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## Main Abbreviations and Acronyms

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A&A	Accounting and Auditing
AAC	Audit Advisory Council
ACCA	Association of Chartered Certified Accountants
AOC	Audit Oversight Commission
CFRR	Centre for Financial Reporting Reform
CPD	Continuing Professional Development
EU	European Union
FEE	Fédération des Experts Comptables Européens
FCMC	Financial and Capital Market Commission
FRTAP	Financial Reporting Technical Assistance Program
F/S	Financial Statements
GDP	Gross Domestic Product
GNI	Gross National Income
IAASB	International Auditing and Assurance Standards Board
IAESB	International Accounting Education Standards Board
IAS	International Accounting Standards (included in IFRS)
IES	International Education Standard
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
ISRE	International Standard on Review Engagements
IFRS	International Financial Reporting Standards (including IAS)
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
ISA	International Standards on Auditing
ISQC	International Standards on Quality Control
LAS	Latvian Accounting Standards (abolished 2011)
LASA	Latvian Association of Sworn Auditors
LFRR	Latvian Financial Reporting Regulations
LRGA	Association of Accountants of the Republic of Latvia
MoF	Ministry of Finance
PAO	Professional Accounting Organization
PIE	Public Interest Entity
QA	Quality Assurance
QAR	Quality Assurance Review
ROSC	Reports on the Observance and Standards of Codes
SAD	Statutory Audit Directive
SIA	Limited Liability Company
SME	Small and Medium Sized Entity
SMO	Statement of Membership Obligation
SRS	State Revenue Service
UL	University of Latvia
USGAAP	United States Generally Accepted Accounting Principles

CURRENCY: EURO (EUR)

1 EURO = 1.29552 USD as of September 12, 2014

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## Executive summary

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This assessment of accounting and auditing practices in Latvia is part of a joint initiative of the World Bank and International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). One of the twelve ROSC modules focuses on Accounting and Auditing (A&A), this assessment addresses the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and includes a review of both mandatory requirements and actual practice. This is the second A&A ROSC for Latvia. The first one was published in 2005,<sup>1</sup> shortly after Latvia acceded to the European Union (EU) on 1 May 2004.

As part of its accession to the EU, Latvia was required to align its legal and institutional framework with the requirements of EU law (*acquis communautaire*). *Acquis* financial reporting and audit requirements—together with International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA)—are the principal benchmarks used for this assessment.

### Latvia at a glance

Latvia regained its independence in 1991 and joined the Eurozone on January 1, 2014.

Latvia has a population of about 2 million and a gross domestic product (GDP) per capita of USD 14,120. The economy is dominated by the services sector; mainly financial services; transport and communications, which account for over 75 percent of GDP.

Latvia ranks 24<sup>th</sup> worldwide in Doing Business 2014 Index. It ranks third in the ease of getting credit, and has improved the effectiveness of starting a business (ranked 57<sup>th</sup>), paying taxes (ranked 49<sup>th</sup>), trading across borders (17<sup>th</sup>) and resolving insolvency (ranked 43<sup>rd</sup>). At the same time, it has become more difficult to register property (33<sup>rd</sup>) and ranking has fallen on protecting investors (68<sup>th</sup>) compared with Doing Business 2013 indexes - 29<sup>th</sup> and 67<sup>th</sup> respectively.

The Latvia ROSC A&A has been prepared as part of the Financial Reporting Technical Assistance Program (FRTAP) and at the request of the Latvian Government. Since 2009, Latvia has been receiving advisory services from the World Bank's Centre for Financial Reporting Reform (CFRR), funded by the Swiss Enlargement Contribution, to enhance the implementation of the portions of the *acquis* that relate to corporate financial reporting and auditing.

The purpose of this A&A ROSC Update for Latvia is to highlight areas of consideration necessary to strengthen the quality of financial reporting in Latvia, which will ultimately contribute to improved investment climate and economic growth. The 2014 A&A ROSC assesses the progress achieved over the past nine years; and seeks to support Latvia, as an EU Member State, in its efforts to align its legislation with EU requirements; and help foster the ongoing enhancement of its private sector.

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<sup>1</sup> [http://www.worldbank.org/ifa/rosc\\_aa\\_lat.pdf](http://www.worldbank.org/ifa/rosc_aa_lat.pdf)

Since the previous A&A ROSC in 2005, Latvia has made significant efforts to align its legal framework with EU requirements, and the Ministry of Finance has been active in EU policy-making through different committees and bodies. There have been improvements to its accounting, reporting and auditing systems, especially with the introduction by the Latvian Association of Sworn Auditors (LASA) of a monitored peer review system for sworn auditors in 2005, the establishment of a single regulator for the financial sector and capital markets, and the extension of the IFRS requirement to cover most PIEs (see Box 2). However, it is concerning that the demand for high-quality financial reporting on the part of banks, investors, regulatory agencies or tax authorities remains quite limited.

### Corporate Financial Reporting in Latvia: Good Practices

**Quality Assurance (paras.67-71):** Despite being a small country with limited resources, Latvia has succeeded in implementing a well-run mechanism for assuring quality of independent audits. It is a monitored peer review system, and all sworn auditors are subject to a review at least once every five years (every three years for auditors of PIEs). A sworn auditor with more than three years of audit experience and a clean disciplinary record is eligible to enroll in the five-hour course to become a reviewer. The QA system is subject to oversight by the Ministry of Finance.

**Integrated financial regulator (para. 60):** having one institution housing the regulatory function over financial and capital markets makes sense in a country such as Latvia. A robust enforcement regime requires significant resources, such as qualified staff, information technology and office space. Consolidating monitoring and enforcement activities into a single agency creates economies of scale and allows using scarce use resources more efficiently.

**Use of Member State option in the IAS Regulation (paras. 28, 31-32):** The EU requires that all consolidated financial statements of listed companies be prepared in accordance with endorsed IFRS. It also gives Member States the option of extending this requirement to legal-entity financial statements and other types of entities. Latvia has used this option for companies listed on the main list, as well as for the legal entity and consolidated financial statements of banks and insurance companies. This is a very significant positive step to ensure all PIEs report according to high-quality standards.

A summary of the principal findings of the ROSC A&A assessment, as well as of the main areas for consideration for reform, is provided on the next pages.



## Latvia ROSC A&A: Summary of Findings

*Financial reporting and audit legislation in Latvia is consistent with the requirements of the EU acquis communautaire that are currently in force.*

The laws governing accounting and financial reporting requirements - mainly the Annual Accounts Law and Consolidated Annual Accounts Law - conform with the Fourth and Seventh EU Company Law Directives, respectively. For audit, the Law on Sworn Auditors is based on the EU Statutory Audit Directive. Publication obligations for listed companies are also consistent with relevant EU requirements.

*Legislation will need to be updated to comply with recent changes to the acquis that will take effect over the next couple of years.*

Similar to other EU Member Countries, Latvia's legal framework will need to be updated to reflect the 2013 EU Accounting Directive and 2014 amendments to the Statutory Audit Directive and new Audit Regulation. Disparities to be addressed include: (i) raising micro, small, and medium company size definitions to align with the new requirements; (ii) adjusting the quality assurance system over sworn auditors to make the review process more independent and risk-based; (iii) establishing a list of non-audit services (including tax services, accounting and bookkeeping services) that statutory auditors are prohibited from providing to the audited entity; and (iv) strengthening the public oversight system for audits of PIEs, to ensure it is independent of audit firms and auditors.

*Small companies are exempted from certain financial reporting and audit obligations, but thresholds defining or applicable to SMEs are significantly lower than the EU's.*

All companies (including sole proprietorships with annual revenues in the previous year exceeding EUR 300,000) are required to prepare financial statements, in accordance with the requirements of the Annual Accounts Law. Small and medium companies are exempted from preparing certain financial reports and from providing a number of disclosures. All large and mid-sized companies are required to have their annual financial statement audited.

*A legal definition of public interest entities is in the process of being set forth.*

Currently, Latvia lacks a legal definition of public interest entities. Many of the requirements under the new Accounting and Audit Directives, and new Audit Regulation, apply to PIEs exclusively. However, a proposed amendment to the Law on Sworn Auditors (not yet enacted) and other legislation<sup>2</sup> would institute PIE definitions in order to resolve this.

*IFRS is mandated for listed companies on the main list and financial institutions.*

Companies listed on the main market segment, banks, insurance companies, investment brokerage firms, investment management companies, private pension funds and open-ended alternative investment funds are required to apply IFRS as endorsed by the European Union in their legal entity and consolidated financial statements. Furthermore, all listed companies must apply

<sup>2</sup> Law on undertaking's active in the extractive industry and undertaking's active in logging of primary forests that report on payments to governments (not yet enacted).

endorsed IFRS in their consolidated financial statements. The Financial and Capital Market Commission (FCMC) issues additional financial reporting rules applicable for financial institutions which are consistent with IFRS as endorsed by the EU.

*The accounting requirements-setting process needs more inputs from specialized and technical resources, in a way that is sustainable and inclusive and results in standards of a high quality.*

The Ministry of Finance is responsible for drafting Accounting Laws and Cabinet of Minister Regulations regulating accounting issues. Between 2003 and 2011, the former Accounting Board was responsible for drafting and issuing Latvian Accounting Standards (LAS) consistent with IFRS and the acquis. Recently, the regulation-setting process has become more participatory where users and accounting professionals are more involved to contribute toward the development and the quality of the requirements for financial reporting. As part of transposing the new EU Accounting

Directive requirements into a Draft Annual and Consolidated Accounts Law, the MoF created a task force comprising representatives of various state institutions, professional organizations and business association which is considered to be more inclusive way for developing accounting regulations.

*The lack of comprehensive requirements for financial reporting undermines the quality of financial statements prepared by non-financial companies.*

The requirements for financial reporting are set out in the Annual Accounts Law, the Consolidated Annual Accounts Law and the regulations of the Cabinet of Ministers. However, the requirements for financial reporting are not comprehensive or detailed, some topics are missing (such as lease accounting and deferred taxes) and others lack sufficient guidance (e.g. how to identify intangible assets arising from a business combination or methodology to arrive

at asset impairment).

*The electronic filing system does not allow access to full sets of audited financial statements.*

All companies are required to fill out a number of online forms using data from their annual financial statements, and submit them to the State Revenue Service (SRS) each year. In turn, SRS forwards the information electronically to the Enterprise Register, which is then made available to the public upon request. However, the electronic filing system

does not allow for extraction of a full set of financial statements together with the auditors' report, which is a significant shortcoming in terms of ease of access to information.

*Audits are required to be conducted in accordance with ISAs, which are approved by LASA.*

The Law on Sworn Auditors requires that all auditors apply ISAs, as issued by the International Auditing and Assurance Standards Board, which are translated into Latvian and published by LASA. LASA has approved the Latvian translations of all assurance and related services standards effective as of 31 December 2014, apart from International Standards on Assurance Engagements 3410 and 3420, and

ISA 610 (revised 2013). LASA is continuously monitoring the standard setting process and is initiating translations as new pronouncements approach their effective date.

*Quality of accounting services, particularly of outsourced accounting services, is uneven. This is due, in large part, to an oversupply of professionals.*

There are approximately 7,000 business entities providing accounting services registered with the State Revenue Service, of which only 15 percent are members of one of the four professional organizations of accountants in Latvia: LASA, the Association of Accountants of the Republic of Latvia (LRGA), the Latvian Association of Accounting Outsourcing, and the Association of ISO Certified Accountants. The profession considers that there is an abundance of outsourced accounting service providers.

Accountants seek to distinguish themselves from their competitors to survive and establish market share, often achieved by lowering prices. In the audit services market, there are extremely competitive fees that have reduced significantly over the past few years. The downward trend in fee levels also suggests that a low premium is placed on accounting (and sometimes auditing) services on the part of companies.

*Entry requirements and continuing professional education requirements for the audit profession are in line with EU requirements and good international practice.*

Prospective auditors must have a university degree, three years of practical experience, and pass a professional examination in order to obtain an auditors certificate and become LASA members. They must also undergo at least 40 hours of continuing professional development (CPD) per year.

*The quality of accounting education in Latvia is sound.*

Latvia's accounting education system benefits from a well-designed curriculum and knowledgeable academic faculty. In order to maintain quality in the long run, Latvia would benefit from addressing the issue of falling enrollment and declining budgets for universities.

*A review of financial statements indicated that the financial statements of banks and insurance companies were of high quality, while the quality of financial statements of other companies was uneven.*

The ROSC team reviewed a sample of 30 financial statements and found that while the quality of IFRS-based financial statements for banks and insurance companies was of a high standard, those of listed companies was uneven. Some financial statements of companies reporting under Latvian Financial Reporting Regulations (LARR) were incomplete, contained errors, and did not include sufficient disclosures, in part due to the limitations of the electronic filing system.

*Enforcement of financial reporting requirements are stronger in the banking and insurance sectors; for the securities market, more robust enforcement is needed.*

The Financial and Capital Market Commission (FCMC) is responsible for verifying whether financial institutions and listed companies comply with financial reporting requirements. In practice, it focuses mainly on enforcing prudential requirements on banks and insurance companies. For listed companies, FCMC lacks the power to issue regulations in respect of financial statement preparation as this is under the Ministry of Finance competence.

*LASA has a well-established monitored peer review system for statutory audits.*

Since 2005, LASA has performed sworn auditor quality assurance reviews (QAR) at least every three years for auditors of financial institutions and listed companies, and at least once every five years for auditors of other companies.

*Specifically for PIEs, the QAR system needs strengthening in order to comply with the new Audit Directive.*

Particularly with regard to audits in PIEs and complex sectors, reviewers sometimes lack the specialized expertise required to meaningfully challenge the work of the sworn auditor. The peer review teams are constrained both in terms of the size of the team and the time allotted to complete the review. Selection criteria for determining sworn auditors subject to QAR is currently based on rotation rules, which are set forth *ex ante*, in a transparent manner. This basis of selection is not risk based and therefore should be updated to comply with the new Audit Directive.

*The Ministry of Finance (MoF) is responsible for public oversight of PIE auditors; it also oversees the activities of LASA through the Audit Oversight Commission (AOC).*

Seven MoF employees, comprising the three staff of the Audit Oversight Commission and four others, regularly inspect PIE audit QARs performed by LASA. MoF inspectors often accompany LASA reviewers to supervise the QAR process for listed companies and financial institutions. In addition, the MoF inspectors also monitor the non-PIE QARs performed by LASA. However, not all MoF inspectors have the necessary professional audit experience or relevant industry knowledge to conduct such inspections, or to be able to challenge the work carried out by LASA reviewers, and they have received insufficient training to develop their expertise. As a result, MoF inspectors largely rely on the methodology and audit expertise of LASA peer reviewers, which can compromise the independence of the QAR process. The current system falls significantly short of new EU Audit Regulation requirements (effective June 2016) that PIE quality assurance review systems be independent of statutory auditors and audit firms.

*The implementation of ISA remains a challenge for small and medium sized audit practices.*

Larger firms were generally found to carry out higher quality audits, supported by the findings from the QARs. Sole practitioners and small firms face greater challenges, as their limited resources are not always sufficient to keep up with technical developments in accounting and auditing. To reduce the “auditing standards compliance gap”, particularly for the smaller audit firms, LASA is currently looking into available ISA compliant audit software which it can offer to its members to be procured centrally. This would be complemented by specific capacity-building for auditors.

## Areas for Consideration

In order for Latvia to reap the full benefit from the reforms it has carried out over the last decade in corporate financial reporting and auditing, the following areas need consideration:

- Aligning the statutory framework with the Accounting Directive and Statutory Audit Directive (as amended 2014), particularly with regard to revising existing thresholds for small and medium enterprises.
- Raising the capacity, and thus independence, of the audit oversight by designating a competent authority with sufficient capacity to carry out the tasks required by the Statutory Audit Directive (as amended 2014)<sup>3</sup> and new Audit Regulation.<sup>4</sup>
- Enhancing LASA's quality assurance review system to make it risk-based and more independent of the auditing profession.
- Making accounting standards for non-PIEs more comprehensive or detailed. To that effect, Latvia should consider adopting the IFRS for SMEs.
- Upgrading the system by which companies file their annual financial statements to enable access to the full set of financial statements and audit reports by the public.
- Strengthening the FCMC's monitoring and enforcement of financial reporting requirements, particularly for listed companies.
- Establishing an approval mechanism for mentors providing practical experience training to future sworn auditors, monitoring the quality of practical experience provided, and verifying sworn auditors self-reported CPD hours.
- Implementing fully the audit software project that LASA in cooperation with the MoF within the FRTAP initiated in 2013 for its small and medium-sized audit firms and individual auditors.
- In the medium to long term policymakers should focus on the need to raise demand for high quality financial statements on the part of users as well as stimulate the strengthening of the qualifications of the PAOs so that accountants with a professional certification are recognized as having better skills whose services add value to the business.

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<sup>3</sup> Article 32 (1) of Statutory Audit Directive (as amended 2014) require Member States to organise an effective system of public oversight for statutory auditors and audit firms and to designate a Competent Authority responsible for such oversight.

