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Ratio Analysis: Myth and Emerging Trends

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Introduction:
In the last few decades the whole concept of financial analysis has changed. The Du Pont phenomena that has given birth to ratio analysis, has now attained a state of maturity and most of the practicing analysts, managers, theoreticians and researchers has realised the limitation of the concept of ratio analysis.
Ratio analysis now being considered as a useful tool but it is no longer a panacea to address all issues related with financial analysis. Interpretation of balance sheet, unearthing the hidden information and giving a chance to correct and fair disclosure of financial status is often not possible by using a simple tool of ratio analysis. Numerical and physical data has its own natural limitations to critically analyse the qualitative dimensions.
Today, we look at financial statement as a tool for fair and truthful disclosure of facts. Correctness is no longer equated with mathematical accuracy. On the contrary, the concepts of financial correctness have achieved many dimensions. How well do we understand this qualitative dimension is a very important issues. Today, the idea of achieving the depth of financial statement by adding qualitative dimension has become an essential aspect for the last three to four decades. Ration analysis was considered as an X-Ray device to know how a firm performs, what are its achievement and limitations. But, there are a thousand plus firms where the numerical and quantitative information has mislead the interpreter. In this paper authors evaluated and interpreted the merits, limitations and new dimension of financial Ratio Analysis.

Statement of the problem:
Financial analysis is a useful tool to every single user and interpreters of financial statement. Whether the analyst is a banker, investor, creditor, shareholder or even a tax authority; one has to look into the credibility, acceptability and authenticity of the financial data of which one interpret. In many cases there is a high degree of numerical accuracy which helps to maintain the checks and balance. But the reality is much different. Numerical data is often like mirage; which appears to exist but never exist. It is a kind of distraction, deception and illusion which create a virtual reality. Not all the financial statements mislead nor every financial statement has inaccurate or incomplete piece of information. As often said, truth is stranger than fiction, so do the financial reality are. In this paper, the authors intend to identify the limitations of financial statement; usually evaluated through a commonly accepted empirical data analysis and that is Ratio Analysis. Hence, the title of the study is, ***"Financial Statement Analysis: Myth and Emerging Trends"***
Rationale of the study:
The writers consider Ratio Analysis as a very important tool of data analysis. Most of the Annual Report of a company, giving details of financial performance are often analysed by using Ratio Analysis. The stock market report, investor's Analysis report, banker's credit appraisal report, the rating by credit agency; all depends on the quantitative data published in the balance sheet. These quantitative data are analysed usually by applying Ratio Analysis. The ratio provides insights to examine the association between various financial term- Assets and Liabilities present in the Balance sheet and income statement.
So long as the numerical accuracy is of high level, there is hardly any reason to doubt the credibility of the statements. But this is where a question of qualitative credibility arises. The issues under consideration are whether quantitative accuracy ensures qualitative accuracy. Furthermore, to what extent the qualitative parameters like truthfulness, reliability, and internal consistency be ensured through quantitative accuracy. Issues like appropriate usage of funds, right and ethical means to raise and procure funds as well as honesty in distribution of profits and earnings are not rightly explained through

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quantitative accuracy alone. Hence, the present paper which discusses limitations of Ratio as a tool of Financial Analysis has its own relevance.

Objectives of the study:

The objectives of the study are narrated as follows:

(i) To understand the role and importance of Ratio as a tool of financial analysis
(ii) To examine various approaches to Ratio Analysis
(iii) To identify limitations of Ration as a predictor of performance
(iv) To test ratios as a model for prediction of failure
(v) To examine the qualitative limitations of ratio
(vi) To question the basic of accepting ratio for financial analysis

Working definition:

For the purpose of the study following terms are defined:

Ratio:

The term ratio means quantitative and numerical performance analysis by using ratios and proportion to compare two or more financial indicator.

Financial performance:

Financial performance means achievement of business firms in terms of economic and financial achievement or success.

Qualitative analysis:

The term qualitative analysis means and includes the dimension of analysis in relation to various qualitative parameters.

Qualitative analysis:

Qualitative analysis means analysis by using standard, numerical and quantitative parameters.

Review of Literature:

Various experts have studies the issues related with the role and application of financial statement analysis for different purposes. There are different approaches to look at Ratio analysis as a useful tool to predict financial behaviour and the implication on the financial behaviour of a firm.

Most of the studies are related with utility and limitations of ratio analysis as a tool of financial health analysis of a firm. Since 1919, when Alexander Wall has published his work study of credit barometer, ratio analysis has become a useful tool. Horrigan has popularised the idea of using many ratios that can provide understanding of financial health of a firm and its predictable failure behaviour. Classifying ratios in a scientific manner and analysis them is one important concept given by Lincoln (1925). The Du Pont analysis designed by Bliss has further popularised the idea of ratio. Walter (1957) has coined the idea of fund statement ratio whereas, Beaver (1966) has used this concept to analyse reasons of failure of companies and their consequences. Today ratio are used for economic analysis, prediction of performance and to develop model explaining future tends of a company's future financial performance (Houghton and Woodliff, 1987).

