

Brydon review: Independent Review into the Quality and Effectiveness of Audit**Dated 10 April 2019****Response from Santander UK Group Holdings plc****Overview**

1. Santander UK Group Holdings plc (Santander) welcomes the publication of the Independent Review into the Quality and Effectiveness of Audit - Call for Views dated 10 April 2019 (the Call for Views) and the opportunity to respond to the questions that are being raised in that paper.
2. Santander is a wholly-owned UK subsidiary of Banco Santander SA, a company incorporated in Spain. Santander is a public interest entity (PIE) as defined by EU law, as are some of its subsidiaries. Santander is required under the Companies Act to have its annual financial statements subjected to an external audit. As a result, Santander would consider itself an interested party with regard to certain of the questions posed by the Call for Views.
3. As our parent, Banco Santander SA, is the sole addressee of the audit reports on our financial statements, we have framed our responses accordingly. As part of a wider group with a significant presence in a number of countries and territories, we are also mindful of the desirability of maintaining a 'level playing field' with other legal jurisdictions so as not to inadvertently disadvantage UK companies that operate in global markets.
4. In the following paragraphs, Santander has commented on certain Questions in Chapters 1-5, 7 and 10 where they are pertinent to us and we are in a position to comment. We have not commented on Questions in Chapters 6, 8 and 9.

Responses**CHAPTER 1 – DEFINITIONS OF AUDIT AND ITS USERS**

5. Whilst the intended users of an audit report are set out in legislation and guidance, as well as at the beginning of the audit report itself, this is often not well enough understood by other interested parties and users of an entity's annual report thus creating a so-called 'expectation gap'. From a theoretical perspective, it is clear that if audits were conducted for the benefit of more of the actual users of the financial statements or annual report, this would more closely align with the commercial reality leading to a reduction in the expectation gap.
6. However, any change which moved the audit from its current purpose, primarily being the review of the financial statements, to a more forward-looking exercise to provide enhanced comfort for the actual users of the financial statements and annual report would require a fundamental shift in approach requiring a clear definition of scope and development of a new audit framework and standards. The practicality of achieving this has to be questioned and as a result perhaps more value would be obtained by seeking to narrow the expectation gap by more clearly defining an audit and explaining its scope.
7. Additional assurance could be obtained through an independent review of the 'front half' unaudited sections of the annual reports and indeed Recommendation 30 from the Independent Review of the Financial Reporting Council considers whether there should be strengthening of regulation around a wider range of investor information. This recommendation will be subject to

further consideration but we would suggest that any extension of review in this regard should be seen separately from the audit of financial statements.

8. The work of rating agencies provides a useful assessment of the financial resilience of an entity within a clearly defined framework. Although the work of rating agencies is undertaken with certain specific stakeholders in mind, it too is used more widely. Further investigation of how that industry addresses its expectation gap might be beneficial to understand what learnings could be applied to the review of audit.
9. Any changes to the definition and explanation of the scope of an audit should be made as clear as possible, including through amendments to UK law.

CHAPTER 2 – THE ‘EXPECTATION GAP’

10. As noted above, we do consider that there is an expectation gap. This issue is regularly raised when the audit profession is reviewed, so to believe that such a gap might not exist seems unreasonable.
11. The main expectation gap appears to be that some commentators (not necessarily the same bodies as ‘users’ of financial statements, as defined in audit legislation and guidance) expect an audit to provide a 100% guarantee of a clean bill of health for a company until the issuance of the next audit report. However, this is clearly an unrealistic expectation as there will always be corporate failures and it is important that this is acknowledged with the focus being on the identification and communication of risk. This is commented upon further in paragraphs 17 to 19 in the context of going concern and viability.
12. We have not however observed a significant ‘delivery’ or ‘quality’ gap between auditors’ existing responsibilities in law and auditing standards, and how those responsibilities are currently met.

CHAPTER 3 – AUDIT AND WIDER ASSURANCE

13. We have not observed any particular lack of clarity around the boundaries between internal and external audit. From a company’s (and investors’) perspective, it would however be more efficient and cost effective if the external auditors were able to maximise their reliance on internal audit work.
14. It is unclear if there is a causal link between an auditor’s focus on independence and a lack of market innovation and the quality of the audit product. A lack of market innovation may be more a symptom of barriers to entry and therefore a reduced level of competition, as in some other industries; an area that has already been considered as part of the CMA’s study into the UK Statutory Audit Market. Commercial cost pressures can be an effective driver of innovation, although this has to be balanced against a need to maintain quality.

CHAPTER 4 – THE SCOPE AND PURPOSE OF AUDIT

Risk and internal controls

15. Santander is already subject to the requirement to evaluate the effectiveness of its disclosure controls, and disclose its conclusions in this regard. However, it could be helpful for management to make a more explicit statement in respect of the design and effectiveness of its internal controls over financial reporting, particularly as a failure of such controls may be at the root of a number of corporate failures, whether due to fraud or not. In some jurisdictions, similar statements are already required. One example is the US, and the requirements of the Sarbanes-Oxley Act. Santander and its parent Banco Santander SA are both subject to the additional requirements for

management to report on the design and effectiveness of its internal controls over financial reporting framework, as set out in Section 404 of the US Sarbanes-Oxley Act. Our experience of this is that it has driven a greater internal focus and engagement with the auditors on internal control matters, but at a significant additional cost.

