International Journal of Auditing
Int. J. Audit. **8:** 1–19 (2004)

A Grounded Theory Model of Auditor-Client Negotiations

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The central research question addressed in this paper is 'How do companies and their auditors resolve important audit issues?' In-depth interviews are conducted with the audit partners and finance directors of a varied group of six major UK listed companies who had recently experienced audit interactions involving 22 significant accounting issues. A grounded theory model is developed of the negotiation process and the factors that influence the nature of the outcome of interactions. This model identifies, as principal analytical categories, a range of general relationship factors and specific accounting issue factors that influence aspects of the negotiation process. These aspects include the parties involved, the strategies adopted, the quality of the financial reporting outcome and the ease with which it is achieved. A secondary outcome of the research is that distinct categories of audit engagement partner are identified, termed the *crusader*, the *safe pair of hands*, the *accommodator* and the *truster*.

Key words: Auditor-client interactions, audit conflict, audit negotiations, grounded theory, negotiation strategy.

SUMMARY

Companies' aggressiveness in financial reporting, and the role of auditors in constraining this, are important contemporary topics (Levitt, 1998; APB, 2001). Very few studies, however, examine the *process* of negotiation between auditors and directors. Although generic negotiation models capture many aspects of this process (e.g., exchange of information, appeal to norms, strategies and tactics adopted), such models (e.g., Gulliver, 1979) are under-theorised given the complexity of the auditor-client relationship and require further development. To date, the only behavioural study to adopt a qualitative, case study based approach using real audit negotiations is Beattie *et al*. (2001), reported in a book titled *Behind Closed Doors: What Company Audit is Really About*. A grounded theory model of the negotiation process was developed and the purpose of this paper is to summarise the findings of that study, making it accessible through the scholarly journal literature.

Matched interviews were conducted with the finance directors (FDs) and audit engagement partners (AEPs) of six major UK listed companies who had recently engaged in significant discussions and negotiations. Interviewees were asked to 'tell the story' of these interactions. The

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ISSN 1090–6738
Received December 2002
Accepted December 2002

analytical procedures followed enable concepts to be identified and grouped into categories. The interaction itself is the core category of the grounded theory analysis. It is a process involving events, strategies, outcome and consequences. The nature of the interaction is influenced by the *specific* context of the interaction: the issue, the objectives of the individual parties, key third parties and other factors. This specific context in turn moderates powerful *general* contextual factors: the quality of the primary relationship, company circumstances, audit firm circumstances and company buyer type. The external economic and regulatory setting has a significant but more peripheral impact.

The primary contextual factors affecting the strategy adopted by each party and the nature of the outcome appeared to be general, rather than specific. High AEP integrity ensured an outcome quality above a certain threshold, although the ease of agreement depended upon other factors. A quality hierarchy of six seller types is hypothesised. The quality of the primary relationship impacted directly upon both the quality of the outcome and the ease of agreement. Other critical general factors were: company type and situation (e.g., conservative or aggressive, the possibility of a bid); the effectiveness of corporate governance arrangements in the company (e.g., powerful, dominant chairman); the clarity of the accounting rules relating to the interaction issue; and the support and quality control procedures of the audit firm. The strategy adopted by the AEP was an intervening variable: assertiveness, reasoning, coalition and sanction strategies were associated with good outcomes and ingratiation and conditional acceptance were associated with poor outcomes.

A secondary outcome of the study was the identification of a hierarchy of six seller types (i.e. AEP types) to complement the taxonomy of buyer types that already exists in the literature. This taxonomy reflects an AEP's level of professional and personal integrity, their level of technical competence and other personal characteristics (such as predisposition towards self-reliance, confrontation and scepticism).

INTRODUCTION

Companies' aggressiveness in financial reporting is an important contemporary topic. In a now famous speech titled *The Numbers Game*, a former Chairman of the SEC lambasted companies for manipulating accounting numbers and thereby eroding the quality of financial reporting (Levitt, 1998). The fundamental importance of this issue has, since the Enron affair, become more widely recognised. Debate has focused upon the general regulatory environment and factors specific to the auditor-client relationship (i.e. client company, audit firm and individual auditor factors).

The general regulatory environment reflects the particular regulatory control strategy adopted, a choice often characterised as the 'principles versus rules' debate. 'Formalism' implies a narrow approach to control, that is, the use of clearly defined, highly administrable rules, which carries the danger of 'creative compliance' (i.e. the use of rules to escape control without actually violating those rules). An anti-formalism strategy involves stressing the overriding purpose of financial accounting in terms of the true and fair view override (in the UK), the use of broad criteria and the avoidance of tight definitions. It can be criticised on the grounds of legitimacy (it being argued that citizens have the right to know exactly what is prohibited in advance of behaviour), imprecision, and the possibility of outrageous results (McBarnet & Whelan, 1991; 1992).[1] McBarnet & Whelan (1999) conclude that controlling creative accounting ultimately depends on instilling a business ethic of compliance within the spirit of the law.

The auditor-client relationship dimension of the debate on aggressive financial reporting is extremely complex. A key question is 'How do companies and their auditors resolve important audit issues?'. In particular, what role do auditors play in preventing overly aggressive financial reporting? In the UK, the Auditing Practices Board has issued a consultation paper that encourages auditors to be more alert and responsive to the risk of aggressive earnings management (APB, 2001). Specifically, auditors are encouraged to understand better the pressures on directors and management to deliver a specific level of earnings; to act with even greater scepticism; to place greater emphasis on the broader factors influencing materiality; to take a more robust attitude with directors; and to communicate openly and frankly with those charged with governance.

The audit firm-client company relationship (hereafter auditor-client relationship) has certain distinguishing features. The audit team must interact with the employees and management of the client company, obtaining information and explanations, with a view to preparing an audit report for the company's shareholders. Added to this, senior company management have *de facto* control over the appointment and remuneration of the auditor. A company's audited financial statements emerge from the interactions that take place between, primarily, the finance director and the audit engagement partner. These interactions can involve conflict, which leads in turn to negotiations and perhaps bargaining.

Many empirical academic studies have investigated the factors that influence (or are perceived to influence) an auditor's ability to resist management pressure (e.g., Knapp, 1985; Gul, 1989; Beattie *et al*., 1999) and auditors' response to ethical dilemmas (e.g., Lord & DeZoort, 2001; Shafer *et al*., 1999, 2001; Thorne & Hartwick, 2001). These studies use large-scale survey or experimental methods. However, very few studies examine the *process* of negotiation and (due to access problems) virtually none uses evidence drawn from real situations. It is only in recent years that a new strand of empirical behavioural research has emerged that possesses one or other or both of these desirable characteristics (Gibbins *et al*., 2001; Beattie *et al*., 2000; Goodwin, 2002).

