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All about: the impact of Brexit on the financial statements and management report

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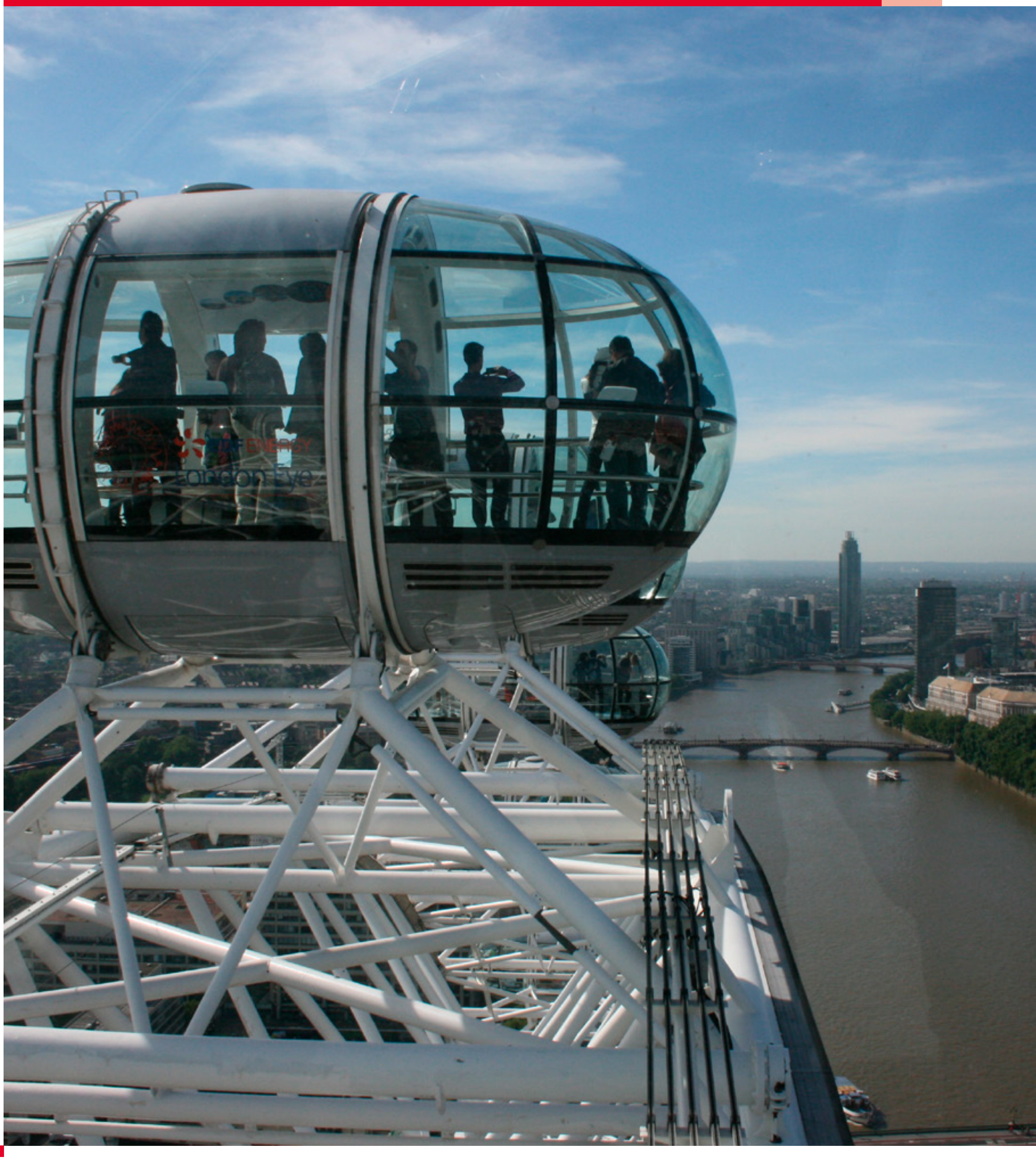

