IAASA

Irish Auditing & Accounting Supervisory Authority

Information Note

Consideration of the impact of Brexit for issuers' half-yearly financial reports

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Mission

To contribute to Ireland having a strong regulatory environment in which to do business by supervising and promoting high quality financial reporting, auditing and effective regulation of the accounting profession in the public interest

Information Note

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1. Context for and purpose of this Information Note

On 23 June 2016, the United Kingdom voted to leave the European Union ('Brexit'). This vote has resulted in uncertainty in economic and political spheres. The timing and outcome of negotiations between the UK and the European institutions as to the manner of the UK's exit is not clear.

Many Irish issuers[1] have very significant trading links with the UK and/or very significant transactions and balances denominated in Sterling.

'Brexit has created significant uncertainty and we believe this is likely to dampen growth in the near term, particularly in the UK but with repercussions also for Europe and for the world economy' – International Monetary Fund spokesman, 1 July 2016

Issuers are required by law[2] to prepare half-yearly financial reports which must include an interim management report. This management report must include an indication of important events that have occurred during the first six months of the financial year together with a description of the principal risks and uncertainties for the remaining six months of the financial year.

Most Irish issuers' half-yearly financial reporting period is for the six months to 30 June 2016. Given that most issuers will shortly commence or have just commenced the preparation of these financial reports, IAASA feels it is timely to issue this Information Note. The purpose of this Note is to assist issuers' management and those charged with issuers' governance in the preparation of high quality half-yearly financial reports by offering observations on:

(a) the more significant financial reporting and legal requirements considered relevant to this topic when preparing the half-yearly financial report; and

(b) the range of factors that IAASA expects issuers to consider when presenting their interim management statement.

It is intended that the matters set out in this Note will be an area of focus for IAASA's examinations of 2016 half-yearly financial reports.

2. Requirements when preparing half-yearly financial reports

Issuers are required by the Regulations to make public half-yearly financial reports (covering the first six months of their financial year) which shall include:

(a) a condensed set of financial statements;

(b) an Interim Management Report; and

(c) a Responsibility Statement.

Where an issuer is required to produce consolidated financial statements, the condensed financial statements must be prepared in accordance with the international accounting standard applicable to interim financial reporting as adopted by the EU, i.e. IAS 34 *Interim Financial Reporting*.

Where the issuer is not required to prepare consolidated financial statements, the condensed financial

[1] 'Issuers' are mainly equity, debt and closed-ended fund entities with shares or debt securities admitted to trading on a regulated market (in most instances, the Main Market of the Irish Stock Exchange)

[2] Transparency (Directive 2004/109/EC) Regulations 2007 as amended

statements must at least include: (i) a condensed balance sheet; (ii) a condensed profit and loss account; (iii) and explanatory notes.

Paragraph 4 of IAS 34 states that an interim financial report means a financial report containing either:

(a) a complete set of financial statements as described in IAS 1 *Presentation of Financial Statements*; or

(b) a set of condensed financial statements (as described in IAS 34) for an interim period.

*"***… the member states most exposed to Brexit are the Netherlands, Ireland and Cyprus.** Each has very strong trade, investment and financial links with the UK and in the cases of the Netherlands and Ireland are closely aligned in policy terms. Among the larger member states Germany would be affected through several channels, but perhaps most profoundly by the loss of the UK as a counterweight to France in policy debates' – *BREXIT: the impact on the UK and the EU,* Global Counsel (June 2015)[3]

3. IAASA's messages to issuers in preparing their half-yearly financial reports

In preparing their financial reports (whether those half-yearly reports include condensed financial statements or a complete set of financial statements), it is IAASA's expectation that the directors and members of the audit committee of issuers will consider a range of factors, some of which are outlined below.

3.1. Preparation of interim management reports

It is IAASA's expectation that directors and Audit Committees will consider a range of factors when preparing the interim management report including, but not limited to, the following:

- risks and uncertainties for the remaining six months: Regulation 8(2)(b)[4] requires issuers to disclose the risks and uncertainties for the remaining six months of the financial year. Given the market volatility that has already resulted from the Brexit decision, the principal risks and uncertainties for issuers have changed since those that were disclosed in their most recent annual reports.

  Issuers should describe the new principal risks and uncertainties arising such as their exposure to currency risk, volatility in demand for products and services, and changes in supply chain costs.

