CIMA

Investment Appraisal in the NHS

For the smaller capital scheme
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INTRODUCTION

Investment Appraisal is an essential tool since it leads to better decisions. By its use the NHS is more likely to achieve its objectives efficiently and effectively. It encourages managers to question and justify what they are doing and it sets the tone for thinking rationally about value for money.

The majority of literature relating to investment appraisal provides instruction for large capital schemes, which are generally funded from centrally controlled resources, known as *discretionary allocations* (that is at the discretion of the NHS Executive), or through private finance. An individual scheme can cost in excess of £1 million; therefore the rigorous and detailed process for obtaining these funds is justified. But this accounts for less than half of capital expenditure by value and a small fraction by volume.

The remaining publicly funded, annual capital allocation, amounting to around £1.2 billion is the subject of much less debate. And yet most NHS finance professionals and their colleagues are more likely to be making investment decisions around this form of capital expenditure, known as *block capital*.

The purchase of capital is an investment and as management accountants we should demonstrate a ‘return’. The return could be measured financially by cost savings; it could be in terms of benefits to staff or patients, or preferably a combination. The aim of the investment appraisal process must be to demonstrate that:

- The investment is necessary and achieves optimum value added.
- The proposed investment scheme stands or falls by its own appraisal, independently of whether funds are currently available.
- There is a commitment to effective project implementation and post-completion reporting.

The aim of this guide is to recommend a process to ensure capital investment decisions are appropriate, whilst ensuring the cost of the process does not outweigh the benefits.

If there is no formal process for assessing capital expenditure then this should be challenged. This process attempts to streamline the investment decision with the Performance Assessment Framework by looking at indicators such as the contribution to ‘Effective delivery of appropriate healthcare’, ‘Efficiency’ and the achievement of value for money, ‘health outcomes’ and so on. The management accountant is welcome to adopt this process in full or part, or adapt it to suit local circumstances.
1. IDENTIFYING SPECIFIC CAPITAL PROJECTS

STAGE 1: Review the Organisational, Divisional and Departmental Objectives

As the business planning process cascades down the organisation specific investment requirements should be identified. The process of investment decision making should therefore be synchronised with the main cycle of business planning. At the strategic level, objectives will be very much directional (referring to National Service Frameworks, Health Improvement Programmes and so forth) and, therefore, divisional and departmental objectives (if available) will inform the process better. In some cases, the business plan will specify capital 'gaps'.

In practice, departmental capital requirements will outweigh the supply of funds available. An obvious reason is the need to renew obsolete equipment. Therefore, objectives provide 'a minimum standard' which potential bids must meet.

The review of objectives could be performed formally by a 'Central Capital Committee' to:

- Identify specific capital bids; a request-to-bid should be sent to the department.
- Identify and issue the minimum criteria that all bids must fulfil.
- Set the criteria against which all bids will be assessed and prioritised.

The Central Capital Committee may be supported by more focused groups such as Medical Equipment, Health and Safety and IM&T Committees. Alternatively each Division/Directorate should review their objectives to achieve the same outcome.

STAGE 2: Asset Register Report

An Asset Register Report will be an additional information source to the Central Capital Committee (or Directorate), prepared by the Capital Accountant. The contents of the report will depend upon the sophistication of the Organisation Fixed Asset Register, but the minimum requirement should be to inform the Committee of assets approaching the end of their useful economic lives, and the cost of replacement. The report may also highlight the capital intensity of departments, services, group assets and give values, for example type, age, and period to obsolescence, and provide information on maintenance costs and service contracts. The aim of reporting is to provide the Committee with an understanding of the capital stock and the potential for future demands, enabling feedback to inform future business/capital planning. The result is proactive management of assets – requiring asset managers to review ageing assets, dispose of or reallocate unused or underused assets, maintain the asset register and prompt applications for replacement or alternative assets, as appropriate.

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1 The generic term ‘Central Capital Committee’ is used to represent a central committee with delegated authority from the Trust Board for all matters relating to capital funds.
A note on apportioning Block Allocations

Many Trusts will allocate the capital budget to directorate or departmental level and allow local managers to make investment decisions. Allocation methods might include in proportion to fixed asset values, proportion to revenue budget, or equivalent to previous year amounts. But why apportion at all? Each method has advantages for example simplicity and disadvantages such as inappropriateness (revenue budgets!).

