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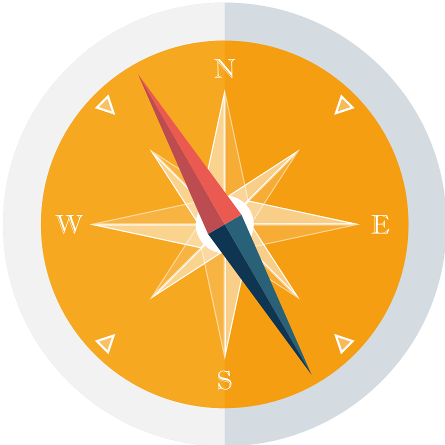

IFRS in Focus

UK referendum on membership of the European Union

Financial reporting implications

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For more information please see the following websites:

www.iasplus.com

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Introduction

On 23 June 2016, a referendum in the United Kingdom returned a result in favour of leaving the European Union (commonly referred to as 'Brexit') by a margin of 52% to 48%. This was immediately followed by the resignation of David Cameron as Prime Minister, with a successor due to be chosen later in the year.

Whilst the longer term political and economic effects of these events are as yet unclear (Article 50 of the Lisbon Treaty, which results in withdrawal within two years, has not yet been activated and there have to date been no negotiations on Britain's future relationship with EU member states), the announcement of the referendum result immediately triggered a significant amount of market turbulence, including:

- Significant volatility in UK equity markets, particularly in the banking sector.
- Sterling falling by 10% against the U.S. dollar and 8% against the Euro.
- Downgrade of the UK's credit rating by major ratings agencies.

The effects of the referendum have also been felt further afield, with significant volatility in, for example, other European, North American and Asian stock markets.

Many entities will be preparing either interim or annual financial reports for the period to 30 June 2016. The on-going financial reporting implications of the political situation in the UK will need to be considered when those reports are prepared.

The purpose of this publication is to remind preparers of the main issues that they will need to think about as entities prepare their IFRS financial statements as at 30 June 2016.

Financial reporting consequences at a glance

Firstly, it is important to note that there are no areas of accounting that are directly dependent on Britain's membership of the European Union and that, for the foreseeable future, the requirements on UK companies for use of IFRSs as endorsed in the European Union (including the need for endorsement of new standards before they can be applied) will not change.

There are, however, a number of areas in financial reporting that could be affected by either the volatility in the financial markets or longer term uncertainty that has resulted from the result of the referendum.

Disclosures on risk and uncertainty

It is important that an entity's financial reports includes information to help investors assess how economic circumstances affect the entity. For annual reports this will include the discussions of critical accounting judgements and areas of estimation uncertainty required by IAS 1 *Presentation of Financial Statements*, which could have changed as a result of recent events. In some cases, this could extend to discussion of the entity's ability to continue as a going concern.

In addition, IFRS 7 *Financial Instruments: Disclosures* requires disclosure of information about credit risk, liquidity risk, market risk and concentrations of risk relating to financial instruments and IFRS 13 *Fair Value Measurement* requires disclosure of inputs to fair value measurements. These standards include requirements to provide a sensitivity analysis for market risks and changes in unobservable inputs to a valuation respectively.

In light of the recent level of market volatility, it may be necessary to revisit the level of volatility that is considered reasonably possible for these purposes.

These disclosures should be specific to the entity, rather than boiler-plate statements about the current political situation, and proportionate to the exposure of an entity to the British economy.

For interim financial statements presented in a condensed format under IAS 34 *Interim Financial Statements*, the disclosures are likely to be less extensive because the notes should focus on highlighting matters that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last *annual* reporting period. But they should still be sufficient to provide users with an understanding of the effect of recent developments on the entity. Again, these need to be specific to the entity.

In addition to the requirements of IFRSs, many local laws or regulations require disclosure of the risks facing an entity. For example:

- Requirements based on the EU Transparency or Non-Financial Reporting Directives include a discussion of the entity's business model and the principal risks linked to an entity's operations.
- SEC Regulation S-K similarly requires disclosure of the risks facing an entity.

