THE UK AND THE EU

What would the impact be if Britain withdrew from the EU?

Introduction
ICAS, in accordance with the public interest mandate in its Royal Charter, seeks to inform public debates on important issues which affect its members and the business sector. We do so in an apolitical way, to facilitate better informed decisions on matters of importance to business and society.

Britain’s membership of the EU is a key issue at the present time. The Prime Minister has promised that he will hold a referendum before the end of 2017 on whether the UK should stay within the EU or leave. Often debate on such matters appears to be lacking in balance and in factual information, and the purpose of this paper is to:

• illustrate how EU policy impacts UK policy and legislation;
• highlight the possible impact on business of any decision to stay in, or leave, the EU; and
• help the electorate make informed decisions.

This paper sets out some of the background to how the EU impacts the UK, drawn from the views of our expert committees and members. It does not speculate or take into account the potential changes which the UK Government might be able to renegotiate with the rest of the EU prior to the planned referendum.

Myths and Markets

The public perception of the EU, as often portrayed by the media, is of a large bureaucracy which costs too much money, spends its time making rules about trivial matters such as the curvature of bananas, and which is overseen by national politicians squabbling about national interests.

In fact, fundamental aspects of much of the UK’s legislation are underpinned by EU law. Whilst this does inevitably represent some loss of sovereignty for the UK, the UK does engage through its MEPs in the European Parliament, through the involvement of UK politicians at the European Council, and through the engagement of UK civil servants and other stakeholders such as ICAS with the European Commission.

A key feature of the EU is the single economic market – a market of over 500 million people in which there is free movement of labour, capital and goods and where, over time, a high degree of uniformity of standards has facilitated that market. In some areas, such as environmental and social protection, and protecting the interests of employees, the EU has moved faster than the UK might otherwise have done. In other areas, such as the “comply or explain” approach to corporate governance, through demonstrating the effectiveness of the UK’s approach at EU level, it has managed to shape the EU’s policy and thus spread UK practice across the EU.

In acting collectively, the EU can be a powerful bloc in global politics – in influencing global events, negotiating international trade treaties and facilitating the globalisation of business. The EU’s decision to adopt international accounting standards in 2005 was a key commitment to the EU’s place in the global community and to international harmonisation of accounting.

As can be seen from the subject specific commentaries which follow, there is a common theme that if the UK did leave the EU, it would not have the totally free hand to change laws and practice which one may expect. The UK has an important place in the global market place and competes in that market place for international investment. Similarly, if the UK is to continue to access consumer markets then it must still conform
to the standards of those markets. Therefore, to maintain exports and international competitiveness, there may only be a narrow range within which UK policy change might be feasible.

EU IMPACT IN DIFFERENT SUBJECT AREAS

Broader Business Issues

UK companies formed under the Companies Act 2006 are subject to UK law as well as EU Directives and Regulations. Directives set out legislation which all EU countries must implement but they normally allow an element of flexibility in how the individual Member States do so. An EU Regulation, on the other hand, is legislation which applies directly as law in Member States.

The EU impacts on the UK in the following areas:

(i) Corporate Governance

Recent EU activity has included the review of corporate governance requirements resulting in the revised Accounting Directive and proposed new Shareholder Rights Directive. Broadly, developments at EU level on corporate governance have tended to encompass areas which the UK has already progressed at a national level. This recognises the UK’s strong international reputation for corporate governance and the variety of starting points across Member States. The UK has also successfully exported the ‘comply or explain’ approach across the EU.

(ii) Trading Bloc

Being part of a large free trade bloc – the EU Single Market, means goods and services can circulate freely between Member States. A ‘Common Customs Tariff’ (CCT) applies to the import of goods from outside the EU. It is not known what tariffs a UK outside the EU may charge on imports, however the EU currently applies a tariff of 32% on wine exported to countries outside the EU and nearly 10% on cars.

