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Accounting Ratios

Limitations of Ratio Analysis

Since the ratios are derived from the financial statements, any weakness in the original financial statements will also creep in the derived analysis in the form of ratio analysis. Thus, the limitations of financial statements also form the limitations of the ratio analysis. Hence, to interpret the ratios, the user should be aware of the rules followed in the preparation of financial statements and also their nature and limitations. The limitations of ratio analysis which arise primarily from the nature of financial statements are as under:

1. **Limitations of Accounting Data:** Accounting data give an unwarranted impression of precision and finality. In fact, accounting data “reflect a combination of recorded facts, accounting conventions and personal judgements and the judgements and conventions applied affect them materially. For example, profit of the business is not a precise and final figure. It is merely an opinion of the accountant based on application of accounting policies. The soundness of the judgement necessarily depends on the competence and integrity of those who make them and on their adherence to Generally Accepted Accounting Principles and Conventions”. Thus, the financial statements may not reveal the true state of affairs and so the ratios will also not give the true picture.
2. **Ignores Price-level Changes:** The financial accounting is based on stable money measurement principle. It implicitly assumes that price level changes are either non-existent or minimal. But the truth is otherwise. We are normally living in inflationary economies where the power of money declines constantly. A change in the price level makes analysis of financial statement of different accounting years meaningless because accounting records ignore changes in value of money.
3. **Ignore Qualitative or Non-monetary Aspects:** Accounting provides information about quantitative (or monetary) aspects of business. Hence, the ratios also reflect only the monetary aspects, ignoring completely the non-monetary (qualitative) factors.
4. **Variations in Accounting Practices:** There are differing accounting policies for valuation of stock, calculation of depreciation, treatment of intangibles, definition of certain financial variables, etc. available for various aspects of business transactions. These variations leave a big

question mark on the cross sectional analysis. As there are variations in accounting practices followed by different business enterprises, a valid comparison of their financial statements is not possible.

5. Forecasting: Forecasting of future trends based only on historical analysis is not feasible. Proper forecasting requires consideration of non-financial factors as well. Now let us talk about the limitations of the ratios. The various limitations are:

1. Means and not the End: Ratios are means to an end rather than the end by itself.
2. Lack of ability to resolve problems: Their role is essentially indicative and of whistle blowing and not providing a solution to the problem.
3. Lack of standardised definitions: There is a lack of standardised definitions of various concepts used in ratio analysis. For example, there is no standard definition of liquid liabilities. Normally, it includes all current liabilities, but sometimes it refers to current liabilities less bank overdraft.
4. Lack of universally accepted standard levels: There is no universal yardstick which specifies the level of ideal ratios. There is no standard list of the levels universally acceptable, and, in India, the industry averages are also not available.
5. Ratios based on unrelated figures: A ratio calculated for unrelated figures would essentially be a meaningless exercise. For example, creditors of Rs. 1,00,000 and furniture of Rs. 1,00,000 represent a ratio of 1:1. But it has no relevance to assess efficiency or solvency. Hence, ratios should be used with due consciousness of their limitations while evaluatory the performance of an organisation and planning the future strategies for its improvement.