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ACCOUNTING MATTERS

Negotiations between auditors and their clients regarding adjustments to the financial statements

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Abstract While financial statements are the responsibility of management, they are ultimately a product of collaboration between management and their auditors—likely involving negotiations over proposed audit adjustments. This installment of Accounting Matters discusses the implications of prior research in psychology and social psychology regarding negotiations as applied to the context of auditor-client management negotiations. Specifically, we consider recently published research by Hatfield and colleagues regarding how these auditor-client discussions may be influenced in unexpected ways if not viewed through the lens of negotiation. This research finds that explicit consideration of negotiation characteristics (e.g., whether the unaudited financial statement data is the 'first offer' of client management, whether negotiations have created reciprocity pressures for the current negotiation) can influence these auditor-client discussions in predictable ways. Understanding the unconscious biases resulting from these 'negotiation rules' is key for auditors to effectively translate audit quality into improved financial statement quality.
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1. Introduction

Over the last few years there has been a growing amount of research that considers the negotiations between auditors and their clients (hereafter referred to as auditor-client management, or ACM, negotiations) with regard to potential adjustments to the financial statements. Anecdotal information from discussions with several audit partners suggests that many partners do not believe they negotiate with their clients over adjustments to the financial statements, but rather they determine the correct number and insist it be posted. Research has been somewhat consistent with such a restricted understanding of negotiations, which may carry a pejorative connotation. For example, Ng and Tan (2003) suggest that auditors will not engage in certain negotiation strategies (e.g., bid high and concede) as it is neither professional nor within the guidelines of their regulatory environment. Furthermore, ACM research has found that auditors do indeed tend to stick to their initial position. For

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example, Hatfield, Houston, Stefaniak, and Usrey (2010) found that 76% of the auditors in their study stuck with their initial offer.

However, discussions between auditors and their clients with regard to whether and to what extent adjustments should be posted are quite common. Gibbins, Salterio, and Webb (2001), for example, found that two-thirds of the auditors in their survey enter into these types of discussions with more than half of their clients. Audit practitioners are better prepared for these discussions—regardless of the term applied—if they understand the social and psychological rules of negotiations as suggested by negotiation research in these fields. Consider the somewhat bizarre decision to break into the Democratic National Committee headquarters and bug offices when the democratic presidential candidate had virtually no chance of winning the general election. Testimony provided after the Watergate scandal indicated that the final plan was a concession from G. Gordon Liddy's initial, expensive proposals, which involved kidnapping, blackmail, and prostitutes, along with breaking-in and bugging DNC offices. This negotiation strategy used by Liddy, rejection-then-retreat, is well known and documented in the negotiation literature. A large committee composed of professional political consultants and campaign managers made one of the worst political decisions in history due to the fact that the participants did not realize they were in a negotiation. Similarly, understanding the subtle pressures that exist in a negotiation environment is crucial for auditors to increase the likelihood that proposed audit adjustments are posted to the client's financial statements. This idea is the basis of a speech by a prominent member of the Public Company Accounting Oversight Board (PCAOB), Kayla Gillan. She suggests that the primary cause of audit breakdowns—discovered during the inspection process—is the occurrence of unconscious biases rather than ethical or competency issues (Gillan, 2007). She believes that helping auditors understand the source of these biases is critical to improving audit quality.

There has been a great deal of regulation enacted with the goal of improving audit quality. For example, the primary goal of the PCAOB is to examine the adequateness of the process of auditing. Furthermore, the majority of research in the area of auditing ultimately seeks to improve the audit process. The presumption for this focus on audit quality is that improved audit quality will advance financial statement quality such that external users will be better equipped to make informed decisions based on these financial statements. However, while the financial statements are the responsibility of management, they are the result of combined efforts of management and their auditors and are likely the result of some negotiations between the two parties. Thus, the impact that audit quality has on financial reporting quality hinges on the relative effectiveness of ACM negotiations (Hatfield et al., 2010). Figure 1 provides a basic representation of this relationship.

