

Communication of External Auditor
with Those Charged with Governance in the Banking Corporation

Introduction

1. As part of the guidance concerning the adoption of American auditing standards by external auditors in the performance of auditing the financial statements of banking corporations, relevant auditing standards related to communication of external auditor with those charged with governance in banking corporation have been applied to the external auditors.
2. These standards include, *inter alia*, the standards relating directly to communication of external auditor with those charged with governance in banking corporation, as follows:
 - (a) SAS 60 - Communication of Internal Control Structure Related Matters Noted in an Audit (and its amendments in SAS 78 and SAS 87).
 - (b) SAS 61 - Communication with Audit Committees (and its amendments in SAS 89 and SAS 90).

The matter at hand is also referenced within the general standards applying to external auditors, e.g.:

 - (c) SAS 54 - Illegal Acts by Clients (see Section 17);
 - (d) SAS 99 - Consideration of Fraud in a Financial Statement Audit (see Sections 79–82).
 - (e) SAS 100—Interim Financial Information (see Sections 29–35).
3. This Directive regulates the application of the American standards relating to communication of external auditor with those charged with governance in banking corporation, and the application of several additional requirements beyond the standards in this regard in the United States, as shown in the Appendix to this Directive.
4. The implementation of this Directive shall not absolve external auditors of banking corporations of the need to implement additional requirements in regard to communication of external auditor with those charged with governance in banking corporation in other auditing

standards that apply under law to the auditing work of an external auditor of a banking corporation.

5. For the sake of clarity, it is stated that if these standards are amended in the future, said amendments shall be applied accordingly.

Applicability

6. This Directive shall apply to communication of external auditor with those charged with governance at:
 - (a) all banking corporations;
 - (b) corporations in Israel that are controlled by banking corporations, if one of the following conditions is met:
 - (1) They are a “major company” as this term is defined in Section 32.i of the Directives concerning Preparation of the Annual Financial Statements of a Banking Corporation;
 - (2) Proper Conduct of Banking Business Directive 311, in regard to “minimum capital ratio,” applies to them (see Section 4 ad loc.), unless the extent of their business is negligible relative to the activity of the group.

Appendix

Explanatory Notes on Communication of External Auditor with Those Charged with Governance in the Banking Corporation

General

1. Communication between an external auditor of a banking corporation with those charged with governance in the banking corporation shall take place in accordance with the rules set forth in the American auditing standards, which have been applied to banking corporations in Israel in order to establish new auditing standards as such standards are published in the United States. The application of said standards shall include amendments and changes made thereto, as are published after they are applied in the United States.
2. The following additional provisions shall apply to external auditors:
 - (a) further requirements in regard to communication by an external auditor of a banking corporation with those charged with governance in the banking corporation that appear in other auditing standards that apply, by law, to the auditing work of an external auditor of a banking corporation.
 - (b) specific explanatory notes for the implementation of the American standards and further requirements as set forth below.
3. For the sake of clarity, it is stated hereby that if the relevant auditing standards are amended in the future, the amendments shall be applied accordingly.

Destination of Reports

4. In addition to the audit committee of the board of directors of the banking corporation, if other elements on the board of directors are charged with governance, the external auditor shall determine the identity of said elements and establish with whom he should meet. Concurrently, the board of directors of the banking corporation shall keep the external auditor up to date on the need to address certain reports to the board itself or to another committee of the board, such as a balance-sheet committee, if the matters at hand fall into their purview.

5. For clarity and to eliminate doubt, it is stated that:

- (a) Compulsory reporting to those charged with governance in the banking corporation does not absolve the need to report to the Chair of the Board of Directors as set forth in Section 169(a) of the Companies Law, 5759-1999.
- (b) In accordance with his powers under Section 5.a of the 1941 Banking Ordinance, the Supervisor of Banks may demand, and use in any way necessary, any information created in communication between an external auditor and the audit committee or between an external auditor and any other official at the banking corporation, even if limits on communication have been established in respect to addressees and use of the information by other elements.

Reporting Due Date

- 6. An annual long-form report, including material findings such as material weakness in internal control and any other matter of relevance for the approval of the financial statements, shall be reported to those charged with governance in the banking corporation before the date of approval of the financial statement.
- 7. If those charged with governance in the banking corporation have been receiving written findings on a current basis during the year, there is no requirement to repeat the findings in the long-form report, provided that the said findings and their source are mentioned.
- 8. If the external auditor has not completed the report on the other audit findings by the date on which the annual financial statements are approved, he shall inform the banking corporation to this effect and present a supplemental report within sixty days after the publication of the financial statement.

