

25 January 2019

Statutory Audit Market Study
Competition and Markets Authority
7th Floor
Victoria House
37 Southampton Row
London
WC1B 4AD

By email: statutoryauditmarket@cma.gov.uk

Dear Sir / Madam,

Response to the CMA's consultation published on 18 December 2018 in respect of its statutory audit services market study (the 'CMA Update Paper')

Rio Tinto is a global mining company, established over 145 years ago. Its shares are listed on the London and Australian stock exchanges, with American Depositary Receipts listed in New York.

Rio Tinto reports its Group financial statements under IFRS and is audited by PwC. Following a competitive tender, the Board has recently appointed KPMG as the Group's external auditors with effect from financial year 2020, subject to shareholder approval.

General comments

We welcome any measures that demonstrably improve audit quality. However, we have a number of general reservations about the issues identified and remedies proposed in the CMA Update Paper:

- We do not believe that a small number of high-profile corporate failures should necessarily be taken as evidence that audit quality in the UK is universally and systemically flawed.
- We believe that the CMA Update Paper undervalues the current controls on audit quality performed by effective Audit Committees, including mandatory auditor rotation.
- The assumption that more choice automatically leads to greater quality is not a given. The current reality is that the challenger firms, outside the Big Four, cannot offer the quality of service or the coverage required to audit complex, multinational companies. Whilst we would welcome measures to improve the quality and coverage offered by challenger firms, we do not believe that it is in the interests of our shareholders and other stakeholders for such measures to come at the expense of quality or choice in the short to medium term, or to impose a disproportionate burden on the Group.

- We note that the CMA Review largely confines itself to the UK, while the audit industry and many companies in the FTSE350 are global. Both the UK audit market capability and the UK Corporate Governance code are widely seen around the world as best practice. We are concerned that some of the remedies proposed are disproportionate, and risk undermining the UK's competitive position.
- We note that two other reviews of the audit market have or will be conducted, alongside the CMA's market study, namely the Independent Review of the Financial Reporting Council ('FRC') led by Sir John Kingman (the 'Kingman Report') and the recently announced Brydon Review into UK audit standards. A more logical order for conducting these reviews might have been to establish the future standards and requirements for the UK audit profession (the Brydon Review); then define an appropriate regulatory framework to police such standards (the Kingman Report); then review the implications, if any, for the effectiveness of competition in the audit market (the CMA Review). Given that this is not the order in which the reviews have been conducted, we recommend that any reforms resulting from these three reviews should be concurrently implemented.

We provide our more detailed comments on the CMA's proposed remedies package below.

A. Issues identified by the CMA

The CMA is concerned that the audit market is not delivering consistently high quality and considers the following issues are driving audit quality concerns.

- **Issue 1: selection and oversight of auditors** – The CMA considers that selection and oversight of auditors is insufficiently focused on quality, in particular: (i) the current tendering approach may reward auditors for being close to management rather than providing independent challenge (Update Paper, para. 3.28); (ii) the involvement of senior management in the selection process enables them to influence auditor appointment (Update Paper, para. 3.31); (iii) Audit Committees may not be effective in overseeing auditors (Update Paper, paras. 3.33 – 3.41); and (iv) shareholder engagement on audit issues is lacking (Update Paper, paras. 3.42 – 3.55).

We disagree with some of these conclusions, for the reasons discussed below in relation to Remedy 1.

- **Issue 2: competition and choice in the audit market** – The CMA considers that choice is key to ensuring quality in the audit market (Update Paper, para. 3.75). It considers that, for a substantial minority of FTSE 350 companies, Audit Committees are faced with fewer than three credible bidders for an audit tender, and that the main drivers of this lack of choice are mandatory rotation rules, concerns about the capabilities of non-Big Four firms, conflicts rules and choices by audit firms not to bid (Update Paper, paras. 3.65 – 3.102).

We agree that there is a limited choice of audit firms capable of delivering the quality and scope of audit required by large, complex and international companies.

- **Issue 3: barriers to challenger firms for FTSE 350 audits** – The CMA considers there are both demand- and supply-side barriers preventing challenger firms from building their presence in the FTSE 350 market (Update Paper, paras. 3.104 – 3.130). On the demand-side, there are genuine concerns about the capability of challenger firms to carry out the most complex audits, particularly those requiring large international teams or particular sector or other expertise. The CMA also saw reluctance on the part of some investors to support Audit Committees who recommended hiring an auditor from outside the Big Four (Update Paper, paras. 3.107 – 3.122). On the supply-side, challenger firms appear reluctant to bid for FTSE 350 audits, given the cost of tendering, likelihood of winning, and risk for a smaller firm of taking on a large audit client (i.e. financial and reputational risk in conducting audits for FTSE 350 companies (e.g. fines from enforcement actions), and the risk that conflicts of interest will bar a firm from securing more lucrative advisory work) (Update Paper, paras. 3.123 – 3.130)

We agree with this analysis. Auditing a global organisation, with the scale and size of Rio Tinto, is a major undertaking requiring global presence and technical skills in depth.

