FINANCIAL RATIOS: THE PRECARIOUS CORE OF FUNDAMENTAL ANALYSIS

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Fundamental Analysis is a school of thought which was conceptually derived from Darwin’s theory of evolution. Fundamental analysis involves evaluation of financial and non-financial factors surrounding the company’s environment to assess its intrinsic value (Spooner, 1984). The financial part of the business is analysed using financial statement analysis which uses past and current financial data (Bernstein, 1975; Woelfel, 1987).

Financial ratios are considered as the vocabulary of financial statement analysis which is an imperative part of business literacy (Mankin & Jewell, 2014). Financial ratios provide a snapshot of the company’s performance and position by transforming accounting data into ratios (Horrigan, 1965; Muresan & Wolitzer, 2004).

Financial ratios have the ability to explain the fundamentals of an entity for any sector or nature and thus possess pervasive analytical abilities.

Financial ratios have been used to study the fundamental aspects of companies ranging from profitability, liquidity to solvency. Financial ratios also enable analysts to undertake inter linkage studies of capital structure, working capital, profitability. The ratios in the form of multiples are also used for the purpose of valuation.

Due to such ability, financial ratios have become a core to fundamental analysis. Various tools crafted using financial ratios as the base are pervasively used. Such tools include and is not limited to Altman Z score, Ohlson O score, Montlier C score, Beneish M score, Piotroski F score. These tools aid analysts in areas such as Insolvency prediction, Earnings Management, fundamental strength evaluation, etc.

Financial ratios also possess certain inherent limitation which any user should be aware of for optimum utilization of ratios as a tool. Using ratios without understanding its inherent limitations would be considered as an erroneous act which may provide the users with wrong conclusions.

The first and foremost limitation of ratios would be proliferation and vagueness. The number of ratios has increased exponentially over a period and there is no standardised terminology or manner of calculation for ratios. The lack of standardisation over the proper
calculation methodology for ratios leads to vagueness. Analysing the outcome ratios without due consideration to the inputs used in its calculation is flawed. (Gupta & Huefner, 1972; Chen & Shimerda, 1981; Shivaswamy et al., 1993; Karatas et al., 2005; Wang & Lee, 2008; De et al., 2011; Erdogan, 2014).

The second being the distributional properties of financial ratios. Normality has been proved to be absent when the pattern of ratios was analysed. Thus, due to this many parametric methods become unusable on financial ratios. (Deakin, 1976; Martikainen et al., 1995; Trigueiros, 1995; Chong et al., 2013; Linares et al., 2018).

The third limitation is the lack of comparability in ratios caused due to the different accounting standards used in different economies. The difference in accounting standards influence the financial statement and thereby impact the financial ratios. Even within the same accounting standards, difference in the accounting policies cause the financials to be incomparable and thus reduce the utility of financial ratios. (Schipper, 2005; Hung & Subramanyam, 2007; Jeanjean & Stolowy, 2008). Researches have proved how the impact of such change exists. Studies have shown how for the same accounting period when the accounting framework changes the financial ratios are affected to a great extent (Cinca et al., 2005; Liu et al., 2013; Faello, 2015).

These limitations of financial ratios are inherently passed down to the fundamental tools as well. Thus, the widespread use of ratios and ratio-based tools have warranted the need to identify techniques to address the limitation of ratios.

REFERENCES