To date, however, the only behavioural study to adopt a qualitative, case study based approach using real negotiations has been Beattie *et al*. (2001). Matched, in-depth interviews were conducted with the audit partners and finance directors of six major UK listed companies who had recently experienced audit interactions involving significant accounting issues. A grounded theory model was developed of the negotiation process and the factors that influenced the nature of the outcome of interactions. The study is reported in a book titled *Behind Closed Doors: What Company Audit is Really About*. Within this book, a chapter is devoted to presenting the interview evidence from each of the six case studies, and the process of development of the grounded theory is set out in detail. This permits the 'huge chasm' that often separates data from conclusions to be bridged (Eisenhardt, 1989, p. 539).

In this paper, the grounded theory model of the auditor-client negotiation process that emerged from the case study analysis is presented. This makes the findings accessible through the journal literature. In writing this summary paper, the opportunity is taken to update the review of related literature.

The remainder of this paper is structured as follows. The next section, a review of relevant literature, begins by examining negotiation, conflict and strategies in non-audit settings. It then reviews the limited prior and contemporaneous literature in audit settings that either examines the process of negotiation or collects real-life data on actual negotiations. Methods are briefly outlined in the third section. The fourth section of the paper presents the grounded theory model of auditor-client interactions. A final section summarises and concludes.

RELEVANT LITERATURE

Negotiation, conflict and strategies in non-audit settings

The generic process of negotiation (and related concepts) has been the subject of detailed analysis in the social sciences. 'Negotiation' is defined as 'processes of interaction between disputing parties whereby, without compulsion by a third-party adjudicator, they endeavour to come to an interdependent, *joint decision* concerning the terms of agreement on the issues between them' (Gulliver, 1979, p. 79, emphasis in original). Negotiation encompasses 'bargaining', which 'consists of the presentation and exchange of more or less specific proposals for the terms of agreement on particular issues' (Gulliver, 1979, p. 71).

The problem faced by negotiators is that of 'being interdependent while having interests which are in contrast to those of the other party' (Mastenbroek, 1989, p. 56). In addition, 'negotiating presumes a certain symmetry in the balance of power' (Mastenbroek, 1989, p. 63). 'Power' can be defined as 'the ability of one actor to overcome resistance in achieving a desired result' (Brass & Burkhardt, 1993). 'Conflict' can be defined as 'the interaction of interdependent people who perceive the opposition of goals, aims, and/or values, and who see the other party as potentially interfering with the realization of these goals (aims, or values)' (quoted in Nicotera, 1993).

Gulliver (1979) develops, from actual cases spanning a wide range of contexts, an analytical framework that captures the economic, social, and psychological aspects of the negotiation process. It is a non-game model that recognises two general processes in negotiation that create and sustain the internal dynamics: a *cyclical process* and a *developmental process*.

The cyclical process involves the ongoing exchange of information between the parties (perhaps incorporating information from third parties). The kind of information exchanged depends on the current phase of negotiation, and may include information about procedural rules, appeals to norms, factual information, threats and promises. When a party receives information, they assess it, adjust their own preference set and their expectations of the other party, and revise their overall strategy. They then make a tactical decision about what information to pass to the other party. Typical tactics are: to concentrate on obtaining further information; to change the subject matter of the information exchange when a current issue seems threatening; to focus on the affective tone of the relationship; to match the behaviour of the other party, for example offer antagonism for antagonism; to offer opposing behaviour to that of the other party; and to make concessions.

The developmental process occurs through successive iterations of this cycle, as they drive the negotiation through a number of overlapping phases. The causes of convergence and the nature of the outcome can often be explained in terms of appeals to norms and other sources of power. It is the conversion of potential power into effective persuasive strength (not actual power) which is important.

Negotiation strategies and tactics are examined by Kipnis *et al*. (1980), who undertake an empirical study of managerial use of influence within organisations. They first asked managers to describe actual incidents and from this constructed a questionnaire containing 58 influence tactics. Responses to this questionnaire were factor analysed to reveal seven dimensions of influence. Kipnis & Schmidt (1982) developed a new scale to measure these seven influence strategies: *reason* – the use of facts and data to support the development of a logical argument; *coalition* – the mobilisation of other people in the organisation; *ingratiation* – the use of impression management, flattery and the creation of goodwill; *bargaining* – the use of negotiation through the exchange of benefits or favours; *assertiveness* – the use of a direct and forceful approach; *higher authority* – gaining the support of higher levels in the organisation to back up requests; and *sanctions* – the use of organisationally derived rewards and punishments.

Negotiation in audit settings

Analytical models of auditor-client bargaining have tended to be abstract, economic, game-theoretic models (e.g., Fellingham & Newman, 1985; Zhang, 1999). Over a decade ago, Murnighan & Bazerman (1990) argued that more behavioural research was needed if we were to further our understanding of negotiation behaviour. Despite this plea, limited work of this nature has been undertaken.

Other, non-analytical models have been developed. Kleinman & Palmon (2001) focus broadly on auditor-client relationships, with a particular emphasis on auditor independence. They synthesise extant research on auditor-client relationships and use this platform, together with established theories from the field of social psychology, to construct a multi-level model of these relationships. The levels considered are those of the individual, the audit firm (together comprising the micro model) and the wider environment (the macro model). The linkages between the different elements of the model and between the micro and macro levels are not really addressed and, as a result, the model is essentially a synthesising framework. Recognising some of these limitations, the authors call for more qualitative, case study research of auditor behaviour (p. 135).

Gibbins & Salterio (2001) develop a cognitive model of the auditor's intended strategy in auditor-client negotiations. They identify, from the generic bargaining literature, two principal strategies – distributive and integrative. Each has an associated range of tactics. Distributive tactics include concession-making and contending, while integrative tactics include creative problem solving and expanding the agenda. Three principal factors influencing intended bargaining strategy are defined: individual issue assessment, auditor motivation and auditor relative bargaining power. Each is presented, for simplicity of exposition, as a dichotomy: overlap/non-overlap between auditor and client acceptable ranges; toward-auditor-favoured outcomes versus toward-client-favoured outcomes; strong versus weak, respectively. Assuming cognitive economy (i.e., a simple strategy is preferred to a complex one) and manipulating auditor motivation and bargaining power factors, predictions are made regarding the general strategy and specific tactics that will be employed.

