I refer to the evidence session on 23 February at which Government officials provided evidence in respect of the Forth Crossing Bill. At the session officials offered or were requested to supply additional material. This note discharges those actions.

I have sought to respond to each of the matters raised during the evidence session by reference to the relevant column number in the Official Report.

**Col 1937 - A more detailed explanation of differing accounting rules, with reference to using PPP for the Forth crossing**

Mr Dow said in his evidence that “there is one answer for Scottish budgets and one answer for Treasury budgets.” Table 1, below, summarises the different treatment required by these two regimes:

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Scottish Parliament budgets, and the Scottish Government’s audited accounts</th>
<th>HM Treasury budgets, and Scottish Government spending power</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis for deciding whether a scheme is on or off balance sheet</td>
<td>Which party has control of the project. In practice this means that if the government is assessed to (1) control or regulate what services the operator must provide with the infrastructure, to whom it must provide them and at what price and (2) the public sector controls – through beneficial entitlement or otherwise – any significant residual interest in the infrastructure at the end of the term of the arrangement then the asset would be deemed to be on balance sheet.</td>
<td>Which party bears the balance of risk associated with the project. On this basis there have been and may in future be cases where the private sector bears enough of the risk for the project to be off the public sector’s balance sheet under ESA 95, while being on balance sheet under IFRS.</td>
</tr>
<tr>
<td>Budgeting impact</td>
<td>The capital cost of the scheme falls on the budget in the year the infrastructure comes into service and the asset will be recorded on the balance sheet. The annual payments relating to services and interest will be a recurring revenue cost for the duration of the contract together with depreciation.</td>
<td>The budget impact is spread over the duration of the contract in the form of the annual payments relating to services and interest (unitary charge elements). These score against our Treasury revenue DEL budget.</td>
</tr>
<tr>
<td>How will the Scottish Government deal with a PPP scheme which is on balance sheet under IFRS but off balance sheet under ESA95?</td>
<td>The approach since Devolution has been to align the way we account with the Scottish Parliament Approved Budget and to provide an appropriate reconciliation between our HMT budget and the Scottish Parliament budget as a Note to our accounts. Accordingly, under IFRS, we will budget and account to the Scottish Parliament for PPP/PFI arrangements in accordance with the Government Financial Reporting Manual (the FReM). For the Scottish Government the application of IFRS has resulted in PPP/PFI projects, previously classed as off balance sheet, coming on balance sheet from 1 April 2009. Going forward any pipeline or new PPP/PFI</td>
<td>Where a project is on balance sheet under IFRS, but off balance sheet under ESA 95, then in respect of the HM Treasury budget, provision will only be required for the unitary charge elements associated with a project i.e. revenue DEL. In essence, for planning purposes, if the total unitary charge is affordable within the HM Treasury budget, then the capital cost and depreciation disclosed in the accounts can be regarded as an accounting adjustment when compiling the Scottish Parliament Budget.</td>
</tr>
</tbody>
</table>
arrangements will be assessed under IFRS with the strong likelihood that the arrangement will be on balance sheet for accounting purposes.

Note that this table summarises some of the technical issues involved.

I attach the detailed guidance note that was prepared on this subject by Accountancy Services within the Scottish Government’s Finance Directorate in June last year. It remains relevant.

**Col 1939 – How the Project has addressed the findings of Audit Scotland, as they relate to its recent review of major capital projects in Scotland, and the conclusions and recommendations of the Holyrood Inquiry**

Table 2, below, provides an updated summary of how the Forth Replacement Crossing Project has addressed the recommendations made by Audit Scotland in their report ‘Review of major capital projects in Scotland’.

