

**Effects of earnings forecasts and heightened professional skepticism on the
outcomes of client-auditor negotiation**

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ABSTRACT

Literature suggests that professional skepticism may lead the auditor to more vigilantly resist the client's position in financial reporting disputes (Hurt, 2010; Nelson, 2009; Quadackers, 2009; Quadackers et al., 2009). To date, the role that professional skepticism potentially plays in the negotiation process has been relatively unexplored (Brown and Wright, 2008). The literature pre-SOX suggests that auditors are more likely to approve a client position when the matter in dispute is relatively ambiguous (Trompeter, 1994) and when changing the client's position will result in the client failing to meet analysts' expectations (Libby and Kinney, 2000; Kadous, et al. 2003). However, changes resulting from SOX have led auditors to be more vigilant and therefore results in the pre-SOX environment may not hold in the current environment where auditors are held more accountable for their actions (Cohen et al., 2008). Accordingly, we examine whether the auditor's final negotiating position may be influenced by (1) whether or not the matter affects a client's ability to achieve analysts' targeted earnings forecasts (potential for earnings management) and (2) heightened auditor professional skepticism. Results from an experiment with 38 experienced managers and partners suggest that in the post-SOX climate, auditors' negotiations do not appear to be substantively influenced by management being able to meet or beat forecasts. Moreover, we find that when auditors exhibit heightened professional skepticism, they are more conservative and stand more resolute than when auditors do not exhibit heightened professional skepticism. Finally, although we do not find a main effect for the influence of earnings forecast we do find a significant interaction between earnings forecast and heightened professional skepticism. Implications for practice and research are then presented.

Key words: Professional skepticism, Negotiation, Earnings management, Audit judgment

The instrument is available from the authors upon request.

Effects of Earnings Forecasts and Heightened Professional Skepticism on the Outcomes of Client-Auditor Negotiation

Introduction

This paper examines the outcome of negotiations over proposed adjusting journal entries between an auditor and client. Specifically, we examine whether the auditor's final negotiating position may be influenced by (1) its effect on a client's ability to achieve analysts' targeted earnings forecasts and (2) heightened auditor professional skepticism. The auditor's ability to withstand earnings-induced-pressure from clients has been of concern for some time to legislators and regulators. For example, in the late 1990s, SEC Chair Levitt and others expressed concerns that registrants were increasingly managing earnings to achieve analysts' forecasts and that auditors were unwilling to prohibit such practices over concerns about losing audit and non-audit revenues (Levitt, 1998; Turner, 1999; Turner and Godwin, 1999; SEC, 2006). However in the post-SOX environment, archival research findings suggest a reduction in earnings management (Bartov and Cohen, 2006; Cohen et al., 2008; Davis et al., 2009; Bennie et al., 2009). Yet, on an individual client basis, managers may still have incentives to engage in earnings management (Beyer, 2008). Consequently, in this post-Sox auditing climate, we experimentally investigate whether, during the negotiation process, auditors will be sensitive to client incentives related to earnings management.

In addition, we examine the extent to which heightened professional skepticism (Hurt 2010) affects the auditor's negotiations.¹ The importance of professional skepticism has long been recognized by the auditing profession (Johnstone et al., 2001) as an essential element of audit practice (e.g., SAS 1 and 82 (AICPA 1997a, 1997b), AUS 202 (AARF, 1995), and Section

¹ In this paper, we follow Hurt's perspective that professional skepticism is a trait.

5090 of the CICA Handbook (CICA, 1997)). Further, following the scandals of the late 1990's and early 2000's, SAS 99 (AICPA, 2002) was enacted, which emphasizes the auditor's responsibility to exercise professional skepticism and to explicitly consider the possibility of fraud in all audits. The literature suggests that professional skepticism is necessary to ensure that audits are performed with an independent attitude (Kadous, 2000) that will moderate aggressive reporting by management especially when the issue is ambiguous. International auditing guidance (ISA 200.15) also addresses the issue by stating, "an attitude of professional skepticism means that the auditor makes a critical assessment, with a questioning mind, of the validity of the evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management." This suggests that auditors who have heightened professional skepticism may search for more objective corroborating evidence and thus they may be more vigilant in the negotiation process and be less willing to compromise on accounting disputes. We adopt in this paper Nelson's (2009 1) perspective on professional skepticism that professional skepticism assumes a "presumptive doubt." Nelson argues (2009 1) that this approach is "implying that auditors who exhibit high professional skepticism are auditors who need relatively more persuasive evidence (in terms of quality and/or quantity) to be convinced that an assertion is correct."

Moreover, Hurtt (2010), Nelson (2009) and Quadackers (2009) all suggest that having a propensity to pay attention to risk factors is an essential element of professional skepticism which potentially can lead to more effective auditing. For example, Nelson (2009 1) defines professional skepticism as "indicated by auditor judgments and decisions that reflect a heightened assessment of the risk that an assertion is incorrect, conditional on the information available to the auditor." This is important as research has demonstrated that litigation risk and

the related fear of significant losses, serve to bolster an auditor's objectivity (e.g., Farmer et al., 1987; Trompeter, 1994; Hackenbrack and Nelson, 1996; Gibbins et al., 2001; Brown and Johnstone, 2009). Further, the profession argues that the risk associated with the litigation environment ensures that auditors remain objective (c.f. AICPA 1978). This sense of objectivity could lead auditors to conduct a more extensive search and evaluate higher quality audit evidence as well as being more resolute in the negotiation process. Thus, we examine in this study whether heightened professional skepticism leads auditors to be less willing to compromise on disputed accounting issues.

We address these issues using an experimental study that requires participants to engage in a negotiation session with a hypothetical client. Thirty-eight experienced auditors from two large, international public accounting firms negotiated the disposition of two proposed adjusting journal entries with a web-based, computer-simulated CFO. The results of our study provide evidence that is consistent with the post-SOX research cited above. In general, in the post-SOX climate, auditor-client negotiations do not appear to be influenced by their effect on the client's ability to meet analysts' forecasts. Moreover, our results reveal that, when auditors exhibit heightened professional skepticism they are more conservative and stand firmer in their positions than when they do not exhibit heightened professional skepticism. Further, although we do not find a main effect for the influence of earnings forecast we do find a significant interaction between earnings forecast and heightened professional skepticism. Finally, exploratory analysis provides evidence that in the post-SOX environment, auditors engage in the integrative negotiation tactic of trading off issues when there is more than one issue at hand (Brown and Wright, 2008; Sanchez et al., 2007). Collectively, the results suggest the importance of

considering professional skepticism within the auditing negotiation research domain as well as highlighting the importance of revisiting auditing research conducted in a pre-SOX context.

