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CapitalQuarter

Page - 14

Why the FRC is focussing on the reporting of impairments

February
In this issue...

Welcome to the February issue of **CapitalQuarter...**

The application of IAS 38 has a significant impact on listed companies reporting their financial positions and performance, but their accounting treatment remains a contentious issue for preparers and users of financial statements. Elorm Numadzi undertakes a deep dive into intangible assets, their scope, measurements and relevance to the capital markets.

Impairments under IAS 36 Impairment of Assets are a key focus of the FRC and can be a challenging area for management, involving significant estimation and judgement. The inputs and assumptions used in impairment models are oftentimes so complex that they can lead to errors in judgement, calculation or disclosure. Alex Adie explores why correct reporting of impairments is so difficult, common pitfalls and summarises finding from the FRC's recent review.

Non-Executive Directors (NEDs) are valuable and powerful individuals in any organisation, often appointed for their industry knowledge and reputation. Many individuals hold a NED position in several organisations at once, providing their services through their own company, meaning tax treatments can often be complex and misunderstood. Aisling McCartan examines the tax and national insurance rules for NEDs in more detail.

Emerging markets are crucial for UK-listed companies due to their rapid economic growth, expanding consumer base, increasing demand for goods and services and new investment opportunities. These regions can offer diversification opportunities, mitigate reliance on mature markets and drive revenue growth through access to dynamic industries and untapped potential. Pamela Ntandane details the key features of these markets, and why your listed business should be paying attention to them.

We hope you find this edition useful. We are always keen to hear your comments and suggestions for future articles, so please do get in touch.

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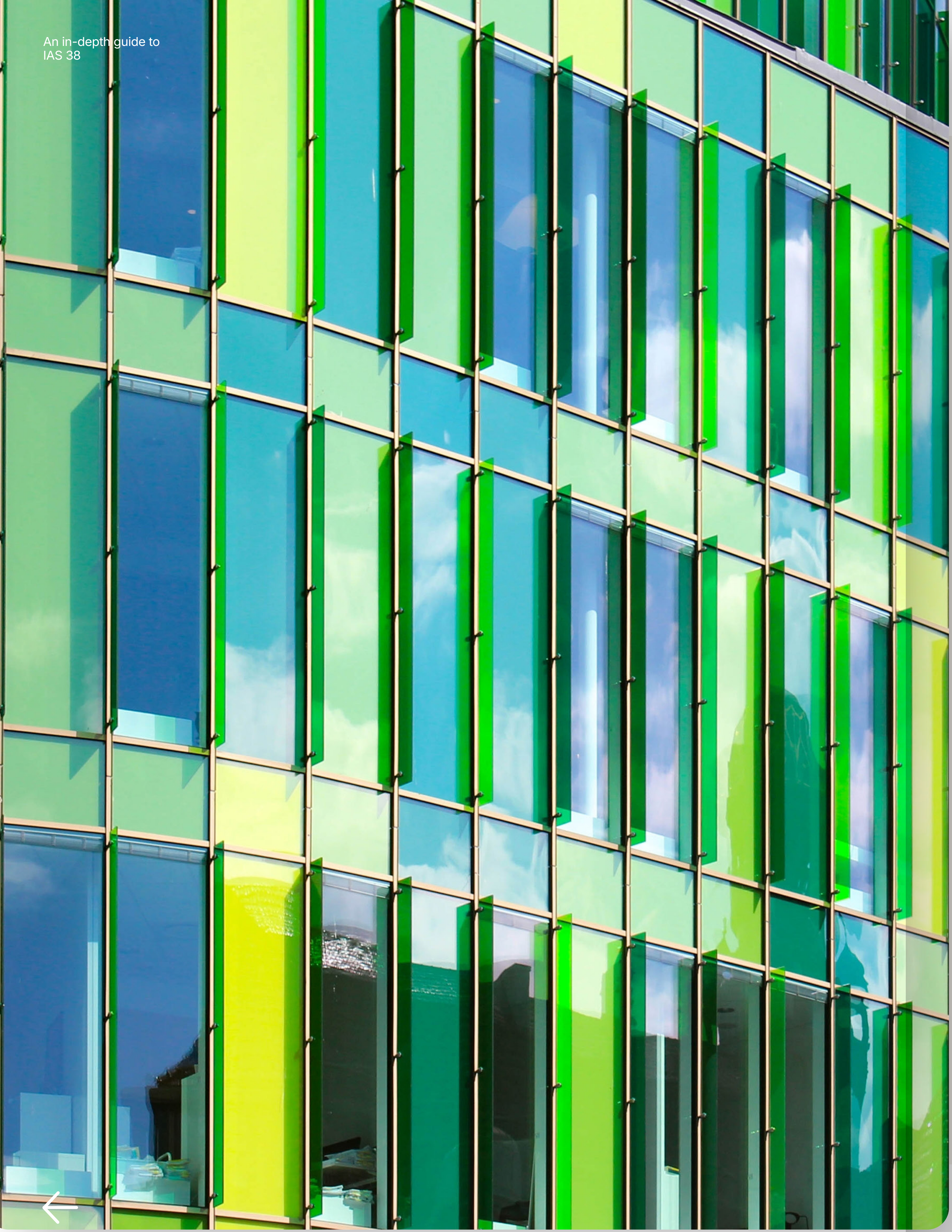


An in-depth guide to IAS 38:

How to account for intangible assets under IFRS for listed businesses

Intangible assets are an increasingly significant metric in the books of many listed companies and their accounting treatment has always been, and remains, a contentious area for preparers and users of financial statements.

