

size in the same industry), but also for (internal) structural or vertical analysis of the financial statements of a company. A common-size statement of financial position reveals the relative magnitude of the major categories of assets, equity and liabilities. The same proportioning procedure can be repeated within the major asset, equity and liabilities categories to reveal the relative importance of subcategories, for example inventories relative to total current assets, the capital structure of the company (debt relative to equity) and the debt structure (long-term relative to short-term borrowing). If multi-period common-size financial statements are available, the structural perspective can be usefully combined with horizontal analysis for pointing out important changes in the relative weight of financial statement components from one year to the next.

Use of financial ratios

Financial ratios standardize financial statement data in terms of mathematical relationships expressed in the form of percentages or times. Instead of comparing absolute amounts from financial statements, a ratio is used to express the relationship between two elements of financial data that are logically linked, and compares that relationship with the same relationship in the other company. That is more easily understood in relation to an example.

Suppose we wished to compare the profit performance of two companies and had the data shown at the top of the next page about each company.

	<i>Company A</i>	<i>Company B</i>
	€	€
Sales	100 000	200 000
Net profit	10 000	15 000

Assuming that their products and activities are similar, a straight comparison would yield the information that company B had more sales than A and made more profit than A. In other words, company B is bigger than A – but that is easy to see and tells us very little about their relative efficiency.

However, a test of efficiency would be possible if we converted the information given to a ratio of profit to sales which would then tell us which company had the lower costs per unit of sales. This ratio is commonly used, and is sometimes called the ‘net profit margin ratio’:

$$\text{Net profit margin ratio} = \frac{\text{Net profit}}{\text{Sales}}$$

Applied to our example companies this yields:

$$\begin{array}{lcl} \text{Company A} & \frac{10\,000}{100\,000} \times 100 & = 10\% \\ \text{Company B} & \frac{15\,000}{200\,000} \times 100 & = 7.5\% \end{array}$$