Methodological Issues in the Use of Financial Ratios

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It appears that the extensive use of financial ratios by both practitioners and researchers is often motivated by tradition and convenience rather than resulting from theoretical considerations or from a careful statistical analysis. Basic questions, such as: Is the control for firm size, a major objective of the ratio form, called for by the theory examined; what is the structural relationship between the examined variables and size; and what is the optimal way to control for industry-wide factors, are rarely addressed by users of financial ratios. The major purpose of this study is to discuss the conditions under which conventional tools, such as financial ratios and measures of industry central tendency, achieve the intended objectives of analysis (e.g., size control). Various issues related to financial analysis, such as spurious correlation due to a common denominator, the choice of an optimal size variable, and the treatment of outlier observations, are also examined.