AUDIT AND BREXIT PART 1: BREXIT-RELATED RISK FACTORS

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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.

Brexit-related risk factors

Some entities may benefit commercially from Brexit. An entity that has recently invested in agricultural machinery may experience competitive advantage if there is a shortage of manual labour, for example. There are currently many uncertainties associated with Brexit that entities will need to identify, assess and respond to. Auditors will also need to identify and assess Brexit-related uncertainties to the extent that they have the potential to have a material effect on the financial statements. Entities will need to analyse and sensitise the key risks arising from a variety of possible Brexit scenarios.

Estimates, forecasts and uncertainties

Risks may arise from uncertainty in management estimates and forecasts relating to, for example:

- asset impairments;
- going concern;
- fair value calculations;
- loss provisions in contract accounting;
- the recovery of deferred tax assets.

Assessment of financial statement level risks may be higher than usual when clients have undertaken no analysis at all. It may also be higher even if analysis has been undertaken, if management has not considered or addressed relevant risks or material uncertainties. Auditors also need to consider the risk of inconsistent approaches to Brexit-related risks by different management teams within a single organisation, such as the identification of different risks, and different assessments of, or assumptions about, the same risk.

Industry-specific risk factors

Brexit will not impact businesses in a uniform manner. It seems likely, for example, that a large group with significant operations in China and Australia and limited operations in the EU is likely to be less affected by Brexit-related risk factors than entities buying in and out of the EU on a day to day basis. Software developers reliant on US labour seem likely to be less affected overall in the short term than channel port hauliers and retailers whose primary markets and/or suppliers are in the EU. However, it is important to acknowledge the wider supply chain: a software developer may be significantly impacted in the short term both positively and negatively if it specialises in software for hauliers and some of those hauliers are already experiencing economic difficulties.

The Department for Exiting the EU has issued over 100 Technical Notices covering a very wide range of issues, many of which are sector-specific under the heading 'How to prepare if the UK leaves the EU with no deal', some of which are likely to be essential background reading for auditors if they have clients in that particular sector, or clients facing the more general issues addressed. The EC has also published a series of 78 Preparedness Notices which '…aim at preparing citizens and stakeholders for the withdrawal of the UK', and '…set out the consequences in a range of policy areas', covering communications, employment, the environment, financial services, the internal market, maritime affairs, health and safety and much more.

Sector-specific risk factors

There are a number of sectors in which the risk of material misstatement generally as well as going concern assessments are more likely to be affected by Brexit. These include entities in sectors such as:

- retail, food manufacturing, distribution and other entities with fast-moving inventory sourced from EU member states, including the Republic of Ireland;
- pharmaceuticals, chemicals, medical equipment manufacturers and distributors and other sectors, such as gambling, where the business model depends on licensing;
- entities with complex supply chains, particularly those involving EU entities;
- financial services;
- aquaculture which depends on EU quotas and requires access to EU markets for sales;
- agriculture and other sectors reliant on EU labour, including some in the public sector such as the NHS where value for money considerations may be affected by a loss of service continuity arising from shortages of staff;
- airlines operating between the UK and the EU, and UK-resident hauliers operating within EU Member States (cabotage);
- biomedical and other sectors heavily reliant on EU tax incentives for research and development and/or periodic large cash flow injections from outside the UK;
- other entities reliant on EU law or regulation to provide services into the EU;
- hospitality, travel, entertainment and aviation, and other entities whose business fluctuates with perceptions about economic well-being;
- food retailing and retail more generally, and other entities in sectors whose business models depend on tight cash flow management;
- entities with significant property portfolios, including those in the public sector, because of potential market volatility. The same applies to entities invested in property, including pension funds.

Other risk factors

Group audits involving the consolidation of subsidiaries located in the EU seem likely to require early communication of any Brexit-related risk factors and any additional work required. Additional reporting considerations seem likely to apply to UK groups listed on EEA exchanges.

10 potential Brexit-related risk factors to consider in the audit risk assessment

ISA 315 requires auditors to understand the business. This includes understanding changes in the economic, regulatory and business environment. Among many other things, auditors will need to consider the potential impact on the financial statements of potential Brexit-related risk factors such as:

1. Increased administrative costs relating to imported EU goods, such as data collection, declaration and customs costs at ports and bonded warehouses; costs related to authorised economic operator (AEO) status; costs arising from delays at UK and EU ports; costs related to proof of origin requirements if the common rule book and facilitated customs arrangements are agreed on;
2. Increases in tariffs and duties on goods exported to the EU, the risk of double duty, paying duty on selling price rather than cost price, and the potential loss of Generalised System of Preferences (GSP) relief on UK exports to GSP partners;
3. Increases in tariffs and duties on goods imported from the EU and elsewhere depending on whether the goods come from, for example: countries benefiting from the EU GSP rules for developing countries; countries benefitting from EU Free Trade Agreements; non-EU countries not benefitting from EU GSP or Free Trade Agreements; EU countries and Turkey; EFTA countries;
4. The impact of 1-3 above on the fulfilment of contractual delivery, quality and supply requirements and the risks associated with of breaches of contract;
5. Impaired market access where a business has relied on 'passporting' rights under EU law to provide services in the EU such as broadcasting, financial services, airlines and hauliers;
6. Restricted access to the EU for business purposes and the need for work permits for UK nationals working or providing services or engaging in business activities other than on a short-term basis, and reciprocal rights for EU nationals;
7. Macro-economic changes such as changes to the value of sterling, unemployment and inflation rates, and their impact on costs;
8. Increased regulatory and compliance risks in areas governed by EU law such as licensing, product compliance, technical restrictions, trademarks and intellectual property, insolvency proceedings and competition law;
9. The loss of EU labour or consequential increased labour costs, particularly if competition for that labour becomes an issue, including the cost of changes in employment contracts and the cost of EU worker Settled Status applications;
10. Legal and compliance issues arising from changes in laws and regulations relating to trading, and from business restructuring where operations or administrative functions are moved in or out of the EU.

Further reading

Further resources are available on icaew.com/brexit.

CONTACT US

brexitsupport@icaew.com

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Chartered Accountants' Hall
Moorgate Place, London

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