Decisions of the past are not always relevant in the future, and not just because of technological advance. As stated above, if the organisation has followed its planning process properly, this should be the guide. The theme for the new millennium is modernisation and NHS Trusts need to look beyond an internal focus, which creates new demands such as contribution to health improvement strategies, and requirements to improve clinical effectiveness. Organisations failing to act upon the direction of Government Policy are at risk of missing out on much-needed funds and, as a result, failing against performance targets.

Often apportionment is promoted as a way of decisions being pushed down the organisation to those facing operational realities; or is it simply the avoidance of difficult decisions? The above process will potentially identify a great deal more demands on capital funds, but this is the first step towards proactively managing the capital 'challenge', taking the difficult decisions when necessary.

STAGE 3: Making a bid for Capital Funds

How much time should be spent preparing each bid?

The size of block capital bids will range from £5,000 to many hundreds of thousands. Clearly, there is little cost benefit in spending large amounts of time on smaller bids. The Capital Investment Manual offers a solution, suggesting 1% of the investment cost is spent on appraisal. Therefore, assuming a staff cost of £15 per hour, the following guideline is derived:

<table>
<thead>
<tr>
<th>Investment</th>
<th>1%</th>
<th>Time (hours)</th>
</tr>
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<tbody>
<tr>
<td>5,000</td>
<td>50</td>
<td>3</td>
</tr>
<tr>
<td>20,000</td>
<td>200</td>
<td>13</td>
</tr>
<tr>
<td>100,000</td>
<td>1,000</td>
<td>67</td>
</tr>
</tbody>
</table>

Above this level economies of scale will arise

The above guideline on time relates to the preparation of the bid, including assessment by the Central Capital Committee. Since the Committee is likely to contain senior members of staff, whose time is valuable, the bid process should enable them to evaluate and decide on bids in the shortest time. Again, the size of the bid will determine the length of time in consideration and no doubt bids prepared over 50 hours are likely to contain more detail than those produced in 3 hours.

Identifying Capital Solutions

The identification of the need to invest may be satisfied through a variety of solutions. To be successful an organisation relies upon its ability to generate creative solutions; in the NHS this translates into more and better care for patients. However, that said, it is important to limit effort to an amount relative to the likely investment, using organisational objectives as the guide. On occasion the investment may appear to be a straight replacement for obsolescent equipment but as a minimum, the following options should be considered:

- Do nothing
- Do the minimum
The need to be creative means that a group including users, relevant technical experts, financial experts (procurement and financial management) should generate solutions facilitated by a Senior Manager.

The group, with the eventual result of a short list, should discuss all ideas. This short list will be subjected to more detailed review and comparison, concluding with the selection of the most suitable option.
2. PRESENTATION OF THE BID:
CAPITAL FUNDING PROPOSAL FORM

To aid the Capital Committee a Capital Funding Proposal form has been devised (See outline form given as an Appendix to this guide). The form itself provides a common structure for bids and an executive summary.

The form focuses on four areas: **Patient, Staff, Commissioner** and **Cost**. Each area is of equal value and, together, the intention is to provide a rounded, summarised view of the bid.

The aims and requirements of each are discussed below. The extent to which perspectives are satisfied will determine the decision to purchase. As the Proposal form itself provides an overview of the bid, more detailed information will be required in support, the level of detail being dependent upon the size of the bid. Examples of supporting information are highlighted below. Essentially this approach follows similar principles to Cost Benefit Analysis, with a focus on the key areas appropriate to a NHS setting.

Finally, the bid should be supported by performance measures to be achieved and assessed in the Post Project Evaluation – see *The Post Project Evaluation* section.

The final section of the form requests authorisation from three main parties:

- **Directorate Chair** Responsible for the bid and the analysis contained therein
- **Finance Manager** Responsible for preparing the financial analysis
- **Procurement Specialist** Responsible for confirming the Capital and Revenue Costs

**The Patient Perspective**

The focus here is on the benefit to ‘the patient’. It considers the number of patients who will benefit and the patient needs being addressed. This section links to the Commissioner Perspective in the way that the investment either advances Government priorities, addresses the local Health Improvement Programme or both.

