THE LATVIAN AUDIT SERVICES MARKET: CURRENT ISSUES AND CHALLENGES

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ABSTRACT

New EU rules on statutory audit reform were adopted by the Council of the EU in April 2014. The changes affect all areas of audit regulation, including market competition, auditor oversight, audit quality and application of standards, audit reporting, corporate governance related to auditors, auditor selection and auditor independence. The purpose of this study is to examine the current state and expected changes in the Latvian audit market within the context of EU audit reform. The research methods are respectively systematic, logical and comparative analysis, analysis of secondary data, as well as expert methods. The principal results of the study provide evidence of the high level of market concentration of Latvia's audit firms/networks, the dominant share of non-audit revenue in total revenue for the four biggest players on the market, the auditing oligopoly in the PIE market, the impact of EU audit reform on auditor-client relationships, and the activities of audit committees in the banking sector. The results of the study indicate that Latvia's audit firms are not fully transparent. Based on the findings and results of the study, the author proposes a set of recommendations aimed at making the Latvian audit market *more transparent* and *less concentrated.*

KEY WORDS

Statutory audit, audit services, non-audit services, public-interest entities.

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Introduction

In April 2014, European Union (EU) legislation to reform the statutory audit market was adopted. The new legislation, which comprises a directive amending the Statutory Audit Directive (Directive 2006/43/EC) and a regulation on specific requirements regarding the statutory audit of public-interest entities[1] (PIEs), became generally effective in June 2016. The new EU rules address a number of shortcomings observed on the audit market: (i) deficiencies, and in some instances misstatements, have been observed in audit reports by Member States' competent authorities; (ii) doubts have emerged amongst investors as to the credibility and reliability of the audited

[1] Article 2, point (13) of the Directive defines PIEs as listed companies, credit institutions and insurance undertakings. Member States may also designate as national PIEs other undertakings that are of significant public relevance because of the nature of their business, their size or their number of employees.

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financial statements of banks, other financial institutions and listed companies; (iii) this has seriously dented the confidence of investors in the reports of statutory auditors; (iv) excessive familiarity between the management of a company and its audit firm, risks of conflicts of interest, and threats to the independence of statutory auditors can challenge the ability of statutory auditors to exert thorough professional scepticism; (v) a lack of choice of audit firms emanating from high concentration levels at the top end of the audit market; (vi) a systemic risk as the audit market is effectively dominated at the top end by the Big Four entities (EC, 2016).

EU audit reform aims to improve audit quality and restore investor confidence in financial information, an essential ingredient for future investment and economic growth.

The main objectives of the reform are to:

- Ensure further *transparency* in terms of the financial information of companies;
- Provide statutory auditors with a strong mandate to be *independent* and exert professional scepticism;
- Contribute to a more *dynamic audit market* in the EU;
- Improve the *supervision of statutory auditors* and the coordination of audit supervision by competent authorities in the EU (EC, 2016).

The purpose of this study is to examine the current state of, and expected changes to, the Latvian audit market within the context of EU audit reform.

Research limitations. Limitations in the study exist due to a focus on Latvian PIEs, in respect of which EU audit reform introduced the most significant changes – mandatory audit firm rotation and restriction on non-audit services.

The research methods are respectively systematic, logical and comparative analysis, analysis of statistical data, as well as expert methods. Sources of data include the annual reports of Latvia's audit firms, their associates and PIE clients, as well as the official statistical data of the Latvian Association of Certified Auditors (LACA), the Association of Latvian Commercial Banks (ALCB), Nasdaq Baltic market and other sources.

1. Literature review

Following the entry into force of the new EU regulation, PIEs will be required to change their statutory audit provider at least every 10 years, although member states are able to extend this period to a maximum of 20 years where a public tender is held after 10 years (or 24 years for joint audits). The duration of the audit engagement shall be calculated as from the date of the first financial year covered in the audit engagement letter. Mandatory audit firm rotation will help reduce excessive familiarity between the statutory auditor and its clients, limit the risks of carrying over repeated inaccuracies, and encourage fresh thinking, thus strengthening the conditions for genuine professional scepticism (EC, 2016).

There has been a controversial discussion for many years as to whether auditor rotation has a positive or negative impact on auditor quality and investor perceptions. According to Burton and Roberts (1967), the appearance of independence might be limited in reality due to a special trust relationship between management and an auditor on a long-term assignment. Burton and Roberts (1967) state that personal relationships between the auditor and management, the combination of audit and non-audit duties, as well as the auditor's intention of maintaining the assignment, are factors which may lead to a reduction in audit quality.

