

The Role of Auditor Strategy in Auditor-Client Negotiations over Proposed
Financial Statement Adjustments: The Rule of Reciprocation

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We would like to thank Hun-Tong Tan, Hank Jaenicke, Kevin Brown, Michael Nugent, and participants at the 2004 International Symposium on Audit Research.

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ABSTRACT: Auditors face the challenging tasks of attesting that the financial statements are free from material misstatement while simultaneously fostering a functional working relationship with the client. As the financial statements may be considered, in part, a product of negotiations between the auditor and client management (Antle and Nalebuff 1991), the negotiation strategy employed by the auditor may be useful in effectively fulfilling both tasks. To investigate the effect of auditor strategy on the resolution of proposed audit adjustments, we examine the client side of the negotiation. We investigate a strategy that draws upon the societal rule of reciprocation we label “full-disclosure,” which makes the waiving of inconsequential audit differences transparent. Specifically, with the full-disclosure approach, the auditor brings to the attention of the client all the audit differences (both significant and inconsequential) discovered during the audit and, subsequently, waives the inconsequential items. In contrast, a strategy of “non-disclosure” of inconsequential items (in which the auditor discloses to the client only the significant audit differences which must be booked) renders the client unaware of the waived inconsequential differences. Results indicate that, relative to a non-disclosure approach, participants representing *client management* (controllers/CFOs) are more willing to post significant income-decreasing adjustments when exposed to a full-disclosure approach in the course of negotiating the final contents of the audited financial statements. Full-disclosure also results in greater client satisfaction and retention. Consistent with these findings, additional experimentation suggests that *auditors* also perceive that altering their approach toward greater disclosure of inconsequential audit differences can improve client satisfaction and retention.

Keywords: *audit adjustment; negotiation; client satisfaction; client retention; audit differences; reciprocation*

Data Availability: *Data are available upon request.*

I. INTRODUCTION

This study examines how auditor negotiation strategy during the resolution of proposed adjustments to the financial statements may affect the client's willingness to post significant income-decreasing audit adjustments, as well as client satisfaction and retention. Antle and Nalebuff (1991) note that the contents of the financial statements are a result of a negotiation between the auditor and the client, and that this negotiation can affect accounting disclosure. In addition to the resolution of proposed adjustments, negotiation has an important influence on client relations (Gibbins et al. 2001). Thus, the process of resolving audit differences could affect client retention and satisfaction, as well as the resulting financial statements.

Auditors are in a unique environment in which they have a duty to users of the financial statements to provide independent assurance regarding the financial statements while fostering an amicable relationship with the management of the corporation, who are responsible for preparing the financial statements. Although auditors and client management may have different motives (e.g., auditors are typically conservative with respect to reported earnings, while management generally would prefer not to record income-decreasing adjustments), an adequate relationship is beneficial to the performance of the audit (Shaub 2003). In addition, auditor compensation depends on their ability to retain clients and, to the extent possible under the Sarbanes-Oxley Act of 2002, increase their level of service (and billing) to their clients. However, the current regulatory environment, brought on by recent high-profile audit failures, has resulted in a climate demanding greater scrutiny of financial statements. Thus, this balance between the need for sound and constructive client relations and the auditors' obligations to shareholders and regulators is becoming increasingly difficult to maintain.

It may be possible for the auditor to ease this balancing act through delicate and judicious negotiation. Suppose, for example, that the audit team uncovers a number of audit differences

(i.e., potential adjustments) during the course of the engagement, some of which are significant (i.e., clearly material or potentially material) and some of which are inconsequential to the financial statements (i.e., have no impact on financial statement users and fall outside the auditor's materiality scope and posting threshold). To receive an unqualified opinion, the auditor determines that the client will need to post only the significant audit differences. The auditor could choose to simply bring to the client the significant differences, which must be booked, and waive the inconsequential items without ever bringing them to the client's attention (hereafter referred to as "non-disclosure" approach). Alternatively, the auditor could disclose to the client all audit differences (inconsequential as well as significant differences) uncovered by the audit team and then waive the inconsequential differences.¹ By waiving the inconsequential differences in full view of the client (rendering the process more transparent), the auditor can foster a collaborative environment that encourages the client to be more cooperative in the posting of significant adjustments. In addition, this approach may serve to foster better client relations and improve the likelihood of client retention. This "full-disclosure" approach draws upon the societal rule of reciprocity (e.g., Pruitt and Carnevale 1993; Cialdini 2001).

To investigate the effect of auditor strategy on the resolution of proposed audit adjustments in a post Sarbanes-Oxley environment, we examine the client side of the negotiation. We investigate the efficacy of a *full-disclosure* approach, in which the waiving of inconsequential audit differences is made transparent to the client, relative to a strategy of *non-disclosure* of waived differences. Results indicate that participants representing client management (controllers and CFOs) are more willing to post significant income-decreasing adjustments when exposed to a full-disclosure approach in the course of negotiating the final contents of the audited financial statements. Client managers are also more satisfied and more likely to prefer to remain as clients of the audit firm when the auditor utilizes a full-disclosure

approach, relative to a non-disclosure approach to waived differences. In addition, a strategy of *selective-disclosure* (i.e., disclosure and waiving of certain inconsequential items) produces many of the same effects as full-disclosure. Through additional experimentation, we also examine the other side of the negotiation table to explore how auditors view the use of this approach and its effect on client satisfaction and retention. Results indicate that the majority of auditor participants believe there are circumstances where it is acceptable to alter their approach toward resolving audit differences with the client. Similar to the results obtained with client management (the main experiment), by altering their approach toward greater disclosure of waived inconsequential audit differences, auditors feel they can improve client satisfaction and retention.