- important events during the first six months: issuers should disclose an indication of important events that have occurred during the first six months of the financial year and their impact on the condensed set of financial statements which would include the impact of the Brexit decision for the issuer [Regulation 8(2)(a)[5]].

These disclosures should be entity specific and issuers should avoid the use of boilerplate disclosures in this regard.

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[3] Source: https://www.global-counsel.co.uk/sites/default/files/special-reports/downloads/Global%20Counsel_Impact_of_Brexit.pdf

[4] Regulation 8(2)(b) states that:

'*The interim management report shall include at least:*

(a) …

(b) a description of the principal risks and uncertainties for the remaining 6 months of the financial year.'

[5] Regulation 8(2)(a) states that:

'*The interim management report shall include at least:*

(a) an indication of important events that have occurred during the first 6 months of the financial year, and their impact on the condensed set of financial statements; …

(b) …'.

3.2. Preparation of condensed financial statements

3.2.1. Recognition and measurement

The following are some of the impacts arising from Brexit which may impact the recognition and measurement of amounts reported in the financial statements:

- impairment triggers: the recent market volatility will, in many cases, necessitate an impairment assessment of assets or cash generating units;
- impairment measurement: the recoverable amount of assets and cash generating units which are based on value-in-use calculations are expected to decrease in value leading to possible impairment charges;
- fair value measurement: the impact on the fair value of financial instruments and, in particular, Level 3 fair values[6];
- discount rate measurement: the impact of changes in risks and/or low yields on the measurement of discount rates In particular the discount rate used to measure pension obligations may need to be re-considered in the context of increased uncertainty and volatility in markets. Paragraph 80 of IAS 19 *Employee Benefits* requires that financial assumptions such as discount rates, benefit levels and future salaries are to be based on market expectations at the end of the reporting period;
- exchange rate volatility: the impact of significant exchange rate movements on the financial performance and financial position of the issuer.

3.2.2. Disclosure

It is expected that issuers will provide disclosures as to how Brexit is expected to impact them in full compliance with the relevant financial reporting standard. However, issuers are also encouraged to provide full information to users of the financial reports (which are not confined to investors) over and above the requirements of the relevant financial standard. In that regard, IAASA highlights paragraph 7 of IAS 34 which states that:

> *… this Standard* [does not] *prohibit or discourage an entity from including in condensed interim financial statements more than the minimum line items or selected explanatory notes as set out in this Standard …*

In particular, the following changes to estimates and key assumptions should be disclosed in the notes to the half-yearly financial statements, as applicable:

- impairment assumptions: the impact on all key impairment assumptions that may change recoverable amount calculations [IAS34.15B(h) and 16A(d)];
- risk reporting: the risk impacts including market risk, credit risk, liquidity risk and counterparty risk [IAS 34.15, 15B(h) and 15C];
- fair value: the fair value of financial instruments (in particular level 3 prices) [IAS 34.16A(j)];
- sensitivity analysis: whether further sensitivity analysis is required for some risks e.g. currency risk or price risk [IAS 34.15 and 15C];
- hedging policy: changes in hedging policy and/or hedge ineffectiveness [IAS 34.16A(a)];
- contingent liabilities: events may trigger break clauses in contracts such that there is exposure to contingent liabilities [IAS 34.15B(m)];

[6] 'Level 3 fair values' are fair values measured using unobservable inputs for the asset or liability and are used in situations in which there is little, if any, market activity for the asset or liability at the measurement date

- segment disclosures: differences from the last annual financial statements in the basis of segmentation or in the basis of measurement of segment profit or loss. [IAS 34.16A(g)(v)]; and

- events after the interim period: relevant events after the interim period should be disclosed [IAS 34.16A(h)].

3.2.3. Issues preparing a complete set of financial statements in its half-yearly report

If an entity elects to present a complete set of financial statements in its half-yearly report (as explained in section 2 above), the form and content of these financial statements shall conform to the requirements of paragraph 10 of IAS 1 for a complete set of financial statements (i.e. comply with all IFRSs).

In addition to matters referred to above, attention is drawn, in particular, to the following additional matters which may also require assessment when preparing a complete set of financial statements matters in the half-yearly financial statements:

- paragraph 25 of IAS 1 regarding the assessment of an entity's ability to continue as a going concern. Issuers may need to re-evaluate the continued applicability of the going concern basis including subsidiaries of a group;

- IAS 1.122 to IAS 1.124 dealing with the requirement to disclose the judgements that management has made in the process of applying the issuer's accounting policies and that have the most significant effect on the amounts recognised in the financial statements; and

- IAS 1.125 to IAS 1.132 requiring issuers to disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

4. Financial reporting standards

The Appendix to this Note sets out the financial reporting standards considered relevant to this subject.

