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Contact information:

Bank of Israel – Keren Benglas Shinar: naomi.alcalay@boi.org.il
Ministry of Finance – Efrat Atik: efratat@mof.gov.il

Outline for Changing the External Auditing Structure of Financial Entities

The Supervisor of Banks at the Bank of Israel and the Commissioner of Capital Market, Insurance and Savings at the Ministry of Finance (hereinafter: "the Supervisors" or "the Supervisor") regulate the activities of entities active in the financial and capital markets which, among other things, manage the money of others (hereinafter: "the Supervised Entities" or "Financial Entities"). As part of the regulation, the Supervisors issue Directives regarding the external auditing of institutional entities and banking corporations in order to improve the quality of the external auditing of the Supervised Entities' financial reports. The document includes an executive summary of the existing situation and problems, and presents alternatives to deal with these problems which the Supervisors are considering implementing in whole or in part.

The Supervisors invite interested parties, including those who make use of the financial reports of financial entities, financial entities themselves, and external auditors, to send responses to this document, particularly to the questions raised in Section 4, by July 25, 2013.

1. Background

The Supervisors traditionally relate to external auditors as an essential element in the overall system that maintains the stability of the financial system. In particular, the Supervisors attribute high importance to the appropriateness of the financial reports of financial entities and to the quality of the external auditing of those reports. Therefore, the Supervisors are active in making sure that the audit and the professional behavior of the accountant auditors are in line with the requirements and with advanced and strenuous professional standards, and they are in constant and close contact with the external auditors.

In the past, the Supervisors have taken actions to improve the quality of the external audit of financial entities, including requiring a rotation among responsible partners and the appointment of a partner responsible for reviewing the audit (accompanying partner). In addition, the Supervisors have applied various reporting obligations on accountant auditors reporting to the Chairman of the Board of Directors, the Audit Committee, the CEO and the Supervisors. The Supervisors' Directives come in addition to that set forth in the Companies Law, 5759–1999 and the Accountants Law, 5715–1955, and in addition to Regulations enacted pursuant thereto[1] concerning conflicts of interest and damage to independence as a result of other employment, which set out limitations on the provision of services that are not auditing services and on partners and employees of accounting firms.

As part of their role, the Supervisors receive reports on deficiencies and weaknesses in the internal controls of financial entities, conduct clarifications with accountant auditors, refer requests to conduct targeted and supplementary audits at certain entities, and so forth. This contact enables the Supervisors to gain an independent impression of the functioning of accountant auditors and of the level of the audit in various entities, and to take steps when the need arises.

Currently, the Supervisors are considering making use of further alternatives, separately or in tandem, to strengthen the position and independence of the auditors and improve their work.

2. The structure of the external audit of financial entities in Israel

The knowledge and professionalism required of the auditors of financial entities, which are complex entities with unique and specific accounting and disclosure rules, require accounting firms to develop expertise in banking and insurance. These requirements may cause a small number of firms to have teams of experts in auditing financial entities, and they will accumulate professionalism and experience in auditing these entities, and will audit a large part of the field. Currently, insurance companies in Israel are audited by

[1] Accountants Regulations (Conflicts of Interest and Harm to Independence as a Result of Other Employment), 5768 – 2008, and the decision by the Israel Securities Authority pursuant to Section 9b of the Securities Law, 5728 – 1968.

three large accounting firms, with each of them auditing about 50 percent of the industry[2] and two jointly audited companies. In pension and savings, more than ten accounting firms audit the management companies. In the banking system, the four largest accounting firms in Israel audit all of the banking corporations, with each of them auditing about 48 percent of the industry.[2] In relation to the five largest banks, one accounting firm audits four of them, while three of them are jointly audited. In addition, there is no significant alternative among the accounting firms auditing a particular audited entity.

The high level of concentration and the absence of an alternative among auditors raises a concern that long-term relationships between the auditor and the audited entity may damage the independence, criticism and professional skepticism of the auditor. Additional, although smaller, concerns relate to malpractice that may take root in the industry as a result of errant interpretation by a single accounting firm, and that the collapse of a single accounting firm could lead to a shutdown of the industry.

In an examination of the financial system in Israel conducted by the FSAP at the end of 2011, the Banking Supervision Department was asked to again consider a structural change in the external auditing of financial entities in Israel:

"The rotation of external auditing firms has been under consideration…. Such a requirement could have the benefit of creating some competition in the industry…".