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

II. BACKGROUND AND HYPOTHESIS DEVELOPMENT

Auditor-Client Negotiations

Although the management representation letter asserts that management bares responsibility, a company's financial statements can be viewed as a joint effort of both management and the auditor (Antle and Nalebuff 1991). Antle and Nalebuff (1991) suggest that the resulting financial statements are dependent on the negotiation strategy employed by the auditor. However, subsequent research has not examined the potential strategies that auditors may employ during the negotiation process, nor has it considered the effectiveness of such strategies. Prior research has typically focused on the disposition of proposed audit adjustments with respect to their type/characteristics, finding that adjustments are more likely to be waived

when: they are not material, they are not income decreasing, the client is small, the audit committee is ineffective, authoritative guidance is lacking, and risk of waiving is low (Wright and Wright 1997; Braun 2001; Nelson et al. 2002; Ng and Tan 2003).

Gibbins et al. (2001) explicitly consider the negotiation process and provide survey evidence regarding negotiation experience of practicing auditors. They find that 67% of audit partners surveyed enter into negotiations with more than half of their clients and that *all* partners surveyed enter into negotiations with at least some of their clients. Additionally, the partners believe negotiation is a frequent and vital part of their responsibilities and is part of the service they provide to the client (Gibbins et al. 2001). Given that Gibbins et al. (2001) find that auditors and their clients tend to meet somewhere in the middle, it is likely that some clients expect the auditor to make concessions and that the auditor may need to go into negotiations prepared to do so.

Collaboration during the negotiation process can result in more successful outcomes than competitive negotiations (Pruitt and Carnevale 1993). Trotman et al. (2003) examine the impact of intervention methods on auditor-client negotiation. Having auditors enter a mock negotiation where they act as the client, or simply having auditors consider the client's positions prior to the negotiation, fostered a more collaborative negotiation effort resulting in better outcomes. Specifically, explicitly considering the positions and concerns of client management resulted in larger client write-down and increased client satisfaction, relative to auditors who did not engage in these intervention methods (Trotman et al. 2003).

The Rule of Reciprocation

The *rule of reciprocation* has been found in a variety of settings and is pervasive in all societies (Gouldner 1960; Cialdini 2001). The basic tenet of this societal rule is that if someone

provides a person with any type of gift or favor, that person is “obligated” to reciprocate. The reciprocation rule creates an environment, within the negotiation context, which mandates mutual concession. Effective negotiators can rely on reciprocity to create social compliance in their counterpart by offering an initial position greater than their ultimate goal. By making a concession off of the initial position (perhaps in partial fulfillment of a counteroffer), the negotiator can expect a concession from his counterpart.

Experimental studies examining negotiation typically conclude that it is more effective to open with a higher initial demand and then make concessions than it is to open with an offer at the level at which one hopes to settle (e.g., Chertkoff and Conley 1967; Komorita and Brenner 1968; Hinton et al. 1974). For example, Komorita and Brenner (1968) compared the strategy of making an initial offer at the level the negotiator expected to settle and remaining steadfastly at that level with the strategy of making greater initial demands, followed by gradual concessions. They demonstrated that the strategy of making concessions achieved higher outcomes than did the strategy of sticking to the initial offer. Similarly, Chertkoff and Baird (1971) found that the greater a negotiator’s initial demands, the higher the compliance rate of the opponent and the greater the opponent’s concessions. Further, studies have found that relatively small concessions can result in relatively large reciprocations and that those exposed to this strategy did not feel manipulated and were more satisfied with the outcome than when this strategy was not used (Benton et al. 1972; Cialdini and Ascani 1976; Miller et al. 1976).

Alternative Auditor Strategies for Negotiation

Current Regulatory Environment

New regulations recently put forth, such as Statement on Auditing Standards (SAS) No. 89 (AICPA 1999) and the Sarbanes-Oxley Act of 2002, speak to the auditor’s responsibility

regarding misstatements uncovered during the course of the audit. A key aspect of these changes relates to whether an item is considered inconsequential to financial statement users. PCAOB Auditing Standard No. 2 (2004, paragraph 91) states, “a misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements.” Nine national and international firms, in *A Framework for Evaluating Process/Transaction-Level Exceptions and Deficiencies* (2004), define an inconsequential item as being less than 20% of the overall annual or interim financial statement materiality (assuming no material qualitative factors), and discussions with partners of a Big Four firm indicate industry position is that greater than one percent of pretax income would be considered more than inconsequential.

With respect to materiality, Generally Accepted Auditing Standards currently do not provide quantitative guidance. SAS No. 47 (AICPA 1983) states that “the auditor’s consideration of materiality is a matter of professional judgment.” Staff Accounting Bulletin No. 99 (SEC 1999) advises auditors to consider qualitative factors in materiality judgments (e.g., concealment of unlawful transactions), as well as quantitative factors. The client must post all of the adjustments that the auditor believes are material before an unqualified opinion can be issued. However, the auditor and client can reach a compromise regarding immaterial adjustments, which allows for the waiving of certain adjustments if they are believed not to significantly affect the fair presentation of the financial statements (Arens et al. 2005). Further, Footnote 6 to SAS No. 89 states that the “auditor may designate an amount below which misstatements need not be accumulated. Similarly, the summary of uncorrected misstatements included or attached to the representation letter need not include such misstatements.” Accordingly, when auditors detect misstatements below this self-determined posting threshold, the auditor has the option of

waiving the adjustment at the workpaper level (non-disclosure) or bringing it to the attention of management (disclosure).

