

Resolving Disputed Financial Reporting Issues: Effects of Auditor Negotiation Experience and Engagement Risk on Negotiation Process and Outcome

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SUMMARY: In an experiment involving a dyadic negotiation between a computer-simulated client and practicing auditors, we examine the effects of engagement risk and auditor negotiation experience on the process and outcomes of client-auditor negotiations. We find that auditors with lower negotiation experience who encounter a high risk client use a more concessionary negotiation strategy, achieve a negotiated outcome that is more aggressive (consistent with the client's aggressive preference), and are less confident that the outcome they negotiate is acceptable under GAAP compared with the negotiation process and outcome results of auditors with higher negotiation experience. In contrast, auditors with higher negotiation experience use a less concessionary strategy, achieve an outcome that is more conservative regardless of risk context, and are more confident that the outcome they negotiate is acceptable under GAAP. This study illustrates the important roles that engagement risk, task-specific negotiation experience, and pressure from the client regarding an aggressive financial reporting preference play in the process and outcomes of client-auditor negotiation.

Keywords: auditor decision-making; experience; negotiation; risk.

Data Availability: Contact the authors.

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INTRODUCTION

This study examines the effects of engagement risk and auditor negotiation experience resolving complex financial reporting issues on the process and outcome of client-auditor negotiation. This examination is important because auditing necessitates negotiation between the auditor and the client to resolve disputed reporting issues, and such negotiations can materially affect the financial statements (Nelson and Kinney 1997; Nelson et al. 2002; Trotman et al. 2005). However, little is known about how contextual features such as risk and auditor characteristics affect client-auditor negotiation, and only a limited amount of research has yet investigated these issues (Hatfield et al. 2008). Understanding the features that affect the negotiation process, in addition to the outcome, is important because such an understanding provides insight on audit practice interventions (e.g., training and personnel assignment) that may improve audit quality and reduce litigation exposure on the contentious issues resolved via client-auditor negotiation.

Emerging research investigates how auditors and their clients interact to resolve disputed financial reporting issues. Gibbins et al. (2001) outline a model highlighting contextual features affecting negotiations (e.g., client and auditor negotiation capabilities, regulation, and risk), and validate the model using survey data of auditors' self-reported negotiations. Gibbins et al. (2001) call for research that examines negotiation strategies (see Sanchez et al. 2007) and outcomes, and that considers contextual features such as negotiator expertise and the riskiness of the negotiation context. Ng and Tan (2003) investigate how authoritative guidance and audit committee effectiveness affect client-auditor negotiations, and illustrate the importance of concession-making behavior in achieving negotiation outcomes. They call for research that considers the role of negotiator expertise and use research designs that enable consideration of interactive negotiation between clients and their auditors. Trotman et al. (2005) demonstrate the effectiveness of a role-playing intervention in improving negotiation processes and outcomes. They call for additional research that investigates reasons for variation in negotiation outcomes, the influence of initial bargaining positions and subsequent negotiation strategies, the role of auditor negotiation experience, and the effect of riskiness of the negotiation context. Most recently, Trotman et al. (2009) consider auditors' pre-negotiation plans and show that auditors with greater general auditing experience are more strategic in their planning (e.g., making more demanding initial offers and planning to offer fewer concessions) compared with auditors who have less general auditing experience.

We extend this line of research, using an experimental task that involves a dyadic negotiation between a computer-simulated client and 65 audit managers and partners to examine how engagement risk and auditor negotiation experience affect the resolution of a contentious accounting issue.¹ We manipulate engagement risk at high and low levels, and measure participants' negotiation experience (the number of client-auditor negotiations to resolve a fairly complex revenue recognition issue that the auditor has recently completed). During each negotiation round, the auditor makes a bid proposal, to which the computer-simulated client responds with its own bid. We measure negotiation process in terms of the concessions that auditors make to the client's aggressive demands. We measure negotiation outcome in terms of the auditor's final negotiated outcome and confidence that the outcome is acceptable under GAAP. Using prior research in both the general negotiation and accounting literatures, we predict more concessionary negotiation processes, less conservative negotiated outcomes (more in line with the client's aggressive preference), and lower GAAP

¹ Engagement risk is the risk that the audit firm will suffer a loss via litigation, loss of reputation, or costs exceeding fees (AICPA 1983; Johnstone 2000; Bell et al. 2002).

confidence levels for less experienced auditors than for more experienced auditors, particularly when the client represents higher engagement risk.

This study makes several contributions. First, we respond to calls for negotiation research that investigates the role of engagement risk (e.g., Trotman et al. 2005), which is particularly relevant today, as auditors operate in a litigious, political environment where negotiation between clients and their auditors may be viewed as a problematic aspect of the financial reporting process. Understanding how client-auditor negotiation is affected by the risk profile of clients is important, given the Public Company Accounting Oversight Board (PCAOB)'s risk-based enforcement/audit firm inspection process. That process emphasizes audits of companies that the PCAOB considers especially risky (McDonough 2005) and focuses on judgmental financial reporting issues that are likely the subject of client-auditor negotiation (e.g., see PCAOB 2005a, 2005b). Therefore, understanding how auditors respond to risky versus less risky clients during client-auditor negotiation is important, and understanding the types of auditors who respond more appropriately has important audit quality and public policy implications.

Second, we use a task-specific measure of *negotiation* experience, linking it to differential reactions to engagement risk in terms of the negotiation process and its outcome. We also report that this task-specific measure of experience is not highly correlated with auditors' rank or years of general auditing experience. This helps to inform practice of the importance of providing auditor experience and training in resolving disputed financial reporting issues, and it extends prior research on negotiation in accounting that has used measures of general auditing experience (e.g., years or rank) (Trotman et al. 2005, 2009). Further, our analysis of task-specific negotiation experience in the auditing context helps inform research in psychology on the relationship between negotiation experience and performance, because that literature has almost exclusively evolved using student subjects without realistic negotiation experience (Thompson 1990a).

Third, using a dyadic negotiation between a computer-simulated client and experienced auditors enables us to consider measures of both the process and outcome of client-auditor negotiation, thereby enabling inferences about a typically unobservable decision setting. We build on research using survey methods that rely on auditor memories of actual negotiations (Gibbins et al. 2001) or role playing that relies on the use of confederates to simulate negotiations with a mock client (Trotman et al. 2005). Our approach allows for strong control over the behavior of the "client" through the negotiation process and provides an innovative method to investigate other questions requiring interaction or that are otherwise difficult to observe (Bryant et al. 2004).

The results show that auditors with lower task-specific negotiation experience in the high engagement risk condition use a more concessionary negotiation strategy, achieve a negotiated outcome that is more aggressive (and more in line with the client's aggressive preference), and are less confident that the outcome they negotiate is acceptable under GAAP compared with both the less experienced auditors in the low-risk condition and the more highly experienced auditors (in both the high- and low-risk conditions). To understand these results, we conduct exploratory tests for the mediating role of client pressure in client-auditor negotiations. We measure client pressure as the extent to which auditors believe they will have to persuade the client toward a more conservative alternative; the more that auditors believe they will have to persuade the client, the greater the pressure they likely perceive from the client to allow more aggressive reporting. Results reveal that auditors with lower negotiation experience perceive a heightened sense of client pressure in the high-risk condition, whereas auditors with higher negotiation experience perceive a similar level of client pressure regardless of engagement risk. The client pressure perceived by the

auditors with lower experience mediates the relationship between risk and both the concessions they make and the confidence they have in whether their negotiated outcomes are acceptable under GAAP.

The remainder of this paper is organized as follows. The second section discusses background literature and hypotheses. The third section outlines our research methods, and the fourth section contains the results. The fifth section includes a discussion of limitations and conclusions.

THEORY AND HYPOTHESIS DEVELOPMENT

Negotiation Process and Outcome Effects

Negotiation is a process by which a joint decision is made by two or more parties with differing preferences, and is one in which the parties' joint decisions ultimately affect the welfare of both (Murnighan and Bazerman 1990). In general, the parties first verbalize contradictory demands and then move toward agreement using a variety of possible negotiation strategies (Pruitt 1981). For distributive negotiation tasks such as the one we study (i.e., situations that involve dividing up a fixed set of resources), there are three potential strategies (Neale and Bazerman 1985; Bazerman 1986; Pruitt and Carnevale 1993). One is a contending strategy, in which the contending party requires the other party to make concessions by using threats, irrevocable commitments, or persuasive arguments that result in a "win-lose" outcome favoring the contending party. Second is a concessionary strategy, in which the concessionary party concedes to the other party, resulting in a "lose-win" outcome favoring the other party. Third is a compromising strategy, where the negotiators seek a "middle of the road" outcome.

