

**FINANCIAL ACCOUNTING
WEEK 12 (LECTURE TWELVE)**

IMPORTANCE AND LIMITATIONS OF FINANCIAL STATEMENT ANALYSIS

DR. JOHN MUHOHO

Lesson Objectives:

Upon completion of this Lesson, you will be able to:

- Explain the importance and limitation of Financial Statement Analysis
- Explain the limitation of Ratio Analysis of Financial Statements
- Explain the Limitations of Horizontal Analysis of Financial Statements
- Explain the Limitations of Vertical Analysis of Financial Statement
- Explain advantages of horizontal statement analysis
- Explain negatives of Horizontal Statement Analysis
- Explain best practices in consumption of Horizontal statement Analysis

Introduction

Financial analysis is a process by which one identifies the company's financial performances by comparing the entities in the Statement of Financial Position / balance sheet and those in the Income Statement/profit and loss account (P&L). This is so because balance sheet entities are usually responsible for those to be found in the P&L i.e. assets shown in the balance sheet are responsible for sales, revenue and expenses to be found in the P&L. Financial statement analysis is defined as the process of identifying financial strengths and weaknesses of the firm by properly establishing relationship between the items of the balance sheet and the profit and loss account. Financial statement analysis (or financial analysis) is the process of understanding the risk and profitability of a firm (business, sub-business or project) through analysis of reported financial information, particularly annual and quarterly reports.

Financial statement analysis consists of;

- ❖ reformulating reported financial statements,
- ❖ analysis and adjustments of measurement errors, and
- ❖ financial ratio analysis on the basis of reformulated and adjusted financial statements.

The two first steps are often dropped in practice, meaning that financial ratios are just calculated on the basis of the reported numbers, perhaps with some adjustments. Financial statement analysis is the foundation for evaluating and pricing credit risk and for doing fundamental company valuation. There are various methods or techniques that are used in analyzing financial statements, such as comparative statements, schedule of changes in working capital, common size percentages, funds analysis, trend analysis, and ratios analysis. Financial statements are prepared to meet external reporting obligations and also for decision making purposes. They play a dominant role in setting the framework of managerial decisions. But the information provided in the financial statements is not an end in itself as no meaningful conclusions can be drawn from these statements alone. However, the information provided in the financial statements is of immense use in making decisions through analysis and interpretation of financial statements.

Procedure of Financial Statement Analysis

The following procedure is adopted for the analysis and interpretation of financial statements: -

1. The analyst should acquaint himself with principles and postulated of accounting.
2. He should know the plans and policies of the managements that he may be able to find out whether these plans are properly executed or not.
3. If the aim is find-out. Earning capacity of the enterprise then analysis of income statement will be undertaken. On the other hand, if financial position is to be studied then balance sheet analysis will be necessary.
4. The financial data be given in statement should be recognized and rearranged. It will involve the grouping similar data under same heads. Breaking down of individual components of statement according to nature. The data is reduced to a standard form. A relationship is established among financial statements with the help of tools & techniques of analysis such as ratios, trends, common size, fund flow etc.
5. The information is interpreted in a simple and understandable way. The significance and

utility of financial data is explained for help indecision making.

6. The conclusions drawn from interpretation are presented to the management in the form of reports.

Analyzing financial statements involves evaluating three characteristics of a company: its liquidity, its profitability, and its insolvency. A short-term creditor, such as a bank, is primarily interested in the ability of the borrower to pay obligations when they come due. The liquidity of the borrower is extremely important in evaluating the safety of a loan. Long-term creditor, such as a bondholder, however, looks to profitability and solvency measures that indicate the company's ability to survive over a long period of time. Long-term creditors consider such measures as the amount of debt in the company's capital structure and its ability to meet interest payments. Similarly, stockholders are interested in the profitability and solvency of the company. They want to assess the likelihood of dividends and the growth potential of the stock.

BENEFITS OF FINANCIAL STATEMENTS ANALYSIS

From the previous chapter, we learnt about the various forms of financial statement analysis and in the introduction of this final chapter of the course, I summarized the whole process of financial statement analysis to help everyone connect with what this chapter will be discussing.

