

Why An Audit Is About More Than Just The Numbers

JULY 29, 2013

BY RON SCHMIDT



I attended a “meet and greet” for the board of a new audit client and the first question out of the box was: “What do you do in the audit?” Not knowing his technical background I responded

that our job was to ensure that the credit union was doing the right thing. Before I had a chance to explain myself he shot back that “my job” was to “just do the numbers.”

Going home that night I contemplated his demand of “just do the numbers” while reviewing the many factors of an organization. And that prompted me to ask the question: “Is just doing the numbers an appropriate approach in today’s business environment?”

In a recent *New York Times* article regarding financial institutions’ risk management models, Jessie Eisinger interviewed John Breit, a former physicist and Wall Street risk management specialist. In response to a question regarding JPMorgan Chase’s “London Whale,” he said, “That debacle encapsulates much about what is wrong about how banks manage their risk and the how regulators oversee those risks. At Chase, the risk models hid risks from the traders and top executives.” (The London Whale, Bruno, was nicknamed the “whale” for the size of his trades, and ran a one-man show. His loss totaled \$6 billion in 2012). “Regulators have reduced risk managers to box checkers, making sure they take every measure of risk and report it dutifully on extensive forms. It just consumes more and more staff, turning them into accountants and rotting brains. Instead of fixating on models,

risk managers need to develop what spies call ‘humint’ — human intelligence from flesh and blood sources.”

The Values At Risk Measure

In a January 2009 article in the *New York Times Magazine*, just months after the financial collapse, Joe Nocera asked: “Were the measures used to evaluate Wall Street trades flawed?” The “measures” he identifies are the VaR — Values at Risk — the most widely used risk model at that time. This model predicts what will happen 99% of the time, but fails considerably the other 1%; built to minimize million dollar risks, but not billion dollar ones. Nassim Taleb, author of *The Black Swan*, identifies this rare event as a “black swan” and is convinced that these events occur more frequently than most people are willing to admit. Gregg Berman of RiskMetrics laments the blame placed on risk modeling for recent losses in the financial sector. “People do risk modeling, not computers... and people got overzealous and stopped being careful ... I do think this was more a failure of management than of risk management ... you can’t blame math. The problem on Wall Street at the end of the housing bubble is that judgment was cast aside.”

“Xs and Os”

Let’s turn our attention to basketball. A coach has two things to focus on, the so called “Xs and Os” and the execution of the game plan. The coach has to come up with a game plan and take the necessary steps to implement it. Therefore the coach must educate the team on the Xs and Os and motivate players to carry it out. Some coaches are stronger in one area than the other; great on strategy but lacking in communication.

Returning to my conversation with the board member, my response was that my job was to ensure the credit union was doing the right thing. As in basketball, my job is to ensure they are doing the right thing by looking at both the strategy and how well the coach communicates and motivates her team. And as this relates to a financial audit, my job is to judge the numbers as they are today and evaluate how well the game plan will be executed going forward.

Judge John G. Roberts in his confirmation hearing before Congress for chief justice of the U.S. Supreme Court, made the analogy of his job to that of a baseball umpire. While we aren’t umpiring a game, we are evaluating a team and judging their ability to carry out a game plan.

Not Just A Box Checker

If we look at the approach in our audit compared to a risk management model, there are two issues raised by these examples. First, don’t be just a box checker. Second, our role is to look at the people and not just the numbers. Our focus is the Xs and Os and how well that game plan is implemented; how well that coach teaches, communicates and motivates her employees; and how well the board understands and communicates this process.

And if we don’t, if we continue down the same old trodden path, we may be on our way out to sea in the wake of the whale under the flapping flippers and the black swan’s snapping beak.

Ron Schmidt, CPA, is with CBS Certified Public Accountants LLC in Solon, Ohio. For info: 440-542-1536
RSchmidt@cbscpasllc.com