

Auditor Industry Range and Auditors Exercise Professional Skepticism¹

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Research Paper

INTRODUCTION

Professional skepticism is necessary to ensure audit quality and audit failures and deficiencies are often linked to a lack of skepticism. Furthermore, the auditor's experiences can play an important role in shaping auditors' knowledge and mindset brings to an audit. While narrowly focused training and experiences can help individuals gain deep knowledge in a specific domain, they can also lead to the development of flawed intuitions and cognitive entrenchment, "when the first idea that comes to mind, triggered by previous experience with similar situations, prevents alternatives from being considered" These effects are more likely to occur in environments where the rules of the process are not well defined, observed patterns do not repeat themselves, and feedback is delayed or inaccurate. Auditors often operate in a complex and unpredictable environment where business innovations and evolving accounting rules are the norm. In this environment, narrowly focused training and experiences in a single industry can lead auditors to lose flexibility and skepticism when performing audit tasks. One way to alleviate cognitive entrenchment is by pursuing a wide range of experiences. Diverse experiences make auditors more likely to encounter exceptions or inconsistencies in different audits and thereby develop mental skepticism and flexibility. In this paper, we examine whether an auditor's degree of professional skepticism is related to "auditor industry range," i.e., the extent to which an auditor has experience in auditing clients from different industries. We Expect that auditors with a broad range of experiences outside their specialized industries often perform better than auditors with experiences only in their specialized industries Therefore, we hypothesize that an auditor's experiences in different industries enhance her professional skepticism.

METHODOLOTY

To test our hypothesis, we use an archival dataset of audit adjustments obtained from the 212 unique firms listed in the Tehran Stocks Exchange (TSE) over twelve

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years 1389–1400 (1,785 firm-year observations). Three different constructions are used for an auditor's industry range based on the auditor's client portfolio. These proxies are the number of clients' industries over the last three years, the Herfindahl index, and the entropy index that assign different weights to the relative importance of each industry within the auditor's client portfolio. We also control for the wide range of variables' effective effects on the relation between auditor industry range and audit adjustments. In supplementary tests, we used financial restatements and discretionary accruals as different proxies of professional skepticism. We then specified the Logit, Tobit, and OLS regression models in which we regress Audit Adjustments, Financial Restatement, and Discretionary Accruals on Range.

RESULTS & DISCUSSION

Results indicate that the auditor industry range positively affects the likelihood of audit adjustments. In addition, auditors with a wide industry need to more downward adjustments. This result provides evidence to this explanation that auditor industry range affects professional skepticism and auditing conservatism, due to we would observe only downward audit adjustments relationship. This effect is similar to the large magnitude of audit adjustments. Auditors with a wide industry range also require more large adjustments, the adjustments required by them are on average larger in magnitude than those required by other auditors. Another prediction from our hypothesis is that the auditor's industry range affects other earnings quality proxies. We have evidence consistent with this prediction. These findings suggest that auditor with a wide industry range negatively affects their clients' financial restatements and discretionary accruals. These results suggest that auditors with a wide range, would play an important role in improving their clients' financial reporting quality.

Overall, these findings are in line with theories in psychology and cognitive sciences that auditors' experiences in different industries enhance their professional skepticism. We interpret our findings as evidence that diverse experiences in different industries help an auditor to develop a higher level of professional skepticism. Our findings have implications for the auditing profession. Audit clients have become more complex with the advance of technology and the increasing interconnectedness of the world. The challenge that auditors face today is how to maintain diverse experiences in a world that increasingly demands and incentivizes hyper-specialization. Auditors cannot pretend that the audit is a simple process where patterns repeat themselves. To avoid a simple compliance mindset and develop professional skepticism, auditors need to embrace a wide range of experiences and perspectives while pursuing specific expertise.

Keywords: Industry Range, Professional Skepticism, Audit Adjustment, Experience, Cognitive Entrenchment.

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