The impact of the existence and timing of concessions in multi-period auditor-client negotiations

Aileen Tse

Supervised by
Professor Ken Trotman and Dr Mandy Cheng
University of New South Wales

ABSTRACT

This study aims to investigate the impact of auditor concessions on CFO’s pre-negotiation judgments and strategy selection in a subsequent negotiation. I will conduct an experiment in which CFOs are given information about the auditor’s negotiation behaviour in last year’s negotiation and are asked to complete a questionnaire in preparation for an upcoming negotiation with the same auditor. The auditor’s past concessionary strategy is manipulated at three levels: no concession, gradual concession and delayed concession. This paper responds to calls in the general negotiation literature for researchers to examine negotiations as a chain of interrelated exchanges, rather than as independent, stand-alone events. Consistent with existing studies on auditor concessions, I argue that concessionary strategies are useful in inducing clients to post income-decreasing audit adjustments. However, auditors must consider the longer-term impact of various concessionary strategies as a precedent of giving non-credible concessions may render clients less cooperative in subsequent negotiations.
The impact of the existence and timing of concessions in multi-period auditor-client negotiations

1. INTRODUCTION

This study examines how the existence and timing of concessions by the auditor in one negotiation affects the client’s behaviour in the subsequent period. Auditors and client management frequently engage in negotiation to resolve disagreements over financial reporting decisions. These disagreements typically arise because of ambiguous or non-existent guidance in GAAP, and often take weeks, or even months to resolve (Gibbins et al 2001, Gibbins et al 2005). Gibbins et al (2001) documents that 67% of audit partners report to having experienced negotiations with at least half of their clients and that negotiations are regarded as a normal part of serving the client. More recently, negotiations between auditors and client management have become a contentious issue. Regulators’ attempts to limit negotiations regarding proposed audit adjustments are evidenced by their efforts to strengthen materiality rules. As well, some auditors in the United States now require the reporting of all unrecorded audit differences that are not clearly inconsequential. Given the current environment, the impact of auditor concessions and in particular, whether or not concessions can be used strategically to induce client cooperation remain worthy questions.

The way in which negotiations are handled are of paramount importance. On the one hand, auditors are required to ensure that the financial statements provide a faithful representation of the company by detecting and correcting misstatements. This is necessary in order to manage litigation risk and potential loss of reputation. On the other hand, auditors need to maintain positive relations with their clients in order to avoid unnecessary conflict and the potential loss of clients (Trotman et al. 2005). The widespread practice of staff training in negotiations in auditing firms (Trotman et al. 2005) reflects the profession’s recognition that there is potential for improvement. A number of studies have sought to find ways of improving auditors’ negotiation performance. Trotman et al (2005) explores the use of intervention methods, focussing particularly on the impact of an improved understanding of the clients’ interests and options. Sanchez et al (2007) investigates the use of a concessionary strategy to induce clients to reciprocate by posting larger income-decreasing audit adjustments, while Tan and Trotman (2007) extends research into the strategic use of concessions by examining the impact of concession timing. This line of research is consistent with Gibbins et al’s (2006) finding that responsibility for the negotiation process, resolution of the disagreement and management of the relationship falls on the auditor’s shoulders. Interestingly, that study also reports that neither audit partners nor client management adopt a strategic approach in negotiations. This is encouraging as it suggests there is potential to improve the quality of negotiations between auditors and auditees by training auditors to use appropriate bargaining tactics.

This study extends the extant research by investigating the impact of negotiation strategies in multi-period negotiations. Specifically, it focuses on the effect of the existence and timing of concessions over time. Three concessionary strategies are examined – no concession, gradual concession and delayed concession. 45 financial officers assume the role of a newly appointed Chief Financial Officer in a hypothetical company. They are given information on the company’s financial position and a description of the prior year’s negotiation with the auditor. Participants are told that the auditor has proposed a material adjustment in the present period. They are required to prepare for the hypothetical negotiation by completing a questionnaire indicating their expectations and intended behaviour in the upcoming negotiation. Consistent with Sanchez et al (2007), I argue that the use of concessions in auditor-client negotiations is beneficial as it induces reciprocation in the form of clients’ willingness to post income-decreasing audit adjustments. However, auditors need to consider the longer-term impact of concessionary strategies, since a strategy that induces favourable outcomes in one period may impair the auditor’s negotiation effectiveness in subsequent periods. Different concession timing engenders differences in the client’s expectations, negotiation parameters (e.g.
initial offers and negotiation limits), interpretations of the auditor’s actions and strategy selection in later periods – this is an important consideration that should be taken into account when auditors enter into negotiations with client management.

