The newsletter for insurance brokers and MGAS.

Issue Two
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PKF

Broking Business

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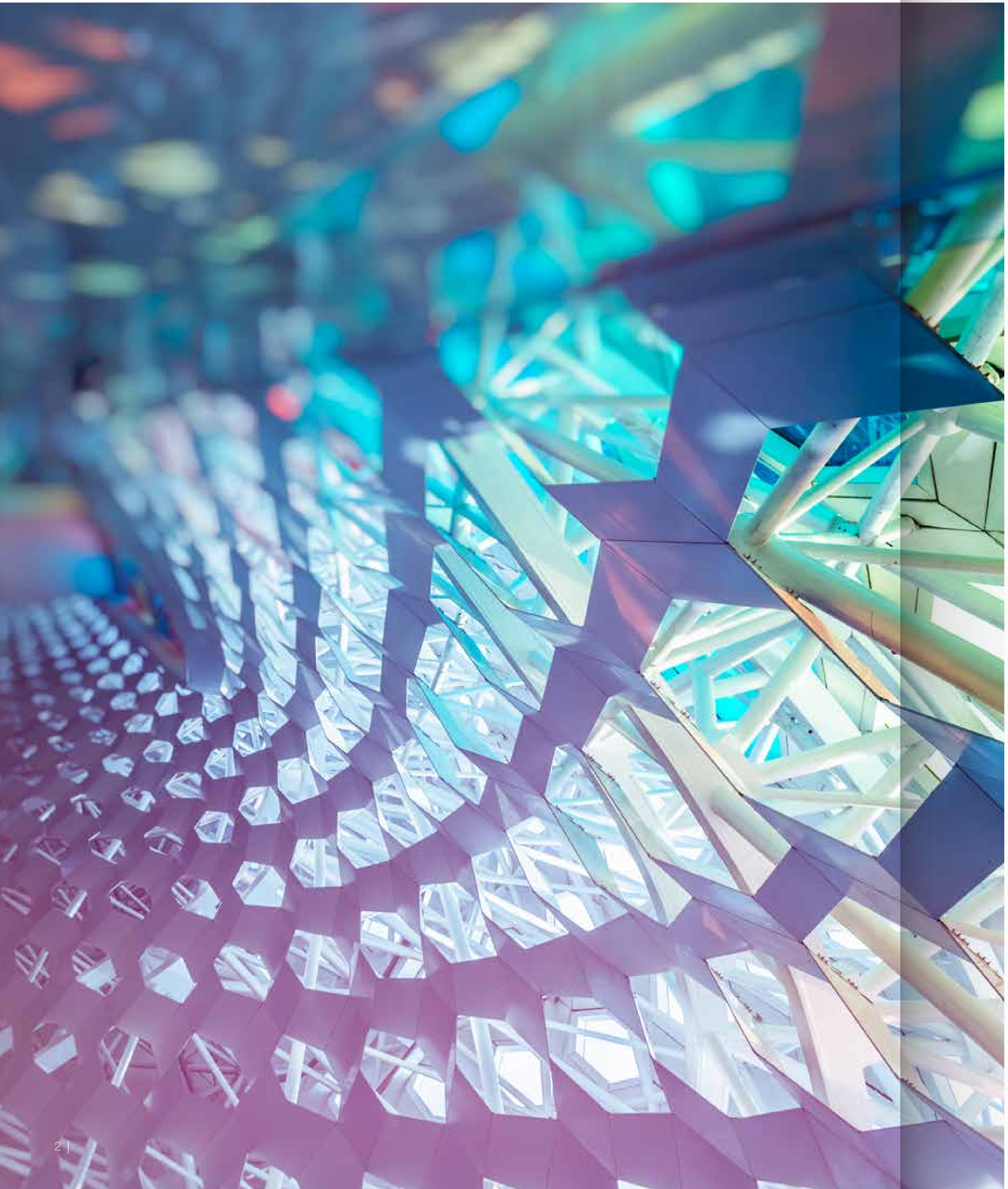

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Welcome to our latest issue of Broking Business...

While 2020 for many could be seen as a year of survival, 2021 and beyond will prove even more challenging. With government props evaporating, banks calling in loans and HMRC claiming deferred taxes, insurance brokers will be facing a perfect storm.

The COVID-19 pandemic and its potential effect on insurance intermediaries has led the Financial Conduct Authority (FCA) to put financial resilience at the top of their agenda. In this latest edition of Broking Business, PKF Partner Paul Goldwin reviews how brokers can maintain financial stability and survive through turbulent times.

With HMRC turning its attention to international brokers, we explain why broking groups could be facing heavier tax compliance in the future. Sticking with tax, and with IR35 finally upon us, our employment taxes expert Daniel Kelly recaps on the new legislation and what it means for your business.

As a key performance indicator, client renewal and retention rates can be seen as a crucial part in assessing the health and quality of a firm. Will Lanyon, Director in PKF's Transaction Services team, explores how building strong relationships with existing clients can boost profits and grow your business.

And finally, Jessica Wills, Head of Governance, Risk and Control Assurance explains the importance of understanding the risks associated with outsourcing.

We hope you find this edition useful. As always, we are keen to hear your views and suggestions for future articles.

