms may be the same industry but have different financial risk profiles. One company may be able to obtain bank loans at reduced rates, is therefore borrowing to expand and will show high gearing levels, while another firm may be judged not credit worthy, therefore will not be successful in obtaining loans and it may show that it is operating at low gearing level. A quick analysis of the accounts may show firm two is in a better financial position when in fact its low gearing level is because it cannot secure funding, whilst the first firms high gearing is part of a well costed business strategy.

Ratio analysis is a useful tool for judging a firms performance, but those examining accounts should be aware of the problems described above and make adjustments as necessary. Ratios analysis conducted without consideration of external influences and without realising the potential for distortion is not good analysis. But if used intelligently and with good judgement, the use of ratios can provide a useful understanding of a firm's operations.

Notes