Unit 2 Discussion (Finance)

Your Name (First M. Last)

School or Institution Name (University at Place or Town, State)

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**What are the limitations of ratio analysis?**

Following are the most important limitations of ratio analysis:

**Changes occur in accounting policies**

Reports of finance would be affected greatly if any company changes its accounting procedures and policies. In such cases, ratio analysis financial metrics that are being used, get altered. It produces a change in the result, obtained before and after the financial results are recorded. It is the responsibility of the analysts to stay updated about the changes in accounting policies.

**Operational changes**

A company can make changes in the operational structure i.e. change from a supply chain strategy to products being made and sold (Jones, et,al,2019). When any significant operational change occurs, visible differences are noticed during the comparison between financial metrics recorded before and after these operational changes. This differences would become of reason of misleading conclusions about the performance of the company as well as future prospects.

**Manipulation of financial statement**

The information obtained from the company’s financial statement becomes the base of the ratio analysis (Bekaert,et,al,2019). This information could be changed by the management of the company and better results than the actual performance could be added in the final report. Hence, ratio analysis may not depict the accurate business nature, so it is important for the analysts to be aware of these manipulations.

**Seasonal effects**

It is important for the analysts to stay aware of the seasonal effects and factors would clearly result in the limitation of ratio analysis. Failure in the adjustment of ratio analysis with seasonal effects would take towards false interpretations of final results of the analysis.

**Inflationary effects**

A company releases its financial statements periodically so if any difference occurs in the time of release, the final report would be affected. Real prices would not be reflected in the financial statements if inflation occurs between the periods of release of the financial statement. So inflation must be adjusted.

**Historical information**

Information used to be based on the analysis of real previous results company releases, so it could be said that the ratio analysis metrics do not always depicts the future performance of a company.

References

Bekaert, G., & Mehl, A. (2019). On the global financial market integration “swoosh” and the trilemma. *Journal of International Money and Finance*, *94*, 227-245.

Jones, S., & Wang, T. (2019). Predicting Private Company Failure: A Multi-Class Analysis. *Journal of International Financial Markets, Institutions, and Money*.