Theory and hypothesis development

Background on negotiation and negotiation outcomes

Negotiation is a process in which a joint decision is made by two or more parties with differing preferences and is one in which the outcome ultimately affects the welfare of both (Murnighan and Bazerman, 1990) and possibly third parties, as is the case in auditing (Brown and Wright, 2009). In general, the parties first verbalize contradictory demands and then move toward agreement using a variety of possible negotiation strategies (Pruitt, 1981). The very nature of the audit function often necessitates negotiation between the auditor and the client and there is an emerging line of research that investigates various contextual factors affecting auditor-client negotiations. Research in auditor-client negotiation builds on the conceptual model developed by Gibbins et al. (2001). This model expands the elements of negotiation examined in prior negotiation research and develops a negotiation process model that highlights factors that are prominent in auditor-client negotiations, such as external conditions (e.g., litigation risk, professional ethics, GAAP and GAAS), interpersonal context (e.g., the client-auditor relationship, personal/organizational agendas, and risk), and both parties' capabilities (e.g., accounting and negotiation expertise).

Several studies investigate the negotiation process and find that auditor-client negotiations—and factors affecting those negotiations—may significantly affect amounts reported in the financial statements (e.g., Antle and Nalebuff, 1991; Gibbins et al., 2001; Ng and Tan, 2003; Trotman et al., 2005; Bame-Aldred and Kida, 2006; Sanchez et al., 2007; Brown and

Johnstone, 2009; Brown and Wright, 2009).² For example, Brown and Johnstone (2009) find that engagement risk and negotiation experience affect the negotiation strategy and the final agreed upon outcome. They find that when engagement risk is high, auditors with less negotiation experience make more concessions that ultimately lead to a final outcome that is more in line with the client's more aggressive preference.

The likelihood of negotiators reaching a solution that benefits both parties is influenced by each party's incentives (Brown and Wright, 2008; Antle and Nalebuff, 1991; Zhang, 1999; Wang and Tuttle, 2009). For example, Antle and Nalebuff (1991) demonstrate that given the client's information asymmetry advantage over the auditor regarding the true state of performance of the company, the financial statements do not necessarily reflect the conservative stance of the auditor. Rather, the extent of compromise on the amounts to include in the financial statements is related to the costs of extending the audit when considered appropriate and the cost-sharing arrangement between the auditor and client. Additionally, when possible misstatements stem from subjective accounting issues, clients become more aggressive in preparing the financial statements, and auditors become more cautious. As a result, this leads to more disputes between the auditor and the client (Zhang, 1999).

While prior research has shown that negotiation outcomes are affected by incentives, it is also the case that changes in the environment can lead to changes in incentives. For example, in the post-SOX environment, Wang and Tuttle (2009) use an experimental setting to investigate the effect of mandatory audit firm rotation on negotiations between auditors and clients. Such changes would affect the auditor's incentive structure by reducing the present value (to the auditor) of an existing client relationship and thus, presumably, reducing the auditor's

² See Brown and Wright (2008) for a review of this literature.

willingness to acquiesce to client demands. Wang and Tuttle find that, under these conditions, auditors adopt less cooperative negotiation strategies (i.e., make fewer concessions). When auditors are less concerned about client retention, the incentive to accept the client's preferred financial statement values is diminished and the final negotiated outcome is more in line with the auditor's optimal position.

More generally, the Sarbanes-Oxley Act of 2002 sought to change incentives by making aggressive earnings management more costly. Through Title I and sections 302 and 906, the act increased accountability for the auditor and management, and it raised the prospect of loss of reputation, financial penalties and potentially imprisonment for top management in the case of the most egregious violations. Recent research presents evidence that incentives have changed in the post-SOX environment (Bartov and Cohen, 2006; Cohen et al., 2008; Davis et al., 2009). These studies have found a decrease in earnings management; a behavior that is consistent with either management becoming less aggressive in its attempts to manage earnings, auditors becoming less willing to allow aggressive accounting, or both. Thus, while earlier research has suggested that auditors' incentives may have, traditionally, made them more likely acquiesce to a client's desires to achieve a specific earnings target (e.g., Libby and Kinney, 2002); it is not clear that such behavior persists in the post-SOX environment.

Hypotheses

Earnings management and auditor-client negotiation

Earnings management is viewed as the purposeful or intentional manipulation of financial statements (Shipper, 1989) and becomes more difficult to effectively monitor when professional judgment is involved (Nelson et al., 2002). Further, there is widespread evidence that management engages in earnings management activities over a wide variety of accounting

issues (Nelson et al., 2003; Healey and Whalen, 1999). Linking audit judgments to this literature, several studies have directly examined how auditor incentives influence their reporting judgments, specifically in situations where the accounting issue is subjective, and the client has a preference to report more aggressively (e.g., Trompeter, 1994; Hackenbrack and Nelson, 1996; Libby and Kinney, 2000; Nelson et al., 2002, 2003). For example, Kadous et al (2003) provide evidence that standards, in certain situations such as when auditors have incentives to accept a client's position, do not lead to more objective decisions by auditors. Further, Trompeter (1994) found that auditors were reluctant to propose a downward adjustment to income when the accounting issue was relatively ambiguous. Hackenbrack and Nelson (1996) report similar results. These studies suggest that auditors permit aggressive reporting when engagement risk is moderate and justify this decision by interpreting the vague criterion in the standards to support the client's choice. However, when engagement risk is high, auditors favor conservative reporting. This suggests that there may be contentious arguments between management and the auditor when an issue involves ambiguity (e.g., inventory obsolescence) and an auditing adjustment is proposed (Brown and Johnstone, 2009; Trotman et al., 2005).

