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FROM RISKS TO REGULATION: RETHINKING COMPANY CATEGORISATION

FROM ACCOUNTANCY EUROPE THOUGHT-LEADERSHIP SERIES

Quantitative criteria currently define how companies are categorised for regulatory purposes. For example the EU SME definition is based on turnover, staff headcount and balance sheet total. These criteria then determine what legislation applies to them.

With global megatrends disrupting business models and markets, Accountancy Europe's new Cogito publication *From risks to regulation: rethinking company categorisation* aims to open the debate on how entities should be categorised. It challenges the quantitative criteria's suitability and proposes a risk-based approach to categorise companies via a risk profile scorecard. A holistic take on companies' risks and impacts would enable policymakers to draft policies better suited for our increasingly complex world.

LIMITATIONS OF QUANTITATIVE CRITERIA

The current quantitative criteria for categorising entities are simple, provide certainty and consistency but have the following limitations:

- **no longer fit for purpose:** they cannot adequately reflect an entity's impact in more global and digitalised markets and society
- **evolving stakeholders' expectations**: they do not capture the growing interest in how businesses deal with environmental, social and governance (ESG) matters
- **divergent across legislation:** they are diverse across different EU laws which can be confusing, costly to administer and navigate for entities to whom different pieces of EU legislation apply
- **'threshold effect':** they may enable companies to divide into smaller legal entities to avoid falling within the scope of additional rules
- **do not reflect complexity or risk level**: they do not reflect how complex a business model is or the entity's external impact

DETERMINE ENTITY'S RISK PROFILE

Instead of the current size criteria, we propose to categorise entities based on the external risks that they can pose. A risk-based approach could have the following benefits:

1. allow for more proportionate regulatory requirements
2. benefit all key stakeholders:
   - policymakers will be able to design better and more efficient policies
   - public authorities can adopt a more risk-based approach to compliance and enforcement, enabling them to more effectively allocate their resources
   - entities can have more tailored regulatory requirements that are proportionate to their business

SCORECARD - SMART GRID FOR SMARTER REGULATION

To determine an entity's risk profile, our paper proposes using a scorecard based on its key characteristics, such as business model, markets, ownership, governance and complexity of its activities and transactions.

The scorecard would attribute to an entity a specific risk profile, which would then trigger appropriate sectoral reporting, auditing, and governance obligations to improve transparency and mitigate risks.

The scorecard consists of two axes: a horizontal axis to map an entity's profile through key criteria, and a vertical axis, listing areas of risk.

The risk score calculation is done by combining the two axes to build the entity's complete risk profile. For each area of risk, the entity would receive an aggregate score that reflects its external risks and impact in that category.

RISK AREAS - *EXAMPLES*	OBJECTIVE CRITERIA - *EXAMPLES*		
	Complexity *business model, types of activities and transactions*	**Ownership** *legal form, public / private, types of shareholders*	**Funding** *debt, equity, venture capital* **Purpose** *profit, public service, social*
Economic *financial, supply chain, geographical*			
Social *employment, health, human rights*			
Fraud & corruption *money laundering, tax evasion, bribery, terrorism*			
Environmental *climate change, pollution, biodiversity, deforestation, resource depletion*			
Technological *cyberattacks, data breaches, hacking*			

MAIN USERS OF THE SCORECARD

As our scorecard concept's aim is to bring about a smarter, better targeted and more proportionate regulatory framework, it could be used by:

1. **public authorities** to inform a more risks-based approach to compliance and enforcement
2. **policymakers** to better map out how legislation should be targeted for different kinds of entities
3. **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.

GIVE US YOUR FEEDBACK

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.

This summary was published in April 2020