Applying IFRS

Heading for Brexit

Accounting and reporting considerations of the UK’s vote to leave the EU
What you need to know

• On 23 June 2016, the people of the UK voted to leave the EU (Brexit).

• There will be no immediate change to UK financial and corporate reporting requirements.

• Entities will need to monitor events to determine how financial and corporate reporting requirements will be affected over the long term.

• More relevant now to preparers and users of financial statements are the effects reflected in volatility in financial markets, the implications of future actions by governments and any decisions entities make about business and investment strategies. These will, in turn, affect entities’ disclosure of risks and uncertainties, assessments of impairment of goodwill and other assets; and the measurement of financial assets and liabilities.
Overview

Entities will need to consider the accounting and financial reporting implications of the United Kingdom (UK) people’s vote to leave the European Union (EU). In addition, entities will need to monitor events in the UK and the EU and consider the accounting and financial reporting implications of both government decisions and any changes they may make to their own operations and/or investment strategies.

There will be no immediate change to UK financial and corporate reporting requirements. How entities with significant operations or investments in the UK and the EU will be affected may not be clear for some time. Negotiations on exit terms are expected to take two years once the UK formally initiates its exit from the EU. Negotiations on new trade agreements may take longer. In the meantime, the UK will remain a member of the EU and will be bound by its legal and treaty obligations. Because the terms of the exit, including the future trade relationship between the UK and the EU, are uncertain, market volatility may continue.

In the short term, entities will need to consider the potential effects of Brexit and related market volatility when preparing their upcoming interim (or annual) reports. Entities with significant UK or EU exposure need to consider whether they should make additional disclosures in the management commentary or in the notes to the financial statements to address the implications of Brexit. Market volatility will have a more immediate effect on the measurement of assets and liabilities, not only in the determination of fair values, but also in considering appropriate parameters for forecasts and estimates. For example, increased volatility might require entities to reconsider what would constitute a reasonably expected change in key assumptions used in impairment testing and require sensitivity testing to be amended accordingly. In addition, because market volatility has not been restricted to the UK and EU, even entities without exposure to the UK or EU may need to consider the accounting and financial reporting implications.

Over the long term, a UK exit from the EU could have implications for entities that have operations in the UK and/or investments in UK entities. For example, how UK entities will access the EU single market is unclear. EU entities with significant customer or vendor relationships with UK entities also need to consider how new trade agreements will affect their operations.

This publication addresses financial accounting and reporting considerations that entities may need to consider in preparing their upcoming interim (or annual) financial statements and reports. In most cases, it is too early to tell how an entity will ultimately be affected by the UK’s separation from the EU. What is certain is that as events unfold, affected entities are likely to experience change. While navigating these changes may be challenging for some entities, it could provide others with opportunities.
Appendix: Reporting and accounting considerations

Financial reporting considerations

There will be no immediate change to UK financial and corporate reporting requirements. However, entities will need to take a fresh look at their disclosures in both the management commentary and other sections of the financial report in light of Brexit.

The additional uncertainty arising in the aftermath of the vote will impact the risks and uncertainties entities face and influence management’s considerations about their future viability and the use of the going concern basis in the preparation of financial information.

Entities subject to IAS 34 Interim Financial Statements must consider the potential impact of the UK vote to leave the EU as they prepare half-yearly financial reports that comply with the following requirements, in particular:

- Under IAS 34, entities must disclose information about ‘changes in the business or economic circumstances that affect the fair value of the entity’s financial assets and financial liabilities, whether those assets or liabilities are recognised at fair value or amortised cost’.
- The areas of the financial statements that may require additional disclosures to reflect adequately the risks that an entity is exposed to are discussed below.
- IAS 1 Presentation of Financial Statements, paragraphs 122 and 125, requires entities to disclose judgements that management has made in applying the entity’s accounting policies that have the most significant effect on the financial statements, and the major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities.
- IFRS 7 Financial Instruments, paragraph 31, requires disclosures that enable users of financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed.