One important incentive-related factor that may heighten disputes between management and the auditor is the ability of a client to meet analyst forecasts. This has been well documented to affect financial statement presentation (Healy and Whalen, 1999) as well as auditor judgments (Libby and Kinney, 2000; Nelson et al., 2002; Kuene and Johnstone, 2009). A dispute could arise when a proposed adjustment would threaten management's ability to meet analyst's forecasts. A number of studies provide evidence that managers manage their earnings to meet or exceed analysts' forecasts³. Nelson et al. (2003) survey audit managers and find that auditors

³ See Healy and Whalen (1999) for a review of the literature on earnings management.

perceive that clients attempt earnings management using various approaches such as cut-off manipulation, deferring too much or too little revenue and bill and hold sales. Further, Libby and Kinney (2000) report that quantitatively immaterial earnings overstatements are not corrected if it will cause the earnings to move below analysts forecast, regardless of SAS 89 (AICPA, 1999), which requires audit committee communication and management representation. Nelson et al. (2002) find further evidence that, in certain situations, auditors are less likely to adjust earnings management attempts by their clients (e.g., transactions structured to comply with precise standards or unstructured transactions that fall under the purview of imprecise standards). However, certain types of earnings management attempts will result in adjustment by auditors (e.g., when they result in a material increase in current income). Kuene and Johnstone (2009), using an archival-based methodology, find evidence that the pressure to meet analysts' forecasts causes client management to report more aggressively, especially in situations where the firm is close to missing its consensus forecast. However, they find that when audit fees are higher, auditors are less likely to allow management to waive qualitatively material income-decreasing misstatements.

While extensive research has shown evidence of earnings management, more recent research has shown a decline in, or perhaps even the elimination of, such activities in the post-SOX era. Bartov and Cohen (2006) and Cohen et al. (2008) examine issues related to expectations management as well as both real and accruals-based earnings management. They report reduced earnings management in the post-SOX period. Similarly, Davis et al. (2009) report that auditor tenure appears to have been associated with earnings management prior to the passage of SOX, but that this relationship is not significant in the post-SOX period. However, as noted above, it is not clear whether these findings are driven by reduced management incentives

to engage in earnings management or less willingness, on the part of auditors, to accept such reporting.

Thus, while recent research shows a general tendency away from earnings management, it is still the case that managers have incentives to achieve analyst forecasts. Consequently, it is of interest to examine the extent to which auditor judgment is affected by such incentives when negotiating with a recalcitrant client. Given the evidence pre and post SOX, we propose the following null hypothesis:

H1: There will be no association between negotiated financial reporting outcomes and the client's ability to achieve analyst forecast targets.

Auditor skepticism and auditor-client negotiation

Professional skepticism is vital in the exercise of independence (Kadous, 2000; Nelson, 2009; Hurtt, 2010) and conservatism (McMillan and White, 1993) - both of which are potentially important to ensure that financial statements are not misstated or biased in management's favor. Thus, SAS 109 (AICPA, 2006) emphasizes that auditors should carry out the audit with an attitude of professional skepticism. As mentioned earlier, Nelson (2009) posits that professional skepticism will be indicated by auditor judgments and decisions that are reflective of a heightened sense of the risks associated with the judgment and decisions that are rendered. Thus, auditors who exhibit more professional skepticism may be more sensitive to risk factors associated with a client. Further, Nelson posits that when auditors believe that managers have an incentive to manage earnings, they may become more skeptical about management explanations regarding adjustments to the financial statements. This is consistent with existing evidence that auditor's beliefs about management's incentives to manage earnings may result in auditor's being more sensitive to the risk of misstatement, causing them to be more skeptical (Quadackers,

2009; Anderson et al., 2004; Hirst, 1994). For example, Anderson et al. (2004) investigate auditors' reactions to clients' incentives to manage earnings, and find that when incentives to manage earnings are high, auditors perceive clients will be more likely to be aggressive to try to make the financial statements look more favorable and to persuade the auditor. Further, when incentives to manage earnings were high, auditors were more skeptical about the information and facts presented by the client.

Heightened attention to risk factors appears to be a characteristic of stronger professional skepticism (Quadackers, 2009; Nelson, 2009; Hurr et al., 2008). For example, Quadackers' (2009) findings suggest that auditors who display a heightened sensitivity to client risk factors will have heightened professional skepticism. If auditors do exhibit heightened professional skepticism they potentially will adopt a conservatism heuristic (Carpenter et al., 2003; McMillan and White, 1993, Smith and Kida, 1991). Heightened professional skepticism will likely result in the auditor making minimal concessions to their clients and being more conservative in their negotiation process. Therefore we examine the following directional hypothesis on professional skepticism:

H2: Auditors who exhibit heightened professional skepticism will negotiate a more conservative financial reporting outcome than auditors who do not exhibit heightened professional skepticism.

Earnings management and skepticism: Interactive effects

Hirst (1994) finds that auditors are sensitive to management's incentive to manage earnings. This sensitivity is likely to lead to heightened professional skepticism in cases where management overstates earnings since in that context the risk to auditors for not challenging management is potentially quite high. For example, in a review of the literature on professional skepticism, Nelson (2009 13) concludes that auditors are more likely to exhibit greater

professional skepticism when the incentives lead auditors to express concern about loss of reputation or the litigation risk of being associated with this type of client. This skepticism takes on what Nelson (2009) calls a presumptive-doubt perspective, where auditors have doubt about management's positions and gather and search for more evidence to validate the assertions made by management. Further, Shaub and Lawrence (1996) equate skepticism with suspicion (and as the opposite of trust) and McMillan and White (1993) suggest that skeptical auditors will adopt a conservatism heuristic in their evaluation of evidence and their decision making. Therefore, when auditors evaluate client information negatively (i.e., earnings management incentives) they may be expected to exercise more professional skepticism (Hurtt et al., 2008) leading, for example, to a more comprehensive information search (McMillan and White, 1993). This effect is especially pronounced for high risk clients (Hurtt et al., 2008). Thus, if auditors demonstrate heightened professional skepticism as evidenced by their sensitivity to the risks associated with earnings management then auditors will be more conservative in their negotiation process.

Based on the above discussion, we examine the following directional hypothesis:

H3: If audit adjustments will cause management to miss analyst's forecasts and the auditor demonstrates heightened professional skepticism then auditors will negotiate a more conservative financial reporting outcome.

Method

Participants

Audit partners and managers were recruited from two Big 4 firms to participate in the study.⁴ These are appropriate participants because they are routinely responsible for negotiating accounting disputes with clients (Brown and Wright, 2008). Thirty-eight auditors with prior

⁴ Auditors came from two of the Big 4 firms with 33 and 12 participants respectively. Inclusion of audit firm membership does not influence the results of our hypothesis tests ($p \geq .10$).

client-auditor negotiation experience completed the experiment.⁵ Of note, there are 21 audit managers and 16 partners with an average of 9.76 and 20.12 years of auditing experience, respectively.^{6, 7} Further, manager and partner participants have sufficient direct task experience in negotiating disputed accounting matters with a mean of 7.14 and 7.38 times, respectively, in which they have resolved a contentious matter with clients.

