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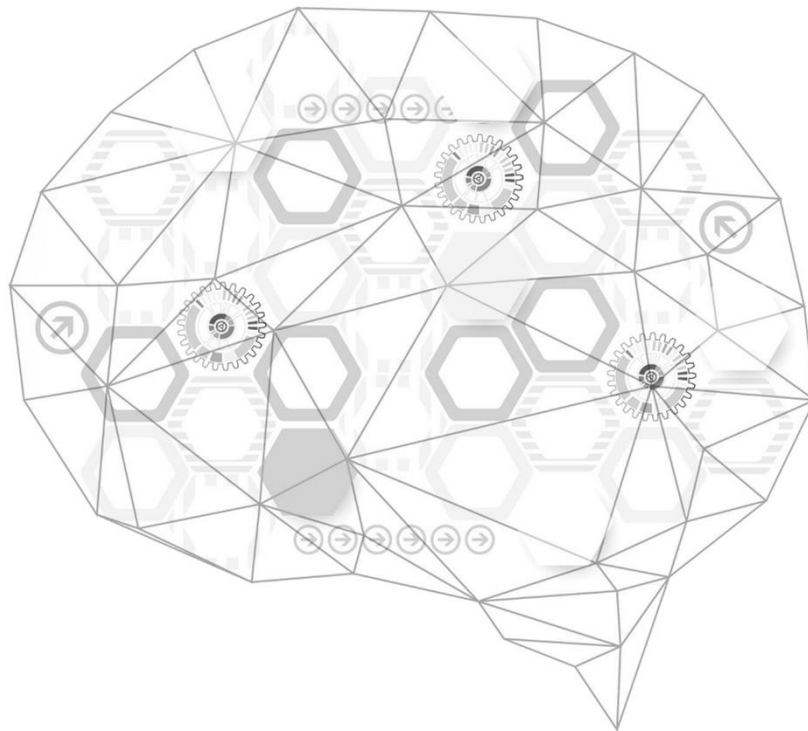
FROM RISKS TO REGULATION: RE-THINKING COMPANY CATEGORISATION

March 2020

COGITO.



Cogito: I think
Accountancy Europe's
thought-leadership series



COGITO

This document is part of the *Cogito* series, a selection of thought-provoking publications by Accountancy Europe. *Cogito* (i.e. *I think*) is set up to provide new ideas for the European accountancy profession. With this series, we aim to enhance innovation and our contribution to business and society.

This publication aims to stimulate debate; the views expressed thus do not reflect the official positions of Accountancy Europe or any of its 51 member bodies.

This paper is based on the work of an independent task force composed of: Anne Adrain, Cédric Gélard, Ralph Korf, Gerhard Prachner, Eilis Quinlan. We are grateful for their involvement, thoughts and dedication. The paper is the product of intense discussions and may not necessarily reflect the views of individual task force members.

HIGHLIGHTS

Quantitative criteria currently define how companies are categorised for regulatory purposes. Their turnover or number of employees often determine what legislation applies to them.

With global megatrends disrupting business models and markets, this publication aims to open the debate on how entities should be categorised. It does so by challenging the quantitative criteria's suitability.

We propose a risk-based approach to categorise companies which better reflects their impacts on the economy, environment and society. The paper also puts this thinking into practice by proposing a conceptual scorecard to assess entities' risk profile. A holistic take on companies' risks and impacts would enable policymakers to draft policies better suited for our increasingly complex world.

We seek the input on the proposed approach from regulators and other interested stakeholders. Please send your views to iryna@accountancyeurope.eu by 2 June 2020.

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EXECUTIVE SUMMARY

In this thought-leadership paper, we explore whether and how the categorisation of entities for regulatory purposes could be made more meaningful and better reflect current and future economic realities. We propose a qualitative risks-based approach to entity categorisation. The aim is to lead to simpler, smarter and more effective regulations that are better aligned with the public interest and mitigate negative impacts on the society, economy and environment.

Quantitative criteria currently define how companies are categorised for regulatory purposes. Their turnover or number of employees often determines the scope of EU legislation used to regulate them. However, quantitative entity categorisation has some limitations. Globalisation, digitalisation and innovation are fundamentally changing and disrupting business models and markets. In such an evolving context, the classical quantitative criteria may no longer be appropriate to grasp an entity's impact, and therefore to define and classify entities for regulatory purposes.

We propose that, irrespective of an entity's label whether a multinational or a SME, policy makers and regulators should focus on the entity's risks. By considering various risks, we can better map an entity's potential impacts on its surrounding society and environment.

SCORECARD TO DETERMINE ENTITY'S RISK PROFILE

We propose a risk mapping scorecard as an example of how a risk-based categorisation could work in practice. Such a scorecard could determine an entity's risk profile to better understand how, where and why an entity impacts its surroundings. This approach could by extension enable a more targeted and proportionate allocation of regulatory requirements, better suited for the more multi-faceted demands of policymakers, investors and the wider society.

The conceptual scorecard is based on two axes: a horizontal axis to define an entity's profile through key criteria (such as complexity of business model, ownership, types of funding and purpose), and a vertical axis listing areas of risk (such as economic, social, fraud, environmental and technological risks). The risk score calculation is done by combining the two axes to build the entity's complete risk profile.

Based on the entity's risk profile, its respective regulatory requirements could be focused on those risk areas with a higher risk score, whilst requirements in areas with a lower risk score could be softened. In this way, a risk-based entity categorisation could incentivise entities to proactively take risk mitigating measures and reduce their risk level- to benefit from regulatory alleviations.

Like with all novel ideas, this approach focusing on risk-based categorisation will raise immediate practical questions. And it is indeed the purpose of this paper to trigger a debate with policy makers and stakeholders and use their feedback in further developing this concept.

HOW COULD THE SCORECARD BE USED?

The scorecard's primary purpose is to categorise entities from a regulatory point of view, and as such can be used by:

- public authorities to inform a more risks-based approach to compliance and enforcement
- policymakers to better map out how legislation should be targeted for different kinds of entities
- regulators and/or stock market operators as a condition for listing and to provide key information to investors

WHICH PURPOSES CAN THE SCORECARD SERVE?