<sup>4</sup> Article 20 (1) and (2) of Regulation No.537/2014 provide additional guidance on designation of Competent Authorities.

## I. Introduction

- 1 This assessment of accounting and auditing practices in Latvia is part of a joint initiative of the World Bank and International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and includes a review of both mandatory requirements and actual practice. This will be the second A&A ROSC for Latvia. The first one was published in 2005,<sup>5</sup> based on information collected between May and September 2004.
- 2 Latvia acceded to the European Union in May 2004, it graduated from the World Bank in 2007 and has ceased to be a World Bank borrower. As such the usual World Bank diagnostics and strategy documents such as a Country Partnership Strategy (CPS) are no longer prepared. The usual linkages between the ROSC A&A and World Bank strategies, economic and sector work, and projects are therefore not included here.
- 3 The Latvia ROSC A&A is a component of a broader financial reporting reform initiative, the Financial Reporting Technical Assistance Program (FRTAP), conducted at the request of the Latvian Government. Since 2009, Latvia has been receiving advisory services from the World Bank's Centre for Financial Reporting Reform (CFRR), funded by the Swiss Enlargement Contribution, to enhance the implementation of the portions of the *acquis* that relate to financial reporting and audit.
- 4 The main objective of this 2014 ROSC A&A is to record progress over the past nine years and support Latvia's continued alignment with EU requirements in this area, as well as to foster the ongoing development of its private sector. The ROSC will assess Latvia's implementation of the 2005 report recommendations (see Annex 1: Status of Implementation of the 2005 A&A ROSC Policy Recommendations). The *acquis* is constantly undergoing amendments and improvements. This report uses the 2014 *acquis* requirements, including the 2013 Accounting Directive, and the 2014 amended Statutory Audit Directive and Audit Regulation, as benchmarks so there may be slight variations when compared to the 2005 recommendations. In 2013 the Ministry of Finance of Latvia established a task force, comprised of representatives of various state institutions, professional organizations and business associations, to transpose<sup>6</sup> the new EU requirements so that they may be adequately reflected in the Latvian statutory and institutional framework and comply with the updated *acquis* (Box 2: Draft Annual and Consolidated Annual Accounts Law).

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<sup>5</sup> [http://www.worldbank.org/ifa/rosc\\_aa\\_lat.pdf](http://www.worldbank.org/ifa/rosc_aa_lat.pdf)

<sup>6</sup> In European Union law, transposition is a process by which the European Union's member states give force to a directive by passing appropriate implementation measures.

## A. Country Context

- 5 Latvia is a country in the Baltic region of Northern Europe, with a population of 2.03 million. Latvia regained its independence in 1991. It has been a member state of the European Union and the North Atlantic Treaty Organization (NATO) since 2004; it joined the eurozone on January 1, 2014. Latvia is a parliamentary republic, in which sovereign power belongs to the people as represented by a unicameral parliament (*Saeima*), with 100 members elected by direct, popular vote for a four-year period. The *Saeima* elects the president, also for a four-year term. The executive branch of government comprises the president, the prime minister (invited by the President and appointed by the *Saeima*), and the cabinet, which has to receive a confidence vote by the *Saeima*.
- 6 Latvia is a high-income country, with a Gross National Income (GNI) per capita of US\$14,120. Gross Domestic Product (GDP) is expected to grow 2.8 percent in real terms in 2014, approximately two percentage points lower than in 2013, due to much weaker external demand.<sup>8</sup> For 2015-18, the economy is expected to expand by an annual average of 4.3 percent, well below pre-crisis levels. The economy is led by the services sector - mainly financial services - and, including the tourism and retail sectors, accounted for nearly 75 percent of GDP in 2012. The transport and communications sectors, which have been greatly modernized in recent years, contributed 12 percent of GDP that same year.<sup>9</sup>
- 7 Latvia ranks highly in the ease of doing business (24<sup>th</sup> worldwide) and is ranked third in access to credit.<sup>10</sup> Latvia has implemented a series of ambitious reforms in recent years, aimed at reducing start-up costs, tax collection, and streamlining insolvency procedures by introducing out of court settlements for insolvencies. As a result, the country has improved the effectiveness of starting a business (ranked 57<sup>th</sup>), paying taxes (ranked 49<sup>th</sup>), trading across borders (17<sup>th</sup>) and resolving insolvency (ranked 43<sup>rd</sup>). At the same time, it has become more difficult to register property (33<sup>rd</sup>) and its ranking has fallen on protecting investors (68<sup>th</sup>) compared with Doing Business 2013 indexes - 29<sup>th</sup> and 67<sup>th</sup> respectively.

## B. Corporate Sector

- 8 Micro, small, and medium-sized companies<sup>11</sup> represent 98.4 percent of all registered companies in Latvia, the majority of which are active in the transport and manufacturing sectors. Large-sized enterprises represent only 1.6 percent of the formal companies but employ 22 percent of the workforce and generate 23 percent of total turnover. In the middle segment, 10,000 small and medium sized enterprises (SME) play an important role, accounting for 14 percent of formally registered firms, but generating about 57 percent of total turnover. Micro firms (1 to 9 employees) account for the vast majority of firms (85.7 percent) and contribute 20 percent of corporate sales. The number of micro enterprises has increased rapidly since the crisis as a consequence of unemployment. The number of micro firms grew by a cumulative rate of 19 percent between 2005-2011. In terms of economic activities, 31 percent of micro-

<sup>7</sup> Source: World Development Indicators, 2012 figure.

<sup>8</sup> Source: Economist Intelligence Unit's Country Report for Latvia, 3<sup>rd</sup> Quarter 2014.

<sup>9</sup> Source: Europa World Online.

<sup>10</sup> <http://www.doingbusiness.org/data/exploreeconomies/latvia>

<sup>11</sup> The size thresholds for micro, small, medium-sized and large companies are provided in Table 2: Company size thresholds in Latvia.

firms, and 46.8 percent of SMEs operate in the manufacturing sector, 24 percent and 23 percent in the transport sector, respectively.<sup>12</sup>

## C. Financial Sector

- 9 The financial sector in Latvia is dominated by commercial banks with a strong presence of foreign banks. There were 17 banks and nine EU bank branches in Latvia at the beginning of 2014.<sup>13</sup> Latvia's financial sector is well integrated into the EU financial system, particularly through its strong linkages to Nordic financial groups; 54 percent of the banking assets are owned by subsidiaries and branches of European Economic Area banks. Banks remain the most important financial institutions in Latvia, accounting for 90 percent of financial system assets. About 8 percent of the banking sector assets are controlled by the sole state-controlled bank, Citadele.
- 10 The securities market plays a marginal role in financing the Latvian economy. Market capitalization of the Riga Stock Exchange<sup>14</sup> was USD 1.3 billion, equal to approximately 5 percent of GDP in 2012. Corporate shares accounted for the vast majority of market capitalization. There are two listing segments on the stock exchange: the Main List and the Secondary List. The Main List comprises the "blue-chip" companies. To be eligible for inclusion, a company must have at least three years of operating history, market capitalization of at least EUR 4 million, and a free float of 25% or worth at least EUR 10 million. Companies listed on the Main List are required to report under International Financial Reporting Standards (IFRS) as endorsed by the EU. The Secondary List comprises companies that do not meet quantitative admission requirements (e.g., free float, capitalization). There were 30 share issuers (five companies on the main list, and 25 on the secondary list) and six bond issuers. The listed debt security market remains dominated by government issuances and this indicates that there is only a limited source of funding for private companies.
- 11 The non-banking segment of the Latvian financial sector remains small compared to the euro area average (approximately 10 percent of the financial sector) and has grown slowly.<sup>15</sup> There were 20 insurance companies (7 local and 13 branches of foreign insurers) operating in Latvia in 2013, of which seven life insurance undertakings accounted for 1.6 percent of the financial sector. Insurance premiums comprise 2 percent of GDP and 54 percent of the share capital was owned by foreign investors<sup>16</sup>. Other entities providing financing (such as leasing, factoring and credit unions) comprise 5 percent of the total financial sector.
- 12 The Financial and Capital Market Commission (FCMC) is responsible for financial supervision. The FCMC supervises Latvian banks; credit unions; insurance companies and insurance brokerage companies; as well as private pension funds, payment institutions, electronic money institutions, investment management companies, investment brokerage firms and alternative investment funds managers. It is also the securities market regulatory authority in Latvia. FCMC may approach the Latvian Association of Sworn Auditors (LASA) with

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<sup>12</sup> Financial Sector Assessment, June 2012.

<sup>13</sup> Per information provided from Financial and Capital Market Commission (FCMC), March 2014.

<sup>14</sup> The Riga Stock Exchange belongs to the NASDAQ OMX group and uses a single trading platform together with other exchanges in the Baltic-Nordic region.

<sup>15</sup> Financial Sector Assessment, June 2012.

<sup>16</sup> Per information provided from Financial and Capital Market Commission (FCMC), March 2014.



inquiries or investigation requests in connection with PIE audits, and it is LASA's responsibility to review the cases and report on results of investigations.

#### **D. State-owned Enterprises**

- 13 State-owned enterprises (SOEs) represent a large portion of the Latvian economy. At the end of 2012, the state owned, directly or indirectly, stakes in 94 companies, representing USD 5.3 billion in total assets, combined turnover of USD 4.7 billion and employed 54,802 workers. Energy sector SOEs make up the largest share of aggregate SOE value (54%), followed by finance (9.5%), telecommunications (9.1%) and transportation (6%). The SOEs share in GDP was 18.16% and SOEs employed 6.5% of the workforce.
- 14 Latvia recently passed a new law on SOEs, which introduces a number of requirements relating to governance and financial reporting. The new law, "Public Persons Enterprises and Capital Shares Governance Law," was passed on October 16, 2014, and will take effect as of January 1, 2015. Among its provisions, it (a) establishes an entity for coordinating state ownership; (b) requires SOEs to publish their full annual financial statements and audit report; (c) requires SOEs to establish a supervisory board provided net turnover exceeds Euros 21 million and balance sheet total exceeds Euros 4 million and (c) requires aggregate reporting on the SOE sector on an annual basis. SOEs are required to follow the same financial reporting requirements as their private sector counterparts.

## II. Institutional Framework<sup>17</sup>

### A. Statutory Framework

- 15 This section describes the statutory framework for corporate financial reporting and benchmarks it, where relevant, to the EU *acquis communautaire*. The statutory framework is an important element for creating adequate standards and requirements for various types of entities in Latvia. It should be compliant with EU requirements and good international practice, including setting formal requirements for financial reporting that aim to support economic decisions. It should also facilitate economic development and be less of an administrative burden, especially for smaller entities that only need basic information for them and their users to be able to take relevant economic decisions. Thus, a robust statutory framework is essential for setting a good financial reporting infrastructure and in facilitating the supply of good financial information to the market.

#### Overview of the Statutory Framework

- 16 Latvia has adopted the portions of the EU *acquis communautaire* currently in force that relate to accounting, financial reporting and auditing. Latvian accounting requirements are governed by national laws and regulations of the Cabinet of Ministers. The Law on Accounting is the main law in the field of accounting and sets forth basic accounting and bookkeeping rules that must be followed by all companies, regardless of size or industry (covering topics such as who is responsible for accounting, what currency should be used, how accounting should be performed, etc.). Requirements for financial reporting are set out in the Annual Accounts Law, the Consolidated Annual Accounts Law and the regulations of the Cabinet of Ministers<sup>18</sup>. The requirements of the Fourth EU Company Law Directive are reflected in the Annual Accounts Law, which contains a number of rules pertaining to legal entity financial statements of non-financial companies (regardless of legal form, including sole proprietorships above a certain size). The Consolidated Annual Accounts Law reflects the requirements of the Seventh EU Company Law Directive and states the requirements for consolidated financial statements. Financial institutions are not subject to these two latter laws; there are industry-specific laws

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<sup>17</sup> This report outlines the legal principles applicable with regard to accounting, auditing and financial reporting and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those rendering it.

<sup>18</sup> The regulations of the Cabinet of Ministers determine the following: (i) the content and procedures for drawing up a cash flow statement and a statement of changes in equity; (ii) the procedures by which events as of the balance sheet date, change of the accounting policy, changes in accounting estimates and corrections of mistakes shall be reflected in financial reports; (iii) the procedures by which income from the sale of goods and provision of services, transfer of company's assets for the use to other persons, acquiring income from interest, royalties and dividends, shall be accounted and evaluated; (iv) the methods for accounting and evaluation of fixed assets and investment property and the procedures for the reflection of the costs related thereto; (v) the criteria and methods for evaluation of the reserves, accumulated income, accumulated liabilities, contingent liabilities and contingent assets; (vi) the procedures by which a company, which is a contractor of a construction contract or a performer of work of another long-term contract, shall account and evaluate income and expenditure related to the construction contract or another long-term contract; (vii) the procedures by which extraordinary dividends shall be accounted and reflected in financial reports; and (viii) the procedures regarding receipt of financial support (financial assistance) from the State, local government, the European Community, other international organisations and institutions, and the reflection of donations and gifts of money or kind in the annual accounts.

as well as regulations issued by FCMC that govern the requirements applicable to banks, insurance companies, pension funds, investment funds, etc. The Law on Sworn Auditors transposes the Statutory Audit Directive (SAD).

- 17 Latvia must transpose the requirements of the recent Accounting and Audit Directives over the next two years and prepare for the requirements of the new Audit Regulation, which take effect in 2016. There are a number of new financial reporting and audit requirements in the *acquis*. These must be incorporated in the statutory framework by July 2015 for the 2013 EU Accounting Directive<sup>19</sup>, and by June 2016 for the 2014 EU Statutory Audit Directive<sup>20</sup>. The 2014 Audit Regulation, which does not need to be transposed into national legislation, will also take effect in June 2016<sup>21</sup>. The main gaps to be addressed are: (i) raise SME thresholds; (ii) make the quality assurance system fully independent of the reviewed auditor and introduce a risk-based system for selecting auditors for review; (iii) establish a list of non-audit services (including tax services, accounting and bookkeeping services) that statutory auditors are prohibited from providing to the audited entity; and (iv) the audit oversight body (MoF) must establish an effective quality assurance review system for PIEs that is independent of audit firms and auditors. Additionally, while there is a need for a legal definition for PIEs; a draft law amending the Law on Sworn Auditors and instituting such a definition has been submitted to Parliament for approval, as of the writing of this report. More detailed lists of divergences between the Latvian statutory framework and the requirements of the new EU legislation are provided in Annexes 2 and 3.
- 18 **Latvia's legal framework differentiates between requirements applicable to listed companies and financial institutions and those for smaller companies.** Companies with substantial public interest have more extensive reporting obligations and face greater requirements, including the need for an annual financial statement audit. Latvia is in the process of instituting a legal definition of public interest entities through a proposed amendment to the Law on Sworn Auditors and other legislation<sup>22</sup>, in order to align with the new EU Directives and Regulation. Under the proposed amendment to the Law on Sworn Auditors (which must be approved by Parliament), financial institutions and listed companies would be defined as PIEs as well as other designated undertakings of significant public interest. Large non-listed and non-financial state-owned enterprises (SOEs) would not be PIEs and would continue to follow the requirements of general companies. Given that SOEs represent a large portion of the Latvian economy as well as the public accountability aspect involved, these may need to be considered for inclusion within the PIE definition as well.
- 19 Small and medium enterprises (SMEs) are subject to less strict requirements, in line with EU Directives; however, the thresholds for SMEs in Latvia must be raised significantly **in order to comply with the EU's new mandatory thresholds**. All companies (including sole proprietorships with annual revenues in the previous year exceeding EUR 300,000) are subject to the requirements of the Annual Accounts Law. Small and medium companies are exempted from preparing certain financial reports and from a number of disclosures. However, all companies, except small companies and microenterprises are required to undergo an annual

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<sup>19</sup> Directive 2013/34/EU.

<sup>20</sup> Auditing Directives 2014/56/EU, 2008/30/EC and 2006/43/EU.

<sup>21</sup> Regulation 537/2014.

<sup>22</sup> Law on undertaking's active in the extractive industry and undertaking's active in logging of primary forests that report on payments to governments (not yet enacted).

statutory audit. All listed companies, regardless of size, must be audited.<sup>23</sup> More information on SME requirements are available in table 1 and 2.

- 20 For companies outside of the financial sector, requirements for financial reporting are set out in the Annual Accounts Law, the Consolidated Annual Accounts Law, and several Regulations of the Cabinet of Minister. Between 2004 and 2010, Latvian Accounting Standards (LAS) consistent with IFRS and the *acquis communautaire* had been issued, however these were repealed in 2011. There is common agreement among practitioners that the current financial reporting regulations are not comprehensive or do not provide sufficient guidance to preparers and auditors. In practice, some accountants refer to the old Latvian Accounting Standards (issued 2004 - 2010) or IFRS, but these can be used merely as “best practice guidance” since they have no legal backing and cannot be enforced. More information on this issue can be found in paragraphs 55-56.

