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The Effect of Client Characteristics on the Negotiation Tactics of Auditors

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The Effect of Client Characteristics on the Negotiation Tactics of Auditors

ABSTRACT: Although the financial statements of an organization are considered a product of management, prior research suggests that a company's financial statements may be affected by the negotiation strategy employed by the auditor when resolving audit differences with management. However, little subsequent research has discussed the potential strategies that auditors may employ during the negotiation process. Our study extends the literature by investigating, in a post-Sarbanes-Oxley environment, whether auditors will employ a reciprocity-based strategy for the resolution of audit differences and what client characteristics (client management's negotiating style and client retention risk) will increase the extent to which it is utilized. Such a strategy involves bringing inconsequential items to management and subsequently waiving these items in an effort to encourage management to be more cooperative in the posting of significant income-decreasing adjustments. The results of our study indicate that client management's negotiating style and retention risk have an interactive effect on auditors' use of a reciprocity-based strategy. Specifically, auditors are more likely to utilize a reciprocity-based strategy when management's negotiating style is competitive and client retention risk is high. Interestingly, the end result of the negotiation process is essentially identical (i.e., similar items are posted), regardless of client characteristics or the auditor's utilization of a reciprocity-based strategy. Thus, it appears that use of a reciprocity-based strategy does not affect the quality of the financial statements, but simply facilitates the process of posting significant items.

Keywords: *negotiation strategy; audit differences; reciprocity; client retention; financial statement adjustments; auditor-client relations.*

Data Availability: *Data are available upon request.*

I. INTRODUCTION

This study examines the conditions under which auditors will use a negotiation strategy based on reciprocity that encourages client management to be more cooperative in the posting of significant adjustments (i.e., clearly material or potentially material audit differences). While the financial statements of an organization are considered the responsibility of management, negotiations between auditors and their clients regarding the contents of the financial statements are quite common and may affect accounting disclosure (Antle and Nalebuff 1991; Gibbins et al. 2001). Consequently, as Antle and Nalebuff (1991) note, a company's financial statements could be viewed as a product of the joint efforts of the two parties. In addition to the resolution of proposed adjustments, negotiation has an important influence on client relations (Gibbins et al. 2001). Thus, the process of resolving audit differences could affect client retention and satisfaction, as well as the resulting financial statements.

The *Rule of Reciprocation* states that when an individual receives something of value, that individual has an obligation to reciprocate. In a negotiation setting, the reciprocation rule can promote a collaborative environment where, if one party makes concessions from his/her initial position, the other party is likely to reciprocate with concessions of his/her own (Putnam 1990; Kelly 1997). In the context of auditor-client negotiations, this could involve the auditor bringing inconsequential audit differences (in addition to any significant items) uncovered by the audit team to management's attention and then waiving the inconsequential items.¹ Sanchez et al. (2005) find that client managers are more agreeable toward posting significant income-decreasing items to the financial statements, and more satisfied with the auditor and the

¹ Nine national and international firms, in *A Framework for Evaluating Process/Transaction-Level Exceptions and Deficiencies* (2004), define an inconsequential item as being less than 20% of the overall annual or interim financial statement materiality (assuming no material qualitative factors), and discussions with partners of a Big 4 firm indicate industry position is that greater than one percent of pretax income would be considered more than inconsequential.

negotiation process, when the auditor uses a reciprocity-based strategy such as this for resolving audit differences. While prior research suggests that auditors may alter their approach to negotiations depending on the characteristics of the client and that changes to the approach may affect negotiated outcomes (Gibbins et al. 2001; Sanchez et al. 2004; Trotman et al. 2005), little is known about the potential effects of client characteristics on auditor negotiation strategy.

In this study we investigate whether, and under what client characteristics, auditors are likely to use a reciprocity-based strategy. Using a computer-simulation, auditor participants engage in an interaction with a hypothetical client to resolve audit differences. Participants are first asked to prepare a preliminary list of audit differences for client management based on a set of eight income-decreasing items (including both significant and inconsequential items) discovered during the audit; any items not on the list are waived by the participant without bringing them to management's attention (i.e., not in view of client management). After providing management with their preliminary lists, participants then determine whether they are willing to waive any of the inconsequential items they brought to the client in an effort to encourage management to be more cooperative in the posting of significant adjustments. A reciprocity-based strategy would involve both i) bringing inconsequential items to client management and ii) later waiving those items in view of the client management.²

We manipulate key characteristics of the client to determine how these characteristics influence the use of a reciprocity based-strategy. Specifically, we consider whether auditors will increase their use of a reciprocity-based strategy when facing a client manager known to be a

² Discussions with 15 audit partners and managers indicate that this preliminary disclosure typically would occur prior to preparation of the summary of unadjusted audit differences required by SAS No. 89, and that inconsequential items disclosed to client management at this point would not need to be included in the summary of unadjusted audit differences presented to the audit committee. It should also be noted that the current regulatory environment (i.e., SAS No. 89 and the Sarbanes-Oxley Act of 2002) does not necessitate that items waived (whether in view of management or not) be communicated to the audit committee if the items are considered inconsequential by the auditor. Additionally, discussions with practicing auditors indicate that both approaches (i.e., disclosure/non-disclosure of inconsequential items to client management) are still available to auditors post Sarbanes-Oxley.

difficult (competitive) negotiator, relative to a collaborative negotiator, given that such a strategy can help steer negotiations into a more collaborative environment (Kelly 1997). In addition, we consider auditor participants' negotiation tactics when client retention risk is high (the client is in the process of soliciting bids for next year's audit). Concern for client retention may place greater pressure on the auditor to have client management form/maintain a favorable opinion of the auditor.³ Negotiation literature suggests that, in an environment where the client is soliciting bids, the auditor may feel inclined to make concessions knowing that client management is in a relatively strong negotiating position and likely to expect greater concessions during negotiations (e.g., Hornstein 1965; Michner et al. 1975). Since competitive negotiators are more likely to use any bargaining tool at their disposal (e.g., auditor concerns about retention risk), we expect that auditors' strategic response to a competitive versus collaborative client will be greatest when retention risk is high.