- **Issue 4: resilience** – The CMA expresses concern that the failure of one of the Big Four could lead to the 'Big Three', with the result that audit quality would suffer (Update Paper, paras. 3.134 – 3.147). It is also concerned that resilience issues might discourage the regulator from taking appropriate action against a poorly-performing large audit firm, for fear this might drive the firm out of business (Update Paper, paras. 3.148 – 3.152).

We agree.

- **Issue 5: structure and culture of multi-disciplinary firms** – The CMA has sought to understand whether the significant non-audit revenues earned by audit firms might influence the way they perform audits, either at the client level (i.e. the audit firm might fear that challenging a company's management could lead to the loss of non-audit work) or the audit firm level (i.e. the culture and focus of the firm is more driven by growth opportunities in non-audit services and this might affect the incentives, resources and values (i.e. the collaborative, consultancy-based approach to non-audit services vs. the independent, challenge-focused culture of audit) on the audit side of the business). The CMA found limited evidence of conflicts between audit and non-audit work at the client level, primarily due to restrictions on cross-selling (Update Paper, paras. 3.160 – 3.172). It is nevertheless concerned that the culture of the Big

Four and other smaller auditors is driven by non-audit services (Update Paper, 3.173 – 3.189).

We note that the CMA evidence (paras 3.157 - 3.172) states that non-audit work for audit clients is at a low and declining level.

We believe that conflicts between firms' audit and non-audit activities are less of a concern for companies than the CMA suggests. An effective Audit Committee and management team will exercise tight control over the provision of any non-audit services.

On the other hand, there are clear benefits from an integrated model that allows the auditor to draw upon the wider technical and business skills within the firm. Furthermore, by providing development opportunities for professionals within the firm, the provision of such services assists with the attraction and retention of talent.

B. Proposed remedies

- **Remedy 1: Regulatory scrutiny of Audit Committees** – To ensure that Audit Committees fully protect the interests of shareholders when selecting and monitoring auditors (thereby improving incentives for high quality audits and reducing barriers for challenger firms), the CMA proposes a requirement that Audit Committees report directly to the regulator before, during and after a tender selection process, as well as throughout the audit engagement (Update Paper, paras. 4.15 – 25). The regulator could also include an observer on all or a sample of Audit Committees, and could issue public reprimands or direct statements to shareholders if not satisfied that Audit Committees have followed proper procedures.

The CMA proposes that this remedy apply to at least all FTSE 350 Audit Committees, but welcomes views on whether it should apply to a wider group of companies, such as all PIEs.

We believe that the proposed remedy is disproportionate and would entail a significant added burden for Audit Committees, with no obvious benefit to competition within the audit market.

- *Effective Audit Committees take their existing duties seriously and discharge them diligently, ensuring the interests of shareholders are properly protected.*
- *Factors such as 'cultural fit' and 'chemistry' are not given any greater weight during the selection process than factors such as the degree of challenge and scrutiny demonstrated by the auditor (Update Paper, para. 3.15).*
- *Effective Audit Committees are involved in all stages of the selection process (with senior management involvement kept to the minimum necessary), and closely monitor the quality of audit work undertaken throughout the appointment (as required by FRC guidance).*
- *We agree with the CMA (Update Paper, paras. 3.42 – 3.55) that a lack of shareholder focus and engagement on audit issues is a concern.*

- *We note that audit quality is a key point of focus in the Kingman Review, and are broadly supportive of its recommendations.*

- **Remedy 2: Mandatory joint audit and Remedy 2A: Market share cap** – To reduce barriers for challenger firms, the CMA proposes mandatory joint audits, with a preference for requiring that at least one of the audit firms is a challenger firm (Update Paper, paras. 4.26 – 4.60). The CMA considers the remedy should apply at least to FTSE 350 companies (with possible limited exceptions where the nature of the company would not justify a joint audit), but seeks views on whether specific types of companies should be excluded.

As an alternative, the CMA proposes imposing a market share cap on the Big Four, thereby reserving a portion of the market for challenger firms (Update Paper, paras. 4.61 – 4.87). Of the two options, the CMA prefers mandatory joint audit, given the risks to short-term quality and competition presented by the market share cap.

