

Modeling the Auditor's Intended Strategy in Auditor-Client Negotiation

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Abstract

This paper develops a cognitive model for an auditor engaged with client management in negotiations over financial statement content. This model defines the three principal factors that affect the auditor's intended bargaining strategy and tactics: individual issue assessment, auditor motivation and auditor relative bargaining power. Employing the issue assessment as background and manipulating the auditor motivation and bargaining power factors, the model makes predictions about the overall strategic approach the auditor intends to take to negotiation (i.e. distributive versus integrative). The model also predicts the specific tactics the auditor would likely employ within each approach considering variations in auditor bargaining power and motivation (e.g., within a distributive strategy when would the auditor use contending tactics). Applications of the model to explaining documented empirical observations, analyzing reported failed negotiations, and framing a field study of a negotiation demonstrates the model usefulness to accounting researchers. The paper concludes with suggestions for testing the model in archival, field and experimental studies.

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1. Introduction

This study presents a cognitive model of the auditor preparing for negotiation with client management over the content of the financial statements. There is increasing evidence that auditors are engaged in this sort of negotiation (Gibbins, Salterio and Webb, forthcoming (GSW henceforth), Beattie, Brandt, and Fearnley, 1999) and that such negotiations lead to changes in both the reported financial statement numbers and disclosures (Beattie et al., 1999). Regulators are questioning whether the auditor is making appropriate judgments over controversial accounting items (Schuetze, 1994, Levitt, 1998, Brown, 1999), which could have arisen from negotiation. We choose to model the auditor in this initial study, as the auditor normally initiates negotiation and it is the auditor, by signing the audit opinion, that brings to a close any negotiations taking place on current year's financial statements (GSW). To better understand the auditor's negotiation judgments we model the various considerations that the auditor must take into account when deciding issues to negotiate and what sort of strategies and tactics to employ. This model is written at a sufficient level of generality to describe auditor changes in cognitions as the negotiation progresses, so it is not limited just to the initial decision to negotiate.

Model development in this area is important for several reasons. First, general research on negotiation has tended to under-emphasize preparation for negotiation and consideration of the context in which the negotiation will take place (Pruitt and Carnevale, 1993). Second, the decision to negotiate and the consequent selection of negotiation strategies and tactics are highly complex, needing detailed analysis to understand the factors affecting judgment. Third, considering the auditor-client context (GSW) and the limited extant research

on intentions going into the negotiation (Babcock, Wang and Loewenstein, 1996) suggests that these are important determinants of negotiation outcomes. Fourth, modeling auditor cognitions suggests new approaches that auditors may take to negotiation and reveals strategies and tactics to be employed to achieve desired outcomes. Finally, GSW auditors reported that 60% of the time it was the auditor that determined whether negotiations would take place therefore their cognitions are important to understand.

This paper is the first to link the vast generic behavioral negotiation literature with prior descriptive research on auditor-client negotiations to generate a model of the auditor in the midst of client negotiation. The model allows us to better understand auditors' cognitions and provides testable predictions that can be examined via experiments, field studies and archival research. Furthermore, the model provides tentative explanations for empirical observations such as why some auditor-client relationships seem to be consistently difficult or why the auditor accepts different preferred accounting policies for different clients with similar fact sets. Finally, the utility of the model to aid empirical research is demonstrated via an examination of an SEC enforcement action (AAER #455).

The remainder of this paper proceeds as follows. In Section 2, we make brief comments on the literature and on four general foundations to our model. In Section 3, we develop and support an auditor-specific cognitive model that focuses on initial preparation for negotiation but that generalizes to auditor cognitions throughout the negotiation. In Section 4, we demonstrate results of the modelling exercise, providing predictions that can be tested based on that model. In Section 5, we discuss the implications of the model for how auditors may carry out negotiations with client management and for further research. Brief conclusions are in Section 6.

2. General modeling background

A cognitive model of negotiation, including the readiness to negotiate and intended negotiation behaviors to which our model is directed, considers what goes on in the heads of negotiators (Neale and Northcraft, 1991, 165). “Negotiators construct mental representations of the negotiation situation and their opponent, and their behavior is influenced by their judgments of the other party, their own bargaining role, and the bargaining situation.” (Thompson, 1990, 524). We model these mental activities and the auditor’s intended strategies and tactics as preparation for entering negotiation and as they are revised as a result of dyadic negotiation activities.

The cognitive model of auditor intention developed in this paper has four general components as its foundation: the auditor’s assessment of the negotiation issue, perception of relevant motivational factors, perception of relative power to achieve a desirable outcome, and selection of intended strategy and tactics to take to the negotiation with the client. As background to the auditor specific cognitive model we present brief comments on the generic negotiation literature’s findings about the four model components.

2.1 Negotiator assessment of the issue to be negotiated

The mental model used by the negotiator is central to his/her assessment of the issue (or issues – for expositional simplicity we will usually use the singular, but our treatment extends to multiple issues). Negotiation research has shown that most negotiators assess the issue with the expectation that their and their opponent’s interests are opposed on almost every dimension (Thompson and Hastie, 1990, Bazerman and Neale, 1983). Furthermore, negotiators tend to frame changes in negotiation outcomes for both themselves and their opponent in terms of “gains” or “losses” from their initial most preferred position (De Dreu,

Carnevale, Emans and Van de Vliert, 1994, De Dreu, Emans, and Van de Vliert, 1992a and 1992b, Babcock, Loewenstein, Issacharoff and Camerer, 1995).

Research also has shown that the negotiators' assessments of their initial most preferred outcome is very important in how they act in subsequent negotiations (Kristensen and Garling, 1997, Northcraft and Neale, 1987, Neale and Bazerman, 1985, Bottom and Studt, 1993). Features in the negotiation setting affect the selection of an initial preference (e.g. in a labor-management negotiation, the initial reference point for developing a most preferred outcome may be last year's wage, management's initial offer, or an estimate of management's top offer). Beyond this, little is known about how the initial most preferred outcome is arrived at (Bazerman, 1983, Neale and Northcraft, 1991). Prior research indicates that negotiators do not fully incorporate all knowledge they have about their opponents when developing beliefs about what their opponents want from the negotiation (Carroll, Bazerman and Maury, 1988, Neale and Bazerman, 1983, Thompson and DeHarpport, 1994, Thompson, 1990, Ball, Bazerman and Carroll, 1991). These findings provide the basis for our further development of auditor issue assessment into which we add contextual features of the auditor-client management setting.

2.2 Negotiator perception of motivational factors

Generic negotiation research has considered motivation from two perspectives: the unidimensional model, having motivation as a continuum that ranges from low to high; and the dual concern model, considering motivation to arise both from concern for one's own outcomes and from one's concerns for the other party (Thompson, 1990). Motivation as a unidimensional construct has frequently been operationalized in research by having the negotiator be accountable to a constituency and/or setting explicit goals for negotiators to

achieve. Both of these factors have been associated with differences in how the negotiator chooses and uses strategies and tactics (Thompson, 1990, Neale, 1984, Tjosvold, 1977, Polzer and Neale, 1995, Benton and Druckman, 1974).

The dual concern model considers that negotiators' cognitions about motivation include considering their own personal need to achieve good outcomes for themselves as well as a concern for the outcomes of others (Pruitt and Rubin, 1986, Thompson, 1990). Research indicates that various combinations of high or low motivations for self and others affect negotiator selection of tactics (Ben-Yoav and Pruitt, 1984a, 1984b). These two dimensions of motivation are addressed later as we argue that the auditor-client setting is likely to raise such dual concerns for self and client.

2.3 Negotiator cognitions about power

The generic negotiation literature has studied cognitions about the relative power among negotiators from two perspectives: relative status of the two parties negotiating, and the effects of each party's perception of his/her own and the other's "best alternative to negotiation" (BATNA). Parties of equal status have been found to use different strategies and tactics in negotiations than do negotiators with unequal status (Neale and Northcraft, 1991, McAlister, Bazerman and Fader, 1986). The parties' perceptions of their own/other's BATNA is thought to affect their cognitions about bargaining power by making it more or less costly for the negotiator to walk away from a negotiation (Pinkley, 1995). Perceptions of BATNA have been found to affect choices by negotiators in the negotiation process (Pinkley, 1995, Pinkley, Neale and Bennett, 1994, Loewenstein, Issacharoff, Camerer and Babcock, 1993). Furthermore, the degree of precision that the parties felt they had about their/others' BATNA affected their negotiating strategy (Fobian and Christensen-Szalanski 1993, 1994). We add

audit context specific factors to the power dimension as part of the auditor model development in the next section.

