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Ladies and Gentlemen

***Consultation Paper – Draft Guidelines on communication between competent authorities supervising credit institutions and statutory auditor(s) and audit firm(s) carrying out the statutory audits of credit institutions***

We appreciate the opportunity to comment on the above Consultation Paper (the Paper).

We are pleased to see that the European Banking Authority is focussing on enhancing communications between auditors and banking supervisors and we strongly support this goal.

**Objectives and benefits of communication and the flow of information**

The stated objective of the draft guidelines is to facilitate the role of the supervisor through promoting effective two-way communication between competent authorities and statutory auditors. We support this objective and agree that effective two-way communication can support the quality of banking supervision.

However, as acknowledged by the Basel Committee on Banking Supervision in its 2014 guidance on *External audits of banks* (the Basel Document), effective two-way communication can support the quality of the external audit – which in turn can help further improve the effectiveness of bank supervision – thus, the competent authority and the statutory auditor have a mutual interest in fostering regular communication of useful information. Therefore, we recommend the inclusion in the Paper of an additional objective of promoting high-quality audits and explaining how competent authorities should support this objective in their communication of information to statutory auditors.

As noted in the Paper, under Article 12(1) of the Audit Regulation or pursuant to Article 63(1) of CRD IV, statutory auditors have a duty to report promptly certain material matters to the competent authorities. These are, broadly, material breaches of laws governing the entity's

authorisation or activities, a material threat or doubt regarding the entity’s functioning and a qualified or adverse audit opinion. Although the Paper contains a general principle that competent authorities communicate with auditors as frequently as necessary to ensure timely sharing of information, we believe that this should be reinforced by a corresponding requirement that competent authorities should promptly notify statutory auditors if they become aware of similar matters, including knowledge about circumstances that indicate a material error in financial statements that have been or are to be issued or a material uncertainty related to events or conditions that may cast significant doubt on an institution’s ability to continue as a going concern.

### **Effective protections for effective communication**

To ensure frank two way communication it is also essential to have effective protections in place so that communications are confidential and protected from disciplinary proceedings, prosecution and liabilities when disclosures are made in good faith between competent authorities and statutory auditors.

In respect of statutory auditors, Article 12(3) of the Audit Regulation attempts to deal with this by providing that ‘good faith’ disclosures under Articles 12(1) or (2) “shall not constitute a breach of any contractual or legal restriction on disclosure of information.”

We consider that Article 12(3) goes a very long way to ensuring effective protections are in place. We also note that engagement letters between statutory auditors and clients should seek consent to such types of disclosure.

Nonetheless, we note that complications may arise where there is a non-EEA law or regulation which has the potential to prohibit, restrict or open the possibility of legal or regulatory action in connection with a disclosure by a statutory auditor as envisaged in the Paper<sup>1</sup>. Such circumstances may arise if, for example, the audit client is dual listed, or if the information originates from a component audit in a non-EEA jurisdiction. In such cases, the shield of Article 12(3) may not provide sufficient protection against action outside the EEA for a breach of a non-EU law.

We note that such conflict of laws questions are often not straightforward. Our recommendation therefore is that the EBA should encourage competent authorities to consider this issue and develop appropriate mechanisms to facilitate resolution of such issues should they arise. It may also be useful for the EBA to engage with its peers outside the EEA to consider whether, and if so, how, legal or regulatory mechanisms can continue to evolve to ensure that, at a global level,

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<sup>1</sup> Without limitation, such applicable rules may concern or relate to data privacy, employment laws, client confidentiality, banking secrecy, professional secrecy, state secrets, professional privilege laws, laws governing the handling of government data. In many (but not all) cases, client consent will provide a mechanism to allow sharing of data under the relevant law or regulation.

effective protections are in place for both statutory auditors and competent authorities in respect of disclosures.

### **Cost-benefit analysis**

We acknowledge that it is difficult to quantify the additional costs and the benefits for the different stakeholders of implementing the proposed guidelines. The Paper contains an estimation of the costs for the audit firm per bilateral meeting of €5,400.

In theory, application of the guidelines should not result in the performance of additional audit fieldwork. Therefore, we agree that additional costs for the auditor in theory relate to direct compliance costs – e.g. time spent on the preparation and review of written communications and the preparation and planning for meetings, time spent in and travelling to meetings, and the tracking and follow up of communications.

It is unclear how the costs for a bilateral meeting are calculated and how many meetings the EBA expects to be necessary to communicate effectively in accordance with the guidelines. We also note that the estimate of €5,400 exclusively relates to meeting costs. Based on our experience with in-depth communication with systemically important institutions and depending on the intensity of the communication and the reporting, the total costs may be many times more than this.

Based on the above, we suggest the EBA include in its impact assessment all direct compliance costs and formulate a more realistic range for the estimate of the average direct compliance costs. We believe that this will help manage both auditors' and institutions' expectations.

