

By email to brydonreview@beis.gov.uk

Brydon review secretariat
Orchard 1, 1st floor
1 Victoria Street
London SW1H 0ET

31 May 2019

Dear Sir or Madam,

Response to the independent review into the quality and effectiveness of audit call for views.

Rio Tinto is a global mining company, established over 145 years ago. Its shares are listed on the London and Australian 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 proposed to appoint 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 and effectiveness. We think there is an opportunity for positive and practical improvements to address any clear and specific gaps that are identified. Any proposed new measures should though be carefully considered in light of the existing body of UK law and regulation and any other pending regulatory developments. The objective should be to have a simple and consistent set of rules that does not duplicate or confuse.

Many of the UK's largest companies are required to comply with several different regimes; Rio Tinto must comply with the listed entity requirements for companies reporting in the UK, USA and Australia. We agree with your view that not everything is broken and that it is appropriate to be mindful of the issues that were at the core of recent corporate failures. Any solutions should seek properly to address the causes of these failures and not discard what is good in search of what is perceived to be better. There should be an acknowledgment that, in any market economy, businesses will fail and, in many ways, that is indicative of a functioning market.

Any solutions should in our view therefore be focused on improving the identification of potential risk and be principally focused on **enforcement** of the current body of law and regulation. UK company law and corporate governance is an economic asset of significant value and a draw to investment in the UK, as well as to UK exports in the services sector. A disproportionate response may cost the UK and could be unhelpful at this time, especially given Brexit.

We also firmly believe that it would be preferable to agree what the future expectation of the audit function should be before proceeding to answer whether the current audit market is fit for that future purpose.

In summary, we think that:

- The role of the auditor must be clear and understandable to all users of a company's annual report;
- The responsibilities of the Board and auditors must be separate and clearly defined and delineated, and their interaction well understood. Changes to the role of the auditor must not undermine or replace the ultimate responsibility of the Board to manage the company and its risks, and report to shareholders;
- The Annual Report and Accounts (ARA) is the key external reporting document for the provision of relevant information to shareholders and other stakeholders. An opportunity exists for broader assurance over components of this document other than the financial statements. However, the scope of any extension of the existing audit and assurance regime needs to be carefully considered and defined; the nature of auditor assurance over non-financial information needs to be valuable to users of the information, and necessarily cannot be expected to be equivalent to a financial statements audit;
- Any expansion in the scope of assurance will necessarily increase the cost and expertise required from the firms providing assurance, as well as adding pressure on the reporting timetable which will impact both the preparers of the ARA and the auditors. We believe that there is tension here with the recommendations from the CMA about joint audits and separation of audit and non-audit service provision which may carry unintended consequences that reduce audit quality and audit market independence and resilience;
- An opportunity exists to use technology to increase audit scope and efficiency, and enable the auditor to focus on the most important issues. Firms could be required to report on the inputs to audit quality that arise from these technologies and training;
- The auditor should provide a clear and unequivocal opinion on the information being audited, although it may be helpful to supplement this with additional narrative information. We think that the target of an unqualified opinion is helpful and graduated disclosure could detract from this;
- Any changes to the role of the auditor should be clearly defined by legislation and regulation and not be on a comply or explain basis to ensure equivalence and consistency; and
- There needs to be an "end to end" approach to lift audit standards and reduce the expectation gap. Any changes made must be deliverable with the context of the UK audit market changes, or the gap will shift from one of expectation to a gap in delivery.

We provide our more detailed comments on some of the specific questions asked below.

Definitions of audit and its users

Q1: For whose benefit should audit be conducted? How is it of value to users?

Q2: Should the audit be designed to enhance the degree of confidence of intended users in the entity or just in the financial statements?

Q3: Should UK law be amended to provide greater clarity regarding the purpose of an audit, and for whom it is conducted? If so, in what way?

Q1 – Currently the auditor’s report is addressed to shareholders, while primary users are defined more broadly. We believe there is potential benefit in formally aligning the scope of assurance (not audit) provided by the auditors with the needs of this wider audience of the ARA, addressing the expectation gap that exists today.

