

The impact of BREXIT on the application of IFRS in the UK

Policy Pulse June 2018 compendium





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This article forms part of the June 2018 **EY Policy Pulse** compendium. A collection of six articles that cover key topics which will become increasingly important to UK policy makers and regulators, company boards and investors. Policy Pulse aims to help ensure boards know about these topics and the associated changes, challenges and opportunities that lie ahead.

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Achieving comparability: International Financial Reporting Standards

UK listed companies were first required to report under International Financial Reporting Standards ('IFRS') in 2005. This was mandated by the European Union, to harmonise accounting across Europe but in a manner that also sought to achieve comparability with reporting in the rest of the world. In this the EU was largely successful: the IFRS Foundation reports that 144 countries now require the use of IFRS for all or most listed companies, with another 12 countries permitting its use. Global financial reporting has ceased to be characterised by numerous disparate national systems, to the point that today there are now essentially only two: IFRS and US Generally Accepted Accounting Principles ('US GAAP').

There are several benefits arising from common accounting standards. The use of a single, familiar accounting framework enhances both the comparability and credibility of financial information across the globe. This leads to more efficient and better informed decisions and has helped spur the development of global capital markets, reducing the costs of capital.

At the same time, an accounting 'lingua franca' has reduced financial reporting costs and enabled more efficient communication, both between reporting entities and their stakeholders but also within organisations.

IFRS is established by the International Accounting Standards Board, based in London, through a transparent process of consultation with preparers, users, regulators, local standard setters and auditors, across the world. This typically involves issuing a discussion paper and then an exposure draft for comment before the publication of the final standard. This takes time, of the order of at least three years but often far longer when there are many different views as to what the standard should say. The new financial instruments standard, IFRS 9, took five years to develop, while the new insurance standard took eighteen.

The IASB is supported by what is called the IFRS Interpretations Committee, whose purpose is to discuss matters of interpretation and:

- ▶ Determine if it needs to issue an interpretation, which has the status of a standard
- ▶ To ask the IASB to amend a standard,
- ▶ More commonly, to decide that there is either no widespread problem or to explain why the required treatment is already sufficiently clear.

Adopting IFRS in the EU

When the EU first decided to require the use of IFRS, it considered that it was inappropriate to completely delegate accounting standard-setting unconditionally and irrevocably to a private organisation over which it had limited influence. Consequently it specified that listed companies should apply IFRS 'as adopted' by the EU, by subjecting all IFRSs to an endorsement mechanism, which confirms that they provide a suitable basis for financial reporting.

The European Commission is advised on IFRS by the European Financial Reporting Advisory Group ('EFRAG'). Since 2014, the EFRAG Board has included, in equal numbers, representatives of European stakeholder organisations and national standard-setters, with its President nominated by the Commission. This Board, in turn, takes technical advice from the EFRAG Technical Expert Group. The Board's recommendations are then submitted to the European Commission, which consults with the EU member states represented in the Accounting Regulatory Committee ('ARC'). The proposed regulation that enacts the accounting standard is then subject to a 90-day scrutiny period by the European Parliament before the European Commission can endorse and publish it in the Official Journal.

The use of a single, familiar accounting framework enhances both the comparability and credibility of financial information across the globe.

To date, all IFRSs issued by the IASB have been endorsed in full by the EU, except for IAS 39 Financial Instruments, where lobbying by certain Continental European banks led to a 'carve out' of some of the requirements for hedge accounting. However, on a few occasions the EU has mandated a later effective date than required by the IASB.

The endorsement process typically takes about a year. However, the EC was able to fast track its endorsement of an amendment to IAS 39 in 2008 so that it took only a few days, while more contentious standards, such as IFRS 9, can take two years or more.

The EU is not alone in introducing an endorsement mechanism. Two examples are the Australian and Canadian processes:

- ▶ In Australia, responsibility for endorsement was given to the Australian Accounting Standards Board, a government agency. Once it endorses IFRS as Australian Accounting Standards, they effectively become law. The agency issues Exposure Drafts (EDs) for comment and subsequently accounting standards. Parliament also has a right to veto the conclusion.

