

# REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Republic of Latvia

## ACCOUNTING AND AUDITING

March 30, 2005

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### EXECUTIVE SUMMARY

This report provides an assessment of accounting, financial reporting, and auditing requirements and practices within the enterprise and financial sectors in Latvia. The report uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks and draws on international experience and good practices in the field of accounting and audit regulation. For European Union (EU) Member States, the assessment also has regard to the relevant requirements of EU law (also known as the *acquis communautaire*).

Limited liability companies are required to prepare their financial statements in conformity with Latvian accounting requirements, which are based on the Fourth and Seventh EU Company Law Directives and provide a simplified financial reporting framework for small and medium sized enterprises. Banks and insurance companies are required to prepare their financial statements in conformity with accounting regulations set by the Financial Capital Market Commission, which are based on the Banking and the Insurance Accounts Directives. Companies listed on the official list of the Riga Stock Exchange are required to prepare their financial statements in conformity with IFRS. Companies listed on the second and free lists are subject to the same financial reporting requirements as non-listed limited liability companies. In order to better meet the expectations and needs of users—especially foreign users—of financial statements prepared by *public interest entities* (e.g., banks, insurance companies, all listed companies), this report recommends that *public interest entities* be required to prepare their consolidated financial statements in conformity with IFRS. Clearly, this measure would go a step ahead of the current requirements of the *acquis*, as this is not yet required by the EU—other than for the consolidated financial statements of listed companies—however, the ROSC team believes that it would be valuable for enhancing the transparency of financial reporting of *public interest entities*.

Latvian enterprises are subject to statutory audit requirements, which are consistent with the existing *acquis* requirements. These audit requirements are generally conducive to greater compliance with accounting standards although the report notes variation in the quality of statutory audits. Consequently, this report strongly recommends that existing arrangements be reassessed in the wake of international corporate accounting scandals and the proposal for a new Eighth EU Company Law Directive, which will require enhanced public oversight of the auditing profession.

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This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Latvia between May and September 2004 and is current as of March 2005. The staff team was led by Frédéric Gielen (ECSPS) and comprised of Ana Cristina Hirata Barros (ECSPS) and a team of consultants. The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

## EXECUTIVE SUMMARY (continued)

As new regulations come into force, this report shows that priorities should now turn to building the monitoring, supervisory and disciplinary regimes necessary to ensure effective compliance. This assessment demonstrates that the effective enforcement of accounting, auditing and ethical standards is the next challenge that Latvia has to tackle. In particular, Latvia must work to enhance the quality of statutory audit, which will require enhanced enforcement mechanisms, improved systems of professional education, quality assurance and discipline, and increased public oversight of the audit profession. In addition, this report draws upon recent international experience in developed economies, as well as the *acquis communautaire* and expected amendments thereto and recommends that Latvia strengthen institutionalized incentives for the rigorous application of high quality financial reporting standards.

The policy recommendations set forth in this report are mutually supportive and contribute to promoting private sector growth through several means:

- Strengthening Latvia's financial architecture and reducing the risk of financial market crises and their associated negative economic impacts, including through increased transparency about the financial condition and performance of public interest entities;
- Contributing to foreign direct and portfolio investment;
- Helping mobilize domestic savings;
- Facilitating the access of smaller-scale corporate borrowers, including small and medium enterprises, to credit from the formal financial sector by shifting gradually from collateral-based lending decisions to lending decision, which are based on the financial performance of the prospective borrower;
- Improving the assessment and collection of taxes on corporate profits;
- Allowing investors to evaluate corporate prospects and make informed investment and voting decisions, which will result in a lower cost of capital and a better allocation of resources;
- Allowing shareholders and the public at large to assess management performance, thus influencing its behavior (financial reporting is also a building block of a market-based monitoring of companies); and
- Assisting the authorities to monitor and enforce compliance with the relevant portions of the *acquis communautaire*.

## I. INTRODUCTION

1. This assessment of accounting and auditing practices in Latvia is part of a joint initiative of the World Bank and the International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSCs). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting and involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)<sup>1</sup> and International Standards on Auditing (ISA) as benchmarks and draws on international experience and good practices in the field of accounting and audit regulation. For European Union (EU) Member States, the assessment also has regard to the relevant requirements of EU law (also known as the *acquis communautaire*).
2. Latvia has a population of 2.3 million and Gross National Income (GNI, *Atlas Method*) per capita of EUR3,250 as of end-2003.<sup>2</sup> The country has successfully attracted substantial inflows of foreign direct investment and achieved solid economic growth. Latvia joined the EU on May 1, 2004.
3. The share of the private sector in the economy grew from near zero in the late 1980s to about 70 percent in 2003, and provided about 73 percent of employment in that year. The Riga Stock Exchange has 43 listed companies (four on the official list, eight on the second list, and 31 on the free list). The Riga Stock Exchange had a total capitalization of approximately EUR 1.1 billion as of end-2004, which represented approximately 10 percent of the Gross Domestic Product in 2003. At the end of 2003, there were 22 banks and one foreign bank branch operating in the Latvian banking system, 19 insurance companies, and 6 investment management companies managing 16 investment funds. Despite a significant increase in private businesses, small and medium enterprises (SME) still find it difficult to secure debt (or equity) financing to fund their growth.

## II. INSTITUTIONAL FRAMEWORK

### A. Statutory Framework

4. **In law, Latvia implemented the *acquis communautaire*.** The existence of a well-developed *acquis* in the area of accounting and auditing regulation facilitated the choice of appropriate models to follow. However—like other EU Member States—Latvia has to address significant issues in the design and strengthening of suitable institutions to implement and enforce the *acquis* requirements. In addition, it is crucial for Latvian policymakers and regulators to take an active role in the policymaking process of the European Union. In this context, it is very positive to note that—in spite of limited resources—Latvia is already active in the EU Accounting Regulatory Committee, and participates in the Committee of European Securities Regulators (CESR). In all, Financial and Capital Market Commission (FCMC) representatives are nominated to eight EU committees, one European Central Bank (ECB) committee and 30 working groups, of which three deal with accounting and auditing issues.

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<sup>1</sup> Within this report, IFRS refer to both International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board and the Standards issued by the Board of the International Accounting Standards Committee, and each applicable Interpretation of the International Financial Reporting Interpretations Committee.

<sup>2</sup> International Monetary Fund, World Economic Outlook Database, September 2004.

5. **The Commercial Law, based on European Company Law Directives, regulates business activities in Latvia.** The Commercial Law, which was last amended in 2002, recognizes three types of companies: *general partnerships*, *limited partnerships*, and *capital companies*. Capital companies are companies where shareholders have limited liability.<sup>3</sup> They comprise:
- *Private limited liability companies*, the shares of which are not publicly tradable. Private limited liability companies generally have a small number of shareholders and a minimum capital of LVL2,000 (equivalent to approximately EUR2,870).<sup>4</sup> Private limited liability companies generally have a single-tier management structure (board of directors). However, the articles of association may provide for the establishment of a council. The council is the supervisory institution of a company, which supervises the activities of the board of directors. The council examines the financial statements and the proposal of the board of directors for the use of profits and submits those, together with its own report,<sup>5</sup> to the meeting of shareholders.
  - *Joint stock companies*, the shares of which may be publicly tradable. Joint stock companies generally have a large number of owners and a minimum capital of LVL25,000 (equivalent to approximately EUR35,900). Joint stock companies have a two-tier management structure (board of directors and council).
6. **The Commercial Law and the Law on Consolidated Annual Accounts establish that members of the board of directors are collectively responsible for the probity of legal entity and consolidated financial statements.**<sup>6</sup> Under the Commercial Law, members of the board of directors are “jointly and severally liable for losses caused as a result of false information, which is submitted to the Register of Enterprises.”<sup>7</sup> In a two-tier structure, it is not entirely clear whether members of the council—supervisory directors—are also responsible for the probity of financial statements. While the Commercial Law is silent regarding the members of the council’s responsibility for the probity of financial statements, the Law on the Annual Accounts of Enterprises requires them to sign the financial statements together with the board of directors. Latvian lawyers contend that this provision would be interpreted by a court as a collective responsibility of the members of the council for the probity of financial statements. If confirmed, this collective responsibility of both members of the board of directors and the council would be an appropriate mechanism to mitigate the risk that a limited number of members of the board of directors, in particular certain executive directors whose performance is to be reflected in financial statements, have a decisive role in determining the content of financial statements.<sup>8</sup>

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<sup>3</sup> The remaining part of this report addresses primarily financial reporting by *capital companies* and refers to them collectively as *limited liability companies*.

<sup>4</sup> Value based on the rate applicable on February 7, 2005: Latvian Lat (LVL) 1.00 = EUR1.44.

<sup>5</sup> Section 175 of the Commercial Law regulates the contents of the council’s report. It must include an evaluation of the activities and financial condition of the company, an evaluation of the work of the board of directors, and a report regarding the work of the council in the accounting period.

<sup>6</sup> Section 2 of the Accounting Law confirms the responsibility of the members of the board of directors. Article 34.1, read in conjunction with Article 35.1 of the Law on the Consolidated Annual Accounts, establishes the collective responsibility of the board of directors for the consolidated financial statements.

<sup>7</sup> This report outlines the legal principles applicable with regard to directors’ liability 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 reading it. See Section 165ff. of the Commercial Law for further details.