Q2 – We do not believe the audit should be designed to provide assurance over the entity as a whole and we think a scope this broad would be impossible to deliver and confuses the roles of the Board and auditor. However, while the audit of financial statements is at the core of the auditor’s responsibilities today, many companies already request auditors to provide some form of assurance over other elements of the ARA. At Rio Tinto, for example, PwC performs consistency checks of the front half of the ARA, assesses a number of specific provisions of the Combined Code, provides assurance in relation to certain aspects of the remuneration report and sustainability disclosures (including limited assurance over selected subject matter about principles, systems, approach and performance data) and, as a US listed entity, internal controls over financial control (ICOFR) are in scope. This increased scope could be extended for companies generally. We think the scope of this needs to be carefully considered and clarified.

In particular, consideration should be given to the exact role (and liability regime) of the auditor in providing assurance over specific content of the ARA. The level of assurance provided over the financial statements is likely to be greater than that provided over non-financial components of the ARA, and not all information within the ARA is auditable. There is an opportunity to establish which components of the ARA should be subject to assurance, define the level of assurance provided over each and the liability regime applicable to each, and clearly communicate this to stakeholders.

Q3 – Yes; If changes are made to the roles of auditors, this should be implemented via primary legislation rather than changes to the UK Corporate Governance Code (and accompanying guidance), which is on a “comply or explain” basis. It is important that there is no confusion between recommended best practice and mandatory requirements. We recognise that the role of the auditor is currently defined by both legislation and regulatory bodies and there needs to be consistency, equivalence and clarity between the two and for companies generally.

Expectation gap

Q4: Do respondents consider there is an expectation gap?

Q5: If so, how would respondents characterise that gap?

Q6. Is there also a significant ‘delivery’ or ‘quality’ gap between auditors’ existing responsibilities in law and auditing standards, and how those responsibilities are currently met?

Q4 to Q6 – Yes; we agree that there is an expectation gap.

The role of the auditor is not sufficiently clearly defined for the wider audience of the ARA, recognising there are multiple stakeholders. We agree with the examples of unmatched audit expectations that you give in paragraph 24: *‘(a) an expectation that the audit will provide assurance over the sustainability of an entity or its business model; (b) an expectation that the auditor will have actively sought out any evidence of fraud; and (c) an expectation that the audit will cover all financial and non-financial information published in an entity’s annual report and accounts’*. These gaps should be addressed carefully, either by explicitly expanding the scope of the audit report or

by clarifying what is outside this scope. It is important that users understand what the role of the auditor is and what it is not.

The responsibilities of Boards and auditors must be separately defined, from the start of the preparation process through to reporting to shareholders. The Board oversees a Company's strategy and risks and monitors the performance of the business, forms views and communicates an understanding of the state of the business and its prospects to stakeholders through the ARA. The auditor performs an audit on the financial statements, but their role currently is wider than this. Limited assurance is provided over the consistency of the other information in the ARA as well as reporting by exception over certain company law and ISA requirements (e.g. that proper books and records have been kept), specific audit aspects of the Remuneration report and specified provisions of the Combined Code. Additional assurance is provided to US listed companies on ICFR and to those who request additional assurance over sustainability.

The auditor's responsibilities must be limited to providing assurance over the integrity and quality of reported financial information, and certain auditable non-financial information. It should not be to report separately on the affairs of the company to its stakeholders from first principles. However, there is an opportunity to clarify which information should be subject to assurance and the nature of this assurance.

We do not feel there is a significant delivery gap against the current obligations of an auditor. However, in placing additional requirements on audit firms, the role of the auditor could become more complex and difficult to fulfil. This risks replacing the current expectation gap with a delivery gap that does not exist today. It is therefore important that any expanded scope in audit / assurance is carefully judged as achievable and practicable.

