

**The Auditor's Negotiation Strategy Selection: Client Management's Initial Accounting Position Flexibility and Auditor-Client Management Relationship**

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### **ABSTRACT**

The auditor's initial negotiation strategy and tactics choice determines how the upcoming negotiation is approached, carried out and potentially the eventual outcome. We experimentally examine two factors key to the auditor's initial formulation of his/her negotiation strategy: the nature of the auditor-client management relationship and the auditor's initial assessment of client management's flexibility in its accounting position. We posit that these two factors will condition the auditor's approach to the upcoming negotiation based on the negotiation literature and previous field studies of audit negotiation research. Our experimental results, obtained from 140 audit partners, indicate that initial client management accounting position inflexibility leads to auditors being more likely to use contending tactics and to be more committed to achieve the negotiation goal of a substantial reduction in income. We also found that higher auditor goal commitment was significantly more likely to lead to use of contending tactics and less likely to the use of concessionary tactics. We also found only insignificant effects for nature of the relationship on tactic use and auditor goal commitment. In addition we re-performed the hypotheses tests employing a structural equations model which allows for greater latitude in individual interpretation of the features manipulated. This model replicated our main experimental results in addition to revealing subtleties that our experiment did not document. In particular, the more positive and cordial the auditor client relationship, the less committed the auditor is to the negotiation goal of a substantial reduction in income and the greater the likelihood the auditor will employ concessionary tactics. Our results have mixed implications for auditors. The experimental results show the auditors react appropriately to an inflexible client management initial accounting position by employing contending tactics and increasing their commitment to the goal of substantial client net income reduction. Furthermore, the insignificant experimental results for effects of client relationship on auditor judgments seems consistent with the observation that relationship quality should not affect audit evidence evaluation hence the acceptability of client's accounting judgments. The structural equations model's more fine-grained results indicates auditors respond to client relationship quality in that a more positive and cordial client relationship leads auditors to using more concessionary tactics and being less committed to the goal of a substantial reduction in client net income. These latter findings, if replicated, suggest that auditors may be inappropriately relying on the quality of their relationship with client management when preparing for negotiation. Furthermore, the virtual non-existent use of integrative strategies and tactics suggests room for audit partner training in negotiations with client management.

# **The Auditor's Negotiation Strategy Selection: Client Management's Initial Accounting Position Flexibility and Auditor-Client Management Relationship**

## ***1. Introduction***

Whenever a disagreement arises between the auditor and the client management about management's proposed accounting or disclosure, auditor-client management (ACM) negotiation is possible. Given this potential, either party can form an initial approach about how to proceed based on his/her understanding that there is a disagreement. We create an experimental context where the auditor is likely to negotiate rather than take one of the other alternative courses of action open to him/her: resign from the audit (e.g., Dhaliwal, Schatzberg, and Trombley [1993], Krishnan [1994]), conclude outright that a reservation of opinion is necessary (e.g., due to a scope limitation that cannot be audited around), or concede without negotiating by waiving the potential adjustment (e.g., Braun [2001], Nelson, Elliot, and Tarpley [2002], Wright and Wright [1997]).<sup>1</sup> This paper focuses on the auditor's initial negotiation strategy formulation in a context where negotiation preparation is seen as a necessity.

The auditor's initial negotiation strategy and tactics choice is important because it conditions how the negotiation is approached and carried out, and likely its outcome. As Pruitt and Carnevale [1993] discuss, the initial choice can affect the length of the negotiation, the likelihood of an agreement, and the parties' relationship, as well as providing a context for future negotiations. Previous negotiation research also shows that the strategy chosen can affect resulting gains or losses (Brett, Shapiro, and Lytle [1998],

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<sup>1</sup> In the negotiation literature, these alternative actions are called BATNA, best alternative to a negotiated agreement (Fisher and Ury [1991]). BATNAs have been studied extensively in negotiation research (e.g., Pinkley [1995], Pinkley, Neale, and Bennett [1994]) and are often important to "one off" or infrequent negotiation occurrences (i.e., a consumer buying a new car). BATNAs like a qualified audit report or an auditor resignation are available in the ACM setting, but they are used after all attempts to negotiate fail.

Greenhalgh and Chapman [1998], Lytle, Brett, and Shapiro [1999]; Olekalns and Smith [2000]).

We carry out an experimental investigation of two factors identified in previous accounting research as being important to the auditor's formulation of his/her negotiation strategy. The first factor is the auditor's assessment of the flexibility of the client management's initial position, a subset of the auditor's overall assessment of the accounting issue. The auditor's assessment of flexibility in client management's initial accounting position is posited to condition the auditor's approach to the forthcoming negotiation, for example, the auditor's negotiation goal and strategy/tactics selection (Gibbins, Salterio, and Webb [2001] and Gibbins, McCracken, and Salterio [2006]). The second factor is the nature of the ACM relationship, is part of the broader negotiation-related construct of auditor bargaining power. Auditor bargaining power is enhanced when the relationship history is positive and cordial, such that the client management is receptive to the auditor's views. Auditor bargaining power is detracted from when the relationship is negative and contentious, such that the auditor is in a constant struggle with client management to achieve minimal GAAP compliance (Gibbins, McCracken, and Salterio [2006]).

This paper reports the results of an experiment participated in by 140 highly experienced audit partners. We examine the effects of the two factors discussed above on the auditor's selection of negotiation strategies and tactics as well as on the auditor's commitment to a high negotiation goal. In addition to manipulating the flexibility of client management's initial accounting position and the ACM relationship, we also construct a structural equations model based on multiple indicator variables of the

auditor's perceptions of the manipulated variables in our experiment. We use this model to simultaneously estimate parameters associated with the ACM relationship, client accounting policy flexibility, the auditor's goal commitment and the auditor's initial strategy selection.

Our experimental results indicate that when the audit partners perceive they are facing client management exhibiting flexibility in its initial accounting position, the auditor is more likely to use conceding and compromising strategies and tactics. In contrast, when the auditors perceive they are facing a client that is inflexible about changing their initial accounting, they are more likely to use a contending strategy and tactics. This strategy choice, while protecting the auditor's position, locks the auditor into a situation where there must be a "winner" and a "loser", when integrative strategies and tactics might be as, if not more, effective. Experimentally, the nature of the ACM relationship does not significantly impact the auditors' intended negotiation strategy and tactics. Finally, our experiment shows that the higher the auditor's goal commitment to a substantial reduction in client net income as a result of the negotiation, the less likely the auditor is to use concessionary tactics and the more likely to use contending tactics.

The structural equations modeling approach allows for a more refined analysis by taking into account individual interpretations of the two variables we manipulated. Three additional findings warrant mention. First, as hypothesized, we find that the nature of the ACM relationship directly affects the decision to use conceding tactics, such that a more positive and cordial relationship increases the likelihood of employing concessionary tactics. Second, consistent with the hypothesized effects the ACM relationship affects the use of both conceding and compromising tactics, albeit indirectly, via its effects on

the auditor's negotiation goal. For both strategies, a positive and more cordial ACM relationship leads to greater use of these strategies and tactics. Third, from an exploratory perspective, the greater the inflexibility of the client management's initial accounting position, the greater the likelihood that the auditor will employ "expanding the agenda" tactics that are integrative in nature.

Overall, our paper's results have mixed implications for audit partners who carry out negotiation. We document that audit partners appropriately react to inflexible initial client accounting positions by employing contending tactics and having a strong commitment to the negotiation goal of achieving a substantial reduction in client net income. Our experiment shows minor effects, at best, for the nature of the ACM relationship on strategy/tactics selection and goal commitment. However, our more fine grained structural equations modeling approach raises concerns about auditors' reactions to a positive and cordial relationship. In particular, we document a lower commitment to a high negotiation goal and a greater likelihood of the auditor using concessionary and compromising tactics. While these tactics are likely to lead to a better relationship with client management, it is unclear whether they will lead to less aggressive accounting. These tactics make the possibility of aggressive accounting being accepted more likely than alternative tactics would. In addition, we raise concerns about the normative appropriateness of employing relationship quality when evaluating audit evidence and client accounting policy choices.

The remainder of the paper is organized as follows. The next section discusses theory related to initial negotiation strategies. Section 3 develops our hypotheses and

Section 4 outlines our experimental design. Our results are discussed in Section 5. The final Section 6 includes a discussion of conclusions, limitations and future research.

## ***2. The Auditor's Initial Negotiation Strategy***

### **2.1 FLEXIBILITY OF MANAGEMENT'S INITIAL ACCOUNTING POSITION**

An accounting or disclosure disagreement means, from the auditor's perspective, that the auditor's preferred accounting or disclosure and the auditor's perception of client management's preferred accounting or disclosure do not initially coincide. Negotiation research has illustrated this possibility using the term "most preferred position", which is, in our context, the auditor's evaluation of appropriate accounting based on the audit evidence collected and client management's initial accounting for the issue. Negotiation research also characterizes an "acceptable range" around this "most preferred position" as being the set of outcomes that are minimally acceptable to either party to the negotiation. See Figure 1 for the two scenarios that are possible in this context.

In the first scenario, the auditor initially perceives at least one potentially mutually acceptable solution that both parties could "live with" (Figure 1 Panel A). Hence, the auditor may believe client management's initial position is flexible, no matter what the current client rhetoric is. Beattie, Fearnley, and Brandt's [2001] field study of ACM negotiations describes a case related to assigning fair values to a piece of property. While both client management and the auditor had an initial position, both parties were willing to move from their initial positions facilitating the negotiations and the resulting outcome. Indeed, participants described the process as "a dynamic model for seeking a solution" (p. 157).

In the second scenario, the auditor does not initially perceive there is the potential for any mutually acceptable solutions (Figure 1 Panel B). Beattie, Fearnley, and Brandt [2001] describe another case that illustrates relatively inflexible initial positions including the lack a potentially mutually acceptable position. The chairman of the company did not want to accept changes in GAAP that required different accounting for goodwill than previously. The audit partner saw no option other than his position given the standards for goodwill accounting. The ensuing negotiations became hostile and were difficult to resolve due to the initial inflexibility on management's part, although, after involvement of the audit committee there was eventual resolution in favor of the auditor's position with some minor concessions on other issues (p. 245).

## 2.2 NATURE OF THE ACM RELATIONSHIP

Prior research has shown that when the negotiators are involved in an ongoing relationship, the negotiations are different from and more challenging than when there is only a one-time interaction (Sheppard and Tuchinsky [1996], Tenbrunsel et al. [1999]). Other research has shown that the nature of the relationship (e.g., cordial or contentious) between the parties to the negotiation also influences the negotiation process (Poitras, Bowen, and Byrne [2003], Pruitt and Carnevale [1993]), including what items become an issue, the length of the negotiation, the strategies and tactics used in the negotiation, and the eventual resolution. In accounting, Gibbins et al. [2001] audit partners report negotiation history as moderately important in resolving the current issue and felt the current issue's resolution was moderately important to future negotiations. Gibbins et al. [2001] (footnote 12) also report significant associations between their reported negotiation's contextual features and relationship history. Gibbins et al. [2005] reports

CFOs felt that relationship history was very important to resolving negotiation issue and significantly more important than the audit partners surveyed a few years earlier.

We consider two types of relationships. The first one is a cordial ACM relationship where both parties have a history of positive interactions and the services provided by the auditor are valued. Gibbins McCracken and Salterio [2006] describe this relationship as one of a “co-creator” of the financial statements where the audit partners’ role is to ensure that the accounting is beyond question from a variety of public audiences. While ‘heated’ negotiations may occur, they are embedded in a relationship based on mutual respect and are rarely damaged by even ‘heated’ negotiations. Beattie, Fearnley, and Brandt [2001] field study provides additional examples of the different relationship types. In one case, client management explains that “why we pay [*the audit firm*] so much money” is to “get the auditor’s judgment” about the best accounting and describe the negotiation as being carried out in a setting where both sides respects, values and welcomes each others’ input.