<sup>8</sup> The High Level Group of Company Law Experts, which was set up by the European Commission in September 2001 to make recommendations on a modern regulatory framework in the EU for company

7. **Shareholders are required to approve the legal entity financial statements and the consolidated financial statements of a company.** The Commercial Law adequately requires that the meeting of shareholders approve the financial statements of the company and the distribution of profits. The Law on Consolidated Annual Accounts of Enterprises requires that shareholders approve the consolidated financial statements of the company.<sup>9</sup> These provisions are in line with what currently prevails in EU Member States.
8. **Financial reporting by Latvian enterprises is governed by various laws and regulations, which include very detailed accounting requirements primarily based on the Fourth and Seventh EU Company Law Directives, the Banking Accounts Directive,<sup>10</sup> and the Insurance Accounts Directive.<sup>11</sup>** Among these is the Law on Accounting, which was last amended in 2004 and applies to all enterprises, companies, and nonprofit organizations registered in the Register of Enterprises, regardless of the form or amount of equity. The application of corporate financial reporting requirements to different enterprises is summarized in Table 1, which should be read in conjunction in paragraphs 9 to 13:

<b>Financial statements</b> <b>Entities</b>	<b>Legal Entity Financial Statements</b>	<b>Consolidated Financial Statements</b>
<b>Limited liability companies</b>		
<b>Large</b> (Paragraphs 9 and 10)	Detailed accounting requirements within the Law on Annual Accounts of Enterprises and Latvian Accounting Standards	Detailed accounting requirements within the Law on Consolidated Annual Accounts of Enterprises and Latvian Accounting Standards
<b>Small and medium</b> (Paragraphs 9 and 10)	Same laws and standards with exemptions allowing for simplified financial reporting	
<b>Banks</b> (Paragraph 12)	Accounting regulations set by the Financial and Capital Market Commission (FCMC)	
<b>Insurance companies</b> (Paragraph 13)	Accounting regulations set by the FCMC	
<b>Listed companies</b>		
<b>Official list</b> (Paragraph 11)	IFRS, as required by the Law on the Financial Instruments Market	IFRS
<b>Second list</b> (Paragraph 11)	Detailed accounting requirements within the Law on Annual Accounts of Enterprises and Latvian Accounting Standards	IFRS
<b>Free list</b> (Paragraph 11)		

**Table 1: Financial Reporting by Latvian Enterprises**

law, recommended that the board should be collectively responsible for the probity of financial statements of the company: in a one-tier structure, this is a collective responsibility of both executive and non-executive directors, and in a two-tier structure, this is the collective responsibility of both the managing directors and the supervisory directors. On October 28, 2004, the European Commission proposed four key revisions of the Fourth and Seventh EU Company Law Directives to enhance confidence in corporate financial reporting. The first revision would establish that board members are collectively responsible for financial statements and key non-financial information.

<sup>9</sup> See Article 34.3 of the Law on the Consolidated Annual Accounts of Enterprises.

<sup>10</sup> See European Council Directive 86/635/EEC dated December 8, 1986 on the annual accounts and consolidated accounts of banks and other financial institutions.

<sup>11</sup> See European Council Directive 91/674/EEC dated December 19, 1991 on the annual accounts and consolidated accounts of insurance undertakings.

9. **The Law on the Annual Accounts of Enterprises enacts the provisions set out in the Fourth EU Company Law Directive, as amended in June 2003.** The Law, which was last amended in November 2003, applies to all limited liability companies except banks, insurance companies, private pension funds, investment management companies, and investment firms. The Law lays down the principles that govern the drawing up of legal entity financial statements; states general principles for the valuation of items in the financial statements (e.g., prudence) and specific valuation rules; and lists the information that must be provided in the notes to the financial statements. It is largely based on the Fourth EU Company Law Directive, including the most recent amendments thereto,<sup>12</sup> with the following interesting elections:<sup>13</sup>

- Like some other Member States, the Law also imposes that all limited liability companies prepare financial statements comprising a balance sheet, an income statement, a cash flow statement, a statement of changes in equity, and notes. This requirement goes beyond what is currently required under the *acquis communautaire*,<sup>14</sup> which does not mandate a cash flow statement and a statement of changes in equity, and is a positive additional step that Latvia has taken to encourage a true and fair presentation of the financial situation of Latvian companies.
- As permitted by the Directive, and in line with the Directive's implementation in most Member States, simplified reporting rules are laid down for SMEs. The Law defines SMEs as companies, which on their balance sheet date do not exceed the limits of two of the three following criteria: balance sheet total of LVL1 million (equivalent to approximately EUR1.4 million), net turnover of LVL2.4 million (equivalent to approximately EUR3.4 million), and 250 employees. These thresholds are considerably lower than the maximum amounts set out in Article 27 of the Directive (EUR14.6 million, EUR29.2 million, and 250 employees).<sup>15, 16</sup>
- Under these simplified financial reporting requirements, Latvia allows SMEs not to report their net turnover and cost of sales but rather to disclose only the gross margin.<sup>17</sup> Non-disclosure of the net turnover and the related cost of sales would jeopardize any useful analysis of a company's performance. For example, supermarkets A and B may both report a LVL100,000 gross margin but a stakeholder's assessment of their performance is likely to be different if their net turnover and cost of sales are disclosed; for example a net turnover of LVL2 million and cost of sales of LVL1.9 million for A and a net turnover of LVL500,000 and cost

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<sup>12</sup> The latest amendment (Directive 2003/51/EC of the European Parliament and of the Council dated June 18, 2003) set out to harmonize the accounting rules applied to non-publicly traded companies with IFRS. Consequently, most IFRS accounting treatments and disclosures can now be applied by companies that retain the accounting Directives as their basic legislation.

<sup>13</sup> The Fourth EU Company Law Directive includes a lot of options, which Member States have to decide upon when transposing the Directive in national law. The report merely highlights the primary striking points in the Latvian transposition of the Directive.

<sup>14</sup> See Article 2 of the Fourth EU Company Law Directive.

<sup>15</sup> Latvia has not made use of the exemption set forth in Article 11 of the Fourth EU Company Law Directive. Therefore, the report only refers to Article 27 of the Directive.

<sup>16</sup> For comparison purposes, the approximate thresholds in select Member States are: Belgium (EUR2.5 million, EUR5 million, 50 employees); Czech Republic (EUR1.3 million, EUR2.6 million, 50); Germany (EUR10.5 million, EUR21 million, 250); Lithuania (EUR1.4 million, EUR2.8 million, 10); Slovenia (same thresholds as in the Directive). The Estonian Accounting Act does not set corresponding thresholds, since Estonian enterprises can elect to prepare their financial statements in conformity with IFRS or Estonian Accounting Guidelines issued by Estonian Accounting Standards Board.

<sup>17</sup> As permitted by Article 27 of the Fourth EU Company Law Directive.

of sales of LVL400,000 for B, respectively. The importance of reporting these elements separately should not be underestimated. For most decisionmakers, the parts of the financial statements will often be more useful than the whole.<sup>18</sup>

- The Law is silent on the issue of capitalization of formation expenses. Since it does not state whether formation (or start-up) expenses may be capitalized, it consequently does not set out a maximum period to write off the capitalized expenses or set restrictions on the distribution of profits.<sup>19</sup> In addition, the Accounting Board's work program for 2005 includes issuing an accounting standard on intangible assets, which will cover the issue of capitalization of formation expenses. However, the current omission of this issue may contradict the *acquis*,<sup>20</sup> which requires that "formation expenses be written off within a maximum period of five years," and that "in so far as formation expenses have not been completely written off, no distribution of profits shall take place unless the amount of the reserves available for distribution of profits brought forward is at least equal to that of the expenses not written off." Indeed, since this is not regulated, a company might capitalize formation expenses and distribute dividends in contradiction of Article 34 of the Fourth EU Company Law Directive.<sup>21</sup>
- The Law also sets out detailed accounting rules on equity accounting for associates, which include formal requirements such as that the financial statements of the associate used in applying the equity method be those approved by the shareholders.<sup>22</sup> This formal requirement may forbid a company from using the most recent available financial statements of the associate.

10. **The Law on Consolidated Annual Accounts of Enterprises enacts the provisions set out in the Seventh EU Company Law Directive, as amended in June 2003.** The Law, which was last amended in November 2003, applies to all limited liability companies except banks, insurance companies, private pension funds, investment management companies, and investment firms. The Law is largely based on the Seventh EU Company Law Directive, including the most recent amendments thereto, with the following interesting elections:<sup>23</sup>

- Like some other Member States, the Law also imposes that all limited liability companies prepare consolidated financial statements, comprising a consolidated balance sheet, income statement, cash flow statement, and statement of changes in equity, as well as notes. This requirement is more demanding than the current requirements of the *acquis communautaire*, which do not mandate a consolidated cash flow statement and statement of changes in equity.
- As permitted by the Directive and in line with the Directive's implementation in most Member States, the Law exempts small groups of companies from consolidation

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<sup>18</sup> The ROSC team was informed that the simplified option is rarely used in practice and hence may not be a pervasive issue.

<sup>19</sup> The ROSC team was informed that this issue may not pose a pervasive or significant problem in Latvia, as formation expenses tend to be low and, hence, expensed rather than capitalized.

<sup>20</sup> See Article 34 of the Fourth EU Company Law Directive.

<sup>21</sup> Creditor protection is at the heart of the Fourth and Seventh Company Law Directives. In addition to what is laid out in Article 34 of the Fourth EU Company Law Directive, Article 37 sets out provisions regarding the legal reserves for the capitalization of formation expenses, as well as research and development, and goodwill. In addition, other parts of the *acquis* also set forth several measures to protect creditors from undue payouts to shareholders.

<sup>22</sup> See Section 39.3 of the Law on the Annual Accounts of Enterprises.

<sup>23</sup> The Seventh EU Company Law Directive includes a lot of options, which Member States have to decide upon when transposing the Directive in national law. The report merely highlights the primary striking points in the Latvian transposition of the Directive.

requirements. Small groups of companies are defined as groups where the parent company and the companies to be consolidated do not together, on the basis of their latest legal entity financial statements, exceed the thresholds in paragraph 9 above. In line with the Directive, this exemption is not available to listed companies.

- The Law provides an exemption from consolidation when a parent company is itself a subsidiary of a Latvian company that prepares consolidated financial statements. The Directive requires that the exemption be extended to any parent company, which is itself a subsidiary of a company incorporated in any EU Member State. The Law's exemption is more restrictive than the Directive's and contradicts the *acquis communautaire*. Based on the importance of foreign direct investment from other Member States, this departure from the *acquis* may have significant implications.<sup>24</sup>

**11. The Law on the Financial Instruments Market (dated November 2003, and effective January 1, 2004) imposes specific financial reporting requirements on listed companies.**

The Law requires that:

- **Companies listed on the official list, which represented 77.8 percent of the Riga Stock Exchange total market capitalization as of end-2004, present their legal entity financial statements in accordance with IFRS.**<sup>25</sup> Latvia has extended the scope of EU Regulation 1606/2002 on the use of IFRS, which only mandates the use of IFRS in consolidated financial statements of listed companies.<sup>26</sup> However, listed limited liability companies remain subject to the Law on the Annual Accounts of Enterprises. Therefore, they may need to prepare a second set of legal entity financial statements in accordance with Latvian accounting requirements in the event compliance with IFRS would be incompatible with Latvian legislation, which may be the cases in certain—albeit rare—circumstances as evidenced in Section III.
- **Companies listed on the official list are also required to present quarterly and half-yearly legal entity or consolidated financial statements prepared pursuant to the laws of their registration country, IFRS, and the regulations issued by the Riga Stock Exchange.**<sup>27</sup> Although the option to present interim legal entity or consolidated financial statements is allowed under the current *acquis communautaire*,<sup>28</sup> it does not comply with IFRS, which requires that consolidated financial statements be presented when a company has subsidiaries. This potential inconsistency between the current *acquis* and IFRS, however, will be rectified once the “Transparency Directive,”<sup>29</sup> is transposed into national legislation. The deadline for transposition is January 20, 2007.