DeAngelo (1981) and Beck et al. (1988) found that client-specific quasi-rents according to 'lowballing' (setting audit fees below total current costs on initial audit engagement) can lead to higher financial incentives to give up the auditor's independence, if the probability of exposure by the investors is low. For this reason, 'lowballing' which is connected with a lack of independence can be prevented by compulsory rotation of audit firms and restrictions on non-audit services.

Literature assumes a stricter and more relentless audit and a higher level of concentration on audit duties under the rotation system, because the auditor intends to diminish the risk of having his successor complain about his low level of performance upon a review of previous years' audits. Organisational blindness is also listed as negatively influencing audit efficiency, even when independence is nominally observed. Hence, the auditor simply trusts his results from previous years instead of anticipating important changes in the client's development and adjusting his auditing strategy (Velte and Loy, 2018).

Arel et al (2005) argue that repeat audit engagements allow auditors to rely on judgements of previous auditors in deciding whether a management estimate is in accordance with GAAP. Therefore, mandatory audit firm rotation will periodically force new auditors to review managerial representations for compliance with GAAP and may force management to adopt more conservative accounting practices. This is accompanied by the view that the costs associated with mandatory rotation are significantly less than the costs associated with audit failures (Porter et al., 2005). Velte et al (2018) state that the necessity of statutory rotation is solely related to PIEs, because agency conflicts are characteristic in this group.

Some recent studies have found that audit quality increases with tenure up to a certain point, but may decline when tenures become very long (e.g., Davis et al, 2009). Bell et al. (2015) found that first-year audits receive lower assessments of audit quality and that quality improves shortly thereafter. For audits of SEC registrants, the probability of a high-quality audit is maximised with very long tenures.

The advantages of mandatory rotation with regard to 'lowballing' are not secured because of disadvantages inherent in the system. A change in auditor and the selection of two firms for audit and non-audit services incurs higher costs and fees, which result in additional costs of the initial audit and transaction costs for management. Since the first audits tend to be of lower quality, negative responses by the capital market are to be expected upon a forced change of auditor. Even a statutory long-term rotation cycle cannot prevent the risk of management concealing their true intentions. A low level of auditor knowledge about the auditee's business risk in the first periods of the audit will also be problematic if he cannot gain knowledge spillovers from additional consulting services (Velte and Loy, 2018).

To date, empirical research has generally been inconclusive regarding an association between NAS and audit quality, with little evidence of a decline in audit quality. On the other hand, there is some evidence supporting the knowledge spillover argument (Antle et al, 2006; Koh et al, 2013; Knechel et al, 2012). On the issue of non-audit services, Bell et al. (2015) state that total NAS fees are positively associated with quality for SEC registrants.

From a theoretical point of view, the overall impact of audit firm rotation and non-audit services rule is not explicit. Mandatory rotation and concentration on audit work cannot themselves ensure higher audit quality, but any interruption or shortfall in learning and spillover effects can negatively affect the quality of audit services supplied.

2. Results and discussion

2.1. Features and structure of the audit services market in Latvia

According to the register held by LACA, there were 130 firms of certified auditors in Latvia in 2017 (LACA, n.d.). An analysis of the financial statements of these firms enabled the author to compile a list of the biggest auditors for the 2017 fiscal year (FY). The list is limited to 100 audit firms/networks, all of which have annual turnover exceeding EUR 23,000.

The results in Table 1 indicate that the total turnover of the 100 biggest Latvian audit firms/networks increased by seven percent to nearly EUR 54 million in 2017. Of that amount, EUR 35 million (65.7 percent) was earned by the Big Four entities – *Ernst &Young* (EY)*, Deloitte, KPMG, PricewaterhouseCoopers* (PwC). Compared to 2016, their combined turnover increased by 8%. These results provide evidence that the audit market in Latvia is effectively dominated at the top end by the Big Four. Concerns emanating from the high level of concentration include a lack of choice, a lack of innovation, higher audit fees, conflicts of interest, a lack of independence, a systemic risk if one Big Four firm should fail, and, above all, poor-quality audits which reduce the credibility and reliability of audited financial statements for the world's largest companies (EC, 2016).

Apart from the Big Four member firms, Latvia's Top 10 audit firms also include entities belonging to five other global networks – *Rödl & Partner*, *Grant Thornton*, *Nexia*, *Baker Tilly*, and *BDO*. Their aggregated turnover amounted to EUR 6.5 million in FY 2017 (an increase of 12 percent as compared to 2016). Only one local firm (Potapoviča un Andersone SIA) was able to get close to the turnover of the global networks in 2017.