The Financial Statement Analysis of organizations vary from one entity to another and has its benefits coupled with problems as well. This chapter will focus in detail these benefits and problems arising from Financial Statement Analysis to organisations, countries and the globe at large.

IMPORTANCE OF RATIO ANALYSIS OF FINANCIAL STATEMENT ANALYSIS

1. Evaluating the efficiency of assets utilisation to generate sales revenue i.e. turnover ratio.
2. Evaluating the ability of the firm to meet its short-term financial obligation and when they fall due (liquidity ratios).
3. To carry out industrial analysis i.e. compare the firm's performance with the average industrial performance of the firm with that of individual competitors in the same industry.
4. For cross sectional analysis i.e. compare the performance of the firm with that of individual competitors in the same industry.
5. For trend/time series analysis i.e. evaluate the performance of the firm over time.
6. To establish the extent which the assets of the firm has been financed by fixed charge capital

i.e. use of gearing ratio

7. To predict the bankruptcy of the firm i.e. use of selected ratios to determine the overall ratio usually called Z-score. The Z-score when compared with a pre-determined acceptable Z-score will indicate the probability of the bankruptcy of the firm in future.

LIMITATIONS OF FINANCIAL RATIO ANALYSIS

1. Primary investment ratios (operating return on equity)

The operating return on equity represents the operating profit before tax as a percentage of the book value of the shareholders' equity. This ratio is at the apex of the ratio pyramid. It is the product of the financial leverage multiplier and the ROCE.

2. Primary financing ratios (financial leverage multiplier)

The financial leverage multiplier expresses how many times bigger the capital employed is than the shareholders' equity. This multiplier demonstrates that assets funded by sources other than the owners will increase the profit or loss of the company relative to shareholders' equity.

3. 3 Primary operating ratios (return on capital employed)

ROCE is a popular indicator of management efficiency and for strategic planning.

Management efficiency

A comparison of the operating profit generated by a company with the total book value of the non-current and current assets indicates how many dollars of profit are obtained from every dollar of resource under management's control. It is useful when making inter-period comparisons for a company.

Strategic planning

ROCE is also used for strategic planning. ROCE is calculated as profit before interest less tax divided by the average of net assets plus net debt plus dividend creditor less net assets held for sale. ROCE is a relative profit measurement that not only incorporates the fund's shareholders have invested, but also funds invested by banks and other lenders, and therefore shows the productivity of the assets of the Group.

4. Primary utilisation ratios (asset turnover)

The asset turnover ratio measures the number of times that one dollar of assets results in a dollar of revenue. An initial view might be that the more frequently a dollar of revenue is produced the better. Although this ratio can act as a good guide to company performance, it needs to be looked at carefully to establish the reason for any change. If asset turnover increases, then either the total value of revenue is increasing or the capital asset base is decreasing, or both. If it is because sales are increasing, this is positive if there has been no change in either the sales mix or selling prices. However, the increase might have been achieved at the expense of the profit margin with discounting.

5. Primary efficiency ratios (operating profit margin)

Operating profit before tax as a percentage of revenue is another widely used ratio in the assessment of company performance and in comparisons with other companies. The percentage achieved depends on the type of industry a company is operating within (e.g. high-volume/low-margin), the company pricing policies, the sales volumes and cost structure. Any change in the percentage would be investigated to establish the reason. For example, has there been a change in the sales mix, the selling prices, and the cost of materials or labour

6. Primary liquidity ratios (current ratio)

The current ratio is a short-term measure of a company's liquidity position comparing current assets with current liabilities. There is no rule of thumb measure, such as 2:1, that can be applied. The appropriate ratio depends on the industry sector and each individual company's experience.

What if the current ratio increases beyond the normal range?

This may arise for a number of reasons, some beneficial, others unwelcome.