<table>
<thead>
<tr>
<th>Audit Scotland Recommendation</th>
<th>Transport Scotland response in relation to the management of the Forth Replacement Crossing (FRC) project</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The Scottish Government should:</strong></td>
<td></td>
</tr>
<tr>
<td>Collect information on all projects and get explanations for cost, time and quality changes, and lessons learned. It should report performance publicly.</td>
<td>Project development for FRC is undertaken within the regime of a Project Execution Plan (PEP) which collects contemporary information so that it will be available for future analysis.</td>
</tr>
<tr>
<td>Strengthen strategic direction and investment planning through a senior, government-wide, investment coordination and challenge function.</td>
<td>Project Governance is established through a formal Project Board and through regular reporting of critical stages to the Strategic Board.</td>
</tr>
<tr>
<td>Ensure robust procurement strategies and cost estimates have been developed prior to awarding funding to projects</td>
<td>Cost estimates for the Forth Replacement Crossing are produced on a regular basis and reported in the various sequential issues of the Project Cost and Project Budget Reports. Detailed consideration has been given to funding and procurement options for the project including comparison with other international projects. Assessment of value for money and accounting and budgetary treatment has been undertaken by Price Waterhouse Coopers. Consideration of contract types and their effect on procurement has been undertaken by specialists from Transport Scotland, the Jacobs Arup Joint Venture and DLA Piper and through consultation with the wider construction industry.</td>
</tr>
<tr>
<td>Take account of market conditions and construction inflation when developing its capital programme</td>
<td>Project costings have been developed using information from comparable national and international projects. Where applicable the costings have been benchmarked against current Scottish construction contracts. Construction price inflation has been assessed from historical information, and is routinely monitored monthly against the latest available published indices.</td>
</tr>
<tr>
<td><strong>Public bodies should:</strong></td>
<td></td>
</tr>
<tr>
<td>Prepare robust business cases for every project. These should be clear about the project aims and benefits, and include assessment of: risks; the range of options to be considered; and a clear basis for assessing, reviewing and reporting</td>
<td>Procurement of the Forth Replacement Crossing is supported by a series of business cases presented at key stages in the procurement process. A strategic business case was presented at project inception in June 2008, and an outline business case was presented in June 2009 before the start of the procurement process. A draft final business case was developed in October 2009 before issue of tender</td>
</tr>
</tbody>
</table>
documents for the Principal Contract (the design, execution and completion of the Bridge and connecting roads) to tenderers, and will be reviewed and revised prior to conclusion of the competitive dialogue period and contract award. Each business case has a substantive discussion of project risks and sets out a clear basis for assessing and reviewing a defined list of options to meet specified project aims.

<table>
<thead>
<tr>
<th>Build whole-life costs into business cases and subsequent project reporting</th>
<th>Assessment of the whole life costs of the project have been undertaken and incorporated into the business case and economic analyses of the project. The whole life costs have been assessed from a project-specific operations and maintenance model with input data collated from current and historical maintenance contracts and from the current operators of the existing Forth Road Bridge.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ensure cost, time and quality targets are clear from the outset, and properly recorded</td>
<td>These are set out in the initial PEP and have been reviewed and updated with scheme development, benchmarking as Government Announcements to the Parliament at appropriate milestones.</td>
</tr>
<tr>
<td>Improve early-stage estimating of the cost and time of projects. They need to ensure better assessment and quantification of risk and uncertainty, and should include a specific risk allowance, optimism bias allowance and take account of construction cost inflation in early cost estimates</td>
<td>Project cost estimates are updated at regular intervals to reflect the development of the project. In tandem, and incorporated within the costs, a quantified risk assessment and optimism bias evaluation are undertaken. Construction price inflation is included within the project’s estimated outturn costs. Detailed programmes have been produced for the development and construction phases of the project.</td>
</tr>
<tr>
<td>Develop an appropriate procurement strategy which considers all procurement routes, competitiveness and capacity within the construction industry. Ensure that risk management strategies explicitly consider and mitigate the risk of changes in scope after the contact has been awarded.</td>
<td>Detailed consideration of procurement strategies has been undertaken as described above. Evaluation of procurement strategies has included analysis of the risk and optimism bias allocations applicable to different procurement options.</td>
</tr>
<tr>
<td>Make more use of tools available to assess and confirm both the quality of design and environmental sustainability to get the best benefits from the available funding</td>
<td>The design uses the conventional Design Manual for Roads and Bridges (DMRB) process and innovative deployment of advance carbon assessments. Crossing design was subject of advice from Architecture + Design Scotland and Ceequal sustainability accreditation is being pursued.</td>
</tr>
<tr>
<td>Ensure appropriate project management and governance arrangements are put in place for every project</td>
<td>Project management within a bespoke Project Execution Plan regime</td>
</tr>
<tr>
<td>From the outset, ensure they have project managers with appropriate experience and knowledge of effectively managing major projects.</td>
<td>Project managed within a joint co-located Transport Scotland and Delivery Partner team (JAJV)</td>
</tr>
<tr>
<td>Ensure project budgets are sufficient to allow for post-project evaluation in all projects.</td>
<td>Carry out post-project evaluations within a reasonable timescale to determine whether projects have delivered the benefits intended.</td>
</tr>
</tbody>
</table>
Evaluations should consider performance against cost, time and quality targets.