It can be observed from Table 1 that the Top 10 audit firms and their related entities jointly generated turnover of EUR 42.7 million in FY 2017; that is nearly 80 percent of the aggregated turnover of Latvia's Top 100 audit firms in FY 2017. Compared to 2016, the Top 10 Latvian audit firms had strong performance growth of nine percent, while the total turnover of the other 90 firms decreased by 0.1 percent.

Table 1. Latvian audit firms/networks' market share based on turnover in FY 2016-2017

Rank	Firm/network	Year end	Net turnover, (x1000 EUR)		Change	Market share, %	
			2017	2016		2017	2016
1	Ernst & Young Baltic	30.06.	11 441	10 841	6%	21.3%	21.6%
2	Deloitte[2]	31.12.	8 964	7 927	13%	16.7%	15.8%
3	KPMG Baltics	30.09.	7 943	7 428	7%	14.8%	14.8%
4	PwC[3]	30.06.	6 990	6 529	7%	13.0%	13.0%
	The Big 4 total		**35 338**	**32 725**	8%	**65.7%**	**65.1%**
5	Rodl & Partners[4]	31.12.	1 618	1 420	14%	3.0%	2.8%
6	Grant Thornton Baltic	30.06.	1 566	1 289	21%	2.9%	2.6%
7	Nexia[5]	31.08.	1 500	1.362	10%	2.8%	2.7%
8	Baker Tilly Baltics	30.06.	914	807	13%	1.7%	1.6%

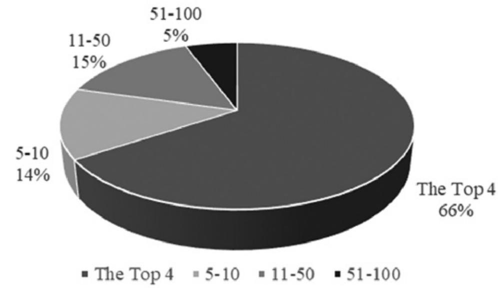
2 Deloitte Latvia SIA and Deloitte Audits Latvia SIA.
3 PricewaterhouseCoopers SIA and PricewaterhouseCoopers Information Technology Services SIA.
4 Rodl & Partner SIA and Rodl & Partner Tax Consulting SIA.
5 Nexia Audit Advice SIA and CBB konsultaciju birojs SIA.

9	Potapoviča un Andersone	30.09.	911	767	19%	1.7%	1.5%
10	BDO[6]	31.12.	881	807	9%	1.6%	1.6%
	The Top 10 total		42 728	39.177	9%	79.4%	78.0%
	The Top 50 total		50 770	46 961	8%	94.4%	93.5%
	The Top 100 total		**53 792**	**50 248**	7%	**100%**	**100%**

Source: Author's calculations based on Latvian audit firms' and their associates' annual reports for FY 2017.

Latvia's Top 100 audit firms' market concentration in FY 2017 is shown in Figure 1.

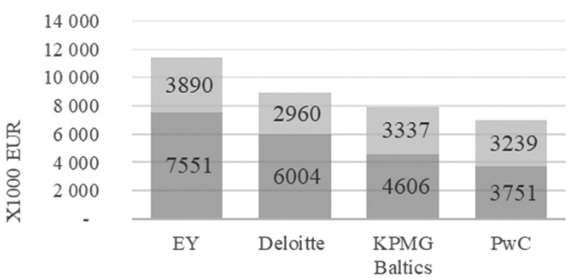
Figure 1. Latvian audit firms/networks' market share based on turnover in FY 2017



Source: Own elaboration based on Latvian audit firms' and their associates' annual reports for FY 2017.

It emerged that the financial statements of Latvia's audit firms and their associates do not include disclosure regarding: (i) revenues by business lines; (ii) services provided to the audited clients. The study also found that of the Top 10 firms, two (the fifth-largest non-PIE audit firm *Rodl & Partner* SIA and the 10th largest PIE-audit firm *BDO Audit* SIA) did not prepare or publish transparency reports for the 2017 financial year. Among the eight audit firms which published transparency reports, the seventh-largest PIE-audit firm *Nexia Audit Advice* SIA did not disclose information about: (i) audit revenues from PIEs; (ii) non-audit revenues from audited clients. Since only seven audit firms/networks from the Top 10 disclosed all relevant information[7], the analysis of the level of non-audit fees in Latvia was carried out regarding only the Big Four firms. Figure 2 illustrates their revenue structure in FY 2017.

