IFRS Alert

Potential financial reporting implications of 'Brexit'

Issue 2016-06

Executive summary

On 23 June 2016, the United Kingdom (UK) voted to leave the European Union (EU). This IFRS Alert addresses some of the possible financial reporting implications of that decision. The issues discussed are potentially relevant to all entities, although they are likely to be particularly significant for entities operating in the UK and the rest of Europe.

Background

The UK held a referendum on 23 June 2016 to decide whether the UK should leave or remain in the EU. Leave won by 52% to 48%. Once the UK delivers formal notice of its intention to leave the EU under Article 50 of the Lisbon Treaty it will have two years to negotiate its withdrawal.

Financial reporting implications

It is difficult to predict the long term implications of the UK's decision as this will depend on the specific results of the withdrawal negotiations and the reactions of policy makers, investors and central banks around the world. What we do know is that the outcome of the referendum has already contributed to considerable currency and stock market volatility with the pound touching a 30-year low against the dollar in the immediate aftermath (retreating slightly from this low at the time of writing).

In addition to recent market volatility, the governor of the Bank of England has made it clear that, in his view, the UK's economic outlook has deteriorated as a result of the vote and some economic intervention is likely to be required in the near term. How these events might impact a company will depend on key factors including the number of transactions with EU-based customers and suppliers and the degree to which any downturn might impact demand for a company's products. The table below highlights some of the possible financial reporting implications arising from recent events.

Standard	Issue
IAS 1 Presentation of Financial Statements	• disclosure of key judgements and sources of estimation uncertainty (impairment may be an area of specific focus) • compliance with debt covenants (potential reclassification of liabilities from non-current to current) • potential impact on going concern for companies with significant foreign exchange exposure (such as EU entities exporting to the UK or UK entities with a high level of imports from the EU) who do not have adequate risk management processes in place.
IAS 2 Inventories	• consider potential impacts on: – net realisable value of inventories – ability to qualify for volume rebates – capacity utilisation and overhead allocation rate.
IAS 10 Events After the Reporting Period	• for companies with fiscal years ending on or before 23 June 2016, any impacts from the vote will be non-adjusting events (ie disclosure only) • possible increased disclosure for items such as post-balance sheet: – restructuring – discontinuance of an operation.
IAS 12 Income Taxes	• possibility for reduced recoverability of deferred tax assets should an economic downturn materialise and lead to reduced expectations of future profitability.
IAS 21 The Effects of Changes in Foreign Exchange Rates	• potential effects of exchange rate swings will need to be considered including: – potential breaches of the 80/125% threshold for hedge effectiveness on a prospective basis – whether it is appropriate to use an average rate as an approximation of the exchange rate when translating income and expenses.
IAS 36 Impairment of Assets	• indicators of impairment may result from: – significant declines in market value – changes in markets – increases in discount rates stemming from increased instability and downgrades of credit ratings • possible impairments due to a decline in recoverable amounts (reduced fair values of assets and/or reduced cash flows associated with value-in-use).
IAS 37 Provisions, Contingent Liabilities and Contingent Assets	• should there be an economic downturn as a result of the UK's decision to leave the EU, then consideration may need to be given to: – contracts becoming onerous – litigation as a result of contract terms being changed – possible reorganisations and redundancies – the effect on discount rates.

Standard	Issue
IAS 38 Intangible Assets	• whether development projects have become less feasible (possible need for an impairment review).
IAS 32 Financial Instruments: Presentation	• consideration may need to be given to the guidance on amending terms relating to convertible bonds.
IAS 39 Financial Instruments: Recognition and Measurement	• increased difficulty in reliably measuring fair value of equity instruments without a quoted price in an active market (possible need to measure at cost) • possible impairment of financial assets arising from increased credit risk • potential need for reclassification of financial assets (current versus non-current; and fair value through profit or loss or available for sale to loans and receivables) • impact of counterparty credit risk on hedge effectiveness.
IFRS 2 Share-based Payments	• there may be potential effects on share-based payment accounting as a result of: – redundancies (cancellation or failure to meet service conditions) – vesting conditions - market or performance conditions not being met – replacement and re-pricing of options.
IFRS 3 Business Combinations	• subsequent changes to the fair value of contingent consideration promised in a pre-vote business combination will impact profit or loss in the period of change but not the original purchase price allocation.

For all companies, maintaining a focus on clear disclosure, in particular relating to risk and sensitivity analyses, will be key.