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8 July 2021

## **AFM Response to consultation on restoring trust in Audit and Corporate Governance**

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:
  - Highlight the difficulties in applying the current PIE arrangements as well as the new proposals for small mutual insurers, and set out how their exemption would lead to a more consistent regime and fairness for small businesses; and
  - Comment on the proposals more generally, and to highlight some of the difficulties in interpreting them for alternative corporate forms.

### About AFM and its members

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £19.6 billion, and employ nearly 30,000 staff<sup>1</sup>.
3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses<sup>2</sup> and to take account of corporate diversity<sup>3</sup>.

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<sup>1</sup> ICMIF, <https://www.icmif.org/publications/market-insights/market-insights-uk-2016>

<sup>2</sup> Financial Services Act 2012, section 138 K: <http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted>

<sup>3</sup> <http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted>

## AFM summary and conclusions

4. Effective audit is a vital component of the control environment in any organisation, and provides important safeguards for the owners. We recognise the concerns expressed by BEIS, that public confidence in corporate reporting and audit will have been 'undermined recent failures': and whilst these are few in number, they are significant in scale.
5. We agree with the prognosis, that action to address problems identified in the various reviews undertaken must be 'focused on the largest companies because that is where there is greatest public interest'. We have three particular concerns however:
  - a. many of the proposals are not focused exclusively on 'the largest companies', and that ill-fitting definitions and approaches to Public Interest Entities means that small, mutual businesses are disproportionately affected;
  - b. not all current Public Interest Entities are subject to the Companies Act or the UK Corporate Governance Code. For example, friendly societies have their own legislation, which has not kept pace with corporate requirements, and in any event deals with a different group of stakeholders (in particular where there are no shareholders). Hence some of the proposed legislative changes will not be fully effective without an overhaul of the Friendly Societies Act 1992; and
  - c. for financial services companies, the role of audit may be quite different from that in less-regulated industries. In insurance for example, external audit sits alongside heightened regulatory responsibilities on senior managers and directors, as well as a strict capital regime and extensive actuarial requirements, which change the nature and extent of risk the auditor is responsible for.
6. We have written previously to BEIS highlighting the damaging problems for small mutuals in applying the requirements for Public Interest Entities (as per the attached document from January), and we also responded to the BEIS survey earlier in the year, and with the Association of British Insurers had a meeting with the relevant BEIS team in April.
7. As our earlier note explained, there is a failing market for audit in mutual insurance, even before the proposals described in the consultation. The pre-existing PIE rules means that the organisations willing to undertake

audit services for small mutuals have reduced significantly, and with only a handful of firms now active, the costs have risen severely. This contradicts the aims of BEIS in improving the supply of effective audit; but it also represents a significant threat to our sector. That threat will be exacerbated if new proposals are introduced indiscriminately.

8. In our assessment, there are intractable anomalies between the bold vision for audit envisioned by the consultation, and the application of that vision to business forms for which the proposals are wholly unsuited. We suggest this is most readily and effectively resolved by re-defining the definition of Public Interest Entity- to exclude all friendly societies, and all 'small mutual insurers' (ie those that fall below the revised threshold proposed for non-insurers in the consultation).
9. Even adopting the lower benchmark for expanding the definition of a PIE in Chapter 2, no AFM member would meet the scale expected, based on a minimum employee count of 500. Our proposal to exclude small mutuals would effect a small number of organisations, since insurance companies below the threshold for Solvency 2, for the purposes of the PIE definition, are already not classed as insurers.
10. We recognise this is contrary to the view expressed in paragraph 1.3.11, though we see no evidence put forward to justify why this has not been explored in the past, or any estimate of the impact of the current and proposed PIE definition on this audience. We have looked at thresholds proposed elsewhere for new disclosure requirements:
  - a. in Europe, there are plans to exclude PIEs with fewer than 500 employees from the CSRD (Corporate Sustainability Reporting Directive), as they are already excluded from the current NFRD (Non-Financial Reporting Directive);
  - b. PRA provides an exemption for small insurers from needing to have an external audit of the Solvency and Financial Condition Report (SFCR); and
  - c. the FCA's consultation on climate-related disclosures (CP21/17) excludes asset managers and asset owners with assets under £5 billion.
11. We think that exclusion as suggested in paragraph 8 above, or threshold approaches as per paragraph 10 should be applied to the current audit/ PIE requirements, and those proposed in this paper. This is because audit regulation is equally onerous and non-proportionate. We are confident that a more careful assessment would show that the high costs

of the application of PIE rules are not justified by any measure of public interest.