Entities should consider whether the potential effects of Brexit materially change their previously disclosed judgements and sources of estimation uncertainty, or whether an entity is exposed to any new factors resulting from the vote. These disclosures should be tailored to an entity's facts and circumstances, including a discussion of the entity's affected operations and the specific effects on its operations, liquidity and financial condition.

Brexit may result in greater uncertainty about the fair value estimates used to measure financial instruments and to test assets for impairment. Entities should consider whether additional quantitative and qualitative information is appropriate. For example, changes in the sensitivity of reasonably possible outcomes related to goodwill impairment assumptions may warrant additional disclosure in accordance with IAS 36 Impairment of Assets, if they are material.

Fair value measurement and disclosures

While the financial market volatility may give rise to concerns by some that the prices observed do not reflect fair value, it would not be appropriate to disregard prices from non-distressed transactions at the measurement date.
As a reminder, the objective of fair value measurement is to estimate the price at which an orderly transaction to sell an asset or transfer a liability would take place between market participants under the current market conditions that exist at the measurement date. The intent is to convey the current value of the asset or liability at the measurement date, not its potential value at a future date.

In times of market volatility, it is more important than ever to ensure that valuation methodologies are adequately explained, key assumptions are disclosed and appropriate consideration is given to the use of sensitivity analysis.

**Foreign currency matters**

*Use of exchange rates*

Generally, revenue and expense items attributed to foreign currency transactions are recognised (or translated) using the exchange rate in effect at the date of the transaction. However, IAS 21 *The Effects of Changes in Foreign Exchange Rates* allows, for practical reasons, entities to use an appropriately weighted average exchange rate for a reporting period if it approximates the actual rate.

Whenever there is a sudden and significant change in foreign currency exchange rates (e.g., the US dollar (USD) to British pound (GBP)), that may affect the way the weighted average is calculated.

*Monetary items included as part of the net investment in a foreign operation*

When an exchange difference arises on an intragroup balance that, in substance, forms part of an entity's net investment in a foreign operation, then the exchange difference is not recognised in profit or loss in the consolidated financial statements, but is recognised in other comprehensive income and accumulated in a separate component of equity until the disposal of the foreign operation. This will include a monetary item that is receivable from or payable to a foreign operation, for which settlement is neither planned nor likely to occur in the foreseeable future (often referred to as a 'permanent as equity' loan) because it is, in substance, a part of the entity's net investment in that foreign operation. Such monetary items may include long-term receivables or loans. They do not include trade receivables or trade payables.

The question of whether or not a monetary item is as permanent as equity may, in certain circumstances, require the application of significant judgement. Entities that have characterised intercompany transactions with entities in the UK or the EU as part of their net investment may need to revisit their assertions and long-term plans for such intercompany transactions to determine whether those intragroup balances still qualify for the exception from recognising exchange differences in profit or loss. For example, changes in the economic environment might require entities to redeploy funds around a group, such that previous assertions of permanence no longer apply.

*Changes in functional currency*

In the medium or long term, entities may adjust their trading relationships with entities in the EU and the rest of the world as a result of trade negotiation and trade agreements between the UK and other countries. In these circumstances, entities need to monitor the primary economic environment in which they generate and expend cash, and assess if there is a change in the functional currency.
Valuation of financial assets

Volatility in global markets may affect the fair value of debt and equity investments held by investors. All financial assets, except for those measured at fair value through profit or loss, are subject to review for impairment. A financial asset, or a group of assets, is impaired (and impairment losses are determined) if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after initial recognition (loss event) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of assets that can be reliably estimated.

A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be when considered with other available information. Other factors that would be considered in determining whether an impairment loss has been incurred include information about the debtors' or issuers' liquidity, solvency and business and financial risk exposures, levels of, and trends in, delinquencies for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees.