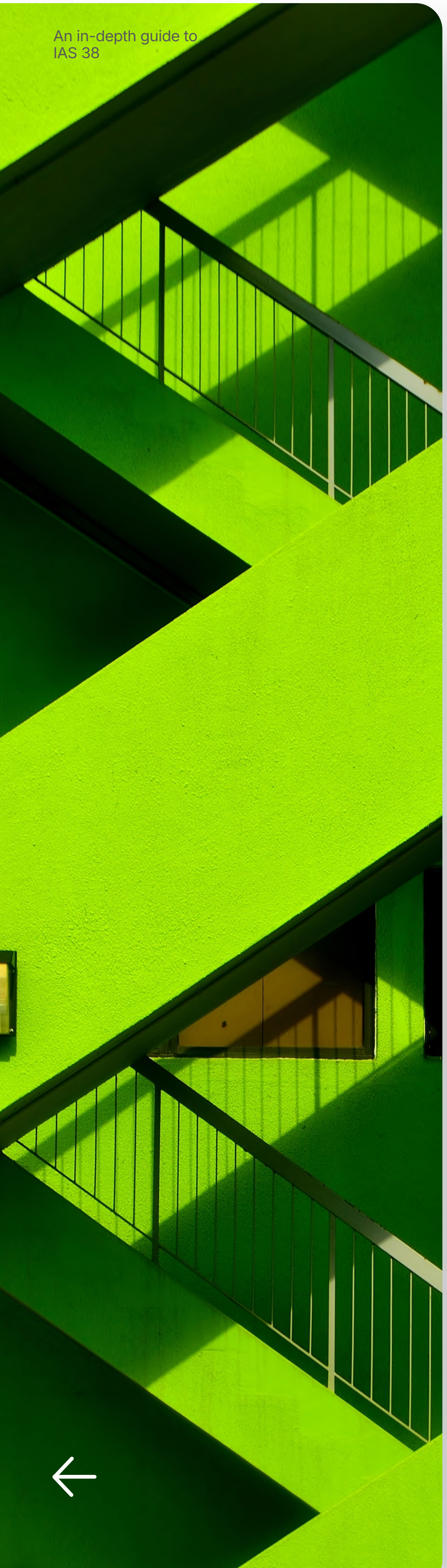
This in-depth guide explores how to appropriately account for intangible assets under IFRS, including its scope and measurement, impacts and information your auditors will need from you.

Definition and scope

IAS 38 defines an intangible asset as an identifiable non-monetary asset without physical substance. Such an asset is identifiable when it is separable, or when it arises from contractual or other legal rights. Separable assets can be sold, transferred or licensed. Examples of intangible assets include computer software, research and development costs, licences, trademarks, patents, films, copyrights and import quotas. Goodwill acquired in a business combination is accounted for in accordance with IFRS 3 and is outside the scope of IAS 38. Internally generated goodwill is within the scope of IAS 38 but is not recognised as an asset because it is not an identifiable resource.

Separate standards prescribe the accounting treatment for specific types of intangible assets and an entity is required to apply that standard instead of applying IAS 38. These are:

- Intangible assets held by an entity for sale in the ordinary course of business; IAS 2 - Inventories
- Deferred tax assets; IAS 12 - Income Taxes
- Leases of intangible assets accounted for in accordance with IFRS 16 Leases
- Assets arising from employee benefits; IAS 19 - Employee Benefits
- Exploration for and Evaluation of Mineral Resources; IFRS 6
- Financial assets as defined in IAS 32. The recognition and measurement of some financial assets are covered by IFRS 10 Consolidated Financial Statements, IAS 27 Separate Financial Statements, and IAS 28 Investments in Associates and Joint Ventures
- Contracts within the scope of IFRS 17 Insurance Contracts and any assets for insurance acquisition cash flows as defined in IFRS 17
- Non-current intangible assets classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations
- Assets arising from contracts with customers that are recognised in accordance with IFRS 15 Revenue from Contracts with Customers.



There are instances where some intangible assets are contained in or on a physical substance, such as legal documentation in the case of a patent or licence, and therefore have both tangible and intangible elements. An entity is required to exercise judgement to determine which element is more significant and whether it should be treated under IAS 38 or IAS 16 Property, Plant and Equipment. In the patent example above, the physical documentation is only a form of information storage and does not form an integral part of the patent. The patent can be stored in any other form such as electronic copies. It would therefore be appropriate to account for it as an intangible asset under IAS 38.

Most entities often expend resources or incur liabilities on the acquisition, development, maintenance or enhancement of intangible resources. Examples of such resources are scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks. If an item within the scope of IAS 38 does not meet the definition of an intangible asset – ie, identifiability, control over a resource, and existence of future economic benefits – expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

Relevance of IAS 38 in capital markets

In the capital markets, where investors need transparent, comparable, and reliable financial information, the application of IAS 38 plays a crucial role in several ways:

1. Recognition of intangible assets

IAS 38 specifies the criteria for recognising an intangible asset. For an asset to be recognised, it must:

- Be identifiable (ie, separable or arising from contractual/legal rights)
- Provide future economic benefits
- Its cost must be reliably measurable.

Where investors evaluate companies based on future growth potential, especially in industries driven by innovation (eg, technology and pharmaceuticals), recognising intangible assets correctly is vital. A failure to properly recognise intangible assets can lead to undervaluation, while over-recognition could lead to inflated asset values, misleading investors.

2. Capitalisation vs expensing of R&D costs

One of the most debated areas in IAS 38 is how to treat research and development (R&D) costs. IAS 38 distinguishes between:

- Research costs, which are expensed immediately
- Development costs, which may be capitalised if certain criteria are met, such as technical feasibility, intention to complete and ability to use or sell.

This has a direct impact on a company's financial statements. Technology companies or pharmaceutical firms involved in extensive R&D can boost their asset base and profitability by capitalising qualifying development costs. However, improper application can lead to manipulation, where companies capitalise costs that should be expensed to inflate profits, which could misinform investors.

3. Amortisation and Impairment

Intangible assets with a finite useful life must be amortised over their useful life, while those with indefinite useful lives (eg, goodwill) are subject to annual impairment testing. The impairment of intangible assets can significantly impact a company's earnings and market valuation. For example, a large impairment charge could signal to investors that a company's previously anticipated growth or success (based on the ability to generate value from its intangible assets) may not materialise. An entity must apply IAS 36 to determine whether an intangible asset is impaired by comparing its recoverable amount with its carrying amount annually and whenever there are impairment indicators present.

