



*Analysing the EU exit charge*

# Foreword

**The financial relationship between the UK and the EU can be difficult to understand. We hope that this ICAEW brief will help make sense of how things work and what is going on, just as ICAEW Chartered Accountants do every day by communicating financial information clearly in order to support informed financial decisions.**

The UK has now started the formal process to leave the EU in 2019 and the respective negotiating strategies of the UK and the EU will become clearer in the coming months.

The scale of the challenge is significant. The negotiations will be complex and, unless all parties agree to an extension, there is now less than two years to conclude an agreement.

A critical element to the negotiations will be about money.

There has been wide-ranging speculation about the exit bill, from claims that the UK will have to pay as much as €100bn on its departure to assertions that the UK will be able to leave the EU without paying a penny.

Our analysis is that the net exit charge is likely to be much lower than those more extreme projections once the rebate and money coming back to the UK is accounted for, ranging from a low of £5bn up to £30bn, with a central scenario of £15bn.

A sensible approach to money will be an important component to achieving a successful outcome to the negotiations.

A strong trading relationship between the UK and the EU after the UK's departure will be critical if there is to be a world of strong economies.

**Michael Izza**  
Chief Executive, ICAEW  
May 2017



## A DEAL TO BE DONE

This ICAEW brief assumes that the UK and the EU will be able to agree terms covering the UK's departure.

We have not considered what might happen if the UK and the EU are not able to reach an agreement.

## FX

All amounts in this brief have been converted into sterling using an exchange rate of €1.20 to £1. The exchange rate could change significantly between now and March 2019.

## GROSS AND NET

In our central scenario, the UK could be asked to contribute a gross amount of £55bn, but the net cost to the UK would probably be closer to £15bn after deducting rebates, spending in the UK, and the realisation of the UK's investment in the European Investment Bank.

Our central scenario excludes contributions to the EU 2019 and 2020 budgets after the UK leaves, as we believe the UK has a strong case for arguing that it should not be liable for authorised spending that will not be committed to until after its departure.

# Potential exit charge scenarios

This ICAEW brief aims to explain the net exit charge that the UK may be asked to pay on departing the EU.

For this purpose, we have extrapolated from the EU's 2015 accounts to consider the main components of the potential bill that could be due in March 2019. Actual amounts may be different and will be subject to review and agreement by both the EU and the UK.

There are many different potential outcomes to the negotiation between the UK and EU on exit charge, but for illustrative purposes we have chosen to highlight just three potential scenarios - low and high scenarios that are possible but unlikely, and a central scenario that might potentially occur.

**These range from the equivalent of six months of net contributions, a central scenario of approximately 18 months and a high scenario of around three years.**

## NOTE

These numbers are dependent on the outcome of complex negotiations, so please read in this context.

Figure 1 - Potential exit charge scenarios

Low scenario	Central scenario	High scenario		Page
		£23bn	2019 and 2020 remaining budget	11
		£16bn	Committed funding	10
	£28bn	£28bn	Authorised spending not yet incurred	9
£28bn	(£11bn)	(£17bn)	Less: rebates	9, 10, 11
(£8bn)	(£13bn)	(£20bn)	Less: spending in the UK	9, 10, 11
(£10bn)				
£10bn	£20bn	£30bn	Net commitments	
£11bn	£11bn	£15bn	Liabilities less assets	5
(£6bn)	(£6bn)	(£5bn)	Less: rebate owed to the UK	6
(£10bn)	(£10bn)	(£10bn)	Less: European Investment Bank	7
(£5bn)	(£5bn)	-	Net balances	
£39bn	£55bn	£82bn	Payments to the EU	
(£34bn)	(£40bn)	(£52bn)	Receipts from the EU	
£5bn	£15bn	£30bn	<b>Net exit charge</b>	

Source: ICAEW analysis, extrapolated from the EU's 2015 accounts.

## What might a deal look like?

Our central scenario provides an illustration of what a deal might look like.