### Company Law Requirements

- 21 The Commercial Law, based on European Company Law Directives, regulates business activities in Latvia. The Commercial Law, which was last amended in January 2014, recognizes four types of companies: general partnerships, limited partnerships, limited liability companies and stock companies. Most companies in Latvia are incorporated as limited liability companies (SIA).

- Limited liability companies,<sup>24</sup> have shares which are not publicly tradable. Limited liability companies generally have a small number of shareholders and a minimum capital of EUR 2,800. Limited liability companies generally have a single-tier board structure (consisting of a board of directors) (which comprises both executive and non-executive members), and are required to hold an annual meeting of shareholders (AGM). However, the articles of association may provide for the establishment of a supervisory board, or council, which is responsible for supervising the activities of the management board.
- Joint stock companies, or corporations,<sup>25</sup> have shares which may be publicly traded. Stock companies generally have a larger number of shareholders and a minimum capital of EUR 35,000. Joint stock companies are required to have a two-tier board structure: management board and council (supervisory board).

- 22 In banks and insurance companies members of both the management board and supervisory board are collectively responsible for the probity of financial statements. In other companies the management board or board of directors are responsible, with the supervisory board as a reviewer. The annual financial statements of companies are required to be signed by the board of directors.<sup>26</sup> In a two-tier board structure, the supervisory board is also required to review the financial statements.<sup>27</sup> For banks and insurance companies, both

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<sup>23</sup> Art. 62 of the Annual Accounts Law.

<sup>24</sup> Division XII of the Commercial Law governs limited liability companies.

<sup>25</sup> Division XIII of the Commercial Law governs stock companies.

<sup>26</sup> The Commercial Law (Section 174) and Annual Accounts Law (Section 61) stipulate that the board of directors must sign the annual financial statements of a company. The Commercial Law goes on to state that the board of directors is “collectively liable for losses caused as a result of false information submitted to the Register of Enterprises” (Section 165).

<sup>27</sup> Section 175 of the Commercial Law

management and the supervisory board are explicitly responsible for the probity of financial statements, per FCMC rules.

- 23 Shareholders are required to approve the legal entity and consolidated financial statements of a company. The Commercial Law requires that the AGM approve the financial statements of a company and the distribution of profits.<sup>28</sup> The Consolidated Annual Accounts Law also requires that shareholders approve the consolidated financial statements of a company.<sup>29</sup> The members of the board of directors of a limited liability company, and members of the supervisory board of a joint stock company (who in turn appoint management board members) are appointed at the AGM, as is the auditor.<sup>30</sup>
- 24 The following table summarizes the requirements relating to accounting, audit, and reporting by Latvian enterprises and should be read in conjunction with paragraphs 25-37.

Table 1: Summary of financial reporting, auditing and publication requirements in Latvia

	Regulatory agency	Accounting standards	Audit requirements*	Submission and Publication of F/S
<b>Listed companies</b>				
Main list	FCMC	IFRS for consolidated and legal entity	Audit required	Within 4 months of year-end to Central Storage of Regulated Information System and Riga Stock Exchange; submit also to the State Revenue Service which submits to Enterprise Registry
Secondary list		IFRS for consolidated; Annual Accounts Law and Cabinet Regulations for legal entity	Sworn auditor or responsible sworn auditor <sup>31</sup> rotation required after 7 years with 2 years cooling off	

<sup>28</sup> Section 213 and 269 of the Commercial Law.

<sup>29</sup> Section 32 of the Consolidated Annual Accounts Law.

<sup>30</sup> Section 210 and 268 of the Commercial Law.

<sup>31</sup> Sworn auditor rotation is required in case the audit is performed by a sole proprietor audit practice, or in case of audit company with two or more practitioners, the rotation applies to the assigned responsible sworn auditor of the engagement.

	Regulatory agency	Accounting standards	Audit requirements*	Submission and Publication of F/S
<b>Non-listed companies</b>				
Micro and Small		Annual Accounts Law; Consolidated Annual Accounts Law; Cabinet Regulations	No statutory audit	Micro, small and medium - within 4 months from reporting year end to State Revenue Service (SRS)
Medium			Audit required	
Large			Audit required	
Banks	FCMC	IFRS for consolidated and legal entity	Audit required: Sworn auditor or responsible sworn auditor rotation required after 7 years with 2 years cooling off	Within 3 months to SRS, which submits to Enterprise Register
Insurance	FCMC	IFRS for consolidated and legal entity	Audit required: Auditor rotation required after 7 years with 2 years cooling off	By May 15 (legal entity) or within 7 months (consolidated) to SRS, which submits to Enterprise Register
State-owned enterprises	SOEs are required to follow the same requirements as their private sector counterparts			

\* Consolidated financial statements must always be audited.

### Requirements for General Companies

- 25 The Annual Accounts Law is the main piece of legislation regulating the annual legal entity financial statements of nonfinancial companies. It applies to all commercial companies and sole proprietorships with annual revenues exceeding EUR 300,000 the preceding year. Banks, insurance companies, pension funds and other financial institutions under the purview of FCMC are not governed by this law.

- 26 The Annual Accounts Law requires companies to prepare annual financial statements comprising a balance sheet, profit and loss account, statement of changes in equity, cash flow statement, and notes, as well as a management report.<sup>32</sup> The complete set of financial statements, together with the management report and the audit report, must be submitted electronically or in paper form to the State Revenue Service (SRS) within four months (for small and medium-sized companies) or seven months (for large companies). The law also sets out detailed requirements on the content of financial statements and valuation rules.
- 27 Non-listed microenterprises and small companies are exempted from a number of requirements, including from the need to prepare certain financial reports and from statutory audits, and some simplifications are allowed. Such exemptions do not apply if a microenterprise or small company is listed. The existing definitions of micro, small, medium, and large companies in Latvia are below the mandatory size thresholds for MSMEs set out in the 2013 EU Accounting Directive, which removes the option for Member States to adjust thresholds according to the size and nature of their national economy. The definitions of MSMEs and their financial reporting and audit requirements are summarized in the table below.

Table 2: Company size thresholds in Latvia<sup>33</sup> (*EU thresholds per new Accounting Directive in italics*)

	Balance sheet total	Net turnover	Average employees	Comments*
Micro <sup>34</sup>	≤ EUR 50,000 <i>(&lt; EUR 350,000)</i>	≤ EUR 100,000 <i>(&lt; EUR 700,000)</i>	≤ 5 <i>(&lt; 10)</i>	<ul style="list-style-type: none"> <li>• Must prepare balance sheet (may be abridged) and profit and loss account.</li> <li>• Exempted from preparing management report, cash flow statement, statement of changes in equity, and notes. Not required to calculate deferred tax assets and liabilities.</li> <li>• Allowed to present gross profit combining the items – net turnover and cost of sales / cost of materials</li> <li>• Exempted from statutory audit.</li> <li>• 4 months after year-end (or at most one month after holding AGM).</li> </ul>

<sup>32</sup> According to Art. 55 of the Annual Accounts Law, the management report is required to include financial performance indicators, as well as information on material risks for the company looking forward. Other relevant information such as significant events, future development plans, and use of financial instruments should be included here.

<sup>33</sup> Two of the three criteria shall be met to be classified in the respective category.

<sup>34</sup> Section 54<sup>1</sup> of the Annual Accounts Law sets forth the thresholds and most exemptions for this category of company. Section 62 of the Annual Accounts Law sets forth the audit exemption. Section 66 sets forth filing deadlines.

	Balance sheet total	Net turnover	Average employees	Comments*
Small <sup>35</sup>	≤EUR 400,000 ( <i>&lt; EUR 4 m</i> )	≤EUR 800,000 ( <i>&lt; EUR 8 m</i> )	≤25 ( <i>&lt;50</i> )	<ul style="list-style-type: none"> <li>• Must prepare balance sheet, profit and loss account and abridged notes.</li> <li>• Exempted from preparing management report, cash flow statement, and statement of changes in equity. They are also not required to calculate deferred tax assets and liabilities.</li> <li>• Allowed to present gross profit combining the items – net turnover and cost of sales / cost of materials</li> <li>• Exempted from statutory audit requirement.</li> <li>• 4 months after year-end (or at most one month after holding AGM).</li> </ul>
Medium	≤EUR 1.4 m ( <i>&lt; EUR 20 m</i> )	≤EUR 3.4 m ( <i>&lt; EUR 40 m</i> )	≤250 ( <i>&lt;250</i> )	<ul style="list-style-type: none"> <li>• Must prepare full set of financial statements.</li> <li>• Allowed to present gross profit combining the items – net turnover and cost of sales / cost of materials.</li> <li>• Exempted from certain related party disclosures.</li> <li>• Statutory audit required.</li> <li>• 4 months of year-end (or at most one month after holding AGM).</li> </ul>
Large <sup>36</sup>	>EUR 1.4 m ( <i>&gt; EUR 20 m</i> )	> EUR 3.4 m ( <i>&gt; EUR 40 m</i> )	>250 ( <i>&gt;250</i> )	<ul style="list-style-type: none"> <li>• Must submit legal entity and consolidated financial statements within 7 months of year-end (or at most one month after holding AGM).</li> <li>• Statutory audit required.</li> </ul>

\* Deadlines are for legal entity financial statements unless otherwise noted. All submissions are made to the State Revenue Service.

<sup>35</sup> Section 54 of the Annual Accounts Law sets forth the thresholds and most exemptions for this category of company. Section 62 of the Annual Accounts Law sets forth the audit exemption. Section 66 sets forth filing deadlines.

<sup>36</sup> Section 24 of the Annual Accounts Law sets forth the thresholds for this category of company. Section 66 sets forth filing deadlines.



- 28 The parent company of a group of companies is required to prepare consolidated annual financial statements with exemptions for small groups. The Consolidated Annual Accounts Law requires parent companies of non-financial conglomerate groups of companies to prepare consolidated annual financial statements comprising: a consolidated balance sheet, consolidated profit and loss account, consolidated statement of changes in equity, consolidated cash flow statement, and notes. Small groups of companies that do not exceed two of the following thresholds are exempted from consolidation requirements (*corresponding EU thresholds are in parentheses*): a balance sheet total of EUR 1.4 million (*EUR 4 million*); annual net revenues of EUR 3.4 million (*EUR 8 million*); and average number of employees of 250 (*50*). A parent company of a group of companies may prepare consolidated annual accounts in accordance with IFRS endorsed by EU. Consolidated financial statements must be submitted electronically or in paper form, together with the management report and audit report, to the State Revenue Service within seven months of the year-end.

### Listed Companies

- 29 The requirements for listed companies vary according to their listing segment on the stock exchange. As mentioned in para. 11, there are two listing segments on the Riga Stock Exchange: the Main List and the Secondary List. Companies on the Main List are required to apply IFRS, as endorsed by the European Commission, in both their legal entity and consolidated financial statements.<sup>37</sup> Companies on the Secondary List are required to apply endorsed IFRS in their consolidated financial statements, and must follow the requirements of general companies for their legal entity financial statements. The financial statements of listed companies are submitted to the State Revenue Service and published electronically on the Central Storage of Regulated Information.<sup>38</sup>
- 30 In addition to these annual reporting requirements, listed companies are required to prepare interim financial statements on a quarterly basis. These interim financial statements are not required to be audited and must be published no later than two months after the period-end. According to the Latvian Commercial Law, an interim report is also required when a company pays out extraordinary dividends.
- 31 Listed companies are also required to disclose significant events affecting the company. Examples of such disclosures include: changes of management and supervisory board members, changes of external auditors, statement of the auditor to withdraw from the audit, information on court cases and decisions, announcements of financial results or forecasts, significant investments, significant acquisitions, entering into or terminating important contracts, plans to change nature of activities etc.

### Banks and Insurance Companies

- 32 Banks are required to apply endorsed IFRS in their legal entity and consolidated financial statements; they must also abide by requirements of the Credit Institutions Law and FCMC regulations. Banks are required to prepare annual financial statements comprising a statement of financial position, statement of comprehensive income, statement of changes in

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<sup>37</sup> Section 56 of the Financial Instruments Market Law.

<sup>38</sup> Information system maintained by the FCMC, <http://www.oricgs.lv> or <https://csri.investinfo.lv/>

equity (capital and reserves), cash flow statement, and notes. Additionally, they are required to prepare a management report and statement of management responsibility<sup>39</sup> on an annual basis.<sup>40</sup> The audited annual financial statements of banks are required to be submitted to SRS, together with the audit report and an extract of the minutes of the AGM meeting that approved the financial statements, within ten days of their approval by the AGM and not later than three months of the year-end. The same deadlines apply for both legal entity and consolidated financial statements.

- 33 Insurance companies are required to follow endorsed IFRS and FCMC regulations in their annual legal entity and consolidated financial statements. Insurance companies are required to submit their audited legal annual financial statements, together with the management report and audit report and extract of the AGM minutes, to SRS within 15 days of AGM approval and no later than May 15. For consolidated financial statements, the deadline is within 15 days of AGM approval and no later than seven months of the year-end.
- 34 Banks and insurance companies also need to comply with interim reporting requirements. Banks and insurance companies are required to prepare quarterly reports in accordance with FCMC rules. These reports must present information on the company's financial position and performance, as well as a risk analysis and updated governance information when relevant.

### Statutory Audit

- 35 All companies—except small companies and microenterprises—are required to undergo an annual financial statement audit. Companies exceeding any two of the following thresholds are required to have their financial statements audited on an annual basis: balance sheet total >EUR 400,000; net annual revenues >EUR 800,000; and average number of employees > 25.

#### Box 1: Who is required to have an audit in the EU?

According to the EU Accounting Directive (2013/34), an independent audit of annual financial statements is required for all PIEs, large enterprises, and medium-sized enterprises established as limited liability legal entities. These categories are defined according to three criteria with numeric thresholds set in the directive (member states are given the option to raise two of the thresholds to differentiate between medium and small enterprises).

Small companies (including micro entities) are not required to undergo audit per the directive. But, under the principle of subsidiarity, member states can require (or continue to require) a financial statement audit from them.

<sup>39</sup> A statement of management responsibility is a document that states, among other things, explicitly that management takes full responsibility for the preparation and content of the financial statements. In the case of banks and insurance companies, the statement of management responsibility must be signed by both the chairpersons of the management board and the supervisory board.

<sup>40</sup> Article 77 of the Credit Institutions Law.

## Box 2 Draft Annual and Consolidated Accounts Law

A MoF established task force (comprising representatives of various state institutions, professional organizations and business associations) was created during 2013 to work on transposing the new EU Accounting Directive requirements into a Draft Annual and Consolidated Accounts Law. The draft law was announced at the State Secretary's meeting on November 27, 2014 and is currently being coordinated amongst various state institutions, Ministries and non-governmental organizations. After approval by the Cabinet of Ministers the law will be submitted to the parliament (Saeima) and will undergo three readings before being passed.

Some of the changes proposed with the Draft Law include: (i) aligning company and group size thresholds with EU requirements, (ii) reducing the financial reporting administrative burden for small companies, (iii) signing of accounts from the part of company accountant or outsourced accountant (with primary responsibility for the annual accounts resting on management), (iv) require mandatory audit for small companies above a certain size (i.e., if two of the following three criteria are exceeded for two consecutive years: total assets exceed EUR 800.000; net turnover in excess of EUR 1.600.000; average employees above 50), or if the company is state or municipality owned and has received state owned guarantees (v) introduce limited reviews for the smallest companies (below audit thresholds).

The final requirements may be different from those described above as the Draft Law is still open for changes and comments.

- 36 The Law on Sworn Auditors sets out how statutory audits must be conducted; it transposes the EU Statutory Audit Directive of 2006.<sup>41</sup> All audits are required to be conducted in accordance with International Standards on Auditing (ISA) recognized in Latvia. As stated in the Law on Sworn Auditors, ISAs recognized in Latvia are International Auditing Standards and other pronouncements relating to audit issued by the International Auditing and Assurance Standards Board, and approved by LASA. LASA has approved the Latvian translations of all assurance and related services standards as of December 2014. Thus, the 2014 Handbook of International Quality Control, Auditing, Review, Other Assurance and Related Services Pronouncements are the most recent ISAs approved by LASA and used in Latvia. Likewise, the IFAC Code of Ethics effective for 2014 has been translated and approved.
- 37 Listed companies and financial institutions face additional requirements pertaining to audit, including the need to form an audit committee (for listed companies) and to rotate the sworn auditor or responsible sworn auditor (for listed companies and financial institutions). FCMC has the right to request change of the external auditor of a bank. In case of audit of listed entities and financial institutions the sworn auditor or the responsible sworn auditor is required to rotate after seven years, with a two-year cooling off period. Listed companies are required to form an audit committee, with responsibilities including proposing an independent auditor and monitoring the financial reporting and audit process in the company.<sup>42</sup> Audit committees are elected by the AGM for a three-year period. There is no minimum number of members specified in law, and in fact there are some companies with audit

<sup>41</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts.