Posting of Significant Audit Adjustments

Based on discussions with practicing auditors, we identify two negotiation approaches currently in use with regard to resolving audit differences. First, auditors can simply bring to the client only those significant adjustments that they believe should be booked, then insist that these adjustments be made before offering an unqualified opinion, which we refer to as the “*non-disclosure*” approach. An alternate approach is one that involves greater disclosure of the audit findings to the client, which we label the “*full-disclosure*” approach. With the full-disclosure approach, the auditor would bring to the client all the audit differences discovered during the audit (both significant and inconsequential). The auditor would then waive the inconsequential items, which would not materially affect the financial statements.² This concession (i.e., overt waiving of certain adjustments) employs the rule of reciprocation to promote cooperation from the client with respect to the posting of significant items. It is important to note that, in either case, the end result is the same. The auditor would have waived the inconsequential items anyway (since they are below the auditor’s posting threshold); the latter approach simply brings to light the waiving of these items.

The above discussion suggests two potential advantages to incorporating a full-disclosure approach in audit negotiations. First, the rule of reciprocation suggests that making the concessions (of inconsequential items) transparent increases the willingness of the client to reciprocate and concede (i.e., post) the significant adjustments. Second, Putnam (1990) asserts that increased disclosure (such as disclosing the inconsequential audit differences that will be waived) is a component of integrative (or collaborative) negotiation. Collaborative negotiation

environments are likely to result in a more positive negotiation outcome (Trotman et al. 2003; Putnam 1990). Therefore, we expect that the use of a full-disclosure approach will increase the client's willingness to post the significant adjustments, relative to an approach of non-disclosure (of waived inconsequential items). The following hypothesis is, therefore, tested:

- H1:** Client managers who are made aware of inconsequential audit differences that are subsequently waived by the auditor will be more willing to post significant audit adjustments than client managers who are unaware of waived inconsequential audit differences.

Client Satisfaction and Retention

Auditors are in the tenuous position of ensuring that financial statements are free from material misstatements while at the same time maintaining a positive relationship with their clients. In surveys of chief financial officers, developing good “working chemistry” with the auditor was cited as a factor important for client satisfaction (*Accounting Today* 1994; 1996). In addition, research has established a link between the quality of the auditor-client working relationship and auditor turnover, with clients indicating a preference for audit firms who are the “best fit” and whose engagement partner has “chemistry” with the client's management (Eichenseher and Shields 1983; McConnell 1984; Fleming 1996; Byrnes 1999; Pandit 1999; Basioudis and Steele 2000; Hughes 2000). However, in the current audit environment, auditors face ever-increasing expectations with respect to their responsibilities regarding their clients' financial statements. A judicious approach to negotiation may help them obtain both of these goals. In fact, Benton et al. (1972) and Schindler (1998) demonstrate that a positive “side effect” of making a concession from a high initial position, beyond improving the negotiated outcomes, is that their negotiation counterparts may actually be more satisfied with the process.

When the auditor uses a reciprocation-based approach in which the waiving of inconsequential audit differences is explicit (i.e., full-disclosure approach), the client may view the auditor as taking more of a collaborative role than an adversarial role, resulting in increased satisfaction with the negotiation (Rubin and Brown 1975; Raiffa 1982; O'Connor and Carnevale 1992). A key component of perceived cooperation/collaboration is the disclosure of information (Putnam 1990). This disclosure is particularly helpful when it demonstrates that the auditor understands the client's point of view (e.g., the client likely would prefer not to post income-decreasing adjustments). Including only the significant audit differences and insisting that they be posted (i.e., non-disclosure approach) may ultimately result in materially similar financial statements as a full-disclosure approach (e.g., auditors can threaten not to provide an unqualified opinion). However, this non-disclosure approach may appear more adversarial, resulting in decreased client satisfaction and increased potential for losing the client. The discussion above suggests that, relative to an approach of non-disclosure, a full-disclosure approach will help the interpersonal dynamics between the auditor and client management, and in turn, increase client satisfaction and the likelihood of retention. Thus, the following hypotheses are tested:

- H2a:** Client managers who are made aware of inconsequential audit differences that are subsequently waived will be more satisfied with the auditor than client managers who are unaware of waived inconsequential audit differences.
- H2b:** Client managers who are made aware of inconsequential audit differences that are subsequently waived will be more likely to support retaining the audit firm than client managers who are unaware of waived inconsequential audit differences.

III. METHOD

Participants

Controllers and CFOs are often the client management with whom the external auditors interact to resolve audit differences and, thus, serve as participants in our study. This is

consistent with prior academic and practitioner research investigating client satisfaction and client perceptions of the audit team/firm (e.g., Accounting Today 1992; 1994; 1996; Behn et al. 1997; 1999). One hundred and twenty-four controllers and CFOs (hereafter controllers) participated in the study.³ Participants were randomly assigned to one of three treatment groups (two main experimental conditions plus an exploratory condition) discussed below.

Experimental Task

The experiment was conducted in three phases in order to simulate the negotiation process (see Figure 1). In *Phase 1*, we provided participants a description of a hypothetical company (including financial statements) and asked them to assume the role of controller. Participants were also asked to assume that they would be in communication with the external auditors (through the hypothetical audit partner in charge of the engagement), who were in the process of completing fieldwork and had come up with a preliminary list of proposed adjustments that they would like the controller to post. Participants e-mailed a researcher after familiarizing themselves with the Phase 1 materials, which initiated *Phase 2* of the experiment. In Phase 2, participants received (via e-mail) the audit partner's preliminary list of proposed audit adjustments. Participants were informed by the partner's correspondence that the list was not yet finalized, as the audit team was still in the process of completing fieldwork. This list included two significant (clearly material) income-decreasing adjustments for all participants.⁴ These two significant adjustments related to sales and to depreciation. Depending on treatment condition (discussed below), the list also included five, two, or no clearly inconsequential income-decreasing adjustments.

