Macroeconomics for audit leaders

A highly valued internal audit function, providing insightful assurance and advice, understands its organisation and the environment in which it operates. Effective audit leaders are more than skilled professionals in governance, risk management, and internal control; they are also consultants, analysts and economists.

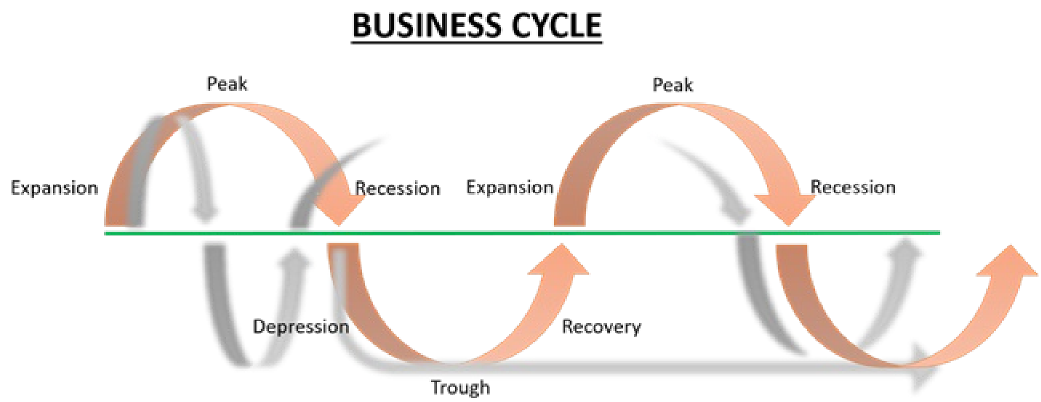
Having a basic understanding of economics is intrinsic to identifying and managing risk; never more so than in challenging times. Even before COVID-19 became a stark reality, the global economy was slowing down in 2019. On average the business/credit cycle of prosperity through to recession lasts about seven years; the financial crisis was 2008.

Macroeconomics is the study of the behaviour of the economy as a whole. This is different from microeconomics, which concentrates more on individuals and how they make economic decisions. While microeconomics looks at single factors that affect individual decisions, macroeconomics studies general economic factors. It is about the characteristics, trends or conditions that apply across all sectors rather than specific segments.

This short piece of thought leadership aims to demystify the complex macroeconomic levers that decision-makers contend with in the boardroom.

Economic cycles and events

The start point for audit leaders is listening to a variety of commentators and reading quality journalism to recognise where a country is in the generic economic cycle and what stage is most likely to be next. Major events such as the financial crisis and coronavirus pandemic disrupt normal cycles; often pushing global economies rapidly into recession. Recoveries can be U, V or L shaped depending on the nature of the recession; some economists are predicting a quick V shape post-coronavirus, others a longer U shape. You may also be interested in our thought leadership on the role of internal audit at the start of a recession.



There are different pressures on the board during each phase, so would it be reasonable for them to have different expectations of the assurance provided by their internal audit function?

Audit leaders need to adapt to maintain relevance throughout the economic cycle. There is always a risk, heightened during downturns, that a function not perceived to be adding value will be reduced in size or outsourced.

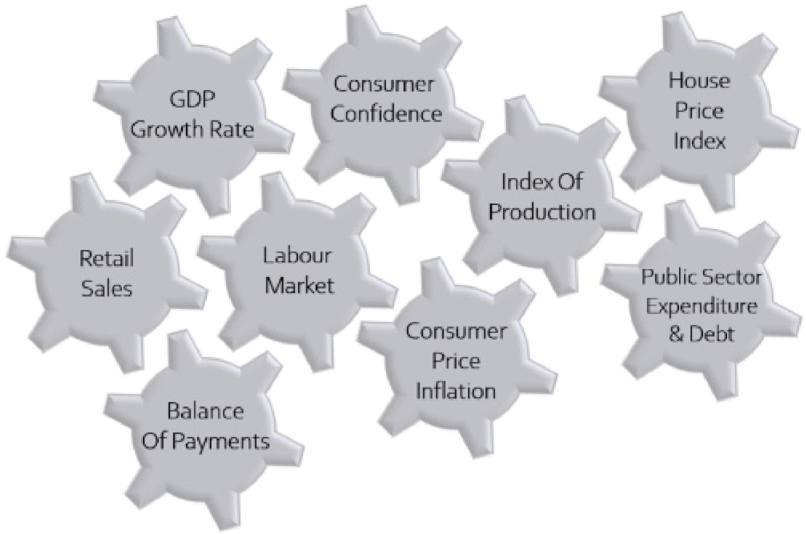
Broadly speaking, in good times the board will have the time and mental capacity to engage with a variety of topics, initiatives and debates over and above the normal agenda. Once the tide turns however, they are likely to entrench into basic survival focusing on cost and resilience.

Macroeconomic risk can arise from changes in economic policies such as the decision not to join the Euro or from other events like a pandemic, leadership change or civil unrest. There is a close relationship between these risks as the broad external considerations that form part of strategic thinking under the well-known acronym PESTLE: political, economic, social, technological, legal, and environmental.