There is a tendency for countries to seek to join rather than leave trading blocs as businesses have an interest in increasing the market they can sell to and consumers benefit from choice and the downward pressure on price. Potential alternatives for the UK outside the EU (although these would be subject to negotiation) are as follows:

• Continue to trade with the EU Single Market by remaining in the European Economic Area (EEA) which allows access to the Single Market as long as the country adopts the majority of EU law (as, for example, Norway). However, not being part of the EU effectively removes the ability to influence how that law is shaped as there is no formal access to EU decision making bodies. The EU is a significant trading partner for the UK, representing 46% of exports in 2012, so negotiation of a free trade agreement would be highly desirable.

• Join another free trade association for non EU states in Europe such as the European Free Trade Association (EFTA) which contains four countries including Switzerland and Norway but is a much smaller market.

• Independently develop bilateral arrangements with key trading partners such as the EU, US and China, India and BRICS countries. The EU has exclusive rights to represent its Member States in negotiating trade and investment agreements with countries outside the EU, and its negotiating stance is strengthened by the size of its consumer market. In the event of an exit the UK would be free to negotiate its own agreements. However, it is likely that the smaller size of the UK compared to the EU would make it harder (and more time consuming and costly) to negotiate a “good deal”.


(iii) Regulation and Product Standards
A complete withdrawal from the Single Market would give the UK freedom to regulate as it wished. However, the divergences which may arise over time between UK and EU regulation may affect trade with the EU. EU product standards create a norm in Europe, and there would be little scope to depart from those standards if the UK wished to continue selling into the EU market.

It is unclear how a future UK government would shape its legislative and regulatory framework if outside the EU. For reasons of practicality and to minimise the disruption to business and the economy, a sudden and immediate change would be unlikely. More likely is an evolution over time, with the UK picking and choosing the best aspects of the EU framework, according to their suitability to UK circumstances.

It is noted that the UK generally prefers a less prescriptive and more principles based approach to regulation than the EU currently demonstrates; one of ‘minimal intervention’ where regulation or legislation are only pursued where a clear policy need is evidenced and non-statutory options have been considered first and rejected.

(iv) London as a Global Financial Centre
London is number one in the league table for global financial centres in 2015, having just inched ahead of New York since 2014, according to the Global Financial Centres Index. This Index includes no other EU cities until you reach Frankfurt and Luxembourg at numbers 14 and 19. It is unclear how being outside the EU might affect the UK financial services industry or the position of London as a global financial centre.

Taxation
There are three main areas where the EU has a very significant impact in the UK in relation to taxation:

(i) VAT
VAT is a European tax and was introduced in the UK when the UK joined the EU in 1973. VAT revenues for the UK Government are very significant – for 2013/14 it raised £102 billion out of total receipts of £490 billion so represents 21% of HMRC revenues. It is therefore inconceivable that VAT would be abolished given its contribution to the Treasury coffers. A similar tax existed before the UK joined the EU and many countries outside the EU have a tax that operates in a similar way.

However, if the UK did leave the EU, the current legislation could be adapted to adjust for the new political realities. The UK would have the power to extend and change the zero-rating of some supplies and the UK courts would not have to take the European Court cases into consideration. The downside for many businesses that operate across the current EU would be the additional compliance costs and complexity they would face in bringing goods into the UK. The UK VAT system could start to diverge from the EU wide system and the broad consistency across the EU would be eroded – the rules on place of supply of goods and services are examples of where there could be changes and where existing practices may well be overturned.

(ii) Customs Duty
Leaving the EU would involve leaving the customs duty union. At the moment, goods moved around the EU are not subject to duty but if the UK was outside the EU then there would be duty imposed when goods left the rest of the EU and entered the UK. This is a real cost to business and would have a significant impact both in terms of cash-flow and the administrative burden as the EU’s simplified procedures for imports and exports of goods would not apply. To give
some illustration of the level of trade that would be affected by this change the UK imported goods worth £191.7bn from the EU in the 12 months to 30 September 2014 and exported goods worth £122.1bn in the same period.