Paul Goldwin
Head of Insurance Intermediaries

+44 (0)20 7516 2251
pgoldwin@pkf-l.com

Financial resilience in the time of coronavirus

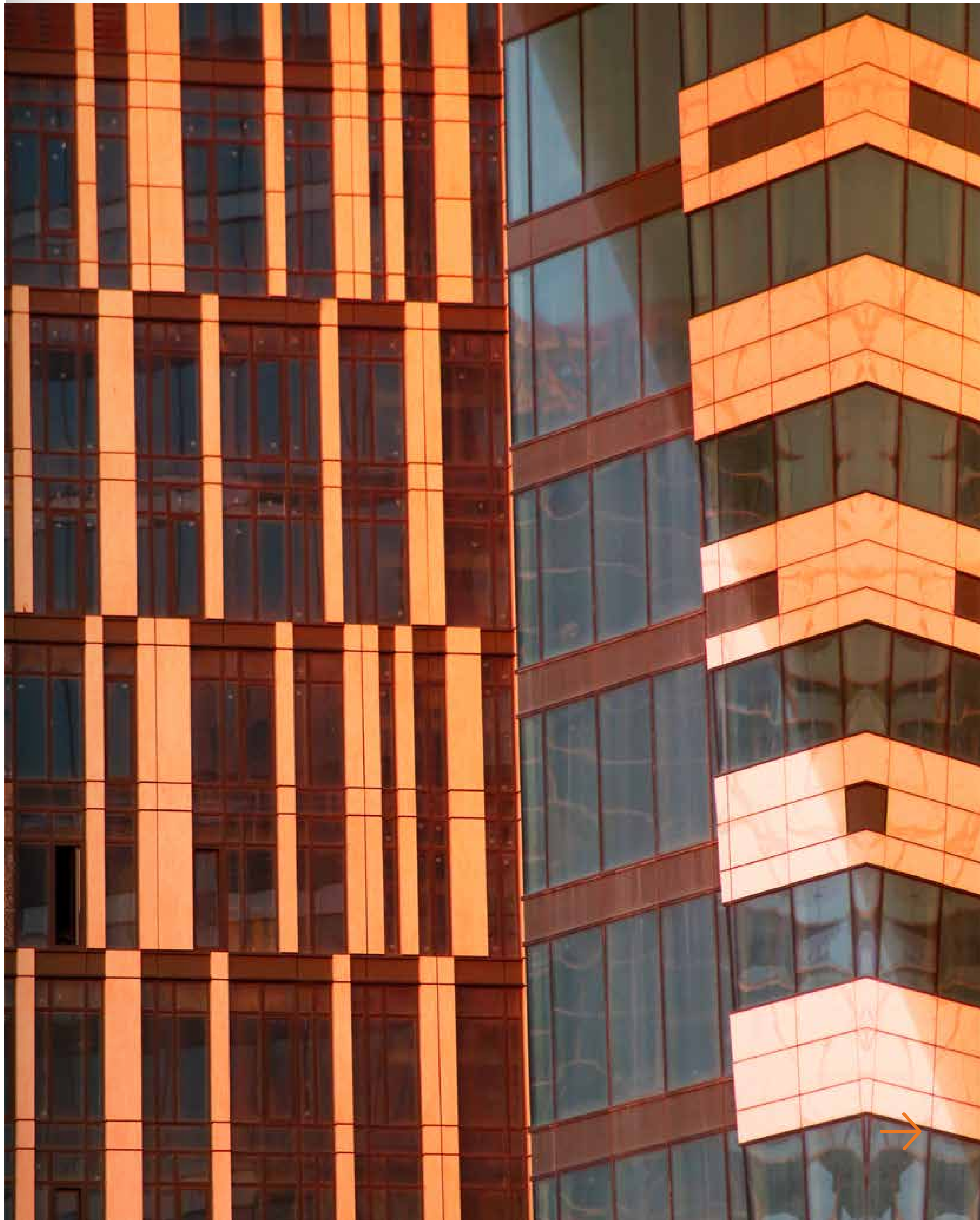
PKF Partner Paul Goldwin reviews how brokers maintain financial stability and survive through turbulent times.

The COVID-19 pandemic and its potential effect on insurance intermediaries has led the Financial Conduct Authority (FCA) to put financial resilience at the top of their agenda.

Depending on their size, financial strength and the sectors that they operate in, COVID-19 has had a mixed impact on insurance intermediaries:

- The larger firms, with good financial reserves and a well-diversified book of business have generally coped well and, in many cases, better than expected. They weren't only buoyed by significant cost savings, particularly in their travel and entertaining budgets, but also by the general hardening of insurance rates.
- The smaller firms, especially in sectors like travel and hospitality, and saddled with thinner capital resources, have struggled. However, thanks to government incentives such as the furlough scheme, tax deferrals, bounce back loans and the Coronavirus Business Interruption Loan Scheme (CBILS) they've survived.

That said, the problem hasn't gone away for many firms. While 2020 was a year of survival, 2021 and beyond will prove even more challenging. With government props evaporating, banks calling in loans and HMRC claiming deferred taxes, insurance brokers will be facing a perfect storm.



Market surveys

In an attempt to identify firms in financial distress and to reinforce its message, the FCA has been engaging with the market via its COVID-19 Impact Survey.

Following 3,370 responses from insurance intermediaries, the FCA published the survey's results on 7 January 2021 that confirmed their worst fears:

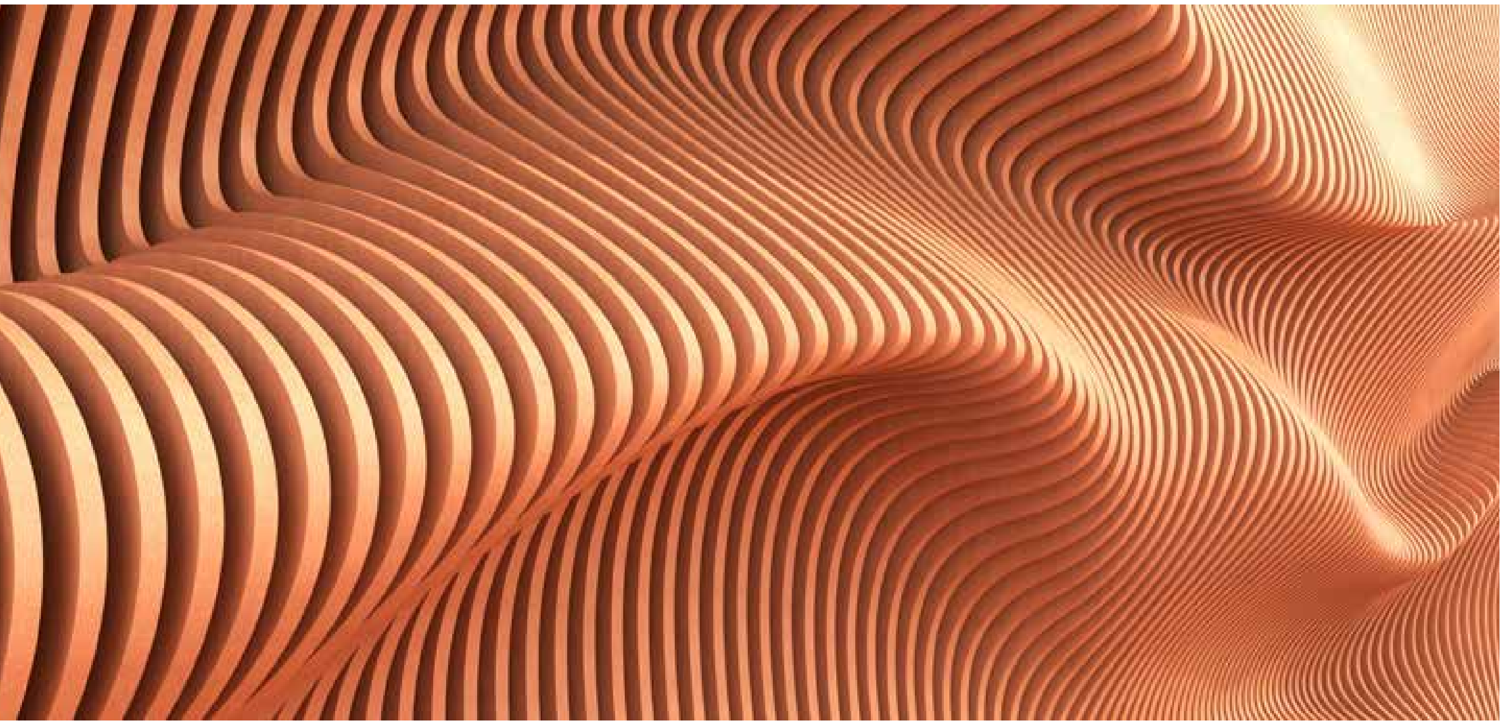
- Although most brokers had sufficient cash to see them through the pandemic, their margin of safety was low – with an average of only 3% of available cash over their cash requirement;
- Forty-four per cent of insurance brokers furloughed their staff: 19% had received a loan; but only 14% had entered into a delayed payments scheme with their creditors; and
- Sixty per cent of firms expected a decrease in net income. However, 75% of these thought their net income would be affected by the lowest range of between 1% and 25%.

