

PERFORMANCE

RELEVANT TO ACCA QUALIFICATION PAPER F7 AND P3

PERFORMANCE APPRAISAL IS AN IMPORTANT ASPECT OF PAPER F7, *FINANCIAL REPORTING*. AT THIS LEVEL YOU ARE NOT ONLY REQUIRED TO PREPARE FINANCIAL STATEMENTS BUT UNDERSTAND THE INFORMATION UNDERPINNING THE RESULTS.

Performance appraisal is an important aspect of Paper F7, *Financial Reporting* and of interest to Paper P3 students. At this level you are not only required to prepare financial statements but understand the information underpinning the results.

In Question 3, you will often be required to make use of ratios to aid interpretation of the financial statements for the current year and to compare them to the results of a prior period, another entity, or against industry averages.

Increasingly, candidate exam performance is demonstrating a lack of commercial awareness and knowledge that barely stretches past the 'rote learned' phase. Candidates regularly state facts such as 'gross profit margin has increased' or, 'payables days have gone down' but this offers no interpretation of the reason behind the change in ratio. As a result markers find it difficult to award sufficient marks to candidates to achieve a pass in Question 3.

This article is designed to aid candidates in understanding what is expected to create a solid answer to a performance appraisal question.

SPECIFIC PROBLEMS

When marking this style of question there are some common weaknesses that are identified, some of which are highlighted below:

- ▣ limited knowledge of ratio calculations
- ▣ appraisal not linked to scenario
- ▣ poor understanding of the topic
- ▣ limited understanding of what accounting information represents
- ▣ lack of commercial awareness
- ▣ discursive elements often not attempted
- ▣ inability to come to a conclusion
- ▣ poor handwriting (often illegible in some instances)
- ▣ poor English.

USE THE SCENARIO

The majority of questions that feature in Question 3 have an accompanying scenario to the question requirement. A weak answer will make no attempt to refer to this information in the appraisal and, therefore, will often score few marks. It is important that you carefully consider this information and incorporate it into your appraisal because it has been provided for a reason. Do not simply list all the possibilities of why a ratio may have changed; link the reason to the scenario that you have been provided with.

EXAMPLE

The question scenario may provide you with a set of financial statements and some further information such as details of non-current assets (potentially including a revaluation, a major acquisition or disposal) or measures undertaken during the year in an attempt to improve performance. When constructing your answer you must consider the effect that information such as this would have on the company results.

A major asset disposal would most likely have a significant impact on a company's financial statements in that it would result in a profit or loss on disposal being taken to the income statement and a cash injection being received. It is worth noting that while the current year results will be affected by this, it is a one-off adjustment and bears little resemblance to future periods. When calculating ratios the disposal will improve asset turnover as the asset base becomes smaller over which revenue is spread and will, therefore, also improve return on capital employed. The operating margin is likely to be affected also as the profit or loss on disposal will be included when calculating this.

APPRAISAL

It is often worth calculating some of the results again (eg ROCE or operating profit margin) as part of your interpretation without the one-off disposal information, as arguably this will help make the information more comparable to the results that do not include such disposals (if time is limited a comment about the disposal's effect will be sufficient).

From a liquidity point of view the cash received on disposal of the asset will have aided cash flow during the year – ask yourself what would have happened if the company had not received this cash, ie are they already operating on an overdraft? If so, the cash flow position would be far worse without the disposal cash.

If a revaluation of non-current assets has taken place during the year the capital employed base will grow – this will have the impact of reducing both the asset turnover and return on capital employed ratios without any real change in operating capacity or profitability.

A major asset purchase again would cause both asset turnover and return on capital employed to deteriorate as the capital employed base would grow. It may appear that as a result of the acquisition the company has become less efficient at generating revenue and profit but this may not always be the case.