The accounting literature recognizes that auditing often necessitates negotiation between the parties to resolve disputed financial reporting issues (Antle and Nalebuff 1991; Nelson and Kinney 1997; Demski and Frimor 1999; Beattie et al. 2000; Nelson et al. 2002). Gibbins et al. (2001) offer and test a three-element process model of negotiation. That model depicts negotiation as a function of the issue (e.g., the accounting implications and materiality, how the issue arose, and whether the issue was a surprise), the process (e.g., its duration, the number and experience level of parties involved in the process, and the initial beliefs of the parties about possible outcomes), and the outcome (e.g., the accounting resolution, the audit opinion, whether the auditor is reappointed, and the importance of the outcomes to the auditor). The model also illustrates accounting contextual features that affect negotiation, including external conditions (e.g., GAAP and GAAS), the interpersonal context (e.g., the client-auditor relationship, personal/organizational agendas, and risk), and both parties' capabilities (e.g., accounting and negotiation expertise).

Several recent papers build on Gibbins et al. (2001). Trotman et al. (2005) find that auditors who practice role-playing as the client in a mock negotiation subsequently achieve performance improvements in terms of both process (satisfaction, desirability of dealing with the client again, and the client's understanding of the auditor's options) and outcome (a more conservative financial reporting choice). They also present results showing that audit partners negotiate a marginally more conservative financial reporting choice than managers. So, their results suggest the importance of rank and training in this decision context. Ng and Tan (2003), using audit managers as subjects, find that the availability of authoritative guidance and the effectiveness of the audit committee jointly affect auditors' judgments about the outcome of client-auditor negotiations. Further, the results show that audit managers respond to client concessions by making concessions of their own.

Bame-Aldred and Kida (2007) investigate initial negotiation positions and tactics of both clients and auditors in a pre-negotiation context, gaining insight on differences between

auditors and their clients in terms of the range of acceptable outcomes, the accuracy with which both parties perceive the other party's goals and limits, and the strategies that both parties plan to employ during the negotiation. The results reveal that in terms of planned negotiation strategies, auditors are less likely than clients to select a conservative alternative initially with a plan to subsequently concede to a more aggressive alternative, to try to appear contentious, and to attempt to trade off one audit issue for another. Auditors are more likely than clients to threaten to terminate their mutual relationship, although neither party plans to use this strategy often. Overall, Bame-Aldred and Kida (2007) yield insights on what auditors and clients plan to do during negotiations, although the nature of their task did not involve actual client-auditor negotiations as our study does.

Only one prior accounting study directly examines the effect of auditor experience on negotiations. Trotman et al. (2009) consider the assessments and expectations that experienced audit practitioners (i.e., partners and managers) make prior to the negotiation process, as they plan to begin negotiations. They find that general audit experience (not task-specific negotiation experience) impacts negotiation planning judgments such that auditors with greater general audit experience plan more demanding initial positions, plan to make fewer concessions, expect to achieve final outcomes that are more favorable to them, and are less likely to utilize the negotiation tactic of bid high/concede later. While Trotman et al. (2009) consider pre-negotiation rather than negotiation itself, the results shed light on potential differences that may exist in negotiation processes and outcomes for auditors of varying experience. Taken together, these studies demonstrate the importance of understanding both the negotiation process and the outcome, and illustrate that contextual features such as risk and general negotiator experience are important to understanding the complex interaction between clients and auditors in financial reporting choice. We discuss each of these issues below, concluding with our hypotheses.

Negotiation Experience

Prior research demonstrates that more experienced auditors sometimes exhibit superior performance (e.g., Farmer et al. 1987; Libby and Frederick 1990; Bedard and Biggs 1991; Tubbs 1992; Shelton 1999), but not always (e.g., Ashton 1991; Bedard and Chi 1993; Nelson et al. 1995; Bonner et al. 1996). Studies considering these mixed results note the inadequacy of general experience measures in predicting superior performance (Bedard 1989; Libby and Luft 1993). It appears that task-specific measures of knowledge/experience are most helpful in identifying "experts" (Davis and Solomon 1989; Bonner and Lewis 1990) and that such measures are associated with superior performance (e.g., Libby and Tan 1994; Ramsay 1994; Jamal and Tan 2001). During negotiation, for example, auditors who have had previous experience negotiating complex revenue recognition issues may be more familiar with revenue recognition principles and outcomes that are acceptable under GAAP, arguments that have been persuasive with other clients, and strategies that are useful in achieving desirable outcomes compared with auditors who have less negotiation experience. In a pre-negotiation context, Johnstone et al. (2002) show that auditors with greater task-specific knowledge (how to resolve a complex financial reporting issue) generate a greater number and monetary range of alternatives for their private consideration as they prepare to negotiate with an aggressive client.

The general negotiation literature provides evidence that negotiation experience improves negotiation performance, although few such studies use individuals with real-life negotiation experience completing realistic tasks in the domain in which they developed that experience. One notable exception is Montgomery and Benedict (1989), who show that an increase in negotiator experience is associated with decreases in the frequency and

duration of teacher strikes. Using individuals with real-life negotiation experience in a task domain different from their actual experience, Neale and Northcraft (1986) show that more experienced negotiators earn greater profits than less experienced negotiators, likely because they have more skill with respect to the decision-making process. Considering the effect of negotiation training on inexperienced individuals, Murnighan et al. (1999) demonstrate that those receiving training (three hours of instruction on conceptual issues, negotiation tasks, and discussion/analysis) are better able to achieve their preferred outcomes than those not receiving such training. Bartos (1977) notes that highly skilled negotiators take great care in formulating their opening bids, and Rubin and Brown (1975) comment that negotiators tend to achieve superior outcomes when they make strategic (i.e., low) initial offers, coupled with minimal subsequent concessions. Finally, in experimental bargaining markets with student subjects, Thompson (1990a, 1990b) finds that more experienced negotiators (those who had completed preliminary rounds of negotiation in the experiment) use a less concessionary negotiation strategy, make higher initial demands, make offers that are low in value to the other party, and are able to claim more resources than less experienced negotiators.

This prior research in both accounting and other contexts suggests a positive association between auditors' negotiation-specific experience and their negotiation performance. While not examining negotiation-specific experience directly, Moreno and Bhattacharjee (2003) find that in the presence of a client preference to avoid an inventory write-down, less experienced auditors judge obsolescence risk lower for clients that present potential business opportunities versus those that do not. In contrast, more experienced auditors' obsolescence judgments were invariant to the pressures implied by the client's preference and potential business opportunities. Moreno and Bhattacharjee (2003) explain their results by pointing to prior research demonstrating that tacit management skills (e.g., the ability to balance competing goals such as client pressure versus litigation risk) are developed through experience (Tan and Libby 1997; Sternberg and Horvath 1999). Thus, while auditors may concede on subjective issues because they feel pressure to satisfy the client (Sanchez et al. 2007), this tendency may decline with negotiation experience.

While these findings have not been previously confirmed in a setting that involves high level audit personnel with documented variation in levels of negotiation experience, it seems reasonable to expect that auditors with less negotiation experience may perceive greater client pressure to acquiesce to a client's aggressive preference than auditors with more negotiation experience, since less experienced auditors will have had fewer opportunities to develop the skills needed to balance the competing demands associated with satisfying the client versus limiting their own liability exposure. DeZoort and Lord (1997, 38) define client pressure as "the pressure to yield, or the anticipation of the pressure to yield, to a client's wishes or influence whether appropriate or not." Auditors with less experience may be particularly concerned with client satisfaction, so they may be especially vulnerable to conceding to a client's aggressive reporting preference. As such, our expectation is that in negotiations with a client seeking inappropriately aggressive financial reporting, auditors with less task-specific experience in client-auditor negotiations will exhibit a more concessionary negotiation strategy, which will result in a negotiated outcome that is less favorable to the auditor (i.e., more aggressive).

Engagement Risk

Engagement risk is the risk that the audit firm will suffer a loss via litigation, loss of reputation, or costs exceeding fees (AICPA 1983; Johnstone 2000; Bell et al. 2002). Prior research demonstrates the importance of engagement risk in auditor decision-making in

general (e.g., Walo 1995; Johnstone 2000), in financial reporting choice (Farmer et al. 1987; Hackenbrack and Nelson 1996), in pre-negotiation (Johnstone et al. 2002), and during actual client-auditor negotiations. For example, Gibbins et al. (2001) demonstrate that the client's risk is ranked as highly important or essential in 46 percent of the negotiation examples that the auditors in their sample experienced.

Regarding the role of engagement risk in financial reporting choice, Hackenbrack and Nelson (1996) find that when risk is moderate auditors accept an aggressive reporting choice, but when it is high they prefer a conservative choice. Similarly, Farmer et al. (1987) find that higher risk is negatively associated with auditors' likelihood of agreeing with a client's questionable financial reporting preference. Johnstone et al. (2002) examine auditors' generation of financial reporting alternatives for their private consideration as they prepare to negotiate a revenue recognition issue, finding that higher risk is associated with the generation of a greater number and range of alternatives, particularly for high-knowledge auditors. As such, these auditors exhibited superior performance because they entered the negotiation better-prepared to contend with the client's aggressive preference than their lower knowledge counterparts. These studies suggest that engagement risk is likely to play a role in the process and outcome of client-auditor negotiation. However, we expect that the specific nature of that role will depend on auditors' negotiation experience.