Beneficial reasons

- ❖ A build-up of inventory in order to support increased sales following an advertising campaign or increasing popular demand as for, say, a PlayStation. Management action will be to establish from a cash budget that the company will not experience liquidity problems from

holding such inventory, e.g. there may be sufficient cash in hand or from operations, a short-term loan, extended credit or bank overdraft.

- ❖ A permanent expansion of the business which will require continuing higher levels of inventory. Management action will be to consider existing cash resources, future cash flows from operations or arrange additional finance, e.g. equity or long-term borrowings to finance the increased working capital.

Unwelcome reasons

- ❖ Operating losses may have eroded the working capital base. Management action will vary according to the underlying problem, e.g. implementing a cost reduction programme, disposing of underperforming segments, arranging a sale of assets or inviting a takeover.
- ❖ Inefficient control over working capital, e.g. poor inventory or accounts receivable control allowing a buildup of slow moving inventories or doubtful trade receivables.
- ❖ Adverse trading conditions, e.g. inventory becoming obsolete or introduction of new models by competitors. We will see when we discuss subsidiary ratios below that the current ratio is further analysed in terms of its constituent parts i.e. inventory, receivables, payables and cash.

LIMITATIONS OF RATIO ANALYSIS

Ratios are useful flags but there may be limitations that the reader needs to bear in mind relating.

External factors

There are a number of external factors that need to be understood. These include:

- ❖ Ratios need to be interpreted bearing in mind the political context within which a business has been operating as, for example, when governments adopt protectionist measures that can impact on a company's sales. For example, in 2009 the Argentine Production Ministry announced new anti-dumping measures to combat what it regarded as unfair competition and restricted foreign imports from a number of countries covering a range of imports such as metal cutlery, air conditioners and terminals.
- ❖ Ratios need to be interpreted bearing in mind the economic context within which a business has been operating by considering any changes that have occurred in the accounting period that could impact on:
 - ✓ non-current assets, e.g. tax incentives to invest;
 - ✓ Inventories, e.g. a downturn in the economy leading to holding excessive amounts of inventory;
 - ✓ Trade receivables, e.g. credit restrictions leading to a longer collection period;
 - ✓ Costs affecting the gross profit, e.g. raw material shortages leading to inflated prices as with gas and oil supplies and wage increases due to a rise in minimum wage rates; and
 - ✓ Costs affecting the profit before tax, e.g. increased bad debts and interest rate increases.

Internal factors

There are internal factors to consider:

- ❖ Ratios need to be interpreted in conjunction with reading the narrative and notes in the annual reports. The narrative could be helpful in explaining changes in the ratios, e.g. whether an inventory buildup is in anticipation of sales or a fall in demand. The notes could be helpful in corroborating the narrative, e.g. if the narrative explains that the increase in inventory is due to anticipated further production and sales, check whether the non-current assets have increased or whether there is a note about future capital expenditure.
- ❖ Whether confident that the financial statements give a true and fair view: Whether there is a risk of fraudulent misrepresentation of facts which can affect even major companies. For example, in the case of Xerox company from the USA, The fraud was that Xerox overstated its true equipment revenues by at least \$3 billion and its true earnings by approximately \$1.5 billion during a four-year period. When Xerox finally restated its financial results for 1997–2000, it restated \$6.1 billion in equipment revenues and \$1.9 billion in pre-tax earnings the largest restatement in US history up to that point.
- ❖ Whether there is a risk of window dressing, e.g. dispatching goods at the end of the period knowing them to be defective so that they appear in the current year's sales and accepting that they will be returned later in the next period.
- ❖ Have the accounts been subject to fundamental uncertainty which could affect the going concern concept? There might be full disclosure in the notes but ratios might not be accurate predictors of earnings and solvency.
- ❖ Have liabilities been omitted, e.g. use of off-balance sheet finance such as structuring the terms of a lease to ensure that it is treated as an operating lease and not a finance lease and special-purpose enterprises to keep debts off the statement of financial position?
- ❖ Ratios might be distorted because they are based on period-end figures: The end of year figures are static and might not be a fair reflection of normal relationships such as when a business is seasonal, e.g. an arable farm might have no inventory until the harvest and a toy manufacturer might have little inventory after supplying wholesalers in the lead up to Christmas. Any ratios based on the inventory figure such as inventory turnover could be misleading if calculated at, say, a 31 December year-end.