In this regard, the CMA recommendations, including separation of audit practices and involvement of challenger firms in a joint audit, are potentially unhelpful as they may carry the unintended consequence of reducing audit quality. Dividing an audit to bring in challenger firms may create, not reduce, audit risk and there is no evidence to suggest that a joint audit will improve audit quality. It may in fact harm it. The combination of an expanded audit and assurance scope and structural changes to the audit market to separate out audit and non-audit services are likely to increase cost and, in practice, part of this increased cost is likely to be passed through by the audit firms to the audited entity. The increased cost will need to be judged against the perceived benefit of the form of additional assurance. Audit firms operating to an audit services only business model, will find it harder to attract, retain and develop the skills and talent required for the future of audit and wider assurance. Currently, audit partners leverage subject matter expertise to support their audit and assurance work from within the firm and on a basis that preserves independence (e.g. specialists in direct tax, indirect tax, share-based payments, valuations and treasury). In future, the "independent" expertise within the firm could be diluted as audit only firms struggle to retain the necessary talent, or it will need to be out-sourced to service providers who may not be able to satisfy "independence" criteria.

There needs to be an "end to end" approach to lift audit standards and reduce the expectation gap. For instance, regulation has to be supportive of technology deployment. At the moment there is a sense that audit regulation is driving a more substantive testing approach when what we need is to accelerate the deployment of technology.

Audit and wider assurance

Q7: What should be the role of audit within wider assurance?

Q8: Can the level of assurance that an audit provides legitimately vary in different circumstances, for example depending on the business sector in question, and the nature of the entity's business risks?

Q9. Are the existing boundaries between internal and external audit clear?

Q10. To what extent should external auditors be able to use evidence obtained from work performed by internal auditors in drawing conclusions?

Q11. Do current eligibility requirements for external auditors focus too much on independence at the potential expense of market innovation and the quality of the audit product?

Q7, Q8: Audit is a particular form of assurance that fits within the broader framework of assurance and we expect this to remain at the core of the role of the auditor. If assurance is provided over other elements of the ARA and other reporting, it is important that users understand type of work performed and the nature of assurance provided over these sections over the different sections of the report.

In the audit of financial statements, auditors have a role as financial reporting experts and can provide a higher level of assurance through detailed testing against a common standards framework. However, there are restrictions to the extent of assurance that can be given over non-financial information. In some cases, the auditor will not have a similar level of expertise – for example in reserves and resources reporting, where there are defined competent persons. In other areas, for example in forward looking statements, auditors can provide some assurance over the quality of internal review processes and the appropriateness of assumptions, but cannot be expected to provide an objective opinion to the level of an audit.

An expansion in the scope of assurance increases complexity and risks exacerbating the perception that audit is not working. It is essential that changes are achievable and practical. The current reality is that only the four largest accountancy firms offer the quality of service and the coverage required to audit complex, multinational companies and, even today, it is unclear how the Big 4 firms would deliver on an increased scope. In conjunction with the CMA recommendations, including increased separation and the introduction of challenger firms, this risks becoming unworkable.

Q11: We believe there is a tension between increasing constraints on auditors to safeguard independence and the efficient and effective delivery of a high quality audit by multi-disciplinary firms with the necessary specialists included within the audit teams. Auditors are increasingly restricted from performing non-audit services, even where the risk to independence is perceived rather than real. Performance of these services could enhance their understanding of the business and therefore the quality of overall assurance provided. Increasing the scope, and therefore the complexity, of the role of auditors, combined with restrictive independence rules, could compromise quality or, worse, disincentivise firms from entering the market or investing in the necessary skill and talent to provide a high quality audit.

Q9: We believe the existing boundaries between internal and external audit are sufficiently clear. At Rio Tinto, our risk management framework comprises a three lines of defence approach to managing risks and controls:

- First line: employees and business leaders own risks.

- Second line: our central support functions and Risk Management Committee control our risk framework and internal control systems.
- Third line: Group Internal Audit assures our internal control systems.