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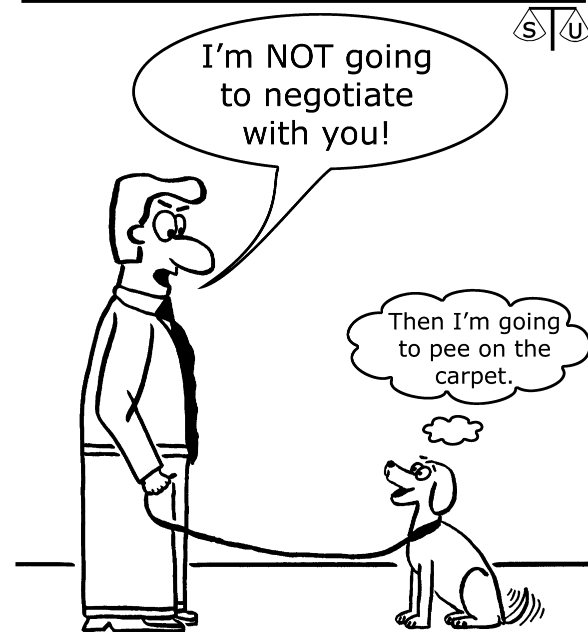
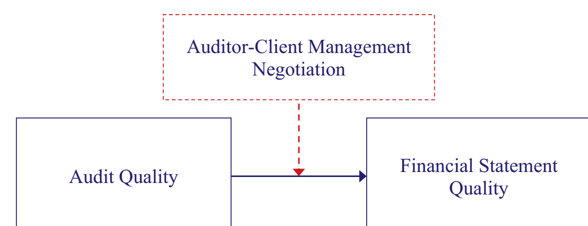


While research on ACM negotiations dates back to the early 1990s, the most impactful studies on the topic began with the work of Gibbins et al. (2001). Their study, which was based on extant behavioral negotiation literature and survey data from senior practitioners, provides a descriptive perspective on ACM negotiations that has helped develop an understanding of the characteristics and incentives affecting these negotiating parties. ACM negotiations are a normal part of the auditor-client relationship and can have a positive or negative impact on this relationship. These negotiations often involve material financial statement issues, some amount of subjectivity, and differences in auditor-client preferences. By considering some of the work of Hatfield and his coauthors, we

Figure 1. The importance of ACM negotiations



will comment on important themes of ACM negotiations that may be of particular interest to audit practitioners.

2. Initial offers

Negotiation research in psychology has demonstrated the importance of the opening move in a negotiation. This first offer frames the remainder of the negotiation, both in terms of magnitude (e.g., the sticker price on a new car in the lot) and potential negotiation strategies. Pruitt and Drews (1969), consistent with many similar studies, demonstrated that 67% of the variance in subsequent offers and negotiation outcomes can be explained by the initial offer. If we view the auditing context through the lens of this negotiation research, the client's unaudited financial statements represent their initial position on all important judgments (e.g., estimates) and thus the opening move in any subsequent ACM negotiation. Taking this approach, Hatfield et al. (2010) considered how the relative size of an estimate in the unaudited financial statements influences the amount an audit partner will demand be posted in a negotiation over that estimate.

Hatfield et al. (2010) defined the magnitude of an audit difference as the difference between the client's unadjusted balance and the auditor's independent estimate, which can range from zero to full adjustment. Holding everything else equal, the magnitude of the ultimate audit adjustment should be based on the auditor's independent estimate (presumed correct amount) and should not be affected by the magnitude of the audit difference. However, negotiation research has implied that the audited balance will be influenced by the client's unadjusted balance (i.e., their initial offer). In Hatfield's experiment, auditor participants in the role of audit partner responded to a scenario in which an audit team's independent estimate of a client's allowance for doubtful accounts was $14 million. Consistent with negotiation theory, the authors found that auditors proposed an audited account balance closer to the auditor's independent estimate when the audit difference was smaller. Specifically, when the client's unadjusted balance was $8 million, auditors proposed an audited account balance of $12.9 million. Alternatively, when the client's unadjusted account balance was $11.2 million, auditors proposed an audited account balance of $13.4 million. Not only was this $500,000 difference statistically significant, but auditors dealing with the smaller unadjusted balance were more likely to make material (i.e., greater than 5% of income before taxes) concessions in their proposal. It is important to note that while auditors did stick to their initial offer in subsequent negotiations, this initial offer—and, thus, the negotiated outcome—was influenced by the magnitude of the client's initial offer (i.e., amount in unaudited financial statements).

3. Reciprocity

3.1. Matching concessions

The rule of reciprocity is prevalent throughout all societies (Cialdini, 2001; Gouldner, 1960) and simply stated requires a person to repay, in kind, when another person provides something to him/her. Research suggests that this rule is hardwired into our decision processes because it is required for society to exist: it allows for the division of labor and the exchange of goods and services (Leakey & Lewin, 1977). In a negotiation setting, the rule states that if one party concedes then the other party should concede as well. The pressure of reciprocity can overwhelm the normative decision process, as was described in the Watergate example. So, how does reciprocity affect an auditor's negotiations? Concession matching is the most likely influence of reciprocity on ACM outcomes. Concession matching implies that the auditor will feel pressure to concede if the client concedes from their position. Furthermore, given that ACM negotiations often involve multiple issues (Gibbins et al., 2001), discussions over an issue may be affected by the resolution of a prior issue.