2.4 Negotiator selection of strategy

Very little generic negotiation research directly deals with the selection of negotiating strategies and tactics (Neale and Northcraft, 1991). While the strategies and tactics are well documented in the literature (e.g., Pruitt and Carnevale, 1993) the research normally examines inputs and outputs and infers what the strategies and tactics must have been to achieve the outcome. Alternatively, negotiators are put in situations where the setting strongly encourages the use of a strategy or tactic and the results of this on negotiated outcome are observed. Neither approach results in much insight into how negotiators intend negotiations to take place nor revise their intentions during the negotiation process (Pruitt and Carnevale, 1993, 201, Lewicki and Litterer, 1985).

Therefore, we consider the auditor's development of strategies and tactics at length in our model, which has been designed to provide specific predictions about this set of auditor intentions in the negotiation setting. The literature about various strategies and tactics is mentioned in Section 3.4's presentation of the model's dependent variable.

3. A Cognitive Model of the Auditor's Intended Negotiation Behavior

The model portrays the auditor's cognitions in a negotiation. As we have begun to show, it is based in the behavioral negotiation literature but has components specific to the auditor-client accounting negotiation setting. Many of these specifics are drawn from the empirical results in GSW. The model has the following general structure:

- ✍ The auditor assesses individual potentially negotiable accounting issues, each of which has certain features and implications;

✍ The auditor combines the assessment of the issue(s) with broader motivational and power factors to develop intended negotiation behaviors (strategies and tactics).

This initial set of intentions is taken into the dyadic bargaining with the client, and after one or many bargaining rounds which include potentially revising the auditor's intended strategies and tactics, the negotiation outcome occurs. Our model focuses on the development of intentions at any point in time, based on the auditor's cognitions to that point – it does not deal with the bargaining behaviors and outcomes themselves. The model is general in that it can be applied at the time the auditor first encounters an issue with the potential for negotiation, or to any iterations when the auditor is revising his/her position based on information and changes in beliefs as a result of the dyadic negotiation. This paper focuses on the auditor's intentions, so those of the client are not modeled, nor is the dyadic negotiation. However, the place of the auditor's cognitions in relation to these is specified.

3.1 Notation and model components

Throughout, our model presumes that the auditor's knowledge, including of relevant regulations (accounting, auditing, ethical, regulatory, taxation, etc.) is applied in all relevant cognitive activities. On occasion where particularly cogent this is specified below.

Table 1 lists the components of our cognitive model, and the model itself is presented in Figure 1. Both show the cognitive operations (those that involve judgment and choice) in italics. The model specifies both cognitions operations and other cognitive activities as at any point in time, from the outset of the negotiation to its conclusion, therefore the components of the model are time-subscripted ($t = 1$ to n). Additionally, issue-specific operations and activities are issue-subscripted ($i = 1$ to k). Each of the model's components will be described more fully below, along with support for it provided by GSW and other studies.

Insert Table 1 and Figure 1 about here

3.2 Issue-specific cognitive factors

The negotiation is modeled as being about a set of one or many issues that affects the client's financial statements as to measurement, valuation or disclosure. Since the model is based on auditor cognitions, the set of issues is those perceived by the auditor, which will change over time as the negotiation process continues. The initial perceptions of the issue(s) invoke a negotiation schema in the auditor's mind and condition subsequent cognitions. Issues are modeled as being considered both individually and in relation with each other.

3.2.1 The issue features

Each issue has a set of accounting issue features, called $ISSUEFEATURES_{i,t}$ in Table 1 and Figure 1, that characterize that issue in the auditor's mind and invoke the negotiation schema we posit. The features include all factors necessary to identify potential outcomes and issue-specific auditor risk and materiality assessment (described later), and they reflect whatever information the auditor has at time t . These are as perceived by the auditor; they may be an incomplete and/or inaccurate set that is modified during the negotiation process. We limit the set of features to those the auditor considers relevant to deriving a preference about how the issue should be handled and to assessing the issue's role in any negotiation. Examples of features that were important to negotiations per GSW were those concerning the applicability of relevant accounting and disclosure standards, securities or exchange regulations, auditing standards, and industry practices.

3.2.2 Identification of the issue's potential outcomes

Accounting negotiation is conducted in order to obtain desired “meta-outcomes,” such as an unqualified audit report on the overall financial statements, client satisfaction with the auditor, continued appointment of the auditor or other client work for the auditor (GSW, Beattie et al., 1999, Antle and Nalebuff, 1991). These meta-outcomes are facilitated via the negotiated agreement on accounting policies that allow the auditor to give an unqualified opinion on the client's financial statements.

The desire for meta-outcomes is modeled as part of the auditor's motivation in Section 3.3.1. However, there is also an issue-specific aspect to outcomes: if any issue is negotiable or potentially so, then there is more than one possible outcome to the issue. Such outcomes may relate to accounting policies, measurements, valuations, disclosures, etc. for that issue.

Proposing that the auditor has perceptions of potential outcomes is consistent with the negotiation and accounting literatures (Neale and Bazerman, 1992, Antle and Nalebuff, 1991). As noted earlier, the auditor's knowledge, including of relevant accounting, auditing, tax and other external standards, is central to this component of the model. We use the label $ISSUEOUTCOMES_{i,t}$ for the cognitive operation of identifying the set of possible issue-specific outcomes. The set is identified via the features of $ISSUEFEATURES_{i,t}$, so that $ISSUEOUTCOMES_{i,t} = f(ISSUEFEATURES_{i,t} | standards)$, as defined in Table 1.

3.2.3 Auditor's preferences over potential outcomes of the issue

A central part of negotiation is identifying one's own preferences over the set of possible outcomes. We denote the auditor's preferences as $ISSUEPREFERENCES_{i,t}$. The model proposes that the outcome identification operation $ISSUEOUTCOMES_{i,t}$, and therefore the auditor's knowledge of standards, informs these preferences (see Table 1 and Figure 1).

GSW found that their auditor respondents were able to identify potential outcomes for the issues the auditors chose as negotiation examples and that they had initial beliefs as to what outcome they preferred.

From among the set of outcomes, the auditor can determine an acceptable range of potential outcomes, within which there exists a most preferred outcome, and can identify any outcomes outside that range that are unacceptable. This means that outcomes fall into four categories: auditor's most preferred (designated **amp**), other outcomes in the auditor's acceptable range (**aar**), outcomes unacceptable to the auditor (**auo**) and remaining outcomes for which the auditor has no preference yet (**anp**). These make up $ISSUEPREFERENCES_{i,t}$, so may also be subscripted **amp**_{i,t}, **aar**_{i,t}, **auo**_{i,t}, and **anp**_{i,t} to include multiple issue and time dimensions. As the negotiation process continues, the auditor may discover other potential outcomes that he/she did not initially consider, for which he/she will develop a preference. It is possible that for some issues the auditor may perceive that there is only one acceptable outcome, which would mean that **amp=aar** and all other outcomes are **auo**. GSW found that 37% of their auditors went into the negotiation believing that their role was to persuade the client that the auditor's position must be adopted, implying that the auditor had a most preferred outcome **amp** as well as an **auo** set.

3.2.4 Auditor's beliefs about client's preferences over potential outcomes of the issue

In the model, as in the literature (GSW, Antle and Nalebuff 1991), negotiation requires that the parties disagree as to preferred outcome. If auditor and client agree, there is nothing to negotiate. In order to make this determination, the auditor must have beliefs about the client's preferences over the set of possible issue outcomes, which beliefs we denote as $CLIENTBELIEFS_{i,t}$. In principle, these relate to the same list of potential outcomes as the

auditor's own preferences $ISSUEPREFERENCES_{i,t}$ were developed for, and so also flows from the outcome identification operation $ISSUEOUTCOMES_{i,t}$. We comment on the correspondence between the two preferences sets below, under the subsequent cognitive operation $ISSUEASSESSMENT_{i,t}$.