Discussions:

The present paper discusses the various facets of utility and limitations of ration analysis. It also identifies how ratio analysis has become a tool with limited application in interpretation and analysis of financial statement.

A) Role and importance of ratio as a tool of financial statement analysis:

Ratio basically is defined as, ***"****is an expression of the quantitative relationship between two numbers****"***. For last many decades ratios are used to evaluate financial performance. Initially used as a simple but effective tool of credit analysis, today ratios are used as a most comprehensive, complete and well defined tool for financial statement analysis. Different stakeholders viz. bankers, investors, credit rating agencies, creditors, Mutual Funds operators, Government agencies, shareholders, financial analysts, consultants all used ratio analysis as a common and suitable measures for analysis of financial performance. The merits of this tool are enlisted as follows:

(i) It is broad based tool of financial analysis and has a large acceptance. Stakeholders have developed faith in the suitability of this tool.

(ii) It has been accepted more as a comprehensive medium of analysis. The result and prediction of ratio are considered scientific.

(iii) They are considered as having better utility to evaluate financial performance

B) Developing right approaches to ratio analysis:

Since the last five decades ratios are identified as effective tools to analyse financial performance. Their initial application and utility has developed a great faith in the application of ratio analysis.

Many companies have published their financial statements along with supplementary statement of ratio analysis to justify their claims. In many cases ratios are found as a simple but effective measure to predict the future performance. The performance so predicted was also accepted being based on ration analysis. There is general belief that ratios being scientific, numerical and quantitative measures; it cannot be wrong. This simple but general belief was found as a major limitation to understand the truthfulness of many claims. The actual financial behaviour was not found in tuned with prediction made by using ratio analysis.

C) Ratio as a predictor of performance:

Many experts considered ratio as an effective tools to evaluate performance of the firm. The report of the committee on the financial system published by RBI (1991) gives emphasis on this particular aspect. Many economists are of the opinion that ratios like Return of Investment (ROI), Return on Capital Employed (ROCE), Asset turn over have a great utility in analysing the financial and business performance of a firm. Sanzo (1960) has rightly argued that performance of small firms can be easily evaluated and predicted by using ratios.

D) Ratio as a model building tool to predict performance, success and failure:

Today, the concept of financial statement analysis has multiple dimensions. It is no longer a mere technique used for analysing financial health of a firm. On the contrary, it has many other applications. Interpretation of financial performance, co-relating financial status with organizational health, understanding the philosophy and approach of the business as well as examining the implication of external and internal variation on the business health are the common application of ratio analysis.

The study conducted by Holdren (1964) helps to know how accounting ratios answer key business performance.

E) Analysing the qualitative implications:

Though ratio analysis is a major tool for analysing financial performance; however, few important questions as to its application and utility are rightly raised by different consultants. The important issues usually associated with broader application of ratio analysis are enlisted here:

(i) Can a large data of a sizable long period be rightly analysed by using one common indicator like ratio?

(ii) Whether there remains a consistency in performance of the firm over a long period?

(iii) Can a firm claim for accuracy of prediction based on mere historical data?

(iv) Whether there is any association between future predictions by using mere quantitative data?

(v) Can quantitative data portrait the qualitative variation in the performance of a firm?

(vi) Whether changes in the philosophy, values and approaches of a firm has any impact on the firm. Similarly, whether changes in the regulation and external environment also influence the financial performance directly or indirectly which is not considered while using ratio analysis?

F) Few important questions related with application of ratio analysis as a model of financial performance indicators:

Even though, many firm use ratio analysis as a tool to predict financial performance; it is no longer considered as the total solution to predict financial performance and future of a firm. On the contrary, ratio analysis is considered as a tool with many practical limitations.

The study of Melmyk and Mathur (1972) has helped to classify corporation according to similar risk group and market rate of return. However, the analysis has clearly indicated the limitations of such kind of grouping as a better prediction of performance. They cannot explain the reason of failure in many cases. Similarly, it is difficult to predict Bankruptcy of failure of a firm just by using ratio analysis alone. The other important limitations of ratios as noticed by Gilman (1925) are:

(i) Changes in ration over time cannot be interpreted correctly because both the numerator and the denominator which comprise a ratio vary.

(ii) Ratios often divert the attention of the interpreter because of relative values considered while analysing the financial performance of a firm. They often provide superficial view of reason of success or failure.

Conclusion:

Thus the above discussion helps to conclude that ratio analysis in its own way has many advantages and applications, however, it cannot be considered as an absolute and complete tool for financial performance analysis and prediction. One must use ratio as a tool of financial analysis with due caution and care.

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