The sample scorecard can eventually be used for a series of different purposes:

- as a tool to categorise entities for regulatory, disclosure and assurance purposes to ensure better outcomes for society, environment and economy
- as a one-stop-shop regulatory compliance tool for entities that want to register with various relevant public authorities and have an overview of potentially applicable regulatory requirements
- as a tool for regulators and policymakers to have an overview of all regulatory disclosure, transparency, assurance, governance etc. requirements and assess whether the regulatory mix is fit-for-purpose

The proposed scorecard is not a ready-to-use model, but rather an illustration that indicates a direction of thinking. Its primary purpose is to categorise entities from a regulatory point of view. The sample scorecard can be developed further on the basis of feedback and discussion with relevant stakeholders. In *Annex 3*, we pose several questions on this approach and invite regulators and other interested stakeholders to provide their input.

Please send your views to iryna@accountancyeurope.eu by 2 June 2020.

INTRODUCTION

Entities are categorised into small companies, medium sized enterprises, large businesses and so on by employing thresholds-based quantitative criteria such as number of employees or annual turnover. This thresholds-based company categorisation then defines the scope of legislation used to regulate different entities.

Globalisation, digitalisation and innovation are fundamentally changing and disrupting business models and markets. In this dynamic and evolving context, the classical quantitative criteria may no longer be appropriate to define and classify entities for regulatory purposes. In the future, these criteria are likely to become even less relevant. Quantitative criteria can also be arbitrary, easy to manipulate, and offer opportunities for entities to avoid regulatory requirements.

We need to re-think how we categorise entities. This paper aims to explore whether and how the categorisation of entities for regulatory purposes (e.g. corporate governance, company law, reporting, auditing and assurance) could be made more effective and better reflect current and future economic realities.

We propose a qualitative risks-based approach to entity categorisation as an alternative to the current quantitative size-based categorisation. A risk-based assessment enables policymakers to better understand entities' impact on their surrounding markets and society, and to link these to desired policy objectives. This alternative method should lead to smarter, simpler and more effective regulations that are better aligned with the public interest and mitigates negative impacts on the society, economy and environment.

This approach could also be beneficial for the entities themselves. It would enable policymakers to draft more targeted and relevant legislation that fits the entities' specific characteristics. In practice, this means less 'one-size-fits-all' and more proportionate and relevant regulatory requirements, and could even mean *less* regulation for the standard no frills entity.

LIMITATIONS OF QUANTITATIVE CRITERIA

Quantitative criteria – such as number of employees or turnover – for defining what is a small business, a micro entity, a large company etc. have their benefits. If properly applied, they provide certainty and consistency. Legislation should be based on clear and comparable criteria that ensure a level-playing-field. Pure size is a simple criterion and there is great inherent value in simplicity.

For example, the EU's current SME Definition (small and medium-sized enterprises) is based on three clear and simple quantitative criteria¹ that are used to determine an entity's standing from the point of view of various pieces of legislation. Other jurisdictions also make use of similar quantitative criteria even if with different figures.²

However, quantitative entity categorisation has some limitations which are becoming ever more apparent.

¹ (1) staff headcount (< 250 in annual full-time equivalents), (2) financial parameters (turnover (\leq EUR 50 million) or the balance sheet total (\leq EUR 43 million), (3) independence/ownership (distinction is made between autonomous enterprises, enterprises with partner relationships (ownership between 25% and 50%) and enterprises with linked relationships (ownership above 50%). See Accountancy Europe (2018) response to EC's review of the SME definition [online] Available at: <https://www.accountancyeurope.eu/consultation-response/european-commission-consultation-on-the-review-of-the-sme-definition/>

² For example, the UK Companies Act 2006 section 382 states that small companies are those that meet two of the three criteria of 1. Turnover <£10.2m; 2. balance sheet total <£5.1m and 3. <50 employees for two consecutive years.

NO LONGER FIT FOR PURPOSE

Pure quantitative criteria are no longer fit for purpose in determining an entity's impact and significance to its surrounding market and society.

Policymakers, investors, companies and the general public are increasingly interested in the environmental, social and governance (ESG) considerations and corporate social responsibility (CSR)³ issues associated with running a business. Such pertinent factors may not be fully captured by categorising entities on the basis of 'one-size-fits all' quantitative criteria alone.

For example, the EU Non-Financial Reporting Directive (NFRD) requires only large undertakings with more than 500 employees to report on their impacts and key risks in relation to environmental, social, human rights, anti-corruption and bribery issues related to their activities and operations. This includes their products or services which are likely to cause adverse impacts in those areas.

ShareAction⁴ has performed an assessment of the NFRD application and recommended to

“expand the application of the non-financial reporting requirements to all large undertakings – regardless of their public/private status, and turnover – as well as to small and medium enterprises which operate in high risk sectors, and require them to publish an annual integrated sustainability report that addresses their full value chain”⁵

DIVERGENCIES ACROSS LEGISLATION

Quantitative criteria that define size categories of companies (micro, small, medium-sized or large) are diverse across different pieces of EU legislation. As a result, they can be confusing, costly to administer and navigate for entities where different pieces of EU legislation apply. They can also result in over-regulation of simple, low-risk, less complex entities purely due to their size.

The European Commission (EC) has specifically acknowledged this drawback in its *fitness check* consultation by pointing out that:

“The metrics of size-criteria for a micro-company in the Accounting Directive differ from those in the Commission Recommendation 2003/361/EC (concerning the definition of micro, small and medium-sized enterprises). The entity's turnover may not exceed €700,000 for micro-companies in the Directive whereas it may not exceed €2,000,000 in the Recommendation”⁶.

'THRESHOLD EFFECT'

Quantitative criteria may enable some entities to avoid additional regulation through so-called 'threshold effects' e.g. companies dividing into smaller legal entities within the group to avoid falling within the scope of additional regulatory obligations.

In its consultation *Review of the SME Definition*, the Commission has acknowledged that mere size “might represent a handicap”⁷ and may be used by large companies to “design structures and set up 'satellite' entities to benefit from support that is intended for genuine SMEs that do not have support from large groups.”⁸

³ The European Commission defines “CSR as the responsibility of enterprises for their impact on society and, therefore, it should be company led” see: https://ec.europa.eu/growth/industry/corporate-social-responsibility_en

⁴ ShareAction is a charity that promotes responsible investment. It aims to improve corporate behaviour as regards environmental, social and governance issues.