<sup>24</sup> As of September 2004 the stock of inward foreign direct investment (FDI) amounted to EUR2.2 billion, equal to about 35 percent of GDP. EU Member States have contributed over 50 percent of all FDI into Latvia, among which the Scandinavian countries have invested the greatest share.

<sup>25</sup> See Section 56.2 of the Law on the Financial Instruments Market. This requirement is also part of Section 11.2 of the Riga Stock Exchange Rules on Listing and Trading of Financial Instruments on the Markets Regulated by the Exchange.

<sup>26</sup> Regulation 1606/2002 of the European Parliament and of the Council of July 19, 2002, on the application of International Accounting Standards.

<sup>27</sup> See Section 57.7 of the Law on the Financial Instruments Market. This option is also included in Section 24.4.4 of the Riga Stock Exchange Rules on Listing and Trading of Financial Instruments on the Markets Regulated by the Exchange.

<sup>28</sup> See Article 74 of Directive 2001/34/EEC.

<sup>29</sup> See Directive 2004/109/EC of the European Parliament and of the Council dated December 15, 2004, on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

- **All listed companies (i.e., those on the official, second and free lists) must prepare interim financial statements.** As noted above, Regulation 1606/2002 has already paved the way for a convergence of financial reporting standards throughout the EU for listed companies, which are required to prepare consolidated financial statements. Interim financial reporting will also be required under the “Transparency Directive.”
- **Companies listed on the second and free lists prepare their legal entity financial statements in accordance with the requirements of the Law on Annual Accounts and the Law on Consolidated Annual Accounts of Enterprises, respectively.** The consolidated financial statements of these companies are prepared in accordance with IFRS, per the requirements of Regulation 1606/2002.<sup>30</sup>

12. **The Law on Credit Institutions (last amended in October 2004) requires banks to prepare financial statements in compliance with the Law on Accounting and regulations issued by the Financial and Capital Market Commission (FCMC), which must comply with IFRS.** The Law sets out that the specific content of the financial statements (balance sheet, income statement, cash flow statement, statement of changes in equity, and notes) shall be determined by the FCMC. Accordingly, the FCMC issued Regulation 24/3 on the Preparation of Annual Reports of Banks dated December 21, 2001, and Regulation 12/6 on the Preparation of Consolidated Annual Reports of Banks dated September 21, 2001. The Regulations purport to be prepared in accordance with IAS 1 to 40, the interpretations issued by the Standing Interpretation Committee (SIC) 1 to 24, and the Banking Accounts Directive. They lay down the principles that govern the drawing up of legal entity and consolidated financial statements; state general principles for the valuation of items in the financial statements and specific valuation rules; and list the information that must be provided in the notes to financial statements. The Regulations are supplemented by Regulation 24/9 on the Assessment of Assets and Off-balance-sheet Liabilities, which requires banks to calculate impairment for loans and receivables and sets guidelines for calculation of provisions. While Latvian banking accounting rules are generally consistent with the Banking Accounts Directive and generally-accepted prudential accounting practices,<sup>31</sup> there may be differences with “full IFRS” with respect to measurement of some of the elements of financial statements (see Paragraph 38 below).

13. **The Law on Insurance Companies and Supervision (amended 2004) requires insurance companies to prepare financial statements in compliance with the Law on Accounting and regulations issued by the FCMC.** The FCMC issued Regulation 357 on the Preparation of Annual Reports and Consolidated Annual Reports of Insurance Joint Stock Companies and Mutual Insurance Co-Operative Societies, which was last amended in 2004. The Regulation is largely based on the Insurance Accounts Directive and also purports to comply with IFRS. However, as discussed in paragraph 39 below Latvian insurance accounting rules may differ from “full IFRS” with respect to measurement of some of the elements of financial statements.<sup>32</sup>

<sup>30</sup> It should be noted that EU Regulations are directly applicable and binding in all EU Member States without the need for any national implementing legislation. Regulations are the piece of EU legislation that most closely resemble a domestic statute and are used when uniformity is crucial. Therefore, transposition in Latvian law is not required for Regulation 1606/2002 to apply in Latvia.

<sup>31</sup> For example, refer to Sound Practices for Loan Accounting and Disclosure, Basel Committee on Banking Supervision, July 1999.

<sup>32</sup> That is, with respect to whether an item is included in the financial statements and for what amount.

14. **Latvian enterprises face significantly greater audit burdens than enterprises in most EU Member States.**<sup>33</sup> The Commercial Law requires that all limited liability companies be audited.<sup>34</sup> However, the Law on the Annual Accounts of Enterprises exempts companies that do not exceed two of three size thresholds from audit requirements. These thresholds are a total balance sheet of LVL100,000 (equivalent to approximately EUR144,000), net annual turnover of LVL200,000 (equivalent to approximately EUR288,000), and 25 employees. These thresholds effectively require that approximately 6,000 out of 60,000 Latvian limited liability companies as well as approximately 500 public and local entities (e.g., municipalities) and other regulated entities (e.g., banks, insurance companies, etc.) be audited by 143 practicing auditors. These thresholds are considerably lower than those set forth in Article 11 of the Fourth EU Company Law Directive (EUR3,650,000 total balance sheet, EUR7,300,000 income statement, 50 employees) and may result in the audit of financial statements when there is no public interest requirement. Such an over-extensive audit requirement may undermine audit quality, even for *public interest entities*,<sup>35</sup> since the entire culture of quality and compliance becomes polluted, with no countervailing safeguards.<sup>36</sup>
15. **Shareholders appoint the statutory auditor annually, but unlike in certain EU Member States, the Commercial Law does not include any termination mechanisms that could provide additional safeguards to auditor's independence.** Hence, a statutory auditor may resign or be dismissed to avoid an audit qualification.
16. **There are additional legal requirements concerning audit of banks, private pension funds, investment management companies, investment firms, and insurance and listed companies.** The following factors apply in relation to statutory auditors of the licensees of the FCMC:
- *The FCMC has the authority to veto the appointment of a statutory auditor in a bank, an insurance company, an investment management company but not in a listed company.* FCMC Regulation 12/4 dated September 28, 2001 requires that banks, insurance companies, investment management companies, and private pension funds inform the FCMC in writing about the statutory auditor they have selected. The Regulation grants the FCMC a right of veto against the appointment of a statutory auditor.<sup>37</sup> The Regulation does not apply to listed companies.

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<sup>33</sup> For comparison purposes, the approximate thresholds applying to limited liability companies in select Member States are: Belgium (EUR3.1 million, EUR6.25 million, 100) Czech Republic (EUR1.3 million, EUR2.6 million, and 50 employees); Estonia (EUR320,000, EUR640,000, 10); Lithuania (EUR1.4 million, EUR2.8 million, 50) ; Luxembourg (EUR3.125 million, EUR6.250 million, 50); Slovak Republic (EUR520,000, EUR1 million, and 20– all joint stock companies have to be audited regardless of their size); Slovenia (same thresholds as the Directive); and United Kingdom (EUR4.1 million, EUR8.2 million, 50).

<sup>34</sup> See Section 176 of the Commercial Law.

<sup>35</sup> Within this report, *public interest entities* are those in which the general public has an interest by virtue of the nature of their business, their size, their number of employees, or their range of stakeholders. Examples include banks, insurance companies, investment funds, pension funds, listed companies, and large enterprises such as the large state-owned enterprises.

<sup>36</sup> Observers, including sworn auditors, pointed to the fact that statutory audits of the smaller enterprises are conducted for as low as LVL500 (equivalent to approximately EUR720). One may question the scope and hence the reliability of an audit conducted for such a low fee.

<sup>37</sup> A review of the audit reports relating to licensees of the FCMC supervision shows that the majority of statutory auditors appointed by these *public interest entities* are local member firms of international audit firm networks.

- ***The appointment of a listed company statutory auditor is subject to prior approval by the Stock Exchange.*** The listing rules of the Riga Stock Exchange require that the statutory auditor of a Latvian company listed on the official list be approved by the Exchange.<sup>38</sup> The listing rules also require that a listed company submit, without delay, the statutory auditor's report to the Exchange if the report is qualified or adverse.<sup>39</sup>
- ***Credit Institutions.*** The Law on Credit Institutions requires that a sworn auditor audit the financial statements of a credit institution in accordance with International Standards on Auditing. The Law denies the shareholders the right to approve the financial statements if such an audit has not been performed. Also, in the event the statutory auditor's report includes an emphasis-of-a-matter, a qualification, an adverse opinion or a disclaimer of opinion, dividends may be paid only upon approval of the FCMC.<sup>40</sup> In addition the Law requires that the statutory auditor communicate certain matters, in writing, to the FCMC. These include violations of laws or regulations and deficiencies that might threaten the credit institution or the interests of its clients. The auditor's duty of confidentiality is overridden by statute, i.e., the supervisory authority is entitled to receive confidential information from the auditors.
- ***Insurance Companies.*** The Law on Insurance Companies and Supervision requires that a sworn auditor audit the financial statements of an insurance company in accordance with the Law on Sworn Auditors. In the event the statutory auditor's report includes an emphasis-of-a-matter, a qualification, an adverse opinion or a disclaimer of opinion, dividends may be paid only upon approval of the FCMC.<sup>41</sup> In addition to the audit report on the financial statements, the Law requires the statutory auditor to prepare a management letter, identifying any particular deficiency and addressing matters identified as relevant by the FCMC, which must be sent to the FCMC. The FCMC also has an explicit right to request any information directly from the statutory auditor.
- ***Mandatory Rotation.*** The Law on Sworn Auditors sets out a mandatory five-yearly audit partner rotation for the statutory audits of banks, insurance companies, investment management companies, private pension funds, and listed companies.<sup>42</sup>

17. **The Law on the Annual Accounts of Enterprises allows larger enterprises to file their legal entity financial statements later than smaller enterprises, which may not be consistent with the public interest.** No later than one month after the approval of the annual report by the shareholders' meeting and, at the latest four months after the end of the year, the audited legal entity financial statements must be filed with the tax authorities and the Register of Enterprises. Companies that, on their balance sheet date, exceed two of the following three criteria: balance sheet total of LVL1 million (equivalent to approximately EUR1,440,000), net turnover of LVL2.4 million (equivalent to approximately EUR3,450,000), and 250 employees, may file their audited legal entity financial statements within seven months after

<sup>38</sup> See Section 9.3.1 of the Riga Stock Exchange Rules on Listing and Trading of Financial Instruments on the Markets Regulated by the Exchange.