Regarding a mandatory joint audit:

- *We believe that joint audits would result in significant inefficiencies and the risk that work would either be duplicated or that issues could ‘fall through the gaps’.*
- *There would be an increased burden (both time and cost) on companies (in particular, in the form of higher audit fees). Both firms would need to develop a deep knowledge of the business, management and the control environment. There would be a need to accommodate and reconcile different audit approaches, and to reach a common position on complex accounting judgements.*
- *We anticipate significant challenges in deciding how joint auditors would split the work, the remuneration and the liabilities, particularly with processes becoming increasingly automated and integrated.*
- *The proposed remedy would reduce competition by precluding two firms from tendering for audits, as well as limiting the choice of providers of non-audit services.*

Regarding a market share cap:

- *A cap would reduce choice and Audit Committees might be compelled to appoint a firm despite concerns over its ability to fulfil the role effectively.*
- *Audit quality might decline, due to lack of experience and capacity, as more companies would be audited by smaller firms.*

- **Remedy 3: Additional measures to support challenger firms** – The CMA welcomes views on certain further measures to support challenger firms (albeit the CMA considers these measures would be largely redundant if its proposed remedies package is implemented), namely: (i) whether there are significant and unreasonable barriers to senior staff switching between firms; (ii) the introduction of a tendering fund

to support challenger firms; and (iii) measures to give challenger firms access to technology (Update Paper, paras. 4.88 – 4.102).

We believe that the key issue for effective competition in the audit market is that the challenger firms do not have the same level of audit quality and coverage as the Big Four firms. These are the principal criteria against which an Audit Committee, acting in the interests of shareholders, will choose a new auditor. The tender process itself (and any accompanying technology) is only ever as good as the audit firms that participate in that process. Steps to bridge the current gap in the market on overall audit quality and coverage would be welcome in presenting Audit Committees with genuine choice.

- **Remedy 4: Market resilience** – The CMA proposes a remedy to create a market oversight and resilience regime in the event of a likely or actual failure of a large audit firm. In essence, the remedy would aim to ensure that the audit clients of a failing Big Four firm are not transferred to another Big Four firm. The CMA recognises that designing such a remedy would be complex, and seeks views on how such a system could be designed (Update Paper, paras. 4.105 – 111). The CMA considers that such a remedy should apply at least to the Big Four, and that it may also be appropriate for some larger challenger firms to come within its scope as they grow.

The proposed remedy raises a number of complex challenges. One obvious issue is that it would take responsibility for selecting an alternative auditor away from Audit Committees, thereby blurring responsibilities and accountabilities.

- **Remedy 5: Full structural or operational split between audit and non-audit services** – The CMA considers that full structural separation of audit and non-audit services would comprehensively address the conflicts caused by firms' audit and non-audit activities (Update Paper, paras. 4.114 and 4.117). Nevertheless, it also seeks views on whether an operational split between audit and non-audit services could be equally effective, given the costs and challenges of full structural separation (Update Paper, paras. 4.115 and 4.118). It proposes that either form of separation should apply to the Big Four, and welcomes views on whether the remedy should also apply to challenger firms.

A full structural split would entail significant costs and challenges – for example:

- *Audit quality would suffer as audit firms would not have ready access to non-audit experts to support an audit and may struggle to recruit the best talent.*
- *Audit-only firms would be more dependent on their large audit clients, risking an adverse impact on incentives to challenge management.*
- *The global nature of audit networks and mandates would make the remedy impractical and inefficient on a UK-only basis.*

Strict measures are already in place to manage conflicts between audit and non-audit activities. The CMA should give these measures time to take effect and then assess their impact before implementing new remedies.

An operational separation of audit and non-audit services may be a viable alternative

- *Developing structures to separate governance, incentives and remuneration pools for audit and non-audit staff might help to reduce potential conflicts.*
- *A further reduction in allowable non-audit fees as a percentage of audit fees might be an alternative, to address the perception of continuing conflicts of interest, and would have limited practical implications, since many Audit Committees are already very conservative in relation to non-audit services.*
- *It might also be helpful to define certain categories of advisory work (such as debt issuance) as in effect just an extension of the main audit.*

- **Remedy 6: Peer review** – To improve professional scepticism and audit quality, the CMA proposes an independent peer reviewer, appointed and paid by the regulator (funded by a levy on audit fees of the FTSE 350 and large companies), whose task is to identify and prevent underperformance by auditors. The regulator could decide which companies were subject to peer review (Update Paper, paras. 4.138 – 4.155).

Issues:

- *Duplication with FRC Audit Quality Review procedures, which the Kingman Review recommends should be further strengthened.*
- *Increased costs for FTSE 350 companies arising from the proposed levy on audit fees.*
- *The likelihood of delays to the audit process (particularly when coupled with the proposal for joint audits).*

Yours faithfully,

Simon Thompson
Chairman