The FCA's position

The FCA has been expecting many firms to fail and, in readiness for this, has been engaging closely with the market since the start of the pandemic.

To put it simply the FCA expects firms to:

- have sufficient capital to get through this period and therefore to be financially resilient;
- figure out what they need, compare this to what they've got and, if there's a deficit, decide how they're going to deal with it;
- contact them if they don't have sufficient capital and, if that's the case, work out a closing down strategy that avoids impacting either their clients or the market; and
- not use their clients' money to keep their businesses afloat.



FCA guidelines

The FCA has provided insurance intermediaries with several recommendations on what firms should concentrate on and thus retain their financial resilience:

01

Firms should always plan ahead and employ sound management of their finances rather than following a 'wait and see' approach.

At a practical level this means:

- **Preparation and adherence to detailed budgets and working capital projections based on realistic and reasonable assumptions; and**
- **Scenario stress testing of budgets to ensure they build in sufficient headroom/buffers to account for all eventualities.**

02

Firms should assess their current capital requirements against their current capital availability and above all, make sure that they meet their regulatory capital requirements at all times.

In practice, this means:

- **Preparation of detailed Capital Resource Requirement (CRR) monitoring and feeding their working capital budgets into their CRR calculations;**
- **Scenario stress testing and taking account of the effect of various alternative scenarios on buffers/headroom; and**
- **If a buffer/headroom is being used up, leaving the firm with very little margin for error, they are expected to inform the FCA so that they can start putting a plan in place to help bolster their capital.**

03

Wherever possible, firms should attempt to conserve capital, by carefully planning on how to meet potential demands on their liquidity. In addition, they should adopt a forward-thinking approach when deciding on dividend distributions, bonus payments, etc and, where there's any sign of a decline in trading leading to potential losses, absolutely not draw on profit and loss reserves which could prove to be a valuable safety net in future.

The message is clear – firms must ensure they're financially resilient or be prepared to demonstrate that they can leave the market in an orderly manner.

Paul Goldwin
Partner

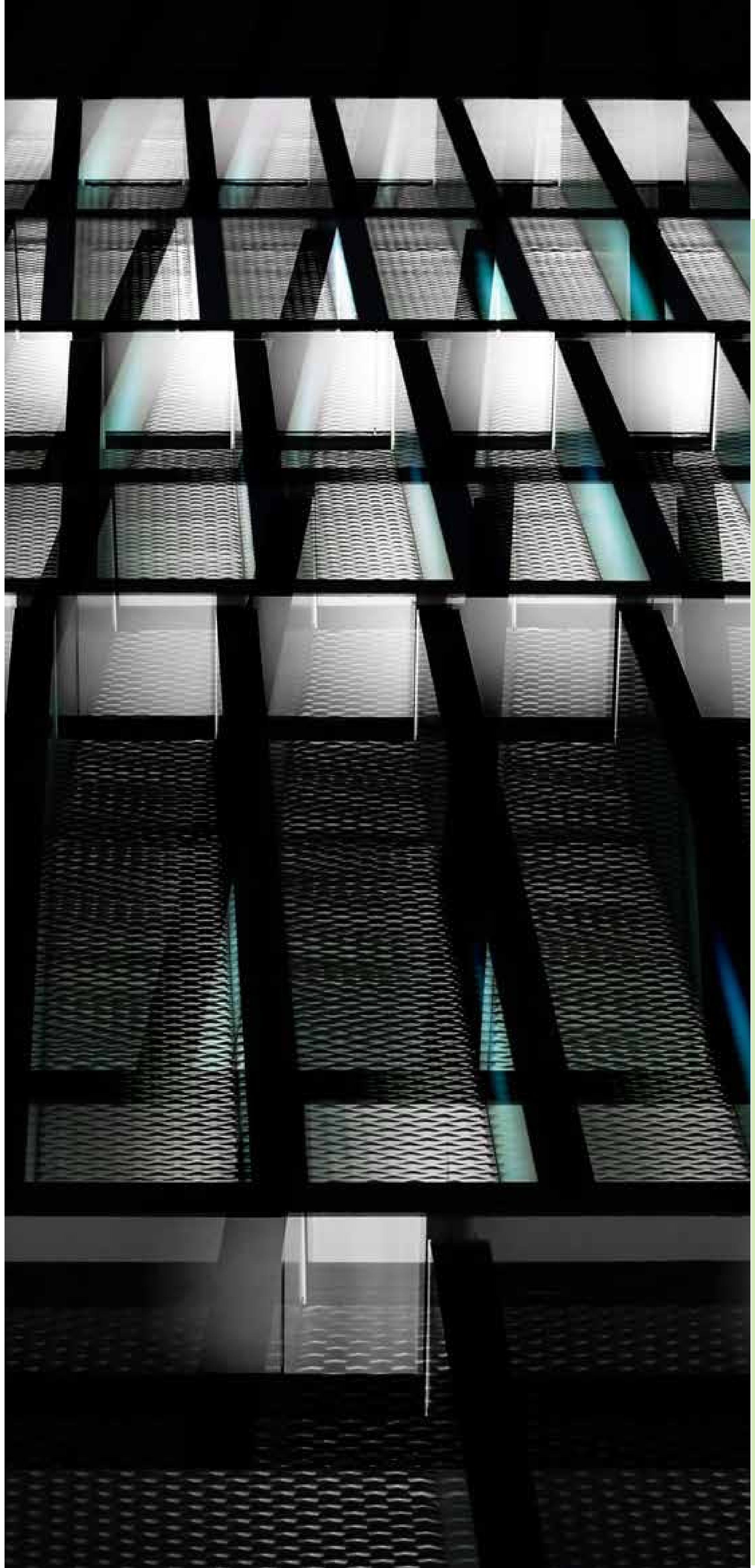
+44 (0)20 7516 2251
pgoldwin@pkf-l.com

Broking groups could be facing heavier tax compliance load

Since HMRC clamped down on tax avoidance with increased emphasis on transfer pricing by multi-national companies, they've now turned their attention to international brokers. We take a look at making sense of it.