**This is likely to involve the UK agreeing to contribute towards expenditure committed to or incurred by the EU up to the date of the UK's departure.**

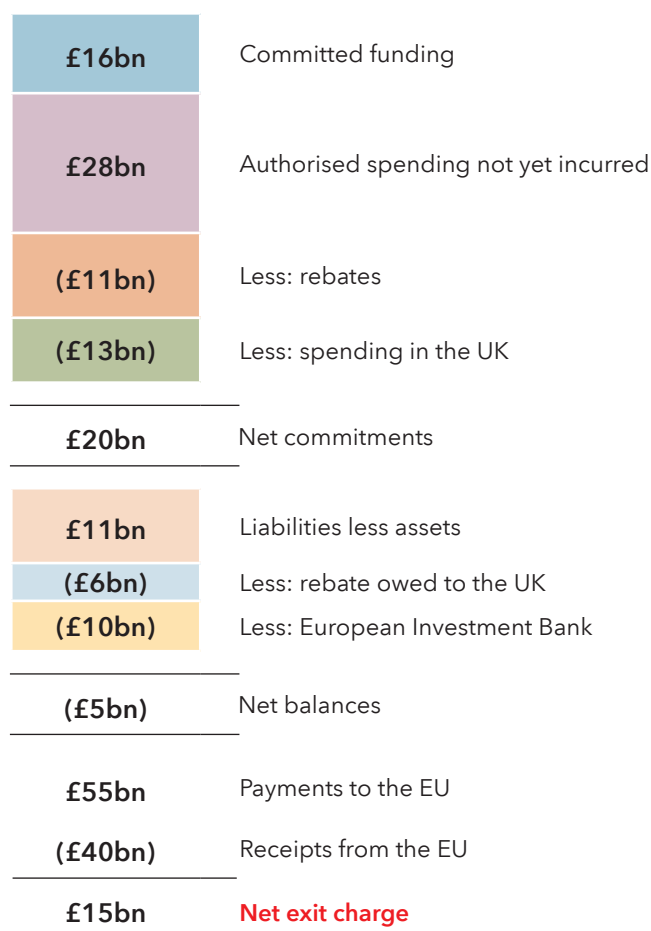
Our central scenario is based on applying the UK's approximate 16% share of EU spending to commitments entered into by the EU up to March 2019 and to the EU balance sheet. It also assumes that the EU will continue to apply the rebate mechanism to contributions made by the UK.

Although agreement in principle in such a scenario could be relatively straightforward, the negotiations would still need to deal with the complexities of agreeing on a final number. For example, the EU prepares its accounts on a calendar year basis and so there would need to be a mechanism agreed to manage movements between 31 December 2018 and the expected exit date of 29 March 2019.

In our central scenario, the UK could be asked to contribute a **gross amount of £55bn, but the net cost to the UK would probably be closer to £15bn** after deducting rebates, spending in the UK, and the realisation of the UK's investment in the European Investment Bank.

This is around £225 per person expected to be living in the UK in 2019, or approximately the amount the UK public sector spends in one week.

Figure 2 - Central scenario



Source: ICAEW analysis, extrapolated from the EU's 2015 accounts.

## The EU balance sheet

A key part of the potential exit charge relates to the EU's balance sheet. According to the most recently published financial statements, there were assets of £128bn and liabilities of £188bn at 31 December 2015, a net liability position of £60bn. The UK's 'share' of the net position is £10bn.

The financial statements report that member states owe a higher amount than this to the EU which, if paid in full, would put it into a net asset position of £4bn, at an additional cost to the UK of £0.6bn.

Net pension and sickness obligations for current and former EU employees can be distinguished from other assets and liabilities as they are subject to an explicit guarantee by member states dating back to 1968, embodied in Article 83 of the European Union Staff Regulations. These liabilities are expected to increase each year, and should be closer to £63bn when the UK leaves the EU in March 2019, equivalent to a UK share of £10bn.