Alternatively, a contentious ACM relationship exists when the parties are involved in a power struggle, such as when the auditor’s role is to police or enforce minimal GAAP compliance (Gibbins, McCracken, and Salterio [2006]). Indeed, audit partners describe such relationships as leading to ‘dangerous’ for the auditor negotiations (Gibbins, McCracken, and Salterio [2006]). Beattie, Fearnley, and Brandt’s [2001] field study describes other cases where the relationship is poor and affects the negotiations. In one case, where the client financial manager did not respect the audit partner due to what the manager described as the lack of auditor experience among other relationship issues. In the negotiation, the client’s financial manager agreed with the auditor’s accounting

position, but he/she would not support the auditor's request for changes to the financial statements that senior company management did not want to make. A resolution was very difficult to achieve and cost more than it should have in both time and money, with both sides resenting the other, and causing future difficulties in the ACM relationship.

### 2.3 NEGOTIATION STRATEGIES

Little is known about auditor negotiation strategy choices and their related tactical implementation. Gibbins, Salterio, and Webb [2001] and Gibbins, McCracken, and Salterio [2006, 2007] only tangentially investigated this area by inferring auditor strategy choices from the CFO and/or auditor discussions of how the issue resolution process took place, the set of solutions considered and the final issue resolution (see also Brown and Johnstone's [2006] analogous experimental approach). Other researchers have tended to limit their investigation to two or three very broad, often ill-defined and not well-distinguished, definitions of the potential negotiation strategies (e.g., Bame-Aldred and Kida [2005], Hatfield, Agoglia, and Sanchez [2005]). Goodwin [2002] focused on auditors' negotiation styles as being fixed and independent of the negotiation context, in the manner of the "individual differences" accounting research stream (Ho and Rodgers [1993]).

Previous studies in the ACM context assume that auditors have not developed negotiation strategies and tactics that are different from those documented in the literature on negotiation (e.g., Blake and Mouton [1964], Rahim [1983], Thomas and Kilmann [1975]). Likewise, we assume that auditors have not invented new negotiation strategies but adapt generic ones to their specific context (Gibbins, Salterio, and Webb [2001]). Hence, drawing on the generic negotiation literature, we describe five major

negotiation strategies (and their process oriented tactics) associated with the two principal strategy groupings that are grouped by negotiated outcome (distributive and integrative), noting that the tactics implemented are often reflect a blending of elements of two or more strategies (Lytle, Brett, and Shapiro [1999], Olekalns, Brett, and Weingart [2003], Olekalns, Smith, and Walsh, [1996], Putnam [1990]).<sup>2</sup>

*2.3.1. Strategies Leading to a Distributive Outcome.* A distributive negotiation strategy may be defined as “a procedure for dividing a fixed pie of resources” (Bazerman [1986, p. 123]) and normally results in a “distributive” outcome where only one, or neither, party “wins.” Distributive negotiation strategies are the most common strategies found in both the laboratory (e.g., Lewicki and Litterer [1985], Pinkley, Griffith, and Northcraft [1995] and field settings (e.g., Babcock et al. [1995]). Consistent with that research, Gibbins, Salterio, and Webb [2001] reported that their audit partners (85%) entered negotiations with a range of options that were encompassed by the definition of distributive outcomes.<sup>3</sup>

Two tasks are essential in all distributive negotiations: influencing where the other party sets his/her “resistance point” (i.e., the closest end of the acceptable range in Figure 1 to your own position, for example, frame the issue to make your preferred solution appear more acceptable), and determining where the other party’s resistance point is (i.e., where they will “walk away,” for example, change auditors (Bame-Aldred

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<sup>2</sup> Near the end of the negotiation process, almost all negotiations have a distributive phase as at some point final outcomes must be allocated and almost all allocation processes are inherently distributive (Lewicki et al [2006]).

<sup>3</sup> The CFOs in Gibbins, McCracken, and Salterio [2007] also primarily viewed that negotiation with the audit partner would lead to a distributive outcome.

and Kida [2005])). We discuss two general strategies for carrying out these tasks: contending and conceding.<sup>4</sup>

*Contending:* This strategy aims “to make the other party make concessions or to resist similar (contending) efforts by others” (Pruitt and Carnevale [1993, p. 30]). Contending tactics might include threats, such as, “a commitment to punish the other party if one’s demands are not met” (Pruitt and Carnevale [1993, p. 30], Hilty and Carnevale [1993]). For example, client management may threaten the auditor with not reappointing him/her (Teoh [1992]). Other contending tactics might include irrevocable commitments such as the auditor clearly stating that he/she unambiguously will qualify the audit report if the current accounting is not changed (e.g., Chow and Rice [1982], McConnell [1984]); or persuasive arguments (Petty and Cacioppo [1981]), such as attempting to convince the client management to change its position by explaining broader implications of an accounting choice (e.g., Beattie, Fearnley, and Brandt [2004]).

The strongest form of contending would be to *insist* that one’s preferred position be adopted. In the audit setting, as the auditor does not directly control the client management’s accounting, the strongest form of contending is to threaten to resign from the audit or to qualify the audit opinion (e.g., McConnell [1984]). While qualified opinions are rendered (e.g., Smith [1986]) and auditors do resign from or are fired by clients (e.g., Smith [1988]), only isolated cases exist where client management and auditors make it clear that such actions were due to a disagreement over an accounting issue and that negotiation likely took place (e.g., Smith [1988]). Prior experimental work in this area corroborates that such an extreme form of contending is rare even in the laboratory (e.g., Brown and Johnstone [2006]).

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<sup>4</sup> See Churchman [1995] for a comprehensive review of negotiation tactics at the micro level.

*Conceding:* This strategy, the conceptual opposite of contending, involves changing one's position so that it provides less benefit to oneself, and therefore more benefit to the other party (Pruitt and Carnevale [1993, p. 28]). While conceding may not sound useful, the timing of the concession, the amount of the concession, and the resistance offered before conceding, among other factors, have been shown to affect the outcome of a distributive negotiation (e.g., Komorita and Esser [1975], Olekalns and Smith [2000]). For example, one application of this strategy to auditing is to have the auditor inform the client management about all potential audit adjustments, and then waive some of the immaterial adjustments, with the expectation that the client management will more readily accept the material adjustments (Sanchez, Agoglia, and Hatfield [2006]).

A concessionary strategy's most extreme form would be to *give in* to the other party's position during the negotiation, so that the other party need not concede anything. For example, an auditor's waiving of all adjustments found during the audit in the process of negotiating with the client management would be an example of this extreme concessionary tactic (e.g. Nelson, Elliott, and Tarpley [2002], Wright and Wright [1997]).

*2.3.2 Compromising.* Most negotiation researchers have come to accept "compromise" as a valid negotiation strategy choice (Lewicki, Barry, and Saunders [2006, p. 24]), frequently, but not always, associated with a distributive outcome. Compromising is often situated as a cross between contending and conceding, perhaps with a little problem solving or expanding the agenda of issues (see next section). It is an attempt to find a middle ground, where both parties move from their preferred positions towards an "in between" solution. While notionally this is a "mutually acceptable" solution (see

Figure 1 Panel A points d and e), normally neither party calls the compromise outcome a “win”, and both can call it a “loss”. When compromising, the goal of the negotiation exercise is accomplished (i.e., in the audit context, unqualified financial statements are issued); however, both parties are not really satisfied (see Gibbins et al. [2007] for CFOs descriptions of compromise outcomes). One key difference between compromising and conceding is that a compromise strategy explicitly proposes a “split the difference” solution and uses mild contending tactics to suggest consequences if it is not accepted, while a concessionary strategy implicitly attempts to have the *other* party make a concession or propose to “split the difference” (see Sanchez, Agoglia and Hatfield [2006] for an example in accounting negotiation).

*2.3.3 Strategies Leading to an Integrative Outcome.* The integrative negotiation strategy attempts to “find a means by which the parties can make tradeoffs or jointly solve problems to the mutual benefit of both parties” (Bazerman [1986, p. 123]). An integrative strategy attempts to lead to an “integrative” solution where both parties are better off (a “win-win” solution). Two principal strategies are usually associated with an integrative solution: problem solving and expanding the agenda of issues.

*Problem solving:* This strategy involves learning more about the underlying interests of both parties and searching for new solutions that are not immediately obvious at the start of the negotiation. Indeed, even without new solutions being generated, a focus on interests as opposed to outcomes can reveal ways to reconcile preferences for different outcomes in a way that benefits both parties (known in the literature as a “bridging” tactic (Fisher and Ury [1981])).

From the viewpoint of the auditor, problem solving is a strategy to find a new solution that essentially preserves the auditor's original accounting position while allowing client managers to feel that they have also achieved their objective. In most cases, management's objective is not focused on the precise accounting initially proposed; rather, the proposed accounting is instrumental to achieving other objectives, such as earning a bonus (Gibbins, Salterio, and Webb [2001], Watts and Zimmerman [1986, Chapters 9 and 13]) or exceeding important accounting reference points such as avoiding a loss (e.g., Burgstahler and Dichev [1997]). Hence, a "win-win" solution can be achieved, from the perspective of both the auditor and client management.

*Expanding the agenda of issues:* This strategy involves adding new issues to the negotiation, such that the resolution of the overall issue set has potential gains for both parties. Given such other issues, the negotiators can trade off something under negotiation with something originally not included when the negotiation began (Neale and Bazerman [1991]), thereby altering the priority of issues and interests (Lax and Sebenius [1986]) and creating the potential for "wins" for both sides. From the auditor's viewpoint, this negotiation strategy would change the context in which the parties viewed the original accounting issue. This context change would allow the auditor to accept accounting that was different from his/her original preferred position by viewing the overall resolution (including the additional issues added to the discussion) as being allowed by GAAP. This could then allow the client management to also achieve its individual objectives. Hence, a "win-win" solution is achieved.

An example of expanding the agenda is when the auditor brings other, individually immaterial, adjustments to the table that he/she had planned to waive.

Client management could adjust for all these items, allowing the auditor to have the overall reported net income correctly stated and client management to get the specific reporting it would like for the original contentious item (Hatfield, Agoglia, and Sanchez [2005], Sanchez, Agoglia, and Hatfield [2006]).<sup>5</sup>

## 2.4 SUMMARY

There are five negotiation strategies, in principle, that an auditor has available to him/her. These strategies can be characterized by the likely negotiation outcome: a “win-win” or integrative outcome (problem solving, expanding the agenda of issues and rarely compromising) or a “win-lose” distributive outcome (concessionary, contending and usually compromising). The strategies can also be viewed as collaborative or “working together” in orientation (problem solving, adding to the agenda, concessionary and most compromising tactics) or as a “self-interested” or competitive in orientation (a contending strategy and some of the more threatening compromising tactics). Furthermore, researchers suggest that a combination of strategies and their related tactics are likely to be employed in any given negotiation context (Lax and Sebenius [1986], Olekalns and Smith [2000]).

### ***3. Hypotheses about Auditor Initial Negotiation Strategies, Tactics, and Goals***

In our ACM setting, we feature an accounting disagreement, a relationship that varies substantially in nature and a client management’s initial accounting position that varies substantially in flexibility (i.e., Figure 1 Panel A versus Panel B). Our hypotheses predict how the nature of the relationship and the client management’s accounting

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<sup>5</sup> The assumption underlying this example is that we are dealing with interpretation of audit evidence, estimates or other items where there can be legitimate disagreement. All clear errors, at least for a public company, subject to US SEC regulations under the Sarbanes Oxley Act of 2002, must be corrected unless trivial in nature.

flexibility are expected to influence the auditor's intended usage of the five available negotiation strategies and the auditor's negotiation goal commitment.