⁵ ShareAction (2019) *Accelerating Process and Reaching Scale* [online] Available at: <https://shareaction.org/wp-content/uploads/2019/02/CSOstatement.pdf>

⁶ EC (2018) Consultation document: fitness check on the EU framework for public reporting by companies [online] Available at:

https://ec.europa.eu/info/sites/info/files/2018-companies-public-reporting-consultation-document_en.pdf

⁷ Accountancy Europe (2018) EC's review of the SME definition [online] Available at:

<https://www.accountancyeurope.eu/consultation-response/european-commission-consultation-on-the-review-of-the-sme-definition/>

⁸ Ibid

SIZE DOES NOT (NECESSARILY) REFLECT COMPLEXITY OR RISK LEVEL

Purely quantitative size criteria do not necessarily reflect the complexity of an entity's business model or its impact on markets, society and the environment. Companies employing less than 10 people can operate on a global scale, with complex structures and a business model with potentially significant impacts on the environment and stakeholders.

Technology and digitalisation enable smaller entities to access potential markets and suppliers with greater ease, and to disseminate their services without necessarily increasing the physical scale of their business. Yet, such companies would currently be exempted from the obligations of the Accounting Directive for example.

Several EU Member States (e.g. France, Nordic region, Italy) have already reflected on the relationship between an entity's size and complexity within the framework of performing an audit, in the context of discussions on the value of audit for SMEs. This has raised questions about whether the traditional entity categorisation criteria based on size alone are still fit for purpose.

The IAASB's recent consultation on audits of less-complex entities⁹ has also explicitly acknowledged that:

*"It is appropriate to focus on the complexity of the entity rather than its size. This is because in today's environment it is not only about size—there may be entities that are smaller but may be considered complex, and there may be other entities that would not be considered smaller, but would be considered less complex."*¹⁰

EXAMPLES

- Small companies that are complex and potentially risky:
 - a high-growth potential innovative start-up or a high-tech pharma/biotech company may have less than 10 employees but large human capital, significant preclinical investments and be active on global markets
 - a sophisticated FinTech firm active on global financial markets that can have disruptive effects on its markets
- Small companies that are simple but risky:
 - a dry cleaner with a negative impact on the environment and public health in its community
 - a small cash-based entity may be used as a money laundering vehicle
- Large companies that are simple in their operations and less risky:
 - a global manufacturer of machine parts that employs thousands of people around the world may have a simple business and operating model

⁹ IAASB Discussion Paper (2019) *Audits of Less Complex Entities: Exploring Possible Options to Address the Challenges in Applying the ISAs* [online] Available at: <https://www.iaasb.org/publications-resources/discussion-paper-audits-less-complex-entities>

¹⁰ Ibid

LINKING AN ENTITY'S PROFILE TO RISKS

Policy makers and regulators should focus on the entity's risks for the surrounding markets and societies to design smart and more fit for purpose legislation, instead of the quantitative criteria that currently determine an entity's label (multinational, SME, etc.). This should be done by linking the entity's criteria such as business model, markets, ownership, governance and complexity of its transactions to areas of risks.

Linking entities' operations to risks is essential to better understand their broader external impacts. Issues such as those linked to ESG matters often "derive from a risk or impact inherent in the core operations/products of a particular company".¹¹

BENEFITS OF A RISK-BASED CATEGORISATION

One of the main purposes of any legislation and entity categorisation is to protect the society at large or specific groups of stakeholders from potential negative impacts stemming from entities' operations. In other words, the potential risks posed by an entity towards its investors and employees, its creditors, society in general and the environment in which it operates.

A risk-based approach to entity categorisation would enable to better map and grasp entities' (potential) impacts on society, the environment and the economy. Legislation drawn up on that basis would be specifically targeted for entities with particular risk profiles – whether across the board or in only specific areas of risks.

A risk-based approach to entity categorisation could:

- allow for a more proportionate, targeted, flexible, effective and fit-for-purpose regulatory requirements that give better perspective to how different entities affect their surroundings and stakeholders.
- benefit all key stakeholders:
 - a. policymakers will be able to design better and more efficient policies
 - b. public authorities can adopt a more risk-based approach to compliance and enforcement, enabling them to allocate their resources and efforts more effectively
 - c. entities themselves, whose regulatory requirements can be better tailored and rendered proportionate to their business. For many entities, this would mean regulatory simplifications, streamlining and relief as their regulatory requirements would be more directly linked to their activities and particular profiles

How could such a risk categorisation exercise be done in practice? We provide below one possible example: a scorecard to determine entity's risk profile.

¹¹ Society for Corporate Governance and BrownFlynn (2018) *ESG Roadmap: Observations and Practical Advice for Boards, Corporate Secretaries and Governance Professionals*. [online] Available at: <https://www.societycorp.gov.org/governanceprofessionals/currenttopiclandingpages/sustainability/esg-briefs>

A SAMPLE SCORECARD TO DETERMINE ENTITY'S RISK PROFILE

We propose a scorecard that would attribute to an entity a specific risk profile for each risk area, influenced by its complexity, funding, ownership structure, and other relevant factors. This approach could enable a more holistic and nuanced mapping of an entity's potential impact and risks that are not captured by the traditional quantitative criteria.

In the scorecard, an entity's final risk score would trigger appropriate sectoral reporting, auditing, and governance obligations to improve transparency and mitigate risks. If an entity scores high across all areas of risk, then all or most regulatory requirements would apply. Conversely, if an entity is high-risk in one or a few areas but has considerably low risks in others, its regulatory requirements could be tailored to address the high-risk areas only.

The scorecard's purpose is not to impose or produce more regulations but to ensure that proportionate and fit for purpose requirements are in place. This would lead to more effective legislation, whilst also enabling a more entity-specific and tailored compliance framework.

The proposed conceptual scorecard consists of two axes: a horizontal axis to define an entity's profile through key criteria, and a vertical axis listing areas of risk. Combining the entity's criteria (horizontal axis) with risk areas (vertical axis) would result in a risk score calculation with the ultimate objective of building an entity's full and comprehensive risk profile.

GENERAL CONSIDERATIONS

We do not put forward a ready-to-use blueprint of the scorecard or calculation methodology, as the sole purpose of this paper is to trigger a debate with policy makers and stakeholders.

