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FINANCIAL REPORTING FACULTY

BREXIT - REFLECTIONS ON IMPLICATIONS FOR FINANCIAL REPORTING

GUIDE

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A summary of the key financial reporting considerations for December 2020 year-ends and beyond.

INTRODUCTION

The Brexit countdown is drawing to a close, with the UK's legal framework for accounting and corporate reporting set to operate independently from EU law from 11pm (GMT) on 31 December 2020. Companies now need to focus on the implications for their year-end reporting. This short guide looks at some of the main areas to focus on, divided into the following four topics:

1. Narrative reporting;
2. Financial reporting;
3. Audit and going concern;
4. Company law.

1. NARRATIVE REPORTING

With Brexit talks continuing right up to the wire, there remains a lot of uncertainty for business. Companies should endeavour to reflect these uncertainties in their reporting and, depending on the significance and sensitivity of different scenarios, should look to make informative, company specific disclosures. Ideally these should cover near-term planning as well as medium and long-term implications.

Brexit implications are likely to vary significantly from business to business. Whether companies have challenges arising from for example, supply-chain, regulatory matters, labour mobility, custom tariffs, or macro-economic issues, these need to be clearly explained to the users of the financial statements. The significance of the impact should correlate with the level of detail of the disclosures provided. Even if the impact is minimal, it is useful for management to convey their conclusions and the basis of their assessment.

One of the key locations for the disclosure of the impact of Brexit will be the strategic report (applicable to all companies except small companies under UK law). In particular, consideration of Brexit-related issues in the strategic report will be needed in the following areas:

i. A fair review of the company's business

Explanations of the impact of Brexit on the current year's performance will be important and should be clear and balanced.

ii. A description of principal risks and uncertainties

When preparing the strategic report, companies are required to provide "*a description of the principal risks and uncertainties facing the company*". The description (which is often disclosed as a list along with detailed explanations) should include only those that are principal, or key, to the business. This, therefore, may not include the impact of the UK's EU exit where it is considered to be negligible or not significant to the business. However, that said, it may still be helpful for companies to explain this fact and the basis for the conclusions reached, given the importance of the issue to the wider economy.

Where the impact is more significant, companies are encouraged to make clear and company specific disclosures explaining the facts and circumstances. In addition, boards are encouraged to provide explanations of how they are managing or mitigating risks.

iii. Information on the main trends and factors likely to affect the future development, performance and position of the company's business

Company law requires that the directors' report provides "*an indication of likely future developments in the business*" (this disclosure may be presented in the strategic report in accordance with Section 414C (11) of the Companies Act).

Where relevant, companies should include forward-looking analysis and discussion on the likely impact Brexit on future performance and development.

iv. Business models

The Strategic Report Regulations require the disclosure of business models by quoted companies (as well as companies voluntarily following the FRC's guidance). It is widely acknowledged that business model reporting provides extremely important information to investors.

In practice, business model disclosures have tended to vary, ranging from very high level to quite detailed, and covering different information sets. Given that Brexit implications can be wide-ranging, impacting areas such as people/workforce, legal, IT, pricing, finance, tax and supply-chains, there is a need to explain the extent to which business models are resilient and flexible.

v. Viability statements

For those companies required to include a viability statement in their annual report and accounts, Brexit will be a key additional consideration for this year-end. As well as any direct impact on the viability statement, disclosures on assumptions applied in assessing the company's viability may also need to be reviewed.

For more information on the scope and content of the strategic report visit icaew.com/strategicreports.

2. FINANCIAL REPORTING

Whether the implications of Brexit on financial reporting are minimal or significant will depend on the nature of a company's business activities and operations; each company will be impacted differently.

Whilst there are certain Brexit-related changes to company law (see section 4 below), there are no new accounting and financial reporting requirements that relate specifically to the UK leaving the EU. However, there are likely to be additional considerations as a result of Brexit under existing financial reporting requirements. In particular, there are many accounting areas that require management to apply judgements and estimations when measuring and determining the carrying amounts of assets and liabilities to be reported in the financial statements. A thorough assessment of the impact of Brexit is likely to be fundamental to ensuring that judgements and estimates are reasonable and appropriate.