Set a clear plan with regard to the need for independent gateway or similar reviews at key stages in projects. Gateway and Key Stage Review programme is being undertaken.

The Holyrood Inquiry conducted by Lord Fraser made a series of recommendations in the light of its inquiry into the Holyrood Building Project.

Table 3, below, provides a short review update of the actions taken by Forth Replacement Crossing Project to address relevant recommendations as set out in the Holyrood Inquiry (pages 259-260), which have a wider application to major public projects.

Table 3

<table>
<thead>
<tr>
<th>Recommendations reported from the Holyrood Inquiry</th>
<th>Actions taken on FRC</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Where a competition is held for the selection of a designer, consultant or contractor for a public building project, I recommend there should be:</td>
<td>Transport Scotland has established a methodical and EC compliant procedure for the pre-qualification and selection of suppliers. The requirements are managed and competitions are undertaken under the supervision of MTRIPS Contracts Branch, acting on behalf of the Chief Executive Transport Scotland and the Director of Purchasing Transport Scotland. Freestanding competitions initiated to date include site investigations contracts, topographical contract, multi-disciplinary management consultant commission (each initiated in 2007), 3 wind tunnel study contracts (awarded July/August 2009), a competition for an Insurance Advisor (awarded December 2009) and the competition for the design, execution and completion of the Principal Contract (the bridge and approach roads) (currently underway). A commission for Auditing Fees associated with the Multi-Disciplinary Management Consultancy Commission was awarded under a framework agreement owned by OGC (Spring 2008). A commission for Procurement and Contract Advisor was awarded under a Framework Agreement owned by the Scottish Government Legal Department. (April 2009).</td>
</tr>
<tr>
<td>a) An orderly evaluation of the Pre-Qualification Questionnaires.</td>
<td>N/A</td>
</tr>
<tr>
<td>b) A consistency of approach and common membership of those making visits to the offices of candidates.</td>
<td></td>
</tr>
<tr>
<td>c) A full and transparent record of all aspects of the competition from start to conclusion.</td>
<td></td>
</tr>
<tr>
<td>2. Where the best design solution is seen to be one of an internationally renowned ‘signature’ architect linking with a Scottish based practice, I recommend a full and rigorous evaluation should be undertaken to confirm a compatibility of working cultures and practices.</td>
<td>N/A</td>
</tr>
<tr>
<td>3. Construction Management as a procurement route should be used sparingly for any public building project. All Procurement process proposals for the Principal Contract were presented to</td>
<td></td>
</tr>
</tbody>
</table>
risk lies with the client and ultimately the taxpayer. Current Treasury Guidance could not be clearer. It is a procurement role of last resort. I recommend civil servants or local government officials contemplating construction management for a public project should reflect long and hard on the advantages and disadvantages of such a route and should set before the political leadership a full evaluation of the risks.

4. The United Kingdom, including Scotland, is a member of the European Union and is bound to observe all the procurement rules from advertisement in the Official Journal through to the debriefing of unsuccessful candidates. Not all those who appeared before the Inquiry appeared to have a necessary familiarity with these rules. I recommend that no-one should be put in charge of any public project without a demonstrable appreciation of what is required under EU procurement rules.

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MTRIPS Contracts Branch maintains a list of delegated purchasers who are required to be familiar with EC procurement rules. Selection of Bidders and approval of each competition process are signed off by a holder of Delegated Purchasing Authority within the project team. Procurement exercises undertaken since April 2009 are assisted or managed by the Procurement and Contract Advisor, DLA Piper. The Interim Project Director is substantially experienced in EC Procurement issues.