Available-for-sale equity securities

In addition to the impairment indicators discussed above, a significant or prolonged decline in the fair value of an available-for-sale (AFS) equity security is also deemed to be objective evidence of impairment. The significance of the decline in value is assessed in comparison to cost. Determining how much is “significant” and how long is “prolonged” requires judgement. However, the fact that the entire market has declined in value does not affect the analysis. Entities with a functional currency other than GBP, that own AFS securities denominated in GBP, should assess whether any decline in fair value of the securities as expressed in their functional currency, represents a significant or prolonged decline in fair value (i.e., a decline in fair value of a GBP equity security will be made worse by a decline in GBP exchange rate).

Available-for-sale and held-to-maturity debt securities

While the debt markets have generally not experienced as much volatility as the equity markets, entities should continue to monitor their investments in debt securities for indications of impairment.

For held-to-maturity debt securities, an entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and then individually or collectively for financial assets that are not individually significant.

Counterparty credit risk

In addition to monitoring the credit risk of their counterparties, entities should consider the effect of market volatility on collateral values when evaluating loans and other receivables for collectability.

Equity method investments

Equity method investments (including investments in joint ventures) may need to be considered for both the assessment of impairment of the assets of the associate or joint venture, and whether it is necessary to recognise any additional impairment loss in accordance with IAS 39 Financial Instruments: Recognition and Measurement with respect to the investor's net investment in the associate or joint venture.
Hedge accounting

The effects on hedge accounting may, in large part, depend on the nature of the agreements that will establish the framework for the UK's future relationship with the EU. If the renegotiated trade deals between the UK and the EU result in significant changes to entities' business practices, the impact on hedge accounting could be greater. For example, if there is a need for a UK or EU entity to modify or amend the terms of any existing financial or non-financial contracts that are part of a hedge relationship, this could result in a de-designation of the hedge or affect whether the relationship is expected to continue to be highly effective in future periods.

Hedge accounting will also be affected by the movements in market prices. Specifically, cross currency basis spreads became very volatile the day after the referendum, but less volatile in the days thereafter. Cross currency basis spreads are generally not part of a documented hedged risk and, consequently, changes in fair value of derivatives from changes in cross currency basis spreads result in ineffectiveness. Entities should assess at the reporting date whether such ineffectiveness has occurred for accounting hedges and whether those hedges are still within the required 80-125% bandwidth for ineffectiveness. Ineffectiveness should be accounted for in profit or loss, and hedge accounting should be ceased when effectiveness is outside the 80-125% bandwidth.

Goodwill and other intangible assets with an indefinite useful life

Entities performing impairment tests for goodwill and other intangible assets need to take Brexit into consideration when defining their expectations of the performance of reporting entities and cash generating units.

Entities are required to test goodwill and intangible assets with an indefinite useful life for impairment at least annually and more frequently if there is an indication that the asset may be impaired. Entities that generally do not perform their annual impairment test in the second quarter should assess whether the outcome of the referendum and Brexit give rise to new indicators of impairment. Entities are expected to have at least a high-level overview on what the effects of Brexit might be on the key financial assumptions used to determine recoverable amounts and other potential consequences for the entity.

If the share price of an entity significantly declined and did not recover since the referendum, that may be an indicator that either fair value or recoverable amount, or both, are perceived by the market to be lower. Entities should consider if there have been significant changes in market assessments of economic growth, interest rates or market liquidity. In addition, entities should also consider if significant changes with an adverse effect are expected to take place in the near future (e.g., plans to discontinue or restructure the operations). If the high-level overview or change in share price are indicators for impairment, goodwill and intangible assets with an indefinite useful life should be tested for impairment in the second quarter of 2016.

When performing the goodwill impairment test, cash flows should reflect the latest estimates. The discount rates used should also reflect the current market assessment of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted.
Property, plant and equipment and intangible assets with a finite useful life

Property, plant and equipment and intangible assets with a finite useful life are tested for impairment when factors are present that indicate the recorded value of a non-current asset (or asset group) may not be recoverable.