Experimental case

Overview

Auditors were randomly assigned to one of three experimental conditions and completed the experimental tasks (described in the next section) on the internet. This provided convenient access for the participants and it provided the researchers with control over the negotiation strategies of the client counterpart. Importantly, there were no significant demographic (i.e., firm, industry experience, etc.) differences ($p \geq .10$) among the experimental conditions, suggesting random assignment of participants was successful.

Experimental tasks

Participants received a realistic case which was developed in conjunction with two former Big 4 partners based on their experiences. The case was further reviewed by, and modified based on the comments and experiences of two partners from a different firm. The case

⁵ Forty-five participants took part in the study; however, seven participants were dropped from the statistical analyses because their final decision resulted in an indeterminable final EPS, resulting in a final sample of 38. For example, if participants did not specify which issue they would book or waive and indicated “other” as their option, we excluded these responses.

⁶ One auditor did not provide rank, general, or negotiation task experience. Exclusion of this participant did not qualitatively affect the results of our hypothesis testing.

⁷ Because prior research indicates that negotiation experience matters (Brown and Johnstone, 2009) we controlled for task experience and years of experience and found no significance for these variables, nor did inclusion of these variables significantly affect our results. Therefore, we do not include them in our primary model. As discussed in footnote 15, we also ran the model with experience as a covariate which did not qualitatively change the results.

is based on a client situation in which the audit team discovers during the year-end audit two potential accounting adjustments. The case requires the auditor to decide whether to book or waive up to two adjusting journal entries. The first adjusting entry, which is relatively less subjective, involves a cutoff error while the second adjusting entry which is relatively more subjective, involves revenue recognition and the delivery of multiple elements. We used a case involving two proposed entries with a similar magnitude of an effect on earnings (each would decrease the pre-adjusted EPS of \$1.55 by approximately \$0.045), to determine if auditors potentially tradeoff⁸ waiving one entry in order to book another entry (Sanchez et al., 2007). Both of these adjustments have been documented as approaches that clients may use to manage earnings (Nelson et al., 2003).

Figure 1 outlines the experimental process. Participants were required to assume the role of the auditor and interact with a simulated “client” that was programmed on the computer. First, auditors accessed the website using a password provided by the research team, and read an explanation of the study. Second, background information was provided about the company (industry, history, and summary financial statements) and the issue at hand. Specifically, the company is described as a publicly held, stable manufacturing firm in a stable industry. The company has an effective audit committee and is followed by analysts. Third, auditors were told that unaudited EPS was \$1.55. Additional information indicated that each of the proposed adjustments would reduce EPS by approximately \$0.045.

⁸ For example, auditors may compromise in a negotiation by waiving a subjective issue in order to induce the client to book the less subjective issue.

In the fourth step, the participants began the negotiation process, which lasted a maximum of five rounds.⁹ In each round the auditor can accept the CFO's position or provide a counter-position. If the auditor accepts the position of the CFO, agreement is reached and negotiations are ended. If no agreement is obtained at that time, auditors were asked to indicate to the CFO an appropriate adjustment for each of the two reporting issues. They were also asked to provide an explanation to the CFO for their counter-position. At the end of each round the computer-programmed CFO responded. The CFO was programmed to use a contending¹⁰ strategy which was held constant over all five rounds. Specifically, during each round the CFO indicated a preference to waive both adjusting journal entries. This type of strategy by the client represents high risk and difficulty for the auditor, since this situation suggests strong client pressures on the auditor to acquiesce. Finally, in the fifth step, if agreement had not been reached by the fifth round, negotiations ended and auditors were asked what actions they would take since agreement could not be reached and whether these issues are the type that they would generally take to the audit committee. In addition, auditors completed a post-experimental questionnaire where we measured negotiation experience, general experience, and industry specialization.

Independent variables

As described below, we use three levels of analysts' earnings per share (EPS) expectations to manipulate the potential economic consequences of booking the adjustments. In

⁹ We used results of prior research internet-based negotiation studies (e.g., Brown and Johnstone, 2009; Brown and Wright, 2008) to determine the maximum number of rounds. Participants were not informed of the maximum number of rounds because auditors in practice do not know how long a client might continue to resist their preferences.

¹⁰ In a contending strategy an individual maintains a favorable position by using persuasive agreements, threats, and/or commitments, ultimately with the intent of resulting in a "win-lose" outcome (Brown and Wright, 2008).

addition, we use a measured variable, heightened professional skepticism (also defined below), to capture the effect that salient risk concerns might have on the auditor's negotiation process and outcome.

We manipulated analyst's forecast using three conditions (*EARNINGS FORECAST*). In the first condition, the analyst forecasted EPS was \$1.53, resulting in a missed forecast if the auditor required the client to book *either* of the proposed adjusting journal entries. In the second condition, the analyst forecasted EPS was \$1.49, which would result in a missed forecast only if *both* adjusting journal entries were booked (e.g., can book one entry, but not both). Finally, in the third condition the analyst forecasted EPS was \$1.45, allowing the client to book both adjusting journal entries and still hit targeted EPS¹¹.

Given Quadackers' (2009) finding of a link between client risk factors and auditor skepticism, we coded the salience of client risk factors as a measure of inclination towards professional skepticism (see also Hurtt, 2010; Nelson, 2009). Recall from our discussion of the task, after each round, participants were required to provide an explanation for their position. We examined those explanations and coded each participant's specific references to risk factors collected during the negotiation process. The research team developed a coding scheme based on auditors' awareness of management incentives during negotiation (1 if risk factors were salient—i.e., explicitly addressed—to the participant and 0, otherwise). For example, if the participant made reference to fraud, errors, management incentives or client competency over the course of the negotiation process, we code heightened professional skepticism as higher and if

¹¹ It should be noted that approximately 89% of participants mentioned materiality in their responses during the negotiation process. This suggests that the adjustments were perceived to be material to the client's financial statements.

auditors did not mention any of the factors we coded it as lower¹². Coding was done by two trained graduate assistants, resulting in a 70% rate of agreement. When differences in coding emerged, a member of the research team independently did the coding. All unresolved differences were ultimately reconciled by another member of the research team. As a result, 25 auditors revealed evidence of heightened professional skepticism and 13 did not.

