

*Capital Investment
Decision Analysis
for management
and engineering*

John R. Canada — John A. White

Capital Investment Decision Analysis for management and engineering

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preface

This book is an extensive revision of *Intermediate Economic Analysis for Management and Engineering*, published by Prentice-Hall in 1971. It continues as a text and reference on capital project economic evaluation that is more concise and yet more advanced than the traditional applied works and that contains abundant example problems and solutions.

In addition to concisely covering the basic principles of interest computations and basic analysis methods, this book extensively treats techniques for the quantitative analysis of investment problems involving risk and uncertainty. Almost all of these techniques are candidates for straightforward and widespread application in practice, while some are presented in the belief that they will prove valuable as progressive analysts and management personnel work to develop their usefulness. This book is significantly more complete than its predecessor because of the inclusion of additional quantitative techniques, particularly mathematical programming for handling capital budgeting problems, and sensitivity and risk analysis techniques.

The book is intended primarily for advanced undergraduate or graduate study and for students of all disciplines, particularly business and engineering. The concise explanatory features also make the book suitable as a reference in industry. It contains a rather succinct summary of basic capital project evaluation techniques (Part I), and it emphasizes more advanced techniques, concepts, and analysis procedures (Parts II and III).

For the use of Part I, only a knowledge of first year algebra is required, while for much of Parts II and III it is assumed that the student understands the basic analysis procedures of Part I and has a fair knowledge of elementary probability. Some fundamental probability concepts are explained in the text, but those who need further background will find that the first half of most probability and statistics texts will provide adequate review material. Com-

plete understanding of the application of some specialized quantitative techniques to investment economic analyses will be facilitated by prior exposure to the theory underlying those techniques. For an abbreviated first course on the fundamentals of engineering or project economy, Part I can serve as an applications-oriented text which contains essentially the same breadth of coverage as traditional undergraduate texts. The integration of project economic analysis into the larger picture of capital budgeting within the firm is accomplished in Chapter 10, which contains an appendix on procedures and forms used in practice.

For a course in economic evaluation of alternative projects at the advanced undergraduate or initial graduate level, Part I can be used for review purposes as needed, with Parts II and III providing the primary study material. Since the chapters in Parts II and III are largely independent of one another, one can include or delete chapters according to the needs of individuals or classes.

Chapter 11 introduces risk and uncertainty concepts with some emphasis on estimating. Chapter 12 illustrates a wide range of tabular and graphical means for exploring sensitivity. Chapters 13 and 14 include techniques for considering variability of outcomes, particularly when probabilities can be estimated. Chapter 15 provides a rather detailed explanation of decision techniques utilizing Bayesian statistics; Chapter 16 focuses on the use of decision tree concepts as a means of taking into account future outcomes, alternatives, and decisions in determining the best initial choice. Chapter 17 presents optimization models for replacing assets that either deteriorate gradually or fail suddenly. Chapter 18 provides useful concepts and solution techniques for applying mathematical programming to capital budgeting analyses involving interrelated sets of alternatives. Chapter 19 illustrates simple quantitative means for weighting objectives and nonmonetary factors.

Innumerable persons—friends, colleagues, and helpers—have contributed to the development of this work, so complete acknowledgment is not possible. Once again, the preparation of this work was made much more tolerable than would have otherwise been possible by the extremely competent secretarial services of Mrs. Martha Jackson and Mrs. Vicki DeLoach. Our wives, Wanda and Mary Lib, helped by providing encouragement and (usually) good working conditions. Dr. Jack Turvaille of Tennessee Technological University and Mr. Nathan Wolf of the International Business Machines Corporation supplied valuable additions to the book. To all these, as well as to the authors and publishers providing reprint permissions, and to many others unnamed, we wish to express our gratitude.