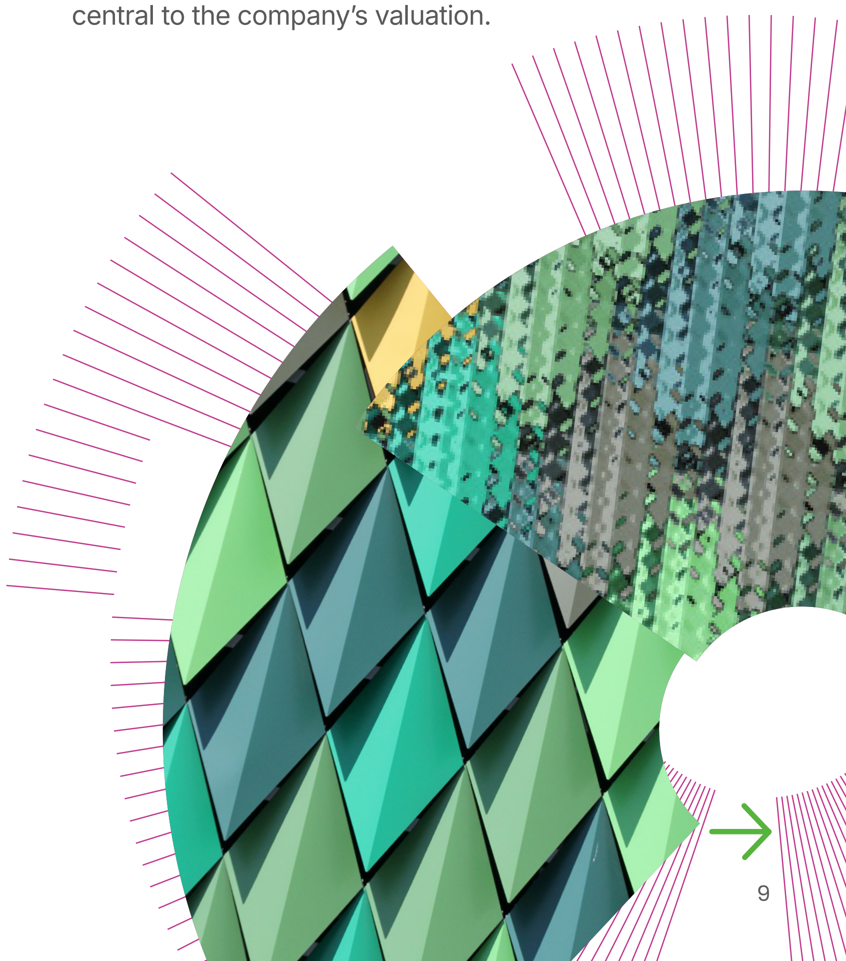
The subjective nature of impairment testing, which requires companies to exercise judgement and utilise estimates in their valuation models, such as growth rates, inflation and discount rate, adds another layer of complexity. Misjudging or manipulating impairment can lead to mispricing of a company's shares in the market.

4. Impact on earnings and share price

The capital markets are highly sensitive to earnings reports, and the treatment of intangible assets under IAS 38 can have a material impact on earnings. For instance:

- If a company capitalises its development costs, its expenses will decrease, leading to higher reported earnings
- Conversely, if intangible assets are amortised or impaired, the company's earnings will be reduced.

Since investors often rely on earnings to value companies, these accounting treatments can influence stock prices. A significant write-down of intangible assets would also be likely to decrease investor confidence, leading to a drop in share prices, particularly if the intangible assets were central to the company's valuation.



5. Valuation and M&A activity

In the capital markets, especially during mergers and acquisitions (M&A), the fair valuation of intangible assets such as goodwill, customer lists, patents and trademarks becomes crucial. IAS 38 helps ensure that acquirers and investors can evaluate the intangible assets of target companies consistently.

Post-acquisition, the handling of intangible assets, including goodwill, is governed by IAS 38 and IFRS 3 (Business Combinations). Companies involved in M&A must carefully assess the fair value of the acquired intangibles including separately identifiable intangibles on acquisition. Improper valuation can lead to financial misstatements, which could potentially impact on both the acquirer's and the target company's stock prices.

6. Disclosure requirements

IAS 38 also mandates detailed disclosures in the financial statements, which are critical for transparency in the capital markets given the wide range of intangible asset types and companies which will have different policies with regard to expensing or capitalising development costs. These disclosures include:

- The carrying amounts of intangible assets
- Amortisation policies
- Impairment losses
- Capitalised development costs
- Reconciliations of opening and closing balances of intangible assets.

Investors, analysts and regulators rely on these disclosures to assess the quality of earnings, the sustainability of intangible assets and the company's potential for growth. Transparency in these disclosures helps mitigate information asymmetry.

7. Sector-specific relevance

The relevance of IAS 38 varies across sectors, for instance:

- **Technology companies:** These often hold a significant portion of their value in intellectual property, software or brand value. Correct application of IAS 38 is crucial for investors to understand the company's innovation pipeline and long-term growth potential
- **Pharmaceutical companies:** The valuation of patents, trademarks and drug development costs is critical, particularly in light of the lengthy R&D processes
- **Media and entertainment companies:** Intangible assets such as copyrights, licensing agreements and brand names are core to these businesses.

Failure to properly apply IAS 38 in these sectors could distort the company's value and risk misinforming investors.

8. Market comparability

IAS 38 is an internationally recognised accounting standard under IFRS, meaning that companies applying IFRS in different capital markets must follow the same rules when accounting for intangible assets. This uniformity enhances comparability across companies in different jurisdictions, which is essential for investors who diversify their portfolios globally.

For example, if two competing tech companies are listed in different countries but both apply IAS 38, investors can more easily compare their respective R&D capitalisation and amortisation policies and the value of their intangible assets.

Measurement of intangible assets

Initial measurement (IAS 38.24-28)

Intangible assets are initially measured at cost. The cost of an intangible asset comprises:

- **Acquisition cost:** If the asset is purchased separately, its cost includes the purchase price, import duties and non-refundable taxes after deducting trade discounts
- **Internally developed assets:** For internally developed assets, the cost includes all directly attributable costs necessary to create, produce and prepare the asset for its intended use, such as materials, labour and overhead. The key issue in measuring internally developed assets is how to identify which costs should be capitalised and how these can be supported by sufficient, appropriate audit evidence. Development costs tend to be mostly staff time which is supported by contracts and timesheets. Management must apply judgement in considering whose time and the quantum of costs to capitalise. Management must consider whether staff activity and the relevant costs are directly attributable to the intangible asset
- **Acquisition as part of business combination:** If an intangible asset is acquired in a business combination, its cost is recognised at fair value at the acquisition date.

Subsequent measurement (IAS 38.72-87)

After initial recognition, an entity must choose between two models for subsequent measurement:

1. Cost model (IAS 38.74)

- The asset is carried at cost less any accumulated amortisation and impairment losses
- Amortisation is based on the useful life of the asset (finite or indefinite) and impairment testing must be conducted if there are indicators of impairment.

2. Revaluation model (IAS 38.75-87)

- Intangible assets can be carried at revalued amounts (fair value) less any subsequent amortisation and impairment losses
- The fair value must be based on an active market, which is rarely available for most intangible assets, so the revaluation model is less commonly used
- Revaluation gains are credited to other comprehensive income (OCI) unless they reverse a previously recognised loss.