This study focuses on the impact of gradual and delayed concessions in past negotiations as an extension to Tan and Trotman’s (2007) finding that these strategies are most effective in inducing CFOs to accept larger audit adjustments in the period they are used. Contrary to evidence in the general negotiation literature, Tan and Trotman (2007) also find no statistically significant difference in client satisfaction between the two strategies. This paper extends their finding, and predicts that gradual and delayed concessionary strategies have different repercussions on clients’ bargaining behaviour in subsequent negotiations. In the third experimental group, I address the concern that gradual and delayed concessions are not desirable from the perspective of regulators (Tan and Trotman 2007). The profession’s push for more stringent materiality rules reflects regulators’ attempt to restrict auditors’ ability to entertain arguments by clients against the booking of qualitatively material audit adjustments. I examine the consequences of employing a no concession strategy and compare its impact on CFOs’ pre-negotiation judgments and strategy selection with the impact of using a gradual or delayed concessionary strategy.

This study makes a number of important contributions. First, it investigates the impact of the existence and timing of auditor concessions and provides evidence on their influence on client expectations and strategy selection in the subsequent period. Second, it responds to calls in the psychology literature for further investigation of negotiations as a chain of interrelated exchanges (Tinsley et al 2002, O’Connor et al 2005). This study is the first to examine the influence of negotiation history in an auditing context. This is an important issue given that CFOs and auditors have consistently reported that negotiations on financial reporting issues are influenced by past interactions between the auditor and auditee and the relationship between the two parties (see Gibbins et al. 2001, Gibbins et al. 2005). Finally, this paper extends the study of past bargaining history in the general negotiation literature. While extant research has examined the effect of past negotiations only in so far as the impact of past negotiation outcomes (in the sense of whether or not an agreement was reached), I consider the impact of past concessionary behaviour on subsequent negotiations.

The remainder of the paper is structured as follows: section two reviews the relevant literature, section three presents a theoretical development of the hypotheses, and section four provides details of this study’s research design.

2. REVIEW OF THE LITERATURE

A number of prior studies on auditor-client negotiations use field-based questionnaires to gather information on the nature and process of these negotiations. Gibbins et al (2001) relies on audit partners’ retrospective recall and provides insights into the way accounting issues are identified, the impact of contextual factors and typical negotiation outcomes. It reports that negotiations often involve material accounting issues. An agreement is reached in the vast majority of negotiations, and results in the issuance of a clean audit opinion and reappointment of the audit firm. Gibbins et al

---

1 Tan and Trotman (2007) examined the impact of four concessionary strategies: start concession, start+1 concession, gradual concession and delayed concession.

2 The International Auditing and Assurance Standards Board (IAASB) attempted to strengthen the standards on materiality over 2005-2006 and has received comments on an exposure draft released in October 2006 (ISA 320 and ISA 450). Similarly, the United States Securities Exchange Commission has released two Staff Accounting Bulletins which provide guidance on materiality judgements. SAB 99 emphasises the need to consider qualitative (as well as quantitative) materiality, while SAB 108 clarifies how past undetected misstatements are to be quantified.
(2005) reports CFOs’ survey responses using a similar questionnaire and documents similar results. Moreover, that study shows that the issue put forward for negotiation is a surprise to the client or the audit partner (or both) 50% of the time. Respondents believed the accounting disagreement could be resolved with a mutually acceptable solution in approximately half of the negotiations recalled. When no mutually acceptable outcome was apparent, both CFOs and auditors were more likely to attempt to persuade the other party than to search for new solutions that are mutually acceptable. Gibbins et al (2006) conducts interviews with CFOs and audit partners and provides insights into the relationship dynamics governing the negotiation dyad. It documents that notwithstanding CFOs differ in their perceptions of the auditor’s role and the ‘rules’ of the audit engagement, responsibility for managing the auditor-client relationship typically falls on the auditor’s shoulders. Further, it shows that auditors and client management approach accounting disputes with incongruent bargaining orientations – while CFOs typically perceive a negotiation as being “win-lose”, audit partners are likely to search for “win-win” solutions.

Researchers have also shown increasing interest in the study of auditors and client management’s negotiation behaviour. Because of difficulties in gaining access to subjects and arranging negotiation dyads (Nelson and Tan 2005), focus has been placed on auditors and auditees’ pre-negotiation judgments (e.g. Bame-Aldred and Kida 2007, Ng and Tan 2003, Sanchez et al 2007, Trotman et al 2007). At the pre-negotiation stage, parties assess the negotiation situation and evaluate whether bargaining is a feasible option (Lebow 1996, Bame-Aldred and Kida 2007). Negotiators make preparation for the upcoming negotiation by determining their interests, bargaining goal and bottom line (i.e. the goals that a negotiator is willing to sacrifice for the sake of reaching an agreement). These decisions inform the negotiators’ strategy selection and hence affect bargaining behaviour when the actual negotiation takes place (Lebow 1996).