If, for example, the purchase took place during the latter half of the year, the new asset will not have contributed to a full year's profit and it may be that in future periods the business will begin to see a better return as a result of the investment. When analysing the performance and position of the company, if management have implemented measures during the year to improve performance it is worth considering whether or not these measures have actually been effective. If, for example, a company chose to give rebates to customers for orders above a set quantity level – this would have the impact of improving revenue at the sacrifice of gross profit margin.

KNOW THE BASICS

Ratios can generally be broken down into several key areas: profitability, liquidity, gearing and investment. As a student taking the Paper F7 exam you need to know the formulae for the relevant ratios and also what movements in these ratios could possibly mean. Provided below is a brief overview of the key ratios and what movements could indicate – further clarification and understanding can be found through your study text and then by practising past questions (due to the limited space of this article, investment ratios will not be discussed but this does not make them any less important).

PROFITABILITY

Return on capital employed (ROCE)

$$\frac{\text{Profit before interest and tax}}{\text{Shareholders' equity} + \text{debt}}$$

This ratio is generally considered to be the primary profitability ratio as it shows how well a business has generated profit from its long-term financing. An increase in ROCE is generally considered to be an improvement.

Movements in return on capital employed are best interpreted by examining profit margins and asset turnover in more detail (often referred to as the secondary ratios) as ROCE is made up of these component parts. For example, an improvement in ROCE could be due to an improvement in margins or more efficient use of assets.

Asset turnover

$$\frac{\text{Revenue}}{\text{Total assets} - \text{current liabilities}}$$

Asset turnover shows how efficiently management have utilised assets to generate revenue. When looking at the components of the ratio a change will be linked to either a movement in revenue, a movement in net assets, or both.

There are many factors that could both improve and deteriorate asset turnover. For example, a significant increase in sales revenue would contribute to an increase in asset turnover or, if the business enters into a sale and operating lease agreement, then the asset base would become smaller, thus improving the result.

RATIOS CAN BE BROKEN DOWN INTO PROFITABILITY, LIQUIDITY, GEARING AND INVESTMENTS. PAPER P7 STUDENTS WILL NEED TO KNOW NOT ONLY THE FORMULAE FOR THE RELEVANT RATIOS BUT ALSO WHAT MOVEMENTS IN THESE RATIOS COULD MEAN.

Profit margins

$$\frac{\text{Gross or Operating profit}}{\text{Revenue}}$$

The gross profit margin looks at the performance of the business at the direct trading level. Typically variations in this ratio are as a result of changes in the selling price/sales volume or changes in cost of sales. For example, cost of sales may include inventory write downs that may have occurred during the period due to damage or obsolescence, exchange rate fluctuations or import duties.

The operating profit margin (or net profit margin) is generally calculated by comparing the profit before interest and tax of a business to revenue, but, beware in the exam as sometimes the examiner specifically requests the calculation to include profit before tax.

Analysing the operating profit margin enables you to determine how well the business has managed to control its indirect costs during the period. In the exam when interpreting operating profit margin it is advisable to link the result back to the gross profit margin. For example, if gross profit margin deteriorated in the year then it would be expected that operating margin would also fall.

However, if this is not the case, or the fall is not so severe, it may be due to good indirect cost control or perhaps there could be a one-off profit on disposal distorting the operating profit figure.

WHEN ASSESSING BOTH THE CURRENT AND THE QUICK RATIOS, LOOK AT THE INFORMATION PROVIDED WITHIN THE QUESTION TO CONSIDER WHETHER OR NOT THE COMPANY IS OVERDRAWN AT THE YEAR-END. THE OVERDRAFT IS AN ADDITIONAL FACTOR INDICATING POTENTIAL LIQUIDITY PROBLEMS.

LIQUIDITY

Current ratio

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

The current ratio considers how well a business can cover the current liabilities with its current assets. It is a common belief that the ideal for this ratio is between 1.5 and 2 to 1 so that a business may comfortably cover its current liabilities should they fall due.