Set out below are certain key measurement and disclosure considerations.

MEASUREMENT CONSIDERATIONS

Brexit adds to the significant market uncertainty brought about by COVID-19. This combination is likely to put substantial pressure on financial statement measurements and forward-looking assessments.

i. Measurement of non-financial assets

Assumptions underpinning the recoverability of the value of assets such as goodwill, intangibles and property, plant and equipment will have to be carefully considered given the potential 'double hit' of COVID-19 and Brexit uncertainties. Alongside mandatory impairment testing, there are also likely to be more indicators of impairment arising.

Cash flow forecasts used in impairment calculations should be based on budgets and forecasts reflecting economic conditions at the balance sheet date, taking account of the potential impact of Brexit. The full implications of Brexit will be unclear for some time, and consequently management forecasts are likely to be subject to significant uncertainty. Hence, disclosures of assumptions and estimates (see below) and appropriate sensitivity analysis are likely to be critical areas for disclosure in the year-end financial statements.

Cash flows used for impairment testing can follow a traditional approach (single predicted outcome) or an expected cash flow approach (multiple probability-weighted scenarios). Where there is significant uncertainty in the cash flows, in practice it might be more appropriate to use an expected cash flow approach.

ii. Financial instruments

Brexit could have wide ranging implications for the valuation of financial instruments, whether this relates to market prices (used for either determining fair value for certain instruments or the inputs used in valuation techniques) or the assumptions used to determine whether there is any impairment of loans and receivables.

Companies reporting under IFRS need to assess the expected credit losses that will be incurred as a result of the impact of Brexit on their customers and recognise credit loss provisions for increases in expected non-recoverability of receivables. Companies reporting under FRS 102 must assess whether, as at the reporting date, there is objective evidence of impairment.

iii. Inventories

Companies must assess whether inventory is held at an appropriate carrying value (the lower of cost or net realisable value) at the reporting date. Brexit may for example affect directly attributable costs, such as potential customs tariffs.

When determining the net realisable value of inventory, management must assess the estimated selling price of the goods less the estimated cost of completion and the estimated costs necessary to make the sale.

iv. Deferred tax assets

The recognition of deferred tax assets depends on the extent that it is probable that future taxable profits will be available. When preparing projections of future taxable profits for the purposes of the deferred tax asset recognition test, companies will need to reflect expectations at the reporting date, including any changes in the economic outlook brought about by Brexit.

v. Foreign exchange

Brexit may also bring more exchange rate volatility. For certain businesses, foreign exchange implications could be significant. Other issues such as foreign exchange hedging may also need to be considered.

vi. Onerous contracts

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Companies will need to consider whether any contracts may become onerous as a result of Brexit, for example where there is expected loss of revenue, and/or increased costs associated with a contract. Where a contract has become onerous, a provision is required.

DISCLOSURE CONSIDERATIONS

Disclosures in financial statements are critically important at the current time given the amount of economic uncertainty, including that related to Brexit. The FRC has announced that one of its priorities for 2020/21 will be the adequacy of disclosures addressing the uncertainties surrounding the UK's EU exit.

One of the key areas where Brexit may impact is disclosures of significant estimates and judgements, including the sensitivities of key estimates. This should be a real area of focus for the year-end. Companies will also need to assess whether there is a change in their financial risks, such as credit risk, liquidity risk and currency risk, that needs to be reflected in the disclosures.

OTHER CONSIDERATIONS

Directors' duties and dividends

As a result of Brexit and other uncertainties it is particularly important that directors consider their fiduciary duties to safeguard the company's assets and ensure that the company is able to pay its debts as they fall due. This is particularly relevant when deciding on dividend payments.

More information is available in the Introduction to the Law on Dividends.

3. AUDIT AND GOING CONCERN

Brexit brings with it an element of uncertainty for many, and for some there may be uncertainty around the ability of the company to continue as a going concern.

Given the increased likelihood of material uncertainties and the possibility that some accounts will be prepared on a basis other than going concern, auditors are likely to view going concern as a heightened and/or significant risk area. A new auditing standard also requires a more comprehensive and structured auditor risk assessment as a starting point when considering going concern.

