

# IFRS Today

KPMG's podcast series on IFRS and financial reporting

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## EPISODE TRANSCRIPT

### Brexit and financial reporting – Reflecting uncertainty in accounts

#### Speakers

- Tim Copnell (Host)
- Pamela Taylor
- Irina Ipatova



**Pamela Taylor**

Director  
KPMG in the UK

#### Tim

Hello – I'm Tim Copnell, head of the Audit Committee Institute at KPMG in the UK.

Welcome to part two of our Brexit-focused discussions.

I'm delighted to welcome back **Pamela Taylor** and **Irina Ipatova** to talk in a bit more depth about some of the specific international financial reporting challenges arising from Brexit.

But before we start, a quick recap if I may... Last time, we established that Brexit is an issue for both UK *and non-UK* companies.

And, while we focused a lot on *disclosures* last time, you both flagged the fact that there are also potential implications for the *numbers* companies are reporting and – therefore – those all-important KPIs.

#### Irina

That's right, Tim. Uncertainty could impact any forward-looking assessments – accounting for long-term contracts or inventory write-offs. Ultimately, the uncertainty around Brexit may impact the bottom line in your profit or loss.

#### Tim

Thank you. So let's start with forward-looking assessments. Can you tell me a little bit more about what the key forward-looking assessments might be, and what companies need to be thinking about?



**Irina Ipatova**

Director  
KPMG International Standards Group

## Irina

Absolutely, Tim! Just to mention a few...

- Cash flow projections for testing your non-financial assets for impairment.
- Expected credit losses for financial instruments, like trade receivables.
- Expected taxable profits for deferred tax assessments.

These are just some examples of forward-looking assessments.

## Pamela

Yes, and the point here is that under International Financial Reporting Standards – IFRS – you need to use judgement to estimate amounts for some assets and some liabilities based on forward-looking projections. When uncertainty is involved, there may be implications for your balance sheet as well as your income statement.

## Tim

Thank you, Pamela. But what's actually changed here? Isn't this what preparers have always done when they've been putting together their financial statements?

## Pamela

That's a good point, Tim. It's true to say that the accounting hasn't changed, but what's different here is that Brexit creates more uncertainty. And uncertainty will make management's task of *preparing* estimates more challenging...

For example, you need to do your annual impairment test and look at the indicators of impairment every year – that's no different. But with increased uncertainty, there might be more tests required if there are new indicators of impairment, plus there might be a much greater range of possible outcomes for each assumption, or more assumptions than there were in the past.

Any uncertainty needs to be taken into account, whether in cash flows or discount rates. That can be hard – no-one has a crystal ball.

## Irina

I agree, Pamela. Essentially the rules aren't different, but making judgements and estimates becomes much harder when you're dealing with this level of uncertainty.

Let me use a metaphor... Usually, on a journey, you know your route and can read the signs. But with Brexit, the existing highway has roadworks. So, you don't know if you'll be diverted off your current course and what alternative route you'll need to take.

In a business context, Brexit makes it harder for you to plan and therefore more challenging for you to come up with your assumptions.

## Pamela

Another challenge to mention is that you often can't just pick up your budget and drop it into your impairment calculation.

Let's say that a company has plans for a significant restructuring or enhancement of assets, but hasn't started implementing those plans. Although the budgets might reflect those future plans, they can't necessarily be considered for impairment tests.

There are specific rules about what can and can't be included in forecasts for impairment testing under IFRS. These projected cash flows might look quite different from budgets, in some situations.

## Tim

Thank you both. There are some really interesting points there. What else do audit committees and preparers need to be thinking about?

## Pamela

Well, Irina mentioned the financial instruments standard and expected credit losses.

IFRS 9 moves away from the incurred loss model to an *expected credit losses* model, so thinking about future conditions is critical there.

## Irina

Another example of forward-looking assessments is the recoverability of deferred tax assets...

## Pamela

... and a key point to remember across all of these is that your assumptions need to be consistent. They won't necessarily be the same across all these estimates and forward-looking assessments – different IFRSs have different requirements – but *consistent*.

## Tim

Irina – is this something that just impacts 31 December reporters? What about March reporters, June reporters, or even quarterly reporting?

## Irina

Good question, Tim. I would say it is relevant for all, but as events evolve the level of uncertainty may change; things may be different on 31 December and on 31 March. This would be reflected differently in the two sets of accounts.

You'll remember that in our last podcast, we talked about not being able to use hindsight when making judgements and assumptions, because assets and liabilities should reflect conditions that existed *at* the balance sheet date.

So, if the outcomes become certain, that certainty absolutely *cannot* be factored retrospectively into assumptions made at a prior date.

## Pamela

And, I'd add to that – even though there *may* be more clarity by 31 March as to what Brexit looks like, there may still be uncertainty over future trading conditions.

For example, you might have budgeted a 5 percent increase in revenues, but that may or may not materialise.

So uncertainty to some degree is still likely to be an issue for March reporters, and indeed any companies preparing quarterly reporting.

