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THE ROLE OF AUDITORS IN THE FINNISH LIMITED LIABILITY COMPANIES AS TO SOLVENCY TEST IN THE CONTEXT OF ASSET DISTRIBUTION

Master´s Thesis
Accounting and Finance

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List of abbreviations

CAAT	Computer Assisted Auditing Technique
CEO	Chief Executive Officer
EC	European Community
EEC	European Economic Community
FAA	Finnish Auditing Act (459/2007)
FCA	Finnish Companies Act (624/2006)
FRC	Financial Reporting Council
HTM	Auditor authorised by a Finnish Chamber of Commerce
IAASB	International Auditing and Assurance Board
ICAEW	Institute of Chartered Accountants in England and Wales
IFAC	International Federation of Accountants
ISA	International Standard of Auditing
IT	Information Technology
KHT	Auditor authorised by the Finnish Central Chamber of Commerce

1 INTRODUCTION

1.1 Background

In most cases the purpose of a limited liability company is to serve the financial interests of its shareholders. Therefore, the purpose of the company and the distribution of assets, the latter being the theme of this thesis, are key issues in companies and also closely linked to each other.

In accordance with Article 15(1)(a) and (c) of the Second Company Law Directive (77/91/EEC), i.e. the so-called Capital Directive, under the old Finnish Companies Act (734/1978, Chapter 12, Section 2) the distribution of profits might not exceed the total profit as confirmed by the profit and loss statement for the fiscal period and the company's other reserves of unrestricted equity less the loss shown in the profit and loss account and the amount which under the Articles of Association was to be transferred to a reserve fund or otherwise left undistributed. This proviso to the distribution of assets, e.g. a payment of a dividend or a stock repurchase from a shareholder, is called a balance sheet test, and it was held in the new Finnish Limited Liability Companies Act (624/2006, hereinafter: FCA). In addition, one of the main innovations of the FCA was the regulation of the distribution of assets partly in a new way: a so-called solvency test, was adopted, as follows: "Assets shall not be distributed, if it is known or should be known at the time of the distribution decision that the company is insolvent or that the distribution will cause the insolvency of the company" (FCA Chapter 13, Section 2). According to FCA Chapter 13, Section 5, unless otherwise ensues from the application of Chapter 13, Section 2, the company may distribute its reserves of unrestricted equity, less the assets that are to be left undistributed under the Articles of Association. In the Finnish Government Bill regarding the FCA (109/2005) it is stated that the content of the present Act Chapter 13, Section 5 corresponds to the provisions of the old Act. The solvency test must be fulfilled at the same time as the balance sheet test in order for the assets to be distributed (Jokinen 2008, 95−96).

As to auditors, prior to the new FCA, an auditor was obliged to express one's view on the asset distribution. However, under the FCA this is to be done if an asset distribution breaches the provisions of the FCA. In the case of solvency test, the problem is that the meaning of solvency is not overtly spelled out in the FCA or in its *travaux preparatoires*. It is therefore important for an auditor to be alert in such situations to avoid liability, but auditors are left somewhat alone in defining such a situation in which a reaction is needed.

Even if some time has elapsed since the adoption of the FCA, only a few sporadic analytical and comprehensive writings and articles have been published on this very theme. Thus, the role of the auditor in this context in Finland remains somewhat unclear, and at best the view is incomplete. To the best knowledge of the author, no previous study on this topic has provided a comprehensive coverage of the auditors' view on this theme (cf. Ruohonen, 2012). There are only some master's theses and short presentations (Markkola 2009; Markkola and Sutinen 2011a and 2011b) that have discussed the issue. At the master's theses level, Lehtimäki (2010) discussed the definition of solvency and interviewed two authorised auditors on their view on the definition, on whether the auditors had faced difficult situations in this context and on how they had reacted to the problems that had arisen.

In May 2009, the Finnish Ministry of Justice published a short description of the status quo and a proposal for the amendment of the aforementioned provision (See: Finnish Ministry of Justice 2009a). I had the honour to be part of the working group, whose description and proposal, however, met critique from many interest groups (See: Finnish Ministry of Justice 2009b). Hence, also the situation was left unchanged and as ambiguous as before. Yet, that assignment gave me a spark to become even more interested in the theme.

1.2 Objective and scope

This thesis is about a regulatory institution, audit, which can be defined as follows (Porter, Simon and Hatherly 2008, 3, adapted from the definition provided by the Committee on Basic Auditing Concepts, 1979, 8):

> "Auditing is a systematic process of objectively gathering and evaluating evidence relating to assertions about economic actions and events in which the individual or organization making the assertions has been engaged, to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to users of the reports in which the assertions are made."

The audit does not develop in a vacuum, but it is shaped by the surrounding society. Understanding the changing needs of society, e.g. the solvency test in the asset distribution, and their effect to the audit are important research objectives (Carmichael 2004, 128; Janvrin and Jeffrey 2007, 296). Therefore, with the aid of existing literature and Finnish authorised auditors *the aim of the current thesis is to find out how they position themselves with regard to the corporate governance framework and new legal setting after the adoption of the new FCA*. In this thesis I will concentrate on the role of the auditor in the context of solvency test in asset distribution in Finland. I will consider a standard audit in accordance with the Finnish law and International Standards of Auditing (hereinafter: ISA) and point out how the applicable provisions are related to the asset distribution. To my knowledge, such extensive coverage has not been made before. In addition, my main focus will not be in the discussion of the meaning of solvency test as a financial test or as a legal test since it has been discussed rather extensively in the Finnish literature.

In the accounting literature it has been stated that there is little information available about the corporate governance factors that influence the actual audit process. Moreover, the auditor work has been described as a black box (cf. Cohen, Krishnamoorthy and Wright 2002, 580; 2010, 754). Thus, probing with questionnaires and semi-structured interviews are some of the few manners to deepen understanding regarding the auditors' work (See: chapter 1.3, below).

As to the focus of the study, I will exclude the audit of a group in this thesis because of the limited space available and because it does not bring any added value to the thesis, as the solvency in the context of asset distributions is considered in one company alone, not in a group. Even if the solvency test is nowadays applicable in many other Finnish enterprise forms than limited liability companies, for instance in cooperatives and housing companies, I will not concentrate on them specifically because of their specific characteristics. In essence, their legal nature as so-called mutual companies leads to accounting treatment of profits and dividends that differs materially from limited liability companies. However, the results of this study may be applicable in those enterprise forms, too, on the condition that due attention is paid to the specific characteristics of those enterprise forms.

1.3 Method

In this thesis I have chosen to employ a combination of existing literature (secondary data) and a survey (primary data). Thereby, the literature with regard to legal provisions and established standard auditing practices are connected to the survey on the practices regarding asset distribution.

I have decided to employ the survey as a contrast to the fact that Lehtimäki (2010) has interviewed two Finnish authorised auditors on the theme. I have assumed that a more comprehensive view on the topic could be obtained by sending out an electronic survey directly to all the Finnish authorised auditors. This research choice has required access to individuals yet unfamiliar to me, and for this purpose, I have asked the Finnish Institute of Authorised Public Accountants (KHT-yhdistys, hereinafter FIAPA), the registered association representing the authorised auditors in Finland, to mediate the survey to all their member auditors. Moreover, I have agreed to maintain anonymity of the respondents and confidential treatment of single answers. Theoretically, FIAPA has been a gatekeeper (Eriksson and Kovalainen 2008, 53‒55), as the alternative research method of sending paper questionnaires or even electronic mail by myself to all the Finnish authorised auditors would have been a true burden for this kind of study. I am thankful for the positive response and aid of FIAPA.

As to the online survey, it has limited the research to those individuals that have access to the relevant information technology (IT) and competence, time and motivation in using it. However, I have assumed that the absolute majority of auditors have access to the internet, and that does not pose a hinder to the study as such. Also I have taken account of that online research allows the respondents to participate in the study when it is suitable to them as regards the time and place of responding to the survey as well as when they otherwise feel comfortable of doing that (Eriksson and Kovalainen, 2008, 103). The problems involved with the online survey may have been that the respondents may have faced a lack of motivation, distrust in confidentiality or other kind of distraction, and lack of authorisation from the audit firm or a third party (Eriksson and Kovalainen, 2008, 106).

For this thesis I have set up a topic-related electronic Webropol survey (See: Appendix 1). Questions of the studies by Janvrin and Jeffrey (2007), Cohen, Krishnamoorty and Wright (2002 and 2010) and Lehtimäki (2010) were used as an example for the type and model of the survey. Preliminary questions were set up by me, and they have been pretested and commented in spring 2014 by one practising yet unauthorised junior auditor, who, at that time, was a student majoring in accounting and finance at Turku School of Economics, University of Turku, and by one practising authorised auditor. The preliminary questions were slightly adjusted on the basis of the comments given by these professionals before sending the final set of questions. A cover letter and an open link to the survey were sent out on 27 May 2014 to all the Finnish authorised auditors mediated by FIAPA. Notwithstanding the contents of the answers, there were no further control mechanisms for controlling that a respondent *de facto* was an auditor. The survey was closed on 20 June 2014. The timing was planned to be such that it could be fairly possible for a willing auditor to respond to the survey, that is, to not be open at the busiest reporting period or the Finnish midsummer fest holiday, and to give sufficient time to respond.

The aim has been to obtain a representative view on whether the auditors themselves consider the solvency test important, on whether they have faced difficult situations that have demanded action from their side, and on what kind of actions have they taken in these situations. No information having a link to, e.g. the management, business operations or future plans of the audit firms was asked. A starting point for the study has been that the results of the survey may be applicable also in practice. When it is exposed how the auditors in general perform the evaluation on the matters of solvency, this information can be also applied by other auditors as they face a similar situation.

1.4 Main sources and the degree of authority

The European audit law is based on the previous, now partly abolished audit directives, and on the 8th Company Law Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (the Audit Directive).

The Audit Directive includes, among other things, provisions on the application of international auditing standards, meaning the ISAs and related Statements and Standards (Article 26, paragraph 2). In accordance with the Audit Directive, the Member States shall require statutory auditors and audit firms to carry out statutory audits in compliance with international auditing standards adopted by the Commission in accordance with the procedure referred to in Article 48(2) (Audit Directive Article 26, paragraph 1). Yet, the Commission has not adopted a single international accounting standard (Mähönen and Villa 2010, 414), and the national audit standards apply. In the Finnish Auditing Act (459/2007, hereinafter FAA) it is provided, in essence, that it is mandatory to comply with the ISAs in a statutory audit (FAA Section 1, Subsection 1, and Section 13). In other audit tasks the ISAs are nationally construed to be a part of the good auditing practice (FAA Section 22; Mähönen and Villa 2010, 414).

In this thesis, unless otherwise is mentioned, the references are made to the international ISAs of year 2010 established by the International Auditing and Assurance Standards Board (IAASB), except for revised ISA 315 that is effective for audits after 15 December 2013, governed under the International Federation of Accountants (IFAC), and not to the nationally adjusted standards. Moreover, the auditors are bound to follow the professional Code of Ethics Professional Accountants by the IFAC Ethics Standards Board for Accountants (Government Bill 194/2006, 41; Mähönen and Villa 2010, 415).

Since the directives oblige the Member States, it is necessary to include the directives, their implementation in the national legislation and the ISAs in the references of this thesis. In addition, since audit law is closely related to company law, company law directives and national company law provisions need to be referenced as well. The aforementioned sources of information are legally binding.

As to the Finnish literature on audit practice, I will use mainly two books: Riistama 1999 as well as Halonen and Steiner 2009. International perspective to these themes is mainly given by Arens, Elder and Beasley 2014. Regarding topics related to the Finnish company law, the two main references are Airaksinen, Pulkkinen and Rasinaho 2010a and 2010b and Mähönen and Villa 2006, 2010 and 2012. Also law and audit-related journals have been referred to in this thesis. These books and journal articles carry only persuasive authority, representing only the views of the respective author in question.

1.5 Structure

In this first chapter I have explained the general background and the fundamental choices that I have made regarding research design. The structure hereafter is as follows:

In chapter 2 the solvency test will be shortly discussed. I will consider it as a financial test and as a legal test under the FCA. In chapter 3 I will introduce the general corporate setting in which auditors conduct their work. I consider it necessary to describe shortly whose interests auditors generally further and why auditing is needed. In chapter 4 the foundations of audit, i.e. objectives and procedural framework of a regulatory audit assignment, are explained. Chapter 5 covers the auditor's duties in a statutory audit. The approach in this chapter is based mainly on the ISAs, but in this chapter I point out only those standards that are relevant with regard to the asset distribution. Chapter 5 also constitutes a basis for chapter 6, in which I will describe the specific tasks of an auditor in the context of the asset distribution. I will show that even if auditing a solvency test was not made by the company, auditors do take it seriously. In chapter 7 I will provide the results of the survey and take up some of the most important results for discussion. Chapter 8 summarises the topics covered in this thesis and includes final conclusions and caveats related to this thesis. At the end of the thesis the readers can find the survey that was sent to the Finnish authorised auditors. The correlation tables that have been obtained as a result of the survey are also annexed.

2 SOLVENCY TEST IN THE CONTEXT OF ASSET DISTRIBUTION

2.1 General

The solvency test is not based on the Capital Directive but on the national legislation. The test has proved difficult to interpret because the FCA and the Government Bill 109/2005 do not specify clearly what is meant by solvency. Therefore, one could argue that multiple perspectives could be taken. In the following I take the view that the solvency test could be seen from a financial point of view and from a legal one.

It is rather a widely accepted view that the financial position of a company consists of four main factors: growth rate of the company (Laitinen and Laitinen 2004, 261) as well as profitability, liquidity and solvency (Blummé, Kaarenoja and Suontausta 2010, 42−45). Each of these main factors can be evaluated on the basis of the financial statements that result also in key financial indicators or ratios. Two main problems seem to be involved with these indicators and ratios in the context of the thesis: 1) too often, however, various economic indicators supporting solvency analyses are reported, but neither are the background assumptions of these indicators presented nor is their application to the solvency test of the FCA justified. Thus, there is a risk that economic arguments may implicitly be transferred to research and practice even if they are not openly presented. 2) What is more problematic is that the company law aspect comprising director's due care has received very little consideration in theory (See: Jokinen 2007 and 2008).

2.2 A financial test: profitability, liquidity and solvency and their economic indicators

Financial statements and annual report. Solvency is often evaluated on the basis of the latest financial statements by the managers and by the auditors (cf. chapter 7, Questions 9 and 10). This is appropriate if the data is still valid on the condition that the circumstances at the moment of the financial statements still prevail despite the events that have occurred after the setting up of the financial statements (Government Bill 109/2005, 125). Where commentators have supported the use of the financial statements, they have paid attention to amounts of some key items therein, such as income, equity and cash flow. For example, Koski and Sillanpää (2014) highlight the importance of unrestricted equity and other voluntary equity reserves, of which the latter are based on the articles of association, shown in the liabilities side of the balance sheet.

Key indicators, ratios and other financial information. When evaluating solvency, the Government Bill 109/2005 does not exclude other sources of information. For example, in addition to the financial statements, as the sources of solvency assessment Mähönen and Villa (2012, 388−389, 416−420; 2010, 422) consider all the available information concerning the company's financial position. In particular, they enumerate company's most recent quarterly report, cash flow statement and key financial ratios concerning funds flow, liquidity and financial solidity. The auditor must evaluate the situation as a whole. Hence, the evaluation cannot be based only on one indicator in the financial statements. Airaksinen et al. (2010b, 45–46) underline the information from the financial statements noting, however, that not all companies are obliged to prepare the cash flow statement. It is necessary only when there is a specific reason to do so, such as a doubt on the development of the solvency in the future.

It is worth an observation that the growth rate is not explicitly mentioned in any of these writings even if it is mentioned by Laitinen and Laitinen (2004). Also, it is to be remembered that the management and auditors may also face serious time pressures in performing their duties (See: Otley and Pierce 1996), which leads to that some selection of data must be made.

Solvency models. Kähkönen (1998, 36−38, 104−107 and 129−130) has modeled a solvency test, but this has been done in order to assess the fulfilment of criteria provided for in Finnish Criminal Code (39/1889) Chapter 39, Section 1 (dishonesty of debtor). This mathematical model is a combination of property reserves at time 0 and the incoming and outgoing cash flows at time period between time 0 and 1. The key finding of the test is that it should be done with the same criteria prospectively and retrospectively. Otherwise the initial financial situation before a transaction cannot be genuinely compared with the resulting financial situation after the transaction. Moreover, he requires that the mathematical model shall be valid, reliable and relevant in order to be useful. As I see it, these qualitative traits distinguish this model from all other evaluation criteria and models in the academic domain.

In addition, Blummé et al. (2010, 126−128) have developed their own model with regard to the distribution of assets. The solvency test is, in essence, composed of three elements: 1) estimating the company's present financial situation, 2) the future prospects and 3) risks. They emphasise the importance of the development of the company's finance and an accurate forecast of the future, e.g. predictions regarding the result, balance sheet and cash flow, cash budget as well as other plans. They consider that the following need to be taken into account: 1) standard adjustments of operating earnings in the financial year, such as deductions of extraordinary items, 2) earnings in relation to the planned amount of distribution of assets, 3) equity ratio, 4) payment behaviour, 5) quick ratio, 6) significant events after the end of the financial year or in past years that have an effect in the future earnings, 7) ability to generate profit, 8) sufficiency of cash flow after the planned distribution of assets, 9) possibilities to realise assets not necessary for the business and 10) threats and liabilities in the near future. The situation with regard to solvency is then analysed and categorised either as non-critical, critical or something in between those categories.

*Going concern testing (*See in more detail: chapter 5.2.6, below*)*. Troberg (2009) has stated from the point of view of an auditor that the assessment of solvency is close to the assessment of going concern, the assessment of which is governed by ISA 570. He also notes critically on the studies regarding bankruptcy prediction that no detailed definition of insolvency exists and will not exist.

Markkola (2009) opines that, in addition to the aforementioned key financial items and ratios, the following factors can be taken into account in measuring solvency: Products and markets payment behaviour, financial position, financial forecasts by the company, cash flow plans, forecasts of need for debt and equity financing, valuation of balance sheet items, risk assessment and management, related party transactions, litigation and legal procedures, threats and liabilities, and other factors. Attention shall also be paid to the company’s realistic ability to obtain cash or other liquid assets in order to pay the liabilities as they become due. For example, financing may be obtained from other companies in a group. Yet, the procedural requirements are the application of the going concern principle, due care, and appropriate documentation. He has also pondered upon whether the auditor is the guarantee of appropriate asset distribution: there seems to be three conditions for that role. First, when the auditor evaluates the legality of proposal for an asset distribution, the proposal shall be based on the financial statements that the ordinary general meeting of the audited company may adopt. Second, the balance sheet test is used to calculate the distributable amount of unrestricted equity. Third, the solvency test is used to complement the balance sheet test. In performing these duties, the auditor shall comply with ISA 315, 320, 330 and 570 (Markkola and Sutinen 2011b, 3−5 and 6−7).

2.3 A legal test: director’s due care

It is generally acknowledged that the purpose of a company is to generate profits for the shareholders. However, articles of association may include a stipulation that a given company may have another purpose (FCA Chapter 1, Section 5). The management of the company shall act with due care. The duties also include the promotion of the interests of the company (FCA Chapter 1, Section 8). The problems of the FCA, the Government Bill 109/2005 and the jurisprudence culminate especially in the question on what is meant by director's duty of care in the distribution of assets. The management referred in the said provision includes the members of the board of directors, and the possible managing director and/or the possible members of the supervisory board (FCA Chapter 6, Section 1, Subsection 1). The section on the duty of care and loyalty applies to the actions of the company management specifically in this capacity. The manager's personal way of dealing with his own matters is not relevant (Government Bill 109/2005, 40−41).

The duty of care falls into two parts, the duty of care and the duty of loyalty. In general, the duty of care requires the management to take active procedures to further the best interests of the company and, thus, indirectly that of the shareholders. The compliance with the duty of care is evaluated from an objective point of view of a prudent person, that is, how such a person would have acted in a like situation (Government Bill 109/2005, 40).

In running a business active decision-making and risk-taking constitute an inherent part of the life of the management. When assessing whether the duty of care is observed to a sufficient degree, attention is paid to the fact that in business some decisions must be frequently taken while uncertainty prevails. The more important or risky a certain decision is, the more the due care is emphasised. Sufficient diligence can generally be deemed to be that appropriate background information for the decision or other action has been acquired. It is also required that on the basis of such information a consistent decision or other measure has been taken. Further, the management shall not have been influenced by conflicts of interest when making a decision (Government Bill 109/2005, 41). Under these conditions, a breach of the duty of care occurs where a certain decision or other action is omitted when it should have been reasonably taken, for example, to proceed to collection of payments or to bring a matter before a court. The duty of care is evaluated on the basis of the information available and the conditions prevailing when the decision or action is made, not in hindsight (Airaksinen et al. 2010a, 47).

The duty of loyalty is closely related to the purpose of the company and to the equal treatment of shareholders (Airaksinen et al. 2010a, 48). The management shall act only in the best interests of the company to maximise the net value of the company, and the duty of loyalty requires that conflicts of interest shall not influence the management's decision-making or other actions. The managers cannot pursue their own interest or further the interest of certain shareholders or group of shareholders, even if a certain manager has been appointed by certain shareholders (Government Bill 109/2005, 41). The management's duty of loyalty is unilaterally binding only on the management and is unconditional (Mähönen and Villa 2006, 116 and 121).

According to Keay (2005, 616–620, 629, 633–635 and 638), in the distribution of assets the board of directors must also take into consideration the interests of the debtors collectively, since distribution of assets always carries the risk of debtors losing their outstanding receivables. The rights of the shareholders must not be ignored at a time of impending insolvency, but the interests of all interest groups should be balanced in such a way that in the long term the value of the entire business unit and not merely the equity is maximised. Thus the board should avoid excessive caution but also reckless risk-taking in the interest of the shareholders. This could be seen as an expression of the enlightened value maximisation principle that aims at balancing the positions of the interested parties in the short and long term (Jensen 2001, 309−310), now acknowledged also in Europe (Mähönen and Villa 2006, 84−85 with references).

As to the general duties of the management bodies in Finland, the board of directors shall take responsibility for the administration of the company and organise its operations and the control of the company accounts and finances appropriately. The managing director shall take responsibility for the executive management of the company, and the managing director shall obey the instructions and orders given by the board of directors. The managing director shall also be responsible for that the accounts of the company are in compliance with the provisions of the accounting law and that its financial affairs have been arranged in a reliable manner. The managing director also gives information to the board of directors, where necessary (FCA Chapter 6, Sections 2, 17 and 21; ISA 200.4). A duty to give out standardised financial information constitutes an incentive to the management to fulfil its fiduciary duties, that is, to run the operations of the company in accordance with its objective and provide distributable profits to the shareholders. By standardising this financial information and by rendering its establishment obligatory the transaction costs are reduced, as contractual provisions to this effect are not needed (Mähönen and Villa 2010, 318–319 with references).

With regard to the distribution of assets, where the board of directors considers that the distribution can be decided, the annual report shall contain a proposal for the use of the profits of the company. This applies also to a proposal, where appropriate, for the distribution of other unrestricted equity (FCA Chapter 8, Section 5, Subsection 2). The board of directors must evaluate the financial position on the company in accordance with the duty of care and loyalty.

Decisions on the use of the profit shown on the balance sheet shall be made at the ordinary general meeting (FCA Chapter 5, Section 3, Subsection 2). Usually the general meeting does not exceed the proposal of the board of directors. However, the general meeting has the authority to do so if it is under the obligation to do so under section 7 (on minority dividend) or the articles of association (FCA Chapter 13, Section 6, Subsection 1).

3 CORPORATE GOVERNANCE AND THE ROLE OF AUDITORS

3.1 The theory of the firm and corporate governance: the theoretical background

In neoclassical economics a firm is considered to be a black box where an input enters into the firm and an output exits the firm to the markets. Nothing else is visible to the interested parties. Although firms seek to maximise their profit, the neoclassical approach focuses on aggregate firm behaviour, the markets (Romano 2010, 1).

However, in the 20th century the focus of interest has shifted towards the company and its bodies. Berle and Means (1932) noted that the ownership rights were to a decreasing degree in the hands of those who manage the firm, that is ownership and control had been separated. They also understood that active ownership becomes passive, and the interests of the owners and the actions of the managers are not necessarily aligned. Later on, with regard to property rights, Coase (1960, 15−19) realised that, instead of transactions being costless, there are always costs involved in carrying out market transactions to transfer the property rights. He understood that the production costs of the firm would in many cases diminish, that is, the firm would function more cost-efficiently, when the firm operates as an organised firm and not solely through the markets. He also noted that the rearrangements of rights are not based on contracts but on administrative decisions.

Jensen and Meckling combined the theories of Berle and Means to that of Coase. The firm is simply one form of legal fiction. The firm serves as a nexus for contracting relationships where the interested parties make divisible residual claims on the assets and cash flows of the organisation which can generally be sold without permission of the other contracting individuals. The firm is a reflection of a complex process in and during which the sometimes conflicting goals of interested parties are brought into equilibrium (Jensen and Meckling 1976, 311).

Jensen and Meckling also analysed the conflicting interests of the parties to the firm. The manager of a wholly-owned firm makes all the operating decisions and maximises one’s profit and wealth and also enjoys all the benefits of non-pecuniary activities. If the owner-manager sells equity claims on the firm, the buyers cannot find out *ex ante* how the owner-manager will behave after the purchase is closed. Agency costs will be generated by the divergence between the interests of the owner-manager and those of the outside shareholders. Prospective minority shareholders may realise that the owner-manager’s interests will not be in symmetry with their own interests. As a consequence of this uncertainty and agency costs, the prospective buyers are willing to pay a lower price for their shares. The price reflects the monitoring costs and the effect of the divergence between the manager's interest and theirs. The more the owner-manager's fraction of the equity falls, the more his fractional claim on the outcomes falls, which encourages him to use more corporate resources to the perquisites. As a result, the minority shareholders are willing to monitor more the behaviour of the owner-manager (Meckling and Jensen 1976, 311−313). Thus, minority shareholders become principals and the owner-manager becomes an agent to the principals.

In practice, conflicts of interest are typical to the agency relationships because the principal and the agent tend to act in pursuit of their respective self-interest, and usually it is not possible to monitor the actions and the omissions of the agent. Contracts define the rights and duties of each principal and agent in the organisation, the evaluation criteria of the agent's performance and the applicable remuneration system (Fama and Jensen 1983, 302). However, like any business, the contracts concerning corporate ownership and management are incomplete, and the conclusion of a complete contract is usually not possible or it is extremely costly (See: Coase 1963, 16−17). The agency problems in companies arise not only because of contracting costs and but also due to monitoring costs. The principal is usually unable ascertain whether the agent is dishonest and whether the reason for the agent's non-optimal result is the agent's breach or some other external factor. The agent has always more private information about the performance than the principals (information asymmetry) both before the agency relationship is established (adverse selection) and even during it, enabling the agent to take advantage of the situation (moral hazard) (See: Akerlof 1970, 488−492 and 495−496). Moreover, between agents there are conflicts of interests which necessitate the establishment and enforcement of costly contracts (Fama and Jensen 1983, 302 and 304).