If the UK agrees that it is liable for a share of EU pension payments then one option is to continue to contribute around £0.2bn a year for the next 50 years or so. Alternatively, it could make a one-off settlement, subject to the UK and EU being able to agree on a valuation.

Excluding pension obligations, all the other assets and liabilities net down to a relatively small negative balance of £7bn, with the UK's share being around £1bn.

There is likely to be some discussion over whether assets and liabilities should be valued differently from the amounts recorded in the balance sheet. In the EU's case, valuation differences on most assets should in theory be offset by corresponding adjustments to liabilities.

The main exceptions are fixed assets, but even if these were worth twice their accounting value, the adjustment to the UK's exit charge would only amount to £1bn.

### £10BN FOR PENSIONS

Pensions are distinguishable from other assets and liabilities because they are guaranteed by EU member states, including the UK.

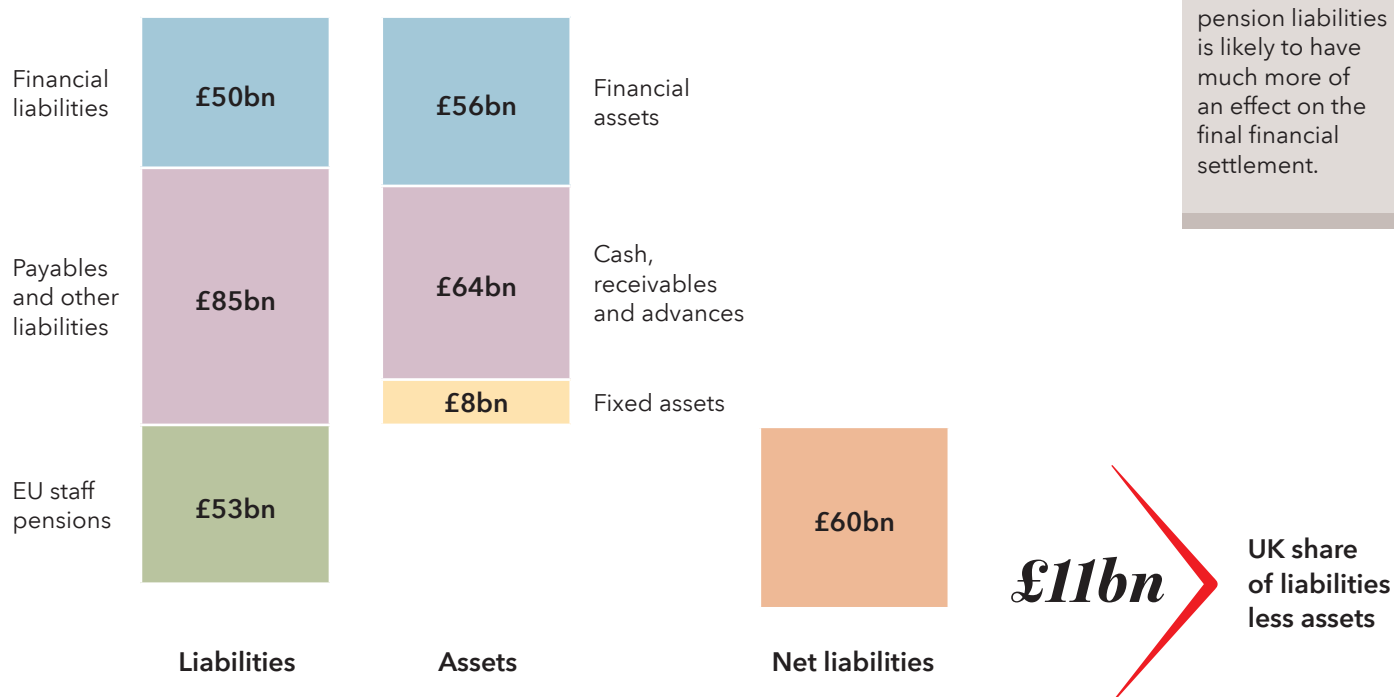
### £1BN FOR OTHER NET LIABILITIES

Excluding pensions, other assets and liabilities currently net to a relatively small amount.