Figure 2. The Big Four firms' revenue in FY 2017



Source: Own elaboration based on Latvian audit firms' transparency reports for FY 2017.

6 BDO Latvia AS and BDO Audit SIA.

7 They are either not required by law to publish the transparency report (*Rodl & Partner*) or do not comply with the requirements regarding the transparency report (BDO Audit, Nexia Audit Advice).

More detailed information about the Big Four firms' financial performance is provided in Table 2 and Table 3.

Table 2. The top 4 Latvian audit firms/networks' revenue in 2017, by service line

	2017					Change vs 2016			
Firm/network name	Total fee income	Audit fee		Non-audit fee		Audit fee		Non-audit fee	
	(x1000 EUR)	(x1000 EUR)	%	(x1000 EUR)	%	(x1000 EUR)	%	(x1000 EUR)	%
EY	11 441	3 890	34%	7 551	66%	683	21.3%	-83	-1.1%
Deloitte	8 964	2 960	33%	6 004	67%	-125	-4.1%	1 162	24.0%
KPMG	7 943	3 337	42%	4 606	58%	-287	-7.9%	802	21.1%
PwC	6 990	3 239	46%	3 751	54%	532	19.7%	-71	-1.9%
TOTAL	35 338	13 426	38%	21 912	62%	803	6.4%	1 810	9.0%

Source: Own elaboration based on Latvian audit firms' transparency reports for FY 2016 and 2017.

Table 3. The top 4 Latvian audit firms' revenue from audited clients in 2017

Firm name	Audit fee	Non-audit fee from audited clients	Non-audit/ audit fees ratio
	(x1000 EUR)	(x1000 EUR)	%
Ernst & Young Baltic	3 890	2 069	53.2%
Deloitte Audits Latvia	2 960	3	0.1%
KPMG Baltics	3 337	733	22.0%
PwC	3 239	794	24.5%
TOTAL	13 426	3 599	26.8%

Source: Own elaboration based on Latvian audit firms' transparency reports.

Among the Big Four entities operating in Latvia, *Ernst &Young Baltic* SIA has the largest market share. In the year ended 30 June 2017, the firm had net turnover of more than EUR 11 million, with a strong year-on-year increase of EUR 600,000 (EY, 2017, p. 19; EY, 2016, p. 21). As Table 2 shows, the bulk of Ernst & Young's revenues come from the provision of *non-audit services* (NAS). Additionally, the firm reported over EUR 2 million in *non-audit* revenues earned from audit clients in FY 2017 (see Table 3). Their *non-audit to audit fees* ratio for FY 2017 was the highest of the Big Four audit firms.

The second-largest share in the market is held by the firms that belong to the *Deloitte* network – *Deloitte Audits Latvia* SIA and *Deloitte Latvia* SIA. The total turnover for these two firms increased to EUR 9 million in the year ended 31 December 2017. This increase was only achieved due to the record growth in revenues from *non-audit services* (see Table 2).

It should be noted that the data on Deloitte's non-audit fees earned from audited clients are available for Deloitte Audits Latvia SIA only (Deloitte, 2018, p. 12), since the consulting firm Deloitte Latvia SIA does not disclose its revenue sources. Assuming that the revenues of Deloitte Latvia SIA from clients audited by Deloitte Audits Latvia SIA as a percentage of total audit fees correspond to the average level of the other Big Four audit firms in Latvia (33 percent), then, in value terms, they could have reached EUR 1 million in 2017 (Table 3).

Among the largest Latvian audit firms/networks, KPMG *Baltics* SIA was ranked third. Compared with 2016, its net turnover increased by seven percent and reached EUR 7.9 million in the year ended 30 September 2017 (KPMG, 2018, p. 31; KPMG, 2016, p. 32). The firm demonstrated the second largest increase in total fees from *non-audit* services. Given that KPMG's total fees from statutory audits fell by EUR 0.3 million (8%), the share of audit-related fees in the firm's total revenue declined by seven percentage points from 2016 to 2017 (see Table 2). At the same time, however, KPMG's revenues from *non-audit services* to audited clients equalled only 22 percent of their audit fees in FY 2017 (see Table 3).

Fourth position in the Latvian audit service market is occupied by the firms that belong to the *PwC* network – *PricewaterhouseCoopers* SIA and *PricewaterhouseCoopers Information Technology Services* SIA (*PwC IT Services*). In the year ended 30 June 2017, their total turnover increased by 1.1 percent to EUR 7 million. *PwC* declared the highest share of audit revenue in total revenues among the Big Four firms in Latvia (see Table 2). *PwC*'s revenue from *non-audit services* to audited clients was 24.5 percent of the audit fee income received by the firm in 2017 (PwC 2017, p. 34). The figure does not include the possible provision of *non-audit services* to such clients by *PwC IT Services* (maximum per EUR 184,000).