Bame-Aldred and Kida (2007) investigates auditors and clients’ negotiation flexibility, judgment accuracy and strategy choice by capturing the pre-negotiation decisions of these parties when faced with the same negotiation situation. Their results on auditors’ and clients’ preferred bargaining tactics are particularly relevant to the present study. They find that auditors and clients have similar strategy selection preferences – both groups favour the use of a persuasion strategy (i.e. providing substantial rationale for your solution to persuade the other party to change their mind) and rarely expect to threaten their negotiation counterpart (e.g. threats to qualify the audit opinion or terminate the relationship). Compared to auditors, however, clients indicate that they are more likely to attempt to trade-off on various issues and are more inclined to employ a bid high/ concede later strategy.

Experimental researchers have explored the impact of contextual factors on auditors’ negotiation behaviour, including the availability of authoritative guidance and effective corporate governance mechanisms (Ng and Tan 2003), the level of engagement risk (Brown and Johnstone 2005) and negotiation experience (Brown and Johnston 2005; Trotman et al 2007). More recently, studies have concentrated on investigating ways of improving auditors’ negotiation performance (Trotman et al 2005, Sanchez et al 2007, Tan and Trotman 2007). Both streams of research examine auditors’ and clients’ negotiation behaviour in a controlled environment – the former investigates the extent to which contextual factors explain strategy choice, while the latter examines the use of negotiation strategies to improve auditors’ ability to persuade clients to willingly post income-decreasing audit adjustments. Specifically, focus is placed on the use of concessions by both auditors and client management. Research documents that auditors’ initial recommendation in a negotiation typically equals their preferred outcome, though they are likely to respond to concessions by client management by allowing more aggressive reporting (Ng and Tan 2003). Further, the likelihood that a concessionary strategy is used by the auditor alters with the level of negotiation experience (Brown and Johnston 2005). Inexperienced auditors have a greater propensity to give concessions when engagement risk is high. By contrast, experienced auditors tend to employ a contending strategy and are less likely to move from their initial proposal, regardless of the level of engagement risk.
In contrast to the above studies, Sanchez et al (2007) examines the use of concessions as a strategic device and not merely an artefact of the negotiation environment. It compares the effects of two concessionary strategies - the first strategy requires the auditor to inform the client about immaterial adjustments that have been waived so it is aware that concessions have been given; in the second strategy, the auditor again concedest on immaterial adjustments, but does not bring them to the attention of the client. In that study, participants are emailed a list of proposed audit adjustments. Participants in two of the treatment groups are given the details of a number of proposed audit adjustments, only two of which are material. By contrast, participants in the no concession group only receive details of the two material adjustments. Later, each participant is given a list of final adjustments which only contain the two material audit differences. The authors find that participants subject to a concession approach are more willing to post significant income-decreasing adjustments, regardless of whether the adjustment in question is objective or subjective. They also have less aggressive negotiation parameters and are more satisfied with the auditor’s performance. In short, that paper shows that auditors can exploit clients’ adherence to reciprocity norms by making clients aware of immaterial adjustments that have been waived.

Tan and Trotman (2007) extend research into the use of concessions to induce desired negotiation outcomes by examining the impact of concession timing. Specifically, it explores whether auditor concessions can be timed strategically to induce greater cooperation by client management in booking audit adjustments. This is an interesting question given that a significant portion of auditor-client negotiations require weeks, or even months before the disagreement is resolved (Gibbins et al. 2001, Gibbins et al. 2005). The study involves four rounds of negotiation between participants and the researchers, who assume the role of the auditor. Negotiation is conducted over email and four concessionary strategies are examined (start concession, start+1 concession, gradual concession, delayed concession). The authors find that gradual and delayed concessionary strategies lead to greater revenue-decreasing counter-offers from client management, in comparison to tactics that involve concessions at an earlier stage in the negotiation process. Further, CFOs who are subject to gradual and delayed concessions indicate greater satisfaction with the process and outcome of the negotiation.

A limitation of the above studies is that the impact of the various concessionary strategies are evaluated using a single-period analysis only. As a result, the present study’s investigation of auditors’ concessionary behaviour in a multi-period setting should complement the prior work and provide a richer evaluation of bargaining tactics in auditor-client negotiations.

