study we can draw conclusions regarding the financial health of the business enterprise.

2.4.2 Limitations of Ratio Analysis

Following limitations should be kept in mind while making use of the ratio analysis:

a) **False accounting Data Gives False Ratios:** Accounting ratios are calculated on the basis of data given in profit and loss account and balance sheet. Therefore, they will be only as correct as the accounting data on which they are-based. For 'example, if the -closing stock is overvalued, not only the profitability will be overstated but also the financial position will appear to be better.

b) **Comparison not possible if the different Firms Adopt Different Accounting Policies:** There may be different accounting policies adopted by different firms with regard to providing depreciation, creation of provision for doubtful debts, method of valuation of closing stock etc.

c) **Ratio Analysis Becomes Less Effective Due to Price Level Changes:** Price' level over the years goes on changing; therefore, the ratios of various years cannot be compared. For example, one firm sells 1,000 Machines for Rs. 10 Lakhs dunng2002, it again sells 1,500 Machines of the same type in 2003 but owing to rising prices the sale price was Rs. 15 Lakhs. On the basis of ratios it will be concluded that the sales have increased by 50%, whereas in actual,-sales have not increased at all. Hence, the figures of the past years must be adjusted in the light of price level changes before the ratios for these years are compared. '

d) **Ratios may be Misleading in the Absence of Absolute Data:** For example, X company produces 10 lakh meters of cloth in 2002 and 15 Lakh meters in 2003, the progress is 50%. Y Company raises its production from 10 thousand meters in 2002 to 20 thousand meters in 2003, the progress is 100%. Comparison of these two firms made on the basis of ratio will disclose that the second firm is more active than the first firm. Such conclusion is quite misleading because of the difference in the size of the two firms. It is, therefore, essential to study the ratios along with the absolute data on which they are based.

e) **Limited Use of a Single Ratio:** The analyst should not merely rely on a single ratio. He should study several connected ratio before reaching a conclusion. For example, the Current Ratio of a firm may be quite satisfactory, whereas the Quick Ratio may be unsatisfactory.

f) **Window-Dressing:** Some companies in order to cover up their bad financial position resort to window dressing, i.e., showing a better position than the one which really exists.

g) **Lack of Proper Standards:** Circumstances differ fro firm to firm hence no standard ratio can be fixed for all the firms. For ex if a firm has such type of relations with its bankers that it can get necessary credit in case of need, the ideal current ratio for the firm would be less than generally accepted current ideal ratio of 2:1.

h) **Ration alone are not adequate for proper conclusions:** They merely indicate the probability of favorable or unfavorable position. The analyst has to use other tools and techniques to further carry out the investigation and to arrive at a correct diagnosis.

i) **Effect of personal ability and bias of the Analyst:** Different person draw different meaning of the different terms. For example one analyst may calculate ration on the basis of profit after interest and tax while another may consider profits before interest and Tax.

2.4.3Classification of Ratios:

a) Liquidity Ratios
b) Leverage Ratios
c) Turnover or Activity Ratios
d) Profitability Ratios
e) Valuation Ratios