Accounting and Financial Reporting Council
會計及財務匯報局

afrc.org.hk

Audit implications of current economic conditions for Hong Kong-listed companies

Policy, Registration and Oversight

October 2024

About the Accounting and Financial Reporting Council

The Accounting and Financial Reporting Council (AFRC) is an independent body established under the Accounting and Financial Reporting Council Ordinance. As an independent regulator, the AFRC spearheads and leads the accounting profession to constantly raise the level of quality of professional accountants, and thus protects the public interest.

For more information about the statutory functions of the AFRC, please visit www.afrc.org.hk.

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Section A
Introduction

1. Introduction

1.1. Macroeconomic conditions have a significant impact on management behaviour and company financials. Persistent high interest rates, coupled with global economic uncertainty created by geopolitical tension and the US presidential election cycle, have collectively contributed to a weakened business sentiment in Hong Kong in 2024.[1] The macroeconomic conditions, and weakened business sentiment influence companies' strategic decisions and have an impact on accounting estimates used in financial reporting.

1.2. To ensure high quality of financial reporting by listed companies, auditors must scrutinise accounting estimates companies make in preparing their financial statements. They must obtain an understanding of the audited entity and its environment. They must maintain professional scepticism, particularly in areas where there is higher possibility of companies using earnings management techniques to present a distorted picture of their financial situation. If a company faces particularly adverse economic or business conditions, the auditors must critically evaluate its ability to continue as a going concern.

Objectives

1.3. The primary objective of this report is to analyse the economic conditions affecting Hong Kong-listed companies in 2024. By examining key indicators such as Gross Domestic Product (**GDP**) growth, inflation, interest rates, and property prices, along with forecasts published by the Hong Kong SAR Government and the Central People's Government, we aim to provide a comprehensive understanding of the economic conditions, and their potential impact on the financial performance and reporting of listed companies.

1 Office of the Government Economist of the HKSAR (2024) Half-Yearly Economic Report 2024

1.4. Furthermore, we analyse the impact of the economic conditions on business strategy, earnings management, and accounting implications. Our insights should be of value for company management, audit committees, and auditors preparing and auditing financial statements, respectively. This analysis also aims to provide a principle for management and auditors for the future.

1.5. Auditors play a critical role in ensuring the accuracy and reliability of financial statements. By understanding potential risks associated with the current economic landscape, auditors can effectively plan and execute audits, thereby enhancing the quality of financial reporting. We highlight areas of focus and the need for heightened professional scepticism for auditors in the context of the current economic conditions.

1.6. In addition, the report will aid audit committees in safeguarding the integrity of the companies' financial information and the effectiveness of the audit. By being aware of economic factors and sentiment, audit committees can critically assess their potential impact on financial statements and identify areas where management might be incentivised to engage in earnings manipulation. This insight allows them to enhance oversight of the financial reporting process, ensuring that financial reports are reflective of the company's true financial health.

Methodology

1.7. The analysis presented in this report is based on a review of relevant economic data from official publications by the Hong Kong SAR Government, the Central People's Government and state agencies such as the National Bureau of Statistics of China and the Census and Statistics Department of Hong Kong. We also present selected insights from empirical research.

1.8. Our analysis used annual data from 2014 to 2023. We also used data from the first nine months of 2024, where available, and 2024 year-end forecasts issued by the Hong Kong SAR Government and the Central People's Government.

1.9. The data presented herein are intended to illustrate the implications of financial reporting and auditing. They are not intended for use in forecasting, preparing, or auditing financial reports, nor for any other purposes. They should not be relied upon by any parties for any other purposes, and the AFRC expressly disclaims any liability or duty to such parties in this regard.

1.10. When analysing accounting implications, we referenced relevant accounting standards and explored their connection with economic factors. In outlining auditor's responsibilities, we cited relevant auditing standards, and highlighted key issues identified through the AFRC's inspection and investigation findings. These findings offer valuable and practical reflection points, pinpointing factors that auditor should consider in performing their duties.

Structure

1.11. Following this introduction (**section A**), in the following sections we discuss:

i. **The effect of economic conditions on financial reporting (section B):** We provide an overview of the current economic conditions in Hong Kong and mainland China. We also outline how economic factors influence corporate behaviour and auditors' actions.

ii. **Economic factors and their impact on accounting estimates (section C):** We look at the impact of economic factors on accounting estimates, focusing on expected credit loss, fair value measurement, impairment of assets, and going concern assessment.

iii. **Auditors' responsibilities in the context of current economic conditions (section D):** We highlight the need for auditors to obtain an understanding of the audited entity and its environment. This understanding is essential to plan an effective audit and obtain sufficient audit evidence for accounting estimates.

iv. **Conclusion (section E):** We set out our key messages for boards of directors and senior management, auditors, and audit committees.

Section B
The effect of economic conditions on financial reporting

2. Current economic environment and outlook

Overall situation

2.1. Global economic growth was generally sustained in the second quarter of 2024, despite persistently high interest rates in advanced economies.[2] The International Monetary Fund (**IMF**) kept its forecast for the global economic growth for 2024 and 2025 at 3.2%, the same pace as in 2023.

2.2. This growth is driven predominantly by the continuing expansion of the US economy on the back of strong domestic demand. Threats to the global economic outlook include persistently high interest rates, potential significant swings in economic policy as a result of elections this year, and new trade tariffs generating cross-border spillovers and triggering retaliation.[3]

2.3. Against the backdrop of ongoing global economic uncertainty, Hong Kong's economy has seen a gradual return to normalcy following the Covid pandemic. The main contributing factor was the recovery in global economic exchange and tourism, which benefits Hong Kong's key sectors, including financial and professional services, trading and logistics, and hospitality.[4] Other factors included the relaxation of property measures by the Hong Kong SAR Government and a decrease in the unemployment rate from 5.8% in 2020 to 3.0% for the three months ended June 2024.[5] These developments are likely to drive real estate market and consumption to support overall growth of the economy.

2 Office of the Government Economist of the HKSAR (2024) Half-Yearly Economic Report 2024
3 International Monetary Fund (2024) World Economic Outlook
4 The Financial Secretary of Hong Kong (2024) The 2024-25 Budget: Budget Speech
5 Census and Statistics Department of the HKSAR (2024) Statistics on unemployment rate

2.4. In the second quarter of 2024, Hong Kong's economy grew moderately, with the performance varying among sectors. However, potential threats persist, such as a long period of high interest rates and heightened geopolitical tensions.