3. THEORY AND HYPOTHESES DEVELOPMENT

Negotiations as interrelated events

The majority of psychology and auditing negotiation research examines negotiations as independent, discreet events. However, numerous studies have recognised the potential impact of past bargaining histories on negotiation behaviour and outcomes in auditor-client negotiations (Gibbins et al. 2005, Tan and Trotman 2007, Sanchez et al 2007). In Gibbins et al. (2005), both CFOs and audit partners agreed that the history of negotiations between auditors and auditees affect future negotiations. Tan and Trotman (2007) finds evidence that CFOs exposed to various negotiation strategies by the auditor evince an intention to change their own negotiation strategies in future negotiations, while Sanchez et al (2007) questions whether the reported reciprocity effect arising from transparent concession-making will persevere with multiple periods of use. These studies identify a need to examine negotiations between auditors and client management as a longer chain of interactions rather than as isolated exchanges.
Psychology research into the impact of negotiation histories documents that the outcome of a past negotiation is a determinant of future bargaining behaviour. Negotiators who experience an impasse are more likely to view the negotiation as a failure, and indicate an intention to be less cooperative in future negotiations, compared to negotiators who reach an agreement (O’Connor and Arnold 2001). Unsurprisingly, past negotiation histories significantly impact the outcomes of subsequent negotiations. Negotiators who reach an impasse on a prior negotiation are less able to reach high quality integrative agreements later, and are more likely to impasse again, regardless of whether they face a different opponent (O’Connor et al 2005).

A negotiator’s perception of his opponent will also affect a subsequent negotiation, even if the parties have never interacted and the negotiator’s judgment of the opponent is informed by nothing more than the opponent’s reputation (Tinsley et al 2002). Tinsley et al (2002) finds that a counterpart’s reputation evokes a schema or stereotype in the mind of the negotiator, and provides him with a set of associated characterisations of the counterpart’s intentions. When faced with a reputedly distributive opponent, (i.e. someone skilled at using distributive tactics and maximising value for himself), a negotiator is likely to view the opponent in a negative light, and attribute a host of negative characteristics to that opponent - for example, the negotiator may characterise the opponent as stubborn, deceptive and uncooperative. He will anticipate further distributive tactics from the opponent in future negotiations, and respond by selecting more distributive tactics himself (Tinsley et al 2002). This may include withholding information or attempting to control the content of the negotiation, though more experienced negotiators are likely to respond by lodging pre-emptive attacks and relying on contending bargaining strategies (Ury, Brett and Goldberg 1988, cited in Tinsley et al 2002).

CFOs’ response to past concessions

The above literature suggests that a CFO’s negotiation parameters and bargaining behaviour are affected by past negotiations involving the auditor. Whether or not a concession was made in past negotiations and the timing of the concessions given will impact subsequent negotiations because they engender different interpretations of why concessions were made and foster different expectations of bargaining behaviour by the auditor in a later negotiation.

(i) Initial offer, negotiation limit and expectation of future auditor concessions

In this study, CFOs are exposed to one of three strategies by the auditor in a prior negotiation: no concession, gradual concession and delayed concession. The evidence indicates that at least some concession from the auditor is expected when subjectivity is required in financial reporting decisions (Tan and Trotman 2007; Gibbins et al 2005). When participants know that the auditor has made concessions, they reciprocate by evincing a greater willingness to post significant income-decreasing adjustments and approach the negotiation with more conservative negotiation limits (i.e. making more conservative initial offers and accepting a larger audit adjustment) (Sanchez et al 2007). Given that negotiators have a tendency to anchor on information they receive prior to the actual negotiation (Brodt 1994), we posit that the reciprocity effect documented in Sanchez et al (2007) will persevere across time (at least in the short term). Therefore, we expect CFOs in the no concession group to have less conservative initial offers and lower negotiation limits in this period’s negotiation (i.e. they will report a lower maximum acceptable writedown). No difference between CFOs in the gradual concession group and the delayed concession group is expected since Tan and Trotman (2007) reports no significant difference in participants’ counter-offers and satisfaction with the outcome and negotiation process in the gradual and delayed concession groups.
H1: The initial proposed writedown reported by participants in the no concession group is lower than the initial proposed writedown reported by participants in the gradual concession group and the delayed concession group.

H2: The maximum writedown that is acceptable to participants in the no concession group is smaller than the maximum writedown that is acceptable to participants in the gradual concession group and the delayed concession group.