While the impact of the G7's commitment to a fairer tax system is yet to be felt, the pressure on multinational brokers to get their transfer pricing (TP) right and be able to defend their international tax position continues to grow.

In the UK, HMRC's consultation on transfer pricing documentation (the Consultation) is designed to bring the UK in line with other countries and assist them in effectively targeting companies or industries. In addition, it will also impose a significant burden on international insurance brokers.



The three significant changes being considered are:

1. Mandatory preparation of master file and local files for those companies within the scope of the Country by Country Reporting (CbCR) regime, ie consolidated income in excess of €750m, and whether these should be filed with the annual corporation tax return or within 30 days of an information request;

2. The preparation of an International Dealings Schedule (IDS) on transactions with associated enterprises that will be filed with the annual corporation tax return; and

3. The creation and maintenance of an Evidence Log (EL). This would demand the collection of data at the same time as when transactions subject to TP occur. This would provide the key facts and evidence to support the TP documentation.

Risk area

TP is a risk area that HMRC are focusing on as they see it as a lucrative source of tax collection Initially, they considered the TP CbCR reports as the greatest identifier of tax risk, so they never mandated for the filing of master files and local files. However, as co-operation between international tax authorities continues to improve and regularly identifies risk areas for HMRC to target, bringing the master file and local file within the annual reporting requirements will be of major help to them.

Some groups prepare a master file and local country files already, especially as other jurisdictions have more draconian TP rules than the UK. Consequently, HMRC believes that demanding their preparation won't result in a significant increase in cost to many brokers. Alternatively, the IDS and the EL will result in additional costs to international insurance intermediaries and will apply to far smaller groups than those currently within the CbCR. Potentially, this will cover UK companies within the scope of TP rules, ie non-SME groups, or those with transactions with associated companies based in non-treaty jurisdictions.

> The main area of concern for international insurance intermediaries will be the amount of data that they may be required to supply, with examples in the Consultation ranging from a 2 to a 24 page return.

The filing of the IDS will bring the UK in line with the international rules of other countries. The standardised format will make it easier for HMRC to analyse data and, when comparing with international data received from overseas tax authorities, allow them to more easily identify where the risk areas are and, consequently, who to look at. The main area of concern for international insurance intermediaries will be the amount of data that they may be required to supply, with examples in the Consultation ranging from a 2-to a 24-page return.

Supplying the evidence

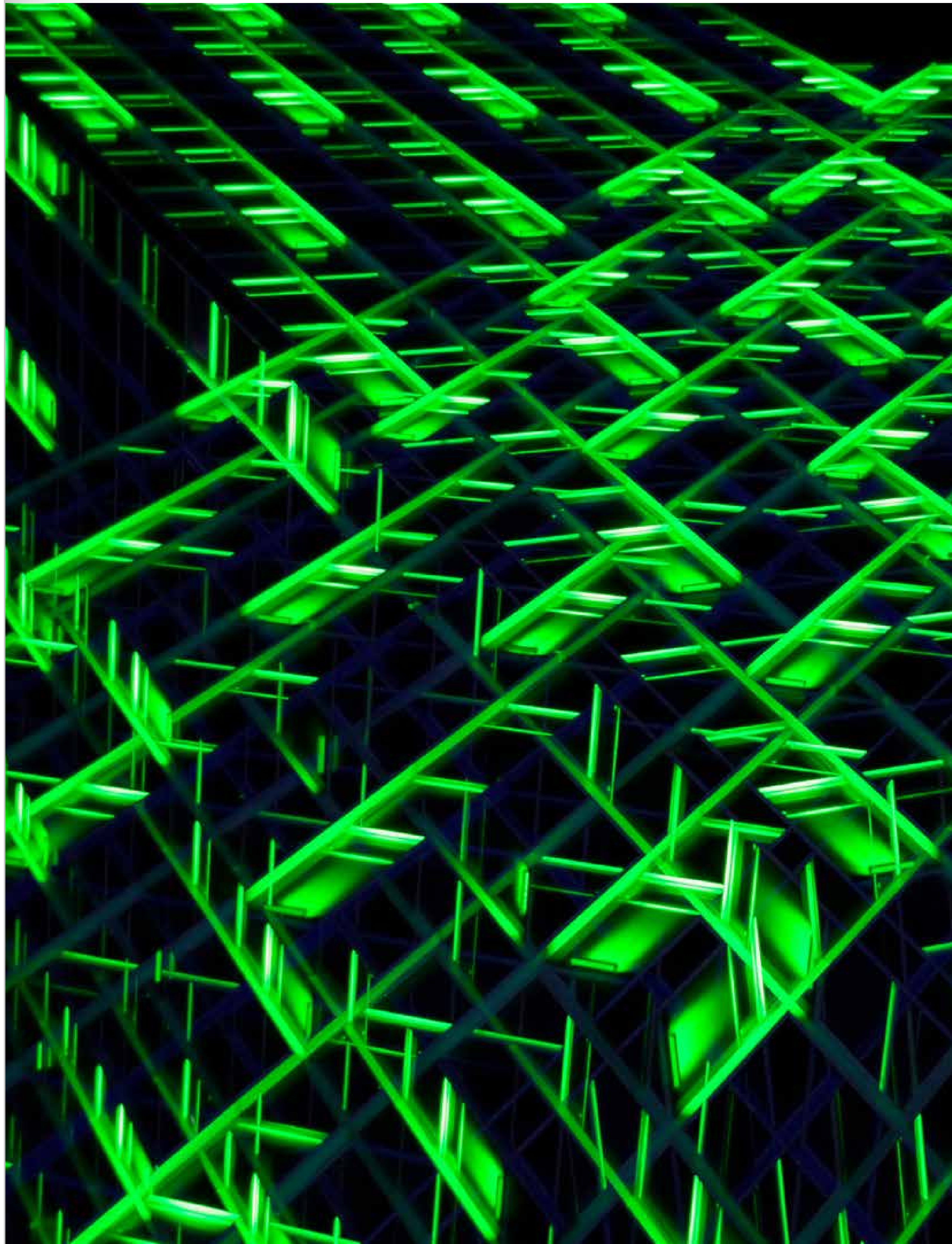
Preparing an EL would prove to be expensive to insurance broking groups. The idea stems from HMRC's Profit Diversion Compliance Facility which was considered a tremendous success in helping to identify and target companies. The EL would show the key facts of transactions as and when they occur and may include such items as interviews with staff or emails. The theoretical advantage for companies is that when subjected to a TP audit, they won't have to go back and try to identify who was there, how the business was operating three or four years ago and what they were thinking at the time, as this information will be recorded in the EL. However, if this is implemented, the creation and maintenance of an EL would be both an expensive and a heavy burden for companies in having to answer questions they may never be asked.