The results of our study indicate that client management's negotiating style and retention risk have an interactive effect on auditors' use of a reciprocity-based strategy (i.e., bringing inconsequential items to management and subsequently waiving them). Specifically, auditors made greater use of a reciprocity-based strategy when confronted with a competitive negotiator *and* greater client retention risk. Interestingly, the end result of the negotiation process is essentially identical (i.e., similar items are posted), regardless of client characteristics or the auditor's utilization of a reciprocity-based strategy. However, use of a reciprocity-based strategy may help the auditor cope with potential management pressures to waive or reduce proposed

³ While Sarbanes-Oxley formalizes/mandates the Blue Ribbon Commission recommendation that (for publicly traded companies) the audit committee hires/terminates the audit firm, discussions with multiple partners from large accounting firms suggest that the more formal rule has not diminished management's significant role in evaluating the audit firm and making retention recommendations. Further, a recent survey of audit committee members and other executives finds that controllers/CFOs have the greatest influence (e.g., greater than the audit committee) over issues such as auditor compensation and retention (KPMG 2004).

adjustments to the financial statements. Thus, these results suggest that use of a reciprocity-based strategy does not affect the quality of the financial statements, but simply facilitates the process of posting significant items.

The remainder of this paper is organized as follows. The next section discusses the background and related research and develops the hypotheses. Sections III and IV present the method and results, respectively. Section V offers conclusions and implications.

II. BACKGROUND AND HYPOTHESIS DEVELOPMENT

Prior research indicates that the characteristics of an adjustment or an engagement can affect the likelihood that the auditor will waive a particular item (e.g., Wright and Wright 1997; Braun 2001; Nelson et al. 2002; Ng and Tan 2003). Prior research also suggests that auditors may alter their approach to negotiation depending on the characteristics of the client (Gibbins et al. 2001; Sanchez et al. 2005). Negotiators may choose to utilize reciprocity during negotiations in an attempt to create social compliance in their counterparts by offering an initial position greater than their ultimate goal.⁴ Our study extends the literature by investigating whether, and under what client characteristics, auditors will utilize a reciprocity-based strategy for the resolution of audit differences.

⁴ However, the findings of Ng and Tan (2003) suggest that auditors do not inflate the dollar amount of proposed adjustments in anticipation of negotiations (i.e., do not employ a reciprocity-based approach in that manner; see also Bame-Aldred and Kida 2005). They posit this is because auditors consider inflated (i.e., inaccurate) dollar amounts on proposed adjustments to be inappropriate and unprofessional under existing auditing standards and guidelines. Alternatively, if accuracy is essential, auditors could utilize a strategy such as the one we investigate here in which insignificant (but accurate with regard to dollar amount) adjustments serve as the initial concession required for a reciprocation-based approach.

Auditor-Client Negotiations

While the management representation letter asserts that management bears responsibility, a company's financial statements can be viewed as a joint effort of both management and the auditor (Antle and Nalebuff 1991). Antle and Nalebuff (1991) suggest that the resulting financial statements depend on the negotiation strategy employed by the auditor. However, little subsequent research has discussed the potential strategies that auditors may employ during the negotiation process. Related research has typically focused on the disposition of proposed audit adjustments with respect to characteristics of the adjustment or the engagement, finding that adjustments are more likely to be waived when: they are immaterial, they are income increasing, the client is small, the audit committee is ineffective, authoritative guidance is lacking, and the risk of waiving is low (e.g., Wright and Wright 1997; Braun 2001; Nelson et al. 2002; Ng and Tan 2003).

Gibbins et al. (2001) explicitly consider the negotiation process and provide survey evidence regarding negotiation experience of practicing auditors. They find that 67% of audit partners surveyed enter into negotiations with more than half of their clients and that *all* partners surveyed enter into negotiations with at least some of their clients. Additionally, the partners believe negotiation is a frequent and vital part of their responsibilities and is part of the service they provide to the client (Gibbins et al. 2001). While auditors are foremost concerned with the final agreement of the client to post any significant proposed audit adjustments, they are generally also concerned with their continuing working relationship with client management. Fostering a good working relationship with clients is important for the conduct of the audit (Shaub 2004; Arel et al. 2005). In addition, the auditor-client relationship may have implications

for auditors' ability to retain clients and, to the extent possible under the Sarbanes-Oxley Act of 2002, increase their level of service (and billing) to their clients.

