

THE PUBLIC OVERSIGHT AND QUALITY ASSURANCE SYSTEMS IN AUDIT: COMMUNITY OF PRACTICE

RESULTS OF SCIENTIFIC RESEARCH

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The aim of this paper is to prove, that the public oversight system is indispensable part of the quality assurance system in statutory audit, to define the problems, that arise in the functioning of public oversight system in Latvia and to suggest possible solutions. In order to achieve the goal, the organization of Latvian public oversight system, its effectiveness of the functioning will be analysed and the issues that may have negative effect on the aims of public oversight system will be defined in this paper. The principles of organisation of public oversight system and the experience of its functioning in other European Union (EU) Member States will be researched by using the method of comparative analysis. Being based on the analysis carried out in paper, the authors will suggest possible solutions and measures for the defined problems in order to provide high quality in statutory audit and to encourage public trust toward the audit profession.

The organization of public oversight system for statutory audit is directed to ensuring high quality in statutory audit and to encouraging public trust toward the audit profession. After some years of research and debates, that took place in Europe and USA in connection with corporate scandals, it has come to the conclusion that the expectation gap exists between the benefit expected by the society from the audit profession and the real results and performance the audit profession is able to provide to the public. During the historical development the audit profession evolved into the complicated system, which involves auditors, their professional organizations, public bodies, which define the procedure of preparation and verification of financial statements in public sector, private entities, banks, insurance companies, public interest entities operated on a regulated market, and carries out the control over the auditor's work and monitors the observation of professional requirements.

Various studies and discussions were held in EU Member States to find the way to organize and provide quality assurance system in statutory audit to ensure high quality audit. Harmonization of the quality in statutory audit at the level of European Union began with the Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on "Statutory Audit of Annual Accounts and Consolidated Accounts", subsequently amended by the Directive 2008/30/EC of the European Parliament and of the Council of 11 March 2008 (hereafter the Directive). The criteria for the quality assurance system are laid down in this Directive. According to the paragraph 1 of the Article 29, each Member State should create the quality assurance system, which will provide high quality in statutory audit and will encourage the public trust to the audit profession [1]. It should be noted that among Member States different models of public oversight system have been created, involving one or several public oversight bodies. The quality assurance system shall be organized in such a manner that it is attributed to

all statutory auditors (in Latvia – sworn auditors), it is independent of the reviewed statutory auditors and audit firms and subject to public oversight as provided for in the Chapter VIII of the Directive. According to the Directive, statutory auditor means a natural person who is approved in accordance with this Directive by the competent authorities of a Member State to carry out statutory audits. Thus, the quality assurance system is functioning not only on the level of internal audit profession, on the corporate level, but also the public is involved in its activity which is a primarily interested user of audit.

Article 32 of the Directive defines the principles of public oversight, the most important principles are:

- 1) the system of public oversight is governed by nonpractitioners who are knowledgeable in the areas relevant to statutory audit. However, Member States may allow a minority of practitioners to be involved in the governance of the public oversight system. Thus the balance between professional self-regulation, corporate activity principles and public interests is saved;
- 2) all statutory auditors and audit firms shall be subject to public oversight;
- 3) the system of public oversight has the ultimate responsibility for the oversight of different activities mentioned in the Directive, among which are the approval and registration of statutory auditors and audit firms, the adoption, introducing and implementation of standards on auditing and professional ethics, continuing education, quality assurance and disciplinary system. The ultimate responsibility means that the public oversight system must be able to take responsibility, as well as to possess the instruments which can influence the issues that fall within its ultimate responsibility;
- 4) to ensure the achievement of the goal – consistently high quality of the audit – the system of public oversight should be “transparent”, this shall include the publication of annual work programmes and activity reports;
- 5) the system of public oversight shall be adequately funded so that it is secure and free from any undue influence by statutory auditors or audit firms [1].