The Contingent Effects of Engagement Risk and Negotiation Experience on Negotiation Process and Outcome

In thinking about the potential joint roles of engagement risk and negotiation experience, consider two situations in which a client has a stated preference for an aggressive financial accounting treatment. In one situation, the client is publicly traded (high engagement risk); in the other situation, the client is privately held (low engagement risk). Both situations involve client pressure because of the client's stated preference, and, as noted previously, auditors with less negotiation experience may perceive more pressure to acquiesce to the client's preference than auditors with more negotiation experience. However, auditors with differing levels of negotiation experience may interpret engagement risk associated with public trading status in alternative ways. Auditors with less negotiation experience may focus on satisfying a public client because of associated practice-development and reputation-building opportunities. Therefore, they may perceive greater pressure to yield to the client's preferences in the public-client situation than in the private-client situation. In contrast, as in Moreno and Bhattacharjee (2003), more experienced negotiators' judgments may be invariant to the pressures implied by the client's preference regardless of whether the client is publicly traded or privately held, understanding the litigation and accountability implications associated with all clients that pursue aggressive financial reporting alternatives (Trompeter 1994; Buchman et al. 1996).

Building on the possibility that auditor negotiation experience may affect how auditors perceive the decision context, we investigate the interactive effects of engagement risk and negotiation experience. Following Johnstone et al. (2002), who report weaker pre-negotiation performance (the development of a lower number and range of negotiable alternatives) for lower knowledge auditors in situations of heightened engagement risk, we expect that auditors with less negotiation experience will be more concessionary when engagement risk is high and will therefore achieve less conservative final negotiated outcomes, whereas auditors with more negotiation experience will have similar negotiation performance regardless of the decision context. This line of reasoning suggests the following hypotheses:

- H1:** Auditors with less negotiation experience will use a *more concessionary negotiation strategy* in the high-risk context than in the low-risk context, whereas auditors with more negotiation experience will use a less concessionary negotiation strategy regardless of risk context.
- H2:** Auditors with less negotiation experience will have a *less conservative final negotiated outcome* in the high-risk context than in the low-risk context, whereas auditors with more negotiation experience will have similar final negotiated outcomes regardless of risk context.

This concessionary process and final negotiated outcome, in turn, should affect auditors' confidence about whether the final negotiated outcome reached is an appropriate method under GAAP. Prior research shows that auditors with less experience are less confident in their control risk assessments (Chung and Monroe 2000), and confidence in general is an importance characteristic of audit specialists (Abdolmohammadi et al. 2004). Confidence is particularly important in the client-auditor negotiation setting because it demonstrates an auditor's belief that the negotiated outcome will be defensible to others who might subsequently view the outcome of the negotiation process (e.g., lawyers). If the predictions in H1 and H2 hold, auditors with less negotiation experience in the high-risk context will have yielded more concessions and will have negotiated a less conservative outcome compared with other auditors. Given this, we expect that the low experience auditors in the high-risk context will have self-awareness of the risks associated with their negotiation process and outcome and will therefore be less confident about whether the final negotiated outcome is an appropriate method under GAAP. As such, we expect that:

- H3:** Auditors with less negotiation experience will be *less confident about whether the final negotiated outcome is an appropriate method under GAAP* in the high-risk context than in the low-risk context, whereas auditors with more negotiation experience will have similar levels of confidence about GAAP appropriateness regardless of risk context.

METHOD

Participants

We recruited U.S. audit partners and managers from each of the Big 4 firms, one international firm, and a regional firm.² These are appropriate participants because they are routinely responsible for negotiating with clients. Sixty-five auditors with prior client-auditor negotiation experience completed the experiment.

Experimental Case

The experimental case, which involves a complex revenue recognition issue for which professional standards are imprecisely defined, is based on a practice situation and is adapted from Johnstone et al. (2002). Within the case, the auditor must decide how to allocate revenue between current and future periods for a multiyear contract. The client's preference is to recognize the majority of the revenue currently even though the majority of the earnings process is incomplete, so this is a highly aggressive alternative.

² Inclusion of audit firm membership does not influence the results of our hypothesis tests.

We conducted the experiment using the Internet. Participants assumed the role of the auditor and interacted with a simulated “client” that was programmed on the computer.³ The experiment lasted an average of 42 minutes. The experiment proceeded as follows (see Figure 1). First, auditors accessed the website using a password that we provided, read an explanation of the study, and electronically signed the human-subjects form. Second, because prior research suggests that conflict management style may affect negotiation (e.g., Pruitt and Carnevale 1993; Rahim et al. 2000), we measure conflict management style using the Rahim Organizational Conflict Inventory-II (ROCI-II; Rahim 1983) instrument.⁴ Third, participants read a description of the client, including the risk manipulation (see description below). Fourth, they reviewed a summary of the disputed issue, including a description of five reporting alternatives compiled by the engagement team (see Appendix A).⁵ Fifth, participants ranked the alternatives in order of their preference, and indicated their initial judgment regarding how confident they were that each alternative was appropriate under GAAP (using a scale that ranged from 0 = not confident to 100 = very confident in ten-point intervals).⁶ Across all experimental conditions, the confidence rating for the most aggressive alternative was 25.07. In contrast, the confidence rating for the most conservative alternative was 65.54; these two amounts are significantly different at $p < 0.05$.⁷ Therefore, while there are no normative benchmarks regarding the “correct” revenue recognition amount in this case, auditors’ responses indicate that more conservative alternatives are judged as superior.

Sixth, they began the negotiation process, which lasted a maximum of ten rounds.⁸ Each round began by having participants indicate the likelihood that they would have to persuade the client that their own preference was the best alternative (used to measure client pressure, as described in subsequent exploratory analyses). Next, they selected a reporting alternative from a drop-down menu and selected a reason for their choice from among a list of seven available reasons (which were based upon pilot testing), to which the computer-programmed client responded (the reasons are shown in Table 5, Panel A). The client response at the end of the first round indicated a preference for the most aggressive reporting alternative, and then the client proposed less aggressive alternatives as the negotiation proceeded. For client responses by round, see Appendix B.⁹ The auditor could then either accept the client’s proposal or counteroffer by moving to round two, etc. The negotiation

³ We pilot tested the experimental instrument using six audit practitioners (two managers and four partners), modifying it slightly based upon their feedback.

⁴ The ROCI-II includes 28 statements that assess the underlying dimensions of an individual’s conflict management style, which vary in terms of the individuals’ concern for themselves and concern for others. This measure does not vary significantly by experimental condition and does not influence the results of our hypothesis tests.

⁵ The description of the alternatives was available for participants’ reference throughout the negotiation process using an on-screen link.

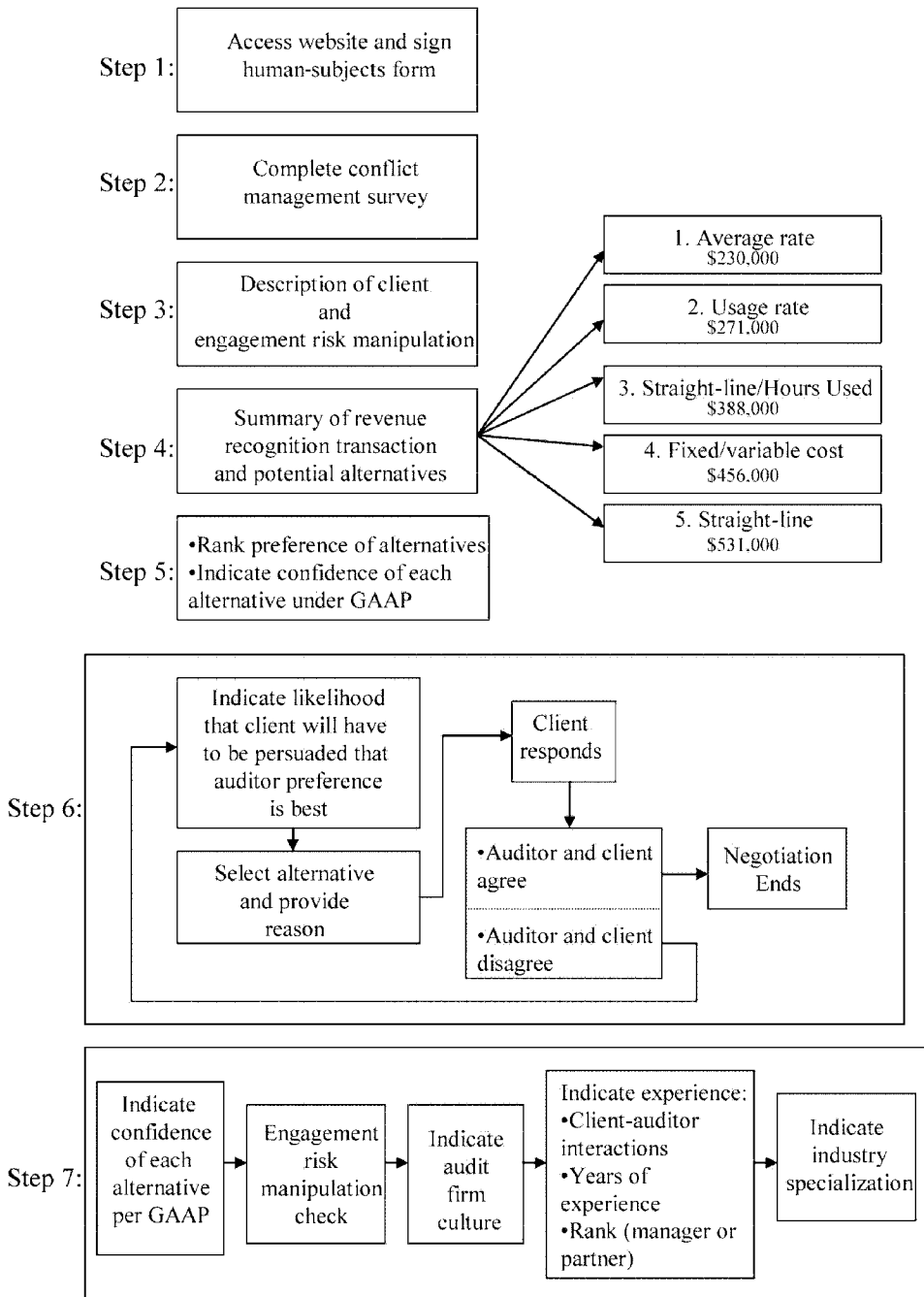
⁶ Measuring auditors’ individual preferences prior to alerting them to the client’s preference enables us to establish a “client-neutral benchmark” against which we can evaluate each auditor’s subsequent decisions.

