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## Letters

Robert J. Opiteck

Alfred Rappaport

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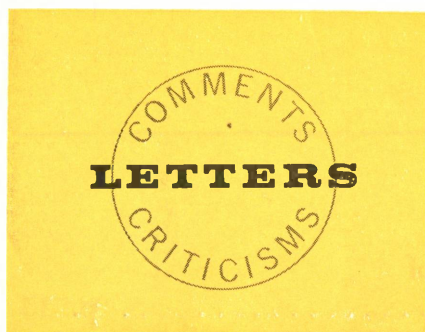
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### 'Palatalizing'

Dr. Rappaport is to be applauded for his efforts to solve the paradox of capital investment decisions (see "The Discounted Payback Period," M/S, July-August '65, p. 30). There are few knowledgeable financial managers today who will deny the merits of money's time value. However, only a small number of these financial managers are using these concepts in investment decisions.

Those of us who are attempting to apply acceptable theory to the solution of business problems run into this type of lip service constantly. Until theories are accepted *and applied*, they remain theory (on the shelf) to be agreed or disagreed with and written about. Dr. Rappaport has attempted (successfully) to make acceptable theory palatable to the financial manager who agrees with but, up to this time, has not used the time value of money in making his investment decisions. Dr. Rappaport modified the payback period approach (accepted and used by most businessmen) to include the concept of the time value of money. This technique allows the financial manager to keep his old approach, which he is familiar with, as well as upgrade his bag of analytical tools. It is precisely this process of palatalizing or packaging which *has to be done*.

The following suggestion is made

to clarify Dr. Rappaport's article with respect to Exhibit 3:

The 15 per cent "opportunity investment rate" should have been plotted as a standard along with management's minimum acceptable "discounted payback profile." His hypothetical company perceived an "opportunity investment rate" of 15 per cent, which would indicate an acceptable "discounted payback profile" of 15 per cent, 32 per cent, 52 per cent, 75 per cent, and 101 per cent. However, an arbitrary "discounted payback profile" of 10 per cent, 30 per cent, 70 per cent, 80 per cent, and 100 per cent was used in the exhibit. This dropping of the "opportunity investment rate" in favor of an assumed "discounted payback profile" (determined by management's time preference), without a discussion of their differences or a representation of the two measures, was confusing.

I recognize that it is possible for management to have a 15 per cent "opportunity investment rate" and at the same time require accelerated returns in the early years. Management's subjective time preference should be the deciding factor in determining a "standard profile"; however, the "opportunity investment rate" should not be excluded from Exhibit 3, without clarification in the text.

Also, the reversing of the legend symbols in Exhibit 3 (proof error?) detracted from what could have been a valuable rather than a confusing exhibit.

*Robert J. Opiteck*  
Management Science  
Burroughs Corporation  
Detroit, Michigan

### Editor's note:

Our apologies to Dr. Rappaport and his readers for the reversing of the legend symbols, an error

committed by our artist for which the author is in no way responsible. As for Mr. Opiteck's other comments on Exhibit 3, see Dr. Rappaport's reply below.

### 'Suggested clarification'

I would like . . . to thank Mr. Opiteck for his kind comments and also to analyze his suggested clarification of Exhibit 3.

Contrary to Mr. Opiteck's contention, I submit that the "opportunity investment rate" was not dropped in favor of an assumed "discounted payback profile." For it is the "opportunity investment rate" and the timing of cash flows which in fact determine the structure of the "discounted payback profile."

Let us consider the suggestion that an "opportunity investment rate" of 15 per cent calls for a standard profile of 15 per cent, 32 per cent, 52 per cent, 75 per cent, and 101 per cent. In my judgment this particular profile is valid only if we are prepared to make the limiting assumption that investments should yield a constant 15 per cent return each and every year. It should be emphasized that an opportunity investment rate represents an *average* rate over project life and the use of a constant compounding rate would assume stability which is rarely present in actual practice. Finally, the standard profile presented in Exhibit 3 is not "arbitrary" but is in fact based on management's subjective time preferences. Significantly, both Mr. Opiteck and I agree that time preferences should be the principal factor in determining a standard profile.

*Alfred Rappaport*  
Assistant Professor of Accounting  
Tulane University  
New Orleans, Louisiana