Tinsley et al (2002) illustrates that social information concerning one’s negotiation opponent gives rise to expectations about that opponent’s future actions. Since concession by the auditor is expected in the resolution of disagreements regarding ‘grey’ accounting issues, CFOs whose auditor refused to concede in last period’s negotiation are likely to perceive the auditor as a tough value-claimer. This information causes CFOs to project a set of expectations about the auditor’s behaviour in the current negotiation, and informs his understanding of the present year’s negotiation situation. We predict that CFOs whose predecessors were exposed to a concessionary strategy last year will anticipate further auditor concessions in the current year’s negotiation. By contrast, CFOs whose auditors had given no concessions last year are less likely to expect concessions in a subsequent negotiation. They will therefore expect a larger revenue writedown to result from this period’s negotiation.

H3: Participants in the no concession group will report a larger expected ultimate writedown, in comparison to participants in the gradual concession group and the delayed concession group.

(ii) Interpretation of auditors’ concessions and expectation of future concessions

The timing of the auditor’s concession is likely to impact CFOs’ judgment as to why the concession was given. Research documents that negotiators subject to a series of gradual concessions are satisfied with both the process and outcome of the negotiation (Tan and Trotman 2007; Kwon and Weingart 2004). The explanation offered in Kwon and Weingart (2004 p.274) is that the giving of gradual concessions demonstrates the opponent’s responsiveness to the negotiator’s own needs. This is unlikely to be true in an auditing context, since CFOs are aware that the total amount (i.e. magnitude) of concession available to the auditor is constrained by GAAP and the auditor’s need to manage audit risk. Therefore, the fact that the auditor was able to provide concession after concession is likely to be seen as indicating that the auditor had built in a large buffer – that is, the writedown initially proposed by the auditor was larger than the adjustment he believed to be necessary.

The above explanation raises the following question – if participants viewed the auditor’s concessions as reflective of the use of a manipulative bid high/ concede later tactic, why did they report a high level of satisfaction with the negotiation? One possible reason is that notwithstanding subjects believed the auditor had proposed an excessive adjustment, they felt as though they had come out of the negotiation on top by successfully persuading the auditor to reduce his buffer and to accept a fairer adjustment. This is consistent with the finding that when negotiators reach agreements and fail to realise that the other party had preferred the same outcome, they have a tendency to erroneously believe that they had come out ahead of the other party as a result of their superior bargaining abilities (Neale and Bazerman 1985).

Kwon and Weingart (2004 p.274) also suggests that subjects in the delayed concession treatment will not view the concession as signalling the counterparts’ responsiveness to their needs, since too much argumentation is required before the concession is given. Again, this argument is unlikely to generalise to auditor-client negotiations. The requirement of a long process of negotiation before the auditor is prepared to concede indicates that the auditor’s initial proposal was credible and that concessions are not lightly given. Moreover, the concession ultimately granted suggests the auditor had taken into account the CFO’s concerns and had undertaken extra audit work to investigate whether those needs can be accommodated. Therefore, we posit the following:
H4a: Participants in the gradual concession group are more likely to interpret the auditor’s concession as signalling that the auditor’s proposed adjustment was larger than the amount he genuinely believed to be necessary, in comparison to participants in the delayed concession group.

H4b: Participants in the delayed concession group are more likely to interpret the auditor’s concession as signalling the auditor’s responsiveness to his needs, in comparison to participants in the gradual concession group.

(iii) Selection of negotiation tactics in subsequent negotiations

Negotiation Tactics

Negotiation strategies are commonly classified as distributive or integrative in the negotiation literature. Distributive strategies involve tactics that are aimed at claiming the maximum share of the available resources from the negotiation, while integrative strategies are directed towards finding mutually beneficial solutions that result in both parties being better off – i.e. a “win-win” solution (Bazerman 1986). This distinction is widely adopted in the extant auditor-client negotiation research (see Trotman et al. (2005), Gibbins et al (2001), Gibbins et al (2005)).

The discussion on negotiation strategies in the auditing literature has tended to consider the use of distributive and integrative strategies in aggregate. However, these characterisations of bargaining strategies encompass a broad spectrum of more specific negotiation tactics. The introduction of new issues into the negotiation, the use of low-cost concessions (also known as logrolling), open communication with the opponent and understanding the opponent’s preferences are examples of an integrative bargaining approach. Any tactic that involves persuading the opponent to make concessions, or resisting similar attempts by the other party can be described as distributive. Common examples include the use of threats, making a positional commitment, and the use of persuasive arguments (Pruitt and Carnevale 1993; Weingart et al 1996). While it is possible for a negotiator to use a number of distributive tactics in combination, these tactics are theoretically distinct. A negotiator who indicates a positional commitment expresses his determination to hold firm at a particular offer. By contrast, a persuading tactic involves the use of arguments which substantiates the negotiator’s point of view and aims to alter the opponent’s views towards the issues under consideration. Finally, a strategy that does not fall into the distributive/ integrative bargaining dichotomy is the use of concessions. Concessions refer to a reduction in demand so that the offer communicated provides less benefit to the negotiator (Pruitt and Carnevale 1993). They can be given strategically – e.g. to elicit reciprocation from the opponent (Sanchez et al 2007), or as part of a bid high/ concede later tactic. Alternatively, concessions can also represent a genuine attempt to compromise with the opponent in search of a mutually acceptable agreement.

