The Hidden Side of Risk Assessment

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The Most Common Peer Review Deficiency Has Been the Same For Years

- The AICPA's Enhancing Audit Quality Initiative has identified risk assessment as its primary focus
- Deficiencies in risk assessment procedures are the most frequently cited peer review finding — year after year
- SAS 145 became effective December 2023. Deficiencies continue.

If this were a knowledge problem, we would have fixed it by now.

SAS 145 Tells You What to Do. It Can't Tell Your Brain to Do It.

- SAS 145 clarifies the risk assessment process — documentation requirements, significant risk definitions, the new stand-back requirement
- But the standard assumes the person applying it is reasoning clearly
- Peer review nonconforming findings aren't failures of knowledge — they're failures of judgment

Your Brain Has Two Operating Systems. You Need Both To Do Good Risk Assessment.

System 1: Fast, automatic, emotional, subconscious — runs most of your day without effort

System 2: Slow, deliberate, analytical, effortful — what genuine risk assessment requires

The problem: System 1 is always on. System 2 depletes.

When you open a prior-year workpaper, System 1 is already forming conclusions.

The Conditions Under Which You Do Risk Assessment Are Precisely the Conditions That Produce Bias

Cognitive depletion: complex, data-intensive engagements push people past their attentional limits

Time pressure: deadlines, busy season, client expectations

Prior-year anchors: the file you open first shapes conclusions before evidence is gathered

Team dynamics: the senior person's view shapes the group before real discussion begins

The Tools We Trust Most May Be Working Against Us

Checklist-style reasoning relieves the cognitive stress of complex decisions — that's why we like it

But that relief comes at a cost: checklist completion disengages us from the underlying situation

Compliance with a checklist produces the *feeling* of thoroughness without necessarily producing the substance of it

"Documentation of risk assessment" is not the same thing as risk assessment.

We Don't Just Ignore Contradictory Evidence. We Work Against It

Confirmation bias: we actively seek evidence that confirms what we already believe

Biased processing of disconfirming information: when contrary evidence appears, we hold it to a higher standard than confirming evidence

The backfire effect: in high-stakes, identity-relevant situations, strong disconfirming evidence can actually *strengthen* the original belief

An accountant or auditor who finds a reason to dismiss a red flag — and then feels more confident because they "tested it" — may be experiencing the backfire effect.

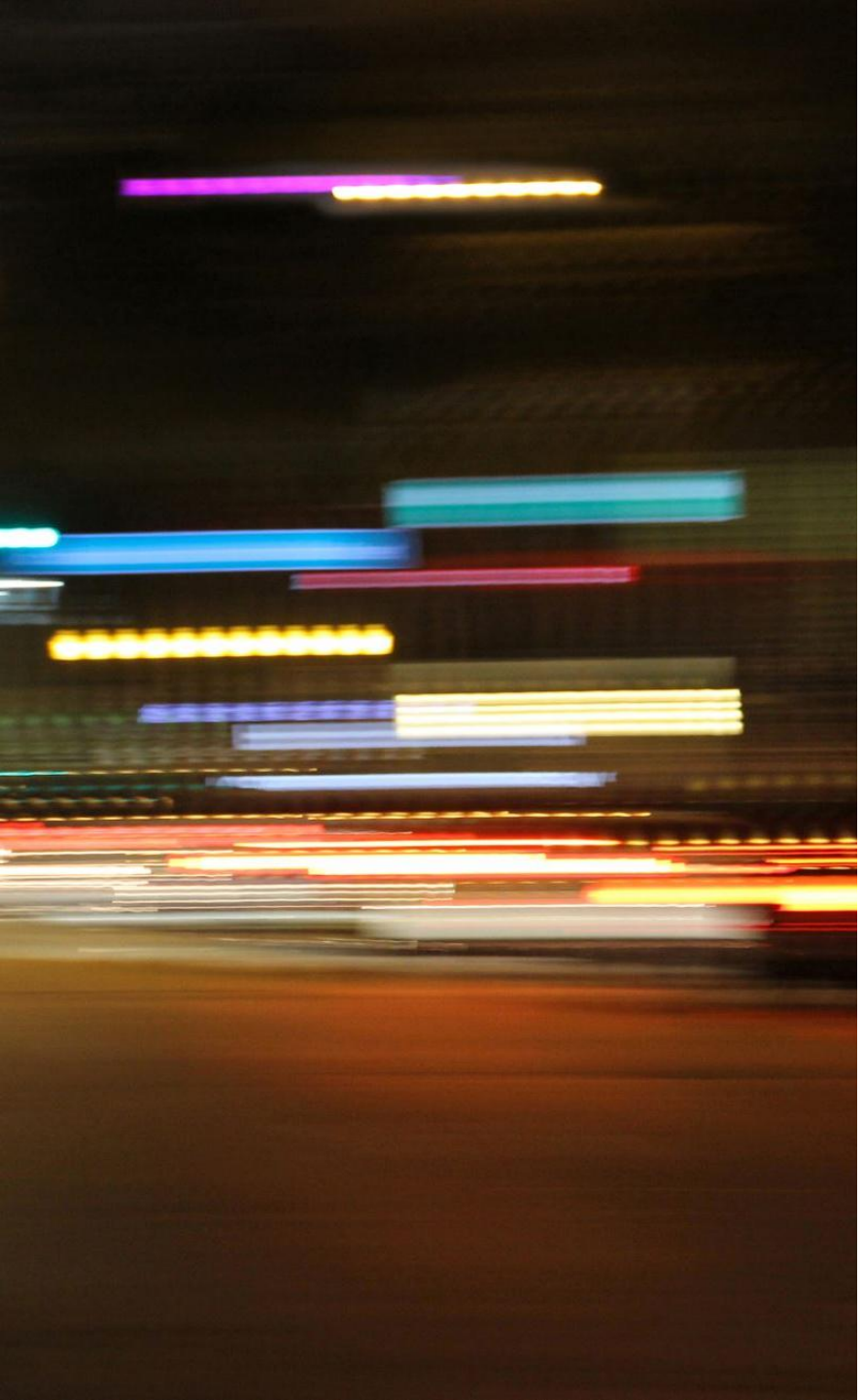
The Brain Substitutes "Easiest to Access" for "Most Accurate"