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contents

Preface, xvii

PART I BASIC CAPITAL PROJECT EVALUATION TECHNIQUES, I

Chapter I Introduction and Cost Concepts, 3

Generation of Alternatives, 6

Importance of Estimates in Economic Analyses, 6

Cost Concepts, 6

Cost Factors, 14

Objectives of Firm and Nonmonetary Factors, 14

The Role of the Engineer and Manager in Economic Decision-Making, 15

Scope and Importance, 15

Problems, 16

APPENDIX I-A ACCOUNTING FUNDAMENTALS, 19

Chapter 2 Computations Involving Interest, 23

- Equivalence*, 23
- Interest Calculations*, 24
- Compound Interest Formulas*, 25
- Interest Formulas Relating Present and Future Sums*, 26
- Applying Interest Formulas to Cash Flow Series*, 27
- Interest Formulas Relating Uniform Series of Payments to Their Present Worth and Future Worth*, 28
- Interest Factor Relationships*, 31
- Interest Formulas for Uniform Gradient Series*, 31
- Interest Formulas for Geometric Series*, 32
- Solved Problems*, 34
- Deferred Uniform Payments*, 38
- Compounding Frequency; Nominal and Effective Rates*, 39
- Continuous Compounding Interest Formulas*, 40
- Continuous Payments Throughout the Year*, 41
- Solved Problems*, 43
- Problems*, 47

Chapter 3 Equivalent Worth Methods for Comparing Alternatives, 51

- Measures of Economic Effectiveness*, 52
- Defining Investment Alternatives*, 52
- A Systematic Procedure for Comparing Investment Alternatives*, 53
- Judging the Economic Worth of Investment Opportunities*, 54
- Present Worth (P.W.) Method*, 55
- Study Period in Comparisons of Alternative Projects*, 56
- Comparing Alternatives Using Present Worth Analysis When Receipts and Disbursements Are Known*, 56
- Comparing Alternatives Using Present Worth Analysis When Receipts Are Constant or Not Known*, 57
- Annual Worth (A.W.) Method*, 58
- Calculation of Capital Recovery Cost*, 58
- Comparing Alternatives Using Annual Worth Analysis When Receipts and Disbursements Are Known*, 59
- Comparing Alternatives Using Annual Worth Analysis When Receipts Are Constant or Not Known*, 60
- Future Worth (F.W.) Method*, 61
- Comparing Alternatives Using Future Worth Analysis When Receipts and Disbursements Are Known*, 62

Comparing Alternatives Using Future Worth Analysis When Receipts Are Constant or Not Known,	63
Assumptions in Comparisons of Alternatives with Different Lives,	64
Relationship of Various Analysis Methods,	65
Problems,	66
 Chapter 4 Rate of Return Methods for Comparing Alternatives,	71
Computation of Internal Rate of Return (I.R.R.) for a Single Investment Opportunity,	72
Principles in Comparing Alternatives by the Rate of Return Method,	73
Alternative Ways to Find the Internal Rate of Return on Incremental Investment,	73
Comparing Alternatives When Receipts and Disbursements Are Known,	74
Comparing Numerous Alternatives,	76
Comparing Alternatives When Disbursements Only Are Known,	77
Differences in Ranking of Investment Opportunities,	79
Problems in Which Either No Solution or Several Solutions for Rate of Return Exist,	80
Explicit Reinvestment of Rate of Return Method,	81
Comparing Alternatives Using the Explicit Reinvestment Rate of Return Method,	82
Comparing Alternatives When Disbursements Only Are Known,	83
External Rate of Return (E.R.R.) Method,	84
Comparing Alternatives Using the External Rate of Return Method,	86
Comparing Alternatives When Disbursements Only Are Known,	87
Comparing Numerous Alternatives for Which Disbursements Only Are Known,	88
Problems,	88
 APPENDIX 4-A USE OF E.R.R. METHOD TO OVERCOME MULTIPLE SOLUTIONS DIFFICULTY WITH THE I.R.R. METHOD,	92

Chapter 5 Benefit-Cost Ratio Methods of Comparing Alternatives, 95

- Computation of B/C for a Single Investment Opportunity, 97
- Comparing Alternatives Using Benefit-Cost Analysis When Receipts and Disbursements Are Known, 97
- Comparing Numerous Alternatives, 98
- Comparing Alternatives When Disbursements Only Are Known, 99
- Which Method of Comparing Alternatives Should Be Used?, 100
- Problems, 103