Amortisation of intangible assets

1. Finite useful life (IAS 38.97-106)

If the asset has a finite useful life, it should be amortised on a systematic basis over that useful life. Key aspects of amortisation include:

- **Useful life:** The useful life of an intangible asset may depend on factors such as the expected usage, legal rights and technical obsolescence
- **Amortisation method:** The amortisation method should reflect the pattern in which the asset's future economic benefits are expected to be consumed (straight-line, diminishing balance, or other method)
- **Residual value:** The residual value of an intangible asset is assumed to be zero unless certain conditions are met (such as an active market).

2. Indefinite useful life (IAS 38.107-110)

If the asset has an indefinite useful life, it is not amortised. Instead, the entity must:

- Test for impairment at least annually and whenever there is an indication of impairment
- Review the useful life each period to determine if there are any changes in the indefinite classification. If the asset is no longer expected to have an indefinite life, it should be amortised prospectively.

Impairment of intangible assets (IAS 38.111-123)

Impairment of intangible assets is governed by IAS 36: Impairment of Assets. Intangible assets must be tested for impairment if there is an indication that the asset might be impaired. For assets with an indefinite useful life or not yet ready for use, impairment testing must be performed annually.

The impairment test involves comparing the carrying amount of the intangible asset to its recoverable amount, which is the higher of its fair value less costs to sell and value in use. If the carrying amount exceeds the recoverable amount, an impairment loss is recognised in the statement of profit and loss.

Derecognition (IAS 38.112-117)

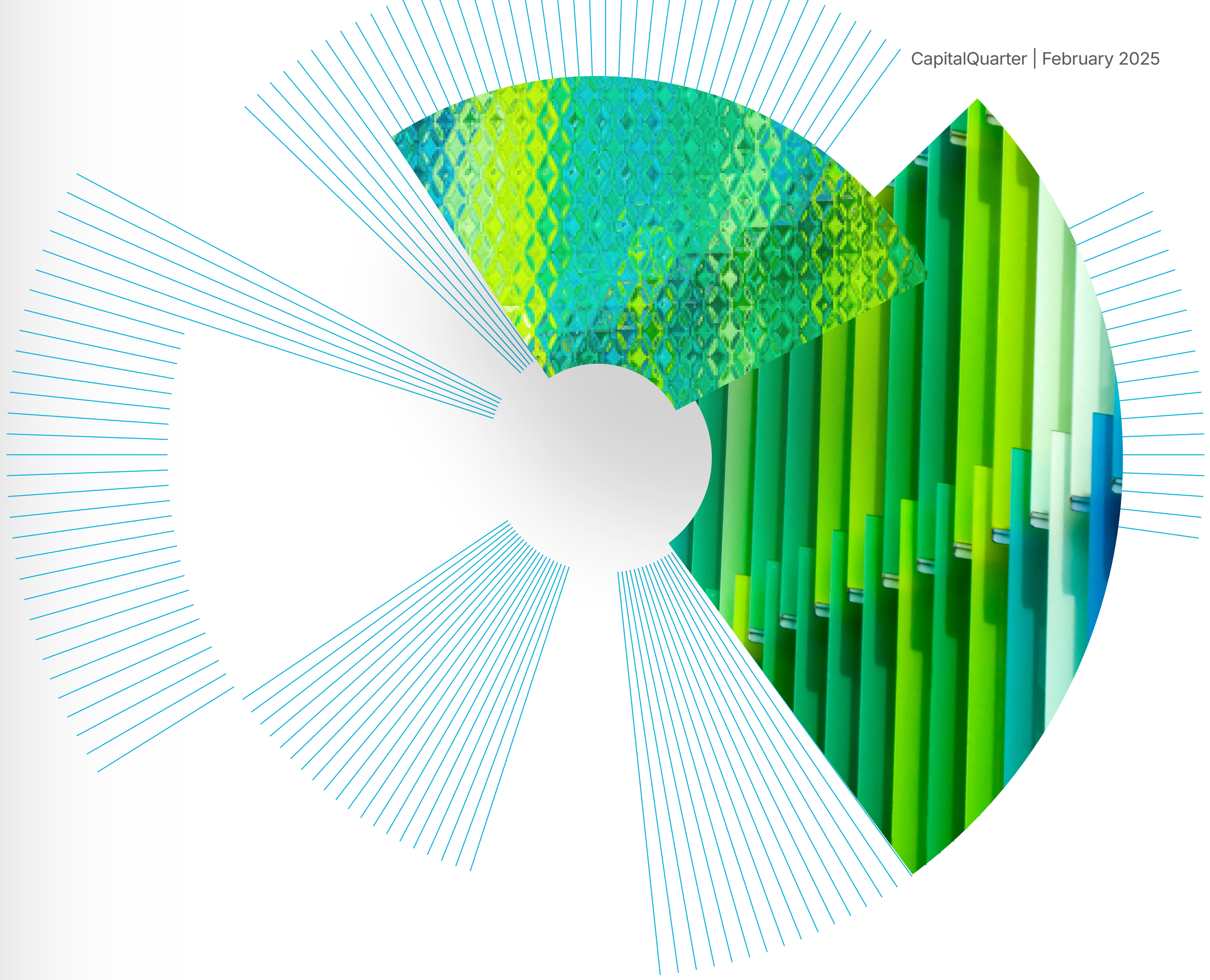
An intangible asset is derecognised:

- On disposal (sale or abandonment)
- When no future economic benefits are expected from its use or disposal.

The gain or loss on derecognition is calculated as the difference between the net disposal proceeds and the carrying amount of the asset. The gain or loss is recognised in the income statement in the period in which the derecognition occurs.

Key information that auditors will require in auditing intangible asset balances

- Ownership agreements and other legal documents to support underlying rights and obligations to the asset
- Management paper outlining the phase at which the asset is, that is, research/ development phase and demonstrating the technical feasibility of completing the asset so it will be available for use or sale, management's intention to complete and ability to use or sell the asset, how the asset will generate probable future economic benefits, the availability of resources to complete the asset and the ability to measure reliably the expenditure attributable to the asset during its development
- Detailed cashflow forecasts to determine the future economic benefits of the asset
- Details of management's key assumptions and estimates such as useful life, future sales and discount factor
- The nature and amount of any significant intangible assets acquired during the period
- The nature and amount of significant intangible asset additions during the period and underlying support such as employment contracts and timesheets
- Board meeting minutes related to the asset.