Two quantitative, questionnaire studies of interactions and negotiations have been undertaken. Gibbins *et al.* (2001) survey ninety-three experienced Canadian public accounting firm partners, who were asked to respond in the context of a specific negotiation example selected from their experience. They find that agreement was reported to have been reached somewhere between both parties' original positions in 41% of cases, on the auditor's original position in 32% of cases, and on the client's original position in 4% of cases. A new solution was generated in 16% of cases. The two factors said to be of most importance to the negotiation were 'accounting and disclosure standards' and 'audit firms' accounting expertise'. They conclude that negotiation is important, frequent and context-sensitive. Client perceptions were not surveyed and so no comparison can be made between the responses of the different parties. The questionnaire is structured using a three-element accounting negotiation process model based on the behavioural negotiation literature and elaborated to include accounting contextual features.

Beattie *et al.* (2000) survey 300 listed UK company finance directors and 307 listed company audit engagement partners (response rates were 51% and 80%, respectively). This survey established the frequency with which, over a three-year period, an extensive set of 46 audit and audit-related issues was discussed, was negotiated, and resulted in a change to either the accounting numbers or disclosures. This large-scale survey allows the extent, nature and outcome of interactions to be assessed for the population as a whole. Compliance issues are found to dominate discussions, while accounting and fee issues dominate negotiations. In aggregate, auditor/auditee interactions have a significant impact upon the content of financial reports, the mean number of reported changes to the accounting numbers (disclosures) being 1.3 (2.9) and 3.4 (6.1) for the FD and AEP groups, respectively.

In response to an open-ended question regarding the factors influencing the outcome of interactions, respondents referred to:

- the client's general attitude, in particular their wish to 'stick to the rules';
- the need for compromise, that is, to balance technical accounting considerations with commercial considerations;
- the influence of third parties, in particular audit firm technical departments and client audit committees;
- fear of referral to the Financial Reporting Review Panel (FRRP), the UK monitoring and enforcement body;
- the threat of audit qualification; and
- the quality of the auditor's argument in support of their position.

Goodwin (2002) uses an experimental approach to explore the conflict management styles used by auditors when resolving disputes with clients concerning financial statement issues. She adopts Rahim's (1983) generic model of conflict management styles, which is based on two dimensions: concern for self and concern for others. From these two dimensions, five distinct styles emerge: integrating (high concern for self and others); dominating (high concern for self and low concern for others); obliging (low concern for self and high concern for others); avoiding (low concern for self and others); and compromising (intermediate in concern for self and others). Seventy-two audit partners and audit managers from Australia and New Zealand took part, based on a scenario involving possible inventory obsolescence. It was found that the integrating style was used most frequently, followed by compromising and dominating styles. The size of the client and the strength of corporate governance mechanisms in place had a significant but relatively minor impact on the choice of styles.

To date, therefore, the only behavioural study to adopt a qualitative, case study based approach using real negotiations is the one summarised in the present paper.

METHODS

Case selection and conduct of interviews

The six cases were identified from the Beattie *et al.* (2000) questionnaire study. Respondents were asked whether they were willing to be interviewed to enable us to explore with them, in greater depth, the responses that they had made, and six finance directors (FDs) who indicated high levels of negotiation and discussion were approached for interview and all agreed. The recommended optimum number of cases in analysis of this type is four to ten (Eisenhardt, 1989). An effort was made to select companies representing a range of company sizes, industry sectors and audit firms

(Eisenhardt, 1989). Written assurances were given that neither the interviewee nor the company would be identified or identifiable in any subsequent publication.

Before the interviews took place, the company's annual reports for the period covered by the questionnaire were studied as a familiarisation exercise. No standard interview guidelines or questions were developed as each case was different. Instead, FDs were asked to 'tell the story', from their perspective, of the discussions and negotiations with their auditors referred to in their questionnaire responses, and encouraged to raise any other issues they wanted to (Thompson, 1988). The interviewer employed both neutral, conversational prompts and a laddering technique. This technique requires that the interviewer keeps asking 'why?', working backwards to antecedent conditions and forwards to anticipated effects (Brown, 1992, p. 293). Where necessary, subsidiary prompts used were:

- who got involved in the various stages of the interaction (e.g., FD, audit committee, main board)?
- what was the role of the audit committee?
- were negotiations conducted informally or at formal meetings?
- what information was exchanged?
- how did the information you received alter your preferences, your expectations of the other party, your strategy (if at all)?
- were any threats or promises made?
- what was the tone of the exchanges?
- were you happy with the outcome?

At the close of each interview, the FD was asked for permission to interview the audit engagement partner (AEP) with whom the discussions and negotiations had taken place.[2,3] All the FDs interviewed gave their consent, and in all cases the key contact was the audit firm's designated AEP, confirming that this was the primary relationship. In one case, however, the condition was that the FD also wanted to be present. We asked the interviewee to effect an introduction to the AEP, before contacting the AEP direct and conducting a similar interview with him.

Each AEP was asked to 'tell the story' from his perspective about the issues which had been discussed with his client and was also encouraged to add any other information he considered relevant. We were very careful not to give any indications to the AEPs of what the FDs had actually said about any of the issues. Eleven interviews were recorded and fully transcribed. Extensive notes were taken at the remaining interview and dictated immediately afterwards.

Analytical procedures

Analysis of the transcribed interviews was undertaken using grounded theory procedures and techniques (Strauss & Corbin, 1990). Grounded theory is the process of building theory inductively by means of the qualitative analysis of data. General theories of negotiation, such as Gulliver's framework, may have some applicability to the audit setting. There are, however, important specific circumstances associated with the audit context that suggest that any general framework will be conceptually underdeveloped and will need special adaptation and extension.[4]

Following a preliminary review of the transcripts, it was decided to adopt a four-stage process: telling the story of each case; within-case analysis; cross-case analysis; and building theory from cross-case analysis. By means of an iterative process, the key events and issues referred to by the interviewees in each case were identified and written up as a chronological story that reflected the differing perspectives of both interviewees on the issues (Hansen & Kahnweiler, 1993).[5,6]

The analytical stages involved coding of three types. During early 'open' coding, conducted during within-case analysis, concepts were identified, labelled and categorised. Concepts, the basic unit of analysis in grounded theory, are names that represent a phenomenon and therefore can be used at a higher level of generality than the raw data. Concepts were identified by asking questions of the raw data and by comparing phenomena so that like phenomena were given the same name. Once concepts began to emerge from this coding, concepts that appeared to relate to the same phenomenon were grouped together, thus forming categories. These categories were also labelled, using higher-level names than those of the concepts grouped under it. To identify and understand the relationships between categories in the later stages of analysis, it was necessary to establish the attributes of the categories (i.e., their properties) and also the dimensions of these properties.