It is important to notice that monitoring problems of similar nature arise also in relation between shareholders, creditors and professional management (Shleifer and Vishny 1997, 737). In the agency relationship between the shareholders and creditors, in a limited liability company it is in the interests of shareholders to demand a compensation for their equity investment to the company. According to the traditional view, the shareholders receive all residual earnings generated by the company after all the fixed non-residual charges are paid to the creditors, such as employees and providers of the company (Kraakman et al. 2009, 35−36 and 115). From the creditors' point of view, the limited liability of shareholders constitutes a risk because the shareholders may appropriate the assets of the company at the cost of the creditors. The creditors require reliable financial information about the financial state of the company simply because the creditors need to evaluate the amount of that risk (Mähönen and Villa 2010, 312). The creditors play a dual role depending on the financial status of the company: Under normal circumstances, the creditors are only counterparties to transactions with the company. As counterparties, the creditors may run the risk of opportunistic behaviour by the company and the shareholders. If, however, the company fails to provide a timely payment to the creditors and becomes bankrupt, the creditors then become the owners of the remaining assets of the company. As a bankruptcy creditor, a creditor may run the risk of opportunistic behaviour by other bankruptcy creditors. Hence agency risks of one creditor may vary considerably over the company's existence (Kraakman et al. 2009, 115–116). This dual role, in particular the bankruptcy scenario, needs to be kept in mind when distributing assets out of the company, since the management and shareholders are not allowed collude in order to harm the interest of the creditors.

In the agency relationship between shareholders and the professional management, the principal, i.e. the shareholders, delegates some, but usually not all, of the management and monitoring duties to the agent, i.e. the board of directors. The board of directors, in turn, delegates some, but not all, of its duties to other secondary agents. As professional managers take over the management of business from the shareholders, to counter the risk of moral hazard the shareholders require information about the conduct of the professional managers. The managers become accountable to the shareholders (Halonen and Steiner 2009, 13−15). The directors and managers should further the residual interests of the shareholders acting in accordance with due care and loyalty, even in the choice of the applicable accounting standards (FCA Chapter 1, Section 5, and Chapter 6, Sections 2 and 17; Mähönen and Villa 2006, 75 with references, 92 and 107). However, the principal's information about the efficiency of the agent does not equal the agent's information, which leads to a situation that the principal is dependent on the information given, limited and potentially manipulated by the agent. The directors and managers have an opportunity to further their own interests at the cost of the shareholders. The principal cannot, however, ascertain himself of the validity of the information given by the agent, which is the main reason for conducting the audit. Therefore, accountability of the agent towards the principal is the theoretic background to audit (Halonen and Steiner 2009, 13−15).

3.2 The role of the auditors in mitigating the agency problems

As a consequence of the separation of ownership and control, the directors and managers need to report to the shareholders and other interested parties. The public sector completes contracts, which have been concluded between stakeholders of limited liability companies, through regulating the financial statements and audits. These provisions on financial statements reduce information asymmetry related to the corporate agency relationships (Mähönen and Villa 2010, 311 with references).

The interested parties need to assure that the financial statements can be relied on (Porter et al. 2008, 9). Shareholders universally employ auditors to verify accounting disclosures (Kraakman et al. 2009, 128). Therefore the auditors should provide a high quality audit in order to fulfil the expectations of the shareholders and other interested parties. The audit enhances the control of the conflict of interests among different stakeholders, and at least the firm characteristics i.e. leverage, firm size, ownership structure and number of accounting-based debt covenants, and the breadth of information asymmetry render it more probable that an external auditor is employed (Chow 1982, 273−277 and 287; Mähönen and Villa 2010, 312; Niemi, Kinnunen, Ojala and Troberg 2012, 189). The auditors act as agents while the shareholders act as main principals. This general view is now provided for in the FCA according to which the general meeting shall appoint the auditor. The same can be said about all listed and public companies in the Member States of the European Union (FCA Chapter 7, Section 2, Subsection 2; the 4th Company Law Directive 78/660/EEC, Articles 11, 12 and 51; European Commission 1996, 23). Also, the auditors act as the agents of creditors even if the creditors do not usually play any role in the selection of the auditor unless otherwise agreed. There is, however, some evidence to the claim that the some sizeable financial institutions require in their debt covenants that Big Four audit firms must be used to verify and report on the financial statements (cf. European Commission 2010, 16; Christodoulou 2010, 2).

An audit duly conducted by an independent auditor, who is free from the management's influence, can fulfil the shareholders' and creditors' demand for verification. There are several reasons why an external verifying party is an efficient solution to overcome the reporting problems. First, there may be a conflict of interest while the management is setting up the financial reporting. A company's financial statements are prepared under the supervision of its directors who, in fact, report on their own performance (Porter et al. 2008, 10). The information may be biased in favour of the information provider who can be either too optimistic or fraudulent (Arens et al. 2014, 27). Second, the information receivers may be remote from the firsthand knowledge of the financial information or they may not have access to it due to legal, physical or economic constraints (Porter et al. 2008, 10). It would be also economically inefficient to for all users to verify the information individually (Arens et al. 2014, 27). Third, the number and complexity of transactions has increased in recent years. Therefore the users are less able and prone to evaluate financial statements by themselves (Porter et al. 2008, 11; Arens et al. 2014, 27), and use auditors instead. The relationships among different parties are described below:

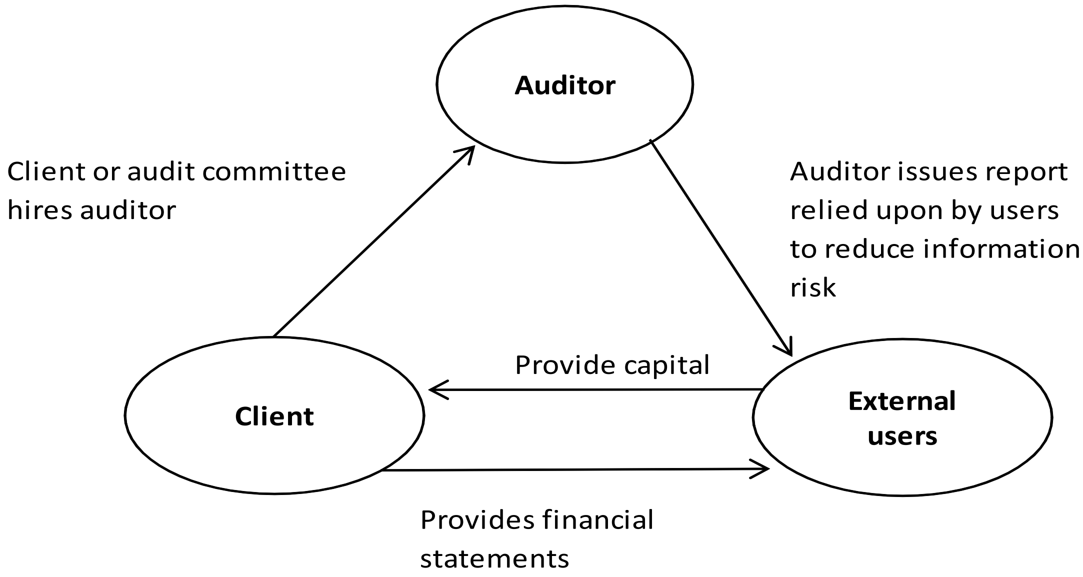

Figure 1. Relationships among auditor, client and external users (Arens et al. 2014, 28, transformed to an Excel broadsheet by the author).

An audit is a control mechanism, which reduces the costs of opportunistic behaviour and increases the overall value of the audited company (Jensen and Meckling 1976, 323 –324). Audited financial statements are considered to give stakeholders a positive signal about the validity of information, which is likely to enhance stakeholders' confidence and willingness to contract with the audited company (Cadbury Report 1992, 39). In addition, it is in the interest of shareholders that the company maintains its operative competitiveness, discharges of its obligations to creditors and acts in accordance with the applicable legislation. In this way benefits accrue to different stakeholders while the value of the company increases (Hirvonen, Niskakangas and Steiner 2000, 116–117; Alakare, Koskinen, Reinikainen, Sedig and Simola 2008, 17).

The necessity of the audit can also be justified not only in the protection of the private but also that of public interest, which includes the protection of minority shareholders and creditors (Halonen and Steiner 2009, 17). Therefore, the audit as an institution serves a more general, societal function. (See: FAA Section 20; Government Bill 194/2006, 41; Handbook of the Code of Ethics for Professional Accountants 100.1 and 100.6; and Halonen and Steiner 2009, 33). To be able to serve multiple and sometimes conflicting interests, an auditor shall also be objective and to act with professional competence and due care. According to the principle of objectivity, the auditors shall not compromise their professional judgment because of bias, conflict of interest or the undue influence of others. In accordance with the principle of professional competence and due care, the auditor shall maintain their professional knowledge and skill at the required level so that the clients receive competent professional service. The auditors shall also act diligently in accordance with applicable technical and professional standards when they perform an audit (IFAC Code of Ethics 120.1 and 130.1−130.5). Based on these duties, FIAPA has given out its own standards that are binding on the Finnish KHT- and HTM-auditors (Halonen and Steiner 2009, 33−36).

Compliance with such requirements is of the essence, as recent negative examples prove. Based on the theory of audit firms' incentives and threat of costs incurred due to a change of a client, DeAngelo (1981, 184) has claimed that the larger the audit firm, the better the quality of the audit. However, in the wake of a series of defaulting audits in the early 21st century, the reputational constraint, which refers to that it would be irrational for auditors to act improperly, is not deemed to hinder the auditors from deviating from the requirement of objectivity when the accounting treatment is less than certain. Accordingly, in the described circumstances the auditors may impair their objectivity and agree with managers' disclosures even if such disclosures deviate materially from the information that the auditor has obtained in performing audit procedures (Mayhew, Schatzberg and Sevcik 2001, 49−50 and 66). Problems may relate to decision-making biases and heuristics, to short-term cultivation of client relationships critical to career of key auditors, and/or to obtaining competitive advantage over second-tier audit firms (Prentice 2006, 785−786 with its references) and the long audit partner engagement tenure, alumni affiliation and the level of non-audit services sold (Ye, Carson and Simnett 2011, 145).

Auditors may even breach their professional duties even in a flagrant fashion and simultaneously enable an illicit distribution of assets. For example, in the United Kingdom Deloitte advised MG Rover Group and one of the partners of Deloitte acted simultaneously as *de facto* corporate finance advisor to four shareholder-managers, known as the Phoenix Four, of MG Rover Group. The Phoenix Four first conducted a management buyout of MG Rover Group and later paid themselves large bonuses before collapsing. It was found before the tribunal that both Deloitte and its partner failed to take into account the public interest, identify their true client, identify conflict of interests, act in the interest of their client, consider and put in place adequate safeguards between the Phoenix Four and MG Rover Group, act according to Fundamental Principles and safeguard against self-interest. As a consequence, the respondents were severely fined and the partner was excluded from the Institute of Chartered Accountants in England and Wales, ICAEW, for 3 years (See: FRC Tribunal Report 2013; The Telegraph 9 September 2013).

Thus, in order for an audit to decrease agency costs and to provide more certainty to the decision-making shareholders and creditors, the principals have to be able to trust that the auditor is independent of the audited company while the auditor is performing one's tasks.

4 OBJECTIVES AND PROCEDURAL FRAMEWORK OF A REGULATORY AUDIT ASSIGNMENT

4.1 Overall objectives according to the FAA and ISA standards

In the FAA certain companies are obliged to have an auditor but it is silent about the overall objective of the audit, i.e. how and why an audit is performed. However, the overall objective and its scope are clearly stated in the ISAs: The auditor shall, first, aim at obtaining reasonable assurance that the financial statements do not contain a material misstatement (See: chapter 4.4 on materiality, below). The auditor must make an overall assessment of the financial statements. Such a misstatement may be caused by a fraud or an error. Second, relying on the results of due audit procedures, the auditor should then have the ability to communicate an opinion to the readers of the auditor’s report if the financial statements are established, in all material respects, complying with the requirements set in the applicable financial reporting framework. Third, keeping in mind the accountability towards one’s principals, the auditor should report on the financial statements and communicate one’s results consistently with the findings that the auditor has made (ISA 200.11). Reasonable assurance is a high level of assurance, but it is not absolute in the sense that the auditor can hardly be absolutely certain that the financial statements contain zero misstatements. Assurance that all the items in the financial statement were correct would render the audit overly expensive and time-consuming, virtually impossible (Halonen and Steiner 2009, 44). There are always inherent limitations in performing an audit, and they relate to the nature of financial reporting and audit procedures, and the time- and cost-budgets of a given audit. As a consequence, the majority of the documents, that the auditor obtains as audit evidence during the audit and on which one’s opinion is based, is persuasive. The audit evidence is therefore not of conclusive nature (ISA 200.5 and A45). Further, there is always a risk that some relevant piece of information is hidden from the auditor and such information may not be detected. That is why it is underlined that the auditor’s opinion neither assures the future viability of the company nor the efficiency or effectiveness of the management’s conduct in running the business (ISA 200.A1).

The FAA only states what the general scope of the audit is: “an audit covers the audit of the accounting records, the financial statements, the annual report and the administration of a corporation or a foundation” (FAA Section 11, Subsection 1). As to the reporting of auditor’s findings, an auditor must issue an auditor's report for each financial period. The auditor’s report shall be dated and signed (FAA Section 15, Subsection 1).

Business processes and financial reporting always involve risks and items, which the management has to accept. It is the duty of the management to reduce such risks by the use of sufficient internal controls, but it cannot mitigate those risks completely. The management functions under business-related uncertainty, and therefore the establishment of financial statements necessitates management's professional judgment as it applies the applicable financial reporting standards in the situation in question. Instead of some interpretation being outright right or wrong, numerous acceptable interpretations or judgments that may be available to the managers in a given situation. Consequently, some financial statement items or the fair values are subject to inherent variability, and the auditor faces identical problems regarding the degree of uncertainty related to the use of professional judgment. The degree of uncertainty may not be mitigated by performing additional auditing procedures (ISA 200.46; Halonen and Steiner 2009, 44).

The aforementioned risks affect the work of an auditor. The auditor is expected to obtain a view about the corporate environment and the efficiency of the internal control and to execute relevant measures in order to obtain sufficient audit evidence. In particular, the auditor shall consider the reasonableness of the accounting estimates and the qualitative aspects of the company's accounting practices, including indicators of possible biases in management's judgments or a fraud (ISA 200.A46−A47; Halonen and Steiner 2009, 42−44).

4.2 The objective of auditing the statements that constitute the financial statements

One of the objectives of the financial statements is to provide a calculus for the distributable amount of assets. According to Riistama (1999, 151), the profit, which can be distributed without diminishing earning power, i.e. profitability or finance of the company, is distributable. Riistama also makes a remark that a deficit is a decrease of the amount of equity and earning power. As profitability and finance are key issues to the company, the audit should include the analysis of these matters.

As to the profit and loss statement, the following general objectives could be mentioned: 1) the profits and expenses are accounting-based, 2) all the profits and expenses of the financial period are recorded in the profit and loss statement in accordance with the good accounting practice so that they produce a true and fair view to the users; 4) the profits and expenses are timely accrued, which is to say in the correct period; 5) the profit and loss statement is established using the same methods and principles that were used in the previous financial period, or at least material changes in these methods or principles are reported in the notes to the financial statements; 6) the differences in the results of external and management accounting can be explained in a reliable manner (Riistama 1999, 161−162).

As to the balance sheet statement, the abovementioned general objectives apply. In addition, the auditor shall see to that the money, the accounts receivable and the assets and liabilities exist. To reach this objective the auditor may conduct, for example, an inventory inspection. Also the auditor shall assure that notes to the financial statements and other specifications fulfil the requirements provided for in the accounting legislation (Riistama 1999, 176−177). In particular, with a view to the distribution of assets, auditing the items of equity and liabilities is important. As to the equity, the following must be audited: 1) changes in the share capital information entered in the trade register; 2) entries regarding the use of profit or loss in the previous financial period. Share capital shall be recorded in the balance sheet in accordance with the FCA, the articles of association and the FAA and the guidelines of the Finnish Accounting Board. As to the liabilities, the balance of each liability account in the subledger shall match with the corresponding account of the general ledger. The short and long-term liabilities shall be distinguished, and it shall be reported if the long-term liabilities include an item that becomes due no earlier than five years. Also, the external confirmations of balances shall be verified. Moreover, subordinated loans, their conformity with the conditions provided for in the FCA and recording in the balance sheet statement shall be audited (Riistama 1999, 194−195 and 200−202).

As to the annual report, it is noteworthy that the auditor is not obliged to give an explicit opinion about the management's assessments about the future. As to the cash flow statement, where it is established, the auditor shall assure, first, that it is established in compliance with the FAA and the guidelines of the Finnish Accounting Board. Second, as the cash flow statement is established to inform interested parties about the amount and sufficiency of revenues, outgoing distributions, investments and capital structure, the auditor should keep these general objectives in mind and consider whether sufficient information is given. In addition, the cash flow statement aids management and interested parties in anticipating future cash flows (Riistama 1999, 223−226).

In sum, the auditor must obtain understanding of the operative result and the financial position and compare it with the objectives of setting up a given statement. In performing analytical audit procedures, the auditor takes advantage of key financial ratios and immerses oneself with the cost-revenue structure in the profit and loss statement. The auditor may compare the numbers of the financial statements with those of previous financial years and establish other key reference numbers or calculations. The auditor should try to find reasons in the real process for changes in the financial statements (Riistama 1999, 174−179). Auditing the profit and loss statement and the balance sheet statement requires professional judgment, and it is not a simple routine task.

4.3 Audit risk and its components

The overall objective of the audit is to reduce the risk of material misstatement in the financial statements to an acceptably low level. By definition audit risk is "the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated". Two kinds of problems, frauds and errors, may cause material or non-material misstatements in the financial statements. Usually a fraud is intentional and an error is unintentional (ISA 200.5, 13(c) and A47). Intentional misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets are of relevance in the audit. Of these two fraudulent acts, the misappropriation of assets is more commonly seen (ISA 240.3 and A5).

Audit risk is "a function of the risks of material misstatement and detection risk" (ISA 200.13(c)), e.g. an unqualified auditor's report is not appropriate where the financial statements include a material misstatement and the auditor does not notice it nor report it (Halonen and Steiner 2009, 45).

Detection risk is "the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements" (ISA 200.13(e)). The auditor reduces the detection risk through efficient audit procedures.

The risk of material misstatement consists of two components: (i) inherent risk, i.e. "the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls", and (ii) control risk, i.e. "the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control" (ISA 200.13(n)). It is not usual for the ISAs to refer to inherent risk and control risk separately. Yet, the auditor may make separate or combined assessments of these risk factors depending on preferred audit techniques, methodologies and practical considerations (ISA 200.A40; Halonen and Steiner 2009, 176). The auditor may communicate the results of one's assessment in the form of numbers or addressing qualitative aspects, but the fact that appropriate risk assessments are made is more important than the approach taken (ISA 200.A40).

Inherent risk is higher for some assertions, classes of transactions, account balances and disclosures than for others (See: Table 1, below). Complex calculations or accounts, which are composed in part or in full of accounting estimates and are carrying significant estimation uncertainty, involve an elevated risk. Also external circumstances, such as technological advancements, or internal factors, such as a lack of sufficient working capital to continue operations, may also influence the inherent risk (ISA 200.A38; Halonen and Steiner 2009, 176). For example, the accrual of income over the period of many years in a long-term project constitutes an elevated inherent risk. The auditor must rely on the plans of the management and his own personal experience as the auditor assesses the ability of the management to foresee costs that fall due. As another example of risky items, cash and bearer securities are more prone to misappropriation than book-entry securities. Other risk increasing factors are also large number of important transactions, transactions with interested parties, flaws in the control functions of the computer-based IT system, errors and flaws in the feed information. It is a common denominator for the inherent risk that the more the management has decision rights over the item, the more risk increases. (Riistama 1999, 83−84). The degree of inherent risk may be even increased when the company runs business in various and unrelated branches. Dispersed functions, potentially situated across the globe, pose a challenge to the monitoring and control systems (Alakare et al. 2008, 61).

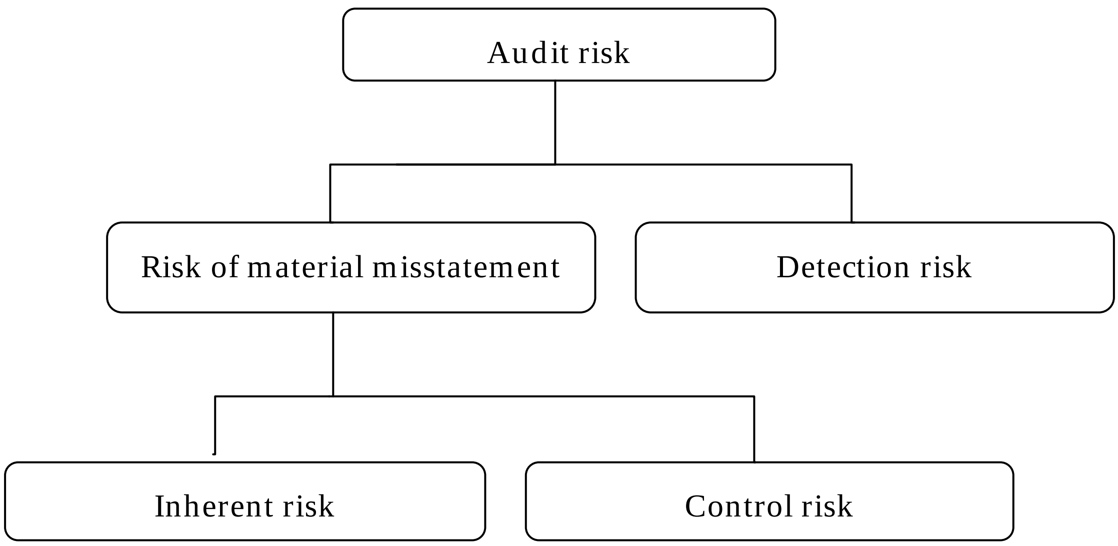

Figure 2. Audit risk and its components (Halonen and Steiner 2009, 42).

Control risk is “the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the company’s internal control” (ISA 200.13(n)(ii)). Proper internal controls may reduce inherent risks. For example, the risk of credit loss increases if the audited company dispatches items to a client whose payments are constantly overdue. This kind of risk might be tackled by an efficient internal audit that sets limits on credit and conducts efficient follow-up and timely reporting. In general, factors that reduce the control risk are well-organised internal control, broad coverage and length of budget control, the management's engagement in analysing budgetary difference and acting consequently, continuous development of the accounting system, and decision-making at a high level in the organisation in matters having a material effect on business and the financial statements (Riistama 1999, 85).

A potential flaw in the internal control may be indicated by that the management has an almost unrestricted authority and it may meddle into virtually all activities in the company. It can also be deemed negative if the management is interested to an unnatural degree in how a certain accounting measure affects the short-term profits or the earnings per share ratio of the company. The may be room for improvement in controls if the profits of the company decrease and the sufficiency of finance causes problems, which take majority of the management's time and attention. This is even more valid if there are important changes in profitability that cannot be explained by the management. The lack of management's time may relate to the lack of personnel, which leads to overtime work or changes in the key personnel. It is also a problem if personnel charged with the treasury do not have their vacation or do not assign their duties to their substitutes during vacation. In addition, material deficiencies in documentation or the acts of setting up or making amendments to documents *ex post* may prove the necessity of improving internal controls (Riistama 1999, 85−86).

The figure below describes the different components and levels of audit risks and factors affecting them:

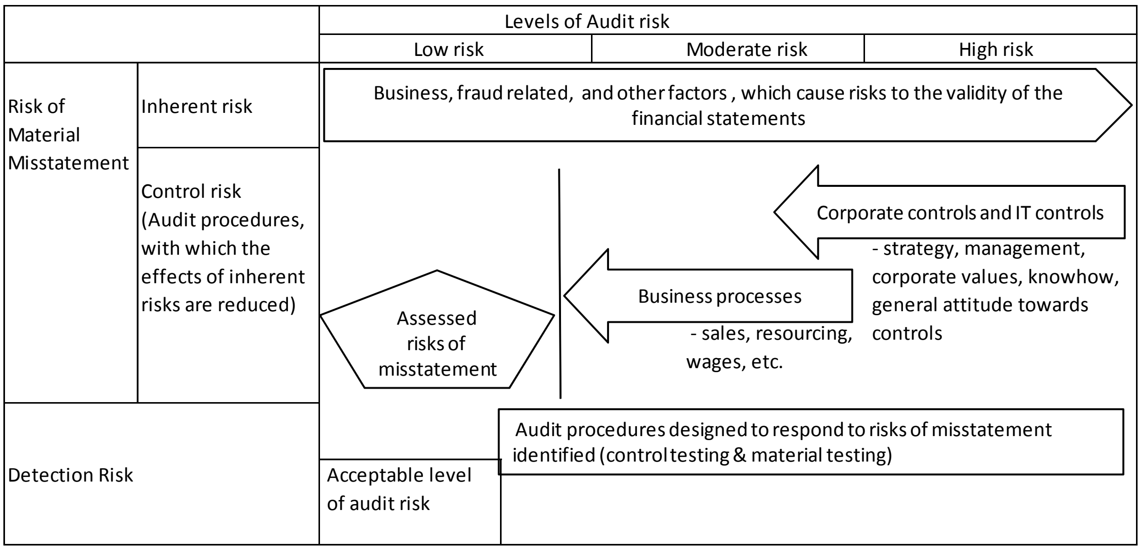

Figure 3. Audit risk, its levels and its components (Halonen and Steiner 2009, 49; SMP1, 41, transformed to an Excel broadsheet by the author).

In practice, the levels of the audit risk are described using terms low, moderate and high risk (See: Figure 3). The more material a certain factor, which affects the validity of the financial statements, is considered to be, the more that factor or business process undergoes efficient audit procedures, and *vice versa*. Assurance that the inherent risk is reduced to an acceptably low level takes place by assessing the risk of failure of internal and IT controls and by testing those controls. The auditor performs audit procedures concerning internal controls and IT controls. When the auditor deems that those controls function normally, usually it can be stated that the level of the audit risk is reduced. The same applies to the audit procedures concerning business processes. Usually the audited company has set its own tolerable risk level by taking cost-efficiency into account. Nevertheless, the auditor shall always conduct sufficient substantive audit procedures in order to reduce the audit risk to the acceptably low level (Halonen and Steiner 2009, 49−50). With a view to the asset distribution, as the risk of material misstatement is reduced to an acceptably low level, the information in the financial statements can be considered reliable and valid to be applied as a basis for the asset distribution.

