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A Review of the Theoretical and Empirical Basis of Financial Ratio Analysis

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Author

Listed:
- Timo Salmi
- Teppo Martikainen
(University of Vaasa, Department of Accounting and Business Finance)

Registered:

Abstract

Moderator's Note: Due to the limited circulation of the Finnish Journal of Business Economics, I decided to classify this paper as substantially "unpublished" for the purpose of applying the newsgroup charter. This is an experiment that may or may not be continued as the newsgroup matures. I would appreciate any comments from readers as to whether this kind of interpretation should be con- sidered in the future. Moderator's address: mailto:arnie@iastate.edu This paper provides a critical review of the theoretical and empirical basis of four central areas of financial ratio analysis. The research areas reviewed are the functional form of the financial ratios, distributional characteristics of financial ratios, classification of financial ratios, and the estimation of the internal rate of return from financial statements. It is observed that it is typical of financial ratio analysis research that there are several unexpectedly distinct lines with research traditions of their own. A common feature of all the areas of financial ratio analysis research seems to be that while significant regularities can be observed, they are not necessarily stable across the different ratios, industries, and time periods. This leaves much space for the development of a more robust theoretical basis and for further empirical research.

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