Whereas open coding focused on the breaking down of data, the second type of coding, axial coding, focused on putting the data back together again in a different way, by making connections between each category and its sub-categories. This process allowed categories to be developed beyond their properties and dimensions. Elements of this type of coding inevitably creep into open coding, for as the data is broken apart it is natural to begin to put it back together in a relational form. The third and final type of coding, selective coding, concerns the final theory development phase of analysis. It involved the selection of a core category, followed by a process of systematically relating all other categories to it at a high level of generality.

During preliminary within-case analysis, labels were attached to the three broad key concepts contained in each case: context, interactions and outcomes. At an early stage, we identified four contextual factors that we thought might influence the nature and outcome of the interactions. These were: company size; the quality of the primary relationship between the FD and the AEP (graded from poor to very good); the existence of an audit committee; and the company reporting style (graded from aggressive to very conservative).[7] Financial reporting interactions were classified in two ways: (i) compliance versus judgement; and (ii) whether recognition, measurement, classification in a primary statement, disclosure or fundamental accounting principle. Outcomes were graded from good to poor.

During detailed within-case analyses, the *general* contextual factors that appeared to influence the nature and outcome of *all* the interactions were identified for each case. Each interaction was then analysed separately and appropriate labels attached to its type and outcome. The *specific* contextual factors that appeared to influence the interaction were then identified. This within-case analysis led to the identification of concepts, categories, sub-categories and relationships specific to the interactions occurring in a single case setting.

As the data was read and reread, all three types of coding took place, although open coding dominated early within-case coding sessions while axial and selective coding dominated later sessions. Moreover, all early coding was viewed as provisional, as concepts and categories evolved and changed as new data was read and compared. Many iterations were required before a stable set of concepts and categories emerged. During coding, notes were written containing the products of the three types of coding, such as concept labels, sub-categories and relationships. Diagrams that visually represent the relationships between concepts and categories were particularly useful. These were modified continuously as the analysis of the data progressed and new insights emerged.

RESULTS

In this paper, only the results of the cross-case analysis and the grounded theory model are presented. The separate within-case analyses can be found in Beattie *et al.* (2001, chs. 5–10).

Overview of principal analytical categories

The core category (the central phenomenon) was the interaction itself. The other principal categories represent a set of conditional features bearing upon the core interaction, with some category groups being quite distant to the interaction and others very close to it. These groups are shown in Figure 1 as a series of embedded rectangles.[8]

At the outermost level, reflecting the weakest and most indirect influence on the interaction, lies the global regulatory climate. This category refers to the tone of pronouncements and policies on accounting and auditing emanating from the SEC in the US and the EC. Although none of our interviewees specifically mentioned these bodies, the global regulatory position influences the national regulatory position and most of the interviewees would be aware of this link. Most of the case companies had overseas operations.

Next closest to the periphery lies the external national climate, encompassing the external trading environment (economic growth, interest rates, exchange rates) and the national regulatory climate. The influence of the regulatory bodies in particular were mentioned by interviewees – the impact of the ASB in curtailing aggressive accounting practices; the desire not to be investigated by the FRRP; and the need to comply with the UK's corporate governance requirements.

Moving one level further towards the core, we come to the general context of the company and the audit firm. This context impacts upon all interactions between these two parties. There are four distinct categories to consider here: the quality of the primary relationship; the company circumstances; the audit firm circumstances; and the company buyer type.

Closest to the core comes the specific context of the interaction. This concerns features of the

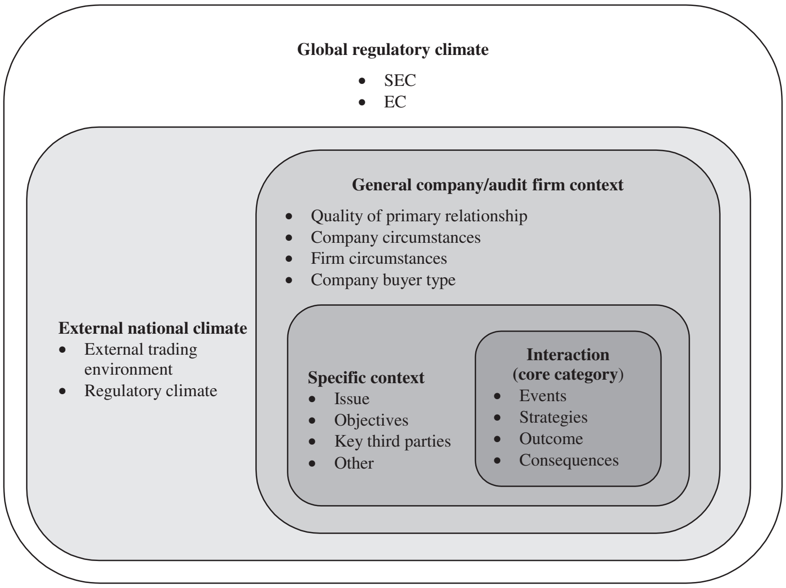

Figure 1: ***Principal Analytical Categories***
Source: Figure 12.1 in *Behind Closed Doors: What Company Audit is Really About*, Beattie *et al*. (2001), Palgrave. Reproduced with permission.

interaction that vary from interaction to interaction, moderating the general contextual factors. We identified four distinct categories: the interaction issue; the objectives of the individual parties; the key third parties; and other factors.

Finally, there is the core category, i.e., the interaction itself. We identified four categories involved in the sequence of related actions: events, strategies, outcome and consequences.

Concepts, properties and dimensions associated with principal analytical categories

From the separate within-case analyses, the concepts, properties and dimensions associated with the principal analytical categories were identified. These are set out in detail in Table 1. In many cases, the concepts related to a category are, to a greater or lesser extent, interdependent. The text offers some additional observations relating to the quality of the primary relationship, company circumstances, and interaction events, strategies and outcomes.

