2. Principal accounting policies (continued)

W. Accounting pronouncements not yet adopted (continued)

IFRS 9 'Financial Instruments'
In November 2009, the IASB issued IFRS 9 which represents the first phase of its replacement of IAS 39 and introduces new requirements for the classification and measurement of financial assets and removes the need to separately account for certain embedded derivatives.

IFRS 9 is effective for annual periods commencing on or after 1 January 2013. Early adoption is permitted, but the standard has not yet been endorsed for use in the European Union.

Amendments to IFRS 2 'Share-based Payment – Group Cash-settled Share-based Payment Transactions'
In June 2009, the IASB amended IFRS 2 to incorporate the guidance previously included in IFRIC 8 'Scope of IFRS 2' and IFRIC 11 'IFRS 2 – Group and Treasury Share Transactions', which the Group adopted in 2007. The amendments to IFRS 2 are effective for annual periods beginning on or after 1 January 2010, but have not yet been endorsed for use in the European Union.

Amendments to IAS 24 'Related Party Disclosures'
In November 2009, the IASB amended IAS 24 to simplify the definition of a related party, clarify its intended meaning and eliminate a number of inconsistencies. The amendments are effective for annual periods beginning on or after 1 January 2011, but have not yet been endorsed for use in the European Union.

'Improvements to IFRSs 2009'
In April 2009, the IASB published its second annual improvements standard which contains minor amendments to standards that address a number of issues, including: disclosure of non-current assets or disposal groups classified as held for sale or as discontinued operations; disclosure of information about segment assets; the unit of accounting for goodwill impairment tests; the measurement of the fair value of an intangible asset acquired in a business combination; and the classification of leases of land and buildings.

Most of the amendments are effective for annual periods beginning on or after 1 January 2010, but have not yet been endorsed for use in the European Union.

IFRIC 19 'Extinguishing Liabilities with Equity Instruments'
In November 2009, IFRIC 19 was issued to clarify the required accounting where a debtor fully or partly extinguishes a liability by issuing equity instruments to the creditor. IFRIC 19 is effective for annual periods beginning on or after 1 July 2010, but has not yet been endorsed for use in the European Union.

Amendments to IFRIC 14 'IAS19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'
In November 2009, the IASB amended IFRIC 14 to remedy an unintended consequence of the pronouncement whereby entities were in some circumstances not permitted to recognise as an asset prepayments of minimum funding contributions. The amendments are effective for annual periods beginning on or after 1 January 2011, but have not yet been endorsed for use in the European Union.

3. Critical accounting estimates

A. Background

When applying the Group's accounting policies, management must make assumptions and estimates concerning the future that affect the carrying amounts of assets and liabilities at the balance sheet date, the disclosure of contingencies that existed at the balance sheet date and the amounts of revenue and expenses recognised during the accounting period. Such assumptions and estimates are based on factors such as historical experience, the observance of trends in the industries in which the Group operates and information available from the Group's customers and other outside sources.

Due to the inherent uncertainty involved in making assumptions and estimates, actual outcomes could differ from those assumptions and estimates. An analysis of the key sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment to the carrying amounts of the Group's assets and liabilities within the next financial year is presented below.

B. Post-employment benefits

The Group operates pension plans throughout the world, covering the majority of its employees. Pension benefits are provided by way of both defined contribution plans and defined benefit plans. The Group's defined benefit pension plans are closed to new entrants. The Group also provides other post-employment benefits, principally health and life insurance cover, to certain of its employees in North America by way of unfunded defined benefit plans.

The Group accounts for post-employment benefits in accordance with IAS 19 'Employee Benefits', whereby the cost of defined benefit plans is determined based on actuarial valuations of the plans that are carried out annually at the Group's balance sheet date. The actuarial valuations are dependent on assumptions about the future that are made by management on the advice of independent qualified actuaries. If actual experience differs from these assumptions, there could be a material change in the amounts recognised by the Group in respect of defined benefit plans in the next financial year.