⁷ The confidence ratings are 70.00, 41.38, and 32.00 for the alternatives valued at \$271,000, \$388,000, and \$456,000, respectively; 65.54 and 70.00 are not significantly different at $p < 0.05$; 41.38 is significantly lower than 65.54 and 70.00 at $p < 0.05$; 32.00 and 25.07 are not significantly different from each other; and 32.00 is significantly lower than 41.38, 65.54, and 70.00.

⁸ We used results of pilot testing to determine the maximum number of rounds. Participants were not informed of the maximum, because auditors in practice do not know how long a client might continue to resist their preferences.

⁹ The client response was the same regardless of the auditor’s proposed alternative to ensure appropriate experimental control. For example, if the auditor selected the alternative resulting in revenue of \$230,000 in round one, the client would respond by rejecting the auditor’s alternative and would counteroffer with the alternative resulting in revenue of \$531,000; if the auditor selected an alternative resulting in revenue of \$271,000 in round one, the client would also counteroffer with the \$531,000 alternative.

FIGURE 1
Flow of Experiment



ended when the auditor's proposed alternative was the same as the client's preference. If agreement had not been reached by the tenth round, the client would concede to the auditor's preference in that round.

Seventh, participants completed a post-experimental questionnaire. They made a final judgment about how confident they were that each alternative was appropriate under GAAP, and they completed the engagement risk manipulation check. They then indicated their audit firm's culture, which we measured because there may be differences across audit firms in the culture they convey to guide auditor conduct.¹⁰ Finally, we measured task-specific negotiation experience, general auditing experience, and industry specialization.

Experimental Manipulation

We use a 2×2 between-subjects factorial design to investigate the effects of negotiation experience and engagement risk on the negotiation process and its outcome. To measure task-specific experience, we used the number of client-auditor interactions that auditors reported they had completed in the last three years to resolve a fairly complex revenue recognition issue.¹¹ Similar to Bame-Aldred and Kida's (2007) general experience measure (years of experience), we constructed a dichotomous negotiation experience variable by splitting the data at the median (ten negotiation interactions), where higher task-specific negotiation experience (11 or more) is indicated as *TASK EXPERIENCE* = 1, and lower experience (ten or fewer) is indicated as *TASK EXPERIENCE* = 0. In addition, we gathered data on measures of general auditing experience (rank and years). Results (not tabled) illustrate that the general auditing experience measures (i.e., rank and years) are highly correlated ($r = 0.743$, $p = 0.000$) to each other, but are less highly correlated with task-specific negotiation experience ($r = 0.238$, $p = 0.056$ and $r = 0.143$, $p = 0.254$, for rank and years, respectively). As in Bame-Aldred and Kida (2007, Table 1, footnote d), these general experience measures are not closely related to negotiation decision-making. We also analyzed industry experience, and find that auditors in the higher task experience group also have a significantly higher percentage of industry experience in the general manufacturing industry ($p = 0.014$).

We manipulated engagement risk at high (*RISK* = 1) and low (*RISK* = 0) levels. Clients with higher engagement risk possess characteristics such as public trading status (e.g., St. Pierre and Anderson 1984; Bell et al. 2002), short auditor tenure (e.g., Stice 1991), and weak financial condition (e.g., Johnstone 2000). Further, manager compensation contracts can provide an incentive for earnings management (Dye 1988; Schipper 1989), and earnings management in its various forms is associated with auditors' risk of loss (e.g., Carcello and Palmrose 1994; Dechow et al. 1996). Therefore, in the high- (low-) risk condition, the client possessed the following characteristics: It was publicly (privately) held; this was the first (12th) year it had been audited by the firm; financial ratios were below (above) the industry average and prior year results; and management bonuses were tied to sales targets, and the client had not yet met (had met) its sales targets.

¹⁰ Prior research has depicted audit firm culture as ranging from a public duty culture to a client advocacy culture (Johnstone et al. 2001). This measure does not vary significantly by experimental condition and does not influence the results of our hypothesis tests.

¹¹ Consistent with the results in Gibbins et al. (2001), we were aware when designing this study that there might be sensitivity in practice to the term "negotiation." In fact, auditors participating in pilot testing mentioned this issue and suggested "interaction" might be a term that would properly convey intended meaning without being offensive. Individuals in charge of distributing the experimental cases at the participating firms also indicated a preference for the term "interaction."

TABLE 1
Measurement of Auditors' Negotiation Strategy and Results by Experimental Cell

Most Preferred Alternative Prior to Negotiation	n, GAAP Appropriateness Judgment (mean, median)	Round 1 Bid	n, GAAP Appropriateness Judgment (mean, median)	Final Outcome	n, GAAP Appropriateness Judgment (mean, median)	Mean Number of Rounds to Resolution	EXPER-TASK = Lower Low Risk	EXPER-TASK = Lower High Risk	EXPER-TASK = Higher Low Risk	EXPER-TASK = Higher High Risk		
\$230,000	n = 19 86.31, 90.00	\$230,000	n = 18 86.67, 90.00	\$230,000	n = 6 88.33, 95.00	10.00	n = 0	n = 0	n = 3	n = 3		
				\$271,000	n = 6 58.33, 65.00	8.67	n = 2	n = 0	n = 2	n = 2		
				\$388,000	n = 4 62.50, 65.00	5.75	n = 0	n = 2	n = 1	n = 1		
				\$456,000	n = 1 80.00, 80.00	5.00	n = 0	n = 1	n = 0	n = 0		
				\$531,000	n = 1 20.00, 20.00	3.00	n = 1	n = 0	n = 0	n = 0		
				\$271,000	n = 1 80.00, 80.00	8.00	n = 0	n = 0	n = 1	n = 0		
				\$271,000	n = 10 55.00, 65.00	\$230,000	n = 3 83.33, 80.00	10.00	n = 2	n = 0	n = 0	n = 1
				\$271,000	n = 1 0.00, 0.00	\$271,000	n = 1 82.50, 85.00	8.00	n = 0	n = 1	n = 0	n = 0
				\$388,000	n = 5 74.00, 70.00	\$388,000	n = 8 91.25, 90.00	5.60	n = 0	n = 2	n = 1	n = 2
				\$531,000	n = 1 82.50, 85.00	\$531,000	n = 11 63.63, 70.00	3.00	n = 0	n = 0	n = 0	n = 1
\$271,000	n = 31 85.48, 90.00	\$271,000	n = 21 87.62, 90.00	\$271,000	n = 8 91.25, 90.00	8.25	n = 3	n = 1	n = 2	n = 2		
				\$388,000	n = 11 63.63, 70.00	5.82	n = 4	n = 4	n = 1	n = 2		
				\$456,000	n = 2 40.00, 40.00	4.00	n = 0	n = 2	n = 0	n = 0		
				\$456,000	n = 2 40.00, 40.00	4.00	n = 0	n = 2	n = 0	n = 0		

(continued on next page)

TABLE 1 (continued)