We also recognise that immediate practical concerns will arise from the proposed risk-based entity categorisation and the scorecard concept. If not properly designed, such a qualitative approach might increase overall complexity of entity categorisation, instead of streamlining and simplifying it. Moreover, using qualitative rather than quantitative methodologies could mean less comparability and thus less certainty.

Further work will be needed on the proposed elements in the scorecard specifically and with the risk-based entity categorisation more broadly. This includes the selection of the specific company criteria, defining the risk categories all the way to the actual scoring exercise to ensure that it is applied in a comparable and consistent manner to different entities and across different jurisdictions. Ensuring consistency and comparability of the risk score calculation between one entity and another will be essential to make the model useful for regulatory purposes.

THE SCORECARD – SMART GRID FOR SMARTER REGULATION

The table below provides a visual representation of the concept described. The criteria and risk areas presented in the sample scorecard are an example of a possible categorisation and are not necessarily comprehensive or exhaustive. Moreover, each of the broad risk areas on the vertical axis and the entity criteria on the horizontal axis could be broken down into more specific categories, and each of these in turn into further sub-risk categories or sub-criteria.

Our choice of risks and criteria can be challenged, altered, expanded and replaced by others. However, the consistency in application should be considered while further developing the scorecard model, since consistency is essential to ensure comparability, objectivity and practicality of the model. Developing specific metrics on the proposed criteria to produce consistent results could be a possible next step.

Further discussions will be needed to determine what are the most appropriate factors to look into. The main purpose is to start the discussion and propose a new perspective into thinking about entities rather than to present a readily designed and full elaborated scorecard for immediate consumption.

SAMPLE – SCORECARD

Mapping of entity's risk profile

	Complexity	Ownership	Types of funding and purpose of an entity
Economic risk			
Social risk			
Fraud & corruption risks			
Environmental risk			
Technological risk			

HORIZONTAL AXIS: BUILDING AN ENTITY PROFILE THROUGH OBJECTIVE CRITERIA

It is essential to understand the entity's nature in order to assess its impacts and potential external risks. The sample scorecard incorporates this dimension with a horizontal axis that establishes a set of objective criteria. This would then be coupled with the entity's risks on the vertical axis.

We made a selection of at least some key criteria that would be necessary to understand an entity's character. However, we do not claim that these selected criteria are necessarily the best or only way.

With the considerations above, we propose the following qualitative criteria to demonstrate how the scorecard would work. Each of these can be further broken down to more specific sub-criteria:

- **complexity:** business model, types of activities and transactions, etc.
- **ownership:** legal form, public / state owned vs. privately owned entity, types of shareholders (e.g. multiple, minority, institutional etc.) etc.
- **types of funding** (debt, equity, venture capital, etc.) **and purpose** (profit, public service, social cause, etc.)

We recognise that some of these criteria will inevitably overlap between each other and cannot be considered as stand-alone.

QUALITATIVE CRITERION 1 - COMPLEXITY

An entity's complexity reflects the ease or difficulty in understanding its business or activities, types of assets etc. This also links to the 'scale' of the entity – whether it operates locally or cross-border, the size of its supply chain and its role in the supply chain.

The entity's supply chain in particular strongly affects its risk rating across the board. Companies with far-reaching global supply chains pose particular risks by virtue of their strong presence across the world. The size of a company's supply chain and its significance to other sectors of an economy can cascade its effects onto others. Such an entity's failure or collapse in its business operations would create a domino effect on its suppliers, subcontractors etc. across the world.

Large supply chains are also notoriously difficult to manage. It is challenging to be fully on track with everything that is happening throughout the chain. A company may not be aware of all potential environmental, human rights, social or financial stability impacts or events occurring throughout its supply chain. Yet, consumers, investors and policymakers hold companies increasingly responsible for issues stemming from their supply chain related activities (e.g. human rights violations, environmental pollution).

QUALITATIVE CRITERION 2 - OWNERSHIP

Relevant matters to consider under this category that would have implications to the external risk of an entity are whether it is publicly (state) or privately owned, who are its shareholders (e.g. multiple, minority, institutional, closed groups, related group such as a family business etc.), and its legal form.

Another issue to consider in this context is the ongoing debate about the broader responsibilities of companies. Should they aim to maximise shareholder value or instead consider additional stakeholders (e.g. as has been recently stated by the Business Roundtable¹²)? The underlying reasoning is that the shareholder primacy mindset can encourage excessive risk taking and short-term profit maximisation. This in turn will have direct implications to the external risks of an entity to the society, environment and economy.

Ownership of an entity tells us who within an entity is effectively in control¹³, who is ultimately responsible, whether these persons can be easily traced and are transparently disclosed for example. It is, therefore, another relevant criterion when assessing an entity's risks for the society.

Control and ownership may have an impact on, for example, the probability of money-laundering and corruption. If a company is owned offshore, its profits and taxes may be reported, registered and levied offshore as well. The main risks associated with shell companies are tax evasion, corruption, money laundering and terrorist financing.¹⁴

QUALITATIVE CRITERION 3 - TYPES OF FUNDING AND PURPOSE

An entity's types of funding and purpose are often dictated by the ownership structure. However, whilst ownership tells us how an entity is organised and who is in control, sources of funding help us understand what underpins an entity's activities (for profit, non-profit, public sector entity) and sustains its business. They also indicate what the entity's objectives are and whether it is run with its owner's or other stakeholders' money.

At the same time, the types of funding do not automatically translate into an entity's purpose. Therefore, under this criterion we also need to consider the entity's mission statement, its effective activities and their outcomes, etc. For example, an entity can be bank funded and pursue a public interest purpose, or receive public funding and pursue a commercial purpose.

The types and sources of funding should be considered together with the purpose of an entity. Such a holistic approach enables us to better understand an entity's actions, as they depend broadly on whether its main purpose is for example to:

- make more money (e.g. to investors and if so, what types of investors (e.g. short-term investors))
- act for a specific cause (e.g. charities or non-governmental organisations that collect money and donations from citizens)
- create a public service (e.g. by using taxpayer funded public money)

It is also relevant to consider what sorts of risks if any are appropriate for the specific types of funding (for example, debt, equity or by owners e.g. in family business), and whether or not such risks are appropriate and should be accepted depending on the entity's purpose. For example, an investment by a venture capitalist inherently entails taking and accepting a higher risk of financial loss. In return, investors have an expectation of financial return for the risk that they take.