(iii) European Tax Cases
There are some key principles from EU law – the free movement of capital, proportionality, human rights – which have had a significant impact on UK taxpayers, and have allowed them to take tax cases to the European Court of Justice (ECJ) to challenge HMRC. An obvious example in corporation tax is the Marks & Spencer group relief case and there have also been proceedings taken by companies established in other EU countries where it was held that the old advance corporation tax system discriminated against them as compared to a UK only group. Even the income tax personal allowance is affected as the UK cannot give an income tax personal allowance to an individual who is resident here but not allow that same allowance to an individual who is resident in another EU country and has UK source income which is subject to UK tax. The ECJ cases have questioned some of the long-held procedures of the UK system and held them up to scrutiny, and in many cases have required the Government to go back and redraft tax legislation to ensure it works as intended.

Departure from the EU would not immediately negate previous rulings, but would remove an additional level of appeal, and would allow the UK’s approach to change over time.

Financial Reporting
EU legislation has a very strong impact on accounting and corporate reporting. The majority of financial reporting requirements for UK companies are set out in the Companies Act 2006, which is in turn based on EU Directives. The following areas are specifically impacted by EU legislation:

(ii) Listed Entities
The EU sources of legislation on financial reporting are the 2013 Accounting Directive and the 2005 IAS Regulation. The latter requires the use of EU-endorsed IFRS for the consolidated accounts of entities listed on a regulated market, so departure from the EU would allow the UK to choose between continuing with EU-endorsed IFRS, moving to full IFRS, or reverting to UK GAAP. Given the growing use of IFRS internationally, it is extremely unlikely that the UK would wish to move away from IFRS as a basis for reporting for its multinational companies. As a single country, no longer part of the EU bloc, however, the UK’s ability to influence the development of IFRS could be adversely affected by withdrawal from the EU – and it is possible that the UK might wish to establish its own endorsement mechanism for IFRS.

(iii) Other Entities
For other companies, EU directives (via the UK Companies Act) govern all the main areas of financial reporting, including company size categories, form and content of financial statements, general accounting principles, and publication requirements. Many EU requirements were already part of the UK reporting structure – for example, the true and fair requirement has existed in UK company law since 1948. Accounting standards for non-listed companies are not specifically referred to in EU legislation, therefore they are a matter for individual Member States and in the UK this is delegated to the FRC. The new Accounting Directive effective from 2016 reduces the autonomy the FRC has in establishing standards for small companies, as it specifies a maximum number of disclosure notes that can be mandated for such companies (although the true and fair requirement still applies).
The UK corporate reporting environment is generally viewed as highly-developed and often exceeds the minimum EU requirements; therefore it is unlikely that UK withdrawal from EU membership would lead to significant changes.

Audit
The impacts of the EU in relation to audit and assurance are as follows:

(i) Adoption of International Standards on Auditing
In 2004, the UK adopted International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). The European Commission has the power to adopt ISAs but has not proceeded down this route, despite the fact that many individual Member States within the EU have unilaterally decided to do so. In the light of the UK’s commitment to international standards, withdrawal from the EU is unlikely to have any impact on the UK in relation to auditing standards.

(ii) Auditor Retendering & Rotation
The recent EU Audit Directive imposes the requirement for auditor rotation after 20 years, so long as an initial tender process has been undertaken at 10 years. UK withdrawal from the EU would allow the UK to loosen some of the EU requirements. However, in light of recent UK experience in audit tendering and auditor rotation and the consequent expectations of investors and other stakeholders, the UK market already seems to have accepted as best practice a culture of more frequent audit tendering and auditor rotation, which could be difficult to reverse.

(iii) Provision of Non-Audit Services to Audit Clients
Again as part of the EU Audit Directive, a more prohibitive regime is being introduced in relation to the provision of non-audit services. Although withdrawal from the EU would remove the need for the UK to comply with this regime, the Financial Reporting Council (FRC) is likely to retain provisions on non-audit services which are at least as restrictive as those proposed by the EU.