<sup>39</sup> See Section 24.5.3 of the Riga Stock Exchange Rules on Listing and Trading of Financial Instruments on the Markets Regulated by the Exchange.

<sup>40</sup> See Sections 85 and 86 of the Law on Credit Institutions.

<sup>41</sup> See Section 54 of the Law on Insurance Companies and Supervision.

<sup>42</sup> See Section 29.4 of the Law on Sworn Auditors.

the year end.<sup>43, 44</sup> These companies are also required to publish their annual report in the national business publication, *Latvijas Vestnesis*.

18. **The Register of Enterprises estimates that only 55 percent of companies comply with the filing requirements, which is not sufficient for proper dissemination of financial information.** The Register of Enterprises has a central office in Riga and eight regional branches across the country. If companies do not submit their annual statements in due time, they receive a reminder from the Register. In cases of noncompliance for two consecutive years, companies may face compulsory liquidation. In 2003, 658 liquidations were initiated by the Register.
19. **Financial statements are available at the Register of Enterprises or electronically on the Internet.** Any interested person can obtain a copy of a company's audited financial statements—including balance sheets, income statements, cash flow statements, changes in equity and reserves, notes to the financial statements and auditor's reports—at the Register. Company financial statements are also readily and electronically available—with the important exception of the notes to the financial statements and the auditor's reports—on the Internet. The notes and the auditor's report are available only on special request for photocopies.
20. **There are additional legal requirements concerning banks, private pension funds, and insurance and listed companies.** The following apply in relation to the licensees of the FCMC:
  - The Law on Credit Institutions requires that audited financial statements be made publicly available no later than three months after the year end and be published in the official gazette within four months of the year end. Although the Law does not specifically require publication of consolidated financial statements, this is required by FCMC Regulation on the "Preparation of Consolidated Annual Accounts of Banks."
  - The Law on Insurance Companies and Supervision requires that audited financial statements be made publicly available no later than four and a half months after the year end and consolidated financial statements no later than seven months after the year end.
  - Listed companies must send their audited financial statements to the stock exchange within a day of receipt of the auditors' report. The Riga Stock Exchange is required to post the financial statements on its website. In the event the financial statements approved by the shareholders differ from those sent to the Stock Exchange, the listed company must send the approved financial statements to the Stock Exchange, which will update the financial statements posted on its website.

## **B. The Profession**

21. **Differences in technical proficiency of Latvian auditors result in significant differences in audit quality.** In line with the *acquis communautaire*, the right to conduct statutory audits of financial statements is reserved for members of the Latvian Association of Sworn Auditors (LASA). LASA, which was established in 1994, has 143 individual members, of which 133

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

<sup>44</sup> The Law on the Consolidated Annual Accounts of Enterprises imposes the same deadline for filing consolidated financial statements.

are in public practice (114 operate within registered audit firms and 19 operate as sole practitioners). Audit firms include local member firms of international audit firm networks, as well as “truly local firms,” a growing number of which were set up by former employees of local member firms of international audit firm networks. Institutional investors, commercial banks, and other users of audited financial statements point to an uneven profession where a number of sworn auditors who were grandfathered into the profession in 1994 may not have been subjected to the same professional qualification requirements as the more recently certified auditors.<sup>45</sup> There is little research to substantiate the public perception that the quality of some members of the profession may not meet generally accepted professional qualification criteria. Still, this negative view may jeopardize the contribution of statutory audits to a well-functioning market economy, since an audit’s value is based on the user’s trust in the audit function. This report’s policy recommendations stress that the present situation requires further initiatives to enhance public trust in the audit function in Latvia.

22. **The mandate of LASA does not explicitly include serving the public interest.** The Law on Sworn Auditors established LASA as “an independent professional corporation of Latvian sworn auditors ... representing the interests of its members and defending them.” However, the mandate of a professional association of auditors should not so much be to defend themselves, but rather the public interest. Hence, the Law should make it the explicit duty of LASA to serve the audit profession’s public, which consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of auditors to maintain the orderly functioning of commerce.
23. **The International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants (as enacted in November 2001) was adopted in full in December 2004.** The Law on Sworn Auditors establishes the principle that a sworn auditor must be independent in his or her professional activity. However, the Law does not prevent auditors from accepting nonaudit work from audit clients, including financial information systems design, and implementation and appraisal or valuation services. In several instances, the ROSC team met with auditors and preparers of financial statements, which admitted to the fact that statutory auditors are involved in bookkeeping activities and prepare the financial statements contemporaneously with the statutory audit. While a breach of generally accepted independence requirements, the ROSC team noted that this situation resulted from an acute lack of professionally trained accountants and bookkeepers. The ROSC team is worried that this issue may be compounded by the 2005 requirement to use IFRS in preparing consolidated financial statements of listed companies because of scarce capacity regarding IFRS in Latvian enterprises (see paragraph 11 above).
24. **While the Law on Sworn Auditors goes beyond what is required by the Eighth EU Company Law Directive (1984) in some areas,<sup>46</sup> it falls short of some of the requirements that will be forthcoming under the proposal for a new Eighth EU Company Law Directive, particularly the requirement for public oversight of the audit profession.** The Law on Sworn Auditors recognizes the profession largely as self-regulated and independent, with state supervision carried out by the Ministry of Finance. The main governing body of LASA is the general meeting of its members, i.e., the sworn auditors. The

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<sup>45</sup> Among the 143 members of the LASA, 72 were grandfathered in 1994 and another 25 certified in 1995. Four auditors were certified in 2002, none in 2003, and seven in 2004.

<sup>46</sup> For example, mandatory five-year audit partner rotation for listed companies, requirement to comply with ISA, and requirement on quality control.

general meeting elects the chairperson of LASA and the members of the board of directors for a three-year renewable term. LASA has established nine permanent committees, among which committees on ethics, certification, examination, education, licensing, and quality. The Ministry of Finance appoints three representatives who are entitled to participate, without having the right to vote, in general meetings and board of directors meetings of LASA, as well as to have access to the decisions taken by the Association.<sup>47</sup> The current self-regulatory regime which includes the involvement of the Ministry of Finance in LASA falls short of the system required under the proposal for a new Eighth EU Company Law Directive.<sup>48</sup> The proposed Directive sets out that the system of public oversight must have the ultimate responsibility for the oversight of the approval and registration of statutory auditors and audit firms, the adoption of standards on ethics, internal quality control of audit firms and auditing, and continuous education, quality assurance and investigative and disciplinary systems.

25. **Latvian legislation relating to auditor's liability has not been tested.** Existing law provides a strong deterrent; however, the lack of court decisions on this issue make it difficult to assess how a court would treat the limits of liability.<sup>49</sup> According to observers, the short history and the unfamiliarity of the profession in the country has made the auditing profession less subject to civil or criminal lawsuits. The main issues concerning the current Latvian legislation of auditors' activities include the following:<sup>50</sup>

- **The Commercial Law and the Law on Sworn Auditors provide for a civil liability mechanism and do not limit the scope of claimants who have the right to file claims against an auditor.** A sworn auditor or an audit firm is liable for the obligation arising from the audit contract and for losses that have occurred to third parties (users of financial statements and consolidated financial statements). In cases of audit reports signed by two or more auditors, they are jointly liable for losses. Compensation for losses is covered by a mutual agreement or by filing a lawsuit within three years after the signature of the audit report.<sup>51</sup> Sworn auditors and audit firms are required to take out a professional indemnity insurance policy of at least LVL30,000 (equivalent to approximately EUR43,120) and LVL100,000 (equivalent to approximately EUR143,730), respectively.
- **The Criminal Law and the Law on Prevention of Legalization of Proceeds from Crime include provisions that could apply to the criminal liability of auditors.** In Latvia, criminal liability issues are regulated by the Criminal Law, which does not

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<sup>47</sup> Within the Ministry of Finance, the Department of Coordination and Analysis of Accounting Methods (DCAAM) is responsible for this task.

<sup>48</sup> It should be noted that although the Eighth EU Company Law Directive (1984) contains some requirements on registration and professional integrity, it does not include requirements on how a statutory audit should be conducted and the degree of public oversight or external quality assurance which is needed to ensure a high-quality audit. The lack of a harmonized approach to statutory auditing in the EU was the main reason behind the Commission's proposal for a new Eighth EU Company Law Directive (March 2004), which maintains the basic conditions on education and training from the existing Directive but broadens the scope of application of EU legislation by introducing new requirements concerning the manner in which an audit should be carried out and the structures needed to ensure audit quality as well as ensure trust in the audit function. As of the date of this report, the new Eighth EU Company Law Directive has not yet been passed by the European Council and Parliament.

<sup>49</sup> The ROSC team is unaware of any court cases against auditors that have been adjudicated in full; instead, the parties have settled.

<sup>50</sup> This report outlines the legal principles applicable with regard to auditors' liability 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 reading it.

<sup>51</sup> See Section 41 of the Law on Sworn Auditors.

contain any direct provisions or references that would be applicable to auditors. However, Latvian lawyers contend that this does not mean that auditors are not subject to criminal liability. Sworn auditors and audit firms are subject several provisions of the Criminal Law<sup>52</sup> and the Law on Prevention of Legalization of Proceeds from Crime; hence, if auditors breach these provisions, they may face criminal charges for their actions. In these cases, penalties range from fines, forced labor, arrest or incarceration.

- **LASA is responsible for compliance with professional standards and ethical norms and other laws and regulations applicable to the professional activity, as well as supervision of professional activity of the members of the Association.** In the event of a violation of the Law on Sworn Auditors, the International Standards on Auditing recognized in Latvia, the code of professional ethics, LASA may suspend or annul the sworn auditor's certificate or suspend or annul the license of the audit firm. Disciplinary sanctions include a warning, a reprimand, a suspension of the sworn auditor's certificate for a specified time period, not longer than a year, or a cancellation of a sworn auditor's certificate.
26. **There is a lack of transparency of audit firms and their networks, including the relationship between the local firms and their international network, which could impede adequate monitoring of the profession and is not in line with the requirements in the proposed Eighth EU Company Law Directive.** The ROSC team was unable to obtain documented information regarding the internal quality assurance arrangements of audit firms, including the size of the audit firm, the owners and management members of the audit firm, the network's membership or the basis for partner remuneration, and the number of clients in sectors of the economy. Transparency should be a natural requirement for audit firms, which fundamentally operate to ensure the transparent financial reporting by companies. In addition, the absence of such information has implications for effectively regulating and monitoring the audit profession.

