Chief Audit Executive | Economic Outlook for 2023 webcast

February 2023

For Chief audit executives (CAEs) to adapt and succeed in a changing risk landscape, they need to be agile in all aspects of function. Understanding the emerging economic challenges and underlying risk drivers enables CAEs to anticipate faster, respond better, and create value.

The webcast shared a broad view of the U.S. economic outlook for 2023 and how it applies to the risks CAEs should consider when planning for Sarbanes-Oxley (SOX), internal audit, and enterprise risk management in 2023.

The panelists discussed the following topics:

- Reflecting on the current economic state
- Looking ahead at longer-term trends
- Taking risk into account

Reflecting on the current economic state

The ongoing Russia-Ukraine war, elevated market volatility and investors' concerns, multidecade high inflation, geopolitical tensions, and tightening monetary policies have taken a toll on global economic growth projections. Continued supply chain disruptions and declining consumer purchasing power have dampened the hopes of regaining lost ground. While the consensus view seems to lean toward a mild global recession, the following key highlights can enable CAEs to map out some of the challenges and opportunities ahead and prepare for an eventual return to sustainable, long-term growth:

Inflation is cooling

Although inflation is still a continuing problem in the U.S. economy, it is improving:

- For November, the annual rate of inflation—as measured by the Consumer Price Index (CPI)—declined to 7.1 percent compared to 7.7 percent in October.
- Following the good news on inflation falling, the U.S. Federal Reserve (the Fed) raised its key rate by only 50 basis points (bps), contrary to the 75 bps increases in its last four meetings.
- CEOs are expecting 6 percent inflation over the next 12 months, followed by 3.6 percent in the next five years. The Fed has committed to raising rates and holding them higher for longer to bring inflation back to its 2 percent target.

- The Fed has raised interest rates aggressively in 2022, from 25 basis points in March, then 50 basis points, to 75 basis points four consecutive times, to repress inflation while hoping to avoid a recession.
- Central banks across the globe have also been raising their interest rates to keep up with the Fed.

The currency crisis

It's been carnage for foreign currencies across the globe due to a sharp appreciation in the U.S. dollar:

- Despite the dollar's strengthening, the Brazilian Real and the Mexican Peso are the only two currencies that have outperformed the developed nations and other emerging markets in 2022. One of the key reasons is their faster response from their respective central bank policies—they didn't hesitate to raise interest rates in anticipation of Fed interest rate hikes, which attracted foreign investment into their countries via a positive rate differential.
- The Japanese Yen is among the most stable currencies in Asia. However, it dropped to its lowest—close to 19 percent against the dollar—which comes as Japan's central bank holds off on raising interest rates. Besides its key policy rate being close to 0 percent, the Japanese government bonds (JGBs) are also targeting close to 0 percent long-term yields, hence losing out due to widening interest rate differentials and more attractive rates of return elsewhere.

On path for a mild, short-lived recession

Economic growth is expected to slow below the economy's potential rate of growth. Employment is expected to stall and lose ground as we get into 2023:

- The combination of persistently high inflation and monetary policy tightening is likely to push the U.S. economy into a mild recession. The anticipated recession will not be as severe as the COVID-19 recession or the 2008 global financial crisis; however, it is likely to cause the U.S. GDP to contract by 2 percent in the first half of 2023.
- Empirically, it's not a good omen when yield curves invert. With the inverted yield curve signaling an economic slump in the first half of 2023, investors are also bracing for additional interest hikes in the first and second quarters of 2023.
- Despite the anticipation of a worldwide recession, not all countries will see negative GDP growth in 2023. India and Vietnam's GDP are expected to grow positively, at 6 percent or more. With China relaxing its zero-COVID-19 policy, its economy is also expected to grow at 5 percent. However, developed economies are stalling, particularly in Europe, as high energy prices act as a key constraint. The UK is already experiencing a recession. Germany is expected to enter recession in early 2023 and the U.S. is expected to enter one as well.

