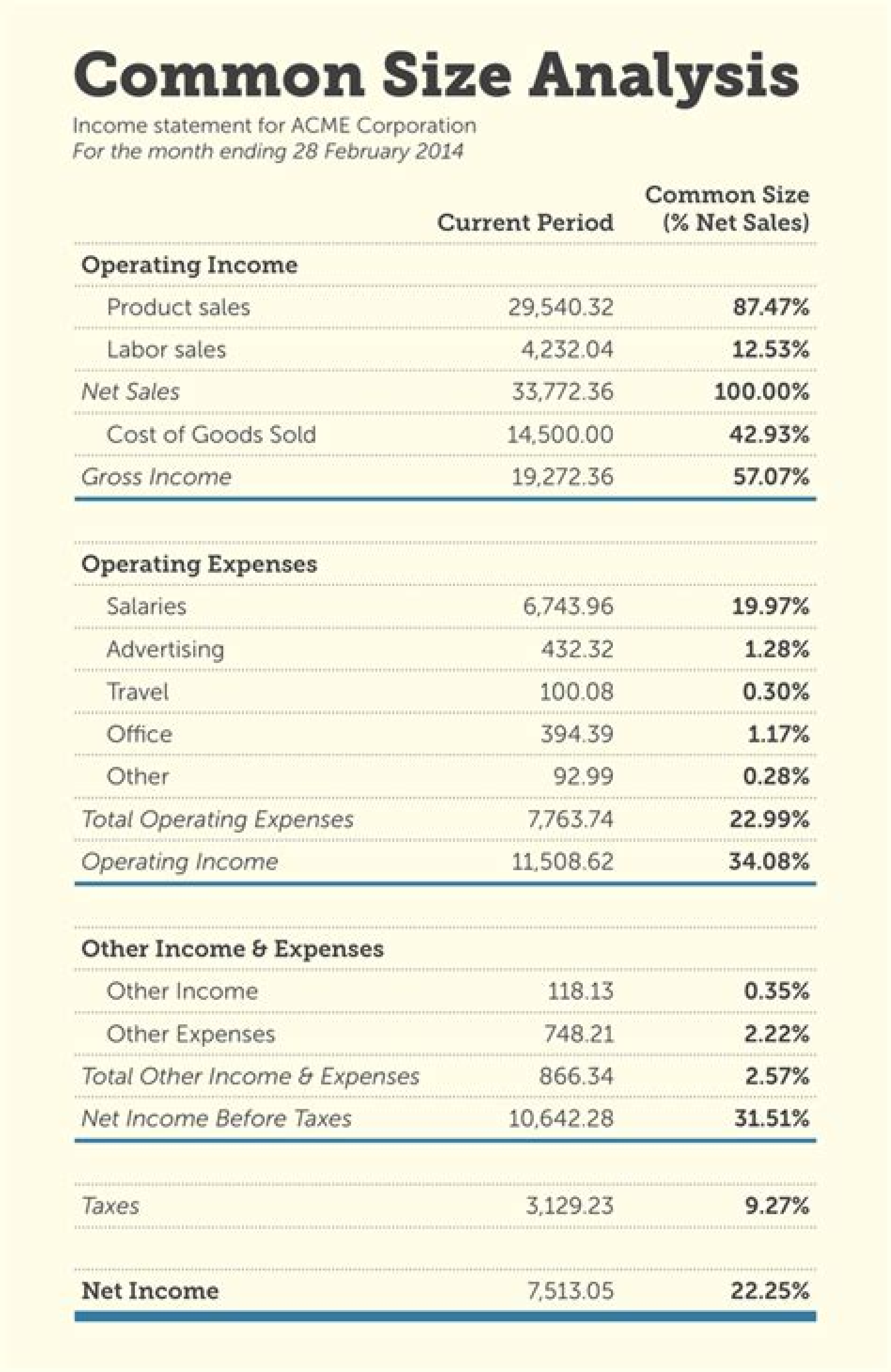
Common Size Analysis Of Income Statement



Common Size Analysis

Income statement for ACME Corporation
For the month ending 28 February 2014

	Current Period	Common Size (% Net Sales)
Operating Income		
Product sales	29,540.32	**87.47%**
Labor sales	4,232.04	**12.53%**
Net Sales	33,772.36	**100.00%**
Cost of Goods Sold	14,500.00	**42.93%**
Gross Income	19,272.36	**57.07%**
Operating Expenses		
Salaries	6,743.96	**19.97%**
Advertising	432.32	**1.28%**
Travel	100.08	**0.30%**
Office	394.39	**1.17%**
Other	92.99	**0.28%**
Total Operating Expenses	7,763.74	**22.99%**
Operating Income	11,508.62	**34.08%**
Other Income & Expenses		
Other Income	118.13	**0.35%**
Other Expenses	748.21	**2.22%**
Total Other Income & Expenses	866.34	**2.57%**
Net Income Before Taxes	10,642.28	**31.51%**
Taxes	3,129.23	**9.27%**
Net Income	7,513.05	**22.25%**

Common size analysis of income statement is a powerful financial tool that allows analysts, investors, and company management to evaluate a company's performance by comparing line items on the income statement against a common benchmark. Typically, this benchmark is total revenue or net sales, which helps to normalize financial data for companies of different sizes and across various industries. By employing common size analysis, stakeholders can gain insightful perspectives on profitability, cost management, and operational efficiency, paving the way for more informed decision-making.