<sup>42</sup> Article 54.1 of the Law on Financial Instruments Market governs audit committees.

committees comprising only one member. At least one member of the audit committee must be independent, have relevant education, and at least three years of experience in accounting or auditing. Listed companies that are SMEs are exempted from forming an audit committee; the supervisory board is permitted to exercise these duties instead.

## Publication

- 38 The Enterprise Register is charged with ensuring that financial statements are publicly available. All companies are required to submit their annual and consolidated financial statements to the State Revenue Service (SRS); SRS then forwards the financial statements electronically to the Enterprise Register.<sup>43</sup> Within 5 days from receipt of accounts from the SRS the Enterprise Register publishes a statement in the official publication that the financial statements of the company are available at the Enterprise Register. A request may be submitted to the Enterprise Register (online or in person) to access the financial statements of a company for a small fee. Frequent users of financial statements prefer to subscribe to a third-party service that provides instant access to the information in a more user-friendly format.
- 39 Listed companies and financial institutions have additional publication requirements. Listed companies are required to publish their audited, annual legal entity and consolidated financial statements within four months of the year-end, but no later than the next working day after the auditor's audit opinion is issued. Interim and annual financial statements are published in the Central Storage of Regulated Information System, maintained by the FCMC. Issuers are also required to submit their financial statements to the Stock Exchange<sup>44</sup> and publish on their websites (provision of information to all recipients shall be performed at the same time to the extent possible). The financial statements of banks are required to be published on the banks' websites, or made available upon request, no later than April 1. The annual financial statements of insurance companies must also be published on the company's website no later than 15<sup>th</sup> May, and consolidated financial statements not later than seven months of the year-end.<sup>45</sup> The interim financial statements of banks and insurance companies are to be published on the company's website within two months of the end of the relevant period.<sup>46</sup>
- 40 There are some issues and limitations with the electronic filing system for financial statements which result in incomplete publicly available information. Companies are required to submit data from the full set of financial statements in a segmented way to SRS: (i) balance sheet, profit and loss account, cash flow statement, statement of changes in equity are entered into predetermined input forms, (ii) while notes to the financial statements, management reports, audit reports, information on approval of accounts by AGM are uploaded as separate files. This segmented uploading of files, and the requirement that companies file the statements in the predetermined input forms and not their original integrated format, makes it difficult to analyze the completeness of the information uploaded as well perform cross references between the statements, notes and audit opinion. The electronic filing system has additional limitations including: maximum file upload size limit, not being able to reflect prior period financial statements restatements using the predetermined input formats provided, etc.

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<sup>43</sup> Section 66 of the Annual Accounts Law.

<sup>44</sup> Per NASDAQ OMX Riga Rules on Inclusion of Financial Instruments and Trade at Regulated Markets of the Stock Exchange (issued in accordance with the requirements of the Law on Financial Instruments Market).

<sup>45</sup> Article 57 of the Law on Insurance Companies and Supervision Thereof.

<sup>46</sup> Article 104 of the Law on Insurance Companies and Supervision Thereof; and FCMC Regulation No 145 on preparation of public quarterly accounts of credit institutions.

The SRS plans to take action in the short term to enhance the electronic filing system and its accuracy by introducing possibility for the sworn auditor to review and approve the annual report filed in the system.

## B. The Profession

- 41 This section describes the development of the accounting and auditing profession in Latvia and its contribution to effective accounting and auditing institutional framework. Financial reporting infrastructure should support the country's economic development with a profession of a size and capacity adequate to serve the economy. Professional accountancy organizations should represent their members as well as contribute to the effective regulation of the profession.
- 42 It is estimated that there are around 7,000 entities registered with the State Revenue Service providing accounting services<sup>47</sup> of which only 15 percent are members of the four Latvian professional organizations of accountants. There are four professional organizations of accountants in Latvia: the Latvian Association of Sworn Auditors (LASA)<sup>48</sup>; the Association of Accountants of the Republic of Latvia (LRGA)<sup>49</sup>; the Latvian Association of Accounting Outsourcing<sup>50</sup> and the Association of ISO Certified Accountants<sup>51</sup>. The profession considers that there is an oversupply of accountants providing accounting services than the market requires, and that the quality of accounting services is often questionable. In the market for accounting services, there is a natural need for qualified accountants to distinguish themselves from their competitors in order to survive and establish market share. There are several ways to address this, including strengthening enforcement of accounting requirements by regulators and strengthening the qualifications of the PAOs so that accountants with a professional certification are recognized on a market basis as having better skills whose services add value to the business (an approach followed by Poland). In the audit services market, the fees are extremely competitive and based on research performed by the Riga Managers School<sup>52</sup>, have reduced significantly over the past few years.
- 43 The leading professional body for auditors is the Latvian Association of Sworn Auditors (LASA). LASA was founded in 1994 and is a full member of the International Federation of Accountants (IFAC) and *Fédération des Experts-Comptables Européens* (FEE). It has a wide range of responsibilities established in the Law on Sworn Auditors, including: (i) organizing professional examinations; (ii) issuing licenses for audit firms and auditors certificates for sworn auditors and thereafter quality controlling their work; (iii) organizing continuing professional education; (iv) reviewing disputes between sworn auditors and their clients, and (v) maintaining registers of auditors, including audit firms and individuals. In addition, the Law on Sworn Auditors stipulates that LASA may initiate disciplinary procedures and impose sanctions against sworn auditors at their own initiative or at the request of a competent court or complaint of a legal and natural person, for which it has an obligation to inform the MoF in

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<sup>47</sup> Of which app. 75 percent legal entities and 25 percent individuals, as per information estimated by the State Revenue Service (SRS).

<sup>48</sup> See <http://eng.lzra.lv/>

<sup>49</sup> See <http://lrga.lv/>

<sup>50</sup> See <http://www.latgraasa.lv/>

<sup>51</sup> See <http://www.gramatvezusc.lv/>

<sup>52</sup> "Overview on financial data of audit firms"; XVI Conference on Audit, Taxes and Accounting organized by the Riga Managers School.

writing. These functions are entirely financed by LASA's operational budget, which in 2013 was approximately USD 224,000, derived from membership fees (approx. 87 percent) and other sources, including examination, education and quality control fees.<sup>53</sup> According to the LASA articles of association, protecting public interest as well as fulfilment of the delegated responsibilities by the Law on Sworn Auditors are the main objectives of the Association.

- 44 In the 20 years since its foundation, LASA membership has grown by merely 96 auditors, indicating an ageing and reducing audit profession<sup>54</sup> The Latvian profession is dominated in numbers by small audit practices usually comprising of sole practitioners. There are 170 certified auditors (2005: 143), of which 12 have their certificates suspended, and 142 firms of certified auditors (2005:114). Audit is the most important line of business for small audit firms; however, certified auditors are permitted to perform other audit and non-audit related services, subject to independence requirements. Approximately 180 professionals based in Latvia have an international accountancy qualification issued by the UK Association of Chartered Certified Accountants (ACCA), however only 17 percent of these are members of LASA. The market for audit services has dropped by approximately 3 percent in 2012, as measured by reported revenues of statutory audit firms. The largest audit market share (approximately 75 percent) is held by affiliates of international audit firm networks. Information on audit fees is fully transparent as all companies subject to audit requirement must provide information on audit fees as a separate disclosure in the notes to the financial statements<sup>55</sup>.
- 45 LASA activities are directed by board. The main governing body of LASA is the general meeting of its members (i.e. the sworn auditors) who elect the Chairman, Deputy Chairman and eight board members. LASA employs a modern committee structure, including committees to address issues of accounting and auditing education, examination, ethics, and quality assurance. Each committee is chaired by a member of the board. LASA has 2 permanent staff, including an Executive Director who is appointed by the board. Representatives of the Ministry of Finance (MoF) and the Audit Advisory Council (AAC) are allowed to participate in general meetings, board meetings and committee meetings of LASA; however, they may not vote. In addition, MoF and AAC representatives have access to documents and decisions taken by LASA.
- 46 The ethical and independence requirements for auditors are in line with the IFAC Code of Ethics for Professional Accountants however there are challenges with practical implementation. These will need to be resolved in order to meet the requirements of new EU Audit Regulation. ROSC team discussions with auditors and preparers of financial statements revealed examples of issues with the separation of accounting and auditing work, with statutory auditors involved in the compilation and preparation of financial statements relating to non-routine calculations and procedures, such as consolidation procedures, preparation of cash flow statements, calculation of deferred taxes, application of certain accounting policies (e.g. percentage of completion method for revenue recognition, capitalization of interest), and formulating disclosures. This situation resulted from a lack of professionally trained accountants with good financial reporting skills as well as expectations from the clients (to receive such assistance as part of audit for the same fee). There were also cases in which auditors, while working full time for government or other institutions, did not

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<sup>53</sup> LASA Annual Report for 2013.

<sup>54</sup> "Overview on financial data of audit firms"; XVI Conference on Audit, Taxes and Accounting organized by the Riga Managers School.

<sup>55</sup> Annual Accounts Law, section 45(6).

suspend their certificates and performed one audit a year to keep active membership status with LASA. The provision of both audit and non-audit services to a client by a statutory auditor represents a risk of breach of generally accepted independence requirements; furthermore, such services have been prohibited for statutory auditors of PIEs under the new Audit Regulation, which takes effect in June 2016.

### Box 3: LASA compliance with IFAC SMOs

**SMO 1 - Quality assurance (QA):** LASA has implemented a quality control system based on the International Standard on Quality Control (ISQC1) since 2005, designed to review quality control at firm level and individual audit engagement level. The scope and design of LASA's QA system are available on their internet page and the Quality Committee of LASA publishes an annual report summarizing the results of the QA program.

**SMO 2 – International Education Standards (IESs):** Statutory auditors follow education requirements in line with the requirements set in IESs, they must have a bachelor degree, pass selected exams, meet a practical experience training period, and are required to participate in a CPD program each year. IESs were revised recently, and the new requirements will become effective in 2015.

**SMO 3 – International Auditing and Assurance Standards (IAASB) pronouncements:** Statutory auditors provide audit and assurance services in compliance with ISA and other relevant IAASB pronouncements. LASA plays an important role in the ISA adoption and implementation and is authorized to translate ISAs and other IFAC standards and publications.

**SMO 4 – International Ethics Standards Board for Accountants (IESBA) Code of Ethics:** LASA has adopted the latest IESBA Code on Ethics and has a focus on providing implementation assistance to its members via its Continuing Professional Development (CPD) program.

**SMO 5 – International Public Sector Accounting Standards (IPSAS):** Although the adoption of IPSAS is not in the scope and responsibilities of LASA, it has assisted with convergence in the public sector and was involved with IPSASs implementation process (translation and training). LASA is working closely with the State Treasury (Ministry of Finance) and the State Audit Office and a significant number of LASA members provide services to the public sector entities.

**SMO 6 – Investigation and discipline:** LASAs investigation and discipline mechanism is generally in line with SMO 6, although further efforts are needed to strengthen the linkages between the results of the quality assurance system (SMO 1) and the investigation and discipline mechanism (SMO 6).

**SMO 7 – International Financial Reporting Standards (IFRS):** Entities listed on the main segment of the regulated market and financial institutions are obliged to prepare their financial statements and consolidated financial statements in accordance with IFRS, as endorsed by EU. LASA provides its members with IFRS education materials, courses and an annual IFRS Update course covering the newly effective IFRSs and commonly identified IFRS implementation issues.

- 47 The Association of Accountants of the Republic of Latvia (LRGA) is another professional accounting body active in Latvia whose main objective is to improve the professional skills of accountants and carry out their certification. LRGA, comprising approximately 400 members, was founded in 1994 and became an associate member of IFAC in November 2013. Membership of LRGA is voluntary and open to all representatives of the accounting profession, including internal auditors, tax consultants, bookkeepers, members of the academia, etc. LRGA is advocating a licensing scheme for accounting services providers but, in the current absence of sufficient support, is implementing a voluntary certification process to highlight the quality and professional skills of accountants and raise the profile of LRGA members. The budget of LRGA is modest, approximately USD 53,000 annually, approximately 70 percent deriving from trainings, seminars and courses, and the remaining 30 percent from membership fees.<sup>56</sup>
- 48 The Latvian Association of Accounting Outsourcing has approximately 80 member-companies and individuals who provide accounting services. Similar to LRGA, the main objective of the Latvian Association of Accounting Outsourcing is to improve the quality and professional skills of accountants involved in public practice. A Memorandum of Intention was signed between the Latvian Association of Accounting Outsourcing and LRGA to merge their operations under one common accountancy professional body due to the synergy of their objectives. The merger was completed during August 2015.
- 49 The Association of ISO Certified Accountants is another organization of professional accountants in Latvia who accredit accounting firms and individuals via their own certification program. The association has approximately 140 members, mainly accountants certified via the ISO certification program, which is accredited by the Latvian National Accreditation Bureau. Membership is also open to sworn auditors and accountants holding recognized accounting certificates. ISO certificates have been issued to more than 500 accountants, however, not all of them have joined the Association of ISO Certified Accountants.

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<sup>56</sup> LRGA Annual Report for the year ended 31 December 2013.



## C. Academic Education, Professional Education, and Training

- 50 The requirements for becoming an auditor are set forth in law and are in line with the requirements of the EU Statutory Audit Directive and IFAC's IAESB International Accounting Education Standards Board. A prospective auditor must have a university degree in economics, management, or finance, obtained from a university in Latvia or abroad, be fluent in Latvian, and be at least 25 years old. They must have at least three years practical experience in auditing, having worked at least 720 hours per year for three of the previous five years. Any sworn auditor may act as a practical experience provider, and there is no mechanism for assessing the quality of providers. However, providers must inform LASA annually of the names of the trainees working for them. Candidates must also pass a professional examination, developed by LASA's Examination committee, and offered at least once a year. The examination comprises five sections (tax, law, audit, business administration and accounting). Few prospective auditors take the examination each year, which makes developing and delivering the examination quite costly, particularly on a per candidate basis. In 2013 there were 23 candidates, of which five passed all the examinations and acquired LASA certificates (a pass rate of 39 percent).
- 51 Undergraduate education is split into two tracks, and students may opt for either a **professional or academic bachelor's degree**. There are several universities in Latvia offering an accounting degree, the largest of which is the University of Latvia (UL) which offers both bachelor's and master's programs. They also offer some shorter, certificate programs. At the undergraduate level, the professional degree incorporates work experience in addition to coursework, and takes four years to complete, whereas an academic bachelor degree is a three-year program. Both count as fulfilling the university degree requirement for becoming an auditor. At UL, there are 80 students currently enrolled in the professional program, 20 in the academic, and 60 in the master's program. There are seven full-time professors (mostly teaching financial accounting), and six part-time professors teaching more specialized subjects such as budgeting, accounting in banks, accounting in insurance companies, and audit. The curriculum is geared toward the current requirements, i.e., Latvian Accounting Regulations (LAR), although in cases where there are gaps they also incorporate material on the now defunct Latvian Accounting Standards (LAS). General information on IFRS, US-GAAP, and ISA are also contained in the curriculum.
- 52 Despite being one of the most popular majors, the accounting department has been facing difficulties in attracting students and retaining highly qualified professors. Academics explained that tuition costs can be a barrier to a university education, particularly after the financial crisis. Additionally, the budget for the university is being cut consistently, which has had an impact on professor salaries. This has had a negative effect on attracting and retaining highly qualified professors. Another impediment academics noted is that there is a limit to the proportion of courses that can be taught in a language other than Latvian. Currently, up to 20 percent of coursework can be taught in other languages, such as English. Academics believe that if more coursework could be taught in other languages, their pool of potential professors could be expanded and their course offerings, also broadened.
- 53 LASA requires its members to undergo 40 hours of continuing professional development (CPD) annually, in line with IES 7. In 1997, LASA established its Education Center for delivery of CPD to its members, however does not require that all CPD hours be verified through trainings offered at the LASA Education Center. Auditors must report to LASA each

year the CPD courses attended over the previous year, including information on the training provider, topic and duration of the course, and outlining their training needs for the upcoming year. Each professional body sets CPD requirements in its bylaws. The Association of Accountants requires 50 hours of CPD per year, beyond what is required by IES 7.

- 54 LASA's monitoring of the quality of practical experience obtained by pre-qualification trainees and of CPD programs needs strengthening. A mentor, who is also a member of LASA, is appointed to each trainee, and this mentor is responsible for monitoring the quality of the trainees' practical experience. However, LASA has not established a mechanism for approving the mentors. In addition, LASA does not monitor the quality of practical training. Members report the CPD hours obtained but, other than for CPD hours attained through its own training center, the education committee of LASA does not monitor (even on a sample basis) whether members actually attended the CPD or check the quality of courses.