We examined each round of the negotiation and if, in a given round, the participant mentioned one of the issues the round was coded as 1, exhibiting heightened professional skepticism. Accordingly, this variable could range from 0 to 5, with 0 indicating no explicit evidence of heightened skepticism in any round, and 5 indicating that heightened skepticism was exhibited in every round. For example, one participant commented “We still need to get an understanding if these were intentional or they were errors. Did the revenue amounts help them hit estimates, bonus targets etc.; any fraud indicators.” In this instance we coded this comment as the participant exhibiting heightened skepticism. Table 1 presents a frequency count for the number of times participants in each forecast group mentioned factors that indicate heightened professional skepticism. We then constructed a dichotomous skepticism variable such that $SKEPTICISM = 1$ for observations where heightened professional skepticism was exhibited during the negotiation, and $SKEPTICISM = 0$, otherwise.^{13, 14}

¹² For example, the following participant statement was considered to represent salience of risk factors; “We need to get on the same page as to the appropriateness of the accounting first. I could probably get comfortable with the CFO's position on the materiality issue but would want to understand more. Did the revenue amounts help them hit estimates, bonus targets etc. where they errors or intentional...any fraud indicators”. However, a statement such as this, “The cutoff problem is basic and unsupportable” does not explicitly address salience of risk factors.

¹³ We also conducted this analysis using a continuous variable for professional skepticism (i.e., the number of times the participant cited a client risk factor) and the results were not significantly different. This suggests that our findings are not sensitive to the frequency of the mention of client risk factors.

Dependent variable

We measure the outcome of the negotiation process as the percentage adjustment (*ADJUSTMENT*) at the end of the negotiation ($[\text{final EPS} - \text{unaudited EPS amount of } \$1.55] / \text{unaudited EPS}$). The final EPS was calculated based on the counteroffer made by the auditor in the final round of the negotiation. For example, if in the final round the auditor proposed that the client book both adjusting journal entries, the final EPS would be \$1.46 [i.e., $\$1.55 - (\$0.045 + \$0.044)$]. As a result *ADJUSTMENT* would be -0.06 ($[\$1.46 - \$1.55] / \$1.55$); indicating that the auditor was unwilling to allow the client's preferred treatment. Alternatively, if *ADJUSTMENT* was other than -0.06, this would mean that the auditor was willing to waive one or both of the adjusting journal entries¹⁵.

Results

¹⁴ To further validate our measure of heightened professional skepticism, we administered a questionnaire to 33 accounting graduate students who already had employment secured in public accounting. Participants were given the basic case and were told that the CFO was opposed to making any adjustments and that the auditor raised a number of arguments to convince the CFO to change the client's position. Participants were presented with two auditor response profiles. In one profile, "auditor A" presented arguments that we coded as heightened professional skepticism (e.g., "If I can not get the CFO to understand the accounting I would continue to press the issue...competency, fraud risk control risk etc."). In the other profile "auditor B" presented arguments that we did not code as heightened professional skepticism (e.g., "The shipping issue is straightforward. It did not ship. You cannot book the sale. The other one I might need to consult to see what flexibility there might be"). After reading these descriptions, participants were asked to complete Hurtt's (2009) professional skepticism scale from the perspective of auditor A and auditor B. Results indicate that our participants significantly ($p < .001$) perceived the professional skepticism of auditor A to be greater than that of auditor B. These results suggest that our measured variable did capture elements of heightened professional skepticism.

¹⁵ Because research shows that experience (e.g., Brown and Johnstone (2009); Trotman et al (2009)) influences auditor's judgment in a negotiation task we ran the model with task experience as a covariate. Additionally, because audit committees have been found to influence auditors' judgment (Cohen et al., 2007b), we also ran the model with the participants decision to involve the audit committee (0 = will not involve the audit committee and 1 = will involve the audit committee). These covariates were not significant and did not significantly change our results.

Table 2, Panel A provides descriptive statistics that reveal that in each of the forecasted EPS conditions, explicitly-skeptical participants required larger adjustments than did other participants. Moving beyond descriptives, we use ANOVA to test our hypotheses. The results of the ANOVA are reported in Table 2, Panel B. Our test of H1 indicates no significant main effects with regard to *EARNINGS FORECAST* and thus we cannot reject the null hypothesis of no significant differences in the negotiation outcome among the three forecasted EPS groups ($F=0.098, p > .10$). However, in testing H2, there is a significant main effect of *SKEPTICISM* on the negotiation outcome *ADJUSTMENT* which indicates that auditors who explicitly displayed a heightened sense of professional skepticism were more conservative in their final position and required a larger adjustment to earnings ($F= 6.640, p = 0.007$)¹⁶. Finally, findings reported in Panel B indicate that the interaction between *EARNINGS FORECAST and SKEPTICISM* (i.e., a test of H3) is marginally significant ($F=1.78; p=0.09$). This suggests that auditors who display a heightened sense of professional skepticism require a greater adjustment to EPS. As shown in panel A of Table 2, the largest adjustment occurs when forecasted EPS is \$1.53 (any adjustment will cause the client to miss forecasted EPS) and skepticism is high. Further, on average, the smallest adjustment is required by the remaining participants in the same forecasted EPS condition (i.e., those that do not explicitly display professional skepticism). It appears that in the case where the client had the lowest flexibility (to report numbers that still achieved the earnings target) heightened professional skepticism played a central role. In fact, auditors that explicitly displayed skepticism in the “no flexibility” condition were the most conservative participants in the study while auditors in the same condition who did not display skepticism were, on average, the least conservative (mean adjustment = 0.053 vs. 0.016, $p < 0.05$). This result suggests that

¹⁶ Results are qualitatively the same if we use a continuous variable for professional skepticism (i.e., the number of times the participant cited a client risk factor).

auditors in the “no flexibility” condition were more skeptical about management’s explanations and assertions about the adjustments. Recall, auditors faced a contentious client who was highly reluctant to book any adjustments. As a result, auditors with heightened professional skepticism may have perceived this behavior as an attempt to manage earnings to meet analyst forecast. Therefore, the results suggest that these auditors were more conservative in their negotiation process and made minimal concessions.

