Sheffield Business School

MANAGEMENT DEVELOPMENT PROGRAM

(LEADING TO THE AWARD OF MBA)

In association with the

CZECH TECHNICAL UNIVERSITY IN PRAHA

DIPLOMA IN MANAGEMENT STUDIES - 1995/1996

Finance assignment

Project evaluation

1. Contemporary project evaluation analysis in a chosen organisation
2. Methods used and their acceptability for a chosen organisation
3. Data acquisition for project evaluation
4. Proposals for improvement

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1. Introduction

If an investment is going to be made, it requires a lot of work to be done in advance. One of aims of this work is to evaluate the project from financial point of view. Noone will invest into a project knowing that only losses and no profit will be generated. In a power industry this applies even more, since this industry is very much capital intensive. Each project has to be assessed thoroughly, maybe even more than in other industries.

In this assignment I want to describe some procedures used in power utilities, both in the Czech republic and abroad.

2. Financial investment review procedure

The procedure is intended to ensure in all cases that, for each investment:

1. responsibility is clearly defined
2. the decision is consistent with relevant Company policies and other investment decisions
3. the proposal satisfies pre-determined financial criteria
4. the proposal contributes to the achievment of defined business strategies

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5. the risks and sensitivities of proposals are clearly highlighted.

2.1 Types of investments

The procedure must be applied to all investments exceeding levels set out in the Delegations of Authority (Podpisový øád). The categories of investment are broken down as follows:

2.1.1 Development expenditure

This means a cost to be incurred in the preliminary assessment of a business opportunity prior to the submission of a full investment proposal.

2.1.2 Capital expenditures

These are usually defined by the Company's accounting policies. They require the capitalisation of costs which bring an asset up to a higher specified performance level, whereas expenditure to maintain operating performance is charged to the profit and loss account.

2.1.3 Working capital

It is defined as actions which lead to a change in a Company's working capital requirements (debtors, creditors or stock).

2.1.4 Special revenue expenditure

It means an expenditure chargeable to the profit and loss account, which, nevertheless, is not expected to be repeated within a five year period. Special commercial agreements not being in the ordinary course of business, business not included in the budget are classified as a "special revenue".

2.1.5 IT projects

These projects, namely software, require an approval of IT department director regardless the total value. This measure is meant to keep the unification within the Company.

2.2 Stages of approval

The "life cycle" of an investment proposal consists of up to 6 stages as follows:

· Identification of opportunity, preliminary appraisal and inclusion in approved plan/budget.
· Approval of development work, where necessary, by submission of preliminary financial investment proposal.
· Formulation of detailed financial investment proposal and submission for approval.
· Implementation stage with regular reports to demonstrate progress.
· Completion and preparation of final cost report.
· Post-completion review and submission of post-completion audit report.

2.3 The parties

There are three principal internal parties associated with any investment proposal:

· the sponsor - normally the director of proposing organisational unit
· the project manager - an individual nominated by a sponsor. He is accountable for delivery of project documents.
· the sanctioning authority - the person with powers to approve the project. In our case this are two board members - one with responsibility for the particular organisational unit and one responsible for capital investments.

3. Financial criteria and evaluation techniques

The financial evaluation should comprise a full analysis of the costs and benefits attributed to the investment with inflation and exchange rate assumptions stated, where applicable.

The financial criteria against which proposals will be assessed are as follows:

1. The net present value of the investment
   For this purpose, the benefits and costs should be at constant prices ruling at the date of the appraisal and should be net of tax.
2. The discounted payback period after discounting the incremental costs and benefits at the presribed discount rate.
3. The internal rate of return.
4. The impact of the investment on Company's cash flow and profit before tax.
5. Where applicable, the impact on other key indicators like earning per share, gearing and return on net assests employed.

Uncertainties within the project must be demonstrated with a proper analysis of risk, generally by the use of sensitivity analysis.

4. Situation in ÈEZ, a.s. and ways of improvement

The above described criteria are the goal which ÈEZ wants to reach. In present days the evaluation process is rather simpler. As regards the life cycle, last two stages are not implemented - with exception of some very special projects. But the final evaluation seems now very important - at least to validate the input assumptions. The same applies to stages of approval.

As regards the financial criteria, the NPP and IRR are calculated.

The rule is a positive NPP and IRR over a special level defined by a CFO. In such a case the project adds value for the Company's shareholders. One indicator is always checked - a working ratio. This is derived from one of our bank loan agreements.

The improvement required is only a minor one. Otherwise ÈEZ wouldn't have got a A- rating. The post-realisation phase needs to be improved and more emphasis put on final evaluation and re-checking the input parameters.

4.1 Data acquisition

The data necessary for all phases of project evaluation come from various sources. The most important is the project documentation, including the bid documents (if applicable) coming from suppliers or contract negotiations documents. Some other data come from internal ÈEZ sources - e.g. cost of undelivered power, prescribed value of IRR etc. The most important data input - the load forecast - is also prepared "in house" by a special department. In a smaller extent external sources are used, like databases etc.

5. Reference

[1] Hardwick, Bahadur Khan, Langmead: An introduction to modern economics
Third edition, Longman, London & New York, 1990
[2] Internal ÈEZ, a.s. documents
[3] MBA course handouts