The current situation may lead entities to consider whether new risks have emerged or previously identified risks have become more significant.

Foreign exchange

For entities with a functional currency other than sterling, the exchange rate as at 30 June 2016 must be used for the retranslation of sterling denominated monetary items. This rate must also be used for translation of the assets and liabilities of foreign operations with a sterling functional currency into a different presentation currency.

Both in recording foreign currency transactions in an entity's functional currency and restranslating the income and expenses of a foreign operation, IAS 21 *The Effects of Changes in Foreign Exchange Rates* permits the use of an average rate as an approximation to the spot rate at the date of a transaction. Given the recent volatility in the exchange rates between sterling and other currencies, it may be necessary to consider whether the methodology for determining any such average needs to be adjusted to reflect the effect on any significant transactions occurring late in June.

Fair value measurement

The measurement of assets and liabilities at fair value should reflect that value as at 30 June, including the effect of market volatility at that date as volatility in the prices in an active market is not sufficient reason to move away from them on the basis that they are not 'orderly' transactions. Inputs to a valuation model (for example, a discounted cash flow calculation) may, however, need to be reassessed in the light of current uncertainties.

Pensions

Considerations of fair value will also apply to the measurement of plan assets of a defined benefit scheme under IAS 19 *Employee Benefits* whilst measurement of a defined benefit obligation will also be sensitive to the yield on high quality corporate bonds, which form the basis for determining a discount rate for that liability.

Entities preparing interim financial statements at 30 June will need to consider whether a significant market fluctuation necessitating remeasurement at that date (in accordance with the requirements of IAS 34) has occurred.

Impairment

Entities will need to consider whether the current conditions give rise to any indicators of impairment that necessitate the performance of a full impairment review. Notably, IAS 36 *Impairment of Assets* (which covers a range of assets including goodwill, intangible assets and property, plant and equipment) refers to significant changes in the economic or legal environment in which the entity operates as one such indicator. IAS 34 also requires a review for indications of significant impairment since the end of the last financial year to determine whether a detailed impairment review is required – this might include a review of goodwill for impairment other than at the point in time when an entity performs its usual annual review.

An impairment review of goodwill, intangibles or property, plant and equipment under IAS 36 will be based on expected future cash flows and profitability at 30 June. Similarly, the recoverability of deferred tax assets is assessed based on taxable profits.

Any such assessment performed as at 30 June must reflect the facts and circumstances that existed at that date and not be influenced by subsequent events. And, as for the risk issues discussed above, proper disclosures of the judgements made in performing an impairment review and the sensitivities to changes in assumptions will be important.

Impairment of inventory, on the other hand, is based on the current estimated selling price that can be achieved.

Impairment of financial assets is governed by the specific requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. Notably:

- impairment of debt assets (including, for example, trade receivables) is considered using an incurred loss model based on the recoverability of contractual cash flows; and
- impairment of equity investments classified as available-for-sale under IAS 39 is required when a "significant or prolonged" decline in the asset's value below cost occurs. The significant falls in stock markets in late June may result in the value of equity investments being significantly below its cost as at 30 June and, therefore, impaired.

Entities that have adopted IFRS 9 *Financial Instruments* (2014) would have somewhat different considerations related to impairment of their financial assets, for example, whether financial instruments carried at amortised cost have experienced a significant increase in credit risk.

Events after the reporting period

As the situation remains fluid, further political developments or market movements may occur between 30 June and the date of approval of annual or interim financial statements. Whilst these are likely to be considered non-adjusting events, consideration of whether the effect of such events need to be disclosed may be necessary.

Other matters

The above highlights some of the main issues likely to be relevant to 30 June 2016 reports, but depending on an entity's individual facts and circumstances there could be others. A more detailed discussion of the financial reporting effects of volatile market conditions is available in the previous publication Turbulent Times.

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