(iv) Small Company Regimes
The separate small company reporting and audit regimes have been driven by EU Directives, and the UK thresholds have risen in accordance with EU increases. If the UK left the EU, it would be able to construct its own small company regimes for reporting and auditing and for any other purposes – and these could be fundamentally different from those in the EU. Care would need to be taken not to impose burdens on UK SMEs which might render them uncompetitive against their EU counterparts – although at the small company level the extent of cross border trade, and therefore competition, is likely to be fairly low. More likely, perhaps, the UK could choose to deregulate further and significantly raise the thresholds under which the various exemptions apply.

Pensions
The EU’s impact on pensions is largely on private pensions rather than on State or public service pensions. Private pensions fall into two categories: contract-based and trust-based, and the impact of the EU is reflected as follows:

(i) Contract-Based Pensions
Contract-based arrangements are regulated by the UK Financial Conduct Authority. The history of modern financial services regulation is UK rather than EU in origin and has developed from the system established in the 1980s of self-regulation by asset managers and the statutory regulation of banks and insurers. Since 2000, the legislative balance of power has shifted to the EU but supervision remains at UK level.
The structure, regulation and taxation of the new pension drawdown arrangements announced in the 2014 Budget are solely UK in origin as are the responsibilities placed on employers to automatically enrol their staff into a pension.

(ii) Trust-Based Pensions
Private sector trust-based arrangements are founded on the law of trusts and the modern UK pensions system was initially shaped by the Maxwell scandal of the early 1990s. However, the EU's Pensions (IORP) Directive 2003 (IORP I), which resulted in the Pensions Act 2004, has shifted power towards the EU.

(iii) IORP Directive
Pre-IORP I, the EU's major impact on pensions was the 1990 ruling by the European Court of Justice in the Barber case, whereby the trustees of pension schemes must now pay equal benefits to men and women with comparable service. This ruling, based on Section 141 of the Treaty of Rome, was formalised in UK law by Pensions Act 1995.

IORP I introduced rules to facilitate the cross-border operation of trust-based arrangements. However, the requirement for defined benefit (DB) cross-border schemes to be fully funded and differing tax regimes across the EU mean that such schemes remain relatively rare.

Plans to introduce insurance industry-style prudential solvency requirements for DB schemes, through IORP II, were unpopular as these could have made DB schemes in the UK and Ireland unsustainable. The EU has since pulled back from this plan and the potentially damaging proposal to professionalise the role of the trustee thereby losing the valuable contribution made by member-nominated trustees. Scope remains for the European Parliament to amend IORP II and therefore to bring back unpopular proposals.

EIOPA, the EU's pensions authority, continues to maintain its interest in the solvency of defined benefit pension schemes and would like to use a holistic balance sheet approach to compare defined benefit pension provision across the EU. While this would fall short of introducing revised solvency requirements, it would place additional regulatory burdens on schemes.

It is unlikely that the UK would make radical changes to pensions if the UK withdrew from the EU but it would certainly lose influence over the future IORP Directives. Outside the EU, the UK would no longer be subject to these Directives, although membership of the EEA or EFTA would likely come with conditions, so that some IORP Directive requirements, such as those on cross-border funding, may remain in place.

Sustainability
Two key implications of EU membership for the area of sustainability are as follows:

(i) Disclosure of Non-financial and Diversity Information
The EU Directive on the disclosure of non-financial and diversity information by large companies and groups requires those entities to disclose policies, risks and outcomes with regards to environmental matters; social and employee related issues; human rights issues; anti-corruption and bribery issues; and board diversity. Withdrawal from the EU would remove the need for relevant UK companies to comply with this Directive in relation to these disclosures. However, disclosure of many of these matters is currently required for all companies in the UK, except small companies, via the Strategic Report. Therefore withdrawal from the EU is unlikely to have any significant impact in this respect.
Greenhouse Gas Emissions