Hatfield et al. (2010) addressed this issue by considering the negotiation of two issues. One was a very objective, and nonmaterial, issue of an expense accrued in the wrong period. Almost all auditor participants required the item to be adjusted. The other issue was a larger (material) and more subjective issue dealing with the estimate of obsolescent inventory. The authors predicted, and found, that when the objective issue was considered first, and the auditor required the client to post the adjustment, then the auditor reciprocated with a concession on the more material and subjective issue that followed. Again, auditors' negotiation judgments should not be affected by the order in which items are negotiated or whether more than one issue is discussed. Nevertheless, auditor behavior was predictable given an understanding of negotiation literature.

3.2. Reciprocity as a strategy

Auditors face the challenging task of attesting that the financial statements are free from material

misstatements while simultaneously fostering functional relationships with their clients. Because ACM negotiations directly affect financial reporting quality and impact the auditor-client relationship, an effective negotiation strategy may enable the auditor to successfully fulfill both tasks. Sanchez, Agoglia, and Hatfield (2007) set out to test the effectiveness of a specific negation strategy based on the societal norm of reciprocity, while Hatfield, Agoglia, and Sanchez (2008) considered whether auditors would use this strategy to help them overcome a tough negotiation environment while maintaining a positive relationship with their client.

Sanchez et al. (2007) investigated a strategy whereby auditors brought to the attention of management some of the waived, inconsequential audit differences identified during an audit. By waiving the inconsequential differences in full view of the client—referred to as a *concession approach*—the auditor can promote a collaborative environment that encourages the client to be more cooperative when negotiating material audit differences. Discussions with auditors suggest that such small issues are generally waived at the 'workpaper' level such that the client is likely unaware that the auditor had an issue and subsequently waived it. Clearly, waiving such minor issues is not at odds with professionalism or the regulatory environment, which may prevent the use of the more general strategy of bidding high and then conceding (Ng & Tan, 2003). This approach of waiving inconsequential items in view of the client is consistent with the societal rule of reciprocity. That is, if the client perceives the waiving of an inconsequential difference as a favor, then the client is likely to reciprocate this favor in the future (e.g., conceding during the course of a future negotiation). Furthermore, prior negotiation research conducted in more general contexts (e.g., Benton, Kelley, & Liebling, 1972) found that small concessions can be used to elicit larger concessions by the other party. Thus, the auditor may be able to promote financial statements that are free from material misstatement while also fostering a functional working relationship with the client by employing such a strategy.

Consistent with prior literature regarding the efficacy of such an approach, Sanchez et al. (2007) found that client management participants—controllers and CFOs—were more willing to post significant income-decreasing adjustments when exposed to a concession strategy. Separate experiments have demonstrated that this strategy improves the client's willingness to post adjustments that are either objective or subjective. Additionally, controllers and CFOs are more satisfied with the audit process and are likelier to retain the auditor when the auditor utilizes the concession approach. Sanchez et al. also found that auditors echoed this sentiment, as they indicated they were able to improve client satisfaction and retention through the use of a concession approach during negotiations. In a related study, Hatfield et al. (2008) examined whether auditors will employ such a concession strategy based on reciprocity and what client characteristics increase the extent to which it is used. Experimental results suggest that auditors are willing to use this concession strategy. Furthermore, auditors increase their use of a concession approach when a client's management is known to be a difficult (competitive) negotiator and when retention risk is high.

Taken together, these studies suggest that the use of a reciprocal strategy is an effective way to convince clients to post audit adjustments as well as a way to positively influence the relationship between auditors and their clients. This approach demonstrates how an understanding of the negotiation literature and the expectations it produces can help auditors manage difficult situations. When the client is known to be a tough negotiator or is perhaps willing to enhance their negotiation power through the use of threats (i.e., threat of switching auditors), auditors can reduce their perceived pressure by simply being more transparent with regard to the waiving of small issues, and by doing so activate the client's need to reciprocate.

4. Deadline pressure

The general negotiation literature has determined that time pressure is a highly influential characteristic in negotiations. As time pressure increases, the desire for each party to reach an agreement is enhanced (Pruitt, 1981). Experimental work conducted by Pruitt and Johnson (1970) suggests that concessions between negotiators are greater when time pressures are high compared to when time pressures are low. Smith, Pruitt, and Carnevale (1982) provided similar results regarding time pressure: they found that concession rates are greater under high deadline pressures. The general rationale for these findings is that deadline pressure increases the importance—and salience—of reaching an agreement and also limits negotiators' ability to employ strategies that take an extended period of time to use (e.g., bid high then concede over time).