In many cases the answer may appear obvious, particularly if the decision is between replace and reject. A piece of equipment may be essential for the running of a theatre or ITU bed, but before an identical replacement is requested, solutions from alternative suppliers should be assessed. Further benefits may be realisable such as greater utilisation through greater flexibility of use, reduced length of stay, improved pain control and better outcome.

*Action by:* Asset Manager in consultation with appropriate staff and users. If the investment is in medical equipment, this will require appropriate clinical input, which must include an end user, not just a senior clinician. In addition, a procurement specialist could offer advice on alternative options available in the market.

*Detailed/Supporting Information for each potential solution examined:*

- List of benefits to the patient (in order of importance) – this list should include incremental benefits only. These benefits should be split into two groups: those which make this option better than the ‘do nothing’ and those which make this option better than the next best alternative.
- Results of any internal trial or pilot.
- Evidence of any trial (indications of whether this was independent or a company claim).
Staff Perspective

This focus should express the benefits to staff such as how the investment improves staff productivity, the ability to deliver better care, health and safety. For example the investment may reduce the labour intensity of tasks or reduce clinical risk (therefore reducing the risk of future negligence claims).

Action by: Asset Manager and Asset User(s)

Detailed/Supporting Information for each potential solution examined:

- List of benefits to staff (in order of importance) – this list should include incremental benefits only that is only those which make this option better than the next best alternative.
- Results of any internal trial or pilot.
- Evidence of any trial (indications of whether this was independent or a company claim).

Commissioner Perspective

A Trust’s objectives should be aligned with those of its main commissioner or commissioners. The commissioner’s objectives will incorporate the healthcare requirements of the local population (Health Improvement Programme (HimP)) and central government policy (National Service Frameworks (NSFs)). This section aims to focus management attention on those requirements.

This perspective is perhaps inappropriate for small investments, however even low value investments represent a lost opportunity to invest in an alternative project and this approach promotes a culture of sharing information and communication between NHS Trusts and commissioners. The current environment in the NHS promotes communication between neighbouring Trusts as well as the host Health Authority and PCG, that is within the health economy or health system, with a particular emphasis on sharing responsibility and co-ordinated planning. There is, therefore, a need to test even the smallest capital investment against the planned direction of the local health economy. For example, a decision to downgrade an Accident and Emergency department to a minor injury clinic in the next twelve months should restrict investment in this area. Clearly, certain investments are unavoidable if the service is to be maintained in the short term but alternative courses of action should be investigated such as borrowing or sharing equipment with a neighbour or short-term hire as opposed to purchase.

Action by: Directorate/Divisional Chair and/or Senior General Manager

Detailed/Supporting Information for each potential solution examined:

- Description of how this investment meets the strategic objectives of the Organisation.
- Details of how this investment contributes to the HimP and NSF objectives.
- Scope for further expansion, modification, and flexibility to contribute to other services.

The Cost Perspective

There is an obvious danger for the cost perspective to over-ride all others. Finance is often the limiting factor and therefore often becomes the focal point of many decisions. In an attempt to mitigate this, the form deals with finance last. The intention is to encourage the reader to consider the non-financial benefits before being influenced by cost in an attempt to present a balanced picture.
The intention to present finance within a balanced view is not a signal to subordinate the importance of the financial analysis. The key to successful analysis is for the user group to define an accurate specification and work with a procurement specialist to gain full and accurate costings for a given solution. Note that it is important for departments to provide procurement specialists with a specification, not a solution, if more suitable, creative solutions are to be gained. In addition, an accurate costing must include all cashflows from initial capital purchase - to running costs – and finally to any potential disposal value. If the potential investment involves a new building, additional specialists will need to advise.

**Action by:** Asset Manager, Finance Manager and Procurement Specialist in consultation with relevant technical advisers. The Procurement Specialist should discuss the purchase requirements and obtain suitable quotations (whilst meeting the requirements of Standing Financial Instructions). The Finance Manager will require this information for the financial appraisal.