### 3.1 FLEXIBILITY OF CLIENT MANAGEMENT'S INITIAL POSITION

Prior research suggests that when the parties are more flexible in their positions and an overlap in acceptable ranges is perceived (Figure 1 Panel A), the negotiation will proceed more smoothly (Pruitt and Carnevale [1993]). Specifically, research has found that when negotiating parties are more flexible in their positions and acceptable ranges, agreements, typically characterized as “compromises”, are reached relatively quickly compared to those exhibiting less flexibility (Bazerman, Magliozzi, and Neale [1985], Ben-Yoav and Pruitt [1984], Pruitt and Carnevale [1993]). There are two strategies that are likely to lead to this result: proposing a compromise along with mild threats based on contending strategies to suggest there will be negative consequences should the “compromise” not be accepted (e.g., Ben-Yoav and Pruitt [1984], Brett, Shapiro, and Lytle [1998], Olekalns and Smith [2000], Olekalns, Smith, and Walsh [1996]) and proposing a concession and implicitly obligating the other party to match it (e.g., Komorita and Esser [1975]). Hence, we expect that the auditors who perceive client management to be flexible in its initial position will use tactics associated with compromising and/or concessionary negotiation strategies when negotiating with client management (e.g., Cialdini [2001], Gouldner [1960], Hatfield, Agoglia, and Sanchez [2005], Sanchez, Agoglia and Hatfield [2006]).<sup>6</sup> Thus we predict:

*H1a: When the client management's initial accounting position is relatively flexible, as opposed to relatively inflexible, the auditor's initial negotiation*

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<sup>6</sup> We make the standard distinction in the underlying negotiation literature that tactics involve the short term implementation activities associated with the overall strategy set selected.

*strategy will feature tactics that are predominately based on a compromising strategy, including concessionary tactics.*

On the other hand, when one party is perceived to be firmly committed to its position, negotiations take longer (Bazerman, Magliozzi, and Neale [1985], Ben-Yoav and Pruitt [1984]) and the resulting relationship is worse off (Greenhalgh and Chapman [1998]). Also, negotiators tend to use contentious tactics when they view the other party as inflexible (Deutsch [1973], Thompson and Hastie [1990]). Thus, we predict that:

*H1b: When the client management's initial accounting position is relatively inflexible, as opposed to relatively flexible, the auditor's initial negotiation strategy will feature tactics that are predominately based on a contending strategy, including contention-oriented compromising tactics.*

### 3.2 NATURE OF THE RELATIONSHIP

The nature and importance of maintaining the relationship have been shown to influence the negotiation process (Lewicki et al. [2003], Pruitt and Carnevale [1993], Savage, Blair, and Sorenson [1989]). In particular, parties to a positive and cordial relationship tend to trust one another and work together to protect and maintain the relationship. Often, these positive relationships are viewed as “working relationships” where the parties need to work together even though they are adversaries (Olekalns and Smith [2000]). Thus, parties in positive and cordial relationships usually are motivated to find “win-win” solutions (Greenhalgh and Gilkey [1993], Olekalns and Smith [2000]). The negotiating parties collaborate but also protect their own interests (Brett, Shapiro, and Lytle [1998]), hence, these types of negotiations tend to involve integrative strategies, such as problem solving and expanding the agenda along with a few

concessionary tactics (Brett, Shapiro, and Lytle [1998], Dant and Schul [1992], Mannix, Tinsley, and Bazerman [1995]). Thus, we predict that:

*H2a: When the ACM relationship is positive and cordial, as opposed to negative and contentious, the auditor's initial negotiation strategy will feature tactics that are predominately based on integrative strategies with some concessionary tactics.*

In contrast, when the relationship is negative and contentious, the negotiating parties are less concerned about the relationship and there is typically an element of distrust (Poitras, Bowen, and Byrne [2003], Pruitt and Carnevale [1993]). In these types of situations, the parties are concerned mainly with their own outcomes, see them as involved in a competitive process, and therefore tend to be confrontational and hostile towards one another (Savage, Blair, and Sorenson [1989]). This hostility leads to the use of a contending strategy when negotiating, including the more contentiously-oriented compromising tactics (Brett, Shapiro, and Lytle [1998]). Hence, we predict that:

*H2b: When the ACM relationship is negative and contentious, as opposed to positive and cordial, the auditor's initial negotiation strategy will feature tactics that are predominately based on a contending strategy, including contending oriented compromising tactics.*

### 3.3 FLEXIBILITY OF INITIAL POSITION AND THE ACM RELATIONSHIP

We also consider what happens when the flexibility and relationship are considered jointly. We expect that auditors in positive and cordial ACM relationships with relatively flexible client management initial accounting position will adopt tactics associated with compromising and concessionary strategies. This collaborative approach

is designed to accomplish the auditor's goal by invoking concessions from client management (Sanchez, Agoglia and Hatfield [2006]). Thus, we predict:

*H3a: When the ACM relationship is positive and cordial and the client management's initial accounting position is relatively flexible, the auditor's initial negotiation strategy will feature tactics that are predominately based on a compromising strategy, including concessionary tactics.*

In contrast, we expect the auditors in negative and contentious relationships with client management that is relatively inflexible in its initial accounting position to adopt tactics primarily of the contending strategy including contentiously oriented compromising tactics (Brett Shapiro, and Lytle [1998], Poitras, Bowen, and Byrne [2003]). In this relationship, the auditor is used to playing the role of a GAAP "policeman" (Gibbins, McCracken, and Salterio [2006]). Based on the historically negative and contentious relationship with the client management, the auditor has no expectation that the client management will change its position unless the auditor resorts to competitive contending tactics that seek to enforce compliance. Thus we predict:

*H3b: When the ACM relationship is negative and contentious and the client management's initial accounting position is relatively inflexible, the auditor's initial negotiation strategy will feature tactics that are predominately based on a contending strategy, including compromising tactics.*

When client management is perceived as relatively flexible in its initial accounting position for *this* issue, but there is a history of a negative and contentious relationship, we expect the auditor to have a low level of concern for keeping this client "happy" and to adopt tactics associated with a contending strategy, including more

contentiously oriented compromising tactics (Poitras, Bowen, and Byrne [2003]). Previous negotiation research suggests that “inaction,” or avoiding negotiation and waiting for the other party to come to you, is the principal strategy that should be employed in such negotiations (Pruitt and Carnevale [1993], Pruitt and Rubin [1986], Savage, Blair, and Sorenson [1989]). In most ACM negotiations, however, the auditor does not have the luxury of “inaction”, given the institutional constraints of public company reporting rules and deadlines. Hence, the auditor must take a more proactive strategy than that prescribed in the generic literature (see Gibbins, Salterio, and Webb [2001] and Gibbins, McCracken, and Salterio [2005, 2007]). Thus we predict:

*H3c: When the ACM relationship is negative and contentious and the client management’s initial accounting position is relatively flexible, the auditor’s initial negotiation strategy will feature tactics that are predominately based on a contending strategy combined with the use of compromising tactics.*

Prior research has shown that integrative strategies are most likely invoked when the negotiating party is concerned both about maintaining a good relationship and achieving his/her initial position (Pruitt and Carnevale [1993], Pruitt and Rubin [1986], Savage, Blair, and Sorenson [1989]). Hence, when an auditor finds him/herself in a setting where the relationship is positive and cordial, but, on this particular issue client management is being relatively inflexible initially, the auditor will attempt integrative strategies along with mild contending and compromising tactics. The auditor wants to keep the relationship positive while also achieving his/her preferred accounting (an integrative outcome), or at least achieve sufficient movement from client management’s initial position (a distributive outcome favorable to the auditor). Thus we predict:

*H3d: When the ACM relationship is positive and cordial and the client management's initial accounting position is relatively inflexible, the auditor's initial negotiation strategy will feature a combination of tactics that are predominately based on integrative strategies and selective compromising/conceding tactics.*

### 3.4 INITIAL ACCOUNTING POSITION, RELATIONSHIP AND GOALS

So far, we have emphasized the role of the client management's initial accounting position flexibility and ACM relationship nature as being key determinants in the development of the auditor's initial negotiation strategy. Now, we examine how these variables affect the auditor's goal commitment when entering into negotiations and how goal commitment relates to the strategy choices.<sup>7</sup> Considerable research has shown a positive association between setting challenging goals and commitment to achieving those goals with better task performance, in a wide variety of contexts including management accounting, compensation, and many other areas (Chong and Chong [2002], Locke and Latham [1990], Locke, Latham, and Erez [1988], Wentzel [2002]). Negotiation research has also shown the importance of goals and goal commitment to obtaining favorable outcomes by negotiation parties (Ben-Yoav and Pruitt [1984], Kelley, Beckman, and Fischer [1967]).

*ACM relationship:* Prior negotiation research suggests that the nature of the relationship will impact the negotiator's goal. Sondak, Neale and Pinkley [1999] found, independent of other factors in their experiment, that the nature of the relationship had additional explanatory power in determining the outcome, participants' willingness to accept lower

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<sup>7</sup> Technically, in the negotiation literature, the auditor's goal would be considered the auditor's "aspiration level" or what they hope to achieve from the negotiation (Lewicki, Barry, and Saunders [2006 Chapters 1 to 3]).

outcomes, and their satisfaction with their negotiated outcomes. Those participants having prior relationships with the other party were less self-serving in their preferred outcomes. Corroborating this, Deutsch [1973] suggests that when the goal includes fostering the relationship, the outcome reflects a more equal split: the parties are not concerned with maximizing their own outcomes. Hence, we predict:

*H4a: The nature of the relationship will be associated with the auditor's commitment to a high goal in the negotiation, with a more positive and cordial relationship being associated with lower auditor commitment to the goal of achieving a substantial reduction of net income.*

Consideration of whether this prediction is a normatively appropriate in the audit context is deferred until later in the paper.

*Flexibility of Initial Position:* Prior studies indicate that higher negotiation goals are associated with the opponents' inflexible initial positions (Pruitt and Carnevale [1993], Thompson and Hastie [1993]). Kristensen and Garling [1997] show that parties' initial positions affect the negotiator's framing of the negotiation process as well as the negotiator's strategy choice. It also has been found that negotiators tend to match strategies, such that when one party is perceived to be inflexible in his/her position, the other party will also become inflexible in his/her position, and thus, will set a higher negotiation goal (Lewicki, Barry, and Saunders [2006], Pruitt and Carnevale [1993]). In our setting, we present the audit partners with a high negotiation goal and measure their relative commitment to achieving it. Hence, we predict that:

*H4b: Client management's initial accounting position flexibility will be associated with the auditor's negotiation goal, with an inflexible management*

*initial position being associated with a higher auditor commitment to a goal of achieving a substantial reduction in net income.*

An interaction between these factors' effects on the auditor's goal is possible, (e.g., in Sondak, Neale, and Pinkley [1999] outcome importance and relationship interacted in an allocation negotiation). However, there are only isolated studies in this area and the results are rarely in the form predicted by the theory put forth in the research. Hence, we test for the presence of an interaction but make no predictions.

Finally, we consider the effects of high auditor goal commitment to reduce accounting net income substantially on strategy and tactic selection. As argued before, most negotiators see negotiation as distributive in nature, hence a high commitment to the goal of net income reduction would lead to the higher likelihood of selecting contending tactics and not employing concessionary tactics in order to obtain the auditor's objective. Contending tactics are associated with achieving the larger share of the "pie" for oneself, hence if a substantial reduction in net income is required, this would be the logical strategy to follow.

*H5: The higher the auditor's commitment to a substantial reduction in net income as his/her negotiation goal, the greater the likelihood of employing contending tactics and the lower the likelihood of employing concessionary tactics.*

#### **4. Experimental Method**

##### **4.1 THE EXPERIMENTAL SETTING**

In this study, we use an experimental case, inspired by a published case of an actual negotiation (Kleinman and Palmon [2000]) and adapted for developments since the

case was written and to incorporate the explicit issues of the ACM setting that we wanted to capture. The case and associated experimental instrument were iteratively developed in three major rounds of pretesting, involving twelve audit partners (in two sets of six) who did not participate in the final study, 50 audit seniors and several hundred auditing students. The initial six audit partners were employed to ensure that the case facts were highly representative of situations they had encountered and that the instructions and questions were interpreted as we meant them to be. The audit seniors' and students' role was to check clarity and to ensure that the instrument we developed had measurement validity (as discussed later). The final six partners were employed to ensure that we had not changed the initial representativeness of the case nor the instruction clarity and that they interpreted the questions as we meant.