As at 2 January 2010, the present value of the benefit obligation was $1,258.1 million. The benefit obligation is calculated using a number of assumptions including future salary increases, increases to pension benefits, mortality rates and, in the case of post-employment medical benefits, the expected rate of increase in medical costs. The present value of the benefit obligation is calculated by discounting the benefit obligation using market yields on high-quality corporate bonds at the balance sheet date. As at 2 January 2010, the fair value of the plan assets was $924.5 million. The plan assets consist largely of listed securities and their fair values are subject to fluctuation in response to changes in market conditions.

Effects of changes in the actuarial assumptions underlying the benefit obligation, effects of changes in the discount rate applicable to the benefit obligation and effects of differences between the expected and actual return on the plan assets are classified as actuarial gains and losses and are recognised in other comprehensive income. During 2009, the Group recognised a net actuarial loss of $143.8 million. Further actuarial gains and losses will be recognised during the next financial year.

An analysis of the assumptions that will be used by management to determine the cost of defined benefit plans that will be recognised in profit or loss in the next financial year is presented in note 34.

C. Impairment of long-lived assets

Goodwill, other intangible assets and property, plant and equipment are tested for impairment whenever events or circumstances indicate that their carrying amounts might be impaired. Additionally, goodwill and capitalised development expenditure relating to a product that is not yet in full production are subject to an annual impairment test. Due to the nature of the Group's operations, it is generally not possible to estimate the recoverable amount for individual long-lived assets and impairment tests are usually based on the value in use of the CGU or group of CGUs to which the asset belongs.

Value in use represents the net present value of the cash flows expected to arise from the relevant CGU or group of CGUs and its calculation requires management to estimate those cash flows and to apply a suitable discount rate to them.

Management bases the estimated cash flows of the CGU or group of CGUs on assumptions such as the future changes in sales volumes, future changes in selling prices, and future changes in material prices, salaries and other costs. Management determines a discount rate for each CGU or group of CGUs using a capital asset pricing model, which is based on variables including the applicable risk-free interest rates and, for determining the cost of equity, the long-term equity risk premium and the assumed share price volatility relative to the market and, for determining the cost of debt, the assumed credit risk spreads.

As at 2 January 2010, the carrying amount of long-lived assets was $1,636.8 million, after taking into account impairments totalling $57.5 million that were recognised during 2009. Further impairment losses may be recognised on these assets within the next financial year if there are adverse changes in the variables and assumptions underlying the estimated future cash flows of the CGUs or the discount rates that are applied to those cash flows. The sensitivity of the carrying amount of goodwill to the key assumptions underlying the value in use calculations is discussed in note 19.

D. Inventory

Inventories are stated at the lower of cost and net realisable value, with due allowance for excess, obsolete or slow-moving items. Net realisable value is based on current assessments of future demand, market conditions and new product development initiatives. As at 2 January 2010, the carrying value of inventories was $590.8 million, net of allowances of $63.9 million. Should demand for the Group's products decline during the next financial year, additional allowances may be necessary in respect of excess or slow-moving items.

E. Financial instruments

Derivative financial instruments that the Group holds for the purpose of hedging its currency and interest rate exposures are recognised as assets and liabilities in the Group's balance sheet measured at their fair value at the balance sheet date. As at 2 January 2010, the Group recognised a net asset of $51.9 million in respect of derivatives. The fair value of derivatives continually changes in response to changes in prevailing market conditions and applicable credit risk spreads. Where permissible under IAS 39, the Group uses hedge accounting to mitigate the impact of changes in the fair value of derivatives on profit or loss but the Group's results may be affected by changes in the fair values of derivatives where hedge accounting cannot be applied or due to hedge ineffectiveness.

F. Workers' compensation

Provision is made for claims for compensation for injuries sustained by the Group's employees while at work. The Group's liability for claims made but not fully settled is calculated on an actuarial basis. Historical data trends are used to estimate the liability for unreported incidents. As at 2 January 2010, the workers' compensation provision amounted to $22.0 million. Further provision may be necessary within the next financial year if the actual cost of settling claims exceeds management's estimates.