Looking first at the quality of the primary relationship, two concepts appeared to have a negative influence – age gap and FD's previous employment with audit firm in a position senior to AEP. While the professional integrity of the two individuals (especially the AEP) impacted very directly on the interaction, it also appeared that the level of professional integrity of one *relative* to the other influenced the interaction indirectly through its impact on the quality of the primary relationship.

Many of the salient company circumstances were also audit risk factors. The latter were of two general types, those related to the corporate culture and those related to the company's current financial and trading circumstances. Buyer type is a culture-related factor. Four distinct buyer types of audit services were identified by Beattie & Fearnley (1998), based on survey evidence: grudger, comfort-seeker, resource-seeker and status-seeker. Essentially, buyer type is determined by the board's attitude to five issues: the overall value of the audit and the importance of four general auditor characteristics (integrity/competence/reputation of auditor; auditor's acceptability to third parties; quality of working relationships with auditor; and non-audit services provided by auditor). Buyer type is associated with both company reporting style and the professional integrity of the FD.

Table 1: Principal Categories and their Concepts, Properties and Dimensions

Category	*Concepts*	*Properties and dimensions*
Quality of primary relationship	Mutual objectives Mutual trust and respect Compatible personalities Experience/competence Level of professional integrity of FD relative to AEP Age gap FD's previous employment with audit firm in a position senior to AEP Length of relationship	Very poor–very good
Company circumstances	Size of company Buyer type: • grudger • comfort-seeker • resource-seeker • status-seeker	Importance of company to client portfolio
	Ownership structure Company reporting style, i.e., board attitude to: • matters of fact (compliance culture) • matters of judgement (aggressive vs. conservative) Professional integrity of FD Effectiveness of audit committee Financial position (healthy/in difficulties) Growth position (expansion/contraction) Bid risk/possibility of sale	Audit risk of client
	Level of technical accounting expertise within company	Level of technical support required
Firm circumstances	Support and monitoring infrastructure Partner incentives	Structures, procedures, schemes
	Professional integrity of AEP Personal integrity of AEP	Low–high
Interaction issue	Fundamental principle Recognition Measurement/valuation Classification in a primary statement Disclosure	Fact vs. judgement One-off vs. continuing Visible vs. not visible Materiality
Objectives of individual parties	Desire to minimise effect and/or visibility of issue Earnings management Revenge Face-saving: – own – another individual – organisation Secrecy Keep out of trouble Avoid escalation Avoid confrontation	—
Key third parties	Chairman Individual non-executive director CEO Board of directors Audit committee Senior management (not main board level)	Affiliation: company, audit firm, external; Influence: direct or indirect via primary party Active involvement vs. passive influence

Table 1: Continued

Category	*Concepts*		*Properties and dimensions*
	Second partner Technical partner Technical department Regulator Specialist advisor Shareholders Analysts Lenders		Nature of involvement: • provide information or opinions/assurance • be informed • give approval/agreement • participate in negotiation • take action
Other specific contextual factors	Party raising issue: – FD – AEP – both		—
	Agreement between primary parties that issue needs to be addressed		
	Negotiation conducted under time pressure/reporting deadlines		
	History of issue, i.e., need to take a tougher stance due to: – regulatory climate – new evidence – change in company risk profile		
	Impact of other current interactions		
	Impact on future accounting periods		
Interaction events	Provision of information by auditor		—
	Primary party seeks advice/opinion of third party		
	Withholding of information from third parties		
	Search for solution to avoid an undesirable outcome for company (e.g., reduce visibility)/ assessment of alternative outcomes		
	Change of position		
	Acknowledgement of mistake		
Interaction strategies	State position very firmly at outset	Assertiveness	—
	Tender/auditor change threat made	Sanction	
	Escalate or threaten to escalate negotiation by involving additional parties	Sanction	
	Qualification or threat of qualification made	Sanction	
	Take blame (to achieve desired outcome)	Ingratiation	
	Use evidence to support argument	Reason	
	Use reasoned argument	Reason	
	Willingness to compromise	Bargaining	
	Strategic give and take across issues	Bargaining	
	Agreed strategy for handling third parties	Coalesce	
	Get third party on side to secure agreement	Coalesce	

Table 1: Continued

Category	*Concepts*		*Properties and dimensions*
	Seek confirmation and authority: – for own position – for other party's position	Higher authority	
	Apply conditions to acceptance of other party's position	Conditions	
Interaction outcome	—		Quality of accounting: poor/not compliant – good/fully compliant Ease of agreement: very difficult–easy
Interaction consequences	Impact on other current accounting interactions Impact on future accounting periods Impact on fee negotiations Impact on quality of primary relationship Impact on third parties		—

Source: Adapted from Tables 12.1 to 12.11, in *Behind Closed Doors: What Company Audit is Really About*, Beattie *et al.* (2001), Palgrave. Reproduced with permission.

The position of the FD may, of course, not be in tune with that of the board as a whole (in reality, the company position tends to be the view held by key, dominant board members such as the chairman). The two buyer types that are incompatible between the FD and the board are that of grudger and comfort-seeker. It is unlikely that the FD will be a grudger if the company is a comfort-seeker, as it is in the FD's interests to adopt the company position unless it compromises his professional integrity. It is more likely that the FD will be by nature a comfort-seeker while the company is a grudger. This is a very difficult position for the FD as he will always be at risk of compromising his professional integrity in order to satisfy the demands of his employer.

Interaction events, which occur during an interaction, can be distinguished from interaction strategies, which are plans. Of course, the two categories are closely related, as the adoption of a strategy often gives rise to events, but not necessarily those planned. The particular mix of strategies used determined certain properties of the interactions, in particular, the number of parties involved, the number of stages, and the level of escalation. The interaction strategy concept 'willingness to compromise' had two distinct forms. The compromise could take place either within the accounting rules or outside the rules.

Of primary interest to external parties is the *quality* of the financial reporting outcome, that is, does the outcome reflect 'good' or 'bad' accounting from a public interest perspective? In addition, for the parties involved directly in the interaction, the ease with which the agreed outcome is reached is important. For a given outcome, it is rational for an individual to prefer an easy interaction to a difficult one. This outcome dimension is also a continuous variable. It captures issues like number of parties involved, number of stages, and the extent to which strategies were used that undermine ongoing relationships. These two dimensions of outcome (quality and ease of agreement) can be perceived as capturing the effectiveness and efficiency of the audit, respectively.