### C. Professional Education and Training

27. **The Law on Sworn Auditors is largely based the Eighth EU Company Law Directive of April 10, 1984, on approval of statutory auditors.** A prospective auditor-trainee must have graduated from college in a bachelor's program in economics, management or finance to start a traineeship. A prospective certified auditor qualifies having graduated from college in a bachelor's program, obtaining three years of additional practical experience in auditing, and passing LASA's examination.<sup>53</sup> A certified auditor must also have command of the Latvian language. An aptitude test, covering public law, civil law, labor law, etc., is prescribed for the approval of statutory auditors from foreign countries, including other EU Member States. The professional examination covers subjects mandated by the Eighth EU Company Law Directive and is handled by the Examination Committee of LASA.

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<sup>52</sup> Relevant portions of the Criminal Law that would be applicable to cases of malfeasance on the part of auditors include the section on "Crimes against national economy," as well as provisions relating to the abuse of power, negligence, unauthorized acceptance of benefits and unauthorized acquisition and disclosure of commercial secrets, as well as unauthorized disclosure of insider information with regard to the financial instruments market.

<sup>53</sup> Two of the three years of practical experience must be obtained auditing financial statements according to Latvian legislation.

28. **LASA does not monitor adequately the quality of the practical experience obtained by individuals (trainees) undertaking pre-qualification work experience and training within audit firms.** 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 supervise the practical training for quality.
29. **The number of new entrants in the audit profession is not sufficient to maintain the current number of statutory auditors over time, let alone increase it to a number in line with the scope of current audit requirements in Latvia.** Observers, including LASA, point to the fact that the small number of new entrants into LASA stems from a lack of interest for the statutory audit profession. Coincidentally, there are now some 80 ACCA members and over 200 ACCA students in Latvia, and the number of both members and students grows each year.
30. **LASA requires continuing professional education (CPE) for its members.** A sworn auditor is required to attend 40 CPE hours every year or 120 hours every three years. LASA has established a subsidiary, LASA Education Centre, which specializes in providing training for sworn auditors. Sworn auditors can elect to get their CPE at any other training institute.

#### **D. Setting Accounting and Auditing Standards**

31. **The Law on Accounting grants authority regarding accounting policymaking to the following bodies:**
- The Accounting Board: is responsible for drafting and issuing accounting standards and regulations consistent with IFRS and the *acquis communautaire*. In order for these standards to have legal force, they must then be formally enacted by the Cabinet of Ministers. The Board is financed from the State budget and consists of twelve members representing the Ministry of Finance (2), LASA (2), higher educational establishments (2), the Financial and Capital Market Commission, the Bank of Latvia, the State Revenue Service, the State Treasury, the State Control, and the Association of Accountants.
  - The Cabinet of Ministers: is responsible for formally enacting the accounting standards drafted by the Accounting Board and determining the scope of application of such standards.
  - The Ministry of Finance: is responsible for elaborating and implementing State policy on accounting.
32. **Lack of human resources constrains the activities of the Accounting Board.** Since January 1, 2005, listed companies present their consolidated financial statements in accordance with IFRS. However, Latvian accounting regulations and standards remain the relevant financial reporting framework for most enterprises, including a large number of *public interest entities*. While the recent harmonization of the Fourth and Seventh EU Company Law Directives with IFRS and their forthcoming further enhancements (e.g., disclosure of related party transactions, disclosure of material off-balance sheet arrangements) are conducive to more transparent financial reporting, and provide a sound model to start with, the successful implementation of these Directives requires an efficient institutional mechanism at country level, i.e. a fully operational Accounting Board.

33. **The Accounting Board perceives standard setting activities to be a priority and has embarked on a project to draft Latvian Accounting Standards.** Two national standards were prepared in 2003, i.e., LGS 1, *Basic principles for preparation of financial statements*, which is inspired from IAS 1, *Presentation of Financial Statements*, LGS 2, which is a simplified version of IAS 7, *Cash Flow Statements*, and includes several illustrative examples. These two standards were enacted by the Cabinet of Ministers in July 2004. The Accounting Board expected to issue eight additional standards in 2004 but only one (LAS 3, *Events after the balance sheet date*) was issued. In February 2005, LAS 4, *Changes in accounting policies and accounting estimates and errors*, was issued, and six additional draft standards have been elaborated and should be issued shortly (*Income taxes, Leases, Revenue, Long-term contracts Fixed assets and provision, and Contingent liabilities and contingent assets*). An additional program of eight new standards has been set up by the Accounting Board for completion in 2005.
34. **The Law on Sworn Auditors requires that statutory audits be carried out in accordance with auditing rules adopted by LASA, which must conform to International Standards on Auditing.** In principle, the requirement is consistent with the proposal by the European Commission to require the use of “endorsed” International Standards on Auditing (i.e., ISAs adopted by the European Commission) as a requirement for all EU statutory audits beginning 2007 onwards.

#### **E. Enforcing Accounting and Auditing Standards**

35. **The FCMC is not geared to enforce accounting standards.** Since July 2001, the banking, insurance, and securities markets have been under the control of an integrated Financial and Capital Market Commission. The Supervision Department of the FCMC employs 36 people (primarily responsible for off-site and on-site supervision in banks and insurance companies, as well as other financial and capital market participants) who have a background in economics and law. The FCMC does not enforce accounting standards in general-purpose financial statements and relies primarily on statutory auditors to ensure compliance with accounting standards. There is no standardized procedure for monitoring compliance with IFRS and ISA. Also, it is not clear whether the law provides the FCMC with authority—under specific circumstances and defined procedures—to request audit work papers and compel the production of documents or the attendance of witnesses. While the FCMC staff possess strong theoretical knowledge and are highly motivated, the FCMC lacks personnel with adequate training to adequately enforce accounting standards in general-purpose financial statements. Also, the FCMC lacks adequate resources to play an active role in CESR-fin.<sup>54</sup> The Riga Stock Exchange does not enforce accounting standards.
36. **LASA has developed procedures for quality control of auditors and audit firms, which were approved by the Ministry of Finance but the system has not yet been implemented. Hence, at present, LASA only reviews the quality of an audit when prompted to do so based on a complaint filed by a stakeholder.** The main features of the proposed system include the following:

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<sup>54</sup> These findings are consistent with the report “Implementation of International Financial Reporting Standards by Listed Companies in the Three Baltic Republics,” available at: <http://files.ee.omxgroup.com/bors/koolitus/Implementation%20of%20IFRS.pdf>, which states in paragraph 6.5: “The Latvian FSA (Financial Supervisory Authority) did not take part in this project as they stated that the IFRS compliance of listed companies is not their responsibility.”

- ***The quality assurance regime focuses on sworn auditors and audit firms.*** All members of LASA, including those employed in audit firms, will be subjected to LASA's quality assurance system.
- ***Each sworn auditor will be subject to quality review once every five years.***

The proposed quality assurance system does not meet the requirements of public oversight required under the proposal for a new Eighth Company Law Directive. The proposed Directive sets out that quality assurance systems should have adequate public oversight governed by a majority of non-practitioners. This public oversight should be conducted with a high level of integrity and assure the quality of reporting in fact and appearance. The proposed Directive requires public oversight of the quality assurance system in order to ensure public confidence in the quality of audit.

### III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

37. **While recent Latvian accounting requirements are generally in line with the Fourth and Seventh EU Company Law Directives, remaining weaknesses impede reliability and comparability.** As discussed in paragraphs 9 and 10 above, Latvian accounting requirements are generally in line with the Fourth and Seventh EU Company Law Directives. Some fundamental differences with IFRS exist and Latvian accounting requirements may not provide the general public with sufficient information about *public interest enterprises*. Selected differences include the following:

- ***The scope of consolidation is less stringent than under IFRS.*** Latvian accounting requirements allow subsidiaries not to be consolidated on the grounds of materiality. Under Latvian standards, investment in subsidiaries presented in the legal entity financial statements of the parent company is accounted under the equity method, similar to IFRS, but there is no requirement to assess the fair value of the net assets of such subsidiaries at the dates of acquisition. As a result, there would, for instance, be no amortization of goodwill or other intangible assets (which might have been recognized had such a valuation been made at the time of acquisition) built into the annual accounting under the equity method.
- ***Earnings per share need not be disclosed.*** Latvian accounting requirements do not mandate the disclosure of earnings per share. Earnings per share is an extremely valuable piece of information used particularly by stockholders and potential investors in evaluating the profitability of a company.
- ***Lax revenue recognition principles.*** Latvian accounting requirements do not include detailed provisions for revenue recognition and require revenue to be recognized on an accrual basis, irrespective of the date of issuance of invoice or receipt for cash. Revenue should be recognized (i.e., revenue should be recorded in a company's books) only when it is realized or when it is earned. The practice of recognizing revenue on an accrual basis should not be used across the board, but rather should be limited only to certain instances, for example, when there is a high degree of certainty that the earning will in fact be realized/earned. Correct application of revenue recognition principles is important to promote greater reliability and relevance of financial statements.
- ***Inconsistent accounting for leases.*** Latvian accounting requirements do not explicitly set out accounting rules for leasing.<sup>55</sup> This may result in inconsistent

<sup>55</sup> However, an exposure draft of LAS, *Leases*, has been prepared.

accounting for leasing transactions and mislead the users of financial statements. For example, a company could lease a piece of equipment for the whole of its useful life and, due to the absence of relevant lease accounting requirements, not record the liability in its financial statements, thereby understating its outstanding debt. IFRS does not permit this.

38. **There are specific differences between IFRS and Latvian accounting requirements pertaining to banks.** As discussed in paragraph 12 above the Law on Credit Institutions requires banks to prepare financial statements in compliance with the Law on Accounting and regulations issued by the FCMC, which must comply with IFRS. Selected differences between current accounting requirements and “full IFRS” include the following:

- ***Differences between Latvian accounting requirements and IFRS may occur.*** FCMC Regulation 24/3 was prepared based on IAS 1 to 40, and SICs 1 to 24, as they existed in 2001. IFRS have changed significantly since 2001 and consequently, the Regulation does not cover the whole scope of current “full IFRS.” While these changes to IFRS did not have a significant impact on Latvian bank financial statements until January 1, 2005 when important changes to IFRS became effective (e.g., amendments to IAS 39, *Financial Instruments: Recognition and Measurement*), FCMC Regulation will need to be updated to reflect these amendments.

IFRS requires an entity, which purports to comply with IFRS, to make an explicit and unreserved statement of such compliance in the notes to its financial statements. In order to affirm IFRS compliance, a company must comply 100 percent with all the recognition, measurement and disclosure provisions of the standards and interpretations; if a company complies with 99 percent of IFRS requirements, it cannot affirm compliance with IFRS. It is for this reason that IAS 1, *Presentation of Financial Statements*, states that “financial statements shall not be described as complying with IFRS unless they comply with all the requirements of IFRS”. The International Accounting Standards Board (IASB) has therefore established unambiguously the principle that full application of its standards and related interpretations is a necessary prerequisite for an entity to assert that its financial statements comply with IFRS.