However, the Directive still allows for considerable differences in the way quality assurance system and public oversight system for statutory auditors and audit firms are set up in EU Member States. But there have to be an effective co-operation between Member States in order to develop these systems on the basis of a common understanding on how quality assurance system and public oversight system should work. To ensure the effective co-ordination of public oversight systems for statutory auditors and audit firms within the European Union, the European Commission set up the “European Group of Auditors’ Oversight Bodies” (EGAOB) in December 2005, that is composed of high-level representatives of the entities responsible for the public oversight in Member States or, in their absence, of representatives of the competent national Ministries [2].

The objective of public oversight is clearly inferred from the regulations of the Directive, i.e. to involve the interested public in quality assurance in statutory audit and in development of audit profession. As the Directive gives to Member States a wide discretion as to the establishment of public oversight system in the institutional aspects, as well as in functions and powers setting, various Member States developed a different approach to the establishment of institutional public oversight system and scope of powers that affect the public oversight system's efficiency. In order to adopt the Directive, significant additional changes in national legislation of Member States were required, because there were countries that already had an oversight body which was consistent with the Directive. Yet there were countries in the European Union, for example, Estonia, Hungary, Latvia, Lithuania, Poland, Romania that had to develop an oversight system

as there were no oversight structure. Providing the implementation of the Directive in Latvian legal system, the Law On Sworn Auditors was amended on June 29, 2008 and some additional normative legal documents have been adapted, thus creating in Latvia the quality assurance system in statutory audit, which provides the quality assurance on three levels:

- 1) at the level of professional organization - the Latvian Association of Sworn Auditors, by creating the quality control system in statutory audit;
- 2) the supervision by governmental authorities, which carries out the Ministry of Finance, over the functioning of professional organisation and over the observation of the quality control requirements in statutory audit;
- 3) at the level of society – the Audit Advisory Council, that consists of delegates from various institutions and organizations that use the results of the auditors' activity. The Audit Advisory Council began its work on July 2, 2009 and is engaged in the searching for the solutions of actual professional problems in statutory audit. The Council develops the cooperation in the public oversight field on the national and international levels. [1]

The second and third levels of the Latvian quality assurance system compose the public oversight system in the notion of Chapter VII of the Directive.

Section 6 of the Law On Sworn Auditors defines that all the sworn auditors of Latvia and commercial companies of sworn auditors are, on the principle of professional activity, united in the Latvian Association of Sworn Auditors [3]. The Latvian Association of Sworn Auditors shall implement the professional self-regulation of sworn auditors. This means that sworn auditors have assigned the right to the Latvian Association of Sworn Auditors to ensure the supervision of compliance with professional standards and ethical norms, as well as other regulatory enactments applicable to the profession, and of the professional activity of the members of the association. On the one hand, professional self-regulation promotes the independence of the profession, the development of unified standards and its uniform application, as well as supervises professional qualification and competence of sworn auditors. On the other hand, the public expects from the auditor an opinion that financial statements prepared by the companies, organizations and institutions give a true and fair view of their financial position, financial performance and cash flows, as well as they are free from material misstatements. The public comprehends professional self-regulation as some seclusion and estrangement from its interests. The public is unable to follow all the changes in the auditors' professional standards, as well as is unable to recognize the limits of professional liability of auditors. As a result the gap appears between what the auditor can provide within the profession and what the public expects from the auditor's profession.