Grounded theory of interaction outcomes

Developing a grounded theory of auditor-client negotiations requires an understanding of the *process* of interaction. The key linkages are between context, strategy and outcome. Each of the 22 significant accounting issues analysed was reviewed to identify the *critical* contextual factors, the strategies adopted and the dimensions of the outcome. The results are shown in Table 2.

Table 2: Cross-case Analysis of Critical Contextual Factors, Strategies Adopted and Financial Reporting Outcome Dimensions

Case ref.	*General context*	*Interaction ref.*	*Issue type*[1]	*Specific context*	*Strategy*	*Quality*	*Ease of agreement*
NS plc	Very good relationship; Integrity on both sides; Severe financial difficulties; Chairman a grudger; Desire/need to moderate aggressive reporting style	NS1	FP	Agreement to address	AEP stated his position very firmly	Good	Easy
		NS2	C	History of issue: regulatory change, change in risk profile Agreement to address	AEP stated his position very firmly; FD and AEP get third party on-side	Good	Easy
TJ plc	Poor relationship; Small, family-controlled company; Chairman a dominant grudger; Possible sale	TJ1	J & C	Agreement to address; Evidence available	AEP willing to compromise; AEP escalated	Poor	Slightly difficult
		TJ2	C	–	Chairman escalated	Creative compliance	Very difficult
		TJ3	C	–	AEP took blame; AEP willingness to compromise; AEP seeks confirmation and authority of his position	Creative compliance	Very difficult
MP plc	Very good relationship; Integrity on both sides; Very conservative, compliant culture	MP1	J	Agreement to address; AEP use of evidence to support argument	AEP stated his position very firmly; AEP seeks confirmation and authority of his position	Good	As easy as could be
		MP2	J	AEP use of evidence to support argument	AEP stated his position very firmly; AEP seeks confirmation and authority of his position	Good	Relatively easy
CRA plc	Very good relationship; High integrity of AEP; Senior accountants fairly aggressive; Possible hostile bid; Respectable, mild comfort-seeker	CRA1	J	Impact of other current interactions	FD strategic give and take	Good	Easy
		CRA2	J	Agreement to address	FD and AEP seek confirmation and authority of their positions; FD and AEP use of evidence and reasoned argument; FD and AEP willingness to compromise	Good	Easy

CRA plc	Very good relationship; High integrity of AEP; Senior accountants fairly aggressive; Possible hostile bid; Respectable, mild comfort-seeker	CRA3	J	–	FD stated his position very firmly AEP escalated	As good as could be	Slightly difficult
		CRA4	J	Agreement to address; Impact on future accounting periods; Time pressure	FD and AEP willingness to compromise	Good	Easy
		CRA5	J	–	AEP stated his position very firmly; AEP escalated	As good as could be	Slightly difficult
RC plc	Fair relationship; Respectable comfort-seeker	RC1	J	Impact on future accounting periods	AEP use of evidence and reasoned argument	Good	Easy
		RC2	J	Impact on future accounting periods	AEP applied conditions to acceptance	Poor	Easy
		RC3	C	–	AEP stated his position very firmly; AEP threatened to qualify	Good	Easy
		RC4	C	–	AEP willingness to compromise	Acceptable	Easy
DA plc	Good relationship; Integrity on both sides; Small, family-controlled company; Chairman grudger; Hostile bid underway	DA1	J	Agreement to address	FD and AEP use of evidence	Good	Easy
		DA2	J	Impact on future accounting periods	AEP use of evidence; AEP escalated; AEP willingness to compromise	Relatively good	Relatively easy
		DA3	C	–	AEP willingness to compromise	Relatively good	Easy
		DA4	J	Time pressure	N/App.	Good	Easy
		DA5	C	–	AEP stated his position very firmly; FD and AEP get third party on-side	Good	Very difficult
		DA6	C	–	AEP stated his position very firmly	Good	Relatively easy

Note
1: FP = fundamental principle; J = judgement issue; C = compliance issue.
Source: Table 12.12, in *Behind Closed Doors: What Company Audit is Really About*, Beattie *et al.* (2001), Palgrave. Reproduced with permission.

The primary contextual factors affecting the strategy adopted and the nature of the outcome appeared to be general to the case, rather than specific to the interaction. In particular, the integrity of the AEP influenced the quality of the outcome – high integrity ensured an outcome quality above a certain threshold, although the ease of agreement depended upon other factors. The quality of the primary relationship impacted directly upon both the quality of the outcome and (in those cases where the position of the FD was in tune with that of the board) the ease of agreement. Where the position of the FD was not in tune with that of the board, difficult interactions could still arise despite a good primary relationship.

The integrity of the AEP and the quality of the primary relationship appeared to be correlated, in practice, insofar as all of the good or very good primary relationships involved AEPs with high integrity. Other general contextual factors that critically influenced both outcome characteristics were: the company type and situation (e.g., conservative or aggressive, the possibility of a bid); the effectiveness of corporate governance arrangements in the company (e.g., powerful, dominant chairman); the clarity of the accounting rules relating to the interaction issue; and the support and quality control procedures of the audit firm. These relationships are shown in Figure 2.

It was also observed that some contextual factors served to constrain the possible outcome to within certain bounds (e.g., AEP integrity), while others acted more as moderating variables (e.g., quality of