IAS 36 uses the term cash generating unit (CGU) for the smallest identifiable group of assets that together have cash inflows that are largely independent of the cash inflows from other assets. If there is an indication that an asset may be impaired, the recoverable amount of the asset (or, if appropriate, the CGU) is determined. The asset or CGU is impaired if its carrying amount exceeds its recoverable amount, defined as the higher of fair value less costs of disposal and value in use.

Defined benefit plans

Market volatility could have implications for the measurement of the pension asset or liability under defined benefit schemes. For example, declines in equity markets and potential changes in interest rates could have a significant effect on the fair value of plan assets and the funded status of plans, as well as the defined benefit obligation. Defined benefit obligations should continue to be discounted at discount rates derived from high-quality corporate bonds in the currency (zone) of the pension obligations.

It is possible that the fair value of plan assets of a particular defined benefit plan has decreased as of the reporting date. Furthermore, interest rates may have moved compared to the previous reporting date, resulting in a different present value of the defined benefit obligation. The effect of such changes is accounted for in other comprehensive income. IAS 34 stipulates that interim measurements may rely on estimates to a greater extent than measurement on annual financial data. Entities may have a practical issue as detailed defined benefit obligations are only determined annually. Such entities should assess whether the outcome of the referendum has such an effect that, in the second quarter of 2016, a more detailed calculation is needed for the defined benefit obligation than generally is considered sufficient at quarter ends.

Income taxes

The decision by UK voters to leave the EU could have numerous implications for accounting for income taxes.

In addition to the accounting associated with changes in operating and legal structures and changes in tax treaties and tax laws, entities may need to consider other income tax accounting matters including:

- The recovery of deferred tax assets
- The deferred tax liability for taxable temporary differences (outside basis differences) associated with the group's investments in subsidiaries, branches and associates or interests in joint arrangements
- The accounting for uncertain tax positions

Future realisation of deferred tax assets in excess of deferred tax liabilities recognised at the reporting date ultimately depends on the existence of sufficient taxable income of the appropriate character under the relevant tax law. Determining whether deferred tax assets qualify for recognition under
IAS 12 Income Taxes often requires an extensive analysis of the positive and negative evidence for the realisation of the related deductible temporary differences and, inherent in that, an assessment of the likelihood of sufficient future taxable income. Volatile economic conditions add complexity to this analysis and may be a source of negative evidence.

Entities with operations in the UK and other affected regions should challenge whether they can continue to assert that temporary differences with respect to subsidiaries, branches and associates or interests in joint arrangements will not reverse in the foreseeable future. For example, groups might need to reconsider the need to repatriate funds from investees in order to satisfy liquidity requirements in their UK operations and elsewhere.

By their very nature, tax laws are often subject to interpretation. Further complicating matters is that in those cases where a tax position is open to interpretation, differences of opinion can result in differing conclusions as to the amount of tax assets or liabilities to be recognised. If a taxing authority (e.g., Her Majesty’s Revenue and Customs) changes how it evaluates an arrangement based on Brexit, that could constitute new information that should be evaluated for financial reporting implications, including accounting for uncertain tax positions. However, the requirement in IAS 12 Income Taxes remains to measure current and deferred tax assets and liabilities by reference to tax rates and laws that have been enacted or substantively enacted by the end of the reporting period. Even in times of economic uncertainty, it is inappropriate to anticipate future changes to tax legislation.

Provisions
IAS 37 Provisions, Contingent Liabilities and Contingent Assets requires the discount rate that is used to calculate the present value of expected expenditures to reflect current market assessments of the time value of money and risks specific to the liability. Changes in interest rates following the outcome of the referendum that do not reflect changes in the time value of money (but, for example, credit risk) or the risk specific to the liability, are not relevant to the measurement of provisions under IAS 37. However, changes to other economic indicators may well effect the estimates of future cash flows inherent in the provision.

Next steps
Entities should monitor developments and consider the effects on their financial reporting.
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