The labor market trends

While a weakening economic environment is likely to see a fall in job vacancies, the labor market could remain relatively tight than otherwise should companies continue to hoard labor. That's one of the key reasons why the U.S. is not in recession yet:

- Although the job market is slowly cooling off, the current job opening rate remains quite high. The labor market disconnect in the U.S. has been mounting—as businesses have reopened following COVID-19, employers are scrambling to find workers to fill the open roles. While there are currently 10.3 million job openings in the U.S., the unemployment rate remains low at 3.7 percent, which is equivalent to 6 million unemployed.
- Weak labor force participation rate is one of the key contributing factors to labor scarcity in the U.S. economy, leading to higher wage rates. Accelerated retirements of baby boomers (people between 58 and 76 years of age)—which amounts to 70 million people in the U.S. economy—is also heavily influencing labor-market dynamics.
- Long COVID has exacerbated staffing shortages, preventing nearly 500,000 to 4 million people from working. Employees absent from work due to childcare issues (such as RSV and flu) are four times higher than before the pandemic.
- High inflation is putting upward pressure on wages, and employers are aggressively resetting their pay strategies to retain workers. However, inflation is still outpacing wage increases.

- Data from Automatic Data Processing shows that the wage gap between those who stay and those who switch jobs has widened since the beginning of COVID-19. The average annual income rise for job switchers is roughly 15.1 percent, which is 8 percent more than the wage hike for job stayers (7.6 percent). The Fed is seeking to tamp this down by raising interest rates. The unemployment rate is expected to cross 5 percent by year-end in 2023 and 5.5 percent before inflation fully cools.
- According to the KPMG Economic Insights on Inflation Survey, one of the most highly regarded cost-saving levers for companies—to reduce the costs associated with employee turnover—is investing in labor-saving technologies and programs. Adopting remote work and outsourcing personnel can also help lower labor costs.

Mounting pressure on household finances and business margins

Long periods of high inflation tend to distort the behaviors of households and firms—reducing households' purchasing power and increasing the cost of business operations while leading central banks to tighten monetary policies.

- Households:
  - U.S. household net worth suffered a record drop in second quarter of 2022, down $6.3 trillion, due to a decline in equity markets. For 2022 so far , net worth is down a combined $6.8 trillion, having lost ground in all three quarters.
  - Checking account balances have dropped sharply for the lowest income quintile. These households are facing significant financial stress as they have a relatively small financial buffer, for which higher-costing food and gas, especially in 2022, represent a large share of their expenditure basket.
- Corporate:
  - As inflation hit the economy, corporations were able to raise the prices of their finished goods and services. As a result, their profit margins soared to their highest since the 1950s, reaching 15 percent to 16 percent over the past few quarters. However, as we expect the economy to go into recession next year, business profits are likely to take a hit. Certain industries, including technology and large retailers with excess inventory are already feeling the hit.
  - As the Fed reduced interest rates and other capital costs in the early COVID-19 phase, corporate debt increased dramatically, but not as rapidly as household debt burden, which is in a better position. Corporations took advantage of the situation and borrowed at low yields. However, businesses that could not take advantage of the low interest rate environment are facing much higher capital costs if they need to roll over maturing debt in 2023.
  - Bond market volatility is now the highest since the global financial crisis because of the combined effect of the Fed's reducing its balance sheet and hiking interest rates. This is a concern as the U.S. Treasury market is the most liquid sovereign bond market in the world. The 10-year yield has risen above 4 percent recently, and it certainly doesn't feel good from a borrowing perspective. However, this is a good time for corporations to think about budgeting for capital expenditures in the upcoming year as KPMG Economics believes the 10-year yield could peak around 4 percent within the next two quarters.

Looking ahead at the longer-term trends

- **Supply-chain frictions:** Pressures on global supply chains have eased since their peak late last year, despite the setbacks caused by the Russia-Ukraine war. Major California ports' backlog of vessels is slowly recovering. At the peak of COVID, there were 130 vessels waiting, which have now been reduced to about 50 vessels. However, there is still room for improvement in terms of supply-chain considering the pre-COVID norm was only three to five vessels. With narrowing wage advantages in China and South-east Asia and increasing supply-chain resilience, many companies are considering reshoring. The 2021 estimate for the ratio of U.S. to China manufacturing is only five dollars now, compared to 34 dollars in 2000, allowing companies to reassess economic advantages to offshoring.
- **Demographic and occupational outlook:** The United States' population is aging, and by 2030, nearly a quarter of the population will be over the age of 65. With an aging population and an elevated need for healthcare and caregiving

facilities, nursing practitioners are at the top of fastest growing occupations in coming decade as per the U.S. Bureau of Labor Statistics. This is followed by green energy, data scientists, and information and cyber security jobs.