Which levers to watch?

There are a wide variety of economic indicators from unemployment rates, bank lending and government spending through to interest rates, commodity pricing, car production and hospital beds. Indicators such as food inflation will have standalone importance to individual organisations; macroeconomic factors sit above these.

There are ten key factors for the UK economy which are summarised with links to data sources at the end of this article.



Avoiding the extremes of the boom/bust cycle is the goal of governments through four basic objectives. Although, their interconnectivity creates tension which makes achieving all of them very difficult.

Objective	Interconnection and tension
Low Unemployment	Low unemployment and low inflation have an inverse relationship, Norman Lamont, a Conservative Chancellor in the 90s said "unemployment is the price worth paying for lower inflation "
Price Stability	Quick economic growth due to high consumer spending can cause supply and demand issues increasing prices. This was seen in some goods during the coronavirus panic buying when the grocery industry self-regulated with price capping. Uncontrolled how much would a packet of toilet rolls have reached?!
Sustainable Economic Growth	High interest rates to limit inflation also restrict growth by limiting spending and investment. A new consideration is the relationship between sustainable growth and the environment. Higher levels of production, goods, services and infrastructure lead to more pollution and waste. Acknowledging the climate crisis, sustainable from an economic perspective must now also consider environmental sustainability.
Balance of Payments Equilibrium	UK consumers have traditionally preferred imported products which during growth periods increases the trade deficit (balance of payments). Solutions could include Devaluing Sterling to make imports more expensive thereby curbing spending but it also causes inflation to rise. Trade tariffs could be introduced but not easily due to existing agreements and maintaining longer term relationships. Increasing tax and reducing government spending also deflate the economy. However, these measures lead to reductions in living standards and low economic growth.

Over recent years, balance of payments has lessened as an economic imperative. However, with increasing geopolitical instability predicted for the 2020s, its importance could increase as it influences power in trade wars and export negotiations. The UK and the US have been in deficit for years while Japan has maintained a surplus. Meanwhile, China's dominant surplus due to goods exported is slowly reducing.

The environment in which organisations and internal audit operates is increasingly volatile and complex. Understanding how the levers impact your organisation can help provide timely and relevant assurance to support the board as they navigate the uncertainty and ambiguity associated with strategic decision making.

Monitoring trends and being sufficiently astute to recognise early warning indicators means that internal audit is not reliant on management to identify the internal risks but is proactive in providing real-time assurance regarding external risks. For example, internal audit leaders should maintain current knowledge of the labour market if their organisation has a high staff turnover, reliance on skilled workers from overseas, pursuing a talent diversification strategy or operates in multiple geographies; all of these elements may highlight a myriad of external risk factors.

Audit leaders in the public sector will be highly cognisant of this as government spending is the source of departmental budgets which were significantly impacted by the austerity measures following the financial crisis.

Auditing macroeconomic risk

Macroeconomic risk is not technically auditable as it is external to the organisation. What is auditable is how the organisation identifies and manages the potential threats and opportunities that macroeconomic risk presents.

Internal auditors need to have sufficient training and guidance within their function to consider macroeconomic factors at the scoping stage of an audit engagement in the same way as they would look at other data sources such as legislation and regulations to inform their thinking. Horizon scanning that encompasses macroeconomic factors both today and, in the future, will enable internal audit to create a realistic and relevant strategic plan.

The risk to the organisation of interest rate changes would be of paramount importance to an audit of the treasury function but is also influential when reviewing property management in respect of landlord negotiations. There will be macroeconomic considerations within most audit engagements to a lesser or greater extent; taking a risk-based approach to engagement scoping will maintain proportionality.

Here are some examples:

- Assurance that the process the board uses to review and communicate its risk appetite is comprehensive, timely and has access to accurate information is an important audit engagement. One of the key inputs will be macroeconomic factors and how they are interpreted which internal audit can form an opinion on.
- Listed companies are required to publish a viability statement, macroeconomic factors will feature within the assumptions and modelling that is used to derive the statement. Auditing the process to produce the statement is within the remit of internal audit although care should be taken to avoid duplication with the external audit team.
- Macroeconomics influences strategy, risk appetite, investment options and other board decisions; an audit of board effectiveness should review the reliability of sources of information to ensure that group think, political affiliations and other bias are avoided.
- Changes to trade policies, tariffs and protectionism, invariably lead to increased costs. The board

may require assurance that supply chain adaptions are progressing at pace or costs are being effectively managed.

- Broadly, all supply chain assurance should acknowledge macroeconomic risks and the organisations management of them; exchange rates, duties and tax are as influential in decision making as risks concerning modern slavery and bribery and corruption which are now stalwarts on the audit plan.
- Independent assurance that the forecasting process is comprehensive may be of value to the board, evidencing that macroeconomic factors are fully evaluated. This is particularly relevant as economies enter and exit downturns to reflect the extent of being able to withstand a recession or capitalise on growth. Considerations should be all encompassing such as return-on-investment assumptions, disruption from third-party failures/new entrants and financial leverage – risk of debt default/access to funds.
- All audit engagements related to products and services, from design through to inventory control, price management, competitor monitoring and costing, should include assurance over the adequacy of understanding and response in respect to macroeconomic risks.
- Labour market volatility due to geo-political factors such as Brexit and civil unrest may exacerbate localised issues and lead to skill shortages or hinder attracting talented overseas individuals. Internal audit can include assurance on the organisation's response to macroeconomic factors in any recruitment, workforce planning or talent management audit engagements.