Most Preferred Alternative Prior to Negotiation	n, GAAP Appropriateness Judgment (mean, median)	Round 1 Bid	n, GAAP Appropriateness Judgment (mean, median)	Final Outcome	n, GAAP Appropriateness Judgment (mean, median)	Mean Number of Rounds to Resolution	EXPER-TASK = Lower Low Risk	EXPER-TASK = Lower High Risk	EXPER-TASK = Higher Low Risk	EXPER-TASK = Higher High Risk
\$388,000	n = 6 78.33, 85.00	\$230,000	n = 1 20.00, 20.00	\$271,000	n = 1 60.00, 60.00	9.00	n = 0	n = 1	n = 0	n = 0
		\$388,000	n = 5 82.50, 85.00	\$388,000	n = 4 82.50, 85.00	5.00	n = 2	n = 0	n = 1	n = 1
				\$456,000	n = 1 80.00, 80.00	5.00	n = 0	n = 0	n = 0	n = 1
\$456,000	n = 4 82.50, 85.00	\$456,000	n = 3 80.00, 80.00	\$456,000	n = 3 83.33, 80.00	3.00	n = 2	n = 0	n = 0	n = 1
		\$531,000	n = 1 0.00, 0.00	\$531,000	n = 1 10.00, 10.00	1.00	n = 1	n = 0	n = 0	n = 0
\$531,000	n = 5 76.00, 80.00	\$230,000	n = 2 40.00, 40.00	\$531,000	n = 2 40.00, 40.00	2.50	n = 0	n = 1	n = 1	n = 0
		\$531,000	n = 3 66.67, 70.00	\$531,000	n = 3 66.67, 70	1.00	n = 1	n = 0	n = 1	n = 1

The GAAP appropriateness judgment is made on a scale of 0 (not confident regarding appropriateness under GAAP) to 100 (very confident regarding appropriateness under GAAP)
n = 65.

Dependent Variables

Our process measure used to test H1 is the level of concessions (*CONCESSIONS*) the auditor makes to the client between the opening bid and the final negotiated outcome, i.e.: $[(\$final\ outcome - \$round\ one\ bid) / \$round\ one\ bid]$.¹²

Our first outcome measure, used to test H2, is the monetary amount of the alternative agreed to in the final round of the negotiation: *FINAL OUTCOME*. Higher final outcomes indicate that the auditor was willing to accept a more aggressive revenue recognition alternative from among the available alternatives. Our second outcome measure, used to test H3, measures auditors' judgments regarding the appropriateness of the final negotiated outcome under GAAP on a scale graduated in ten-point intervals from 0 (not confident regarding appropriateness under GAAP) to 100 (very confident regarding appropriateness under GAAP): *GAAP APPROPRIATE*. Using this variable, we are able to make inferences about auditors' perceptions of the final negotiated outcomes that they achieved.

RESULTS AND DISCUSSION

Manipulation Check

To test the experimental manipulation, we analyzed responses to the question: "The term engagement risk refers to an audit firm's exposure to loss or injury to his or her professional practice from litigation, adverse publicity, or other events arising in connection with financial statements audited or reported on. Based on the information presented in this case, how would you assess engagement risk?" Responses were on a scale from 1 (extremely low risk) to 7 (extremely high risk). The mean (standard deviation) responses were 4.73 (1.10) and 4.00 (1.41) for auditors in the high risk and low-risk conditions, respectively. The difference in means is significant ($t = 2.320$, $p = 0.012$, one-tailed), indicating a successful experimental manipulation.

Descriptive Analyses

Table 1 provides descriptive analyses concerning auditors' negotiation strategies, enabling an anecdotal understanding about how auditors proceeded through the negotiation process. For example, results in the first row of the table reveal that 19 auditors preferred the most conservative alternative (\$230,000) prior to starting the negotiation process, and they were quite confident (about 86 percent) that this alternative was acceptable under GAAP. Eighteen of these auditors bid this alternative during the first round of negotiations, while one auditor bid \$271,000. Of the 18 auditors bidding \$230,000 in the first round of negotiations, only six auditors (all of whom had higher negotiation experience) ultimately achieved that bid as the final outcome, and all refused to concede to the client's aggressive preference across all ten rounds of the negotiation.

In addition to examining specific auditor behaviors through the negotiation process, notice that, overall, auditors are often not very strategic in terms of offering their opening bid at an amount that enables them more bargaining space in subsequent rounds of the negotiation, which is consistent with the audit adjustment results in Ng and Tan (2003) and the planned negotiation strategy results in Bame-Aldred and Kida (2007). Of the 46 auditors whose preferred bid was \$271,000 or more, only 13 of these auditors' opening bids were less than (i.e., more conservative than) their most preferred alternative.

¹² We test the sensitivity of our results to alternative specifications of this variable. We measure concessions based on (1) the round-two bid and (2) the most preferred alternative prior to round one, and find that results are essentially equivalent to those we report, with no changes in inferences for hypothesis tests.

Hypothesis Tests

The results in Table 2 provide descriptive statistics by experimental cell, and the results in Table 3 report the results of analyses used to test H1, H2, and H3. Regarding H1, we investigate whether auditors with lower negotiation experience use a more concessionary negotiation strategy in the high-risk context than in the low-risk context, and whether auditors with higher negotiation experience use a less concessionary negotiation strategy regardless of risk context, i.e., an ordinal interaction of *RISK* × *TASK EXPERIENCE* on *CONCESSIONS*. Because we are testing an ordinal interaction, we use contrast coding to test our predictions (Buckless and Ravenscroft 1990).

Results in Table 2 and Table 3 Panel A provide support for H1, showing that lower negotiation experience auditors in the high-risk context make significantly more concessions (mean = 48 percent) than auditors in the other cells ($F = 6.113$, $p = 0.008$) (means ranging from 18 percent to 26 percent). Panel B provides sensitivity tests, relaxing the stringent assumption from Panel A that cell weights of the lower negotiation experience/low risk group are equivalent to those of the high negotiation experience groups. Panel B assumes that the weights for the lower negotiation experience/low risk group fall between the weights of the lower negotiation experience/high risk group and the higher negotiation experience groups. These sensitivity tests also support H1 ($F = 5.278$, $p = 0.013$). We also

TABLE 2
Descriptive Statistics
($n = 65$)

		Auditor Negotiation Experience	
		Lower	Higher
		<i>TASK EXPERIENCE</i> n = 18	<i>TASK EXPERIENCE</i> n = 14
Low	<i>CONCESSIONS</i>	= 0.18 (0.33)	= 0.25 (0.39)
	<i>FINAL OUTCOME</i>	= \$369,667 (\$103,708)	= \$333,000 (\$104,123)
	<i>GAAP APPROPRIATE</i>	= 62.22 (32.99)	= 77.86 (15.28)
	<i>ROUNDS</i>	= 6.00	= 7.00
<i>RISK</i>			
		n = 15	n = 18
High	<i>CONCESSIONS</i>	= 0.48 (0.29)	= 0.26 (0.37)
	<i>FINAL OUTCOME</i>	= \$388,133 (\$73,783)	= \$350,778 (\$102,645)
	<i>GAAP APPROPRIATE</i>	= 63.33 (26.63)	= 81.11 (14.91)
	<i>ROUNDS</i>	= 5.60	= 6.67

Data represent the mean (standard deviation).

Variable Definitions:

TASK EXPERIENCE = 1 if auditor has participated in 11 or more client-auditor interactions in the last three years to resolve a complex financial reporting issue, 0 if auditor has participated in 10 or fewer such interactions;

RISK = 1 for high engagement risk manipulation, 0 for low engagement risk manipulation;

CONCESSIONS = (final outcome – round one bid)/round one bid;

FINAL OUTCOME = cost of final alternative to which auditor and client agreed;

GAAP APPROPRIATE = auditor's judgment about whether the final outcome is an appropriate method under GAAP on a scale from 0 (not confident that it is appropriate) to 100 (very confident that it is appropriate); and

ROUNDS = number of negotiation rounds completed.

TABLE 3
Planned Contrasts

Panel A: Hypothesis Tests

	Hypothesis, Variable, and Expectation	F	p-value
H1	<i>CONCESSIONS</i> (low experience/high risk cell highest) Cell Weights: 0.1875 for low experience/high risk and -0.0625 for the other three cells	6.113	0.008
H2	<i>FINAL OUTCOME</i> (low experience/high risk cell highest) Cell Weights: \$56,250 for low experience/high risk and -\$18,750 for the other three cells	1.756	0.095
H3	<i>GAAP APPROPRIATE</i> (low experience/high risk cell lowest) Cell Weights: -18.75 for low experience/high risk and 6.25 for the other three cells	2.281	0.068

Panel B: Sensitivity Tests with Less Restrictive Cell Weights

	Hypothesis, Variable, and Expectation	F	p-value
H1	<i>CONCESSIONS</i> (low experience/high risk cell highest) Cell Weights: 0.175 for low experience/high risk, -0.025 for low experience/low risk, and -0.075 for the other two cells	5.278	0.013
H2	<i>FINAL OUTCOME</i> (low experience/high risk cell highest) Cell Weights: \$135,000 for low experience/high risk, \$35,000 for low experience/low risk, and -\$8,500 for the other two cells	2.629	0.055
H3	<i>GAAP APPROPRIATE</i> (low experience/high risk cell lowest) Cell Weights: -16.25 for low experience/high risk, -1.25 for low experience/low risk, and 8.75 for the other two cells	5.419	0.012

Reported probabilities are one-tailed for directional expectations. We determined contrast weights by subtracting the overall expected mean for all cells from the expected mean for each cell as in Buckless and Ravenscroft (1990). For example, in testing *CONCESSIONS*, the overall expected mean for all cells was 0.3125 $([0.50 + 0.25 + 0.25 + 0.25]/4)$ and the individual expected means were 0.50, 0.25, 0.25, and 0.25; $n = 65$. The contrasts in Panel A are stringent tests of the hypotheses because they assume responses of the low experience/low risk group are equivalent to those of the high experience/high risk and high experience/low risk groups.