Management may need to be prepared for the possibility of a 'modified audit report' on the accounts given current levels of uncertainty. More information on why a modified audit report might be necessary and the different types of audit report wording is available in the guide Coronavirus: understanding audit reports.

4. COMPANY LAW

Brexit-related changes to UK company law come into effect after the end of the transition period ie, after 31 December 2020. Where previously UK company law referred to the EEA or an EU regulated market, these references have been amended to refer to the UK only.

All changes are effective for accounting periods beginning on or after 1 January 2021 unless otherwise noted.

i. Small and medium-sized companies and groups

Companies that qualify as 'small' are eligible to use a number of accounting, auditing and filing exemptions. Companies that are part of an 'ineligible group' are excluded from the small companies regime. The current definition of an ineligible group is one that includes, inter-alia, a company whose shares are traded on a regulated market in an **EEA State**.

When the reference is changed to a company whose shares are traded on a regulated market in the **UK** (only), the definition of an ineligible group will be less restrictive. More companies could, potentially, qualify as small.

For more information on the eligibility criteria visit icaew.com/smallcompanyreporting.

ii. Exemption from preparing group accounts for intermediate parents

A UK intermediate parent company is currently exempt from preparing group accounts (subject to certain additional conditions) when:

- The UK intermediate parent and its subsidiaries are included in the consolidated accounts of an **EEA parent** (CA 2006 s400); or
- The UK intermediate parent and its subsidiaries are included in the consolidated accounts of a non-EEA parent whose accounts are prepared in an 'equivalent' manner. Accounts that are considered equivalent would include, inter-alia, accounts that are prepared in accordance with IFRS as issued by the IASB and IFRS as adopted by the EU (CA 2006 s401).

When the reference in s400 is changed to the consolidated accounts of a **UK parent,** the exemption under this section will no longer be available when the parent is established in one of the remaining EEA states. However, the exemption from preparing group accounts may still be available if the higher parent company prepares its consolidated accounts in an equivalent manner.

iii. Change of accounting framework

A company that has elected to prepare its individual accounts under EU-adopted IFRS (or a group that has elected to prepare its consolidated accounts under EU-adopted IFRS) can switch to UK GAAP if there has been a 'relevant change of circumstance' (CA 2006 s395). A relevant change in circumstance currently includes:

- An entity ceasing to be traded on an **EU-regulated market**; and
- Ceasing to be a subsidiary of a parent whose securities are traded on an **EU-regulated market**.

When the reference is changed to a **UK-regulated market**, it will restrict the opportunities for a company to switch back to UK GAAP. However, a company can still switch to UK GAAP provided five years have elapsed since the last time it switched from IFRS to UK GAAP.

iv. Dormant companies

Dormant subsidiaries are not required to prepare or file individual accounts for a financial year when certain conditions are met, including the existence of a statutory guarantee by the parent of all of the subsidiary's outstanding liabilities at the year-end (CA 2006 s394).

Currently the parent giving the guarantee must be incorporated in an **EEA state**. When the reference is changed to the parent being registered in the **UK**, subsidiaries with parents incorporated in the remaining EAA states will no longer be eligible for the exemption.

v. Exemption from audit by way of parent company guarantee

Similarly, a subsidiary may be exempt from audit when certain conditions are met, including the existence of a statutory guarantee by the parent of all the subsidiary's outstanding liabilities (CA 2006 s479A). The parent providing the guarantee must be incorporated in an **EEA state** and the subsidiary included in the consolidated accounts prepared in an 'equivalent' manner (see above).

When the reference is changed to the **UK**, subsidiaries with parents incorporated in the remaining EAA states will no longer be eligible for the exemption.

vi. Accounting reference period

Generally, a company may not extend its accounting period more than once in any five-year period. An exception to this rule is that a subsidiary or parent of a **UK or EEA** undertaking may change its accounting reference date to coincide with that of the other undertaking.

When the reference is changed to the **UK** only, the exception to the general rule will be restricted to UK parents and subsidiaries. This change comes into effect on at 11pm on 31 December 2020.

FURTHER GUIDANCE

You can find more information on the implications of Brexit at icaew.com/brexit.

For more guidance on the requirements of IFRS and UK GAAP visit icaew.com/financialreporting

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