### **Review of effectiveness**

We recommend that the Paper include an additional principle requiring competent authorities to review the effectiveness of their communications with auditors on a periodic basis (e.g. by surveying the views of individual supervisors and auditors, analysis of examples of good or poor practice) and to make improvements to practices based on these reviews.

We include in the Appendix our more detailed comments and our answers to the questions in the Paper.

If you have any questions about our comments or wish to discuss any of these matters further, please contact Chris Spall at +44 (0)20 7694 8871.

Yours faithfully

*KPMG IFRG Limited*

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## Appendix – Detailed observations

The following are our detailed observations relating to the Paper, organised by page and paragraph number, and our responses to the specific questions in the Paper. This appendix should be read in the context of the covering letter.

Page	Para	Observation/response
12	6	See comments on the objectives included in the covering letter.
12	7	The scope is stated to be limited to “communication between ... auditors while ... carrying out the statutory audit of those credit institutions.” We suggest the scope refers in this regard to statutory auditors of credit institutions and deletes the reference to “while ... carrying out” since communication may occur even when audit work is not currently being carried out.
12	Question 1	<i>Is the scope of application of the guidelines appropriate and sufficiently clear?</i>  Subject to the comment on paragraph 7 above, yes.
15	Question 2	<i>As currently foreseen, the application date will be in the last quarter of 2016. Is the date of application of the guidelines appropriate?</i>  Yes.
16	17	The first clause of the first sentence is clearly incorrect (“Neither party should discharge their respective responsibilities...”). We assume that the intention is to reflect the notion better expressed in paragraph 78 of the Basel Document: “An effective relationship should enable each party to carry out its respective statutory responsibilities while not implying that either party is responsible for or should or can perform the statutory responsibilities of the other party.”
16	18	We suggest that the reference to “different scope of their functions” would be better as “different scope and purpose of their functions.”
17	Question 3	<i>Is the general framework of the communication between competent authorities and auditors appropriate and sufficiently clear? Please indicate any additional elements to be included.</i>  Subject to our comments in the covering letter, we agree that the general framework is appropriate and sufficiently clear. See the covering letter for

Page	Para	Observation/response
		suggested additional guidance on communication from competent authorities to statutory auditors.
17	Question 4	<p><i>Please provide any comments you may have on the appropriateness of the proposed proportionality approach.</i></p> <p>We agree with the approach taken to proportionality.</p>
17 (and 13)	23 (and 11)	<p><b>In-depth communication</b></p> <p>This comment is related to our observation in the covering letter on objectives and benefits of effective communication in which we note that the draft is more focused on the facilitation of supervision.</p> <p>The definition of in-depth communication in paragraph 11 on page 13 refers to intensified communication when a greater supervisory effort may be needed. In addition, paragraph 23 on page 17 tasks the competent authority with the assessment of whether in-depth communication is necessary.</p> <p>We believe that the objectives and benefits of effective communication should include the facilitation of the task of the auditor and enhancement of audit quality. Therefore, we recommend the EBA adjust the definition of in-depth communication to reflect that and to set out that the supervisor may initiate (or the auditor may request) in-depth communication if deemed appropriate to support the performance of a high-quality audit. For example, this might be the case if the credit institution is subject to an investigation by the competent authority or if there are compliance or capital problems that are potentially material to the financial statements and about which the competent authority has special knowledge.</p>
20	Question 5	<p><i>Are the guidelines on the scope of the information to be shared during the communication appropriate and sufficiently clear? Are the issues on which information may be shared in Annex I appropriate and sufficiently clear? Please indicate any additional issues to be included.</i></p> <p>We agree that information that is relevant to the tasks of both parties may vary over time and by institution and that it is impracticable to come up with an exhaustive list. However, we recommend the EBA include the following items in Annex I:</p> <ul style="list-style-type: none"> <li>• Material actual or threatened litigation and disputes</li> </ul>

Page	Para	Observation/response
		<ul style="list-style-type: none"> <li>• Fraud risks, especially due to weaknesses in internal controls</li> <li>• Adjusted audit differences</li> <li>• Disagreements between management and the auditor</li> </ul>
20	Question 6	<p><i>Are the guidelines on the form of communication appropriate and sufficiently clear? Please indicate whether any particular form of communication should be used and under which circumstances it should be used.</i></p> <p>We agree that the guidelines are appropriate and sufficiently clear. It might be helpful to note that:</p> <ul style="list-style-type: none"> <li>• in some cases both written and oral communication may be appropriate – e.g. agenda papers to be discussed at meetings, minutes or written summaries of meetings; and</li> <li>• it may enhance efficiency and effectiveness if the competent authority routinely copies the statutory auditor on certain significant official correspondence with the credit institution (e.g. SREP<sup>2</sup> letters setting out capital and liquidity requirements and views on risk management and supervisory actions).</li> </ul>
21	42, Question 7	<p><i>Are the guidelines on the participants in the communication between competent authorities and auditors appropriate and sufficiently clear? Are there any other participants that should be considered participating? Under which circumstances should other participants be considered?</i></p> <p>We generally agree with the proposed participants and as credit institutions and their specific circumstances differ we prefer in general to leave it open as to which other participants may be required in which specific circumstances.</p> <p>However, in our view other participants can only participate if that would not result in any confidentiality breaches. In addition, any such other participants should be required to treat any information communicated during such meetings as confidential in a similar way as is established for</p>