2.5. The economy of Hong Kong is highly interlinked with that of mainland China. Deepening integration with mainland China, through projects such as the Guangdong-Hong Kong-Macao Greater Bay Area and the Belt and Road Initiative, provides new growth opportunities. The Hong Kong SAR Government's focus on attracting talent and international events, as well as investing in infrastructure and technology also boosts economic confidence.[6]

2.6. The economy of mainland China expanded by 4.7% year-on-year in the second quarter of 2024, moderating somewhat from 5.3% in the first quarter.[7] Since the early 2020s, mainland China's real estate sector has been facing challenges, creating concerns about the momentum of the country's economic recovery. These challenges include delays in completing pre-sold homes, declining house prices, and low demand, leading to an oversupply of unsold properties.[8] Several property developers have defaulted on their debts, further undermining the confidence of house buyers and investors.[9]

2.7. In response, in May 2024, the Central People's Government introduced measures to ease developer capital pressure and stabilise market expectations. These measures include eased buying restrictions, lowered minimum down payment ratios, and support for state-owned enterprises in providing affordable housing through the acquisition of unsold properties.[10]

2.8. Furthermore, in September 2024 the People's Bank of China (**PBoC**) announced a set of stimulus measures to boost the country's economy. They include cuts in the benchmark interest rate, mortgage interest rates, and the banks' reserve requirement ratio. The PBoC also signalled further policy support to real estate companies and the stock market.[11]

6 The Financial Secretary of Hong Kong (2024) The 2024-25 Budget: Budget Speech
7 Office of the Government Economist of the HKSAR (2024) Half-Yearly Economic Report 2024
8 Bloomberg (2024) China Considers Government Buying of Unsold Homes to Save Property Market
9 S&P Global (2024) China Default Review 2024
10 The State Council, PRC (2024) China abolishes mortgage floor rates, cuts minimum down payment ratios to boost property market
11 The State Council, PRC (2024) China unveils fresh stimulus to boost high-quality economic development

2.9. Barring an unexpectedly severe downturn, strong US demand for imports will continue to benefit the manufacturing economies of Asia, including mainland China's.[12] The Central People's Government has been effectively implementing macro policies and regulations that have led to a generally stable environment, and a steady progress of the national economy. In turn, this will create new opportunities in the job market. In addition, mainland China's economy will likely benefit from new policy initiatives following the Third Plenum of the Chinese Communist Party held in July 2024, which aim to increase production and bring about sustained recovery of demand.[13]

2.10. Certain key economic indicators – such as GDP growth, interest rate and inflation, among others, wield substantial influence over management strategies and decisions, impacting multiples financial statement line items. These indicators are discussed in this section. Additionally, factors like trading volume, percentage of classified loans of the banking sector, which also play a role in shaping company financial reporting, will be addressed in section C.

GDP growth

2.11. GDP growth is the main indicator of the stage in the economic cycle. As the economic cycle progresses through expansion, peak, contraction, and trough, companies' behaviour and management incentives evolve. The forecasted GDP growth is also a significant piece of forward-looking information that management factors into the assessment of the ability to continue as a going concern, and other accounting estimates, when preparing their financial statements.

2.12. By 2024, the economies of Hong Kong and mainland China have recovered to their pre-pandemic level of growth. Hong Kong's economy grew by 3.3% year on year in the second quarter of 2024, and China's by 4.7%.[14] The Hong Kong SAR Government expects the city's GDP to grow between 2.5% and 3.5% year on year in 2024, on par with its pace of growth in the late 2010s.[15] The Central People's Government aims for GDP growth of 5.0% in 2024,[16] which is lower than before the pandemic, but in line with the secular trend of gradually slowing GDP growth as mainland China's economy matures.[17]

12 IMF (2024) Regional Economic Outlook: Asia and Pacific

13 The Commissioner's Office of China's Foreign Ministry in the HKSAR (2024) Communique of the Third Plenary Session of the 20th Central Committee of the Communist Party of China

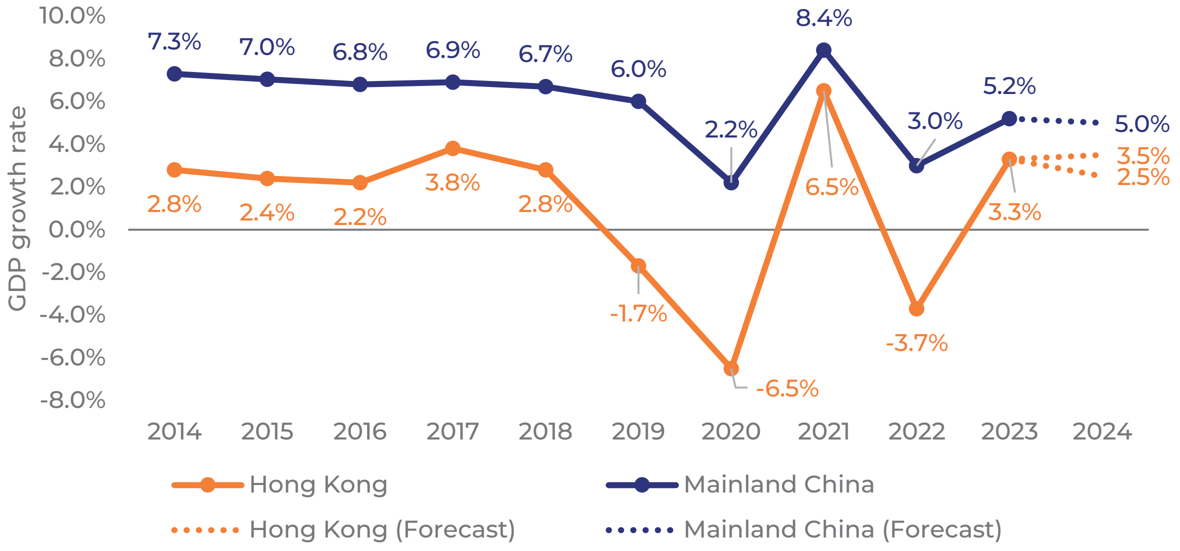
14 Office of the Government Economist of the HKSAR (2024) Half-Yearly Economic Report 2024

15 Hong Kong SAR Government (2024) Economic Situation in the Second Quarter of 2024 & Latest Economic Forecasts for 2024

16 Report on the implementation of the 2023 plan for national economic and social development and on the 2024 draft plan for national economic and social development. National Development and Reform Commission, 5 March 2024

17 IMF (2023) World Economic Outlook, Chapter 3

Figure 1. GDP growth in Hong Kong and mainland China



Sources: The Government of HKSAR Census and Statistics Department, National Bureau of Statistics of China

