41 CRITICAL ACCOUNTING JUDGEMENTS AND KEY SOURCES OF ESTIMATION UNCERTAINTY continued

For those arrangements determined to be leases, further judgements are required to determine whether the arrangement is a finance or operating lease. This assessment requires an evaluation of where the substantial risks and rewards of ownership reside. For finance leases it is necessary to calculate the proportion of total capacity payments which should be treated as finance income, capital repayment and as a fee for service provision. For operating leases it is necessary to determine the allocation of total capacity payments between rental payments and fees for service provision.

Evaluation of levels of control and influence

The determination of the level of influence the Group has over a business is often a mix of contractually defined and subjective factors that can be critical to the appropriate accounting treatment of entities in the consolidated accounts. We achieve influence through Board representation and by obtaining rights of veto over significant actions. We generally treat investments where the Group holds less than 20% of the equity as investments available for sale. These investments available for sale are carried at market value where market prices are available. Where quoted market prices in an active market are not available, and where fair value cannot be reliably measured, unquoted equity instruments are measured at cost.

Where the Group owns between 20% and 50% of the equity of an entity and is in a position to exercise significant influence over the entity's operating and financial policies, we treat the entity as a joint venture or an associate. Equally, where the Group holds a substantial interest (but less than 20%) in an entity and has the power to exert significant influence over its operations, we treat it as a joint venture or an associate. This treatment is applied to our interests in Malakoff Berhad in Malaysia of which we own 18% and The Hub Power Company in Pakistan of which we own 17% (refer to note 40).

Exceptional items

The Directors consider that items of income or expense which are material by virtue of their nature and amount should be disclosed separately if the financial statements are to fairly present the financial position and financial performance of the entity. The Directors label these items collectively as 'exceptional items'.

Determining which transactions are to be considered exceptional in nature is often a subjective matter. However, circumstances that the Directors believe would give rise to exceptional items for separate disclosure would include:

(i) disposals of investments;

(ii) discontinued operations;

(iii) impairments and impairment reversals.

All exceptional items are included under the appropriate income statement line item to which they relate. In addition, for clarity, separate disclosure is made of all items in one column on the face of the income statement.

Taxation

The level of tax provisioning is dependent on subjective judgement as to the outcome of decisions to be made by the tax authorities in the various tax jurisdictions around the world in which International Power operates. It is necessary to consider the extent to which deferred tax assets should be recognised based on an assessment of the extent to which they are regarded as recoverable.

b) Key sources of estimation uncertainty

Useful economic lives of property, plant and equipment

The original cost of greenfield developed power plant and other assets includes relevant borrowings and development costs:

(i) Interest on borrowings relating to major capital projects with long periods of development is capitalised during construction and then amortised over the useful life of the asset.

(ii) Project development costs (including appropriate direct internal costs) are capitalised when it is virtually certain that the contract will proceed to completion and income will be realised.

Depreciation of plant and other assets is charged so as to write down the value of those assets to their residual value over their respective estimated useful lives. The Directors are required to assess the useful economic lives of the assets so that depreciation is charged on a systematic and proportionate basis to the current carrying amount. It is Group policy to depreciate gas turbines and related equipment over 30 years to a 10% residual value, unless the circumstances of the project or life of specific components indicate a shorter period or a lower residual value. Coal and hydro plants are considered on an individual basis.

Fair values on acquisition

The Group is required to bring acquired assets and liabilities on to the Group balance sheet at their fair value. Power plant and equipment usually have long operating lives, and are often bought with associated long-term contracts such as PPAs. Hence determination of the fair values of these long-life assets and contracts can require a significant amount of judgement.

Impairment analysis

Management regularly considers whether there are any indications of impairment to the carrying amounts of its power plants and other long life assets. This includes a review of market conditions in both the short-term and long-term. Impairment reviews are generally based on pre-tax risk adjusted discounted cash flow projections that require estimates of discount rates and future market prices over the remaining lives of the assets. We benchmark the results of this testing against post-tax risk adjusted cash flows, discounted on a post-tax basis. At each balance sheet date, consideration is also given as to whether there is any indication that an impairment loss recognised in prior periods has reversed. During the year the Group reversed the impairment of its Rugeley plant in the UK (refer to note 14).

Provisions

Within the Group there are a number of long-term provisions. The carrying amount of these provisions is estimated based on assumptions about such items as the risk adjustment to cash flows or discount rates used, future changes in prices and estimates of costs. For example, the pensions liability is based on assumptions relating to discount rates used, future changes in salaries and future changes in prices affecting other costs. A change in estimates could have a material impact on the carrying amount of these provisions.

42 EXPLANATION OF TRANSITION TO IFRSs

As stated in note 1, these are the Group's first consolidated financial statements prepared in accordance with Adopted IFRSs.

The accounting policies set out in note 1 have been applied in preparing the consolidated financial statements for the year ended 31 December 2005, the comparative information presented in these consolidated financial statements for the year ended 31 December 2004 and in preparation of an opening IFRS balance sheet at 1 January 2004 (the Group's date of transition).

In preparing its opening IFRS balance sheet, the Group has adjusted amounts reported previously in consolidated financial statements prepared in accordance with its old basis of accounting (UK GAAP). An explanation of how the transition from UK GAAP to IFRSs has affected the Group's financial position and financial performance is set out in the following tables and the notes that accompany the tables.

The transition to IFRS has no impact on the cash flows of the Group.

Implementation of IAS 32 and IAS 39

The Group has taken the exemption from the requirement to restate comparative information for IAS 32 (Financial Instruments: Disclosure and Presentation) and IAS 39 (Financial Instruments: Recognition and Measurement) in accordance with IFRS 1 (First-time Adoption of International Financial Reporting Standards).

The Group has continued to apply UK GAAP in respect of financial instruments for the comparative period presented. If IAS 32 and IAS 39 had been adopted, the market value of derivative financial instruments would have been recognised on the face of the balance sheet with the movements accounted for through the income statement or hedging reserve as appropriate.

IAS 32 and IAS 39 have been implemented with effect from 1 January 2005.