CONTENTS

Preface 5

PART I UNDERSTANDING MONEY AND ITS MANAGEMENT 19

Cha	oter i	Engineering Economic Decisions 20	
1.1	The F 1.1.1 1.1.2 1.1.3	Rational Decision-Making Process How Do We Make Typical Personal Decisions? How Do We Approach an Engineering Design Problem? What Makes Economic Decisions Different from Other Design Decisions?	22 22 25
1.2	The E	-	27
1.2	1.2.1	Engineer's Role in Business Making Capital-Expenditure Decisions	28 28
	1.2.2		28
	1.2.3	Impact of Engineering Projects on Financial Statements	30
1.3	Types of Strategic Engineering Economic Decisions		31
	1.3.1	New Products or Product Expansion	32
	1.3.2	Equipment and Process Selection	32
	1.3.3	Cost Reduction	33
	1.3.4	Equipment Replacement	34
	1.3.5	Service or Quality Improvement	34
1.4	Fundamental Principles in Engineering Economics		35
	Sumn	nary	36
	Self-T	Test Questions	37
	Probl	ems	37
Cha _l	oter 2	Time Value of Money 38	
2.1	Intere	est: The Cost of Money	40
	2.1.1	The Time Value of Money	40
	2.1.2	Elements of Transactions Involving Interest	42
	2.1.3	Methods of Calculating Interest	44
2.2	Economic Equivalence		46
	2.2.1	Definition and Simple Calculations	47
	2.2.2	Equivalence Calculations Require a Common	
		Time Basis for Comparison	50
2.3	Interest Formulas for Single Cash Flows		
	2.3.1	Compound-Amount Factor	51
	2.3.2		53
	2.3.3	Solving for Time and Interest Rates	56

2.4	4 Uneven-Payment Series		
2.5	Equal-Payment Series	60	
	2.5.1 Compound-Amount Factor: Find F , Given A , i , and N	60	
	2.5.2 Sinking-Fund Factor: Find A, Given F, i, and N	64	
	2.5.3 Capital-Recovery Factor (Annuity Factor):		
	Find A , Given P , i , and N	66	
	2.5.4 Present-Worth Factor: Find P , Given A , i , and N	69	
	2.5.5 Present Value of Perpetuities	74	
2.6	Dealing with Gradient Series	76	
	2.6.1 Handling Linear Gradient Series	76	
	2.6.2 Handling Geometric Gradient Series	82	
2.7	More on Equivalence Calculations	86	
	Summary	92	
	Self-Test Questions	93	
	Problems	97	
Cha _l	pter 3 Understanding Money Management 112		
3.1	Market Interest Rates	114	
	3.1.1 Nominal Interest Rates	114	
	3.1.2 Annual Effective Yields	115	
3.2	Calculating Effective Interest Rates Based on Payment Periods	118	
	3.2.1 Discrete Compounding	118	
	3.2.2 Continuous Compounding	119	
3.3	Equivalence Calculations with Effective Interest Rates	121	
	3.3.1 Compounding Period Equal to Payment Period	121	
	3.3.2 Compounding Occurs at a Different Rate than		
	That at Which Payments Are Made	124	
3.4	Debt Management	128	
	3.4.1 Borrowing with Credit Cards	128	
	3.4.2 Commercial Loans—Calculating Principal		
	and Interest Payments	131	
	3.4.3 Comparing Different Financing Options	134 139	
	Summary Sulf Text On a tile us		
	Self-Test Questions Problems		
	Toolems	144	
Cha	pter 4 Equivalence Calculations under Inflation 158		
4.1	Measure of Inflation	159	
	4.1.1 Consumer Price Index	160	
	4.1.2 Producer Price Index	161	
	4.1.3 Average Inflation Rate	163	
	4.1.4 General Inflation Rate (\bar{f}) versus Specific Inflation Rate (f_i)	164	