**Detailed/Supporting Information for each potential solution examined:**

- If the size of the investment requires a process of tendering, provide evidence and details.
- Details of quotations including offer deadline (the number of quotes will be defined by the Standing Financial Instructions (SFIs)).
- The Financial Appraisal.

**The Financial Appraisal**

All capital bids should include an appraisal of the costs and cost savings involved. The financial appraisal is essentially a forecast of the financial impact of this investment on the organisation - it should therefore enable the organisation to test whether the option is, from a cost perspective, appropriate and affordable.

There are many ways of performing a financial appraisal, and in the case of a substantial investment, more than one method should be used. The difficulty with many approaches to financial investment appraisal is twofold, firstly appropriateness to an NHS or public sector setting and secondly the (lack of) technical understanding of non-accountants.

In view of the fact we are concerned with the small to medium sized investment and the NHS is a not-for-profit organisation, two methods are suggested, firstly discounted cash flow, then the incremental impact on the Income and Expenditure Account and unit costs:

**A Discounted Cash Flow (DCF) using the Net Present Value (NPV) method** (or more appropriately the Net Present Cost (NPC) Method): this analysis follows the principle that £1 today is worth more than £1 in the future. Note that this is not caused by the effects of inflation; instead the analysis recognises that £1 received today can be invested to earn interest. Therefore DCF provides a means of turning cash flows over a period of time to equivalent sums for a common date. This then provides a mechanism for comparing schemes with different cashflow profiles and compares the NPC of each.

**B Incremental Impact on Income and Expenditure (I&E) or Affordability Analysis:** this analysis attempts to identify the impact on organisation costs and therefore provide a basis to consider whether commissioners can afford to fund the investment on an ongoing basis.

Note: As mentioned above the cost perspective forms the ‘Cost’ part of the Cost Benefit Analysis supported by the ‘Benefits’ described in the Patient, Staff and Commissioner Perspectives. Hopefully, in some cases an investment would realise financial benefits in addition to the non-financial benefits described in the other perspectives.
The two methods explained

**Method A – Application of the Discounted Cash Flow**

1. This method uses discounted cash flows (DCF) to identify the present cost of the key options.

2. Most of the costs will be straightforward since they will be taken from information provided by a procurement specialist. Note: it should not be assumed that historical costs will remain the same in future for a ‘do nothing’ option.

3. The costs will include the initial capital purchase and all the revenue consequences (excluding Value Added Tax). All cash flows should be expressed in today’s prices; they should exclude inflation since a real discount rate is being used. Note the importance of cash flows, DCF is an economic appraisal and therefore only considers costs that involve a cash transfer; for example the utilisation of an asset already owned is considered a sunk cost and is therefore excluded from the analysis.

4. However, care must be taken to include any opportunity costs².

5. The analysis attempts to compare the cash flows of the ‘do minimum’ option to the different solutions, or range of options, over the full life of the option and calculate the difference in net present cost/value. If a potential solution is to ‘do nothing’ this should be the benchmark to compare all other solutions.

6. In the case of larger investments the analysis should consider financial risk. Financial risk arises because cash flow estimates are largely uncertain; they are estimates and can be over optimistic, as it will be in the interest of the project sponsor to describe the investment in its ‘best’ light. In certain instances the financial manager may wish to perform the analysis on different scenarios (often referred to as sensitivity analysis), particularly where cash flows are uncertain. Each scenario would need an explanation together with some indication of its probability. The result could be to express the cost as a range with an appropriate description. Alternatively, an expected value analysis could be applied to give a single figure. As a minimum, supporting information should clearly identify the data sources and the extent of estimates to allow a third party to assess the potential for subjective bias.

7. The discount factor to be used is 6%. This represents the real rate of return as prescribed by HM Treasury. Note: if the analysis covers a lease option the discount rate of 6% is exchanged for the National Loans Fund (NLF) interest rate plus 2%. NHS Executive guidance should be referred to in relation to Private Finance.

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²Opportunity Costs are defined as the best alternative value foregone. For Example: the purchase of a particular asset means branded consumables and a specific maintenance contract must be purchased. Under previous arrangements consumables and maintenance were dealt with through generic, non-branded contracts, supporting a range of departments and assets, the result is to take advantage of bulk purchase discounts. The implications of this purchase would be a dilution of the discounts available – therefore this cost should be included as part of the financial analysis.
Simple example of a typical DCF analysis: this example only illustrates the ‘do minimum’ compared to the favoured option. In reality supporting information would include a comparison of a number of different options.

