Accounting policies

The principal accounting policies adopted in the preparation of these financial statements are set out below. Further detail can be found in note A7.

Basis of preparation

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union (EU). They have been prepared on the historical cost basis, except for the revaluation of financial instruments, accounting for the transfer of assets from customers and the revaluation of infrastructure assets to fair value on transition to IFRS.

The preparation of financial statements, in conformity with IFRS, requires management to make estimates and assumptions that affect the amounts of assets and liabilities at the date of the financial statements and the amounts of revenues and expenses during the reporting periods presented. Although these estimates are based on management's best knowledge of the amount, event or actions, actual results ultimately may differ from these estimates.

The financial statements have been prepared on the going concern basis as the directors have a reasonable expectation that the group has adequate resources for a period of at least 12 months from the date of the approval of the financial statements, and that there are no material uncertainties to disclose.

In assessing the appropriateness of the going concern basis of accounting, the directors have reviewed the resources available to the group, taking account of the group's financial projections, together with available cash and committed borrowing facilities as well as consideration of the group's capital adequacy, consideration of the primary legal duty of United Utilities Water Limited's (UUW) economic regulator to ensure that water and wastewater companies can finance their functions, and any material uncertainties. The board has also considered the magnitude of potential impacts resulting from uncertain future events or changes in conditions, the likelihood of their occurrence and the likely effectiveness of mitigating actions that the directors would consider undertaking.

Adoption of new and revised standards

The following standards, interpretations and amendments, effective for the year ended 31 March 2017, have had no material impact on the group's financial statements:

- Amendments to IAS 1 'Disclosure initiative', in respect of improved financial statement disclosures;
- Amendments to IFRS 11 'Accounting for Acquisitions of Interests in Joint Operations', requiring business combination accounting to be applied; and
- Improvements to IFRS (2014), comprising a collection of narrow-scope amendments across a number of standards.

Critical accounting judgements and key sources of estimation uncertainty

In the process of applying its accounting policies set out in note A7, the group is required to make certain estimates, judgements and assumptions that it believes are reasonable based on the information available. These judgements, estimates and assumptions affect the amounts of assets and liabilities at the date of the financial statements and the amounts of revenues and expenses recognised during the reporting periods presented. Changes to these estimates, judgements and assumptions could have a material effect on the financial statements.

On an ongoing basis, the group evaluates its estimates using historical experience, consultation with experts and other methods considered reasonable in the particular circumstances. Actual results may differ significantly from the estimates, the effect of which is recognised in the period in which the facts that give rise to the revision become known.

The following paragraphs detail the estimates and judgements the group believes to have the most significant impact on the annual results under IFRS.

Revenue recognition and allowance for doubtful receivables

Accounting judgement – the group recognises revenue generally at the time of delivery and when collection of the resulting receivable is reasonably assured. When the group considers that the criteria for revenue recognition are not met for a transaction, revenue recognition is delayed until such time as collectability is reasonably assured. Payments received in advance of revenue recognition are recorded as deferred income.

Accounting estimate – at each reporting date, the company and each of its subsidiaries evaluate the estimated recoverability of trade receivables and record allowances for doubtful receivables based on experience. Judgements associated with these allowances are based on, amongst other things, a consideration of actual collection history. The actual level of receivables collected may differ from the estimated levels of recovery, which could impact operating results positively or negatively.

Accounting estimate – UUW raises bills in accordance with its entitlement to receive revenue in line with the limits established by the periodic regulatory price review processes. For water and wastewater customers with water meters, the receivable billed is dependent on the volume supplied including the sales value of an estimate of the units supplied between the date of the last meter reading and the billing date. Meters are read on a cyclical basis and the group recognises revenue for unbilled amounts based on estimated usage from the last billing through to each reporting date. The estimated usage is based on historical data, judgement and assumptions; actual results could differ from these estimates, which would result in operating revenues being adjusted in the period that the revision to the estimates is determined. For customers who do not have a meter, the receivable billed and revenue recognised is dependent on the rateable value of the property, as assessed by an independent rating officer.

Property, plant and equipment

Accounting judgement – the group recognises property, plant and equipment (PPE) on its water and wastewater infrastructure assets where such expenditure enhances or increases the capacity of the network, whereas any expenditure classed as maintenance is expensed in the period it is incurred. Determining enhancement from maintenance expenditure requires an accounting judgement, particularly when projects have both

Accounting policies

elements within them. In addition, management capitalises time and resources incurred by the group's support functions on capital programmes, which requires accounting judgements to be made in relation to the appropriate capitalisation rates.

Accounting estimate – the estimated useful economic lives of PPE is based on management's experience. When management identifies that actual useful economic lives differ materially from the estimates used to calculate depreciation, that charge is adjusted prospectively. Due to the significance of PPE investment to the group, variations between actual and estimated useful economic lives could impact operating results both positively and negatively and, as such, this is a key source of estimation uncertainty, although historically few changes to estimated useful economic lives have been required.

Accounting estimate – the group is required to evaluate the carrying values of PPE for impairment whenever circumstances indicate, in management's view, that the carrying value of such assets may not be recoverable. An impairment review requires management to make uncertain estimates concerning the cash flows, growth rates and discount rates of the cash generating units under review.