12. We agree that ARGA should be funded via a statutory levy. We are concerned however that this must be levied proportionately and fairly. Currently FRC derives much of its income from subscribers to the UK Corporate Governance Code and Stewardship Code, but since neither of these are relevant to mutual organisations, these organisations will not (except in specific circumstances) be a subscriber. We have proposed in our opening comments that friendly societies and mutual insurers with fewer than 500 employees should be excluded from the PIE definition for the purpose of audit work: in this case the levy would not be levied on these organisations. Should the government reject this view, it will be important that any levy on financial mutual organisations is more narrowly levied, to reflect the more limited range of ARGA supervision necessary, as well as the pre-existing supervisory role of the PRA and FCA.

13. We have responded to specific questions raised in the consultation below, and would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'MS' followed by a stylized flourish.

Martin Shaw  
Chief Executive  
Association of Financial Mutuals

## Areas of the consultation we have considered further

As stated above, we do not consider the public interest is best served by the application of the PIE definition to friendly societies and small insurers. We have though considered some of the proposals in the bulk of the paper, and based on our experience of current audit rules, offer a limited set of responses.

(Q1) We agree that companies should be included in the definition of PIE based on their size and not their trading status. Of the two options proposed, we consider neither adequately addresses the stated need, since they adopt a contrived measure of size. Option 2, with an 'either/ or' approach to size and turnover, rather than 'and' might be a satisfactory solution.

(Q9) Based on our own experience, extending the PIE definition will lead to an increase in audit costs, particularly for small organisations. It is likely that lower charging audit work will prove unattractive to some audit firms, so auditors will impose high minimum prices. There will also be bottlenecks around year end, and this will further intensify the problems of availability and proportionality.

(Q14) We generally agree with the Government's preferred option, and consider that it is important that Directors take primary responsibility for assessing the adequacy of internal control arrangements, and that auditors are only asked to review them in specified circumstances. We note that not all Companies Act reporting requirement apply to organisations not governed by the Act, so amending expectations there might leave gaps in coverage.

(Q15- 18) In the context of realised profits and this section of the consultation, the paper presumes that all businesses operate under the same legal framework, and owe an obligation to external shareholders. It is not clear how the Government intends to apply the requirements, if it does, to other legal forms, including friendly societies and mutual insurers.

(Q19) The proposals overlap with a range of other requirements, especially for financial services organisations, so the proposals may not be onerous, as long as they are properly aligned with pre-existing requirements. Where ARGAs intends to make changes to the UK Corporate Governance Code, we will consult on similar changes to the AFM Corporate Governance Code, to maintain broad alignment-where that is appropriate to the business model of our members.

(Q24) We think the Audit and Assurance Policy should be published every three years, as we do not think the policy will change significantly from one year to the next.

(Q27) We agree with the Government proposal not to require publication of a public interest report at this time, as it will compete with other new reporting expectations, and may therefore make the annual report less easy to understand.

(Q28) As per footnote 110, the FRC Conduct Committee's powers extend to all companies that prepare reports under the Companies Act, and again we point out that this does not wholly address other legislative frameworks. By implication therefore, to extend the remit to all PIEs would extend Companies Act requirements to organisation that are not subject to the Act. Where for example the Corporate Insolvency and Governance Act led to changes to the Companies Act, there was a separate requirement to change the Friendly Societies Acts and the building societies legislation.

(Q33) The capacity for the financial services regulators (PRA and FCA) to investigate breaches in directors' duties and in their behaviours, offers important protection for consumers. Extending enforcement powers to ARGAs, in relation to other corporate entities should be actively explored, to the benefit of society at large.