<table>
<thead>
<tr>
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<th>Yr. 0</th>
<th>Yr. 1</th>
<th>Yr. 2</th>
<th>Yr. 3</th>
<th>Yr. 4</th>
<th>Yr. 5</th>
</tr>
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<tr>
<td><strong>Do Minimum</strong></td>
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<tr>
<td>Purchase</td>
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<tr>
<td>Residual Value</td>
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<td></td>
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<td></td>
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<tr>
<td><strong>Sub Total</strong></td>
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<td>8,000</td>
<td>8,500</td>
<td>8,500</td>
<td>8,500</td>
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<tr>
<td><strong>Favoured Option</strong></td>
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<tr>
<td>Purchase</td>
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<tr>
<td>Maintenance</td>
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<td>3,500</td>
<td>5,000</td>
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<tr>
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<td></td>
<td></td>
<td>(5,000)</td>
<td></td>
</tr>
<tr>
<td><strong>Sub Total</strong></td>
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<td>Marginal Cash flows</td>
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<td>(1,000)</td>
<td>(1,500)</td>
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<td>(5,500)</td>
</tr>
<tr>
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<td>(1,259)</td>
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<td>(4,110)</td>
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<td>7,063</td>
<td>5,804</td>
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<td>1,694</td>
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</table>

The above example illustrates that the favoured option results in a Net Present Cost of £1,694 above the ‘Do Minimum’ option. This will need to be compared to the DCF results of other potential solutions to understand whether this would be preferred from a purely financial viewpoint. However, in reality the preferred option should be placed alongside the benefits outlined in the other perspectives to reveal the full value of the investment.
What if different investment options provide solutions with different lifespans?

Where an asset life is longer it is likely the cumulative net present cost will be greater. In order to remove the prejudice against longer life solutions we require a method for comparing potential investments to assess which is most beneficial from a cost perspective. The solution is to adapt the Equivalent Annual Cost (EAC) method i.e. the Net Present Cost for each option is divided by the annuity factor. The solution realising the largest Equivalent Annual Value or least Equivalent Annual Cost is the favoured from a cost perspective.

The annuity factor is calculated by the formula:

$$\frac{1}{r} \times \frac{1}{r(1 + r)^t}$$

Where $r =$ discount rate i.e. 6% and $t =$ lifespan of the investment option in years.

In the example above this would translate as:

Net Present Cost (£1,694) divided by the annuity factor (4.2124) giving an Equivalent Annual Cost of £402. The Annuity Factor is derived as follows:

$$\frac{1}{0.06} \times \frac{1}{0.06(1 + 0.06)^5}$$

**Method B – Incremental impact upon the Income and Expenditure Account and Unit Costs**

– sometimes referred to as the financial analysis or an affordability appraisal.

1. The potential impact upon the I&E statement, that is identifying the ‘revenue’ costs is important for four reasons:
   - The organisation needs to understand the potential impact on its future cost base to ensure future income flows will follow.
   - Where income flows are unlikely to come from external sources the shortfall will need to be addressed by internal savings if the investment is not to cause an I&E deficit.
   - The capital charge impact needs to be assessed, together with any potential impairment issues and the need to obtain an additional flow of funds.
   - An increase in overall Trust Unit Cost will adversely affect the ‘technical’ efficiency.

2. This analysis may appear unnecessary at an individual asset level, especially smaller investments; however, this table could be included within an overall summary of all investments (to be done by the Capital Accountant) to inform the planning process, contracting discussions, review and monitoring Trust efficiency targets and reconcile the capital charges exercise.

