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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.

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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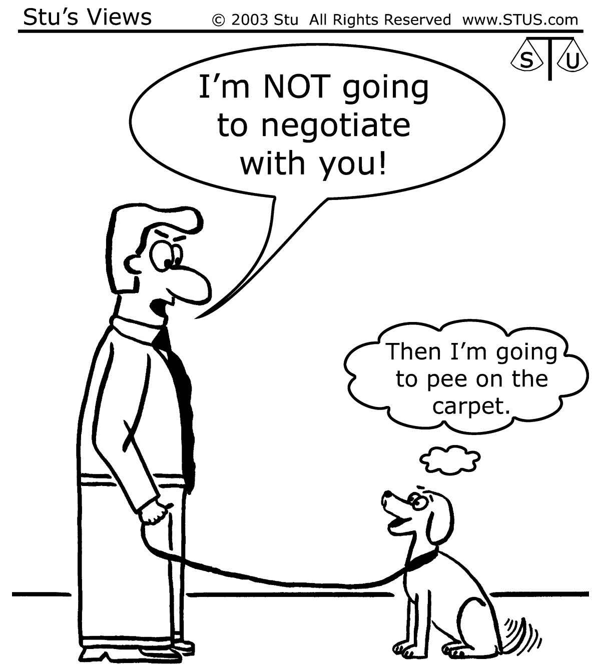

example, Hatfield, Houston, Stefaniak, and Usrey (2010) found that 76% of the auditors in their study stuck with their initial offer.

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.

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