Our internal audit team provides objective assurance to the Board that our risk management and internal control systems are adequate and effective. The role of internal audit is set out in a written charter which is published internally and approved by the Audit Committee. The internal audit methodology used by Rio Tinto is consistent with the International Standards of the Institute of Internal Auditors which is assured by regular external independent quality assessments. The internal audit plan and all internal audit reports are provided to the External auditor.

Q10: Subject to performing procedures to test the quality of the internal audit procedures, the External auditor should be able to place reliance on the evidence obtained from relevant work performed by internal auditors in drawing their conclusions.

Separate to the work of Internal Audit, the Rio Tinto Audit Committee has a responsibility to perform a review which includes the effectiveness of the Group's internal controls over financial reporting, and the Group's disclosure controls. At Rio Tinto, this includes the procedures in accordance with sections 404 and 302 of the Sarbanes-Oxley Act 2002 (SOx) and internal audit manages, performs and reports on the management testing of ICOFR under section 404. External audit places some reliance on management's ICOFR testing but will re-perform a selection of management's control testing to satisfy themselves as to whether it was performed appropriately as well as completing its own independent testing of ICOFR controls particularly in higher risk areas.

Scope and purpose of audit

Q12: Should directors make a more explicit statement in respect of risk management and internal controls? If so, should such a statement be subject to audit?

Q13: Should auditors' responsibilities regarding assessing the effectiveness of an entity's system of internal control be extended or clarified?

Q14: Auditors are currently required to report to audit committees their views on the effectiveness of relevant internal controls for listed and other relevant entities. Should auditors be required to report publicly these views?

Q15: Is the current regulatory framework relating to going concern fit for purpose (including company law and accounting standards)?

Q16: Should there be greater transparency regarding identified "events or conditions that may cast significant doubt on the entity's ability to continue as a going concern"?

Q17: Should directors make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement?

Q18: Should such a statement be subject to assurance?

Q19: Who might be capable of giving such assurance?

Q20: Is there a case for a more forward-looking audit? What would be the main benefits and risks?

Q21: Would audit or assurance over financial and non-financial information outside the annual financial statements (for example KPIs or non-financial metrics, payment practices or half-yearly reports) enhance its reliability and therefore be of benefit to users?

Q22: If so, what information might usefully be subject to audit or another form of assurance and why?

Q12-Q14: We believe all UK public interest entities should make explicit statements in respect of risk management and internal controls. Within this context, assertions regarding internal controls over financial reporting specifically should be subject to assurance. Extending this assurance over the wider risk management and control framework is likely to be problematic given the breadth of this scope.

SOx applies to many of the FTSE100 and, at Rio Tinto, we find the SOx framework helpful. However, it is important that there is consistency between any new UK requirements and existing frameworks: divergence and duplication would be problematic.

We think it is important to distinguish between highly subjective, forward-looking information about broader risks and uncertainties and the development of clear procedures and controls over financial information. The Audit Committee review for companies complying with SOx includes “the effectiveness of the Group’s internal controls over financial reporting, and the Group’s disclosure controls and procedures in accordance with sections 404 and 302 of the Sarbanes-Oxley Act 2002” and we think the auditor should provide assurance over ICFR. By contrast, we do not think there is value in an auditor opining on the effectiveness of non-financial risk management processes and controls (e.g. operational risks, environmental risks and strategic risks).

We recognise the introduction of a programme similar to SOx in the UK could be costly and burdensome for non-US filers and the range of companies to which this would apply needs to be determined (FTSE-350 or all premium listed companies, for example). However, this should be balanced against the need to maintain a level playing field amongst UK corporates.

Q15: Concerns raised by recent high profile corporate failures suggest that the current regulatory framework relating to going concern may not be fit for purpose, but it is important to understand the root causes of the recent failures in designing appropriate solutions. In our opinion, the issues relate as much to corporate governance (values and culture) as they do to going concern and viability.

The assumption underpinning a number of the ongoing reviews (including Brydon and Kingman) is that the problems with recent corporate failures such as BHS and Carillion are not addressed by the current body of UK law and regulation. This is not necessarily the case. Taking consideration of directors’ duties (whether in relation to going concern, the preparation of a company’s accounts, or more widely) away from the courts and placing them for adjudication with a new corporate regulator (with no previous experience of how those duties are applied in law) is potentially problematic.