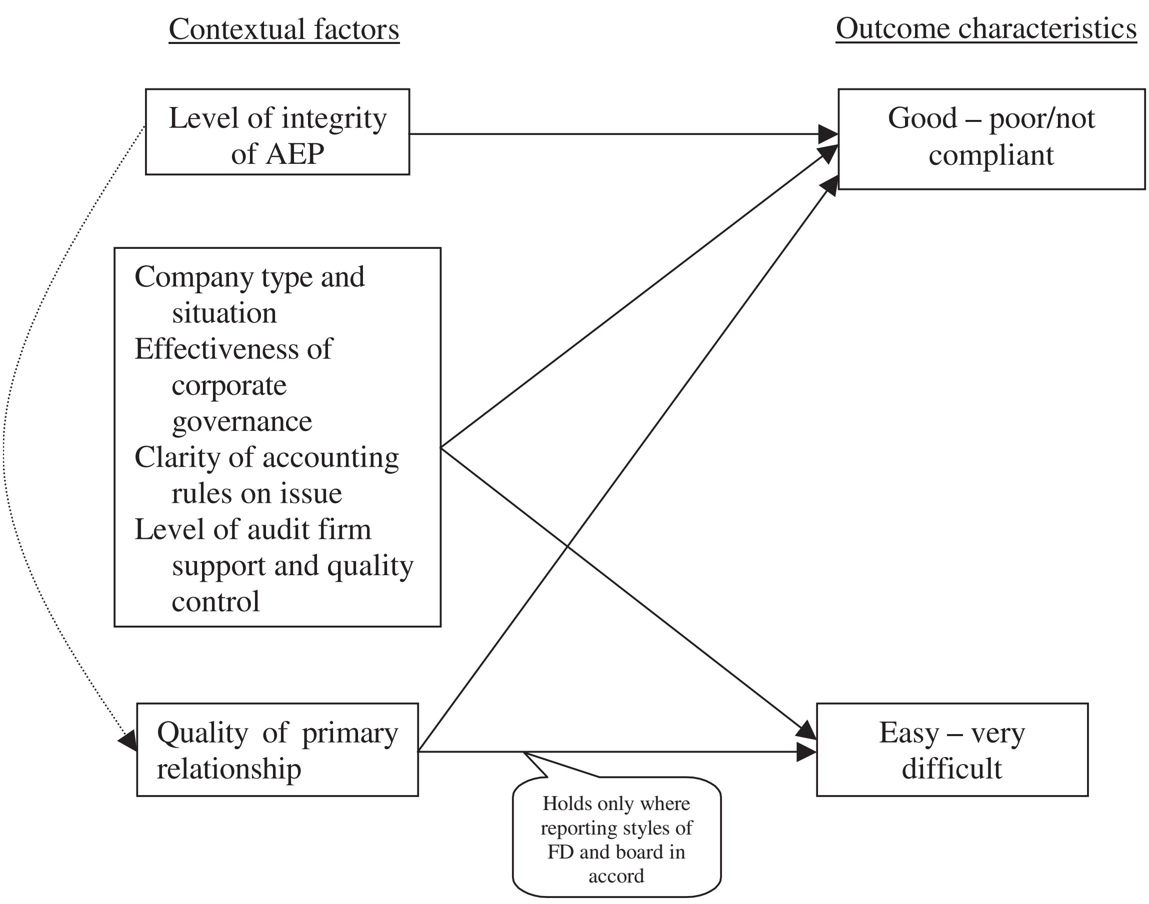

Figure 2: ***Relationships between Contextual Factors and Outcome Characteristics***
Source: Figure 12.3, in *Behind Closed Doors: What Company Audit is Really About*, Beattie *et al*. (2001), Palgrave. Reproduced with permission.

company's corporate governance arrangements). The strategy adopted by, in particular, the AEP, was an intervening variable in these relationships. In general, assertiveness, reasoning, coalition and sanction strategies were associated with good outcomes, although whether they were attained easily or not depended on other contextual factors. By contrast, ingratiation and conditional acceptance were associated with poor outcomes. The use of bargaining and authority strategies were associated with outcomes of varying quality and so no stable relationships emerged.

Six interactions had outcomes that were, to varying degrees, difficult to achieve, irrespective of the quality of the outcome. The cases involved had certain characteristics in common: two were small, family-controlled companies where the chairman was a grudger, while two involved hostile bids (with a third considering a sale). Notably, they also had one critical characteristic not in common, as a mix of relationship qualities was represented – from poor to very good. However, in those cases where the relationship was at least good, the FD and the board were not in harmony in their reporting style, and it was this that contributed to the difficulty.

Four interactions had outcomes that were of low quality (either poor or creative compliance). Both cases giving rise to these four interactions involved AEPs who exhibited moderate rather than high levels of integrity and where the primary relationship was less than good. In none of these four interactions did the AEP state their position firmly, and the failure to use this assertiveness strategy seems to have contributed significantly to the poor outcomes.

Seller types

A secondary outcome of the study was the identification of a hierarchy of six seller (i.e. AEP) types to complement the taxonomy of buyer types that already exists in the literature. 'Crusaders', the highest quality AEP, exhibit an extremely high level of professional and personal integrity. In other words, they display a social conscience as well as a professional conscience. They are prepared to take their responsibilities beyond their strict statutory duty if they feel that it is the right thing to do. The 'safe pair of hands' AEP displays a high level of professional integrity and their actions are designed to ensure that the company's financial reporting complies not only with the letter of the regulatory framework, but with the spirit. Although this seller type identifies strongly with the client company, and acts as advisors to it, they do not compromise themselves in any way.

'Accommodators' have a moderate level of professional integrity, complying with the letter of the rules. However they are prepared, under certain circumstances, to bend the rules, that is, to condone creative compliance or rather aggressive accounting treatments. The circumstances might be pressure from the client company, or historical 'baggage' relating to the issue that make it difficult to insist on what is known to be the 'right' accounting outcome. Above all else, they want to be helpful to the company where possible. This approach can, however, easily backfire if the client company loses respect for the AEP. 'Trusters', when dealing with a client company that is known to have a conservative reporting style and to be concerned to preserve its reputation, adopt an attitude that is insufficiently critical and questioning given their role as auditor. They take the company to be fireproof and are not sufficiently sceptical. While their underlying professional integrity may be high, this trusting attitude serves to 'dilute' their effective level of professional integrity.

Both the accommodator and the truster can exhibit 'do-it-yourself' characteristics, in that they do not consult appropriately within their firm. This behaviour could arise for a number of reasons: it may be that the AEP thinks that they know it all, or that they are doing something that they know they should not be doing, or because of personal style. Both the crusader and the safe pair of hands do, however, consult when appropriate.[9]

'Incompetents' lack the necessary level of technical competence to secure good outcomes in cases where the client company is ignorant or non-compliant. 'Rogues' have no sense of professional integrity. They will knowingly flout the regulatory framework for personal gain if they think that they can get away with it.[10] No examples of the lowest two quality levels were found among the case studies in the present study.

SUMMARY AND CONCLUSIONS

The study reported here shows audit to be a complex, interactive and judgemental process, which requires a high level of technical knowledge, integrity and interpersonal skills from the AEP. The outcome of each interaction is found to be influenced by a range of factors that emanate from the general circumstances of each case, the specific nature and significance of the issue and the clarity of the regulatory framework surrounding it.