Bame-Aldred and Kida (2007) identify six negotiation tactics from the literature above and applies them to the auditor-client negotiation context (see Table 1 in the Appendix). In this study, we examine the impact of the auditor’s past concessionary strategy on CFOs’ tactic selection in a subsequent negotiation using those strategies.

---

3 Pruitt and Carnevale (1993) uses a contentious/ problem-solving classification rather than a distributive/integrative one. However, the tactics described and under each approach and the authors descriptions of the respective approaches are very similar to the distributive/integrative distinction adopted in other studies.

4 This is more correctly classified as a distributive strategy, since the negotiator relies on the appearance of making meaningful concessions, and does not offer any genuine sacrifice of benefits to himself.
Selection of negotiation tactics as a response to past negotiation history

Past studies have examined negotiators’ reactions to their opponents’ behaviour at various stages of the negotiation (see Pruitt and Carnevale 1993), but have not investigated the issue in a multi-period setting. However, evidence that the nature of the relationship between negotiators is persistent and that this relationship influences the parties’ negotiation behaviour (Pruitt and Carnevale 1993) suggests that past negotiation experience is likely to affect strategy selection in subsequent exchanges. Further, Tinsley et al. (2002) documents that a negotiator’s reputation, which can be based on past interactions or an external source, influences his opponent’s strategy choice in later negotiations. Together, these studies lend support to our prediction that negotiators’ strategy selection is influenced by their negotiation history with the auditor.

(i) CFOs in the no concession group:

An auditor’s refusal to concede in a prior negotiation earns him a distributive reputation. This causes the CFO to anticipate further distributive behaviour from the auditor in the present negotiation, and to respond by selecting distributive strategies himself (Tinsley et al. 2002). Therefore, we expect that participants in the no concession group will report a high likelihood of using distributive strategies in this period’s negotiation.

(ii) CFOs in the gradual concession group:

A negotiator’s attribution for his opponent’s behaviour exerts significant influence over his reaction to that behaviour and his subsequent strategic decisions (Schelling, 1960, Bar-Tal and Geva 1986; Hewstone 1988; Kelley and Stahelski 1970). CFOs facing auditors with a precedent of giving gradual concessions are likely to interpret those concessions as merely a reduction of the auditor’s buffer, rather than a genuine compromise directed at finding a mutually acceptable outcome. In proposing an overly conservative position, the auditor indicates that he is not to be trusted (Kwon and Weingart 2004). He establishes himself as a distributive negotiator and causes the CFO to view his character in a negative light. As before, this endows the CFO with an expectation of further distributive behaviour and acts as a catalyst for distributive responses by the CFO. Therefore, we expect that participants in the gradual concession group will report a high likelihood of using distributive strategies in this period’s negotiation.

(iii) CFOs in the delayed concession group:

CFOs attribute a delayed concession to the auditor’s willingness to accommodate the company’s needs and his commitment to maintaining a positive auditor-client relationship. The CFO can react in two ways. Firstly, he can exploit the auditor’s commitment to the relationship by relying on the use of persuasive arguments to alter the auditor’s opinion, or by pressuring the auditor to accept an accounting position that allows his needs to be met (e.g. by insisting on an aggressive financial reporting position that allows the company to meet important targets). Alternatively, he can respond to the auditor’s commitment to maintaining an open, collaborative relationship by adopting a more cooperative approach, e.g., by proactively providing information about the transaction concerned, collaborating with the auditor to arrive at an appropriate interpretation of GAAP, attempting to get more information about the auditor’s preferences, or compromising with the auditor to arrive at a mutually acceptable outcome. Given that prior research suggests negotiators are less likely to be exploitative when they expect to interact with each other in the future (Marlowe, Gergen and Doob 1966), we predict that CFOs in the delayed concession group will approach this period’s negotiation

---

5 For example, past studies document that trust encourages negotiators to exchange information about values and priorities (Kimmel et al. 1980, Lindskold and Han 1988). Researchers also argue that more trusting negotiators make more concessions, though this claim has not been directly tested (Pruitt and Carnevale 1993).
with a more cooperative orientation and will report a lower likelihood of relying on distributive strategies. Therefore, we make the following predictions:

H5a: Participants in the delayed concession group will report a lower likelihood of using a distributive negotiation strategy in the present negotiation, in comparison to participants in the no concession group and the gradual concession group.