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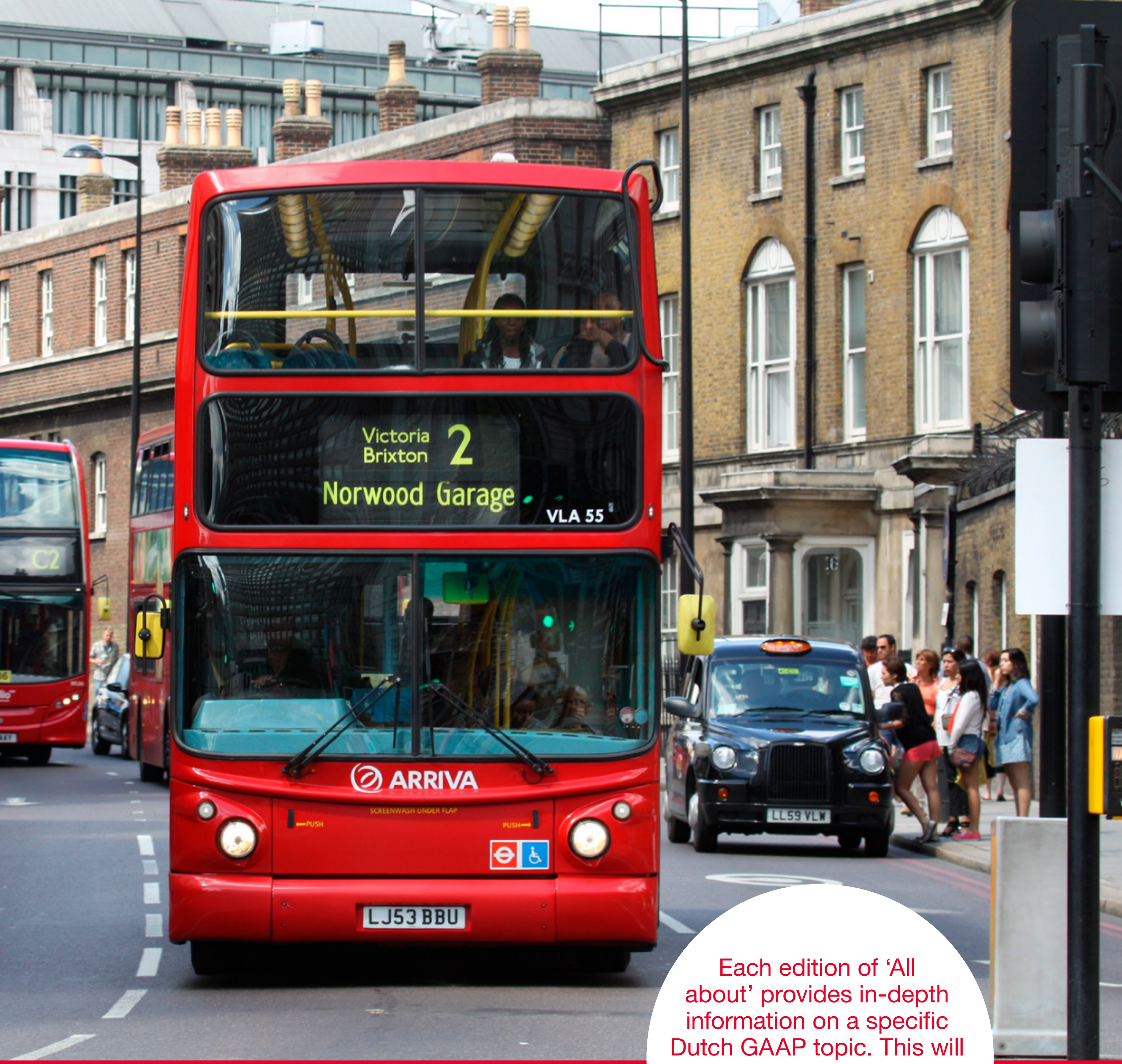


Each edition of 'All about' provides in-depth information on a specific Dutch GAAP topic. This will provide you with a handy overview of everything you need to know about the relevant topic.

Contents

Introduction

The British people have chosen to leave the European Union. Where do we go from there, and how does it affect the financial statements of Dutch and British companies? The financial statements may indeed be impacted since many rules will no longer apply to British companies once the United Kingdom is no longer a part of the EU. Whether, and to what extent, new agreements will be reached between the Netherlands and the UK is not yet known. More will become known in due time, during the actual negotiation process. What do we know about potential issues so far?