Collaborative Negotiation and Reciprocity-Based Strategies

The rule of reciprocation has been found in a variety of settings and is pervasive in all societies (Gouldner 1960; Cialdini 2001). The basic tenet of this societal rule is that if someone provides a person with any type of gift or favor, that person is "obligated" to reciprocate. The rule of reciprocity creates an environment, within the negotiation context, which promotes mutual concession. Effective negotiators can rely on reciprocity to create social compliance in their counterpart by offering an initial position greater than their ultimate goal. By making a concession off of the initial position, the negotiator can expect a concession from his/her counterpart. Further, studies have found that relatively small concessions can result in relatively large reciprocations and that those exposed to this strategy did not feel manipulated, but were more satisfied with the outcome than when this strategy was not used (Benton et al. 1972; Cialdini and Ascani 1976; Miller et al. 1976; Schindler 1998).

By coming to the negotiation table with a reciprocity-based strategy (e.g., disclosing certain inconsequential items to client management and subsequently conceding them), auditors can help create a collaborative negotiation environment (Kelly 1997). *Collaborative* negotiation is characterized by concessions and disclosure of information (Putnam 1990). A collaborative approach will likely lead to *integrative reciprocity* on the part of client management (Olekalns and Smith 2000). Integrative reciprocity implies not only that the auditor's concessions be matched by management, but also that the resulting collaborative environment promotes more satisfaction with the negotiation process and outcome (Benton et al. 1972; Schindler 1998). In

the context of auditor-client negotiations over proposed audit adjustments, it may be helpful to achieve some level of collaboration, since client management will be asked to concede to post any significant items in order for the auditor to issue an unqualified opinion on the financial statements. Further, improved client satisfaction with the process/outcome could lead to greater client retention and future billing.

While collaborative negotiation is likely to result in mutually beneficial outcomes, competitive negotiation can lead to conflict escalation and win-lose outcomes (Lax and Sebenius 1986).⁵ *Competitive* (or *non-collaborative*) negotiation centers on minimizing concessions and concealing information (Putnam 1990). A competitive environment can negatively affect not only the negotiated outcome, but also the relationship between negotiators (Putnam 1990). An approach by the auditor of waiving adjustments without disclosing them to management while insisting that significant items (i.e., the only items the client management does see) be posted, will appear less collaborative and will likely lead to a more competitive negotiation environment.

Sanchez et al. (2005) investigate the effect of a reciprocity-based auditor strategy on the resolution of proposed audit adjustments by considering the client side of the negotiation process. They investigate a potential auditor strategy where auditors disclose income-decreasing, inconsequential items to client management. These inconsequential items could be waived with or without disclosing them to management. However, this “disclosure” strategy makes the waiving of inconsequential items transparent. Specifically, the auditor brings to the attention of management all the audit differences (both significant and inconsequential) discovered during the audit and, subsequently, waives the inconsequential items. In contrast, a strategy of “non-disclosure” results when inconsequential items are waived at the workpaper level without

⁵ A win-lose outcome (or one party victory) occurs when one of the parties gets most or all of what they want at the expense of the other party.

disclosing them to client management (i.e., management is only aware of the significant audit differences, which must be booked). This “disclosure” strategy is compliant with the current regulatory environment including SAS No. 89 and Sarbanes-Oxley.⁶ Their findings indicate that, relative to a non-disclosure approach, client managers were more willing to agree to post significant income-decreasing adjustments when exposed to a disclosure approach during the negotiation process. Disclosure also resulted in greater client satisfaction and retention. Sanchez et al. (2005) provide additional evidence that auditors perceive this strategy to be both viable and effective for maintaining client satisfaction while encouraging client management cooperation with the posting of significant adjustments. Our study extends their work by considering whether auditors will initiate and employ a reciprocity-based strategy and what client characteristics will increase the extent to which it is used.

Client Characteristics and the Negotiation Environment

Prior research suggests that auditors may alter their approach to negotiations depending on the characteristics of the client (Gibbins et al. 2001; Sanchez et al. 2005). Thus, auditors’ use of a reciprocity-based strategy may be affected by certain client characteristics. That is, an auditor would not need to use a reciprocity-based strategy unless the client/negotiation environment warrants it. One characteristic that may affect the negotiation environment is negotiator style (Pruitt and Carnevale 1993). A negotiator’s tendency for contentious tactics

⁶ While SAS No. 89 and Sarbanes-Oxley require that unadjusted immaterial misstatements be communicated to the audit committee, they allow inconsequential differences to be waived at the workpaper level without communication to the audit committee. According to footnote 6 of SAS No. 89, “auditors may designate an amount below which misstatements need not be accumulated. Similarly, the summary of uncorrected misstatements included or attached to the representation letter need not include such misstatements.” Thus, the waiving of inconsequential misstatements at the workpaper level is allowable under the current regulatory environment, regardless of whether the items are disclosed to management. Further, discussions with numerous audit partners and managers confirm that waiving audit differences that are below the posting threshold (i.e., inconsequential misstatements), without bringing such differences to the attention of management or the audit committee, is not prohibited by either SAS No. 89 or Sarbanes-Oxley.

typically results in competitive, or non-collaborative, environments (e.g., Druckman 1986). In contrast, actions such as information sharing and concession can help promote a more collaborative environment (Putnam 1990). Discussions with audit partners from Big 4 firms reveal that some client managers are very reluctant to post any adjustments to the financial statements (competitive clients), while others are more open to posting adjustments (collaborative clients). Given that a collaborative environment is typically in the auditors' best interest, a competitive client manager can present a dilemma for the auditor. Consequently, auditors may be more likely to initiate a reciprocity-based strategy when the client is a competitive negotiator since such a strategy may induce a more collaborative environment (Kelly 1997). Thus, we expect auditors to disclose, and subsequently waive, more inconsequential items when resolving audit differences with a competitive client than with a collaborative client. The following hypotheses are, therefore, tested:

- H1a:** Auditors will disclose more inconsequential items when negotiating audit differences with a competitive client than with a collaborative client.
- H1b:** Auditors will waive more inconsequential items in view of the client when negotiating audit differences with a competitive client than with a collaborative client.