There has been some speculation about the value of fixed assets owned by the EU, such as its art or wine collections.

Determining the value of pension liabilities is likely to have much more of an effect on the final financial settlement.

Figure 3 - EU balance sheet at 31 December 2015



Source: ICAEW analysis, extrapolated from the EU's 2015 accounts.

## *Background to the EU budget*

The EU is currently operating within a multi-year financial framework that started in 2014 and which ends in 2020.

The framework set out plans to incur expenditure in the order of £130bn on average each year, with annual average cash funding required of £122bn.

The final budget for each year is usually slightly different from the provisional numbers in the multi-year framework, with some adjustments to increase or decrease planned spending based on changes in circumstances and any new priorities.

**The UK's share of the EU budget each year is around £20bn to £21bn, before an estimated rebate of approximately £5bn to £6bn a year and spending coming back to the UK of around £6bn to £7bn. The UK's net contribution generally varies between £8bn and £10bn a year.**

A substantial proportion of the net contributions paid by the UK go towards development programmes, including around £1bn in aid to countries outside the EU that is counted as part of the UK's 0.7% commitment.

The UK will be involved in setting the EU budget for years up to and including 2019, but it is expecting to have left the EU before the final 2020 budget is agreed.

## *The rebate*

Under the EU's existing budgetary arrangements, the UK is entitled to a rebate on its contributions.

The rebate depends on multiple factors, including the amount of EU spending paid to or incurred in the UK. It is calculated on an annual basis and then netted off the UK's contributions for the following year, subject to further adjustment over the following three years.

When the UK leaves the EU at the end of March 2019 it will, in theory, be entitled to a rebate from the preceding 12 months of its membership. The calculation of the rebate is difficult to forecast, so although we have assumed it will be around £6bn based on expected trends, **the amount due to the UK at the date of departure could be different by several billion pounds either way.**

Whether and how any outstanding rebate balance might be paid back to the UK will be a matter for negotiation. If the UK agrees to continue to participate in certain EU programmes, it is possible that historic rebates would be applied against those future contributions rather than refunded in cash.

**The UK has a strong argument for the rebate to apply to any exit charge in that it is a key part of the existing financial arrangements that provide the basis for the EU's claim.**

**£6bn**

Estimated rebate expected to be due to the UK in March 2019

### **WILL THE UK GET ITS FINAL REBATE PAYMENT?**

The EU could, in theory, attempt to withhold outstanding rebates at the date of exit if there is no agreement on the wider exit charge.

# The European Investment Bank



The European Investment Bank (EIB) provides low-cost project finance to governments, local authorities, businesses, universities and other organisations in Europe.

The EIB is a separate legal entity from the EU and so is not consolidated within the EU accounts. This is despite the requirement for shareholders to be EU member states and the EIB description of itself as 'the EU bank'.

The UK has a 16% shareholding in the EIB.

At 31 December 2015, the EIB reported net assets of £53bn, of which the UK's share was £8bn, reflecting its original investment in the EIB and accumulated profits.

The EIB's net assets are likely to grow as it earns more over the period between now and March 2019, and so the UK's share is likely to amount to closer to £10bn by March 2019.

As ownership is restricted to EU members, it may be necessary for the UK to sell its stake to other EU members, or for the rules to be changed to allow it to continue to participate as a non-EU member.

One potential scenario might involve converting the UK's shareholding into interest-bearing debt, allowing the UK to be repaid over time. This would also allow the relative shareholding proportions of the remaining EU members to be automatically adjusted without them needing to contribute additional capital.

An even more radical approach could be to create a UK Investment Bank by demerging the UK part of the EIB's operations, however, such a move would present a number of challenges and so is unlikely to be a practical option in the time available.

In theory, the UK could forfeit its investment if there is no agreement with the EU over the exit charge, given that under the current rules it will be ineligible to remain a shareholder after its departure from the EU. Such a move by the EU would be subject to legal challenge by the UK, but could be conceivable in a scenario where the UK refused to agree to contribute towards EU pension payments.