Some may say that instead of maintaining an EL, other methods could be adopted, such as third-party certification. Either way, the cost of compliance is going to increase significantly for international insurance intermediaries that are within scope.

If you have any questions please contact

Howard Jones
Partner - Corporate Tax

+44 (0)20 7516 2295
hjones@pkf-l.com



Retain, renew and accurately record to thrive

Focusing on client retention and renewal

Building strong relationships with existing clients and making sure you retain them, not only makes perfect sense, but can also boost your profits and grow your business.

As a key performance indicator, client renewal and retention rates can be seen as critical in assessing the health and quality of a firm. However, the way in which they're calculated can often lead to uncertainty or doubt over the results achieved. This uncertainty could lead to underperformance of the book or affect the price realised in a sale. In these days of increasing premiums the underlying renewal rate can be distorted by these rate increases. This can make renewal rates look better than they really are.

Why are they so important?

Renewal rates indicate the 'stickiness' of your clients and therefore whether or not your firm enjoys 'recurring' revenue. Not only does this inform you on the underlying performance of your business, but it's also key to the value of your company should you wish to undertake any M&A or fundraising. Recurring income is also one of the underlying features of brokers that both potential investors and acquirers can find attractive. As such renewal rates are a key part of any due diligence by an acquirer or debt provider.

Choosing a calculation method

There are several ways you can calculate your renewal rates:

- Client or policy?

Do you aggregate all the client policies or not? By going to a client level it may be the most accurate measure to look at whether clients renew all policies. However, when a client returns but decides not to renew all their policies, then you may have artificially increased your rate.

- Value or count?

Do you base your calculation on the total value of Gross Written Premiums (GWP)/commission income, or the number of clients/policies? The count tells you how many clients/policies are renewing, but not if important clients have been lost. If you're using total value, the renewal rate can be depressed or increased depending on whether premium rates are softening or hardening.

- Inclusion of mid-term adjustments (MTAs), refunds, etc?

If you decide to use your policy administration system (PAS) to identify renewals, 'new business' and 'renewals' tags can be used as well as many others, such as 'cancellations' and 'MTAs'. You need to decide what to include to ensure that the figures are as accurate as possible.

The key lies in the data

As with all calculations, using high quality data is crucial in ensuring an accurate outcome. We suggest that you use data from your PAS, taking the following into account while doing so:

- Ensure that the format of client names within the data is the same year on year, e.g.capitalisation and the use of 'Limited' against 'Ltd'.
- Include a 'Group' name where client names need to be different but are linked.
- Make sure your data is free from obvious errors such as dates that aren't correct.
- Ensure that your internal tags are appropriate, e.g.some systems tag clients that have moved carriers as 'new business', when they should be tagged as a 'renewal'.

It's critical that information is entered 'correctly' into your PAS so that your company's processes and controls are maintained. However, we recommend reviewing and 'cleaning' data before you use it. PKF always reviews the information supplied to us for accuracy both before and after completing any such calculation.

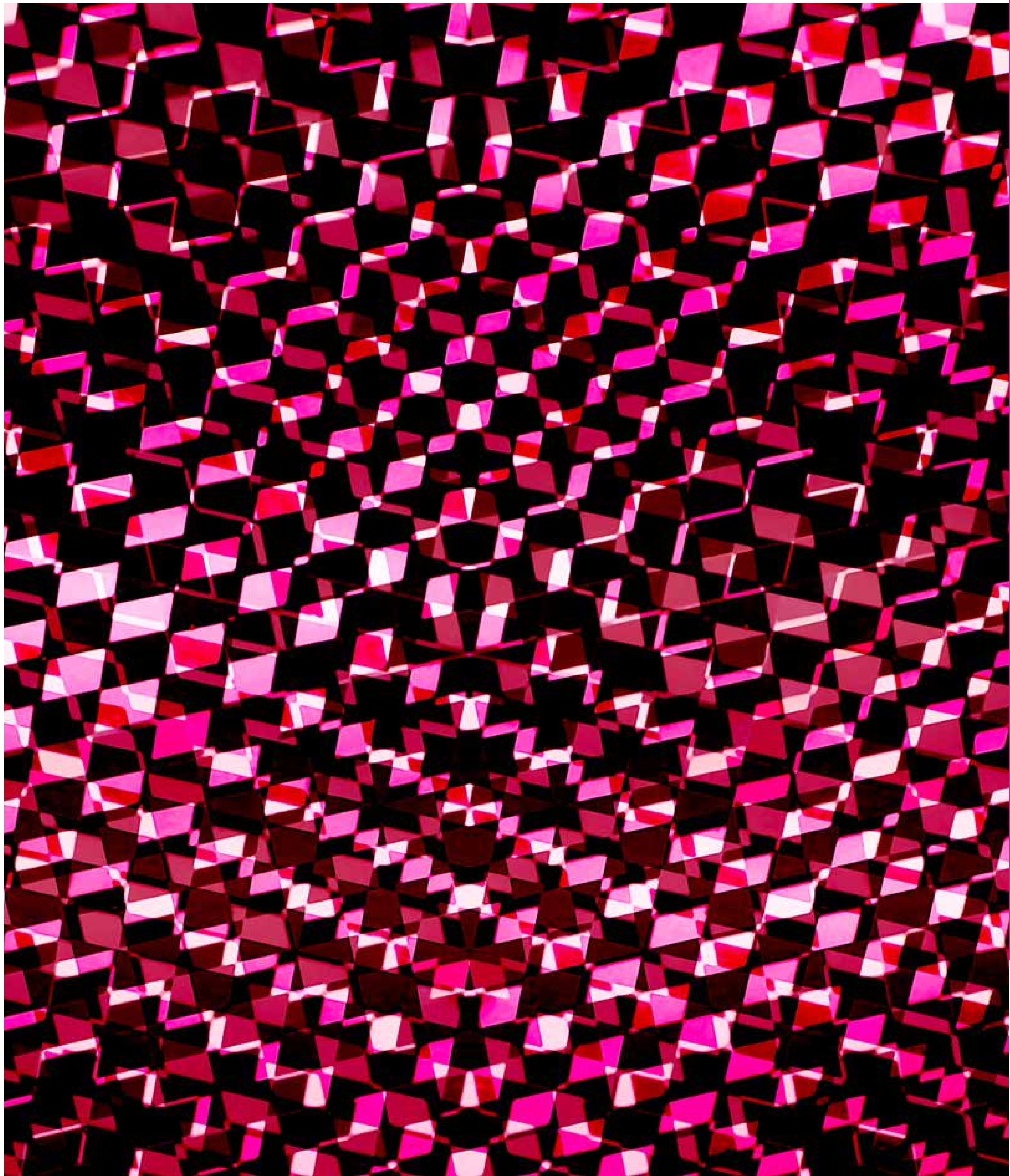
How does PKF handle it?