Because H3 posits an ordinal interaction (see Figure 2), we also employed contrast coding (Buckless and Ravenscroft 1990). We coded the position of auditors in the group where the client had the least flexibility to achieve earnings targets (i.e., EPS = \$1.53) and auditor skepticism is high as 5 and the position of auditors in the other five groups as -1. H3 states that auditors will require a larger audit adjustment when professional skepticism is higher and booking the proposed audit adjustments will result in the client missing forecasted EPS. Using contrast coding reported in Table 2, panel C, we find that auditors in the target group adopt a significantly more conservative position than an equally weighted composite group from the other experimental conditions ($t_{32} = -2.918$, $p = 0.003$). Thus, H3 is supported.¹⁷

Additional analysis

¹⁷ To increase the power of the test, we further collapsed the data into a 2 x 2 where the independent variables were “*TARGET EPS*” (could adjust and still hit the target vs. could not adjust and still hit the target) by “*SKEPTICISM*” (higher vs. lower professional skepticism). There is a significant main effect of *SKEPTICISM* on *ADJUSTMENT* (p -value = 0.023), suggesting that when auditors exhibited heightened professional skepticism, they adopt a more conservative position and require a larger adjustment be made to the financial statements. Additionally, there is a significant interaction of *SKEPTICISM* x *TARGET EPS* (p -value = 0.002). Consistent with results described above, when audit adjustments will result in the client missing the forecasted EPS and auditors exhibit a heightened sense of earnings management risk, they will make fewer concessions during negotiations, resulting in a more conservative financial reporting outcome. Because we specify an ordinal interaction, we also conducted contrast coding. Results indicate that auditors in the target group require the largest adjustment to the financial statements as compared to an equally weighted composite group from the other experimental conditions ($t_{34} = -2.525$, $p = 0.008$). This lends additional support for H3.

We also examined if there was a trade off on the issues where auditors were willing to compromise on the more ambiguous issue (revenue recognition) while standing firm on the cut-off issue. There were no differences in the tradeoff of issues across the three EPS conditions. We find across all conditions that 55% of auditors were willing to waive the revenue recognition issue as opposed to the 34% who were willing to waive the cutoff issue. More in-depth analysis reveals that approximately 55% of the participants were willing to waive the more judgmental revenue recognition issue regardless of the level of professional skepticism. However, with respect to the less ambiguous cut-off issue only 24% of the auditors with heightened professional skepticism were willing to waive the adjustment as opposed to over 50% in the other condition. Collectively these results are consistent with existing auditor-client research that finds auditors are more willing to negotiate when issues are more subjective and ambiguous (i.e., principled based) as opposed to more definitive rules-based issues (Gibbins et al., 2001).

Conclusion

This study examines whether auditors are influenced in the negotiating process by management's incentives and by the degree that auditors exhibit heightened professional skepticism which, building upon the prior work in professional skepticism (Hurt, 2010; Nelson, 2009; Quadackers, 2009), we operationalize as the auditor's explicit acknowledgement/consideration of risk factors during the negotiation process. Results from a computerized experiment with 38 experienced managers and partners suggest that auditors' negotiations, on average, do not appear to be influenced by the potential of earnings management. These results are consistent with archival post-SOX research which can only examine associations and it can not tease out effects that are due to auditor's actions as opposed

to management's actions (Bartov and Cohen, 2006; Cohen et al., 2008; Davis et al., 2009; Bennie et al., 2009).

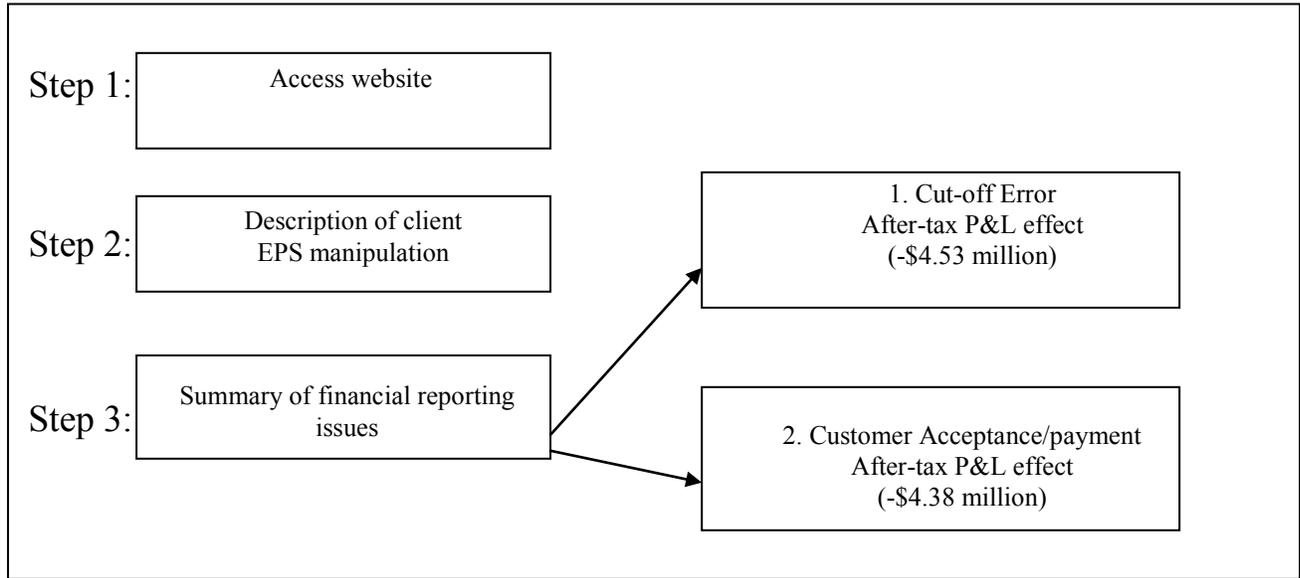
Further, we also find that when auditors exhibit heightened professional skepticism they are significantly more conservative and stand more resolute in their final negotiating positions, especially in situations where management has an incentive to manage earnings to meet EPS targets. These results reinforce prior research (Hurttt, 2010; Nelson, 2009; Quadackers, 2009) that suggests that professional skepticism is an important construct in all aspects of the audit process including the negotiation stage. One implication is that training at the manager and partner level should also include components on the negotiation process especially geared to sensitize auditors to explicitly consider risk factors when management is concerned with analyst's forecasts. Future research can explore if auditors who undergo more training that emphasizes heightened professional skepticism will be more conservative in the negotiation process than auditors without such explicit training.

