Common Size Statements Analysis

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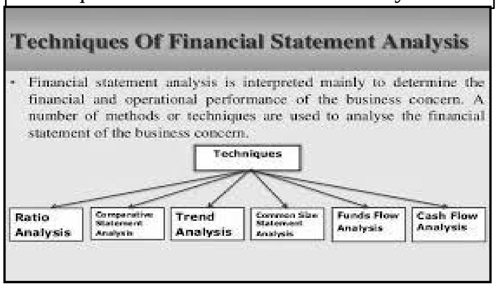
Common Size Statements

Common size statements is one of the technique of Financial Statement Analysis



Common Size Statements

Meaning of Common-Size Statement:

Under the common-size statements, balance sheet and income statement are shown in analytical percentages. The figures appearing in balance sheet are shown as percentages of total assets and total liabilities. The figures appearing in income statement are shown as percentage of sales. The total assets and total liabilities are taken as 100 each and different assets are expressed as a percentage of the total assets and different liabilities are expressed as a percentage total liabilities. Similarly, various figures of income statement are taken as a part of total sales which is equal to 100. Every individual item of financial statements is stated as a percentage of the total 100.

Example of Common Size Statements

Common Size Balance Sheet

	Standard Balance Sheet	Common Size Balance Sheet
Assets		
Cash	3600	23%
Inventory	6800	44%
Accounts Receivable	5000	32%
Total Assets	15400	100%
Liabilities		
Accounts Payable	6500	42%
Notes Payable	8910	58%
Total Liabilities	15410	100%
Equity		
Common Stock	25000	62%
Retained Earnings	15560	38%
	40560	100%

Example of Common Size Statements…(Cont.)

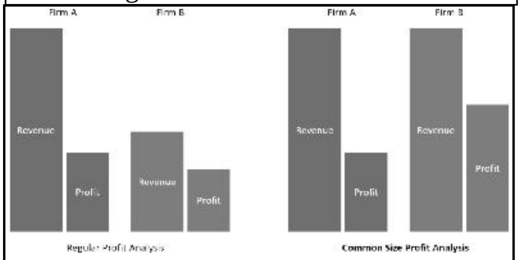
Common Size income statement		
Sales	2500	100.0%
Less : Cost of Goods sold	1300	52.0%
Gross Profit	**1200**	**48.0%**
Less : Operating Expenses	1000	40.0%
Earning Before Interest and Tax	**200**	**8.0%**
Less : Interest Expenses	30	1.2%
Earning Before tax	**170**	**6.8%**
Less : Income Tax expenses	60	2.4%
Net Profit	**110**	**4.4%**

Objectives of Common Size Statements

Objectives of preparing common size income statements are as follows:

1. To compare two or more companies
2. To analyze changes in individual items of financial statements during a given period
3. To know comparative significance of each individual item
4. To analyze the distribution of profits in the form of interest, taxes and dividends
5. To assess the efficiency of business
6. To study the trends of different items over a number of years

Comparing Two Firms with different Regular Profits and Revenues



Firm A's profit looks larger from an absolute basis, but is actually smaller in relative terms as shown in the **Common Size Analysis**

Importance/Benefits of Common Size Statements

1. Investors/analysts can easily identify drastic changes in a company's financial statement.
2. An excellent tool to compare companies of different sizes in the same industry
3. Looking at the financial data can reveal competitors' strategy.
4. Easy to Understand
5. Helpful for Time Series Analysis:
6. Comparison at a Glance
7. Helpful in analyzing Structural Composition

Limitations of Common Size Statements

1. No Standard Ratios regarding various items of financial statements
2. Does not incorporate change in inflation
3. Requirement of Consistency accounting principles
4. Fail to convey proper records during seasonal fluctuations in various components of sales, assets liabilities etc.
5. Window Dressing
6. Common-Size Statement fails to recognize the qualitative elements e.g. quality of works, customer relations etc.
7. Liquidity and Solvency Position cannot be measured by Common-Size Statement.

How to Prepare Common Size Statements

The common-size statements may be prepared in the following way:

1. Total sales are taken equal to 100
2. All individual items of income statements are converted into percentage accordingly for example, if sales are 3,50,000 and salaries and wages are 50,000 then the salaries and wages in percentage term would be expressed as =50,000/3,50,000x100=14.28%
3. The totals of assets or liabilities are taken as 100.
4. The individual assets are expressed as a percentage of total assets, i.e., 100 and different liabilities are calculated in relation to total liabilities. For example, if total assets are Rs 5 lakh and inventory value is Rs 50,000, then it will be 10% of total assets (50,000×100/5,00,000)

Concluding Remarks

1. Common size statements is one of the tools of financial analysis.
2. All the items of income statements are converted into percentages taking sales, total assets and total liabilities as a base of 100.
3. Common size statements are important as various items and their comparison with others become easier for the analyst.
4. Financial analysis with the help of common size statements has limitations of limited ratios, lack of qualitative study, impact of inflation and accounting inconsistency, window dressing etc.
5. In spite of its limitations, common size statement analysis is popularly used by the analyst for assisting their financial decisions of investment and efficiency measurement.