H5b: Participants in the delayed concession group will report a greater likelihood of using an integrative negotiation strategy in the present negotiation, in comparison to participants in the no concession group and the gradual concession group.

4. METHOD

Participants

45 participants will be required for the experiment. Participants are personal contacts of the researchers, and are identified based on their experience in the accounting profession.

Research Design

This experiment employs a 3 x 1 between-subjects research design. Participants are randomly allocated into one of three treatments: no concession, gradual concession, and delayed concession. Our independent variable is the auditor’s past negotiation strategy. Manipulation of this variable is achieved by providing participants with a description of the previous year’s negotiation. The psychology literature suggests that this is sufficient to induce a response to an opponent’s behavior in a prior negotiation - because a high degree of uncertainty is necessarily involved with any negotiation, negotiators tend to afford great weight to any available background information (Brodt 1994, Tinsley et al 2002). Participants are instructed to assume the role of a new CFO in a listed Australian company, and are given a description of the predecessor’s negotiation with the auditor in the prior year. Participants in the no concession group are told that the auditor has proposed a writedown of $7 million. Participants in the gradual and delayed concession groups are told that the auditor proposed a writedown of $14.5 million. For the gradual concession group, the auditor is described as having given a small concession in the first and final rounds of the prior year’s negotiation. For the delayed concession group, the auditor did not move from his initial position until the final round. In all three treatments, the ultimate audit adjustment is kept constant at $7 million. Table 2 in the appendix provides a brief summary of the three treatments.

Procedure

The researcher will contact participants individually by phone to arrange an appointment for the purpose of conducting the experiment. This experiment is expected to last approximately one hour.

We provide participants with a case study and a questionnaire designed to capture their pre-negotiation judgments and strategy choice. The word “negotiation” is not used in our research instrument. We deliberately avoid describing the resolution of accounting disagreements between the auditor and client management as a “negotiation” following evidence from Gibbins et al (2005) that CFOs regard the term as pejorative (p176). Our case study is a modified version of the instrument used in Tan and Trotman (2007). Participants are asked to assume the role of a new CFO in a listed Australian company, which leases satellite time to customers. They are given background information of the company and details of a proposed audit adjustment, which relates to the recognition of penalties under a major contract with a government department. Participants are asked to make a number of judgments concerning this audit adjustment in the questionnaire. The materials
also contain a description of last year’s negotiation with the auditor. Details of the substance of the accounting disagreement are deliberately excluded to encourage participants to focus on the negotiation process, particularly with regards to the existence and timing of auditor concessions. This information is presented as a timeline. It describes four stages: the auditor’s initial proposal for a revenue writedown, two rounds of discussions between the auditor and the former CFO, and the auditor’s final decision on the audit adjustment the company must book. The entire process spans over two weeks – this is consistent with survey evidence that auditors and clients often require weeks before an accounting disagreement can be resolved (Gibbins et al 2001).

To ensure that participants have absorbed the information on the prior year’s negotiation, they are required to answer two revision questions before proceeding onto the main part of the questionnaire. The first question asks whether or not the auditor was willing to accept a revenue writedown that was smaller than the one he had initially proposed. Participants who answer yes to this question are also required to specify the timing of the concession(s).

Testing the hypotheses

The dependent variables are gathered through participants’ responses in the questionnaire. Hypothesis 1 predicts that participants in the no concession group will nominate an initial proposed writedown that is greater than the amount proposed by participants in the gradual and delayed concession groups. Data is obtained using a modified version of the question used in the Tan and Trotman (2007) instrument. We ask participants “If you are not willing to accept the amount of audit adjustment proposed by the auditor, what amount of audit adjustment would you propose to the auditor that is acceptable to you?”

Hypothesis 2 predicts that the maximum writedown that is acceptable to participants in the no concession group is smaller than the maximum writedown that is acceptable to participants in the gradual concession group and the delayed concession group. The subjects are asked “What is the absolute maximum amount of revenue writedown you would be willing to report under the contract before negotiations break down?” Note that the difference between participants’ responses in the two questions above provide insights into the extent to which a precedent of auditor concessions impacts participants’ willingness to concede in a later negotiation.

Hypothesis 3 predicts that participants in the no concession group will report a larger expected ultimate writedown, in comparison to participants in the gradual concession group and the delayed concession group. Following Ng and Tan (2003) and Tan and Trotman (2007), we ask participants “What is the amount of the proposed audit adjustment that you believe will ultimately be recorded in (the company’s) audited financial statements?” Subjects’ responses to this question will allow us to infer the extent to which auditor concessions in a past negotiation gives rise to expectations of further concessions in subsequent negotiations.