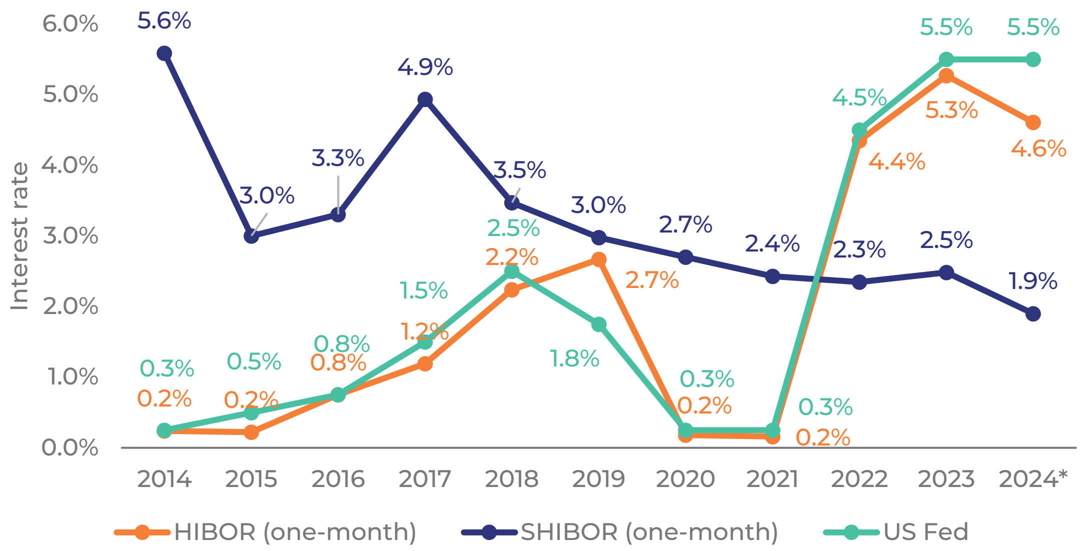
Interest rates and inflation

2.13. Interest rates and inflation have a wide-reaching effect on companies' operations and credit risks, especially in industries that are capital-intensive or heavily dependent on borrowing. They create a ripple effect that extends beyond business sentiment to influence investment sentiment, consumer spending, and the property market, thereby directly impacting companies' ability to finance projects and day-to-day operations. Moreover, they are the key inputs used in various accounting estimates.

2.14. Interest rates in Hong Kong are closely aligned with the US Federal Reserve's (**US Fed**) interest rates, because of the Hong Kong dollar's currency peg to the US dollar. The recovery of Hong Kong's economy has been dampened by a long period of high interest rates, with the one-month HIBOR standing at 4.6% as of June 2024 (Figure 2). As the US Fed lowers the interest rates in the second half of 2024 (the first of several expected rate cuts was announced on 18 September 2024), the economy of Hong Kong is likely to benefit. Conversely, any delay in lowering the US Fed rate will extend the dampening effect.[18]

18 Hong Kong Monetary Authority (HKMA) (2024) Half-yearly Monetary and Financial Stability Report

Figure 2. Interest rates in Hong Kong, mainland China and the US[19]



Sources: The Government of HKSAR Census and Statistics Department, China Foreign Exchange Trade System & National Interbank Funding Center, Federal Reserve Bank of St. Louis.

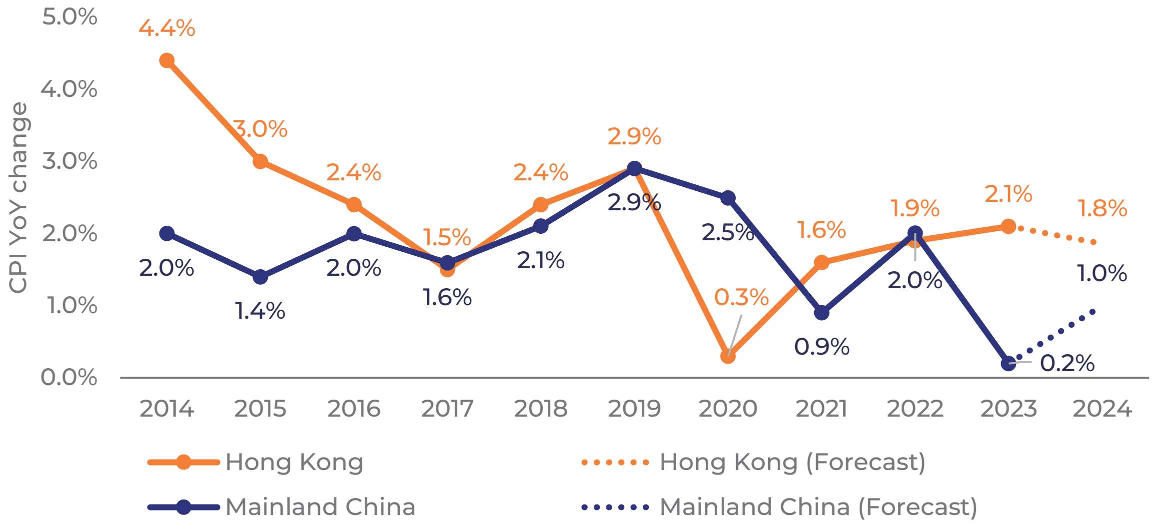
* As of 30 June 2024

2.15. Mainland China, on the other hand, has not seen interest rates rise during or after the pandemic. As long as consumer and business confidence remain weakened, upward pressure on interest rates is not likely. The stable interest rate should be beneficial to mainland China's economy.

2.16. Neither Hong Kong nor mainland China experienced the post-pandemic bout of inflation that affected many overseas markets. Based on the latest government forecasts, after bottoming out at 0.3% in 2020, inflation in Hong Kong is expected to stay below 2% in 2024 (Figure 3). In mainland China, inflation is expected to rise to 1% after coming at 0.2% in 2023.

19 HIBOR: HKAB HKD Interest Settlement Rate, SHIBOR: Shanghai Interbank Offered Rate.

Figure 3. Annual changes in Consumer Price Index (CPI) in Hong Kong and mainland China



Sources: The Government of HKSAR Census and Statistics Department, National Bureau of Statistics of China

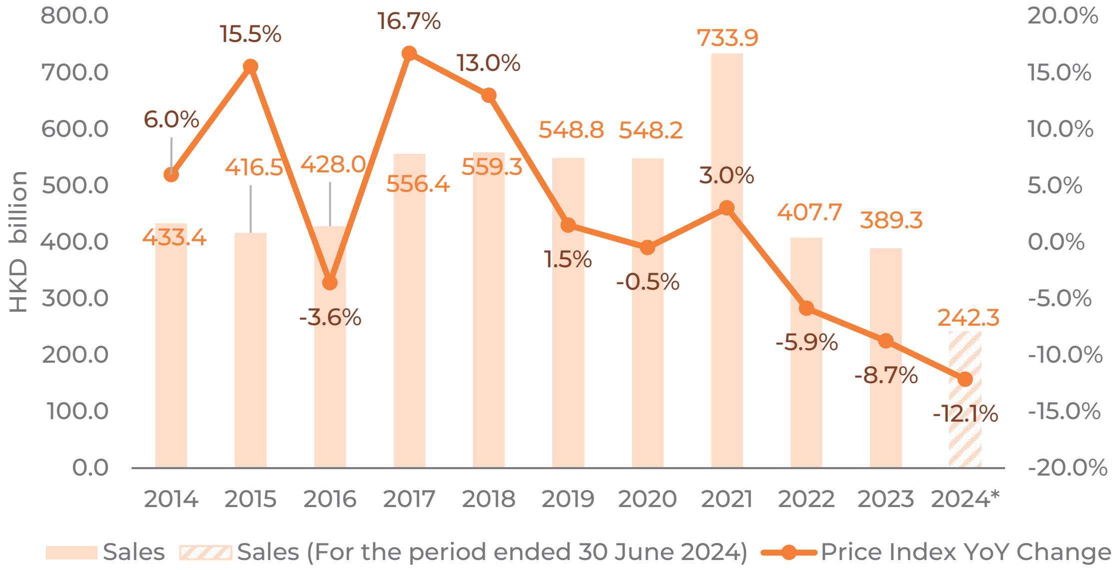
Residential property prices

2.17. In Hong Kong and mainland China, residential property prices are an important factor for the overall economy since real estate constitutes a significant portion of assets. A decline in property prices may affect consumer confidence and sap demand.

