Financial Reporting Council
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By email to: competition@frc.org.uk

27 February 2023

AFM Response to FRC Policy paper on Competition in the audit market

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:

   - Comment on the actions taken by FRC, and highlight again our concerns about problems in the market for audit for members of AFM.

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 32 million people in the UK and Ireland, collect annual premium income of over £22 billion, and employ nearly 30,000 staff[1].

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[2] and to take account of corporate diversity[3].

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[1] ICMIF and AFM, 2022: https://financialmutuals.org/wp-content/uploads/2022/10/UK-Market-Insights-2022.pdf

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

[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

The current market for audit in our sector

4. We welcome the Policy Paper and the opportunity to comment, and are pleased that FRC is considering the market for audit across smaller businesses as well as listed ones. We have raised concerns over several years, with FRC, Treasury, BEIS and the PRA about the functioning of the audit market for mutual insurers.

5. As all friendly societies are required to have a financial year-end of 31 December, and many mutual insurers inherited one, and as most professional services (including audit and actuarial) are outsourced, the sector is forced to buy those services from the market at its busiest time of year. This makes it more difficult to source a provider, and also means that the cost of audit and actuarial support is higher than it might be at a time of lower demand (estimated to be around 20% less).

6. In addition, any mutual insurer in the scope of Solvency 2 is also classified as a Public Interest Entity (under EU rules). In its response to the consultation on 'Trust in Audit and Governance', BEIS accepted that there was a case for exempting 'certain small entities'. The BEIS commentary closely followed the arguments made by AFM in our response to the consultation. This included that most mutually-owned PIEs are much smaller businesses than the main target audience, that the impact of being PIE had been perverse in our market, by reducing choice and competition. This is in part because, as regulated businesses, the PIE requirements added an extra layer of scrutiny on top of the PRA and FCA rules which have similar effect.

7. In 2022, we undertook a review of audit costs in the sector, as part of our report on corporate governance. This indicated that the PIE requirements had pushed audit costs up to an average of £187,000 in 2021; by comparison, for AFM members outside the PIE regime, the average cost was £12,000. The cost for a smaller PIE friendly society equates to between 2 and 3% of premium income (turnover) typically. Most comparable sized private companies are obliged only to present *accounts for a smaller company*, which omit detailed information, making comparison difficult, though a comparison of FTSE350 companies for 2018 showed that the audit costs of Wetherspoons was £200,000 (whose revenue at that time was £1.7 billion, comparable to the entire membership of AFM). An extract from the AFM governance report, plus two case studies submitted as part of our evidence to BEIS, are attached in the Annex.

Our comments on FRC policy

8. We note that whilst the policy document reiterates that “our approach to takes account of such differences across the market”, the same paragraph (12) fails to recognise that currently many of the PIEs in the insurance market are not FTSE350 firms, and that within PIEs there is a range of businesses that are distinctive and materially different. That misunderstanding leads us to question the assertion that FRC’s approach does take proper account of differences in the market.

9. The analysis in chapter 2 reflects many of the issues we see in the market for audit for AFM members. However, whilst the report indicates a reasonable range of audit firms available for “unlisted credit institutions and insurers”, in our experience a number of auditors have exited the insurance market in recent years, and some large auditors are no longer interested in working with smaller mutual insurers. In addition, whilst the paper reports a relatively modest increase in total fees across the audit market, our members report regular increases of over 20% (and often much more). This reinforces earlier points about the FRC/ ARGA having a limited knowledge of how the audit market serves firms outside the FTSE350.

10. The proposals in chapter 3 to take forward policy on competition in the audit market are clearly informed by the data which indicates the Big Four continue to earn over 90% of all audit firm fees. The fact that this falls to 70% for firms outside the FTSE 350 is not an indicator of more effective competition, more a case that the Big Four are increasingly turning away smaller firms, either directly or by pricing themselves out of contention.

11. We would encourage FRC/ ARGA, as part of their ongoing analysis, to include Executive-level discussions on the effectiveness of audit, as well with Audit Committees. It is very apparent that when the topic is discussed at the AFM Board, CEOs have formed strong views on the topic. As the analysis in the Annex indicates, whilst audit fees have increased significantly, the extra work involved appears to be devoted to fact-checking and back-covering: audit work itself has become formulaic, with an off-the-shelf approach taken to reviewing standard items, and few material issues identified as a result.