A second client characteristic that may affect the negotiation environment is the relative strength of a negotiator's position (Pruitt and Carnevale 1993). In an audit context, client retention risk may influence the strength of the client management's negotiating position. A client that is soliciting bids for next year's audit would represent a greater risk to client retention than one that is not explicitly considering an auditor change. Although the responsibility for engaging/terminating the auditor ultimately lies with the audit committee (at least for public

companies), management generally still has considerable input.⁷ Therefore, it could be advantageous to the auditor for management to view them favorably, particularly when a retention decision is imminent. If management is unfavorable toward the auditor, the audit committee is less likely to retain the auditor. Thus, when a client is soliciting bids, client management is likely put in a relatively stronger position than when retention risk is low. The negotiation literature demonstrates that when one of the negotiators has greater (or increased) strength relative to a counterpart, the relatively stronger party is likely to expect greater concessions (Hornstein 1965; Michner et al. 1975). Consequently, auditors may be more likely to use a reciprocity-based strategy when client retention risk is high than when it is low. Thus, we expect auditors to disclose, and subsequently waive, more inconsequential items during the resolution of audit differences when the client is known to be soliciting bids for next year's audit (high retention risk). This leads to the following hypotheses:

- H2a:** Auditors will disclose more inconsequential items to client management when client retention risk is high than when it is low.
- H2b:** Auditors will waive more inconsequential items in view of client management when client retention risk is high than when it is low.

The negotiation literature suggests that, when put in a position of relative strength, negotiators known to use contentious tactics are more effective at utilizing (and more willing to utilize) that relative advantage (Pruitt and Carnevale 1993). Therefore, in an environment where the client is a competitive negotiator and the risk of retaining the client is high, the auditor may encounter a particularly tough negotiation environment. That is, the client is known to be a tough

⁷ While the audit committee is responsible for engaging/terminating the auditor, discussions with several Big 4 partners (including a national officer in charge of practice issues) indicate that management's role in the auditor retention decision has not significantly diminished. Further, a recent survey of audit committee members and other executives finds that controllers/CFOs have the greatest influence (e.g., greater than the audit committee) over issues such as auditor compensation and retention (KPMG 2004).

negotiator and has a stronger bargaining position relative to the auditor. Such a setting would be the most likely to benefit from a judicious negotiation strategy that encourages a more collaborative negotiation environment. Thus, we expect the relative strength of the auditor's negotiating position and client management's negotiating style to interact to affect the auditor's use of a reciprocity-based strategy. Specifically, auditors will make greater use of a reciprocity-based strategy when confronted with a competitive client *and* high client retention risk. We therefore test the following hypotheses:

- H3a:** The difference in disclosure of inconsequential items between auditors negotiating with competitive clients and auditors negotiating with collaborative clients will be greater when client retention risk is high than when it is low.
- H3b:** The difference in the number of inconsequential items waived (during negotiations) between auditors negotiating with competitive clients and auditors negotiating with collaborative clients will be greater when client retention risk is high than when it is low.

III. METHOD

Participants

Participants were sixty audit managers and partners from large, international public accounting firms who had, on average, about 10 years experience.⁸ Prior research and discussions with practicing auditors revealed that managers and partners would be familiar with the process of negotiating with clients to resolve audit differences (e.g., Gibbins et al. 2001). All participants completed this experiment after the adoption of SAS No. 89 and the Sarbanes-Oxley Act of 2002.

⁸ There are no significant differences in mean years audit experience between the groups (overall mean = 10.05 years; $p > .50$). Also, there are no significant differences (for all, $p > .20$) between groups on other demographic variables (e.g., familiarity with relevant authoritative guidance, experience resolving audit differences).

Experimental Task

Participants completed a computer-based instrument that simulated the process of resolving audit differences with client management. In the simulation participants were provided with detailed instructions for the task, a description and history of the client, current and prior year financial statements, and a list of items compiled by the audit senior in-charge. This list of items includes eight (income-decreasing) audit differences to be reconciled with management/disposed of by the auditor. Of these eight items, four represented significant adjustments that audit experts determined should be posted to avoid material misstatement of the financial statements and four items that were clearly inconsequential.⁹ Items that are deemed inconsequential by the auditor are not required to be reported under the current regulatory environment.¹⁰

The experiment took place in two phases (see Figure 1). The first phase involved determining which items to consider posting as audit adjustments. In preparation for discussing proposed adjustments with client, participants prepared a preliminary list of items to bring to management. Specifically, for each of the eight items, participants indicated whether they would waive the item without bringing it to management's attention (i.e., management is never made aware of the item) or bring it to management as a proposed adjustment. For items they decide to

⁹ Two of the significant items are judgmental in nature (relating to warranties and goodwill) and two are "hard" errors (relating to research and development costs and to sales). Of the four inconsequential items, two relate to judgmental items and two to "hard" errors. The nature of the judgmental inconsequential items would allow the auditor an opportunity to revisit the assumptions upon which the auditor's judgment was made, potentially altering the amount of any final adjustment. However, combined, these adjustments (if made in full) represent 0.015% of net sales, with no effect on EPS. Additionally, the two inconsequential "hard" errors, combined, represent 0.014% of net sales, with no effect on EPS.