## **NO CHANGE FOR THE EBRD**

The UK has a separate investment of £1bn in the European Bank for Reconstruction and Development (EBRD), which also provides low cost loans to support development in emerging European countries.

The UK's 8.6% stake in the EBRD is not linked to its membership of the EU and so should be unaffected by the UK's departure.

**£10bn**  UK shareholding in European Investment Bank

## *Contingent liabilities*

The EU accounts disclose contingent liabilities of £23bn at 31 December 2015, comprising £18bn in guarantees and £5bn in disputed claims. Most of the guarantees relate to loans granted by the European Investment Bank.

**These are potential liabilities that will only be payable in certain circumstances and, by definition, the UK is unlikely to need to pay any significant amounts to the EU with respect to these exposures.**

Contingent liabilities can cause confusion as they encompass both disputed amounts to be resolved through a legal process and guarantees that will only be called upon if specific events occur in the future.

Although it would be possible to agree a payment to be relieved of these exposures, it is much more likely that the UK will instead provide new guarantees to replace its share of EU guarantees and give an indemnity for its share of any potential future losses on disputed claims.

This is likely to involve the UK agreeing to take over £3bn in guarantees for loans provided by the EIB to businesses, universities, local authorities and other organisations based in the UK and potentially a share of loans made to non-EU countries.

For disputed claims, the UK's exposure from any indemnity would amount to a maximum of less than £1bn.

### **RISK TRANSFER**

Contingent liabilities 'may never happen' and so valuing them in a negotiation can be difficult.

In practice, a simpler way to deal with these EU exposures is to replace them with equivalent UK exposures.

## *Legal commitments*

The EU accounts for 2015 disclose several legal commitments, including £13bn committed to the European Fund for Strategic Investments, an £8bn commitment to the Connecting Europe Facility for broadband rollout, and £2bn to the Copernicus satellite observation programme, as well as £3bn in other legal commitments.

We have assumed that these commitments either relate to investments in assets to be funded by borrowing, or have already been included in authorised spending not yet incurred.

In either case, no further cash funding beyond those amounts already included in the different exit scenarios would be required from the UK, or indeed from other member states. We have therefore not ascribed any potential payments for these amounts within our potential exit charge scenarios.





## Authorised spending not yet incurred

The largest component of any potential exit charge relates to spending that has been authorised as part of the EU budget process, but which has not yet been incurred.

**The EU tracks this unspent budget through a mechanism known as the 'amounts still to be paid' or 'reste á liquidar' (RAL). This is the difference between spending that has been authorised and the amounts that have been paid out to date.**

At 31 December 2015, amounts still to be paid totalled £181bn, comprising £62bn carried over from previous multi-year financial frameworks and £119bn from the first two years of the 2014-2020 budget framework. This reflects the time lag between authorising programmes, many of which operate over periods of several years, and the eventual payment of bills.

The EU 2014-2020 multi-year financial framework indicates that authorisations are expected to exceed cash spending by around £27bn over the period between December 2015 and March 2019. The total amount still to be paid is therefore expected to increase to £208bn by the exit date, although this could change depending on the final EU budgets agreed for 2017, 2018 and 2019.

At 31 December 2015, some £34bn of this amount had been incurred as expenditure and recorded as liabilities in the EU balance sheet. This element therefore needs to be excluded to avoid double counting. This excluded amount varies over time, but as any changes will be offset by corresponding changes in the EU balance sheet, there should not be any effect on the overall exit charge calculation in most scenarios.

**Table 1 - Authorised spending**

Extrapolation to March 2019	EU total £bn	UK share £bn
Economic, social, territorial cohesion	121	19
Growth and jobs	33	5
Rural development	27	4
Global Europe	23	4
Security, citizenship, administration	4	1
Amounts still to be paid (RAL)	208	33
Less: incurred but not paid	(34)	(5)
Authorised spending not yet incurred	174	28
Estimated rebate on this spending		(8)
Estimated spending in the UK		(10)
Possible net contribution to the EU		10

Source: ICAEW analysis, extrapolated from the EU's 2015 accounts.