- ❖ Similarly, a decline in the rate of inventory turnover might have arisen from the management decision to stockpile scarce raw materials which will allow the company to meet customer demand when competitors are out of stock.
- ❖ Factors that could invalidate inter-company comparisons, such as:
 - ✓ use of different measurement bases with non-current assets reported at historical cost or revaluation and revaluations carried out at different dates;
 - ✓ use of different commercial practices, e.g. factoring trade receivables so that cash is increased – a perfectly normal transaction but one that could cause the comparative ratio of days' credit allowed to be significantly reduced;
 - ✓ applying different accounting policies: e.g. adopting different depreciation methods such as straight-line and reducing balance; adopting different inventory valuation methods such as FIFO and weighted average; or assuming different degrees of optimism/ pessimism when making judgement-based adjustments to non-current and current assets, e.g.:
 - ✓ on the impairment review of intangible and tangible non-current assets;
- ❖ On R&D spend (an interesting research study¹³ looking at 243 initial public offerings from 1986 to 1990 found that there was a reduction by managers in R&D spending to increase current earnings and a manipulation of discretionary current accruals. One explanation might be that potential investors attach greater weight to current earnings and this could benefit insiders on the sale of their pre-offering shareholding);
- ❖ Having different definitions for ratios, e.g.:
 - ✓ The numerator for ROCE could be operating profit, profit before interest and tax, profit before interest, profit after tax, etc.;
 - ✓ The denominator for ROCE could be total assets, total assets less intangibles, net assets, average total assets, etc.;
- ❖ The use of norms can be misleading, e.g.:
- ❖ A current ratio of 2:1 might be totally inappropriate for a company like Tesco which does not have long inventory turnover periods and as its sales are for cash it would not produce trade receivable collection period ratios;
- ❖ Making the appropriate choice of comparator companies for benchmarking by finding companies with the same mix of products and markets and deciding on appropriate criteria,

e.g. deciding if it should be the industry average ratios. However, these may be based on many companies of different size regarding the amounts of capital employed, turnover, number of employees, etc. The choice of benchmark is important as it affects the conclusions that are made but it is difficult to get an exact fit.

PROBLEMS WHEN USING CONSOLIDATED ACCOUNTS

Certain limitations need to be recognised when analysing a consolidated statement of financial position, making inter-company comparisons and forming a judgement on distributable profits based on the consolidated statement of comprehensive income. These are as follows:

1. The consolidated statement of financial position aggregates the assets and liabilities of the parent company and its subsidiaries. The current and liquidity ratios that are extracted to indicate to creditors the security of their credit and the likelihood of the debt being settled will be valid only if all creditors have equal rights to claim against the aggregated assets. This may be the case if there are cross-guarantees from each company, but it is more likely that the creditors will need to seek payment from the individual group company to which it allowed the credit. One needs to be aware that the consolidated accounts are prepared for the shareholders of the parent company and that they may be irrelevant to the needs of creditors. This is not a criticism of consolidation, merely a recognition of the purpose for which the accounts are relevant.
2. The consolidated statement of comprehensive income does not give a true picture of the profits immediately available for distribution by the holding company to its shareholders. It shows the group profit that could become available for distribution if the holding company were to exercise its influence and control, and require all its subsidiary companies and associated companies to declare a dividend of 100% of their profits for the year. Legally, it is possible for the company to exercise its voting power to achieve the passing up to it of the subsidiary companies' profits although commercially this is highly unlikely. The position of the associated companies is less clear: the holding company only has influence and does not

have the voting power to guarantee that the profit disclosed in the consolidated statement of comprehensive income is translated into dividends for the holding company shareholders.