The case requires participants to assume the role of an audit partner receiving a report from the audit team manager about disagreements that the manager and team were unable to resolve with the client management. Hence, the audit partner must prepare to negotiate. The audit manager's report indicates that a disagreement exists between the audit team and the client management regarding a potential overstatement of net income. Specifically, the audit team believes net income is overstated by a material amount, some of which is due to clear-cut errors and the remainder being due to differences in estimates, such as the amount of allowance for doubtful accounts, inventory obsolescence write-downs, and capitalization of interest costs. The case also describes the nature of the relationship between the audit firm (including the current audit) and the client management, the audit team's assessment of client management's flexibility with respect to management's initial accounting position regarding the appropriate accounting

treatment of the items under negotiation, and a brief history of the client company and audit firm.

Key aspects of the case that are held constant across experimental conditions are: the company is described as a conservative financial reporter that is involved in merger discussions; the company is an average size public company for the office but is a minor client for the firm overall; partner compensation is firm-wide rather than based on individual partners' client portfolios; the audit firm is a conservative international firm; and the board, audit committee and the concurring (or review) partner are considered to be effective. The participants were asked to prepare for an upcoming meeting with the client management to resolve the issue. Once they finished reading the case, participants were asked to rate how likely they would be to use each of the five tactics related to the five negotiation strategies (see Table 1) in their discussions with the client.<sup>8</sup> Following that, participants completed demographic and extensive manipulation check questions.

## 4.2 EXPERIMENTAL DESIGN

We used a 2x2 between subjects factorial design to investigate the effects of client management's initial accounting position flexibility and the nature of the ACM relationship on the auditor's initial negotiation strategy.

### *4.2.1 Independent Variables: Flexibility and Relationship*

*Flexibility of client management's initial accounting position.* The flexibility of the client management's initial accounting position is incorporated into the second-last paragraph of the case and is set out in Appendix A. In the flexible version, the audit team reports to the audit partner that it suspects that the client management has a range of net income

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<sup>8</sup> Two random orders of tactics were employed and no differences were found. One order of the tactics and the mapping of the tactics to strategies are found in Table 1.

numbers that it would be able to “live with”, although probably not as low as the audit team’s initial preferred position. In contrast, in the inflexible version, the team reports that the client management is not likely to move from its initial accounting position.

*Nature of the ACM relationship:* Appendix B enumerates some of the differences between the positive and cordial relationship and the negative and contentious relationship versions of the case. In the positive and cordial relationship version, the relationship is long term, has mutual respect, and the services provided by the audit firm are valued by the client management. In contrast, the relationship in the negative and contentious version is only 3 years old, has a history of being difficult to manage, and the services provided by the audit firm are not valued by the client management.

*4.2.2 Dependent Variables: Auditor’s Likelihood of Employing a Tactic.* Participants were asked to indicate their likelihood to employ 25 tactics that underlay the five major strategic approaches (Table 1). The tactics were drawn from an inventory of tactics validated by Rahim [1983] as part of the development of an instrument for identifying individual differences in negotiating style. We modified these tactics to apply them to our auditor-client management negotiation case. Part of our extensive pre-testing ensured that the five original strategies were reflected in the revised instrument (i.e., there was a five factor solution) and that the five tactics loaded onto the five strategies in the manner envisioned by the underlying theory. For each tactic, participants were asked to indicate their likelihood of using the tactic on an eight-point scale ranging from 0 (“Very **unlikely** to use”) to 7 (“Very **likely** to use”).

### 4.3 PARTICIPANTS

140 audit partners from four international public accounting firms participated in this study, of whom 125 provided a full panel of data. The most limiting missing data item was the 15 non-responses to the goal commitment question.<sup>9</sup> We used all data available to test each hypothesis. The participating firms identified appropriate participants. The participants either completed the experimental materials via paper and pencil on their own, at firm annual partners' meetings, or online. No differences were detected across the different means of administration. All participants completed the materials in the fall of 2005.<sup>10</sup>

All audit partner participants had at least 10 years of audit experience, with 70% having more than 20 years of experience. 11% were female. 50% had experience auditing public companies and a further 27.5% had experience auditing large private companies, with the remainder having audit experience with medium to small private companies, government, and not for profit organizations. Many had a mixture of audit experience with several types of organizations. All of these participant demographics indicate a sample similar to that in Gibbins, Salterio, and Webb [2001]. 50% of our respondents were from three different Big 4 firms and the other 50% were from one of the next largest two firms. All participants reported encountering similar issues to that in the case, with a range of 10% to 100% of their clients. The participants reported that the case was only moderately difficult (3.41 on a scale of 0 to 10).

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<sup>9</sup> These omissions were not just for that one question but normally were missing as part of a series of non-responses to questions later in the instrument.

<sup>10</sup> Because of the means we employed to distribute the instrument we are not able to determine what percentage of potential participants did not complete the instrument. There were no statistical differences between those instruments we received in October from those we received in December and early January.

## **5. Results**

### 5.1 MANIPULATION CHECKS

To test our manipulation of client management's initial accounting position flexibility (and to facilitate construction of a structural equations model), we used three auditor perception items (management's commitment to their position, management's incentive to increase income, and perceived overlap with auditor's accounting position) based on the manipulations documented in Appendix A. A MANOVA on the three items jointly indicated that the statistical relationship was as expected, with a strong effect for client management flexibility (Wilks'  $\lambda = 0.74$ ,  $F(3,118)=14.10$ ,  $p<.0001$ ) and no other significant effects for the ACM relationship or the interaction of flexibility and relationship. The univariate results for each item were in the expected direction and all were significant ( $p<.01$ ), indicating that the manipulation of client management flexibility was successful.

To test the success of our manipulation of the ACM relationship type (and again to facilitate construction of a structural equations model), we asked participants to evaluate eight items based on the manipulations (see examples of manipulations in Appendix B). A MANOVA of the eight items jointly indicated show a strong effect for these eight elements that comprise the relationship manipulation (Wilks'  $\lambda = 0.17$ ,  $F(8,122)= 74.10$ ,  $p<.0001$ ) and no significant effects for client accounting flexibility or the interaction of flexibility and relationship. All eight items were in the direction expected and all were significant ( $p<.001$ ), indicating a successful manipulation of nature of the ACM relationship.

Because the ACM relationship is conceptualized as being an important part of auditor bargaining power, but not the only part, we elicited an overall measure of bargaining power (“You assess your bargaining power with JEL’s management as high.”) on a 11 point scale anchored with 5 labeled as “completely agree” and -5 as “completely disagree.” An ANOVA of the responses onto the two independent variables revealed a marginally significant relationship main effect ( $F(1, 120)=2.34$   $p<.07$  one tailed) and a marginally significant interaction ( $F(1, 120) = 3.02$   $p< .09$ ) with client management’s initial accounting position flexibility. Examination of the interaction finds that perceived bargaining power differed with relationship nature in the flexible initial accounting condition ( $p<.04$ ) but not the inflexible condition ( $p>.80$ ). This result indicates that although relationship is associated with overall bargaining power as we expected, the relationship manipulation did not fully capture all aspects of auditor bargaining power as we intended.

Finally, to ensure that the auditors perceived the same motivational effects across experimental conditions (i.e., that we held constant what we hoped to hold constant) we measured eight items that represent various auditor motivations across the experimental conditions (e.g., perception of litigation risk). A MANOVA of the eight items jointly indicates that there were no significant differences ( $p>.50$ ) across experimental conditions; hence the results cannot be attributed to differences in auditor motivations.

## 5.2 TESTS OF H1 TO H3 – FLEXIBILITY AND RELATIONSHIP

We commence our hypotheses testing by examining the results for the interaction predictions for client management’s accounting flexibility and ACM relationship on auditors’ initial negotiating strategy and tactics (H3) before examining the main effects

predictions (H1 and H2). As discussed in Section 4, our dependent measure was a twenty-five item set reflecting five overall strategies with five tactics in each strategy (Table 1). We employ MANCOVA in our main statistical analysis to allow us to detect a pattern in the differences in likely tactic use overall. Our hypotheses define certain strategies as likely to dominate in a particular experimental condition, but with the use of tactics from other strategies likely to be employed along with the dominant one, hence we also carry out univariate follow-up hypothesis tests.

Based on the MANCOVA, Table 2 shows potential support for H1 about client accounting flexibility (Wilks'  $\lambda = 0.70$ ,  $F(25, 110) = 1.91$ ,  $p < .015$ ) and no support for H2 and H3. We say potential support for H1 because H1 specified a specific pattern for three distributive strategies and their associated tactics. Hence, we reran the analysis without the integrative strategies. Table 3 shows that the result is even stronger (Wilks'  $\lambda = 0.74$ ,  $F(15, 120) = 2.80$ ,  $p < .001$ ) for differences in client management's initial accounting position flexibility when including only the subset of distributive strategies and tactics posited to be affected by H1.

Table 4 tabulates the mean likelihood of use for each tactic in the three sets (compromising, Panel A; contending, Panel B; and concessionary, Panel C). H1a is supported, as three of the five compromising tactics are more likely to be employed when the client management's initial accounting position is flexible, and a summation of the five tactics (bottom of Panel A) indicates an overall tendency towards a compromise strategy. H1b is supported in that four of the five contending tactics are more likely to be employed when client management states it is relatively inflexible about changing its initial accounting position and an overall tendency towards a contending strategy is

indicated at the bottom of Panel B. Regarding concessionary tactics (Panel C), we had expected more extensive use of these tactics in the flexible initial accounting position case, and four of the five tactics shown in Panel C are in the direction hypothesized but none are significant.

### 5.3 TESTS OF H4 AND H5 – GOAL COMMITMENT

For H4, we test whether the two factors, client management's initial accounting position flexibility and ACM relationship nature, affect the auditor's commitment to a high negotiation goal (see the middle of Figure 2). We elicited on a ten point scale (-5 "completely disagree" to 5 "completely agree") the partners' commitment to the negotiation goal of "You feel **strongly** that you have to achieve a resolution that will result in a substantial reduction in JEL's unaudited net income." Consistent with goal setting theory (Locke and Latham [1990]), we set a high goal of "a substantial reduction", then asked participants to rate their commitment to this goal.

Table 5 shows the result of the analysis for the two main effects hypothesized in H4. H4a is not supported ( $F(1,120)=0.46$   $p>.50$ ) in that ACM relationship type does not affect the auditor's goal commitment to a high goal entering into negotiation. H4b is supported ( $F(1,120)=7.55$ ,  $p<.007$ ): the more inflexible the client management's initial accounting position, the more the audit partners agreed that they "feel **strongly**" committed to a goal of "a substantial reduction" in JEL's income.<sup>11</sup>

Table 5 and Figure 3 present weak evidence of an interaction ( $F(1,120) = 2.34$ ,  $p<.13$ ) between relationship and flexibility. The more positive and cordial ACM relationship marginally lowers the auditor's goal commitment ( $p<.09$ ) but only when the client management exhibits flexibility in its initial accounting position.

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<sup>11</sup> Sample size is reduced due to 15 partners not providing a goal commitment assessment.