"The question whether to require banking corporations to rotate external auditors periodically has been under consideration, but no decision has been made. Practically speaking, with a minimal number of firms in Israel offering auditing services to the banking industry, the rotation of external auditors may create some added competition."

In assessing the appropriate outline for the external audit of financial entities, it is very important to implement the proposed outline in the best possible manner, while preventing as much as possible damage to the functioning of the industry and the quality of the auditing work. Therefore, we must consider making the proposed changes with appropriate caution, in light of the complexity and uniqueness of the industry. In addition, we must assess, among other things, gradually implementing the changes, and the industry's ability to implement the outline in the proposed periods.

3. The situation around the world

Characteristics similar to those of the auditing of financial bodies in Israel exist in many other countries. With the aims of strengthening the independence of the external auditors, improving the quality of the audit, and reinforcing competition, a small number of countries have decided to apply various models for rotation between audit firms. For instance[3], in Italy (since 1974), a rotation every 9 years was adopted. In Brazil (since

[2] The calculation takes into account joint audits.

[3] Source: "What do we know about mandatory audit firm rotation" , Research Committee, Institute of Chartered Accountants of Scotland (ICAS), December, 2012

1999), a rotation every 5 years was adopted for publicly traded non-bank companies, and in India, there is a rotation every 4 years for banks at insurance companies. Other countries that considered or began rotations (such as Germany, France, Canada, Spain, South Korea, Austria, Ireland, Turkey and Singapore) decided in the end not to apply a rotation requirement. The main reasons raised in this context concerned cost-benefit considerations, increasing costs, and attaining the goal of increased competition.

In the US and in EU authorities, the 2008–09 global crisis led to the consideration of various alternatives for improving audit quality, including imposing a rotation requirement among accounting firms, limitations on the provision of non-audit services, accountants' fees, and others. At this stage, discussions are continuing and decisions have not yet been reached.

A summary outline of the situation around the world is below:

A. The European Union

Discussions are being held on the changes required in the accounting market, including the issue of rotations. At this stage, legislative proposals[4] and changes proposed by various committees[5] have not yet been accepted or passed. In general terms, the European Commission's legislative proposal from 2011 included a proposal that the appointment of an accountant auditor for a public company should be for no less than 2 years and no more than 6 years, and that in the case of a joint appointment, the maximum should be 9 years. Discussions were held in various committees on this proposal, with the committees expressing reservations on the proposal and suggesting other alternatives:

The Committee on Legal Affairs recommended that an accountant be appointed for a period of one year, renewable to a maximum period of 25 years. The recommendation was recently updated so that appointments are for a maximum period of 14 to 25 years, according to certain circumstances.

The Committee on Economic and Monetary Affairs recommended not limiting the appointment period of an accountant auditor.

[4] On November 30, 2011, the European Commission published the legislative proposal: "Proposal for a Regulation of European Parliament and of the Council on Specific Requirement Regarding Statutory Audit of Public Interest Entities 2011/0359 (COD).

[5] On September 5, 2012, the European Parliament Committee on Legal Affairs (hereinafter "JURI") published Draft Report 2011/0359 (COD) with many changes to the European Commission's legislative proposal. On September 25, 2012, the Committee on Economic and Monetary Affairs published Draft Opinion 2011/0359 (COD) detailing its position regarding the changes required in the legislative proposal. On December 3, 2012, the European Parliament Committee on Industry, Research and Energy published a position paper (Opinion 2011/0359 (COD)) detailing its position regarding the changes required in the legislative proposal. In a discussion on the legislative proposal held by the JURI on April 25, 2013, a decision was made that the maximum term for an accountant auditor would be 14 years, and that in certain circumstances, the term could be extended to 25 years.

The Committee on Industry, Research and Energy recommended that the appointment of an accountant auditor be for at least three years and a maximum of 12 years, and a maximum of 15 years for a joint audit.

B. The Basel Committee

In March 2013, the Basel Committee on Banking Supervision of the BIS published a Consultative Document regarding the External Audit of Banks. The document contains 16 principles, explanations and guidelines for improving the quality of bank audits and increasing their effectiveness, in order to contribute to financial stability. The document presents supervisory expectations regarding the manner in which:

- External auditors fulfill their responsibility more effectively;
- The Audit Committee contributes to the quality of the audit by supervising the external auditors; among other things, the Audit Committee must conduct a policy that will relate to the frequency of tenders of external auditors and periodically assess the need for limiting the duration of the association with the external auditor;
- Effective contact between external auditors and the supervisor, which will enable to formulation of mutual understandings regarding the laws and responsibilities that apply to the supervisor and to the accountants; and
- Effective ongoing communication between the Supervisor of Banks and the bodies supervising the over-all audit, which could improve the quality of the audit at the banks.

