

vertical analysis is also commonly known as size analysis

Vertical Analysis is Also Commonly Known as Size Analysis: A Deep Dive into Financial Statement Analysis

Ever wondered how a company's performance changes over time? Or how different line items within its financial statements relate to each other? Then you need to understand vertical analysis, also commonly known as size analysis. This comprehensive guide will demystify this crucial financial analysis technique, providing you with a clear understanding of its application, benefits, and limitations. We'll explore the intricacies of vertical analysis, showing you how to perform it and interpret the results effectively. By the end, you'll be equipped to leverage this powerful tool to make informed financial decisions.

What is Vertical Analysis (Size Analysis)?

Vertical analysis, also known as common-size analysis or size analysis, is a financial statement analysis technique that expresses each line item of a financial statement as a percentage of a base figure within the same statement. This process normalizes the data, making it easier to compare performance across different periods, companies of varying sizes, or even different industries. Imagine trying to compare the sales of a small bakery to a multinational food conglomerate – direct comparison is difficult. Vertical analysis provides a standardized way to make this comparison meaningful.

Instead of looking at raw numbers (like \$1 million in sales), you're examining percentages (like 100% of sales). This relative comparison allows for a more insightful understanding of the financial health and operational efficiency of a business.

For the income statement, the base figure is typically total revenue or net sales. Each line item (cost of goods sold, gross profit, operating expenses, net income) is then expressed as a percentage of total revenue. This allows you to see, for example, how much of your revenue is consumed by cost of goods sold, or what percentage represents your net profit margin.

For the balance sheet, the base figure is usually total assets. Each asset and liability is expressed as a percentage of total assets. This helps identify the relative proportion of each asset or liability to the overall financial structure of the company. For example, you can see the percentage of assets tied up in inventory, receivables, or fixed assets.

Why Use Vertical Analysis (Size Analysis)?

Several compelling reasons exist to utilize vertical analysis as part of your financial analysis

toolkit:

Benchmarking: Vertical analysis facilitates easy comparison between different periods for the same company, revealing trends in profitability, efficiency, and financial structure over time. This trend analysis is invaluable for spotting emerging issues or successful strategies.

Industry Comparison: By comparing the vertical analysis results of a company to its industry peers, you can assess its relative financial strength and identify areas where it excels or lags behind the competition. This competitive benchmarking is essential for strategic planning.

Improved Decision Making: The insights gleaned from vertical analysis inform more informed and strategic business decisions. Whether you're an investor, creditor, or internal manager, this information is crucial for evaluating financial health and performance.

Identifying Potential Problems: Significant changes in the percentage of certain line items can highlight potential problems. For instance, a sharp increase in the percentage of cost of goods sold relative to sales could indicate rising input costs or inefficiencies in production.

Simplifying Complex Data: Converting raw numbers into percentages makes the financial data more readily understandable and digestible, even for individuals without extensive financial expertise.

How to Perform Vertical Analysis (Size Analysis)

The process of performing vertical analysis is straightforward. For each line item, simply divide the line item amount by the base figure (total revenue for the income statement, total assets for the balance sheet) and multiply the result by 100% to express it as a percentage.

Example (Income Statement):

Let's say a company has total revenue of \$1,000,000 and its cost of goods sold is \$600,000. The percentage of cost of goods sold is calculated as: $(\$600,000 / \$1,000,000) 100\% = 60\%$.

This process is repeated for every line item on the statement.

Interpreting the Results of Vertical Analysis

Once you have completed the vertical analysis, the real work begins – interpreting the results. Look for trends and significant deviations from previous periods or industry averages. For instance:

Increasing Cost of Goods Sold Percentage: This could indicate rising input costs, inefficient production processes, or pricing pressures.

Decreasing Gross Profit Margin: A declining gross profit margin could point to these same issues, or perhaps increased competition.

High Percentage of Accounts Receivable: This might signal problems with credit collection or an overly lenient credit policy.

High Percentage of Long-Term Debt: A high percentage of long-term debt relative to total assets could indicate high financial risk.

Limitations of Vertical Analysis

While vertical analysis is a valuable tool, it's essential to acknowledge its limitations:

It doesn't provide absolute figures: Vertical analysis expresses data as percentages, not absolute dollar amounts. While useful for comparisons, it doesn't tell you the overall size or scale of the business.

It should be used in conjunction with other analyses: Vertical analysis provides valuable insights, but it's most effective when used in conjunction with other financial analysis techniques like horizontal analysis (trend analysis) and ratio analysis.

It doesn't account for external factors: External factors, such as economic conditions or industry-specific events, can influence a company's financial performance and are not directly reflected in vertical analysis.

Conclusion

Vertical analysis, also known as size analysis, is a powerful tool for analyzing financial statements. By expressing each line item as a percentage of a base figure, it provides a normalized view of a company's financial health, operational efficiency, and profitability. By understanding how to perform and interpret vertical analysis, you can make more informed decisions, identify potential problems, and benchmark your performance against industry standards. Remember to combine it with other analytical techniques for a truly comprehensive understanding of a company's financial position.

FAQs

1. Can I use vertical analysis for both profit and non-profit organizations? Yes, vertical analysis is applicable to both for-profit and non-profit organizations. The interpretation might differ slightly, but the methodology remains the same.
1. What software can I use to perform vertical analysis? Many spreadsheet programs like Microsoft Excel, Google Sheets, and specialized financial analysis software can easily calculate vertical analysis percentages.

1. Is vertical analysis the same as horizontal analysis? No, vertical analysis compares line items within a single financial statement, while horizontal analysis compares the same line items across different periods (e.g., year-over-year).
1. How often should I perform vertical analysis? The frequency depends on your needs. Quarterly or annual analysis is common, but more frequent analysis might be necessary for businesses with volatile operations.
1. Can I use vertical analysis to compare companies in different industries? While you can perform vertical analysis on companies in different industries, direct comparisons are less meaningful because industry norms and practices vary significantly. It's more useful for internal comparisons or comparing a company to its direct competitors within the same industry.

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