FRC – Competition in the audit market

Our response to FRC policy paper December 2022

Restricted
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Building Societies Association

Introduction

The BSA welcomes the opportunity to respond to the FRC policy paper "competition in the audit market." The topic of increasing capacity and competition in the audit marketplace is a very important topic for our members, particularly given developments in recent years.

Current state perspective of audit market competition

We agree with the highlighted stakeholder concerns about the functioning of the UK audit market, including the limited choice of audit firm and the lack of effective competition. We agree with the statement in the policy paper "In broad terms, the recent developments in the audit market suggest no significant improvements with competition in the audit market since the CMA's audit market study in 2018/19."

The building society sector has experienced a number of factors that have impacted capacity, cost and competition in its audit market in recent years:

- During 2019, the sector's largest auditor by number of audits, began reducing its exposure to the sector, and subsequently relinquished a significant amount of its audit market share;
- Tender processes have often struggled to receive multiple bids. This makes it difficult for audit committees to demonstrate due process and effectively compare approach and quality;
- Significant fee increases across the sector, as auditors face increased scrutiny, compliance costs and reputational considerations; to the extent that many societies now face audit fees that are a material percentage of their annual PBT;

Future developments that will likely impact audit capacity and competition

The May 2022 paper "BEIS: Restoring trust in audit and corporate governance - Government response to consultation" proposes a threshold "750 Turnover:750 Employees" which ensures the largest public and private companies adopt the full suite of new corporate reporting requirements, including a Resilience Statement, an Audit & Assurance Policy, a Directors statement on fraud measures, and new disclosures about dividends and distributable reserves. The number of Public Interest Entity ("PIE") status firms[1] will increase as a result of the proposed criteria, with additional requirements on those PIEs that meet the 750:750 threshold.

PIE firms, particularly the 750:750 population, face existing and potentially further audit-related pressures, with increasing audit fees, reducing audit choice and more audit work for society executives as a result. Best practice considerations will likely be considered in that firms newly classed as 750:750 PIEs will seek auditors from the existing core auditors of PIE entities, further reducing capacity and competition.

We have advocated that there are strong arguments and benefits for carving out the majority of building societies from PIE status, and we welcome the most recent BEIS 'next steps' regarding a government review of requirements on existing PIEs to identify potential deregulatory measures and to use the legislation it is developing to put them in place. This will go some way towards addressing the current significant capacity constraints in the audit industry.

[1] All firm types currently classed as PIE's i.e., companies with transferable securities, credit institutions and insurance undertakings

Building society sector considerations for exclusion from PIE status

We believe that in order to resolve the capacity and lack of competition in the audit market, this can be done in two ways. Firstly by improving the *supply* and secondly by reducing *demand*. The FRC paper talks only about ways in which supply of capable audit firms can be increased over time. In our view the FRC should also consider ways to reduce the demand for complex audits thereby also improving the proportionality of the regime for smaller low-risk business models such as building societies.

The following factors support a more proportionate approach by removing PIE status for smaller building societies while not increasing risks:

a) Risk related

Building societies, even the larger societies, operate a lower risk business model compared to many banks. The primary driver of this lower risk model is a result of societies' desire to serve their members with straightforward, well-designed, low-cost products.

b) Mutual structure

Building societies face additional restrictions under the Building Societies Act and the PRA's supervisory statement on building societies treasury and lending activities. SS20/15 states "Their mutual status means that there are particular constraints on societies' access to external capital that make safe management of the business and conservation of capital resources a high priority."

Mutuality also means a society does not face any short-term share price or dividend pressure but a 'shared value' approach regarding customers, community, colleagues and change meaning a longer-term, less risky business perspective.

c) Regulatory oversight

Building societies are highly regulated by the FCA and PRA, resulting in them already facing significant public interest considerations and high levels of oversight. As described by the BSA in its response to the original proposals "PIE status imposes a burden out of all proportion to the (perceived) potential benefit such status confers". We highlighted the aggregate impact on a small society which had already faced a doubling of audit costs, a reduction in the pool of potential auditors and the amount of annual audit work involved in a PIE audit.

The PRA and FCA have significant supervisory powers [2] to improve board governance, accountability and performance. The resultant high levels of personal board accountability would therefore continue under strict regulation, irrespective of PIE status and associated requirements.

d) Convergence across regulatory sphere on increasing proportionality

We note and welcome the focus on proportionality across different areas of regulation. For example, the PRA are currently developing a Strong and Simple framework: simpler-regime firm population which in future would be subject to a strong yet simpler framework to reduce the burden for smaller banks and building societies.

The PRA's CP16/22 sets a size criteria of £20bn for the Simpler Firm regime meaning that we now estimate that 36 societies will now meet the simpler-regime firm definition.

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[2] The Senior Managers & Certification Regime (SMCR) is one part of this as well as broader powers to enforce against the Fundamental Rules and any other part of the regulators' rulebooks. Under the SMCR all senior managers require regulatory approval before they can perform their role. This often includes a formal interview

Potential beneficial impact on competition in the audit market

As acknowledged in the consultation paper, both time and a range of actions are needed to deliver a future landscape which reflects higher quality, more capacity and more choice. We believe that excluding a significant number of building societies from PIE status will support the achievement of this future landscape:

Barriers to entry for challenger audit-firms should reduce: challenger firms should be able to tender for, and subsequently audit smaller financial service firms, away from the 'PIE glare', which would enable them to learn and develop necessary audit skills on smaller, less complex, FS audits.

FTSE350 market competition ultimately improved: as challenger firms then progress, which in future puts them in a stronger position to be able to bid for bigger, more complex PIE status FS firms.

Pricing of audits reflect appropriate risk-adjusted return considerations, rather than demand vs supply imbalances: Pricing of PIE audits are likely to further reflect additional direct costs, for example, training, approval and reviews within audit firms and indirect related costs, for example, demand vs supply imbalance premium as the number of PIE audits required challenges the capacity and capability of firms to supply accordingly. Excluding them from PIE status should ensure audit costs are commensurate with the relative risk of the firm.

Audit scope and timeframes are proportionate: time spent on the audit process and procedures for the auditor and the society's senior managers reduce, reflecting a proportionate approach to the overall risk of the firm.

We support the external research that the FRC states that they have commissioned, which will cover audit firm activity in the broader PIE and non-PIE markets. We encourage this research to specifically cover audit firm's differences in appetite for auditing a PIE versus a non-PIE equivalent firm, and the extent to which the benefits above could materialise over the medium to longer-term.

We would welcome the opportunity to discuss our proposals further as the FRC continues with its work on this important topic.

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