C. The United States

In 2002, Congress assessed the possibility of requiring a rotation among audit firms. The General Accounting Office (GAO) researched the issue and published a report in 2003, which concluded that a rotation among audit firms is not the most efficient means of ensuring independence and audit quality. At the same time, the report notes that further knowledge and experience are necessary in order to make a final decision on the issue.[6]

On August 16, 2011, the Public Company Accounting Oversight Board (PCAOB) published a position paper (Concept Release on Auditor Independence and Audit Firm Rotation) on the issues of independence and rotation, with the aim of assessing how independence between auditing firms and audited entities, and the objectivity and professional skepticism of auditors, can be strengthened.[7] The PCAOB is currently considering how to continue its handling of the issue in light of the responses it has received.

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[6] GAO: Public accounting firms – Required study on the potential effects of mandatory audit firms rotation, November 2003.

[7] PCAOB Release No. 2011-006.

4. Alternatives for dealing with the problem of auditor concentration

The supervisors have recently been assessing the appropriate structure for external audits of financial entities in Israel. The Supervisors' conclusions were that there is room to improve the existing structure in order to strengthen the independence and professional skepticism of the accountant auditor and to reinforce the involvement of additional accountants while maintaining the required quality of the accounting work.

The steps recommended in order to improve the existing structure are below:

A. Requiring a periodic rotation among audit firms

In light of the concern that long-term relationships between the auditor and the audited entity may create a proximity system between them, which could harm the criticism and professional skepticism of the auditor, it is recommended to require a periodic rotation among auditing firms.

Such a rotation requirement could assist in lowering the concerns of misuse of information collected in an individual office, that improper practice might take root in the industry, as a result of mistaken interpretations by an individual accountant, and that the collapse of an individual accounting firm could lead to the shutdown of the industry.

At the same time, there are certain concerns in carrying out a rotation, since requiring a rotation every few years may harm an accounting firm's ability to build a proper internal infrastructure to reach and maintain the required professional level over time, particularly in an industry with specific specialization in a small economy such as Israel. In addition, a rotation may weaken the accountant's interaction with the management in the knowledge that he will not be able to assess prolonged processes over time.

The relevant questions in this matter are:

1) How will a rotation affect the quality of the audit, and the independence, objectivity, and professional skepticism of the auditor, as well as the professional standing and strength of the auditor vs. the audited entity?
2) In light of all the considerations, will a rotation of accountants improve the quality of the audit's products?
3) Should the supervisors expand their operations as complementary steps to a rotation in order to ensure independence, objectivity and professional skepticism through reviews or critiques?
4) Are there steps that will provide a supervised entity with sufficient time to release itself from contractual associations with an accounting firm to provide non-auditing services, in order to associate with it to conduct an audit? Is it necessary to set a cooling-off period from the date that non-auditing services were received from a certain accounting firm until that firm can serve as the accountant auditor of a supervised entity? How can we ensure that an accountant auditor who has consulted for a supervised entity in formulating procedures, systems, controls and

accounting policy can thereafter independently examine those policies and procedures?

5) What is the correct frequency for replacing accountant auditors, and why?
6) Are there requirements that the supervisors must consider in order to minimize the risks inherent in a rotation, and how can we deal with the expected increase in auditing risk in the first few years of a new auditor's work? What means of quality control should be required, or what other steps should be taken to minimize this risk?
7) Is it desirable that for each replacement of an accountant, the departing accountant be required to transfer to the new accountant a written report outlining the audit risks and other information relevant to the company? Is it desirable to require an overlap period or similar means? What are the costs of these means?
8) How should the supervisors be involved in the replacement of accountants? Should the supervisors conduct an F&P process for a new accountant and ensure the propriety of the contact with the departing accountant in each replacement?
9) How can increased systemic audit risk be prevented, both in the first implementation and thereafter, particularly if during a certain year there are rotations of many offices?

B. Setting limits on the maximum market share allowed for an individual accounting firm in the financial system.

The benefit in this type of solution is in its control over the dominance of one or two accounting firms in the industry, and encouraging the entry of additional accounting firms. This limitation also lowers the concern over the negative professional ramifications discussed in the rotation solution. Implementing this type of solution would require ongoing close supervision over accounting firms operating in the industry, with planning, caution and gradualness, such that a new accounting firm can build the proper professional infrastructure while avoiding the replacement of a significant portion of the accounting staff of supervised entities during too short a period. In addition, there will be room to consider steps such as requiring joint auditing (overlap) and the transfer of working papers from the departing auditor to the incoming auditor. Such limitation does not directly deal with the concern that long-term relationships between the auditor and the audited entity may harm the auditor's criticism.