The same four categories of outcomes as in the $ISSUEPREFERENCES_{i,t}$ set may be specified for the set of $CLIENTBELIEFS_{i,t}$. We denote these by the prefix “**abc**” to indicate the auditor's beliefs about the client therefore specifying the auditor's belief of the client's most preferred outcome as $abcmp_{i,t}$, the believed rest of client's acceptable range as $abcar_{i,t}$, the outcomes believed unacceptable to the client as $abcuo_{i,t}$, and outcomes on which the client is believed to have no preference as $abcnp_{i,t}$.

At this time, there is no evidence as to auditors' understanding of their clients' preferences (beyond the assumption of rational evaluation found in modeling papers such as Antle and Nalebuff 1991), however GSW's auditor respondents were unanimous in reporting experiences with negotiation, therefore de facto had experienced differing preferences. Over 40% reported in an open-ended question that their reason for selecting their negotiation example was due to differences in auditor-client preferences. The combination of these two facts leads to our inference that the auditors would have known something about client preferences upon entering a negotiation. Furthermore, Beattie et al (1999) provide evidence that client chief financial officers' recalls of issues negotiated are highly correlated with auditors' recalled issues, again leading to the inference that preference differences must have existed for these issues to have been negotiated.

3.2.5 Auditor's risk perception and materiality considerations arising from the issue

At the individual issue level, the features of the issue result in a set of issue specific risks that includes materiality considerations. We denote this factor as $ISSUERISKS_{i,t}$. For example, risk considerations can arise from the auditor's knowledge of various regulations (i.e. accounting standards) applied to this specific issue, which may indicate relative aggressiveness of client accounting leading to the auditor's perception of risk. The auditor may also apply his/her knowledge of the environment to realize that issues with these features have been subject to more extensive regulatory scrutiny or have been the subject of lawsuits. The auditor also considers materiality of the issue (both for present and future years) as a related consideration to his/her perception of risk. GSW's auditors were not asked to indicate issue specific risk considerations, but they reported that all of their negotiations involved a material issue. As shown in Figure 1, this risk and materiality factor is modeled as following from the issue features $ISSUEFEATURES_{i,t}$.

3.2.6 Individual issue assessment

Cognitive operation $ISSUEASSESSMENT_{i,t}$ represents consideration of whether that issue is one that will be negotiated, dropped or considered only if needed because of other issues the auditor wishes to negotiate with the client. An important assessment contemplated by the model is to determine whether there is agreement between the auditor's preference and his/her belief about the client's preference on an issue. If the auditor perceives that the two parties agree, there is no need to negotiate the issue.¹ As shown in Figure 1, the auditor is modeled as comparing $ISSUEPREFERENCES_{i,t}$ and $CLIENTBELIEFS_{i,t}$, and (if there is a difference in the two preference sets or a strategic reason), bringing in risks and materiality

¹ This issue therefore would not be the focal issue of a negotiation, however, it may be raised in connection with another issue if the auditor sees a strategic advantage in doing so. We have more to say about this below.

factors from $ISSUERISKS_{i,t}$, to assess the situation *for that issue at that point in time*. If a preference difference is perceived and the issue is material, the issue would be a strong candidate for being a focal issue in the negotiation.

Formally, $ISSUEASSESSMENT_{i,t} = f(ISSUEPREFERENCES_{i,t}, CLIENTBELIEFS_{i,t}$ and $ISSUERISKS_{i,t})$. $ISSUEFEATURES_{i,t}$ and $ISSUEOUTCOMES_{i,t}$ inform all the components on the right, and all reflect the auditor's knowledge of standards and other factors. The $ISSUEASSESSMENT_{i,t}$ operation would include the auditor's being aware of the details of the preference sets, such as the acceptable range of outcomes **aar** and what he/she believes the client's acceptable range of outcomes **abc_{ar}** to be. The auditor's perception of whether there is overlap between his/her preference set and the client's preference set is a key input into the negotiations strategy and tactics choice (considered in detail later).

Table 2 illustrates the $ISSUEASSESSMENT_{i,t}$ operation, using two issues. For Issue X, there is a disagreement, in that the auditor's and client's believed most preferred outcomes are not the same. So the auditor would expect to negotiate. The auditor would then consider issue specific risk factors, which Table 2 indicates are relatively low. Overall, these factors suggest that potentially this would not be a difficult negotiation because each party's most preferred outcome is in the other party's acceptable range (overlap exists) and issue risk is low. For Issue Y, the situation is quite different. The disagreement is wide, with the most preferred outcomes and acceptable ranges not overlapping, and the risk factors indicating high risk. This suggests the potential for a difficult negotiation due to non-lapping acceptable ranges and high issue risk. How such scenarios will develop depends critically on the auditor's relative bargaining power and motivation as described in the next section.

Insert Table 2 about here

In summary, the $ISSUEASSESSMENT_{i,t}$ operation determines if the auditor believes there is an issue(s) that needs to be negotiated. If negotiation is indicated, this operation determines if there is overlap between the auditor's acceptable range (**aar**) and the auditor's perception of the client's acceptable range (**abcarr**). This latter determination is modeled as one of three critical inputs (the others being relative bargaining power and motivation) into the auditor's selection of intended bargaining strategies and tactics.

3.3 Strategy and tactics choice inputs

The remaining two critical inputs into the auditor's selection of strategy and tactics are motivation and relative bargaining power. We conceptualize these as each affecting all potential issues at a given time although each may vary over time, so the model subscripts them for time, but not for issue. Figure 1 indicates that the auditor's cognitions now shift from the "issue level" to the "strategy/tactics level." The figure's arrows point right, but we emphasize that cognitions can cycle back to the issue level if the auditor perceives some issue ambiguity or incompleteness when considering strategy and tactics. Our model includes all of this cognitive activity within the same time t prior to a bargaining session with the client.

3.3.1 Auditor's motivation

$MOTIVATIONS_t$ represents all the incentives, accountabilities, and other motivational factors affecting the auditor's selection of strategy and tactics in negotiation as at time t . Motivation includes both direct and indirect self-interest (in the latter, the auditor is motivated to satisfy the client's interests in order to obtain a meta-outcome the auditor

prefers, such as reappointment). These are modeled as cross-issue factors because they reflect the auditor's overall position and relationship with the client.

There is a variety of motivational factors, which we group for expositional convenience. First is the desire to reach an agreement. The monetary and other incentives, and risks, behind the auditor's appointment give the auditor (and client) some jointness of interests and a likely desire to get along and avoid trouble (Antle and Nalebuff, 1991, Palmrose, 1991). GSW's auditors agreed very strongly that in the negotiations they described, both auditor and client wanted to reach an agreement. The auditors did not rate other business considerations (client retention, client service considerations and effects on relations with other clients) as important overall, but such considerations were found to be associated with particular events in the negotiation process.²

A second group of motivation factors is the monetary, personal and career incentives and costs salient to the individual auditor. GSW's auditors agreed that the negotiation outcome was important to them personally, but were less in agreement about career importance. They rated ethical considerations as moderately important and the costs incurred in negotiation and data gathering to be of relatively low overall importance but again these were associated with important events in the negotiation process.

A third group are situational constraints such as time pressure or deadline pressure. These are motivational in the sense that the auditor's strategy may be designed to cope with them, and they may produce premature or incomplete strategies. Such situational constraints

² GSW auditors rated a total of thirty-seven factors either for their importance to the "respondents chosen negotiation example and its outcome" (29 factors) or their relative degree of agreement with the importance of a factor (eight factors). GSW report these ratings as well as the association of these rated factors with selected negotiation process elements (e.g., who identified the issue, audit committee involvement with issue, importance of negotiation to partner). See Tables 5-8 of GSW for details.

have been examined in auditor judgment studies (e.g. McDaniel, 1990, Kadous, Kennedy and Peecher, 1999), and auditor negotiation assessments are a kind of auditor judgment. The GSW auditors rated time pressure as a moderately important overall factor in negotiations and it was associated with important events in the negotiation process.