In summary, among the Big Four firms in Latvia, the share of *non-audit* revenue varies from 54 percent (*PwC*) to 67 percent (*Deloitte*) and averages 62 percent of all revenues. Due to the activities of *Deloitte Latvia* and *KPMG Baltics*, *non-audit* revenue is increasing at a stronger rate than *audit* revenue, contributing substantially to the Big Four firms' combined revenue growth.

Among the Big Four auditors, *Ernst & Young Baltic* had the highest 2017 *non-audit* revenue earned from audited clients in both absolute value (EUR 2 million) and relative to total fees from auditing (53 percent).

Before proceeding to the next section, one important methodological point has to be made. In Latvia, almost all PIE audit firms (excluding *Deloitte Audits Latvia* SIA) have fiscal years which end on 30 September, while their audit clients follow the calendar year for financial reporting purposes. This difference leads to the fact that the audit firms' revenues as reported in FY 2017 refer to services disclosed by their audit clients in the financial statements for FY 2016. Therefore, to further analyse the audit firm-audit client relationships, the author used the annual reports of Latvia's PIEs for FY 2016.

2.2. Concentration of the PIE statutory audit market in Latvia

As of 1 January 2017, the following companies are defined as PIEs for audit purposes under the Latvian *Audit Service Act* [*Revîzijas pakalpojumu likums*]: (i) financial institutions: credit institutions, investment fund management companies, alternative investment fund managers, insurance companies, branches of a non-Member State insurer, reinsurance companies, branches of a non-Member State reinsurer or private pension fund; (ii) companies with transferable securities listed on EU regulated markets (The Audit... 2001).

Table 4 illustrates how many Latvian entities fell under each category defined as a PIE in 2016. The table also includes information on their statutory auditors.

Table 4. PIE statutory audit market in Latvia (based on data for FY2016)

	KPMG	PWC	EY	Deloitte	Grant Thornton	Others	TOTAL
Number of entities in each category defined as PIEs, including:							
(a) Listed companies	2	2	3	2	2	16	27
(b) Non-financial corporate bond issuers	-	1	2	1	-	8	12
(c) Commercial banks	8	6	1	1	-	-	16
(f) Investment funds	4	3	1	1	-	1	10
(d) Insurance undertakings	3	1	-	1	1	-	6
(e) Pension funds	1	4	-	1	-	-	6
TOTAL	18	17	7	7	3	25	77

Source: Own elaboration based on Latvian PIEs' annual reports for FY 2016.

As Table 4 shows, of all Latvian entities falling under the new definition of a PIE, the largest such group in 2016 comprised listed companies (26 out of 77). This group was followed by commercial banks (16), non-financial corporate (NFC) bond issuers (12) and investment fund managers (10). In addition, there were six insurance undertakings and six private pension fund managers in Latvia in 2016. It can be observed from Table 4 that, in 2016, the Big Four were dominant in terms of the number of Latvian entities falling under the new definition of a PIE. The Big Four auditors created a monopoly in the banking sector, whereas they had the smallest share in terms of listed companies and NFC bond issuers. However, in terms of clients' total market capitalisation and corporate bond value, the Big Four firms covered around 90 percent of the Latvian listed audit market in 2016 (Table 5).

Table 5. Audits of Latvian listed companies and NFC bond issuers: share based on audited clients' total market capitalisation as of 30 December 2016

	Auditor	Audits of Latvian listed companies			Audits of Latvian NFC bond issuers		
		Number of clients	Market capitalisation (millions EUR)	Share, %	Number of clients	Bonds outstanding (millions EUR)	Share, %
1	PWC	2	406.7	50.5%	2	214.8	81.4%
2	EY	3	135.0	16.8%	1	20.1	7.6%
3	Deloitte	2	116.4	14.5%	1	6.2	2.3%
4	KPMG Baltics	2	96.0	11.9%	-	-	-
	The Big 4 total	9	737.0	93.7%	4	234.9	91.3%
	Others	18	50.5	6.3%	8	22.8	8.7%
	Total	27	804.6	100.0%	12	263.9	100.0%

Source: Own elaboration based on *Nasdaq Baltic* data base (Nasdaq Baltic, 2016a) and PIEs' annual reports for 2016.