The importance of heightened professional skepticism leads to the question of what factors may influence an auditor's ability to be vigilant during the negotiation process. For example, Nelson (2009) argues that one potential personality factor that may be of interest is "moral reasoning" (Jones, 1991). For example, auditors with high moral development may act more ethically (Jones et al., 2003) and exhibit heightened professional skepticism. A future study can examine if auditors with higher moral development or auditors who place a stronger emphasis on the construct of fairness (Cohen et al., 2007) will be more vigilant in the negotiation process.

As in all studies there are limitations that represent opportunities for future research. In this study, we inferred heightened professional skepticism by subjects' explicit consideration of risk factors (Quadackers, 2009). A future study could employ Hurttt's (2010) professional skepticism

scale and/or Quadackers et al.'s interpersonal trust scale (2009) to determine if auditors who exhibit greater scores on predetermined skepticism oriented scales would be more conservative in the negotiation process. Further, one of our errors was relatively straight forward and most of our subjects did not compromise on that issue. With the advent of IFRS and the anticipated increased use of professional judgment in auditing a future study could use a range of ambiguous accounting disputes to explore the tradeoffs that auditors may employ in the negotiation process. Finally, we held constant the governance structure of the client. Future research could examine the audit committee's role in the negotiation process. For example, Beasley et al. (2009) and Cohen et al. (2009) have found that audit committees are now taking a more substantive monitoring role in the financial reporting process. Thus, a future study could examine if auditors are more resolute in their negotiation process in the presence of stronger audit committees. Despite these limitations, this study presents evidence that in the post-SOX climate, auditors appear to be vigilant negotiators in upholding the integrity of the financial reporting process especially when auditors exhibit heightened professional skepticism. These results could be useful in developing training for auditors to ensure that they do not minimize the potential downside of a loss of objectivity. Further, these results lend support to the thrust of Nelson's (2009) and Hurr's (2010) papers on the importance of professional skepticism in auditor decision making.

Fig. 1. Flow of experiment



Negotiation phase

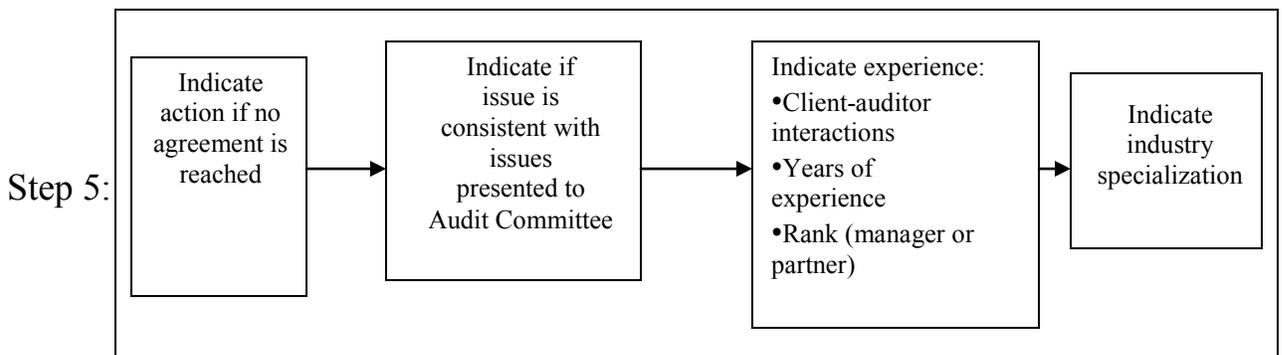
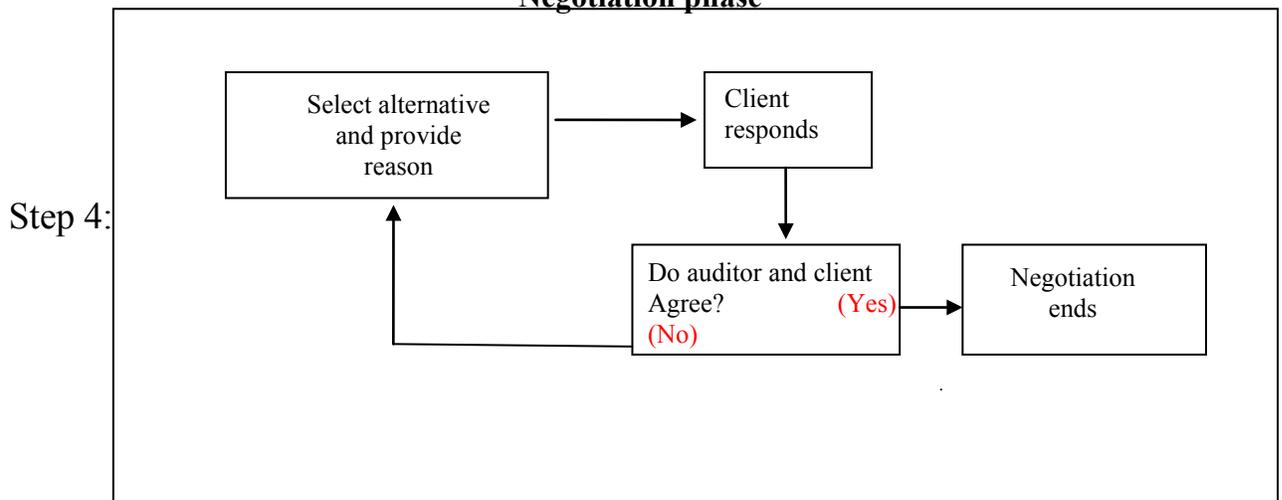


