Brexit
The vote to leave – key considerations for half year reporting
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’). This was immediately followed by the resignation of the 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 and Article 50 of the Lisbon Treaty has not yet been activated, the announcement of the referendum result instantly 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
- Downgrade of major Banks and Financial institutions by major ratings agencies
- Significant volatility in major European, North American and Asian stock markets

For corporates and financial institutions, this is the beginning of a period of heightened uncertainty. For many businesses, this could also bring opportunity and planning should also focus on identifying and exploiting these.

With half year reporting season upon us, management will wish to present Boards of Directors with analysis of the potential impact on their business and actions being undertaken to mitigate any uncertainties.

Audit committees will need to consider the broader implications across all aspects of their remit. We would expect the interim audit committee to include a discussion of the audit risks arising from Brexit and the impact on both the external and internal audit plans, ahead of year end:

- **Internal audit scope** – should the scope of internal audit now include any contingency planning, or testing the robustness of key risk indicators which provide early warning/horizon scanning intelligence?
- **Significant risks** – is the audit committee satisfied that the internal auditors have identified all the significant risks in light of this event, and have they considered whether the changes to the political and economic environment impact risk classifications and are the planned responses to risks still appropriate?
- **Specialists** – where the external audit involves the use of specialists, in particular financial instrument, pension and valuation specialists, is there a need to discuss with them and/or revisit the scope or timing of their work?

There is also an immediate need to assess whether there are any accounting and reporting matters to address – consider risk and uncertainty disclosures, financial risk disclosures, liquidity issues and asset impairment indicators.

The purpose of this publication is to provide an overview of:

- The most significant risks to Corporates and Financial institutions in Cyprus, affected by a possible Brexit to facilitate discussion at Board and Senior Management level and
- The key financial reporting considerations Corporates and Financial institutions should consider as part of Interim and annual financial reporting
The immediate business impact
In the aftermath of the UK Referendum, businesses now need to ensure that they are set up to navigate the immediate risks and impacts of a UK exit, and have the processes and people in place to manage a period of uncertainty. We have identified six major channels through which Cyprus based Corporates and Financial Institutions could be affected:

Market uncertainty and reduced availability of capital: Higher uncertainty would tend to fuel capital outflows and depress the value of UK denominated assets. Short term market liquidity fears have prompted HM Treasury and the Bank of England to make available £250bn of additional liquidity.

For Cyprus corporates and financial institutions looking to raise capital in the London Stock Exchange or through UK Financial institutions, it would be wise to review the financing needs over the short and medium term, review the terms of facilities and consider the impact of any plans to raise or refinance debt. Considerations should include whether the lending facilities include Brexit clauses and, if so, what this means for the businesses and whether contingency plans need to be put in place.

Sterling depreciation: Cyprus export companies, should consider if their hedging strategies remain effective in light of the depreciation in the value of sterling. Worth noting that a reduction in sterling combined with low interest rates may also make UK assets attractive to opportunistic buyers.

Fall in business confidence: Over the last 8 years Deloitte’s CFO survey has shown that lower business confidence and risk appetite is associated with weaker capital spending, M&A and hiring. Whilst economists are reviewing their forecasts, it would be wise for businesses to consider how they would react to a more risk averse business environment and potentially reduced spending in the UK.

A premium on communications: Organisations which are likely, or at least perceived to be, most impacted by Brexit will need to communicate in a timely and effective fashion with investors, employees and customers. Other organisations such as large exporters to the UK may wish to re-assure stakeholders that the effect on them is limited. After the initial wave, all stakeholders will wish to have regular updates as the situation evolves and effective communicators will normally be admired. Businesses need to ensure they have a clear communication plan in place.

Direct tax implications: In the short term, the vote to leave the EU will have little, if any, immediate impact on the approach to or structure of indirect or direct taxes. The UK remains an EU Member State until a secession agreement has been concluded.

Few changes are likely to occur while the secession negotiations take place and the scope of future tax changes would be determined by the outcome of those negotiations. Following secession it is possible that the UK’s approach to taxation could diverge from the current position, as future governments could have additional freedom of choice. Some of the possible models for post-EU arrangements would include continued adherence to the EU’s direct tax obligations, though.