All about: the impact of Brexit on the financial statements and management report

Companies that are domiciled in the EU are subject to European Financial Reporting Directives. These Directives are adopted into local laws and regulations by the various Member States. Some facilities provided for in European regulations require a company to have its registered office in a EU Member State. Following the UK's departure from the EU, a UK registered company may be faced with the fact that it is no longer eligible to claim some of those facilities. EU companies that are part of a UK group of companies may be similarly affected, of course. In this 'All about' edition, these types of consequences will be discussed in more detail.

Brexit may naturally also impact the performance of businesses in other ways. What comes to mind is exchange rates, a possible economic downturn in the UK, different or more stringent import or export requirements, etc. All this may have an effect on the valuation of assets and liabilities of EU companies, and may even cause impairments. It may be required to include an explanation in the financial report, for example when the UK is an important trading partner. These factors will be addressed in this 'All about' edition as well.

The legislative texts *highlighted in red* are relevant to the topic concerned.

1. The exemption from consolidation of Article 408 is no longer certain

Article 408 BW (excerpt)

1. *A part of a group may be excluded from consolidation, provided that:*
   b. *the financial information that the legal person should consolidate has been included in the consolidated financial statements of a larger entity;*
   c. *the consolidated financial statements and management report have been prepared in accordance with the provisions of Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the financial statements, consolidated financial statements and related reports (…), [or] if these rules need not be followed, in an equivalent manner;*

2. *Our Minister of Justice may designate provisions for financial statements that, with such supplementary provisions as he shall consider necessary, shall be considered equivalent to provisions made in accordance with(…)*

'Article 408' is a familiar concept in the financial reporting world. Any auditor will immediately understand that this concerns the application of the immensely popular interim consolidation exemption. This is how it works: When a Dutch intermediate holding company holds subsidiaries, generally speaking, that intermediate holding company must prepare consolidated financial statements. However, there are some exceptions to this rule. Small groups as defined in Article 407, paragraph 2 of the 'Burgerlijk wetboek, BW' (the Dutch Civil Code, DCC) are exempted from this rule. Article 408 of the DCC also provides for an exemption. Under the latter exemption, no consolidation at the level of the intermediate holding company is required, provided that certain conditions are met. Moreover, a Dutch intermediate holding company may value its subsidiaries at cost, which carrying amount is almost always used in practice.

The financial information of a Dutch intermediate holding company must be included in the group financial statements of a larger entity, the parent company. Furthermore, it is required that the group financial statements of that larger entity are prepared in accordance with EU law or, in other words, in accordance with European Directive 2013/34/EU or in an equivalent manner. Dutch legal entities with a British parent may continue to apply this exemption for as long the UK remains a member of the EU as, by definition, EU law continues to apply. However, following the UK's departure from the EU, this will change. Perhaps it is possible to revert to the 'equivalent manner' rule when that happens. IFRS is currently considered to be equivalent to EU law (DASB 217.214). US GAAP, the system that applies in the US, and some other financial reporting systems that are more or less based on IFRS, are also considered to be equivalent in practice.

Although it is not yet certain that the UK reporting standards will be deemed to be 'equivalent' to EU law going forward, it would be the most obvious conclusion. At present the UK standard is FRS 102, which is largely based on 'IFRS for SMEs' or Small and Medium-sized Entities, as published by the IASB in 2009. As the UK is still an EU Member State, this standard has to comply with any conditions imposed by the EU in this respect. Should the UK continue to apply this standard following Brexit, the exemption of Article 408 BW should remain available to Dutch intermediate holding companies with a UK parent, although we cannot be absolutely certain hereof yet. A thorough analysis of the relevant accounting principles (valuation and determination of results) and the other provisions of FRS 102 must be performed to review whether the rules are indeed equivalent.

Conclusion
Once the UK has left the EU, the UK will no longer apply EU reporting standards (EU law) and will revert to their own system. This may affect the eligibility for the consolidation exemption of Dutch intermediate holding companies with a UK parent company.
The standard that will be applied in the UK following Brexit must be analysed to determine whether it is 'equivalent' to EU law. Should such a new standard not be deemed equivalent, a Dutch intermediate holding company must prepare consolidated financial statements as the exemption will no longer be available to the company.