APPENDIX – Financial Reporting Standards

IAS 34 *Interim Financial Reporting*

IAS 34 sets out the minimum content of an interim financial report and the principles for recognition and measurement in interim financial statements.

IAS 34.6 states that:

> *In the interest of timeliness and cost considerations and to avoid repetition of information previously reported, an entity may be required to or may elect to provide less information at interim dates as compared with its annual financial statements.* ***This Standard defines the minimum content of an interim financial report*** [bold emphasis added] *as including condensed financial statements and selected explanatory notes. The interim financial report is intended to provide an update on the latest complete set of annual financial statements.* ***Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported*** [bold emphasis added].

IAS 34.15 states that:

> *An entity shall include in its* ***interim financial report 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*** [bold emphasis added]*. Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report.*

IAS 1.15B states that:

> *The following is a list of events and transactions for which disclosures would be required if they are significant: the list is not exhaustive.*
>
> *…*
>
> *(h) changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets or liabilities are recognised at fair value or amortised cost;*
>
> *…*

IFRS 13 *Fair Value Measurement*

IFRS 13 requires that the assumptions made in valuing Level 3 assets and liabilities may need to be updated to reflect market conditions at the reporting date.

IAS 10 *Events after the Reporting Period*

It is likely to be the case that there will have been significant developments between the reporting date and the date on which the interim financial statements are approved by the issuer; consequently, issuers should assess the application of IAS 10 and provide the relevant disclosures on the topic.

For issuers electing to present a complete set of financial statements as described in IAS 1 for their interim financial statements consideration has to be given to the full suite of financial reporting standards. In such instances, issuers will need to consider:

(a) matters related to impairment, to going concern and/or to capital issues (e.g. the impact of volatility in the currency markets may increase the import costs into the UK which may be relevant to consider for risk of impairment and/or going concern judgements (IAS 1.125 to IAS 1.133);

(b) the risk disclosures required by IFRS 7 *Financial Instruments: Disclosures* would need to take account of market volatility.

Paragraph 31 of IFRS 7.31 states that:

> *An entity shall 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 end of the reporting period.*

Issuers should disclose quantitative and/or qualitative information of market, credit and liquidity risks. In relation to market risk disclosure, information about interest rate risk, currency risk and other price risk may need to be disclosed separately. Consequently, issuers should give consideration as to whether or not it is relevant to provide more detailed disclosure regarding their exposure to Sterling and to present a sensitivity analysis.

(c) IAS 1.112(c) states that:

> *The notes* [to the financial statements] *shall:*
>
> *(a)* …
>
> *(b)* …
>
> *(c) provide information that is not presented elsewhere in the financial statements but is relevant to an understanding of any of them..*

(d) IAS 1.129 states that:

> *An entity presents the disclosures in paragraph 125 in a manner that helps users of financial statements to understand* ***the judgements that management makes about the future and about other sources of estimation uncertainty****. The nature and extent of the information provided vary according to the nature of the assumption and other circumstances. Examples of the types of disclosures an entity makes are:*
>
> *(d)* …
>
> *(e) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;*
>
> *(f)* …
>
> *(g) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.*

(e) Paragraph 12 of IAS 36 *Impairment of Assets* states that:

> *In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:*
>
> *External sources of information*
>
> *(a)* …
>
> *(b) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.*
>
> *(c)* …

> *(d) the carrying amount of the net assets of the entity is more than its market capitalisation.*
>
> …

While it may not be possible to yet conclude with certainty on the impacts of the Brexit, issuers should assess whether the outcome increases the risk of impairment. Issuers should re-evaluate the amount of the cash flows, re-evaluate the exchange rates used to translate foreign currency cash flows, adjust expectations of demand and supply for products and services, and, if appropriate, adjust the discount rate used.

(f) Paragraph 61 of IAS 36 *Impairment of Assets* states that:

> *In addition to the types of events in paragraph 59, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.*

The volatility observed in capital and currency markets following the outcome of the Brexit referendum and some large decreases in the market value for some stock prices, issuers may need to re-assess whether or not the significant or prolonged criteria have been met.