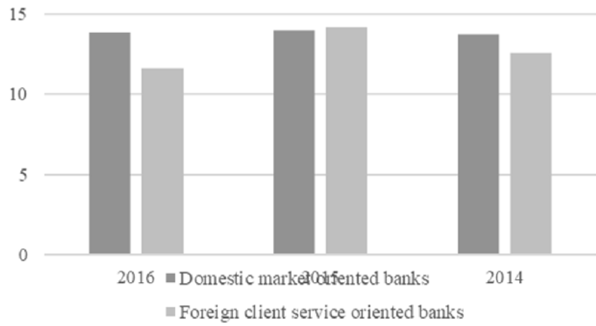
Table 5 shows that the Big Four firms were responsible for the audits of 13 listed issuers representing almost 94 percent of the market capitalisation of Latvian listed companies and over 91 percent of outstanding Latvian NFC bonds at the end of 2016. It should be clarified, therefore, that the Big Four's consolidated share in the Latvian PIE statutory audit market in 2016 varied from a concentrated oligopoly among companies with listed securities to a monopoly among commercial banks.

2.3. Challenges arising from EU Audit reform in the banking sector

Before proceeding to analyse the relationship between the banks and their auditing firms, it is necessary to highlight the major characteristics of the Latvian banking sector directly related to the study. Firstly, it is worth noting the *high degree of asset concentration* in Latvia's banking sector – the top six had 84% of all banks' assets at the end of 2016. Another critical feature of the Latvian banking system is the fact that 12 out of 16 banks operating in 2016 (including two of the top six) were primarily or solely dedicated to servicing *non-resident business* (FCTC, 2016). Finally, it is also worth emphasising that banks focused on the non-resident sector experience significant fluctuations in the values of total assets due to their *deposit base volatility* (see Figure 3).

The following table (Table 6) provides information about the statutory auditors of Latvian commercial banks in 2016. As Table 6 shows, in 2016, *KPMG Baltics* SIA had the largest audit market share in terms of Latvia's banking sector as calculated based on the total number of banks (eight out of 16) as well as the value of their assets (EUR 12 billion, with a 47% market share at the end of 2016).

Figure 3. Latvian commercial banks' assets in 2014-2016 (at end of period; in billions EUR)



Source: Own elaboration based on the quarterly reports released by the ALCB (ALCB, 2017).

PwC was the second-largest provider of statutory audits to Latvian banks – its clients were six credit institutions with combined assets of EUR 5.9 billion (a 23% market share). The third position, based on client size, was taken by Deloitte Audits Latvia SIA which has been the auditor of Latvia's largest bank Swedbank every year since 2000. Fourth spot was occupied by EY, auditor of the sixth-largest DNB Bank.

Table 6. Audits of Latvian commercial banks: share based on audited clients' total assets at the end of 2016

Rank	Auditor	Number of clients	Total assets[8] (in billions EUR)	Share of the total assets, %
1	KPMG Baltics	8	12.06	47.4%
2	PWC	6	5.88	23.1%
3	Deloitte Audits Latvia	1	5.32	20.9%
4	Ernst & Young Baltic	1	2.2	8.6%
	Total	16	25.46	100.0%

Source: Own elaboration based on the ALCB (ALCB, 2017) and Latvian banks' annual reports for FY 2016.

[8] As of December 30, 2016.

As mentioned above, one of the key requirements of the 2014 audit legislation is that PIEs in the EU must change their statutory audit firm after 10 years. This period can be extended to 20 years if a tender is undertaken. Following rotation, a statutory audit firm is not eligible for reappointment as statutory auditor to that PIE for at least four years. The legislation came into force from June 2016 but transitional arrangements have been put in place for audit engagements concluded before June 2014 (EU, 2014).

The following table provides statistics on the number of Latvian commercial banks and market shares (% of total assets) in different categories of audit tenure as of the end of 2016.

Table 7. Statutory auditor tenure among Latvian commercial banks (December 2016)

Length of tenure	Number of banks	Market share, % of total assets
15 years and over	6	55.0%
10-12 years	2	2.0%
5-9 years	1	9.0%
1-4 years	7	34.0%
Total	16	100.0%

Source: Own elaboration based on the ALCB (ALCB, 2017) and Latvian banks' annual reports for FY 1996-2016.