Fig. 2. Interactive effect of EPS forecast and skepticism

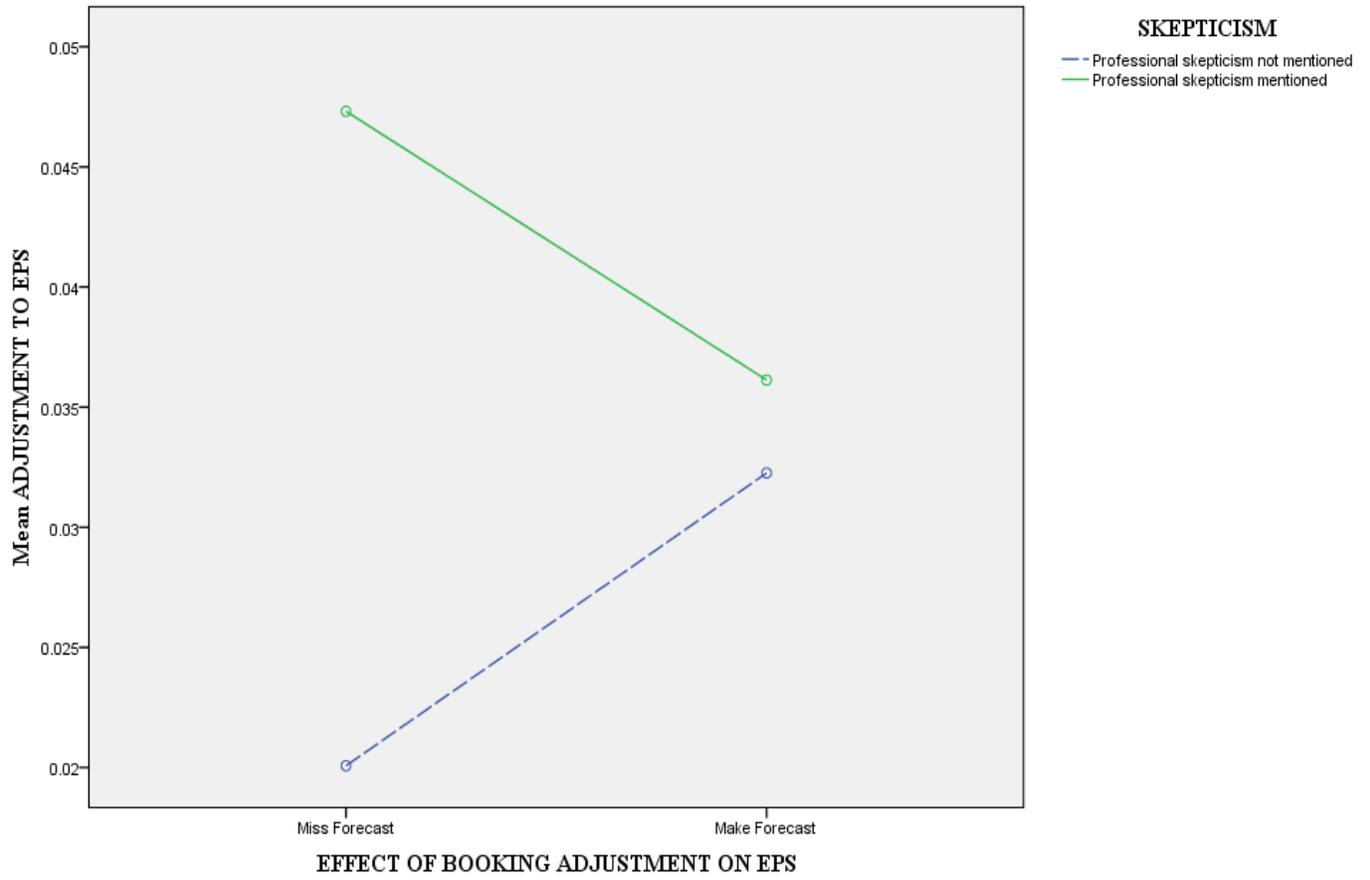


Table 1

Frequency of Professional Skepticism Factors Mentioned

*Forecasted EPS (\$1.55)**Number of times skepticism factors mentioned across all rounds of negotiation*

	<i>\$1.53</i>	<i>\$1.45</i>	<i>\$1.49</i>	<i>Total</i>
<i>0</i>	<i>4 (31%)</i>	<i>5 (45%)</i>	<i>4 (29%)</i>	<i>13 (34%)</i>
<i>1</i>	<i>2 (15%)</i>	<i>3 (27%)</i>	<i>4 (29%)</i>	<i>9 (24%)</i>
<i>2</i>	<i>3 (23%)</i>	<i>2 (18%)</i>	<i>3 (21%)</i>	<i>8 (21%)</i>
<i>3</i>	<i>2 (15%)</i>	<i>1 (9%)</i>	<i>3 (21%)</i>	<i>6 (16%)</i>
<i>4</i>	<i>1 (8%)</i>	<i>0</i>	<i>0</i>	<i>1 (3%)</i>
<i>5</i>	<i>1 (8%)</i>	<i>0</i>	<i>0</i>	<i>1 (3%)</i>
<i>Total</i>	<i>N = 13</i>	<i>N = 11</i>	<i>N = 14</i>	<i>N = 38</i>

Notes:

- Skepticism factors may have been mentioned in multiple rounds (potentially all five) of the negotiation.
- Cells represent the number (percentage) of participants making skeptical comments in a given number of rounds of negotiation.

TABLE 2

Panel A: Descriptive Statistics-Mean Adjustment made to EPS

		Unaudited EPS (\$1.55)			
		\$1.53	\$1.45	\$1.49	Total
Skepticism	Low	<i>N</i> = 4 0.016 (0.006)	<i>N</i> = 5 0.023 (0.023)	<i>N</i> = 4 0.032 (0.025)	<i>N</i> = 13 0.024 (0.020)
	High	<i>N</i> = 9 0.053 (0.019)	<i>N</i> = 6 0.039 (0.023)	<i>N</i> = 10 0.036 (0.023)	<i>N</i> = 25 0.043 (0.022)
	Total	<i>N</i> = 13 0.042 (0.024)	<i>N</i> = 11 0.032 (0.023)	<i>N</i> = 14 0.035 (0.022)	<i>N</i> = 38 0.036 (0.023)

Panel B: ANOVA Results

<i>Effects</i>	<i>Dependent Variable</i>	<i>F</i>	<i>Significance</i>
<i>Forecasted EPS</i>	<i>ADJUSTMENT to EPS</i>	0.098	0.907
<i>Skepticism</i>	<i>ADJUSTMENT to EPS</i>	6.640	0.007
<i>Forecasted EPS x Skepticism</i>	<i>ADJUSTMENT to EPS</i>	1.780	0.092

Panel C: Contrast coding to test for the hypothesized ordinal interaction

Hypothesis, Variable, Expectation	<i>t-Statistic</i>	<i>DF</i>	<i>p-Value</i>
<i>H3: ADJUSTMENT</i> (Forecasted EPS = \$1.53/High Skepticism (cell = highest))	-2.918	32	0.003

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