Critically discuss how ratio analysis can help in the prediction of bankruptcy

Finance

Critically discuss how ratio analysis can help in the prediction of bankruptcy

Financial ratio analysis is recognized to be one of the easiest and most spread techniques used for detection of company's operating and financial problems or difficulties. Thus, with the development of quantitative measures of company performance, financial ratio analysis was used in a bankruptcy-prediction context (Altman, 1968). Many financial ratios were integrated into professional statistical and intelligent techniques as variables for assessing the company's financial health (Kumar & Ravi, 2006). Especially popular multivariate techniques built on the basis of financial ratios and used for predicting company's bankruptcy are: logistic regression, multiple discriminant analysis, and probit models (Ramana, Azash, Ramakrishnaiah, 2012). By analyzing and interpreting financial statements using different ratios and techniques shareholders, potential investors, bankers, analysts and all other potential stakeholders can gain valuable information about the financial status of a company, its borrowing power and solvency position (Yap & Yong, 2010). Financial ratio variables are used for assessing the financial information and historical trends of financial performance of a business, which in turn serve as good indicators of financial troubles ahead (Yap & Yong, 2010). However, there are also some criticisms of accounting-ratio-based models. Some researchers suggest that the accounting ratios have limited capacity for predicting bankruptcy as accounting information is usually formulated to describe the financial condition of the company, assuming that it will not go bankrupt (Hillegeist, Keating, Cram & Lundstedt, 2004). Thus, for example, Hillegeist, Keating, Cram & Lundstedt (2004) have concluded that traditional accounting-based

measures (such as accounting ratio analysis) are not sufficient enough for predicting the probability of bankruptcy.

References:

Altman E, 1968. ‘ Financial Ratios, discriminant analysis and the prediction of corporate bankruptcy’. The Journal of Finance, vol . 23 (4), pp. 589-609.

Hillegeist, S., Keating, Cram, E., & Lundstedt, K., 2004, ‘ Assessing the probability of bankruptcy’, Review of Accounting Studies, vol. 9, pp. 5–34.

Kumar P, and Ravi V, 2006. ‘ Bankruptcy prediction in banks and firms via statistical and intelligent techniques – A review’, European Journal of Operational Research, 180, pp. 1-28.

Ramana N, Azash S, Ramakrishnaiah K, 2012. ‘ Financial performance and predicting the risk of bankruptcy: A case of selected cement companies in India’, International Journal of Public Administration and Management Research, vol. 1(1), pp. 40-56.

Yap B, and Yong D, 2010. ‘ How well do financial ratios and multiple discriminant analysis predict company failures in Malaysia’, International Research Journal of Finance and Economics, 54, pp. 166-177.