## D. Setting Accounting and Auditing Standards

- 55 The requirements for financial reporting are set out in the Regulations of the Cabinet of Ministers and in 2011 have replaced the Latvian Accounting Standards (LAS). Between 2003 and 2011, the Accounting Board<sup>57</sup> was drafting and issuing LAS<sup>58</sup> consistent with IFRS and the *acquis communautaire*. However, a legal ruling of the Ministry of Justice found that LAS could not be considered enforceable regulatory instruments, and therefore had no legal backing, so companies could not be required to apply them. The Law on Accounting was therefore amended to remove the mandate given to the Accounting Board with respect of setting accounting standards. As a result, in 2011, Regulations of the Cabinet of Ministers have replaced LAS in regulating the application of the relevant laws on financial reporting. The Cabinet of Ministers Regulations are, however, not sufficiently comprehensive or detailed. On the other hand LAS are outdated, since they have not been revised since their approval by the Accounting Board.
- 56 The Ministry of Finance is responsible for drafting Accounting Laws and Cabinet of Minister Regulations relating to accounting issues. Recently, the regulation-setting process has become more participatory where users and accounting professionals are more involved to contribute toward the development and the quality of the requirements for financial reporting. As part of transposing the new EU Accounting Directive requirements into a Draft Annual and Consolidated Accounts Law, the MoF created a task force comprising representatives of various state institutions, professional organizations and business association which is considered to be more inclusive way for developing accounting regulations.

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<sup>57</sup> The Accounting Board was financed by the State budget and consisted of twelve members representing the Ministry of Finance (2), LASA (2), higher educational establishments (2), FCMC, the Bank of Latvia, the State Revenue Service, the State Treasury, the State Control and the Association of Accountants of the Republic of Latvia.

<sup>58</sup> During the period of its operation, the Accounting Board issued eleven LAS: LAS 1, *Basic principles for preparation of financial statements*; LAS 2, *Cash flow statements*; LAS 3, *Post Balance sheet events*; LAS 4, *Changes in accounting policies and estimates, correction of errors*; LAS 5, *Long term contracts*; LAS 6; *Revenues*; LAS 7, *Property, plant and equipment*, LAS 8, *Provisions, contingent assets and contingent liabilities*; LAS 9, *Investment properties*, LAS 10, *Leases* and LAS 11, *Inventories*, LAS 1-9 being approved by the Cabinet of Ministers as mandatory

- 57 Audits must be conducted in accordance with ISA, which are translated and approved by LASA. The Law on Sworn Auditors requires that all auditors apply ISA as issued by the International Federation of Accountants (IFAC) approved by the Latvian Association of Sworn Auditors (LASA). LASA is responsible for translating ISA, and they use their own human and financial resources to do so. LASA approved the Latvian translations of all assurance and related services standards effective as of 31 December 2014, apart from International Standards on Assurance Engagements 3410 and 3420 and ISA 610 (revised 2013), for which permission to translate has been requested from the IFAC. Nevertheless, LACA members have been trained in the specific assurance standard changes effective for 2014. LASA has also requested permission to translate the 2014 Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements, and the IFAC Code of Ethics effective for 2014 has been translated and approved. LASA is continuously monitoring the standard setting process and is initiating translations as new pronouncements approach their effective date. The process of approving ISAs includes obtaining translation permits from IFAC; translating the standard into Latvian language and having this approved by the Board of LASA; publishing the standard on LASA internal website which can be accessed by LASA members only; and setting the date from which the standard shall be applied by LASA members.

## E. Ensuring Compliance with Accounting and Auditing Standards

### Accounting Standards

- 58 The electronic filing system facilitates processing of data mainly for tax purposes. Changes made to the Annual Accounts Law in 2008 aimed to reduce the reporting burden on companies. Financial statements are required to be filed with the State Revenue Service (SRS), who forward them to the Enterprise Registry for publication. The SRS ensure filing deadlines are met (failure to file accounts by the set term may attract fines imposed on all board members who are collectively responsible for annual accounts), and contain the required information (all components of the financial statements, management report, audit report, information on approval of accounts by AGM). SRS performs only basic checks of the information it receives, ensuring the required files are attached and other visual controls, and verifying arithmetic and cross referencing, before passing it electronically to the Enterprise Registry. It does not usually perform any other checks of submitted data, even on a sample or risk selection basis, such as whether the requirements of the financial reporting standards have been complied with; if the attached auditor's report in fact corresponds to the relevant financial statements, or whether the attached files are complete (e.g. all pages are included). More detailed analysis of submitted information may be undertaken by the tax control department of the SRS at a later stage if the particular tax payer is selected for tax audit procedures.
- 59 There are no controls to determine whether companies that should file consolidated accounts do so in practice. The SRS checks if companies that filed consolidated financial statements the previous year did so in the current year. However, if a company did not file the previous year, there is no way to determine whether it is required to do so in the current year, unless a third party (e.g., investors or lenders) files a complaint. As consolidated financial statements are not relevant for taxation, they are not the focus of SRS attention. Additional tools for identifying companies required to prepare consolidated financial statements ought to be considered. Companies could be asked to indicate if they have any subsidiaries and whether

they file consolidated accounts - requiring an explanation of the basis for exemption if not, such as specific reference to legislation - and enforcement mechanisms should be strengthened to ensure compliance.

- 60 The Financial and Capital Market Commission (FCMC) is the integrated regulator for financial institutions and listed companies; its powers are generally in line with those of financial sector supervisors in other European countries. The FCMC is an independent<sup>59</sup> public institution, which carries out the integrated supervision of the financial sector of Latvian banks, credit unions, insurance companies and insurance brokerage companies, private pension funds, payment institutions and electronic money institutions, as well as investment management companies, investment brokerage firms and alternative investment funds managers. It is also the securities market regulatory authority in Latvia. On the enforcement side, the sanctions it applies range from warnings and fines, to de-listings (in the case of listed companies) or license withdrawals (in the case of banks, insurance companies, and other financial institutions). The Financial Instruments Law caps fines for listed companies at approximately EUR 14,000, which may not be sufficient to deter non-compliance, particularly for larger listed companies.
- 61 FCMC may approach LASA with inquiries or investigation requests in connection with audits of financial institutions and listed companies **and it is LASA's responsibility to review the case and report on result of investigation.** It is also a statutory duty of sworn auditors of financial institutions, electronic money institutions or payment institutions under purview of FCMC to co-operate with FCMC (including through providing working papers and responding to requests for information), and to inform FCMC of breaches, as required by law. Auditors of a listed company have no duty to inform the FCMC of breaches.
- 62 For the financial sector, FCMC follows a risk based approach to supervision consisting of both off-site monitoring and on-site inspections. Both supervision methods are interlinked, responsible divisions cooperate closely and use risk assessment as the basis for planning and application of supervisory methods. There are a total of 25 enforcement staff (off- and on-site), which works out to one staff member for every two or three banks.<sup>60</sup> Banks and insurance companies are notified and asked to explain or resolve any discrepancies from the supervisors' standpoint. FCMC has the power to require a change in the auditor of a bank, but this has never been exercised. There was one recent case of significant non-compliance with legal requirements by a bank, including non-compliance with accounting requirements. The FCMC imposed restrictions on the rights and activities of the bank, suspended the provision of financial services, appointed a group of the authorized persons of the FCMC in the bank to perform ongoing monitoring. In the end, the bank's license was withdrawn by FCMC.

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<sup>59</sup> The Law on Financial and Capital Market Commission sets forth that FCMC is an independent institution. As such, the chairperson and deputy chairperson are appointed by Parliament—upon a joint proposal of the Minister of Finance and Governor of the Central Bank—for a set term of six years. FCMC funding comes contributions from financial market participants. Each year, FCMC must report on its performance, as well as submit its audited annual financial statements to Parliament.

<sup>60</sup> The departments responsible for enforcement in the banking sector are the Monetary Financial Institutions Operations Analysis Division (off-site supervision) and Monetary Financial Institutions Risk Assessment Division (on-site supervision and supervision of credit unions), both housed within the Supervision Department of FCMC.

- 63 In the case of the insurance sector, there are five staff monitoring compliance with financial reporting requirements,<sup>61</sup> although their main focus is on reviewing quarterly prudential reports. In recent years, they have applied a number of sanctions for non-compliance with accounting requirements, including suspending insurance licenses, withdrawing an insurance license, and proposing removal of the chairperson of a company. One insurer has been required to restate their annual financial statements.
- 64 Similar to many financial market regulators, FCMC follows an off-site supervision model where a sample of financial statements is reviewed each year to check the compliance with financial reporting and transparency requirements. Seven FCMC<sup>62</sup> staff members review the financial statements of listed companies. They use a method similar to audit firm reviews of the completeness of disclosures by companies preparing financial statements using IFRS and Latvian accounting regulations. Companies on the official list are included in the reviewed sample each year, while others are sampled based on rotation and risk factors, such as whether a qualified opinion had been issued. The rotation rule requires that the annual financial statements of all companies must be reviewed at least once in a four year-period, and the interim financial statements of all companies must be reviewed at least once in a two-year period. Recent sanctions have been applied for late filing of annual or interim financial statements. Penalties included warnings, admonition letters requiring corrective action, and fines ranging from EUR 1,420-7,115. FCMC may apply fines up to EUR 14,200 for violations of financial reporting requirements.
- 65 FCMC does not currently exercise its full range of legal powers to ensure that issuers' financial statements meet the required standard. For example, the right to require review of the auditors' working papers has never been exercised. On the other hand, it lacks certain powers that are common for such a supervisory body, such as the power to issue its own regulations regarding financial statement preparation for listed companies (FCMC must submit a request for a new regulation to the Ministry of Finance, who may then issue it in the form of an amendment to a relevant law); it also lacks the power to require a listed company to change its external auditor.

## Auditing Standards

- 66 The public oversight and quality assurance system in Latvia is implemented at three levels (i) oversight and external inspections by government authorities: the Ministry of Finance (MoF); (ii) quality assurance by the professional organization level: the Latvian Association of Sworn Auditors (LASA); and (iii) promoting higher audit quality at the level of the Audit Advisory Council (AAC).<sup>63</sup> The MoF is the main institution responsible for public oversight. It oversees the activities of LASA through the Audit Oversight Commission (AOC).<sup>64</sup> LASA both licenses and is responsible for performing quality assurance of all sworn auditors and commercial companies of sworn auditors.

## Quality Assurance

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<sup>61</sup> Insurance Division under the Supervision Department of FCMC.

<sup>62</sup> The Financial Instruments Market Division, under the Supervision Department, is responsible for monitoring and enforcement of financial reporting requirements in listed companies.

<sup>63</sup> <http://www.fm.gov.lv/en/s/auditing/>

<sup>64</sup> The AOC is a collegial body within the MoF and does not have a status of a legal person.

- 67 **LASA’s quality assurance review (QAR) model is based on a “monitored peer review” system.** About 20 LASA reviewers perform QAR of all sworn auditors. The QAR system is overseen by a seven-member Quality Committee, which is responsible for compiling and maintaining the list of qualified peer reviewers, the annual plan for QAR, as well as the individual results and conclusions of the reviews. Peer reviewers are LASA members and practicing sworn auditors with at least three years audit experience (and not subject to sanctions in the last three years) who have completed a mandatory quality assurance training organized by LASA. Reviewers must adhere to confidentiality rules in performing their QAR.
- 68 LASA performs QAR of sworn auditors and commercial companies of sworn auditors at least once every 5 years, while sworn auditors and commercial companies of sworn auditors of financial institutions and listed companies are subject to QAR at least once every 3 years. LASA uses a comprehensive questionnaire to document findings of QAR performed at the statutory practice level and at the engagement review level. The reviewers issue grades on a three-point scale (A: satisfactory; B: minor issues found; C: significant issues found). Auditors graded a “C” will automatically be subject to a review the following year.<sup>65</sup> Resources to fund the QARs are fully sourced by LASAs operating budget<sup>66</sup> and are therefore limited.
- 69 LASA reviewers do not always have the experience and expertise to perform QARs in specialized sectors (e.g., banking, construction) and sometimes lack appropriate training in sophisticated IT audit packages and sampling tools to enable them to meaningfully challenge the work of the inspected sworn auditors. Peer review teams are small in size, usually constituting two professionals, and are required to complete the QAR and document their findings within one to two days. LASA should consider inviting specialist personnel to assist in the QAR of audits in specialist sectors, perhaps including representatives from the financial industry regulators (i.e., FCMC). LASA would also benefit from expanding its range of experience through, for example, visits, exchanges or secondments with QAR teams of other European professional accountancy bodies, as well as specialized training in sophisticated IT audit documentation and sampling tools.
- 70 LASA’s methodology for QAR should be enhanced to include risk-based selection criteria for reviews and extend its outreach to include other assurance engagements beside audits. There is currently no element of surprise in determining sworn auditors subject to QAR. LASA might want to enhance the QAR selection criteria to take into consideration risk-based indicators such as: risks identified during the previous year’s QAR, statistics on engagement revenue and hours incurred (e.g. significant concentrations or unusual statistics compared to market), type of audit opinion issued, and the client portfolio risk. Also, at the engagement level, only audits of annual accounts are selected and subject to inspection checks, while other assurance engagements are out of scope during the regular QAR. When other assurance work represents a significant source of income for the auditor, the QAR methodology should be further developed to include such engagements on a sample basis.

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<sup>65</sup> Auditors who are graded a B had minor problems, generally with the wording in the audit report. In these cases, the auditor is required to submit all audit reports containing qualifications or emphasis of matter paragraphs in the subsequent year to LASA.

<sup>66</sup> Unless a grade “C” and repeat review is required, in which case the sworn auditor is charged the costs of the repeat audit.

- 71 The implementation of ISA remains a challenge for small and medium sized audit practices. Forty one sworn auditors were subject to QAR during the period May – December 2013, of which 35 were regular QAR and six were extraordinary.<sup>67-68</sup> The most frequent deficiencies arising from the QAR relate to: (i) no written communications with predecessor auditor during the client acceptance process; (ii) inadequate documentation regarding procedures on opening balances during first time audits, going concern assessment, related party transactions and fraud risk; (iii) vague wording used in modified audit opinions; (iv) audit agreements in certain cases include vague wording on client and auditor responsibility; (v) lack of appropriate and sufficient documentation regarding communications with management; (vi) inadequate work done or documented on significant disclosures in the financial statements. Over the last 3 years the Ethics Committee has made 29 rulings based on disciplinary actions:

Table 3: Disciplinary actions over the past three years.

Year	Total rulings	Warnings	Reprimands	Suspension	Cancellation
2011	13	6	6	1	-
2012	9	2	2	5	-
2013	7	2	1	3	1
Total	29	10	9	9	1

### Public Oversight

- 72 The Ministry of Finance (MoF) is the main institution responsible for public oversight and, through its Audit Oversight Commission (AOC), MoF oversees the activities of LASA. The AOC is a collaborative body established in 2012 and does not have legal personality; it operates as a separate Commission under the Department of Taxes Administration and Accounting Policy within the MoF. Up to December 2014, AOC is comprised of three professionals employed by the MoF: the Head of the AOC (senior expert on auditing), one senior desk officer and one legal counsel. Starting December 2014, a senior expert from the European Union Funds - Audit Department assists the AOC department. Besides overseeing LASA activities, AOC responsibilities also include drafting laws in the field of auditing, co-operation with institutions of other EU<sup>69</sup> countries in the field of audit, coordinating the authorized representatives of the MoF who perform inspections of compliance with the quality control requirements over sworn auditors of PIEs, report on the findings of the compliance reviews and issue recommendations.
- 73 MoF regularly inspects QARs of PIE audits performed by LASA. Up to October 2014, the MoF has seven staff, three of which are members of AOC who, in addition to other

<sup>67</sup> Extraordinary reviews are either a follow up review due to low grade the previous year, or may be initiated by LASA Committee and approved by the Board.

<sup>68</sup> Source: Summary Report on the Quality Control Reviews, March 2014, Quality Control Commission.

<sup>69</sup> AOC participates in the meetings of the EU Audit Regulatory Committee (AuRC), the European Group of Auditors' Oversight Bodies (EGAOB), European Audit Inspection Group (EAIG) and is a member of EAIG.

responsibilities at the Ministry, accompany LASA reviewers to supervise the QAR process.<sup>70</sup> Following October 2014, the MoF has reduced the number to four inspectors, two of which are members of AOC. Inspections can be conducted both on-site (usually jointly with LASA QAR), or off-site, through a request to review the documents and information collected by the LASA reviewers or as separate independent inspections. During 2013, twelve regular inspections and one extraordinary inspection were performed, of which six were off-site and seven were on-site inspections.<sup>71</sup>

- 74 Most MoF staff who supervise the QARs lack the requisite professional audit experience as well as specific industry knowledge to conduct such inspections, and thus rely on the methodology and audit expertise of LASA peer reviewers. Further, the few who do have audit experience either have limited availability for inspection work due to other duties within the MoF's European Union Funds - Audit Department, or their skills and knowledge are not always effectively used. In light of recent EU audit reform and the new Auditing Directive<sup>72</sup> and Audit Regulation<sup>73</sup>, which require that the Public Oversight should establish a QAS system for PIEs that is independent of audit firms and auditors where the inspectors are not practicing auditors and have no conflict of interest with sworn auditors, the AOC would benefit from technical assistance to devise robust work programs and engage professional expertise to conduct such QAS.
- 75 The Audit Advisory Council (AAC), established by the MoF, promotes a high level of audit quality in Latvia. The AAC consists of delegates from various institutions and organizations, including representatives of the MoF, Ministry of Justice, FCMC, LASA, Latvian Association of Accountants, Riga Stock Exchange, Foreign Investor Council, Employers' Confederation and the BA School of Business and Finance, i.e. four representatives of state administrative bodies and five representatives of public or private organizations.<sup>74</sup> AAC began its work during July 2009 and, according to the Law on Sworn Auditors, the activities of AAC are to be technically ensured by the MoF from the funds allocated for this purpose in the State budget, however to date the members of AAC do not receive remuneration for the discharge of their duties.
- 76 The decisions of AAC have recommendation status as stipulated by the Law on Sworn Auditors, AAC has the right to review and comment on all by laws and acts prepared by LASA, including those relating to quality control and examination. AAC can attend LASA board and committee meetings and can submit proposals to the MoF with a view to improving legislation and ensuring that decisions made are in the public interest. AAC powers are much narrower than the MoF's, and its ability to influence the decisions of LASA is limited. Its main contribution has been raising public awareness of issues in the field of auditing, and defending the public interest given the many functions delegated to LASA. Going forward, the role and responsibility of AAC will be required to be revisited considering the recent EU audit reform and the requirements of the new Auditing Directive and Regulation.