When we complete due diligences or assist clients going through a sale process, we always review the renewal rates. In order to avoid inaccuracies, we often use a combination of different calculations to validate the rates provided. What's more, to decide on the best approach, we rebuild the calculations from scratch to give us a detailed understanding of the data.

The process for our main recalculation is as follows:

- We identify all the clients available in the chosen period, while also comparing clients from the previous year, to make an accurate calculation of the rate of renewal.
- After creating a single unique client list, we'll add the commission and GWP for every client for each year that we need.
- Each client will then be assigned one of the following tags: 'new business', 'renewal', 'lost client', or 'not a policy', for the periods involved.
- Using these tags can give us the number and the total value of each type of client per year. This allows us to calculate the renewal rates on both a 'value' and 'count' basis.
- These are then cross-referenced to the PAS's renewal rates.

This gives us the renewal rate by client. However, you can also achieve the same via business line, date or any other metric you choose.



What do I have to do next?

After ascertaining the renewal rate using your chosen method, you should compare the results to your expectations. If they don't make sense you should investigate further to understand why there's a difference and use them to inform your strategy and identify areas where improvements are needed.

Get in touch

If you wish to discuss how you can implement, improve or use renewal rates within your business, get in touch with Will Lanyon, Director, PKF Transaction Services.

Will Lanyon
Director -
Transaction Services

+44 (0)20 7516 2411
wlanyon@pkf-l.com

Green light for off-payroll working changes

IR35 is finally upon us. Our employment taxes expert Daniel Kelly recaps on the new legislation.

Any hopes for a further delay to the introduction of off-payroll working (known as IR35) rules were dashed in the March Budget. They came into effect for medium and large private sector organisations on 6 April 2021. It's important to remember that the rules for corporate entities apply equally to entities classed as 'relevant undertakings'. These include limited liability partnerships, overseas companies and unregistered companies.

For consultants engaged via their personal service company (PSC), the obligation to assess the employment status of that engagement moves to the end user organisation (the company receiving the consultant's services).

Where that status is assessed to be 'employment', all payroll obligations and NIC liabilities move from the consultant's PSC to either the end user or the intermediary who pays the PSC.

The new rules significantly increase the compliance burden and potential risks associated with engaging contractors. The work required should not be underestimated.

Insurance intermediaries use external consultants on a regular basis and many of these relationships may well initially be outside of IR35. However, as with all business relationships, the connection with a contractor may develop to become more regular and dependent. Therefore this is a risk that requires constant monitoring, and not only upon initial engagement.

How to assess employment status

Organisations must assess the employment status of a contractor "with reasonable care", formally documenting their assessment using accepted employment status indicators in a status determination statement (SDS).

This may mean investing in training for those completing SDSs or seeking support from a third-party advisor more familiar with the subjective nature of employment status.

HMRC's CEST online tool is expected to be the most popular way for organisations to complete the assessments. But problems remain with the assessments made by CEST and many organisations are instead using one of the many independent assessment tools on the market.

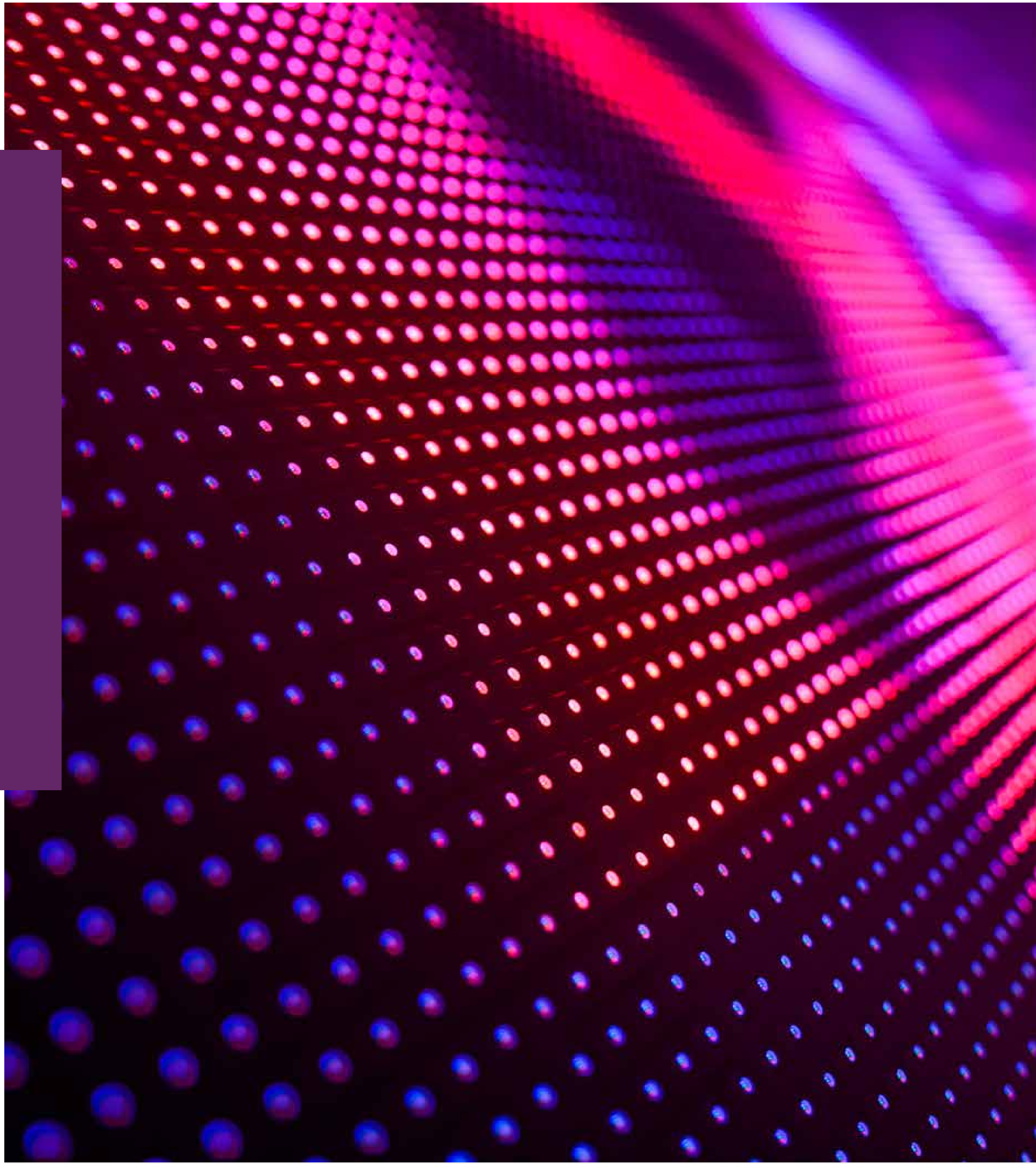
In particular, it should be noted that CEST does not consider sector specific requirements. For an intermediary, subject to FCA regulation, certain roles and obligations carried out by contractors may imply a greater level of control, and risk of capture under IR35, than other businesses.