Although there are some who argue that the UK should have no liability for unspent budget amounts at the date the UK leaves the EU, many in Europe believe that by agreeing to the multi-year financial framework the UK accepted that it would be liable for authorised spending irrespective of when it is due for payment.

If the UK agrees to contribute to authorised spending not yet incurred it is probable that this will be on the basis that the rebate mechanism would continue to apply; we have estimated this would reduce the net contribution by £8bn.

We have also estimated that £10bn of this expenditure should be spent in the UK, for example in the form of research grants to universities, regional development aid or in spending by EU agencies within the UK.

**On this basis, the net cost to the UK of agreeing to pay for authorised spending not yet incurred would be around £10bn.**

### MONEY

Authorised spending not yet incurred is significant because of multi-year programmes, such as research grants to universities.

We have included authorised spending not yet incurred in the low, central and high scenarios.

## Committed funding

The next area for the potential exit charge is more controversial and in effect arises because the UK will be leaving the EU partway through the 2014–2020 multi-year financial framework.

The framework includes planned funding for certain EU programmes of an average of £55bn a year over the seven years of the framework. These comprise the European Regional Development Fund, the Cohesion Fund, the European Social Fund, the Fund for European Aid for the most Deprived, the European Agricultural Fund for Rural Development, the European Maritime & Fisheries Fund, the Asylum & Migration Fund and the Internal Security Fund.

According to the EU accounts, almost all this spending has been legally committed to by the EU to provide certainty to recipients. The EU therefore believes that the UK should contribute to the full committed amount, even if that includes expenditure in the 2019 and 2020 budgets after the UK's departure from the EU.

The balance of committed spending included in the EU accounts at 31 December 2015 was £282bn. This is expected to reduce to £97bn by March 2019.

### Post-2004 EU members



**Table 2 - Committed funding**

Extrapolation to March 2019	EU total £bn	UK share £bn
Committed funding	97	16
Estimated rebate		(3)
Estimated spending in the UK		(3)
Net amount potentially payable		10

Source: ICAEW analysis, extrapolated from the EU's 2015 accounts.

**If the UK were to contribute to this spending on EU programmes, its share would be £16bn before taking account of an estimated £3bn rebate and £3bn of spending coming back to the UK.**

The estimated rebate and UK spending elements are smaller proportions than apply to EU spending more generally. This is partly because this includes development funding that is focused on poorer parts of the EU, but it also reflects the rebate mechanism agreed to by the UK, which does not apply to much of the funding going to newer EU member states.

In addition, this includes funding going to countries outside the EU that the UK counts as part of its 0.7% international development obligation.

**Given the UK's post-cold war political commitments to support eastern Europe it is possible that the UK will establish its own development programmes for those countries. If it does so, the UK could argue that it should not also have to contribute to EU programmes at the same time.**

### DEVELOPMENT

Most of the UK's net contributions to the EU go towards development funding for newer EU members, mainly in eastern Europe.

Most of this has been committed up until the end of 2020.

Committed funding has been included in our central and high scenarios.

## 2019 and 2020 budgets

Some in the EU have argued that, by agreeing to a multi-year financial framework for the EU budget, the UK should be liable for the last one and three quarter years of the framework period. In effect, this view is based on treating the entire seven-year financial framework as being payable by the UK, with 'no refund' for periods of unused membership.

If this was agreed to, it would require the UK to contribute a further £10bn to the EU, net of the rebate and spending in the UK. With the time lag between authorisation and cash payments, this would involve activities that extend into the early 2020s.

We have excluded these amounts from our central scenario.

