AUDIT AND BREXIT PART 2: CORPORATE REPORTING CONSIDERATIONS

27 November 2018

This guide is part of a series intended to help auditors of SMEs deal with current Brexit-related uncertainties associated with a potential no-deal exit as they affect 31 December 2018 and 31 March 2019 audits. The series does not deal with the longer-term potential opportunities or risks associated with Brexit more widely.

Corporate reporting, Brexit-related risk disclosures, cash flows, impairments and dividends

Corporate reporting

An example of extensive disclosure of a company's Brexit-related risks appear in *Next Plc's* Brexit Preparation Impact Analysis in its half-year results published in September 2018.
Larger audit firms have focussed resources internally on financial reporting issues and on what companies need to do to determine what to report, including:

- whether Brexit-related disclosures may be necessary;
- what information is likely to be needed; and
- how that information can be captured.

Brexit-related risk disclosures

The FRC's October 2018 open letter to UK listed companies describes the disclosures it expects to see in 31 December 2018 financial statements. While this is directed at listed entities, unlisted entities reporting to listed parent entities (whether in the UK or elsewhere) may find parent entities asking for this type of information. Unlisted entities may need to include these issues in their principal risk and uncertainties disclosures in any case. It is the responsibility of parent entities who are required to make these disclosures to ask subsidiaries to provide them with information needed for the purposes of the group financial statements.

The FRC notes a variety of approaches to reporting on Brexit risks so far and suggests that outstanding uncertainties present a challenge for boards preparing financial statements for 31 December 2018 year-ends, because many will be published shortly before the March deadline. The Brexit-related disclosures the FRC appears to expect to see include:

- the specific and direct challenges to the business model and operations rather than broader economic uncertainties;
- particular threats, such as changes in import or export taxes or supply chain delays, which are to be clearly identified;
- actions taken or being taken to mitigate or manage the potential impact, which may in some circumstances mean recognising or re-measuring certain items in the balance sheet;

- sensitivity analyses to help users understand the sensitivity of assets and liabilities to changes in management's assumptions, and possibly a wider than usual range of reasonably possible outcomes regarding cash flow projections which should be disclosed and explained.

While the FRC acknowledges that not all companies will require extensive disclosure, where 'sensitivity or scenario testing indicates significant issues', relevant information and explanations will need to appear in the impairment disclosures, for example. It will be for entities to decide whether Brexit uncertainties impact their viability statements and their ability to continue as a going concern.

Entities will need to plan for a comprehensive post balance sheet events review to identify adjusting and non-adjusting events.

Cash flows and impairments

Brexit-related risk factors include uncertainty generally, and the extent to which impairment and going concern assessments in particular are affected by Brexit. In both cases, the underlying audit issue is the potential impact of Brexit on cash flows in the form of:

- increased costs, loss of revenues and operational challenges (which may ultimately result in material going concern uncertainties);
- changes in the value of sterling and/or volatility and uncertainty relating to foreign exchange more widely;
- the tax implications of cash flow issues.

Auditors will need to look carefully at management's evidence supporting impairment models and assumptions, value in use calculations, and the impact of any changes to the classification of cash generating units. These in turn will all be affected by foreign exchange volatility. Management may resist the disclosure of the assumptions on the basis that they have planned and mitigated the risk, and that such disclosures are commercially sensitive. There is no commercial sensitivity override in IAS 36 or FRS 102 for disclosures and auditors will need to be prepared to challenge management on the adequacy of reporting here, and in the reporting of risks facing the business and business prospects more generally.

Impairments of non-financial assets: Brexit-related impairments of goodwill and other intangibles are possible. Goodwill will be affected by revenue growth assumptions. Auditors will need to understand how uncertainty and risk have been accounted for in cash flow forecasts and discount rates. Determining whether these are reasonable may be difficult. Changes in residential or commercial property prices will affect investment property valuations and assets invested in such properties. Auditors will need to consider the recoverability of deferred tax assets and valuations of pension deficits, particularly those invested in property and other assets likely to be subject to volatility. The NRV of inventory may be affected by the effect of shipping delays on shelf life.

Impairment of financial assets: management and auditors will need to consider investments in subsidiaries, associates and joint ventures, and the interaction of the new expected credit loss (ECL) model with expectations about the economic environment in the form of likely default rates, etc.

Tax: there is a risk of increased tax liabilities in the event of a no-deal exit as some EU-related tax reliefs may fall away. Management will need to have thought about how these can be settled and when. In some cases, this might give rise to going concern issues.

Dividends

The legality of dividend payments is an issue for management, but auditors should be aware of it. There is a risk that unlawful dividends might be paid if:

- the directors fail to take account of losses between the year-end and payment date under common law; or
- fail in their fiduciary duty to consider whether the dividend payment might threaten future solvency.

FRS 102 and the audit of smaller entities.

Regardless of which section of FRS 102 an entity applies, there is an overriding requirement for the financial statements to give a true and fair view. The same applies to entities choosing to prepare an abridged balance sheet and/or profit and loss account. The financial statements of micro-entities reporting under FRS 105 are assumed to give a true and fair view if they comply with FRS 105.

If Brexit-related issues can be construed as having a bearing on truth and fairness, the fact that a disclosure is not specifically required is not relevant, particularly if the financial statements are not solely used for management purposes, and third parties such as lenders or creditors are likely to read the financial statements.

The nature and extent of any potential Brexit-related disclosures will be determined partly by whether the entity applies FRS 102 in its entirety, or section 1A as a smaller entity, or FRS 105. FRS 102 requires financial statements to give a true and fair view, FRS 102 section 1A requires additional disclosures, if necessary, to give a true and fair view, and FRS 105 assumes a true and fair view.

FRS 102, paragraph 8.7 requires disclosure of, '…key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.'

This disclosure is not required under Section 1A for smaller entities, but some auditors may suggest that management consider a Brexit-related disclosure to show that some thought has been given to the issue, and that the related risks have been managed. Disclosing the sensitivity of debtors to sharp changes in the value of sterling might be one example.

All entities, regardless of their size, are required, or at the very least encouraged (under FRS 105), to disclose material uncertainties related to events or conditions that may cast significant doubt on their ability to continue as a going concern.

Many smaller entities will file their 31 December 2018 financial statements some months after 29 March 2019. This will give rise to considerations about which Brexit-related events or conditions should be adjusted for and which disclosed as adjusting and non-adjusting subsequent events respectively.

While the requirements for the preparation of a basic Directors' Report are limited (unlike the requirements for listed entities producing Strategic Reports), and there is no requirement to file Directors' Reports, some auditors may suggest that clients consider the potential downsides of saying nothing at all in times of significant uncertainty.

Further reading

Further resources are available on icaew.com/brexit.

CONTACT US

brexitsupport@icaew.com

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 150,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

As leaders in accountancy, finance and business our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. Together we contribute to the success of individuals, organisations, communities and economies around the world.

Because of us, people can do business with confidence.

ICAEW is a founder member of Chartered Accountants Worldwide and the Global Accounting Alliance.
www.charteredaccountantsworldwide.com
www.globalaccountingalliance.com.

Chartered Accountants' Hall
Moorgate Place, London

icaew.com/