Understanding Common Size Analysis

Common size analysis transforms the income statement into percentages, which simplifies the comparison of financial performance across different periods or companies. Each line item on the income statement is expressed as a percentage of total revenue, allowing for an easy evaluation of the relationships between revenues and expenses. This method is particularly useful for:

- Comparing companies of different sizes within the same industry.
- Tracking a company's performance over multiple periods.
- Identifying trends in expense management and profitability.

Components of the Income Statement

To effectively conduct a common size analysis, it’s essential to understand the main components of the income statement. The typical structure includes:

1. Revenue

Revenue, also known as sales or turnover, represents the total income generated from normal business operations. In common size analysis, total revenue is the baseline against which all other line items are measured.

2. Cost of Goods Sold (COGS)

COGS includes all direct costs associated with producing goods or services sold by the company. This figure is crucial for calculating gross profit.

3. Gross Profit

Gross profit is calculated as revenue minus COGS, representing the profit a company makes after deducting the costs directly tied to the production of its goods.

4. Operating Expenses

Operating expenses consist of selling, general, and administrative expenses (SG&A) that are not directly tied to production but are necessary for running the business.

5. Operating Income

Operating income, or operating profit, is the result of subtracting operating expenses from gross profit. It indicates how much profit a company makes from its core operations.

6. Other Income and Expenses

This category includes non-operating income and expenses, such as interest income, interest expense, and gains or losses from investments.

7. Net Income

Net income is the bottom line, representing the total profit of the company after all expenses have been deducted from total revenue. It reflects the company's profitability.

How to Conduct Common Size Analysis

Conducting a common size analysis of the income statement involves a few straightforward steps:

Step 1: Gather Financial Statements

Start by collecting the income statements for the periods you want to analyze. Make sure to have the figures for total revenue and all other relevant line items.

Step 2: Calculate Common Size Percentages

For each line item on the income statement, divide the line item by total revenue and multiply by 100 to convert it into a percentage. For example:

- COGS Percentage = (COGS / Total Revenue) × 100
- Gross Profit Percentage = (Gross Profit / Total Revenue) × 100
- Operating Expense Percentage = (Operating Expenses / Total Revenue) × 100

Step 3: Create a Common Size Income Statement

Compile the calculated percentages into a new format of the income statement, where all figures are expressed as a percentage of total revenue.

Step 4: Analyze the Results

Examine the common size income statement for trends, anomalies, and performance indicators. Compare these results across periods or with industry benchmarks.

Benefits of Common Size Analysis

The common size analysis of the income statement offers several advantages:

1. Simplified Comparisons

By converting figures into percentages, stakeholders can easily compare companies of varying sizes and assess how effectively they manage costs.

2. Enhanced Trend Analysis

Tracking percentages over time can reveal important trends in a company's financial health, such as increasing or decreasing profit margins.

3. Performance Benchmarking

Common size analysis allows for benchmarking against industry standards or competitors, helping identify areas where a company may be underperforming or excelling.

4. Improved Decision-Making

Management can make informed decisions about budgeting, resource allocation, and strategy development based on insights gained from common size analysis.

Limitations of Common Size Analysis

While common size analysis is a valuable tool, it’s important to acknowledge its limitations:

1. Context is Key

Common size analysis does not provide context about the absolute figures. A company may have a high percentage of operating expenses, but if those expenses are significantly lower than competitors, it may still be in a strong position.

2. Non-Operating Factors Ignored

The analysis focuses solely on the income statement, potentially overlooking other critical financial metrics found in the balance sheet or cash flow statement.

3. Industry-Specific Differences

Different industries have varying cost structures and profit margins. A common size analysis may not be fully useful if used for cross-industry comparisons without proper context.

Conclusion

In conclusion, the **common size analysis of income statement** is a powerful method for evaluating a company's financial performance. By converting income statement figures into percentages, stakeholders can gain essential insights into profitability, cost management, and operational efficiency. While it does come with some limitations, when used in conjunction with other financial analysis methods, common size analysis can significantly enhance decision-making processes. Whether you're an investor, analyst, or company executive, understanding and applying common size analysis can be invaluable in navigating the complex world of finance.

Frequently Asked Questions

What is common size analysis of an income statement?

Common size analysis of an income statement expresses each line item as a percentage of total revenue, allowing for easier comparison between companies of different sizes and across time periods.

Why is common size analysis important for investors?

Common size analysis helps investors assess a company's cost structure and profitability by providing insights into how effectively a company manages its expenses relative to its revenue.

How do you calculate common size percentages on an income statement?

To calculate common size percentages, divide each line item by total revenue and multiply by 100. For example, if total revenue is $1,000, and the cost of goods sold is $400, the common size percentage for COGS would be (400 / 1000) 100 = 40%.

What are the key components typically analyzed in a common size income statement?

Key components include total revenue, cost of goods sold (COGS), gross profit, operating expenses, operating income, and net income, all expressed as a percentage of revenue.

How can common size analysis aid in industry comparison?

Common size analysis standardizes financial data, making it easier to compare companies within the same industry regardless of their size, revealing insights into relative performance and operational efficiency.

What limitations should be considered when performing common size analysis?

Limitations include the potential for misleading conclusions if companies have different accounting practices, variations in industry norms, or if external factors significantly impact revenue or expenses.

Can common size analysis be used for forecasting future performance?

Yes, common size analysis can aid in forecasting by providing a clear picture of historical trends in revenue and expenses, which can help in projecting future income statement components as a percentage of anticipated revenue.

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