The grounded theory model of auditor-client interactions presented in this paper suggests that existing negotiation models (e.g., Gulliver, 1979 and Nicotera, 1993) do not adequately encompass all dimensions of these interactions. The quality of the primary relationship and the integrity of the AEP are shown to be critical in securing a good (i.e., high quality) outcome. A quality hierarchy of six seller types is hypothesised. Fully compliant outcomes are easier to achieve where the company board has a conservative attitude to financial reporting and where there is a good working relationship between the FD and the AEP. A key driver of aggressive accounting was found to be financial difficulty, and particularly the need to stay within debt covenants. Financial reporting quality could change rapidly as a company's circumstances change (e.g., a decline in profitability or the expectation of a hostile bid). Good relationships occurred where there was mutual trust and respect and where both parties had a high level of integrity.

Fully compliant outcomes were more difficult to achieve where one or more of the following circumstances existed: the board's culture was less conservative; the issue was a sensitive one within the company; the issue arose at a late stage in the financial reporting cycle; the buyer type was a grudger; or the firm was disorganised. To achieve a fully compliant outcome in these more difficult circumstances, the AEP needed to take a firm position from the outset. Additional useful strategies were for the AEP to call on other parties in his firm for support and also seek support from the company's audit committee. Support from the audit committee was not, however, necessarily forthcoming. A well-researched argument grounded in the regulations greatly helped the AEP to carry his point. Where the issue was a matter of judgement rather than a straightforward matter of compliance with a regulation, the AEP found it more difficult to get his point of view accepted. An important mechanism for avoiding confrontation was for the FD and the AEP to maintain a continuous, interactive relationship, so that issues were resolved as they arose. Late interventions from an audit firm's technical reviews caused irritation to FDs. Proposed last minute adjustments to accounts created undue time pressure and had the potential to lead AEPs to compromise the outcomes.

The four low quality outcomes arose in cases where the relationship between the FD and the AEP (i.e., the primary relationship) was not good. Poor relationships may arise because the FD and AEP do not trust and respect each other and lack goal congruence. Contributory factors to this situation occur where the FD has previously been in a position senior to the AEP in the same audit firm (which appears to put the AEP at a disadvantage) or where there is a significant age and experience gap between them.

Non-compliance with accounting standards that is visible on the face of the accounts appeared to be extremely rare, since companies and auditors run the risk of visible breaches being picked up by FRRP. The FRRP is perceived as a deterrent to non-compliance, particularly by the larger, more conservative companies who do not wish to incur reputation damage. Ownership structure and corporate culture were found to have a major influence on attitudes to corporate governance and financial reporting.

There was strong awareness among FDs and AEPs of the possibility of sanctions being applied. The key sanction available to a company board is to remove an auditor, subject to legal process. This puts economic pressure on the audit partner. Another form of economic pressure is to try and get the audit fees reduced. The threat of putting the audit out to tender (made in two of the cases) is normally the first step in the auditor change process and can be used either for the purpose of intimidating an auditor and/or as a means of getting a fee reduction.

The key sanction available to an auditor is to qualify the audit report (or, *in extremis*, to resign and draw attention to the reasons for the resignation). However, lack of regulatory clarity and materiality can render this sanction ineffective. Lesser sanctions, such as referring the matter to the audit committee and/or the main board, are not always effective – these groups may choose to support the FD.

All the audit firms in the six cases had in-house quality control procedures in place, such as technical departments, consultation procedures and second partners assigned to the clients. However, the extent and timeliness of the use of these resources appeared to lie in the hands of the AEPs. Critically, the ones who most needed to consult appeared to be the least inclined to do so.

The findings of this study suggest several useful avenues for future research. Further work is required to verify (and develop) the grounded theory model presented here. This could involve further case studies, particularly in other jurisdictions where some of the general contextual factors will be different. In addition, it would be useful to conduct experimental studies that focus on subsets of the critical variables to emerge from the grounded theory. Examining the attitudes, beliefs and motivations of secondary parties to the interaction could also extend the model presented here.

ACKNOWLEDGEMENTS

The research upon which this paper is based was funded by the Institute of Chartered Accountants in England and Wales. We would like to thank Professor Andrew Chambers for encouraging us to write this paper.

NOTES

1. McBarnet & Whelan (1991, 1992) argue that a strategy of anti-formalism was adopted by the newly formed Accounting Standards Board (ASB) post-Dearing in an explicit bid to restrain creative accounting. There has, however, been a drift (or push) back to formalism throughout the 1990s in the UK, with many accounting standards now including detailed guidance notes in addition to the broad principles (e.g., FRS 15).
2. To support the accuracy of the interviewee's statements, reference was made to the company's annual reports where the outcomes of some of the discussions and negotiations were observable, thus providing assurance about the reliability of the evidence collected (Yin, 1984, p. 80).
3. Without the client's permission, no AEP would talk to us because of professional confidentiality rules.
4. In particular, there is the regulatory environment in which the negotiation takes place, together with the professional connections of the main participants.
5. As confidentiality assurances had been given to the interviewees, certain distinguishing features about the companies have been omitted and changes made to information provided about the company and its activities in order to protect its identity. The omissions and changes do not alter the substance of the stories. Changes necessitated by ethical considerations such as these have been made in other accounting research projects (e.g., Anderson-Gough *et al*., 1999, p. 47).
6. In the cases where a continuing business relationship still existed between the two parties, particular care was taken to ensure that each party was comfortable with the remarks about his peer being included in the story. Although the companies themselves would not be identifiable, we were conscious that the interviewees could recognise each other, and we have no wish to undermine any business relationship. Other than very minor edits to improve clarity, which were suggested by the interviewees themselves, no other changes have been made to the material taken from the original transcripts.
7. Because of confidentiality constraints we referred to company size as being merely larger or smaller. For the same reason, the size of the audit firm was not disclosed. The existence of an audit committee was either yes or no, but attached to yes was an indicator as to whether it was (or was perceived to be) effective.
8. This figure is a useful analytical aid for considering the wide range of conditions and, to a lesser extent, consequences related to the phenomenon under study. Strauss & Corbin (1990, ch. 10) refer to it as a 'conditional matrix'.
9. It should also be noted that not all of the seller types are mutually exclusive. In particular, it would be possible for an AEP to display accommodator and truster characteristics.
10. The well-publicised US case of ESM provides an example of this AEP type (*Wall Street Journal*, 1987). The engagement partner stated that the loss of status within the partnership, were he to lose the client, was one of the reasons that he acquiesced to the client's fraudulent accounting practices.

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