A fourth group of motivational influences are auditor risk factors beyond those associated with particular issues (already included in $ISSUERISKS_{i,t}$). These have also been examined in auditor judgment and more general auditing research (e.g. Houghton and Fogarty, 1991, Johnstone, 2000, Shibano, 1990). These include legal or lawsuit risk, the client's inherent risk and the client's business reputation. GSW found that client inherent risk and reputation were rated as highly important to negotiation, but legal considerations were less important. Again, this fourth group of motivational factors was frequently associated with important events in negotiation.

A fifth group within $MOTIVATIONS_t$ is auditor accountability, examined in several recent studies (Gibbins and Newton, 1994, Hoffman and Paton, 1997, Kennedy, 1993). The auditor is formally or informally accountable to various external parties, and that accountability provides both incentive and risk. GSW's auditors rated owner/investor considerations, dominant shareholder/owner, and the client's audit committee as moderately important to negotiations and creditor/lender considerations as less important. Accountability factors were also related to important negotiation events. Beattie et al (1999) found in their survey of British auditors and client management that less negotiation takes place with an audit committee present than with no audit committee, indicating the potential importance of audit committee accountability.

These motivational factors can provide the auditor with strong motivation to obtain outcomes consistent with his/her issue preferences (e.g., high accountability to third parties, high threat of litigation) or to allow outcomes that achieve desired meta-outcomes such as reappointment via accommodating the client's preferences (e.g., strength of various economic incentives from payments by client to audit firm). This posited tension between motivation to achieve the auditor's preferences and that to achieve the client's preferences is a major input into the auditor's bargaining strategy and tactics.

3.3.2 Auditor's relative bargaining power

$POWER_t$ represents the auditor's perceived likelihood of succeeding in the negotiation. We propose that the auditor considers several groups of factors in assessing whether negotiation on the issue(s) will lead to preferred, or at least acceptable, outcomes.

The first set of power factors represents the auditor-client relationship, how strong and how positive it is. A good relationship should increase the auditor's expectation that the client can be convinced of the auditor's case. The history of the relationship and any past negotiations will inform the auditor about the likelihood of success this time. GSW's auditors rated the past relationships with the client as moderately important in their negotiations. This relationship also includes interpersonal matters such as a dominant client CEO and other client personality factors. Both these ranked as moderately important in GSW's auditors' negotiations. These three factors were also associated with negotiation process events. Incidental to direct auditor-client relationships are those dealing with interpersonal relationships within the audit firm, in that a strong team supporting the auditor and supportive upper management in the audit firm should increase the auditor's bargaining confidence, hence power. GSW's auditors rated interpersonal relationships within the audit firm as having

moderate importance to their negotiations and it was associated with negotiation process events. We note also that the auditor's legal and contractual role provides some power to insist, such as to threaten a qualified opinion, and that such power may produce some tension with the motivational factors discussed earlier and the client relationship factors mentioned in this paragraph. Exercising such power may not be attractive because it may interfere with desired meta-outcomes such as reappointment.

A second set of power factors relate to the size of the auditor and client. If the audit firm is large relative to the client, the auditor may have more power, through both reputation and less dependence on the particular client (e.g. Trompeter, 1994). These factors may have motivational implications also, but we model them primarily as affecting the auditor's ability to insist. GSW's auditors saw both auditor size and relative auditor-client size as low in overall importance. Auditor size was associated with several important events in negotiation but relative size was only associated with the career importance meta-outcome.³

A third set of power factors relates to expertise and relative expertise, in both accounting and negotiation. Considering negotiation as a form of auditor judgment raises similar issues to those in auditor expertise studies (e.g. Bonner and Lewis, 1990, Tan and Libby, 1994). The greater the auditor's expertise, absolutely and relative to the client's, the more power the auditor should have to achieve his/her desired outcomes, by both a better understanding of issues and a greater ability to make convincing arguments. Expertise factors include the audit firm's accounting expertise, the client's accounting expertise, the firm's

³ Given the emphasis on relative size as being important in the generic negotiation literature, this was a surprising finding in GSW. However, it may well have been driven by GSW's sample selection criteria, which emphasized that the firms select auditors of public company clients and large private companies. This may have reduced significantly the variation in relative sizes as all auditors were from either Big 5 firms or the next largest international firm.

central consultation unit (expertise to call on), and the firm's negotiation expertise. GSW's auditors rated as highly important their firm's accounting expertise, and as moderately important the auditor's negotiation expertise, the client's accounting expertise, and their firm's central consultation unit, and associated all four with various events in the negotiation.

In summary, we see these power factors as providing the auditor with relatively high to relatively low amounts of bargaining power vis à vis the client. It appears from GSW that relative expertise (both negotiation and accounting) is most important, with some additional power coming from the strength of the underlying auditor client relationship. It appears that audit firm size (absolute and relative) may only play a role in rare cases (or cases involving large audit firms and much smaller clients than GSW studied).

3.3.3. *Strategy and tactics choice*

Table 1 and Figure 1 label this choice as *STRATEGY/TACTICS_t*. The model specifies three inputs into the auditor's strategy and tactics choice operation: the individual issue(s) assessment(s) the auditor's motivation and the auditor's relative bargaining power (*ISSUEASSESSMENT_{i,t}*, *MOTIVATIONS_t* and *POWER_t*). The set of choices that the auditor has to make is the focus of predictions based on combinations of these three factors in Section 4. Little is known about auditor negotiation strategy and tactics. GSW, for example, only tangentially investigated this area. Therefore, the remainder of this section describes the two principal strategies (distributive and integrative) and the main tactics that are associated with each strategy found in the generic negotiation literature. We assume that auditors have not invented new strategies and that tactical refinements would be relatively minor to adjust the tactics to the specifics of the auditor-client setting. Evidence from GSW presented in this section demonstrates the reasonableness of this assumption.

Distributive negotiations

Distributive negotiation is defined as “a procedure for dividing a fixed pie of resources” (Bazerman, 1986, 123) and normally produces a *distributive solution* where only one, or neither, party “wins.” In other words, any change in one of the parties’ positions is cast as either a gain or a loss for that party. Even among solutions that are defined as acceptable, any movement away from a party’s most preferred position is viewed through the “win/lose” lens. Distributive negotiations tend to be the most common form of negotiations found in field settings and extensive research has been carried out on factors affecting these negotiations (Churchman, 1995, Lewicki and Litterer, 1985). Consistent with that finding, GSW report that 48% of their auditors (the largest single group) entered negotiations believing that a range of solutions was available between the auditor’s initial position and his/her perception of the client’s initial position. Therefore the GSW auditors implicitly believed they were entering into distributive negotiations.

Several tactics are most associated with this form of negotiation. We discuss the two most prominent (see Churchman, 1995 for a review of negotiation tactics). One tactic in a distributive bargaining strategy is *concession making*: one party could change his/her proposal so it provides less benefit to him/her (Pruitt and Carnevale, 1993, 28). The most extreme form of this would be *give in* to the other party’s position.

Three general observations about concession making (or being firm, and so avoiding concessions) can be found in the negotiation literature. First, negotiators who are firm about not conceding tend to reach solutions that favor them (McAlister, Bazerman and Fader 1986). Second, firmness tends to lengthen negotiations and makes eventual agreement less likely (McAlister, Bazerman and Fader 1986, Pruitt and Carnevale, 1993, 29). Third, there tends to

be an inverted-U relationship between firmness and achieving a desired negotiation outcome (Weingart, Thompson, Bazerman and Carroll, 1990). Increasing negotiator firmness results in a greater likelihood of achieving desired outcomes but firmness that borders on inflexibility likely results in not achieving the desired outcome.