More about the interim consolidation exemption of Article 408
An 'All about' publication is available (in Dutch) on the application of Article 408 BW: *www.pwc.nl/publicaties*. In this publication, you will find all you need to know about how to establish equivalence.

2. Group exemption of Article 403 (group company rules) no longer available

Article 403 BW (excerpt)

1. *A legal person which forms part of a group need not present its financial statements in accordance with the provisions of this Title, provided that:*
   c. *the financial information on the legal person has been consolidated by another legal person or company in consolidated financial statements to which, pursuant to applicable law, Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the financial statements, consolidated financial statements and related reports of certain types of undertakings (…) applies.*
   f. *the legal person or company referred to in letter c has declared in writing that it assumes joint and several liability for any obligations arising from the legal acts of the legal person;*

2. *If, in the group or part of the group whose information has been included in the consolidated financial statements, the legal person or company referred to in paragraph 1, letter f, is juxtaposed with another legal person or company, paragraph 1 shall apply only if such other legal person or company has also issued a declaration of assumption of liability; (…)*

If Article 403 applies, a legal entity is exempt from preparing financial statements or, in other words, does not have to prepare financial statements in accordance with the provisions of Title 9, Book 2. Also, it is not required to file such financial statements. Furthermore, such legal entities are exempt from mandatory auditing.

Conditions

This exemption is available only if certain conditions are met, of course. To qualify for the group exemption the parent company of the relevant subsidiary must assume joint and several liability for any obligations arising from legal acts of that subsidiary in writing. Furthermore, the financial data of that subsidiary must be consolidated into the group financial statements of the parent, which are either prepared in accordance with the IASB (IFRS) standard accepted by the EU, or in accordance with European Directive 2013/34/EU (in other words, in accordance with EU law).

Generally speaking, this means that the exemption is only available to a parent company that is domiciled in an EU Member State. In contrast to the conditions for application of Article 408, here the legislator has not accepted that consolidated financial statements may also be prepared in an equivalent manner.

At the moment, British parent companies regularly assume liability for a Dutch subsidiary in order for the Dutch subsidiary to benefit from the so-called Article 403 exemption. However, as soon as the UK leaves the EU, an essential group exemption condition will no longer be met, and the Dutch subsidiary will most likely have to prepare financial statements in accordance with the provisions of Title 9, Book 2 of the BW. Where applicable, these financial statements must be audited by an auditor and subsequently filed as well. This means a substantial increase in burden for companies that are currently benefiting from the group rules.

Conclusion

Dutch subsidiaries that currently prepare their own financial statements using UK GAAP as the generally acceptable standards of another EU-Member State can no longer do so following Brexit. They will have to switch to Dutch GAAP, IFRS, or another acceptable system. Most likely, this will make consolidation of that Dutch subsidiary into the group financial statements of the British more difficult.

3. Use of a reporting standard of another EU-Member State

Article 362 BW (excerpt)

1. *The financial statements, prepared in accordance with generally acceptable accounting principles, must provide such a view as enables a sound judgment to be formed on the equity and results of the legal person and, insofar as the nature of financial statements permit, of its solvency and liquidity. If justified by the international structure of a group, a legal person may prepare its financial statements in accordance with accounting principles that are deemed generally acceptable in another Member State of the European Community and that provide the view referred to in the first sentence.*

A company domiciled in the Netherlands subject to the provisions of Title 9, Book 2 of the BW must prepare its financial statements in accordance with generally acceptable accounting principles. The statutory provisions of Title 9, together with Dutch Accounting Standards Board (DASB) guidelines, are often referred to as 'Dutch GAAP'. Under certain conditions, the legislator allows the preparation of financial statements in accordance with accounting principles that are deemed generally acceptable in other Member States of the EU (Article 362, paragraph 1, BW), provided that this is justified in respect of the international structure of a group. Another important condition is that the relevant EU GAAP provide such a view that it enables a sound judgment in accordance with generally acceptable accounting principles.