2.18. Hong Kong's residential property market became active at the beginning of the second quarter of 2024, following the relaxation of ownership restrictions by the Hong Kong SAR Government. However, it quietened progressively thereafter as pent-up demand faded. Property prices have been declining since late 2021. The market is expected to remain cautious as long as interest rates remain elevated (Figure 4).[20]

20 Office of the Government Economist of the HKSAR (2024) Half-Yearly Economic Report 2024

Figure 4. Hong Kong residential property sales and year-on-year change

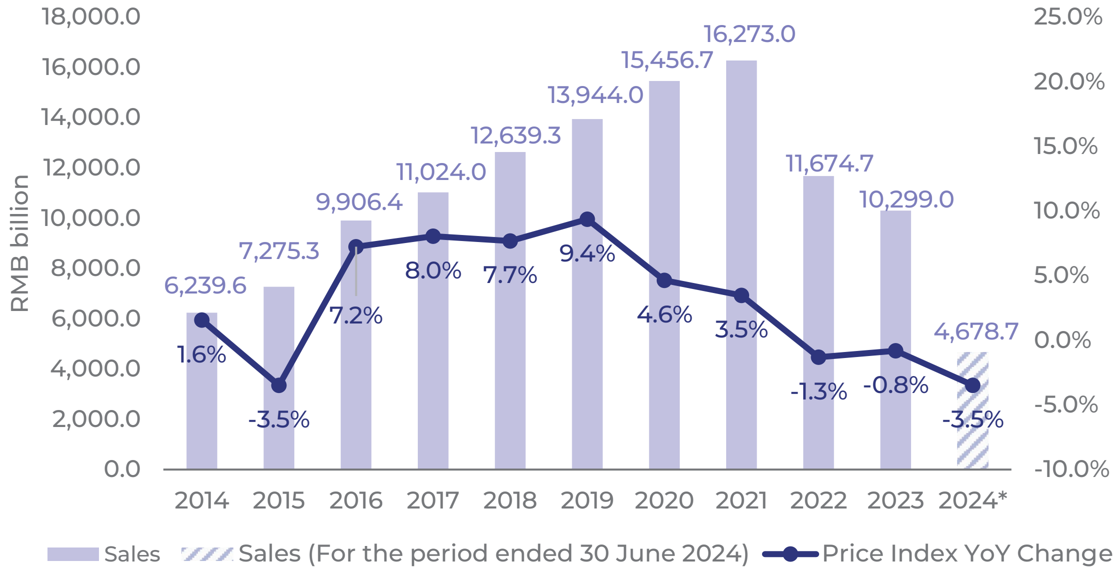


Source: The Government of HKSAR, Rating and Valuation Department

* For the period ended 30 June 2024

2.19. Mainland China's real estate sector has been facing challenges since early 2020s as new restrictions on borrowing by property developers were introduced. The sales volume of commercialised residential buildings has steadily declined from its peak in 2021. Prices decreased by 3.5% in the first two quarters of 2024.

Figure 5. Mainland China commercialised residential buildings sales and year-on-year change



Sources: National Bureau of Statistics of China, Bloomberg

*For the six-month ended 30 June 2024

International trade

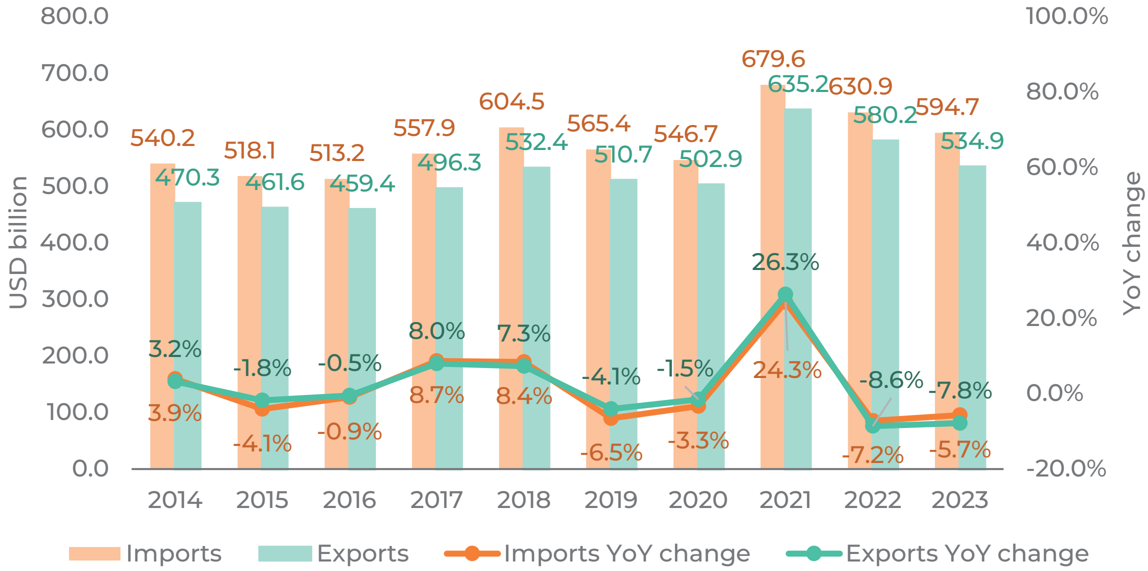
2.20. International trade plays a significant role in the economies of Hong Kong and mainland China. The latter in particular has been described as “the workshop of the world” for over two decades, since it joined the World Trade Organization in 2001. Hong Kong handles a substantial portion of mainland China’s external trade. At the same time, the city relies on imports for most of industrial and consumer goods.