5. I recommend that where independent professional advisers have been retained, their view should not be filtered by the Civil Service but should be put to Ministers alongside any disagreement officials may have with the judgements expressed by those advisers.

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Professional advisers have access to Project Board and where necessary Ministers and are invited to participate, as appropriate to the provision of evidence to Parliamentary Committees. No disagreement or differences of judgement between civil service Project team and Consultants/Advisors have been filtered from Ministers.

6. I recommend that where civil servants are engaged on public projects, governance should be as clear as is now required in the private sector.

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Project Governance follows the Guidance given in the Scottish Public Finance Manual and incorporates the roles of investment decision maker (IDM), Project Owner and Project Director. IDM is supported by a Project Board including external non-executive members and a Finance and Risk Advisory Group. Decisions at critical breakpoints are referred to Ministers and where appropriate Cabinet and the Strategic Board for ratification. The Project has been subject to independent Peer and Gateway and Key Stage Reviews. These reports are submitted to the Project Owner and reported to the Project Board.

7. As I have expressed in the body of my Report, the lawyers for the Scottish Parliament were ingenious in their side-stepping of the maxim, delegatus non potest delegare. If there had been a legal challenge to their solution I would not have been confident that it would have survived. The Clerk and Chief Executive, Mr Paul Grice, nodded an understanding of the problem. Accordingly I recommend that Section 21 of the Scotland Act 1998 should be amended to give the SPCB wider powers of delegation than exist at present.

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N/A

8. After 9/11 and other more recent events, the security and safety of our public buildings has become paramount as much to protect the innocents as those who work within them. I am aware from the evidence heard in camera what steps have been taken to secure the integrity of the

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Security for the Forth Replacement Main Crossing and critical bridges / viaducts on the approach roads is being considered within the design process by the designers and
Parliament building and the safety of those who occupy it and I am impressed by that without revealing detail. Nevertheless I recommend that the considerations of the security and safety of public buildings should not be regarded as late ‘add ons’ to the design but primary integral parts of the User Brief and the assessment of any proposed design.

appropriate external security specialists and necessary measures are being included in the Principal Contract.

9. The previous Presiding Officer, Sir David Steel, expressed in his evidence his frustration and that of other MSPs that the procedures of the Scottish Parliament did not allow for oral questioning of the Presiding Officer. My understanding is that since 13th February 2004 the Standing Orders of the Parliament have been altered to allow such questioning. If that change had not been made since I embarked on this Inquiry, I would have wanted to recommend the change and, with respect, commend the Scottish Parliament for making it.

N/A

10. The Auditor General for Scotland in his June 2004 Report records at page 27 in relation to the Flour City contract:

‘In September 2002 I informed the Accountable Officer of what I considered then were the key concerns emerging from the work. He accepted that some interim contracts were allowed to continue long after trade contracts should have been finalised and that there were significant delays in obtaining some performance bonds and parent company guarantees. Fortunately, except in the Flour City case, none of the risks implicit in this situation appeared to have crystallised. Following my audit the Accountable Officer took action to ensure that where necessary full contracts, bonds and guarantees were put in place and to prevent similar risks arising again’

Once again, with respect. I agree with this careful analysis by the Auditor General for Scotland.

In the light of his recommendations I trust this to be an unnecessary recommendation but nevertheless I advise: Where an architect, consultant or other contractor is comparably employed, on his own account or as part of a joint venture, full contracts, guarantees and bonds should be secured at the outset to prevent risks to the public purse emerging.

For all contracts referred to in Section 1 above, agreements or contracts were executed or awarded prior to eligibility for payment, along with the confirmation of such necessary insurances and guarantees.

Col 1955 - What percentage of non-health and non-local government capital expenditure does the Forth crossing project represent?

On the same broad assumptions that indicate that capital spending on the Forth Crossing, in its peak years of construction, is likely to form around 13% of the total Scottish Government capital budget, the same capital spending is expected to peak at about 25% of the capital budget excluding health and local government.

