The Effect of Magnitude of Client Reporting Error and Order of Multiple Issues on Auditor-Client Negotiations

This study reports the result of an experiment examining the impact of the magnitude of the difference between an auditor’s preferred balance and the client’s unaudited balance as well as the order of issues discussed on the outcome of an auditor-client negotiation. Audit quality has been the focus of several streams of research as well as the object of recent and substantial changes in audit regulation. However, the influence of audit quality on the quality of the associated financial statements is contingent upon the discussions and negotiations between auditors and the client’s management. This study considers two aspects of the auditing context that normatively should not influence financial statement account balances but that negotiation theory suggests will have an influence: magnitude of the client’s unaudited balance and the order of potential adjustments discussed. Theory from negotiation literature suggests that negotiators’ initial demands (e.g., client’s unaudited balances) as well as feelings of reciprocity created by prior negotiations serve to create expectations for the current negotiation and, in turn, the outcomes of such negotiations. Results of an experiment using audit partners and managers as participants suggest that both the magnitude of the client’s initial, and materially misstated, balance as well as the order of discussion of multiple proposed adjustments influences the auditor’s expectations regarding the ensuing negotiation (e.g., goals, limits, and initial offer). Further, these manipulations influence the negotiated outcome and this influence is fully mediated by the auditor’s starting point in the negotiation (i.e., initial offer). These results suggest that financial statement quality may suffer as a result of these common characteristics of discussions regarding the disposal of audit adjustments.