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APPENDIX 3

Mr S Sanderson
Head of Capital Finance
NHS Ayrshire and Arran
Crosshouse Hospital
Crosshouse
Kilmarnock
KA2 0BE

24 September 2004

Dear Stuart

Crosshouse Maternity Hospital PPP Project
Final Judgment on Proposed Accounting Treatment

In response to your request for my comments on your final judgement on the accounting treatment of the Crosshouse Maternity Hospital PPP Project, I include my comments on its reasonableness and summarise the context in which they are given.

Responsibilities of the audited body and the external auditor

NHS Ayrshire and Arran is accountable to the public for the stewardship of funds under its control. It is for the body alone to take decisions about the most appropriate accounting treatment for any transactions it is considering entering into, after taking whatever advice it deems necessary.

It is the external auditor's role to form an independent view on how the body has discharged its stewardship of public funds. It is not part of the auditor's role to provide accounting advice nor to act as an accounting adviser. The public sector audit regime requires that auditors should not, nor appear to, compromise their independence.

Audit Scotland's Code of Audit Practice sets out clearly the nature of public sector audit and the general duties of external auditors operating under that audit regime. The Statement of Responsibilities of Auditors and of Audited Bodies provides further clarification of the respective roles of both parties.

The Treasury Taskforce Technical Note 1 (revised) - 'How to Account for PFI Transactions' summarises the relative responsibilities of the purchaser and auditor and recommends that the following outputs are obtained at progressive stages of the procurement process

Audited body	Auditor
Provides an **initial view** on the proposed accounting treatment based on Outline Business Case information.	Comments on whether the purchaser's initial view on the proposed accounting treatment is reasonable.
Updates initial view to provide a **provisional judgment** on the proposed accounting treatment based on the design solution/financial models of the preferred bidder.	Comments on whether the purchaser's provisional judgment on the proposed accounting treatment is reasonable.
Provides a **final judgment** on the accounting treatment by weighing up all the relevant indicators of which party has an asset of the property.	Comments on whether the purchaser's final judgment on the accounting treatment is reasonable.

Status of audit view

The purpose of this letter is to provide NHS Ayrshire and Arran with my comments on the reasonableness of your final judgment on the accounting treatment of the project from the perspective of the external auditor. The views are expressed in my capacity as external auditor and should not be regarded as advice. The letter is provided to inform you of my views at this stage as external auditor and for no other purpose. In particular, no responsibility is accepted towards any other organisation or individual who may seek to place reliance on its contents.

Changing circumstances

The views set out in this letter are based upon the information presented to me as at 22 September 2004 in the documents listed in the annex. If circumstances change, or further information becomes available, then my views may have to be reconsidered.

The views are also expressed in recognition of the current underlying guidance which is Application Note F to FRS 5-Reporting the substance of transactions: Private Finance Initiative and similar contracts (which provides clarification of how the principles and requirements of FRS 5 should apply to transactions conducted under the UK Government's Private Finance Initiative), as supplemented by Treasury Taskforce Technical Note No. 1 (Revised)-How to Account for PFI Transactions.

Mr S Sanderson
Head of Capital Finance
NHS Ayrshire and Arran

24 September 2004

Comments on reasonableness of final view on accounting treatment

In your capacity as Head of Capital Finance, you have confirmed to me that your final view on the accounting treatment is that the transaction should be accounted for as off NHS Ayrshire and Arran's balance sheet.

The body appointed Quayle Munro as its financial advisers in respect of this scheme. As part of their remit, they have provided the body with advice on whether the transaction should be accounted for as on or off the body's balance sheet.

The identification and evaluation of the key risks by the body's officers and professional advisers is based on their technical analysis, and their subjective judgements on the likelihood of various events occurring. I note in particular that the quantitative analysis is substantially based upon the financial advisers' previous PPP project involvement and upon the contractor's financial model.

Quayle Munro's accounting advice, dated 6 August 2004 (updated 22 September 2004), is that the transaction should be accounted for as off the body's balance sheet. This is supported by their qualitative analysis and their analysis of quantitative risks, which allocates 81% of identified risk to the provider and 19% to the purchaser (NHS Ayrshire and Arran).