Response to Reports and Correction of Deficiencies

- 9. (a) Those charged with governance in the banking corporation, or an oversight group deputized thereby, shall provide the external auditor with a written response to the audit

findings within sixty days of their receipt of the report, including reference to all deficiencies.

- (b) In this procedure, the banking corporation shall certify the correction of all deficiencies that the external auditor, after receiving the response of the banking corporation, deems to be in need of correction. When the procedure for the correction of specific deficiencies entails long-term action, such as thorough repair of a computer system, the banking corporation shall make the corrections on the basis of a specific schedule.
- (c) If said deficiencies are not corrected in a timely fashion, and especially deficiencies that the banking corporation has certified as having been corrected, repeat deficiencies shall be reported separately or as part of the report on “Material Weakness in Internal Control,” if such exists (see Section 13 below).

Contacting the Supervisor of Banks

10. In material cases and as the case may be, an external auditor shall weigh the necessity of contacting the Supervisor of Banks when he believes that:

- (a) After all discussions and correspondence, including discussions and correspondence with the Board of Directors, a disagreement remains in matters that entail no change in the standard format of the external auditor’s report;
- (b) The schedule for the correction of the deficiencies, set forth by the banking corporation, is unreasonable;
- (c) Those charged with governance in the banking corporation have not responded properly, within a reasonable period of time, to his notice about matters found in an audit of a financial statement or in a review of interim statements that cause him to believe that said statements are in need of material change.

Written Reporting Requirement

11. A written reporting requirement is needed, especially in matters that SAS 60 defines as reportable and other material matters in regard to which communication with those charged with governance in the banking corporation is needed.

Additional Reporting by External Auditor

12. An external auditor shall also report the following to those charged with governance in the banking corporation, either on the long-form report or on a current basis, as the case may be:

(a) Report on the scope of the audit:

- (1) General description of the scope of the audit;
- (2) Areas in which the audit was expanded and the reasons that prompted the external auditor to expand the audit in them;
- (3) Evaluation of the internal-auditing actions and the soundness of the internal-control system and the extent to which the external auditor relied on them in determining the scope of the audit.

(b) Reliance on experts:

When an external auditor relies on other experts (accountants, attorneys, adjusters, economists, etc.) in material matters, he should apprise those charged with governance in the banking corporation of the names of the experts and the matters on which he relied on them.

- (c) The possible effect on the financial statements of significant risks and exposures of any kind, such as a lawsuit, that must be disclosed in the financial statements;
- (d) Material uncertainty about events and situations that may create meaningful doubts about the ability of the banking corporation to function as a going concern;
- (e) Expected changes in the standard format of the external auditor's report;
- (f) Any other matters that demands the attention of those charged with governance in the banking corporation, such as questions relating to the integrity of management;
- (g) Non-auditing services—review of non-auditing services that the external auditor, or a service firm controlled by the external auditor, has provided for the banking corporation during the year (in accordance with the definitions in the report of the Board of Directors, Appendix C, p. 630-10);
- (h) Reports submitted during the year—a list of all reports from the external auditor during the year, and to whom they were submitted.

Material Weakness in Internal Control

13. Due to material considerations and to prevent a situation whereby a material deficiency is “submerged” in a large series of findings, the external auditor shall identify and report to those charged with governance in the banking corporation, each material weakness, as defined in SAS 60, separately.

Clarifications—Protection of assets

14. The Appendix to SAS 60 gives examples of matters that may be reportable, including, but not limited to, improper conditions for the protection of banking corporation assets or evidence of failure to protect banking corporation assets from loss, damage, or misuse. For clarity, it is stated that the foregoing also relates to assets held for others in custodianship or as a trustee.
15. The term “protection of assets” is related to internal-control processes and policies that pertain to the financial statements. In the context of the structure of internal control at the banking corporation, assets protection relates only to protection against loss due to errors and irregularities in the performance of transactions and to the protection of the applicable assets. It does not include, for example, asset loss due to operational decisions of management.
16. In this matter, it is explained that the function of management is to establish protection of assets policies and that the function of an external auditor is to assure the said safeguarding policies and to check for compliance with said policies in the context of the financial statements. An external auditor is not required to attest to the adequacy of the policies. For example, an external auditor’s examination of controls in the context of financial reporting on loans should include, for example, tests indicating whether the banking corporation has carried out the transactions in accordance with management policy related to the financing and documentation of loans. These processes may include, for example, comparison of loan performance certifications with written management policy.

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