**We believe that the UK has a strong case for arguing that it should not be liable for authorised spending that will be committed to after it leaves the EU, especially in the case of the 2020 budget which it will not be involved in setting.**

However, there are scenarios where the UK could end up paying these amounts as part of the exit charge, for example in exchange for achieving other objectives. As a consequence, we have included these future budget authorisations in our high exit charge scenario.

### HIGHER

The balance of the 2019 and 2020 budgets are only included in our high scenario.

**£23bn**  **Balance of 2019 and 2020 gross EU budget**

## Transitional arrangements

The exit charge may be affected if the UK and the EU decide on a transitional arrangement.

A transition period would provide the UK with more time to implement new systems and processes, as well as giving businesses more time to plan ahead.

The EU would benefit from extending UK financial contributions to the EU budget until the end of its 2014–2020 multi-year framework and potentially beyond.

In such an arrangement, it is likely that the transition payments would be on the similar basis to the UK's current contributions.

Net contributions under such an arrangement, assuming the rebate mechanism continues, would probably be in the order of £20bn up until the end of 2020. This includes £10bn for committed funding and £10bn for the balance of the 2019 and 2020 budgets.

A transition arrangement on this basis would reduce the headline exit fee, as committed funding would instead be covered by transition contributions.

The total amount payable by the UK in the case of a transition arrangement up until the end of 2020 would be £25bn in our central scenario, comprising net contributions under the transition arrangement of £20bn and a reduced exit charge of £5bn.

### HEADLINES

The headline exit charge could be reduced by a transition deal, even though it would involve the UK paying more to the EU in total.

## *The cost of leaving*

The process of separating the UK from the EU will cost money, potentially running into hundreds of millions of pounds. This will include costs of hiring staff to do the negotiations, costs for relocating EU agencies, and costs for establishing new UK and UK-EU bodies to deal with activities currently managed by the EU, for example.

It is unlikely that the UK will be able to justify recharging any of its own costs to the EU, given that it is the UK's decision to leave.

However, the EU is likely to argue that costs incurred by the EU caused by the UK's decision to leave should be paid for by the UK rather than by other member states.

Examples might include the costs of relocating the European Medicines Agency and the European Banking Authority from London to other cities in the EU.

In practice some of these costs, such as redundancies payable to staff working in the UK, are likely to be effectively paid for by the UK under the rebate mechanism, as spending by the EU in the UK is one of the factors going into that calculation.

Whether other costs, in particular those not captured by the rebate mechanism, will be paid for by the UK or the EU will be a matter for negotiation.

### **DISAGREEMENT**

Generally, each side in an international negotiation funds their own costs.

The EU is likely to argue that this normal convention does not apply.

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## *Other amounts*

There may be other amounts that get included in the exit charge negotiation, even though they do not arise from the exit process.

For example, there has been some press speculation that the UK may have to agree to pay fines for infringements of EU laws or procedures as a condition of reaching an exit agreement.

In practice, the extent to which such items might become part of the negotiation will depend on the strength or otherwise of the cases concerned.

If an infringement claim is strong and a fine is likely, the negotiation may present an opportunity for the UK to agree a settlement for that litigation that might otherwise go on for years with an uncertain outcome.

However, if a claim against the UK is less likely to be successful, it may make more sense to refuse to settle and instead allow it to proceed through the courts.

**More issues are likely to emerge as EU and UK negotiators will each seek to identify potential claims that might add to or reduce the exit charge, or which might provide leverage to use in the negotiations.**

## *Future contributions after 2020*

**The negotiation is not just about the exit charge – there will need to be agreement on whether the UK will continue to participate in EU programmes and agencies and, if so, on what terms.**

For example, the UK has indicated that it would like to cooperate closely with EU countries on justice and security matters after its departure. This might involve the UK contributing towards EU agencies such as Europol or the European Defence Agency.

The terms of any contributions have yet to be agreed, but are likely to result in the

UK paying more than it does today to participate in those specific agencies. The rebate mechanism has, up until now, capped the amount the UK pays to participate in EU programmes and agencies, compared with the higher contributions paid by countries such as Germany. This is likely to change after the UK leaves.

