Limitation of ratio analysis

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Learning Objective

- Explain to the participants on the limitation of ratio analysis.

Important Terms

- Creative accounting.
- Accounting Policies.

As we have alredy discussed, it is important to compare in order to be able to analyse and to be able to comment and subsequently recommend in order that a business is as efficient as possible.

Limitations of Ratios

1. Accounting Information
    - Different Accounting Policies

      The choices of accounting policies may distort inter company comparisons. Example IAS 16 allows valuation of assets to be based on either revalued amount or at depreciated historical cost. The business may opt not to revalue its asset because by doing so the depreciation charge is going to be high and will result in lower profit.
    - 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. Like the IAS 16 mentioned above, requires that if an asset is revalued and there is a revaluation deficit, it has to be charged as an expense in income statement, but if it results in revaluation surplus the surplus should be credited to revaluation reserve. So in order to improve on its profitability level the company may select in its revaluation programme to revalue only those assets which will result in revaluation surplus leaving those with revaluation deficits still at depreciated historical cost.

2. Information problems

- Ratios are not definitive measures

  Ratios need to be interpreted carefully. They can provide clues to the company's performance or financial situation. But on their own, they cannot show whether performance is good or bad. Ratios require some quantitative information for an informed analysis to be made.

- Outdated information in financial statement

  The figures in a set of accounts are likely to be at least several months out of date, and so might not give a proper indication of the company's current financial position.

- Historical costs not suitable for decision making

  IASB Conceptual framework recommends businesses to use historical cost of accounting. Where historical cost convention is used, asset valuations in the balance sheet could be misleading. Ratios based on this information will not be very useful for decision making.

- Financial statements certain summarised information

  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. The ratios are based on the summarised year end information which may not be a true reflection of the overall year’s results.

- Interpretation of the ratio

  It is difficult to generalise about whether a particular ratio is ‘ good’ or ‘ bad’. For example a high current ratio may indicate a strong liquidity position, which is good or excessive cash which is bad. Similarly Non current assets turnover ratio may denote either a firm that uses its assets efficiently or one that is under capitalised and cannot afford to buy enough assets.

3. Comparison of performance over time

- Price changes

  Inflation renders comparisons of results over time misleading as financial figures will not be within the same levels of purchasing power. Changes in results over time may show as if the enterprise has improved its performance and position when in fact after adjusting for inflationary changes it will show the different picture.

- Technology changes

  When comparing performance over time, there is need to consider the changes in technology. The movement in performance should be in line with the changes in technology. For ratios to be more meaningful the enterprise should compare its results with another of the same level of technology as this will be a good basis measurement of efficiency.

- Changes in Accounting policy

  Changes in accounting policy may affect the comparison of results between different accounting years as misleading. The problem with this situation is that the directors may be able to manipulate the results through the changes in accounting policy. This would be done to avoid the effects of an old accounting policy or gain the effects of a new one. It is likely to be done in a sensitive period, perhaps when the business's profits are low.

- Changes in Accounting standard

  Accounting standards offers standard ways of recognising, measuring and presenting financial transactions. Any change in standards will affect the reporting of an enterprise and its comparison of results over a number of years.

- Impact of seasons on trading

  As stated above, the financial statements are based on year end results which may not be true reflection of results year round. Businesses which are affected by seasons can choose the best time to produce financial statements so as to show better results. For example, a tobacco growing company will be able to show good results if accounts are produced in the selling season. This time the business will have good inventory levels, receivables and bank balances will be at its highest. While as in planting seasons the company will have a lot of liabilities through the purchase of farm inputs, low cash balances and even nil receivables.

4. Inter-firm comparison

- Different financial and business risk profile

  No two companies are the same, even when they are competitors in the same industry or market. Using ratios to compare one company with another could provide misleading information. Businesses may be within the same industry but having different financial and business risk. One company may be able to obtain bank loans at reduced rates and may show high gearing levels while as another may not be successful in obtaining cheap rates and it may show that it is operating at low gearing level. To un informed analyst he may feel like company two is better when in fact its low gearing level is because it can not be able to secure further funding.
- Different capital structures and size

  Companies may have different capital structures and to make comparison of performance when one is all equity financed and another is a geared company it may not be a good analysis.
- Impact of Government influence

  Selective application of government incentives to various companies may also distort intercompany comparison. One company may be given a tax holiday while the other within the same line of business not, comparing the performance of these two enterprises may be misleading.
- Window dressing

  These are techniques applied by an entity in order to show a strong financial position. For example, MZ Trucking can borrow on a two year basis, K10 Million on 28th December 2003, holding the proceeds as cash, then pay off the loan ahead of time on 3rd January 2004. This can improve the current and quick ratios and make the 2003 balance sheet look good. However the improvement was strictly window dressing as a week later the balance sheet is at its old position.

- Ratio analysis is useful, but analysts should be aware of these problems and make adjustments as necessary. Ratios analysis conducted in a mechanical, unthinking manner is dangerous, but if used intelligently and with good judgement, it can provide useful insights into the firm’s operations.