

HOW TO SPEND MONEY (CAPITAL BUDGETING TOOLS)

Accounting ratios

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ACCOUNTING RATIOS

Measure the ratio of A/B

Decision rule:

Invest if the ratio $> X$

PAYBACK PERIOD: ROIC

► ROIC = return on invested capital

Decision rule

Invest if $\text{ROIC} > X$

ROIC: EXAMPLE

	<u>Year 0</u>	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Book investment	450	300	150	0
Revenue		600	500	400
Cash outflows		300	250	200
Depreciation		150	150	150
Accounting Profit		150	100	50

OTHER ACCOUNTING RATIOS

- ▶ Return on assets (ROA)
- ▶ Return on equity (ROE)
- ▶ Gross margin ($\text{Gross Profit} / \text{Sales}$)
- ▶ Profit margin ($\text{Net profit} / \text{Net Sales}$)
- ▶ Profitability index

ACCOUNTING RATIOS

The good:

More money is better!

Reflects the use of capital

The bad:

Neglects timing

Includes accounting distortions

Neglects risk

Arbitrary cut off

ACCOUNTING RATIOS: WRAP-UP

- ▶ Accept projects where $\text{Ratio} < X$
- ▶ Weak capital budgeting tool
- ▶ Arbitrary, no risk or timing, ad hoc
- ▶ Not focused on cash creation