As Table 7 shows, at the end of 2016, more than half of banks' assets in Latvia were owned by six credit institutions that had not changed auditors for over 15 years. Another 11 percent of the banks' assets belonged to three credit institutions, the auditors of which had been the same for 9-12 years. Only one-third of all banking sector assets belonged to seven credit institutions that had rotated the auditors during the previous four years. Therefore, the new regulations requiring the rotation of audit firms after 20 years would appear to be likely to cause significant disruption to the audits of leading commercial banks in Latvia.

The 2014 EU regulation rules that audit firms are restricted from providing certain *non-audit services* (NAS) to PIEs. According to article 5(1) of the regulation, the audit firm and the network it belongs to may not provide their PIE audit client (including the PIE's EU parent company and EU controlled undertakings) with blacklisted services during the audited year and the year preceding it (EU, 2014). Examples of services covered by the '*black lis*t' include: specific tax, consultancy, and advisory services to the audited entity; services that involve playing any part in the management or decision-making of the audited entity; services linked to the financing, capital structure and allocation, and investment strategy of the audited entity.

As of 29 November 2016, Latvian credit institutions should disclose, in the notes to their statutory accounts, the remuneration for services provided by the statutory auditor in each of the following categories: (i) audit of the bank's annual accounts and consolidated accounts; (ii) other assurance services; (iii) tax advisory services, and (iv) other non-audit services (FCMC, 2006).

The study found out that only 56% of Latvian commercial banks (nine of 16) fully comply with the disclosure requirement with respect to remuneration paid for the services provided by the statutory auditors in 2016 (see Table 8). Three Latvian commercial banks with a 36% market share disclosed only the remuneration for the audit of their 2016 accounts. The largest bank *Swedbank* was included in this group, since its audit firm (*Deloitte Audits Latvia*

SIA) does not provide *non-audit services*. These are provided by *Deloitte Latvia* SIA, whose remuneration is formally outside the scope of Latvia's transparency requirements. However, within the context of EU audit reform, information regarding the value of these services (if they were provided during the year) is essential and needs to be properly disclosed.

At the same time, it emerged that four Latvian commercial banks with combined assets amounting to EUR 7 billion (a 27% market share) at the end of 2016 did not disclose any information regarding the statutory auditor's remuneration in their annual reports.

Table 8. Information on the disclosure of auditor remuneration for the audit accounts and other (non-audit) services among Latvian commercial banks (December 2016)

	Number of banks	Market share, % of total assets
Disclosed	9	37.1%
Partly disclosed	3	35.4%
Not disclosed	4	27.5%
TOTAL	16	100.0%

Source: Own elaboration based on the ALCB and Latvian commercial banks' annual reports for FY 2016.

Among the 12 banks which disclosed their audit firms' remuneration, the price of auditing varied from EUR 24,000 to 143,000 in 2016, making a total of EUR 746,000. In our estimation, the value of all assurance services provided in Latvia's banking sector was around EUR 1 million in 2016. Compared to 2015, it grew slightly due to the non-resident banking industry.

The 2014 EU regulation establishes that when an audit firm has been providing permissible *non-audit services* to the audited PIE for a period of three or more consecutive financial years, the total fees for such services shall be limited to a maximum of 70% of the average of the fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity and, where applicable, of its parent undertaking, of its controlled undertakings and of the consolidated financial statements of that group of undertakings (EU, 2016).

As Table 8 shows, only nine out of 16 Latvia's banks disclosed the costs of *non-audit services* provided by their auditors. This group included one bank focused on non-resident business, for which the *non-audit to audit fees* ratio reached almost 80% in 2016. Due to the lack of information disclosed on Latvia's largest banks (*Swedbank, Rietumu Banka, SEB banka*, *DNB banka)*, it is impossible to estimate the total value of *non-audit services* provided by statutory auditors in the banking sector in 2016.

The *Statutory Audit Directive* (2006/43/EC) introduced the requirement for PIEs to have an audit committee. As part of an effective internal control system, audit committees help minimise financial, operational and compliance risks. They also have a decisive role to play in contributing to high-quality statutory audits (EC 2006).

The new rules strengthen the audit committee, both in its composition (most members shall be independent; the committee as a whole shall now have competence relevant to the sector in which the audited entity is operating), and in its competences. The list of functions assigned to the audit committee has been extended to encompass, amongst other items: approving any permitted *non-audit services* following an assessment of the threats to independence and the safeguards that can be applied to mitigate or eliminate those threats; to be responsible for the procedure for the selection of a statutory auditor or audit firm to be appointed; and reviewing and monitoring the independence of the statutory auditor (EC, 2016).