Of the five inconsequential items, three related to estimates. For two of these proposed adjustments, the client's figures fell within the auditor's acceptable range (which the auditor

disclosed to the client), and the auditor proposed an adjustment to bring the balance of the account closer to the high end of the range. As any amount within the range is acceptable under GAAP, these two proposed adjustments could be waived without jeopardizing the integrity of the financial statements. For the third inconsequential proposed adjustment relating to an estimate, the client's figure fell just short (0.0004% of sales, 0.008% of pretax income, and 0.01% of net income, with no effect on earnings per share) of the lower-end of the auditor's acceptable range. The two remaining inconsequential proposed adjustments were not estimated figures and totaled 0.01% of sales, 0.2% of pretax income, and 0.4% of net income, with no effect on earnings per share. Accordingly, these inconsequential proposed adjustments that were shown to the client subjects as part of the "preliminary list" could be waived by the auditor without any effect on net income or earnings per share, and remain compliant with the current regulatory environment (i.e., SAS No. 89 and the Sarbanes-Oxley Act).⁵

After receiving a participant's e-mailed reply to Phase 2, we sent a second e-mail to the participant, beginning *Phase 3* of the experiment. This second e-mail included the final list of proposed adjustments (which was identical for all participants in all conditions), consisting only of the two significant adjustments. After examining the final list of adjustments, participants were asked to indicate how willing they were to post the two significant adjustments. Participants also indicated their satisfaction with the audit partner and how likely they were to recommend using the same auditing firm next year. Finally, participants responded to a manipulation check and demographic questions.

[Insert Figure 1]

There were two primary experimental conditions used to test the hypotheses, which relate to the efficacy of the full-disclosure approach relative to a non-disclosure approach. The manipulation occurred primarily in Phase 2. In the Non-Disclosure (ND) condition, participants

received only the two significant adjustments on the Phase 2 preliminary list of audit adjustments. Participants in the Full-Disclosure (FD) condition received five inconsequential adjustments in addition to the two significant adjustments. In Phase 3, participants in both conditions received a final list of adjustments, which included only the two significant items. The FD group was provided with the following communication from the audit partner regarding the partner's concession of the inconsequential items: "I will waive five of the initial proposed adjustments. Therefore, you will only need to post two adjustments instead of the initial list I provided you with seven adjustments." Thus, in the FD condition, the partner's actions result in five waived items, which are waived in full view of the controllers. In contrast, participants in the ND condition are not aware of any concessions by the partner.

A third treatment condition was utilized to investigate whether the level of concession (i.e., the quantity of waived items of which the controller is aware) may affect the controllers' judgments and perceptions. The only difference between this third condition, which we label Selective-Disclosure (SD), and the FD group is in the number of *inconsequential* adjustments received during Phase 2 and subsequently waived in Phase 3. Specifically, two inconsequential items were received by participants in the SD condition and subsequently waived by the partner versus five for the FD condition.⁶ Analysis regarding this additional treatment condition is exploratory and does not relate to any of the stated hypotheses; results regarding this condition are discussed in the section labeled "Selective Disclosure."

IV. RESULTS

Willingness to Post Significant Items

Recall that, in all conditions, the auditor's final request is that only the two significant adjustments be posted.⁷ Hypothesis 1 predicts that participants in the FD condition (in which the

auditor disclosed all five inconsequential items to participants before waiving them) will be more willing to post the two significant income-decreasing adjustments than participants in the ND condition (in which participants are unaware of any waived items).⁸ Participants recorded their willingness to post the adjustments on ten-point scales, where 1 = “extremely unwilling” and 10 = “extremely willing.” Table 1 reports group means and the results of the planned contrasts used to test H1.⁹ The mean willingness to post the significant Sales adjustment for the ND group is 6.40, which is significantly less than the FD group mean of 7.87 ($p = .002$). Similar results are obtained for the significant Depreciation adjustment, with controller participants indicating a mean willingness of 5.98 for the ND group and 7.13 for the FD group ($p = .025$). These results provide support for H1.¹⁰

[Insert Table 1]

Client Satisfaction and Retention

Hypotheses 2a and 2b predict client satisfaction and retention will be higher for the FD group than for the ND group. Participants recorded their satisfaction with the auditor on a ten-point scale (where 1 = “extremely dissatisfied” and 10 = “extremely satisfied”), and their likelihood of retaining the auditor on a ten-point scale (where 1 = “extremely unlikely” and 10 = “extremely likely”). Group means and the results of planned comparisons are provided in Table 2. Client satisfaction for the FD group (mean = 6.74) is significantly greater than that reported by the ND group (mean = 5.47, $p = .011$). Similar results are found for client retention, where the FD mean (6.61) is significantly greater than the mean for the ND group (5.31, $p = .010$). Thus, these results are supportive of H2a and H2b.

[Insert Table 2]

Selective Disclosure

Prior negotiation research suggests that higher initial positions lead to higher concessions on the part of the opponent (Chertkoff and Baird 1971). However, the rate of concession does not seem to be as important a factor in the level of reciprocating concessions made by the opponent (e.g., Liebert et al. 1968; Pruitt and Drews 1969; Benton et al. 1972). Thus it is unclear as to whether, in the context of negotiating proposed audit adjustments, the *quantity* of waived items of which the client is made aware by the auditor will affect the controllers' willingness to post. It may be that the greater the number of disclosed (and subsequently waived) inconsequential audit differences, the more cooperative the client views the auditor. This, in turn, may lead to increased client satisfaction and likelihood of retaining the audit firm. In order to explore the potential relationship between the *extent* of disclosure/concession on the part of the auditor and client judgments and perceptions, we included an additional condition for the controller experiment. Recall that this additional treatment (labeled SD) involves the disclosure (and subsequent waiving) of only two inconsequential audit adjustments, rather than the five inconsequential adjustments waived in the FD group.