For hypothesis 4, we ask participants to provide their interpretation of the auditor’s concession in last year’s negotiation. Participants are asked “To what extent do you believe the following explains why the auditor was willing to accept a lower adjustment than the one he initially proposed last year?” They are given two possible explanations: (a) the auditor listened to the former CFO’s point of view and was trying to accommodate his needs, (b) the auditor was flexible because his initial position as more extreme that what he genuinely believed to be necessary. Participants indicate their beliefs on

---

6 This question is modified from the question used in Bame-Aldred and Kida (2007). In that study, participants were asked to indicate they absolute minimum amount of profit they would be willing to report before they would feel the need to terminate the auditor relationship (emphasis added). We replace the notion of terminating the auditor relationship with the breakdown of negotiations following Sanchez et al (2007), since the option of terminating the relationship is not open to participants until the following financial year.
an 11-point scale, with ends labelled “not at all likely” and “extremely likely”. They are also invited to provide a different interpretation of the auditor’s concession, and to indicate the extent to which they believe it explains the concession on an 11-point scale.

In hypothesis 5, we predict that participants in the delayed concession group will report a lower likelihood of using distributive negotiation strategies, and a higher likelihood of using integrative negotiation strategies, in comparison to participants in the no concession and the gradual concession groups. We capture participants’ strategy selection by asking them to assess the likelihood of using each tactic on a 7-point scale with “very unlikely” at 1 and “very likely” at 7, consistent with Bame-Aldred and Kida (2007). Hypothesis 5a is supported if participants in the delayed concession group select a lower likelihood of using each of the four distributive tactics in Table 1. Similarly, hypothesis 5b is supported if participants in the delayed concession group select a higher likelihood of using the two integrative tactics included in Table 1.
APPENDIX

Table 1

<table>
<thead>
<tr>
<th>Tactic</th>
<th>Description</th>
<th>Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Select an initial revenue recognition solution to get the most from the auditor. If necessary, you can concede to a more conservative position later in the negotiation.</td>
<td>Distributive</td>
</tr>
<tr>
<td>B</td>
<td>Try to get information about the auditor’s preferences on the revenue recognition issue.</td>
<td>Integrative</td>
</tr>
<tr>
<td>C</td>
<td>Threaten to terminate the relationship if the auditor does not agree with your revenue recognition solution.</td>
<td>Distributive</td>
</tr>
<tr>
<td>D</td>
<td>Whatever initial revenue recognition solution you communicate to the auditor, do not appear as if you will back down from that position. Appear firm.</td>
<td>Distributive</td>
</tr>
<tr>
<td>E</td>
<td>Attempt to trade-off certain issues. They may be issues that are important to you and not very important to the auditor and vice versa.</td>
<td>Integrative</td>
</tr>
<tr>
<td>F</td>
<td>Provide substantial rationale for your revenue recognition solution to persuade the auditor to change their mind.</td>
<td>Distributive</td>
</tr>
</tbody>
</table>

Table 2

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
<th>No Concession</th>
<th>Gradual Concession</th>
<th>Delayed Concession</th>
</tr>
</thead>
<tbody>
<tr>
<td>19th Aug 2006</td>
<td>The auditor proposed a revenue writedown of $7m</td>
<td>The auditor proposed a revenue writedown of $14.5m</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20th Aug 2006</td>
<td>Discussion re revenue writedown – round 1</td>
<td>The auditor did not move from his initial proposal. He maintained that revenue should be written down by $7m</td>
<td>The auditor partly moved from his initial position after hearing our argument. He was willing to accept a revenue writedown of $11m</td>
<td>The auditor did not move from his initial proposal. He maintained that revenue should be written down by $14.5m</td>
</tr>
<tr>
<td>27th Aug 2006</td>
<td>Discussion re revenue writedown – round 2</td>
<td>The auditor still would not agree to a smaller adjustment. He insisted that a $7m revenue writedown was necessary.</td>
<td>The auditor would not move from this position. He insisted that a $11m revenue writedown was necessary.</td>
<td>The auditor still would not agree to a smaller adjustment. He insisted that a $14.5m revenue writedown was necessary.</td>
</tr>
<tr>
<td>3rd Sep 2006</td>
<td>Final writedown</td>
<td>The auditor did not agree with our arguments. He remained firm that a revenue writedown of $7m was appropriate.</td>
<td>The auditor agreed partly with our arguments and accepted a revenue writedown of $7m</td>
<td>The auditor agreed partly with our arguments and accepted a revenue writedown of $7m</td>
</tr>
</tbody>
</table>
REFERENCES