However, in more recent years all new IFRSs have been endorsed and no amendments have been made to the texts: to do so is viewed as a 'nuclear option'.

- ▶ In Canada, in contrast, endorsement is delegated to the Canadian Accounting Standards Board, which is fully independent of Government. As in Australia, it publishes all EDs and asks for responses, adding the question, "The proposed standard has been developed by the IASB Board for application by entities around the world. Assuming the Exposure Draft proposals are approved by the IASB Board, do you believe that there are aspects of the proposed standard that make some or all of it inappropriate for Canadian entities, even though it is appropriate for entities in the rest of the world?" To date all IFRSs have been endorsed in full and incorporated into Canadian GAAP.

The future of IFRS in a post-BREXIT UK

With the approach of BREXIT, one of the many matters to be decided is how IFRSs will in future be required to be applied in the UK.

The requirement for UK listed companies to apply IFRS is enshrined in UK law, by cross reference to the European regulations, referring to IFRS as adopted by the EU. We have four possible choices:

- To replace the requirement to apply IFRS with a return to UK GAAP
- To replace the requirement with 'IFRS as issued by the IASB', rather than as adopted by the EU
- To keep the status quo, or
- To replace the requirement with 'UK-adopted IFRS'.

Of these four, the first is the least attractive. First, 'old' UK GAAP was a mixture of accounting standards and Company Law that had developed over time, which were sometimes in conflict and was largely silent on important modern issues, such as how to account for financial instruments. Second, it was abolished from 2015 when accounting



for smaller companies was moved from old UK GAAP to Financial Reporting Standard (FRS) 102, which is a simplified version of IFRS, designed for non-listed entities. It therefore gives priority to being a practical, cost-effective and proportionate solution. Consequently, it does not address more complicated transactions, it requires much less disclosure than would be required by users of public company financial information and, by providing less guidance than IFRS, allows diversity of application. Hence, UK GAAP would need to be recreated to provide an adequate basis of accounting for our largest companies which would promote transparency and comparability (with the parallel development of an XBRL taxonomy). Plus, in future it would need to be maintained. This could be both expensive and disruptive for preparers, auditors, regulators and educators, as well as for users.

Further, given that listed companies have been reporting under IFRS for thirteen years, only older UK-trained accountants would be likely to have a deep knowledge of old UK GAAP. Many accountants in the UK who prepare, audit or use accounts of listed companies will have been trained on IFRS. It should also not be forgotten that many UK listed companies are global organisations, and many of the people who prepare, audit, or use their accounts, are either not located in the UK or have been trained elsewhere.

A common accounting language is essential in a global economy. It is sometimes easy to forget just how much more globally integrated the business world now is, compared to 2004. These companies also have obligations to prepare accounts for subsidiaries around the world, usually under IFRS. Maintaining reporting under more than one accounting framework is not only inefficient but also creates potential for misunderstanding and error.

Perhaps most important, requiring international companies to adopt a unique body of UK GAAP would not be popular with users, who need to understand the accounts and want transparency and comparability with reporters' peers around the globe. It would risk restricting UK companies' access to overseas investors, raising their cost of capital and creating competitive disadvantage. Those companies who have overseas listing may also be required to prepare additional accounts prepared under IFRS or a reconciliation to IFRS, which would again be expensive to prepare and audit. Also, a return to UK GAAP would mean giving up the UK's leadership role in accounting development and diminish its ability to influence future change .

This leaves the UK with three options: to keep IFRS either in its 'pure' form, or as adopted by the European Union, or as adopted by the UK. There are considerable advantages of applying IFRS as issued by the International Accounting Standards Board. It would be the least expensive option to adopt and it would most help avoid the risk of delays in application, or for 'carve outs' or UK-specific additions, which would be undesirable for all the reasons already mentioned. Another approach may be to maintain the status quo and continue to require application of EU-adopted IFRS. Both of these options are politically out of line with the political mood that has led to BREXIT, with a desire in the UK to take greater control. There would also be practical difficulties in copy-pasting isolated elements of EU legislation. Meanwhile, reliance on the European Commission to endorse our accounting standards could be unattractive unless the UK can retain the role it has currently has in the endorsement process, something that is unlikely to come without cost. Hence, the most likely outcome is UK-endorsed IFRS.