(Q59) The proposal for greater involvement from the audit committee chair and the auditor during the AGM may be of benefit to large or institutional investors in shareholder-owned businesses. For member-owned mutuals, the presentation of financial and control information must be carefully measured against the aptitude and interests of the audience.

(Q61) Our experience of the introduction of PIE requirements for small mutuals was that it increased concentration, so we are not convinced by the expectation that the proposals will automatically widen choice. We also saw a significant increase in cost coincide with lack of choice, and this may affect some of the assumptions in the government impact assessment.

(Q74) We agree with the general objective proposed for ARGAs.

## External audit for smaller mutual insurers: a failing market?

In recent times, AFM members have reported significant problems in the supply of external audit. To illustrate we've included two case studies (anonymised), reflecting reported problems in the last few months.

The problems emanate from two recent changes to audit regulation. First, the UK's definition of Public Interest Entity has been extended to all insurance companies. Second, given mounting concern about the effectiveness of audit following some notable business failures, audit standards have, quite properly, been raised. However, some of the regulatory changes have exacerbated problems in supply, such as requirements on non-audit services and re-tendering requirements.

The combined effect of these changes is that there has been a significant contraction in the supply of external audit. Previous audit suppliers have exited, indicating that the PIE rules are overly onerous and make the work unviable. There are now only a handful of firms willing to provide audit services to our members, and these firms are becoming more selective about which work they will take on.

Prices of audit have increased significantly. This is blamed on external forces, such as new audit oversight requirements; however, auditors appear to have imposed very high minimum fee levels, so for small organisations there is increasingly less correlation between the work being undertaken and the price paid. It seems likely there is some co-ordination of pricing amongst the large audit firms, though we have no evidence of cartel arrangements.

Insurance companies in the UK are highly regulated, and with the help of their actuaries they manage their businesses cautiously. Business failures are therefore very rare, and large parts of the audit role are devoted to verifying the work of other professionals. The purpose of the current PIE definition does not sit accurately with AFM members, who are small insurers and represent no systemic risk to the economy or their policyholders; equally, the nature of audit reform seeks to tackle problems which are not prevalent in the sector, and which did not take account of its impact on unlisted/ mutually owned insurers.

In summary, **the supply and price of audit now represents a significant threat to our sector, and as a result we consider the market for external audit is not working competitively.** Some of the possible solutions that should be considered are:

- To revise the definition of PIE in the UK, to exclude unlisted insurance companies below a threshold of, say, £500 million annual premium income (BEIS);

- To revise the threshold for inclusion of Solvency 2, to take more small insurers out of the regime which currently adopts inclusion in the Directive as the definition of insurer (HM Treasury and PRA);
- To investigate the supply of external audit to small insurers (CMA/ FCA);
- To review audit reforms, to consider whether they are having the desired outcomes, both in terms of maintaining effective audit standards, and retaining an approach which is proportionate to the risk and scale of the business (FRC).

## **AFM member case studies**

### Case study 1

The incumbent audit firm indicated during 2020 that they would not seek to renew audit services beyond the year-end 2020 report and accounts. The insurer has begun to tender for a new audit provider, and found that prices quoted are typically three or four times the current price. The insurer has premium income below £5 million and in 2020 has had to reduce headcount from 7 to 5, and considers that within the next 3 to 5 years, the cost of audit will be so significant that it will be unable to justify the expenditure to its members. Put another way, audit fees from one of the Big 4 audit firms are projected to be around 50% of the wages and salary bill for this organisation; by comparison, Aviva, the UK's largest insurer paid less than 0.1%.

### Case study 2

To meet rules on re-tendering, this insurer approach ten audit firms to quote for audit of the 2020 year-end accounts. Only one of the ten were willing to undertake the work- the incumbent auditor- and only then at a significantly inflated price. The insurer is exploring how it might undertake a more successful retendering exercise in 2021, as audit rules expect the audit committee to make a recommendation of the successful candidate to the Board, and to identify both its first and second choice candidates and the reasons for its selection.

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