Funding according to their different goals – to earn profit, to provide public service, to pursue social cause – could be expected to trigger respective reporting and assurance requirements. This is because funding is not only about how the money is managed but also whether the objectives of that funding are achieved. Different

¹² “A new “statement of purpose” from the BRT on Monday placed shareholders as one of five stakeholders, alongside customers, workers, suppliers and communities.” This is a significant shift from the traditional model that placed maximizing returns to shareholders at the center of company purpose. The new “purpose statement” says – “Companies should “protect the environment” and treat workers with “dignity and respect” while also delivering long-term profits for shareholders.” See: <https://www.ft.com/content/e21a9fac-c1f5-11e9-a8e9-296ca66511c9>

¹³ See for example: <https://www.oecd.org/tax/transparency/beneficial-ownership-toolkit.pdf>

¹⁴ http://www.europarl.europa.eu/cmsdata/155724/EPRS_STUD_627129_Shell%20companies%20in%20the%20EU.pdf

information levels and different control types will be required to ensure that these funding objectives and expectations are met, and that the money is managed properly to meet those goals.

In this respect, different types of funding (equity, debt financing, venture capital, crowdfunding, public funding etc.) entail associated risks. The risk of equity funding rests mainly with investors. Equity investment from family members is different from crowd or business angel funding. Venture capital is different from institutional investment or family investment. Venture capital and business angel investors assume higher risk for the financing that they provide.

An entity's purpose and types of funding may trigger broader consequences from the perspective of the entity's external risk (e.g. risk to private (investors) vs. public funding (i.e. state – taxpayers' money)). In the scorecard, we consider these respective risks from the public interest perspective. For example, the economic risk of debt funding might be very different from equity funding from the public interest perspective.

VERTICAL AXIS: MAPPING AN ENTITY'S EXTERNAL RISKS

A vertical axis representing the risk areas will complement the horizontal axis' company criteria. Each risk area on the vertical axis will be coupled with the relevant company criteria to assess an entity's risk profile¹⁵. This risk profile enables to better understand how, where and why an entity impacts its surroundings.

In identifying an entity's risk profile, we need to consider several factors. As a first step, to choose risk areas that enable us to assess the relevant external risks to stakeholders as well as legitimate stakeholders' information needs.

We propose to look into five broad risk areas – each of which can be broken further down into smaller, more specific segments:

- **economic** (e.g. financial, supply chain, geographical)
- **social** (e.g. employment, pension funds, health and safety, human rights, societal risks)
- **fraud and corruption** (e.g. money laundering, tax evasion, bribery, terrorist activities)
- **environmental** (e.g. climate change, pollution, biodiversity, deforestation, resource depletion)
- **technological** (e.g. cyber, data protection, hacking)

These five proposed risk areas are not set in stone. For example, the World Economic Forum in its *Global Risks Report 2018* has mapped out the Global Risks Landscape 2018 reflecting the following major risks - economic, geopolitical, environmental, societal and technological.¹⁶ Whilst broadly similar to our selection of risk areas, there are obvious differences too. The point is, there are alternative sets of risk categories that could be considered too.

Our five risk areas will also to some extent inevitably overlap and are inter-linked. This is merely reflective of the reality of risks, which are complicated in part exactly due to the way in which they interrelate and even reinforce one another.

ECONOMIC

Economic risks are linked to the scope, type and scale of an entity's activities, where the company operates (locally, globally, in high risk countries) and financials. They encompass financial, supply chain and geographical risks. An entity's systemic impact can be assessed by mapping an entity's 'scale', reach, supply chain and interconnectivity to other parts of the economy. It will also determine whether and how severely and adversely market participants might be affected in case of an entity failure.

¹⁵ "The risk profile is the aggregation of the total portfolio of risks the organization faces."

<https://business.nasdaq.com/marketinsite/2016/Understanding-Your-Companys-Risk-Profile.html>

The meaning we attribute to the 'risk profile' relates to externalities i.e. impact on the markets, environment and society at large.

¹⁶ The World Economic Forum (2018) *The Global Risks Report 2018* 13th Edition, see: http://reports.weforum.org/global-risks-2018/?doing_wp_cron=1582630157.3998360633850097656250

Some entities' rapid success and strong market presence can also pose an economic risk to markets and jurisdictions if they become almost completely reliant on these entities' services, such as big tech companies.

As a result of these risks, entities have the capacity to create a catastrophic effect on the rest of the economy, society or the environment. It is not necessarily due to their financial or employee size alone, but also the potential cascading effects that their malfunction, failure, misuse or manipulation by others could have (e.g. election manipulation through social medial platforms).

SOCIAL

Social risks relate to the population's well-being, health and integrity, and welfare. This broad category of risks can be further broken down to more specific categories, such as employment, worker health and safety, gender equality and human rights.

For example, the EC acknowledges that companies' actions have a direct impact on people's lives¹⁷. Companies create value through their goods and services, as well as job creation. Their actions may however also inflict negative outcomes for society in terms of inadequate working conditions, human rights violations, or adverse impact on public health.

It is only right for citizens to expect that companies not only understand their positive and negative social impacts but also prevent, manage and mitigate any negative impact they may cause, including within their global supply chain.¹⁸ It is therefore vital for entities to manage risks stemming from social issues.

FRAUD AND CORRUPTION

The category of fraud and corruption risks pinpoints an entity's impact from the financial crime and public finances perspectives.

Certain entities, business models or transaction types can be particularly prone to fraud, tax evasion, corruption, money laundering or terrorist financing. They pose a risk to the host country's public finances, financial stability and even security. These risks are not necessarily linked to the entity's size. For example, a small cash-based corner shop is also well-placed to hide its full tax liabilities from the authorities. A small arts dealer can be used for money laundering purposes.

Whilst sheer size remains a relevant criterion for this category of risks – the larger the entity, the larger the potential amounts of money laundered or tax evaded – the cumulative impact of several smaller entities engaging in such activities can be significant.