With the approach of BREXIT, one of the many matters to be decided is how IFRSs will in future be required to be applied in the UK.

How would the UK adopt IFRS?

If a UK adoption process is implemented, legislation would need to be passed to establish an endorsement body with appropriate powers. We would need to decide:

- ▶ What would be the endorsement criteria? and
- ▶ Who or what would form this body?

One possibility for selecting the endorsement criteria is to take those currently used by the EU. The current EU criteria are that any IFRS should:

- ▶ Not be contrary to the notion of a 'true and fair view'
- ▶ Result in understandable, relevant, reliable and comparable financial information, and
- ▶ Be consistent with the 'public good'.

It is difficult to say that any of these are undesirable or that there are any obvious holes, although the last of these three is (arguably deliberately) vague. It includes the interaction with wider economic concerns, such as financial stability and growth, but it would be helpful to flesh out what this would mean

in a UK context. In particular, we should avoid focussing on what is good just for the UK, given that our larger companies have global operations and global users of their financial information.

The main alternatives are to establish the criteria by law, or to let the endorsement body establish its own criteria (through due process, involving interested parties, including users).

Over the last few years there has been increasing recognition that users of accounts need more information than has traditionally been required by accounting standards. At the same time, certain companies (based on various criteria) are now required to disclose a large variety of other information, such as details of directors' remuneration, corporate governance, payments to suppliers, greenhouse gas emissions, modern slavery, country-by-country payments to governments, tax strategy, and gender pay. Some of this information must be provided in the Annual Report and some through other channels.

The push for 'integrated financial reporting', reflects a number of initiatives, of which the two most pressing have been reporting on sustainability and to encourage long term investment.

While these developments are important, and there is a need for globally consistent requirements in this area, they mostly focus on forward-looking and non-financial information, which should supplement accounting information rather than change it. Hence it is not clear that this information should affect the IFRS endorsement criteria.

There are three main options for the endorsement body:

- i. Identify an appropriate Government agency to take on the role, as in Australia
- ii. Delegate the role to an independent body but with the Government retaining a power of veto, or
- iii. Make endorsement fully independent of Government, as in Canada.

A related question is whether the endorsement body should also be responsible for regulation and enforcement or whether the two functions are better performed by separate organisations.

Conclusion

Whichever choice the UK ultimately makes, it is important that:

- ▶ A choice is made as soon as is practical, so as to limit uncertainty in the short term. This may mean arranging for an interim solution, so as to allow adequate time to consult widely and think carefully on the path to follow.
- ▶ The endorsement process should involve adequate consultation and due process, engaging with a broad community of users, preparers, regulators, standard setters and auditors, so that special interests do not have too much influence.
- ▶ If the UK authority is given the power to amend IFRS, this must be used sparingly, based on strict criteria, and in such a manner that does not add undue cost for preparers or lose transparency or comparability for users.
- ▶ The process should work in parallel with that of the IASB, so that IFRS EDs are issued for UK comment, rather than waiting for final standards to be issued to begin the process. Otherwise, there is a risk that UK reporting development will always lag that of other jurisdictions.

Wherever possible, it is also important that the UK should not only proceed through an endorsement process, but should aim to help steer the development of IFRS. This would be best achieved by pushing for UK representation on the IASB, by seconding staff to the IASB, by encouraging the IASB to remain based in London and by being involved in accounting research activities. As with many aspects of BREXIT, it is important that the UK does not lose its global influence.

Subject matter expert

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Questions the board should be asking itself

- ▶ How does the company's board engage in the review and development of reporting standards?
- ▶ What steps will the company's board take to ensure it is up-to-speed with Government plans to develop the UK IFRS endorsement process?
- ▶ To what extent are potential changes in reporting standards reflected in the company's risk management reviews and discussions?

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