Conclusion

IAS 38 plays a significant role in ensuring the accurate and consistent reporting of intangible assets. Its application affects a company's earnings, asset values and stock price, directly influencing investor perception and market valuations. Transparent and consistent treatment of intangible assets is critical for investor confidence, as intangible assets often represent a significant portion of a company's value in knowledge-driven industries. Capital market participants, including analysts, investors and regulators, heavily rely on the proper application of IAS 38 to assess the long-term growth potential and financial health of companies.

For more information on IAS 38 and intangible assets, please contact Elorm Numadzi or Imogen Massey.

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Why the FRC is focussing on the reporting of impairments

Correct reporting of impairments is undoubtedly difficult. We look at some of the reasons for this and summarise findings from the FRC's recent review.

Impairments under IAS 36 (Impairment of Assets) are a key focus of the FRC and can be a challenging area for management, involving significant estimation and judgement.

The inputs and assumptions management uses in its impairment models are often so complex that they lead to errors in judgement, calculation and disclosure.

What do the standards say?

IAS 36 is prescriptive in its assessment of whether an asset is impaired or not. If the carrying amount of an asset is higher than its recoverable amount, that asset is classed as impaired. The recoverable amount is determined as the higher of the fair value less costs to sell, and its value in use (VIU).

These are defined as:

- **Fair value less costs to sell:** the price that would be received on sale of an asset or paid to transfer a liability in a transaction between market participants, at the measurement date, less costs directly related to the disposal of the asset.
- **VIU:** the present value of the future cash flows expected to be derived from an asset or cash-generating unit.

This assessment is applicable to all assets on the statement of financial position, other than those covered by their own standards (eg, deferred tax assets in the scope of IAS 12, or financial assets in the scope of IFRS 9). So, its impact on companies can be wide-ranging, especially those that have undergone business combinations in the past and may therefore hold material goodwill and other intangible assets.

When should an impairment assessment be considered?

For assets held on the statement of financial position which are carried with an indefinite useful life (ie not amortised), an impairment assessment must be carried out every year – whether impairment indicators exist or not (see the next page).

For other assets, an assessment is required if there's an indication that they may be impaired. IAS 36.12 asks management to look at two distinct (but not exhaustive) sources of information when considering impairment indicators:

External sources:

- Declines in market value
- Negative changes in technology, markets, economy or laws
- Significant increases in interest rates
- When net assets of the company are higher than its own market capitalisation.

Internal sources:

- Obsolescence or physical damage of the asset(s)
- If the asset is currently or planned to be idle, changed as part of a restructuring or held for disposal
- When the asset has a worse economic performance than budgeted
- For investments in subsidiaries, joint ventures or associates, when the carrying amount is higher than that of the investee's assets, or a dividend exceeds the total comprehensive income of the investee.

Calculating impairments: the complexities

Calculations of impairments through impairment models can be some of the most complex pieces of financial data the company puts together annually. The discounted cash flow (DCF) model is the most used to calculate the VIU. It should typically cover five years, with an explanation if that period differs.

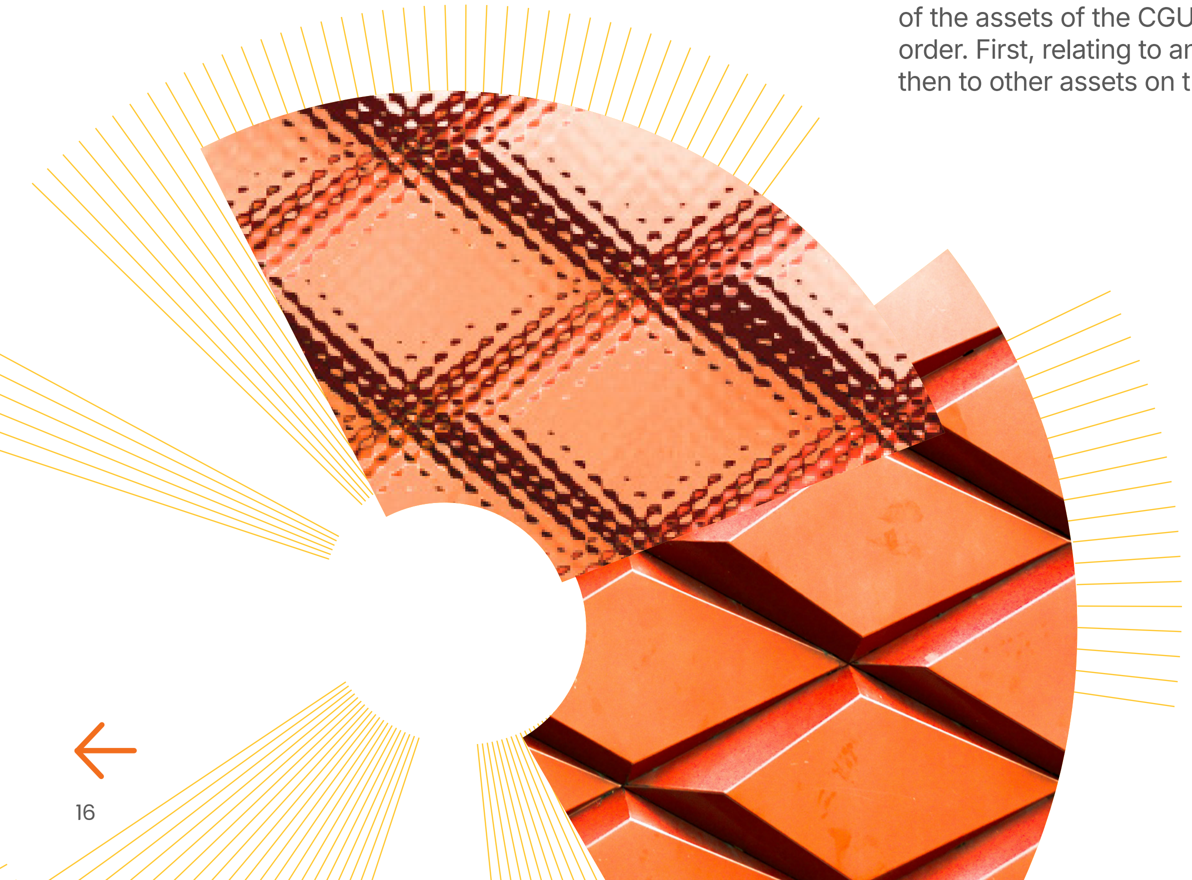
The use of internal and external, historic and future-looking data, above what a company would usually prepare in its going concern analysis, means significant estimates and judgements must be made about the company's future outlook.

This might include expected trends in sales demand, cost fluctuations and potential changes in the industry in which it operates, against a backdrop of current economic instability caused by world events (eg the potential impact of ongoing wars in the Middle East on global economies).