ENVIRONMENTAL

It is important to also consider entities on the basis of their environmental and climate impacts. Certain sectors are riskier than others from these perspectives. The state of environment is degrading, and social, geopolitical and economic consequences are becoming ever more apparent. There is a strengthened focus on environmental factors by consumers, governments and investors alike.

Entities may contribute to air pollution, toxic waste and climate change through their operations, logistics and supply chains. In worst cases, an entity's environmental impacts can contribute to resource depletion, biodiversity loss, deforestation, and ecosystem collapse.

Sheer quantitative size related factors may be insufficient to provide the full picture of an entity's environmental impacts and risks.

TECHNOLOGICAL

Technology is a source of immense potential for innovation, but it also brings certain new forms of exposure to risks such as cyberattacks, data breaches and hacking.

¹⁷ https://ec.europa.eu/growth/industry/corporate-social-responsibility_en

¹⁸ Ibid.

An entity can pose particular risks to society and the economy due to technology failures irrespective of its physical scale or volume. The most obvious example is theft of customer data that an increasing number of relatively small companies (by size of workforce, at least) are collecting on users of their digital services. Such data can breach customers' privacy rights and be used for malicious purposes.

Technology also creates new forms of dependence that must be safeguarded. Many communication systems and infrastructures are increasingly cyber dependent e.g. internet of things¹⁹. If a company with a highly digitalised business model operating in these sectors fails, this can pose a threat to the increasingly digitalised communication and infrastructure systems. They can also have a systemic impact on financial stability and undermine global financial markets.

¹⁹ The internet of things is a "system of interrelated computing devices, mechanical and digital machines, objects, animals or people that are provided with unique identifiers (UIDs) and the ability to transfer data over a network without requiring human-to-human or human-to-computer interaction." See: <https://internetofthingsagenda.techtarget.com/definition/Internet-of-Things-IoT>

THE SCORECARD – PRACTICAL APPLICATIONS

In this section we elaborate how the proposed scorecard could be used, by whom and for what purposes. In *Annex 1* we elaborate in more detail how the scorecard's calculation could function in practice.

MAIN USERS OF THE SCORECARD

The scorecard's primary purpose is to categorise entities from a regulatory point of view. It can be used by:

- public authorities to inform a more risk-based approach to compliance and enforcement
- policymakers to better map out how legislation should be targeted for different kinds of entities
- regulators and/or stock market operators as a condition for listing and to provide key information to investors

The scorecard could also be used by entities themselves through internal self-assessments to inform their management about potential risks that they are facing, and how to address them. However, such self-assessments have limitations and for the purpose of this paper we would at this stage mainly propose to focus on the regulatory applications listed above.

RISK ASSESSMENT, SCORING AND MITIGATION

Through the scorecard, an entity would be subject to a comprehensive risk assessment. However, this assessment should not turn into a box-ticking exercise. The assessment per each risk category will require the involvement of various experts, as well as various levels of verification to ensure that the resulting scoring is robust and credible. On this basis, appropriate risk mitigating measures and internal controls can be implemented.

The risk scoring and possible subsequent mitigation measures should be an on-going and circular process, which is the true benefit of the scorecard. An entity that at the initial assessment scores high in certain areas can decrease its scoring by being voluntarily more transparent and by introducing appropriate risk control measures. The reward of this process is less burdensome, more fit for purpose and proportionate regulatory requirements.

We will illustrate how this model could work via a case study (see *Annex 2*), bearing in mind that it is not our intention to set a fixed model for the scoring or the method, but to provide suggestions and thoughts for further discussion and feedback.

Some of the risks are simply not applicable to certain entities. For others, a certain risk as such will never completely disappear but the likelihood of it materialising will be lower due to the risk mitigating measures introduced.

The scorecard process is only valuable if it prompts changes in behaviour. We hope that this approach could incentivise companies to voluntarily apply additional measures to reduce their external risks (voluntary risk management), and that the authorities 'reward' them accordingly with a lighter touch enforcement and regulatory approach.

PRACTICAL USES OF THE SCORECARD

The sample scorecard can be further developed on the basis of feedback and discussion with relevant stakeholders, and eventually used for a series of different purposes:

1. as a tool to re-think whether there is a more suitable way to categorise entities for regulatory, disclosure and assurance purposes to ensure better outcomes for society, environment and economy
2. as a one-stop-shop regulatory compliance tool for entities that want to register with various relevant public authorities and have an overview of potentially applicable regulatory requirements.

3. as a tool for regulators and policymakers to have an overview of all regulatory disclosure, transparency, assurance, governance etc. requirements and assess whether the regulatory mix is fit-for-purpose, overly burdensome, lacking in some areas and such.

USE 1: TOOL TO CATEGORISE ENTITIES

The first way that the scorecard can be used is to define what kinds of regulatory requirements an entity, irrespective of its quantitative size, should be subject to on the basis of its potential impacts. This would replace the current approach to risk prevention under which different entities are assigned regulatory obligations based purely on their size.

Mitigating an entity's risks and adverse impact on its environment, economy and society could be done more effectively through regulatory requirements that are tailored to a specific entity's risks and impacts, with ensuing reporting on KPIs and related assurance.

As the goal is to minimise risks, it is important to first identify what the risks are. The scorecard produces a risk grade for each of the risk areas. The outcome of this scoring could ultimately lead to legal obligations linked to the relevant risk category, with respective accounting, reporting, including non-financial and other requirements based on the associated risk to society, stakeholders or the environment.

This could result in more focused and smarter regulation that would potentially exempt smaller entities that do not bear wider strategic interest risks or significant stakeholder impacts from onerous obligations.

This alternative approach to categorisation should lead to:

- appropriate level of transparency
- risk management to ensure that appropriate mechanisms are in place
- appropriate level of external scrutiny/assurance
- appropriate levels of compliance procedures based on risk, not just size

As to the scorecard process itself, *Annex 1* elaborates further on how the scoring could work. In terms of the actual approach to the scoring, there are at least four different ways:

- a. a self-assessment conducted by the entity itself with no external or independent scrutiny. The purpose of such a self-assessment could be, for example, to make the entity's management aware of potential risks and enable them to address these risks in a targeted manner. However, we are aware of the potential limitations of such purely 'internal' self-assessments and would not explicitly propose that at this stage. Moreover, this paper's scope is on entity categorisation for regulatory purposes rather than for the entity's management
- b. a self-assessment conducted by the entity but verified by an external independent expert
- c. an external assessment of the entity conducted by an external independent expert
- d. an external assessment of the entity conducted directly by a regulator. The main challenge here is that regulators may struggle to find the necessary resources, scale and expertise to assess on their own all regulated entities within their jurisdictions.