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<sup>70</sup> Sources: According to Regulation No 536, June 17, 2009, Inspection of Compliance with Quality Control and Order No 446 of 21 October 2013 On assigning authorized representatives of the Ministry of Finance.

<sup>71</sup> AOC draft report on results and recommendations regarding review over compliance with the quality control requirements, April 2014.

<sup>72</sup> Directive 2006/EC of 17 May 2006, amended by Directive 2008/30/EC and Directive 2014/56/EU of 16 April 2014.

<sup>73</sup> Regulation 537/2014 of April 16, 2014.

<sup>74</sup> The composition of the AAC was approved on November 25, 2008 by the Cabinet of Ministers.



### III. Accounting standards as designed and practiced

77 This chapter articulates how financial reporting standards are designed and practiced. They must be robust enough to ensure that entities can provide suitable financial information for economic decision making, but sufficiently simple for smaller entities that do not need complex financial information for economic decisions. Actual practice in Latvia is assessed by reviewing examples of financial statements to assess whether they appear to deliver the expected quality and quantity of financial information according to the specific accounting standards for various types of entities.

#### A. The Accounting Standards Gap

78 There is no financial reporting standards gap for listed entities. The EU endorsed IFRS, translated in local language and published by the MoF and EC, are required for company financial statements of entities listed on the main market segment, legal entity and consolidated financial statements of banks, insurance companies, and pension and investment funds, and consolidated financial statements of listed companies.

79 There are a number of differences between the Latvian Financial Reporting Regulations (LFRR) -- comprising the Annual Accounts Law, Consolidated Annual Accounts Law and Regulations of the Cabinet of Ministers- and IFRS. Some of these differences arise due to differing measurement and recognition criteria, others are due to different classification methodologies, and some are due to the fact that LFRR are silent or do not provide sufficient guidance on the accounting treatment of certain balance sheet or profit and loss account captions. Selected key differences include:

- a) *Lease accounting*: No provisions for lease accounting are incorporated in LFRR providing room for inconsistent practices among preparers. On the other hand IFRS principles require the recognition of finance leases and operating leases in accordance with IAS 17, supplemented by the additional guidance for identifying arrangements that contain the lease (IFRIC 4);
- b) *Impairment of long term assets*: LFRR requires that the carrying value of the asset should be decreased by impairment provision when the decrease is anticipated to be lasting. There is, however, only very limited guidance on how the impairment provision should be derived. IAS 36 provides detailed guidance on the causes and valuation methods used to derive asset impairments;
- c) *Amortization of goodwill*: LFRR requires that Goodwill recognized in the stand-alone accounts be amortized over a period of useful life; if it is not possible to specify the useful life of the cost of Goodwill, LFRR permits the item be valued at acquisition costs less accumulated impairment losses. IAS 38 requires that Goodwill is not amortized but instead annually tested for impairment;
- d) *Revaluation reserve*: LFRR permits the decrease of the revaluation reserve only when the revalued asset is disposed or when the revaluation surplus is reversed as a result of revaluation downwards. When the asset is disposed the respective amount from the revaluation reserve is transferred to the profit and loss account for the reporting year. In accordance with IAS 16, allowable transfers from revaluation surplus to retained earnings are not made through profit or loss but instead are charged to retained earnings reserves forming part of equity;

- e) *Revenues*: In general the requirements of LFRR and IFRS are aligned, however LFRR is less specific and does not provide much guidance about specific revenue recognition arrangements such as the measurement of revenues arising from deferred payment terms, exchange of goods and services and barter transactions, component sales and multi-element arrangements, subsequent servicing, and loyalty programs. As such, entities may be unaware of these arrangements, or lack sufficient guidance when encountering them;
  - f) *Provisions*: LFRR and IAS 37 are similar, however LFRR guidelines are less precise and allow for more judgment in respect of classification between provisions and contingencies. In addition, there are no clear guidelines in LFRR distinguishing between provisions and accruals, so it is quite common for preparers to classify certain accruals as provisions (e.g. vacation, bonus accruals);
  - g) *Business combinations and intangible assets*: The concept of business combinations, as defined in IFRS 3, has not been introduced in LFRR which describes only consolidation of the parent entity and its subsidiaries. In addition, LFRR contains little guidance on recognition of intangible assets as a result of business combinations. The result could be different intangible assets and goodwill being recognized on the balance sheets prepared under LFRR and IFRS;
  - h) *Deferred taxes*: LFRR requires the recognition of timing differences which give rise to deferred taxes similar to IAS 12, however does not include any further guidance on their computation and recognition as well as what information should be disclosed;
  - i) *Treasury shares (own shares)*: LFRR requires treasury shares to be presented as assets on the balance sheet, while according to IAS 32 if an entity reacquires its own equity instruments, those instruments are to be deducted from equity.
- 80 Accounting profit before taxes, either IFRS or LFRR, requires some adjustments and is closely related to the base for taxation allowable per the Law on Corporate Income Tax. The main adjustments for calculating the tax base concern: (i) non-deductible costs, (ii) differences between accounting and tax depreciation, (iii) transfer pricing adjustments, (iv) income not subject to corporate tax, and (v) changes in provisions and valuation adjustments.

## B. The Compliance Gap

- 81 The ROSC team reviewed a sample of financial statements to assess the extent to which they complied with the financial reporting standards in accordance with which they had been prepared (either LFRR or IFRS). The selected sample of financial statements included twenty sets of financial statements prepared based on Latvian Accounting Regulations, and ten IFRS-based financial statements. Types of entities were selected based on their importance to the national economy, taking into consideration state-owned enterprises (SOEs) and consolidated financial statements. Conclusions should be regarded with a degree of caution, given the limited sample size, as well as inherent problems in examining the compliance gap as a desk review of financial statements cannot determine whether everything that should have been disclosed has indeed been disclosed.
- 82 Overall, IFRS reporting was carried out to a high standard by the banks, the insurance company and one listed company. In view of the nature of the activities of the companies whose financial statements were reviewed, the policy notes were lengthy and clearly intended to be comprehensive. The reviews of financial statements of the financial sector companies

focused on the measurement and disclosure in relation to financial instruments, and concentrated on compliance with IAS 39 'Financial Instruments: Recognition and Measurement' and IFRS 7 'Financial Instruments: Disclosures'. The reviews put particular emphasis on the accounting policies for impairment, valuation of financial assets, and risk disclosures.

- 83 The quality of one set of IFRS financial statements prepared by a listed company in the enterprise sector was not satisfactory. The main reason for the low quality was that much of the terminology used was not consistent with IFRS terminology to the extent that sections of the financial statements were unclear and ambiguous. For example, the statement of financial position described under caption investments, a line labeled "intangibles and deferred tax assets". According to IFRS, the former are usually "intangible assets" which if material are disclosed as a separate caption on the face of the statement. Also, according to IFRS, both intangible assets and deferred tax assets do not constitute part of investments.
- 84 The financial statements prepared under the LFRR were of uneven quality. These financial statements are publicly available and accessible from the Enterprise Registry and cannot represent the overall quality of implementation of LFRR, however they can provide some information to the national authorities to help them better enforce accounting standards and filing regulations. Some of the financial statements were incomplete, in one instance the numbers entered in the input tables contained errors, supporting pages containing notes were not properly numbered and cross referenced. Some of these deficiencies are due to the limitations of the electronic filing system explained in paragraph 40, however there were other quality concerns mainly arising from incomplete and insufficient disclosures. The quality of non-audited financial information was lower compared with audited financial statements reviewed. Some specific findings, many of which relate to inappropriate or insufficient disclosures, include:
- a) *Failure to describe company specific accounting policies in the notes to the financial statements.* For example, in three reviewed cases the companies had an equity revaluation reserve, while the accounting policy for property, plant and equipment referred to cost less depreciation; in two cases the revaluation method of accounting for property, plant and equipment was described, however, the fixed assets had been carried at cost less accumulated depreciation and impairment; a construction company did not describe its accounting policy for recognition of construction contract revenues; another company described a specific policy for making warranty provisions, however there was no warranty provisions recognized in the balance sheet;
  - b) *Accounting policies inconsistent with LFRR.* A company listed on the second listing was recycling the fixed asset revaluation reserve through profit and loss while the asset was in use and there had been no disclosures of the policy or the reason for such accounting treatment; in four cases there was no recognition of timing differences with respect of revalued fixed assets giving rise to deferred taxes;
  - c) *Low quality of consolidated financial statements.* Consolidated financial statements prepared by a large group were obviously not meeting LFRR requirements. The notes to the financial statements were limited to three pages and most of the significant disclosures had been omitted. The consolidated balance sheet included a balance with a material interest in a subsidiary however there were no disclosures on exemption from consolidation, minority interest was not presented as a separate line item on the balance sheet but profit was allocated to minority shareholder in the profit and loss account;

- d) *Lack of, or insufficient disclosures.* In four cases when assets had been revalued there had been lack of disclosures on when the last time a revaluation was performed, who performed it, what the book value would be if a cost model was applied, etc. One of those companies was a listed company on the secondary listing. Another company (SOE) restated significantly its opening balances, however the notes did not contain sufficient information to understand the reason for the restatement. The quality of the risk analysis disclosures varied a great deal from useful company specific analysis to formal standard phrases or no risk information at all.

## IV. Auditing Standards as Designed and as Practiced

- 85 Auditing standards provide a basis for auditors to be able to provide an opinion on whether financial statements, in all material respects, present a true and fair view of the financial position and performance of an entity, in line with the requirements of specific accounting/financial reporting standards. This section, therefore, assesses whether auditing standards follow international benchmarks (ISA), and how these are applied in practice to increase the reliability of financial information for users, especially current or potential owners and creditors. While many countries have successfully adopted ISAs, implementation is often an issue, as it requires changes in behavior and also rigorous and detailed methodologies, as well as deep understanding of businesses and the potential impact of poor quality audits. The appropriate implementation of auditing standards is essential for the reliability of published financial statements.

### A. The Auditing Standards Gap

- 86 Latvia has adopted ISAs and as such there is no standards gap in the area of auditing standards. The Law on Sworn Auditors requires that all auditors apply ISA as issued by the International Federation of Accountants (IFAC) approved by the Latvian Association of Sworn Auditors (LASA). The 2010 ISA have been translated into Latvian language and have been published by LASA. LASA is currently working on translations of the most recent version of the ISAs while special permission was obtained to translate the new standard on review engagements ISRE 2400. The timing gap between the most recent ISAs and the Latvian translations is being monitored by LASA and actioned on a continuous basis.

### B. The Auditing Standards Compliance Gap

- 87 The ROSC team reviewed a sample of financial statements to assess the extent to which they complied, in practice, with ISA (mainly those related to forming an opinion and reporting on financial statements- ISA 700, ISA 705, and ISA 706) The sample was the same as the one used to assess the financial reporting standards compliance gap as described in paragraphs 81 and 84; the same limitations apply in analyzing a relatively small sample of audit reports and the team mainly reviewed compliance with the standards relevant to audit reporting.
- 88 The quality of ISA implementation is uneven for a variety of reasons including audit methodologies that are not always updated, ISA compliant, some misunderstanding of fundamental audit issues, and limited training and capacity-building opportunities. The overwhelming majority of statutory auditors and audit firms have limited capacity to develop and maintain an audit methodology and thus audit firms' compliance with ISA can be expected to be uneven at best. For the sake of illustration, based on in-country meetings with large, small and medium-sized audit practitioners: audit firms that are current members of international networks appeared to use their networks' ISA-compliant audit methodologies; firms of former members of international networks appeared to use ISA-compliant methodologies as best as they could recollect them from their days working for the international networks; and other firms used methodologies developed by sworn auditors over one decade ago. In cooperation with the MoF through the FRTAP, LASA is currently looking into available IAS-compliant

software which it can offer to its members to be procured centrally. This should be complemented by specific capacity-building for auditors.

89 Some specific findings arising from the reviewed audit opinions include:

- a) One of the consolidated financial statements was quite obviously non-compliant with LFRR, however, the auditor had expressed an unmodified audit opinion. The amount of audit fees disclosed in the notes to the financial statements was surprisingly low given the size and complexity of the group, indicating that the quality of the audit performed may not have been adequate;
- b) In three cases when qualified opinions had been expressed, the auditor's responsibilities had not been presented fully in line with ISA 705 as it was not clearly stated that the audit evidence obtained was sufficient and appropriate to provide a basis for the auditor's qualified audit opinion.

## V. Perception of the Quality of Financial Reporting

- 90 Bankers in Latvia generally consider that the quality of financial reporting has improved since 2005. On the other hand, there is relatively little demand for high quality financial statements in Latvia since the securities market is fairly small and plays a limited role in the Latvian economy. As primary users of financial statements, bankers indicated that the consistency of audit quality needs to be improved and enforcement mechanisms strengthened to enhance corporate financial reporting.
- 91 There is a difference in the perceived quality of audits and the value that an audit brings between the large international network audit firms<sup>75</sup> and the rest. The ROSC team, through its meetings with users of financial information and reviews of financial statements and audit reports, found that smaller firms tend to carry out audits of lower quality, lack familiarity with International Financial Reporting Standards (IFRS), have little ability to comply with ISQC1, and lack capacity to deal with complex financial issues. Recognizing that the overwhelming majority of statutory auditors and audit firms have limited capacity to develop and maintain a robust audit methodology, LASA is currently searching for appropriate audit automation software that incorporates ISA-compliant methodology which would be available to be procured by its members.
- 92 Users of financial statements are particularly skeptical about the reliability of non-audited financial statements in the MSME segment, a view that was supported by the findings of the ROSC financial statements review. Observers highlighted unreliable profit and loss information due to tax evasion, fraud, areas of significant judgments and assumptions, such as valuations and impairments of assets, and segments where there is high volume of cash transactions as the core instances of accounting irregularities. Users also mentioned that municipalities financial statements are very difficult to access as there is no requirement for these to be published, and even when available they are of little use as they are prepared on the cash basis of accounting. Considering that many companies are affiliated or have business dealings with the municipalities, comparison and cross reference of information is quite difficult. Disclosures are often insufficient or non-existent, undermining the usefulness of the available financial statements. In order to mitigate the risk of inadequate accounting information, credit officers very often perform their own inventory checks, verify cash balances, and perform special procedures in order to increase confidence in provided financial information.
- 93 It is generally agreed among practitioners in Latvia that LFRR are not sufficiently comprehensive or detailed which undermines the quality of financial statements prepared by non-financial companies. For example, LFRR do not contain sufficient guidance on particular topics, (e.g. how to identify intangible assets arising from a business combination or methodology to arrive at asset impairment) and are silent on certain areas, (such as lease accounting and deferred assets).

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<sup>75</sup> The four largest audit firms in Latvia are: PricewaterhouseCoopers, Ernst & Young, Deloitte and KPMG.