Common pitfalls in impairment assessments

Regulatory and thematic reviews continue to highlight problems in the preparation of impairment assessment calculations. Key issues include:

- **Calculation of unrealistic recoverable amounts and a lack of sensitivity analysis:** optimistic future assumptions which do not appropriately consider both past performance and sensitivities on key suppositions, leading to overstatement of the future potential values of the asset(s)
- **Inappropriate identification of cash generating units (CGUs):** the majority of assets tested for impairment are done at a CGU level, as opposed to an individual asset level. This is often because the respective asset is not generating its own, independent cash flows. The CGU is defined as the smallest identifiable group of assets that generates cash inflows largely independent of those from other assets or groups of assets. This lowest level of cash flows from a group of assets is often not adequately considered, leading to inflated cash flows and valuations for the assets being tested. Management should be conscious of the levels of cash flows reported internally, as this often indicates the lowest level
- **Consistency of information:** projections should be consistent with other management-prepared financial information (such as internal budgets and forecasts), as well as with information prepared for the audit in relation to going concern (ISA 570)
- **Material enhancements of assets:** when completing an impairment analysis using the VIU method, the recoverable amount should not be based on forecasts which incorporate large-scale upgrades to the assets but, instead, on their current future potential outputs
- **Calculation of terminal values:** the last period being terminally valued must represent a constant state of affairs, being careful not to include any one-off income amounts that could overvalue future cash flows
- **Discount rates:** the valuation of future cash flows can be highly sensitive to the discount rate applied. Care should be taken to apply a rate for each CGU which takes account of business, country or climate-specific risk. The weighted average cost of capital (WACC) should be taken only as a starting position for the calculation of the discount rate, not a proxy. Beginning with the WACC, management must take guidance from IAS 36 (A15–A31) as to the adjustments required
- **Allocation of impairment:** when an impairment loss is recognised, it must be allocated to reduce the carrying amount of the assets of the CGU in a prescribed order. First, relating to any goodwill, and then to other assets on the CGU.



Disclosure requirements for impairments

IAS 36 (paragraphs 126–134), together with IAS 1 (Presentation of Financial Statements), explains disclosure requirements for impairment considerations in detail.

For assets in which an impairment is recognised, or an impairment from previous periods is reversed, details must be included for each class of asset. This can be done as part of the other information disclosed for the class of asset, for example within the year-on-year reconciliations provided in the property, plant and equipment notes required by IAS 16.

IAS 36 also asks for sufficient detail for each CGU, so that readers of the financial statements can understand the estimates used to measure recoverable amounts. These include but are not limited to: each key assumption in the cash flow projections; any sensitivity to risks and uncertainty; and the discount rate applied to management's projections. As mentioned below, this is a key area of focus of the FRC for listed businesses, based on failures noted from their annual Corporate Reporting financial reviews.

For any entity within the scope of IFRS 8 (operating segments), being those entities which have either debt or equity instruments traded in a public market or in the process of filing its financial statements with a securities commission or other regulatory organisation for the purposes of trading, the impairment losses and reversals must also be disclosed at the reportable segment level.

What are the shortcomings exposed by disclosure reviews?

A recent review of corporate reporting by the FRC has continued to highlight weaknesses in impairment disclosures. In 2023/2024 this was the most common area of cases opened with companies (12% of all cases related to impairment for the second consecutive year).

Some of the most notable disclosure omissions continue to relate to:

- Companies not providing enough relevant information for significant judgements and key assumptions when estimating the recoverable amount of assets and cash-generating units
- Companies not explaining the sensitivity to changes in key assumptions, where possible changes could cause impairment of goodwill or significant further adjustments to already-impaired assets.

At a granular level, specific findings also relate to:

- Inconsistency between assumptions used in disclosures relating to impairment and those in other sections of the financial statements, such as the viability statement
- Climate change: lack of disclosure about potential uncertainties and/or sensitivities relating to the impact of climate change on projections
- Period of assessment: where a period other than the expected five years was used, this was sometimes not adequately explained or justified
- Impairment method: unclear disclosures about how goodwill had been allocated to CGUs, and a lack of explanation for changes in methodology implemented period on period. Discrepancies between the allocation of assets in impairment disclosures, compared to those made in line with segmental information.

The FRC's 2023/2024 review of corporate reporting can be found **here**. For further guidance on impairments, please contact Alex Adie or Nick Joel.

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Tax and National Insurance rules for Non-Executive Directors

Non-Executive Directors (NEDs) are valuable and powerful individuals in a listed company. They provide an impartial opinion and constructive challenge to the executive directors.

NEDs are often appointed for their business knowledge and reputation. This means they frequently hold a NED position in several organisations at once and provide their services through their own company – in which they hold a material interest. Whilst NEDs play a key role, the tax treatment of such appointments is often misunderstood.

At a glance...

- NEDs are taxed in the same way as an employee because they are viewed as 'officers' of the organisation
- The assessment of the employment tax status is the responsibility of the organisation that engages the individual. The rules place responsibilities on the business to make sure the right tax and NICs are paid to HMRC
- The location of the board meetings, if that's where the NED is engaged most of their time for the specific organisation, is likely to be viewed as their permanent workplace
- Any fees associated with NED duties are considered employment income
- For consultancy services, if this work is seen as self-employment rather than an employment engagement, then any fees will not be subject to PAYE and NICs.

What is the default position?

Although NEDs act independently for organisations, they are taxed in the same way as an employee. This is because they are viewed as 'officers' of the organisation and any fees paid for their duties should be subject to PAYE and national insurance (NICs) through the payroll.

Is it different for personal service companies?

Where NEDs act for a number of unrelated organisations, they often set up their own personal service company (PSC) and invoice for their services through this entity.

Historically, it's been mistakenly thought that fees can be paid gross if they're invoiced through a PSC. However, this is not true.

The reformed off-payroll working rules (commonly referred to as IR35) were introduced to public sector entities in 2017. From April 2021, they were extended to include medium- and large-sized entities in the private sector.

Following on from the amendments to IR35, the assessment of the employment tax status is now the responsibility of the organisation that engages the individual, whereas previously this was undertaken by the individual's PSC. The rules also place responsibilities on the deemed employer, to make sure the right tax and NICs are paid to HMRC.

When assessing employment status for IR35, the business engaging with the NED can use the **HMRC tool 'check employment status for tax' (CEST)** to help them decide. It is important to note that where the individual is an 'officer' of the company, (which a NED is), the tool will determine that the engagement is inside IR35. That means PAYE and NICs will apply to payments made to the PSC.