This means, for example, that a Dutch legal entity may apply 'UK GAAP' or the UK reporting system known as 'FRS 102', if this is justified by the international structure of said Dutch legal entity. In practice, sporadic use is made of this option. This is partially due to the fact that it is often not easy to test whether Italian or Greek GAAP are organised in such a way that the view required by the Netherlands is indeed provided.

Where this option is used at all, often the UK system is used and, more specifically, in situations in which Dutch companies have a British parent company. The entire British group, including the Dutch subsidiary, then uses the same UK GAAP financial reporting system, which naturally results in efficient consolidation. When the UK ceases to be a member of the EU, this option will no longer be available to these Dutch subsidiaries, and a choice must be made for another acceptable system.

The obvious choice would be to switch to Dutch GAAP, or, if the situation so demands, to the IASB (IFRS) standards. In any case, a switch must be made to another system and the effects of such switch on the balance sheet (equity) and the profit and loss account must be explained. Comparative figures must also be adjusted. In the event of a switch to the IASB standards, IFRS 1 'First-time adoption' could become applicable.

Conclusion

Dutch subsidiaries that currently prepare their own financial statements using UK GAAP as the generally acceptable standards of another EU-Member State can no longer do so following Brexit. They will have to switch to Dutch GAAP, IFRS, or another acceptable system. Most likely, this will make consolidation of that Dutch subsidiary into the group financial statements of the British more difficult.

4. Macroeconomic consequences of Brexit may cause impairments

Impairment

Article 387 BW (excerpt)
1. (…)
2. (…)
3. Upon the determination of the value of fixed assets, any indications that an asset may be impaired must be taken into account. Any impairment on the balance sheet date may in any case be taken into account upon the determination of the value of financial fixed assets.
4. A write-down in accordance with the preceding paragraphs is charged to the profit and loss account, to the extent it is not charged to the revaluation reserves pursuant to Article 390, paragraph 3.
A write-down is reversed as soon as the value of the asset is no longer impaired. Any write-downs in accordance with paragraph 3, as well as any reversals must be stated separately in the profit and loss account or in the explanatory notes.

DASB 121.101
In addition to systematic reductions of carrying amounts of assets caused by depreciation, for example, impairment losses may occur. In this chapter, such impairments of fixed assets as referred to in Article 2:387, paragraph 4 of the BW (…) are discussed.

DASB 121.202
On every balance sheet date, a legal entity must assess whether there are any indications that an asset may be impaired. In the event of such indications, the legal entity must determine the recoverable amount of such an asset.

DASB 121.203
Upon assessing whether or not the asset is impaired, the legal entity must, in any case, include the following indications:

External:
a. During the reporting period, there are clear indications that the fair value of an asset is clearly lower than is to be expected on the basis of normal use or expiry of the relevant period;
b. Important technological, market-related or economical changes or changes to the statutory obligations in the environment in which the legal entity operates or in which the asset is used have occurred or will occur in the reporting period, which changes adversely affect the legal entity;
c. Market interest rates have increased or the market requires higher returns on investments and these are expected to affect the discount rate and, consequently, to an important degree, the recoverable amount; and
d. The carrying amount of the net assets of a legal entity exceeds the fair value of the outstanding share capital.

Internal:
a. (…)

Many businesses saw the financial crisis that broke out in 2007 as a so-called 'triggering event'. This is an indication that an asset or a business unit may be impaired. The impact of Brexit is not yet entirely known, but a number of businesses may perhaps see Brexit as such an indicator as well. This may not only be the case for international-orientated companies that directly trade with the UK, but may also be the case for domestic businesses simply because of macro-economic developments. A similar requirement applies to businesses that apply IFRS. Significant technological, market-related, economical, or legislative changes potentially having an adverse effect are an indication of impairment as referred to in IAS 36.

If such an indication is observed, the company must perform an 'impairment test'. In such a test the recoverable amount for a so-called cashflow generating unit – being a unit able to independently generate cashflows – is compared to the carrying amounts. If the recoverable amount, which is often the value in use defined as the present value of future cashflows, is lower than the carrying amount, a write-down for the difference is charged to the profit and loss account (DASB 121.401 and 402; IAS36 pp. 59 and 60). The UK's departure from the EU may therefore be such an indicator.