Bennett, Hatfield, and Stefaniak (in press) compared the effect of deadline pressure on both auditor and client (controllers) participants. They considered the concessionary behavior of both sides of the negotiation (i.e., the extent to which the

parties concede from their initial positions). While deadline pressure is a ubiquitous concern in most audit tasks, and a highly important contextual characteristic in the general negotiation literature, audit researchers had not examined its impact. Prior auditing research found that most ACM negotiations occur near the end of the audit, when deadline pressures are likely high: 64% of survey responses indicated as much (Gibbins, McCracken, & Salterio, 2005). Deadline pressures in an audit context are typically imposed by regulatory agencies. For example, SEC filing deadlines constrain the amount of time available to conduct ACM negotiations. Accordingly, consideration of how deadline pressure affects auditors' and their clients' negotiation behavior is increasingly important as these deadlines are compressed (e.g., accelerated filers).

Predictions regarding the differential effect of deadline pressure on auditors and their clients are based on the relative power each have during negotiations. While the inability to reach an agreed-upon outcome is undesirable for both the client and the auditor, the authors suggest it is potentially worse for the client, tipping the power in favor of the auditor. They conclude that the potential negative outcomes of a modified opinion for the auditor (i.e., potential loss of client offset by reduced audit risk) are less damaging than the potential negative outcomes for the client. For example, archival research has demonstrated that a modified opinion can lead to client outcomes such as negative market return, decreased market share, and negative earning signals (Frost, 1994; Loudder et al., 1992; Taffler, Lu, & Kausar, 2004). Thus, failing to reach an agreement potentially carries a heavier penalty to the client, resulting in enhanced negotiation power for the auditor. Consistent with this notion, Bennett et al. (in press) found that in general, clients are more willing to concede during ACM negotiations, while auditors tend to use their enhanced power to hold firm to their negotiation position and concede less.

However, the general negotiation literature suggests that use of relative power within negotiations requires time. That is, a rigid and non-concessionary strategy takes time (e.g., time to go back and forth and hold firm for a period). Client negotiators, who already concede to a greater extent than auditors, have less room and less reason to change their strategies when time runs short. Bennett et al. (in press) predicted and found that auditors are more affected by deadline pressure than their client counterparts. Furthermore, they demonstrated that auditors changed their strategies—became more concessionary and relied on their relative power less—while under deadline pressure, whereas the client participants did not.

Bennett et al. (in press) demonstrated the benefit of considering both sides of the table in ACM negotiations, especially when certain factors/pressures are present for both parties. For example, if this study had followed the research design of most prior accounting negotiation research and only evaluated how CFOs' concessions varied under different deadline pressure (high vs. low), then a possible conclusion would be that the end of the audit deadline does not impact auditor-client negotiations.

5. What have we learned?

The financial statements are a result of collaboration between client management and their auditors, which often includes a negotiation process to resolve any differences in opinion about the content of the financial statements (Antle & Nalebuff, 1991). There has been a great deal of research regarding negotiations in the psychology and social psychology literature. Auditing research is catching up, and Hatfield and colleagues have conducted several studies looking at how we can expect these findings from the general negotiation literature to influence ACM negotiations. Even though auditors are somewhat peculiar negotiators, given their general lack of concession, they are nonetheless influenced by many of the characteristics identified in the general negotiation literature. For example, Hatfield et al. (2010) demonstrated that auditors rarely move off their initial recommendation to the client regarding an adjustment. However, their study also demonstrated that this initial recommendation is highly influenced by the magnitude of client position and the occurrence, or not, of a prior adjustment required by the auditor. It is important that auditors access research, like that discussed here, to better prepare for ACM negotiations such that financial statement quality can be maximized. It is interesting to note that few audit partners receive training in negotiations; indeed, only 28% of the auditors in the study by Hatfield et al. (2010) received significant training in negotiations, and much of that was related to fee negotiations. Research has demonstrated that auditors can improve their negotiation outcomes if they explicitly consider their position as well as that of the client prior to entering discussions with their client (Trotman, Wright, & Wright, 2005). In general, auditors should heed the warnings of Gillan (2007) and Bazerman, Loewenstein, and Moore (2002) that many of the problems experienced by auditors in recent years cannot be resolved with regulations or penalties for unethical behavior, but rather only via explicit consideration of the unconscious biases that lead to suboptimal audit judgments.

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