<sup>2</sup> Supervisory Review and Evaluation Process

Page	Para	Observation/response
		<p>the competent authority and the auditor in accordance with Articles 53-62 of Directive 2013/36/EU<sup>3</sup>.</p> <p>Furthermore, when deciding whether to invite third parties, we also believe that the effect of the presence of those other participants on the openness and effectiveness of the communication between the competent authority and the auditor should be taken into account. Also, as we recommend the inclusion of promoting high-quality audits as an additional objective in the covering letter, we are of the view that facilitation of the role of the supervisor and audit quality should both be taken into account in assessing whether the presence of other relevant authorities is appropriate.</p> <p>Considering the above and other factors, we believe that it would be more relevant to cite an authority responsible for the public oversight of auditors as an example of a possible attendee at a meeting between competent authorities and auditors collectively rather than – as is currently the case in the Paper – as an attendee at a meeting about the audit of an individual institution.</p>
22	46, Question 8	<p><i>Are the guidelines on the frequency and timing of communication appropriate and sufficiently clear? Please provide information on any additional circumstances which may necessitate a different frequency and timing of communication.</i></p> <p>As stated in the covering letter, we believe that the guidelines should state that competent authorities should promptly notify statutory auditors of certain specified material matters. Also, please see our recommendation on the copying of certain significant correspondence in response to Question 6 above.</p> <p>Regarding paragraph 46, we note that communication could also take place during the performance of the auditor’s review of interim reporting.</p> <p>We also recommend that communications intended to occur 'before signing of audit report' (as per paragraph 46) are planned in advance so that they do not interfere with or detract from the performance of a high-quality audit during its most intense phase.</p>

<sup>3</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

Page	Para	Observation/response
		Except for the above, we agree that the guidelines are appropriate and sufficiently clear.
23	49-52, Question 9	<p><i>Are the guidelines on the communication between competent authorities and auditors collectively appropriate and sufficiently clear? Please indicate any additional element which should be included in the guidelines regarding the communication of competent authorities and auditors collectively.</i></p> <p>The current drafting does not make clear how the EBA envisages that communication at the institution and collective level should interact. We recommend the guidelines address this in section 4.1. We believe that communications at the institution and collective level are part of an iterative process. Furthermore, we recommend that the guidelines explain how confidentiality may impact or limit information flows from institution-specific communications to collective discussions.</p> <p>Additionally:</p> <ul style="list-style-type: none"> <li>• The guidelines do not explain comprehensively what is meant by ‘auditors collectively’. It may mean representatives of: a single firm that audits a number of institutions (i.e. the communication is not in the context of the audit of a single institution and would therefore appear to be outside the scope of section 4.2), a network of firms from across a number of member states (e.g. across the SSM area), multiple firms or multiple networks of firms, or a professional association of accountants. It may be helpful to recite that interactions at all these levels may be useful but might have a different focus.</li> <li>• Paragraph 49 requires that “Competent authorities and auditors collectively should ensure they develop a common understanding...” We believe that this objective is stated in terms that are unrealistically strong – i.e. to require that they ‘ensure’ a common understanding across a wide class of persons. We think it would be better to express this goal in more aspirational terms (e.g. “... endeavour to develop...”) and, like the Basel Document, comment more on the quality of the dialogue – e.g. frank, open, etc.</li> </ul>
24	53.f	We suggest that the terms ‘material control weaknesses’ and ‘significant deficiencies in internal control processes’ are switched since the former are very serious examples – and a subset – of the latter. It also is not clear why



Page	Para	Observation/response
		“auditor’s observations on matters that are significant...” are cited as examples of material control weaknesses as they may not be.
28	56	Paragraph 56 on page 28 explains that one of the problems is that the scope of assurance provided by auditors varies across Member States and this could impede a level playing field between credit institutions in the European Economic Area (‘EEA’). Although we do not disagree with this statement, we note that the guidelines as set out in this Paper will not address this issue.
36	Question 10	<p><i>Do you agree with the impact assessment and its conclusions, having regard to the baseline scenario used for this impact assessment? Please provide any additional information regarding the costs and benefits from the application of these guidelines?</i></p> <p>See our comments in the covering letter.</p>
36	Question 11	<p><i>Please provide any additional comments on the draft guidelines.</i></p> <p>See our comments in the covering letter and our detailed observations relating to the Paper that are in addition to our responses to the specific questions in the Paper.</p>