A second tactic that could be employed in a distributive bargaining strategy is *contending*, “the aim of which is to make the other party make concessions or to resist similar efforts by others” (Pruitt and Carnevale, 1993, 30). Contending might include: threats, e.g., “a commitment to punish the other party if one’s demand are not met” (Pruitt and Carnevale, 1993, 30, Hilty and Carnevale, 1993); irrevocable commitments, e.g., statements about holding firm at a particular position; and persuasive arguments, e.g., attempting to convince the other party to change its position (Petty and Cacioppo, 1981). The most extreme form of contending would be to *insist* that one’s position be adopted. The effectiveness of these tactics on outcomes tends to be context dependent, involving motivation and bargaining power (Pruitt and Carnevale, 1993, 34-35).

Integrative negotiations

Integrative negotiations attempt to “find a means by which the parties can make tradeoffs or jointly solve problems to the mutual benefit of both parties” (Bazerman, 1986, 123). An *integrative bargaining strategy* attempts to lead to an *integrative solution* where both parties are better off (a “win-win” solution). The achievement of integrative solutions has become the “gold standard” of negotiation research (Churchman, 1995) and factors that influence whether or not integrative solutions are found, when available, are common in the literature (Pruitt and Carnevale, 1993). Only 14% of GSW’s auditors entered negotiations

believing that a new solution (not one between the perceived initial positions) was required in their negotiation, so integrative bargaining was not commonly expected.

As is the case in distributive negotiations, several tactics are usually associated with achieving integrated solutions. One is *creative problem solving* (Pruitt and Carnevale, 1993). A creative problem solving approach is to learn more about the underlying interests of both parties to the negotiation. A focus on interests as opposed to outcomes may reveal ways to reconcile preferences for different outcomes in a way that benefits both parties (known in the literature as a *bridging* approach to the situation (Fisher and Ury, 1981)).

Another integrative bargaining strategy is *expanding the agenda* of issues, bringing to the table issues not apparently involved in this situation. Given such other issues, the negotiators can exchange concessions by trading off something under negotiation with something originally outside the negotiation (Neale and Bazerman, 1991), thereby altering the priority of issues (Lax and Sebenius, 1986) and creating “wins” for both sides.

Research has revealed great difficulties in getting parties to negotiations to realize that there is the potential for integrative negotiations and solutions (Bazerman, 1986). Some reasons found in the generic negotiation literature include: parties’ making a “fixed pie” assumption that only distributive negotiation is possible (Bazerman, Magliozzi and Neale, 1985); framing potential changes to either party’s position as gains or losses (Northcraft and Neale, 1987); and inability to understand the other party’s perspective (Thompson and Hastie, 1990). Each of these reasons has been shown to be very powerful both in laboratory experiments and field studies (Neale and Bazerman, 1991). Consistent with these findings, GSW reported, as mentioned above, that only 14% of the reported negotiations featured

auditors looking for a creative new solution at the beginning of the negotiation and found that only 16% reported achieving a new solution as a result of negotiation.

In summary, the strategy and tactics choice assessment operation is informed by the individual issue assessments and two cross-issue factors, the auditor's motivation and relative bargaining power. Formally, $STRATEGY/TACTICS_t = f(ISSUEASSESSMENT_{i,t}, MOTIVATIONS_t, \text{ and } POWER_t)$. The time subscripts indicate that all these are likely to change over time, particularly over the negotiation process, as information is gathered and discussions are held. Based on the generic negotiation literature we would expect that auditors would default to the less cognitively difficult distributive negotiations except where issue assessment suggests that the more cognitively effortful strategy of integrative bargaining is needed in order to achieve acceptable outcomes.

3.4 The auditor's intended negotiation behavior, strategy and tactics

The model's dependent variable, at the right side of Figure 1, is the auditor's intended behavior in the negotiation's bargaining, which is a function of the strategy and tactics choice assessment. Formally, $INTENTIONS_t = f(STRATEGY/TACTICS_t)$. Such intentions are converted to behavior as the negotiation process proceeds. Figure 2 illustrates how the modeled intention connects to the negotiation behavior: the auditor's intentions are combined with the client's in a process that informs both parties' behavior, potentially induces changes in cognitions and intentions, and produces the issue-specific negotiation outcomes (e.g., specific accounting choices) and meta-outcomes (e.g., auditor reappointment).

Insert Figure 2 about here

4. Modelling Results: Predictions About Strategy and Tactics Selected by Auditor

This section demonstrates the usefulness and systematic nature of the model. The results of the modelling effort are shown by developing predictions about the auditor's intended bargaining strategy and tactics given the three inputs posited by our model: issue(s) assessment, motivation and relative bargaining power. In accordance with the paper's objectives, we focus on intended strategy and tactics predictions, though predictions may also be made at earlier stages in the model, such as in predicting a "roster" of potential negotiation issues based on the comparisons at the *ISSUEASSESSMENT*_{*i,t*} stage. We discuss these further implications of the model in Section 5. This section also deals with the possibility of inaccuracies or biases in auditor cognitions.

4.1 The model inputs

The issue assessment operation, as discussed in Section 3, results in an assessment as to whether the auditor believes there is an overlap in his/her acceptable range (**aar**) and his/her beliefs about the client acceptable range (**abcar**). Here we focus on the acceptable ranges and make predictions from them as they are central to nearly all negotiations according to the generic negotiation literature. With an overlap in acceptable outcome ranges, both parties may achieve acceptable issue specific outcomes that will lead to acceptable meta-outcomes. With no overlap in the acceptable ranges, acceptable issue-specific outcomes cannot readily be achieved, potentially leading to undesirable meta-outcomes for the auditor (e.g., qualification, resignation and/or non-reappointment).

For expositional simplicity we present the predictions based a dichotomy for each of the three factors while recognizing that in practice more subtle distinctions will emerge.

When an overlap in acceptable ranges exists we denote this as the “**overlap**” condition while no overlap between the acceptable ranges will be denoted as “**apart**.”

As characterized in Section 3, motivation (e.g., strong accountability to third parties) can lead the auditor to be highly concerned about achieving issue-specific outcomes favorable to him/her, therefore achieving the auditor’s desired meta-outcomes. Motivation can also be towards achieving desired meta-outcomes (e.g. reappointment due to high economic incentives to retain the client) via attempting to accommodate the client’s wishes on the issue-specific outcomes. We denote the former as motivation to achieve “**auditor**” outcomes and the latter as motivation to achieve “**client**” outcomes.

Relative auditor bargaining power, as characterized in Section 3, can vary from strong to weak likelihood of the auditor succeeding in the negotiation depending on the various components that make up the power factor (e.g., strength of auditor-client relationship). Strong auditor bargaining power can has the potential for the auditor to be able to impose his/her desired issue specific outcomes while still achieving desirable meta-outcomes such as reappointment. Weak auditor bargaining power implies that the auditor may only be able to impose his/her desired outcomes via audit qualification or resignation which in most cases is not a desired auditor meta-outcome. For expositional purposes we dichotomize this relationship into “**strong**” and “**weak**” relative auditor bargaining power.

In summary, $ISSUEASSESSMENT_{i,t}$ = overlap or apart, $MOTIVATION_t$ = auditor or client, and $POWER_t$ = strong or weak.

4.2 The model's outputs

The model's outputs are predictions at two levels. First, there are predictions about overall bargaining strategy (i.e. distributive negotiation or integrative negotiation). These will depend whether it is likely that there is a need to develop a new innovative solution to a focal issue (either an innovative accounting policy or a combination of accounting policies through bringing in other issues) or whether it is likely that an acceptable issue-specific solution can be found based on current set of options available. Integrative negotiation strategies are intended to achieve the former whereas distributive negotiation strategies are intended to achieve the latter. Recall that distributive negotiations are less cognitively effortful and normally are the default negotiation strategy unless situation features suggest the need for the more cognitively effortful integrative negotiation strategy.

Second, where possible, we develop specific predictions about the nature of tactics within a strategy. For example, within a distributive negotiation we predict whether contending or concessionary tactics (or a mixture of the two) are most likely to be used by the auditor based on the model inputs.

4.3 The model's predictions

The model's predictions are the results of combining the three input factors at two levels each (a 2x2x2 matrix) and determining the bargaining strategy consistent with that combination of auditor motivation, relative auditor bargaining power and issue assessment.