Chapter 6 Consideration of Income Taxes and Depreciation, 106

- Introduction to Depreciation, 106
- Units-of-Production Depreciation, 111
- Choosing a Depreciation Method, 112
- Items Not Depreciable for Tax Purposes, 113
- Useful Life and Salvage Value for Tax Purposes, 113
- Main Types of Taxes, 114
- When Income Taxes Should Be Considered, 114
- Understanding Income Taxes, 115
- Some Basic Principles Relating to Income Taxes, 115
- Taxable Income of Individuals, 116
- Taxable Income of Business Firms, 116
- Income Tax Effects and Rates, 117
- Taxes on Capital Gains and Losses for Individuals, 121
- Taxes on Capital Gains and Losses for Corporations, 122
- Gains and Losses for Disposal of Depreciable Property, 124
- Investment Tax Credit, 125
- Tabular Procedure for Computing After-Tax Cash Flow, 127
- Illustration of Computations of After-Tax Cash Flows for Various Common Situations, 128
- Illustration of After-Tax Analyses Using Different Economic Analysis Methods, 131
- Illustration of After-Tax Analyses with Receipts Known, Different Lives, Capital Gains and Capital Losses, and Applicable Investment Tax Credits, 133
- Tax Rates on Gains or Losses on Disposal of Old Assets, 135
- Problems, 137

Chapter 7 Replacement Analyses, 142	
Importance of Replacement Studies, 142	
Causes of Retirement, 143	
Replacement Considerations and Assumptions, 143	
Salvage Value of Old Asset in Trade-In, 144	
Specifying the Planning Horizon for a Replacement Study, 144	
Cash Flow Approach, 146	
Indefinite Planning Horizon, 149	
Asset Life Types, 150	
Calculation of Economic Life—New Asset by Itself, 151	
Calculation of Remaining Economic Life—Existing Asset, 155	
Relationship of Economic Life to the Planning Horizon, 159	
Intangibles in Replacement Problems, 161	
Models for Replacement Analysis, 161	
Problems, 161	
APPENDIX 7-A THE MAPI METHOD FOR REPLACEMENT AND GENERAL INVESTMENT ANALYSES, 165	
Chapter 8 Analyses for Government Agencies and Public Utilities, 172	
Investments by Government Agencies, 172	
Characteristics of Privately Owned Public Utilities, 178	
Problems, 189	
Chapter 9 Estimating for Economic Analyses, 195	
Consideration of Inflation, 195	
Estimating—Difficulty and Perspective, 201	
Estimation Reliability, 202	
Sources of Data, 203	
Ways Estimates Are Accomplished, 209	
The Delphi Method of Estimating, 209	
Quantitative Techniques, 211	
Problems, 218	

Chapter 10 Capital Planning and Budgeting, 223

Sources of Funds, 224

Identification and Evaluation of Opportunities, 224

Minimum Requirements of Acceptability, 225

Project Selection, 228

Postmortem Review, 233

Budget Periods, 234

Timing of Capital Investments and Management Perspective, 235

Leasing Decisions, 235

Capital Expenditure Practices and Example of Forms for Analysis, 238

Problems, 240

APPENDIX 10-A GIDDING & LEWIS DCF INVESTMENT EVALUATION PLAN, 242

Introduction, 242

Policy for Use, 243

Approvals, 243

Post Audit, 243

PART 2 CAPITAL PROJECT EVALUATION UNDER RISK AND UNCERTAINTY CONDITIONS, 249

Chapter 11 Introduction to Risk and Uncertainty, 251

Difference between Risk and Uncertainty, 251

Causes of Risk and Uncertainty, 253

Weakness in Probabilistic Treatment of Project Analyses Involving Risk, 255

Ways to Change or Influence Degree of Uncertainty, 255

Return, Risk, and Choice, 256

Decision Guides on When and How Much to Consider Risk and Uncertainty, 257

General Model for Risk and Uncertainty Problems, 261

Estimating in Terms of Probability Distributions, 262

Responses to Risk and Uncertainty, 268

Problems, 269

Chapter 12 Sensitivity Analysis,	272
One-At-A-Time Procedure,	273
Multiparameter Procedures,	278
Problems,	283
Chapter 13 Risk Analysis,	287
Analytical Methods,	288
Monte Carlo Simulation,	298
Generation of Random Normal Values,	301
Generation of Uniformly Distributed Values,	303
Use of Computers,	309
Method for Determining Approximate Number of Monte Carlo Trials Required,	309
Limitations,	310
Problems,	310
APPENDIX 13-A COMPUTER SIMULATION LANGUAGES AND INFORMATION ON AVAILABLE PROGRAMS FOR CAPITAL INVESTMENT ANALYSIS,	315
Chapter 14 Decision Criteria and Methods for Risk and Uncertainty,	317
General Model for Risk Problems,	318
Decision Criteria,	318
Dominance Criterion or Elimination Check,	318
Aspiration Level Criterion,	319
Most Probable Future Criterion,	320
Expected Value Criterion,	320
Expectation-Variance Criterion,	321
Certain Monetary Equivalence Criterion,	324
Expected Utility Criterion,	324
Expectation and Variance Criteria Applied to Investment Prospects with One or More Discrete Probabilistic Variables or Elements,	330
Comparing Alternatives with Continuous Distributions of Measure of Merit,	332
Miscellaneous Decision Rules for Complete Uncertainty,	333
Problems,	337