Should you have any queries in relation to this letter or require any further information, please do not hesitate to contact me. I have copied this response, for information, to the Clerk to the Forth Crossing Bill.

Yours sincerely

Frazer Henderson
Bill Manager
Enc.
1. 1. Background

2. From the financial year 2009/10 onwards the accounts of the Scottish Government, Agencies, Health Boards and NDPB's will be prepared under International Financial Reporting Standards (IFRS). HMT have interpreted IFRS within the public sector context and provided guidance in the form of a Financial Reporting Manual based on IFRS. In relation to accounting for PPP and PFI contracts under IFRS the relevant sections of the FReM are paragraphs 6.2.34 to 6.2.51. The adoption of IFRS significantly changes the basis of accounting for PFI/PPP arrangements from the current risk allocation model based on FRS 5 to a control based model. The guidance provided is primarily based on HMT's interpretation of the International Financial Reporting Interpretations Committee Interpretation 12 – “Service Concession Agreements” (IFRIC12). Other relevant guidance is contained in:

- International Accounting Standard (IAS) 17 – “Leases”
- IFRIC 4: “Determining Whether an Arrangement Contains a Lease”

3. This paper is not intended to replace the IFRS based FReM but to provide an overview of the guidance and, where necessary, further explanation on implementation issues.

4. 2. Scope of IFRIC12

2.1 Paragraphs 6.2.34-6.2.37 of the FReM deal with the scope of IFRIC 12. In essence IFRIC12 should be applied to an arrangement contract when (FReM Para 6.2.30 - 31):

“To be within the scope of IFRIC 12, the service concession arrangement must contractually oblige the private sector operator to provide the services related to the infrastructure to the public on behalf of the grantor (the public sector) (IFRIC 12.3). Contracts that do not involve the transfer or creation of an infrastructure asset for the purpose of the contract fall outside the scope of IFRIC 12, as do arrangements that do not involve the delivery of services to the public.”

“The private sector operator will apply IFRIC 12 to those arrangements where:

a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price; and

b) the grantor controls – through beneficial entitlement or otherwise – any significant residual interest in the infrastructure at the end of the term of the arrangement.”

4.1 2.2 The reference to the private sector is due to IFRIC 12 being written from a private sector viewpoint. During the development of the FReM it was decided that the public sector accounting would “mirror” that of the private sector, therefore, these tests are integral to the public sector accounting for arrangements that fall within the scope of IFRIC 12. It is worth noting that arrangements where there is little or no residual value will fall within the scope if the grantor has control over the price and provision of the services associated with the infrastructure.

3. Assessing the Accounting Treatment of Arrangements:

3.1 The flow chart below (reproduced from the FReM) is designed to assist a public sector grantor in determining the appropriate accounting treatment of PPP/PFI arrangements:

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3.2 In terms of recognition those arrangements that fall under IFRIC12 the following guidance is provided by the FReM (paras 6.2.38-6.2.39):

*Where there is infrastructure, whether previously owned by the contractor or the grantor, or constructed or acquired from a third party for the purpose of the service arrangement, and the grantor controls:
a) or regulates what services the operator must provide with the infrastructure, to whom it must provide them and at what price; and

b) through beneficial entitlement or otherwise, any significant residual interest in the infrastructure at the end of the term of the arrangement (or there is no residual interest),

then the PPP arrangement or PFI contract is a service concession within the meaning of IFRIC 12 from the grantor’s viewpoint.

The grantor should recognise the infrastructure as a non-current asset and value it in the same way as other non-current assets of that generic type. The asset will be recognised when:

a) it is probable that future economic benefits associated with the asset will flow to the organisation; and

b) the cost of the asset can be measured reliably.

In practice, this means that the grantor will usually only recognise the asset when the asset comes into use. Where the grantor makes contributions to the operator in advance of the asset coming into use, the grantor should account for those payments as prepayments.