## VI. Areas for Consideration

### A. Principal findings

- 94 Since the 2005 ROSC, Latvia has made significant efforts to improve accounting, reporting and auditing systems. Notable improvements include: (i) alignment of the legal framework with EU requirements, and continuous dedication to maintain alignment with the *acquis*, which is ever-changing; (ii) the audit professional body's (Latvian Association of Sworn Auditors, LASA) establishment of a monitored peer review system for quality assurance over statutory auditors in 2005, which is now quite solid and comprehensive; and (iii) establishment of a public oversight system for the audit profession. Furthermore, Latvia—through the Ministry of Finance—has made an effort to participate more systematically in the European policy-making process by taking a more active role in EU committees and bodies (Annex A of the report details to what extent recommendations of the 2005 ROSC have been implemented).
- 95 Despite these accomplishments, the demand for high quality financial reporting seems to have remained stagnant since the last ROSC. Demand—on the part of users, such as banks or investors; regulatory agencies such as the Financial and Capital Market Commission (FCMC), and tax authorities—is quite limited and there seems to be little concern on the part of policymakers to increase such demand, be it through business, regulatory or tax channels. Thus, the goal in the medium to longer term for Latvia will be to go beyond simply complying with the *acquis* requirements de jure, to truly focusing on implementing the requirements as a means to enhance the quality of financial reporting and auditing activities in the country.
- 96 The main findings arising from this ROSC are presented hereafter
- a) The European Union has acknowledged that SME simplified reporting is an urgent issue and has raised the thresholds for defining micro, small, and medium-sized companies (MSMEs) in the new EU Accounting Directive. The new Directive sets mandatory size thresholds for MSMEs, i.e., Member States no longer have the option to adjust the thresholds proportionate to the size and nature of their national economy. Consequently, Latvia must raise their existing thresholds, as they are currently well below the new Directive's.
  - b) The Latvian Accounting Standards (LAS) were repealed in 2011. Since then, rules relating to accounting and financial reporting, collectively referred to as Latvian Financial Reporting Regulations (LFRR) have replaced LAS. It is generally agreed among practitioners in Latvia that LFRR are not sufficiently comprehensive or detailed. For example, LFRR do not contain sufficient guidance on particular topics, (e.g. how to identify intangible assets arising from a business combination or methodology to arrive at asset impairment) and are silent on certain areas, (such as lease accounting and deferred assets). The Ministry of Finance is responsible for drafting Laws and Cabinet of Minister Regulations with respect to accounting issues. Between 2003 and 2011, the former Accounting Board was responsible for drafting and issuing Latvian Accounting Standards (LAS) consistent with IFRS and the *acquis*. Recently, the regulation-setting process has become more participatory where users and accounting professionals are more involved to contribute toward the development and the quality of the requirements for financial reporting. In addition, Latvia should specifically consider improving the accounting standards for non-PIEs by adoption of IFRS for SMEs.



- c) The electronic filing system for financial statements facilitates processing of data mainly for tax purposes. The system relies on a number of forms which were designed for tax reporting, and their use for financial reporting can result in the loss of relevant data. SRS performs only basic checks of the information it receives, such as arithmetic, cross reference and matching ones, and does not usually perform any other checks of submitted data, even on a sample or risk selection basis, such as whether financial reporting standards were applied correctly; if the attached auditor's report in fact corresponds to the relevant financial statements, or whether attached files are complete (e.g. all pages are included). There are also no controls to determine whether companies that should file consolidated accounts do so in practice. Improvements to the electronic filing system are necessary, together with enforcement mechanisms to ensure compliance.
- d) The quality of ISA implementation is uneven. The reasons include audit methodologies that are not always updated and ISA compliant. In cooperation with the MoF through the FRTAP, LASA is currently looking into available ISA-compliant software which it can offer to its members to be procured centrally. This process should reduce the auditing standards compliance gap, particularly for the smaller audit firms and efforts should be focused in completing this in the near future.
- e) LASA needs to establish a mechanism to approve mentors providing practical experience training to future sworn auditors, as well as to monitor the quality of practical training that is delivered. Likewise, LASA needs to verify whether members actually attend self-reported CPD hours when these take place outside of the LASA Education Centre, and monitor the quality of these courses.
- f) Enforcement of financial reporting requirements are stronger in the banking and insurance sector, however more robust enforcement is needed for the securities market. FCMC, the integrated financial sector regulator for listed companies, lacks certain enforcement powers, (e.g. no power to issue regulations regarding financial statement preparation of listed companies).
- g) Aspects of the QAR system implemented by LASA must be improved to comply with the new Audit Directive. Currently, LASA uses a rotation approach to select auditors subject to review; however, the new Directive requires the introduction of risk-based criteria for this. Furthermore, capacity development is needed to raise the ability of peer reviewers to deal with specialized industries and complex financial reporting issues. Finally, constraints regarding the team size, available financial resources and time to perform the review need to be addressed.
- h) The Audit Oversight Commission's skills and resources need upgrading to ensure it carries out its oversight role effectively, and in line with the new EU audit requirements. AOC lacks personnel with professional audit experience and specific industry knowledge to conduct quality inspections. There is too much reliance on the methodology and audit expertise of LASA peer reviewers. The recent EU audit reforms --the new Auditing Directive and Regulation-- require public oversight bodies to establish a QAS system for PIEs in which inspectors are independent of audit firms and practicing auditors, the AOC would therefore benefit from technical assistance to devise robust work programs and engage professional expertise to conduct such QAS.

## B. Developing recommendations

- 97 The above findings and policy options will be discussed with the Ministry of Finance and the other stakeholders. Instead of including prescriptive recommendations in the draft ROSC, the approach used in this case is to propose policy options incorporating as many inputs as possible from the national authorities and the local private sector to provide a framework of identified issues.
- 98 To support and contribute to the development of recommendations at this stage a few guiding principles for developing the recommendations include:
- building and continuously improving existing mechanisms;
  - simplifying, where possible, the institutional set up;
  - balancing short term needs with long term priorities;
  - focusing a large part of the effort on building capacity to implement standards and ensure compliance;
  - following an inclusive approach, including preparers, auditors, regulators and users.
- 99 Based on the above policy options, the Latvian authorities and in-country stakeholders may develop further reform. The World Bank is ready to continue working with the national authorities, informing the policy response and assist in developing resources to further the effective implementation of the EU *acquis* to advance Latvian accounting and auditing practices.

## Annex 1: Status of Implementation of the 2005 A&A ROSC Policy Recommendations

2005ROSC recommendation	Status of implementation
<p><b>Enhance the statutory framework</b> The 2005 report recommended that authorities create a multi-disciplinary working group, including all relevant public and private sector stakeholders, to review the statutory framework with a view to clarify and align it with the <i>acquis communautaire</i>, with particular focus on the following actions:</p> <ol style="list-style-type: none"> <li>a) Ensure that board members are collectively responsible for financial statements.</li> <li>b) Transpose the Fourth and Seventh EU Company Law Directives.</li> <li>c) Remove conflicting or ambiguous financial reporting requirements from the legal framework.</li> <li>d) Exempt small companies from a statutory audit requirement.</li> <li>e) Ensure that the legal provisions regarding the dismissal and resignation of statutory auditors provide adequate safeguards for his or her independence.</li> <li>f) Ensure that laws provide FCMC with a sound framework to fully leverage the work of statutory auditors</li> <li>g) Adopt the new EU Statutory Audit Directive.</li> <li>h) Ensure that audited financial statements of limited liability companies are made publicly available in accordance with the requirements of the First EU Company Law Directive.</li> </ol>	<p><b>Implemented.</b> Latvia has enhanced the statutory framework and transposed the EU directives relating to accounting and auditing.</p>
<p><b>Participate more actively in the European policymaking process</b> Latvian institutions were encouraged to participate actively and systematically in the European policy-making process, through an active role in relevant EU Committees.</p>	<p><b>Implemented.</b> Latvian institutions have made significant steps toward participating more actively and systematically in the European policy-making process, mainly through an active role in relevant EU Committees and bodies. Some examples include the EU Audit Regulatory Committee (AuRC), the European Group of Auditors' Oversight Bodies (EAOB), European Audit Inspection Group</p>

2005ROSC recommendation	Status of implementation
	(EAIG), the Accounting Regulatory Committee (ARC), Company Law Working Party of the Council (CLWP) and others.
<p>Enhance statutory audit quality and public trust in the audit profession, with particular emphasis on the following:</p> <ol style="list-style-type: none"> <li>Create systems of continuing professional education, quality assurance and discipline that are mutually reinforcing and effectively enforced.</li> <li>Ensure that the Latvian Association of Sworn Auditors (LASA) formally endorse and follow its mandate to serve the public interest.</li> <li>Fully adopt the current version IFAC Code of Ethics for Professional Accountants.</li> <li>Increase public oversight of the auditing profession, in line with the requirements of the amended Statutory Audit Directive. The report encouraged authorities to consider the establishment of a pan-Baltic public oversight body.</li> <li>Ensure greater transparency on the relationship between local firms and their international networks, according to the requirements under the amended Statutory Audit Directive.</li> </ol>	<p><b>Partially implemented.</b> Although there has been an increase in public oversight over the profession, further enhancements are required to implement a system that is independent of the profession and where adequate capacity exists.</p>
<p>Improve the mechanisms for issuing interpretations of financial reporting standards. The Accounting Board (standard setter) have the necessary resources to actively and systematically contribute to the enhancement of financial reporting requirements and practices, particularly through developing interpretation capacity within the Board. The report also recommended that authorities consider a pan-Baltic solution.</p>	<p><b>Not Implemented.</b> The Accounting Board and Latvian Accounting Standards (LAS) had been repealed. LAS have been replaced with Cabinet of Minister Regulations which further regulate the application of the accounting Laws, however are not sufficiently comprehensive, detailed and often stipulate tax driven accounting rules</p>
<p>Strengthen monitoring and enforcement financial reporting requirements in the financial and enterprise sectors FCMC was encouraged to develop a dedicated unit responsible for monitoring of financial information in listed companies in the short term.</p>	<p><b>Implemented.</b> FCMC developed a separate department to monitor compliance of listed companies with financial reporting regulations.</p>

2005ROSC recommendation	Status of implementation
<p>Establish a pan-Nordic Financial Reporting Council, as a cost-effective and efficient umbrella for the development, monitoring and possibly enforcement of financial reporting requirements in the Nordic States, including a Standards Board, Oversight Board for Accountancy, Financial Reporting Review Panel, and Investigative and Discipline Board.</p>	<p><b><i>Not Implemented.</i></b> At present the pan-Nordic Financial Reporting Council is not established. An annual Nordic Accounting Forum is held each year.</p>

## Annex 2: Aligning Latvian Accounting Legislation to New Accounting Directive Requirements

The following table illustrates changes that need to be made into Latvian accounting legislation (Annual Accounts Law, Consolidated Annual Accounts Law), and the Law on Sworn Auditors (to the extent the Accounting Directive's requirements are incorporated into auditing legislation) in order to align the accounting system to the requirements of the Directive 2013/34/EU.

New Accounting Directive Requirement	Details of level of implementation
<p><b>Classification of entities</b></p> <p><i>Micro</i> Balance sheet total ≤ 350,000 EUR Net turnover ≤ 700,000 EUR Employees ≤ 10</p> <p><i>Small</i> Balance sheet total ≤ 4 mil EUR Net turnover ≤ 8 mil EUR Employees ≤ 50</p> <p><i>Medium-sized</i> Balance sheet total ≤ 20 mil EUR Net turnover ≤ 40 mil EUR Employees ≤ 250</p> <p><i>Large</i> Entities that exceed at least two of the three criteria for medium entities.</p>	<p>The EU decided to apply "think small first" approach in this Directive enabling companies to prepare profit and loss accounts, balance sheets and notes that are more proportionate to their size. More undertakings will be considered as small and will be released from administrative burdens to provide extensive information mainly in the notes. The thresholds are fixed and member states are not provided the options to define them proportionately to the overall national economy. Thresholds currently applied for Latvian companies are far below the mandatory thresholds. For example, for small companies thresholds for balance sheet total and turnover are 400,000 EUR and 800,000 EUR, respectively; for medium-sized companies those criteria are 1.4 mil EUR and 3.4 mil EUR, respectively. Harmonizing the classification criteria will mean reduced information disclosure requirements and complexity of financial reporting for large number of Latvian companies.</p>
<p><b>Classification of groups</b></p> <p><i>Small</i> Balance sheet total ≤ 4 mil EUR Net turnover ≤ 8 mil EUR Employees ≤ 50</p> <p><i>Medium-sized</i> Balance sheet total ≤ 20 mil EUR Net turnover ≤ 40 mil EUR Employees ≤ 250</p>	<p>Thresholds currently applied for Latvian groups of companies are different from the suggested thresholds. Currently, for small groups thresholds for balance sheet total and turnover are below the suggested thresholds (1.4 mil EUR and 3.4 mil EUR, respectively). The threshold for employees is 250 employees which is higher than the one set by the Directive. The category <i>medium-sized group</i> is not used.</p>

New Accounting Directive Requirement	Details of level of implementation
<p><i>Large groups</i> Groups that exceed at least two of the three criteria for medium-sized groups</p>	
<p>When calculating whether thresholds for group classification are met Member States shall permit the set-off referred to in <a href="#">Article 24(3)</a> and any elimination as a consequence of <a href="#">Article 24(7)</a> not to be effected when the limits in are calculated. In such cases, the limits for the balance sheet total and net turnover criteria shall be increased by 20%.</p>	<p>No requirement to increase limits by 20% if set-off (consolidation adjustments, eliminations) not effected.</p>
<p>The Directive defines <i>investment undertaking</i> and <i>financial holding undertakings</i>, and requires that certain exemptions which may be permitted to micro entities are not applied to investment undertaking or financial holding undertakings.</p>	<p>The Latvian laws do not prescribe such restrictions on exemptions with respect of investment undertaking or financial holding undertakings.</p>
<p>According to Directive, 'material' means the status of information where its omission or misstatement could reasonably be expected to influence decisions that users make on the basis of the financial statements of the undertaking. The materiality of individual items shall be assessed in the context of other similar items.</p>	<p>Latvian laws do not define materiality (e.g. when information is deemed to be material), although there are references to material information in several provisions.</p>
<p>The layout of the balance sheet and of the profit and loss account shall not be changed from one financial year to the next. Departures from that principle shall, however, be permitted in exceptional cases in order to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Any such departure and the reasons therefor shall be disclosed in the notes to the financial statements.</p>	<p>Latvian legislation prescribes different allowable reason for change of layout of profit and loss account – departures may be driven by changes in group structure and requirements by the parent company (rather than necessity to give a true and fair view).</p>
<p>Directive does not use term 'extraordinary income or expenses' and there are no such lines included in the layout of profit and loss account. However, it requires to disclose the amount and nature of individual items of income or expenditure which are of <i>exceptional</i> size or incidence</p>	<p>Latvian law defines extraordinary income and expenses and the current layout of profit and loss account includes separate lines for these items.</p>

New Accounting Directive Requirement	Details of level of implementation
When reporting income from participating interests, other investments and long term loans, as well as reporting other interest income or expenses, the Directive requires a separate indication of that derived from affiliated undertakings.	The Latvian legislation does not require separate indication of income (of these types) derived from affiliated undertakings.
Measurement at the lower figure attributed to fixed assets at the balance sheet date may not continue if the reasons for which the value adjustments were made have ceased to apply; this provision shall not apply to value adjustments made in respect of goodwill.	Latvian accounting legislation does not specifically set forth that value adjustments of goodwill cannot be reversed.
Measurement at the lower value of current assets may not continue if the reasons for which the value adjustments were made no longer apply.	In the Annual Accounts Law, it is not specifically indicated that value adjustments of current assets may not continue if the respective reasons no longer apply.
In exceptional cases where the useful life of goodwill and development costs cannot be reliably estimated, such assets shall be written off within a maximum period set by the Member State. That maximum period shall not be shorter than five years and shall not exceed 10 years. An explanation of the period over which goodwill is written off shall be provided within the notes to the financial statements.	The current law requires different method for goodwill - if useful life cannot be determined reliably, it shall be valued at cost less impairment (in stand alone accounts). In consolidated financial statements – cost less impairment.
Distribution of profits is restricted if development costs are recognized as assets. The amount of the reserves available for distribution and profits brought forward should be at least equal to that of the costs not written off.	This restriction is not transposed in accounting legislation.
Where fixed assets are measured at revalued amounts, a table showing movements in the revaluation reserve in the financial year shall be presented, with an explanation of the tax treatment of items therein.	When reporting movements in the revaluation reserve there is no specific requirement to explain tax treatment in the notes.
Article 16 of the Directive prescribes the contents of the notes to the financial statements that should be followed by all entities. In addition, Member States may	Current disclosure requirements for small entities should be optimized making them in line with Directive requirements. Currently the law requires such disclosures



New Accounting Directive Requirement	Details of level of implementation
<p>require mutatis mutandis that small undertakings are to disclose certain information required in Article 17(1). Member States shall not require disclosure for small undertaking beyond what is required or permitted by the Directive.</p>	<p>for small entities as audit fees, management remuneration, information on associated companies and subsidiaries, on prepaid expenses and deferred income and some other.</p>
<p>According to article 17 of the Directive, disclosures on the nature and the financial effect of material events arising after the balance sheet date which are not reflected in the profit and loss account or balance sheet shall be provided in the notes.</p>	<p>Annual Accounts Law currently requires to include information on post balance sheet events in the management report.</p>
<p>Directive requires to disclose the name, the head or registered office and the legal form of each of the undertakings of which the undertaking is a member having unlimited liability. Directive requires also disclosures applicable to entities which are subsidiaries of a parent company drawing up consolidated financial statements</p>	<p>No such disclosure requirements in the legislation. The requirements of the laws should be extended to include all disclosures required by the Directive.</p>
<p>Article 34 of the Directive requires that statutory auditors also express an opinion on whether the management report has been prepared in accordance with the applicable legal requirements, and state whether, in the light of the knowledge and understanding of the undertaking and its environment obtained in the course of the audit, he, she or it has identified material misstatements in the management report, and shall give an indication of the nature of any such misstatements.</p>	<p>According to the Law on Sworn Auditors, an auditor's report prepared by a sworn auditor shall include (among other things) the view of the sworn auditor regarding the fact whether the management report is consistent with the financial statements, but in relevant cases – whether the consolidated report is consistent with the consolidated financial statements. Therefore the law requires only reporting on consistency of management report and financial statements, but does not require the auditor to provide all statements required by the Directive.</p>
<p>The Accounting Directive introduces new requirements in Article 42 for large entities and all public interest entities active in the extractive industry or lodging of primary forests to prepare and make public a report on payments made to governments on annual basis.</p>	<p>These requirements are new and introduced with the revision of the 4<sup>th</sup> and 7<sup>th</sup> Accounting Directives. The requirements have not been transposed in Latvian legislation, so far.</p>

## Annex 3: Aligning Latvian Auditing Legislation to New EU Regulatory Framework on Statutory Audit

The following table illustrates changes that need to be made into Latvian auditing legislation (the Law on Sworn Auditors) in order to align laws and regulations in the country to EU regulatory requirements for statutory audit (Auditing Directives 2014/56/EU, 2008/30/EC and 2006/43/EU). The table also highlights the main gaps to be addressed in connection with the Regulation 537/2014 becoming applicable in June 2016.