OTHER PROBLEMS OF USING RATIO ANALYSIS INCLUDE:

- ❖ They ignore the size of the firm being compared e.g. in cross-sectional analysis, the firm being compared might be of different size, technology and product diversification.
- ❖ Effect of inflation: Ratio ignores the effect of inflation in performance e.g. increase in sales might be due to increase in selling price caused by inflationary pressure in the economy. Taking analysis of a firm for a long period more than two financial years may not give an appropriate view of the entity due to currency fluctuations brought about by inflation and its allied factors.
- ❖ Ratios ignore qualitative or non-quantifiable aspects of the firm e.g. important assets such as corporate image, efficient management team, customer loyalty, quality of product, technological innovation e.t.c. are not captured in ratio analysis.
- ❖ Ratios are computed only at one point in time i.e. they are subject to frequent changes after computation e.g. liquidity ratios will constantly change as the cash, debtors and stock level changes.
- ❖ Monopolistic firms: It is difficult to carry out industrial and cross-sectional analysis for monopolistic firms since they do not have competitors and they are the only firms in the whole industry. Comparison of such firms with others may not give a true state of affairs of not equitable at all.
- ❖ Historical Data: Ratios are computed in historical information or financial statement thus may be irrelevant in future decision-making of an entity.

BENEFITS AND LIMITATIONS OF HORIZONTAL ANALYSIS

Horizontal analysis (also known as trend analysis) looks at trends over time on various financial statement line items. Financial professionals and those working in business management may use vertical analysis to make comparisons within a budget. Specifically, they may help you more fully understand how each part of a larger financial statement contributes to the overall spending or income. They often do this within a certain period. For example, one may perform a vertical analysis as part of a quarterly company review to better understand how each department is using its money.

While vertical analysis makes comparisons within a certain period, a vertical analysis may also be useful when making comparisons over time. This may allow financial professionals to understand how changing certain items in the budget has affected the overall monetary baseline from one financial period to the next. This can be useful when making predictions, forming strategies or deciding how to distribute money in the future.

A business will look at one period (usually a year) and compare it to another period. For example, a business may compare sales from their current year to sales from the prior year. The trending of items on these financial statements can give a business valuable information on overall performance and specific areas for improvement. It is most valuable to do horizontal analysis for information over multiple periods to see how change is occurring for each line item. If multiple periods are not used, it can be difficult to identify a trend. However, the horizontal analysis has its own benefits and limitations to the users of the information contained.

BENEFITS OF HORIZONTAL FINANCIAL STATEMENT ANALYSIS

1. Identification of Trends:

Horizontal analysis allows companies to identify specific trends over a period of time. By comparing financial statements from different periods side by side, analysts can pinpoint where growth or decline has occurred, which can then inform strategic decisions.

2. Comparative Insight:

Horizontal analysis provides a relative perspective rather than an absolute one. This means that companies can compare their performance against themselves in the past, helping to track their own progress and growth.

3. Informs Investment Decisions:

For investors, horizontal analysis can provide a clearer picture of a company's historical performance. This can be invaluable when determining the potential risks and returns of investing in a particular stock or bond.

4. Basis for Budgeting and Forecasting:

By examining past financial data through horizontal analysis, companies can make more informed predictions about future revenues, expenses, and other financial metrics, aiding in the budgeting process.

5. Enhances Credibility with Stakeholders:

Providing a transparent view of financial performance over time can build trust among stakeholders, as it shows that the company is open about its historical performance and growth trajectory.

6. Facilitates Benchmarking:

Horizontal analysis allows businesses to benchmark their performance against industry peers, by comparing similar time frames and noting differences in growth or decline.

7. Highlights Anomalies:

Any sudden spike or dip in a financial metric will be easier to spot with horizontal analysis. This can be useful for detecting errors, fraud, or any significant business events that might need further investigation.

8. Aids in Financial Reporting:

Preparing comprehensive financial reports becomes easier when horizontal analysis is employed. It allows for more detailed commentary on the changes in financial performance over time.

9. Comprehensive Overview:

Instead of looking at a single year or quarter in isolation, horizontal analysis offers a broader view. This panoramic perspective can provide insights that might be missed in a narrower analysis.