Moreover, this event may also affect the outcome of the calculation of the present value of the company:

- (If a group holds a participation in a UK company that uses GBP as its currency) the present value of future cashflows in a foreign currency must be converted into the functional currency of the company using the 'spot rate'; naturally any fluctuations in the exchange rate (EUR – GBP) will affect the calculation of the present value of the UK entity.
- Cashflows may be affected (reduced!), due to uncertainties about the economic consequences of Brexit.
- Brexit may have an effect on the interest rates used to calculate the present value of cashflows; a higher rate of interest would result in a lower present value of the company.

All these possible effects must be analysed in the event of an indication.

Alert

Finally: in extreme situations, even the continuity of the company must perhaps be assessed. In the event of an economic downturn in the UK or even a recession, Dutch businesses that are somewhat or very dependent on UK sales will be hit hard.

Conclusion
Brexit may demand that Dutch companies keep a keen eye on impairments of assets or cashflow generating units. This applies equally to businesses that use Dutch GAAP or IFRS. In both cases, Brexit may qualify as an indicator, dependent on the actual situation. In the event an indicator is present, an impairment test must be performed, in which Brexit may influence the calculation of the value in use and, consequently, the results of the impairment test. In extreme cases the continuity of the company must be assessed as well.

5. British companies operating in the Netherlands may be seen as a company formally registered abroad

Article 1 WFBV
Paragraph 1
In this Act, a company formally registered abroad is a capital company incorporated under foreign law that possesses corporate personality and that, for the most part or almost entirely, performs its activities in the Netherlands and has no real ties to the foreign state under which law the company has been incorporated.
(…)

Paragraph 2
The following articles of this Act apply (…) to companies that are subject to the laws of one of the Member States of the European Union or of a State that is party to the Agreement on the European Economic Area of 2 May 1992.

Article 5, paragraph 2
Within five months of the end of a financial year, subject to an extension of this period by a maximum of six months by the general meeting pursuant to a resolution adopted with the authority to do so on the grounds of special circumstances, the board of directors must prepare financial statementsand a management report. Title 9 of Book 2 of the BW applies to the financial statements, the management report and the other information mutatis mutandis, with the proviso that the disclosure requirement under Article 394 of that book must be complied with by filing [a copy] at the Commercial Register.

A company formally registered abroad is defined as a capital company incorporated under foreign law that possesses corporate personality and that, for the most part or almost entirely, performs its activities in the Netherlands and has no real ties to the foreign state under which law the company has been incorporated, Wet op de formeel buitenlandse vennootschappen (Companies Formally Registered Abroad Act, “WFBV”). The objective of this Act is to prevent the misuse of foreign companies.
Under this Act, such companies must apply certain Dutch regulations. However, the provisions of the WFBV do not apply to EU or EEA companies (European Economic Area).

Following Brexit, the WFBV will apply to a company incorporated under UK law, if 1) that company performs all or almost all of its activities in the Netherlands and 2) has no real ties to the United Kingdom. Such a UK Ltd., which is the equivalent of a Dutch BV, must be entered in the Commercial Register, for example. Furthermore, the company must comply with the obligations arising from Title 9 of Book 2 of the BW in respect of the preparation and filing of financial statements.

Increased burden

This will substantially increase the burden for such companies, as the financial statements must comply with the requirements of Title 9 of Book 2 of the BW. The British Ltd. is treated as a Dutch company and must apply Dutch GAAP or IFRS for its financial statements. Application of UK GAAP, which is currently still possible, will no longer be allowed going forward. See also ‘Use of a reporting standard of another EU-Member State’. Furthermore, the group exemption of Article 403 may not be applied either, whereas the application of another facility, the interim consolidation exemption of Article 408, will not be certain.

Conclusion
Companies incorporated under UK law that operate in the Netherlands are currently not affected by Dutch legislation on companies formally registered abroad. This legislation currently does not apply to companies registered in another EU Member State. This will change once the UK has left the EU. Then such companies, often Ltds., will most likely be required to comply with the provisions of Title 9, Book 2 of the BW that also requires them to prepare their financial statements in accordance with the Dutch regulations. This also depends on future treaties between the Netherlands and the UK, for that matter, and whether or not the UK will join the EEA.

