

Overview of Horizontal and Vertical Analysis

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Financial statement analysis is a crucial aspect of evaluating a company's performance. Two common methods employed for this purpose are horizontal analysis, also known as trend analysis, and vertical analysis, termed common size financial statement analysis. In this guide related to horizontal and vertical analysis, we will help you learn about these analytical approaches, exploring their definitions, applications, and the key distinctions between them.

What is Horizontal Analysis?

Horizontal analysis is also known as trend analysis. It is a dynamic tool that assesses financial data trends over several years. This method involves comparing line items in financial statements across consecutive periods. By scrutinising the year-on-year changes, analysts gain insights into a company's evolving financial landscape.

Example Scenario

Consider a company's income statement. Horizontal analysis for revenue might involve comparing the sales figures from 2020, 2021, and 2022. This comparison aids in identifying patterns, growth trajectories, or areas that need attention.

What is Vertical Analysis?

In contrast, vertical analysis focuses on a specific reporting period, dissecting financial statements to identify the proportional relationship between various line items. Commonly referred to as common-size financial statement analysis, this method expresses each line item as a percentage of a base figure, typically the total revenue or assets.

Example Scenario

In a vertical income statement analysis, each expense line item, such as cost of goods sold or operating expenses, is represented as a percentage of the total revenue. This allows for a detailed examination of the cost structure's composition with revenue.

Difference between Horizontal and Vertical Analysis

Here are the basic differences between horizontal and vertical analysis.

1. Time Horizon

- **Horizontal Analysis:** Spans multiple years, revealing trends and changes over an extended period.
- **Vertical Analysis:** Specific to a single reporting period, providing a snapshot of the financial structure at that moment.

2. Focus on Relationships

- **Horizontal Analysis:** Emphasises changes and growth patterns within individual line items over time.
- **Vertical Analysis:** Concentrates on the relationships between line items within a single period, highlighting the composition and structure.

3. Purpose

- **Horizontal Analysis:** Aids identify patterns, opportunities, and potential challenges through year-over-year assessments.
- **Vertical Analysis:** Helps in understanding financial statements' internal structure and each component's relative significance.

4. Application

- **Horizontal Analysis:** Often utilised for long-term strategic planning, forecasting, and identifying areas for operational improvement.
- **Vertical Analysis:** Valuable for understanding the composition of financial statements, facilitating benchmarking, and identifying areas for cost optimisation.

5. Representation

- **Horizontal Analysis:** Involves percentage changes or absolute variances between corresponding line items across years.
- **Vertical Analysis:** Represents each line item as a percentage of a base figure, offering insights into the proportional contribution of each element.

6. Scope

- **Horizontal Analysis:** Offers a comprehensive view of the company's performance evolution, capturing overall trends and patterns.
- **Vertical Analysis:** Provides a detailed breakdown of the internal structure, elucidating the composition of financial statements.

7. Decision-Making Focus

- **Horizontal Analysis:** Supports strategic data-driven decision-making by identifying long-term trends and areas for improvement.
- **Vertical Analysis:** Informs operational decisions by detailing the relative importance of each component within a specific period.

8. Time Sensitivity

- **Horizontal Analysis:** Requires a historical dataset for meaningful insights, making it more reflective and comprehensive.
- **Vertical Analysis:** This can be promptly conducted using a single set of financial statements, offering immediate insights into the internal proportions.

Follow the table below for the difference between **horizontal and vertical analysis**.

Difference Between Horizontal and Vertical Analysis		
Difference	Horizontal Analysis	Vertical Analysis
Time Horizon	Spans years	Single period snapshot
Focus	Changes and growth	Relationships within a period
Purpose	Long-term planning	Internal structure understanding
Application	Strategic, forecasting	Benchmarking, cost optimization
Representation	Percentage changes	Percentage of base figure

Scope	Overall trends	Internal structure breakdown
Decision Focus	Strategic decisions	Operational decisions
Time Sensitivity	Reflective, historical	Immediate with a single set

Importance of Integrating Both Horizontal Analysis and Vertical Analysis

In financial analysis, integrating both horizontal and vertical analysis is crucial for a comprehensive understanding. While horizontal analysis reveals trends and growth trajectories over time, vertical analysis provides a detailed snapshot of the internal financial structure.

Integrating these methodologies offers a holistic perspective, empowering stakeholders with insights into historical performance trends and the current composition of financial statements.

Comprehensive Understanding

Integrating horizontal and vertical analysis ensures a thorough grasp of a company's financial health by considering temporal trends and current structural nuances.

Informed Decision-Making

By combining horizontal and vertical analyses, stakeholders can make well-informed decisions considering the long-term trajectory and current financial composition.

Strategic Planning

The integration enables effective strategic planning by leveraging historical trends and understanding the current proportional significance of financial components.

Operational Optimization

Both horizontal and vertical analysis contribute to operational efficiency – horizontal for identifying areas needing improvement over time, and vertical for optimising costs based on current proportions.

Benchmarking Accuracy

Combining these analyses enhances the accuracy of benchmarking efforts, considering both the historical context and the current structure.A

Identifying Growth Areas

Integration assists in pinpointing growth areas by leveraging historical trends and understanding the present composition of revenue and expenses.

Holistic Financial Health Assessment

Stakeholders gain a holistic view of a company's financial health, blending insights into long-term trends with an understanding of the current financial structure.

Enhanced Forecasting

The synergy between both analyses improves forecasting accuracy, incorporating historical patterns and current financial proportions into predictive models.

Conclusion

In financial statement analysis, both horizontal and vertical analysis play pivotal roles. Horizontal analysis helps unveil trends and growth patterns over multiple periods, offering valuable insights for long-term strategic planning. Meanwhile, vertical analysis provides a snapshot of the internal composition of financial statements, aiding in understanding the proportional significance of each component.

By integrating these two approaches, analysts can gain a more holistic perspective, empowering them to make informed decisions and recommendations for the future.

Additional Points of differentiation

Meaning	Horizontal analysis is the comparative evaluation of the financial statement for two or more period, to calculate the absolute and relative variances for every line of item.	Vertical analysis is proportional evaluation of the financial statement wherein each item on the statement is expressed as a percentage of the total, in the respective section.
Use	It represents the growth or decline of an item.	It helps in forecasting and determining the relative proportion of an item to the common item in the financial statement.
Aims at	Ascertaining the trend and changes in an item over time.	It aims at ascertaining the proportion of items to the common item of the single accounting year.
Expresses	Item from past financial statement are restated to a percentage of amount from base year.	Each item of financial statement is denoted as a percentage of another item.
Comparison	Helpful in intra-firm comparison	Helpful in both intra-firm comparison and inter-firm comparison
Horizontal analysis is a procedure in the fundamental analysis in which the amounts of financial information over a certain period of time is compared line by line in order to make related decisions.		Vertical analysis is the method of analysis of financial statements where each line item is listed as a percentage of another item to assist decision making.
Main Purpose		

The main purpose of horizontal analysis is to compare line items to calculate the changes over time.

Main purpose of vertical analysis is to compare changes in percentage terms.

Usefulness

Horizontal analysis becomes more useful when comparing company results with previous financial years.

Vertical analysis is more useful in comparing company results with other companies.