2.21. As shown in Figures 6 and 7, import and export activity in Hong Kong and mainland China has decreased in 2023. However, the Hong Kong SAR Government remains optimistic, suggesting that exports of goods should maintain positive performance as long as external demand holds up, despite potential risks from ongoing trade conflicts.[21] The situation in mainland China also shows an improvement in the first half of 2024. The total value of imports grew by 2.0% and of exports by 3.6% compared to the same period in 2023, reversing the downward trend.[22]

21 Office of the Government Economist of the HKSAR (2024) Half-Yearly Economic Report 2024
22 Source: National Bureau of Statistics of China

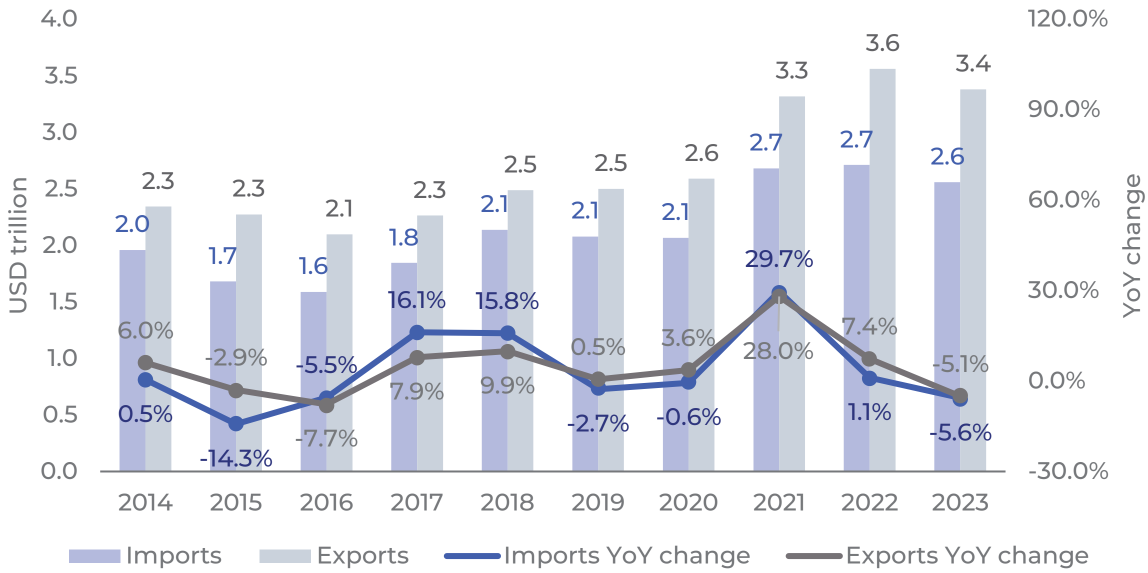
2.22. Supply chain disruptions can significantly impact imports and exports. Delays in product delivery, fluctuations in prices, and inventory levels can impact accounting estimates related to write-downs of inventory.

Figure 6. Hong Kong international trade volume and year-on-year change



Source: The Government of Hong Kong SAR, Census and Statistics Department

Figure 7. China international trade volume and year-on-year change



Source: National Bureau of Statistics of China

3. How economic factors influence companies' business strategies

3.1. The relationship between economic conditions and the corporate behaviour is complex, especially since many economic factors are interconnected.

3.2. Rising interest rates may lead to economic downturns. When that happens, a reduction in consumer spending and uncertainty about the continuing economic growth may lead to decreased sales and profitability, forcing companies to cut costs. They may lay off staff, freeze hiring, scale back investments, and postpone expansion plans. Companies may restructure, streamline operations, and seek efficiencies. In severe cases, businesses may face bankruptcy or closure.

3.3. Reduction in interest rates generally stimulate economic growth. An expanding economy leads to a more positive business sentiment. Companies become more willing to take risks – to expand, invest in technology, or launch innovative products. This behaviour aims for higher profits and market share. Consequently, companies increase capital expenditures, engage in mergers and acquisitions, and hire more employees. Meanwhile, consumers tend to increase their spending, leading to a higher demand for goods and services.

3.4. In Hong Kong, a reduction in interest rates, following a decrease in the US Fed's interest rate as mentioned in paragraph 2.14, is likely to stimulate the economy.

3.5. Credit cycles – periodic fluctuations in the availability and pricing of credit – also play an important role in shaping the business environment and economic outlook, and they are closely connected with interest rates. In times of low interest rates, investment sentiment tends to be strong, credit is typically abundant, and lending criteria are more lenient. Lenders may scrutinise borrowers' credit quality and their financial performance less rigorously in such periods, and require less collateral.

3.6. The current situation is quite the opposite; with persistent high-interest rates, and heightened credit risk, credit controls have been tightened. We have observed a decrease in total loan volume in Hong Kong in the first-half of 2024.[23]

23 HKMA (2024) Half-yearly Monetary and Financial Stability Report

3.7. Corporate behaviour is also shaped by market competition and industry dynamics. In highly competitive sectors, businesses must adapt to survive and thrive. They focus on cost reduction, innovation, and diversification for a competitive edge. Such competition influences pricing, marketing, and product development as companies respond to changing consumer preferences and purchasing power.

3.8. Corporate behaviour, in turn, affects economic conditions. Business actions of companies impact employment, investment, and economic growth. Research and development investments drive technological advancements and productivity gains, stimulating economic expansion. Companies prioritise sustainability and social responsibility, contributing positively to environmental and social outcomes, thereby shaping the economic landscape.

4. How economic factors influence earnings management

4.1. Preparation of financial statements involves making discretionary choices (i.e. management judgement) regarding accruals and impairments when valuing inventory, financial assets, receivables, goodwill, etc. These judgements, such as adjusting economic forecasts in expected credit losses, have the potential to alter reported financial results and present a different picture of the company's financial health.

4.2. Management may be motivated to manage earnings upwards to meet the conditions of their compensation contracts (to secure a performance-based bonus), to boost their reputation, or to avoid being ousted for poor performance. They may also be motivated to manage earnings downwards, for example to set a lower base in their initial year to facilitate future earnings growth, or to report all adverse effects within one reporting period when a bonus is already unlikely, in order to make it easier to rebound in the future.

4.3. Earnings management encompasses a broad range of activities. It includes activities that are permissible within the financial reporting framework set out by the Hong Kong Financial Reporting Standards (**HKFRS**); it also includes earnings management that misleads financial statement users and is impermissible as it would compromise the financial reporting quality.

4.4. In extreme cases a company's management may intentionally provide misstated information by violating the requirements of the applicable financial reporting framework. Such actions constitute financial fraud. They include:

i. Manipulation, falsification, or alteration of accounting records

ii. Misrepresentation, or intentional omission in the financials

iii. Intentional misapplication of accounting principles

4.5. Empirical research based on a survey of CFOs of public companies shows that an estimated 20% of companies engage in some form of earnings management to misrepresent their economic performance in any given reporting period. "*CFOs feel that most earnings misrepresentation occurs in an attempt to influence stock price, because of outside and inside pressure to hit earnings benchmarks, and to avoid adverse compensation and career consequences for senior executives.*"[24] A typical misrepresentation for these firms results in an estimated 10% change in reported earnings per share. Around 60% of instances of earnings management increases the company's income, and 40% decreases it.

