

in horizontal analysis the percent change is computed by

in horizontal analysis the percent change is computed by comparing financial data from different periods to evaluate the relative growth or decline of specific account balances. This method is a fundamental technique in financial statement analysis, enabling analysts, investors, and management to identify trends, assess company performance, and make informed decisions. Horizontal analysis focuses on the changes in line items over time, typically across two or more consecutive accounting periods. The percent change calculation is central to this process, as it quantifies the magnitude of change relative to a base period. Understanding how to compute and interpret this percentage change is essential for accurate financial analysis and strategic planning. This article explores the formula used in horizontal analysis, its application in various financial statements, advantages, limitations, and practical examples to provide a comprehensive understanding of the concept.

- Understanding Horizontal Analysis
- Formula for Computing Percent Change in Horizontal Analysis
- Application of Percent Change in Financial Statements
- Advantages and Limitations of Horizontal Analysis
- Practical Examples of Percent Change Calculation

Understanding Horizontal Analysis

Horizontal analysis is a financial analytical technique used to evaluate changes in financial statement items over multiple periods. It involves comparing line items from one period to the next, providing insights into growth patterns, trends, or potential areas of concern. This approach is particularly useful for identifying whether specific accounts, such as revenues, expenses, or assets, have increased or decreased and by what proportion. By expressing these changes as percentages, horizontal analysis standardizes comparisons and allows for easier interpretation across different companies or industries.

Purpose of Horizontal Analysis

The primary objective of horizontal analysis is to assess financial

performance over time. Investors, creditors, and management use this method to:

- Detect trends and patterns in financial data.
- Evaluate the consistency and sustainability of growth.
- Identify unusual fluctuations or anomalies in account balances.
- Support budgeting and forecasting activities.
- Facilitate comparative analysis across multiple periods or competitors.

Key Components

The analysis typically involves two components: the base period and the comparison period. The base period serves as the benchmark against which changes are measured, while the comparison period represents the current or subsequent accounting period. The difference between the two periods' values forms the basis for calculating the absolute and relative changes.

Formula for Computing Percent Change in Horizontal Analysis

In horizontal analysis the percent change is computed by using a standard formula that expresses the change in an account balance as a percentage of the base period's amount. This formula is essential for quantifying the relative change and providing a meaningful comparison across periods.

Percent Change Formula

The percent change is calculated as follows:

1. Subtract the base period amount from the comparison period amount to find the absolute change.
2. Divide the absolute change by the base period amount.
3. Multiply the result by 100 to convert it to a percentage.

Mathematically, the formula is:

$$\text{Percent Change} = [(\text{Comparison Period Amount} - \text{Base Period Amount}) / \text{Base Period Amount}] \times 100$$

Interpreting the Percent Change

A positive percent change indicates growth or an increase in the account balance, whereas a negative percent change signifies a decline. The magnitude of the percentage helps stakeholders assess the significance of the change. For example, a 10% increase in sales revenue may be viewed differently than a 10% increase in expenses.

Application of Percent Change in Financial Statements

The percent change computed through horizontal analysis is applicable to various financial statements, including the income statement, balance sheet, and cash flow statement. Each statement provides unique insights into different aspects of the company's financial health.

Income Statement Analysis

On the income statement, horizontal analysis helps evaluate trends in revenues, cost of goods sold, operating expenses, and net income. By calculating the percent change for these items, analysts can determine whether the company is improving profitability, managing costs effectively, or facing declining sales.

Balance Sheet Analysis

Horizontal analysis of the balance sheet involves examining changes in assets, liabilities, and shareholders' equity over time. Percent changes reveal shifts in the company's financial structure, liquidity, and solvency. For instance, a significant increase in accounts receivable might indicate slower collections, while an increase in long-term debt could suggest financing activities.

Cash Flow Statement Analysis

Analyzing cash flow statement items through percent changes can uncover trends in operating, investing, and financing activities. This insight helps in understanding the cash generation capacity and how the company manages its cash resources over time.

Advantages and Limitations of Horizontal

Analysis

While horizontal analysis is a powerful tool for financial evaluation, it offers both benefits and drawbacks that must be considered.

Advantages

- **Trend Identification:** Enables clear visualization of financial trends and growth patterns.
- **Comparative Analysis:** Facilitates comparing financial performance across multiple periods.
- **Simplicity:** The calculation is straightforward and easy to understand.
- **Decision Support:** Assists stakeholders in making informed investment and management decisions.

Limitations

- **Ignores Inflation:** Does not adjust for inflation or changes in purchasing power over time.
- **Base Period Bias:** Results may be skewed if the base period is abnormal or not representative.
- **Does Not Explain Causes:** Percent changes highlight differences but do not explain underlying reasons.
- **Potential Misinterpretation:** Large percentage changes on small base amounts can be misleading.