## Tim

Thank you. Again, some really good points to think about there. Up front, you mentioned long-term contracts; can you talk us through some of the issues there?

## Pamela

Yes. If you've got a long-term contract for which you recognise revenue over time and use a cost-to-cost measure to do that – the total cost projections impact the amount of revenue that you're recognising in each period.

So, any potential increases in cost might affect that.

## Tim

And I guess some contracts might become loss-making as a result of Brexit. What do we need to be thinking about from an accounting perspective there?

## Irina

That's a very relevant topic, Tim. Your assessment of whether a contract is onerous will focus on the costs that you cannot avoid.

But – just a note of caution – if you realise that your contract is loss-making, do not jump straight to making a provision. There are actually three things that you need to do:

- first, check if you have any inventory dedicated to the contract. If so, you'll need to write it down to net realisable value (NRV);
- second, if you have machinery that you use for the contract – you'll need to consider if it is impaired; and
- only then would you create a separate provision.

## Pamela

It's a good point, Irina. And don't forget, as well, that the valuation risks might be compounded if you're building up inventory to mitigate against potential border delays.

And, actually, the potential considerations around valuation apply for all inventory and needs to be carried at the lower of cost and net realisable value.

## Tim

Thank you. So we've talked a lot about impact on assets so far... What about liabilities? What if, say, you realised after the balance sheet date that you're going to breach a bank covenant at some point in the future? Do you reclassify your debt as current at the balance sheet date?

## Irina

I have to say, Tim, debt covenants are much more clear-cut than forward-looking assessments, because uncertainty about the future does not impact the classification at the balance sheet date.

Your analysis needs to focus *purely* on the position at the balance sheet date. If, after that date, a breach of covenant becomes probable, then it should be disregarded.

So, if at 31 December you *hadn't* breached your covenants, then the debt should continue to be classified as non-current. But, don't forget about disclosures. Transparent disclosure of the changed circumstances is important. And, in addition, you will need to think about the impacts on your going concern assessment.

## Tim

Thank you. Pamela – one of the things I hear a lot about in the news and in the papers is taxes. What do we need to be thinking about there?

## Pamela

Well, for all income taxes – be they current or deferred – the UK's tax status at 31 December hasn't changed. So the rates you'll be using to calculate current or deferred tax are the same as they would otherwise be.

The problem arises because nobody really knows if this status will change and when or how...

## Irina

I agree, Pamela. And that's an issue because, if it does change, it could have an impact on your tax liability.

For example, if you previously benefited from specific tax exemptions and did not pay tax on some gains from an internal reorganisation involving your UK subsidiary, it is uncertain if it may become due when the UK leaves the EU.

I think the issue here is that when the tax laws were written, they did not contemplate a country leaving the EU. So this is an unknown...

But going back to disclosures, given the uncertainty with taxes, it's very important to make relevant and meaningful disclosures, so that the users of your financial statements can understand your assumptions.

## Pamela

That's a good point, Irina. And talking about taxes reminds me of another forward-looking assessment that we mentioned earlier. And that's the recoverability of deferred tax assets. You need to know that you're going to have enough taxable profits in the future before you can put the asset on your balance sheet.

## Tim

Thank you both... So what I'm hearing here is that the important thing is that audit committees are happy that their CFOs and finance teams have:

- done the calculations correctly;
- considered the uncertainty around Brexit, and
- complied with the disclosure requirements.

## Pamela

That's absolutely right. You might just need to brush up on the accounting requirements to remind yourself how to deal with uncertainty when you're making judgements and estimates.

## Tim

Thank you. This is really helpful in building up a picture of what companies need to have front-of-mind in accounting terms in the current climate.

We're getting towards the end of this discussion now so it would be great if both of you could just summarise for the listeners what you think two or three key messages might be.

## Pamela

Yes. Absolutely. So, I'd say the accounting hasn't changed. But uncertainty makes it difficult.

Preparing future cash flow estimates is commonplace, but factoring in this level of uncertainty may not be something you've had to deal with on a day-to-day basis. So, make sure you leave enough time and have enough resources to do this...

## Irina

I absolutely agree, Pamela. Tim, I would add another three things to that.

- First, ensure that your financial reporting team works closely with other business units – that's the only way that you're going to be able to identify all of your potential Brexit impacts and the related financial reporting implications.
- Second, provide clear and transparent disclosures of management judgements, assumptions and impacts on financial statements.
- And, last but not least, consider bringing in some external resources that provide both experience and knowledge of best practices.

## Tim

Thank you, Irina. Thank you, Pamela.

You'll be able to find out more about some of the issues we've discussed today on our website.

And if you like what you've heard, please subscribe to *IFRS Today* – on [iTunes](#), [Google Play](#) or any other podcast app.

You might also want to take a look at the podcast produced by KPMG in the UK. [The Business of Brexit](#) looks at some of the wider implications – specifically from a UK perspective...

But for now, thank you all very much for taking the time to listen to this edition of *IFRS Today*.

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