12. We would welcome greater commitment from FRC/ ARGA to resolving how well audit offers:

    a. value for money;

b. how effectively the approach of auditors demonstrates an understanding of the business, and how the content of the audit varies accordingly; and
c. how well audit routinely identifies operational and accounting errors.

13. We would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

Martin Shaw
Chief Executive
Association of Financial Mutuals

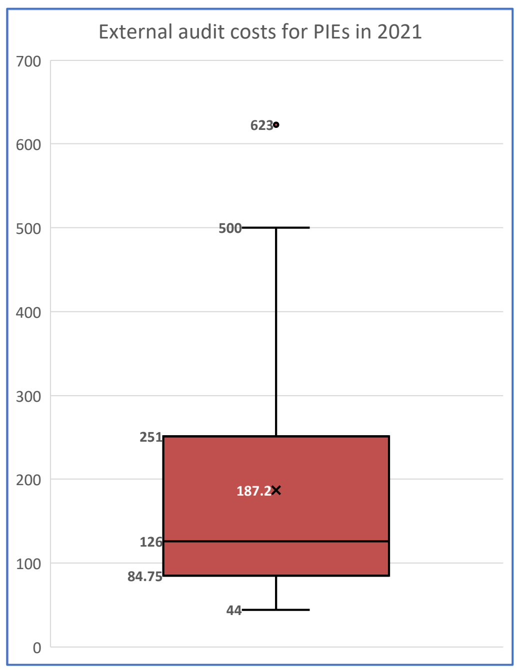
Annex: supporting information

1. Extract from AFM Corporate Governance Report, covering Audit, September 2022

"As part of the review for this document, the approach to audit reporting in members' accounts was explored. Audit reports have grown in length in recent years, partly as a result of requirements for the audit of Public Interest Entities (PIEs). A typical audit report now occupies around 6 pages in the annual report, though length does vary and there is no apparent correlation between the length of the report, the range of issues reviewed, and the cost of the audit. Most audits are undertaken by a small number of firms now, and it is apparent that each audit firm pursued a narrow list of key risks in 2021, giving the impression that each firm has a standardised approach for the year. Possibly the most extensive review was undertaken by EY for National Friendly[4], which agreed an extended scope, to include a review of climate change disclosures and Code application statements.

Of concern to many AFM members in recent years has been the reduction in the availability of auditors, alongside a rapid increase in price. This is particularly the case for AFM members in the scope of Solvency 2, since that also means that currently they are assessed as a PIE.

Across 19 PIEs whose accounts were reviewed, the average (mean) cost of audit in 2021 was £187,200 (marked by an X in the Box & Whisker chart). There was one outlier, excluded from the calculation of the mean, and otherwise the range was between £44,000 and £500,000. The central box in red shows that, when costs are listed in ascending order, the second lowest quartile ranges from £85,000 to the median of £126,000, with the second highest quartile up to £251,000.



Put another way, audit costs of the firms in the sample represented 0.5% of premiums earned in the year, with a range from 0.2% to 3.3%. They also equated to 24% of total remuneration costs of the Board for the entire year.

[4] https://nationalfriendly.co.uk/media/eodpk3f2/annual-report-2021.pdf , from page 42

The average cost for PIEs compares to a mean for those outside the PIE regime of £12,000.

Amongst the 19 organisations in the scope of PIE, seven used one of the 'Big 4 consultancies', at an average cost of £325,000; this compares to an average of £101,000 for those using other firms. Notably, two sets of accounts commented that the firm was ceasing to use a Big 4 firm, due to price, in 2022.

Of the 23 sets of accounts reviewed, most audit reports included a review of the valuation of technical provisions and the risks of irregularities like fraud. In only one set of accounts did the auditor raise an issue of concern (relating to a past error in the accounts)."

2. Two case studies included in our response to BEIS's consultation July 2021

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.

Case study 2

To meet rules on re-tendering, this insurer approached 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.