- **New business formation surged:** Despite the economic uncertainties, new business formation is still going strong. Retail, professional services, and constructions are among the top industries where new businesses are being created rapidly.

Key focus areas for CAEs

- Elements to consider as part of SOX planning include:
  - Impact on all estimates, assumptions, and forecasts as a result of the dynamic variables impacting interest rates, inflation, inventory valuation, Forex, and receivables collectibility, etc.
  - Changes in process with respect to technology, automation, offshoring, and outsourcing, particularly to overcome labor shortages
  - Impact of supply-chain disruption on revenue recognition and inventory
  - Continued focus and monitoring of fraud risks—periods of volatility make it easier to disguise fraud schemes
  - Impact of headcount turnover, unfilled positions, and temporary absences.
- Internal control over financial reporting predictions for the 2022–2023 fiscal year-end show a sharpened focus on:
  - Revenue, including reserves and price/delivery modifications
  - Inventory existence and valuation, particularly net realizable value given the increased costs related to inventory
  - Cyber and associated threats
  - Cloud and third-party outsourcing
  - Increased demand for environmental, social, and governance (ESG) transparency and consistency and reliability of ESG metrics
  - Controls around acquisitions and transactions
  - Estimates, including cash flow and forecasts.

Taking risk into account

The economic outlook underscores the value of better risk assessment capabilities. CAEs and Internal Audit (IA) play a crucial role as a strategic adviser—helping to identify the right risks and perform the right audits that achieve the mission of IA and the enterprise, through:

- Assessing risk at a frequency closer to the pace it changes
- Leveraging data and technology like other functions in the organization
- Demonstrating and visualizing audit efforts to protect and enhance business value
- Providing an independent, organization-wide view of risk for agility in approach.

Identifying the biggest opportunity areas for IA to impact organizations

- We live in an increasingly interconnected world today. Interconnectedness gives rise to interdependencies, making our risk landscape inherently more complex and dynamic. It's crucial to think about the interrelation of different risks to create impact through IA.
- Unlike traditional risk assessment, more dynamic risk assessments take a stakeholder-driven view, which gives a greater perspective on what the most critical risks to business strategy are and how these influence key stakeholders.
- It is essential for organizations to consider the economic forecast to identify their potential triggers with respect to various stakeholders and reapply their IA team's focus to make more informed decisions about how to best tackle and monitor these threats and create opportunity.
- Three stakeholders with a high degree of impact from the economic outlook discussed include customers, employees, and third-party providers—each facing economic triggers (e.g., borrowing costs, product costs, staffing shortages) that should create differentiated audit responses to impacted areas of the enterprise (e.g., underwriting, business resiliency plans, vendor management, product management).

Risk program focus areas

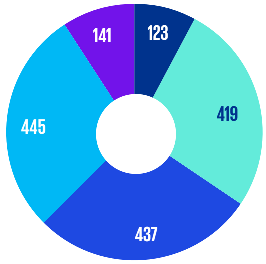
An effective risk program starts with a company's ability to understand and identify signals of change for their company, their industry, and the business environment in general. With macroeconomic factors at play, risk and audit leaders are focused on enhancing their program capabilities to deliver value and insights to senior management and the board through:

- Build foundation:
  - Maturity review: Assessing current program structure and positioning, governance, headcount, service delivery model, and capabilities to industry peers using benchmarking data, followed by developing fit-for-purpose target operating model and supporting roadmap
  - Strategy and governance: Designing risk strategy and risk governance, such as board and management oversight, policies and procedures, risk appetite and tolerances, risk forums, and related training and communication materials, to embed risk identification, assessment, and decisioning in the enterprise
- Assess and measure:
  - Dynamic risk assessment: Establishing a unique risk assessment process that focuses on risk networks to identify risk clusters and expected contagion effects between risks to better prioritize vulnerabilities and opportunities for investment
  - Scenario planning and wargaming: Seeking to challenge underlying business assumptions and simulate customer, competitor, or market responses to develop an informed view of plausible end states
- Manage, monitor, and report:
  - Risk analysis: Performing ongoing management activities and developing mitigating activities with defined risk owners and managers through risk profiles, bowties, or deep dives into risk areas to develop detailed assessments and root cause analysis
  - Risk metrics and dashboarding: Establishing risk metrics for ongoing monitoring of top enterprise risks to better plan for risk mitigation activities and report to executives using dashboards and visuals.