4.4 Materiality

The principle of materiality is present in the planning phase and risk response phase of the audit. It is present in the final assessment and reporting phase as well (ISA 320.5; See: chapter 5 on the phases of audit, below). The materiality is defined in ISA 320.2 as follows: “Misstatements including omissions are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgments about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both. Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.” Such decisions range from the purchase of the company’s shares to engaging in business relationship with the audited company in general. Materiality is not an absolute number but a continuum between relevance and irrelevance (Halonen and Steiner 2009, 132 and 134). Thus, a material misstatement in the financial statements may affect the asset distribution and existing or potential shareholders’ expectations about the return on their investments.

The auditor must always assume some kind of risk or uncertainty, the degree of which is hard to quantify. For example, there are natural constraints in the efficiency of the internal control or the applicability of the audit evidence. An auditor must manage risks by performing well-considered audit procedures (Halonen and Steiner 2009, 136).

With the aid of the following exemplary grid it is described how the auditor assesses the risks of different functions and their effect on the required audit evidence:

	Sales and Collection	Acquisition and Payment	Payroll and Personnel	Inventory and Warehousing	Capital Acquisition and Payment
A: Inherent risk	Expect some misstate-ments (medium)	Expect many misstate-ments (high)	Expect few misstate-ments (low)	Expect many misstate-ments (high)	Expect few misstate-ments (low)
B: Control risk	Medium effectiveness (medium)	High effectiveness (low)	High effectiveness (low)	Low effectiveness (high)	Medium effectiveness (medium)
C: Accepted audit risk	Low willingness	Low willingness	Low willingness	Low willingness	Low willingness
D: Planned detection risk	Medium level (medium)	Medium level (medium)	Low level (high)	High level (low)	Medium level (medium)

Table 1. Illustration of differing evidence (Adapted from: Arens et al. 2014, 279).

In the first line of Table 1 the inherent risk (A) regarding different functions is described. Internal controls are ignored in setting inherent risks because they are considered separately in the audit risk model (See: formula, on the next page). In the table inherent risk was assessed high for acquisitions and payments as well as inventory and warehousing, and low for payroll and personnel as well as capital acquisition and repayment (Arens et al. 2014, 279). This is due to the fact that payroll transactions are simple and routine-like, whereas inventory transactions are complex (Halonen and Steiner 2009, 136). As to the asset distribution, a decision on the applicable amount of distribution may be difficult for the company, but executing those transactions from one account to another could be described as routine. Alternative ways of asset distributions, such as share buybacks or transfers, involve more complex and inherently risky transactions. The auditor regards the functions and financial statements as a whole, and all the risks involved with the functions of the company may potentially have an effect on the financial statements and auditor’s evaluation of solvency.

Likewise, in the example, the auditor assumes differences in the risk levels of the internal controls regarding different functions (Halonen and Steiner 2009, 136). The audit risk model shows the close relationship between inherent and control risks. For example, an inherent risk of 40 percent and a control risk of 60 percent have exactly the same effect on planned detection risk and planned evidence as in the case where the ratios are *vice versa*. Inherent risk multiplied by control risk produce the risk of material misstatement. Therefore the auditor may consider them either separately or combined (Arens et al. 2014, 280).

The auditor sets objectives for each assertion, and these objectives encompass assertions for classes of transactions, balances and disclosure. In planning audit procedures auditors consider the risks of material misstatements by applying the audit risk model, which helps auditors to decide how much and what types of audit evidence needs to be accumulated (Arens et al. 2014, s. 277):

Planned detection risk = Accepted audit risk / (Inherent risk x Control risk).

The relationship between control risk and planned detection risk is inverse, whereas the relationship between control risk and substantive evidence is direct. If the auditor concludes that internal controls are effective, planned detection risk can be increased and evidence therefore decreased (Arens et al. 2014, 280). It is usual to set the level of accepted audit risk (C) low, which enables the auditor to give out a non-qualified auditor's report (Halonen and Steiner 2009, 136).

All the above-mentioned points of view (A, B and C) affect the auditor's decision on the required audit evidence. If, for example, the auditor expects that there are only few misstatements in payroll functions and that the internal controls work efficiently, the auditor considers requiring less audit evidence in payroll functions than in inventory functions in accordance with Table 1 (Halonen and Steiner 2009, 137).

When the auditor constitutes the overall audit strategy for a given audit, the auditor defines two levels of materiality: materiality as a whole and performance materiality. It is recognised that in qualified situations amounts of one or more particular classes of transactions, account balances or disclosures may be below the level of materiality as a whole, but nevertheless the auditor may anticipate that those amounts are likely to influence the users' decision-making. In such occasions the auditor shall also determine the materiality level or levels specifically for those particular classes of transactions, account balances or disclosures (ISA 320.10). Therefore, it may be necessary to define multiple levels of materiality for particular classes of transactions, account balances or disclosures (Halonen and Steiner 2009, 140). By performance materiality reference is made to the amount or amounts that are set at a lower level than materiality for the financial statements as a whole (ISA 320.9). By doing this the auditor reduces the probability that the total amount of uncorrected and undetected misstatements is higher than the amount of materiality as a whole, and that probability should be reduced to an acceptably low level. The difference between the performance materiality and the materiality as a whole gives some margin of manoeuvre to the auditor (Halonen and Steiner 2009, 141). The actions regarding setting these levels of materiality are extensively discussed in ISA 320.

4.5 Professional judgment and scepticism

Exercising professional judgment in the planning and risk response phase is important in order for the auditor to comply with the statutory requirements for auditor's ethics and the ISAs. As the audit is by nature a human activity, the auditor should make informed decisions from the beginning of the audit to its ending. They cannot be made without relevant knowledge of and experience in audit, accounting procedures, accounting standards and the code of ethics, all of which are applied to the prevailing facts and circumstances. Professional judgment is particularly relevant regarding making decisions on different levels of materiality, the degree of audit risk, the nature, timing and extent of audit procedures, judging the sufficiency and appropriateness of audit evidence, and evaluating management's assertions with a view to the applicable financial reporting framework (ISA 200.6, 16 and A23; Halonen and Steiner 2009, 50).

The application of professional judgment is a personal quality, and training and experience improve the pertinence of conclusions. Yet, even if conclusions made by different auditors may differ, professional judgment is deemed appropriate if another experienced auditor arrives at the same result. Professional judgment can be evaluated on the basis of whether the auditor's conclusion, which has been drawn, proves that the auditor has applied auditing and accounting principles in an acceptable manner that is generally deemed competent. The appropriateness of that conclusion is considered in the light of the facts and circumstances that were known to the auditor up to the date of the auditor's report (Halonen and Steiner 2009, 50; ISA 200.A26).

In all phases of audit, the auditor shall apply professional scepticism, which refers to that the auditor recognises that there may exist circumstances that cause the financial statements to be materially misstated (ISA 200.15). Professional scepticism could be described as a somewhat dubious attitude under the influence of which the auditor questions and assesses critically the value of the obtained audit evidence. It is also about understanding different situations due to which the financial statements may be materially misstated. While the auditor applies due scepticism, he or she is in a state of alert that, for example, some piece of audit evidence contradicts some other results obtained as a consequence of audit procedures. In particular, critical assessment is needed where the reliability of documents and the management's responses to inquiries and other information are questionable. Professional scepticism covers the whole audit process since the auditor must be able to make appropriate decisions on the nature, timing and extent of audit procedures and to gather audit evidence. It is present particularly when the auditor evaluates critically the audit evidence (Halonen and Steiner 2009, 51; ISA 200.A18−A20).

Professional scepticism does not refer to that the auditor considers the management outright dishonest, but the auditor shall take this possibility into account. Professional scepticism also refers to that the auditor shall not presume that the management and the personnel are completely honest, even if the auditor appreciates past experience of the honesty and integrity of the company’s management and those charged with governance (Halonen and Steiner 2009, 51; ISA 200.A22). Alert is required in particular in auditing the finance function, which is closely related to the asset distribution such that distribution procedures are duly conducted to the benefit of the entitled parties (shareholders) and do not transgress the creditors’ rights to payment.

4.6 Assertions used by the management

It is the duty of the management to apply relevant accounting principles, set up appropriate internal control and to establish the financial statements (See: FCA Chapter 6, Sections 2, 17 and 21). Due to running daily business of the company, the management has superior knowledge of the transactions and the financial status. In applying the applicable financial reporting framework the management makes explicit or implicit assertions, which relate to the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures (ISA 315.A123), e.g. occurrence, completeness, accuracy, cutoff, classification, existence, rights and obligations, valuation and allocation (See: Table 2). The auditor may use the abovementioned assertions or may express them differently. In both cases all those aspects need to be described (ISA 315.A124−A125).

Financial Statement Level (Overall) Financial Statements
- Pervasive risk that could apply to many assertions

Assertion Level (partial)
Account Balances: Inventory, Cash, Payables
Classes of Transactions: Revenues, Expenses
Presentation & Disclosures: Commitments, Related Parties

Relevant assertions - assess risk for each assertion	Inventory	Commitments	Revenues	Cash	Expenses	Related Parties	Payables
Occurrence		x	x		x	x	
Completeness	x	x	x	x	x	x	x
Accuracy		x	x		x	x	
Cutoff			x		x		
Classification		x	x		x	x	
Understandability		x				x	
Existence	x			x			x
Rights and Obligations	x	x		x		x	x
Valuation and Allocation	x	x		x		x	x

Table 2. Assertions at different levels (SMP 1, 85; Halonen and Steiner 2009, 53, transformed to an Excel broadsheet by the author).

The auditor evaluates the risk of material misstatement at the financial statement level and at the assertion level (ISA 315.25). The risk of material misstatement at the overall financial statement level (See: Table 2) concern the financial statements as a whole and potentially affect many assertions (ISA 200.A35). Such risks are not necessarily risks that relate to some specific and identifiable assertions only. Instead, it is more likely that the risks of material misstatement at the assertion level may be increased in a more general manner. This kind of increase in the general risk level may occur in the mediation of deficient control environment or management override of internal controls and as a consequence of a fraud (ISA 315.A118−A119). Material misstatements at the financial statement level are usually so holistic and all-encompassing that the financial statements cannot be concluded to have been established in accordance with the applicable accounting standards. Even the auditability of the company's financial statements may be seriously questioned, for example if the auditor has serious concerns about the integrity of the management, company's records or internal control (ISA 315.A120; Halonen and Steiner 2009, 170−171).

The risks of material misstatement at the assertion level are evaluated separately for classes of transactions, account balances, and disclosures (See: Table 2). Such risks are assessed in order for the auditor to decide which audit procedures are needed, when they are to be performed and what is their scope and extent. This applies to the procedures to be conducted in the first stage and to those further procedures that the auditor deems necessary to reach the overall objective of audit and to fulfil the requirements of sufficiency and appropriateness of audit evidence. This evidence renders the auditor capable of expressing an opinion on the financial statements at an acceptably low level of audit risk. It is allowed and even required that the auditors employ different methods in order to reach the overall objective of audit (ISA 200.A36). The risks at the assertion level need to be considered on an assertion-by-assertion basis (Halonen and Steiner 2009, 52). In evaluating the risks of material misstatement at the assertion level, the auditor may arrive at a conclusion that the identified risks do not relate to some specific assertions only but that they affect the financial statements as a whole and potentially many assertions (ISA 315.A122).

Table 2 is important in that it needs to be understood that the distribution of assets can be seriously flawed due to a misstatement at the financial statement or even at the assertion level. Yet, if the financial statements are misrepresented only at the assertion level, it is more likely that the misrepresentation can be corrected in a proper manner or, from the point of view of the asset distribution, it may not have a material effect so as to prohibit it. If the misstatement lies at the financial statement level, the financial statements are not likely to be established correctly and, consequently, the distribution of assets is without a legal basis. If, despite this, the board of directors makes a proposal for the asset distribution, the board of directors may be found liable for a breach of its duties and damages to those that have incurred harm due to the proposal. Therefore, in such a situation, the auditor shall make an explicit remark on the matter in the auditor’s report (See: chapter 6.2).

5 PHASES AND TASKS IN A STANDARD AUDIT ASSIGNMENT

5.1 Risk assessment

The auditor shall comply with a certain audit process, which is generally divided into three phases: 1) risk assessment and planning; 2) performing audit procedures (risk response); and 3) reporting. Each phase includes several subphases and methods.

The overall objective of the audit is achieved through understanding the company and its environment, which constitutes a basis for planning and executing audit procedures to counter the assessed risks of material misstatement (ISA 315.3). Obtaining that understanding is a continuous, dynamic process of gathering, updating and analysing information, and these actions are performed from the beginning of the audit to its ending (ISA 315.A1). The auditor is not expected to obtain as in-depth comprehension as the management, even if the auditing standards set comprehensive requirements. The auditor's primary consideration is that one has such an insight on the company's business environment, which enables the auditor to meet the overall objective of the audit (ISA 315.A3).

Risk assessment procedures are "the audit procedures performed to obtain an understanding of the company and its environment to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels" (ISA 315.4(d)). The risk assessment procedures shall include inquiries of management, individuals within the internal audit function and others who the auditor considers to have information, which might help to identify the risks of material misstatement. The risk assessment procedures also cover analytical procedures as well as observation and inspection (ISA 315.6). The auditor is not required to perform all of the risk assessment procedures for each aspect of understanding. Other procedures may be performed where the data is thought *ex ante* helpful in identifying relevant risks, such as reviewing information obtained from external sources or posing questions to the company's lawyers or those having insights in the valuation matters (ISA 315.A5).

The structure and content of the risk assessment are defined in relation to the audit in question. The content is also affected by the fact if the audit is performed for the first time or if it has been audited before by the same auditor (Riistama 1999, 77). It is usual that the auditor uses information based on one's knowledge of the audited company that has been obtained through previous audit procedures. However, the auditor shall determine whether amendments have taken place after the ending of the latest finalised audit and whether those changes affect the relevance of the past information with a view to the current audit (ISA 315.9 and A20). The prior finalised audits may give the auditor data about, *inter alia*, past misstatements, their timing and rate of correction, and significant amendments that the company or its business functions may have undergone (ISA 315.A19).

The risk assessment phase includes e.g. performing procedures in order to understand the audited company, its business operations and internal controls including their implementation so as to identify inherent risk and control risk, and to communicate to the management significant identified weaknesses. In particular, the auditor shall obtain an understanding of the company's business environment, including industry, its ownership and governance structures and relationships, types of investments that the company is making and plans to make, and finance. The auditor shall identify such risks that require professional judgment and risks that are not covered by substantive procedures alone but require control procedures. In the risk assessment phase the auditor shall recognise the risks of material misstatement and assess them at the financial statement level as a whole and at the assertion level (Halonen and Steiner 2009, 54−56; Arens et al. 2014, 234−240).

The information about business environment is needed to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. The auditor must also deepen one's knowledge of the company's selection and application of accounting policies and changes therein, as well as the company's objectives and strategies, and those related business risks that may result in risks of material misstatement, and the financial performance (ISA 315.11, A24−A26 and A30−A31; Halonen and Steiner 2009, 159−164; Arens et al. 2014, 234−235). This information enables a general evaluation of the level of accounting, budgeting, budget control, reporting, finance and fiscal planning**,** key financial ratios and their development, key clients and providers as well as recent material changes in business, such as new field, products, product lines, mergers and acquisitions, divisions and research and development. Business plans and their credibility are of the importance in auditing a company that faces financial conundrums. Unless the auditor has a view on the future of the company, he or she has a hard time in evaluating the plans of the management (Riistama 1999, s. 79−83).

The auditor shall develop an audit plan that shall include a description of the planned risk assessment procedures, planned further audit procedures at the assertion level and any other planned audit procedures that are required to be carried out so that the engagement fulfils the general objective of audit (ISA 300.9; Halonen and Steiner 2009, 233**)** and the quality of the needed resources is sufficient. The auditor must also choose which targets are audited and in which order (Riistama 1999, 77−79).

The evaluation process of material misstatements commences when an auditor is becoming familiar with the company and its business environment. The evaluation process is ended as the auditor gives out one's report for the financial year in question. In order to provide a basis for designing and performing further audit procedures, the auditor shall first identify risks and relevant controls that relate to those risks. The auditor shall then assess the identified risks, in particular, whether they are prone to affect pervasively the entire financial statements and potentially many assertions, or only bring about a material misstatement at the assertion level. Finally the auditor shall consider if the potential misstatement could result in being a material one (ISA 315.26; Halonen and Steiner 2009, 175).

For some risks the auditor may conclude that it is not practical to obtain audit evidence solely by substantive testing and, therefore, control testing is required. This is usually the case where business transactions are automated and involve little or no manual operations. Transactions of this nature, such as company's revenue, purchases, and cash receipts or cash payments, may, however, be subject to inaccurate or incomplete processing. Nowadays, a considerable number of companies' transactions are initiated, recorded, processed and reported electronically only. Audit evidence, too, may be available electronically only, and the effective operation of the IT system and controls affects directly the quality of the audit evidence. These controls are relevant from the audit point of view and the auditor shall obtain a view of their performance (ISA 315.A140−A141; Halonen and Steiner 2009, 175).

The auditor should evaluate the distribution of assets at the initial phase of the audit. This seems to be a valid practice, too (cf. chapter 7, Question 7).

5.2 Risk response

5.2.1 General

Description. The audit procedures at the assertion level are defined in the audit plan, and they are a combination of tests of controls that are designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting material misstatements at the assertion level, and substantive procedures including tests of details of classes of transactions, account balances and disclosures, and substantive analytical procedures (ISA 330.4 and 6). During the risk response phase the auditor implements the planned audit procedures to address the assessed risks of material misstatement at the financial statement level (ISA 330.6). The audit plan links the identified assessed risks of material misstatement to the audit procedures to be performed. If the audit procedures are not related to the identified assessed risks, either useless work is done or the effect of new evidence cannot be integrated to the overall audit strategy and to the audit plan. As a result of e.g. unexpected events or variation in the company's environment, inadequate audit evidence necessitates additional procedures and the auditor needs to modify the overall audit strategy, audit plan and audit procedures (Halonen and Steiner 2009, 233−234).

Usually the tests of control and the substantive procedures are directed to a certain item simultaneously. If, based on the misstatements that have been detected in performing substantive procedures, the auditor concludes that the controls are not operating effectively or if important deviations are detected, the auditor shall make specific inquiries and determine whether additional tests of controls or substantive procedures need to be implemented (ISA 330.16−17; Halonen and Steiner 2009, 57).

An audit is a cumulative and iterative process. New information may come to the auditor's attention, and such new information may cause the auditor to adjust the nature, timing or extent of other planned audit procedures to the new situation (ISA 330.A60). The results of the tests of controls and substantive procedures, which have been performed during the audit, affect the auditor's final assessment on likelihood of the material misstatement in the financial statements. Assessing this likelihood as low, medium or high affects the evaluation on the sufficiency and appropriateness of audit procedures and audit evidence (Halonen and Steiner 2009, 58).

At the financial statement level, overall responses to the assessed risks may range from simply emphasising to the audit team the importance of maintaining professional scepticism to providing more supervision and adding up the degree of unpredictability in performing the audit procedures (ISA 330.5 and A1; Halonen and Steiner 2009, 230).

Planning and performing audit procedures. The auditor should consider what the nature of the risk is and what the underlying reasons for that risk are (e.g. particular characteristics of the relevant class of transactions, account balance, or disclosure), assess the level of risk of material misstatement at the assertion level for each class of transactions, account balance and disclosure, and have a regard to the relevant controls that seek to mitigate that risk. Usually relevant internal controls, if tested, reduce the need or scope for substantive procedures. However, the auditor shall also obtain more persuasive audit evidence the higher the auditor's assessment of risk is. Some procedures provide more reliable audit evidence in relation to some assertions than others. For example, as to the completeness of sales revenue, on the one hand, the tests of controls usually provide the best audit evidence. On the other hand, the valuation of items in stock is best audited by the substantive procedures. As to accounts receivable, external confirmation of balances provide more reliability than that of simple verification of invoices or analytical substantive procedures. Also, the higher the assessed level of risk of material misstatement, e.g. due to deficient internal controls, the more reliable and the more relevant the audit evidence is needed. If the information regarding frequent transactions is generated by an automated IT system, the auditor shall verify and obtain audit evidence of its validity and completeness through the tests of controls rather than through the substantive procedures (ISA 330.7; Halonen and Steiner 2009, 235−236 and 240).

Some of the matters the auditor should consider, when the auditor is planning the appropriate mix of audit procedures to respond to identified risks, include, among other things, the use of tests of controls, use of substantive analytical procedures and unpredictability of audit procedures. The auditor should also pay specific attention to the probability of management override and the need for specific audit procedures to reduce that risk to an acceptably low level. Moreover, the response to the identified significant risks always calls for relevant substantive procedures (SMP 1, 46; Halonen and Steiner 2009, 234).

Extent and timing of the audit procedures. Extent of an audit procedure refers to the quantity of audit procedures that will be performed (sample size, number of observations) (ISA 330.A7). When the auditor decides the necessary extent of a certain audit procedure, the auditor shall take into account the materiality levels, the assessed risk and the degree of assurance that the auditor plans to obtain. Usually the extent of audit procedures changes in relation to the assessed risk of material misstatement on the condition that increasing the extent of a certain audit procedure can be done only if that audit procedure itself is effective. The extent of each procedure is considered separately, even if a combination of procedures is used for a certain audit objective (ISA 330.A15). When the auditor assesses that there is an elevated risk of material misstatement in the financial statements and that one needs to obtain more persuasive audit evidence, in this occasion the auditor may increase the quantity of the evidence, and obtain evidence that is more relevant or more reliable (ISA 330.A19). As the auditor decides to modify the extent of the testing, the use of computer-assisted audit techniques (CAATs) may enable more extensive testing of electronic transactions and account files. Such techniques are applicable to selecting an appropriate sample of transactions from key electronic files, to sorting qualified transactions or to testing an entire population of transactions. Testing the entire population may occur, for example, in the case of testing the events of long-term liabilities (ISA 330.A16; Halonen and Steiner 2009, 238), and this may also be applicable to the items of equity, which are closely related to the asset distributions.

The timing of audit procedures refers to the time of performance of audit procedure, and to the coverage period of the audit evidence. The auditor may perform tests of controls or substantive procedures at an interim date or at the period end. Excluding the smallest audited enterprises, the audit procedures are performed during the financial year, at the period end and after that date. As a rule of thumb, the higher the risk of material misstatement, in particular due to fraud, the more likely substantive procedures are performed near to or at the period end or at unpredictable times (ISA 330.7, A6 and A11; Halonen and Steiner 2009, 237).

However, numerous reasons support the intra-period performance of audit procedures. When audit procedures are performed before the period end, this may assist the auditor in identifying significant matters early in the audit and in finding a timely response to these identified risks (ISA 330.A12). It is also important to try to balance the auditor's workload more equally during the year, not only because of tight reporting schedules after the period end but also to counter the risks of fraud by performing audit procedures unexpectedly (Halonen and Steiner 2009, 238).

Typically at the end of the financial year the inventory of current assets is audited to cover assertions on the existence and completeness of the current assets. Different aspects of events relating to the turn of the financial year are performed at or after the period end (Halonen and Steiner 2009, 237−238). Certain audit procedures can be performed only at or after the period end, for example reconciling accounting records to the financial statements, examining adjustments made to the financial statements, and performing audit procedures to verify that that the company has not entered into improper sales contracts at the period end, or verifying transactions that may not have been finalised (ISA 330.A13).

5.2.2 Tests of controls

Description. Control activities, automated or not, are the policies and procedures, which are applied to ensure that the personnel execute the directives of the management. Examples of specific control activities include authorisation, performance reviews, information processing, physical controls and separation of duties (ISA 315.A96).

The information obtained in establishing the overall audit plan and in assessing risks is applied in performing the audit procedures. The auditor's understanding of the control environment has an effect on the assessment of the material risks and, thus, the auditor's decisions to counter those risks. The auditor must assure not only that the internal controls are adequate and efficient but also that the internal controls of different functions are well planned, organised and applied effectively (ISA 330.A2; Riistama 1999, 91−92). If the company designs and applies internal controls effectively, this may allow the auditor to have more confidence in them and the reliability of audit evidence. Deficiencies in the control environment, however, have the opposite effect, in which case the auditor may conduct more audit procedures as of the period end rather than at an interim date, emphasise the use of substantive procedures, and/or increase the number of locations to be audited, where possible (ISA 330.A2).

Considerations regarding the effectiveness of the internal controls affect significantly the auditor's general approach, that is, whether one places more emphasis on substantive procedures (substantive approach), or an approach that uses tests of controls as well as substantive procedures (combined approach) (ISA 330.A3 and A23). To determine the actual level of control risk, the auditor must obtain a sufficient amount of relevant audit evidence. On the basis of the test of controls the auditor decides whether one relies on those controls or whether more substantive audit procedures are required (Halonen and Steiner 2009, 233). The relevant controls need to be tested when the auditor concludes that the substantive procedures alone do not provide good enough audit evidence at the assertion level. This may occur when a company conducts its business using IT and documentation of transactions is produced or maintained only through or in the IT system. It may not even be possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures (ISA 330.A24−A25). Therefore the controls relating to such mass transactions have a direct effect on the validity, appropriateness and completeness of the audit evidence. The auditor must perform the tests on those controls that are designed to mitigate the risks of the relevant mass transactions (Halonen and Steiner 2009, 240).

The auditor has to decide which controls are suitably designed to prevent a material misstatement in a given assertion. Alternatively relevant controls may be designed to detect and correct such misstatements. The tests of controls are performed on the aforementioned controls only. If the company has applied substantially differing controls at different times, each of those controls is tested separately (ISA 330.A20). The auditor may decide that it is efficient to evaluate their design and implementation and simultaneously test their operating effectiveness (ISA 330.A21).

Extent and timing of tests of controls. In designing and performing the tests of controls, the auditor shall perform other audit procedures in combination with inquiry and other audit procedures, such as observation or the CAATs, to obtain audit evidence about the operating effectiveness of the controls. Such evidence may relate to the application of the controls at relevant times, the consistency of application, and the personalities using the controls or means of application (ISA 330.10 (a)). Inquiry combined with inspection or reperformance usually provide more reliability in the audit evidence than inquiry combined with observation, as the observation covers only the time at which the observation is made. Also, the nature of the particular control influences the type of procedure required to obtain audit evidence about whether the control was operating effectively. For example, if operating effectiveness is evidenced by documentation, the auditor may decide to inspect that documentation. Yet, there are controls for which the documentation may not be available or even relevant, such as assignment of authority and responsibility or control activities performed by a computer. In such occasions, the use of CAATs may provide more reliable audit evidence (ISA 330.A26 and A27). As to the effectiveness of a control, when more persuasive audit evidence is needed, it may be appropriate to increase the frequency, time and/or extent of testing of the control (ISA 330.A28).

In general, IT processing is inherently consistent. Where such control is effectively applied, the extent of testing of an automated control need not may be held steady. The auditor is allowed to deem that an effective IT-based control continues to operate consistently unless the program (such as tables, files or other permanent data used) is amended. Such tests of consistent effectiveness may include, for example, determining that changes to the program are not made without controls and verifying that the authorised version of the program is used for processing transactions and not for illegitimate purposes. For example, the auditor may inspect the record of the administration of IT security to obtain audit evidence that unauthorised access has not occurred during the period (ISA 330.A29).