Panel B uses less stringent contrast weights that relax this assumption, such that the weight for the low experience/low risk cell falls between the weights of the low experience/high risk cell and the other two cells.

Variable Definitions:

CONCESSIONS = (final outcome - round one bid)/round one bid;

FINAL OUTCOME = cost of final alternative to which auditor and client agreed; and

GAAP APPROPRIATE = auditor's judgment about whether the final outcome is an appropriate method under GAAP on a scale from 0 (not confident that it is appropriate) to 100 (very confident that it is appropriate).

test the sensitivity of our results to using a continuous measure of the dollar value of concessions, and those results also support H1 ($F = 6.984$, $p = 0.005$).

To test H2, we investigate whether auditors with lower negotiation experience have a less conservative final negotiated outcome in the high-risk context than in the low-risk context, and whether auditors with higher negotiation experience have similar final negotiated outcomes regardless of risk context, i.e., an ordinal interaction of *RISK* \times *TASK EXPERIENCE* on *FINAL OUTCOME*. Results in Table 2 and Table 3, Panel A provide support for H2, showing that lower negotiation experience auditors in the high-risk context have a marginally less conservative outcome (mean = \$388,133) than auditors in the other

cells ($F = 1.756$, $p = 0.095$) (means ranging from \$333,000 to \$369,667). Table 3, Panel B provides sensitivity tests, relaxing the stringent assumption from Panel A regarding cell weights. These sensitivity tests also support H2 ($F = 2.629$, $p = 0.055$).

Regarding H3, we investigate whether auditors with lower negotiation experience are less confident about whether the final negotiated outcome is an appropriate method under GAAP in the high-risk context than in the low-risk context, and whether auditors with higher negotiation experience have similar levels of confidence about GAAP appropriateness regardless of risk context, i.e., an ordinal interaction of *RISK* \times *TASK EXPERIENCE* on *GAAP APPROPRIATE*. Results in Table 3, Panel A provide support for H3, showing that lower negotiation experience auditors in the high-risk context are marginally less confident about whether their final outcomes are appropriate under GAAP (mean = 63.33 on a scale where 0 equals “not confident regarding appropriateness under GAAP” and 100 equals “very confident regarding appropriateness under GAAP”) than auditors in the other cells ($F = 2.281$, $p = 0.068$) (means ranging from 62.22 to 81.11). Table 3, Panel B provides sensitivity tests, relaxing the stringent assumption from Panel A regarding cell weights. These sensitivity tests also support H3 ($F = 5.419$, $p = 0.012$).¹³

Exploratory Analysis of Mediating Role of Client Pressure

In this exploratory analysis, we seek to test a potential behavioral explanation for why lower negotiation experience auditors in the high-risk context behave as they do during negotiations. To conduct our analysis, we examine auditors' perceptions of the pressure imposed on the auditor by the client during negotiations (*CLIENT PRESSURE*) by measuring the extent to which auditors believe they will have to persuade the client toward a more conservative alternative. We assert that the more an auditor believes they will have to persuade the client, the greater the pressure they likely perceive from the client to allow more aggressive reporting. We explore whether auditors with lower negotiation experience will perceive greater client pressure in the high-risk context than in the low-risk context, whereas auditors with higher negotiation experience will perceive a similar level of pressure regardless of risk context, i.e., an ordinal interaction of *RISK* \times *TASK EXPERIENCE* on *CLIENT PRESSURE*.

Prior to each round of negotiation we asked, “What is the likelihood that you will have to persuade the client that your alternative is the best method?” with response scales ranging from 0 percent (“I will not have to persuade the client”) to 50 percent (“There is a range of mutually acceptable outcomes within which agreement can be found”) to 100 percent (“I will have to persuade the client”). As noted previously, auditors were unaware during round one of the client's aggressive preference, but they became aware of that at the end of round one. We measure client pressure as the pre-round-two likelihood assessment minus the pre-round-one likelihood assessment, thereby using each subject as his or her own control in a within-subject assessment of the change in likelihood prior to and after learning

¹³ We also tested the sensitivity of these results to (1) using a continuous measure of negotiation experience and (2) controlling for manufacturing experience in the contrast coding calculations. Using a continuous measure of negotiation experience, the regression results are essentially equivalent to those we report, with interaction results as follows: *CONCESSIONS* ($F = 5.868$, $p = 0.009$), *FINAL OUTCOME* ($F = 1.765$, $p = 0.094$), and *GAAP APPROPRIATE* ($F = 2.183$, $p = 0.073$). Controlling for manufacturing experience in the contrast coding calculations, the results are also essentially equivalent to those we report, with the results as follows: *CONCESSIONS* ($F = 6.378$, $p = 0.007$), *FINAL OUTCOME* ($F = 1.727$, $p = 0.097$), and *GAAP APPROPRIATE* ($F = 5.347$, $p = 0.012$).

about the client's aggressive preference. The larger the positive change in this measure, the greater client pressure we infer.¹⁴

We present results of this exploratory analysis in Table 4. Results in Panel A show that auditors with lower negotiation experience in the high-risk condition perceive an increase in client pressure upon learning the client's aggressive alternative (+9.33; $t = -1.836$, $p = 0.045$), with a mean shift toward the high point of the scale. In contrast, all the other auditors show relative movement toward the midpoint of the scale (although only the change for higher experience auditors in the high-risk context is significant, -18.89 ; $t = 2.287$, $p = 0.036$). This implies that auditors with lower negotiation experience in the high-risk condition moved toward the "I will have to persuade the client" end of the scale, possibly reflecting a belief that they will have a tough fight ahead with this aggressive client. The other auditors moved toward the "There is a range of mutually acceptable outcomes within which agreement can be found" end of the scale, possibly reflecting a belief that they will be able to work with the client to find some mutually acceptable outcome.

We provide contrast coding results in Table 4, Panel B, revealing an ordinal interaction of *RISK* \times *TASK EXPERIENCE* on *CLIENT PRESSURE* ($F = 5.143$, $p = 0.014$). To understand how this behavior affects the negotiation process and outcome, we then conduct a mediation analysis to determine whether client pressure mediates the relationship between *RISK* and *CONCESSIONS*, *FINAL OUTCOME*, and *GAAP APPROPRIATE*. Mediator variables are those that help to explain how external events (i.e., the riskiness of the audit engagement) take on internal psychological importance (i.e., client pressure) to affect another variable (i.e., negotiation process or outcome). To conduct the analysis, we use the procedures introduced by Baron and Kenny (1986), and updated in Kenny et al. (1998), Shrout and Bolger (2002), and Frazier et al. (2004).

To test for mediation in our context, we examine whether two conditions are met: (1) the independent variable (*RISK*) must influence the potential mediator (*CLIENT PRESSURE*)—we refer to this relationship as "path a," and (2) the potential mediator must affect the dependent variable (*CONCESSIONS*, *FINAL OUTCOME*, or *GAAP APPROPRIATE*) after controlling for the effects of the independent variable—we refer to this relationship as "path b." In our setting, we are interested in understanding the differing negotiation process and outcome behavior of auditors with less versus more negotiation experience. Therefore, to conduct our tests, we estimated mediation models in which the dependent variable is *CONCESSIONS*, *FINAL OUTCOME*, or *GAAP APPROPRIATE*, and we estimate these models separately for the two auditor experience groups. We present results in Table 4, Panel C.

The results reveal that *CLIENT PRESSURE* does not mediate the relationship between *RISK* and the negotiation process or outcome for auditors with higher negotiation experience. However, *CLIENT PRESSURE* does mediate the relationship between *RISK* and *CONCESSIONS* and between *RISK* and *GAAP APPROPRIATE* (but not between *RISK* and *FINAL OUTCOME*) for lower negotiation experience auditors. Therefore, client pressure seems to mediate the effect of risk on both the negotiation process and the confidence that those lower negotiation experience auditors have in the final outcomes that they ultimately achieve.

¹⁴ A plausible alternative is that auditors perceive this question to reflect "negotiation bargaining power." Auditors with more experience may believe that they have equal bargaining power in both the high and low-risk conditions, while auditors with less experience may believe that they have less bargaining power, especially in the high-risk condition, with a greater likelihood of management's desire to achieve higher earnings.