Why your supply chain matters

The new rules apply regardless of whether you directly contract with a contractor's PSC or via another intermediary. If there's a PSC in the labour supply chain, the end user organisation must complete an SDS.

Where other intermediaries are involved in the supply chain, an end user is only obliged to communicate the SDS to the contractor and the first intermediary in that chain. Payroll and NIC obligations rest with the last intermediary in the chain – who pays the PSC.

Where the services of a contractor involve a chain of intermediaries, the end user organisation may not even know a PSC is being used. So understanding the labour supply chain is going to be vital for compliance.



What if there is disagreement?

End users must complete an SDS and send it to the contractor and any intermediaries in the supply chain before the first payment for services under the engagement is made. Contractors and/or the intermediary deemed to be the employer (who pays the PSC) can dispute the employment status assessed by the end user.

Organisations must have a process for dealing with disputes within 45 days of receipt. They aren't obliged to change their assessments if disputed, but should re-visit the original SDS in light of any new information or documentation provided.

What does 'small' mean?

It's important to note that small businesses are exempt from the legislation, and won't need to apply the new off-payroll working rules. A business is small if it meets two of these three criteria – considered on a global consolidated basis. Note that if an Insurance intermediary recognises client money on balance sheet on a gross basis, these assets will be considered as part of gross assets for this test, potentially breaching the threshold tests for an otherwise small business.

- Annual turnover less than £10.2million
- Gross assets less than £5.1million
- Fewer than 50 employees

It's the size of the end user organisation that is relevant for the application of the new rules, but not so for the contractors themselves. Where the end user is a small company, the contractor and their PSC will continue to be governed by the existing legislation which places all obligations for assessing employment status and operating payroll, where necessary, on the PSC.

Contracting consultants directly

One point which seems to have been lost is that the new rules do not apply to contractors who are engaged directly, not through a PSC. It has long been the case that the engaging company assesses the employment status of the contractor and operates payroll where appropriate. These rules remain unchanged.

Daniel Kelly
Senior Manager - Tax

+44 (0)20 7516 2461
dkelly@pkf-l.com

The risk of outsourcing

Jessica Wills
Head of Governance, Risk and Control Assurance

+44 (0)20 7516 2229
jwills@pkf-l.com

In recent months, the regulators have reminded firms in the insurance sector of the importance of understanding the risks associated with outsourcing, and managing the risks and pitfalls that come with operating outsourced arrangements. In March, the PRA published PS7/21 and SS2/21 Outsourcing & third party risk management which clarified and modernised the PRA's expectations in this area, particularly from an operational resilience perspective. Insurers and other in scope firms will be expected to comply by 31 March 2022.

Then in April, the FCA imposed a public censure and financial penalty on Alsford Page & Gems (APG) following serious control failings and regulatory breaches relating to appointed representative (AR) sales of extended warranty insurance products.

The FCA found APG's oversight of its ARs both limited and ineffective. While the issues and pitfalls highlighted by the FCA are specific to APG and principal/AR relationships in the insurance broking sector, they provide useful insights on regulatory expectations for effective oversight and monitoring of outsourcing arrangements more generally.

A wealth of failings

In 2013, APG diversified its lines of business and started selling extended warranty insurance products to retail customers via a network of six ARs. The additional conduct risks associated with this type of business and customer base (which included vulnerable customers), signalled a change in the firm's risk profile. The FCA's final notice highlighted not only the additional conduct risks and associated failings by APG, but also the weaknesses in APG's control and oversight of the outsource relationships with ARs. This included:

- Inadequate resources – The firm did not properly assess the adequacy of its resources, skills and capacity to effectively monitor ARs.
- Deficiencies in contractual agreements – AR agreements did not clearly articulate the oversight role of the firm and delegated too much responsibility to ARs.
- Lack of clear guidance – The firm did not provide sufficient policy or procedural guidance to ARs in key compliance areas, resulting in inconsistencies in processes and control procedures across the ARs.
- One size fits all approach – The firm's AR monitoring programme was neither risk based nor tailored for each AR. The FCA highlighted the lack of a robust risk based monitoring approach which should have considered the terms of the contractual agreement, ongoing suitability and solvency of the third party, the product sold, the sales method, sales volumes, the target market and the number and experience of sales agents involved.
- Weaknesses in key controls – Key controls such as sales call scripts, file reviews, and audits/visits were poorly designed and implemented. Key controls were ineffective. For example, call scripts mandated by the firm were not sufficient to ensure that sales calls were consistently clear, fair and not misleading to customers. AR audits/visits were not risk based in terms of either frequency or scope and, as a result, provided little value as controls.
- Over-reliance on AR self-monitoring – There was little input or challenge from the firm. Specifically, ARs monitored their own sales calls with very limited guidance or input from the firm, contributing to variability in approach and quality. Complaints made against ARs were handled by ARs themselves, with limited oversight by the firm. And although ARs were required to submit compliance monitoring reports to the firm, their design did not enable issues to be flagged and were deemed not fit for purpose.
- Ineffective MI – MI collected from ARs was insufficient, failed to properly consider conduct risks and was poorly used by the firm. Specifically, the FCA referred to the firm's lack of analysis of the MI provided by ARs. This included failure to perform analysis (including root cause analysis) of AR sales call monitoring results, cancellations, claims and complaints data. This analysis would have enabled APG to identify thematic or systemic issues.
- Weaknesses in the three lines risk management framework –There was a lack of oversight and challenge from the second line and no proper (i.e. independent) third line.