The auditor shall perform the tests of controls at a certain point in time or over a period for which one intends to rely on the effective working of those controls. Typically the auditor prefers to trust in the effective working of controls, including IT controls, during the entire audited financial period. Audit evidence pertaining only to a point in time may be sufficient with regard to inventory counting. Where the auditor intends to rely on a control over a period, continuous tests appropriate (ISA 330.11 and A32; Halonen and Steiner 2009, 243). Controls over significant risks shall always be tested in the current period (ISA 330.15).

As to continuous tests, an auditor may even have audit evidence from the previous audit (ISA 330.13 and A35). If the auditor cannot find any material changes to the IT controls that were considered effective in the previous audit, the auditor may conclude that those controls are still working effectively. The auditor shall test such controls at least once in every third audit and test some controls in each audit (ISA 330.14(b)). This is how the auditor avoids a situation where all the relevant controls are tested in the same year and in the two following years no audit procedures on controls are performed at all. In this manner the auditor obtains continuous information about the efficiency of the control environment. This, in turn, has an effect on a decision on whether the information received in the previous audits is applicable (Halonen and Steiner 2009, 244).

In general, as the risk of material misstatement or the reliance on controls increases, the auditor shall perform audit procedures at shorter intervals, if any. A deficient control environment, general IT controls or monitoring of controls, a significant manual element (human error), changes in key personnel applying controls, significant seasonal fluctuations in volume of transactions and changing circumstances indicating need to amend the control may decrease the period for retesting a control. These factors may also result in that the auditor does not rely on audit evidence obtained in previous audits at all (ISA 330.A38; Halonen and Steiner 2009, 246).

Evaluating the operating effectiveness of controls. On the basis of the misstatements that have been detected by substantive procedures, the auditor shall evaluate whether the controls are operating effectively or not. However, even their absence does not entitle the auditor to conclude that the controls having bearing on the tested assertion are effective (ISA 330.16). Such a material misstatement is only a strong indicator of a significant deficiency in the internal controls (ISA 330.A40).

If the auditor detects deviations from controls on which the auditor is willing to rely, the auditor shall make specific inquiries to obtain understanding of the matters in question and their potential consequences. The auditor shall determine whether the controls can be relied on or whether additional tests of controls or substantive procedures are needed (ISA 330.17). Some deviations in the way controls are applied by the company may occur. The detected rate of deviation in comparison with the expected rate may indicate that the control is not reliable (ISA 330.A41).

Control activities relevant to distribution of assets. In principle, each transaction requires a due authorisation in order for a given control to be satisfactory. The authorisations can be either general or transaction-specific. Under general authorisation management establishes policies and subordinates are instructed to implement these by approving all transactions within their limits. Specific authorisation applies to individual transactions (Arens et al. 2014, 317). According to ISA 315, Appendix 1, Paragraph 10, certain control activities may depend on the existence of appropriate higher level policies established by the management. For example, authorisation may be delegated under established guidelines, which include but are not limited to investment criteria set by the management. It is also recognised that to proceed with major non-routine transactions a high level transaction-specific authorisation may be needed. In some cases even the specific authorisation from the (qualified) majority of shareholders is needed. In effect, the distribution of assets fulfils the latter condition.

In accordance with ISA 315, Appendix 1, Paragraph 9, different people should be assigned the responsibilities of authorising and recording transactions, and maintaining custody of assets. Separation of duties is intended to reduce the opportunities to allow any person to be in a position, which enables that person the possibility to both perpetrate and conceal errors or fraud in the normal course of the person’s duties. Adequate segregation of duties involves four general guidelines: 1) the authorisation of transactions for the custody of related assets and segregation of 2) the custody of assets from accounting, 3) the operational responsibility from record-keeping responsibility and 4) IT duties from user departments (Arens et al. 2014, 316). In the distribution of assets points 1 and 2 seem to be especially relevant.

5.2.3 Substantive procedures

Description. In every audit the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. This duty shall be fulfilled without regard to the assessed risks of material misstatement (ISA 330.18). It is obvious that the auditor's assessment of risk is judgmental. The auditor may not even identify all risks of material misstatement, but on the other hand one may not consider them as material even if they were identified. Moreover, there are inherent limitations to internal control, and in many occasions the management has the opportunity and even capacity to override those controls (ISA 330.A42).

The auditor may apply external confirmation procedures as substantive audit procedures (ISA 330.19) in addressing assertions associated with account balances and their elements, the terms and provisions of contracts, or transactions between the company and related and third parties. Other potential situations, where relevant audit evidence may be obtained through these procedures, may include inventories held by third parties, property title deeds held by third parties for safe custody or as security, investments held by third parties for safekeeping or delivery purposes, and amounts due to lenders. In these situations the auditor may also ask for external confirmations to understand the relevant terms of the contract and restrictive covenants (ISA 330.A48).

As to the financial statement closing process, the auditor's substantive procedures shall include the following: "agreeing or reconciling the financial statements with the underlying accounting records; and examining material journal entries and other adjustments made during the course of preparing the financial statements" (ISA 330.20). The nature and the extent of these procedures depends on the nature and complexity of the financial reporting process and its risks (ISA 330.A52).

Substantive procedures responsive to significant risks. The auditor shall perform substantive procedures that are specifically responsive to significant risks. When the auditor takes the substantive approach, the audit procedures shall include tests of details (ISA 330.21).

Through external confirmations received directly by the auditor from appropriate confirming parties the auditor obtains audit evidence having high level of reliability. As one example, the auditor may be aware of the management's bonus-based remuneration scheme and the auditor identifies that the management faces pressure to carry out earnings expectations. In such an occasion there may be a risk that the management is inflating the amount of sales by recognising revenue related to sales agreements prematurely. In these circumstances, the auditor may, for example, have the outstanding amounts and, in addition, the relevant terms and provisions contracts confirmed (ISA 330.A53).

Extent and timing of substantive procedures. On the basis of circumstances prevailing at the moment of the audit in question, the auditor may come to the conclusion that performing only substantive analytical procedures will be sufficient to achieve the general objective of audit. Again, circumstances may lead the auditor to decide that only tests of details are appropriate. The auditor may also consider that the two approaches need to be combined, i.e. a combination of substantive analytical procedures and tests of details are most responsive to the assessed risks (ISA 330.A43−A44).

The nature of the risk and assertion is relevant to the design of tests of details. The auditor may have regard to the auditable items from various points of view. On the one hand, with a view to the existence or occurrence assertion, tests of details may involve selecting a group of auditable items from items *de facto* contained in a given financial statement amount and verifying the existence and occurrence of those items. On the other hand, as to the completeness assertion, tests of details may involve selecting a group of auditable items from those that one could reasonably expect included in the relevant financial statement amounts and verifying if these items are *de facto* and fully included in the financial statements (ISA 330.A45).

As it is mentioned above, the assessment of the risk of material misstatement takes account of the level of internal control. Hence, when the auditor concludes that results from tests of controls do not satisfy the general objective of audit, the extent of substantive procedures may need to be increased on the condition that that those audit procedures function effectively and are relevant to the to the specific risk (ISA 330.A46).

Substantive procedures are performed at an interim date and after period end (Halonen and Steiner 2009, 249). In accordance with the auditor's professional judgment, these procedures can be performed *in solo* or alternatively combined with tests of controls, but they shall provide reasonable basis for extending the audit conclusions from the interim date to the period end (ISA 330.22). In most cases, audit evidence from a previous audit's substantive procedures provides only little audit evidence for the current period (ISA 330.A54). If the auditor performs substantive procedures at an interim date but does not conduct any further procedures at a later date, such an omission scales up the detection risk at the period end. The longer the omitted period is, the more the risk increases (ISA 330.A56).

If misstatements, that the auditor did not expect in the risk assessment phase, are detected at an interim date, the auditor shall evaluate whether the related assessment of risk and the planned nature, timing or extent of substantive procedures covering the remaining period need to be modified (ISA 330.23). When they do need to be modified, such modification may include extending or reperforming the previously performed procedures at the period end (ISA 330.A58).

5.2.4 Analytical procedures

Description. In the ISAs the term “analytical procedures” refers to “evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass such investigation as is necessary of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount” (ISA 520.4).

Various methods may be used to perform analytical procedures ranging from performing simple comparisons to performing complex statistical analyses (ISA 520.A3). The company’s financial information can be compared with, for example, comparable data obtained during the audits of prior periods, forecasts of the company, or expectations of the auditor. Comparable information may also include relevant similar industry information about the financial statements or key ratios, if such information is available to the auditor (ISA 520.A1). Analytical procedures also include consideration of relationships between pieces of financial information that can be expected to move in accordance with a certain pattern, for example in direct or inverse relation to each other. Such relationships may cover gross margin percentages and relationships between financial information and relevant non-financial information, such as payroll costs to number of employees (ISA 520.A2).

When designing and performing substantive analytical procedures, either alone or in combination with other substantive procedures, the auditor evaluates 1) the suitability of such procedures for given assertions and 2) the reliability of data from which the auditor’s expectation of recorded amounts or ratios is developed. Moreover, the auditor must evaluate 3) whether one’s expectation is sufficiently precise to identify a material misstatement individually or in aggregate with other misstatements. The auditor must also determine 4) the acceptable amount of difference between recorded amounts and expected values (ISA 520.5). The auditor may make inquiries to the management with a view to obtaining reliable information in order to execute an analysis on the aforementioned matters. Such information may cover also eventual results of any analytical procedures that the company itself has performed prior to the auditor’s request. When the auditor applies the data obtained from the audited company, the auditor shall be satisfied that such data is properly prepared (ISA 520.A5).

Suitability of particular analytical procedures for given assertions. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The planned analytical procedures are based on the expectation that relationships among data continue to prevail, unless the auditor has specific reasons to make a conclusion to the contrary. The auditor shall also assess how effective the planned analytical audit procedure will be in detecting a misstatement, and conclude whether there is still reason to perform that procedure (ISA 330.A44 and ISA 520.A6).

If the auditor does not seek to obtain absolutely correct numbers but instead deems that a quick and rough estimate is sufficient for some specific purpose, in such occasions even an unsophisticated calculation or a model may prove to be effective. For example, recourse to widely recognised trade ratios, such as profit margins, can often be used effectively to support the reasonableness analysis of recorded amounts (ISA 520.A7). However, it is obvious that different types of analytical procedures provide different levels of assurance. For the purposes confirming a revenue figure, the calculation and comparison of gross margin percentages may provide less persuasive evidence, but such analytical procedure is likely to support findings that are obtained through other more appropriate audit procedures (ISA 520.A8).

As in the case of tests of details, the nature of the risk and assertion is relevant to the design of analytical procedures, too. These two types of procedures may be simultaneously applied to address to a given assertion. As to the valuation assertion for accounts receivable balances, the auditor may apply analytical procedures to an aging of customers' accounts in addition to performing tests of details on subsequent cash receipts to determine the collectability of the receivables (ISA 520.A9−A10).

The reliability of the data. The reliability of data is influenced by its source (insider or outsider information) and nature (company or industry information) and is dependent on the circumstances and controls under which it is set up and obtained (completeness, accuracy and validity of the data) (ISA 520.A12).

The internal controls over provision of financial and non-financial information affect even the results of the analytical procedures. While the auditor is performing substantive analytical procedures in response to the assessed risks, the auditor may simultaneously test the operating effectiveness of controls, if any, over the company's preparation of information. If such controls prove to be effectively designed and applied, the auditor is entitled to rely on the information obtained and on the results of the analytical procedures. The aforementioned applies to the testing of non-financial information also: in establishing controls over the processing of sales invoices, a company may include controls over the recording of unit sales. In these circumstances, the auditor may test the operating effectiveness of both controls (ISA 520.A13).

Evaluation whether the expectation is sufficiently precise. The auditor shall evaluate whether one's expectation is sufficiently precise to identify a material misstatement individually or in aggregate with other misstatements. In this sense, relevant matters include the predictive accuracy of the expected results which can be obtained through the use of substantive analytical procedures. The auditor may consider important the degree to which information can be disaggregated. The procedures are usually more effective when they can be applied to individual sections or components of an operation than to the financial statements as a whole. The auditor may have a regard also to the availability of information, both financial and non-financial, to enable considerations regarding the reliability of the information (ISA 520.A15).

Amount of acceptable difference. The auditor must determine the acceptable amount of difference between recorded amounts and expected values. Determining the amount of difference that is acceptable without further investigation is influenced by materiality and the consistency with the desired level of assurance. The auditor must obtain more persuasive audit evidence the higher the assessed risk is. Accordingly, as the assessed risk increases, the acceptable amount of difference decreases (ISA 520.A16).

Timing and use in asset distribution. The auditor shall perform analytical procedures near the end of the audit, so that the results of the performed analytical procedures are of aid to the auditor when one makes an overall conclusion on whether the audited financial statements are in line with the auditor's understanding of the company (ISA 520.6). If, on the basis of the results of analytical procedures, the auditor identifies fluctuations or relationships that are inconsistent with other relevant information or differ from expected values significantly, the auditor shall make inquiries to the management and perform any other necessary audit procedures. The aim of the auditor is to obtain audit evidence that is consistent with other information, taken account of the prevailing circumstances (ISA 520.7).

The whole range of analytical procedures is particularly pertinent when the auditor evaluates the solvency in the context of the asset distribution. These procedures have been widely applied in practice, too (cf. chapters 2.2 and 7).

5.2.5 Auditing business processes: finance function

Description. In general, the companies strive to achieve the goals pronounced in the corporate strategy through business processes. In Figure 4 below, the functions outside the circle describe the general principles and procedures in the organisation that are needed to run effective business management. The functions inside the circle depict the business processes or functions to handle business transactions:

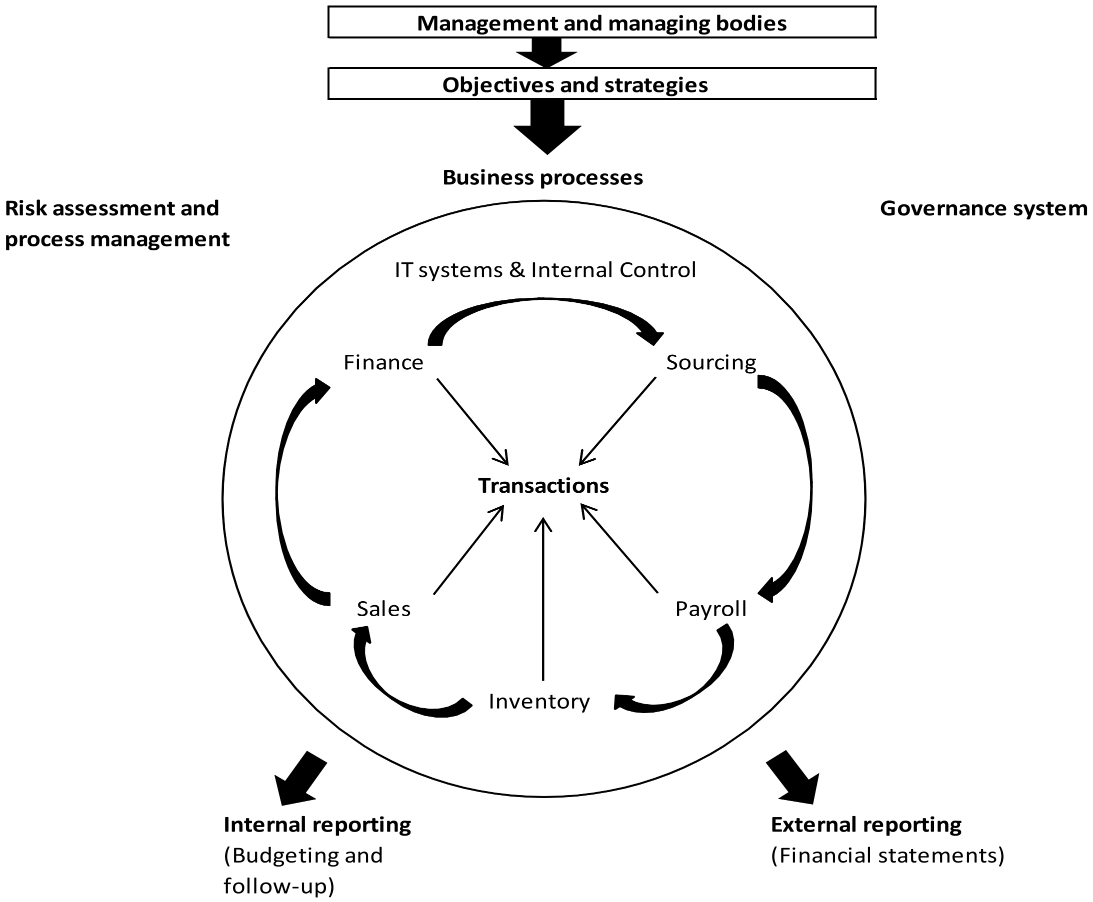

Figure 4. Business processes (Halonen and Steiner 2009, 269, transformed to an Excel broadsheet by the author).

In addition to the functions inside the circle, IT systems and internal control are also needed to take care of business transactions. It is the duty of the management to plan and implement controls to assure that business transactions, regarding at least sales, sourcing, inventory, payroll and finance, are entered for and reported in the IT systems in a correct and complete manner. All the business processes may involve numerous subprocesses. In practice, an audit assignment is often divided in smaller parts, which enables the division of tasks, for example by business process or function, and also renders the audit assignment more easily controllable. In the end, the journal entries and accounts are recorded to the general ledger, finally establishing the financial statements, and the audit results of different processes are combined in order to draw overall conclusions (Halonen and Steiner 2009, 270).

The auditor obtains a view about the function and assesses its control risk. In doing this, during the financial period the auditor uses five assertions related to transactions, namely occurrence, completeness, accuracy, cutoff and classification. The auditor must also recognise the key controls, whose the non- or malfunctioning is likely to cause a material misstatement in the financial statements. Next, the auditor combines the identified controls or the deficiencies therein to the transaction-related assertions and evaluates controls and assertions in unison. The control risk is evaluated on an assertion-by-assertion basis, which is a critical phase. On this basis the auditor decides the necessary test of controls and substantive audit procedures. The assertions presenting at least medium control risk require sufficient amount of appropriate audit procedures (Halonen and Steiner 2009, 272 and 280−281).

Processes of finance function. Business processes relating to finance occur in each firm, and it involves at least cash, equity and debt management. In the most basic form, the finance function is all about managing and recording incoming revenues and outgoing payments. The cash management includes the cash flows in different forms. Cash reserves cover cash in register, liquid money in the bank accounts and investments to different kinds of liquid securities. The cash management is closely related to other functions, such as sales, sourcing and payroll, because many of these transactions are simultaneously cash management transactions. In case the controls of the said processes do not work effectively, misstatements in the cash accounts may occur. The cash reserves constitute important objects of audit because there is a significant risk of error or fraud involved (Halonen and Steiner 2009, 381−382). The finance function is also in a key position in the asset distribution.

As to the cash management, the auditor shall assure through substantive procedures that all the cash and other liquid assets exist because they are the most susceptible to be embezzled. The auditor shall assure that all the payment transactions are recorded at the right time. The auditor shall evaluate whether the management of material amounts of money is effective. As to the organisation, the liability of each employee who takes part in the management of cash and other liquid assets shall be clearly determined through tests of controls. In practice, the most important requirement is that one person only is responsible for taking care of each cash register and of each cash account. In addition, these persons shall have deputy persons who take over the cash register and cash account in question at least while the main responsible is enjoying a yearly vacation. It is also appropriate that the auditor obtains understanding about the applicable procedures in the cash management. Emphasis should be placed on the appropriateness of the authorisations and instructions as well as on the unexpectedness of the audit procedures, in particular in small and medium-sized companies (Riistama 1999, 92−94).

The debt management consists of applicable corporate principles and procedures regarding short and long-term credit as well as collaterals. The number of the debt transactions is usually low but their nominal value can be significant. Therefore, the risks involved with these transactions are usually considered material. The audit of these transactions may be quite straightforward, but complex terms and provisions in debt agreements may complicate the audit considerably as the information needed for the financial statements shall be presented in a true and fair manner (Halonen and Steiner 2009, 382).

The equity management covers share capital, mandatory and voluntary reserves and other eventual investments in equity by the shareholders. As to the audit, it is crucial whether the audited company is a public company or a private company. In a private company the number of shareholders and equity transactions are usually rather limited, which factors are bound to decrease the tasks of the auditor regarding equity management. Hence, it may be that the only equity transactions are the entry of the after-tax profit to the balance sheet and the amount of the distribution of assets in accordance with the decision of the annual general meeting. Yet, in a public company equity transactions may prove to be numerous and their nature to be complicated (Halonen and Steiner 2009, 382−383), which increases risks and necessitates more audit procedures.

Documents and information systems of the finance function. When the auditor is obtaining a view about the finance function, it is important to find out the nature of documents and business procedures that are being used and applied (Halonen and Steiner 2009, 270−271). This applies to the management of cash, debt and equity.

As to the cash management, the most important system is the payment and bank connection program. Through the application of these programs companies pay the bills that have become due and obtain information about the clients' and other parties' payments transferred to the accounts of the company. Today, IT systems and appropriate applications enable the automatic transfer of bank account information, for example clients' incoming payments received to the company's bank account and to the accounts receivable ledger on the basis of a sales bill. In a like manner, outgoing payments can be recorded automatically. Therefore, substantive external confirmations on the bank account balances, which are printed out and sent directly to the auditor by the bank, still play an important role in the audit. Such information about balances given by the bank is compared and matched with the bank account balances given to the auditor by the company (Halonen and Steiner 2009, 383−384).

Companies with high leverage and a high number of debt-specific terms and provisions usually have some kind of system for the management of debt and collateral. Usually such a system not only contains the debt agreement but also enables the calculation of interest to be paid and recorded for the current period. Also here the creditors are asked to confirm the debt balances and collaterals, and this information is matched with that of the audited company (Halonen and Steiner 2009, 384).

As to the equity, in a Finnish limited liability company the board of directors shall keep a register on shares (share register) if the shares in the company have not been incorporated in the book-entry system. Also an alphabetical register shall be kept of the shareholders in the share register (shareholder register) (FCA Chapter 3, Section 15, Subsections 1 and 2). In such a company, the liability for organising the recording of amendments to the registers lies with the board of directors. The audit must cover the fact that the changes in the registers are based on reliable evidence on the acquisition and that the transfer tax has been paid (FCA Chapter 3, Section 16, Subsection 1; Riistama 1999, 262−263). There may be a specific program or system to that effect, and the auditor shall assure oneself of the reliability and effectiveness of such a program or system (Halonen and Steiner 2009, 265−266). If the shares in the company are incorporated in the book-entry system, a computerised share and shareholder register is kept at the central securities depository (FCA Chapter 4, Section 3, Subsection 1).

Relevant controls of the finance function. The auditor assesses control risk by investigating the relevant IT systems, key controls and compliance measures (Halonen and Steiner 2009, 280). The personnel involved in making transactions and hence dealing with the cash flows should not involve in dealing with accounting or subledgers. In practice, optimal segregation of duties is possible only in quite large companies. In small and medium-sized companies these burdens could be tackled by applying information technology, user restrictions and/or internal controls. It is likely that these means would reduce the need for extensive audit procedures (Halonen and Steiner 2009, 277 and 385).

Many of the transactions in the finance function are material in the financial statements. Therefore, it is necessary to have relevant authorisation for such transactions and power to conclude them. In Finnish companies it is usually the board of directors who authorises debt transactions and the general meeting that authorises equity transactions. Due to the material nature of the finance transactions, it is also of the importance that the transactions are duly documented and their recording is instructed. Usually such transactions are first recorded to subledgers or auxiliary accounts before entering the transaction for the general ledger. Whether the entry is made through automated or manual means, in both situations the audit trail between the transaction and the entry shall exist. There shall be a matching procedure for information transferred from one system to another. Matching refers to that the amounts and numbers of transactions are the same in the emitting and receiving system (Halonen and Steiner 2009, 385−386).

5.2.6 Audit of administration

In Finland, “an audit covers the audit of the accounting records, the financial statements, the annual report and, in addition, the administration of a corporation or a foundation” (FAA Section 11, Subsection 1). In practice, these objects of audit are superfluous to some degree. The audit of administration is clearly a national requirement. It is not covered in the ISAs established by the IFAC, but it is covered in the Finnish adaptation of the ISAs established by FIAPA (FIN-ISA Standard 260, Title B). However, in the provisions or in the *travaux preparatoires* of the current FAA the aims and contents of the audit of administration are not discussed. This was done in the Government Bill of the now repealed auditing act: it is about monitoring the legality of the management’s actions, including the duty of due care, and not about the business rationale of those actions (Government Bill 295/1993, 34; Alakare et al. 2008, 65; cf. Riistama 1999, 249, emphasises also that the auditor, as having expertise in business matters, may have a reason to pay attention to the business rationale of a decision and the competence of the management even if one is not legally obliged to do that). This division clarifies the auditor’s role: the auditor cannot meddle in the business judgments of the management. In practice, the auditor must assess on a case-by-case basis whether one reacts to a measure taken by the management; and when one reacts, it shall be based on the compromised legality of that measure (Halonen and Steiner 2009, 428).

The aim of the audit of administration is to provide audit evidence for assessing whether “a partner, a member or the chairperson or the deputy chairperson of the board of directors or of the supervisory board or of an equivalent governing body, or the managing director or any other accountable person in the corporation or is guilty of an act or negligence which may result in liability in damages towards the corporation or foundation, or has violated a law applicable to the corporation or foundation, or the articles of association, deed of partnership, or bylaws of the corporation or foundation”. If any of the conditions above is fulfilled, the auditor shall make a remark in the auditor’s report (FAA Section 15, Subsection 4; See also: chapter 6.2 on making a remark).

The main tasks of the auditor are to obtain understanding, among other things, of the minutes, annexes and memorandums of the corporate bodies’ meetings, important contracts and background materials with regard to liability for the decision making process and of pledges and collaterals. It is also important to audit internal control systems, accounting information systems as well as the share and shareholder registers. The auditor should also assure that management of insurance and tax matters are duly organised. The objective in auditing matters of accounting law, securities law, tax law and criminal law, including frauds and embezzlements, is to hinder the audited company from incurring unnecessary losses due to negligent or intentional acts or omissions (Riistama 1999, 248−249). Attention shall be paid to that all the necessary matters shall be duly decided in accordance with relevant provisions of the FCA and the articles of association of the audited company, documented accordingly and maintained in a reliable manner. However, the shareholders' contracts are not covered by a statutory audit unless the company has included them or their provisions to the articles of association or the company is committed to comply with such contract (Halonen and Steiner 2009, 431).

In a Finnish limited liability company the annual general meeting shall decide on the distribution of assets (FCA Chapter 5, Section 3, Subsection 2, Point 2). However, according to the current FCA, the annual general meeting does not necessarily have the auditor's statement on this matter. On the other hand, the auditor's report includes one's remarks, where necessary (See: chapter 6.2 below).