In the Climate Change Act 2008, the UK government announced its commitment to cut greenhouse gas emissions by 80% by 2050. The EU has also set out a 2050 roadmap which commits to a similar reduction. The EU Emissions Trading Scheme (EU ETS) was introduced as a key policy to help certain industries meet this target by allowing companies to trade their surplus carbon emissions allowances. The scheme operates by fixing an annual emissions allowance cap, set by the EU, and allowing the participant to buy or sell allowances as they require. The current cap, which was set in 2013, will reduce each year until 2020. As at 2013, almost one thousand installations participated in the scheme across the UK. More ambitious targets are expected to be introduced for the years 2021 to 2030 under proposed reforms to the scheme.

The UK’s withdrawal from the EU would not in itself change the UK Government’s commitment to reduce the level of greenhouse gas emissions and, as a result, the EU carbon trading scheme could be replaced by a similar scheme in the UK.

Public Sector Accountability and Audit

Some of the ways in which the EU exerts influence on the UK public sector are as follows:

(i) Financial Governance and Accountability

The UK public sector has implemented international financial reporting and auditing standards so little would be expected to change if the UK left the EU. As noted above, EU law has provided the power to adopt international standards on auditing for all audits of annual and consolidated accounts, and although this has not been adopted at EU level, most but not all Member States have adopted and enforced the ISAs.

The UK public sector has adopted International Financial Reporting Standards (IFRS). Although internationally based, they are subject to EU endorsement before application by Member States, resulting in an EU-endorsed IFRS framework, which closely reflects IFRS.

Eurostat is currently considering the most appropriate means of mandating accruals based accounting across EU Governments and the public sector. We would not envisage that any proposals would have a significant impact on the current UK public sector reporting regime. Certainly, if the UK left the EU in the future, it would no longer necessarily be affected by such EU developments.

(ii) Public Service Delivery – State Aid Rules and VAT

The way public services are delivered is evolving. A greater variety of business models exist to help deliver public services more efficiently and effectively. This includes increasing use of arms-length organisations, subsidiary companies and the third sector to achieve national outcomes. Any consideration of possible outsourcing of service delivery would need to take into account EU State Aid rules and the effect of VAT (not all organisations are eligible for the exemptions accorded to local authorities).

State Aid rules were created to promote competition and control state subsidy levels so as to maintain a level playing field across Europe. In practice, this means that government funding such as grants to a small enterprise, the creation of targeted tax reliefs to stimulate economic growth or investing in a framework to facilitate a move towards more preventative spend could be classed as ‘state aid’. The UK Government can and does apply for exemptions when a case exists to boost growth and address areas of market failure.
If the UK were to vote to leave the EU, the UK Government would inherit greater flexibility as to how it would apply State Aid rules and VAT rates. However, the policy needs underlying the creation of these regulations would still exist.

(iii) **Disparities in EU Funding & Grants**

The UK, being one of the richer Member States is a net contributor to the EU – to the extent of £8.6 billion in 2013, which works out at a cost per person of £134. This calculation is net of around £5.2 billion of UK public sector receipts supporting common policies such as agriculture, social and regional development. However, there are also EU grants directly payable to the private sector of around £925 million and direct EU funding in areas such as roads and business grants.

The impact of funding across the various UK jurisdictions is variable. For example, although the UK overall has a net contribution, Wales and Northern Ireland are net recipients.

The Common Agricultural Policy (CAP) represents almost 40% of the EU budget. The CAP provides direct support to UK farmers so leaving the EU would reduce those farm incomes which are dependent on EU policy.

A departure from the EU would therefore have a variety of impacts across different sectors and regions of the UK.

Additionally, there are various public sector supervisory and regulatory functions currently provided by the EU aspects of which might need to be resourced and potentially replicated for a separate UK, including in the areas of agriculture, fishing, financial services, transport and competition rules. These additional functions could be costly for the UK to set up and run.

(iv) **EU Funded Projects**

There are likely to be many on-going projects which receive EU funding. In the event of the UK leaving the EU, potential claw backs would need to be clarified and quantified to identify exit costs and additional funding needs.