We also test whether the auditor's goal commitment affects the auditor's selection of strategies and tactic. There is a strong association between the auditor's goal commitment and the auditor's use of the various strategies/tactics (Wilks'  $\lambda = 0.63$ ,  $F(25, 98) = 2.32$ ,  $p < .002$ ). Formal test of H5, which focuses on the increased likelihood of use of contending tactics and the lower likelihood of use of concessionary tactics, shows a significant relationship nature effect (Wilks'  $\lambda = 0.73$ ,  $F(10, 113) = 4.13$ ,  $p < .0001$ ).<sup>12</sup> Table 6 shows that the pattern predicted in H5 is supported in the univariate regression results where higher auditor goal commitment to reducing net income is significantly positively related to the auditor's likelihood of using a contending strategy's tactics (Panel A) and significantly negatively related to the likelihood of using conceding strategies' tactics (Panels B). In an exploratory analysis Panel C indicates compromising strategies are significantly less likely to be used whereas Panels D and E again show the relatively low attention paid by the audit partners to integrative strategies with only three out of the ten tactics showing even marginal significance.

#### 5.4 RE-EXAMINING THE HYPOTHESES VIA MODELING

We also examine our hypotheses by measuring partner reaction to our manipulated features to allow for a more direct and refined testing of the theoretical model in Figure 2. Therefore, we had an extensive measurement section at the end of our experimental instrument, which served as a manipulation check for the experiment's manipulations (reported above) and as the data for the structural equations model (see Figure 4 for theoretical model). Given only 140 audit partner participants, the

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<sup>12</sup> Including auditor goal commitment as a variable in MANCOVAs that include the variables in Tables 2 and 3 results in no substantive difference in those reported results. Furthermore, auditor goal commitment is significant in both cases (Table 2 replicated Wilks'  $\lambda = 0.64$ ,  $F(25, 94) = 2.15$ ,  $p < .005$ ; Table 3 replicated Wilks'  $\lambda = 0.72$ ,  $F(15, 99) = 2.54$ ,  $p < .004$ ) with univariate results in the predicted directions.

measurement model needed to be kept parsimonious, because, at a maximum, only 28 items (e.g., variances and covariances) could be estimated (140 divided by 5 participants per item estimated, which is the low end of the number of participants per item estimated for a relatively homogenous sample recommended in the literature (Bollen [1989], Thompson [2000])).

We employed 8 items to test the relationship manipulation and hence these items became the indicator variables for the “RELATIONSHIP” latent variable. Higher values of this variable are associated with a more positive and cordial relationship. We used three items to test the flexibility of client management’s initial accounting position manipulation and these items became the indicator variables for the “FLEXIBILITY” latent variables. Higher variable scores here are associated with a more inflexible client initial accounting position. An observed variable, audit negotiation goal commitment, served as a single item measure of commitment to a high goal. Higher scores here indicated a greater commitment to achieving a substantial client income reduction in the negotiation.

We elicited responses for five tactics within each of the five strategies (Table 1). To use these individual tactics responses to model latent variables for all five negotiation strategies, at least twice the number of respondents we had would have been necessary (Bollen [1989]). Hence, we re-performed the analysis on H1 to H5 employing the summation of the five items for each strategy as the dependent variables. Whilst the fineness of detail reported previously is lost by this approach, we were able to replicate overall results (i.e., supporting H1, H4 and H5 but not H2 and H3). Hence, we used the sum of the five items as composite measures for each of the five negotiation strategies.

The model presented in Figure 4 is used to instantiate the theoretical constructs presented in Figure 2. It contains two latent variables (relationship and flexibility) and five observed variables: the auditor's negotiation goal commitment and four strategies (expanding the agenda, compromise, concede, and contend). The problem solving strategy was not significant in the structural model, hence it is dropped from the reported analysis. Confirmatory factor analysis on both the relationship and flexibility variables shows that each is a one-dimensional construct that fits well (e.g., relationship goodness of fit statistics:  $\chi^2(17) = 11.97$ ,  $p > .80$ , CFI = 0.99, RMSEA = 0.001).<sup>13</sup> The means and standard deviations of and correlations among the indicator variables are shown in Table 7. The measurement model in Figure 5 fits well ( $\chi^2(94) = 11.70$ ,  $p > .10$ , CFI = 0.97, RMSEA = 0.037), exceeding all conventional norms for goodness of model fit (see footnote 11).<sup>14</sup>

Re-examining our hypotheses (see predictions in Figure 4) via the structural model in Figure 5, we find our major experimental results are replicated. A more inflexible client management initial accounting position is positively associated with the auditor's use of contending tactics (coefficient (standard error) = 5.99 (3.15),  $p < .03$ ), replicating H1b. A relatively more inflexible initial management position is also associated with the auditor being more committed to the goal of substantially reducing

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<sup>13</sup> Thompson [2000, p. 270-271] describes the CFI, comparative fit index, and the RMSEA, root mean square error approximation, as being the two most informative criteria for assessing the fit of indicators to latent variables, especially for smaller samples. The normal benchmarks for goodness of fit are a non-significant  $\chi^2$ , a CFI approaching 1 with anything over 0.95 indicating a good fit and a RMSEA approaching 0 with either 0.08 or 0.05 being the benchmark of a good fit (Thompson [2000, p. 270-271]).

<sup>14</sup> Note that our structural model package, AMOS, uses average values for missing data, hence increasing the power of the test by employing the full 140 observations. No qualitative differences occur when these 15 observations are eliminated.

net income (1.71 (.92),  $p < .04$ ), replicating H4b. Lower auditor goal commitment also led to greater use of a concessionary strategy (-0.48 (.20),  $p < .01$ ) partially replicating H5.

We find no direct significant path between flexibility of client initial accounting position and compromising tactics, failing to replicate H1a. However, the combination of a significant positive path between flexibility and audit goal (1.71 (0.92),  $p < .04$ ) with the significant negative path from audit goal to compromising (-0.73 (.26),  $p < .003$ ), suggests that the negative path posited in H1a is indirectly present in our measurement model (i.e.,  $1.71 \times -0.73 = -1.25$ ).<sup>15</sup> Hence, while consistent with H1a, it appears that the path between flexibility and compromising tactics is completely mediated by the effects of audit goal commitment.

The structural model also reveals significant hypothesized effects that the experimental analysis did not. First, as predicted in H2a, a more positive and cordial relationship is marginally more likely to lead to the auditor's use of a concessionary strategy (1.47 (0.96),  $p < .07$ ) and this is reinforced by the positive indirect effect via audit goal commitment ( $-0.76 \times -0.48 = 0.36$ ). Second, as predicted in H4a, a more positive and cordial relationship results in a marginally lower auditor commitment to the goal of substantially reducing net income during the negotiations (-0.76 (0.51),  $p < .07$ ).

Finally, we find an unhypothesized path: a relatively inflexible initial client management accounting position is marginally significantly associated with greater auditor likelihood of "expanding the agenda" of issues to be negotiated (2.94 (1.63),  $p < .08$ ). This is the first time any indication has been found in the audit negotiation literature of auditors considering integrative strategies. Given the unhypothesized nature

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<sup>15</sup> These values are obtained by multiplying the path coefficients together (e.g.,  $-0.73 \times 1.71 = -1.25$  for compromising). Statistical tests are difficult to carry out directly but Bollen [1989] indicates that it is rare for the combination of two significant paths not to lead to a significant indirect association.

of this effect, it should be viewed as strictly exploratory. Alternative specifications of the model, including dropping this link, do not substantively change the reported results.<sup>16</sup>

## ***6. Conclusions, Limitations and Future Research***

This paper investigates the auditor's initial negotiation strategy when faced with a disagreement with client management that requires negotiation in order to be resolved. We experimentally vary two factors previously identified as being important to the auditor's initial negotiation strategy: the degree of flexibility in the client management's initial accounting position for the issue and the nature of the ACM relationship. Further, we investigate the impact of these variables on the auditor's commitment to a high goal entering the negotiation and the effects of goal commitment on strategy selection. Finally we estimate, using a structural equations modeling approach, simultaneously the links among the ACM relationship, flexibility of management's initial accounting, auditor goal commitment and the various strategies.

Experimentally, we find that the degree of flexibility in the client management's initial accounting position significantly affects the auditor's initial negotiation strategy. Those auditors facing a client management relatively inflexible in its initial position were more likely to use a contentiously oriented negotiation strategy and tactics, whereas those facing a relatively flexible client management position were more likely to use compromising tactics. The more inflexible the client management's position, the more committed the auditor was to the goal of a substantial reduction in client net income and this commitment lead to an increase in the likelihood of using contending tactics and a decrease in using concessionary tactics. Both of these results suggest that when client

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<sup>16</sup> We also carried out a path analysis employing the manipulated variables as observed values and the results are also substantially the same as those reported herein.

management is inflexible in its initial accounting position, agreement is likely to be difficult to achieve. Hence, our experimental results suggest that auditors default to distributive strategies when preparing for negotiation.

Our structural model replicates these results although it suggests that auditor goal commitment completely mediates the direct effect between inflexible client accounting and concessionary strategy use. Interestingly, the structural model provides weak evidence that auditors, when faced with an inflexible management position, consider using a strategy of expanding the agenda of issues. This is the first indication of any consideration of the use of integrative strategies by auditors and, while interpretable, was not predicted hence must be considered an exploratory finding. Future research could investigate further the auditor's tendency to use distributive strategies including how they affect negotiation outcomes compared with employing more integrative negotiation strategies.

Experimentally, the nature of the ACM relationship was not shown to influence the auditors' intended negotiation strategies and tactics nor the auditor's commitment to the goal of a substantial reduction in net income. This finding appears to be normatively appropriate, however, when we employed the more fine-grained structural equations modeling approach this conclusion needed to be qualified. Specifically, a more positive and cordial relationship resulted in auditors being more likely to use concessionary tactics, having a lower commitment to the goal of a substantial reduction in client net income and indirectly to greater use of a compromising strategy. Further investigation of relationship nature is warranted as it may indicate inappropriate reliance on a non-diagnostic cues (i.e. client relationship) when preparing for negotiation. Overall, both sets

of findings suggest that future research could examine the effects of negotiation training on preparation for negotiation (e.g. see Trotman et al 2005 for one type of intervention).

As with any study, there are limitations to these findings. The experiment considers whether relative client flexibility about the initial accounting affects the auditors' goal commitment and strategy selection. We have used only one kind of each where the preferred position being at the far end of the acceptable range from the other party's position/range. In future research various refinements could be investigated, such as the initial preferences being located near or far from the limits of the acceptable ranges, the auditor and client having acceptable ranges of different sizes, other range asymmetries, or differences between non-overlapping acceptable ranges being large or small. All of these would reflect the different degrees of client accounting position inflexibility that the auditor might need to adapt to.

Our sample size, though utilizing 125 to 140 usable responses from partners, limits the power of our tests. Further, although the audit partners rated the case as being representative of negotiations they had faced, the task was simplified such that the audit partners were supplied with only the minimal information required to complete the materials, with most not finding the case difficult. When negotiating actual cases, audit partners would have more information, resources, experience and incentives in dealing with the client, which may also influence their negotiation strategies.

Overall our findings indicate, as expected, that auditors do not as a matter of course employ integrative strategies instead they default to distributive strategies. Given these findings, it is important for auditors and audit firms to be made aware of alternative negotiation strategies, as they currently do not seem to be utilizing the full spectrum of

negotiation strategies that are available to them. We conjecture that if auditors have a wider array of appropriate strategies and tactics available to them, combined with the ability to use them effectively available, then they would be better prepared to deal with client management in these material and often contentious matters that can affect financial reporting.