16. We would not be supportive of extending this work beyond the internal controls over financial reporting (for example to the risk management and internal control systems as a whole) given the broad scope of the work that would be involved and the difficulty to drive a consistent approach across all business sectors.

Going concern

17. Greater transparency regarding identified 'events or conditions' that may cast significant doubt on an entity's ability to continue as a going concern could be helpful. If there were a greater understanding of the inherent risks, it might reduce the perception that an audit is a 100% guarantee of a clean bill of health for a company. This could include the going concern statement covering areas such as possible dividends to be paid or proposed in the coming 12 months or pension funding obligations in that period.

Viability

18. We believe it is important to ensure a consistent approach between going concern and viability disclosures. A requirement for directors to make a statement about the sustainability of the entity's business model beyond that already provided in the viability statement has some merit, as some viability statement language can currently appear boilerplate. A requirement for Directors to explain why they believe that the business model they have chosen is sustainable for 3-5 years would give useful insight into their views of the market, the company's position, competitors, regulatory environment and prospects.
19. If such a statement were subject to assurance, this would no doubt be welcomed by users, but it is difficult to see what substantive 'assurance' might be provided, as the statement is fundamentally forward-looking. This speaks to the heart of the expectation gap i.e. that an audit is seen by some as a 100% guarantee that the entity will not fail. If any substantive assurance provided on such a statement were to be less than this (which it inevitably would be) without being very clear about what assurance is actually being provided, it might only exacerbate the expectation gap.

Unaudited information

20. We believe that companies should be clearer about which information has been audited, and which information has not, particularly where documents, or sections of documents, contain a mix of audited and unaudited information.
21. We have found that informal auditor involvement in our quarterly earnings releases, the content of which reappears in our Annual Report as part of the Financial review section, provides useful challenge around the balance, robustness and consistency of the disclosures.

CHAPTER 5 – AUDIT PRODUCT AND QUALITY

22. Considering questions around the value and quality of the audit product separately from the effectiveness of the audit process would be beneficial, to avoid blurring the issues being considered. As there are existing programs conducted by regulators to monitor how well audits

deliver against existing auditing standards, greater benefit may be obtained by investigating how the scope and requirements of an audit might usefully be expanded.

23. With respect to the content of the audit opinion, replacing a binary opinion with a more graduated disclosure might have limited value due to the difficulty of calibrating what a 'top' grade might actually be. Furthermore, if the audit report were to report on individual items within the financial statements, it would be hard for users to formulate an aggregated view and as such it is likely that an overall conclusion would be required.
24. It might be more valuable and effective to build on the 'enhanced audit report' approach introduced in recent years and expand the narrative to be disclosed as part of the opinion to provide more informative insights. An explicit requirement for any such disclosures to be specifically tailored to the entity and its risks, including to its industry, regulatory framework, and the legal jurisdiction(s) it operates in might be useful to prevent them becoming boiler plated.

CHAPTER 7 – THE COMMUNICATION OF AUDIT FINDINGS

25. The introduction of an extended audit report has provided greater insight into the extent and depth of work performed by auditors, and it might be useful to further enhance it, including to provide an update on key audit matters in the previous audit report.
26. With respect to providing greater transparency around discussions between external auditors and audit committees, we support greater dialogue between external auditors and the users of audit reports. The audit committee report in the annual report discusses its work in monitoring the integrity of the financial statements, including details of how it reviewed, challenged and satisfied itself with respect to the financial reporting issues that involve the most subjective and complex assumptions and judgements. Most of these areas are also the key areas of audit risk that the auditors discuss in the extended audit report. We believe that the focus should be on enhancing the explanations of the positions reached and why they are robustly supportable rather than the discussions and debates undertaken to reach those conclusions.

CHAPTER 10 - OTHER ISSUES

Proportionality

27. With respect to any aspects of current audit procedures or output that are no longer necessary or desirable, we do not see any current audit requests that are not appropriate.

Culture

28. Auditors might provide some insight on an entity's culture by reporting on its whistleblowing framework, arrangements and activities, as well as related issues and trends.

Cost

29. Users of financial statements might benefit more from entities providing additional context to the audit fees, rather than more detail on the make-up of the actual audit fees. One example might be a comparison of the amounts paid by an entity for non-audit services to its external auditors compared with the other Big 4 firms. Santander voluntarily provided this disclosure on page 47 of its 2018 Annual Report in the Board Audit Committee Chair's report in the section entitled 'Non-audit fees'.

Conclusion

30. Santander recognises that there can be confusion amongst users and other interested parties as to the purpose and scope of the audit of financial statements and welcomes the review of this with a view to creating greater clarity to meet the needs and expectations of the users of both financial and non-financial reporting.
31. Santander would however reiterate the importance of retaining the competitiveness of UK companies and thus the need that any changes should be not only applied consistently across UK entities but also should seek to maintain a 'level playing field' with other legal jurisdictions.