TABLE 4
Exploratory Analysis of Auditor Perceptions of Client Pressure

Panel A: Descriptive Statistics

	<u>Round 1</u>	<u>Round 2</u>	<u>Round 2 Minus Round 1 (CLIENT PRESSURE)</u>	<u>t-test (p-value)</u>
Lower Experience, Low Risk	53.33	46.88	-7.78	1.155 (0.266)
Lower Experience, High Risk	59.33	68.57	9.33	-1.836 (0.045)
Higher Experience, Low Risk	62.14	50.77	-11.43	0.983 (0.345)
Higher Experience, High Risk	63.33	44.12	-18.89	2.287 (0.036)

Panel B: Supplementary Planned Contrast Tests

<u>Variable and Expectation</u>	<u>F</u>	<u>p-value</u>
<i>CLIENT PRESSURE</i> (low experience/high risk cell highest) Cell Weights: 7.5 for low experience/high risk and -2.5 for the other three cells	5.143	0.014

Panel C: Mediation Analysis

	<u>Lower Experience</u>	<u>Higher Experience</u>
Does client pressure mediate the relationship between <i>RISK</i> and <i>CONCESSIONS</i> ?	Yes	No
Path A	B = 18.75 p = 0.030	B = -7.69 p = 0.304
Path B	B = 0.003 p = 0.078	B = 0.002 p = 0.206
Does client pressure mediate the relationship between <i>RISK</i> and <i>FINAL OUTCOME</i> ?	No	No
Path A	B = 18.75 p = 0.030	B = -7.69 p = 0.304
Path B	B = 469.88 p = 0.226	B = 162.13 p = 0.360
Does client pressure mediate the relationship between <i>RISK</i> and <i>GAAP APPROPRIATE</i> ?	Yes	No
Path A	B = 18.75 p = 0.030	B = -7.69 p = 0.304
Path B	B = -0.439 p = 0.020	B = -0.147 p = 0.021

Values in the table represent auditors' assessment of the likelihood they will have to persuade the client that their own alternative is the best method on a scale anchored from 0 percent (I will not have to persuade the client; the client preferred alternative is acceptable) to 50 percent (There is a range of mutually acceptable outcomes within which agreement can be found) to 100 percent (I will have to persuade the client that my alternative is the most acceptable). The assessment occurs prior to each round of negotiation. Prior to Round 1, the auditor is unaware of the client's aggressive revenue recognition preference, but learns that fact after round 1 (i.e., just before round 2). Reported probabilities are one-tailed for the directional expectation associated with the lower experience, high risk group, and are two-tailed otherwise; n = 65. Reported probabilities are one-tailed.

Variable Definition:

CLIENT PRESSURE = auditor's pre-round two assessment of the likelihood they will have to persuade the client that their own alternative is the best method minus auditor's pre-round one assessment, i.e., change in the likelihood of having to persuade the client.

Exploratory Analysis of Auditors' Reported Reasons for Their Strategy

To provide additional descriptive insight on auditors' behavior, we analyze their reported reasons for their choices during negotiation. We report the results of this analysis in Table 5, with Panel A detailing the available alternatives and Panel B detailing the results

TABLE 5
Auditors' Reasons for Negotiation Strategy

Panel A: Menu-Provided Reasons

Menu-Provided Reasons for Strategy

1. This is a low risk engagement, so I am inclined to allow for an alternative that is more in line with the client's preference.
2. I believe that the alternative that I propose is the most logical choice.
3. The issue is not precisely defined by GAAP and an argument can be made to recognize revenue based on elapsed time or based on usage.
4. I am attempting to provide an alternative that is mutually acceptable to both me and the client but also one that is not overly aggressive.
5. This is a risky engagement; therefore, there is no room for discussion in support of an alternative other than the one that I have indicated.
6. I believe that the client proposed method is reasonably defensible, so I am willing to agree to that.
7. I am attempting to provide an alternative that is mutually acceptable to both me and the client, but I cannot accept a method that recognizes revenue based solely on elapsed time.

Panel B: Results by Experimental Cell (n = 65)

EXPERIENCE-TASK = Lower, Engagement Risk = Low

Round	1	2	3	4	5	6	7	8	9	10	Total Reasons (%)
Reason 1	0	0	0	0	1	0	0	0	0	0	1 (1%)
Reason 2	9	6	6	9	7	6	5	4	2	1	55 (51%)
Reason 3	4	3	2	2	1	0	0	0	0	0	12 (11%)
Reason 4	2	1	3	3	1	0	2	2	1	0	15 (14%)
Reason 5	1	1	0	0	2	0	0	0	0	0	4 (4%)
Reason 6	0	0	0	0	0	0	0	0	2	1	3 (3%)
Reason 7	1	6	6	1	1	1	0	1	0	0	17 (16%)
Total	17	17	17	15	13	7	7	7	5	2	107

EXPERIENCE-TASK = Lower, Engagement Risk = High

Round	1	2	3	4	5	6	7	8	9	10	Total Reasons (%)
Reason 1	0	0	0	0	0	0	0	0	0	0	0 (0%)
Reason 2	8	3	2	6	7	1	0	0	0	0	27 (29%)
Reason 3	3	4	1	1	1	1	0	1	0	0	12 (13%)
Reason 4	3	4	5	8	4	3	3	1	1	0	32 (34%)
Reason 5	0	0	0	1	0	0	1	1	0	0	3 (3%)
Reason 6	0	1	0	0	1	1	0	0	0	0	3 (3%)
Reason 7	2	4	6	1	3	0	0	1	0	0	17 (18%)
Total	16	16	14	17	16	6	4	4	1	0	94

(continued on next page)

TABLE 5 (continued)

EXPERIENCE-TASK = Higher, Engagement Risk = Low

Round	1	2	3	4	5	6	7	8	9	10	Total Reasons (%)
Reason 1	0	0	0	0	0	0	0	0	1	0	1 (1%)
Reason 2	10	4	4	7	6	5	2	3	2	2	45 (44%)
Reason 3	1	0	1	0	1	1	1	0	0	0	5 (5%)
Reason 4	2	4	4	4	2	2	1	0	0	0	19 (19%)
Reason 5	0	0	0	0	1	1	2	2	0	0	6 (6%)
Reason 6	0	0	1	0	0	0	0	1	1	0	3 (3%)
Reason 7	2	6	4	2	3	1	2	2	1	0	23 (23%)
Total	15	14	14	13	13	10	8	8	5	2	102

EXPERIENCE-TASK = Higher, Engagement Risk = High

Round	1	2	3	4	5	6	7	8	9	10	Total Reasons (%)
Reason 1	0	0	0	0	0	0	0	0	0	0	0 (0%)
Reason 2	9	3	6	6	6	4	2	2	1	1	40 (34%)
Reason 3	2	4	2	1	2	0	1	0	0	0	12 (10%)
Reason 4	4	5	4	5	5	3	3	3	1	1	34 (29%)
Reason 5	0	0	0	2	1	1	2	2	0	0	8 (7%)
Reason 6	0	0	1	0	0	2	0	0	1	1	5 (4%)
Reason 7	2	4	5	1	1	2	1	1	2	0	19 (16%)
Total	17	16	18	15	15	12	9	8	5	3	118

Numbers represent the frequency with which each reason was selected by round.

by experimental cell. The results reveal that the most common reason describing choices during negotiation was reason 2 (choosing an alternative because it is a logical one), followed by reasons 4 and 7 (choosing an alternative because it is mutually acceptable to themselves and the client). However, the rationale for choices made during negotiation diverges between auditors with lower versus higher negotiation experience. For lower negotiation experience auditors, the results show that higher engagement risk moves them from choosing an alternative based on a logical choice toward choosing an alternative based on something that is mutually acceptable. For example, lower negotiation experience auditors indicated reason 2 51 percent (29 percent) of the time in the low (high) engagement risk contexts. Further, lower negotiation experience auditors indicated reasons 4 and 7 30 percent (14 percent plus 16 percent) of the time when engagement risk was low, but indicated these reasons 52 percent (34 percent plus 18 percent) of the time when engagement risk was high. Thus, the lower negotiation experience auditors in the high-risk condition shifted the rationale underlying their choices during negotiation from one based on logic to one based on mutual acceptability with the client's preferences.

CONCLUSIONS

This study has some limitations. First, our programmed "client" responded uniformly and in a concessionary manner regardless of auditor choice, which was done to assure experimental control. In actual negotiations, the persuasiveness of client reasons might

affect negotiations, so future research could investigate the role of persuasion in client-auditor negotiation. Second, our setting has certain external validity limitations. For example, we do not study the role of audit committees as a mediator of negotiations between management and the auditors; we study a single period game, so we do not measure long-term client-auditor relationship satisfaction; and the setting does not allow for consideration of multiple issues that would enable integrative solutions. Third, our measure of task-specific negotiation experience is narrow, which thereby limits generalizability of our results to other task experience contexts. Future research is needed to further explore the interrelationships and nature of various dimensions of negotiation experience and knowledge, and how they affect the negotiation process and outcomes. Finally, we require the auditors in our experiment to identify a preferred alternative before knowing the client's preference, which may not be reflective of the actual audit environment.