With evident limitations in a purely internal self-assessment (point a.) and a purely external assessment by a regulator (point d.), we propose that the scorecard assessment either needs to be done independently of the entity by an external independent expert (point c.), or it can be a self-assessment subject to external scrutiny by an external independent expert (point b.).

The exact nature of this external verification as well as the expertise needed to conduct it will require further thought and discussion with stakeholders.

USE 2: ONE-STOP SHOP TOOL FOR REGULATORY REGISTRATION PURPOSES

The scorecard could be used as a one-stop shop web portal by building on the initial assessment of the entity (see *use 1*). This would allow an entity to sign up to all relevant regulatory obligations and register to all relevant authorities within each of the risk areas.

For example, a standard scorecard could be developed at the European level and then used by the enforcement authorities of all Member States. An entity registers itself by completing the scorecard, populates a set of risk-area and criteria specific checklists and on the basis of the results, the entity is registered at once with all relevant authorities. The results would also give the entity an overview of all relevant regulatory, disclosure, transparency, assurance and governance requirements that it needs to fulfil.

This could enhance operations of entities operating across borders within the EU Single Market, or for third country entities that want to operate in and be compliant with relevant requirements that apply across the Single Market.

USE 3: LEGISLATIVE MAPPING TOOL FOR POLICYMAKERS AND REGULATORS

As a completely separate use from the above two, the scorecard could also be used for pieces of legislation directly. This means that it could be filled with individual pieces of legislation or specific regulatory requirements that is relevant for each area of risk and entity types (based on the criteria).

For example, entering all relevant EU legislation into the scorecard could provide a visual mapping overview of the 'regulatory patchwork'. Policymakers could identify those areas with too many unnecessary or even duplicate requirements for certain types of entities, or conversely highlight where more robust disclosure, assurance and other rules could add value.

Using the scorecard in this way could enable the planning of a horizontal, cross-cutting and holistic regulatory framework that is better tailored for each entity's particularities, and is proportionate and more effective.

ANNEX 1: HOW THE SAMPLE SCORECARD WOULD WORK

In this paper, we saw what the key components – entity criteria and areas of risk – for a scorecard could be. These criteria and risk areas can be further broken down into sub-criteria and -risks. There can also be further debate about whether the proposed selections are the most appropriate ones.

To trigger the discussion, our goal is to introduce the scorecard as a concept. How then would the scorecard work?

The scorecard gives an entity risk scores on a scale of 1 to 5 – 1 being lowest risk, and 5 the highest level of risk.

An entity's scoring outcome will help to distil its risk profile, which will trigger specific obligations in relevant risk areas. For example, economic risk coupled with qualitative categorisation criteria will trigger accounting, auditing, corporate governance, transparency, prudential obligations corresponding to the identified risk profile. Conversely, exemptions can be granted to entities if the score is low in specific areas, meaning that the entity does not have direct risk implications. The aim is to arrive at more proportionate and relevant requirements.

In each risk area, the entity gets a score for each of its criteria (in the case of the scorecard, complexity/ownership /types and purpose of funding). This is then aggregated into a total score for that particular risk area. However, this aggregate number is not necessarily an average of the scores in that risk category. If a company scores high economic risk 4/5 due to its ownership structure but only 1/5 economic risks due to sources of funding and complexity, the grand total for economic risk would still be 4/5 or at least 3/5. This is because a lower risk rating in some areas does not compensate for a high rating in others. One risk (or the absence of it) does not negate another.

An entity that scores a full 5 or 4 across all risk areas could qualify as 'very high risk'. These entities pose the greatest and most systemic risks for societies at a global level. They would also naturally face the most comprehensive sets of relevant requirements to minimise those particular risks through appropriate set up and exercise of controls. The implication is that entities whose potential failure could trigger wider ramifications require higher scrutiny.

At the other end of the scale would be entities that have a low risk scoring (1, 2 or even 'not applicable') across all areas. These low-risk entities would have only very little minimum obligations set for them, or could even be granted full exemptions.

In more realistic terms, however, most entities would be expected to score relatively high in at least one or few risk categories but very low in others. Their regulatory requirements would then be targeted mostly to those specific areas of risk only. By extension this would enable a more tailored and proportionate allocation of regulatory requirements, better suited for the more multi-faceted demands of policymakers, investors and the wider society.

For example, a high fraud and corruption risk scoring will lead to more transparency requirements through reporting and assurance, anti-money laundering and counter-terrorist financing regulations. Environmental risks will require that the ESG factors are disclosed, non-financial reporting rules are respected, and that policies, as well as KPIs, targets and performance measurement tools are put in place.

RISK SCORING CONSIDERATIONS

Impact and probability of the risk materialising are also critical components of the scoring exercise. There may be a high potential impact or risk but low probability of the risk materialising. However, certain inherent risks due to the nature and scale of the entity will always be present. Impact and probability will ultimately determine which obligations should be followed to ensure that regulation serves the intended purpose.

In addition, relative impacts should also be taken into consideration. Relative impacts are important, for example, when assessing an entity's social risks. To fully grasp the social impact of an entity, such as on employment, it is not enough to simply consider the number of employees in absolute terms. Rather, this number should be considered in relation to the size of the local job market. A small entity of 50 employees in a small

community can have a big impact locally. Conversely, the loss of 50 jobs in a larger country with a larger labour market would have a lesser impact on social well-being.

Another consideration is over-reliance of an economy on an entity's activities. For example, a mid-sized airline that is not different from its larger global competitors or its peers would not necessarily stand out. The situation will be different, however, if for example an island-nation is dependent on the connectivity and tourism that this airline provides.

Overall, the point is that the risk scoring must always be made in the context in which the particular entity operates.

ANNEX 2: FICTITIOUS CASE STUDY OF A MANUFACTURING COMPANY

This fictitious case study is an illustration of how a risk-mapping scorecard could function. It is not intended as a conclusive elaboration of how a scorecard would or should be applied.