¹⁰ The inconsequential proposed adjustments were determined to be "clearly inconsequential" by seven audit partners and managers. It was also determined by these experts that the inconsequential adjustments were small enough in magnitude that they would need neither to be brought to the attention of the audit committee nor included in the management representation letter to remain in compliance with SAS No. 89 or Sarbanes-Oxley. Accordingly, these inconsequential proposed adjustments could be waived by the auditor without ever having been brought to the attention of the client.

bring to management, participants could choose to insist the item be posted or consider waiving it in view of client management.

In the second phase of the experiment, participants determined which items must be posted by the client before issuing an unqualified opinion on the financial statements. After submitting the preliminary list of proposed adjustments to client management, simulated interaction with client management revealed that management agreed to post the significant items, but would like the auditor to consider waiving some or all of the inconsequential items on the preliminary list. At this point, participants indicated which (if any) of the inconsequential items they would waive and which they would insist the client post. Participants then answered a series of case-related and demographic questions, including a check of the manipulations.

Independent Variables

Two independent variables (client negotiating style and client retention risk) were manipulated between participants resulting in a 2x2 ANOVA design. Client negotiating style refers to the manager's predisposition to act as either a competitive or a collaborative negotiator. Prior research suggests that competitive negotiators act individualistically, avoid making concessions, and tend to prolong discussions in hopes of a "win-lose" outcome (e.g., Putnam 1990). Half of the participants (*competitive client* condition) were informed that discussions over proposed adjustments are often difficult and "contentious," that the manager has been extremely reluctant to post any audit adjustments, and that reaching agreement typically involves protracted discussions. The remaining half (*collaborative client* condition) were informed that the manager has been reasonable during such discussions in the past and has a goal common to that of the auditor (i.e., fairly stated financial statements). These characteristics are consistent with

collaborative negotiators discussed in prior literature (e.g., Putnam 1990). We operationalize client retention risk by manipulating whether or not the client is soliciting bids for next year's audit. Half of the participants were informed that the client is soliciting bids (*high retention risk* condition), while the other half received no such statement (*low retention risk* condition).¹¹ Participants were randomly assigned to one of the four treatment groups.

Dependent Variables

Recall that, for a disclosure approach to be demonstrated, two separate actions must occur. First, auditors must choose to bring to client management inconsequential items that they are willing to waive. Second, they must waive these items in an effort to encourage management cooperation in the posting of significant adjustments. Therefore, we consider two dependent variables: 1) the number of inconsequential adjustments included in the preliminary list of items to be viewed by management and 2) the number of inconsequential items waived (in view of management) by the participant during the negotiation process with the client.

IV. RESULTS

Results are analyzed within a 2x2 ANOVA framework (client management's negotiating style condition by client retention risk condition). Due to the directional nature of expectations, all tests of hypotheses are one-tailed. Manipulation checks for both independent variables indicate that participants understood the manipulations.¹²

¹¹ This can be considered an indirect threat by the client. Prior research indicates that indirect threats are typically more effective than direct threats (Pruitt and Carnevale 1993).

¹² On separate ten-point scales, participants were asked to respond to: a question relating to client management's general willingness to post audit adjustments (1 = "generally against posting adjustments" and 10 = "generally open to posting adjustments") and a statement referring to the client's soliciting of bids for next year's audit (1 = "strongly disagree" and 10 = "strongly agree"). Means were significantly different and directionally consistent with the manipulation for both questions (p-values < .001). Mean responses to the first item were 1.77 and 8.83 for the

Client Management's Negotiating Style

Hypothesis 1a predicts that participants in the competitive client condition will bring more inconsequential audit items to the attention of client management than will participants in the collaborative client condition. Consistent with this expectation, ANOVA results demonstrate that the competitive/collaborative manipulation significantly affects the number of inconsequential items brought to client management on the preliminary list ($p = .033$; Panel A of Table 1). Examination of the means (Table 1, Panel B) indicates that participants facing a competitive negotiator brought 2.47 inconsequential items to management, while participants facing a collaborative negotiator brought 1.77 inconsequential items, on average. Hypothesis 1b states that participants in the competitive client condition will waive more inconsequential items (in view of client management) than will participants in the collaborative client condition.

ANOVA results for the number of inconsequential items waived support H1b ($p = .002$; Table 2, Panel A). Participants in the competitive client condition waived 1.90 inconsequential items that they earlier brought to the client management's attention (i.e., waived in view of management), while participants in the collaborative client condition waived 1.07 inconsequential items, on average (Table 2, Panel B). Taken together, these results are consistent with the expectation that auditors facing a competitively negotiating client will make greater use of a reciprocity-based negotiation strategy than those interacting with a collaborative client.