6. Additional disclosures required in financial statements and management reports

Relevant IFRS provisions:

IFRS7p31
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.

IAS1p125
An entity shall 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. (…)

IAS1p129
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:(…)

Relevant Dutch GAAP provisions:
Article 362 BW (excerpt)
1. *The financial statements, prepared in accordance with generally acceptable accounting principles, must provide such a view as enables a sound judgment to be formed on the equity and results of the legal person and, insofar as the nature of financial statements permit, of its solvency and liquidity. (…).*

Provisions that are relevant to all companies (management report):
Article 391 BW
1. *The management report shall give a true and fair view of the position on the balance sheet date, developments during the financial year and the results of the legal entities and of the group companies whose financial information is included in its financial statements. The management report shall contain, taking into account the size and the complexity of the legal person and group companies, a balanced and complete analysis of the position on the balance sheet date, developments during the financial year and the results (…). The management report shall also describe its principal risks and contingencies to which the legal person is subject. (…)*
2. *Information shall be given in the management report on the business outlook; particular attention shall be paid to investments, financing and number of staff and circumstances affecting future turnover and profitability to the extent that this is not contrary to its vital interests. (…)*

Often the amount of a certain item in the financial statements cannot be determined exactly, but needs to be estimated. This is a consequence of uncertainties that are inherent to the company activities. The UK's departure from the EU is such an uncertainty. Dutch companies that depend on trade with the United Kingdom or may otherwise be affected by Brexit will have to deal with this, depending on the specific circumstances. And that also means that their financial statements need to disclose these facts. The depth thereof depend on the applicable GAAP: if IFRS is applied, a more extensive disclosures are required compared to the disclosures as required if Dutch GAAP is used.

Companies applying IFRS will, as a result of increased volatility in financial markets, probably mention the resulting operational and financial risks. IFRS7p31 requires companies to include information that enables users of financial statements to evaluate the nature and extent of risks arising from financial instruments. Think of quantitative and qualitative disclosures on market risks, including interest rate risks and price risks, credit risks and liquidity risks. Furthermore, sensitivity analyses are expected and the related notes thereto (IAS 1 p125 and p129). That sensitivity may concern goodwill (impairment), for example, and the fair value of derivatives and other financial instruments.

Less detailed provisions apply for Dutch GAAP. However, already on the basis of the overarching principle of Article 362, paragraph 1, (to provide a true and fair view) a company that is affected by Brexit is expected to disclose this in the financial statements. Specifically for financial instruments DASB 290.918 et seq. stipulates that information must be provided on the degree to which the company is exposed to interest rate, cash flow and liquidity risks. Incidentally, this disclosure is mandatory for large companies only.

In addition to the financial statements, the possible consequences of Brexit must also be explained in the management report. This applies to large and medium sized entities that apply Dutch GAAP and all Dutch companies that apply IFRS. Pursuant to Article 391, paragraph 1 of the BW, the company must describe the principal risks and contingencies. This may relate to a strategy, for example. Does or did the company have a strategy to expand in the UK in the future because of a favourable business climate, for example? Brexit could throw a wrench in the works. Such a disclosure could also refer to laws and regulations. What happens to the legislation in the UK when the UK is no longer subject to European regulations? Will things change and, if so, what does that mean for the company actively trading with the UK? Such an uncertainty must also be described in the management report.