Prediction basis

Our predictions use the cognitive (and behavioral) efficiency basis suggested when presenting the model in Section 3: a simple strategy or tactic is preferred to a complex one. Cognitive economy is generally observed in human cognitive operations, that is, humans are

cognitive misers (Fishe and Taylor, 1991, 176, Payne, Bettman and Johnson, 1993, 13). On this basis, and in accord with negotiation findings mentioned earlier, a distributive strategy will be chosen over an integrative strategy.

Within the distributive strategy, cognitive economy suggests that contending tactics are more suited to cases the auditor thinks can be won, and concessionary tactics are more suitable when the auditor thinks winning is unlikely. If contending tactics are used, their extreme, insisting, is simplest, and if concessionary tactics are used, their extreme, giving in, is simplest. Using a mixture of contending and concessionary tactics to seek a compromise is more complex, and so less preferred, than either set of tactics on its own. Similarly, in the area of integrative strategies, it is cognitively less effortful to expand the agenda of issues to be discussed and tradeoff among them than to develop a deep understanding of each party's interests in order to develop an innovative solution.

Continuing with the cognitive economy principle, an overlap of acceptable ranges presents a simpler situation than does a lack of overlap. When there is an overlap, the simpler of available tactics is predicted (distributive tactics preferred over integrative ones, and a preference for the extreme of either contending or concessionary tactics).

Specific predictions

The above prediction basis leads to the following specific predictions:

1. When *motivation = auditor* and *power = strong*. The auditor feels able and willing to achieve his/her own preferences. The prediction, based on cognitive economy, is that distributive contending tactics will be used, insisting when there is an acceptable range overlap.

2. When *motivation = client* and *power = weak*. The auditor feels unable and unwilling to achieve his/her own preferences. The prediction is that distributive concessionary tactics will be used, giving in when there is an acceptable range overlap.
3. When *motivation = auditor* and *power = weak*. The auditor's motivation and power are inconsistent in their effects on ability and willingness to achieve his/her own preferences. The prediction is that distributive mixed tactics will be used if there is an acceptable range overlap (with the mixture favoring contending tactics given the motivation is for the auditor's outcomes), and integrative tactics if there is no overlap (as the auditor is motivated to find a solution that is acceptable to him/herself but has low bargaining power he/she employs the more effortful integrative strategy of creative problem solving).
4. When *motivation = client* and *power = strong*. Again, the auditor's motivation and power are inconsistent in their effects on ability and willingness to achieve his/her own preferences. The prediction is that distributive mixed tactics will be used if there is an acceptable range overlap (with the mixture favoring concessionary tactics given the motivation is for the client's outcomes), and integrative if there is no overlap (the auditor has strong bargaining power and can impose an acceptable solution but has some motivation to satisfy the client, therefore engages in integrative bargaining but uses the less cognitively effortful strategy of expanding the issue agenda).

The specific predictions for the eight cells of the motivation-power-assessment matrix are set out in Figure 3, reflecting the above four predictions.

Insert Figure 3 about here

To illustrate the predictions, we comment on the upper left cell in Figure 3, focusing on the case in which the auditor's issue assessment is that there is an overlap between the auditor's and client's acceptable ranges of outcomes. Given the overlap in acceptable ranges, there would be no need to move to a more cognitively effortful integrative negotiation strategy. Therefore, the auditor would default to the less effortful negotiation strategy of "distributive" negotiation. In this cell, the auditor's motivation is to achieve the "auditor's" outcomes and the auditor has "high" bargaining power (e.g. a strong auditor-client relationship), giving him/her the ability to insist on his/her position. Hence, the auditor is most likely to use "contending" tactics to the point of "insisting" that the client adopt the auditor's position. No doubt the auditor will try gentler contending tactics at first such as persuasion that the auditor is correct and giving a detailed rationale as to why that is so. If these tactics did not succeed, the auditor would ultimately insist that his/her position be adopted and the client would likely accede given auditor strong bargaining power. In the end the negotiated outcome would allow the auditor to achieve the desired meta-outcome.

4.4 Inaccurate or biased auditor cognitions

The generic negotiation literature has frequently reported that negotiator cognitions (e.g. issue features and beliefs about others' preferences) can be inaccurate or biased (Bazerman, 1994, 149-164, Babcock, Loewenstein, Issacharoff and Camerer, 1995) and that preference sets (i.e. preferences for issue outcomes) may be incompletely specified (Fobian and Christensen-Szalanski, 1993, 1994). Auditors may be subject to these shortcomings also. If the auditor cognitions are inaccurate or incomplete, multiple rounds of dyadic negotiation should reveal this (see Figure 2), resulting in additional iterations through the auditor's cognitive model. This may come at a cost in terms of data collection, client annoyance or

greater difficulty in employing the necessary strategy and tactics needed to bring the negotiation to a successful conclusion (from the auditor's viewpoint). Indeed, we explicitly include negotiation expertise in our model as part of the auditor's relative bargaining power. This is based on the premise that the more expert auditor negotiator will more likely be able to achieve his/her outcomes and meta-outcomes through use of appropriate strategy and tactics based on an accurate issue assessment.

In addition, as the dyadic negotiations proceed, it is possible that the issue features that were originally thought to exist are quite different given further information. Again, given that the auditor learns this through the dyadic negotiation process, all that should happen in our model terms is additional iterations through the auditor's cognitive model based on the new information. There is a danger, however, if the original perceived features are not the actual features of the accounting issue. If at the issue assessment stage the auditor concludes, based on an incorrect or incomplete set of features, that the issue is not one for negotiation, the lack of further action may mean no corrective information is received. This might lead to unpleasant auditor surprises later.

5. Discussion: Consistency of predictions with observed auditor-client negotiation phenomena

Our model should provide additional explanations over any that are in the existing literature. We suggest that the model provides tentative explanations for: 1) the limits to auditors' employing different negotiation strategies and tactics for different issues within the same client; 2) why auditors may employ different strategies and tactics for the same issue across different clients; and 3) why auditors may change negotiation strategies and tactics over time for the same issue within the same client. In addition, we show how our model can

be applied to analyze an actual negotiation as found in Securities and Exchange Commission (SEC) enforcement actions.

5.1 Different negotiation strategies and tactics for different issues within the same client

An examination of Figure 3 suggests limits to the types of strategies and tactics employed on a single client despite different types of issue feature patterns. For a client for whom the auditor has consistent motivation and bargaining power (the diagonal cells in Figure 3) the auditor will be involved in distributive negotiations with either consistent contending tactics or consistent concessionary tactics. For a client for which the auditor has mixed bargaining power and motivation (off-diagonal cells), the auditor will be involved consistently in either integrative negotiation or mixed tactics distributive negotiation with clients. These limits tend to explain why auditors tend to have consistent relationships with clients – either easy or difficult – across many different issues with different feature patterns (e.g., de Ruyter and Wetzels, 1999, Seabright, Levinthal and Fichman, 1992).

5.2 Different negotiation strategies and tactics for the same issue across different clients

An examination of the auditor's motivation and power factors in Figure 3 provides an additional explanation for why issues with similar features may result in different observed accounting policies in the published financial statements (Salterio, 1996, Salterio and Koonce, 1997, Levitt, 1998). Given that the set of factors influencing relative bargaining power and auditor motivation can easily be different for different clients, the auditor will probably enter negotiations with a different negotiation strategy and tactics for different clients. For different clients with the same accounting issue feature pattern, the auditor could find himself/herself in different cells of Figure 3. The limited generic negotiation literature on this point shows that entering negotiations with different strategies results in different outcomes (Olekalns,

Smith and Walsh, 1996, Oskamp, 1971, Neale and Northcraft, 1990). The experimental markets accounting literature provides a similar observation in abstract accounting settings (e.g. Bloomfield, 1997, Zimbleman and Waller, 1999) and analytical accounting models would predict power and motivation differences would effect probability of disputes occurring (Zhang, 1999). Our model suggests that auditor negotiation strategy choice and thus ultimately the outcomes in the audited financial statements are dependent on auditor relative bargaining power and motivation and not just the feature pattern of the issue the client has encountered. This explanation may partially account for the observations of those, especially regulators, who find public accounting firms advocating different preferable accounting policies for different clients based on highly similar feature sets (e.g. Levitt, 1998).