Client Retention Risk

Hypothesis 2a predicts that auditors in the high client retention risk condition will bring more inconsequential items to the attention of client management than will participants in the

competitive and collaborative client conditions, respectively, while mean responses to the second item were 8.77 and 2.03 for the high and low retention risk conditions, respectively.

low retention risk condition. ANOVA results reported in Table 1 (Panel A) are consistent with this prediction. The retention risk manipulation significantly affects the number of inconsequential items brought to the attention of client management, with participants in the high risk condition bringing 2.47 items to management and those in the low risk condition bringing 1.77, on average ($p = .033$; Table 1, Panel B). Hypothesis 2b states that participants in the high risk condition will waive more inconsequential items than participants in the low risk condition. Results also reveal a significant effect of retention risk on the number of inconsequential items waived in view of client management ($p = .007$; Table 2, Panel A), providing support for H2b. Participants in the high retention risk condition waived 1.84 inconsequential items that they earlier brought to management's attention, while participants in the low risk condition waived 1.14 items, on average (Table 2, Panel B). These findings, when considered jointly, suggest that auditors will utilize a reciprocity-based strategy to a greater extent when there is a higher risk of losing the client.

The Moderating Effect of Retention Risk on Client Management's Negotiation Strategy

While results regarding the main effect hypotheses (H1 and H2) are significant, they need to be viewed in the context of the interaction results (H3). Hypothesis Set 3 predicts client retention risk will moderate the influence of client management's negotiating style on the extent to which auditors utilize a reciprocity-based strategy, such that auditors' use of a reciprocity-based strategy will be greatest when retention risk is high and the client is a competitive negotiator. With respect to the number of inconsequential items brought to client management's attention, ANOVA results indicate the interaction term is significant at $p = .048$ (Table 1, Panel A). For the number of inconsequential items subsequently waived, the interaction is significant at

$p = .007$ (Table 2, Panel A). In order to test the form of the interactive effect specified in Hypothesis Set 3, the following planned contrast was conducted for both dependent measures:

$$(\text{Cell 4 Mean} - \text{Cell 3 Mean}) > (\text{Cell 2 Mean} - \text{Cell 1 Mean})$$

where:

- Cell 1 = collaborative client/low retention risk group
- Cell 2 = competitive client /low retention risk group
- Cell 3 = collaborative client/high retention risk group
- Cell 4 = competitive client/high retention risk group.

Results of the planned contrasts are consistent with the predicted moderating effect for both dependent variables (see Panel C of Tables 1 and 2). The planned contrast results are significant for both the number of inconsequential items brought to client management ($p = .048$) and the number of inconsequential items waived in view of management ($p = .007$). This finding lends support to the notion that retention risk moderates the effect of client management's negotiating style (competitive vs. collaborative) on auditors' use of this reciprocity-based negotiation strategy. Figure 2 plots the means for both dependent variables, demonstrating the form of the interaction. The form of the interaction in Figure 2 suggests a more specific form of the predicted moderating effect. That is, it appears that the main effects found in the testing of H1 and H2 are being driven by the cell in which participants faced a competitive negotiator and the client was soliciting bids for next year's audit. Post-hoc tests (Duncan's multiple means comparison where $\alpha = .05$) indicate that only the means in Cell 4 (where client management is competitive and retention risk is high) are different from the other means.

Thus, given the pattern of results across both dependent variables, it appears that the effect of client management's negotiating style is moderated by retention risk. Specifically, management's negotiation style appears to affect the extent to which auditors will utilize a reciprocity-based strategy only when retention risk is high. Using the language of the negotiation

literature, reciprocity is invoked *only* when the opponent is negotiating from a position of relative strength *and* is known to use contentious tactics, thus increasing the likelihood that this relative strength will be brought to bear (that is, the results of the main effect hypotheses H1 and H2 are driven by Cell 4).

Total Items Posted

Interestingly, the end result of the negotiation process is essentially identical, regardless of client characteristics. Recall that, in the experimental instrument, there were four significant items and four inconsequential items. Ultimately, the auditor would need to negotiate that the significant items be posted, regardless of any pressure brought by the client. Prior research indicates that the result of negotiations are typically somewhere between the initial positions of the auditor and the client (e.g., Gibbins et al. 2001). These prior findings can be consistent with a reciprocity-based negotiation strategy in that the final outcome may actually result in positions consistent with auditors' initial (but unstated) position. To gain a better understanding of the negotiated outcome, we analyze the total number of items posted by the auditor. Table 3, Panel A indicates that neither of the manipulations significantly affected the total number of items (of the original eight items) ultimately posted (p 's > .50, two-tailed). Examination of the means (Panel B) indicates that auditors in all conditions typically posted slightly more than four items. Further examination of the data reveals that only one participant posted just three of the four significant items, resulting in no significant differences between conditions with respect to the posting of significant items (p 's > .40, two-tailed). These results suggest that, regardless of the auditor's utilization of a reciprocity-based strategy, the end result is that the significant items are

posted, as are a similar amount of inconsequential items across conditions.¹³ Thus, it appears that this strategy does not affect the quality of (i.e., the posting of material adjustments to) the financial statements, but simply facilitates the process of posting significant items.¹⁴

V. DISCUSSION AND CONCLUDING REMARKS

The current regulatory environment (e.g., the Sarbanes-Oxley Act of 2002), brought on by recent high-profile audit failures, has placed auditors of financial statements under increased scrutiny. While the financial statements of an organization are considered the responsibility of management, negotiations between auditors and their clients regarding the contents of the financial statements are quite common and may affect accounting disclosure (Antle and Nalebuff 1991; Gibbins et al. 2001). Prior research has suggested that a company's financial statements can be affected by the negotiation strategy employed by the auditor when resolving audit differences with the client (Antle and Nalebuff 1991). Research has also found that altering the auditor's strategy/approach to the negotiation process can have positive effects on the negotiated outcome, as well as the relationship between the auditor and client (Trotman et al. 2005; Sanchez et al. 2005). Our study extends the literature by investigating, in a post-Sarbanes-Oxley environment, whether auditors will employ a reciprocity-based strategy for the resolution of audit differences and what client characteristics will increase the extent to which it is utilized. Such a strategy involves both bringing inconsequential items to client management and

¹³ The average number of inconsequential items posted was .63 items. This number was not significantly different across conditions (all p-values > .50).