Specific concerns in the asset distribution: related party transactions. The good auditing practice requires that the audit covers transactions between the audited company and its related parties. The objectives are that, first, the auditor obtains a sufficient understanding of related parties, the relevant relationships and transactions and, second, is able to recognise relevant fraud risk factors to which those relationships and transactions give rise. Third, on the basis of the obtained audit evidence, the auditor shall ascertain that the financial statements achieve the objective of fair presentation, and are not misleading as well as that the related party relationships and transactions are duly identified, accounted for and disclosed in the financial statements (ISA 550.9).

The auditor shall make inquiries to the management regarding the company's related parties, including changes therein, the nature of the relationships, possible transactions with these related parties during the period and, if so, their type and purpose (ISA 550.13−14). From the beginning of the audit to its ending the auditor shall stay in the state of vigilance that there may exist related party relationships or transactions not previously identified or disclosed to the auditor. Bank and other external confirmations, minutes of the shareholders' and management's meetings and other such records are key sources to the identification of the related party relationships or transactions (ISA 550.15).

When the auditor assesses the risks of material misstatement, the auditor shall classify unusual related party transactions, which occur outside the scope of business stipulated in the articles of association, as giving rise to significant risks of material misstatement (ISA 550.18). Such unusual transactions may cover, *inter alia*, complex equity transactions. The auditor shall examine the underlying contracts or agreements. While doing this, the auditor shall evaluate whether the business rationale of the transactions or the lack thereof refers either to fraudulent financial reporting or to misappropriation of assets (ISA 550.23). It should be kept clearly in mind that such transactions may involve undercover distributions of assets to all or some of the shareholders.

As one part of the audit of administration, the auditor shall pay attention to and react to circumstances, which might clearly refer to abuse of or otherwise undue influence by the majority shareholders (Riistama 1999, 256 with references). In this manner the majority shareholders may attempt to not to pay the minority shareholders a dividend or not to perform any other distributions of assets, force the minority shareholders out of the company and after that grant a larger stake of the distribution to the majority shareholders.

Specific concerns in the asset distribution: going concern assessment. It is the auditor's duty to "obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements". The auditor shall also "conclude whether there is a material uncertainty about the company's ability to continue as a going concern" (ISA 570.6). "A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for in the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or in the case of a compliance framework, the financial statements not to be misleading" (ISA 570.17).

In the risk response phase the auditor shall consider whether some events or conditions, present at the time of audit procedures, cast a significant doubt on the company's ability to continue as a going concern. The auditor may rely on the prior assessment by the management or make one's own assessment. The auditor may make inquiries to the management if the latter has already performed a preliminary going concern assessment and evaluate that assessment, if any. The auditor shall also remain in the state of vigilance from the beginning of the audit to its ending for events or conditions that may cause a change to that assumption (ISA 570.10−12). The auditor shall assess the situation himself or herself, and the assessment shall cover at least 12 months (ISA 570.13), and the auditor shall ask the managers if they have insights into negative events or conditions that have taken place after the management's assessment was established or have an effect on a posterior period that was covered in the management's assessment (ISA 570.15). In such a case, the auditor is required to take active additional measures to conclude whether or not a material uncertainty exists in reality (ISA 570.16, introduction). Such procedures may include, for example, 1) analysing and discussing the company's latest available interim financial statements, cash flow, profit and other relevant forecasts with management, 2) reading the terms and provisions of contracts and determining whether any have been breached, 3) reading minutes of the shareholders' and management's meetings with an objective to find out references to financing difficulties, 4) making inquiries to the company's legal counsel or others regarding the existence of litigation and claims, the reasonableness of management's assessments of their outcome and the estimate of their financial implications, the existence, legality and enforceability of arrangements to have financial support or planned disposals of assets. The auditor may also 5) try to identify those events that either mitigate or otherwise affect the company's ability to continue as a going concern (ISA 570.A15).

Analytical audit procedures are especially pertinent in occasions where there is a risk of placing the company into liquidation under FCA Chapter 20 or in the conditions that may cast a significant doubt on the company's ability to continue as a going concern (Riistama 1999, 153). According to the ISAs the going concern principle is applicable unless there is explicit evidence to the contrary, and the auditor shall actively monitor whether or not such negative signals exist. The following may indicate that there might be a need to liquidate the company: 1) the operative result has been in the deficit for rather a long period, 2) the liabilities or claims exceed the assets, 3) bills fallen due cannot be paid or the credit cannot be novated, 4) long-term investments are financed with short-term credits, 5) key financial ratios are weak, 6) suppliers require cash payments, 7) key personnel resign, 8) market position is lost, 9) loss of a key supplier or 10) a lack of materials occurs. These problems may be mitigated by the management, and where such issues occur, their plans play an important role (Riistama 1999, 155−157).

5.3 Reporting

5.3.1 General objectives of evaluating audit evidence and communication

"The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework" (ISA 200.3), that is, to give a true and fair view in accordance with that framework.

In the final phase of the audit, the auditor shall evaluate whether the obtained audit evidence is sufficient and appropriate and whether the assessments of the risks of material misstatement at the assertion level remain appropriate (ISA 330.25−26). The sufficiency and appropriateness of audit evidence are interrelated and matters of professional judgment. Sufficiency is the measure of the quantity of the audit evidence, whereas appropriateness is the measure of the quality of the audit evidence (ISA 200.A29−A31).

The auditor shall consider whether the level of risk material misstatement level has changed, whether the conclusions made are appropriate even in the light of analytical audit procedures and whether suspicious events have arisen during the audit or even after the end of the financial year, and what is the effect of uncorrected misstatements to the auditor's report. The auditor writes the auditor's report and communicates one's reasonable conclusions to the governing bodies. Last, the auditor shall archive the documentation obtained during the audit (Halonen and Steiner 2009, 59 and 442−443).

One misstatement in the financial statements may suggest that other misstatements exist as well. This may be true, for example, where the auditor is convinced that a given internal control does not function as it is supposed to function, or inappropriate assumptions or valuation methods have been widely applied by the company (ISA 450.A4). During the audit, the auditor shall accumulate the identified misstatements. However, this duty does not apply to trivial ones under a given nominal limit (ISA 450.5).

Moreover, if the amount of detected aggregate misstatements is close to the level of materiality as a whole, there may be an unacceptably high risk that possible undetected misstatements, taken with the amount of detected aggregate misstatements, could exceed the level of materiality as a whole (ISA 450.A5). Thus, the levels of materiality and the assessment of effects related to those misstatements are tightly interwoven, because only material misstatements are of the essence. Moreover, the combined amount of uncorrected misstatements shall not exceed the level of materiality set to the financial statements as a whole. The effect of each individual misstatement on the relevant classes of transactions, account balances or disclosures is considered by the auditor. This assessment includes an assertion-by-assertion consideration if the materiality level for those misstatements is surpassed. If an individual misstatement is judged to be material, it is unlikely that it can be offset by other mitigating and opposite misstatements (Halonen and Steiner 2009, 447−448).

As to the communication, a well-planned, organised and executed audit is a prerequisite for precise reporting. If the auditor neither sets clear objectives nor plans the audit procedures to achieve those objectives, effective communication in writing or otherwise is difficult. Also the reader has difficulties to take in the contents. The auditor must distinguish fact-based documented conclusions from opinion-based assumptions and consider how to mediate the key issues clearly. These reporting qualities are highlighted in the case of the audit report, in particular where it is qualified (Riistama 1999, 266).

Many matters may be and, in practice, are discussed with the management and other personnel in the ordinary course of an audit (ISA 260.A32). The auditor shall communicate actively and clearly the matters stipulated in ISA 260 to the management of the audited company. These matters concern, in particular, the auditor independence, the statutory tasks of the auditor and an overview of the execution of the audit. The auditor shall also communicate the observations arising from the audit that are relevant to the managers' responsibility to organise and oversee the financial reporting of the company, such as qualitative aspects of the company's accounting practices, including accounting policies, accounting estimates and financial statement disclosures, as well as significant difficulties, if any, encountered during the audit (ISA 260.4−5, 15−17 and A20).

The auditor shall communicate to the management on a timely basis and in writing significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that have arisen during the course of the audit, but auditor independence shall always be communicated in writing (ISA 260.19−21).

Usually the auditor is also bound to communicate the non-trivial misstatements with the appropriate level of management and to ask the management to correct those misstatements (ISA 450.8). If the management refuses to correct some or all of the misstatements communicated by the auditor, the management must disclose its reasons to the auditor. The auditor, on the other hand, shall take those explanations into account when evaluating whether the financial statements as a whole are free from material misstatement (ISA 450.9 and 11).

Usually the auditor's written communication takes place in the form of inspection reports, which are discussed in the meetings of managing bodies. Their processing is presented in the minutes of the relevant meetings. The auditor possesses a copy of those inspection reports as a part of the audit documentation (Halonen and Steiner 2009, 479).

5.3.2 Auditor's report

Description. "The auditor's report shall contain an opinion on whether the financial statements and the annual report give a true and fair view, in accordance with the applicable financial reporting framework, of the result of operations and the financial position of the corporation or foundation, and whether the information included in the annual report is consistent with the information included in the financial statements" (FAA Section 15, Subsection 2). In Finland, the applicable financial reporting framework includes the FAA and the decree related thereto or, where applicable, the IFRS, and the regulations and guidelines of the Finnish Accounting Board and those of the Finnish Financial Supervisory Authority (Alakare et al. 2008, 77).

Emphasis of Matter. The auditor's report shall include any further information considered necessary. The requirement is unconditional in case the requirements presented in the subsection are fulfilled (FAA Section 15, Subsection 3). "If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements" (ISA 706.6). As an example, significant doubts on the applicability of the going concern principle or otherwise uncertain events may be brought up in a separate paragraph of the auditor's report. In these cases the auditor may be willing to direct the readers' attention to the circumstances or events that are pervasive but not to a degree, which would necessitate a qualified or adverse opinion (Government Bill 194/2006, 39; Alakare et al. 2008, 79). The necessary supplementary information does not affect the duty of the audited company to correct the misstated information in the financial statements (Alakare et al. 2008, 79). The Emphasis of Matter paragraph does not affect the auditor's opinion, but an Emphasis of Matter paragraph cannot be used to substitute a qualified or adverse opinion, disclaimer of an opinion, or disclosures in the financial statements, when they are required (ISA 706.A3; Halonen and Steiner 2009, 453; cf. Alakare et al. 2008, 79, Chapter 3.5.3 express a view that is slightly contrary to the said application guideline).

Supplementary information, whose presentation is not provided for in the applicable accounting and reporting standards, may or may not be considered as a part of the financial statements. Supplementary information, whose presentation is not provided for in the applicable accounting and reporting standards, must be clearly distinguishable from the statutory financial statements (ISA 700.46). Supplementary information, whose presentation is not provided for in the applicable accounting and reporting standards but constitutes an integral part of the financial statements, shall be covered by the auditor's opinion. In the latter situation such information cannot be clearly distinguished from the audited financial statements for reasons of the nature and presentation of such information, for example notes or cross-referenced supplementary schedules (ISA 700.47 and A46−A47).

Modifications to the auditor's report. The auditor's opinion shall be "unqualified, qualified or adverse. If the auditor cannot express an opinion, a disclaimer of opinion shall be expressed in the auditor's report" (FAA Section 15, Subsection 3). The auditor shall express a qualified opinion when the auditor concludes that misstatements in the financial statements are material but not pervasive. A qualified opinion shall be also expressed when the auditor is unable to obtain sufficient appropriate audit evidence but nevertheless concludes that the possible effects on the financial statements do not exceed the level of materiality but only that of pervasiveness (ISA 705.7). A qualified opinion covers only the misstatements or conditions that are explicitly stated in the opinion, whereas the other parts of the opinion are unqualified (Government Bill 194/2006, 39).

The auditor shall express an adverse opinion when the auditor concludes that misstatements in the financial statements are both material and pervasive (ISA 705.8). An adverse opinion must be given when a qualified opinion would not express clearly enough the degree of the misstatements (Government Bill 194/2006, 39).

The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence and considers that the possible effects on the financial statements exceed the levels of materiality and pervasiveness. The same must be done in some extremely rare circumstances involving multiple uncertainties the interaction and effect of which the auditor cannot assess. Consequently, in such occasions the auditor cannot form an opinion on the risks of material misstatements (ISA 705.9−10).

The situation may be such that the auditor deems the use of the going concern assumption acceptable, but nevertheless a material uncertainty about the continued functioning of the company exists. In such an occasion it is the duty of the auditor to decide then if the financial statements give a true and fair presentation of the significant doubt-casting events or conditions as well as of the management's plans to counter these risks. Furthermore, the auditor shall and disclose clearly that there is a material uncertainty related to these events or conditions and that it may be unable to realise its assets and discharge its liabilities in the normal course of business (ISA 570.18). If the financial statements do represent and disclose the situation fairly, the auditor shall express an unmodified opinion with the addition of an Emphasis of Matter paragraph. Moreover, the auditor shall make a reference to the note in the financial statements where the matters described above are clearly disclosed (IAS 570.19). If the auditor deems that the financial statements do not give a true and fair presentation of the significant doubt-casting events or conditions, a qualified opinion or adverse opinion in accordance with ISA 705 shall be expressed (ISA 570.20).

Submission of the auditor's report. The auditor's report shall be submitted to the board of directors no later than two weeks before the shareholders' meeting where the board of directors present the financial statements to be adopted (FAA Section 15, Subsection 6). However, unanimous shareholders may agree on shortening the period. Usually, the auditor's report is directed to the general meeting because the decisions on the adoption of the financial statements and on the use of the profit shown on the balance sheet shall be made at the ordinary general meeting. In other occasions it can be directed to the governing bodies of the audited company (Government Bill 1994/2006, 40; Halonen and Steiner 2009, 453-454; Mähönen and Villa 2010, 422). With a view to the distribution of assets, the timely submission of the auditor's report is of the essence so as to enable the shareholders' effective familiarisation and decision-making on the matter.

5.3.3 Audit memorandum

"An auditor may make remarks to the board of directors, the supervisory board, the managing director or other accountable party about matters not covered in the auditor's report. These matters shall be entered into the audit memorandum. The audit memorandum shall be submitted to the governing body responsible for the administration of the corporation or foundation and for the proper conduct of its operations. This body shall process the audit memorandum without delay and retain it in a reliable manner" (FAA Section 16). The audit memorandum shall be clearly titled because of its non-public nature, which is different from the public nature of the auditor's note and auditor's report. However, if there is a cross-reference, the audit memorandum becomes a public document (Halonen and Steiner 2009, 455−456). The objective of the audit memorandum is to inform the responsible managing bodies in a confidential manner, and therefore, usually the public documents make no reference to the fact that the audit memorandum has been given (Government Bill 295/1993, 35; Riistama 1999, 271).

There are no exact provisions in the legislation with regard to the form and content of the audit memorandum. In general, the audit memorandum includes practicalities relating to the accounting and administration that are not necessary to present publicly in auditor's report. Such practicalities are nevertheless important to the management, such as findings that urge for a swift correction. The subject matters relate to audit findings, usually of the accounting, financial statements, annual report, internal control, asset management or administration (Halonen and Steiner 2009, 456). Unless the audit memorandum has not been processed and its negative findings duly corrected by the company, its content may later be repeated and presented in the auditor's report. Usually it is considered satisfactory that the audit memorandum is discussed in the next meeting after that it has been given. Its content may, however, necessitate a specific meeting of a managing body. The audit memorandum shall be maintained and documented in order to be a source of information for later responsible persons and auditors (Riistama 1999, 273; Halonen and Steiner 2009, 455).

5.3.4 Inspection report and working papers

An inspection report refers to all reports that are not auditor's reports or audit memorandum provided for in the FAA. Thus, the auditor may give out an informal, internal inspection report, where the auditor may describe the performed audit procedures, findings, (legal and non-legal) conclusions and suggestions for improvement to be made. In the inspection report the auditor may also review whether the audited company has executed any of the auditor's previous suggestions for improvement (Halonen and Steiner 2009, 475; Riistama 1999, 269).

Inspection reports are usually initiated and established by the auditor, but it is possible that the company has included a stipulation in its articles of association or the general meeting has asked the auditor to report about the progress of the audit. It is a good practice to discuss the findings with the managing bodies before giving out the inspection report (Riistama 1999, 269). With a view to the distribution of assets, this means of communication could be used for the purpose of improving the distribution process.

Working papers refer to all the documents that the auditor establishes or obtains for his or her own documenting purposes. Working papers are neither published nor disclosed. Their purpose is to aid the auditor in planning and executing the audit, to prove the methodology used and to provide assurance of the quality of the audit. The working papers are also the auditor's notes, which refer to copies of the audited documents that are also included in the working papers. The auditor needs to maintain one's working papers long enough and in a reliable manner. They can be divided into permanent documents, such as basic client data, and temporary documents, such as audit of a certain period (Riistama 1999, 314). With a view to the distribution of assets, the auditor could provide a calculus for the solvency test, yet for one's personal use.

6 AUDITOR'S TASKS IN THE CONTEXT OF ASSET DISTRIBUTION IN FINLAND

6.1 Inspecting matters regarding asset distribution

There are neither explicit provisions nor a recommendation on what the auditors should do when assessing solvency in the context of the asset distribution. Therefore, the auditors are relying *mutatis mutandis* on ISA 570 "Going Concern" and good auditing practice, which includes principles (e.g. independence, objectivity, integrity, due care) and methods. The relevant sources of good auditing practice in Finland are acts and decrees, decisions and statements by Auditor Board of the State, Auditor Board of the Central Chamber of Commerce, courts and authorities, auditing standards as adopted in Finland, professional literature and observations about how diligent professionals generally act (Halonen and Steiner 2009, 31–32).

In effect, ISA 570 is considered central to evaluating solvency of the audited company. Under the going concern assumption, a company is viewed as continuing in business for the foreseeable future. Assets and liabilities are recorded assuming that the company will be able to realise its assets and discharge its liabilities in the normal course of business. The assumption is used unless there is clear evidence to the contrary (ISA 570.2).

Some jurisdictions, such as Finland (FAA Chapter 3, Section 3, Subsection 1, Point 1) and some financial reporting frameworks, such as International Accounting Standard (IAS) 1, paragraphs 25−26, explicitly require that the management makes a specific assessment of the company's ability to continue as a going concern. In this context, there are also some specific standards regarding matters that need to be considered and disclosed (ISA 570.3). While the management assesses the ability of the company to continue as a going concern, the management has the best but yet only a limited knowledge and it is bound make certain estimates about inherently uncertain future outcomes of events or conditions. Furthermore, the longer the assessment period is, the more uncertain the outcome of that estimate will be. Also the size, nature and complexity of the company and its business affect the outcome (ISA 570.5).

In considering the application of the going concern assumption, the auditor inquires of the management whether it has already performed a preliminary assessment on the use of the going concern assessment (See: chapter 5.2.6 and ISA 570.10−12). The auditor shall make his or her own assessment of the situation and cover the same period as that used by management, or a longer period if required by law or regulation. The auditor asks the managers if they have insights into negative events or conditions that have taken place after the preliminary assessment was established or have an effect to a posterior period that was covered in the preliminary assessment (ISA 570.13 and 15).

In performing the solvency test in the context of the asset distribution, the auditor may use the same methods and procedures as one applies in a general solvency assessment. If the auditor identifies any doubt-casting events, such as asset distribution, or conditions, such as declining profitability of the company, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty over these events or conditions exists. Through performing additional audit procedures, including consideration of mitigating factors, the auditor shall assure that the asset distribution does not cause the insolvency of the company (cf. ISA 570.16). Relevant audit procedures may include the ones enumerated above (See: chapter 5.2.6 *Specific concerns in the asset distribution: going concern assessment* and ISA 570.A15).

6.2 Reporting matters regarding asset distribution: a remark and a Going Concern opinion

The auditor shall make a remark in the auditor's report if a member of a managing body or any other accountable person in the corporation or foundation may be found guilty or liable of an offence within the meaning of FAA Section 15, Subsection 4 (See: chapter 5.2.6). The auditor must take into account the materiality principle such that a minor breach does not cause a remark (Government Bill 194/2006, 40).

In particular, in FAA Section 15, Subsection 4, Point 2, the question is mainly about a breach against the FCA and articles of association. In addition, the auditor must monitor the application of provisions of accounting law, securities law, tax law, fraud and embezzlement in the criminal law. The list is not exhaustive, taken account of the audited company's field of business (Government Bill 194/2006, 40). One important situation where this provision is applicable is when the auditor finds out that the board of directors' proposal for an asset distribution is in contradiction with the solvency test or the balance sheet test (i.e. FCA Chapter 13, Section 2 or 5), or with the articles of association. In such an occasion, the auditor shall make an explicit remark (Government Bill 194/2006, 38 and 40). In other occasions, the auditor gives an implicit opinion on the asset distribution (Alakare et al. 2008, 80). If the remark is omitted, the auditor considers the proposal for the distribution of assets to be legal (Mähönen and Villa 2010, 422).

The auditor shall justify one's remark, and in doing so the audit evidence obtained during the audit procedures is of the essence (Halonen and Steiner 2009, 452–453). The evaluation on how important the remark is the duty of the management and the general meeting of the company (Government Bill 194/2006, 39; Mähönen and Villa 2010, 420). Importantly, the auditor is no longer automatically bound by the law to express a specific opinion on the distribution of assets because those opinions are considered to be included in the general opinion in the auditor's report. Yet, the FAA or the ISAs do not prohibit the auditor from expressing such opinions, and one may do so voluntarily or on the basis of the articles of association or a request by or agreement with a relevant corporate body, e.g. the general meeting or the audit committee, where applicable. Complying with such a demand is considered to be in accordance with the good auditing practice and therefore such a demand shall be fulfilled (FAA Section 19, Subsection 3 and Section 22, Subsection 2; ISA 700.38; Auditor Board of the State 1/2009, given out 31 August 2009). Such requests are not included in the accounting directives or the ISAs (Government Bill 194/2006, 22–23). Therefore, such requests may be confusing in multinational companies as these requirements do not constitute a part of ISA 700 (Mähönen and Villa 2010, 417−418 with references).

Hence, there are occasions where the auditor shall make a conclusion on the appropriateness of the management's assessment on the solvency in the context of the asset distribution. If the management has accepted that the company remains solvent after the assumed asset distribution and that the relevant financial statements are established by applying the going concern assumption, but the auditor deems that a material uncertainty about the continued functioning of the company exists and therefore the management's use of the said assumption is unacceptable in a pervasive and material manner, it is the duty of the auditor to make a remark or even express an adverse opinion (cf. ISA 570.17 and 21). If the auditor deems that the financial statements give a true and fair view about the situation and the doubt-casting events or conditions are duly disclosed, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph, where one considers it necessary (cf. ISA 570.19 and A21). If adequate disclosure about the solvency and/or the doubt-casting events or condition is not made in the financial statements, the auditor shall give a modified opinion (cf. ISA 570.20).

7 SURVEY OF FINNISH AUTHORISED AUDITORS

7.1 General

The survey used comprised four different parts. First, descriptive information about the respondents and the size of their employee and their clients were collected. Second, the respondents were asked whether they consider the topic important. Third, some questions about the solvency test, documentation, lack of solvency and reporting of solvency were asked. Finally the auditors were given open space to express their topic-based comments freely. All the questions in the survey were visible to the respondents at once.

7.2 Descriptive results

Q1-2: In the beginning of the survey, it was found that the majority of the respondents (40/53) had worked more than 10 years as an authorised auditor. The distribution among the rest of the respondents was rather equally divided (Question 1). The majority of the respondents (42/53) did not work in a so-called Big Four audit firm, whereas the rest of the respondents (11/53) worked in such an audit firm (Question 2).

Q3: The majority of the respondents (35/53) consumed most of the total budgeted hours in the audits of companies with revenues less than 999.999 €. Apart from that, 11 respondents audited mainly companies with revenues of 1.000.000 – 9.999.999 €, 2 respondents companies with revenues of 10.000.000 – 49.999.999 €, and 5 respondents companies with revenues of at least 50 000.000 €.

Importance of analysing solvency

Q4: The respondents were requested to define solvency in the distribution of assets. In total, 47 answers were given. The answers can be divided into five general categories and, in addition, into a combination category, as follows:

1) In the first and the most important category (32/47), the respondents stated that the solvency in the asset distribution refers to that the company is able to discharge itself of the decided asset distribution and of its liabilities to the creditors. This idea was expressed in various terms, but the idea remained uniform among the answers.

2) In the second category, certain calculation formulas and financial ratios were presented (7/47).

3) In the third category, the respondents mentioned some items in the financial statements, the sufficiency of which the respondent assures (3/47).

4) In the fourth category (2/47), the solvency was defined as a possibility to obtain financing so as for the company to be able to perform the asset distribution.

5) In the fifth category, some general principles were presented, one respondent stated that the liquidity and the going concern principle are in central position in evaluating the proposal for the asset distribution. Another respondent highlighted the importance of the creditors in the payment order, even when the financial forecasts seem bad. Third respondent referred to the definition of solvency in the Bankruptcy Act (120/2004).

6) In the sixth combination category, the respondents paid attention to a certain item in the financial statements (for example, the amount of cash or other liquid assets) or financial ratio (for example, current ratio), and an assessment of solvency was considered through these items or financial ratios.

In addition, outside any clear categories, one respondent deemed that it must be clarified from the financing parties of the company whether there are possibilities to obtain further finance, possibilities to increase share capital or find a new financer, and whether there is any realisable property. Unless any of these are executable, company restructuring is an option. Moreover, many respondents limited their assessment to 12 months at most.

Q5: The respondents were asked how common it is that the audit client has established a documented assessment on solvency in the context of a distribution of assets, measured as a percentage of asset distribution events. The following distribution was found:

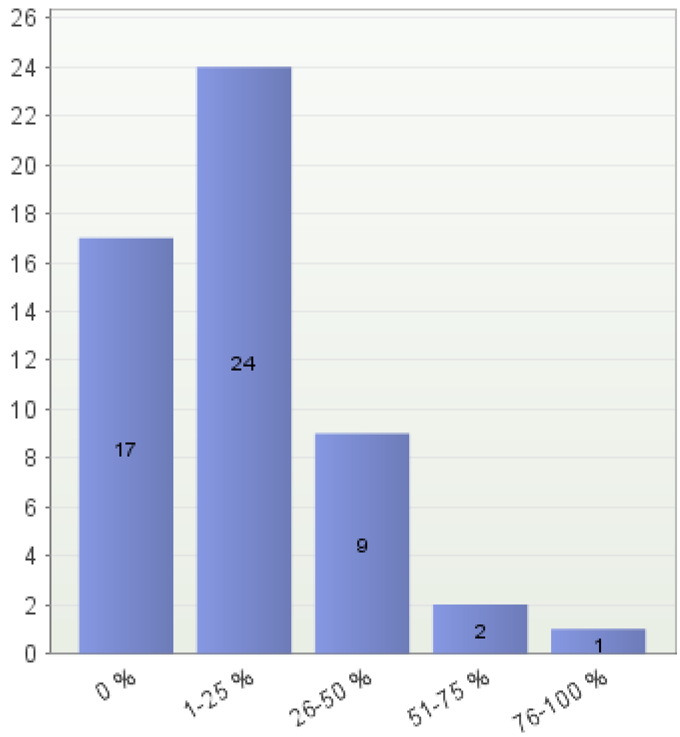

Figure 5. Occurrence of a documented assessment of solvency in the context of asset distribution.

