Keith Billing
Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

20 March 2015

Dear Keith,

AFM Response to FRC consultation on auditing and ethical standards

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

   - Respond to the consultation proposals; and
   - Highlight the specific impact on small mutual organisations that voluntarily apply the UK Corporate Governance Code.

2. The Association of Financial Mutuals (AFM) represents 52 member companies, and in most of our member companies, customers present and future are the owners of the business. Between them, AFM members manage the savings, pensions, protection and healthcare needs of over 20 million people in the UK and Ireland, and have total funds under management of over £100 billion. The nature of their ownership and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. The main UK financial regulators have a statutory obligation to consider the specific consequences for mutuals of any new regulation.

3. We welcome this consultation from FRC. We are not responding directly to BIS, as their discussion paper is largely outside the scope of most mutual organisations (who are not subject to company law). In any event, we are focused on the practical consequences of the Audit Directive, the way that FRC plans to apply it, and the impact on our members.

4. As a sector, we fully recognise and support the need for robust and independent audit. We have actively welcomed FRC's work in this area, which helps to provide confidence to the general public, as well as to the owners of organisations, who in a mutual are also our customers.

5. Compliance with AFM's Annotated Corporate Governance Code is a condition of membership. Hence AFM members 'voluntarily' adopt the UK Corporate Governance Code, including those aspects relevant to audit and auditors. We have seen consistently high standards of compliance with the accountability section of the Code, from both small and large mutual organisations. Through our 'comply or explain' approach, our voluntary adoption of the Code is sympathetic to proportionality, allowing for the limited resources available to some smaller mutuals.

6. We have a general concern that as a result of the proposals in the consultation, all mutual insurers, regardless of size and complexity, will be treated as equivalent to Listed entities, and that this may create an overly rigid and burdensome regime at the smaller end in particular. This could reduce choice of audit firms, increase cost in relation to audit and non-audit services, and rather than alleviate risks in financial information and financial reporting it could create them.

7. We explore these issues further below, and suggest alternative ways of achieving the same goals. We would be pleased to discuss further any of the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

AFM comments on sections of the consultation

Section 1 – Auditing Standards

We generally support the notion that a properly constituted UK body such as the FRC has the ability to impose requirements beyond EU regulation in the interests of improving the credibility and quality of financial statements, including through regulation of audit firms. Our concern would be that this ability is not undertaken in a carte blanche fashion, so that all the standards suitable for the largest and riskiest reporting entities are applied to all; rather we consider that proportionality be considered in each case.

Whilst all insurers may be considered "PIE" for the purposes of the Regulation, many smaller mutual insurers have relatively simple and unsophisticated business models, for which a proportionate approach to audit might be considered appropriate in the same way as there remains a proportionate approach to accounting. Those firms have limited resources and regulation imposed on them should have due regard to the costs and benefits likely to accrue, whether through the extent of audit or any other requirement.

Our comments to this section apply equally to any extension of the auditors' report to members and the auditors' report to those charged with governance. We note these areas are already largely covered in the UK.

Section 2 – Proportionate application and simplified requirements

We note the historical view that there has been no perceived need to modify Auditing Standards to allow for smaller entities but that, importantly, the common standards can be applied in a proportionate manner. We support that view. Our concern is that additional requirements for Listed entities, whether in terms of Auditing Standards or Ethical Standards for auditors, are applied universally to all insurers' auditors without thought to scale, complexity and risk.

As highlighted already, the risk characteristics of some "SME" mutual insurers are quite different to those of Listed entities. In determining what constitutes "small" in the context of insurance entities, given their special nature, regard might be given to the criteria used by the financial services regulators; one such benchmark is the de minimis levels set as to revenue and assets with respect to Solvency II application; another is in relation to the minimum size of with-profits fund to which realistic reporting should apply.

There is a risk that if allowance for proportionality is denied with respect to the smallest mutual insurers, their choice of audit firms could become limited unnecessarily, with a probable increase in compliance cost and risk for them.

We will endeavour to consult further with audit firms active in the mutual sector as part of your planned 2015 consultation in this area.

Section 3 – Extending the more stringent requirements for public interest entities to other entities

We note that auditors of all insurers will be caught as providing services to "PIEs" under the EU Regulation and therefore subject to more stringent ethical standards than auditors of the general run of companies. As the FRC's consultation paper states, in the current UK regime only auditors of certain insurance undertakings are within scope of the FRC's Audit Quality Review (AQR) team. These are: Industrial and Provident Societies with revenue in excess of £0.5bn; Friendly societies with net assets in excess of £1bn; and life mutual having with-profits funds in excess of £1bn.

There is potential therefore for considerable widening of the extent to which auditors of insurers are caught by more stringent requirements whether or not this is justified. To illustrate, based on data to the end of 2013, of AFM's 52 current members, 35 fall below one or more of these thresholds. This includes 10 friendly societies with assets below the Solvency 2 threshold of €25 million, who will retain a different accounting and regulatory regime from directive insurers once Solvency 2 is implemented.

We would advocate in respect of auditors of mutual insurers that fall below the FRC's current scale criteria that the additional requirements are kept to the minimum, in other words that the UK does not prescribe requirements beyond those of the EU regulations. This is not to say that additional requirements may not be appropriate in particular circumstances. We expect there will still be scope for the UK's audit regulator to deal with these appropriately. Our concern, once again, is that proportionality be allowed for in the system given the range and diversity of the insurer sector (and mutual insurers in particular).

Section 4 – Prohibited non audit services

The EU Regulation will clearly restrict non-audit services provided by the auditor beyond those currently permitted, even for the largest UK listed entities. When applied to other PIEs, such as mutual insurers (particularly the smaller ones), this will represent an even greater restriction. For smaller mutual insurers, with limited resources, using the auditor for other services such as tax or payroll, can offer important cost and operating efficiency advantages. We would be keen that a new stricter regime be limited as far as possible in order that the impact be contained. In this context, we would support the use of derogations in the UK to the extent they are available under the Regulation.

Section 5 – Audit and non-audit services fees

For the same reasons as set out in Section 4, recognising the potential impact on smaller mutual insurers, we would be keen that the cap on no- audit fees be no stricter that that laid down in the EU Regulation for PIEs.

Section 6 – Record keeping by auditors

We have no particular comments on this section at this time.

Section 7 – Audit firm and key partner rotation

We understand and support the principle that the independence of the audit firm and audit partner be safeguarded through periodic re-tendering and rotation rules. We believe that the rules laid down within the EU Regulation are sufficient to serve the needs of the mutual insurance sector without recourse to stricter rules, for example, those on audit partner rotation currently applicable to Listed entities in the UK.

Consultation Stage Impact Assessment

We note the ABI response to the impact assessment, with which we fully agree: *"The requirements will place disproportionate burdens on mutuals and other unlisted insurers. Very many of these are small, have limited resources, and lack finance other than from their policyholders - the protection of whose interests is already at the very heart of extensive and substantial regulation and supervision by the Prudential Regulation Authority. Every effort should be made to reduce the effects."*

We have seen similar concerns about gold-plating in other responses, and we urge attention by FRC to heed this.