3.3 If the grantor does not control the price or form of the services to be provided or, has no significant residual interest in the asset then it is necessary to determine whether the arrangement contains a lease IFRIC 4 provides guidance in this respect (paragraphs 6-9):

“Determining whether an arrangement is, or contains, a lease shall be based on the substance of the arrangement and requires an assessment of whether:

(a) **fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and**

(b) **the arrangement conveys a right to use the asset.**

**Fulfilment of the arrangement is dependent on the use of a specific asset**

Although a specific asset may be explicitly identified in an arrangement, it is not the subject of a lease if fulfilment of the arrangement is not dependent on the use of the specified asset. For example, if the supplier is obliged to deliver a specified quantity of goods or services and has the right and ability to provide those goods or services using other assets not specified in the arrangement, then fulfilment of the arrangement is not dependent on the specified asset and the arrangement does not contain a lease. A warranty obligation that permits or requires the substitution of the same or similar assets when the specified asset is not operating properly does not preclude lease treatment. In addition, a contractual provision (contingent or otherwise) permitting or requiring the supplier to substitute other assets for any reason on or after a specified date does not preclude lease treatment before the date of substitution.

An asset has been implicitly specified if, for example, the supplier owns or leases only one asset with which to fulfil the obligation and it is not economically feasible or practicable for the supplier to perform its obligation through the use of alternative assets.

**Arrangement conveys a right to use the asset**

An arrangement conveys the right to use the asset if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying asset. The right to control the use of the underlying asset is conveyed if any one of the following conditions is met:

(a) The purchaser has the ability or right to operate the asset or direct others to operate the asset in a manner it determines while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(b) The purchaser has the ability or right to control physical access to the underlying asset while obtaining or controlling more than an insignificant amount of the output or other utility of the asset.

(c) Facts and circumstances indicate that it is remote that one or more parties other than the purchaser will take more than an insignificant amount of the output or other utility that will be produced or generated by the asset during the term of the arrangement, and the price that the purchaser will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of delivery of the output.”
3.4 IFRIC 4 also provides a number of examples to illustrate how the criteria above should be applied. It is also worth noting that where there are changes to the contractual terms (e.g. renegotiation or extension) or to the asset a reassessment of whether a lease is present should be made (paragraph 10).

3.5 If it is determined that an arrangement does contain a lease, further consideration is required as to whether the lease is a finance lease or an operating lease. Guidance is provided in IAS 17 (Paragraphs 8-13):

“A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

Because the transaction between a lessor and a lessee is based on a lease agreement between them, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them. For example, this may be the case if the lessor benefits from a residual value guarantee provided by a party unrelated to the lessee.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract.[*] Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;
(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;
(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;
(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and
(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.

[*] See also SIC-27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease.

Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor’s losses associated with the cancellation are borne by the lessee;
(b) gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and
(c) the lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

The examples and indicators in paragraphs 10 and 11 are not always conclusive. If it is clear from other features that the lease does not transfer substantially all risks and rewards incidental to ownership, the lease is classified as an operating lease. For example, this may be the case if ownership of the asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are contingent rents, as a result of which the lessee does not have substantially all such risks and rewards.

Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7-12 if the changed terms had been in effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term. However, changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes.”

3.4 It is also worth noting that, where a lease concerns land and buildings, IAS17 requires that the land and building elements of a lease are considered separately. Where the land is considered to have an indefinite economic life and the title does not pass to the lessee at the end of the lease term then the land element would be considered as an operating lease. Where the title does transfer to the lessee the land element would be classified as a finance lease (see IAS17 paragraphs 14-16).

4. Measurement - New Projects
4.1 On the measurement of new projects that are assessed to be “on balance sheet” The FReM provides the following guidance (6.2.40-6.2.41):

“The asset will be measured in one of two ways: a) where the contract is separable between the service element, the interest charge and the infrastructure asset (see also paragraph 6.2.41), the asset will be measured as under IAS 17, with the service element and the interest charge recognised as incurred over the term of the concession arrangement; or

b) where there is a unitary payment stream that includes infrastructure and service elements that cannot be separated, the various elements will be separated using estimation techniques as set out in paragraph 6.2.42.