The amendments to the Law On Sworn Auditors provided also the establishment of Audit Advisory Council with the purpose of promoting the increase of quality of audit services. This Council acts in accordance with a by-law approved by the Cabinet of Ministers. The composition of Audit Advisory Council was approved on November 25, 2008 by the Cabinet of Ministers and it is composed of one member from each of the following: the Ministry of Finance, the Ministry of Justice, the Finance and Capital market Commission, the Latvian Association of Sworn Auditors, the Latvian Association of Accountants, Riga Stock Exchange, the Foreign Investors Council in Latvia, the Employers' Confederation of Latvia and one of the University of Latvia, i.e. 4 representatives of state administrative bodies and 5 representatives of public or private organisations. Wherewith, the Council was established as an independent public institution. By comparison, Audit Oversight Commission in Poland, which carries out public oversight, is composed of nine members of whom six are government officials, two auditors and one public organization [4]. In other EU Member States national regulatory authorities are also involved in the establishment of public oversight institutions and its further activity. For example, in Spain the public oversight institution - Instituto de Contabilidad y

Auditoria de Cuentas - represents the Ministry of Economics, public oversight institution also works under its responsibility. All members are appointed by the Ministry [2]. The Spanish public oversight institution's composition differs from that of other Member States national institutions with the fact that its auditors have no voting rights. Thus the Directive supported model is provided, where the public oversight system is composed of persons who are nonpractitioners. Also in Germany the public oversight system consists of an independent institution - the German Auditor Oversight Commission, which consists of 6 to 10 members appointed by the Federal Ministry of Economics and Technology. German public oversight body members are appointed for four years and they should not be public accountants in at least past five years prior to their appointment as members of public oversight institution. They are supposed to be or have been active in the fields of accounting, finance, economy, academics or jurisdiction [5]. This Commission holds the ultimate responsibility and decision making power, including right to instruct and overrule. However, the majority of EU Member States - Austria, Belgium, Bulgaria, Czech Republic, Denmark, Finland, France, the United Kingdom etc., also Latvia engages in public oversight institutions practitioners, but they are represented in the minority. The oversight system in the United Kingdom is very structured. The Financial Reporting Council (FRC) was set up in the Secretary State for Trade and Industry and it consists of majority of non-practitioners and its work is carried out by a number of subsidiary boards. In France the "Haut Conseil" consists of three judges, the President of the "Autorite des Marches Financiers", one person representing the Minister of Economy and one academic with appropriate skills representing university, three individual representatives of the business community and not-for-profit sector and three statutory auditors [2]. Comparing Latvian Audit Advisory Council with the other EU Member States public oversight institutions composition and procedures for setting up, it is concluded that the Audit Advisory Council represents the public more directly, because the majority of representatives come from public or private organizations. At the same time, government representatives and representative of certified auditors, who are involved in the work of the Council, provide the balance and facilitates the mutual dialogue between state, public and the auditors' profession.

The competence of Audit Advisory Council is defined in the Section 37³ of the Law On Certified Auditors – the Council examines the documents prepared by the Latvian Association of Sworn Auditors regarding examination and certification of applicants of sworn auditors, licensing of commercial companies of sworn auditors, maintaining the qualification of sworn auditors and the quality control of the professional activity, as well as regarding international auditing standards and ethical guidelines recognised in Latvia and makes recommendations to the Latvian Association of Sworn Auditors for their improvement while concurrently informing the Ministry of Finance of the recommendations it has made. Within the framework of its functions, the Council:

- 1) has a right to receive from the Latvian Association of Sworn Auditors information and documents necessary for the execution of the tasks of the Council;
- 2) has a right to participate in general meetings and meetings of the board of directors and committees of the Latvian Association of Sworn Auditors;
- 3) get familiarised with the decisions taken in these general meetings and sessions of the Latvian Association of Sworn Auditors;
- 4) has a right to make recommendations to the Ministry of Finance regarding the necessary amendments to the regulatory enactments concerning the field of auditing [3].

On the basis of the Law On Certified Auditors' regulations, Audit Advisory Council has set the following tasks:

- to participate in the development and implementation of the government policy in audit area by providing proposals for the Ministry of Finance on the necessary amendments to the laws and regulations that regulate audit field;
- to examine the normative documentation or its drafts that regulate auditors professional activity and the organization of the profession, including the implementation of professional standards and the Code of Ethics, the licensing and certification, in order to provide opinions on them or make recommendations to the document draft approval;
- to provide an opinion on the auditors' professional qualifications improvement and programs for examining applicants;
- to cooperate with similar public oversight bodies in other countries, various groups of users of auditors results and professional communities of these users;
- to cooperate with the Latvian Association of Certified Auditors to exchange the information, participate in general meetings and meetings of the board of directors and committees of the Association to ensure the discharge of functions of the Council [6].