Indirect tax: The UK would need to introduce its own customs duty system, although some models would allow the UK to remain in Customs Union with the EEA and EU states. VAT is already a part of UK law and would continue without the VAT Directive, subject to future changes and new legislation for some minor points. Importantly, going forward decisions of the Court of Justice of the European Union would no longer impact UK VAT rules.

Even without EU legal constraints, the UK is unlikely to develop wholly new tax systems. The EU direct tax restrictions are relatively minor and the focus on a territorial system of corporate tax is a model adopted by many other countries.
Corporate reporting – implications for half yearly and annual reports

The ongoing financial reporting implications of the UK political situation, the volatility in the financial markets or longer term uncertainty that has resulted from the referendum in the UK will need to be considered by senior management and board members, in light of the upcoming half year reporting and in preparation of the full year end reporting.

Disclosures on risk and uncertainty

It is important that an entity’s financial reports include 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.

- Critical accounting judgments and areas of estimation uncertainty – For the half yearly report, Senior Management and Audit Committees should consider the requirements to provide an explanation of events and transactions 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. Sterling depreciation will likely affect many end of June balance sheets.

- Principal risks and uncertainties – what is the impact on the company’s principal risks and how are they being managed? Disclosure could include new risks that need to be disclosed or changes to the potential impact or likelihood and mitigating activity for existing risks. Based on the expected impact on businesses outlined above, the current situation may also lead entities to consider whether new risks have emerged or previously identified risks have become more significant.

- Going Concern –Senior Management and Directors would need to consider the effect of any of the risks, identified above, on the company’s longer term viability. In the second half of the year most companies will be embarking on their medium term planning cycle prior to budget approvals in Q4. Directors and Senior Management should consider refreshing their analysis and underlying assumptions to reflect changes in the market.

Per IAS 34 Interim Reporting, disclosures prepared should be less extensive as 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. They should still, however, be sufficient to provide users with an understanding of the effect of recent developments on the entity.

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.

Foreign exchange

For corporates with a Euro functional currency, the exchange rate as at the interim reporting date 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 re-translating 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 for corporates and financial institutions with UK operations, to consider whether the methodology for determining any such average needs to be adjusted to reflect the effect on any significant transactions occurring near the interim reporting date.
Fair value measurement
The measurement of assets and liabilities at fair value should reflect that value as at the date of interim reporting, 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.

In particular, it is worth considering asset valuations, pension assumptions, financial instruments and foreign exchange impacts, especially for valuations as at the date of interim reporting as valuations could be impacted by short term (and possible longer term) volatility and market liquidity issues. Inputs to a valuation model (for example, a discounted cash flow calculation) may need to be reassessed in the light of current uncertainties.

Impairment
For interim reporting IAS 34 requires determining whether a detailed impairment review is required. Directors and Senior Management will, therefore, have to form a view as to whether they believe the market reaction to Brexit is a trigger event for impairment reviews. They will need to consider whether the current conditions give rise to any indicators of impairment that necessitate the performance of a full impairment review.

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. Corporates with UK operations (either via subsidiaries or acting through branches) should consider what Brexit and IAS 36 mean for their financial statements.

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 the date of interim reporting. Similarly, the recoverability of deferred tax assets is assessed based on taxable profits. Any such assessment performed as at the date of interim reporting must reflect the facts and circumstances that existed at that date and not be influenced by subsequent events.

Impairment of financial assets is governed by IAS 39 Financial Instruments: Recognition and Measurement. The significant falls in stock markets in late June may result in the value of equity investments being significantly below its cost as at the date of interim reporting and, therefore, impaired. For Corporates, impairment of inventory assessment, should be based on the current estimated selling price that can be achieved.

Pensions
For employers who make pension contributions and pension fund managers and pension funds, 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 as at the date of interim reporting will need to consider whether a significant market fluctuation necessitating re-measurement at that date (in accordance with the requirements of IAS 34) has occurred.

Events after the reporting period
As the situation remains fluid, further political developments or market movements may occur between the date of interim reporting 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.
Contacts

If you require any further information on any of the issues mentioned above, and on how Deloitte can help you address the challenges ahead, please do not hesitate to contact

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