What about travel expenses?

It's very common for organisations to meet the cost of travel expenses for NEDs to attend board meetings. In some cases, the costs of accommodation and subsistence are also met.

Many NEDs will say that they are home-based and therefore these costs represent business travel, not 'home to work' travel. But HMRC is likely to challenge this position, particularly if most of a NED's time working for an organisation is at the location where the board meetings take place.

The focus must be on the location where they spend their time working for the specific organisation, rather than where they are based for 'working in general' (for example, if they work for multiple organisations).

So, the location of the board meetings, if that's where the NED is engaged most of their time for the specific organisation, is likely to be viewed as their permanent workplace. In this case, associated expenses would also generally be taxable. If the company is reimbursing a NED for these costs, they must be processed through the payroll – along with any fees paid to them – and subject to PAYE and NICs.

Providing consultancy services

Any fees associated with NED duties are considered employment income and subject to both PAYE and NICs. But there can be cases where the NEDs also provide consultancy services, either directly or via a PSC.

For consultancy, the employment status tests must be considered. If this work is seen as self-employment rather than an employment engagement, then any fees will not be subject to PAYE and NICs.

Documentation must be carefully drafted, as HMRC will often challenge it. The key point is that the consultancy work must be entirely separate and distinct from the NED duties.

It's important to note that NEDs are a key area of HMRC scrutiny and investigation. So, it's vital that organisations adhere to compliance obligations and make sure any engagement has been reviewed and taxed correctly.

For advice or further information, please speak to our employment tax specialists Aisling McCartan, Liam Condron or Tom Golding.

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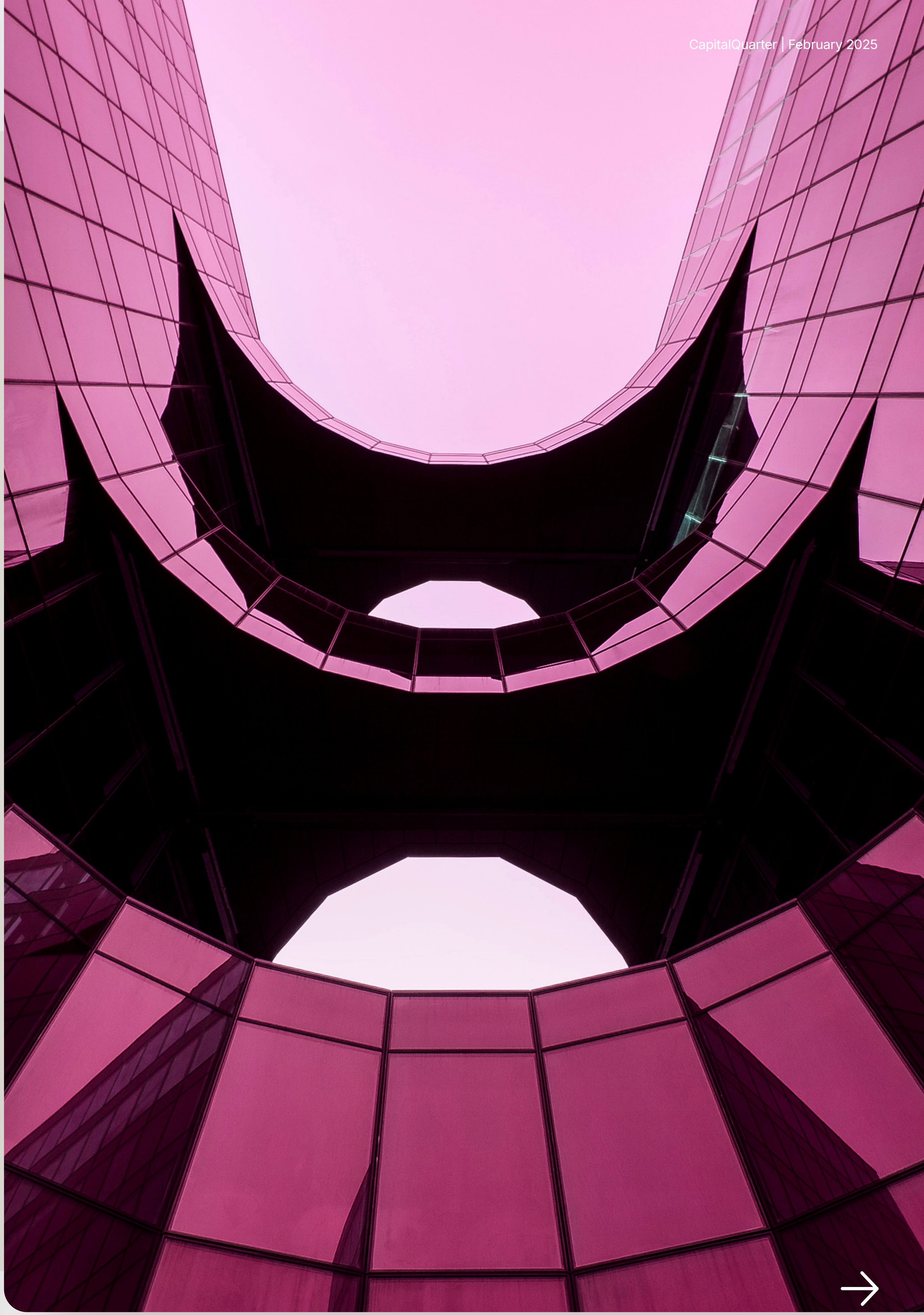

Emerging markets: How will they affect your listed business?

Emerging markets are crucial for UK-listed companies due to their rapid economic growth, expanding consumer base, increasing demand for goods and services and new investment opportunities. These regions offer diversification opportunities, mitigate reliance on mature markets and drive revenue growth through access to dynamic industries and untapped potential. With rising global connectivity, successful engagement with emerging markets can enhance competitiveness and long-term shareholder value.

An emerging market (or an emerging country or an emerging economy) is a market that has some characteristics of a developed market, but does not fully meet its standards – ie, high income, openness to foreign ownership and ease of capital movement, amongst others. This includes markets that may become developed markets in the future or were in the past, which means an emerging market status can come and go. Emerging economies are in the process of transitioning from low-income, less developed status to a more advanced state.

The characteristics of these markets (amongst others) are low per capital income, undeveloped financial markets, improving living standards, and some still face challenges relating to political instability.