Analyzing the scope of powers of Audit Advisory Council, the authors conclude that the Council carries out the monitoring function, but the Council activities are generally declaratory in nature. As stated in the European Federation of Accountants study, the term “public oversight system” used in the Directive includes at least two functions - monitoring function and supervisory function of audit profession, which allows Member States to allocate different powers to the institutions that are the part of public oversight system. Consequently, the ultimate responsibility for which the Directive attributes the public oversight system can be divided.

In Latvia the public oversight system operates on two levels. At the national level it is implemented by the Ministry of Finance, which has a broad power and the instruments for this power. According to the Sections 37 and 37¹ of the Law On Certified Auditors, as regards issues, which are associated with the certification of sworn auditors, the licensing of commercial companies of sworn auditors and other tasks delegated to the Latvian Association of Sworn Auditors, the Association is under the supervision of the Ministry of Finance. Complying with the Paragraph 5 of Section 7 of State Administration Structure Law, the supervision means the rights of the Ministry of Finance to examine the lawfulness of decisions taken by the Association and to revoke unlawful decisions, as well as to issue an order to take a decision in case of unlawful failure to act [7].

As Audit Advisory Council is entitled, the authorised representatives of the Ministry of Finance are also entitled to participate in general meetings, committee and commission meetings of the Latvian Association of Sworn Auditors, to become acquainted with the decisions taken by the Association, to request from all information, documents and explanations, which are necessary to ensure supervision. The articles of association, code of ethics, committee and commission by-laws of the Latvian Association of Sworn Auditors, as well as other regulatory normative documents of the Latvian Association of Sworn Auditors can be approved by the Latvian Association of Sworn Auditors after the coordination with the Ministry of Finance. Moreover, the Ministry of Finance is the responsible institution for the purpose of the Article 33 of the Directive for the cooperation with the competent institutions of other Member States and third countries in the field of audit. The Ministry of Finance is also involved in the disciplinary liability procedures that are realized by the Latvian Association of Sworn Auditors. The Association informs the Ministry of Finance in writing about all disciplinary proceedings and all the decisions taken at the disciplinary proceedings. Latvian Association of Sworn Auditors decisions, which are associated with the certification of sworn auditors, the licensing of commercial companies of sworn auditors and other tasks delegated to the Latvian Association

of Sworn Auditors, may be disputed to the Ministry of Finance. According to the 4, 5 and 6 Paragraphs of Section 35¹ of the Law On Certified Auditors, the authorised representative of the Ministry of Finance inspects the observance of requirements for the auditing services quality control at least once a year and draws up a report of this inspection. Consequently, the Ministry of Finance is the person that implements the ultimate responsibility principle of the public oversight system – it has the instruments to influence activity of the Latvian Association of Sworn Auditors in such issues that are important for the public as it is stated in the Paragraph 4 of the Article 32 of the Directive.

Compared with the powers of the Ministry of Finance, the Audit Advisory Council powers are much narrower, as well as the ability to influence decisions of the Latvian Association of Certified Auditors is limited. However, since the Audit Advisory Council started its activity in July 2009, the Council actively used its right to participate in general meetings and meetings of the board of directors and committees of the Latvian Association of Sworn Auditors, afterwards presenting in proposals connection with the quality assurance in statutory audit. By participating in several conferences, the Council drew public attention to a number of problems existing in the field of audit concerning public interests, among them are the problems of update of auditors professional liability, the need to inform the public about the changes in the regulation of auditors professional activity, the need to conduct studies in the field of audit, etc. [8]