The other key decision will be around development funding. The UK could decide to continue to work with the EU by funding joint development programmes or it could decide to run its own programmes separate from the EU.



## *Future savings?*

The UK should pay much less to the EU after 2020 than it does today. It will not want, nor be able, to participate in many EU programmes and agencies and it will no longer need to contribute to the running of institutions such as the European Parliament.

**Paying less to the EU does not necessarily mean that the UK will save money overall.**

If the costs of operating outside the EU cost the UK more than the current cost of contributing to EU institutions, then it may not save money on administration.

Similarly, many EU programmes and agencies undertake activities that the UK is likely to want to continue even if separate

from the EU. Hence, until the UK's plans become clearer it is difficult to assess whether there will be any savings on activities currently run by the EU, whether in the form of agricultural support to UK farmers, research programmes undertaken by UK universities, or space exploration efforts conducted jointly with other countries.

The most significant decision that will affect whether there are any savings on an ongoing basis relate to the UK's intentions towards development funding. This is because the largest element of the UK's current net contributions to the EU goes towards development funding, particularly to eastern Europe.

### **WILL THE UK SAVE MONEY?**

UK Government spending will increase after the UK's exit from the EU, offsetting at least some of the savings from lower payments to the EU.

# Conclusion

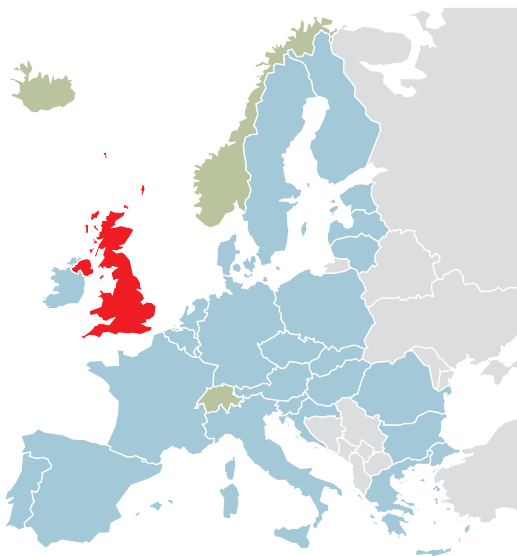
Ultimately the amount the UK will pay on or after its departure will be a matter for negotiation. Pensions, future development programmes and the continuation of EU spending in the UK from April 2019 onwards will be some of the key elements of the deal to be discussed.

**Although the potential one-off net exit charge of between £5bn and £30bn is relatively small in the context of UK taxes and other government income of around £800bn a year and a UK public sector balance sheet that contains £3.6tn in liabilities, the sums involved still run into billions of pounds.**

They are deserving of diligent attention by both the UK and EU negotiators, who each have fiduciary duties to get the best deal for their respective citizens.

The negotiations will therefore be intense and challenging, both in terms of agreeing the principles of what is or is not payable, as well as in verifying the accuracy and validity of the numbers.

## UK after leaving the EU and EFTA



Politics will also intrude, making perceptions even more important - something that could drive suboptimal decision-making if expectations are not managed well.

Negotiators on both sides are also aware that agreeing the exit charge is only one component of the overall financial deal that needs to be done. There will also need to be an agreement on which EU programmes the UK will participate in, and how much the UK should contribute accordingly.

Another key financial decision for the UK will be whether, and to what extent, it decides to participate in EU development programmes or alternatively establishes its own development programmes.

**Both sides will also be very aware that there is more at stake than just money.**

### TIMING IS EVERYTHING

The UK is unlikely to write a single cheque for the exit charge - instead payments are likely to be spread over many years.

## *Media enquiries*

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### **ACKNOWLEDGEMENT**

This ICAEW brief is based on research carried out for ICAEW by Martin Wheatcroft FCA, fiscal accountant and author of *Simply UK Government Finances*.

### **SOURCES AND FURTHER INFORMATION**

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