**TABLE 1**  
*Five Negotiation Strategies and Related Tactics\**

	Contend	Compro- mise	Concede	Expand agenda	Problem solving
<u>Response Intention Questions</u> (not numbered in the experiment)					
1. I would bring other issues to the discussion, such that I could trade off on other issues to resolve this issue in my favor.				X	
2. I would try to satisfy the expectations of JEL management.			X		
3. I would use “give and take” so that a compromise could be made with JEL management.		X			
4. I would use my ability to qualify JEL’s financial statements to obtain a resolution in my favor.	X				
5. I would argue with JEL management to show them the merits of my position.	X				
6. I would attempt to find other issues with JEL, so I could accede to their wishes at the same time as achieving my position on this issue.				X	
7. I would try to find some middle ground to resolve this issue with JEL management.		X			
8. I would use my influence to get my position accepted by JEL management.	X				
9. I would attempt to accommodate the wishes of JEL management.			X		
10. I would collaborate with JEL management to come up with a new solution acceptable to both of us.					X
11. I would use my expertise in accounting to influence the resolution in my favor.	X				
12. I would provide all relevant information to JEL management so we could solve this issue together in the context of other issues.				X	
13. I would try to work with JEL management to find new solutions to this issue that satisfy both of our expectations.					X
14. I would try to investigate the issue further with JEL management to find a new solution acceptable to both of us.					X
15. I would try to play down the differences with JEL management to reach a compromise.		X			
16. I would try to satisfy the needs of JEL management.			X		
17. I would make concessions from my position to JEL management.			X		
18. I would attempt to find other issues with JEL, which I could add to the discussion.				X	
19. I would try to bring all my concerns about this issue out into the open with JEL management so that the issue could be resolved in the best possible way.					X
20. I would propose some middle ground on this issue at some point during the process of resolving the disagreement with JEL management.		X			
21. I would negotiate with JEL management so that a compromise could be reached.		X			
22. I would be firm in pursuing my position.	X				
23. I would give in to the wishes of JEL management.			X		
24. I would try to work with JEL management to develop a proper understanding of this issue in the context of other issues.				X	
25. I would try to integrate my ideas about how to resolve this issue with JEL management to come up with a new solution jointly.				X	

\* Two random orders were employed. No differences were noted due to order effects. This table reflects one of the orders. Pretest factor analysis gives a five factor solution with items loading on appropriate factors.

TABLE 2

*Test of H3: MANCOVA of Likelihood of 25 Negotiation Tactics Selection on Flexibility of Client Management's Initial Accounting Position and ACM Relationship Controlling for Audit Firm Type*

	<i>Wilks' Lambda</i>	<i>DF</i>	<i>DF error</i>	<i>F</i>	<i>p</i>
<b>Independent Variables</b>					
ACM Relationship	0.806	25	110	1.06	0.402
Flexibility of Client's Initial Accounting Position	0.697	25	110	1.91	0.012
Relationship x Flexibility	0.792	25	110	1.15	0.300
<b>Control Variable</b>					
Big 4/Non Big 4 audit firm type	0.597	25	110	2.97	<0.0001

Higher order interactions were tested among the three variables and none were significant (lowest  $p > 0.20$ ).

**TABLE 3**

*Test of H1: MANCOVA of Likelihood of 15 Negotiation Tactics Selection on Flexibility of Client Management's Initial Accounting Position and ACM Relationship Controlling for Audit Firm Type*

	<i>Wilks' Lambda</i>	<i>DF</i>	<i>DF error</i>	<i>F</i>	<i>p</i>
<b>Independent Variables</b>					
ACM Relationship	0.876	15	120	1.14	0.333
Flexibility of Client's Initial Accounting Position	0.741	15	120	2.80	0.0009
Relationship x Flexibility	0.866	15	120	1.23	0.257
<b>Control Variable</b>					
Big 4/Non Big 4 audit firm type	0.691	15	120	3.58	<0.0001

Higher order interactions were tested among the three variables and none were significant (lowest  $p > 0.20$ ).

**TABLE 4**

*Follow-up Univariate Tests of H1: Flexibility of Client Management's Initial Accounting on Likelihood of Auditor Negotiation Tactic Selection*

**Panel A: Tactics Associated with a Compromising Strategy (H1a)**

	Inflexible initial client position N=64	Flexible initial client position N = 76	Based on one tailed t-test
<b>Prediction:</b> Flexible initial client position would more likely lead to use of each tactic.	Mean Std Dev	Mean Std Dev	
I would propose some middle ground on this issue at some point during the process of resolving the disagreement with JEL management.	2.37 1.75	3.47 1.90	p < 0.001
I would negotiate with JEL management so that a compromise could be reached.	2.28 1.60	3.05 2.00	p < 0.01
I would try to find some middle ground to resolve this issue with JEL management.	2.83 1.84	3.48 1.86	p < 0.03
I would use "give and take" so that a compromise could be made with JEL management.	2.18 1.47	2.47 1.63	n.s.
I would try to play down the differences with JEL management to reach a compromise.	2.17 1.85	1.83 1.53	n.s.
<b>Strategy: Compromising with client management</b>	<b>11.83 6.35</b>	<b>14.26 6.41</b>	<b>p &lt; 0.02</b>

**Panel B: Tactics Associated with Contending Strategy (H1b)**

	Inflexible initial client position N=64	Flexible initial client position N = 76	Based on one tailed t-test
<b>Prediction:</b> Inflexible client accounting position would lead to greater use of each tactic	Mean Std Dev	Mean Std Dev	
I would use my influence to get my position accepted by JEL management.	5.13 1.68	4.67 1.82	p < 0.03
I would argue with JEL management to show them the merits of my position.	4.74 2.07	4.28 2.09	p < 0.09
I would use my ability to qualify JEL's financial statements to obtain a resolution in my favor.	4.13 2.14	3.26 2.06	p < 0.01
I would be firm in pursuing my position.	5.72 1.49	5.66 1.21	n.s.
I would use my expertise in accounting to influence the resolution in my favor.	5.74 1.26	5.26 1.68	p < 0.01
<b>Strategy: Contend or challenge client management</b>	<b>25.46</b> <b>5.83</b>	<b>23.13</b> <b>5.78</b>	<b>p &lt; 0.01</b>

**Panel C: Tactics Associated with Concessionary Strategy (H1a)**

	Inflexible initial client position N=64	Flexible initial client position N = 76	Based on one tailed t-test
<b>Prediction:</b> Flexible client initial accounting position leads to more likely use of tactic	Mean Std Dev	Mean Std Dev	
I would try to satisfy the expectations of JEL management.	1.78 1.55	1.70 1.28	n.s.
I would try to satisfy the needs of JEL management.	1.90 1.68	2.11 1.65	n.s.
I would attempt to accommodate the wishes of JEL management.	1.51 1.40	1.77 1.35	n.s.
I would give in to the wishes of JEL management.	0.49 0.74	0.55 0.73	n.s.
I would make concessions from my position to JEL management.	1.90 1.96	1.93 1.50	n.s.
<b>Strategy: Conceding as part of setting</b>	<b>7.59</b> <b>5.29</b>	<b>8.05</b> <b>4.52</b>	<b>n.s.</b>

**TABLE 5**

*Test of H4: Flexibility of Client Management's Initial Accounting Policy and ACM Relationship on the Auditor's Negotiation Goal*

**Panel A: Auditor Negotiation Goal by Experimental Condition**

Mean (standard deviation)	ACM Relationship Nature	
<b>Flexibility of Client Management's Initial Accounting Position</b>	Negative and contentious	Positive and cordial
Flexible	3.25 (1.74) N= 32	2.48 (2.56) N=12
Inflexible	3.62 (1.42) N= 32	3.86 (1.49) N= 24

**Panel B: Between Subjects ANCOVA on Auditor Negotiation Goal Controlling For Audit Firm Type**

Source		Sum of Squares		p <
<b>Independent Variables</b>				
ACM Relationship	1	1.62	0.46	0.55
Flexibility of Client's Initial Accounting Position	1	26.70	7.55	0.007
Relationship x Flexibility	1	8.28	2.34	0.13
<b>Control Variable</b>				
Big 4/ non-Big 4	1	18.43	5.21	0.03
Model	4	53.97	3.81	0.006
Error	120	424.51	3.54	
Total	124	478.48		

**TABLE 6***Auditor's negotiation goal commitment on likelihood of using 25 negotiation tactics***Panel A: Tactics Associated with Contending Strategy (H5)**

<b>Strategy: Contend with or challenge client management (positive coefficient predicted)</b>	Univariate Regression Results	
Tactics	Coefficient Std Error	Significance
I would use my influence to get my position accepted by JEL management.	+0.18 0.08	p < 0.03
I would argue with JEL management to show them the merits of my position.		n.s.
I would use my ability to qualify JEL's financial statements to obtain a resolution in my favor.	+0.17 0.09	p < 0.07
I would be firm in pursuing my position.	+0.22 0.05	p < 0.0001
I would use my expertise in accounting to influence the resolution in my favor.	+0.27 0.06	p < 0.0001

**Panel B: Tactics Associated with Concessionary Strategy (H5)**

<b>Strategy: Concede (negative coefficient predicted)</b>	Univariate Regression Results	
	Tactics	Significance
	Coefficient Std Error	
I would try to satisfy the expectations of JEL management.	-0.18 0.06	p< 0.004
I would try to satisfy the needs of JEL management.		n.s.
I would attempt to accommodate the wishes of JEL management.	-0.17 0.06	p< 0.004
I would give in to the wishes of JEL management.	-0.13 0.3	p< 0.001
I would make concessions from my position to JEL management.		n.s.

**Panel C: Tactics Associated with a Compromising Strategy**

<b>Strategy: Compromise</b>	Univariate Regression Results	
	Tactics	Significance
	Coefficient Std Error	
I would propose some middle ground on this issue at some point during the process of resolving the disagreement with JEL management.	-0.18 0.09	p< 0.04
I would negotiate with JEL management so that a compromise could be reached.	-0.17 0.08	p< 0.04
I would try to find some middle ground to resolve this issue with JEL management.	-0.25 0.08	p< 0.003
I would use “give and take” so that a compromise could be made with JEL management.	-0.17 0.07	p< 0.02
I would try to play down the differences with JEL management to reach a compromise.		n.s.

**Panel D: Tactics Associated with Expanding the Agenda**

	Univariate Regression Results	
<b>Strategy: Expand the Agenda</b>		
Tactics	Coefficient Std Error	Significance
I would bring other issues to the discussion, such that I could trade off on other issues to resolve this issue in my favor.		n.s.
I would try to work with JEL management to develop a proper understanding of this issue in the context of other issues.	+0.21 0.07	p< 0.005
I would provide all relevant information to JEL management so we could solve this issue together in the context of other issues.		n.s.
I would attempt to find other issues with JEL, which I could add to the discussion.		n.s.
I would attempt to find other issues with JEL, so I could accede to their wishes at the same time as achieving my position on this issue.		n.s.