G. Environmental liabilities

Provision is made for the estimated cost of known environmental remediation obligations in relation to the Group's current and former manufacturing facilities. Cost estimates include the expenditure expected to be incurred in the initial remediation effort and, where appropriate, in the long-term monitoring of the relevant sites. Management monitors for each remediation project the costs incurred to date against expected total costs to complete and operates procedures to identify possible remediation obligations that are presently unknown.

As at 2 January 2010, the provision for environmental remediation costs amounted to $6.5 million. Further provision may be necessary within the next financial year if actual remediation costs exceed expected costs, new remediation obligations are identified or there are changes in the circumstances affecting the Group's legal or constructive remediation obligations.

3. Critical accounting estimates (continued)

H. Product warranties

Provision is made for the estimated cost of future warranty claims on the Group's products. Management bases the provision on historical experience of the nature, frequency and average cost of warranty claims and takes into account recent trends that might suggest that the historical claims experience may differ from future claims. As at 2 January 2010, the Group's provision for warranty claims amounted to $11.3 million. Further provision may be necessary within the next financial year if actual claims experience differs from management's estimates.

I. Taxation

The Group is subject to income tax in most of the jurisdictions in which it operates. Management is required to exercise significant judgement in determining the Group's provision for income taxes.

Estimation is required of taxable profit in order to determine the Group's current tax liability. Management's judgement is required in relation to uncertain tax positions whereby additional current tax may become payable in the future following the audit by the tax authorities of previously-filed tax returns. As at 2 January 2010, the Group holds a provision for uncertain tax positions amounting to $79.5 million. It is possible that the final outcome of these uncertain tax positions may differ from management's estimates.

Estimation is also required of temporary differences between the carrying amount of assets and liabilities and their tax base. Deferred tax liabilities are recognised for all taxable temporary differences but, where there exist deductible temporary differences, management's judgement is required as to whether a deferred tax asset should be recognised based on the availability of future taxable profits. As at 2 January 2010, the Group recognised net deferred tax assets amounting to $57.6 million, including $21.7 million in respect of tax losses and tax credits. Deferred tax assets of $783.7 million were not recognised in respect of tax losses and tax credits carried forward. It is possible that the deferred tax assets actually recoverable may differ from the amounts recognised if actual taxable profits differ from management's estimates.

As at 2 January 2010, deferred tax liabilities were not recognised on retained profits of foreign subsidiaries and associates amounting to $3,225.7 million because the Group is able to control the remittance of those profits to the UK and it is probable that they will not be remitted in the foreseeable future. Income tax may be payable on these amounts if circumstances change and either their remittance can no longer be controlled by the Group or they are actually remitted to the UK.

4. Segment information

A. Background

The Group's operating segments are identified by grouping together businesses that manufacture similar products, as this is the basis on which information is provided to the Board for the purposes of allocating resources within the Group and assessing the performance of the Group's businesses.

The Group's business segments are described in note 1.

During 2009, the Group substantially completed its long-term programme of disposing of or exiting its non-core businesses and changes were made to the Group's internal reporting structure to assist the Board in focusing on the performance of the Group's ongoing businesses. Distinction is now drawn between those of the Group's continuing operations that are ongoing and those that have been exited but do not meet the conditions to be classified as discontinued operations. The following changes were made:

– the Stant and Standard-Thomson businesses that were sold in 2008 were removed from the Fluid Systems segment and are now presented as a separate segment named Caps & Thermostats;

– the remainder of the Fluid Systems segment was renamed Sensors & Valves;

– the Dearborn Mid-West business that was sold in 2007 was removed from the Other Industrial & Automotive segment and is now presented as a separate segment named Materials Handling;

– the Air Systems Components segment was renamed Air Distribution;

– the Philips Doors and Windows business that was closed during 2009 was removed from the Other Building Products segment and is now presented as a separate segment named Doors & Windows;

– the Lasco Fittings business that was sold in 2007 was removed from the Other Building Products segment and is now presented as a separate segment named Fittings; and

– the remainder of the Other Building Products segment was renamed Bathware.

Also during 2009, the Group's Water Pumps business was transferred from Other Industrial & Automotive to Power Transmission.

Comparative information for 2008 and 2007 has been re-presented to reflect these changes.