10. Facilitates Decision Making:

By providing clear insights into the financial trajectory of a company, horizontal analysis supports executives in making informed strategic decisions that align with the company's historical performance and future goals.

BENEFITS AND LIMITATIONS OF VERTICAL ANALYSIS

Vertical analysis shows a comparison of a line item within a statement to another line item within that same statement. For example, a business may compare cash to total assets in the current year. This allows a business to see what percentage of cash (the comparison line item) makes up total assets (the other line item) during the period. This is different from horizontal analysis, which compares across years. Vertical analysis compares line items within a statement in the current year. This can help a business to know how much of one item is contributing to overall operations. For example, a business may want to know how much inventory contributes to total assets. They can then use this information to make business decisions such as preparing the budget, cutting costs, increasing revenues, or investments in property plant or equipment. Regardless of the valuable information the Vertical Statement Analysis contains, it has its benefits and a myriad of limitations which are highlighted below.

LIMITATIONS OF VERTICAL FINANCIAL STATEMENT ANALYSIS

1. Limited to Past Data:

Horizontal analysis relies on historical data, which means it doesn't account for future potential or upcoming market changes. This can potentially lead to decisions based on outdated trends.

2. Doesn't Provide Cause:

While it shows the change in financial metrics over time, horizontal analysis doesn't necessarily explain the reasons behind those changes, which might require further analysis or research.

3. **Ignores Inflation:** If not adjusted for inflation, the numbers might give a skewed perspective, especially over longer periods of time.
4. **Not Always Suitable for Diverse Companies:**
Companies with diverse business segments might find horizontal analysis less useful, as the consolidated numbers may mask significant segment-specific trends.
5. **Requires consistent accounting methods:**
If a company changes its accounting methods over the years, the figures may not be directly comparable, thus rendering the horizontal analysis less reliable.
6. **Can Overemphasize Short-term Fluctuations:**
Minor changes from year to year can seem more significant than they actually are, potentially leading to overreactions or misguided strategies.
7. **Dependent on Accurate Financial Statements:**
If the initial financial statements have errors or omissions, the horizontal analysis will perpetuate those mistakes, leading to incorrect conclusions.
8. **Time Consuming:**
Properly conducting horizontal analysis, especially over extended periods, can be time-consuming, which might deter some businesses from regularly employing it.
9. **May Overlook Vertical Relationships:**
By focusing on horizontal trends, companies might overlook important vertical relationships within a single period's financial statement.
10. **Potential for Misinterpretation:**
Without a comprehensive understanding of the business and its context, there's a risk that stakeholders might misinterpret the trends highlighted by horizontal analysis, leading to misguided perceptions or decisions.

Advantages of Horizontal Analysis

Looking at how numbers have changed over time can give you a deeper understanding of your business's financial health. This is where horizontal analysis comes in handy. One of the benefits of this technique is that it allows you to identify trends and patterns that might not be immediately obvious.

For example, if you compare your company's revenue from one year to the next, you might notice that certain products or services are becoming more popular while others are declining in popularity. Another benefit of horizontal analysis is that it can help you monitor changes in your company's financial performance over time. For instance, if you notice a decline in sales revenue

over the past few years, but an increase in net income during the same period, this could indicate that your business has become more efficient at managing costs and expenses. By analyzing these trends, you can make informed decisions about where to allocate resources and how best to improve profitability.

Negatives of Horizontal Analysis

If you want to gain a full understanding of your business's financial health, it's important to consider both the benefits and limitations of comparing data over time. While horizontal analysis can be a useful tool for identifying trends and changes in financial performance, it's not without its drawbacks.

One major limitation is that the method only compares data from two periods, which may not provide a complete picture of your business's financial situation. Another potential drawback of horizontal analysis is that it may overlook significant changes or events that occurred between the two periods being compared.

For example, if your business underwent a major restructuring or acquisition during one of the periods, this could significantly impact your financial results but wouldn't necessarily be reflected in a simple comparison of the two sets of data. Additionally, there is always the potential for errors when conducting any type of data analysis, which could lead to incorrect conclusions about your business's financial performance.