The grantor should separate out the service, interest and infrastructure elements. A contract may be separable in a variety of circumstances, including but not limited to the following.

a) the contract identifies an element of a payment stream that varies according to the availability of the property itself and another element that varies according to usage or performance of certain services;

b) different parts of the contract run for different periods or can be terminated separately. For example, an individual service element can be terminated without affecting the continuation of the rest of the contract; or

c) different parts of the contract can be renegotiated separately. For example, a service element is market tested and some or all of the cost increases or reductions are passed on to the grantor in such a way that the part of the payment by the grantor that relates specifically to that service can be identified.”

4.2 In terms of IAS 17 fair value is defined as (para 20):

“At the commencement of the lease term, lessees shall recognise finance leases as assets and liabilities in their balance sheets at amounts equal to the fair value of the leased property or, if lower, the present value of the minimum lease payments, each determined at the inception of the lease. The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Any initial direct costs of the lessee are added to the amount recognised as an asset.”

4.3 Subsequent measurement of the project sees the asset treated consistently with other assets within its class (i.e. IAS16). The leasing liability is measured using the appropriate discount rate also taking into account the reduction arising from the capital element of the unitary payment.

5. Measurement of Existing “Off Balance Sheet” Projects:

5.1 The non current asset should be measured at fair value at the opening balance sheet date and valuation should be on the same basis as other non current assets of the same generic type. The lease liability should be measured at its fair value as at the balance sheet date, this will normally be outstanding liability in respect of the non-current asset discounted at the interest rate implicit in the contract. This effectively means that it will be necessary to model the lease liability back to the inception of the contract.

5.2 Subsequent measurement is the same as for new projects outlined at 4.3 above.

6. Measurement Where Contract is Not Separable:

6.1 Bearing in mind that one of the conditions relating to an off balance sheet classification under UKGAAP was that the contract should not be separable it may be difficult to determine the service and financing elements of a unitary payment. The FReM recognises this and, where the service charge cannot be identified or reliably estimated, provides the following (paragraphs 6.2.42-6.2.44):

“In situations where it is not possible to separate the contract due to commercial reality, the service element of the payments must be estimated, which could be achieved by obtaining information from the operator or by using the fair value approach. The fair value of the asset determines the amount to be recorded as an asset with an offsetting liability. The total unitary payment is then divided into three: the service charge element, repayment of the capital element of the contract obligation and the interest expense on it (using the interest rate implicit in the contract).
For both existing and new contracts, where it is not practicable to determine the interest rate implicit in the contract, the grantor shall use its cost of capital rate (including inflation). It is expected that this situation would be rare. The rate should not be changed unless the infrastructure element or the whole of the contract is renegotiated.

Entities covered by the requirements of this manual should use the cost of capital rate given in chapter 11 (paragraph 11.5.4). This rate is stated in real term and must be adjusted by adding the inflation rate to arrive at the nominal rate. The nominal rate can be calculated using inflation rates given in the table 16 of the Treasury’s Pocket Data Bank. The Pocket Data Bank can be found at: http://www.hm-treasury.gov.uk/data_indic_index.htm.”

7. Income Generated by the Grantor:

7.1 Any revenue received by the grantor (e.g. revenue sharing) should be recognised in line with IAS18 – Revenue.

8. Financial Instruments:

8.1 It is common for contracts to have undertakings by the grantor relating to revenue shortfalls and repayment of debt in the event of contract default. These should be accounted for and disclosed in line with the requirements of IAS32 and IAS39.

9. Items Provided to the Operator:

9.1 In order to facilitate an arrangement the grantor may provide assets for the operators use (e.g. land, buildings etc). The FReM provides guidance at paragraph 6.2.50:

“The grantor should derecognise a non-current asset provided to the operator (and not used in the arrangement) and recognise any consideration received at fair value. If the consideration received is in the form of a reduction in future payments, this should be recognised as an asset representing a reduction in the future liability (normally as a prepayment).”

10. Disclosure:

10.1 Disclosure of commitments under PFI contracts is required (FReM paragraph 5.4.59):

“Entities shall disclose the payments it is committed to make during the next year, analysed between those in which the commitment expires:

- within one year;
- in the 2nd to 5th year inclusive;
- in the 6th to 10th year inclusive;
- and so on in five year bandings.”