Charities

In the UK, charity law and regulation are not driven by EU law. Three separate jurisdictions operate within the UK. Powers in this area are devolved to the Scottish Parliament and the Northern Ireland Assembly, England and Wales being the third jurisdiction.

However, there are many aspects of the EU and EU law which impact on charities in much the same way as they do on other organisations which deliver services and employ staff, for example, UK charities with operations in other Member States can relocate key staff with relative ease to where their skills are most needed. There are also aspects which have particular implications for the sector.

(i) **EU Funding**

UK charities can access grant funding from various EU initiatives. For example, the EU encourages international collaborations through funding scientific research. UK scientists, working within the charitable sector, play a significant role in these collaborations. There are also UK-based international aid charities undertaking projects overseas which benefit from EU funding.

(ii) **Procurement**

Public sector procurement rules, including thresholds for competitive tendering, originate from the EU with UK public sector bodies tending to apply these rigidly without using any of the flexibilities available. This approach is viewed by charities as a barrier to competing effectively for public service contracts.
(iii) VAT
As noted above, VAT is a European tax but the UK has a degree of flexibility around the setting of reliefs and VAT shelter arrangements. This means that charities can be disadvantaged relative to other organisations, for example, charities are not able to reclaim VAT on purchases whereas commercial businesses can.

Being in the EU does provide some benefit to charities in respect of VAT, for example, charities can import some donated goods free of charge providing that there is no commercial intent by the donor.

(iv) Preventative Spend
Charities are major providers of public services. There is a desire to shift from crisis spending to preventative spend. This approach is designed to save money in the long-run but needs working capital to make a decisive shift. However, there are challenges in this for government as debt financing provided to charities would likely be caught by the EU state aid rules (see above).

New grant funding, procurement rules and tax rules would be needed if the UK left the EU, and government policy of the day would determine how these impacted on charities. There would certainly be scope for departure from the current EU state aid rules, so as to facilitate preventative spending initiatives.

Data Protection and Anti-Money Laundering
UK Data Protection laws currently stem from the EU's Data Protection Directive. The UK is a member of the Organisation for Economic Co-operation and Development (OECD) which has set guidelines for the Protection of Privacy and Transborder Flows of Personal Data. Likewise Anti-Money Laundering compliance originates with the UK's membership of the global Financial Action Task Force (FATF).

Should the UK leave the EU, it would be unlikely that any of the current requirements would disappear or be amended significantly, as the UK would still need to meet its international obligations.

CONCLUSION
As indicated above, EU policies and principles as set out in EU Regulations and Directives have established themselves at the heart of much of UK legislation and practice, especially in those areas relevant to business. The scope for the UK to follow radically different policies and practices if it was outside the EU would appear to be limited, given the likely desire to continue to be a key player in European and international markets.

There are a series of larger scale questions relevant to businesses and their advisers which continue to be asked. These relate to: (i) the short term effects of the uncertainty this debate is generating; (ii) how the transition would work in the event of a UK departure from the EU and the consequent impact on UK business; and (iii) the impact which the UK’s departure would have over the medium and longer term. These questions include:

• What impact is the possibility of an EU referendum having on business currently?
• If a referendum vote was to leave the EU, how long would it actually take to do so? What would the transition look like?
• How much is current inward investment into the UK driven by easy access into EU markets?
• How would leaving the EU (or a referendum result to do so at a point in the future) affect investment into the UK?
• If the UK left the EU, would multi-national enterprises relocate UK activities into the rest of the EU?
• How long would it take for the UK to negotiate new trade deals with its key trading partners, if it left the EU?

Many of these are difficult, if not impossible to answer. Clearly though, they will need to be considered by many businesses in their risk and contingency planning, and by the government of the day when considering the impact on the UK economy.

It is hoped that this paper will be useful – to business and to members of the public – as a high level summary of the impact of the EU on UK business.