Lessons for internal audit

The importance of the role of internal audit functions within the three lines risk management framework is clear from the FCA's conclusions on APG. The firm should have tasked its internal audit function (or equivalent) to review the extended warranty business and ARs. Instead, it treated its Board as the third line, despite its lack of independence.

In light of the ongoing regulatory focus on outsourcing and the lessons learned from APG, what should internal audit functions in the insurance sector be doing in this area?

- Identify the full scope of outsourcing arrangements – All firms are likely to have outsourcing arrangements in some shape or form. It is essential that internal audit functions identify the full scope of outsourcing across their organisations. Some may be obvious, such as an outsourced IT or HR function, but others less so, such as where there is delegation of activities to third parties.

  Since the FCA's thematic review TR 15/7: Delegated authority: Outsourcing in the general insurance market, the regulator has consistently emphasised that delegated arrangements should be treated as outsourcing. That means firms and their internal audit functions must consider the whole spectrum of outsourcing within their control framework.
- Assess the risks – When assessing the risks that outsourcing presents, firms need to consider a range of factors. In the case of APG, there was a failure to properly consider the conduct risks.

  When assessing risks and deciding which outsourcing arrangements to prioritise for review, internal audit functions should consider the full range of risks. This should include conduct, financial, operational and reputational risks and also the associated resilience.

  In today's Covid-19 world, the risks presented by outsourcers may be very different to 12 months ago so it is important that internal audit functions continually monitor these.

- Define approach – There are different options when it comes to the approach to auditing outsourcing arrangements.

Audit approach	Pros	Cons
Review of outsourcing governance and control framework	Provides assurance on the overall governance and control framework for outsourcing. Will help internal audit functions form a view on higher risk outsourcing arrangements which could be the focus of future audits.	May be too high level to provide real challenge/insights on specific outsourcing arrangements/ controls.
Consideration of outsourcing risks and controls within all audits	May provide a deeper understanding and assessment of the outsourcing arrangement in the context of the area being audited.	Risk that some outsourcing arrangements would not be covered depending on which audits are undertaken in any one year. To mitigate this, internal audit would need to map the various outsourcing arrangements to the audit plan so there is clarity over coverage.
Deep dive review of specific outsourcing arrangements	Can focus and target higher risk or material outsourcing arrangements and provide deeper challenge over the control framework.	Less appropriate or useful if the firm doesn't have higher risk or material outsourcing arrangements. Need to have a good understanding of each outsourced arrangement to select the deep dive target.

- Provide proper challenge – Whatever approach is taken, it is critical that internal audit functions provide proper challenge over the adequacy of outsourcing arrangements and the control framework. In the case of APG, a number of key controls that were heavily relied upon by the firm were found to be ineffective.

  Internal audit functions should ensure that their firms' controls are effective in mitigating outsourcing risks. Internal audit functions should learn from lessons from APG and ensure they're asking a number of key questions:

  - Does the firm have adequate resources to manage outsourcing arrangements or are there signs of resource stretch?
  - Does the second line of defence have a clear and effective role?
  - Do contractual arrangements with outsourcers provide a sufficient legal basis and are expectations and roles clearly articulated?
  - Has the firm provided clear guidance to outsourcers and what is the quality of this guidance to ensure consistent application?
  - Is the firm's monitoring approach to outsourcing risk based? Is the risk assessment truly reflective of the full spectrum of risks?
  - Are key controls of sufficient quality and substance? How are the outputs of key controls (e.g. outsourcer audits/visits) acted upon to demonstrate their use and value?
  - Is the firm sufficiently proactive in managing outsourcing risks or too reliant on outsourced providers' own monitoring and reporting?
  - How is MI received from outsourcers actually being used? Is it complete and how is it analysed and reported to aid decision-making?

How can PKF help?

PKF can help you in many ways:

- If your firm does not currently have an internal audit function, please contact us to discuss your options. We can help you to establish an internal audit function that is independent, appropriate for your organisation and meets the expectations of the regulators.
- If your firm does have an internal audit function, we can help you develop your approach to reviewing your firm's outsourcing arrangements and risks.
- If you have outsourcing arrangements in place, we can help you assess these against the PRA's expectations set out in PS7/21 and SS2/21 Outsourcing & third party risk management.

About PKF
Simplifying complexity for our clients

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

With over 100 years' experience in the insurance market, PKF has built up a solid and comprehensive reputation as one of a small number of UK accounting firms with in-depth expertise in supporting businesses, their owners and investors across the insurance industry.

Ranked as the largest auditor of insurance intermediaries in the UK and the 7th largest auditor of general insurers, our dedicated insurance team acts for major carriers and syndicates, brokers and MGAs including many businesses harnessing the power of technology to transform the insurance industry.

How we can help

- Statistical Audit →
- Governance, risk and control assurance →
- Tax →
- Transaction advisory →
- Restucturing →
- Business outsourcing →

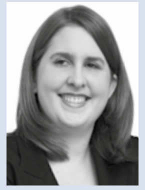
PKF UK in numbers	Insurance intermediaries in numbers	PKF International in numbers
8th Largest audit practice in the UK in the latest Accountancy Daily rankings	**1st** Largest auditor of insurance intermediaries	**Part of the 14th** Largest global accounting network
30 Offices across the UK	**90+** Insurance intermediary clients	**480** Offices in 150 countries
2,025+ Employees and 167 partners	**30%** Advisor to one third of the UK's Top 50 Brokers	**$1bn+** In aggregate fee income
£150m Fee income and growing rapidly	**15** PE backed insurance intermediary clients	**20,000** Employees

Get in touch today
to see how we can help...

Paul Goldwin
Partner – Audit & Assurance
+44 (0)20 7516 2251
pgoldwin@pkf-l.com

Martin Watson
Partner – Audit & Assurance
+44 (0)113 524 6220
mwatson@pkf-l.com

John Needham
Partner – Transaction Services
+44 (0)20 7516 2284
jneedham@pkf-l.com



Jessica Wills
Partner – Goverance, Risk & Control Assurance
+44 (0)20 7516 2229
jwills@pkf-l.com

Howard Jones
Partner - Corporate Tax
+44 (0)20 7516 2295
hjones@pkf-l.com

Chris Riley
Partner – Tax
+44 (0)20 7516 2427
criley@pkf-l.com

Azhar Rana
Partner - Audit & Assurance
+44 (0)20 7516 2232
arana@pkf-l.com

Ian Singer
Senior Consultant - IT Assurance
+44 (0)20 7516 2393
isinger@pkf-l.com

Will Lanyon
Director - Transaction Services
+44 (0)20 7516 2411
wlanyon@pkf-l.com

PKF Littlejohn LLP
15 Westferry Circus
Canary Wharf
London E14 4HD

Tel: +44 (0)20 7516 2200
www.pkf-l.com