Closing comments

As inflation accelerates, putting pressure on households' finances and businesses' margins, and causing central banks to tighten monetary policy aggressively, a recession is again on the horizon in many economies. Agility and resilience are key to thriving in this new paradigm of uncertainty. It's critical for CAEs to be proactive, plan for expanded oversight, acquire a deeper understanding of the future, and learn how to turn potential obstacles into opportunities now more than ever.

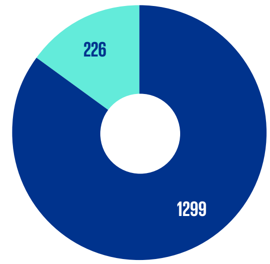
How fast do you expect overall inflation to grow in 2022?



- Higher than 8%
- 6.1-8%
- 4.1-6%
- 21.4-4%
- 0-2%

1565 responses

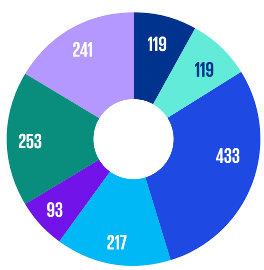
Do you believe the U.S. economy is headed for recession within the next 12 months?



- Yes
- No

1525 responses

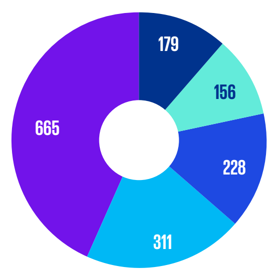
What do you think will be the biggest challenge for your SOX program as you close out your fiscal 2022 program



- Supply Chain impact on Revenue recognition and Inventory
- N/A
- Impact on all estimates, assumptions and forecasts - interest rate, inflation, liquidity, Going Concern, ForEx, inventory valuation, receivables collectability
- Impact of reduced headcount/headcount turnover, unfilled positions, temporary absences
- Fraud Risk
- Changes in process: Technology, automation, offshoring, outsourcing
- All of the above

1475 responses

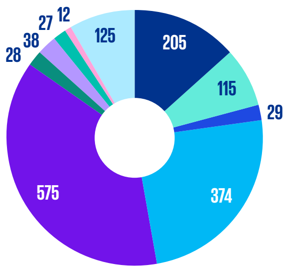
Given the impact of the economic outlook discussed, which adjustments do you expect to make the biggest impact on the value created by internal audit?



- Slowing or stopping innovation initiatives and innovation related spend
- Reducing internal headcount or repurposing current team to other non-IA work
- Reducing external spend
- Increasing or speeding up innovation initiatives
- Changing audit plan focus to topics/areas most impacted by economic outlook

1539 responses

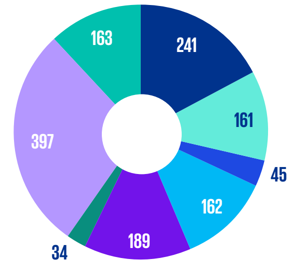
Which risk or trend do you believe will have the biggest impact on your business in 2023?



- Supply Chain
- Regulatory/Compliance
- Other
- Interest Rates
- Inflation
- Geopolitical
- Cyber
- Consumer Preferences
- Climate
- Access to Capital

1528 responses

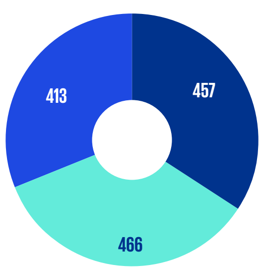
What additional risk management activity or instrument has your organization implemented in 2022?



- Scenario Analysis
- Risk Deep Dives
- Risk Bowties
- Risk Appetite & Tolerances
- N/A
- Expanded Insurance Coverage
- Data-driven Risk Assessment
- Continuous Monitoring

1392 responses

Given the impact of the economic outlook discussed, which audit areas could present the biggest opportunity for IA to impact your organization?



- External party areas of focus (e.g. third-party risk management, supplier viability, hedging programs, corporate real estate)
- Employee areas of focus (e.g. talent strategies, business continuity plans, technology initiatives)
- Customer areas of focus (e.g. underwriting, credit and collections, product and services portfolio, modeling

1336 responses

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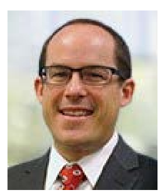

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