Availability bias: recent events, news stories, and vivid examples shape our risk estimates even when base rates say otherwise

Anchoring: previously held beliefs are gravitational — new evidence updates them less than it should

Research finding: auditors who knew prior unaudited balances came significantly closer to those numbers in their conclusions — and their evidence-gathering was shaped by the anchor before they were consciously aware of it

The prior-year workpaper isn't a starting point. It's a magnet.



Your Intuition Is Confident. Your Intuition Might Be Wrong.

- A cab is involved in a hit-and-run at night.
  - 85% of cabs in the city are Green. 15% are Blue.
  - A witness says the cab was Blue.
  - Witnesses correctly identify cab color 80% of the time.
  - **What is the probability the cab was actually Blue?**

Correct answer: **41% likely Blue**

The math: Witnesses see a green cab and call it blue 17% of the time (.85 × .20). Witnesses correctly call a blue cab blue 12% of the time (.15 × .80). So when a witness reports blue: 12 ÷ (17+12) = 41%.

In a Large Enough Dataset, Meaningful-Looking Patterns Are Mathematically Guaranteed to Appear

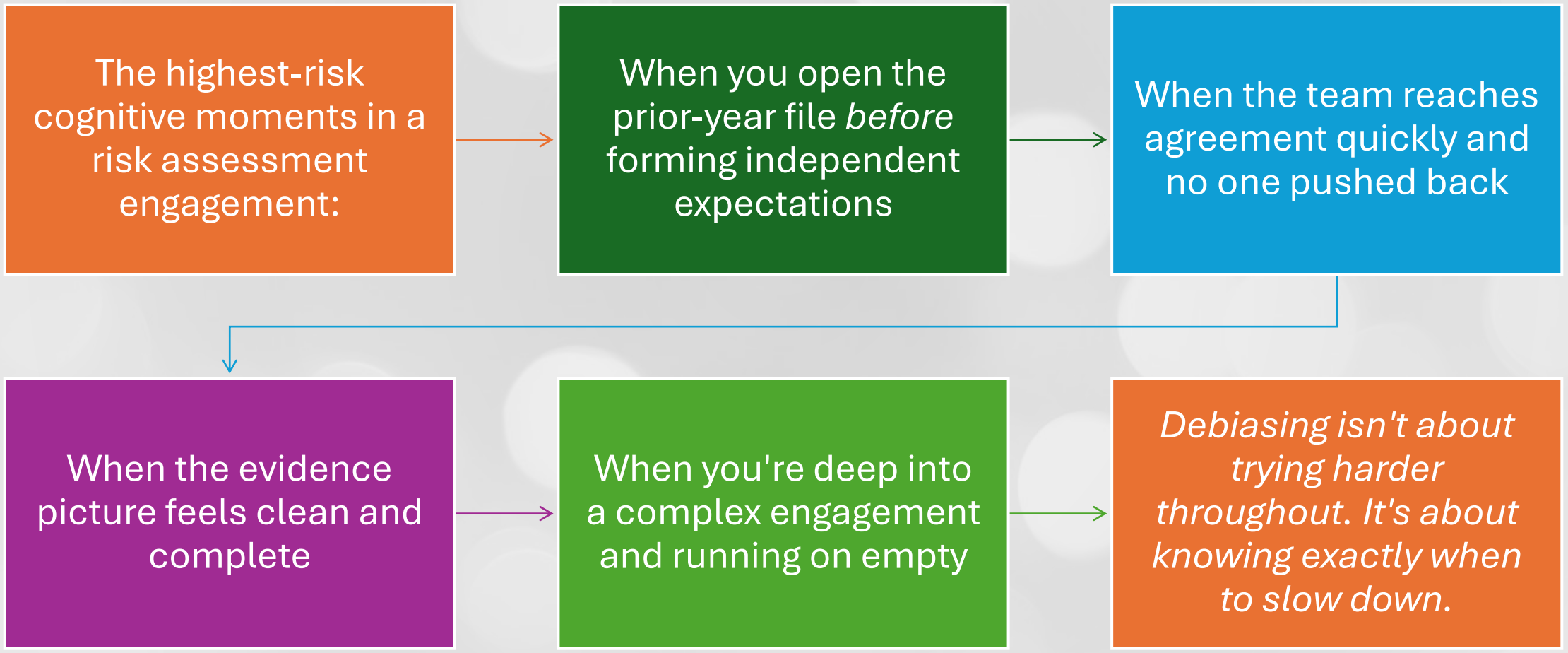
- **Illusory correlation:** perceiving a relationship between variables where no real relationship exists
- **Ramsey theory:** with a set of just 48 variables, there are 21,128 possible correlational configurations
- Patterns emerge that appear to have astronomically low odds — but may have no causal meaning

As data analytics becomes standard in audit practice, the risk of finding what isn't there grows alongside the risk of missing what is.

We Accept Risks We Would Never Accept If They Arrived All at Once

- **Small steps bias:** we are blind to significant changes when they arrive through many small, incremental steps
- Research finding (Gino, Moore & Bazerman, Harvard): auditors were **twice as likely** to approve inflated estimates when they arrived through gradual increases vs. arriving abruptly at the same final level
- A client whose risk profile has been quietly drifting for three years looks lower-risk than a new client who looks identical