**Panel E: Tactics Associated with Problem Solving**

	Univariate Regression Results	
<b>Strategy: Problem solving</b>		
Tactic	Coefficient Std Error	Significance
I would try to bring all my concerns about this issue out into the open with JEL management so that the issue could be resolved in the best possible way.	+0.09 0.04	p< 0.04
I would try to investigate the issue further with JEL management to find a new solution acceptable to both of us.		n.s.
I would try to work with JEL management to find new solutions to this issue that satisfy both of our expectations.		n.s.
I would try to integrate my ideas about how to resolve this issue with JEL management to come up with a new solution jointly.		n.s.
I would collaborate with JEL management to come up with a new solution acceptable to both of us.	-0.15 0.08	p< 0.06

**TABLE 7**  
*Means and Correlations for Indicator Variables Used in Constructing Latent Variables*

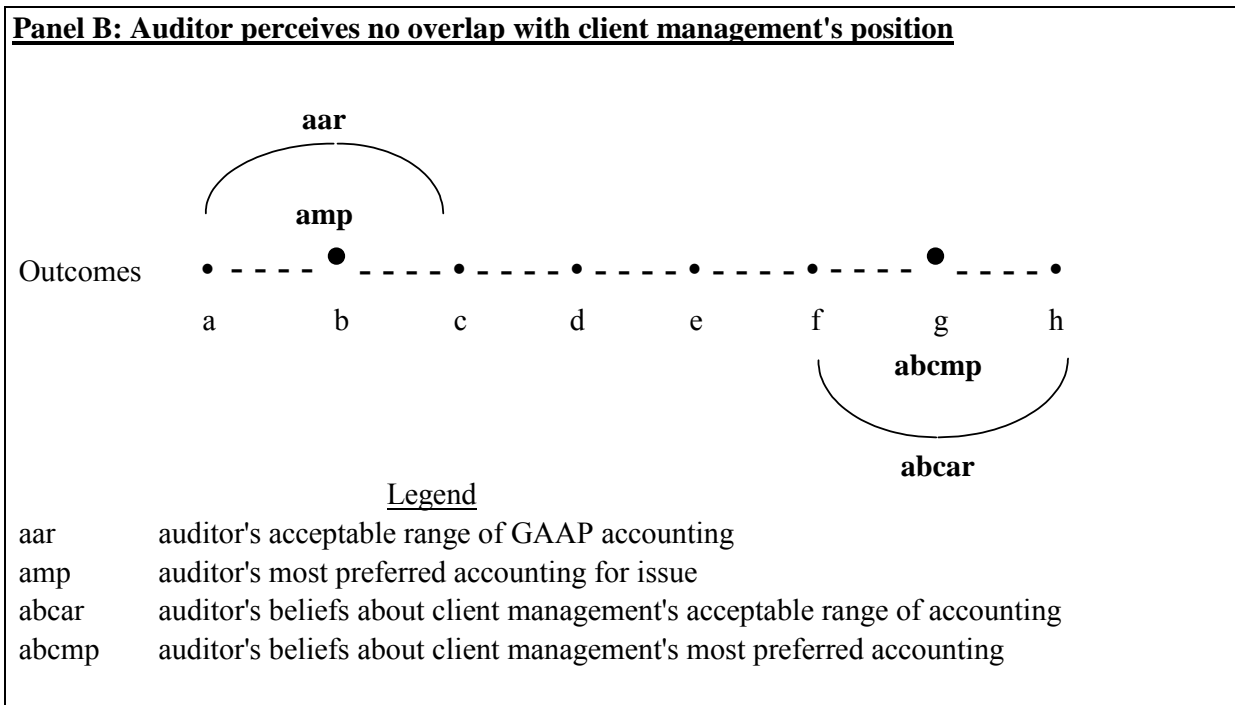
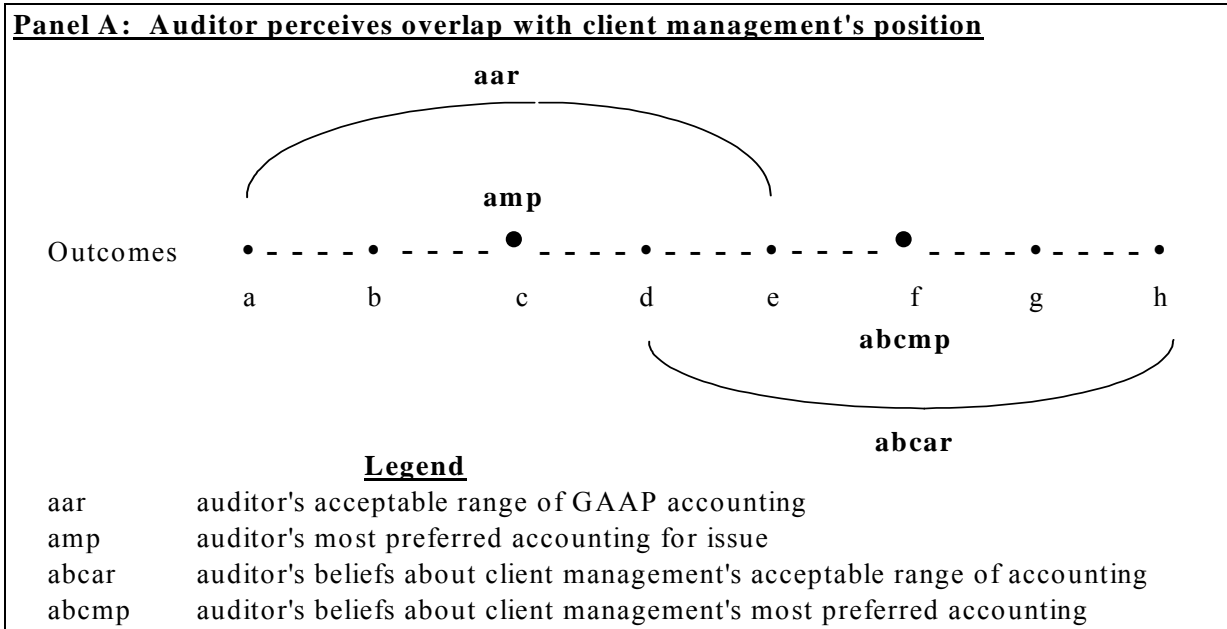
Panel A: RELATIONSHIP Questions	Variable	Mean	Std Dev	Pearson Correlations and p-values						
				trust	cfo	nval	adj	audtm	tenur	ncontrol
The Chief Financial Officer of JEL and you have a relationship based on <b>mutual trust</b> .	trust	-0.79	2.95	1						
The Chief Financial Officer of JEL has <b>weak</b> technical accounting skills.	cfo	1.46	2.16	0.289 <0.001	1					
JEL's management does <b>not value</b> your firm's consulting expertise and tax services. (Reverse scored.)	nval	0.20	2.77	0.487 <.0001	0.140 0.102	1				
JEL's Chief Financial Officer <b>accepts most adjustments</b> proposed by your audit firm.	adj	-0.32	3.57	0.721 <.0001	0.176 0.039	0.486 <.0001	1			
Your firm has assigned a <b>technically competent</b> engagement team to this audit.	audtm	2.73	1.91	0.308 0.000	0.201 0.019	0.298 0.000	0.351 <.0001	1		
Your audit firm has been the <b>long time</b> auditor of JEL.	tenur	1.87	3.20	0.440 <.0001	0.210 0.015	0.400 <.0001	0.559 <.0001	0.424 <.0001	1	

<b>Panel A: RELATIONSHIP</b>		Variable	Mean	Std Dev	trust	cfo	nval	adj	audtm	tenur	ncontrol
The engagement team reports continued <b>contentious relationships</b> with JEL staff. (Reverse scored.)		ncontrol	-0.66	3.27	0.538 <.0001	0.138 0.110	0.451 <.0001	0.639 <.0001	0.341 <.0001	0.432 <.0001	1
JEL has an <b>effective</b> internal audit department.		intaud	-0.93	2.64	0.502 <.0001	0.124 0.148	0.438 <.0001	0.602 <.0001	0.285 0.001	0.403 <.0001	0.568 <.0001

<b>Panel B FLEXIBILITY</b>		Variable	Mean	Std Dev	Pearson Correlations and p-values		
Questions					nover	incent	commit
Your analysis leads you to believe that you have a range of acceptable net income numbers that would <b>overlap</b> with JEL management's range of acceptable net income numbers. (Reverse scored)		nover	0.220	2.833			1
JEL's management has <b>strong incentives</b> to report higher net income.		incent	3.353	1.475	0.192 0.032		1
Your understanding of JEL's position is that they are <b>strongly committed</b> to reporting the net income figure as is, unless your firm threatens to qualify the report.		commit	1.334	2.478	0.13 0.15	0.287 0.001	1

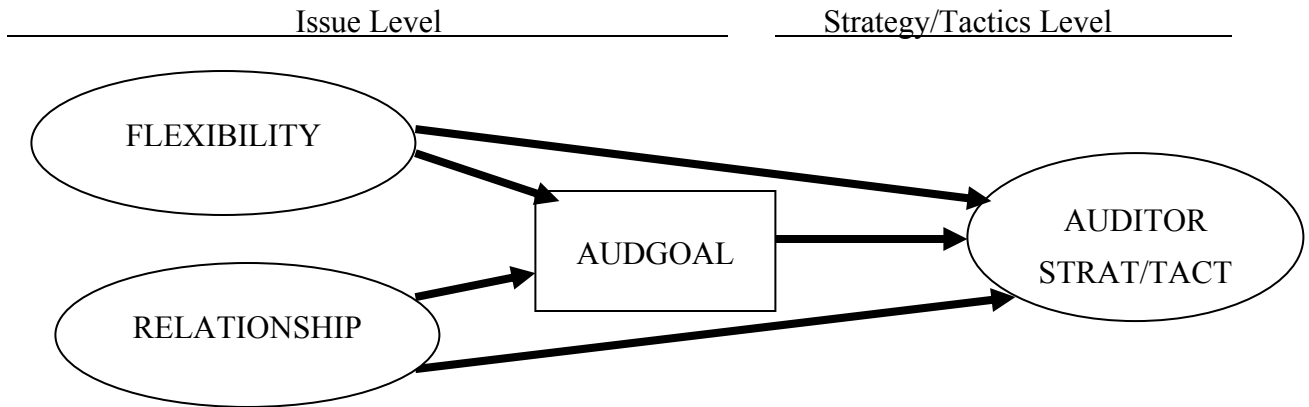
**FIGURE 1**

*Auditor's Assessment of Client Management's Initial Accounting Position Flexibility*



**“Overlap”** of auditor and client management acceptable ranges indicates potentially more flexibility in client management’s initial accounting position.

**FIGURE 2**  
*Model of Auditor Preparation for Negotiation with Client Management*



**FLEXIBILITY** – Auditor’s Assessment of Client Management’s Initial Accounting Position Flexibility: the auditor’s assessment of the client management’s flexibility about initial accounting positions for an issue is manipulated across experimental conditions and measured as a three item construct:

- Client management expresses a firm preference that does not indicate a willingness to change the highly likely materially misstated initial accounting or
- Client management indicates some flexibility to make adjustments to the highly likely materially misstated initial accounting;

**RELATIONSHIP** – Auditor Client Management Relationship: the auditor’s perception of the quality of the auditor client management relationship is manipulated across experimental conditions and measured as an eight item construct:

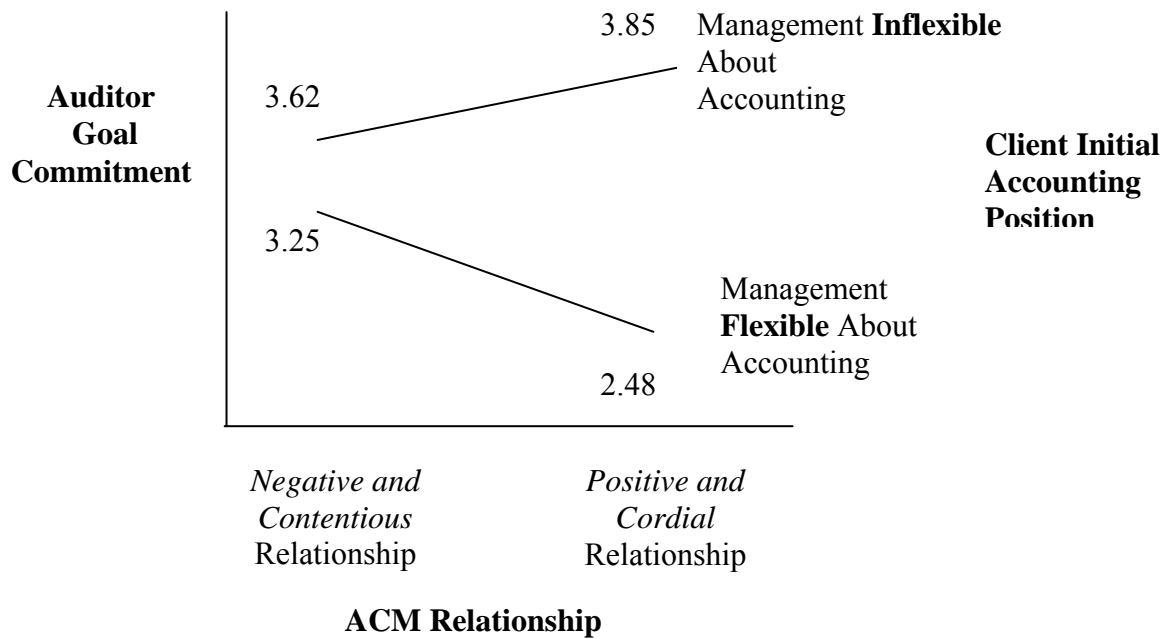
- The prior auditor client management relationship was positive and cordial
- The prior auditor client management relationship was negative and contentious.