5.3 Changes in negotiation strategies and tactics over time for the same issue and client

GSW's auditors reported that 49% of the time they expected that the same issue would be revisited with the client in the next audit. Given that auditor relative bargaining power and motivation can change over time based on the set of factors that compose these constructs, it is likely that the auditor's negotiation strategy and tactics for an issue could change over time. Changes in authoritative standards or common practice by organizations to which the client might be compared may also change the issue assessment. Therefore the auditor could move from one cell in Figure 3 to another over time. This might help to explain why an auditor who waives an adjustment one year will make it a focal negotiation issue another year (e.g. Wright and Wright, 1997, Braun, forthcoming).

5.4 Model applied to an SEC enforcement action

Table 3 summarizes an SEC enforcement action: Accounting and Auditing Enforcement Release (AAER) #455 (SEC, 1993).⁴ The case involves a partner of a then Big 8 firm signing the audit report of a client that contained at least five material misstatements, all of which had been negotiated between the audit partner and senior client management. The SEC attributed the problem to lack of objectivity and professional skepticism. In each of the five misstatements, the auditor in one way or another “compromised” with the client or in other words had agreed, in terms of our model, to a distributive solution. In all cases the adjustments to the financial statements were relatively small compared to the initial adjustment requested by the auditor (see inventory example in Table 3). Therefore, the auditor had, in terms of our model, engaged in concessionary tactics almost to the point of giving in. Since the auditor was fully aware of each of these issues and their magnitude, all steps in the issue assessment cognitive operations appear to have been carried out correctly. Based on our Figure 3, concessionary tactics tend to dominate when the auditor’s motivation is toward achieving client-favored outcomes and the auditor’s bargaining power is perceived by him/herself to be weak. If a field study were done in this case, our model suggests investigating the auditor’s motivation and bargaining strength, not the issue fact pattern.

Based on our model, a field investigator would expect to find factors that would cause the auditor’s motivation to be strongly toward achieving client favored outcomes, e.g., desire to reach agreement was strong, incentives were strong for the auditor to retain client for personal or career reasons, tight deadline pressures, and high auditor accountability pressures towards the client with correspondingly lower pressures towards third parties. From AAER

455 we find that deadline pressures were tight as the statements were filed with the SEC for a March 31 yearend on June 29, which is one day before final deadline to file (SEC, 1993, 4388). Further, after one meeting with the client management, the partner mistakenly concluded “that the firm had been removed as Star’s independent accountant because he would not agree to certain accounting treatments proposed by Star’s top management.” (SEC, 1993, 4388). This suggests that the client was strongly attempting to influence the audit partner’s incentives by threatening to discharge the audit firm.

Based on our model, we would also expect a field study to find factors that would indicate the auditor’s bargaining power was relatively low, e.g., a negative and contentious client relationship, poor past relationships with client, low support for auditor from the audit firm, that the client was a sizable client of the audit office, strong client negotiating expertise, and a low willingness of auditor to use audit’s firms expertise to his/her advantage. There was evidence a “very contentious” relationship between the audit field team and the client staff as evidenced in the AAER by “Star’s CFO ultimately asked that the manager and other members of the audit staff be removed from the audit.” (SEC, 1993, 4388). Furthermore, it was noted in the AAER that the partner “misrepresented to national office personnel (i.e. the consultation unit) certain material facts pertaining to the audit” (SEC, 1993, 4388) indicating that the partner did not want to use the firm’s expertise to buttress his position.

This subsection has demonstrated how our model can be employed to structure a field study of an actual negotiation and used to provide context to an actual negotiation scenario. Furthermore, despite the sparse and highly summarized nature of SEC’s AAER we found

⁴ We performed a computer search of all AAERs from 1980-1996 employing various synonyms for negotiation. This case was selected from among the forty that were found in the computer search as it provided the richest descriptive detail of any of the AAERs about the auditor’s negotiation activities.

evidence of the factors at work in the area of motivation and relative bargaining power that we expected to find based on our model.

5.5 Summary

In this section we argued that our model explains three empirical regularities that have been observed about auditor client relationships over accounting issues. We also have our model to analyzing an actual negotiation as recorded in an SEC enforcement action, to demonstrate that the factors our model suggests were present in that example.

6. Conclusions

This paper developed a model of the auditor's intended strategy and tactics going into a potential negotiation with client management. The model was based on the generic negotiation literature but its features were designed to suit the auditor-client accounting setting as suggested by the auditing literature and by the empirical results in GSW. The model was designed to generate specific empirically testable predictions, and we demonstrated its ability to do that. We look forward to the model's use in experimental or archival research. Experiments can examine the various cognitive stages and the auditor's development of negotiation intention, and archival or field study research can explore the outcomes and the negotiation context.

The model was designed to focus on the auditor's intended strategy and tactics. However, it could be extended empirically or analytically in several ways. First, a thorough inventory of the factors influencing the auditor's cognitions at the various pre-negotiation stages could be undertaken. Our model categorizes such influences, and our explanation of it suggested a number of them (largely with reference to GSW and other literature), but they are by no means fully described yet. Second, there could be modelling or empirical elaboration of

some of the pre-intention stages, such as the assessment of individual issues. Third, our model was not designed to deal with the actual dyadic bargaining: there is a generic literature about this behavior, and that could be incorporated in modeling the auditor-client setting. Fourth, our model focuses on the auditor: while this is appropriate in understanding the auditor's intentions, a similar model development of the client's intention could be undertaken. This might relate to the literatures on voluntary disclosure and earnings management, and may be necessary if dyadic bargaining behavior between auditor and client is to be fully understood. Fifth, our model focuses on negotiation, not on other auditor (or client) behaviors, such as further research, internal consultation, or obtaining legal advice. While these are consistent with the modelling approach, they may be worth further study on their own, perhaps related to the literatures on auditor lawsuits, independence and waiving of adjustments.

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Table 1: Specification of Model Components

(Cognitive operations are shown in italics.)

<i>ISSUEFEATURES</i> _{i,t} :	the features of accounting issue i perceived by the auditor at time t;
<i>ISSUEOUTCOMES</i> _{i,t} :	the auditor's cognitive operation of identifying potential outcomes of issue i at time t based on the auditor's knowledge of standards (these issue-specific outcomes are distinguished from "meta-outcomes" desired by the auditor, such as issuing an unqualified opinion or being reappointed, and that are included in <i>MOTIVATIONS</i> _t below);
<i>ISSUEPREFERENCES</i> _{i,t} :	the auditor's preferences over potential outcomes of issue i at time t, informed by his/her knowledge of standards;
<i>CLIENTBELIEFS</i> _{i,t} :	the auditor's beliefs about the client's preferences over potential outcomes of issue i at time t;
<i>ISSUERISKS</i> _{i,t} :	the auditor's risks and related materiality considerations arising from issue i at time t;
<i>ISSUEASSESSMENT</i> _{i,t} :	the auditor's cognitive operation of assessing issue i at time t based on <i>ISSUEPREFERENCES</i> _{i,t} , <i>CLIENTBELIEFS</i> _{i,t} and <i>ISSUERISKS</i> _{i,t} .
<i>MOTIVATIONS</i> _t :	the auditor's motivations at time t;
<i>POWER</i> _t :	the auditor's relative bargaining power at time t;
<i>STRATEGY/TACTICS</i> _t :	the auditor's cognitive operation of choosing a negotiation strategy and tactics, based on <i>MOTIVATIONS</i> _t , <i>POWER</i> _t , and <i>ISSUEASSESSMENT</i> _{it} aggregated over i issues;
<i>INTENTIONS</i> _t :	the auditor's resulting intended negotiation behaviors, strategies and tactics at time t.