- Chapter 15 Statistical Decision Techniques, 343
- Bayesian Statistics, 344
 - Expected Value of Perfect Information, 348
 - Classical and Bayesian Statistical Decision Approaches Compared, 359
 - EOL with Continuous Distribution of Outcomes, 362
 - Problems, 366

- Chapter 16 Decision Tree Analysis, 370
- Deterministic Example, 371
 - Deterministic Example Considering Timing, 372
 - Consideration of Random Outcomes, 373
 - Typical Problem and Solution, 374
 - Decision Tree Steps, 377
 - General Principles of Diagramming, 377
 - Use of Bayesian Method to Evaluate the Worth of Further Investigation Study, 378
 - Useful Notation Conventions, 382
 - Alternate Method of Analysis, 383
 - Certain Monetary Equivalents, 385
 - Stochastic Decision Trees, 387
 - Examples of Decision Tree Applications, 390
 - Advantages and Disadvantages of Decision Tree Analysis, 392
 - Summary, 394
 - Problems, 394

PART 3 SELECTED TOPICS FOR ECONOMIC EVALUATION OF INVESTMENT DECISIONS, 401

- Chapter 17 Replacement Models, 403
- Replacement of Assets Not Subject to Sudden Failure, 403
 - Replacement of Assets Subject to Sudden Failure, 411
 - Problems, 417

- Chapter 18 Mathematical Programming for Capital Budgeting, 420
- Indivisible, Independent Investment Opportunities, 420
 - Indivisible, Dependent Investment Opportunities, 420

<i>Independent Collections of Mutually Exclusive Opportunities,</i>	
424	
<i>Divisible Investment Opportunities,</i>	428
<i>The M.A.R.R. Controversy,</i>	431
<i>Capital Rationing,</i>	432
<i>Portfolio Selection,</i>	434
<i>Goal Programming,</i>	437
<i>Problems,</i>	443

Chapter 19 Consideration of Multiple Objectives and Criteria, 447

<i>Alternatives-Objectives Score Card,</i>	448
<i>Indifference Curves,</i>	448
<i>Ordinal Scaling,</i>	450
<i>Weighting Factors,</i>	451
<i>Weighted Evaluation of Criteria,</i>	454
<i>Multi-Criteria Utility Models,</i>	455
<i>Summary,</i>	463
<i>Problems,</i>	464

APPENDICES, 467

APPENDIX A TABLES OF DISCRETE COMPOUNDING
INTEREST FACTORS (FOR VARIOUS COMMON
VALUES OF i FROM 1% TO 50%), 469

APPENDIX B TABLES OF CONTINUOUS COMPOUNDING
INTEREST, 491

APPENDIX C TABLE OF RANDOM NUMBERS, 498

APPENDIX D TABLE OF RANDOM NORMAL DEVIATES, 499

APPENDIX E UNIT NORMAL LOSS INTEGRAL (UNLI), 500

APPENDIX F THE STANDARDIZED NORMAL DISTRIBUTION
FUNCTION, $f(s)$, 501

APPENDIX G GLOSSARY OF COMMONLY USED SYMBOLS
AND TERMINOLOGY, 502

BIBLIOGRAPHY, 503

REFERENCES, 504

ANSWERS TO SELECTED EVEN-NUMBERED PROBLEMS, 517

INDEX, 521

PART

1

*Basic
Capital Project
Evaluation
Techniques*

Chapter

1

introduction and cost concepts

Project economic analysis involves techniques for comparing and deciding between alternatives on the basis of monetary or economic desirability. With the increasing complexity of our industrial technology, economic decision-making is becoming more difficult and at the same time more critical. Economic analyses serve to quantify differences between alternatives and reduce them to bases which provide for ease of project comparison. The importance of use of these methods varies with alternatives under consideration. In general, the use of these techniques is vitally important, for there is much to be saved or lost by virtue of the particular alternative chosen in usual project investment decisions. Indeed, project investment decisions are critically important factors in determining the success or failure of a firm.