Information disclosed by Latvian commercial banks for FY 2016 shows that separate audit committees were formed in only four banks with corporate bonds listed on the Nasdaq Baltic market (including three banks focused on servicing high-risk foreign clients). It should be noted that the majority of audit committee members in two banks focused on non-resident clients were individuals related to the credit institutions (major shareholders and top managers). Also, the total number of audit committee members in another bank servicing non-residents did not exceed the minimum effective in Latvia until 31 December 2016 (Table 9).

Table 9. Composition of the audit committees in Latvian listed banks (at the end of 2016)

Bank	Issued bonds outstanding (millions EUR)	Total number of members	Number of independent members
ABLV Bank[9]	689.9	3	1
Rietumu Banka	57.5	3	1
Citadele banka	40.2	5	5
Baltic International Bank	10.1	2	1
TOTAL	797.7		

Source: Own study based on Nasdaq Baltic data base (Nasdaq Baltic, 2016b).

Therefore, at the beginning of 2017, at least three Latvian listed banks were forced to bring their audit committees in line with the EU Directive. It is worth emphasising that in three subsidiaries of Scandinavian banks (namely *Swedbank, SEB banka*, and *DNB banka*), the audit committees are formed at their parent companies.

The results of the study support previous findings that Latvian PIEs should pay special attention to enhancing the transparency of their audit committees (Nasdaq Baltic, 2015). The author identified an insufficient level of disclosure from the audit committees of Latvian banks about matters such as the responsibility of the audit committee for the appointment, compensation, and oversight of the external auditor; audit firm tenure; audit firm fee determination; and audit committee involvement in the selection of the audit engagement partner.

Conclusions and recommendations

The analysis of the data on the revenues of Latvian audit firms/networks revealed a *high level of market concentration* – the Top 10 firms and the Big Four represented almost 80 percent and 66 percent, respectively, of the aggregated turnover of the Top 100 in FY 2017.

The results of the study indicate that Latvia's audit firms *are not fully transparent*. Among the Top 10 audit players, only eight firms created and published a transparency report for FY 2017. Of those eight firms, only seven disclosed information about: (i) revenues from the statutory audit of PIEs; (ii) revenues from permitted NAS to audited entities. At the same time, it emerged that the financial statements of the audit firms and their associates do not include disclosures regarding: (i) revenues by business lines; (ii) services provided to the audited

9 On February 26, 2018, ABLV Bank announced its decision to enter voluntary liquidation.

clients. To improve their transparency, it is recommended that firms auditing PIEs strengthen transparency in terms of reporting controls that are designed to meet the prescribed information requirements. Non-PIE audit firms are offered to disclose details on principal sources of income in the financial statements, such as: (i) assurance services; (ii) tax advisory services; (iii) other NAS. Entities related to PIE-audit firms need to disclose information about revenue earned from the clients audited by their associates in the annual reports.

The analysis of the Big Four audit firms' revenues showed an increase in the share of revenue from NAS, which averaged 62 percent in 2017. Also, the analysis showed that their *non-audit to audit fees* ratio averaged less than 27 percent in 2017. However, this ratio was calculated without taking into account the data on the structure of *non-audit fee* income of *Deloitte Latvia* SIA (EUR 5.86 million euros) and *PwC IT* SIA (EUR 0.18 million). As for the market leader *Ernst & Young Baltic* SIA, it noted a significant economic dependence on the provision of NAS to its audit clients (EY's *non-audit to audit fees* ratio exceeded 53 percent in 2017).

The Big Four auditors dominated the number of statutory audits of the Latvian PIEs in 2016. They created a monopoly in the market for the statutory auditing of commercial banks, whereas they had the smallest share in the number of listed companies and NFC bonds issuers. However, in terms of client size, the Big Four covered over 90% of the Latvian listed audit market in 2016. Mandatory *rotation*, together with the incentives for *joint audit* and *tendering*, as well as the prohibition of certain NAS to audit clients, are examples of measures that should make the Latvian audit market *more dynamic* and *less concentrated*.

The study found out that, as of 2016, six out of 16 Latvian commercial banks had not changed auditors for over 15 years. They will be forced to rotate their audit firms in the short term. Another three credit institutions whose auditors had been the same for 9-12 years are required to implement a tender process when considering either the selection of a new auditor or the reappointment of the existing auditor.

It is apparent that Latvia's commercial banks should encourage improvement in the disclosures regarding the services provided by the statutory audit firms and their associates. They should also pay special attention to enhancing the effectiveness and transparency of their audit committees.

Future research could extend to examining a wider time period in order to evaluate the impact of EU audit reform on market concentration and the ratio of non-audit to audit services fees.

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