It seems that the Finnish audit clients seldom establish a solvency assessment. Only 3 out of 53 respondents opined that the setting up of a documented assessment is a standard practice.

Q6: The auditors expressed their opinion on whether they disagreed or agreed with the statement "I consider auditing the evaluation of solvency by audited company an important part of the tasks of the auditor". The majority of the respondents (43/53) agreed or completely agreed with that statement. The rest of the respondents were equally distributed among the other options (completely disagree, disagree, neutral).

Some respondents considered it rare that a single asset distribution event would lead the company to insolvency. Therefore the entire solvency test was deemed useless. Either other decisions cannot be made so that the solvency is jeopardised. Yet, if the solvency is already at risk and a proposal for the asset distribution is made, then reporting in the auditor's report in combination with other solvency-related issues could be realistic.

Auditing the evaluation of solvency in practice

Q7: The auditors were asked whether they take into account the solvency of the audited company and its evaluation in the asset distribution in certain phases of audit. Multiple options were simultaneously available. The following findings were found:

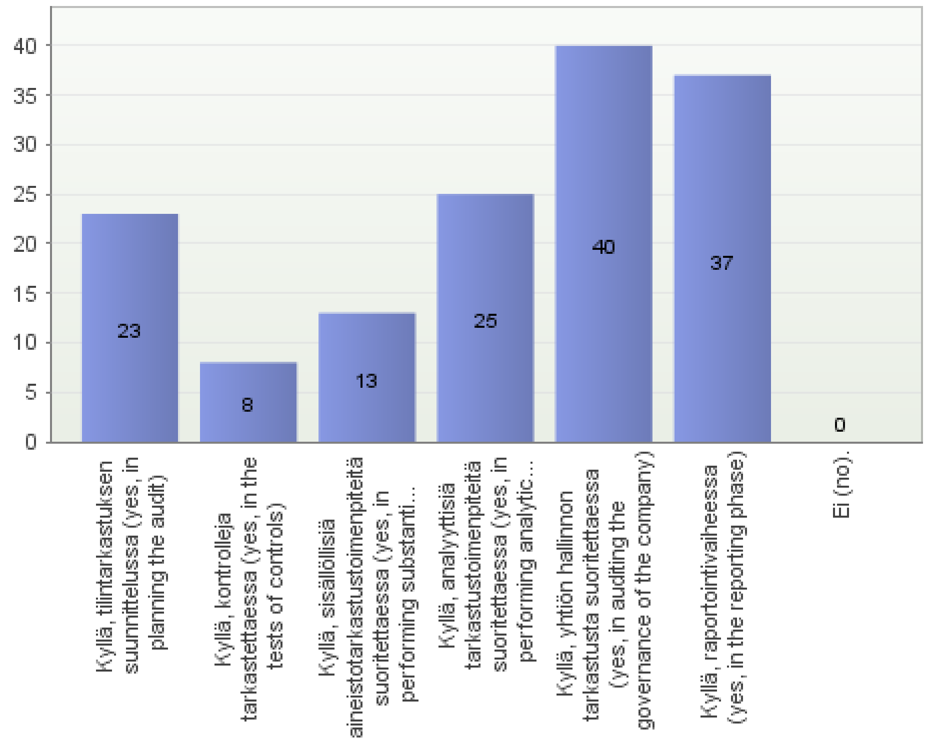

Figure 6. Taking into account the solvency of the audited company and its evaluation in the asset distribution in different phases of audit.

Figure 6 proves that the solvency is taken into account in all phases of the audit. Yet, its pervasiveness varies considerably depending on the phase. Its occurrence is at its minimum in the tests of controls and in performing the substantive procedures, in particular tests of details. In planning the audit (23/53) and in performing analytical procedures (25/53) approximately half of the respondents have paid attention to the solvency. The majority of the respondents have considered solvency in audit of administration (40/53) and when reporting (37/53). Therefore, it seems that the importance of taking account of solvency increases in the beginning and towards the end of audit process.

Q9-10: The majority of the respondents (38/53) have always paid attention to the documents that the audited company has made. Moreover, 14 respondents have done that sometimes. Only one respondent has never paid attention to the said documents (Question 9). Next, those who answered in affirmative in Question 9 were asked to elaborate to which documents they have paid attention (Question 10). Multiple options were simultaneously available. The following results were obtained:

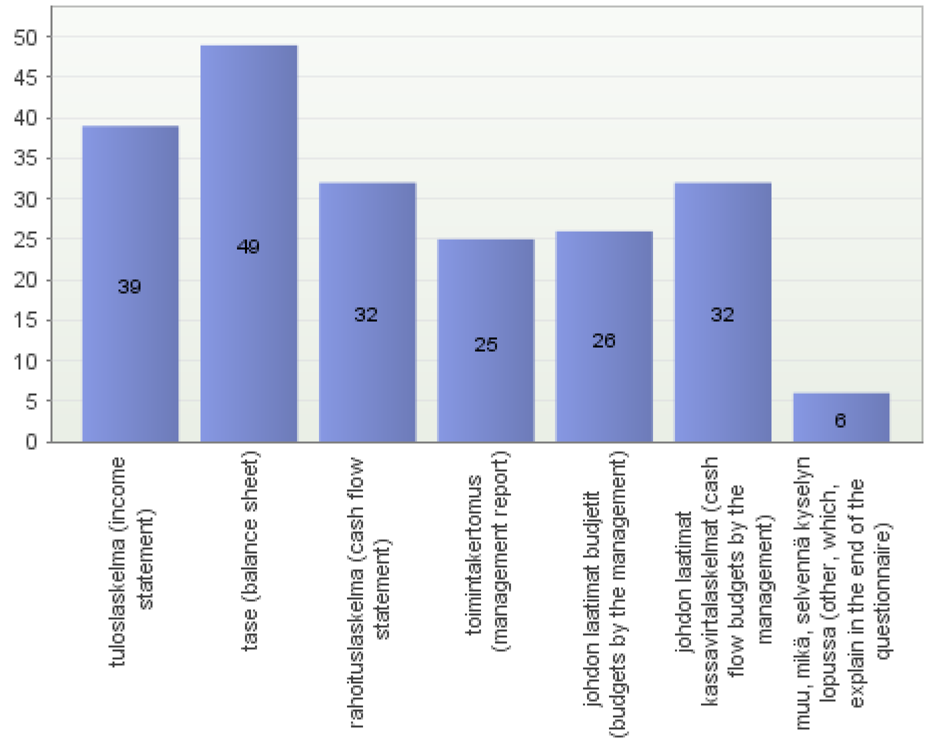

Figure 7. Documents to which attention is paid.

The respondents have mostly looked at the income statement (39/52) and the balance sheet (49/52). The respondents have considered slightly less the cash flow statements and cash flow budgets by the management (both 32/52), followed and budgets by the management (26/52) and the annual report (25/52). One auditor mentioned notes to the financial statements as an alternative source of evaluation.

Q11-12: Approximately half of the respondents (25/53) have always paid attention to indicators or ratios characterising the financial position of the audited company. Moreover, 22 respondents have done that sometimes. Only six respondents have never paid attention to the said indicators or ratios. Next, those who answered in the affirmative in Question 11 were asked to elaborate to which indicators or ratios they pay attention (Question 12). Multiple options were simultaneously available. The following results were obtained:

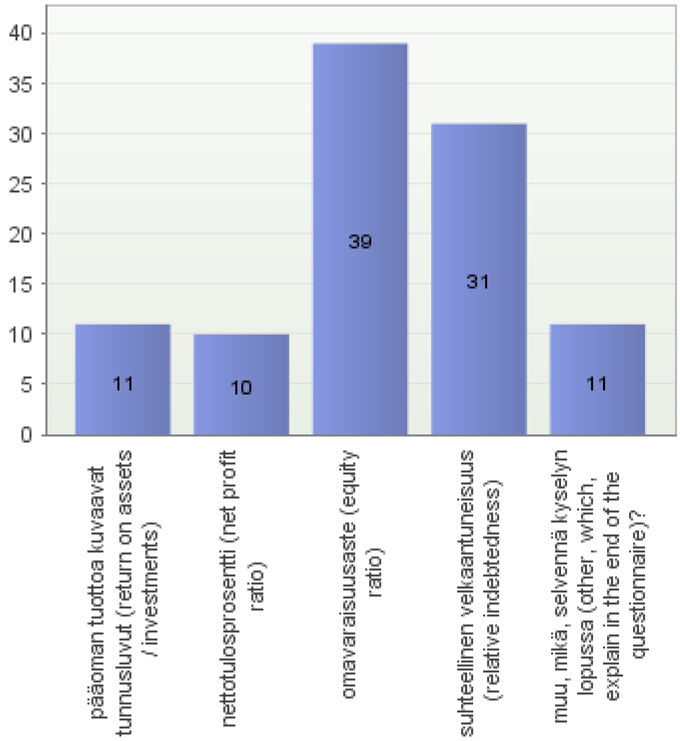

Figure 8. Ratios or indicators to which attention is paid.

The majority of the respondents have paid attention to the equity ratio (39/47) and to the relative indebtedness (31/47). Return on assets/investments, net profit ratio and other options, of which quick ratio, current ratio and a calculus of financial assets minus short-term debt, obtained some support, too. One respondent also mentioned that he or she has applied the solvency test established in 2007 by the HTM-tilintarkastajat ry (HTM-auditors' association, another auditor organisation representing authorised auditors in Finland, now merged with FIAPA in spring 2014), which includes 20 different sections regarding the solvency test.

Q13: The ones who answered in the negative to Question 11 were asked to elaborate their views. Varied answers were given. As many companies have not set up any specific calculations, certain respondents deemed that usually the information in the financial statements or a certain line therein, for example the amount of working capital, is enough to evaluate solvency. Some respondents make their own calculations, for example one respondent stated that he or she finds out whether the audited company has paid the taxes, whether there are any subordinated loans, and whether the equity is positive or negative. One respondent has inspected the credit agreements and has turned to the financial institutions, another has turned directly to the management.

Reacting on the evaluation of solvency

Q14: A question was posed on whether the respondent has been in a situation where the evaluation of solvency by the audited company has been deemed inadequate to a degree that, in one way or another, the respondent has been obliged to react on the evaluation of solvency, under the new Finnish Limited Liability Companies Act (the FCA entered into force on 1 September 2006). More than half of the respondents (30/53) have been in a described situation, while the rest (23/53) have not faced such a situation.

Some respondents highlighted the rarity of the solvency testing. For instance, one respondent stated that he or she has given out over 6.000 auditor's reports during the career, of which the solvency testing has been applied in three occasions only. Under the new FCA, this responded has assessed the solvency only in other ways than the alternatives given in the survey and has documented every occasion in his or her working papers. Another respondent mentioned that he or she has succeeded in avoiding situations where the asset distribution has been proposed as the solvency has been limited.

On a number of occasions, the respondents considered that the matter has been discussed with the board of directors during the period or at the period end, and the companies have abstained from the proposal for the asset distribution or from share buybacks.

Q15: Those who answered in the affirmative in Question 14 were asked that in how many years this had occurred to them. The following distribution was found:

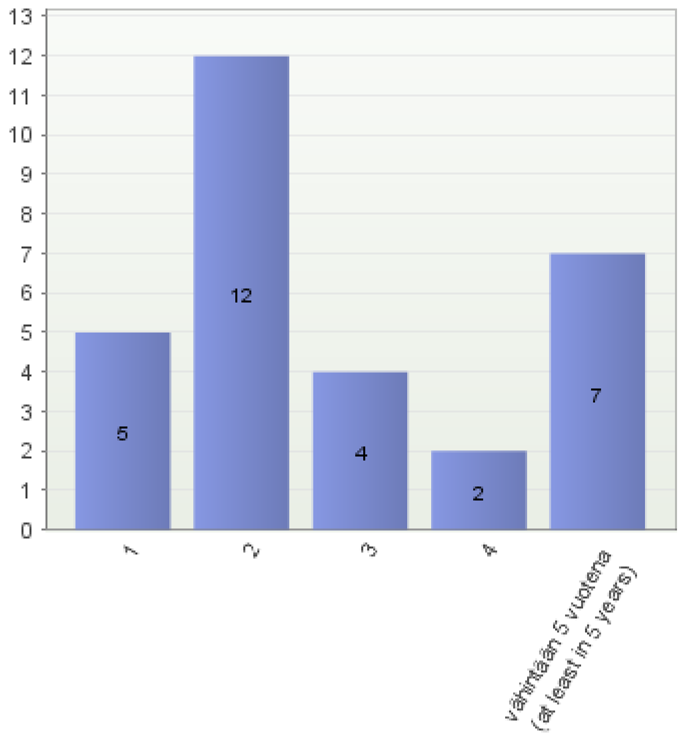

Figure 9. Occurrence of a reaction to an inadequate evaluation of solvency, in years.

During the eight years from the entry into force of the FCA to May-June 2014 when the survey was conducted, the answers to Question 15 seem to have been bipolar. On the one hand, those who have reacted to an inadequate evaluation of solvency have done it in one or two years only. On the other hand, there is a group of respondents who have done it rather frequently, at least in five years. The results are wholly descriptive in nature as this question was not commented in Question 23.

Q16: The respondents were also asked that how many times they have been obliged to react on the evaluation of solvency altogether, under the new Finnish Limited Liability Companies Act. The following answers were given:

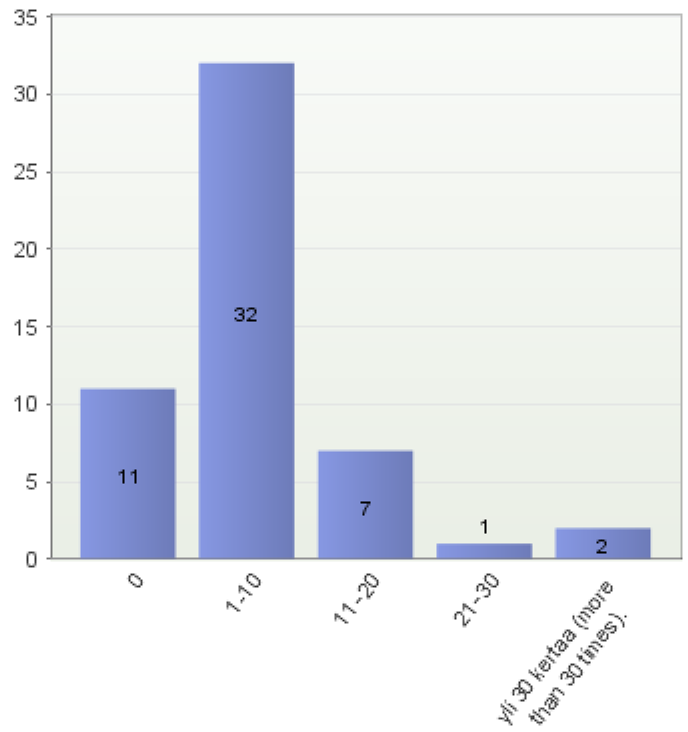

Figure 10. Occurrence of a reaction to an inadequate evaluation of solvency, in times.

Compared with the answers given in Question 14 above, the outcome of Question 16 is mixed. In Question 14 we could see that 23 respondents stated that they had not been in a situation where a reaction was to be taken. It was anticipated that that number would equal to or be close to the option “0 times” in Question 16. That does not seem to match, as the number in the latter question is only 11.

However, the answers give a persuasive indication that the majority of respondents to this question have reacted to an inadequate evaluation of solvency 1-10 times during eight years of the FCA. Also a considerable number of respondents opted for 0 times and 11-20 times. Contrasting the results for option “0” with the options “21-30” and “more than 30 times”, it could be reasonably asked whether this is a coincidence or whether the auditors’ personalities play a role, as some respondents do not react to the in a described situation and others react tens of times during the same period.

Q17-18: The respondents were also asked whether they, in one way or another, have been obliged to react on the evaluation of solvency by the audited company in the asset distribution context during the last 12 months (Question 17). The majority of the respondents (31/53) answered in the negative. The rest (22/53) answered in the positive.

Those who answered in the affirmative in Question 17 were asked whether there was a specific situation involved at the same time with the distribution (Question 18). Multiple options were simultaneously available. In 3 situations there had been an audit of a group involved and in 5 situations a company restructuration.

In 11 situations there was other event occurring. For example one respondent stated that in one case the amount of tax liability of the audited company was more the amount of distributable assets. Another respondent stated that in one case the dividend was paid throughout the year even if there were not enough distributable assets. The same respondent opined that the evaluation of solvency is usually non-existent when unrestricted capital is distributed in the middle of the period, of which the auditor takes account only later next year when the financial statements are audited. Accounting firms do not propose the distribution of assets unless enough distributable unrestricted equity exists (on the basis of the balance sheet test). In the smallest companies no one even sets up the solvency test.

Q19: It was asked which measures the respondent has taken when reacting on the evaluation of solvency. Multiple options were simultaneously available. The following distribution ensued:

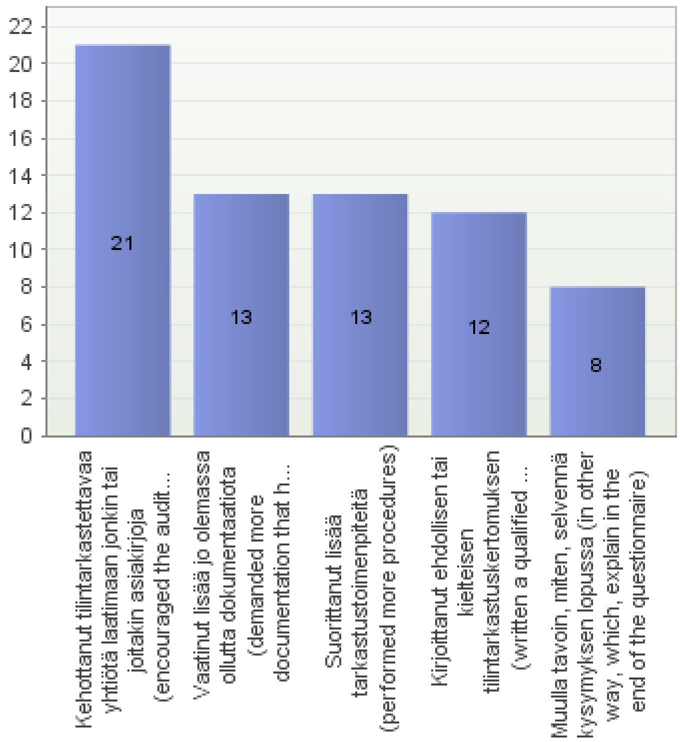

Figure 11. Reactive procedures.

Compared with the answers given in Question 17 above, the outcome of Question 19 is mixed. In Question 17 we could see that 30 respondents stated that they had reacted to an assessment of solvency. It was anticipated that that number would equal to or be close to the total number of respondents in Question 19. That does not seem to match, as the number of respondents in the latter question is even 40.

However, the answers give a persuasive indication that the majority of respondents to this question have reacted to an inadequate evaluation of solvency by encouraging the audited company to establish one or more documents (approximately half of the respondents). The rest of the options have also been met in practice.

As other way of reaction it was often mentioned that the audited company had postponed the decisions on the asset distributions. One respondent stated that if the financial status of the company were critical, the proposal for the asset distribution would be subject to discussion, at least in the small companies. If the situation improved, such a company would have the possibility to execute distribution later. In a company where the ownership is not dispersed, a dividend, that has been decided to be paid without an exact payment date, is usually executed at a date that is appropriate for the company.

Reporting the audit of the evaluation of solvency

Q20: The respondents were asked about the way and level that they have, in general, reported on the evaluation of solvency by the audited company. Multiple options were simultaneously available. The following distribution ensued:

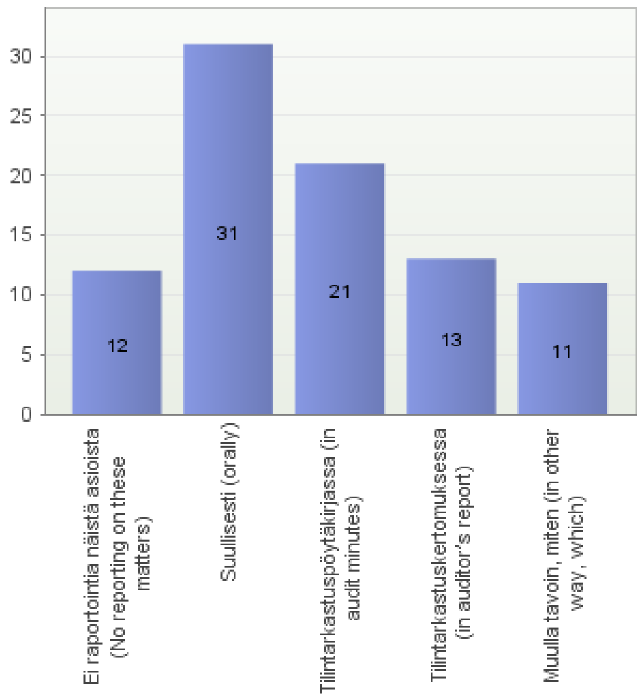

Figure 12. Way and level of reporting on the solvency.

Some of the respondents (12/53) have not reported on the matters of solvency. However, the majority of the respondents (41/53) have reported on the topic. The most of it has occurred orally, but also various ways of reporting (in audit minutes; in auditor's report; in other way, which, explain in the end of the questionnaire), mainly in writing, have taken place. As an alternative way of reporting electronic mail was mentioned.

Q21: The respondents were asked about the way and level that they have, in general, reported on the shortcomings in the evaluation of solvency by the audited company. Multiple options were simultaneously available. The following distribution ensued:

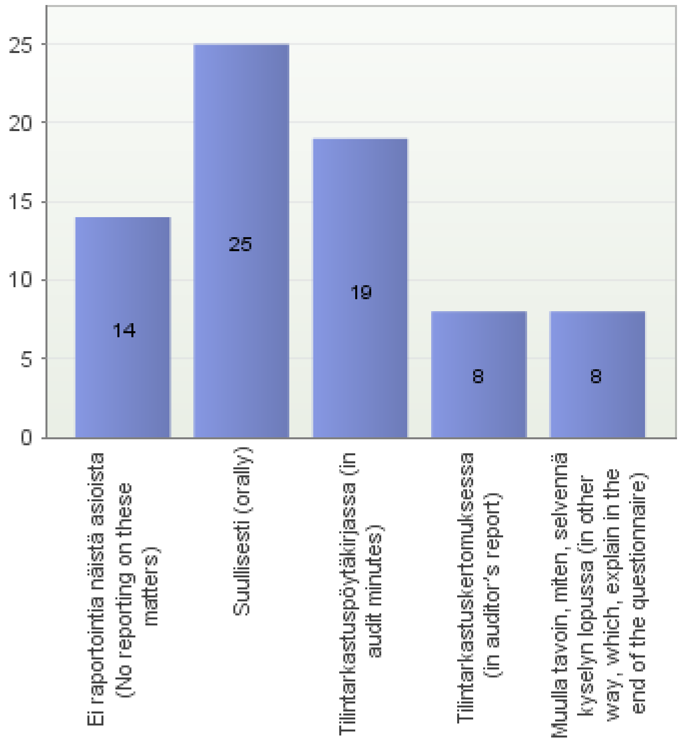

Figure 13. Way and level of reporting on the shortcomings of solvency.

The majority of respondents (39/53) have reported on the topic. Mostly this kind of reporting has taken place orally, but also written ways of reporting (in audit minutes; in auditor's report; in other way, which, explain in the end of the questionnaire), have been used. Even here electronic mail was mentioned as one medium. However, a considerable number of the respondents (14/53) have not reported on the shortcomings of solvency.

As other ways of reacting, three respondents stated that, in small companies in particular, they have discussed the matter with the management, and usually the management has decided to revise the proposal for the asset distribution or to abstain from the asset distribution before the final reporting by the auditor. Some respondents have either favoured oral reporting or written reporting, but the non-public manner of reporting on the matter was emphasised. Instead of writing the matter in the auditor's report or the audit memorandum, electronic mail, inspection reports or management letters were mentioned as a means of communication. One respondent deemed that the fact, that the auditor reports to the right body at the right time and documents it, is only relevant, not the non-public reporting in itself. One respondent considered that the size and ownership structure have affected the appropriate means of reporting.

Q22: In addition, the respondents were asked to whom they have reported on the shortcomings in the evaluation of solvency by the audited company. Multiple options were simultaneously available. The following distribution ensued:

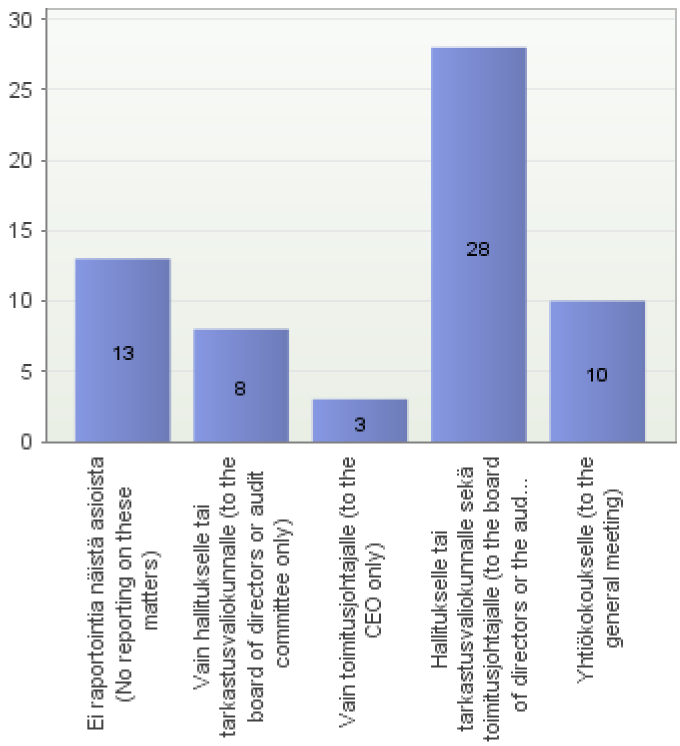

Figure 14. Corporate bodies to which the reporting was made.

The majority of respondents (40/53) have reported on the topic. In most cases (28/53) the corporate bodies receiving reporting have been the board of directors or the audit committee and the chief executive officer. Also the other options have reached some support. Here, too, a considerable number of the respondents (13/53) have not set up a report to any corporate body.

Q23 / Other comments: One auditor remarked that in general the auditor may encourage the company to but does not demand it to abide to the law. If the law is not followed, it is written down in the auditor's report.

Another respondent described the audit process in practice. First, the financial statements are established and then audited. If material misstatements are found, they are fixed. For example, if the proposal for the asset distribution jeopardises the solvency, the proposal is amended. No writing reports to the audit committee or alike is done. As to the evaluation solvency, especially in small and medium-sized companies, one thing that was not taken into account in the survey is that the general meeting may decide otherwise than the proposal for the board of directors. There the auditor's evaluation loses its significance.

