Paper F2 Financial Management

F2 students know that their grasp of ratio analysis is sure to be examined, yet many still let marks go begging for the want of proper calculations. Here's a top-five countdown of the worst-understood ratios

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Those students preparing to sit the F2 paper will know that question 7 has always been a 25-mark analysis and interpretation question. The examiner expects candidates to include some ratio calculations in their answers, followed by a report explaining how the company concerned has been performing.

The number of marks available for the ratio calculations will be indicated in the question. This gives an idea of the number of ratios that need to be calculated. Traditionally, this has been between six and eight. The examiner therefore expects six to eight ratios to be calculated correctly for the two accounting periods under consideration. It is up to you to choose the ratios, but you should take these from under each of the headings "profitability", "solvency" and "liquidity". One mark will be awarded for each correct ratio, based on the financial statements in the question, calculated for both periods. So your answer will be either right or wrong – it's all or nothing.

Over the past few F2 sittings it's become clear that there are some ratios that candidates keep getting wrong. So here I will count down the top five most incorrectly calculated ratios and offer some advice on how to get them right in future. It's widely agreed that if you know the formulas you will be able to interpret them more meaningfully.

5. Price/earnings (P/E) ratio

- **Calculation:** the P/E ratio (a number) is derived by dividing a firm's share price by its earnings per share (EPS). The share price will be given. EPS is earnings divided by the number of ordinary shares. The earnings figure is the profit available to ordinary shareholders – i.e. profit after tax and dividends due to irredeemable-preference shareholders.
- **Meaning:** how confident the market is in the business. The larger the figure, the more that shareholders are prepared to pay for a share in that company compared with the firm's historic earnings. The P/E ratio is a relatively new entry to the chart.

'Gearing is an old favourite on the chart. Use whichever method you like to calculate it unless the examiner specifies the one to apply'

4. Non-current-asset (NCA) turnover

- **Calculation:** the NCA turnover (a number) is derived by dividing the revenue shown on the company's income statement by the total figure for non-current assets on its statement of financial position. This ratio is rarely calculated correctly. The figure for non-current assets should not include "Investments in associate", because the revenue figure doesn't include revenue generated from that investment (it appears further down the income statement).
- **Meaning:** how the use of NCAs generates revenue. In theory, a large number is better for the company, but remember that the figure can be distorted by the policy of revaluations as well as by the age of these assets.

3. Gearing

- **Calculation:** the gearing ratio is derived either by dividing the company's debt by its equity (giving a number) or by dividing the debt by the sum of the debt and the equity (giving a percentage). Gearing is an old favourite on the chart. Use whichever method you like to calculate it unless the examiner specifies the one to apply. Equity is the figure for total equity on the statement of financial position. Debt is the figure for long-term debt on the statement of financial position. This includes pension liabilities. An overdraft should also be included in the debt figure if it's being used as a long-term source of finance, but not if it's a very short-term measure. If in doubt, your answer should set out your reasons for including or excluding the overdraft.
- **Meaning:** how the organisation is financed. A high number suggests that the company relies on long-term debt to fund its activities rather than relying on funds provided by shareholders.

2. Interest cover

- **Calculation:** interest cover (a number) is derived by dividing the company's operating profit by the finance charge. This has been in the top three of

Further reading *CIMA Official Study Text – Financial Management (2012-13 edition)*, Kaplan Publishing, 2012.

problem ratios for several sittings. Operating profit is also described as profit before interest and tax (PBIT) and is found on the income statement. This figure should not include any profit/loss from "Investments in associate". The finance charge is the interest payable shown on the income statement.

- **Meaning:** how comfortably the company can cover its interest payments from profits. A high number suggests there should be few problems. It's nothing to do with cash and ability to pay.

1. Return on capital employed (ROCE)

- **Calculation:** the ROCE (a percentage) is derived by dividing the company's operating profit by the capital employed. This has been top of the chart for umpteen consecutive sittings. Students often get the top *and* bottom lines of the formula wrong. The operating profit is the same figure as that used for the interest cover ratio – i.e. it's found on the income statement and is also known as the PBIT. Capital employed is the total funds used to generate the profit – i.e. total equity plus non-current liabilities in the statement of financial position. As with the gearing ratio, the overdraft should be included in this figure if the company is using it as a long-term source of finance, but not if it's only a short-term measure. "Investments in associate" should be deducted from the figure.
- **Meaning:** how efficiently the company is generating profits from the financial resources available to it. A large percentage is a good result, but this ratio can be distorted by revaluation policies and the age of assets.

Students often believe that the calculation of accounting ratios is not important as long as they interpret them correctly. That may be true in practice, but in the world of the F2 paper it is certainly not true. To maximise your chances of success in the exam, calculate ratios in the traditional way – the examiner expects it.

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