4.6. A recent study of banks[25] shows that the occurrence of earnings management, and specifically income smoothing, significantly increased during the Covid-19 pandemic (2020-21). The same research also showed that "*the presence of high-quality audit is a limiting factor on the incidence of earnings management in the face of crisis*."

4.7. A similar phenomenon was observed among mainland China's A-share listed companies.[26, 27] The Covid-19 pandemic intensified earnings management, especially among companies with a higher degree of financial constraints.

24 I. Dichev et al. (2013) Earnings quality: Evidence from the field Journal of Accounting and Economics

25 D. Taylor et al. (2023) COVID-19 pandemic, a catalyst for aggressive earnings management by banks? Journal of Accounting and Public Policy, Vol. 24, Iss. 1

26 H. Yan et al. (2022) How does the COVID-19 affect earnings management: Empirical evidence from China Research in International Business and Finance, vol. 63

27 A. Aljughaiman et al. (2023) The COVID-19 outbreak, corporate financial distress and earnings management, International Review of Financial Analysis, vol. 88

4.8. Research also shows[28] that companies facing higher levels of uncertainty tend to opportunistically manage earnings downwards, while the opposite is true in calmer times. Income-decreasing earnings management in times of greater uncertainty is more common when the CEO's compensation depends on the value of the company's stock and options.

4.9. Which strategies companies use depends on the management's motivation and probability of being detected. The most frequent motivation behind earnings management is the management's compensation and meeting or exceeding analysts' forecasts. If such motivation exists, the auditor should maintain heightened professional scepticism to ensure the integrity of the financial statements.

5. How economic factors influence auditors' actions

5.1. Economic factors are not only reflected in financial reporting practices, through accounting estimates and disclosures requirements (see section C), they also directly impact how auditors identify and assess the risk of material misstatement and the development of audit procedures to respond to those risks (see section D).

5.2. There are positive indicators suggesting that some auditors exhibit greater caution during periods of economic uncertainty. Some studies indicate that auditors adjust their audit procedures and assign more experienced personnel (senior auditors, audit managers and partners) to audits at such times.[29] Moreover, research also indicates that auditors increase their reliance on non-financial data and information as supporting evidence when assessing audit risk during periods of economic uncertainty.

5.3. Conversely, other studies indicate that higher levels of macroeconomic uncertainty are associated with lower audit fees. Market-wide uncertainties can provide companies greater leverage over auditors during fee negotiations.[30] The level of audit fees not only impacts the audit firm's profitability but can also influence audit quality.

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28 L. Stein and C. Wang (2016) Economic Uncertainty and Earnings Management Harvard Business School

29 A. Abdelmoneim and E. Haitham (2020) Investigating the impact of macro-economic changes on auditors' assessments of audit risk: a field study Journal of Applied Accounting Research

30 J. Chen et al. (2019) Macroeconomic Uncertainty and Audit Pricing Accounting Horizon

5.4. Based on the results of a survey of PIE auditors conducted by the AFRC[31], the top three areas where PIE auditors indicated that audit fees will impact audit quality are: sufficiency of compensation and benefits to retain staff (89.6%), level of people resources deployed in audit engagements (77.1%), and investment in staff training and development (75.0%). Given that PIE auditors in Hong Kong are contending with a landscape of stagnant audit fees, heightened pressure on audit fees could strain their resources further, potentially resulting in inadequate allocation of resources to audits, and posing risks to audit quality.

5.5. Conversely, economic uncertainty could increase the complexity of audits, particularly in the assessment of the appropriateness of going concern assumptions and impairment of assets, making them more challenging. Additional audit procedures may therefore be required, necessitating request for additional audit fees.

5.6. As highlighted in paragraph 4.2, management may adjust earnings upwards or downwards based on their motivations. Therefore, the auditor is required to obtain an understanding of the entity and its environment, plan the audit, and maintain appropriate professional scepticism throughout the audit. We will cover this in detail in section D.

31 AFRC (2024) Report on the Analysis of the Public Interest Entity Audit Market in Hong Kong

Section C
Economic factors and their impact on accounting estimates

6. Impact of economic factors on accounting estimates

6.1. Economic factors not only affect management decisions and business strategy, but also the accounting estimates the management makes when preparing financial statements. Below, we aim to describe how market conditions can affect the assessment of these estimates and highlight accounting standards that are more likely to be impacted.

6.2. In this section we present examples to demonstrate how prevailing market conditions can lead to changes in the accounting estimates. These examples are not exhaustive but are intended to illustrate considerations for management and auditors. While these scenarios may not precisely reflect the unique circumstances of every company, they highlight important factors to consider when assessing if an accounting estimate is well supported by evidence.

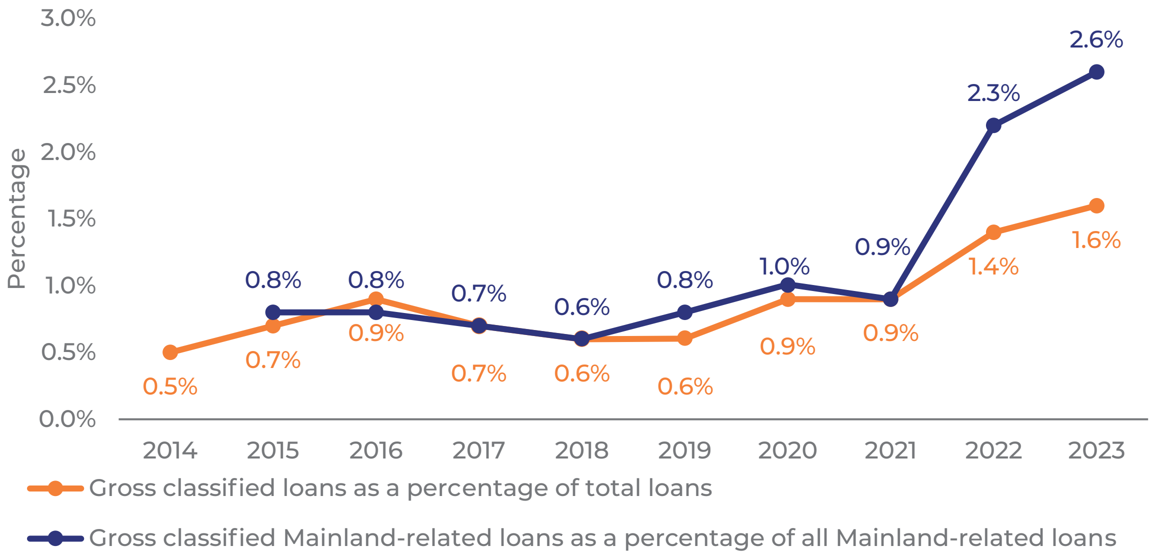
7. Expected credit loss (ECL)

7.1. In the current economic climate, the challenging credit landscape necessitates companies to exercise prudent credit risk management. While industry's overall asset quality remained healthy, there is a growing trend in the classified loan ratio indicating a deteriorating asset quality, which may signal an elevated credit risk (see Figure 8).[32]

32 Under the HKMA's loan classification system, loans are to be classified into Pass, Special Mention, Substandard, Doubtful, and Loss. Loans in the substandard, doubtful and loss categories are collectively known as "classified loans". In general, loans on which payments of interest and/or principal are overdue for more than three months and six months should be classified at least as substandard and doubtful respectively. Loss refers to loans which are considered uncollectible after exhausting all collection efforts.

