Ratios

Science, Mathematics

Ratios Ratios are important in simplifying financial information for easy interpretation by different users of the financial information. The ratios do not however tell the whole story about a firm and may therefore mislead stakeholders in their decisions. Pending litigations about an entity are for example not reflected in financial statements and therefore do not affect financial ratios. Such cases are however fundamental to an entity's sustainability and are therefore important to stakeholders such as investors, debtors, and suppliers whose interest lies in an entity's ability to exist in future. The standardized scope of financial ratios also limits quantitative aspects of the communicated information because the ratios do not communicate exact values of financial information. Profitability is for example expresses in ratios and a firm with relatively lower profit level may report higher profitability ratio than a firm that has recorded higher profit volume. Ratios also assume linear relationship between variables and this mislead stakeholders because most variables are not linearly related (Lee, 2006).

Investors could use liquidity ratios to make decisions, on whether to invest in a company or not, by comparing the ratios to the value one. Ratios that are less than one means that a company is overwhelmed by debt, is liable to creditors' terms and should inform a potential investor against the company. Ratios, which are greater than one, however mean an organization's independence from creditors' adverse influences and offers short-term stability for investment. Investors can also use the magnitude of liquidity ratios to understand the level of a company's liquidity for investment decision because a more liquid company is more secure for investors' short

term interests (Lee, 2006).

Reference

Lee, T. (2006). Financial reporting and corporate governance. Hoboken, NJ: John Wiley & Sons.