A newly empowered regulator might instead be vested with more power to refer adjudication and enforcement to the courts.

Q16-Q18: We support greater transparency regarding going concern and viability assessments, but recognise this is a complex and often subjective topic, which is difficult to audit. The going concern assumption has to be an integral part of the financial statements and so must continue to be covered by the audit opinion. In our opinion, we do need to clarify what the viability statement is intended to represent, and not represent, as it is clearly not fit for purpose in its current form. The viability statement is a forward-looking statement and should be considered appropriate for a safe harbour in this context, while also providing greater assurance to shareholders and other stakeholders.

First, the obligations of the Board and associated disclosure requirements should be reviewed and clarified. This needs to consider the needs of the intended audience. Adding complex new disclosures could increase confusion – instead companies should be encouraged to clearly explain why directors believe the company is a going concern and the key risks that they have considered.

The role of the auditor should be to provide assurance over these disclosures. This would include confirming that directors have conducted an appropriate assessment and disclosed the key matters arising from it. However, this stops short of providing an independent assessment of viability from first principles. We think a broader assurance role for the auditor is impractical and could impair independence; for example it could require auditors to be present in all decision-making forums.

Q19 Capability is a serious question, and any changes to the requirements could further prevent challenger firms being able to perform quality audit work for largest companies. Any expansion in the scope of assurance will necessarily increase both the expertise required from the audit firms and increase cost. There is a tension with the recommendations from the CMA regarding separation of audit practices and existing independence rules.

Q20-Q22 The ARA is the key external reporting document for provision of the relevant information and an opportunity exists for broader assurance over this. We see benefit in clarifying which elements are subject to assurance and the nature of assurance provided. This might extend comfort from existing requirements to include more consideration of forward-looking information, design and effectiveness of key performance indicators and assurance over non-financial information. However, this would need to be considered carefully and the level and type of assurance may be different for information outside of auditable frameworks (e.g. financial statements). International Standards in Auditing for the UK (ISAs) may need to be updated to reflect any extensions to scope.

Audit product and quality

Q25. What additional benefit might a switch from a binary audit opinion to a more graduated disclosure of auditor conclusions provide?

Q26. Could further narrative be disclosed alongside the opinion to provide more informative insights?

Q25-26 All stakeholders benefit from the expression of an unequivocal opinion by the auditor. The audit report should continue to highlight key issues and judgements in narrative, but must conclude on an overall assessment of whether the financial statements give a true and fair view.

Graduated disclosure requires users to form their own judgements and collate them to an overall view which is problematic for less sophisticated users of the accounts. We do not support numerical grading, which would increase subjectivity: It is not clear how numerical grading could be applied consistently from one audit to another.

The current format of an audit report already includes a significant narrative component, explaining the nature of audit work and Key Audit Matters. Any expanded scope would need separate explanations of the type of work performed on the broader ARA and significant items considered. However, the provision of narrative information should not contradict or detract from the overall opinion provided.

Legal responsibilities

Q29. What role should auditors play in determining whether the directors are complying with relevant laws and regulations, including with respect to matters of capital maintenance? Is it appropriate to distinguish between matters which may materially affect the financial statements and other matters?

Q30. Does a perceived inconsistency between company law and accounting standards as regards distributable reserves inhibit auditors from meeting public expectations? How might greater clarity be achieved?

Q31. Should distributable and non-distributable reserves be required to be disclosed in the audited financial statements?

Q29-31 We think these questions should be addressed at a legal and regulatory level in the first place; the role of the auditor can then be defined in light of this framework.

Communication of audit findings

Q33. Should there be more open dialogue between the auditor and the users of their reports? For example, might an annual assurance meeting open to all stakeholders prove valuable?

Q34. Should more of the communication and resulting judgments that occur between the auditor and the audit committee be made transparent to users of the financial statements?