Bias Doesn't Strike Randomly. It Strikes at Predictable Moments.



Five Questions That Interrupt the Automatic

- Before finalizing a risk assessment conclusion:
  - What assumptions am I working from — and where did they come from?
  - How confident am I, and does that confidence have an actual evidence basis?
  - Is there any evidence in this file I haven't fully reconciled with my conclusion?
  - If I had to argue the opposite position, what would the case be?
  - Does my conclusion look a lot like last year's — and is that because nothing changed, or because I anchored?

Build the Case For the Risk Before Deciding There Isn't One

- Before concluding a risk is low, actively construct the argument that it is high:
- Not to reach that conclusion — but to see what evidence you'd need to dismiss, and whether you've actually dismissed it or simply didn't look
- The SAS 145 stand-back requirement is, at its core, a codified alternative hypothesis exercise

"The disciplined use of alternative hypotheses could have helped counter the natural cognitive tendency to force new information into existing paradigms." — 2005 Silberman-Robb Commission Report to President Bush on the Iraq WMD intelligence failure

The Environment Produces the Bias. The Environment Has to Change.

- **Leaders: withhold your view until others have spoken** — stating it first anchors the group before discussion begins
- **Build second-chance reviews** for significant risk conclusions before they're finalized
- **Assign a devil's advocate role** on high-stakes designations

What Good Risk Assessment Actually Requires

- SAS 145 gives you the framework. Understanding how judgment works gives you the threat model.
- Know your high-risk cognitive moments — and build interruptions there
- Use the five forcing questions as workflow checkpoints, not afterthoughts
- Practice alternative hypothesis reasoning — especially when the picture feels clean
- Design your team's decision *process*, not just your documentation

The standard can tell you what to look for. Only you can manage how you look.

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