Overall, while horizontal analysis can be a helpful tool for gaining insight into how your business is performing over time, it's important to recognize its limitations and potential drawbacks. As with any analytical method, it should be used in conjunction with other tools and techniques to get a more comprehensive understanding of your business's financial health.

Best Practices for Using Horizontal Analysis

When using horizontal analysis, it's important to set clear goals and objectives for your financial statements. This will help you identify trends and make informed decisions based on the data.

BENEFITS OF VERTICAL FINANCIAL STATEMENT ANALYSIS

1. You can make comparisons within a company

Vertical analysis can make it much easier to compare the financial statements and budgets of different departments within an organization. For example, you may use the percentage calculated during the vertical analysis process to understand how much of the overall budget two different departments are spending on personnel. This is one tool that company managers and chief financial officers (CFOs) may use to analyze their company spending.

2. You can make comparisons between companies

This tool can also be a helpful way to make comparisons across different companies or even between companies in different fields. The percentages of the whole can allow two companies from different industries to compare their income, even if the product they're selling or the way they sell it differs. In this way, vertical analysis is a powerful tool that may help individuals understand the financial standing and structure of their company within the industry and in the world of business.

3. You can create a better business strategy

Vertical analysis can help financial managers to better understand how money is being spent. They may use this to help understand the success of their current financial strategy. One way to do this is to compare the monetary value of a line item based on the percentage of spending allocated to it against the overall success of that line item.

For example, if a certain marketing campaign has taken up 15 percent of the marketing budget for a project, a financial team might review the results to understand its effectiveness. If they determine it was worth 15 percent of the budget, they may continue or expand that campaign. If they decide that the money may have been more valuable elsewhere, they may re-allocate the funds or use the information to help craft a better marketing and financial strategy next time.

4. You can communicate about finances more easily

One advantage of vertical analysis is that it simplifies the line item impact and the overall financial statement. This may make financial matters easier to discuss with non-financial personnel. This can prove helpful for internal company matters, like cross-departmental meetings, company reports or presentations. It can also be useful for communicating with external individuals, like investors or news outlets.

LIMITATIONS OF VERTICAL STATEMENT ANALYSIS

While useful, there are some aspects of vertical analysis that make it disadvantageous. When making analyses, it may be useful to combine it with another financial analysis strategy. Here are some disadvantages of vertical analysis:

1. Lack of standardized percentages

When performing a vertical analysis, you might only consider a specific set of line items as compared to the overall financial total. This means that these analyses may lack the context of standardized percentages to compare your findings. Seeing the percentage that each item represents may not help you understand the meaning of that data.

For some types of financial statements, you may try to find guidelines surrounding standardized or recommended percentages for different line items. This process can take time and may not be available for more niche industries or document types. Without standardized percentages to compare your findings to, this form of standardized analysis may have limited use.

2. Not helpful in liquidity measurements

A liquidity measurement or ratio is the financial system by which a company may understand its ability to pay debts and remain financially viable. This is an important financial tool for a company, and performing vertical analysis does not contribute to this understanding. This is a good example of a situation in which financial officers may have to combine vertical analysis

with other financial tools, such as trend analysis or ratio assessments, to assemble a complete understanding of their company's financial standings.

3. Simplicity over quality

While vertical analysis is very helpful for simplifying a financial statement, its ability to do so may leave out some important factors. For example, it may not reflect the importance of a particular line item, what sort of work went into developing it, or why it is important. This means that when using vertical analysis, financial analysts may increase the quality of their findings by implementing an understanding of surrounding factors besides the percentages discovered in the vertical analysis process.

4. No explanation of "why"

Vertical analysis results in concrete mathematical data as percentages. While this may help you understand what's occurring in financial statements, it may not help you understand why it occurs. For example, in a statement of income for a business, you may use vertical analysis to see that a particular project created a large percentage of the gross income that quarter. The vertical analysis may not address why it was so successful and what the company may do in the future to sustain that success. To understand this, you may have to supplement the work with a distinct form of analysis.

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