An external expert is conducting an independent risk score assessment of an electronic components manufacturing firm. It has 100 employees and is based in a mid-sized European country called Randomia, with two factories and has a turnover of EUR 50 million. It is owned by family shareholders and has bank funding from a major international financial institution for major capital assets, thus minimizing overall the potential negative financial impacts and exposure on external stakeholders.

The firm also has a solid long-term business vision with strong continued demand for its electronic components expected for the future. It also has an industry standard level of manufacturing process automation, and operates in a competitive market.

Under current Randomian legislation and thresholds, the firm is a large entity that is subject to statutory financial audit requirements and accounting legislation, and prepares financial statements.

The external experts reach the following scoring for the firm:

	Complexity	Ownership	Types of funding and purpose	Total
Economic risk	1	1	1	1
Social risk	2	N/A	1	2
Fraud and corruption risks	1	N/A	N/A	1
Environmental risk	3	N/A	2	3
Technological risk	2	N/A	1	2

Their reasoning was the following:

ECONOMIC

The firm is fairly simple but under Randomian legislation with 100 employees, it is already subject to statutory public audit, accounting legislation and prepares financial statements. It has a broad customer base of well-established and reputable multinationals and other large companies, and is not reliant on any specific client or supplier. The firm is family-owned and has bank funding for key capital assets. This gives the firm a base-line level economic risk of only 1/5 but nothing really stands out as particularly risky here.

SOCIAL

With just 100 employees in a mid-sized country and a high degree of automation, its impact on the local labour market is not overly significant. However, some of the 100 employees operate heavy machinery and the production process produces several chemical by-products harmful to human health. This grants it a score of 2/5 for its complexity factors, as there is scope for improvements in its health and safety in the workplace. There is nothing inherent in its ownership that would link to even a baseline level risk. Therefore, for this criterion the external experts simply put 'not applicable'. For types of funding and purpose, with the exception of bank funding for key capital assets, the firm's funding is mainly internal and stems from its business activities. As a profit-making entity in a market with several competitors, its profit margins can at times be tight. This could limit its capacity to further fund reinforcements to its workplace health and safety, granting it a baseline minimum risk of 1/5 in that category. The overall social risk score of 2/5 is not an average number, but a qualitative

reflection of the company's health and safety conditions. The absence of risk in the "ownership" criterion bracket does not negate the 2/5 risk from complexity and 1/5 for types and purpose of funding.

FRAUD AND CORRUPTION

The firm's customers are mostly reputable larger businesses and it operates mainly in the EU. A baseline risk of 1/5 exists as it is dealing with high-value contracts in a large supply chain and involved in regular tendering processes, but overall its criteria do not link to potential elevated fraud and corruption risks.

ENVIRONMENTAL

By virtue of its business model and activities, the firm has high energy requirements and operates in a country that is still mostly reliant on fossil fuels, rendering its operations carbon intensive. Moreover, the production process generates potentially environmentally harmful chemical by-products. And as the firm services a lot of clients across the EU, its business-to-business logistics are transport intensive and, including air freight. The firm has recently invested in more energy efficient technologies, which may reduce its overall environmental risk scoring somewhat in the future, but it will take some time for the new technology to be introduced into the production line. On ownership, nothing links directly to higher environmental risk. On the types of funding and purpose bracket, the firm's main funding is internal, and it operates in a highly competitive market, potentially putting a strain on its ability to invest in potentially costly new and more environmentally friendly production methods. It receives an overall environmental risk score of 3/5.

TECHNOLOGICAL

On ownership/sources of funding and purpose, nothing stands out that would pertain to a higher technology risk. On complexity, the firm operates on a business to business basis and does not directly handle particularly sensitive client or private data. However, it does have access to some of its customers' data systems, including some public interest entities (PIEs). The fact that it has such direct links to its customers' databases puts it in an enhanced risk of being a target for hacking. This grants it a baseline technology risk score of 2. As in the other risk areas, the firm's mainly internally funded activities and operation in a competitive market may limit its ability to invest in additional cybersecurity.

CONCLUSION

The external experts, having completed the risk scoring exercise, conclude that the firm could benefit from additional investment and internal controls to mitigate their environmental, social and technology risks. Its recent investments into energy efficiency are expected to somewhat lower its environmental impact and risk scoring potentially from 3/5 to 2/5, but only in the future once the new systems are in place. Additional health and safety investments can likewise cut its social risk score to 1/5. The external experts also recommend for the firm to start designing appropriate internal measures and monitoring processes with the view of reporting under an international NFI standard such as the global reporting Initiative (GRI). Moreover, more robust internal cyber security controls and training of relevant staff members could help reduce its technology risk from 2/5 to 1/5. The external experts recommend for the firm to consider additional sources of funding to cover additional investments in these areas.

Lowering the risk scores with such measures could make the firm eligible for relevant regulatory alleviations in those areas.

ANNEX 3: QUESTIONS FOR STAKEHOLDERS

1. Do you agree that we should challenge the current quantitative approach to categorising companies Why/why not?
2. Broadly speaking, would you consider risks as an appropriate alternative to assessing an entity's impact on society for regulatory purposes? Why/why not? Are there any other qualitative approaches than risks that could be fit for a more qualitative company categorisation framework?
3. We have proposed to measure an entity's risk profile by bringing together certain risk areas with an entity's key criteria/characteristics. Do you think that this is an appropriate way to measure an entity's impact?
4. We have identified the following criteria to better understand an entity's character: complexity, ownership and types and purpose of funding. Are these appropriate criteria? Would you have additional ones to propose?
5. We have identified the following risk areas for defining an entity's impact on society: economic, social, fraud & corruption, environment and technology risks. Are these appropriate risk areas? Would you have additional ones to propose?
6. In this paper, we have identified several ways in which the scorecard could be used: as a tool to categorise entities, as a one-stop shop for regulatory compliance purposes and as a tool for policymakers and regulators. Can you think of any other potential uses or benefits for the proposed scorecard concept?
7. With the scorecard approach, we want incentivise companies to reflect on their impact on society and encourage changes in behaviour, through voluntary risk management. We also want to encourage lawmakers to draft legislation that is more proportionate and targeted for each entity's risk profile. Is the proposed scorecard approach conducive to these objectives? Why/why not?



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