- ***Loan loss allowances.*** Regulation 24/9 on the Assessment of Assets and Off-balance-sheet Liabilities, which requires banks to calculate impairment of loans and receivables, prescribes several methods for calculation of provisions:
  - Loans are classified into five loan categories (i.e., standard, monitored, etc.) depending on the number of days in arrears, the borrower's financial standing, its credit history, trends in the borrower's industry, etc. The Regulation sets out a range of fixed minimum provisioning rates for each of the four loan categories classified as below standard (i.e., 10%, 30%).
  - Impairment is calculated as the difference between the carrying amount and expected future cash flows discounted at the original effective interest rate.
  - For collateral dependent loans, provisions are calculated as the difference between the carrying amount and fair value of the collateral.

However, the FCMC methodology may, in some instances, result in loan loss allowances that exceed those calculated in conformity with IAS 39. IAS 39 requires impairment or loan losses to be calculated as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred), discounted at the financial asset's original effective interest rate for assets carried at amortized cost.

- **Scope of consolidated financial statements.** Section 3 of Regulation 12/6 on the Preparation of Consolidated Annual Reports of Banks sets out a certain number of cases when daughter companies may not be consolidated in the consolidated financial statements of a mother company. IAS 27, *Consolidated and Separate Financial Statements*, requires that consolidated financial statements include all subsidiaries of the parent, except if on acquisition, a subsidiary meets the criteria to be classified as held for sale in accordance with IFRS 5, *Non-Current Assets Held for Sale and Discontinued Operations*. In particular, IAS 27 states that a subsidiary should not be excluded from consolidation because its business activities are dissimilar from those of the other entities within the group.

39. **There are specific differences between Latvian accounting requirements pertaining to insurance companies and IFRS.** As discussed in paragraph 13 above the Law on Insurance Companies and Supervision requires insurance entities to prepare financial statements every year, and the valuation of the items of financial statements shall be performed according to IFRS, insofar as these do not contradict regulations of the FCMC. Selected differences between current accounting requirements and full IFRS include the following:

- ***Differences between Latvian accounting requirements and IFRS may occur.*** The Regulations for Preparation of Annual Accounts and Consolidated Annual Accounts of Insurance Stock Companies and Mutual Insurance Co-operative Societies (the “Regulations”) set out which international standards to apply, including some IASs that have already been superseded at the international level and excluding some IASs and IFRSs that were issued since the Regulations were issued, including IFRS 4, *Insurance Contracts*, released in March 2004. Consequently, the Regulations do not cover the whole scope of current “full IFRS.”
- ***Impairment treatment for financial assets available for sale.*** Paragraph 12.36 of the Regulations sets out that “if impairment losses to financial assets available for sale, which have been valued at fair value, are recognized in the balance sheet item “Revaluation reserve” and there is objective evidence (see Paragraph 12.32) that the value of assets has decreased, the accumulated losses shall be excluded from the balance sheet item “Revaluation reserve” and included in the profit or loss statement, although the assets themselves have not been excluded from the balance sheet”. Further, paragraph 12.38 states that “if in the subsequent periods the fair value or the recoverable value of financial assets referred to in Paragraph 12.36 increases and this increase may be objectively related to an event which has taken place after the loss was recognized in the profit or loss statement, the value increase shall be included in the profit or loss statement for the accounting year”, which is contradictory to IAS 39 (revised), which does not allow a reversal of impairment of financial assets available for sale until the company disposes of such financial asset.
- ***Embedded derivatives.*** Under IFRS 4, where an insurance contract or investment contract is not already measured at fair value, embedded derivatives that are not themselves insurance contracts and not closely related to the host contract must be separated and valued at fair value. Consequently, companies will need to investigate and evaluate which guarantees and options will fall within the scope of fair value measurement. Such treatment is not foreseen in the Regulations.
- ***Expanded disclosures.*** The expanded disclosure requirements should not be overlooked. For insurance contracts, the disclosure requirements are found in IFRS 4. IFRS 4 has two main disclosure requirements: Principle 1: Explanation of reported amounts – “an insurer shall disclose information that identifies and explains the

amounts in its financial statements arising from insurance contracts;” and Principle 2: Amount, timing and uncertainty of cash flows – “an insurer shall disclose information that helps users to understand the amount, timing and uncertainty of future cash flows from insurance contracts.” Section 13 of the Regulations includes the contents of the notes and may be not broad and detailed enough to comply with IFRS disclosure requirements.

The disclosures likely to generate the greatest added effort or the greatest interest include:

- Risk management objectives and the policies established to mitigate insurance risk.
- Terms and conditions of insurance contracts that are likely to have a material impact on the amount, timing, and certainty of future cash flows.
- Information on interest risk and credit risk that is likely to be particularly important for reinsurance contracts.
- Insurance risk, including sensitivity analysis, and information about concentration of insurance risk (e.g., exposures on a group life portfolio).
- Details of actual claims development compared to previous estimates.

40. **The ROSC team made assessments of the compliance gap sampling five sets of financial statements that purport to be prepared in accordance with IFRS and 12 sets that purport to be prepared in accordance with Latvian accounting requirements.** For the sample review, the ROSC team selected 11 enterprise sector companies (listed and nonlisted), three banks, and three insurance companies.<sup>56</sup> The quality of the sample financial statements of most *public interest entities* is generally very good with only a few significant issues. This finding is consistent with that of Know Ltd.,<sup>57</sup> which found that the IFRS financial statements of companies on the main list of the Riga exchange were generally of high quality; however, the quality of those on the second list was very irregular. The following issues include circumstances when there may be material non-compliance with Latvian accounting requirements or IFRS and also raise questions about the reliability of the related audit opinions:<sup>58</sup>

- ***Overstatement of cash and cash equivalents.*** A listed company presenting IFRS financial statements included a blocked deposit of EUR1.8 million in “cash and cash equivalents” in the cash flow statement and the balance sheet. A blocked deposit may not meet the definition of cash in IAS 7, *Cash Flow Statements*, as it is not a demand deposit. This blocked deposit is also shown as a current asset, which may not comply with IAS 1, *Presentation of Financial Statements*.
- ***The assessment of impairment losses may not comply with IFRS.*** A listed company presenting IFRS financial statements revalued its buildings in 1997. These revaluations have not been kept up to date may not comply with IAS 16, *Property, Plant and Equipment*, and IAS 36, *Impairment of Assets*. Under IFRS, an enterprise

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<sup>56</sup> 12 entities in the sample are audited by local member firms of international audit firm networks. Five entities are audited by local audit firms.

<sup>57</sup> Please refer to the report in footnote 54.

<sup>58</sup> The ROSC team used stratified random sampling to select the companies that were analyzed in this report. However, due to the sample’s small size, it cannot be considered to be representative of all companies. Hence, the findings, although useful for illustrating potential problems in financial reporting, pertain to shortcomings found in the financial statements of specific companies. The findings may not reflect systemic problems that would apply to companies in general.

should assess at each balance sheet date whether there is any indication that an impairment loss recognized for an asset in prior years may no longer exist or may have decreased. The same company recognized impairment losses on two gas carrier vessels. The market value provided by professional valuers was lower than the carrying amount. Management has estimated value in use which is, presumably, higher than market value and which results in an impairment loss of EUR7.6 million. Value in use has been calculated using a discount rate of 9 percent. The ROSC team was unable to compare this with the rate on borrowings as these rates are not disclosed (contrary to IAS 32, *Financial Instruments: Disclosure and Presentation*).

- ***The measurement of loan losses (banks) may not comply with IFRS.*** In one instance, a bank—which purports to comply with IFRS—disclosed the following: “A provision for possible credit losses is established when a loan or advance has been classified as non-performing or high risk. A loan is classified as non-performing when contractually due principal is 30 days or more overdue, contractually due interest is 90 days or more overdue or management otherwise believes that interest or principal will not be received. The bank’s management has carried on with a policy to establish general provisions for regular loans not secured by deposits. These provisions are established in accordance with the bank’s internal credit rating category within the range of 0.35 percent to 1 percent of the outstanding principal amounts, whereas general provision for loans issued to enterprises and non-secured credit facilities on the settlement cards is at 1.5 percent and 2 percent level, respectively. General (portfolio) provision for overdrafts is established in accordance with the overdraft programs, i.e., at 0 percent to 1.5 percent level of the outstanding principal of the overdraft.” This approach may not comply with IAS 39 and the resulting provision may exceed that required by IAS 39.
- ***Inconsistent accounting for deferred taxes.*** Preparers indicated that they turn to the audit profession to develop interpretations when accounting requirements are silent. While all enterprises audited by local member firms of international audit firm networks accounted for deferred taxation, only one among the five enterprises audited by local audit firms did. The related audit reports were not qualified, which begs the question as to the appropriate accounting treatment for deferred taxes in Latvia.
- ***Accounting policies and disclosures are incomplete.*** The accounting policies and disclosures in financial statements of enterprises audited by local audit firms did not include several important disclosures such as the revaluation policy for non-current assets, depreciation rates for fixed assets, the policy for recognizing allowances for doubtful debt, amounts due from related parties, etc.
- ***Lack of capacity of companies to prepare IFRS financial statements.*** In a number of sample financial statements, it was unclear who had prepared the IFRS-based financial statements. The ROSC team discussed significant accounting policies and disclosures with company management during its due diligence mission. At times, the lack of ownership by management and senior financial personnel suggest that companies may not have the resources or ability to prepare IFRS financial statements. It is possible, therefore, that the auditors either prepared or provided significant assistance with the preparation of such financial statements. This raises a significant independence issue that was subsequently confirmed on a few occasions as to whether the actual accounting policies followed by the companies comply with the “boilerplate” disclosures in IFRS-based financial statements. A cursory review of financial statements does not allow the ROSC team to conclude on the pervasiveness of the issue, but the external quality assurance process of the audit profession,

together with increased monitoring of financial reporting by the FCMC should address these concerns.