Other EU Member States differ as to the scope of powers that have the established institutions within the framework of public oversight system. For example, Denmark, Finland, France, Germany set up public oversight institutions with broad powers that makes an effective supervision of external quality assurance systems with ultimate responsibility within the meaning of the Directive. Recent international developments and tendencies in the oversight of auditors and audit firms, particularly those who audit listed companies, have been marked by the establishment of external quality assurance systems. These systems are managed independently from the audit firms, while the inspections are performed by non-practising auditors. The United Kingdom, Netherlands and Germany have already set up such systems. Due to possible conflicts of interest, inspections should no longer be left exclusively to the audit profession, but – as in the area of financial services - to independent oversight bodies. These developments are also relevant with regard to the US, Japan and Canada, who are currently examining the recognition of the EU oversight bodies [9]. In Poland Audit Oversight Commission also has a broad power, including Independent Auditors National Court statute, professional standards, disciplinary regulations approval, auditors and audit firms registration, an annual quality control (inspection) plan and quality inspectors candidates approval. If the auditor's disciplinary offence affects public interests, Audit Oversight Commission is empowered to perform a charge function in disciplinary proceedings against the offender. Also in Austria, Ireland, Great Britain, Germany, Finland, Denmark, the public oversight institutions are working effectively in representing the public interests in the disciplinary procedures. In this regard, Latvian Audit Advisory Council's powers are evaluated as declarative, i.e. the activity of the Council is fully based on the initiative of its members, which is confined with the rights defined in the Law On Sworn Auditors. In authors' opinion, the rights the Audit Advisory Council has should be extended, as at the moment the public oversight systems functions provided in the Directive are fully realized by the supervision of the Ministry of Finance and the public that is represented by the Council has only the role of consultant.

However, the Directive aim, introducing the requirements for a public oversight system, was focused on the participation of public provide high quality in statutory audit.

The authors offer proposals to extend the powers of the Audit Advisory Council with the following actions:

- 1) the receipt of applications, complaints and suggestions from legal or physical persons on the issues on audit services quality;
- 2) the right to submit a proposal to the Latvian Association of Sworn Auditors to commence disciplinary proceedings against the certified auditor;
- 3) the right to challenge decisions of the Latvian Association of Sworn Auditors that contravened laws and regulations.

Thus, the Audit Advisory Council activity will become more effective and it will positively affect the public oversight system feasibility to realize the ultimate responsibility in statutory audit high quality assurance.

The funding of public oversight system is also one of the most important issues that relates to effective functioning of public oversight system. Paragraph 7 of Article 32 of the Directive defines that the system of public oversight shall be adequately funded. The funding for the public oversight system shall be secure and free from undue influence by statutory auditors or audit firms. Member States practice has developed two funding models:

- 1) the public oversight system is funded publicly from resources allocated to the Ministry or directly from the State budget (for example, Austria, Denmark, France, Hungary, Italy, Slovak Republic, Spain);
- 2) the public oversight system's funding comes both from the state and auditors' professional corporations (for example, Belgium, Finland, Ireland, Malta, Sweden).

According to the Paragraph 3 of Section 37² of the Law on Sworn Auditors, the activities of the Audit Advisory Council shall be financed by the Ministry of Finance from the funds allocated for this purpose in the State budget. In practice, this is expressed as remuneration of the work of secretariat, which acts within the framework of the Ministry of Finance. But the members of the Council don't receive the remuneration for the discharge of their duties. That fact means that the Council's possibilities of effective functioning are placed in unequal conditions comparing with public oversight institutions of other Member States of the European Union. Consequently, the authors think that the lack of funding seriously impedes the realization of the Directive's objectives relating to the high quality assurance in statutory audit. In this context, the author's proposal is to provide the remuneration to the Audit Advisory Council members for the discharge of their duties at least in an amount that will be appropriate to the time spent.

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