Macroeconomics	
Factor	**Explanation and Information Source**
GDP growth Rate	The ONS (Office of National Statistics) issues estimates on GDP on a monthly and quarterly basis. GDP is the monetary value of all finished goods and services made within the UK during a defined period of time. This is the main indicator of economic growth, as it captures the total value of everything within the country from shoes to haircuts. There are four main sectors contributing to the economy: agriculture, construction, production, and services. Two consecutive quarters of negative GDP constitute a recession.
Labour market	The ONS issues a monthly Labour Market Overview. Key data on the employment market in the UK, such as the net change in employment, unemployment rate, economic inactivity, claimant count, average weekly earnings, labour productivity, and vacancies.
CPI index	The ONS releases monthly reports on the Consumer Price Inflation Index and Producer Price Index. The CPI is constructed by comparing the changes over time in the cost of a fixed basket of goods and services purchased by consumers. The CPI is the inflation measure used in the British government's target for inflation and is also used for indexing pensions, as well as wages and benefits.
Balance of payments	The ONS summarise the economic dealings of the UK with the rest of the world on a quarterly basis. Balance of payments has a significant bearing on the value of Sterling. The UK has run a combined current and capital account deficit every year since 1983, meaning that it is a net borrower from the rest of the world. It takes into account UK trade in goods and services, as well as income, current and capital transfers, and transactions in UK external assets and liabilities.

Household expenditure	The quarterly Consumer Trends report from the ONS reflects price and volume. Household expenditure measures the contribution of households to economic growth and accounts for some 60% of the expenditure measure of the UK's GDP. While 'current prices' shows the value of household spending in a given quarter, the 'volume terms' adjusts for price inflation, providing a more accurate picture of whether households are actually buying more goods and services.
Retail sales	A monthly report on retail sales by the ONS shows changes in sales activity compared to the previous month and the previous year. The data is from a survey of 5,000 retailers, including all those employing at least 100 people. The report defines contributions based on four sectors; food stores, non-food stores, non-store retailing and petrol stations.
Index of production	The ONS provides monthly estimates of the Index of Production for the UK's production industries, which account for close to 15% of GDP. The Index of Production is one of the earliest indicators of growth, measuring output in manufacturing, mining and quarrying, energy supply, water supply, and waste management industries. Index values are referenced to 2011, which means that an index value of 115 would indicate output is 15% higher than the average for 2011. Estimates are based on a monthly survey of about 6,000 businesses across the UK.
GfK consumer confidence	Consumer confidence in the UK is obtained from the findings of the GfK Consumer Climate Europe survey. The survey is completed by research firm GfK—Growth from Knowledge—in all EU countries on behalf of the European Commission. There are five key indicators: economic expectations, price expectations, income expectations, willingness to buy, and propensity to save.
Halifax house price index	This is the UK's longest-running monthly house price series, with data for the entire country from January 1983 to present. The index is named after the UK's largest mortgage lender, a subsidiary of Lloyd's Banking Group Plc. These data are used to calculate a standardised house price, with the annualized change computed as an average for the latest three months (to smooth out short-term fluctuations) compared with the year-earlier period. Changes in house prices are provided on a national and regional basis.
Public sector expenditure and debt	Data on public sector expenditure, receipts, investments, borrowing, and debt are reported in the monthly *Public Sector Finances* statistical bulletin from the ONS. These figures enable the evaluation of the UK government's fiscal position.

Questions to consider

1. Would you consider yourself to be reasonably well informed about the UK and overseas economies or is this topic a development opportunity?
2. Is there opportunity to discuss and debate broad topics within your internal audit team?
3. How does internal audit stay abreast of changes to economic policies?
4. Could macroeconomics be a quarterly agenda item on the team meeting? Maybe invite guest speakers.

5. COVID-19 has highlighted the fragility of entire sectors; what have you learnt about your own sector?
6. What are the external levers that influence productivity within your organisation?
7. How do the principal risks for your organisation inform you about which macroeconomic factors are most important to monitor?
8. Which roles within the organisation are most likely to be accessing and using macroeconomic data? What relationships does internal audit need to build?
9. When you read your internal audit strategy, is it reflective of the external environment, particularly macroeconomic risk factors?
10. What are you going to do differently having read this?

Closing thoughts

The majority of economists did not predict the 2008 financial crisis; even the experts find the subject of macroeconomics complex and unpredictable. Internal auditors rarely have all of the answers about how specific risks should be managed but internal audit does need to know the questions to ask to provide assurance that the risks are being managed effectively.

"When the facts change, I change my mind. What do you do?"

John Maynard Keynes, Economist