**Audit Issues Arising From Liquidity Risk**
(Relevant to Paper 8 – Principles of Auditing and Management Information Systems)

David Chow, FCCA, FCPA, CPA (Practising)

In view of the recent collapse of the Shanghai stock market, financial market conditions have been characterized by significant trading difficulties, compounded by a reduction in liquidity. For some listed companies on the Shanghai Stock Exchange stocks might have ceased trading, and some stocks faced severe curtailments in their transaction volumes. As a result, investors investing in these stocks may face difficulties in valuing those investments; similarly, some entities may face difficulties in financing their operations as a result of reduced liquidity in the financial markets. This article discusses the audit issues arising from liquidity risk.

## RESPONSIBILITIES OF THE AUDITOR

According to HKSA 570 (Revised) *Going Concern*, the auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding the appropriateness of the management's use of the going concern basis of accounting in the preparation of the company's financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists as to the entity's ability to continue as a going concern.

A material uncertainty exists when the magnitude of its potential impact and the likelihood of occurrence is such that appropriate disclosure of the nature and implications of the uncertainty is necessary for the fair presentation of the financial statements, or for the financial statements not to be misleading.

## IMPACTS OF LIQUIDITY RISK

### (I) Going Concern

In a poor liquidity environment, the auditor cannot rely on the past experience of the entity in obtaining financing arrangement to provide sufficient evidence of the entity's ability to obtain financing in the future. Lenders may be more risk-averse when considering whether to provide financing facilities with tougher terms or even not to renew the existing financing facilities. Consequently, the entity may not obtain the required capital to maintain the current operations and this may cast significant doubt on the entity's ability to continue as a going concern.

What constitutes a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern is a judgment involving not only the nature and materiality of the events or conditions giving rise to uncertainty, but also the ability of the entity to adopt the strategies that mitigate any uncertainty. For instance, through a rights issue an entity can successfully mitigate the uncertainty arising from difficulty in obtaining external financing.

In order to obtain sufficient appropriate evidence, the auditor may need to obtain confirmations of the existence and terms of financing facilities, and to make an independent assessment of the intentions of the lenders relating thereto. If the auditor is unable to obtain such evidence, a material uncertainty may exist and needs to be disclosed in the financial statements, and/or referred to in the auditor's report.

**Implications for the Auditor's Report on Going Concern**

If an adequate disclosure of a material uncertainty is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "**Material Uncertainty Related to Going Concern**", which serves two purposes.

Firstly, it draws attention to the note in the financial statements that discloses:
(a) the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and
(b) that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

Secondly, this section states that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

However, if no disclosure of a material uncertainty is made in the financial statements, the auditor shall express an adverse opinion; and in the **Basis for Adverse Opinion** section of the auditor's report, the auditor shall state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not disclose this matter.

If only inadequate disclosure of a material uncertainty is made in the financial statements, the auditor shall express a qualified opinion; and in the **Basis for Qualified Opinion** section of the auditor's report, the auditor shall state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not adequately disclose this matter.

Based on past experience, a liquidity risk could lead to recession. Due to the pervasive risks in the economy, should every audit report be modified? The answer is "no". Uncertainty in the economy does not necessarily lead to material uncertainties for all entities. Some entities have huge cash reserves and no debt, or are in a business less affected by recession. Even in recession, neither will these entities make going concern disclosures, nor is a modified audit report justified.

Indeed the auditor should consider issuing a modified audit report only where there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

**(II) Valuation and Disclosure of Financial Instruments**

Due to a lack of liquidity in the market, difficulties may arise in determining the "fair value" of complex financial instruments, such as collateralized debt obligations (commonly known as "CDOs"). A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions.

When the auditor determines that there is a significant risk related to fair value, the auditor should evaluate whether the significant assumptions used by management in measuring fair values, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures. This evaluation includes consideration of whether these assumptions reflect current market conditions and information.

With severe curtailment in the transaction volume or even without any transaction executed, those complex financial instruments that have previously been marked to market may need to be valued using a model. If management has changed the valuation method, the auditor considers whether management can adequately demonstrate that the valuation method to which it has changed provides a more appropriate basis of measurement. Sometimes the auditor may have to use experts with particular knowledge of the valuation of complex financial instruments to assist in obtaining sufficient appropriate audit evidence. The auditor should then follow the audit procedures as stated in HKSA 620 (Clarified) *Using the Work of an Auditor's Expert*.

The auditor also needs to evaluate whether the disclosures about fair values made by the entity are in accordance with the financial reporting framework. In such circumstances, it is important that disclosures of material risks and uncertainties related to fair value measurements be appropriate to the entity. For entities applying HKAS 1 (Revised) *Presentation of Financial Statements*, disclosure requirements include (i) the judgments that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements; and (ii) information about the key assumptions concerning the future and other key sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment in the carrying amount of assets and liabilities within the next financial year.

**Implications for the Auditor's Report on Valuation and Disclosure of Financial Instruments**

If there is a significant uncertainty relating to the valuation of financial instruments <u>disclosed</u> in the financial statements, the resolution of which is dependent upon future events and which may affect the financial statements, the auditor is required to consider adding an **Emphasis of Matter** paragraph to highlight that uncertainty. In determining whether an uncertainty is significant, the auditor considers:

(a) the risk that the estimate included in the financial statements may be subject to change;
(b) the range of possible outcomes; and
(c) the consequences of those outcomes on the view shown in the financial statements.

Nevertheless, the inclusion of an Emphasis of Matter paragraph in the auditor's report does not affect the auditor's opinion. It is not a substitute for:

(a) a modified opinion in accordance with HKSA 705 (Revised) when required by the circumstances of a specific audit engagement; or
(b) disclosures in the financial statements that are required by the applicable financial reporting framework.

**References:**

HKSA 570 (Revised) *Going Concern*, issued August 2015 by the Hong Kong Institute of Certified Public Accountants

HKSA 620 (Clarified) *Using the Work of an Auditor's Expert*, revised July 2010 by the Hong Kong Institute of Certified Public Accountants

HKSA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*, issued August 2015 by the Hong Kong Institute of Certified Public Accountants

HKSA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, issued August 2015 by the Hong Kong Institute of Certified Public Accountants

*Audit Issues when Financial Market Conditions are Difficult and Credit Facilities may be Restricted*, published January 2008 by the Auditing Practices Board, Financial Reporting Council Limited, UK

*Going Concern Issues during the Current Economic Conditions*, published December 2008 by the Auditing Practices Board, Financial Reporting Council Limited, UK

HKFRS 13 *Fair Value Measurement*, issued June 2011 by the Hong Kong Institute of Certified Public Accountants

HKAS 1 (Revised) *Presentation of Financial Statements*, revised January 2015 by the Hong Kong Institute of Certified Public Accountants

- END -