Impact of Brexit on financial reporting
What happened?

The UK voters’ decision to exit the EU came as a surprise to many observers, as well as the markets, with the Leave campaign even hinting at defeat as the polls closed. The vote has unleashed political, economic and financial uncertainty that will play out over the months ahead. This uncertainty will likely impact all UK businesses and those that do business/invest in the UK. There has been an immediate impact on the financial markets, both in the UK and across the world, with the pound significantly weakening against other currencies and share prices fluctuating as the market reacts to the decision.

Investment by India in the UK

According to a report by UK Trade & Investment (a government department), India is the third largest source of foreign direct investment (FDI) into Britain after the US and France. Indian companies are estimated to have employed over 1,10,000 employees in the UK currently. The number of Indian companies in the UK has nearly doubled from 36 in 2014 to 62 firms in 2015, with a combined turnover of more than 26 billion GBP in 2015. Apart from direct investment, many Indian companies have significant transactions—purchases and sales—with UK companies. Any challenges faced by the latter may have an adverse impact on the operations of Indian companies.

What you need to know

- On 23 June 2016, the UK voted to leave the EU.
- The specifics of how the UK will exit the EU will be the subject of negotiations for at least the next two years.
- Economists and market watchers anticipate market and currency volatility in the short term, but the long-term implications will depend heavily on the specifics of how the UK unravels its participation in the EU.
- Indian companies that participate in the UK or EU markets, either through the financial or stock markets, or by selling to, purchasing from, or having operations in those geographies, will likely experience some financial effects.
Impact on financial reporting

With such substantial investment and transactions in the UK, it is likely that companies that participate in this market will experience the financial effects of Brexit—some more than others. Another aspect to consider is the transition to Ind AS this year by companies which are covered under Phase I of the roadmap issued by the Ministry of Corporate Affairs (MCA). The extent of financial reporting considerations and resulting disclosures to be made by these companies are likely to be much higher.

Risk and uncertainty

An immediate impact of volatile currency markets is that the cost of imports into the UK could increase, which could be relevant to impairment and going concern judgements. Entities in the UK or those who trade with the UK will likely have to reassess their trading outlook once there is more clarity on the impact of the decision, as the impact could be substantial.

Risk disclosures (operational and financial) will undoubtedly need to take into account the volatility in financial markets. Ind AS 107, ‘Financial Instruments: Disclosures’, requires a company to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date (Ind AS 107 para 31). This includes both quantitative and qualitative disclosure of market and credit and liquidity risks, with the market risk disclosure being broken down into interest rate risk, currency risk and other price risk. Companies should also consider impairment of financial assets and whether there has been a significant decline in the fair value of an investment in an equity instrument below cost.

Sensitivity calculations and related disclosures will also be affected. Ind AS 1 requires disclosure about ‘sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity’, along with ‘explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved’ (Ind AS 1 para 129). Both of these requirements clearly specify that any assumptions and related sensitivity calculations should be disclosed.

Ind AS 34 has additional disclosure requirements for interim financial reporting which should be considered. These are relevant to listed entities that need to publish their quarterly results. An entity is required to disclose ‘changes in the business or economic circumstances that affect the fair value of the entity’s financial assets and financial liabilities’ [Ind AS 34 para 15B(h)].

Impairment testing

Irrespective of the accounting standards used, whether Ind AS or the accounting standards notified under Companies (Accounting Standards) Rules, 2006 (as amended), impairment is another aspect which will need to be considered in this context. One of the indicators of impairment is ‘significant changes with an adverse effect…in the technological, market, economic or legal environment’. While it might be too early to conclude whether the impact is ‘adverse’, in the short term, many entities will need to consider whether the vote does increase the risk of impairment.

For the purposes of impairment testing for non-financial assets, there are a number of areas to consider. Firstly, for value in use calculations, the present value of future cash flows denominated in a foreign currency must be translated to the entity’s functional currency at the spot rate of exchange at the date of the calculation. The concept of functional currency is relevant to companies that will apply Ind AS. Over time, any significant swings in the foreign exchange rate could lead to impairment indicators in future accounting periods, which would lead to additional forecasts being prepared to support current asset values. Secondly, companies may need to reconsider cash flows that are included in the forecast. Although the impact of the leave vote will only be known after some time, sales and cost projections may well need to be updated to reflect any initial impact on the demand and supply of the products or services underlying cash flows. Further, companies should also consider any impact on determining the discount rate used for impairment testing.

Other considerations

Additionally, Indian companies engaged in business transactions with UK (and, potentially, even EU) entities will need to assess the typical financial reporting considerations that come with foreign currency volatility, such as impact on hedging strategies, treasury management, collectability of receivables and inter-company transactions.
Understanding the road ahead

The formal exit of the UK from the EU will take time and there is great uncertainty over specifics. The rules governing cross-border business conduct, prudential requirements and market operations are all to be negotiated once the UK has formally sought its exit.

EU member states are party to a number of treaties and agreements that facilitate the free movement of people, goods, services, and capital across member state borders. Even though it will leave the EU, the UK could remain party to some or all of these treaties and agreements. This scenario would eliminate much of the uncertainty around the potential negative impact on companies; however, it is unlikely to accomplish many of the changes that Britons were seeking when they voted to exit the EU.

If the UK negotiates new treaties or agreements, the period of economic uncertainty could be extensive due to the time it would take to negotiate with both the EU and non-EU countries (since the UK would no longer be party to the trade agreements the EU negotiated with non-EU countries). The possible implications for trade, economic growth, currency volatility, free movement of labour across borders, availability of credit, and other key business considerations are all tied to the specifics of how the UK moves forward. Much will depend on the tenor of the negotiations—if the EU wants to dissuade other member states from considering a similar referendum, it may take a tough negotiating position with the UK.

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