7.2. The classified loan ratio of the banking sector increased to 1.6% at the end of 2023 from 1.4% at the end of 2022, while the classified loan ratio for mainland-related lending rose to 2.6% from 2.2% over the same period. By March 2024, these ratios further climbed to 1.8% and 2.8%, respectively. The increases were mainly driven by the high-interest rate environment and continued weakness in the mainland property market.[33]

Figure 8. Gross classified loans of the banking sector in Hong Kong



Source: HKMA

7.3. Companies should carefully assess their accounts receivable to determine if there are indications of significant increases in credit risk since initial recognition, or even credit impairment. Such evaluations are important to credit risk management, and aid in estimating a more representative ECL provision.

7.4. GDP growth, unemployment rate, interest rate, house price index and inflation are the top five commonly used macroeconomic factors for ECL estimation as forward-looking information.[34] Multiple scenarios and estimates are often required, making the process highly subjective, particularly concerning the interest rate, house prices, and their potential impact on GDP growth.

7.5. When new information emerges, such as a reduction in the interest rate, economic scenarios forecasts and their associated probabilities must be updated, possibly resulting in a revised ECL provision.

33 HKMA (2024) 2023 Annual Report
34 European Securities and Markets Authority (2021) On the application of the IFRS 7 and IFRS 9 requirements regarding banks' expected credit losses (ECL)

8. Fair value measurement

8.1. Valuation techniques used to measure fair value shall be applied consistently. However, a change in valuation technique is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Such a change may be warranted if market conditions shift.

8.2. A quoted price in an active market provides the most reliable evidence of fair value. However, current quoted prices may not be available in case of illiquid assets. This becomes relevant for private assets, thinly traded stocks and bonds, and those that trade over the counter. Liquidity may disappear during times of dampened market sentiment, for example during prolonged periods of high interest rates.

8.3. The volume of stock trading on the Stock Exchange of Hong Kong has been declining in the past two years. Bond markets are more susceptible to liquidity challenges, as certain corporate bonds and other debt instruments, such as asset-backed securities, may trade infrequently.

8.4. When the quoted price does not represent fair value, as may happen during a significant decrease in the level of trading activity, an adjustment to the quoted price is necessary. In such circumstances, it would be advisable to employ an alternative valuation technique that provides a more accurate fair value.

8.5. While stock trading volume provides a rough indication for debt instruments and other over-the-counter securities, it also offers insights into overall market sentiment which can impact the trading volume of these instruments.

8.6. It is crucial that any change in valuation technique should be grounded in a valid rationale to better capture fair value measurements. Unjustified alternations in valuation techniques are not acceptable.

8.7. Similarly, the challenges in fair value measurement extend to property, plant, and equipment, as well as investment properties, for those entities opting for the revaluation model and fair value model, respectively.

9. Impairment of assets

9.1. Hong Kong Accounting Standard **(HKAS)** 36 Impairment of Assets states that a decrease in market interest rates may indicate a need for reversing an impairment loss previously recognised for an asset other than goodwill. Given the expected decrease in interest rates, it is essential to stay vigilant and thoroughly assess whether such a reversal is necessary.

9.2. Conversely, significant changes in the technological, market, economic, or legal environment in which the company operates may adversely affect the company and lead to asset impairment.

9.3. Sales volume and prices of residential building units in Hong Kong and mainland China have been on a downward trend in recent years, as discussed in subsection 2. The trend may suggest that potential impairment of the properties is needed. However, a comprehensive assessment should be conducted, taking into consideration factors such as the size, location, age, and condition of the properties. Similarly, other assets should also be evaluated if there are any indicators requiring impairment assessment.

10. Going concern assessment

10.1. In accordance with HKAS 1 Presentation of Financial Statements, "*an entity shall prepare financial statement on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.*"

10.2. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the going concern basis of accounting is appropriate. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.

10.3. The economy of Hong Kong has continued to recover after the pandemic, however, some companies, especially small and medium-sized enterprises, are still facing challenges in their business operations amid uncertainties in the external and local economic environment. There has been a recent increase in the classified loan ratios, as highlighted in subsection 7.

10.4. The HKMA has introduced measures for banks not to demand early repayments from mortgage customers repaying on schedule, and a six-month transition period for cases requiring adjustment of credit limits.[35] The increase in classified loans suggests that companies evaluate their own abilities to sustain operations in the current credit tightening environment. This evaluation is crucial in deciding if it is still appropriate to prepare the financial statements on a going concern basis.

10.5. A research study has shown that receiving a going concern audit opinion can lead to an increase in the cost of equity due to the higher perceived risk, prompting investors to demand a higher rate of return.[36] Another study has also shown that cost of equity can increase by as much as 5.7% for firms that receive a going concern opinion for the first time.[37] Despite that, the management should always prepare accounts on an accurate going concern basis.

35 HKMA (2024) HKMA and HKAB set up joint Taskforce on SME Lending [Press Release]

36 D. Yulfa et al. (2019) Impact of Going-Concern Audit Opinion on Cost of Equity with Institutional Ownership as Moderation, Advances in Social Science, Education and Humanities Research, vol 348

37 K. Amin et al. (2014) Going Concern Opinion and Cost of Equity, AUDITING: A Journal of Practice & Theory

Section D
Auditor's responsibilities in the context of current economic conditions

11. The necessity of understanding the audit entity and its environment

11.1. An auditor is required to obtain an understanding of the audited entity and its environment, the applicable financial reporting framework and the entity's system of internal control in accordance with Hong Kong Standard on Auditing (**HKSA**) 315 (Revised 2019) Identifying and Assessing the Risks of Material Misstatement. This understanding includes the entity's business model, market dynamics, demand and supply, economic conditions (interest rates, inflation, availability of financing) and internal and external measures used to assess its financial performance.

11.2. This understanding assists the auditor in recognising the events and conditions that are relevant to the entity, and in identifying and assessing how risk factors affect the risk of misstatement in the financial statements. Such information establishes a frame of reference to assist in planning the audit, and in exercising professional judgement and professional scepticism throughout the audit. Details are provided in subsection 12 and 13, respectively.

11.3. The outline of the current economic environment and outlook provided in section B and C of this report, covering factors such as GDP growth and the economic cycle, interest rates, inflation, real estate prices, international trade, etc., benefit both management and auditors in their respective roles.