Amended Audit Directive and Regulation	Details of level of implementation
Directive 2006/43/EC of 17.05.2006, amended by Directive 2008/30/EC and Directive 2014/56/EU of 16.04.2014	Law on Sworn Auditors
<p>One of the main objectives of the audit reform is to reinforce the independence and the professional scepticism of the statutory auditor.</p> <p>The Article 21 of the New Directive 2014/56/EU (the New Directive) requires Member States to ensure that the statutory auditor or audit firm maintains professional scepticism throughout the audit.</p>	There is no such requirement in the Law on Sworn Auditors although through ISA application in statutory audits there is requirement regarding professional scepticism.
<p>The New Directive 2014/56/EU provides more details on circumstances that pose threat to auditor's independence. As per amended article 22, a statutory auditor or an audit firm, or any employee or natural person in a position to directly or indirectly influence the outcome of the audit, shall be independent of the audited entity and not involved in the decision-making of the audited entity. A statutory auditor or any employee or natural person whose services are engaged for the audit, should not have material and direct beneficial interest in any transaction in any financial instrument issued, guaranteed, or otherwise supported by, any audited entity within their area of statutory audit activities, other than interests owned indirectly through diversified collective investment schemes, including managed funds such as pension funds or life insurance.</p>	Amendments should be made to article 26 of the Law on Sworn Auditors in order to align its descriptions of potential conflicts of interest and other threats to independence to the new provisions of the Directive 2014/56.
The Article 22a of the New Directive regulates limitations for employment of former statutory	The article 29 of the Law on Sworn Auditors forbids only statutory auditors of

Amended Audit Directive and Regulation	Details of level of implementation
<p>auditors or employees of statutory auditors and audit firms. These limitations are considered important in order to increase auditor's independence and objectivity.</p>	<p>PIE to be members of managing or supervisory body of the PIE until two years have elapsed since he or she ceased to act as statutory auditor. The restrictions (for at least one year) should be added for all sworn auditors and all entities subjected to audit according to new EU requirements.</p>
<p>Member states shall ensure that a statutory auditor or audit firm are compliant with internal organisational requirements, including policies and procedures covering:</p> <ul style="list-style-type: none"> <li>- independence and objectivity of the audit team,</li> <li>- internal quality control,</li> <li>- human resource allocation and management,</li> <li>- outsourcing of important audit functions,</li> <li>- remuneration and profit sharing policies,</li> <li>- self-evaluation of internal control arrangements.</li> </ul> <p>Member States may provide simplified requirements for the audits of small companies, if such audits required by national law or undertaken voluntarily.</p>	<p>Transposition of these requirements of the Directive 2014/56/EU should be made in the Law on Sworn Auditors when future changes are made.</p> <p>Although similar requirements are included in 1 ISQC, which is applicable in Latvia, the requirements should also be transposed into the Law.</p>
<p>The New Directive includes more detailed requirements with respect of organisation of the work. When statutory audit is performed by audit firm, at least one key audit partner should be engaged in the audit and devote sufficient time to the engagement. Also, according to the Article 24b of the New Directive, client account record for each client should be maintained by the audit firm or statutory auditor, the records of any complaints shall be kept.</p>	<p>The Law on Sworn Auditors currently does not include all the requirements set out in Article 24b of the New Directive.</p>
<p>The amended article 28 of the New Directive sets forth the contents of the audit report (applicable to all audits).</p>	<p>The Law on Sworn Auditors should be amended to transpose the requirements for inclusion in the audit report of a statement on any material uncertainty relating to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern, as well as information on place of establishment of statutory auditor or audit firm.</p>

Amended Audit Directive and Regulation	Details of level of implementation
	<p>The audit report shall also include an opinion and statement as per second subparagraph of Article 34 (1) of the Accounting Directive 2013/34/EU (on management report). Current law requires to report only on consistency of management report and financial statements.</p>
<p>The paragraphs 3 and 4 of the Article 28 stipulates requirements for reporting when audit was carried out by more than one statutory auditor or audit firm.</p>	<p>The Law on Sworn Auditors does not contain requirements with respect of joint audit reports and opinions.</p>
<p>Quality assurance system shall be organised in such manner that it is independent of the reviewed statutory auditors and audit firms and is subject to public oversight. Quality assurance reviews shall be appropriate and proportionate in view of the scale and complexity of the activity of the reviewed statutory auditor or audit firm. Quality assurance reviews shall take place on the basis of an analysis of the risk.</p>	<p>Current arrangements in the Law on Sworn Auditors delegates the responsibility for the quality assurance system to the LASA, with monitoring authority delegated to the Ministry of Finance (Public Oversight body). In case of PIEs auditors, the Ministry of Finance representatives either participate in quality assurance reviews together with a peer review team (LASA), which in practice occurs in most instances or can perform their independent inspections, In cases when MoF representatives perform QARs together with LASA peer review teams, they rely heavily on conclusions reached by the LASA QAR team. Such a system cannot be considered as fully independent of the reviewed statutory auditors and audit firms. The requirements of the Directive should be transposed in the Law on Sworn Auditors in such a manner that the complete process is owned by an public oversight body that is truly independent of statutory auditors and audit firms. Also, the funding of the assurance system should be free from possible undue influence by sworn auditors.</p> <p>Also, the current system of selecting auditors/audit firms subject to review is not risk base (scheduled reviews each 3 or 5 years).</p>

Amended Audit Directive and Regulation	Details of level of implementation
	<p>It should be stated in the Law that quality assurance inspections shall be appropriate and proportionate in view of the scale and complexity of the activity of the reviewed statutory auditor or audit firm</p>
<p>According to the chapter VII of the New Directive Member States shall provide for competent authorities to have the power to take and/or impose the measures and sanctions for breaches of the provisions of this Directive and, where applicable, of Regulation (EU) No 537/2014.</p> <p>Member States shall require that, when determining the type and level of administrative sanctions and measures, competent authorities are to take into account all relevant circumstances.</p> <p>Competent authorities shall publish on their official website information on administrative sanctions including information concerning the type and nature of the breach and the identity of the natural person or legal person on whom the sanction has been imposed. In certain specific circumstances the sanctions imposed can be published on an anonymous basis.</p>	<p>According to Article 38<sup>1</sup> of the Law on Sworn Auditors, the LASA may initiate disciplinary proceedings against a sworn auditor at the proposal of the court, the complaint of a legal or natural person or on its own initiative and should inform the Ministry of Finance in writing. The procedure of initiation and adjudication of disciplinary matters and imposition of sanctions shall be prescribed in the by-law and shall be approved by the LASA, after the consultation with the Ministry of Finance.</p> <p>The Law on Sworn Auditors (Article 6 (6)) requires LASA to inform annually the public on its activities, including on disciplinary sanctions. However, it is not required to publish the names of the persons responsible for the breach, nature of the breach, and sanctions imposed.</p> <p>The Law should be amended and place responsibility for imposing sanctions to independent competent authority, rather than to LASA itself. The competent authorities should be transparent about the sanctions and measures that they apply. Criteria, as per the New Directive, should be established to be taken into account by competent authorities when applying sanctions.</p>
<p>Article 30e of the New Directive established that Member States shall ensure that effective mechanisms are established to encourage reporting of breaches of this Directive or of Regulation (EU) No 537/2014 to the competent authorities.</p>	<p>More effective and transparent mechanisms for reporting breaches should be established in Latvia.</p>

Amended Audit Directive and Regulation	Details of level of implementation
<p>According to the Article 32 of the Directive 2014/56/EU, an effective system of public oversight for statutory auditors and audit firms in the country shall be established. The Member States shall designate a competent authority responsible for such oversight.</p> <p>The competent authority shall be governed by non-practitioners who are knowledgeable in the areas relevant to statutory audit. They shall be selected in accordance with an independent and transparent nomination procedure.</p> <p>The system of public oversight shall be adequately funded and shall have adequate resources to initiate and conduct investigations, as referred to in paragraph 5. The funding of the public oversight system shall be secure and free from any undue influence by statutory auditors or audit firms.</p>	<p>According to Law on Sworn Auditors, currently the oversight responsibilities are performed by the Ministry of Finance. The duties are performed by the Audit Oversight Commission comprising three officers of the Tax Administration and Accounting Policy Department of the Ministry of Finance. Commencing December 2014, another professional is reallocated to the AOC undertaking responsibility as a senior expert.</p> <p>In order to enhance oversight of auditors and audit firms, the oversight system should be strengthened and aligned with the requirement of the amended Audit Directive, which will require investments in human resources and capacity to ensure the Public oversight body can carry out its mandate effectively.</p>
<p>According to the Article 38 of the Directive 2014/56/EU it shall be ensured that in case of a statutory audit of a PIE the shareholders representing 5% or more of the voting rights or of the share capital, the other bodies of the audited entities when defined by national legislation, or the competent authorities referred to in the Directive should be permitted to bring a claim before a national court for the dismissal of the sworn auditor where there are proper grounds for doing so.</p>	<p>Latvian Commercial Law (Section 176(5)) prescribes that the board of directors, the council or shareholders, who jointly represent not less than one tenth of the equity capital, may, during a meeting of shareholders or not later than two months after the meeting of shareholders, raise substantiated objections to the elected auditor. Objections raised shall be decided by a meeting of shareholders. If the objections are rejected, the shareholders who have raised them, who jointly represent not less than one tenth of the equity capital, have the right, at their own expense, to invite another auditor. If such other auditor is invited, the status and scope of the rights of the elected auditor shall not change.</p> <p>With respect of PIEs the requirements on possibility to dismiss sworn auditor should be aligned with the Directive.</p>
<p>Each PIE should have an audit committee, where a majority of the members are independent of the entity, and at least one</p>	<p>In accordance with the Law on Financial Instruments Market (Article 54.<sup>1</sup>Audit Committee), at least one of the committee</p>

Amended Audit Directive and Regulation	Details of level of implementation
<p>member has competence in accounting and/or auditing.</p> <p>The New Directive and furthermore – the Regulation, also reinforces the role and competences of the audit committee giving it a prominent direct role in the appointment of the sworn auditor or the audit firm, as well as in the monitoring of the audit.</p>	<p>members shall be independent, and shall have competence in accounting or audit. The requirements for greater independence of audit committees through independence of the chairman and majority of members, as well as reinforced role and competences of the audit committee should be transposed in the legislation.</p>
<p>Regulation 537/2014 of 16.04.2014</p>	<p>Law on Sworn Auditors</p>
<p>Article 4 of the Regulation on Statutory Audit of PIEs provide limits for audit and other fees received by statutory auditor or audit firm from certain PIE. Also, the article asks for reporting obligation to audit committee regarding fees from other services provided by the auditor.</p>	<p>The Law on Sworn Auditors recognizes the liability of the statutory auditor to report to the Audit Committee of a listed company regarding other services provided to it under audit, and request audit committees to consider threats to auditor’s independence. However, limits on fees exposures as independence threats are not specifically provisioned.</p>
<p>Article 5 of the Regulation prohibits non-audit services for statutory auditors of PIEs, including specific tax services, payroll, bookkeeping, and accounting, specific legal services or human resource services, valuation services etc.</p>	<p>A list of non-audit services that cannot be provided by the statutory auditor or audit firm to the audited entity – PIE, shall be established, as per Regulation.</p>
<p>Article 6 requires a statutory auditor or an audit firm to confirm annually in writing that the statutory auditor, the audit firm and partners, senior managers and managers, conducting the statutory audit are independent from the audited entity.</p>	<p>The requirements of the Law on Sworn Auditors with respect to the written confirmation of auditor’s independence do not extend to partners, senior managers and managers.</p>
<p>According to Article 8 of the Regulation, before issuing reports, engagement quality review should be performed by statutory auditor who was not involved in the audit. The regulation also prescribes what should be reviewed and documented and how disagreements should be resolved.</p>	<p>ISAs and 1 ISQC are applicable in Latvia. However, according to 1 ISQC, engagement quality review is mandatory only for listed entities, and not for all PIEs.</p>
<p>The audit report for PIEs should be more informative for investors. The Article 10 of the Regulation requires to include in the audit report additional reference to the length of the</p>	<p>There are no such special reporting requirements with respect of the statutory audit report for PIEs included in the Law on Sworn Auditors.</p>

Amended Audit Directive and Regulation	Details of level of implementation
<p>period of appointment of the auditor, declaration of independence and non-provision of prohibited services, description of most significant assessed risks of material misstatement and audit response, confirmation that the audit opinion is consistent with the additional report to the audit committee etc.</p>	
<p>The Article 11 of the Regulation requires the auditor to submit an additional written report to the audit committee of the audited entity not later than the date of submission of the audit report. The additional report to audit committee will provide the audited PIE with more detailed information on the scope of the statutory audit, outcome of the audit, methodology used, significant deficiencies identified, valuation methods applied, scope of consolidation etc.</p>	<p>These detailed requirements with respect to reports to audit committees are not included in the Law on Sworn Auditors.</p>
<p>The statutory auditor of PIE should have the duty to promptly report to supervisory authorities of PIE when there is material breach of the laws and by-laws, threat concerning continuous functioning of the PIE or refusal to issue audit report.</p>	<p>These requirements have been transposed for financial institutions. However, the requirements are not imposed for other PIEs, such as listed entities.</p>
<p>In the transparency report the Regulation requires to provide more detailed breakdown of the total turnover of the statutory auditor or audit firm than it was required in the Directive 2006/43/EC</p>	<p>There is no such requirement in the Law on Sworn Auditors.</p>
<p>Statutory auditors of PIEs should provide to competent authorities annually a list of audited PIEs by generated revenue.</p>	<p>There is no such requirements in the Law on Sworn Auditors.</p>
<p>According to the Article 16 of the Regulation, restrictive third-party contractual clauses, restricting the choice of auditors are prohibited.</p>	<p>There is no such requirement in the Law on Sworn Auditors.</p>
<p>The Article 17 of the Regulation determines maximum duration period and cool-off period for statutory auditor or audit firm of PIE, including respective periods for key audit partners involved in the audit.</p>	<p>The Law on Sworn Auditors determines the maximum duration period of 7 years of involvement in statutory audit with PIE of particular sworn auditor or responsible sworn auditor. However, there is no limitation of the maximum period of</p>



Amended Audit Directive and Regulation	Details of level of implementation
<p>Member States may extend the maximum period where a public tendering process is conducted, or where more than one statutory auditor or audit firm is simultaneously engaged and joined audit report is issued.</p>	<p>consecutive appointment of an audit firm or sworn auditor (in EU there is 10 years/ 4years cool-off period rule).</p>
<p>Competent authority shall establish effective quality assurance review system for PIEs that is independent of audit firms and auditors where inspectors are not practicing auditors and have no conflict of interest with statutory auditors.</p>	<p>Currently, according to the Law on Sworn Auditors, auditors of public interest entities are subject to quality assurance reviews performed by LASA; the Ministry of Finance representatives, based on the provisions of the Law on Sworn Auditors, are entitled to perform their quality control procedures as independent inspections, and in practice they usually accompany LASA peer review teams on field. The authorized representatives of the MoF inspect the compliance with the requirements for the audit services quality control at least once a year and draw up an annual report of these inspections which summarize the findings. The Ministry of Finance representatives lack appropriate capacity and technical expertise to conduct independent quality review inspections of statutory auditors of PIEs. They rely, to a great extent, on conclusions made by peer reviewers.</p>
<p>Article 27 of the Regulation requires the competent authorities to regularly monitor the developments in the market for providing statutory audit services to PIEs, and shall assess such aspects as the risks arising from high incidence of quality deficiencies of a statutory audit or an audit firm, market concentration levels, performance of audit committees.</p>	<p>There is no such task given to the competent authorities in Latvia.</p>



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