Table 2: Illustration of Auditor Issue Assessment

(Auditor preferences come from the details of $ISSUEPREFERENCES_{i,t}$ and client preferences, as perceived by the auditor, come from the details of $CLIENTBELIEFS_{i,t}$.*)

<u>Issue X Assessment – overlapping ranges</u>			<u>Issue Y Assessment – ranges apart</u>		
Potential Outcome	Auditor preferences	Client preferences	Potential Outcome	Auditor preferences	Client preferences
Xa	auo_{x,t}	abcuo_{x,t}	Ya	amp_{y,t}	abcuo_{y,t}
Xb	aar_{x,t}	abcar_{x,t}	Yb	aar_{y,t}	abcuo_{y,t}
Xc	amp_{x,t}	abcar_{x,t}	Yc	auo_{y,t}	abcar_{y,t}
Xd	aar_{x,t}	abcmp_{x,t}	Yd	auo_{y,t}	abcar_{y,t}
Xe	anp_{x,t}	abcar_{x,t}	Ye	auo_{y,t}	abcmp_{y,t}
Xf	auo_{x,t}	abcuo_{x,t}	Yf	auo_{y,t}	abcar_{y,t}
			Yg	auo_{y,t}	abcuo_{y,t}
<p>Risk factors $ISSUERISKS_{i,t}$: Issue features ($ISSUEFEATURES_{i,t}$) do not indicate any unusual risks for the auditor.</p> <p>Xc and Xd are materially different outcomes but the auditor believes these differences can be justified as acceptable.</p>			<p>Risk factors $ISSUERISKS_{i,t}$: Issue features ($ISSUEFEATURES_{i,t}$) indicate that this issue has been subject to extensive regulatory scrutiny and therefore is a high-risk issue.</p> <p>Ya and Ye are materially different outcomes and the auditor believes these differences cannot be justified as acceptable nor is there an acceptable overlapping range.</p>		

* Notation for outcomes:

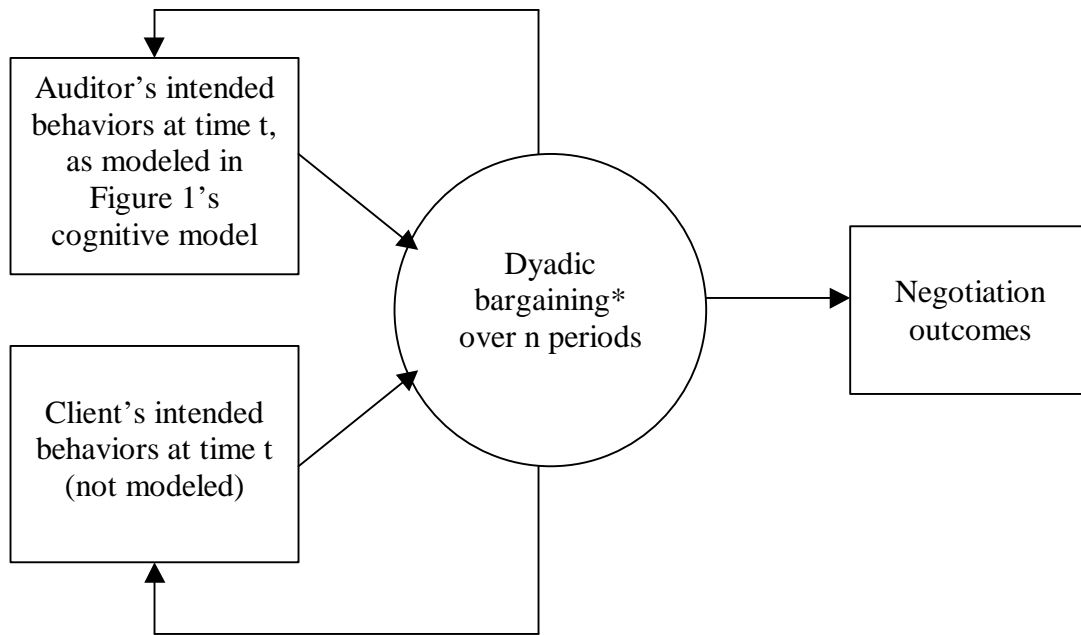
	<u>Auditor's preference</u>	<u>Client's believed preference</u>
Most preferred	amp_{i,t}	abcmp_{i,t}
Rest of acceptable range	aar_{i,t}	abcar_{i,t}
No preference	anp_{i,t}	abcnp_{i,t}
Unacceptable	auo_{i,t}	abcuo_{i,t}

Table 3: Summary of Accounting and Auditing Enforcement Release #455

(SEC 1993)

- ? The auditor signed the audit report of a publicly traded company, Star Technologies, Inc., that had five material accounting misstatements (e.g., recording research and development as an asset, failure to write down obsolete inventory) according to the SEC.
- ? The audit partner, based on information provided by the audit manager and team, was aware of each of these issues. The team had correctly analyzed each of them as being potential misstatements and had estimated the correct numbers according to the SEC.
- ? In each case the audit partner entered discussions (or in our model's terms "negotiations") with client management (the client Chief Financial Officer and Chief Executive Officer depending on the issue) "initially resist{ing} certain demands of the client" (SEC, 1993, 4394).
- ? The audit partner, during "meetings and conversations with Star's management at the end of the audit, agreed to certain accounting treatments that included arbitrary, compromise adjustments that were improper and not in accordance with GAAP" (SEC, 1993, 4388). For example, in the case of the obsolete inventory an increase in provision for obsolescence of \$350,000 was agreed upon instead of the \$1.5 million that audit staff had deemed to be necessary (SEC, 1993, 4392).
- ? The SEC's conclusion was "In a situation where an auditor is faced with pressure from a client to accept potential improper accounting treatments, the auditor must maintain his independence, objectivity, and an attitude of professional skepticism." (SEC, 1993, 4394).

Figure 2: Illustrative Extension to Bargaining and Negotiation Outcomes



* Bargaining can include information gathering, information exchanges and discussions between the parties from time t over n periods (days, weeks, or more). As bargaining proceeds, intentions can change, as represented by the arrows going back to intentions from bargaining. After n periods of bargaining, the negotiation outcomes occur.

Figure 3: Predictions About the Auditor’s Intended Negotiation Strategy and Tactics Based on Auditor’s Motivation, Relative Bargaining Power and Issue Assessment

		Auditor’s Motivation¹	
		<u>Toward Auditor</u>	<u>Toward Client</u>
Auditor’s Relative Bargaining Power²	<u>Strong</u>	<u>Apart³: Distributive⁴</u> (contend ⁵) <u>Overlap³: Distributive⁴</u> (insist ⁵)	<u>Apart³: Integrative⁴</u> (expanding the agenda ⁶) <u>Overlap³: Distributive⁴</u> (mixed favoring concessionary ⁵)
	<u>Weak</u>	<u>Apart³: Integrative⁴</u> (creative problem solving ⁶) <u>Overlap³: Distributive⁴</u> (mixed favoring contend ⁵)	<u>Apart³: Distributive⁴</u> (concessionary ⁵) <u>Overlap³: Distributive⁴</u> (give in ⁵)

¹**Auditor’s motivation** is classified as two levels: toward achieving “auditor” favored issue specific outcomes, and toward achieving “client” favored issue specific outcomes.

²**Auditor’s relative bargaining power** is classified at two levels: “high” and “low”.

³**Issue assessment** has two outcomes: the auditor’s acceptable range (**aar**) and the auditor’s belief about the client’s acceptable range (**abcar**) “overlap,” or do not, the latter denoted as “apart”.

⁴**Strategy prediction** is either as a “distributive” or an “integrative” strategy.

⁵**Tactic prediction** within distributive negotiations strategies: “contend” and “insist” are tactics where the auditor is aggressive about achieving his/her preferred outcomes; “concessionary” and “give in” are tactics whereby the auditor tends to move to the client’s preferred outcomes. “Mixed” is a combination of contending and concessionary tactics to attempt to get a compromise solution with motivation governing when contending tactics or concessionary tactics dominate the mixture.

⁶ **Tactic prediction** within integrative negotiation strategies: “expanding the agenda” of issues is a tactic whereby the auditor adds issues that allows him/her to make tradeoffs allowing the client and the auditor to “win”; “creative problem solving” involves a range of tactics to better understand the underlying interests of both parties to allow the construction of a novel new position allowing both parties to “win”.