Practical Examples of Percent Change Calculation

To illustrate how in horizontal analysis the percent change is computed by applying the formula, consider the following examples involving financial statement items.

Example 1: Revenue Growth

A company reported \$500,000 in revenue in the base year and \$600,000 in the current year. The percent change in revenue is calculated as:

$$\text{Percent Change} = [(600,000 - 500,000) / 500,000] \times 100 = (100,000 / 500,000) \times 100 = 20\%$$

This indicates a 20% increase in revenue compared to the base year.

Example 2: Expense Decrease

Operating expenses were \$200,000 in the base year and decreased to \$180,000 in the current year. The percent change is:

$$\text{Percent Change} = [(180,000 - 200,000) / 200,000] \times 100 = (-20,000 / 200,000) \times 100 = -10\%$$

This shows a 10% reduction in operating expenses.

Example 3: Asset Growth

The balance sheet shows total assets of \$1,000,000 in the base year and \$1,200,000 in the current year. The percent change is:

$$\text{Percent Change} = [(1,200,000 - 1,000,000) / 1,000,000] \times 100 = (200,000 / 1,000,000) \times 100 = 20\%$$

This reflects a 20% growth in total assets over the period.

Frequently Asked Questions

In horizontal analysis, how is the percent change computed?

The percent change in horizontal analysis is computed by subtracting the base year amount from the current year amount, dividing the result by the base year amount, and then multiplying by 100 to express it as a percentage.

What is the formula for calculating percent change in horizontal analysis?

$$\text{Percent Change} = [(\text{Current Year Amount} - \text{Base Year Amount}) / \text{Base Year Amount}] \times 100.$$

Why is the base year amount important when computing

percent change in horizontal analysis?

The base year amount serves as the reference point for comparison, enabling the calculation of growth or decline relative to that year.

Can percent change in horizontal analysis be negative, and what does that indicate?

Yes, a negative percent change indicates a decrease in the amount compared to the base year.

How does horizontal analysis help in financial statement evaluation using percent change?

Horizontal analysis helps identify trends over time by showing the percentage increase or decrease in specific financial statement items from one period to another.

Additional Resources

1. Financial Statement Analysis: A Practitioner's Guide

This book offers a comprehensive approach to analyzing financial statements, emphasizing techniques such as horizontal analysis. It explains how to compute percent changes over time to assess trends and company performance. Readers will gain practical insights into interpreting financial data for better decision-making.

2. Fundamentals of Financial Management

A foundational text that covers the core principles of financial management, including detailed sections on horizontal and vertical analysis. The book explains how percent change is calculated in horizontal analysis to track growth or decline in financial items. It is ideal for students and professionals seeking a solid understanding of financial statement evaluation.

3. Financial Reporting and Analysis

This book delves into various methods of financial analysis, with a focus on horizontal analysis and the computation of percent changes over different periods. It highlights the importance of trend analysis in evaluating a company's financial health. The text is enriched with real-world examples and case studies.

4. Analysis of Financial Statements

A practical guide that teaches readers how to perform horizontal analysis by computing percent changes to identify financial trends. The book covers step-by-step procedures for comparing financial data across time frames. It is well-suited for accountants, analysts, and finance students.

5. *Corporate Financial Reporting and Analysis*

This title explores corporate financial statements and the use of horizontal analysis to measure percent changes in revenues, expenses, and other financial metrics. It provides insights into interpreting these changes to support strategic business decisions. The book balances theory with practical application.

6. *Principles of Accounting*

An introductory accounting text that explains the fundamentals of horizontal analysis, including how to calculate percent changes in financial statement items. It offers clear examples and exercises to reinforce learning. This book is designed for beginners who want to grasp financial analysis basics.

7. *Financial Analysis with Microsoft Excel*

Focusing on the use of Excel for financial analysis, this book demonstrates how to compute percent changes in horizontal analysis efficiently using spreadsheets. It guides readers through formula creation and data visualization techniques. The book is ideal for those looking to enhance their technical skills in financial analysis.

8. *Intermediate Accounting*

A detailed accounting textbook that covers horizontal analysis in depth, including the computation of percent changes and their significance in financial reporting. It provides comprehensive explanations suitable for advanced students and professionals. The book also includes numerous exercises to practice analysis skills.

9. *Accounting for Decision Making and Control*

This book integrates financial analysis techniques such as horizontal analysis with managerial decision-making concepts. It explains how to calculate percent changes and interpret them to support business control processes. Readers will find a blend of accounting theory and practical application throughout the text.

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