4.2	2 Actual Versus Constant Dollars		
	4.2.1 Conversion from Constant to Actual Dollars	167	
	4.2.2 Conversion from Actual to Constant Dollars	168	
4.3	Equivalence Calculations under Inflation	172	
	4.3.1 Market and Inflation-Free Interest Rates	173	
	4.3.2 Constant-Dollar Analysis	173	
	4.3.3 Actual-Dollar Analysis	174	
	4.3.4 Mixed-Dollar Analysis	178	
	Summary	181	
	Self-Test Questions	182	
	Problems	184	
	PART 2 EVALUATING BUSINESS AND ENGINEERING		
	ASSETS 191		
Chan	iter 5 Present-Worth Analysis 192		
5.1	Loan versus Project Cash Flows	194	
5.2	Initial Project Screening Methods	195	
3.2	5.2.1 Benefits and Flaws of Payback Screening	197	
	5.2.2 Discounted-Payback Period	198	
5.3	Present-Worth Analysis	200	
5.5	5.3.1 Net-Present-Worth Criterion	200	
	5.3.2 Guidelines for Selecting a MARR	205	
	5.3.3 Meaning of Net Present Worth	206	
	5.3.4 Net Future Worth and Project Balance Diagram	210	
	5.3.5 Capitalized-Equivalent Method	211	
5.4	Methods to Compare Mutually Exclusive Alternatives	213	
5.1	5.4.1 Doing Nothing Is a Decision Option	214	
	5.4.2 Service Projects versus Revenue Projects	214	
	5.4.3 Analysis Period Equals Project Lives	215	
	5.4.4 Analysis Period Differs from Project Lives	219	
	Summary	225	
	Self-Test Questions	225	
	Problems	228	
Char	oter 6 Annual Equivalence Analysis 248		
•	•		
6.1	Annual-Equivalent Worth Criterion	250	
	6.1.1 Benefits of AE Analysis	254	
	6.1.2 Capital (Ownership) Costs versus Operating Costs	254	
6.2	Applying Annual-Worth Analysis	259	
	6.2.1 Unit-Profit or Unit-Cost Calculation	259	
	6.2.2 Make-or-Buy Decision	263	

6.3	Comparing Mutually Exclusive Projects	200
	6.3.1 Analysis Period Equals Project Lives	266
	6.3.2 Analysis Period Differs from Project Lives	271
	Summary	274
	Self-Test Questions	274
	Problems	277
Chai	oter 7 Rate-of-Return Analysis 294	
Cita	otel 1 Nate-OI-Return Analysis 294	
7.1	Rate of Return	296
	7.1.1 Return on Investment	296
	7.1.2 Return on Invested Capital	297
7.2	Methods for Finding Rate of Return	298
	7.2.1 Simple versus Nonsimple Investments	298
	7.2.2 Computational Methods	300
7.3	Internal-Rate-of-Return Criterion	307
	7.3.1 Relationship to the PW Analysis	307
	7.3.2 Decision Rule for Simple Investments	307
	7.3.3 Decision Rule for Nonsimple Investments	311
7.4	Incremental Analysis for Comparing Mutually	
,,,,	Exclusive Alternatives	313
	7.4.1 Flaws in Project Ranking by IRR	313
	7.4.2 Incremental-Investment Analysis	314
	7.4.3 Handling Unequal Service Lives	320
	Summary	322
	Self-Test Questions	322
	Problems	326
CI	74	
Cna	pter /A Resolution of Multiple Rates of Return 342	
7 A -1	Net-Investment Test	342
7 A -2	2 The Need for an External Interest Rate	344
7 A -3	3 Calculation of Return on Invested Capital for Mixed Investments	345
Cha	pter 8 Benefit-Cost Analysis 350	
8.1	Evaluation of Public Projects	352
	8.1.1 Valuation of Benefits and Costs	353
	8.1.2 Users' Benefits	353
	8.1.3 Sponsor's Costs	353
	8.1.4 Social Discount Rate	354
8.2	Benefit-Cost Analysis	355
J.2	8.2.1 Definition of Benefit-Cost Ratio	355
	8.2.2 Incremental B/C-Ratio Analysis	358
	one in the state of the state o	220

8.3	Profitability Index	362
	8.3.1 Definition of Profitability Index	362
	8.3.2 Incremental PI Ratio for Mutually Exclusive Alternatives	364
8.4	Highway Benefit-Cost Analysis	366
	8.4.1 Define the Base Case and the Proposed Alternatives	366
	8.4.2 Highway User Benefits	367
	8.4.3 Sponsors' Costs	367
	8.4.4 Illustrating Case Example	368
	Summary	372
	Self-Test Questions	372
	Problems	375
P	ART 3 DEVELOPMENT OF PROJECT CASH FLOWS	383
CI		
Chap	oter 9 Accounting for Depreciation and Income Taxes	384
9.1	Accounting Depreciation	386
	9.1.1 Depreciable Property	386
	9.1.2 Cost Basis	387
	9.1.3 Useful Life and Salvage Value	388
	9.1.4 Depreciation Methods: Book and Tax Depreciation	388
9.2	Book Depreciation Methods	390
	9.2.1 Straight-Line Method	390
	9.2.2 Declining-Balance Method	392
	9.2.3 Units-of-Production Method	396
9.3	Tax Depreciation Methods	397
	9.3.1 MACRS Recovery Periods	397
	9.3.2 MACRS Depreciation: Personal Property	398
	9.3.3 MACRS Depreciation: Real Property	401
9.4	Corporate Taxes	403
	9.4.1 How to Determine "Accounting Profit"	403
	9.4.2 U.S. Corporate Income Tax Rates	405
	9.4.3 Gain Taxes on Asset Disposals	407
	Summary	411
	Self-Test Questions	412
	Problems	414
Chap	oter 10 Project Cash-Flow Analysis 426	
10.1	Understanding Project Cost Elements	428
	10.1.1 Classifying Costs for Manufacturing Environments	428
	10.1.2 Classifying Costs for Financial Statements	430
	10.1.3 Classifying Costs for Predicting Cost Behavior	431
10.2	Why Do We Need to Use Cash Flows in Economic Analysis?	435