3. As above the Organisation should only be interested in incremental costs. In this analysis assumptions will need to be made about inflation for future periods and unrecoverable VAT will need to be included.
Simple Example:

<table>
<thead>
<tr>
<th></th>
<th>Yr. 0</th>
<th>Yr. 1</th>
<th>Yr. 2</th>
<th>Yr. 3</th>
<th>Yr. 4</th>
<th>Yr. 5</th>
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<tbody>
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</tr>
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</tr>
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<td>0</td>
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</tr>
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<td>(125)</td>
<td>(125)</td>
<td>(135)</td>
<td>(135)</td>
</tr>
<tr>
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<td>540</td>
<td>550</td>
<td>566</td>
</tr>
<tr>
<td>Capital Charges</td>
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<td>1,500</td>
<td>1,500</td>
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<tr>
<td>Expenditure Change</td>
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<td>1,915</td>
<td>1,915</td>
<td>1,931</td>
</tr>
<tr>
<td>I&amp;E Change</td>
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</tr>
</tbody>
</table>

Note: brackets denote an expenditure reduction.

In this simple example this investment adds around £2,000 per annum to the cost base of the organisation. The source of this funding must be identified if, other things being equal, the organisation is to avoid an adverse effect on the I&E position. The above information can be combined with other investments to inform contract discussions and the impact on the organisation’s ‘technical’ efficiency.
3. THE POST PROJECT EVALUATION

As a basis for evaluation there should be a statement included in the appraisal documentation that covers:

- The name of the person responsible for implementation.
- The key performance measures to be achieved, including quantified targets, implementation benchmarks and how performance data will be collected.
- The dates at which targets and milestones will be compared to actual performance and interim performance reports will be completed.
- The date for completion of the Post Project Evaluation by the responsible officer.

As with other stages in the process, the post project evaluation must reflect the size of the original investment. Nevertheless, if lessons are to be learned and the process improved, appraisals should be reviewed.

The process could be carried out by a number of independent parties including Management Accounts, Capital Accounts or Internal Audit (this department certainly ought to be considered for reviewing a sample of larger investments). In addition, asset managers themselves should review the original analysis. The aim of the review is clear, that is to learn and improve rather than gather evidence of failure. In either case, evidence will need to be gathered from the ground.

In general, a review should cover the following:

- Did the investment return the proposed benefits?
- Identify any further benefits which were omitted from the original appraisal.
- Identify any unforeseen problems and how these might be avoided in future analyses.
- Review the sources of information used and establish the accuracy of cost and activity assumptions.
- Review the forecasting methods and identify the reasons for cost and activity variances.
- In hindsight, would a different course of action been have proposed? If so, why? How might this be applied to improve future decision-making?

The process could involve an interview/questionnaire with key individuals (including users) related to the original proposal. The results should be reported to the Central Capital Committee and catalogued for reference in future similar Investment proposals.
4. CONCLUSION

This prescription for assessing smaller capital schemes may not suit all environments, but organisations must carefully consider certain principles in any capital investment. These are that:

- The process should be formalised.
- All investments should be considered in the light of organisational objectives.
- The appraisal should be objective, with assumptions and estimates clearly explained.
- The scheme should stand or fall by its own appraisal.
- If the process of investment appraisal is to be improved – a formal review process should be agreed.
GUIDE TO FURTHER READING


APPENDIX

Capital Funding Proposal Form

<table>
<thead>
<tr>
<th>Description:</th>
<th>Asset Manager:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Location:</td>
<td></td>
</tr>
<tr>
<td>Use Useful Economic Life (years):</td>
<td>New / Replacement*</td>
</tr>
</tbody>
</table>

**PATIENT PERSPECTIVE**
How will Patients benefit from this investment? Health need addressed/improved outcome

How many patients will benefit per annum?
What is the result of not purchasing this asset?

**STAFF PERSPECTIVE**
How will staff benefit from this investment?

How many departments benefit from using this asset?
What is the result of not purchasing this asset?

**COMMISSIONER PERSPECTIVE**
How does this asset promote the strategic direction of the Organisation?

How does this investment promote the local HIImP and/or NSF priorities?
What is the result of not purchasing this asset?

**COST PERSPECTIVE**
Capital Cost £
Estimated Revenue Cost £ per annum (supporting calculations attached)
Next Best Lower cost alternative: Reason for dismissal?

Description:
Capital Cost: £

Authorised:
Divisional Chair: Date:
Finance Manager: Date:
Procurement Specialist: Date:

*Delete as appropriate*