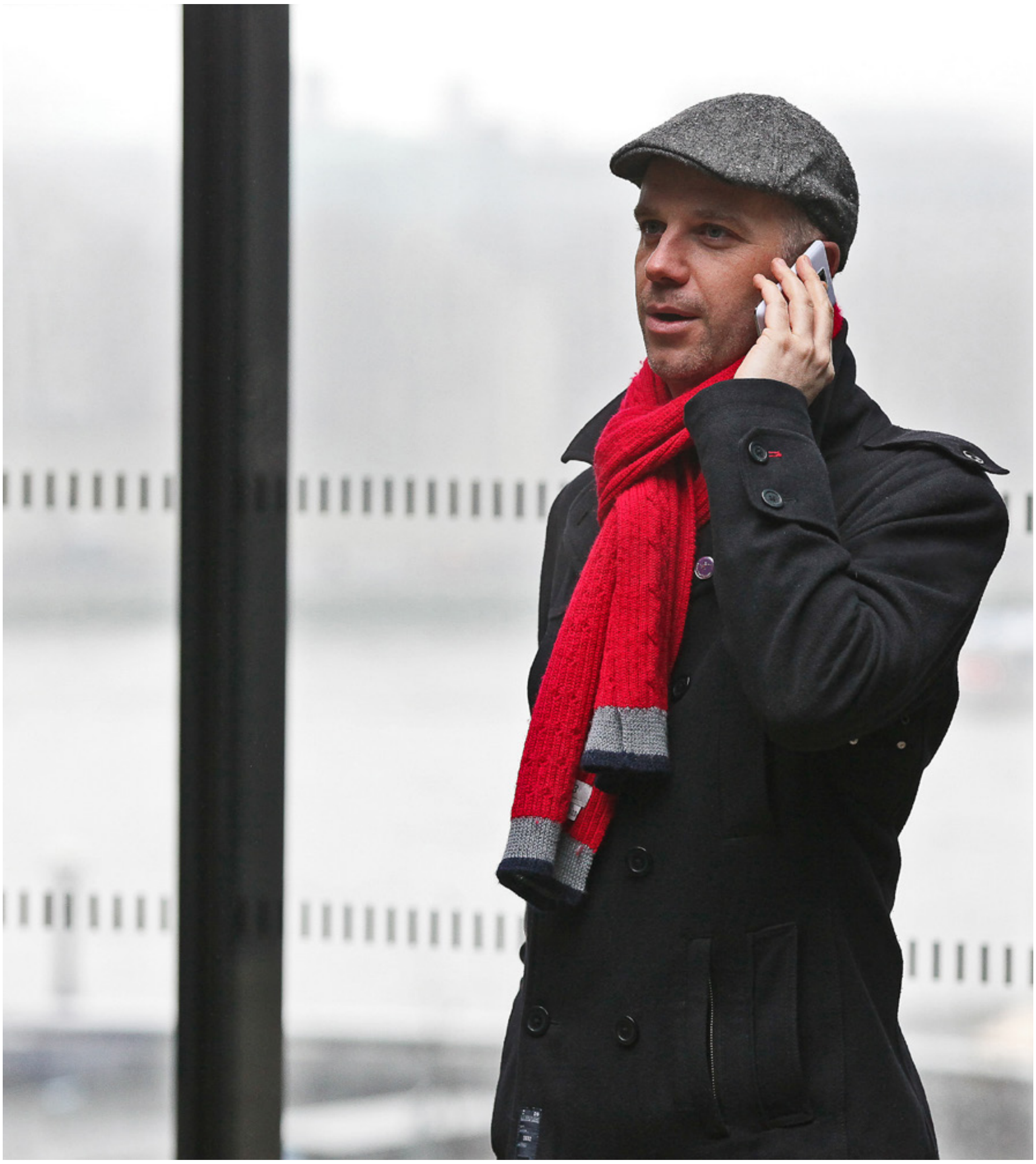
The law furthermore stipulates in management reports on the business outlook (Article 391, paragraph 2, BW). If Brexit, for example, is expected to affect future investments, staffing, and/or the development of sales and profitability, this must be explained in the management report (see also DASB 400.132).

As far as financial instruments are concerned, the company must report on the objectives and policies concerning risk management (Article 391, paragraph 3 of the BW). The law requires that attention is paid to price risks as well as credit, liquidity and cashflow risks. These explanatory notes are more or less similar to the disclosures required under IFRS 7 for companies that use IFRS.

Conclusion
Brexit results in additional risks and uncertainties in all areas. Businesses trading with or having operations in the UK are expected to make mention hereof in their annual reporting. Conditions are imposed under IFRS as under Dutch GAAP (the law and DASB), but those under IFRS take it a step further and are more detailed. In addition to the required disclosure in the financial statements, some thought must be given to what information pertaining to Brexit should be included in the management report.

7. Would you like to know more?

Should you have any questions about this topic, feel free to get in touch with your contact person at PwC. It will be our pleasure to assist you with your needs.



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