10.3	Income-Tax Rate to Be Used in Project Evaluation	436
10.4	Incremental Cash Flows from Undertaking a Project	439
	10.4.1 Operating Activities	439
	10.4.2 Investing Activities	442
	10.4.3 Financing Activities	443
10.5	Developing Project Cash Flow Statements	443
	10.5.1 When Projects Require Only Operating and Investing Activities	443
	10.5.2 When Projects Are Financed with Borrowed Funds	447
10.6	Effects of Inflation on Project Cash Flows	449
	10.6.1 Depreciation Allowance under Inflation	449
	10.6.2 Handling Multiple Inflation Rates	453
	Summary	455
	Self-Test Questions	456
	Problems	459
Chap	oter 11 Handling Project Uncertainty 480	
11.1	Origins of Project Risk	483
11.2	Methods of Describing Project Risk	483
	11.2.1 Sensitivity Analysis	483
	11.2.2 Sensitivity Analysis for Mutually Exclusive Alternatives	488
	11.2.3 Break-Even Analysis	491
	11.2.4 Scenario Analysis	492
11.3	Probabilistic Cash Flow Analysis	495
	11.3.1 Including Risk in Investment Evaluation	496
	11.3.2 Aggregating Risk over Time	497
	11.3.3 Estimating Risky Cash Flows	500
11.4	Considering the Project Risk by Discount Rate	504
	11.4.1 Determining the Company Cost of Capital	504
	11.4.2 Project Cost of Capital: Risk-Adjusted Discount Rate Approach	509
	Summary	511
	Self-Test Questions	512
	Problems	514
	DA DE A COSCIAL TODICO IN ISNICIA ISSUA	
	PART 4 SPECIAL TOPICS IN ENGINEERING	
	ECONOMICS 529	
Cha _l	pter 12 Replacement Decisions 530	
12.1	Replacement-Analysis Fundamentals	532
	12.1.1 Basic Concepts and Terminology	533
	12.1.2 Approaches for Comparing Defender and Challenger	535
12.2	Economic Service Life	539
	*	-

12.3	12.3.1 Re	nent Analysis When the Required Service Period Is Long equired Assumptions and Decision Frameworks and Indian Unequal Service Life Problems	545 545	
		Replacement Analysis	546	
	12.3.3 Re	placement Strategies under the Infinite Planning Horizon	546	
12.4	Replacem	nent Analysis with Tax Considerations	552	
	Summary		559	
		Questions	560	
	Problems		561	
Chap	iter 13	Understanding Financial Statements 574		
13.1	Accounti	ng: The Basis of Decision Making	576	
13.2	Financial	Status for Businesses	577	
		e Balance Sheet	579	
		e Income Statement	584	
	13.2.3 Th	e Cash-Flow Statement	586	
13.3		tios to Make Business Decisions	592	
		ebt Management Analysis	592	
		quidity Analysis	595	
		sset Management Analysis	596	
		ofitability Analysis	597	
		arket-Value Analysis	599	
		mitations of Financial Ratios in Business Decisions	601 603	
10.1	13.3.7 Where We Get the Most Up-to-Date Financial Information			
13.4	Principle of Investing in Financial Assets			
		ade-Off between Risk and Reward	603	
		oader Diversification Reduces Risk	603 605	
	13.4.3 Broader Diversification Increases Expected Return			
	Summary Self-Test Questions			
	Problems		608 612	
Арре	endix Å	Answers to the Self-Test Questions 621		
Арре	ındix 8	Interest Factors for Discrete Compounding	649	
Арре	endix C	How to Read the Cumulative Standardized N Distribution Function 679	Iormal	