The SD group's mean willingness to post the significant Sales and Depreciation adjustments are 8.14 and 7.26, respectively (see Table 1). While these means are significantly higher than the ND group means ($p < .001$ for the Sales adjustment and $p = .016$ the Depreciation adjustment), they are not significantly different than those of the FD group (p 's $> .10$). This pattern of results suggests that, while the use of a disclosure approach (either full or selective) appears to raise the likelihood of the significant adjustments being booked, increasing the number of adjustments included in the auditor's initial position does not. That is, it does not appear that the number of items waived is as important as the fact that some items are waived. A similar pattern of results is found for the client satisfaction and retention variables (see Table 2).

Additional Experimentation

Auditor Perceptions

The results discussed above suggest that the full-disclosure approach is effective, not only as a means to increase the clients' willingness to post significant adjustments, but also for improving client satisfaction and the likelihood of client retention. In light of these results, it is interesting to investigate auditors' perceptions regarding this type of approach. In other words, while a full-disclosure approach may produce a more collaborative environment that results in better negotiated outcomes, auditors' perceptions may lead them to choose not to consider it. Through additional experimentation, we examine the other side of the negotiation table to explore how auditors view the use of this approach and its effect on client satisfaction and retention.

As previously discussed, Gibbins et al. (2001) note that auditors regard negotiation as a frequent and important part of their responsibilities and part of the service they provide to the client. In addition, prior research suggests that experience in a negotiation setting leads to increased use of a reciprocation-based approach (Kelley 1966; Thompson 1990). Thus, as experienced negotiators, auditors may be inclined to utilize a strategy that draws upon reciprocation when they deem it appropriate for the negotiation at hand. While Gibbins et al. (2001) do not explore the strategy of disclosing an initial position that is greater than the ultimate goal, they report that the outcome of most negotiations lies somewhere between the initial position of the auditor and that of the client. However, Ng and Tan (2003) find that auditors do *not* inflate the dollar amount of proposed adjustments in anticipation of negotiations (i.e., do not employ a reciprocation-based approach in that context). Auditors in their study tended to base their initial recommendations purely on what they considered the most appropriate dollar amount. One potential explanation for this may be that their participants did not feel it was

honest or ethical (or even accurate) to inflate dollar amounts beyond what they felt they really ought to be. Alternatively, if accuracy is essential, auditors could use a full-disclosure approach in which insignificant (but accurate with regard to dollar amount) adjustments serve as the initial concession required for a reciprocation-based approach. Thus, we explore auditors' perceptions regarding the appropriateness and effectiveness of a full-disclosure approach.

Auditor Task and Procedure

Participants were thirty-six audit managers and partners from large, international public accounting firms who had, on average, about 10 years experience. Discussions with practicing auditors revealed that managers and partners would be familiar with the process of negotiating with clients to resolve audit differences. Participants were asked to consider an interaction between a hypothetical auditor and client regarding the resolution of audit differences. The interaction was presented as a brief scenario in which the participant was informed that the hypothetical audit team had compiled a list of seven proposed audit adjustments. On the list, two of the adjustments were significant (clearly material) and five were clearly inconsequential to financial statement users (both separately and in aggregate).¹¹ Participants were informed that the client is generally reluctant to post audit adjustments. They were then presented with the hypothetical auditor's approach to resolving the audit differences (the manipulation). As with the controller experiment, there were two primary levels of the manipulation, non-disclosure and full-disclosure, plus a selective-disclosure condition. Auditor negotiation strategy was manipulated between subjects, with participants randomly assigned to one of three strategy conditions.

The Non-Disclosure (auditor) scenario provided to participants in the NDa condition involved a hypothetical auditor who decides to waive all five inconsequential adjustments

without bringing them to the client's attention, such that the client in the scenario is unable to observe the waiving of these adjustments. The auditor in the scenario then brings only the two significant adjustments to the client's attention and insists that the client post both. For the Full-Disclosure (FDa) condition, the hypothetical auditor discloses all seven items to the client, but requires the client to post only the two significant items (while informing the client that the five inconsequential items will be waived). The Selective-Disclosure (SDa) and FDa conditions are identical except that the auditor presented in the SDa scenario chooses to disclose (and subsequently waive) only two of the five inconsequential items. Participants were asked to indicate their perceptions regarding the level of client satisfaction and likelihood that the client would retain the audit firm, given the negotiation strategy of the hypothetical auditor presented in the scenario.

Auditor Results

To explore auditor perceptions, we asked participants whether there are circumstances under which it would be appropriate to adjust their approaches to resolving audit differences. Thirty-two out of 36 participants responded that it is appropriate to adjust their approach toward the resolution of audit differences depending on the nature and characteristics of the client. The same proportion of participants felt it is appropriate to adjust their approach if it results in the posting of material adjustments. Thus, it appears the majority of participants believe that there are circumstances where it would be acceptable to alter their negotiation tactics.

Participants also believe that, by altering their approach toward greater disclosure of inconsequential audit differences, auditors can improve client satisfaction and retention. Participants recorded their perceptions of: (a) client satisfaction on a ten-point scale (1 = "very dissatisfied;" 10 = "very satisfied") and (b) likelihood of client retention on an eleven-point scale

(-5 = “decreased likelihood of client retention;” 0 = “no change;” +5 “increased likelihood of client retention”).¹² The mean perceived satisfaction score for the FDa condition (7.58) is significantly greater than that reported for the NDa condition (4.33, $p < .001$, Table 3). Similar results are obtained with the mean perceived likelihood of retention scores (2.25 and -1.00, respectively, $p < .001$).