I note their conclusions and comment as follows:

Demand risk

Application Note F to FRS 5 makes clear that demand risk, where significant, will normally give the clearest evidence of who should record an asset of the property. The accounting view states that demand risk is not considered significant and I had sought specific assurances on this issue. In this context I note the supporting evidence provided by NHS Ayrshire and Arran in its letter dated July 2004 which confirms that the data used is sourced from the most recent GRO census information. The letter also confirms that, within all anticipated limits of variability of demand, movements in usage "are unlikely to have any impact in capacity terms in respect to beds or accommodation provision".

Residual value risk

I note that the range of expected annual price indices used in the calculation is relatively narrow (varying between 3.72% and 3.92% per annum). This is based upon the advisers' analysis of past trends in construction industry inflation, although the judgement on the risk spread is their own. I also note that the calculation of the residual value in the quantitative analysis uses the project life as the basis of calculating the depreciated replacement cost rather than the residual life of the asset. In my view the chosen spread of expected annual price indices may understate the purchaser's risk in this area. However, the use of project life rather than residual life in this calculation would, conversely, tend to overstate that risk.

Inflation

I have enquired whether the purchaser may face a degree of inflation risk in the context of the agreement, as the payable unitary charge is fully indexed against RPI. The Financial Advisers have argued that this would not impact on the analysis as funding received by the Board would broadly match RPI movements. They also point to a degree of inflation risk being inherently provided within the residual value calculation. In my view there would remain a quantifiable inflation risk in terms of future variability of this factor. I do not anticipate that this would impact materially on the outcome of the quantification.

Life Cycle Costs

The quantitative analysis models the anticipated variability of the provider's life cycle costs across the duration of the project. This is based on the contractor's financial model. It is not clear whether this is appropriately modeled, as the analysis profiles total expected costs over the project life on the basis of variable scenarios. The risk of variation in the overall quantum of such costs may not be fully considered. However, additional variability in this factor is likely to increase the risk value to the contractor and is not likely to impact materially on the outcome of the analysis.

The quantitative analysis also models both the provider's life cycle costs and an element of costs relating to the preparation of the property for return to the purchaser at the end of the contract in satisfactory condition. I note the advisers' assurances on the separate nature of these potential costs, but in my view it remains unclear to what extent there may be some element of duplication here with life cycle costs during the project life.

Symmetrical accounting treatment

Where a purchaser adopts an off balance sheet treatment of a PPP asset, there is persuasive evidence of the appropriateness of this approach if the contractor, conversely, recognises the asset on its balance sheet. I am advised that the provider intends to treat the property as a financial asset on its balance sheet – effectively a long term debtor rather than a tangible fixed asset. It is, of course, for the provider to determine its own accounting treatment in conjunction with its auditors, however, the occurrence of "off/off" balance sheet treatments has been a source of concern for public sector auditors considering PPP and related arrangements, particularly where this may derive from the purchaser and provider having different perceptions of the allocation of risk.

I have enquired with the Board as to the reasons for the provider's proposed treatment. The Board and its advisers comment that:

" the SPV has elected to treat the property as a financial asset in its financial model (and likely in its statutory accounts when they are first prepared), rather than a tangible fixed asset, because, having completed a review of the risks and rewards of ownership of the asset for that SPV, the directors have come to the opinion that the risks have been mitigated to such an extent that the most appropriate treatment is as a financial asset. The SPV is able to mitigate risk by transferring construction risk to its construction contractor, Dawn

Construction Limited, operational risk to its FM contractor, FES Limited, and will hedge its financial exposure through an interest rate swap. This form of treatment is in line with HM Treasury guidance and has financial benefits to the Purchaser in the form of reduced unitary charge with no impact on risks retained by the Purchasing Authority."

I note these comments. The Board and I now concur that construction risk would not be relevant here, as this would not feature in an analysis of which party would have an asset of the property. In general, there remain concerns over the fact that the asset will not appear on either public or private sector balance sheets.

Overall conclusion

In my view, and in the context of my preceding remarks

- the process followed to determine whether the body should account for the transaction on or off its balance sheet was in accordance with the current underlying guidance; and
- your final judgment on the accounting treatment is reasonable.

Yours sincerely

David McConnell
Chief Auditor

ANNEX

Nature of document	Prepared by	Date
Full Business Case	NHS Ayrshire and Arran	23 July 2004
Advice on Accounting Treatment	Quayle Munro	6 August 2004 (updated at 22 September 2004)
Draft Project Agreement	MacRoberts Solicitors	30 July 2004
Financial Model	Ayrshire Hospitals Ltd	6 February 2004
Crosshouse Hospital – Demand Risk Paper	A Hood – NHS Ayrshire and Arran	July 2004

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