However this ideal will vary from industry to industry. For example, a business in the service industry would have little or no inventory and therefore could have a current ratio of less than 1. This does not necessarily mean that it has liquidity problems so it is better to compare the result to previous years or industry averages.

Quick ratio (sometimes referred to as acid test ratio)

$$\frac{\text{Current assets} - \text{inventory}}{\text{Current liabilities}}$$

The quick ratio excludes inventory as it takes longer to turn into cash and therefore places emphasis on the business's 'quick assets' and whether or not these are sufficient to cover the current liabilities. Here the ideal ratio is thought to be 1:1 but as with the current ratio, this will vary depending on the industry in which the business operates.

When assessing both the current and the quick ratios, look at the information provided within the question to consider whether or not the company is overdrawn at the year-end. The overdraft is an additional factor indicating potential liquidity problems and this form of finance is both expensive (higher rates of interest) and risky (repayable on demand).

Receivables collection period (in days)

$$\frac{\text{Receivables}}{\text{Credit sales}} \times 365$$

It is preferable to have a short credit period for receivables as this will aid a business's cash flow. However, some businesses base their strategy on long credit periods. For example, a business that sells sofas might offer a long credit period to achieve higher sales and be more competitive than similar entities offering shorter credit periods.

If the receivables days are shorter compared to the prior period it could indicate better credit control or potential settlement discounts being offered to collect cash more quickly whereas an increase in credit periods could indicate a deterioration in credit control or potential bad debts.

Payables collection period (in days)

$$\frac{\text{Payables}}{\text{Credit purchases}^*} \times 365$$

*(or cost of sales if not available)

An increase in payables days could indicate that a business is having cash flow difficulties and is therefore delaying payments using suppliers as a free source of finance. It is important that a business pays within the agreed credit period to avoid conflict with suppliers. If the payables days are reducing this indicates suppliers are being paid more quickly. This could be due to credit terms being tightened or taking advantage of early settlement discounts being offered.

Inventory days

$$\frac{\text{Closing (or average) inventory}}{\text{Cost of sales}} \times 365$$

Generally the lower the number of days that inventory is held the better as holding inventory for long periods of time constrains cash flow and increases the risk associated with holding the inventory. The longer inventory is held the greater the risk that it could be subject to theft, damage or obsolescence. However, a business should always ensure that there is sufficient inventory to meet the demand of its customers.

Gearing

$$\frac{\text{Debt}}{\text{Equity}} \text{ or } \frac{\text{Debt}}{\text{Debt} + \text{equity}}$$

The gearing ratio is of particular importance to a business as it indicates how risky a business is perceived to be based on its level of borrowing. As borrowing increases so does the risk as the business is now liable to not only repay the debt but meet any interest commitments under it. In addition, to raise further debt finance could potentially be more difficult and more expensive.

If a company has a high level of gearing it does not necessarily mean that it will face difficulties as a result of this. For example, if the business has a high level of security in the form of tangible non-current assets and can comfortably cover its interest payments (interest cover = profit before interest and tax compared to interest) a high level of gearing should not give an investor cause for concern.

CONCLUSION

In the exam make sure all calculations required are attempted so that you can offer possible reasons for any change in the discussion part of the question.

There is no absolute correct answer to a performance appraisal question. What sets a good answer apart from a poor one is the discussion of possible reasons for why (specifically in the given scenario) changes in the ratios may have occurred.

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IN THE EXAM MAKE SURE ALL CALCULATIONS REQUIRED ARE ATTEMPTED, SO THAT YOU CAN OFFER POSSIBLE REASONS FOR ANY CHANGE IN THE DISCUSSION PART OF THE QUESTION. THERE IS NO ABSOLUTE CORRECT ANSWER TO A PERFORMANCE APPRAISAL QUESTION. WHAT SETS A GOOD ANSWER APART FROM A POOR ONE IS THE DISCUSSION OF POSSIBLE REASONS FOR WHY CHANGES IN THE RATIOS MAY HAVE OCCURRED.