By email to: nfr.review@businessandtrade.gov.uk

12 June 2024

AFM Response to Department for Business and Trade: Non-financial reporting review; simpler corporate reporting

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 proposals and
- Seek commitment from DBT to act on opportunities for simplification of reporting for firms outside the scope of these proposals, including small mutual insurers and friendly societies.

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). As a whole, the mutual insurance sector manage the savings, pensions, protection and healthcare needs of over 26 million people in the UK and Ireland, collect annual premium income of over £23 billion, and employ nearly 23,000 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].

[1] ICMIF and AFM, 2023: https://financialmutuals.org/wp-content/uploads/2023/10/UK-Market-Insights-2023.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

Introductory comments

4. We welcome the opportunity to respond to this consultation. We fully support the work of government to streamline the bureaucracy endured by businesses, and to make corporate reporting simpler. This will not only reduce costs to firms, but is likely to make corporate reports easier to understand for their users, and to reduce the enormous costs of external audit.

5. AFM has regularly responded to the Department for Business and Trade on issues relating to the current Public Interest Entity regime and the burden that mutual insurers face for external audit as a result. We will revisit these themes in our response to this paper, since they directly correlate with the theme of excessive bureaucracy and unwarranted costs on industry.

6. Whilst we would have hoped that this consultation would have more directly addressed these issues, it is clear from discussions we have had with Ministers and officials, in both DBT and HM Treasury, that there is no intention to create an extra competition disadvantage on UK mutual insurers/ friendly societies [and building societies], and indeed, every sympathy with the punitive costs our members currently face, as small businesses, by having to incorporate audit and accounting standards that have been designed for the very largest of UK organisations. We very much hope to continue discussions on this topic.

7. We also encourage the government to consider how the changes it proposes to the companies' act can also be carried over for firms subject to different legislation; there does not appear to be any automatic mechanism to amend reporting requirements for friendly societies or building societies without changes to their respective legislation.

Q1. The medium-sized company employee threshold

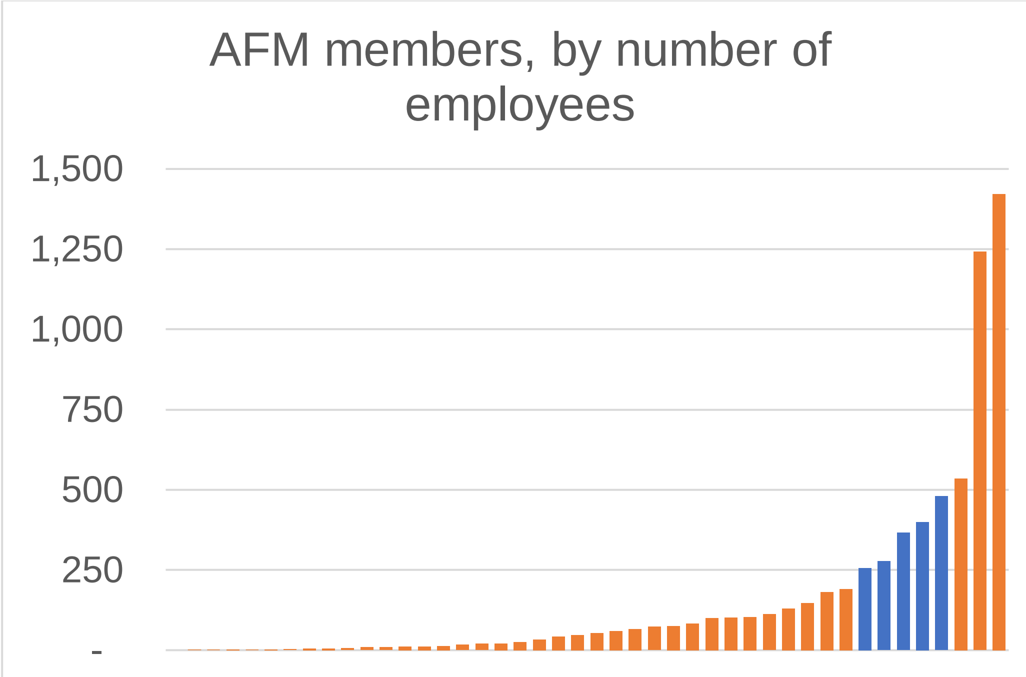
8. We agree with the proposal to raise the employee upper limit/ threshold for a medium-sized company, from 250 employees to 500. The government estimates a significant number of firms will enjoy a significant reduction in corporate reporting requirements as a result. The annex to the consultation indicates this will result in the removal for those firms from the strategic report of the need for a section 172(1) statement and the removal of non-financial KPIs (such as environmental and employee matters), as well as other simplified disclosures in the directors' report.

9. We consider this has the potential to reduce the amount of work relevant firms will need to produce in preparing their report and accounts, and to reduce/ simplify their external audit requirements. However, for financial services firms, particularly those that are classed as public interest entities, such as insurers and banks, regulatory rules will lessen the impact (for example in relation to effect of the company's operations on the environment and community, and the need to act fairly between members of the company). In addition, the changes in requirements will not remove the necessity or desire for mutually-owned businesses to set out in their report and accounts how they are running the organisation in the best interests of their members. We would envisage that the full consequences of the changes may be reduced for firms that seek to engage transparently and effectively with a range of stakeholders.

10. Under these proposals as well as those announced in March, a medium-sized business will be one that meets two of the three criteria: turnover of between £15 million and £54 million; a balance sheet of between £7.5 million and £27 million; and employee numbers of between 50 and 500.

