Horizontal Analysis of Balance Sheets and Financial Statements

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Horizontal analysis sometimes referred to as trend analysis, is used to identify trends over a particular number of accounting periods. It can be used with a balance sheet or an income statement.

You need at least two accounting periods for a valid comparison, but if you want to really spot trends, you should have at least three, if not more accounting periods of data available for calculating horizontal analysis.

The level of detail in your financial statements depends heavily on the accounting software you use. If you use entry-level software, you'll most likely need to use spreadsheets like Excel or Google Sheets to conduct your horizontal analysis.

What is Horizontal Analysis?

You use horizontal analysis to find and monitor trends over a period of time. Instead of creating an income statement or balance sheet for one period, you would also create a comparative balance sheet or income statement to cover quarterly or annual business activities.

From that comparative statement, you highlight increases or decreases within that time frame. This way, you can quickly see growth, as well as any red flags that require attention.

With horizontal analysis, you use a line-by-line comparison (compare each line item from base to the chosen accounting period) to the totals. For instance, if you run a comparative income statement for 2019 and 2020, horizontal analysis allows you to compare the revenue totals for both years to see if it increased or decreased, or remained relatively stable. If possible, you should aim to add 2018 to the mix, so you'll be able to see if it was a trend or just a fluke.

By comparing historical financial information you can easily determine your growth and position compared to your competitors.

For the greatest accuracy, you should ensure all the financial statements are prepared consistently according to the Generally Accepted Accounting Principles (GAAP). The consistency constraint means that you have to use the same accounting methods and principles every year.

The comparability constraint dictates that your statements and documents need to be evaluated against companies similar to yours within the same industry. Horizontal analysis improves and enhances the constraints during financial reporting.

Analysts and investors will be able to identify factors that drive growth over a period of time. This also makes it easier to see growth patterns and trends, like seasonality. With this approach, you can also analyze relative changes between lines of products to make more accurate predictions for the future.

> *Though the 2020 pandemic meant many industries saw significant changes, the data will still be useful for horizontal analysis in the future.*

Metrics in Horizontal Analysis

Your financial statements, including your balance sheet, income statement, and cash flow statement provide operational information and provide a clear picture of performance. These documents can also show a company's emerging successes and potential weaknesses, based on metrics such as inventory turnover, profit margin, and return on equity.

For instance, if management establishes the revenue increase or decrease in the cost of goods sold (COGS) is the reason for rising earnings per share, the horizontal analysis can confirm. With metrics like the cash flow to debt ratio, coverage ratios, interest coverage ratio, and other financial ratios, the horizontal analysis can determine whether sufficient liquidity can service the company. It can also be used to compare growth rates and profitability over a period of time, across companies in the same industry.

Horizontal and Vertical Analysis

With horizontal analysis, you look at changes line-by-line, between specific accounting periods – whether it be monthly, quarterly, or annually. Usually, it's quarterly or annually, and compares at least three years. The more data available, the easier it is to spot trends.

With vertical analysis, however, you restate either the income statement or the balance sheet amounts as a percentage of either the total assets (balance sheet) or net sales (income statement.)

Vertical analysis is more often used by creditors and investors to compare a company's financial performance to others in the same industry.

For more information on horizontal vs. vertical analysis, take a look at our blog post.

Steps to Perform a Horizontal Analysis

First, run both a comparative income statement and a balance sheet for each of the periods you want to compare. You'll need at least two to compare, but it will easier to find trends if there are three or more.

Then, decide how to approach the analysis, using one or more of these options:

- **Direct Comparison:** This is what it sounds like – directly comparing the results of one accounting period to another. For instance, if your 2019 revenue was $2.5 million and your 2020 revenue was $2 million, then the difference is $500,000. This method allows you to quickly spot changes from one period to another, and whether those changes are good or require you to go a bit deeper.
- **Variance:** You can also choose to calculate the variance between the periods to determine whether there was a positive or negative impact. Many businesses use the variance method when someone outside the company (creditors or investors) wants to see more about your company's financial health.

- **Percentage Change:** This approach is best when you require a deeper analysis. With this approach, the first period is the base period, and each subsequent period compares to the base period line by line. For instance, if the difference in revenue between 2018 and 2019 is $1 million, you would use the following formula to calculate the percentage of increase or decrease. Let's assume 2018's revenue was $5 million, and 2020's revenue was $6.5 million

$5,000,000 / $1,000,000 = 20%

Your revenue increased by 20% from 2018 to 2019. To compare your 2020 revenue to your 2018 revenue, you need:

2020 revenue – 2018 revenue = variance

$6,500,000 – 5,000,000 = $1,500,000 variance

Variance / 2018 revenue x 100 = % growth/decline

$1,500,000 /5,000,000 =.3 x 100 = 30% increase in revenue between 2018 and 2020.

You may also opt to calculate income statement ratios like gross margin and profit margin.

In the final step, you'll review your results. The fastest way to see trends is to look at the changes from period to period. But, if you need more detailed analysis, you'll want to view variances – either as percentages or dollar amounts.

If you want to see both variances and percentages, you can add columns to your spreadsheet to see the changes in both. Though this format does take longer to create, it makes it much easier to spot trends and get a look at business performance compared to the previous year or previous quarter. This method works best when comparing two years side by side.

Let's assume an investor is looking to invest in Company ABC. The investor wants to determine how the company grew over the past year, to see if his investment decision should provide solid ROI. Let's say that in the Company ABC base year, they reported a net income of $5 million and retained earnings of $25 million. This year, Company ABC reports a net income of $10 million and retained earnings of $27 million. As a result, there's a $5 million increase in net income and $2 million in retained earnings year over year.

Therefore, the net income grew by 100% (($10 million – 5 million) / 5 million * 100). But, the retained earnings only grew by 8%. (($27 million – $25 million) / $25 million * 100).

Spotting Trends

Though financial statements are crucial for managing your business, a balance sheet or income statement from a single accounting period won't tell the whole story. With horizontal analysis, you can answer a variety of questions, including:

1. How much has revenue increased (or decreased) in the past quarter? Past year?
2. Has the COGS gone up? Down?
3. What areas of the business have seen the most changes? Positive or negative?
4. Is the net income increasing or decreasing?

Looking at horizontal analysis, you can easily see why it's also known as trend analysis. It helps you compare the financial position and performance of your business from one period to the next. Using your findings, you know what's working well, and can easily see areas that need improvement and require attention.

Horizontal Analysis Drawbacks

Though there's value in this approach, the current period may appear uncommonly good or bad, depending on the choice of the base year and the chosen accounting period the analysis begins with. Given how 2020 was so widely different from years past, it's hopefully an outlier for many industries as the global economy begins to recover from the pandemic.

A big problem with this method is that the compilation of financial information may change over time, meaning that elements of the company's financial statements (expenses, current assets, liabilities, etc.) may change between periods. This results in variations since balances for each period are compared sequentially. You can make your current year (or quarter) look better if you choose historical periods of poor performance as your base comparison year.

This means that some organizations maneuver the growth and profitability trends reported in the analysis with a combination of methods to break down business segments. Even so, one-off events and accounting changes can be implemented to correct these anomalies to improve the accuracy of the analysis.

Whether you perform this analysis every fiscal year or every quarter, the information it provides is well worth the time and effort required. Once you create a template, you can use it again and again as needed.

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