Limits on the maximum market share should be set separately for the banking sector and the insurance sector. Such separation would enable, for instance, limiting one accounting firm from auditing more than one large banking corporation or more than two larger insurers.

The relevant questions in this matter are:

1) How would limiting market share affect the quality of the audit, the independence, objectivity and professional skepticism of the auditor, and the professional standing and strength of the auditor vs. the audited entity?

2) In light of all the considerations, will limiting market share improve the quality of the audit's products?
3) Does this limitation integrate with a rotation requirement, and how? Does this limitation affect the advantages and risks of a rotation requirement?
4) Is it worth setting market share limitations for each industry in the financial sector or for the financial sector as a whole?
5) To what extent will market share limitations limit the ability of a supervised entity to select a proper accountant auditor?
6) Will market share limitations affect non-auditing services?
7) How can the audit risk be minimized in the first years of the process to shrink market share? Is it appropriate to take similar steps to those that should be taken to deal with the risks that you think exist in a rotation requirement?
8) What is the proper way to implement market share limitations and enforce them over time? What steps can be taken to make sure that the limitation actually improves the quality of the audit?

C. Limiting joint audits

There are advantages and disadvantages to joint audits. On one hand, joint audits reduce the concern over harm to criticism and professional skepticism and allow the joint accounting firms to build a proper infrastructure of knowledge, professionalism and experience. On the other hand, joint audits maintain the dominance of the specialist accounting firms and increase the costs to the audited entity due to the need to coordinate between firms.

Canceling this option may strengthen the standing of the accountant auditor opposite the financial entity, save resources in coordinating between firms, and prevent competition between firms over less conservative positions, such that pressure would be created on a conservative firm to "converge" with the position of a less conservative firm. On the other hand, canceling the option contains the risk that a firm without sufficient professional ability may be the only auditor of a financial entity.

The relevant questions in this matter are:

1) How would joint auditing affect the quality of the audit, the independence, objectivity and professional skepticism of the auditor, and the professional standing and strength of the auditor vs. the audited entity?
2) In light of all the considerations, will limiting market share improve the quality of the audit's products?
3) Does the limitation on joint auditing integrate with the rotation requirement and the market share limitation, and how?
4) Does joint auditing prevent a rotation or market share limitation of accounting firms?
5) How would a joint auditing prohibition affect the concentration of accounting firms that audit supervised entities?

6) How can the audit risk be minimized in the first years of the move from joint auditing to auditing by a single firm?

D. Expanding the limitations on an accountant auditor firm in the provision of peripheral services to an audited entity

This solution limits the auditor to providing peripheral services to an audited party that are not connected to the auditing work, such as: Economic valuation, business and financial due diligence, planning and implementation of information systems to improve data, risk management, and actuarial services.

The solution provides a response to harm to the independence, critical observation and professional skepticism of the auditor as a result of economic dependence between the auditor and the audited entity, which may lead to damage to the auditor's critical observation due to concern over the loss of other, non-auditing, sources of income. The disadvantage of this solution is in terms of the higher costs to the audited entity, which needs to obtain services from two different accounting firms, rather than through a single firm that already knows the company's behavior.

According to the European Commission's legislative proposal from 2011, the accounting firm that conducts the audit of a public company shall not provide the company with services that are not connected to auditing services. The legislative proposal lists services that are not auditing services in each case, such as: planning and conducting internal audit and risk management, conducting control over financial information included in financial reports, and expert services not connected to audits, such as: taxes, general management and consulting services, evaluation and opinion services, legal and actuarial consulting services, financial information systems services, and investment and financial consulting.

Services that are connected to audit services, but which the accountant auditor may provide, are also listed: confirmation of the veracity of financial reports to the authorities, examining tax adjustment reports, and any other service connected to auditing and required by law.

The relevant questions in this matter are:

1) What limitations will reduce the auditor's economic dependence on the audited entity?
2) Could such limitations cause higher costs to the audited entity due to the need for bodies other than the accountant auditor to develop or strengthen their professionalism and expertise in the regulatory environment of the supervised entities and to develop a good acquaintance with the supervised body?