Q35. Should there be enhancements to the extended audit report, such as an obligation to update on key audit matters featured in the previous audit report?

Q33 The ARA is and should continue to be designed to be read rather than discussed, and the audit opinion should be similar. If further discussion is needed, it indicates that the ARA disclosure and audit findings are not being clearly reported. An unequivocal clear opinion, in writing, is key.

There is already adequate opportunity for auditors and stakeholders to interact (e.g. at AGMs). We do not support the creation of parallel reporting channels.

The responsibilities of the Board and auditors must be separate and clearly defined and delineated, and their interaction well understood. Changes to the role of the auditor must not undermine or replace the ultimate responsibility of the Board to manage the company and its risks, and report to shareholders.

Q34 Too much information can cause confusion to users of the audit report, may be taken out of context and raises risks relating to commercial confidentiality. Audit opinions already include significant information relating to judgements, particularly since recent improvements. The separate role of Board and auditor must be clear.

Q35 Audit opinions should not be too boiler plate or too formulaic. It may be appropriate to provide an update on matters reported previously where there is significant new information or an ongoing uncertainty, but the focus should be on succinctly explaining the key audit matters in the current period.

Fraud

Q36. Do you believe that users' expectations of auditors' role in fraud detection are consistent with the requirements in UK law and auditing standards? If not, should auditors be given greater responsibility to detect material fraud?

Q39. Should auditors be required to evaluate and report on an audited entity's systems to prevent and detect fraud?

Q36 The obligations of the auditor in identifying and reporting fraud are proportionate and fit within a broader corporate governance framework. There is an expectation gap whereby some users assume a higher level of assurance than is required (or reasonable to expect). Auditors should not be expected to detect all instances of fraud. It is important to clarify the respective roles of the Board and the auditor in the prevention, identification and reporting of fraud.

Q39 For the reasons explained in our responses above, we agree auditors should evaluate and report on the entity's internal controls designed to prevent and detect fraud (specifically ICOFR), in the context of broader assurance provided over the controls framework.

Auditor liability

We think the audit firms are best placed to answer the questions on auditor liability.

Other issues

Q45. How far is new technology actually used in audits today? Does the use of technology enable a higher level of assurance to be given?

Q46. In what way does new technology enable assurance to be given on a broader range of issues than is covered by the traditional audit?

Q50. How should the cumulative costs of any extension of audit (whether stemming from this Review or other drivers of change) be balanced against the likely benefits to users?

Q52. Would interaction between shareholders and auditors outside the AGM be practical and/or desirable?

Q53. How could shareholders express to auditors their ex ante anxieties to help shape the audit plan? Should shareholders approve planning matters for each audit, including scope and materiality?

Q45, Q46 A big opportunity exists to use technology to increase audit scope and efficiency. The largest firms are just beginning to develop solutions and improve ways of working; the challenger firms are further behind. Opportunities from greater insight into the company need to be balanced against independence concerns. Successful deployment of technology would enable the auditor to focus on the really important issues.

Q50 Spiralling costs of audit is in no-one's interest – it increases costs to shareholders and puts the economics of audit firms at risk (particularly if separated from service lines perceived to be more lucrative parts of the firms). While we recognise there is value in broader assurance over the ARA, this needs to be appropriate to each section, proportionate and clearly defined. Items must be prioritised and simple, clear reports are key rather than long lists of requirements. The introduction of technology, such as Artificial Intelligence should deliver significant cost and efficiency benefits and enable auditors to focus on the right issues.

Q52, Q53 We do not believe there is a need for shareholders to interact with auditors outside of the AGM, and experience at AGMs shows limited appetite. Shareholders expect the Board, Audit Committee and Management to act on their behalf, including interaction with auditors. The Audit Committee comprises independent non-executive directors who understand the company well and are therefore the appropriate body to shape the audit plan. We do not support a more formal role for shareholders in shaping the audit – this would add significant complexity to the process but add little value.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'S Henry', with a stylized flourish at the end.

Simon Henry
Chairman of the Audit Committee