This study examines how auditors negotiate with clients, focusing on the effects of engagement risk and auditor negotiation experience. We report that auditors with lower negotiation experience (1) use a more concessionary negotiation strategy, (2) have a less conservative final negotiated outcome, and (3) are less confident about whether the outcome is an appropriate method under GAAP in the high-risk context than in the low-risk context, whereas auditors with higher negotiation experience have a similar negotiation process and outcome regardless of risk context.

In exploratory analyses, we seek to provide a behavioral explanation for the actions of the lower negotiation experienced auditors who encountered high engagement risk. We find that these auditors perceive a heightened sense of what might be characterized as client pressure, whereas auditors with higher negotiation experience perceive a similar level of client pressure regardless of risk context. This pressure, in turn, mediates the relationship between risk and both the negotiation process and lower experience auditors' confidence in its outcome. These results extend prior literature on the relationship between auditor experience and perceptions of client pressure (e.g., Moreno and Bhattacharjee 2003; Farmer et al. 1987) by using a task-specific measure of auditor experience (rather than auditor rank), which provides further insight on the important role of tacit management skills in high level auditors' performance of complex decision-making tasks. In essence, some managers and partners have more exposure to being engaged in negotiation (i.e., practice) and therefore develop better tacit management skills associated with negotiation compared with other managers and partners. Future research could extend our results by investigating the specific types of tacit management skills that more experienced negotiators use and how they develop those skills.

These results extend the auditor-client negotiation literature in Bame-Aldred and Kida (2007), which reports that auditors are less flexible in their negotiation strategies compared with clients. We show that variation in negotiation strategy is associated with auditor experience and the interaction of that experience with client-specific characteristics. The practical implication is that despite the expectation of conservatism required by GAAP, under certain circumstances some auditors may acquiesce more readily to client pressures than other auditors. From the perspective of stakeholders (e.g., investors and regulators), this is not necessarily an optimal criterion for decisions that impact financial statements, and from an audit firm perspective this is not optimal for portfolio risk management. Our experience-related results complement those in Trotman et al. (2005) and Trotman et al. (2009), who use general experience measures. Future research that documents performance improvements associated with training interventions in practice, or that develops knowledge measures for client-auditor negotiation tasks, would provide useful extensions to the literature.

In addition, future research could consider how training interventions versus actual task-relevant practice achieve performance improvements differentially.

Other exploratory analyses reveal that for auditors with lower negotiation experience, heightened engagement risk is associated with a shift in choosing an alternative based on a *logical choice* toward choosing an alternative based on something that is *mutually acceptable* to both the client and the auditor. Such a shift might imply that the negotiated outcome is less justifiable than the original alternative. Justification of negotiated outcomes is particularly important given the requirement in Sarbanes-Oxley, Section 204 (U.S. House of Representatives 2002) and Regulation S-X (SEC 2003) that auditors report to the audit committee “all alternative treatments within Generally Accepted Accounting Principles for policies and practices related to material items that have been discussed with management of the issuer or registered investment company, including: ramifications of the use of such alternative disclosures and treatments; and the treatment preferred by the registered public accounting firm” (Rule 2–07). Future research can extend our analysis by examining the roles of accountability and justification in client-auditor negotiations, from the perspective of auditors, clients, and regulators.

APPENDIX A

Summary of Case Facts and Revenue Recognition Alternatives

Panel A: Case Facts

- 12-Month contract, of which 8 months have elapsed
 - Contract price = \$797,000
 - Contract hours = 500
 - Average revenue per hour = $\$797,000/500 = \$1,594$
- Gross margin percentage = 30%
- Actual hours used as of 12/31 = 144
 - 78 Flight hours
 - 66 Ferry hours
- Contract per usage hour
 - Flight hours = \$2,274
 - Ferry hours = \$1,423
- Total costs per hour of usage = \$531
 - Fixed (75%) = $75\% \times \$531 = \400
 - Variable (25%) = $25\% \times \$531 = \131

Panel B: Potential Revenue Recognition Alternatives

1. Average Rate

Actual hours	144
Average revenue per hour	$\times \$1,594$
Revenue recognized (rounded)	<u><u>\$230,000</u></u>

3. Straight-Line/Hours Used

Hours Used:

Actual hours	144
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Hourly rate based on usage:

$[\$531/(100\% - 30\%)]$	$\times \$759$
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Revenue based on hours used:	(a) \$109,000
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Straight-Line:

Contract hours	500
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Hourly rate based on usage	$\times \$759$
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2. Usage Rate

Revenue based on flight hours (78 h × \$2,274)	\$177,372	Subtotal	\$379,500
Revenue based on ferry hours (66 h × \$1,423)	<u>\$93,918</u>	Contract revenue remaining (\$797,000 – \$379,500)	\$417,500
Revenue recognized (rounded)	<u>\$271,000</u>	Percent time elapsed (8 months/12 months)	66.67%
		Revenue based on straight-line:	(b) \$279,000
		Revenue recognized (rounded)	(a + b) <u>\$388,000</u>

4. Fixed/Variable Costs

Revenue based on fixed costs:
(75%) × (8 months/12
months) × (\$797,000) \$398,500

5. Straight-Line

Revenue based on variable costs: (25%) × (144 h/500 h) × (\$797,000)	<u>\$57,384</u>	Contract price × percent time elapsed (8 months/12 months):	\$797,000 66.67%
Revenue recognized (rounded)	<u>\$456,000</u>	Revenue recognized (rounded)	<u>\$531,000</u>

APPENDIX B**Client Responses to Auditor Bid Proposals by Negotiation Round**

Round	Client's Proposed Alternative	Client's Programmed Response to Auditor
1	Straight-Line (\$531,000)	I disagree. I believe that the best method is the straight-line method. This is a take or pay contract so the Navy is committed to the guaranteed 500 h of usage. In this situation the Navy has not established a pattern of use or provided a projected timetable for when they will use the hours. I believe that it is reasonable to recognize revenue evenly over the life of the contract.
2	Straight-Line (531,000)	GAAP allows us to use reliable estimates as long as they can be reasonably ascertained. Further, SAB 101 allows recognition of revenue based on elapsed time if services are recorded continuously over time.
3	Fixed/Variable Cost (\$456,000)	If you are adamant about not allowing the straight-line method, the fixed/variable cost method may be more acceptable to you. Under this method revenue is matched with costs used to generate the revenue. Additionally, I believe that other companies in this industry also use this method.
4	Fixed/Variable Cost (\$456,000)	I am not sure why you disagree with this method since it provides a better matching of revenues and costs. Also, the fixed/variable cost method allows for revenue to be recognized based on the time elapsed and usage, which I believe is an acceptable way of recognizing revenue under a guaranteed contract.

(continued on next page)

Round	Client's Proposed Alternative	Client's Programmed Response to Auditor
5	Straight-Line/Hours Used (\$388,000)	I disagree with your reasoning. However, we need to agree on an alternative that we can both live with. I suggest that we split the difference. The straight-line/hours of usage method should provide a number that you can live with. Further, this method provides for revenue based on costs, which should satisfy matching concerns, but it also allows for revenue based on the amount of time that the contract has been outstanding, which is a more realistic economic measure.
6	Straight-Line/Hours Used (\$388,000)	Again, I reiterate my objection. Your proposed method is no more defensible than the method that I proposed given that GAAP allows us to report revenue based on reasonable estimates in these types of situations and I believe that the method I propose is more than reasonable.
7	Straight-line/Hours Used (\$388,000)	I think that you are being somewhat unreasonable in this situation. I believe that I have offered a viable alternative that satisfies both of our concerns. Besides, the method meets all four of the principles for recognizing revenue. We are matching revenues with costs; given that this is a take or pay contract, it makes economic sense to recognize a portion of the revenues based on time elapsed; the amounts and assumptions are reasonable and reliable given the contract terms; and GAAP allows reasonable estimates in these types of situations.
8	Usage Rate (\$271,000)	Okay, this is my final offer. I have been reasonable in trying to come up with reporting alternatives that satisfy both of our objectives. Under this method revenues will be recognized based on usage. While I believe this alternative ignores the economic substance of the transaction, it clearly satisfies the matching and reliability principles.
9	Usage Rate (\$271,000)	I believe this method is very conservative. Yet you are still not satisfied with it. Surely, reporting revenue based on usage is an acceptable method given that all of the principles required to record revenue have been met. Let me qualify that by going on record that I do not believe this method provides for a true picture of the economic substance of the transaction.
10	No Alternative Proposed—Client Accepts Auditor's Alternative	While I strongly disagree with your conclusion, I can see that you will not budge. So I have no other choice but to accept your final decision. Therefore, I will tell the Controller to book the revenue based on the alternative you want. Thank you.

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