[Insert Table 3]

It is interesting to note that, while the quantity of waived items did not influence controller perceptions, it did affect the auditors’ perceptions. Table 3 indicates that auditor participants believe that clients will respond more favorably to selective-disclosure (SDa) of inconsequential items than to non-disclosure (NDa), but not as favorably as to full-disclosure (FDa). With respect to perceptions of client satisfaction, auditor participant means for the SDa condition were significantly higher than those reported for the NDa condition (6.58 vs. 4.33, $p < .001$), but significantly lower than those for the FDa condition (6.58 vs. 7.58, $p = .035$). These results suggest that auditors perceive that the number of inconsequential items the client observes the auditor waive is positively related to the client’s satisfaction. Similar results were found for the client retention variable (SDa mean = 1.17 vs. -1.00 and 2.25 for NDa and FDa, $p < .001$ and $p = .035$, respectively).

V. DISCUSSION AND CONCLUDING REMARKS

Auditors are in the tenuous position of ensuring that financial statements are free from material misstatements while at the same time maintaining a positive relationship with their client who, it is important to note, is responsible for creating the financial statements and has substantial influence regarding retaining the auditor. A judicious negotiation strategy may help them obtain both of these goals. In this study we examine how auditor strategy during

negotiations with the client over the resolution of proposed financial statement adjustments may affect the client's willingness to post significant audit adjustments, as well as client satisfaction and retention.

We investigate an approach that draws upon the societal rule of reciprocity. In an audit context, a reciprocity-based strategy could involve an approach of "full-disclosure," which makes the waiving of inconsequential audit differences transparent. Specifically, the auditor could choose to disclose to the client the inconsequential audit differences discovered during the engagement (which the auditor could have chosen to waive without bringing to the client's attention), and subsequently waive these inconsequential differences. Negotiation theory suggests that making the waiving process more transparent, by disclosing the adjustments before waiving them, may result in a more collaborative negotiation with the client causing them to be more agreeable toward posting significant items to the financial statements. We examine, from the client perspective, the efficacy of a full-disclosure approach by the auditor during the resolution of audit differences relative to a strategy in which the client is unaware of inconsequential items that the auditor waives (i.e., a strategy of "non-disclosure" of inconsequential items in which the auditor starts with the desired end position and sticks to it).

The results of our study, conducted post Sarbanes-Oxley, indicate that auditor negotiation strategy can affect the resolution of proposed adjustments to the financial statements, as well as client perceptions regarding the resolution process. Specifically, client managers (controllers and CFOs) are more willing to post significant adjustments if the auditor includes and subsequently waives some inconsequential adjustments (full-disclosure approach), relative to an approach of non-disclosure. In addition, client managers reported greater satisfaction and likelihood of recommending retention of the auditor when exposed to a full-disclosure approach, compared to a non-disclosure approach. We also investigate whether "selective disclosure" (i.e.,

disclosure/waiving of certain inconsequential items) produces many of the same effects as full disclosure. Our findings suggest that the extent of disclosure does not matter from the client perspective since both full and selective disclosure improve the outcome of the negotiation process.

While a full-disclosure approach appears to produce a more collaborative environment that results in better negotiated outcomes, auditors' perceptions may lead them to choose not to consider it. Through additional experimentation (also conducted post Sarbanes-Oxley), utilizing auditors as participants, we examine the other side of the negotiation table to explore how auditors view the appropriateness of this approach and its effect on client satisfaction and retention. Results indicate that the majority of auditor participants view altering their negotiation tactics as appropriate, depending on the nature and characteristics of the client and if it facilitates the client posting significant adjustments. Similar to the results obtained with client management (the main experiment), auditors perceive that both full- and selective-disclosure approaches can lead to greater client satisfaction and retention relative to a non-disclosure approach. However, in contrast to the client results, selective disclosure was not viewed as favorably as full disclosure by auditors. Given that client managers are only aware of the items disclosed by the auditor, they might have perceived both full and selective disclosure as full disclosure. For example, many controller/CFO participants in the two disclosure groups noted that they were more satisfied with the process since the auditor "seemed willing to compromise" (i.e., make concessions) and consider their viewpoint. In contrast, auditor participants were aware of all audit differences and could recognize that a selective approach does not disclose all differences to the client. As a result, they may have discounted its appeal.

The results of this study have implications for practice and future research. With respect to practice, results of this study suggest that the auditor's negotiation strategy matters.

Specifically, in this case, “disclosure” approaches appear to lead to increased client satisfaction and retention and better negotiated outcomes. Further, the fact that auditors have been found to waive adjustments or change estimates in concession to client demands (e.g., Gibbins et al. 2001) could be part of a negotiation strategy and may actually result in positions consistent with auditors’ initial (but unstated) position. That is, the fact that an auditor may make concessions to a client does not necessitate that the resulting financial statements differ from the auditors initial intended outcome. Future research might be aimed at determining the purpose of auditor concessions and their impact on audit quality. This research could investigate and compare auditors’ intended outcomes with the actual outcome of the negotiation. While it is likely that auditors utilize a variety of approaches when negotiating with the client to resolve audit differences, they do appear to recognize certain benefits of a full-disclosure approach. Further research could be designed to determine the conditions under which auditors are likely to use such an approach. Also, this study presents results obtained from only a single negotiation context. Future research could investigate other auditor-client negotiation settings to broaden the generalizability of these findings. Such research will further our understanding of the impact of auditor-client interactions on the resulting financial statements.