11. Members of AFM tend to be small in insurers terms: overall our 45 members account for less than 1% of the UK insurance market. They are therefore the type of business that would expect to be in scope of DBT's plans. However, it is difficult to translate the turnover definition used here to insurance, since the term is not used in insurance accounting, and the premium income that insurers collect each year (sometimes used as a proxy for turnover) includes a majority for products sold in previous years. Similarly, as insurance balance sheets include the total liabilities of policyholders, the balance sheet threshold does not have any useful adaption to insurers.

12. As the chart below shows, the vast majority of AFM members have a very small workforce: over 80% have fewer than 250 employees; of these, 22 (or 61%) are classified as public interest entities. The proposed change in definition would mean that from an employee perspective, a further five AFM members would be categorised as medium-sized (highlighted in blue in the chart). However, as explained above, because the turnover and balance sheet definitions do not translate into insurance accounting, and because the UK has not revisited the blanket insurance company inclusion in the public interest entity regime, none would be able to benefit from the proposed change.



Q2. Exempting medium-sized private companies from producing a strategic report

13. We agree that there are numerous disclosure requirements in the strategic report, and that the production of these may be onerous to some organisations. However, we do consider that non-financial reporting is valuable: as mutual organisations, members of AFM need to set out in terms that the average policyholder will understand, how the business is being run, and why that is in the best interests of key stakeholders. We also consider that good practice, such as that described in the UK Corporate Governance Code, sets out the benefits of clear and transparent non-financial reporting.

14. We expect therefore that many firms would wish to present the information in the report and accounts, even if there was no stand-alone strategic report. They may though elect to present less evidence and KPIs to support their contentions, and whilst this will reduce cost, it may also increase the risk that the information is misleading or can be interpreted in different ways. Whilst responses to the 2023 consultation raised concerns[4], many of these have been allayed by the decision from the Financial Reporting Council to abandon proposals for an Audit and Assurance Policy, and to soften other requirements in their review of the UK Corporate Governance Code.

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[4] https://assets.publishing.service.gov.uk/media/65ef11ec5b6524100bf21acf/non-financial-reporting-review-call-for-evidence-summary-of-responses.pdf

15. But whilst some elements of the strategic report set out important information for stakeholders about the priorities of the business and how they might align with the reader's values and beliefs, other elements are less valuable. For example, looking at the report and accounts for members of AFM, a lot of the strategic report is given over to describing the key risks of the business. These take significant resources to produce, and many of them duplicate the requirements for insurers to produce a Solvency and Financial Condition Report (SFCR). There is also little evidence to show that consumers read and understand this information[5]. It is also the case that including this information in parts of the report and accounts that are subject to external audit increases the complexity and cost of this work significantly (see below).

16. Also, it is not the case that a private company cannot be a public interest entity; for example, in past government consultations, the definition of private companies includes mutual businesses, and as stated above, many of these are PIEs[6]. We assume therefore that the scope is intended to cover private companies that are not PIEs.

Q3. Further evidence

17. We are taking the opportunity afforded by question 3 to present evidence we collected in 2022 on the costs of external audit. An extract from our 2022 corporate governance report is included as an Annex, and this describes the significant differences in audit costs between AFM members that are categorised as public interest entities (by dint of being above the threshold for Solvency 2), and those that are not PIEs. The scale of difference is very significant: an average of £187,000 versus £12,000. Whilst external audit is one factor in the preparation of the report and accounts, it is a useful illustration of the implications for firms that benefit from simplified corporate reporting.

18. This also reinforces arguments we have made in separate discussions with officials and Ministers, for DBT and HM Treasury to create exemptions for the PIE regime for mutual businesses, which DBT has previously acknowledged would be one tangible example of the post-Brexit benefits available to government. We would be very happy to continue those discussions and present further evidence of the obstacles our members face due to the current UK rules.

[5] In research we undertook in 2018 on the value of the SFCR for mutual organisations, many of our members reported that only a handful of people read the SFCR, and that it was likely that no policyholders found this information useful.
[6] See table 7: Green Paper on Corporate Governance Reform, Nov 2016

19. We would welcome the opportunity to discuss further the issues raised by our response. We are happy to be included in the published list of respondents.

Yours sincerely,

Martin Shaw
Head of Policy
Association of Financial Mutuals

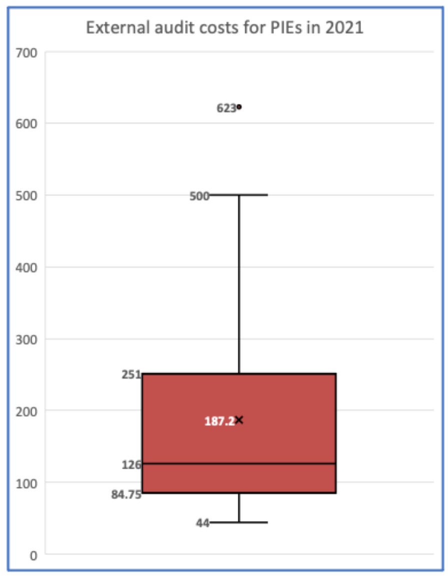
Annex: extract from AFM Corporate Governance report 2022 (p.5)[7]

Audit

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 taken 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] (from page 42), 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.

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).

[7] https://financialmutuals.org/wp-content/uploads/2022/10/AFM-Report-on-Corporate-Governance-2022.pdf