11.4. As underscored in section B, the way an entity measures its financial performance might exert pressure on management to achieve performance targets. Such pressure may motivate the management to use earnings management techniques which increases the risk of a misstatement. It is important for auditors to understand an entity's measures of financial performance, as it helps the auditor evaluate the extent of such risk.

12. Planning an effective audit based on the evolving economic conditions

12.1. In its publication "*Audit focus Effective Planning: The Key to High-Quality Audits*," the AFRC emphasises the importance of audit planning. "*Effective audit planning is fundamental for ensuring a high-quality audit. It is of paramount importance as it enables auditors to focus their efforts on identifying and addressing areas where potential risks or issues are most likely to arise*."[38]

12.2. Inadequate audit planning has been identified as a common root cause in our inspection findings. This deficiency could lead to failure to identify areas of higher risk, inadequate design of audit procedures to address them, or insufficient allocation of time and resources to address potential audit issues, ultimately impacting audit quality negatively.

12.3. Thorough planning entails strategic allocation of resources to specific audit areas. This may involve deploying experienced team members to high-risk areas or assigning experts to address complex matters effectively.

12.4. Areas of higher risk of material misstatement contain elements that are complex, subjective, subject to change, uncertain, or prone to misstatement due to management bias. Accounting estimates that are based on various economic factors, like those captured in section C of this report, often involve one or more of these elements and result in a higher risk of material misstatements, requiring seasoned team members who could apply heightened professional scepticism during audit execution.

12.5. As part of the planning process, the auditor shall determine the need to involve experts from non-accounting or auditing fields to acquire sufficient and appropriate audit evidence. This includes expertise in evaluating underlying assumptions and methods used by management in making accounting estimates, especially in the valuation of complex financial instruments, land and buildings, plant and machinery, intangible assets, liabilities assumed in business combinations and assets that may have been impaired. Further details can be found in subsection 14.

38 AFRC (2023) Audit Focus Effective Planning: The Key to High-Quality Audits

12.6. Planning is not a discrete phase of an audit, but rather a continual and iterative process. Therefore, the auditors must continuously reassess economic conditions and the underlying factors throughout the audit, taking into account how they evolve and what implications they have on accounting estimates. We also re-emphasize the importance of early involvement by engagement partners and engagement quality reviewers in this process.

13. The importance of professional scepticism in obtaining sufficient audit evidence for accounting estimates

13.1. The auditor identifies and assesses risks of material misstatement to determine the nature, timing and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence from the events occurring up to the date of the auditor's report. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

13.2. As noted in paragraph 12.4, accounting estimates that are significantly impacted by economic factors could be prone to a heightened risk of material misstatements. In assessing these accounting estimates, auditors need to apply greater professional scepticism in obtaining sufficient appropriate audit evidence.

13.3. The AFRC 2023 Annual Inspection Report[39] highlights key audit risk areas with recurring high deficiency rates. These problematic spots include the assessment of ECL of financial assets and impairment assessment of non-current assets, with deficiency rates of 80% and 73%, respectively. In both areas, the deficiencies were commonly attributed to over-reliance on management's subjective assessment without exercising necessary professional scepticism to scrutinise the potential management bias and independently obtain sufficient audit evidence.

13.4. In a specific inspection finding, the management showed optimism bias in growth forecasts related to assets impairment assessment, by exceeding economic growth without sufficient supporting evidence. This highlighted situations where auditors may have failed to leverage on a proper understanding of the economic factors to critically challenge management in making such assumptions when formulating accounting estimates.

39 AFRC (2024) 2023 Annual Inspection Report

13.5. In addition to our inspection findings, the AFRC identified key areas of potential misconduct by PIE auditors. Insufficient appropriate audit evidence was observed in 83% of investigations and inquiries initiated by the AFRC for the year ended March 2024.[40] This highlights the need for audit teams to address this pressing issue to ensure that sufficient evidence is obtained before issuing the auditor’s report.

14. The auditor’s responsibility when engaging experts in testing accounting estimates

14.1. If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate evidence, the auditor shall determine whether to use the work of an auditor’s expert. If it is decided that an auditor’s expert will be used, the auditor shall evaluate whether the auditor’s expert has the necessary competence, capabilities and objectivity for the auditor’s purposes.

14.2. When using the work of an auditor’s expert, the auditor shall also evaluate the adequacy of the auditor’s expert’s work. The auditor has sole responsibility for the audit opinion expressed and that responsibility is not reduced by the use of the auditor’s expert.

14.3. In its 2023 Annual Inspection Report[41], the AFRC noted an improvement in the use of auditor’s experts compared to the previous year; however, 35% of the inspected PIE engagements still showed deficiencies in this area. This may suggest that many PIE auditors continue to over-rely on experts and may have the misconception that the responsibility for obtaining sufficient evidence has been transferred to the expert. Such transfer of responsibility should be strictly prohibited.

14.4. Applying professional scepticism to the expert’s work is necessary, especially in areas involving high complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias. Auditors must thoroughly evaluate the expert’s work to identify any biases or limitations that could undermine the expert’s work.

40 AFRC (2024) 2024 Annual Investigation and Compliance Report
41 AFRC (2024) 2023 Annual Inspection Report

Section E
Conclusion

15. Call to action for key stakeholders

Boards of directors and senior management

15.1. In accordance with the Companies Ordinance, it is the duty of the directors to prepare the financial statements and to exercise reasonable care, skill and diligence in doing so. Hence, the financial statements must be prepared and presented fairly, ensuring they do not mislead users.

15.2. Senior management should use reasonable and well supported evidence in making accounting estimates to ensure fair representation of the company's financial conditions in its financial statements. Proper oversight by the directors is also expected to ensure compliance with the Companies Ordinance.

Auditors

15.3. Audit firms' leadership should set and reinforce the right tone at the top that fosters a culture of ethical behaviour, integrity and commitment to audit quality, especially during periods of economic uncertainty.

15.4. Auditors should analyse current economic factors and incorporate them into risk assessment and audit planning process. However, such analysis is not limited to the planning stage and should continue throughout the audit. Early involvement by engagement partners and engagement quality reviewers in this process is crucial.

15.5. Auditors should always remain vigilant and maintain professional scepticism in obtaining sufficient audit evidence, regardless of the economic environment.

15.6. Auditors should determine whether there is a need to engage an auditor’s expert. If an expert is used, the auditor must evaluate the adequacy of the expert. The auditor has sole responsibility for the audit opinion expressed and that responsibility is not reduced by the use of the auditor’s expert.

15.7. Auditors should maintain open, transparent, and timely communication with audit committees to ensure audit procedures on significant accounting estimates are properly reported.

Audit committees

15.8. Audit committees should challenge both management and the auditors in their assumptions and audit procedures when preparing and auditing financial statements, respectively, especially in considering current economic factors.

15.9. Audit committees should evaluate the auditor’s assessment of their utilisation of auditor’s experts and analyse the limitations of the experts’ work along with their mitigating measures.

Contacts

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