Some respondents considered that small and big companies live in different worlds.

One respondent opined that, in general, legal precedents would be needed on what solvency means in practice, e.g. is it enough it the company has liquid cash or taken a loan as the financial statements are established.

7.3 Correlations and their implications

Even if the low number of respondents, 53, renders the statistical results weak, on the basis of the descriptive statistical correlations (See: Appendix 2, for further information) the following remarks could be made.

When the survey was established, in any question, Webropol program gave the smallest numerical value (1) to the response alternative that was situated at the top, above all other response alternatives. The numerical values increased (2, 3, etc.), as the other response alternatives went downwards. In general, when comparing any two questions, if a respondent has opted for the response alternative at the top (bottom) in Question X and also the response alternative at the top (bottom) in Question Y, the two questions represent a positive correlation. By contrast, if a respondent has opted for the response alternative at the top (bottom) in Question X and the response alternative at the bottom (top) in Question Y, the two questions represent a negative correlation.

It would seem that the answers to Questions 1 and 2 correlate positively at a statistically significant level ($p<0{,}01$), and the answers to Questions 1 and 3 correlate negatively at a statistically significant level as well as the answers to Questions 2 and 3 correlate negatively at a statistically very significant level ($p<0{,}001$). For the purposes of this study, these indicators would suggest that the more the respondents have had working years, the more likely it is that they do not work for a so-called Big Four audit firm and have small and medium-sized companies as their clients. The results can be explained by the fact that, measured in size and in the number of personnel, the Finnish non-Big

Four audit firms are considerably smaller than Big Four audit firms, and the non-Big Four audit firms do not usually perform the audits of the Finnish listed companies.

The positive correlation at a significant level between the answers to Questions 6 and 22 would suggest that the respondent's esteem of the solvency test in the asset distribution is related to whether one reports on these matters at all and, if yes, to the corporate body to which the respondent reports. On the basis of the answers it would seem that those respondents, who have appreciated the solvency test less, have made no reports on the solvency matters to corporate bodies in the context of the asset distribution. By contrast, those respondents, who have appreciated the solvency test highly, have made reports to higher corporate bodies in the organisation. However, this result is weak but interesting, keeping in mind that similar written answers were given as additional comments regarding Question 6.

The answers to Questions 9 and 11 correlate positively at a statistically significant level. This would implicate that those respondents, who have paid attention to the documents that the audited company has established, also take notice of the financial indicators or ratios of the company. Moreover, the answers to Questions 11 and 16 correlate negatively at a statistically significant level. It would seem that those respondents, who have paid attention to the financial indicators or ratios of the company, have been obliged to react on the evaluation of solvency fewer times in total.

The answers to Questions 14 and 16 correlate negatively at a statistically significant level. Those respondents, who have been obliged to react on the audited company's assessment on solvency, have done so only a certain number of times. On the other hand, Questions 14 and 17 correlate positively at a statistically very significant level. Those respondents, who have been obliged to react on the audited company's assessment on solvency, have done so also within the last 12 months preceding the answer. The answers to Questions 14 and Questions 21 and 22 correlate negatively at a statistically very significant level. This result could be interpreted that those respondents, who have been obliged to react on the audited company's assessment on solvency, have reported, if any, on the shortcomings in the evaluation of solvency in a statutory way and mainly to the board of directors and/or the CEO (cf. Appendix 2.1, Question 22: Mean 3,22 and Median 4). However, those respondents who have answered in Question 14, that they have not been obliged to react on the company's evaluation of solvency, seem to have answered in Question 19 that they do not report on these deficiencies. Together the answers are consistent and make perfectly sense.

The answers to Questions 15 and 16 correlate positively at a statistically very significant level. This result would suggest that when the more the respondent has been obliged to react in terms of absolute years, the more times one has been obliged to react. The answers to Questions 15 and 17 correlate negatively at a statistically very significant level. That result would indicate that the more the respondent has been obliged to react in terms of absolute years, the more likely it is that the respondent has reacted within the last 12 months preceding the answer.

The answers to Questions 16 and 17 correlate negatively at a statistically very significant level. Those respondents who have answered that the more times the respondent has been obliged to react, the more likely is that the respondent has reacted within the last 12 months preceding the answer. The answers to Questions 16 and 18 correlate negatively at a statistically very significant level. This refers to that the more times the respondent has been obliged to react, the more likely is that the respondent has made some of those reactions in some specific situations. The answers to Questions 16 and 22 correlate positively at a statistically very significant level. On the basis of the answers it would seem that those respondents, who have been obliged to react more times, have reported on the deficiencies to higher corporate bodies in the organisation.

The answers to Questions 17 and 20 correlate negatively at a statistically significant level. This would suggest that those respondents, who have been obliged to react within the last 12 months preceding the answer, have made some reporting in various ways. By contrast, for those who have not been obliged to react within 12 months preceding the answer, the more likely it is that they have not reported on the evaluation of solvency matters at all. The answers to Questions 17 and 21 correlate negatively at a statistically very significant level, which would suggest that this tendency is highlighted where the report has bearing on shortcomings in the evaluation of solvency. Questions 17 and 22 correlate negatively at a statistically significant level. This would suggest that those respondents, who have been obliged to react within the last 12 months preceding the answer, have made some reporting on the deficiencies to higher corporate bodies. By contrast, for those who have not been obliged to react within 12 months preceding the answer, the more likely it is that they have not reported on the shortcomings of in the evaluation of solvency matters at all to corporate bodies.

The answers to Questions 20 and 21 correlate positively at a statistically very significant level. This result reveals that those respondents, who have not made reports on the evaluation of solvency, have neither reported on their shortcomings. When these matters have been reported, it is very likely that those reports have discussed also shortcomings related thereto.

The answers to Questions 21 and 22 correlate positively at a statistically very significant level. This result uncovers the trite fact that those respondents who have not made reports on the shortcomings in the evaluation of solvency have neither directed such reports to any corporate body. By contrast, when these matters have been reported, it has been directed usually to the board of directors and/or the CEO (cf. Appendix 2.1, Question 22: Mean 3,22 and Median 4).

8 SUMMARY AND CONCLUSIONS

8.1 General considerations regarding the study, solvency test and audit framework

Study. The theme of this Master's thesis has been the role of the auditor in the context of solvency test in asset distribution in Finland. The topic has been approached mainly from the point of view of a standard audit in accordance with the Finnish law and the ISAs. The approach has been task-based. I have proved that a duly planned, performed and reported standard audit in accordance with the applicable ISAs provides reliable financial information on solvency in the asset distribution and serves the execution of the solvency test, even where the auditor neither gives any specific opinion about it in the auditor's report nor makes any specific assessment on the directors' solvency report related to the asset distribution.

I have gathered related secondary data from the existing audit, accounting and legal literature where, to my knowledge, such an extensive task-based coverage has not been made from this point of view. Further, to obtain first-hand primary data I have conducted an internet-based survey to the Finnish authorised auditors, mediated by FIAPA.

Solvency test and corporate governance. The solvency test is based the national Finnish legislation. It is the duty of the management to execute the test before all the asset distributions (Government Bill 109/2005, 125). The test has proved difficult to interpret because the FCA and the Government Bill 109/2005 do not specify clearly what is meant by solvency. I have taken the view that the solvency test could be seen from a financial point of view and from a legal one. As to the financial point of view, the financial position of a company consists of four main factors: growth rate of the company, profitability, liquidity and solvency (Laitinen and Laitinen 2004, 261; Blummé et al. 2010, 42−45). Each of these main factors can be evaluated on the basis of the financial statements that result also in key financial indicators or ratios. Excluding the growth rate, these factors are implicitly present in the Government Bill 109/2005 and more explicitly present in the relevant Finnish legal and audit literature, which refer to e.g. income, equity, liabilities, and cash flow and solvency models. One theoretical problem is however, that these key financial figures, ratios and models may provide contradictory results. Another problem is that they do not necessarily fulfil the criterion of assessing solvency in the same terms ex ante and ex post (cf. Kähkönen 1998). Moreover, often the background assumptions of the various economic indicators supporting solvency analyses are not presented or their application to the solvency test of the FCA is not justified (Jokinen 2008, 96). The information should be relevant, precise and reliable.

The auditor should assess the solvency as a whole, but in practice both the management and the auditors often work under stringent time pressures (See: Otley and Pierce 1996), and it is likely that some selection of data has to be made. As to the legal point of view, the due care is of the essence. What is most problematic is that the company law aspect comprising directors and auditors' due care has received very little consideration in theory (Jokinen 2008, 96). It seems that this is also the situation in practice as no references, at least explicit ones, to the due care were made in the answers to the survey.

From the point of view of the corporate governance, the board of directors acting as an agent shall act in the best interests of the company, acknowledge due care and loyalty (FCA Chapter 1, Section 5) to shareholders and creditors, who both are acting as the principals. This applies to the daily running of business, choice of applicable accounting standards and to the asset distribution. The board of directors shall find a balance between the conflicting interests of these principals (See, for example: Schleifer and Vishny 1997 and Keay 2005). Due to the separation of ownership and control (See: Berle and Means 1932), the principals' information about the efficiency of the agent is deficient, and the principal is dependent on the information given, potentially limited and manipulated by the agent (Porter et al. 2008, 10−11; Arens et al. 2014, 27). The principals ask for reliable financial data. In this setting the auditors provide the needed assurance service, if and when they succumb to the procedural requirements of due care and appropriate documentation. Therefore, the audit also is likely to decrease agency costs (Jensen and Meckling 1976, 323−324) even in the asset distribution.

The scope and overall objectives of audit. In Finland, an audit covers the audit of the accounting records, the financial statements, the annual report and the administration of a company. In essence, the audit of administration seeks to assure the legality of the management's decisions and actions including the due care (FAA Section 11).

The overall objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. The auditors shall reduce the risk of material misstatement to an acceptably low level. The auditor shall express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Moreover, the auditor should communicate one's findings clearly (ISA 200.11). Yet the auditor's opinion neither assures that the company will remain viable nor that the management has acted efficiently in running the affairs of the company.

In Finland, it is generally considered that one of the objectives of the financial statements is to provide a calculus for the distributable amount of assets (Riistama 1999, 151). Hence, it could be also argued that the task of the auditor is to provide more reliability and legitimacy to the distribution of assets, even if the auditor cannot and is not expected to detect all the misstatements in the financial statements.

Financial statements, management's assertions and auditor's tasks. It is the duty of the management to organise business functions and internal controls in an efficient manner, to record transactions regarding at least sales, sourcing, inventory, payroll and finance in the IT systems in a correct and complete manner, and to apply relevant accounting principles, i.e. either Finnish Accounting Standards or the IFRS, in order to establish the financial statements (FCA Chapter 6, Sections 2, 17 and 21). The management explicitly or implicitly makes assertions regarding the recognition, measurement, presentation and disclosure in the financial statements and related disclosures, e.g. occurrence, completeness, accuracy, cutoff, classification, existence, rights and obligations, valuation and allocation (ISA 315.A123−A125; Halonen and Steiner 2009, 269−270).

It is the duty of the independent auditor (FAA Section 24) to take a stand whether the management's assertions are duly applied (Porter et al. 2008, 3). General objectives may be set to the auditing of each statement of financial reporting (See: Riistama 1999, 161−162 and 176−177). The auditor evaluates the application of management's assertions at the financial statement level and at the assertion level. Material misstatements at the financial statement level are usually so holistic and all-encompassing that the financial statements cannot be concluded to have been established in accordance with the applicable accounting standards (ISA 315.25; ISA 315.A120; Halonen and Steiner 2009, 170−171). As a consequence, the distribution of assets can be seriously flawed due to a misstatement at the financial statement level or even at the assertion level and thus without a legal basis. If the financial statements are misrepresented only at the assertion level, it is more likely that the misrepresentation can be corrected in a proper manner or, from the point of view of the asset distribution, it may not wholly prohibit it. If the auditor has a substantiated doubt that the management has breached its duties, e.g. it has proposed the asset distribution on the basis of the financial statements that include a material misstatement, the auditor shall make an explicit remark in the auditor's report (FAA Section 15, Subsection 4).

Auditor inevitably carries the audit risk, i.e. the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. The audit risk is a function of the detection risk and the risk of material misstatement including inherent risk and control risk (ISA 200.13). To mitigate the audit risk, auditor shall make a thorough assessment of risks, perform tests of controls and substantive audit procedures and report in a due manner (See: Figure 3 and references therein). The auditor shall exercise professional judgment and professional scepticism in planning and performing the audit. The inherent risk is higher for some assertions, classes of transactions, account balances and disclosures than for others. It is elevated, for example, due to cash and liquid assets, large number of transactions, complexity of transactions, calculations of value, accounting estimates, long-term projects, dispersed functions and increased influence of the management on a given assertion (Riistama 1999, 83−84;

Alakare et al. 2008, 61). In the same manner, the auditors assume differences in the risk levels of the internal controls regarding different functions (Halonen and Steiner 2009, 136). The efficiency of a given internal control affects the nature, extent and timing of the substantive audit procedures and the needed audit evidence (Arens et al. 2014, 280). However, the more material a certain factor, which affects the validity of the financial statements, is considered to be, the more that factor or business process undergoes efficient audit procedures, and *vice versa*. When audit procedures concerning internal controls, IT controls and business functions are performed and when they are functioning efficiently, the risk of material misstatement in the financial statements is reduced to an acceptably low level. Then also the level of audit risk is considered to be reduced (Halonen and Steiner 2009, 49−50). The reliability of financial information that passes such a scrutiny is enhanced, and it is applicable as a basis for the distribution of assets.

8.2 The audit process

Risk assessment. The auditor shall comply with a certain audit process, which is generally divided into risk assessment phase, risk response phase and reporting phase. Each phase includes several subphases and methods.

In the risk assessment phase the auditor obtains a basic understanding about company, its business environment and its control environment, including the inherent risk and company’s internal controls that have a close relationship (Arens et al. 2014, 280). This enables the auditor to continuously understand the relevant risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures (ISA 315.3 and A1). The auditor should consider the underlying reasons for a given risk. Risk assessment provides a basis for setting materiality levels, designing and implementing responses to the assessed risks of material misstatement, and deciding the appropriateness and sufficiency of the needed audit evidence that are required for the audit to be carried out in compliance with the ISAs (ISA 300.9; Halonen and Steiner 2009, 233; Riistama 1999, 77−79). The auditor performs risk assessment procedures through inquiries, analytical procedures and other procedures, such as reviewing information obtained from external sources. The auditor should obtain understanding of corporate decision-making through the minutes, annexes and memorandums of meetings of the corporate bodies, of important contracts and background materials with regard to liability for the decision making process. The auditor should also obtain information about pledges and collaterals and about share and shareholder registers (Riistama 1999, 248−249).

On the basis of the survey conducted in this study, it seems that in the risk assessment phase it is common for auditors to have considerations regarding solvency in the asset distribution, as nearly half (23/53) of the respondents have responded to this effect in the survey (See: Question 7). It is obvious that the auditor should have a good understanding about where the company stands financially, what the relevant business risks and internal controls are, and where the company's economy and finances are heading. The auditor should also try to obtain information about the capital needs of shareholders. An asset distribution should be assessed against this background. However, it is for the later studies to show *how* exactly solvency in the asset distribution is taken into account in the risk assessment phase by the auditor.

Risk response. During the risk response phase the auditor implements the planned audit procedures to address the assessed risks of material misstatement at the financial statement level and at the assertion level (ISA 330.6). The audit procedures are a combination of tests of control and substantive procedures including tests of details and substantive analytical procedures (ISA 330.4). The identified significant risks, which are likely to relate to e.g. debt and equity transactions, always call for substantive audit procedures that are specifically responsive to that risk, often tests of details (ISA 330.21 and A53). The auditor shall also pay attention to the unpredictability of audit procedures to counter the possibility of the management to override controls (ISA 330.18 and 42).

The auditor's understanding of the control environment is crucial to the assessment of the risks of material misstatement and thereby the auditor's overall responses. Properly planned, organised and applied internal controls reduce inherent risks: factors that usually improve the control are good organisation of internal control, broad and extended budget control, the management's engagement in analysing budgetary difference and acting consequently, continuous development of the accounting system, and efficient decision-making in matters having a material effect on business and the financial statements. An effective control environment may allow the auditor to have more confidence in the internal control and the reliability of the audit evidence. High assessed risk level or deficiencies in the control environment, such as unrestricted authority of the management to meddle into virtually any activity in the company or the lack of responsible persons' time, deputy persons or documentation, may force the auditor to perform more tests of controls and/or substantive procedures to obtain more extensive audit evidence and/or to increase the extent of the previously performed audit procedures (ISA 315.14 and A78−82; ISA 330.A2; Riistama 1999, 85−86 and 91−92).

With a view to the asset distribution, the internal controls of the accounting function and finance function are especially important. Therefore, the auditor should assure, *inter alia*, that the automated controls have not undergone unauthorised amendments nor been overridden by the management. A considerable number of companies' transactions are initiated, recorded, processed, reported and stored electronically only. Therefore, the effective operation of the IT system and controls affects directly the validity, appropriateness and completeness of the audit evidence (ISA 315.A140−A141; Halonen and Steiner 2009, 175 and 240). Moreover, the auditor should assure that human controls work effectively. First, the personnel involved in dealing with the cash flows should not involve in dealing with accounting or subledgers (separation of duties). This is not, however, possible in small companies that constitute the majority of the Finnish limited liability companies, but instead information technology, user restrictions and other internal controls should be used to the same end in these companies. Second, the auditor shall also see to that the board of directors has authorised material debt transactions and the general meeting has authorised equity transactions (authorisation). These transactions must be appropriately documented (audit trail) and their recording duly instructed (Riistama 1999, 92−94; Arens et al. 2014, 316−317; ISA 315, Appendix 1, Paragraphs 9 and 10). The tests of controls are typically performed during the entire period (ISA 330.11 and A11; Halonen and Steiner 2009, 237). The higher the assessed risk, the more audit evidence is needed.

The audit of the financial statements is a cumulative and iterative process. Some audit procedures provide more reliable audit evidence in relation to some risks or assertions than others. Usually the tests of control and the substantive procedures are directed to a certain object simultaneously. Their evidence may relate to the application of the controls at relevant times, the consistency of application, the personalities using the controls, or to means of application (ISA 330.10 (a)). After the tests of controls, the auditor shall make an assessment on whether one relies on those controls or not. If the auditor concludes that relevant internal controls are not operating effectively or if significant deviations are detected, the auditor shall make further inquiries and observations, and determine whether the performed tests of controls provide an appropriate basis for relying on those controls and whether additional tests of controls and/or substantive procedures are necessary (ISA 330.16−17; Halonen and Steiner 2009, 57 and 233). The auditor may need to modify the nature, timing or extent of other planned audit procedures (ISA 330.25 and A60). The necessary extent of an audit procedure can be increased only if the audit procedure in question is relevant to the specific risk involved (ISA 330.A15).

The auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. These include in-depth inspection of the said objects (tests of details). The substantive procedures may also relate to the closing process of the financial statements. Moreover, the substantive procedures include external confirmation procedures that are effective in addressing assertions associated with account balances, collaterals, their elements and the terms of agreements, contracts or transactions (ISA 330.19 and A48). They may produce valuable pieces of basic information for the analysis on the sufficiency of assets in relation to known liabilities.

As to the finance function and cash management, that are important for the asset distribution, the auditor shall assure that all the cash and other liquid assets exist because they are the most susceptible to be embezzled. The auditor shall also evaluate whether the management of material amounts of money is effective (Riistama 1999, 83−84 and 92−94). The audit of debt management consists of verifying applicable corporate principles and procedures regarding short and long term credit as well as collaterals. Also, the external confirmations of balances shall be verified. Moreover, subordinated loans, their conformity with the conditions provided for in the FCA and recording in the balance sheet statement shall be audited. The audit of equity management covers share capital, mandatory and voluntary reserves and other eventual investments of equity. At least in minor companies it also covers share capital information entered into the share register. The number of the transactions is usually low but their nominal value can be significant. Therefore, the risks involved with these transactions are usually considered material (Riistama 1999, 194−195 and 200−202; Halonen and Steiner 2009, 382−383), and they should be subject to particular attention. With a view to the asset distribution, it is advisable to audit the entire population of transactions of liabilities and equity. Also the conformity of the amount of the asset distribution with the authorisation and the decision of the general meeting shall be verified afterwards.

Analytical procedures are generally applicable to predictable and large volumes of transactions (ISA 330.A44), but their pertinence is closely related to the nature of assertion and risk, to the efficiency of internal controls and also to the quality of the data used, i.e. whether data is obtained from the audited company or outside it. Analytical procedures are evaluations of financial information through analysis of plausible relationships among both financial and non-financial data (ISA 520.A6), varying from simple comparisons to complex analyses. For example, a company's current financial information could be compared with comparable information for prior financial periods, anticipated results of the company or its competitor(s), expectations of the auditor or general predictable patterns (ISA 520.A1−A3). The auditor shall evaluate the suitability, reliability and precision of analytical procedures for given assertions. The auditor must determine the acceptable amount of difference between recorded and expected values (ISA 520.5). The riskier the item is, the lower the accepted difference is (ISA 520.A16).

Analytical procedures assist the auditor to form an overall conclusion as to whether the financial statements are consistent with the auditor's understanding (ISA 330.22). It is evident that the analytical procedures can be useful in assessing the application of the going concern assumption or the solvency in the asset distribution. In the latter context, the auditor takes advantage of key financial ratios and considers the cost-revenue structure of the company. The auditor should try to find reasons in the real process for changes in those results (Riistama 1999, 174−179). Different key financial figures or ratios or solvency models described in the legal and accounting literature are applicable, taken into account their background assumptions, validity, relevance and reliability.

Due to high risk and relation to the closing process of the financial statements, solvency-related transactions and the distributable amount itself can be assessed reliably only after the establishment of the financial statements (cf. ISA 330.7, A6, A11 and A13 and Halonen and Steiner 2009, 237). In addition, by the end of the audit the auditor shall have recognised related parties and audited the related party transactions through which undercover directed asset distribution may be effected. To this end, the auditor shall make inquiries within and outside the company, classify unusual transactions and examine the relevant underlying agreements (ISA 550.13 and 23).

Going concern analysis and asset distribution. The auditors are used to making an analysis on the use of the going concern assumption while analysing the financial situation of the company. Under the going concern assumption, a company is considered to continue running its business operations for the foreseeable future (ISA 570.2). Assets and liabilities are recorded assuming that the company will be able to realise its assets and discharge its liabilities in the normal course of business. However, the auditor may have reasons to doubt the use of going concern assumption on the basis of important negative events, e.g. the operative result is seriously in the deficit, the liabilities or claims exceed the assets, or due bills cannot be paid timely. The auditor shall actively monitor whether or not such negative signals exist and whether the management has an emergency plan in case such negative signals occur (Riistama 1999, 155−157).

In making this analysis, the auditor shall also evaluate the validity of the management's going concern assessment, which should cover at least 12 months or a longer period equivalent to the management's preliminary assessment if it exists. If such events or conditions have been identified that the application of the going concern assumption may be inappropriate, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists (ISA 570.6 and 10−12). The auditor may further analyse and discuss the latest available interim financial statements and forecasts, read the terms of financial agreements and minutes of the meetings of the relevant governing bodies and confirm whether financial support is available (ISA 570.16−17 and A15).

Regarding the evaluation of the solvency in the asset distribution, there are neither explicit provisions nor a recommendation on what auditors should do. The auditors are relying *mutatis mutandis* on ISA 570 (cf. Troberg 2009; Markkola 2009; Markkola and Sutinen 2011a and 2011b) and good auditing practice, which includes the relevant principles (e.g. independence, objectivity, integrity, due care) and audit methods. The going concern assumption may well be used unless there is clear evidence to the contrary, that is, the management either intends to liquidate the company, to cease its operations, or has no other realistic alternative. However, there are some differences. In the solvency test (cf. FCA Chapter 13, Section 2) there is no 12 months limit to which the auditors seem to limit their solvency assessment (Question 4). In some specific companies the time period of the solvency test may be more extensive than 12 months. Also the performance of additional analytical procedures is advisable to support the results of the adjusted going concern analysis. The auditors commonly use audit procedures and evaluate the use of going concern assumption, but it is for the later studies to expand our knowledge of *how* exactly solvency in the asset distribution is taken into account in the risk response phase.

Reporting. The purpose of the audit is to enhance the users' confidence in the financial statements by mitigating the opportunities of the management to biased reporting (ISA 200.3; See also: Porter et al. 2008, 10 and Arens et al. 2014, 27). To this end, the auditor evaluates the sufficiency and appropriateness of the obtained audit evidence (ISA 330.25−26) and communicates one's findings in an active manner orally and in writing to the corporate bodies of the audited company (ISA 260.4−5, 15−17 and A20) and in the auditor's report to the public. In the auditor's report the auditor expresses an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The auditor's opinion shall be unqualified, qualified or adverse. In certain circumstances auditor shall disclaim an opinion (See: ISA 700). The auditor's report may also include a separate Emphasis of Matter paragraph, e.g. when the auditor has significant doubts on the applicability of the going concern principle or otherwise uncertain events may have occurred that are pervasive but do not necessitate a qualified or adverse opinion (Government Bill 194/2006, 39; Alakare et al. 2008, 79). The auditor shall submit the auditor's report to the management (FAA Section 15, Subsection 5), and this important to enable the shareholders' effective decision-making in the general meeting (FCA Chapter 5, Section 3, Subsection 1, Point 2). Last, the auditor shall archive the audit documentation (Halonen and Steiner 2009, 59 and 442−443).

It is a national requirement in Finland that the auditor shall make a remark in the auditor's report if a shareholder, the management or any other accountable person in the corporation 1) is guilty of an act or negligence which may result in liability in damages towards the company, or 2) has violated a law applicable to the company, or the articles of association, deed of partnership, or bylaws of the company (FAA Section 15, Subsection 4). The auditor must take into account the materiality principle such that a minor breach does not cause a remark. The auditor shall justify the remark, in practice on the basis of the audit evidence obtained during the audit (Government Bill 194/2006, 40).

According to the current FCA, the annual general meeting does not usually have the auditor's statement on the distribution of assets. Therefore, in a normal situation where no offence has been committed, the auditor gives one's implicit opinion on that the asset distribution can be made. As the remark is omitted, the auditor considers the proposal for the distribution of assets to be legal (Mähönen and Villa 2010, 422). On the other hand, the auditor's report includes a remark, where necessary. Such a situation occurs, for example, when the auditor finds out that the board of directors' proposal for an asset distribution is in contradiction with the solvency test or the balance sheet test or with the articles of association (Government Bill 194/2006, 38 and 40). Such a situation might occur also where the auditor has ascertained that the related party relationships and transactions are not duly identified, accounted for and disclosed in the financial statements (cf. ISA 550).

However, the auditor may agree with the board of directors or, where applicable, the audit committee that the auditor establishes an expressive statement on the matter in all situations. The company's articles of association may also contain a stipulation to that effect. The audit committee, general meeting or unanimous shareholders may ask the auditor to establish such a statement, and complying with such a demand is considered to be in accordance with the good auditing practice (FAA Section 19, Subsection 3 and Section 22, Subsection 2; ISA 700.38; Auditor Board of the State 1/2009, given out 31 August 2009).