41. **The assessments revealed that financial statements are often influenced by taxation and regulatory rules.** To satisfy requirements of taxation authorities and regulators, preparers of general-purpose financial statements of SMEs and *public interest entities* tend to follow tax and regulatory rules rather than the accounting treatment required by Latvian accounting requirements in various areas (e.g., depreciation, revenue recognition, provisions). Transparency and accountability suffer from this emphasis on tax and prudential requirements, and deviation from applicable financial reporting standards.
42. **Statutory auditors estimate that the number of qualified audit reports ranges between 10 to 15 percent.** They indicated that qualifications result from understatement of provisions, non-recognition of deferred taxes, and overstatement of accounts receivables and inventory. Such noncompliance resulting in overstated assets, understated liabilities, and overstated net income typically result from (1) a willingness to overstate results in certain enterprises, which contemplate applying for or have a commercial bank loan or (2) a refusal to record in the general purpose financial statements any amount that is not tax deductible.

#### IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

43. **Since statutory audits are required to be conducted in accordance with ISA, the concern is obviously one of compliance rather than quality of the standards.**
44. **Observers point to a problem of low quality of statutory audits.** From the review of a sample of audited financial statements and discussions conducted by the ROSC team with sole practitioners, small and large audit firms, and LASA, specific issues surfaced that adversely impact the average quality of auditing practices in Latvia:
- **Misleading auditor's report.** The 2001 and 2002 financial statements of a listed company were audited by the local member firm of an international audit firm network. The audit reports express the opinion that the 2001 and 2002 financial statements were presented in accordance with IFRS as well as Latvian accounting requirements. The 2003 financial statements were audited by another local member firm of an international audit firm network. There is no reference to IFRS in the 2003 audit report or in the financial statements. In addition, an appendix to the 2003 financial statements summarizes the significant differences between Latvian accounting requirements and IFRS.
  - **Lack of documentation.** Some auditors do not document some matters that are important in providing evidence to support their audit opinion and evidence that the audit was carried out in accordance with applicable standards.
  - **Fraud and error.** Responding to recent international corporate reporting scandals, the international standard on fraud and error has been reinforced by a recent amendment, which has not yet been reflected in the majority of Latvia auditing practices. More worrisome is that few auditors appear to understand their responsibility to consider fraud in audits of financial statements.
  - **Internal control systems.** Some auditors tend to start with substantive testing and do not always seek to obtain an understanding of the accounting and internal control systems. As a result, auditors may not become aware of weaknesses in these systems. Consequently, they may fail to make management aware of material weaknesses in

the design or operation of the accounting and internal control systems. This is a missed opportunity to enhance financial management in Latvia.

- **Related parties.** Strict application of the ISA-based related party transactions seems to give rise to tension between the auditor and management and may result in inadequate disclosure of related party transactions.
- **Lack of audit evidence.** Some auditors do not appear to systematically attend physical inventory counting even though inventory is material to the financial statements. In addition, some auditors do not appear to use external confirmations (e.g., from banks) even though circumstances may warrant it.

## V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

45. **As primary users of financial statements, bankers indicated that audit quality needs to be enhanced and enforcement mechanisms strengthened to improve the quality of corporate financial reporting.** Investors, lenders, and other users place little reliance on the information contained in corporate financial statements. Most interviewees consider that bank financial statements are generally more reliable than those of companies in the enterprise sector. Few observers commented on insurance undertakings. In the enterprise sector, interviewees generally consider the audited financial statements as more reliable than unaudited financial statements. Observers cited tax evasion and fraud as the core motivations behind accounting improprieties.

## VI. POLICY RECOMMENDATIONS

46. **The recommendations of this ROSC accounting and auditing report are mutually supportive in some obvious ways.** For example, superb accounting standards are jeopardized at the beginning if people do not understand how to translate the standards into a journal entry. Without attempting to provide a detailed tactical design for reform, and without pretending to do justice to the true specificity of the country's conditions, this ROSC accounting and auditing report sketches the policy recommendations to enhance the quality of corporate financial reporting. This will contribute to promoting private sector growth and reducing financial system instability, through:
- Strengthening Latvia's financial architecture and reducing the risk of financial market crises and their associated negative economic impacts, including through increased transparency about the financial condition and performance of public interest entities;
  - Contributing to foreign direct and portfolio investment;
  - Helping mobilize domestic savings;
  - Facilitating the access of smaller-scale corporate borrowers, including small and medium enterprises, to credit from the formal financial sector by shifting gradually from collateral-based lending decisions to lending decision, which are based on the financial performance of the prospective borrower;
  - Improving the assessment and collection of taxes on corporate profits;
  - Allowing investors to evaluate corporate prospects and make informed investment and voting decisions, which will result in a lower cost of capital and a better allocation of resources;

- Allowing shareholders and the public at large to assess management performance, thus influencing its behavior (financial reporting is also a building block of a market-based monitoring of companies); and
- Assisting the authorities to monitor and enforce compliance with the relevant portions of the *acquis communautaire*.

47. **Further enhancements to the statutory framework are needed.**<sup>59</sup> In this context, the authorities may want to 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 recent developments in the *acquis communautaire*. The working group should also undertake a comprehensive review of Latvian legislation to assess the effects of the forthcoming *acquis communautaire* in light of Latvia's recent experience as a new EU Member State in implementing the *acquis communautaire*. Due consideration should be given to the forthcoming amendments to the Fourth and Seventh EU Company Law Directives, the Eighth EU Company Law Directive, as well as to the recently-enacted Transparency Directive. Some issues on which the working group may want to focus include:

- ***Collective responsibility of board members.*** The working group should ensure that board members are collectively responsible for financial statements and consolidated financial statements both *de jure* and *de facto*. With a view to enhancing accountability, all company board members should be collectively responsible for the true and fair view of financial statements by law and in practice (see paragraph 6 above). As noted above, this existing legal provision in Latvia is consistent with the forthcoming *acquis communautaire* (see footnote 8). However, it is recommended that this requirement be clarified in the Commercial Law rather than addressed in a somewhat piecemeal manner in several laws. Any changes should conform with the forthcoming amendments to the Fourth and Seventh EU Company Law Directives, once approved by the European Parliament and Council.
- ***Transposition of the Fourth and Seventh EU Company Law Directives.*** The working group should undertake a thorough review of the Law on Annual Accounts of Enterprises and the Law on Consolidated Annual Accounts of Enterprises with a view to foster more transparent and reliable corporate financial reporting. In this context, the working group should work closely with the Accounting Board. For example, the Accounting Board may issue an accounting standard on intangible assets that deals with the issue of capitalization and amortization of formation expenses, in line with the Fourth EU Company Law Directive (see paragraph 9). The Directive includes such requirements, among other reasons, to ensure that users of financial statements, particularly creditors and investors, have a truthful representation of a company's financial situation. Considering that a large number of start-up companies fail within their first year, this issue becomes even more acute, as creditors need to have reliable information to determine if a company's assets will cover its liabilities in case of bankruptcy. In addition, such requirements preclude companies from distributing "profits" that were realized only because formation expenses were capitalized as assets and not written off in a timely manner.
- ***Conflicting or ambiguous financial reporting requirements.*** The working group should review the Latvian legal framework to ensure that there are no conflicting or

<sup>59</sup> In Latvia, accounting and auditing are primarily regulated by the Commercial Law, the Law on Accounting, the Law on Annual Accounts of Enterprises, the Law on Consolidated Annual Accounts of Enterprises, the Law on the Financial Instruments Market, the Law on Credit Institutions, the Law on Insurance Companies and Supervision, and the Law on Sworn Auditors.

ambiguous financial reporting requirements (see paragraphs 11, 12, and 13 above). In this context, the working group should ensure that regulatory requirements do not affect IFRS-based general-purpose financial statements. Where the regulators need additional (unpublished) information for prudential supervision purposes, this should come by topping up IFRS. However, since the regulators would have a keen interest in ensuring that the fundamental IFRS-based general-purpose financial statements are correct (since their reports would be built on that foundation) this would mobilize them to assist in the enforcement of shareholder or stakeholder-oriented financial statements as well. This report analyzes this issue regarding the banking sector in paragraphs 12 and 38 above. It analyses this issue in the insurance sector in paragraphs 13 and 39 above.

- **Statutory audit requirements.** The working group should review statutory audit requirements and propose amendments that take increased advantage of the auditing exemption in the Fourth and Seventh EU Company Law Directives for SMEs when there is no public interest requirement for the financial statements (see paragraph 14 above). Consequently, small enterprises would not be required to have a statutory audit.
- **Appointment and dismissal of statutory auditors.** The working group should ensure that the legal provisions regarding the dismissal and resignation of statutory auditors provide adequate safeguards for his or her independence (see paragraph 15 above). The law could introduce the principle that the statutory auditor or audit firm can only be dismissed if there are proper grounds, and the audited entity and auditor must inform the relevant authority about the dismissal or resignation during the term of appointment and explain why. These amendments should conform to the Eight EU Company Law Directive's requirements, once approved by the European Parliament and Council.
- **Use of the work of statutory auditors by the FCMC. Appointment and dismissal of statutory auditors.** The working group should ensure that the laws provide the FCMC with a sound framework to fully leverage the work of statutory auditors.<sup>60</sup> While present laws do give the FCMC relevant authority with respect to banks and insurance companies, the FCMC appears to have less authority regarding the statutory auditors of listed companies (see paragraph 16 above). The working group may want to propose amendments to existing laws drawing on the experience gathered by the FCMC in the banking and insurance sectors. For example, just as the FCMC has the authority to veto the appointment of a statutory auditor in banks, insurance companies, investment management companies, the FCMC should also have the same authority for listed companies. Additionally, the FCMC should be informed in advance of the proposed appointment of auditors of listed companies, and have power to enquire about the capacity of the auditor that will carry out the engagement to ensure the auditor meets established standards of practice (e.g., technical competence, independence from the client, etc.). The FCMC should therefore be provided with sufficient resources to establish and carry out an effective monitoring system.
- **Adoption of the forthcoming Eighth EU Company Law Directive.** The working

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<sup>60</sup> In this regard, the working group may want to draw on the paper, "The Relationship between Banking Supervisors and Banks' External Auditors," published by the Basel Committee for Banking Supervision, which is an internationally recognized benchmark on this matter (<http://www.bis.org/publ/bcbs87.htm>). The applicability of this paper is not limited to only the banking sector, but may be extended to listed companies and the insurance sector as well.

group should assess the effects of the forthcoming Eight EU Company Law Directive and the sweeping changes that it will introduce in the regulation of statutory audits (see paragraph 49 below for a more comprehensive analysis).