FIGURE 1
Outline of Experimental Procedure

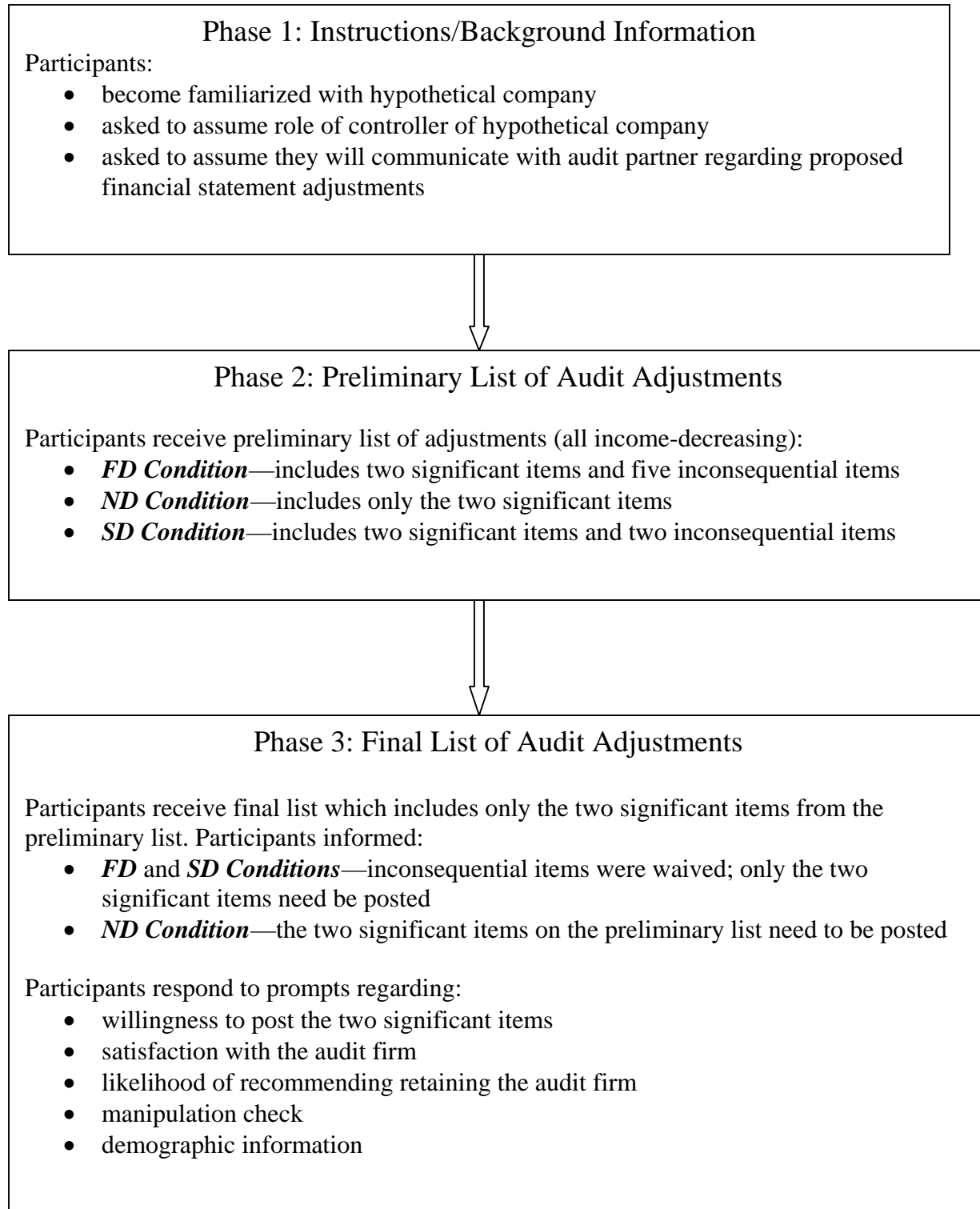


TABLE 1
H1: Controllers' Willingness to Post Significant Adjustments

Panel A: ANOVA Results for Willingness to Post Significant Adjustments

Dependent Variable ^a	ND Group (n = 43)	SD Group (n = 43)	FD Group (n = 38)	F-Statistic	p-value
Sales Adjustment					
Mean ^b	6.40	8.14	7.87	7.46	<.001
(Std. Dev.)	(2.70)	(1.89)	(2.03)		
Depreciation Adjustment					
Mean	5.98	7.26	7.13	2.84	.062
(Std. Dev.)	(2.96)	(2.70)	(2.46)		

Panel C: Contrast Tests Between Groups

Sales Adjustment	F-Statistic	p-value ^c
ND Group vs. SD Group	13.02	<.001
ND Group vs. FD Group	8.71	.002
SD Group vs. FD Group	0.30	.294
Depreciation Adjustment		
ND Group vs. SD Group	4.74	.016
ND Group vs. FD Group	3.63	.025
SD Group vs. FD Group	0.04	.419

^a Two dependent variables (willingness to post the significant Sales adjustment and willingness to post the significant Depreciation adjustment) were included in the analysis of the three treatment groups.

^b The means represent the participants' willingness to post the adjustment recorded on ten-point scales where 1 = "extremely unwilling" and 10 = "extremely willing."

^c p-values are based on one-tail tests since expectations regarding mean differences were directional.

TABLE 2
H2: Controllers' Assessment of Client Satisfaction and Retention

Panel A: ANOVA Results for Client Satisfaction and Retention

Dependent Variable	ND Group (n = 43)	SD Group (n = 43)	FD Group (n = 38)	F-Statistic	p-value
Client Satisfaction					
Mean ^a	5.47	6.61	6.74	3.45	.035
(Std. Dev.)	(2.89)	(2.15)	(2.19)		
Client Retention					
Mean ^b	5.31	6.58	6.61	3.82	.025
(Std. Dev.)	(2.70)	(2.40)	(2.13)		

Panel B: Contrast Tests Between Groups

Client Satisfaction	F-Statistic	p-value ^c
ND Group vs. SD Group	4.70	.016
ND Group vs. FD Group	5.50	.011
SD Group vs. FD Group	0.06	.404
Client Retention		
ND Group vs. SD Group	5.74	.009
ND Group vs. FD Group	5.59	.010
SD Group vs. FD Group	0.00	.483

^a The means represent the participants' responses to the question "How satisfied are you with the performance of the audit partner?" Responses were recorded on ten-point scales where 1 = "extremely dissatisfied" and 10 = "extremely satisfied."

