

LIMITATIONS OF RATIO AND TREND ANALYSIS

Ratio analysis is not foolproof. There are many problems in trying to identify trends and make comparisons. Below are just a few.

1. Information problems:

- ◆ The base information is often out of date, so timeliness of information leads to problems of interpretation.
- ◆ Historical cost information may not be the most appropriate information for the decision for which the analysis is being undertaken.
- ◆ Information in published accounts is generally summarised information and detailed information may be needed.
- ◆ Analysis of accounting information only identifies symptoms not causes and thus is of limited use.

2. Comparison problems:

- ◆ Effects of price changes make comparisons difficult unless adjustments are made.
- ◆ Impacts of changes in technology on the price of assets, the likely return and the future markets.
- ◆ Impacts of a changing environment on the results reflected in the accounting information.
- ◆ Potential effects of changes in accounting policies on the reported results.
- ◆ Problems associated with establishing a normal base year to compare other years with.

3. Comparison problems: inter-firm

- ◆ Selection of industry norms and the usefulness of norms based on averages.
- ◆ Different firms having different financial and business risk profiles and the impact on analysis.
- ◆ Different firms using different accounting policies.
- ◆ Impacts of the size of the business and its comparators on risk, structure and returns.
- ◆ Impacts of different environments on results e.g. different countries or home-based versus multinational firms.