- ***Readily and publicly available audited financial statements of limited liability companies.*** The working group should ensure that all accounting documents are made available in accordance with the forthcoming requirements of the First EU Company Law Directive (see paragraph 19 above). The *acquis communautaire* (through the July 15, 2003, amendment to the First EU Company Law Directive) only recently introduced a requirement that, no later than January 1, 2007, audited legal entity and consolidated financial statements, starting 1997, be obtainable from the court register by paper means or by electronic means as the applicant chooses. This should not be viewed as simply a formal requirement; but rather an opportunity for factoring companies, credit insurance companies, commercial banks, and the corporate sector in general when assessing and managing credit risk. In this context, it is important to establish effective sanction mechanisms to improve the compliance rate of companies with filing requirements (see paragraph 18 above). Common types of sanctions that are used in other countries with effective results are: fines (imposed not only on the company, but also on the directors), and prosecution of directors.
  - ***Readily and publicly available audited financial statements of listed companies.*** The working group should ensure the Latvian legislation is aligned with the requirements of the Transparency Directive (see paragraphs 11 and 20 above). The Transparency Directive, which should be transposed by Member States no later than January 20, 2007, requires listed companies to prepare and present annual financial reports and half-yearly financial reports, including consolidated financial statements, within four months of the year end and two months of the end of the semester, respectively.
48. **Latvian institutions should have resources to actively and systematically participate in the European policy-making process, through an active role in relevant EU Committees (see paragraph 4 above).** This is important not only to keep abreast with the ongoing changes to the *acquis communautaire*. It will also allow Latvia to both promote policies that are in the national interest, as well as act to prevent decisions that could cause difficulties in regard to practical implementation at the national level. This necessarily involves effective participation by Latvian institutions in relevant EU advisory committees, including CESR-fin Sub-Committee on Enforcement, CESR-fin Sub-committee on International Standards Endorsement, CESR-fin Audit Task Force, the Committee of European Insurance and Occupational Pensions Supervisors, the Committee of European Banking Supervisors, the Contact Committee, and the Committee on Auditing (or its successor). In addition, relevant Latvian ministries should have the resources to actively participate in those committees that assist the European Commission in its decision making, including the European Securities Committee, the European Insurance and Occupational Pensions Committee, the European Banking Committee, the Accounting Regulatory Committee, and the soon-to-be-established Audit Regulatory Committee.
49. **Enhance statutory audit quality and public trust in the audit profession.** The following major issues should be addressed in order to effectively rectify the problems set forth in Section II.B and II.C (paragraphs 21 to 30 above). While the transposition of the Eighth EU Company Law Directive's requirements, once approved by the European Parliament and Council, should establish a sound framework for enhanced statutory audit quality, this report highlights areas of immediate concerns:

- ***Create systems of continuing professional education, quality assurance and discipline that are mutually reinforcing and effectively enforced.***
  - Continuing professional education rules should be stringent and in line with relevant IFAC standards, as well as the requirements set forth in the new Eighth EU Company Law Directive.
  - Quality Assurance should also be stringent, with public oversight, and in line with the requirements set forth in Chapter VII of the proposal for a new Eighth EU Company Law Directive.<sup>61</sup> The quality assurance system should ensure that auditors comply with applicable auditing and ethical standards, as well as independence requirements. It should also include in-depth quality reviews of audit firms and specific audit engagements based on an established schedule, so that every firm or sole practitioner be subject to regular oversight.
  - Disciplinary sanctions: LASA should apply sanctions against its members, in line with the requirements set forth in the new Eighth EU Company Law Directive, while also respecting Article 6 of the Human Rights Convention of the European Court of Justice.
- ***Ensure that LASA formally endorse and follow its mandate to serve the public interest.***
- ***Fully adopt the IFAC Code of Ethics for Professional Accountants, including the enhancements enacted in 2001,*** which is consistent with the requirements of the new Eighth EU Company Law Directive as well as with IFAC's Statements of Membership Obligation (SMO) No. 4, *IFAC Code of Ethics for Professional Accountants*.
- ***Increase public oversight of the audit profession.*** As deficiencies in self-regulatory arrangements become clearer on the international scene, the current accounting and audit profession's largely self-regulatory arrangement should be balanced with an adequate public oversight system. The system should be in line with the requirements of the new Eighth EU Company Law Directive, and hence, the scope of oversight should extend to education, licensing, standard setting, quality assurance and disciplinary systems.

Since Latvia is a small country with a relatively small profession, public oversight could be carried out through a modest oversight body that includes representatives from a wide range of stakeholders including LASA, FCMC, the Riga stock exchange, the Accounting Board, etc. The ROSC team believes this body should not be a part of LASA. This body should be independent of the industry that it regulates and free from undue political pressure. Therefore, it should have, within its membership, a

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<sup>61</sup> In addition, stakeholders may wish to refer to IFAC's Statement of Member Obligations No. 1, Quality Assurance, and No. 6, Investigation and Discipline. SMO 1 is to be applied by member bodies of IFAC to quality assurance review programs for their members performing certain audit engagements of financial statements. It applies whether the member bodies carry out such programs on their own behalf, on behalf of the profession, or on behalf of governments, regulators or other agencies, or whether the programs are carried out by another body. SMO 6 is to be applied by member bodies of IFAC in the investigation and discipline of misconduct, including, but not limited to, breaches of professional standards and rules by their individual members (and, if local laws and practices permit, by their member firms). SMO 6 specifically acknowledges that legal systems are very different from country to country. It also states reduced requirements that enable member bodies to comply with SMO 6 in countries where the investigative and disciplinary process is wholly or largely the responsibility of government or other outside agency.

majority of non-practitioners.

Given the importance of regional trade and company ownership structure in the Baltic States, and with a view to avoid the disproportionate costs of developing uniquely national solutions in small states with competing demands on the limited resources (both financial and human) at their disposal, this report encourages the authorities to consider the establishment of a pan-Baltic public oversight body modeled along the principles of the new Eighth EU Company Law Directive.

- ***Ensure greater transparency on the relationship between local firms and their network, according to the forthcoming requirements under the proposal for a new Eighth EU Company Law Directive.***<sup>62</sup> As a condition of using an international network name, the authorities should require the local member firms of international audit firm networks to disclose sufficient information about the structure and operation of their respective networks and about their individual relationships with them. The disclosure would address the issues set forth in paragraph 26 above, and would enable an audit report user to assess the extent of reliance that can be placed on the implicit quality assertion that underlies the use of a common international network brand name. Such disclosures should describe the quality standards applied by the networks, the quality assurance for enforcement of standards, and details of how frequently the local firm is subject to network review. This would force the networks to exercise a much higher standard of care with respect to the quality of their member firms—since their procedures would be publicly transparent—and would ensure that quality weaknesses are addressed rapidly.

**50. The Accounting Board should have resources to actively and systematically contribute to the enhancement of financial reporting requirements and practices (see paragraph 32 above).** Among other things, the Board should review accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching consensus as to the appropriate accounting treatment (see paragraph 37 above). In the absence of such mechanisms, preparers generally turn to the audit profession to develop interpretations. As recent scandals have demonstrated, relying solely on the audit profession, at a time where accounting principles allow for interpretations ranging from the conservative to aggressive, may need to be revisited. Developing interpretation capacity within the Accounting Board should obviously reflect the EU process and structure for consistent interpretation and application of IFRS. As with the public oversight body (see paragraph 49 above), the authorities may want to consider a pan-Baltic solution.

**51. Latvia should strengthen the institutionalized incentives for the rigorous application of high quality financial reporting requirements in the financial and enterprise sectors.** With respect to listed companies, the key recommendations are drafted to build on the positive steps that the FCMC has undertaken to implement measures to comply with the CESR principles but at a level that is more likely to meet the challenges of increasingly integrated Northern European capital markets.<sup>63</sup> They offer both short term actions (targeted and focused reviews) and a longer term proposal that would need additional funding commitment and a more thorough review of the institutional landscape. Scarcity of appropriate and informed resource is a clear and immediate problem but one that may not be

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<sup>62</sup> Please refer to Article 38 of the proposal for a new Eighth EU Company Law Directive.

<sup>63</sup> The three Baltic stock exchanges have chosen OMX as their strategic partner. Observers regard this as an important step in integrating the Northern European (Finnish, Swedish, and now Danish) and Baltic (Estonian, Latvian, Lithuanian) capital markets.

able to be addressed in the short term. While encouraging the development of a dedicated and experienced enforcement resource, the recommendations seek, as a priority, to address how FCMC might make more effective use of the little resource it has.

In the short-term, the FCMC should develop a unit dedicated to, and with clear responsibility for, the monitoring of financial information staffed by appropriately experienced and senior personnel. Given the number of issuers the unit need comprise two to three staff members with clear public responsibility for the monitoring function. The unit should not be available for other functions of the wider FCMC and should develop a public profile that is distinct from other functions of the FCMC. A secondment might be considered to a regulatory body of an EU Member State as a practical means of demonstrating how a unit might be developed. To enable it to effectively enforce accounting standards (see paragraph 35), the unit should consider and develop a targeted approach to the monitoring of financial information consistent with the risk-based approach identified in CESR Standard No. 1 on the Enforcement of Standards on Financial Information in Europe. This standard requires that the enforcement body, among other responsibilities, should have:

- Ultimate responsibility for the enforcement of compliance of financial information with the reporting framework.
- Adequate independence from government and market participants, possessing the necessary power and having sufficient resources.
- Among its necessary powers, that of monitoring financial information, requiring supplementary information from issuers and auditors, and taking measures consistent with the purposes of enforcement.
- Responsibility for setting up and implementing an appropriate due process of enforcement, consistent with the application of the CESR enforcement principles.

In the medium to long-term, and for the reasons set out in paragraph 49 above, this report recommends that the authorities consider the establishment of a pan-Baltic review panel modeled on the UK Financial Reporting Review Panel.

**52. In addition to the policy recommendations set forth above, the ROSC team would like to suggest that the authorities consider the establishment of a pan-Nordic Financial Reporting Council.** The obvious conclusion that can be drawn from all the recommendations above and the review of the Accounting and Auditing ROSC reports for Estonia and Lithuania is that a pan-Nordic Financial Reporting Council (FRC) would provide a cost-effective and efficient umbrella for the development, monitoring, and possibly the enforcement of reliable financial reporting requirements in the Nordic States. The FRC would avoid the disproportionate costs of developing uniquely national solutions in small states with competing demands on the limited resources (both financial and human) and be mirrored on the U.K. model. It would include:

- a pan-Nordic Accounting Standard Board (as proposed in the recommendation set forth in paragraph 50 above);
- a pan-Nordic Professional Oversight Board for Accountancy (as proposed in the recommendation set forth in paragraph 49 above);
- a pan-Nordic Financial Reporting Review Panel (as proposed in the recommendation set forth in paragraph 51 above); and
- a pan-Nordic Accountancy Investigative and Discipline Board (as proposed in the recommendation set forth in paragraph 49 above).