There is no definitive list of countries classified as 'emerging markets'. The International Monetary Fund (IMF) classifies 96 countries as emerging, using criteria such us how much citizens of that country earn, how diverse the country's exports are and how sophisticated its financial system is. In comparison, investment research firm, MSCI classifies 24 countries as emerging markets, with their classification based on how investible a country's stock market is, which ultimately influences foreign investment.

Countries commonly classified as emerging markets include China, India, Brazil, South Africa and Mexico. Many emerging markets are part of the BRICS group (Brazil, Russia, India, China and South Africa), which signifies their importance in the global economy.

Key features of emerging markets include:

1. Economic growth

Emerging economies tend to have higher growth rates compared to developed economies. They are often industrialising rapidly and expanding sectors like technology, manufacturing and services. In the two decades before the pandemic, emerging markets largely outperformed developed markets. Rapid growth resulted in an increase in emerging markets' share of global GDP, largely at the expense of western Europe. According to a statistics.com report, 1 out of every 4 emerging economies outperformed their peers and developed countries, growing at an average of >3.5% compared to 2.7% in the US.

2. High volatility

Market volatility is the frequency and degree of price fluctuations, whether up or down. Market volatility is the frequency and degree of price fluctuations, whether up or down. These markets can be more volatile than developed economies due to political risks, regulatory changes and fluctuations currency values. In the past, we've seen emerging markets' currencies fall to historic lows against the US dollar.

3. Investment opportunities

Many fast-growing emerging markets have investment climates that are difficult to navigate, but investors often appear willing to put up with the inconvenience of difficult operating conditions in exchange for natural resources, efficiency gains, or the potential rewards that come with a large domestic market. Due to their growth potential, emerging markets attach foreign direct investment and capital inflows, offering opportunities for investors seeking higher return and though often at a great risk, hence the love-hate relationship investors tend to have with them.

4. Expanding middle class

The middle class is experiencing significant growth in emerging countries and the speed of growth has typically increased considerably. A growing middle class leads to higher consumption, which boosts domestic demand and can support long-term economic growth.

Why should listed companies pay attention to emerging markets?

Emerging markets play a crucial role due to their increasing economic influence, investment potential and unique challenges. Here are some of the key areas where the importance of these markets can be seen:

1. Growth opportunities

The rapid economic growth and expansion in emerging economies represents new multinational opportunities. As these countries industrialise, they experience rising consumer demand, creating opportunities for companies to enter untapped or less saturated markets.

Many emerging economies, such as India, China, and Brazil, have large and growing populations (increasingly part of the middle class) and therefore providing a large consumer base. These populations offer significant potential for demand in areas like consumer goods, technology, healthcare and financial services.

2. Diversification of risk

By expanding into emerging economies, companies reduce their reliance on mature, slower-growing markets. This diversification helps mitigate risks associated with economic downturns or regulatory changes in developed markets.

3. Resource access

Many emerging economies are rich in natural resources, such as energy, minerals and agricultural products. Companies can benefit from gaining direct access to these resources, ensuring a stable supply chain for critical materials.

4. Government incentives

Governments in emerging markets seek to attract foreign investment while maintaining economic stability. As such, they often provide incentives for foreign investment, including tax breaks, favourable trade policies and subsidies. These initiatives make entering and operating in these countries more attractive and financially viable.

5. Cost saving

Typically, emerging markets offer lower labour and production costs, allowing companies to reduce operational expenses. This can enhance competitiveness, especially in manufacturing and labour-intensive industries. We've seen the positive impact of large corporations moving their manufacturing plants to emerging economies.

6. Global influence

As emerging economies grow, companies that engage with these regions can position themselves to benefit from policy changes, trade agreements and evolving global standards.

Companies operating in emerging markets often face higher levels of business risk due to volatile economic conditions, regulatory uncertainty, political instability, differences in accounting and legal framework and exchange rate fluctuations .

How can we help?

With this multinational growth, investors need to ensure transparency, compliance and reliability of financial reporting in these regions. The PKF team has years of experience and a presence in emerging economies either through the PKF network or directly working with clients whose main offices are based in, amongst others, Central and South America, Africa and Asia.

Our Capital Markets team has extensive experience of working with clients breaking into untapped markets by providing due diligence on identified opportunities across the globe. We are here to help with the following :

- Assessing and mitigating the unique risks that come with investing in these economies, providing greater assurance to stakeholders
- Providing a deep understanding of the economic and business environments, including navigating different in local and international accounting standards, legal frameworks and compliance requirements
- As businesses in emerging markets grow, there is increasing demand for environmental, social, and governance (ESG) reporting. Assessing non-financial information, such as sustainability reports and ESG disclosures, ensures companies in these regions meet international standards of social responsibility and transparency
- Many emerging markets are rapidly adopting new technologies, including advancements in accounting and financial management tools. We can navigate the technological transformation challenges together.

Effective accounting can provide better insights into a company’s risk exposure, aiding decision-making and strategic planning.

For more information, please contact Pamela Ntandane or Joseph Archer.

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About PKF

Simplifying complexity for our clients

PKF is one of the UK's largest and most successful accountancy brands.

We have a strong reputation with publicly listed companies, and understanding these highly regulated, technically complex businesses has become a specialism of ours. We focus on delivering consistent quality and making all our clients feel valued.

Our specialist capital markets team has vast experience working with companies listed, or looking to list, on a range of international markets including the London Stock Exchange Main Market, AIM, AQUIS, NASDAQ & OTC, ASX and TSX & TSX-V.

PKF in the UK...

12

Ranked 12th largest Audit practice in the UK in the latest Accountancy Daily rankings

£202 million annual fee

1,450+ staff

5th ranked auditor of listed companies

Our **Capital Markets** credentials

Our **auditor rankings** from ARL

- 2 Total AIM listed clients
- 1 Basic materials sector
- 2 Energy sector
- 5 Total UK stock market clients
- 4 Technology sector
- 7 Financials and Real Estate sector

How we can help...

- Pre-IPO →
- IPO →
- Specialist transactions →
- Audit & assurance →
- Tax →
- Business advisory →
- Business soultions →

PKF UK in numbers

12th
Largest audit practice in the UK

20
Offices across the UK

1,450+
Employees and 180 partners

£202m
Fee income and growing rapidly

Capital Markets in numbers

180+
Listed audit clients

£2.7bn
Value of transactions advised on in last 10 years

100+
Transactions advised on in last 5 years

26
International businesses brought to the UK in last 10 years

PKF Global in numbers

Part of the **14th**
Largest global accounting network

480
Offices in 150 countries

$1.4bn+
In aggregate fee income

21,000
Employees

Get in touch today

To see how we can help...

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