The auditor may also use non-public means of communicating to the management deficiencies that do not necessitate a paragraph or a remark in the auditor's report. In particular, oral communication, inspection reports and in some specific events audit memorandum could be used for the purpose of mediating the auditor's view on the asset distribution. For the auditor's personal use only the audit working papers might include a calculus for the solvency test and other related notes.

8.3 The survey

In the survey conducted to obtain evidence for this study, the Finnish auditors were asked *en masse* for the first time what they think about the subject matter. The majority of the respondents had worked more than 10 years as an authorised auditor, and the majority of the respondents did not work in a so-called Big Four audit firm. The respondents audited mainly small and medium-sized companies.

The majority of the respondents (43/53) agreed or completely agreed with the statement that auditing the evaluation of solvency by audited company in the context of the asset distribution is important. The rest of the respondents were equally distributed among the other options (completely disagree, disagree, neutral). The responses prove, however, that the audited companies seldom set up a documented solvency assessment.

As to the definition of solvency in the context of asset distribution, five qualitative categories and one combination category could be distinguished. The absolute majority of the respondents (32/47) stated that the solvency in asset distribution refers to that the company is able to discharge itself of the decided asset distribution and of its liabilities to the creditors. Also certain calculation formulas, financial ratios and solvency models have been presented (7/47). Also some items in the financial statements (3/47) and possibilities to obtaining finance (2/47) have been mentioned. Some respondents have presented general principles for the definition of solvency. In the last sixth category different combinations of the former categories were given. However, it is noteworthy that many respondents limited their assessment to 12 months at most, and no reference to the management's duty of care was made.

The answers to the survey prove that the solvency has been taken into account in all the phases of the audit. Yet, its pervasiveness has varied considerably depending on the phase, and it has been at its highest when the audit of administration has been performed. It seems to have been often present also in the planning, analytical procedures and reporting phases. The fact that solvency has been ubiquitous in the audit may be due to that ISA 570 "Going Concern" is applicable during the whole audit process. It is then natural for the auditor to have paid attention to the solvency from the beginning to the end of the audit process. However, it would seem that considerations that have been made during the audit process complement each other, as the audit process is cumulative and iterative.

With a view to the solvency test in the asset distribution, the auditors have mostly looked at the income statement (39/52) and the balance sheet (49/52). It is worth noting that other documents established by the companies and key financial ratios, especially equity ratio and the relative indebtedness, have also been studied. Hence, the auditors seem to have acted as the literature suggests in that they have not limited their evaluation to the financial statements only, even if they may have had serious time budget pressures.

The answers to the survey reflect the fact that it seems to have been rather common for the auditors react to the shortcomings in the management's assessment of solvency. In essence, more than half of the respondents (30/53) have been obliged to react since the entry into force of the FCA, which took place on 1 September 2006. Even if the results of Question 16 are somewhat inconsistent with those of Question 14, it would seem that the most of the respondents have had to react to inadequate assessments of solvency during two years and 1-10 times in total. It would also seem that the human part of the auditors' position has come into the picture, as some of the respondents have considered that a single event of the asset distribution could never lead the company to insolvency, whereas other respondents have reacted tens of times during the same period.

Question 18 on the specific situations was formed to test the findings of Lehtimäki (2010) who found out that asset distributions are often related to some specific situations. These situations were given as answer options in Question 18. According to the answers to the survey, in 3 distribution-related situations there has been involved an audit of a group, and in 5 situations a company restructuration. In 11 situations there was other event occurring, e.g. where the tax liability of the audited company amounted to more the amount of distributable assets or the dividend was paid throughout the financial year. Therefore, the answers of my study have given some support to the findings of Lehtimäki. An execution of an asset distribution may be attempted in situations where the viability of the company and the interests of the creditors are at stake or even without any assessment on the solvency. It is in these situations in particular where the auditors must remain alert and employ professional scepticism and judgement.

The objective of the survey was also to find out how the auditors have reacted to the shortcomings of the management's solvency assessments. Even if the results of Question 19 are somewhat inconsistent with those of Question 17, it would seem that approximately half of the respondents have encouraged the audited company to establish one or more documents. The rest options (demand for more documentation that has already existed; perform more procedures; give a qualified or adverse auditor's report; and in other way, which, explain in the end of the questionnaire) have also been met in practice. As one example that has been often mentioned, some respondents have stated that the audited companies have postponed the decisions on the asset distributions or the execution of such decision after the auditor has discussed with the board of directors. This seems to be a current practice in the small and medium-sized companies.

As to the reporting, the majority of the respondents (41/53) have reported on shortcomings of solvency, mostly orally and mostly to the board of directors or the audit committee and the chief executive officer. Nevertheless, various ways of reporting in writing (in audit minutes; in auditor's report; in other way, which, explain in the end of the questionnaire) also take place. It should be highlighted, too, that a considerable number of the respondents (13/53) have not reported on shortcomings to any corporate body.

As to the correlations, some topics could be brought up. First, a weak but interesting positive correlation at a significant level was found between the answers to Questions 6 and 22 in the survey. It seems that the auditor's attitudes on the solvency test in general have played a role with regard to reporting to corporate bodies. The result would suggest that the respondent's esteem of the solvency test in the asset distribution is related to whether one reports at all and, if yes, to the corporate body to which the respondent reports. Second, the answers to Questions 9 and 11 correlate positively at a statistically significant level. It is rather obvious that that those respondents, who have paid attention to the documents that the audited company has established, also take notice of the financial indicators or ratios of the company. However, on the basis of the negative correlation (value: -0,41) at a statistically significant level for the answers to Questions 11 and 16, it would seem that those respondents, who have paid attention to the financial indicators or ratios of the company, have been obliged to react on the evaluation of solvency fewer times in total. This correlation of this significance seems to apply to financial indicators or ratios only, but not to the various parts of financial statements in Question 9 (cf. correlation value between Question 9 and 16: -0,18). This result would implicate that the financial indicators or ratios might have more relevance than the financial statements in analysing solvency in the context of the asset distribution.

Moreover, cohorts of easily explained correlations were found. For example, if the respondent has not reacted on the evaluation of solvency by the audited company, one has not done so within the last 12 months preceding the answer either, nor reported on its shortcomings or directed such report to the corporate bodies. In a similar fashion, the more times the respondent has been obliged to react on the evaluation of solvency by the audited company, the more likely one has reacted in many years and within the last 12 months preceding the answer, communicated on the solvency matter in general and in particular on its shortcomings, and directed the oral communication or written reports to corporate bodies.

8.4 Limitations of the study

There are a number of limitations related to the survey. First, even if FIAPA was kindly mediating the access link to the survey, apart from that there was no control of the respondents. However, the quality of the answers suggests that the respondents have been auditors. Second, there are about 1400 members in FIAPA but only 53 responses were received. Hence, the number of respondents remained at a low level, even if it is the most extensive data collected to date on this topic. The low number of respondents renders the statistical results weak, but nevertheless the results shed light on how the auditors have performed their duties in practice. Those results are supported by written descriptions of the auditors in the open space for further information. Third, the majority of the respondents audit small and medium-sized companies. Therefore the answer may not depict the situation accurately with regard to the biggest audited companies. Some respondents even stated in the open space that the small and biggest companies function in different business worlds.

That said, the quality of the responses reflects a good knowledge of the subject matter and the audit process. Therefore I have reasons to believe that the view given by the respondents is, in all material respects, true and fair.

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APPENDIX 1: SURVEY

Turun yliopisto
University of Turku

Tilintarkastajan asema ja tehtävät varojenjakoon liittyvän maksukykytestin yhteydessä (kyselyssä ei käsitellä yleistä going concern -arviota)

Kyselyn tarkoituksena on selvittää laaja-alaisesti varojenjaon maksukykytestiin liittyviä yksittäisten tilintarkastajien kokemuksia. Tämän vuoksi tämä kysely lähetetään KHT-yhdistys ry:n välityksellä niiden jäsenille.

Kysely on suomenkielinen, mutta kysymykset on käännetty englanniksi. Voitte vastata suomeksi, ruotsiksi tai englanniksi. Kirjoitan tutkielmani englanniksi.

Pyydän Teitä vastaamaan kyselyn kysymyksiin. Vastaaminen kestää arviolta 15–30 minuuttia.

Vastauksianne käytetään anonyymisti maisterinopintojen tutkielmassani ja voidaan käyttää anonyymisti mahdollisissa jatko-opinnoissani.

(The role and tasks of the auditor in the context of the solvency test in the distribution of assets (the survey is not about general going concern assessment)

The aim of the survey is to find out extensively the experiences of auditors with regard to the solvency test in the distribution of assets. For this reason, this survey is mediated by FIAPA to its members.

The survey is in Finnish, but the questions have been translated to English. You may answer in Finnish, Swedish or English. I will write my master's thesis in English.

I ask You to answer the questions of the survey. It will take approximately 15-30 minutes.

Your answers will be used in anonym in my master's thesis and they can be used in anonym in my doctoral studies, if any.)

I: Kuvailevat kysymykset

(Descriptive questions)

1. Kuinka monta vuotta olette toiminut HTM- tai KHT-tilintarkastajana?
   (How many years have you been working as an authorised auditor?) *
   - Alle 3 vuotta (less than 3 years)
   - 3-5 vuotta (3-5 years)
   - 6-8 vuotta (6-8 years)
   - 8-10 vuotta (8-10 years)
   - Yli 10 vuotta (more than 10 years)

2. Toimitteko tällä hetkellä tilintarkastajana ns. Big Four -tilintarkastusyhteisössä?
   (Do you work as an authorised auditor in a so-called Big Four audit firm?) *
   - Kyllä (Yes)
   - Ei (No)

3. Tilintarkastajat voivat käyttää tilintarkastukseen suunnitellun tuntimäärän eri tavoin; joku voi käyttää nuo tunnit yhteen suureen yhtiöön, toinen samat tunnit moneen pieneen yhtiöön. Ottaen huomioon yhtiön tilintarkastukseen käyttämienne tuntien määrä ja niiden suunniteltu yhteismäärä, minkä kokoisten yhtiöiden tilintarkastamiseen käytätte eniten tunteja yhteismäärästänne, ts. minkä kokoisia yhtiöitä pääsääntöisesti tilintarkastatte (vastauksen luvut viittaavat liikevaihtoon)?

   (Auditors may use their budgeted audit hours in different ways; one may consume those hours to one big company, another may consume the same hours to many small companies. Taking into account hours used on a company and your total budgeted hours, to the audit of which companies you consume most of the total budgeted hours, that is, what sized companies do you usually audit (the numbers in the answers refer to revenue) ?) *
   - Alle 200 000 € (less than 200 000 €)
   - 200 000 – 999 999 €
   - 1 000 000 – 9 999 999 €
   - 10 000 000 – 49 999 999 €
   - Vähintään 50 000 000 € (at least 50 000 000 €)

II: Maksukyvyn määrittely, maksukykyarvioiden yleisyys sekä arvioinnin tärkeys

(Definition of solvency, occurrence of solvency assessment and Importance of analysing solvency)

4. Miten ymmärrätte ja määrittelette varojenjaossa vaadittavan maksukyvyn, lyhyt avoin vastaus?
   (How do you understand and define the solvency needed in the asset distribution, short open-ended answer?)

5. Miten yleistä on, että varojenjaon yhteydessä tilintarkastusasiakas on laatinut dokumentoidun maksukykyä koskevan arvion, mitattuna prosentteina varojenjakotilanteista?
   (How common is it that the audit client has established a documented assessment on solvency in the context of a distribution of assets, measured as a percentage of asset distribution events?) *
   - 0 %
   - 1-25 %
   - 26-50 %
   - 51-75 %
   - 76-100 %

6. Pidän tilintarkastettavan yhtiön maksukyvyn arvioinnin tarkastamista tärkeänä osana tilintarkastajan tehtäviä: täysin eri mieltä = 1, täysin samaa mieltä = 5.
   (I consider auditing the evaluation of solvency by audited company an important part of the tasks of the auditor: completely disagree = 1, completely agree = 5.) *
   - 1
   - 2
   - 3
   - 4
   - 5

III.A: Maksukyvyn arvioinnin tarkastus käytännössä

(Auditing the evaluation of solvency in practice)

7. Otatteko tilintarkastettavan yhtiön maksukyvyn ja sen arvioinnin varojenjaossa huomioon tilintarkastuksessa?
   (In audit, do you take into account the solvency of the audited company and its evaluation in the asset distribution): *
   a. Kyllä, tilintarkastuksen suunnittelussa (yes, in planning theaudit)
   b. Kyllä, kontrolleja tarkastettaessa (yes, in the tests of controls)
   c. Kyllä, sisällöllisiä aineistotarkastustoimenpiteitä suoritettaessa (yes, in performing substantive procedures)
   d. Kyllä, analyyttisiä tarkastustoimenpiteitä suoritettaessa (yes, in performing analytical procedures)
   e. Kyllä, yhtiön hallinnon tarkastusta suoritettaessa (yes, in auditing the governance of the company)
   f. Kyllä, raportointivaiheessa (yes, in the reporting phase)
   g. Ei (no).

8. Jos vastasitte myöntävästi yhteen tai useampaan edellisen kysymyksen vaihtoehdoista, miten otatte huomioon tilintarkastettavan yhtiön maksukyvyn ja sen arvioinnin varojenjaossa, lyhyt avoin vastaus?

(If you answered affirmatively in any of the options of the previous question, how do you take into account the solvency of the audited company and its evaluation in such cases, short open-ended answer?)

III.B: Dokumentaatio

(Documentation)

9. Kiinnitättekö huomiota tilintarkastettavan yhtiön tuottamiin asiakirjoihin maksukyvyn arvioinnin tarkastuksen yhteydessä?
   (When auditing the evaluation of solvency, do you pay attention to the documents that the audited company has made?) *
   - Kyllä, aina (Yes, always)
   - Kyllä, toisinaan (Yes, sometimes)
   - Ei koskaan (Never)

10. Jos kiinnitätte huomiota, mihin asiakirjoihin?
    (If you pay attention to such documents, which ones?)
    - tuloslaskelma (income statement)
    - tase (balance sheet)
    - rahoituslaskelma (cash flow statement)
    - toimintakertomus (management report)
    - johdon laatimat budjetit (budgets by the management)
    - johdon laatimat kassavirtalaskelmat (cash flow budgets by the management)
    - muu, mikä, selvennä kyselyn lopussa (other, which, explain in the end of the questionnaire)

11. Kiinnitättekö huomiota tilintarkastettavan yhtiön taloudellista asemaa kuvaaviin tunnuslukuihin maksukyvyn arvioinnin tarkastuksen yhteydessä?
    (When auditing the evaluation of solvency, do you pay attention to the financial indicators or ratios characterising the financial position of the audited company?) *
    - Kyllä, aina (Yes, always)
    - Kyllä, toisinaan (Yes, sometimes)
    - Ei koskaan (Never)

12. Jos kiinnitätte huomiota, mihin tunnuslukuihin?
    (If you pay attention to such indicators or ratios, which ones?)
    - pääoman tuottoa kuvaavat tunnusluvut (return on assets/investments)
    - nettotulosprosentti (net profit ratio)
    - omavaraisuusaste (equity ratio)
    - suhteellinen velkaantuneisuus (relative indebtedness)
    - muu, mikä, selvennä kyselyn lopussa (other, which, explain in the end of the questionnaire)

13. Jos ette kiinnitä huomiota tilintarkastettavan yhtiön tuottamiin asiakirjoihin ettekä tunnuslukuihin, mihin asioihin kiinnitätte huomiota, lyhyt avoin vastaus?
(If you pay attention neither to the documents that the audited company has made nor to the financial indicators and ratios, to which matters do you pay attention, short open-ended answer?)

III.C: Maksukyvyn arviointiin reagointi

(Reacting on the evaluation of solvency)

14. Oletteko ollut tilanteessa, että tilintarkastettavan yhtiön maksukyvyn arviointi on katsottu siinä määrin riittämättömäksi, että olette tavalla tai toisella joutunut reagoimaan maksukyvyn arviointiin uuden osakeyhtiölain voimassa olon aikana
(Have you been in a situation where the evaluation of solvency by the audited company has been deemed inadequate to a degree that, in one way or another, you have been obliged to react on the evaluation of solvency, under the new Finnish Limited Liability Companies Act)? *
    - Kyllä (Yes)
    - Ei (No)

15. Jos vastasitte edelliseen kysymykseen Kyllä, kuinka monena vuonna olette joutunut reagoimaan maksukyvyn arviointiin?
(If you answered Yes to the previous question, in how many years you have been obliged to react on the evaluation of solvency?)
    - 1
    - 2
    - 3
    - 4
    - vähintään 5 vuotena (at least in 5 years)

16. Kuinka monta kertaa yhteensä olette joutunut reagoimaan maksukyvyn arviointiin uuden osakeyhtiölain voimassa olon aikana?
(How many times have you been obliged to react on the evaluation of solvency altogether, under the new Finnish Limited Liability Companies Act?) *
    - 0
    - 1-10
    - 11–20
    - 21–30
    - yli 30 kertaa (more than 30 times).

17. Oletteko joutunut tavalla tai toisella joutunut reagoimaan tilintarkastettavan yhtiön maksukyvyn arviointiin varojenjaossa viimeisten 12 kuukauden aikana?
(Have you, in one way or another, been obliged to react on the evaluation of solvency by the audited company in the asset distribution context during the last 12 months?) *
    - Kyllä (Yes)
    - Ei (No)

18. Jos vastasitte edelliseen kysymykseen Kyllä, oliko kyse jostakin erityistilanteesta, kuten:
    (If you answered Yes to the previous question, was there a specific situation involved, such as:)
    - Konsernin tilintarkastus (an audit of a group)
    - Epäselvä omistusrakenne (an unclear ownership structure)
    - Yrityssaneeraus (a company restructuration)
    - Konkurssi (a bankruptcy)
    - muu, mikä, selvennä kyselyn lopussa (other, which, explain in the end of the questionnaire)

19. Mitä toimenpiteitä olette tehnyt, kun olette reagoinut maksukyvyn arviointiin?
    (Which measures have you taken when you have you reacted on the evaluation of solvency?)
    - Kehottanut tilintarkastettavaa yhtiötä laatimaan jonkin tai joitakin asiakirjoja (encouraged the audited company to establish one or more documents)
    - Vaatinut lisää jo olemassa ollutta dokumentaatiota (demanded more documentation that has already been existing)
    - Suorittanut lisää tarkastustoimenpiteitä (performed more procedures)
    - Kirjoittanut ehdollisen tai kielteisen tilintarkastuskertomuksen (written a qualified or adverse auditor’s report)
    - Muulla tavoin, miten, selvennä kysymyksen lopussa (in other way, which, explain in the end of the questionnaire)

III.D: Maksukyvyn arvioinnin tarkastuksen raportointi

(Reporting the audit of the evaluation of solvency)

20. Millä tavoin ja millä tasolla olette yleensä raportoinut tilintarkastettavan yhtiön maksukyvyn arviointiin liittyvistä seikoista?
    (In which way and at which level have you, in general, reported on the evaluation of solvency by the audited company?) *
    - Ei raportointia näistä asioista (No reporting on these matters)
    - Suullisesti (orally)
    - Tilintarkastuspöytäkirjassa (in audit minutes)
    - Tilintarkastuskertomuksessa (in auditor’s report)
    - Muulla tavoin, miten (in other way, which)

21. Millä tavoin ja millä tasolla olette raportoinut tilintarkastettavan yhtiön maksukyvyn arviointiin liittyvistä puutteista?
    (In which way and at which level have you reported on the shortcomings in the evaluation of solvency by the audited company?) *

- Ei raportointia näistä asioista (No reporting on these matters)
- Suullisesti (orally)
- Tilintarkastuspöytäkirjassa (in audit minutes)
- Tilintarkastuskertomuksessa (in auditor's report)
- Muulla tavoin, miten, selvennä kyselyn lopussa (in other way, which, explain in the end of the questionnaire)

22. Kenelle olette raportoinut tilintarkastettavan yhtiön maksukyvyn arviointiin liittyvistä puutteista?
    (To whom have you reported on the shortcomings in the evaluation of solvency by the audited company)?
    - Ei raportointia näistä asioista (No reporting on these matters)
    - Vain hallitukselle tai tarkastusvaliokunnalle (to the board of directors or audit committee only)
    - Vain toimitusjohtajalle (to the CEO only)
    - Hallitukselle tai tarkastusvaliokunnalle sekä toimitusjohtajalle (to the board of directors or the audit committee and the CEO)
    - Yhtiökokoukselle (to the general meeting)

IV: Muut kommentit

(Other comments)

23. Olkaa hyvä ja kirjoittakaa muut aiheeseen liittyvät kommenttinne.
    (Please write your other topic-related comments.)

☐ Vahvista vastausten lähetys (Confirm sending the answers)

Kiitos vastauksestanne! (Thank you for your response!)

APPENDIX 2: CORRELATIONS

2.1 Statistical description of answers given to the survey (calculated by Webropol)

Q	Amount	Mean	Confidence interval of mean	Median	Std. Deviation	Skewness	Curtosis
1.	53	4,377358	4,04 – 4,71	5	1,243853	-1,82695	1,865824
2.	53	1,792453	1,68 – 1,9	2	0,409432	-1,484602	0,21054
3.	53	2,433962	2,14 – 2,73	2	1,083254	1,119868	0,9026
5.	53	1,981132	1,74 – 2,23	2	0,909154	0,995516	1,296465
6.	53	4,075472	3,77 – 4,38	4	1,124022	-1,419907	1,500165
7.	146	4,109589	3,83 – 4,39	5	1,738503	-0,673722	-0,839136
9.	53	1,301887	1,17 – 1,44	1	0,503255	1,35072	0,841909
10.	209	3,334928	3,09 – 3,58	3	1,82735	0,329557	-1,172347
11.	53	1,641509	1,46 – 1,83	2	0,682032	0,59566	-0,684209
12.	102	3,205882	2,99 – 3,42	3	1,111045	-0,418955	-0,278169
14.	53	1,433962	1,3 – 1,57	1	0,500363	0,274311	-2,001798
15.	30	2,8	2,28 – 3,32	2	1,447947	0,519922	-1,160754
16.	53	2,075472	1,84 – 2,31	2	0,873742	1,467746	3,479368
17.	53	1,584906	1,45 – 1,72	2	0,497454	-0,354748	-1,949215
18.	19	3,842105	3,15 – 4,53	5	1,537066	-0,936667	-0,541842
19.	67	2,597015	2,26 – 2,93	2	1,404103	0,319854	-1,212363
20.	88	2,772727	2,52 – 3,03	3	1,229216	0,409472	-0,78784
21.	74	2,608108	2,33 – 2,89	2	1,225501	0,522841	-0,559978
22.	62	3,225806	2,87 – 3,58	4	1,430572	-0,516589	-1,22597

2.2 General correlations and statistical significance (calculated by Webropol)

Q	1	2	3	5	6	7	9	10	11	12	14	15	16	17	18	19	20	21	22
1	1	0,38	-0,37	-0.03	-0.01	0.16	-0.06	-0,12	-0.15	-0,07	-0.18	-0.04	0.24	-0.11	-0.27	0	0.23	0.22	0.13
2	0,38	1	-0,62	0.04	0.12	0,28	-0.06	-0,11	-0.2	-0,03	-0.21	-0.33	0.1	-0.05	-0.09	0.25	0.18	0.26	0.06
3	-0,37	-0,62	1	0.05	-0.01	0.04	0.18	0,16	0.21	0,13	0.18	0.32	-0.08	-0.09	0.44	-0.23	-0.05	-0.11	-0.08
5	-0.03	0.04	0.05	1	0.19	0.02	0.05	-0,12	-0.14	0,1	-0.02	-0.12	0.1	0.07	0.01	-0,34	0.08	0.09	0.19
6	-0.01	0.12	-0.01	0.19	1	-0.02	-0,28	0,08	-0,34	0,09	-0.23	-0.2	0,31	-0.15	0.07	0.04	0.26	0.12	0,36
7	0.16	0,28	0.04	0.02	-0.02	1	0.1	0,04	0.15	-0,1	-0.03	-0.14	-0.05	-0.11	-0.06	0.02	0.02	0.08	-0.09
9	-0.06	-0.06	0.18	0.05	-0,28	0.1	1	0,01	0,43	-0,13	0	-0.16	-0.18	-0.03	-0.21	-0.19	-0.07	-0.13	-0.11
10	-0.12	-0.11	0.16	-0.12	0.08	0.04	0.01	1	0.15	0,1	-0.05	-0.11	0.06	0.05	-0.27	-0.17	0.07	0	-0
11	-0.15	-0.2	0.21	-0.14	-0,34	0.15	0,43	0,15	1	0,01	0,3	0.03	-0,41	0.23	-0.03	0.12	-0.19	-0,33	-0,4
12	-0.07	-0.03	0.13	0.1	0.09	-0.1	-0.13	0,1	0.01	1	-0.1	0.15	0.1	-0.19	0.41	-0.13	0.11	0.25	-0.02
14	-0.18	-0.21	0.18	-0.02	-0.23	-0.03	0	-0,05	0,3	-0,1	1	0	-0,56	0,66	0.17	-0.2	-0,27	-0,53	-0,53
15	-0.04	-0.33	0.32	-0.12	-0.2	-0.14	-0.16	-0,11	0.03	0,15	0	1	0,58	-0,52	-0.21	0.04	-0.32	-0.1	0.18
16	0.24	0.1	-0.08	0.1	0,31	-0.05	-0.18	0,06	-0,41	0,1	-0,56	0,58	1	-0,5	-0,57	0.02	0.11	0,31	0,5
17	-0.11	-0.05	-0.09	0.07	-0.15	-0.11	-0.03	0,05	0.23	-0,19	0,66	-0,52	-0,5	1	0	-0.01	-0,36	-0,53	-0,36
18	-0.27	-0.09	0.44	0.01	0.07	-0.06	-0.21	-0,27	-0.03	0,41	0.17	-0.21	-0,57	0	1	0,51	0.34	0.31	0.02
19	0	0.25	-0.23	-0,34	0.04	0.02	-0.19	-0,17	0.12	-0,13	-0.2	0.04	0.02	-0.01	0,51	1	-0.05	0.01	0.07
20	0.23	0.18	-0.05	0.08	0.26	0.02	-0.07	0,07	-0.19	0,11	-0,27	-0.32	0.11	-0,36	0.34	-0.05	1	0,58	0.22
21	0.22	0.26	-0.11	0.09	0.12	0.08	-0.13	0	-0,33	0,25	-0,53	-0.1	0,31	-0,53	0.31	0.01	0,58	1	0,55
22	0.13	0.06	-0.08	0.19	0,36	-0.09	-0.11	-0	-0,4	-0,02	-0,53	0.18	0,5	-0,36	0.02	0.07	0.22	0,55	1

p<0,001 statistically very significant

p<0,01 statistically significant