**AUDGOAL** – Auditor’s Commitment to a High Negotiation Goal: the auditor’s assessment of his or her commitment to a negotiation goal that is challenging. This is a measured single item construct employed as both a dependent and independent variable.

**AUDITOR STRAT/TACT** - Auditor’s Strategy/Tactics Selection: the auditor’s selection of overall negotiation strategy(ies) and tactic(s). See Table 1 for five principal strategies and the specific tactics that were measured.

**FIGURE 3**

*Interaction Plot for ACM Relationship and Flexibility of Client Management's Initial Accounting Position on Auditor Negotiation Goal Commitment*



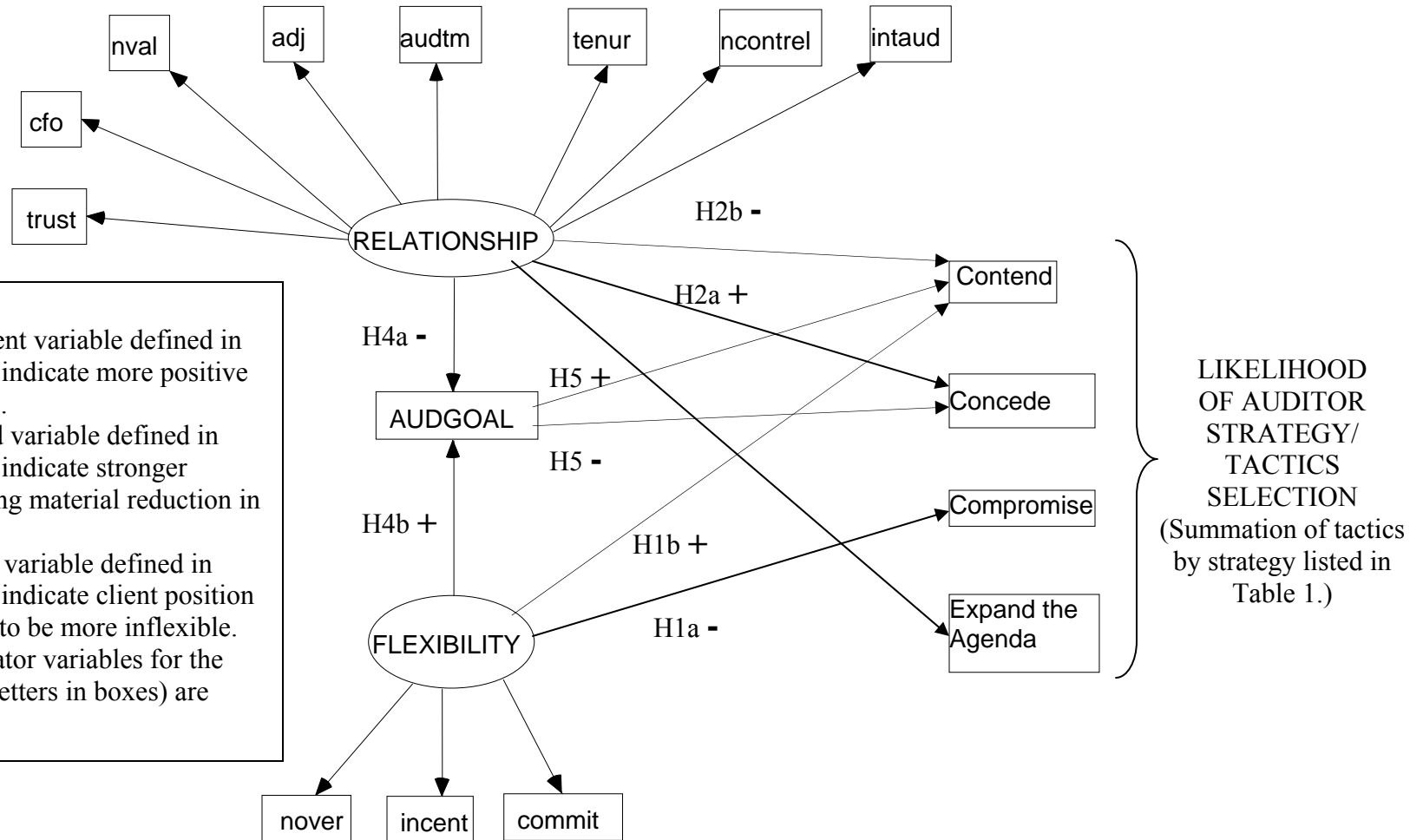
**Auditor goal commitment:** Agreement on an 11 point scale (-5 “completely disagree” to 5 “completely agree”) with the goal “You feel **strongly** that you have to achieve a resolution that will result in a substantial reduction in JEL’s unaudited net income.”

**Flexibility of Client Management’s Initial Accounting Position:** Manipulated as client management being inflexible versus flexible to changes to their initial accounting position. See Appendix A.

**ACM Relationship:** Manipulated as a negative and contentious relationship versus a positive and cordial one. See Appendix B.

**FIGURE 4**

*Theoretical Structural Equations Measurement Model for ACM Relationship, Flexibility of Initial Accounting Position, Auditor’s Goal Commitment and Likelihood of Auditor’s Negotiation Strategy Selection*



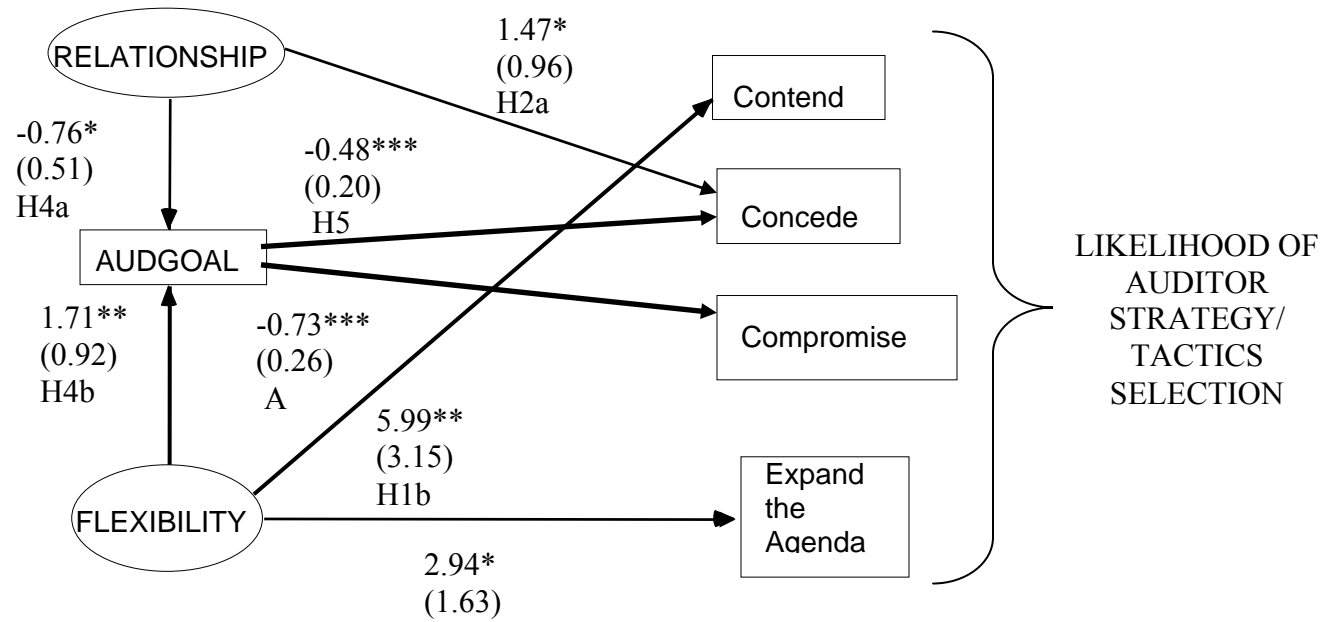
**Legend:**  
 RELATIONSHIP – latent variable defined in Figure 3, higher values indicate more positive and cordial relationship.  
 AUDGOAL – observed variable defined in Figure 3, higher values indicate stronger commitment to achieving material reduction in income.  
 FLEXIBILITY – latent variable defined in Figure 3, higher values indicate client position is perceived by auditor to be more inflexible.  
 “trust” and other indicator variables for the latent variables (small letters in boxes) are defined in Table 7.

**FIGURE 5**

*Structural Model for ACM Relationship, Flexibility of Initial Accounting Position, Auditor's Goal Commitment and Likelihood of Auditor's Negotiation Strategy Selection*

Coefficient  
(standard error)  
\* p<0.10  
\*\* p<0.05  
\*\*\* p<0.01  
All one tailed tests.  
Variable definitions in  
Figure 5.

H1a indirect  
= H4b X A  
= 1.71 X -0.73  
= -1.24



**Goodness of Fit Statistics**

$\chi^2 = 111.70$       CFI = 0.969  
df = 94              RMSEA = 0.037  
p > 0.10  
n=140

## APPENDIX A

### *Manipulation of Flexibility in Client Management's Initial Accounting Position*

*Flexible Management Initial Accounting Position:* “Your discussions with the audit manager indicate that he believes the CFO is committed to the unaudited net income number of \$11,200,000. However, the audit manager suspects that the CFO would accept some adjustments to the financial statements, hence the CFO likely has a range of net income numbers that he would be able to “live with”, although probably not as low as the \$9,400,000 number. The audit manager also suggests that, while he prefers the client to report a net income of \$9,400,000, there is probably a range of acceptable net income numbers that would overlap with the CFO’s acceptable range of numbers and, if those adjustments were made, the financial statements would not be materially misstated.”

*Inflexible Management Initial Accounting Position:* “Your discussions with the audit manager indicate that he believes the CFO is strongly committed to the unaudited net income number of \$11,200,000. The audit manager suspects that it will be extremely difficult to move the CFO from his position of \$11,200,000, however, the audit team is very confident that, after adjustments are made, the net income number should be \$9,400,000. Thus, the client’s draft financial statements as is are unacceptable to you, as the financial statements would likely be materially misstated if adjustments are not made.”

## APPENDIX B

### *Manipulation of ACM Relationship*

*Positive and Cordial ACM Relationship:* Various sentences throughout the case:

“(The audit firm) have been the auditors since the inception of JEL.”

“The chief financial officer (CFO) of the firm, Dan Carroll, .... Dan is typically agreeable to the changes that the auditors have suggested to the draft financial statements.”

“The Director of Internal Audit ... is a Certified Internal Auditor . . . . Linda reports directly to the Audit Committee and is known for her support of the external auditors’ position.”

“Relations with client accounting staff have been cordial again this year. The CFO continues to admire the work that your firm has done for the client over the years and is particularly happy with the strong relationship he has with you. The CFO also mentions that he finds your firm’s consulting and tax services very valuable.”

*Negative and Contentious ACM Relationship:* Above sentences altered:

“(The audit firm) have been the auditors for the last three years.”

“The chief financial officer (CFO) of the firm, Dan Carroll CA,.... Dan has had a contentious relationship with his auditors and his relationship with you is no exception. He actively contests every adjustment to the financial statements.”

“The Director of Internal Audit is ... a Certified Internal Auditor. . . . Linda reports to the CFO and only rarely interacts with the Audit Committee, except for her annual fifteen minute update.”

“Relations with client accounting staff have been difficult again this year. The CFO continues to be very stubborn about making adjustments even for clear errors. The CFO also complains about the quality of the consulting and tax work received from your firm.”

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