¹⁴ Given that the purpose of our study is to explore whether and under what circumstances a reciprocity-based strategy will be used (and not the ultimate effect on auditors' willingness to make concessions), our context and client management responses were not designed to allow us to examine auditor actions when management refuses to post significant items. Future research could consider how the use of such a strategy may reduce pressure on the auditor to concede these items and thus result in the auditor reaching outcomes nearer their negotiation goals.

subsequently waiving these items in an effort to encourage management to be more cooperative in the posting of significant adjustments.

Our results indicate that client management's negotiating strategy and retention risk have an interactive effect on auditors' use of a reciprocity-based strategy (i.e., bringing inconsequential items to client management and subsequently waiving them). Consistent with our expectations, auditors made greater use of a reciprocity-based strategy when confronted with a competitive negotiator *and* greater client retention risk. Interestingly, the end result of the negotiation process is essentially identical (i.e., similar items are posted), regardless of client characteristics or the auditor's utilization of a reciprocity-based strategy. These results suggest that use of a reciprocity-based strategy does not affect the quality of the financial statements, but simply facilitates the process of posting significant items.

The findings of this study have implications for practice and future research. With respect to practice, results of this study suggest that auditors alter their negotiation strategies dependent upon the characteristics of the client. Our results show that, under certain client characteristics, auditors will engage in a negotiating approach designed to produce a more collaborative negotiation environment. The observation that auditors have been found to waive adjustments or alter estimates during the negotiation process (e.g., Gibbins et al. 2001; Braun 2001) could be part of a negotiation strategy and does not necessarily indicate that auditors are signing off on financial statements that differ from the auditors' initial intended outcome. Our findings suggest that auditors may use a reciprocity-based strategy to reduce anticipated client management pressure to waive proposed adjustments. This may result in negotiated outcomes nearer the auditors' ultimate goals. Future research could investigate and compare auditors' intended outcomes with the actual outcome of the negotiation. Since we consider auditor judgments only

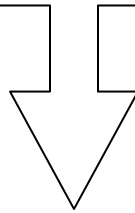
with regard to proposed adjustments that are either clearly significant or clearly inconsequential, future research could explore the use of a reciprocity-based strategy with respect to more ambiguous adjustments or estimates involving a range of values. For example, future work could explore whether a reciprocity-based strategy will result in more conservative values for such estimates post-negotiation. While this and other studies (e.g., Sanchez et al. 2005) suggest that reciprocity-based strategies enhance both the current negotiation and the relationship of negotiators, further research could examine the use of reciprocity-based strategies (and other negotiation strategies) in multi-period, multi-negotiation contexts. Finally, while the negotiation itself can be conducted in a variety of ways (e.g., face-to-face interaction, by telephone, electronically, through third parties), our study utilizes only a computer-based (simulated) interaction with the client management. Future research could investigate other methods of interaction between negotiating parties. Such research will further our understanding of auditor negotiation strategy use and its effect on the financial statements, as well as on the relationship between auditors and their clients.

FIGURE 1
Outline of Experimental Procedure

Phase 1: Assemble Preliminary List of Audit Differences

Participants:

- asked to assume role of auditor on hypothetical engagement and become familiarized with hypothetical company
- asked to assume they will communicate with client management regarding proposed financial statement adjustments
- receive client characteristics manipulations:
 - client management's negotiating style (collaborative versus competitive)
 - client retention risk (low versus high)
- view a list of eight audit differences discovered by the staff auditor and determine which items to bring to management on a preliminary list



Phase 2: Resolution of Audit Differences

Computer-simulated interaction with client management reveals that management agrees to post the significant items, but requests participant to waive the inconsequential items brought to negotiation

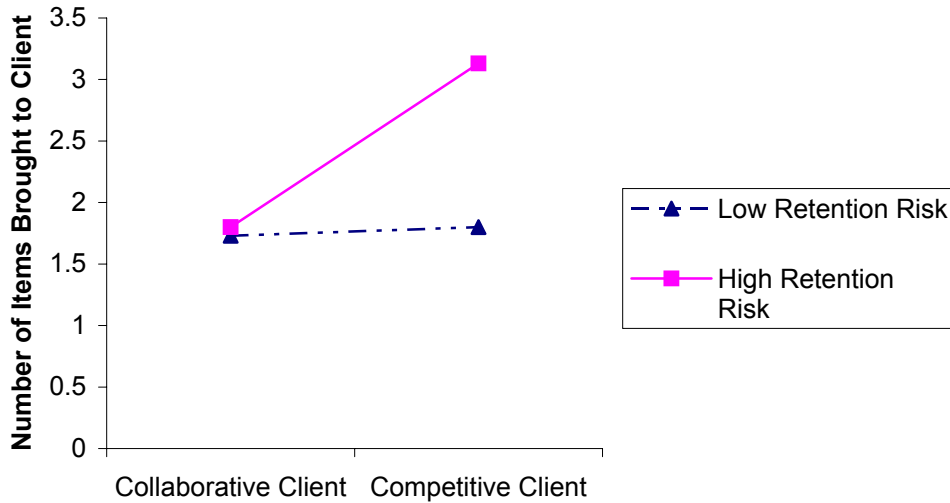
Participants:

- indicate which (if any) of the inconsequential items they will waive and which must be posted
- respond to demographic and manipulation check prompts

FIGURE 2

The Interactive Effect of Client Management's Negotiating Strategy and Retention Risk

Panel A: Dependent Variable = Number of Inconsequential Items Brought to Client



Panel B: Dependent Variable = Number of Inconsequential Items Waived

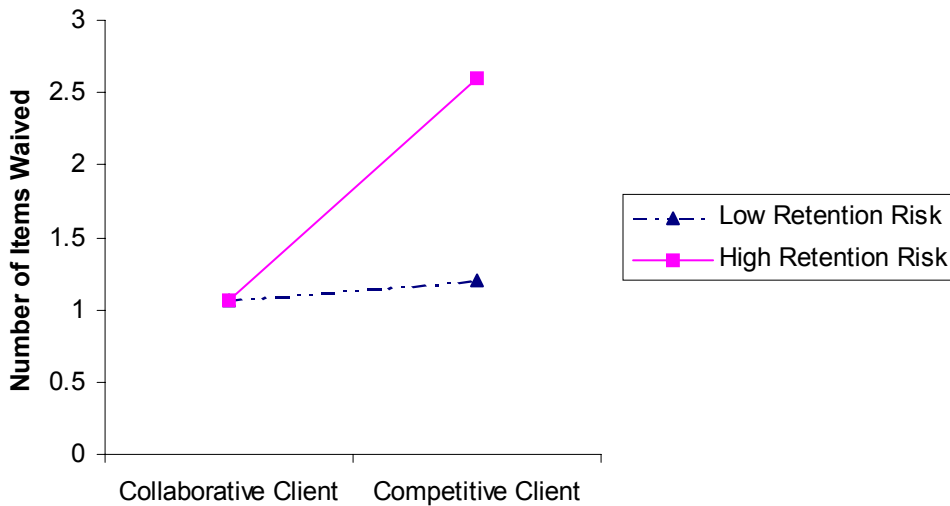


TABLE 1
Number of Inconsequential Items Brought to Client Management (n = 60)

Panel A: ANOVA Results Number of Inconsequential Items Brought to Client

Independent Variable	df	F-Statistic	p-value ^a
Competitive/Collaborative Client	1	3.504	.033
Retention Risk	1	3.504	.033
Interaction	1	2.868	.048

Panel B: Mean (Standard Deviation) Number of Inconsequential Items Brought to Client^b

	Collaborative Client	Competitive Client	Row Means
Low Retention Risk	¹ 1.73 (1.75)	² 1.80 (1.21)	1.77 (1.48)
High Retention Risk	³ 1.80 (1.47)	⁴ 3.13 (1.30)	2.47 (1.53)
Column Means	1.77 (1.59)	2.47 (1.41)	

Panel C: Results of Planned Contrast

(Cell 4 Mean – Cell 3 Mean) > (Cell 2 Mean – Cell 1 Mean)

F statistic = 2.87

p-value^a = .048

^a p-values are based on one-tailed tests since expectations were directional.

^b For all cells (1-4), n = 15.

TABLE 2
Number of Inconsequential Items Waived (n = 60)

Panel A: ANOVA Results Number of Inconsequential Items Waived

Independent Variable	df	F-Statistic	p-value ^a
Competitive/Collaborative Client	1	9.134	.002
Retention Risk	1	6.445	.007
Interaction	1	6.445	.007

Panel B: Mean (Standard Deviation) Number of Inconsequential Items Waived^b

	Collaborative Client	Competitive Client	Row Means
Low Retention Risk	¹ 1.07 (1.22)	² 1.20 (0.68)	1.14 (0.97)
High Retention Risk	³ 1.07 (1.03)	⁴ 2.60 (1.24)	1.84 (1.37)
Column Means	1.07 (1.11)	1.90 (1.21)	

Panel C: Results of Planned Contrast

(Cell 4 Mean – Cell 3 Mean) > (Cell 2 Mean – Cell 1 Mean)

F statistic = 6.45

p-value^a = .007

^a p-values are based on one-tailed tests since expectations were directional.

^b For all cells (1-4), n = 15.

TABLE 3
Number of Items Posted (n = 60)

Panel A: ANOVA Results Total Number of Items Posted

Independent Variable	df	F-Statistic	p-value ^a
Competitive/Collaborative Client	1	.182	.671
Retention Risk	1	.046	.832
Interaction	1	.046	.832

Panel B: Mean (Standard Deviation) Total Number of Items Posted^b

	Collaborative Client	Competitive Client	Row Means
Low Retention Risk	¹ 4.60 (0.91)	² 4.53 (1.46)	4.57 (1.19)
High Retention Risk	³ 4.73 (1.44)	⁴ 4.53 (0.92)	4.63 (1.19)
Column Means	4.67 (1.18)	4.53 (1.20)	

^a p-values are based on two-tailed tests.

^b For all cells (1-4), n = 15.

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