Retirement benefits

Accounting estimate – the group operates two defined benefit schemes which are independent of the group's finances. Actuarial valuations of the schemes are carried out as determined by the trustees at intervals of not more than three years. The pension cost under IAS 19 'Employee Benefits' is assessed in accordance with the advice of a firm of actuaries based on the latest actuarial valuation and assumptions determined by the actuary, which are used to estimate the present value of defined benefit obligations. The assumptions are based on information supplied to the actuary by the company, supplemented by discussions between the actuary and management. The assumptions are disclosed in note A5.

Accounting estimate – profit before tax and net assets are affected by the actuarial assumptions used. The key assumptions include: discount rates, pay growth, mortality and increases to pensions in payment and deferred pensions. It should be noted that actual rates may differ from the assumptions used due to changing market and economic conditions and longer or shorter lives of participants and, as such, this represents a key source of estimation uncertainty.

Tax

Accounting judgement – assessing the outcome of uncertain tax positions requires judgements to be made regarding the application of tax law and the result of negotiations with, and enquiries from, tax authorities in a number of jurisdictions.

Derivative financial instruments

Accounting estimate – the model used to fair value the group's derivative financial instruments requires management to estimate future cash flows based on applicable interest rate curves. Projected cash flows are then discounted back using discount factors which are derived from the applicable interest rate curves adjusted for management's estimate of counterparty and own credit risk, where appropriate.

Provisions and contingencies

Accounting judgement – the group is subject to a number of claims incidental to the normal conduct of its business, relating to and including commercial, contractual, employment and environmental matters, which are handled and defended in the ordinary course of business. The group routinely assesses the likelihood of any adverse judgements or outcomes to these matters as well as ranges of probable and reasonably estimated losses.

Accounting estimates – reasonable estimates are made by management after considering information including notifications, settlements, estimates performed by independent parties and legal counsel, available facts, identification of other potentially responsible parties and their ability to contribute, and prior experience. A provision is recognised when it is probable that an obligation exists for which a reliable estimate can be made after careful analysis of the individual matter. The required provision may change in the future due to new developments and as additional information becomes available. Matters that either are possible obligations or do not meet the recognition criteria for a provision are disclosed as contingent liabilities in note 24, unless the possibility of transferring economic benefits is remote.

New and revised standards not yet effective

At the date of authorisation of these financial statements, the following relevant major standards were in issue but not yet effective. The directors anticipate that the group will adopt these standards on their effective dates.

IFRS 9 'Financial Instruments'

The standard is effective for periods commencing on or after 1 January 2018. Under the provisions of this standard, where the group has chosen to measure borrowings at fair value through profit or loss, the portion of the change in fair value due to changes in the group's own credit risk will be recognised in other comprehensive income rather than within profit or loss. If this standard had been adopted in the current year, an £11.9 million loss would have been recognised in other comprehensive income rather than within the income statement.

The standard also broadens the scope of what can be included within a hedge relationship, which may enable the group's regulatory swaps to be designated within cash flow hedge relationships. If the standard had been adopted in the current year, with all such swaps being designated and all hedges being fully effective, £0.8 million of fair value losses would have been recognised in other comprehensive income rather than within the income statement.

In addition, the standard requires entities to use an expected credit loss model for impairment of financial assets instead of an incurred credit loss model. This is expected to impact the way in which the group provides for bad and doubtful receivables. Work in this area is ongoing and it is not currently possible to quantify the expected impact as this will be dependent on the design of the model and the economic circumstances at the point of implementation; however, the current expectation is that it is unlikely to have a material impact on the overall level of provisions.

IFRS 15 'Revenue from Contracts with Customers'
The standard is effective for periods commencing on or after 1 January 2018. This standard introduces a new revenue recognition model and replaces IAS 18 'Revenue', IAS 11 'Construction Contracts', IFRIC 13 'Customer Loyalty Programmes', IFRIC 15 'Agreements for the Construction of Real Estate', IFRIC 18 'Transfer of Assets from Customers' and SIC-31 'Revenue – Barter Transactions Involving Advertising Services'. While the introduction of IFRS 15 is expected to have a significant impact for many companies, the directors have carefully considered the potential effects in the context of the group's revenues and have concluded that on adoption there will be no significant changes to the way in which the group's performance obligations to customers are identified or deemed to be satisfied and, therefore, no material impact on the revenues recognised in the financial statements.

IFRS 16 'Leases'
The standard is effective for periods commencing on or after 1 January 2019 but has not yet been endorsed by the EU. Under the provisions of the standard most leases, including the majority of those previously classified as operating leases, will be brought onto the statement of financial position, as both a right-of-use asset and a largely offsetting lease liability. The right-of-use asset and lease liability are both based on the present value of lease payments due over the term of the lease, with the asset being depreciated in accordance with IAS 16 'Property, Plant and Equipment' and the liability increased for the accretion of interest and reduced by lease payments.

If the standard had been adopted in the current year a depreciation charge of around £4 million in relation to the right-of-use asset and a finance expense charge of around £1 million would have been recognised in the income statement in place of the operating lease charge of £4.4 million. In addition, a right-of-use asset and largely offsetting lease liability of around £105 million would be recognised in the statement of financial position, assuming application of the modified retrospective transitional approach as permitted by the standard and current incremental costs of borrowing. The actual impact on adoption will be sensitive to the incremental costs of borrowing at the 1 April 2019 application date.

All other standards, interpretations and amendments, which are in issue but not yet effective, are not expected to have a material impact on the group's financial statements.