^b The means represent the participants' responses to the question "How likely are you to recommend using this firm next year?" Responses were recorded on ten-point scales where 1 = "extremely unlikely" and 10 = "extremely likely."

^c p-values are based on one-tail tests since expectations regarding mean differences were directional.

TABLE 3
H3: Auditors' Perceptions of Client Satisfaction and Retention

Panel A: ANOVA Results for Auditors' Perceptions

Dependent Variable	NDa Group (n = 12)	SDa Group (n = 12)	FDa Group (n = 12)	F-statistic	p-value
Perception of Client Satisfaction					
Mean ^a	4.33	6.58	7.58	33.25	<.001
(Std. Dev.)	(1.07)	(1.31)	(1.51)		
Perception of Likelihood of Retaining Audit Firm					
Mean ^b	-1.00	1.17	2.25	32.86	<.001
(Std. Dev.)	(1.28)	(1.12)	(1.77)		

Panel B: Contrast Tests Between Groups

Perception of Client Satisfaction	F-Statistic	p-value
NDa Group vs. SDa Group	17.74	<.001
NDa Group vs. FDa Group	37.02	<.001
SDa Group vs. FDa Group	3.50	.035
Perception of Likelihood of Retaining Audit Firm		
NDa Group vs. SDa Group	14.10	<.001
NDa Group vs. FDa Group	37.73	<.001
SDa Group vs. FDa Group	3.53	.035

^a The means represent the participants' perception of client satisfaction which was measured on a ten-point scale where 1 = "very dissatisfied" and 10 = "very satisfied."

^b The means represent the participants' perception of the likelihood of client retention which was measured on an eleven-point scale where -5 = "decreased likelihood of client retention," +5 = "increased likelihood of client retention," and 0 = "no change."

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FOOTNOTES

¹ Discussions with 15 audit partners and managers indicate that this preliminary disclosure typically would occur prior to preparation of unadjusted audit differences required by SAS No. 89, and that inconsequential items disclosed to client management at this point would not need to be included in the summary of unadjusted audit differences presented to the audit committee. It should also be noted that the current regulatory environment (i.e., SAS No. 89 and Sarbanes-Oxley) does not necessitate that items waived (either at the workpaper level or in view of the client) be communicated to the audit committee if the items are considered inconsequential by the auditor. Additionally, discussions with practicing auditors indicate that both approaches (i.e., disclosure/non-disclosure of inconsequential items to client management) are still available to, and utilized by, auditors post Sarbanes-Oxley.

² Discussions with 15 audit partners and managers confirm that waiving audit differences below the posting threshold (i.e., inconsequential misstatements) without bringing such differences to the attention of management or the audit committee is not prohibited by either SAS No. 89 or Sarbanes-Oxley.

³ Out of 1,000 letters requesting participation in the study (addressed to controllers/CFOs randomly selected from a membership list provided by the Institute of Management Accountants), eighty letters were returned because of an incorrect address, and six respondents indicated that they could not participate in the study because they were retired, ill, or unfamiliar with the issues. A total of 124 controllers/CFOs agreed to participate, representing a 14% response rate (124 useable responses out of 914 potential responses).

⁴ Financial statement audits typically result in the detection of two or more misstatements (Kreutzfeldt and Wallace 1986; Wright and Ashton 1989). Following Braun (2001), the current study uses two material proposed adjustments. Seven audit experts determined that these

material adjustments were significant and would need to be posted in order for an auditor to issue an unqualified opinion. Experts were three practicing auditors and four academics with significant audit experience.

⁵ The inconsequential proposed adjustments were determined to be “clearly inconsequential,” both individually and in the aggregate, by seven audit experts. It was also determined by these experts that the inconsequential adjustments were small enough in magnitude that they would need neither to be brought to the attention of the audit committee nor included in the management representation letter. Accordingly, these inconsequential proposed adjustments could be waived by the auditor without ever having been brought to the attention of the client.

⁶ It should be noted that, given they do not have knowledge regarding the complete list of audit differences uncovered by the audit team, participants are not able to discern whether the audit partner is fully or selectively disclosing the inconsequential differences. Thus, relative to the FD condition, the SD condition is simply a manipulation of the *quantity* of observed concessions. As with the FD and ND conditions, participants in the SD condition received only the two significant audit differences in Phase 3.

⁷ There were no significant differences (p 's > .10) for controllers across the experimental conditions for any of the demographic variables (e.g., experience, company publicly traded, revenues, industry).

⁸ A manipulation check revealed that controllers were generally aware of their audit partner's actions. However, nine participants in the ND group indicated that they did not realize the partner had not waived any of the proposed adjustments. Removing these participants' responses from the analysis does not affect the conclusions drawn.

⁹ Since the hypotheses in this study examine the effect of the treatment groups across multiple dependent variables, multiple analyses of variance (MANOVA) were performed. Results were significant at $p < .01$, allowing us to consider univariate tests of the hypotheses.

¹⁰ A Shapiro-Wilk test indicated that some of the data reported in this study violated the assumption of normality. Therefore, nonparametric tests were also performed (Kruskal-Wallis and Mann-Whitney tests) which resulted in nearly identical significance levels.

¹¹ The seven items were identical to the seven items used in the FD condition of the controller experiment. All items were income-decreasing.

¹² A MANOVA, which considered both of these dependent variables simultaneously, resulted in a significant F value of 12.00 ($p < .001$) allowing us to consider separate ANOVAs for the two dependent variables.