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The Effects of Performance-based Profit-sharing Schemes and Client Flexibility on Auditors' Judgements

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Abstract

Prior studies in auditing have examined the impact performance-based profit-sharing schemes (PES) and client's attitude in terms of flexible attitude and inflexible attitude on auditors' judgements independently, and there is an ex-ante expectation that these two factors will interact in the context of proposed audit adjustments in a pre-negotiation setting. Based on theory of motivated reasoning, this study examines whether client attitude will have a smaller effect when auditors' PES is based on firm-wide scheme as compared to divisional scheme. The findings show that auditors' PES and client attitude interact to affect auditors' negotiated behaviour in a simulated setting. Our results exhibit concessionary (i.e., waiving a material audit adjustment) behaviour of experienced auditors from the US. The findings extend the contemporary research on auditor-client negotiation by providing evidence to the literature that PES schemes influence the behaviour of auditors in a simulated negotiation setting. The findings suggest that auditors do not only act as motivated reasoners due to PES schemes since client's attitude may also influence their behaviour.

Keywords: Theory of Motivated Reasoning, Concession, Profit-sharing schemes, Flexibility

1. INTRODUCTION

This paper reports the result of an online experiment that examines how performance-based profit-sharing schemes (hereafter, PES) and client flexibility affect audit partners' judgements in an auditor-client negotiation setting. Specifically, we investigate the concession-making behaviour of experienced auditors from the US. In this study the audit judgement involves the auditors deciding on the magnitude of the provision for obsolete inventory to be reported in the client's financial statements. The study of provision for obsolete inventory is important because subjective accounting estimates require professional judgements by the auditor and client management to determine the appropriate amount of provision to be reported in the financial statements. The auditor and client management (hereafter, client) may differ in their professional judgements of accounting estimates. The "differences in professional judgement" often result in disagreements over such accounting issues and require negotiations between clients and auditors to resolve the disagreements (Gibbins, Salterio, and Webb 2001; Gibbins, McCracken, and Salterio 2005; Tan and Trotman, 2010). Auditors may propose audit adjustments that reduce client income to ensure the financial statements are free from material misstatements so that an unqualified audit opinion represents a true and fair view of the financial statements.

However, prior auditing studies have shown subjective audit adjustments involving professional judgements are typically more contentious to resolve than objective audit adjustments (i.e., clear-cut errors) and are more likely to be waived by auditors (Braun, 2001; Wright and Wright, 1997). Furthermore, results of prior studies in auditing have provided evidence that explicitly stated client preferences influence the behaviour of auditors (Buchman, Tetlock, and Reed, 1996; Gramling, 1999; Jenkins and Haynes, 2003; Salterio, 1996; Salterio and Koonce, 1997). Our paper visualises that explicitly stated client preference can take the form of a client's flexible and inflexible attitude towards the recording of a subjective audit adjustment in a negotiation situation. The findings of prior auditing studies have indicated auditor decisions are influenced when subject to client pressure, thereby reducing the quality of financial statements (Messier Jr and Schmidt, 2018; Hackenbrack and

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Nelson 1996; Ng and Tan, 2003, 2007; Hatfield, Jackson, and Vandervelde, 2003). The effect of client pressure will be further exacerbated when Generally Accepted Accounting Principles (GAAP) require recording of the transaction but allows some latitude in the amount of the proposed audit adjustments (Kadous, Kennedy and Peecher, 2003; Hackenbrack and Nelson 1996; Lord 1992). Limited evidence in auditing research also showed the behaviour of auditors is affected by the client's attitude to adjust or waive audit adjustments (Gibbins, McCracken, and Salterio 2010).

On the other hand, in the auditor-client negotiation literature, the effect of performance-based profit-sharing schemes on concession-making behaviour is under-explored. This is despite prior studies in auditing providing evidence that auditing firms have increasingly adopted PES to compensate audit partners (Burrows and Black, 1998; Coram and Robinson, 2017; Ernstberger, Koch, Schreiber, and Trompeter, 2020; Brenk, Majoor & Wright, 2021; Wyatt, 2004). In a study Zeff (2003, p 280) points out that "the root cause of the questionable decisions attributable to audit firms in recent years has been purely financial incentives given to audit partners by their firms." The audit partner's financial incentives depend on how the audit partners are compensated. The extant literature on other accounting research provides evidence that incentive-based compensation schemes can influence self-interested behaviours (Evans III, Kim, and Nagarajan, 2006; Gong and Ferreira, 2014; Nagar, 2002). The auditing environment is not an exception. This study aims to examine an ongoing tension between auditors' professionalism (i.e., auditor concession-making behaviour (e.g., Bame-Aldred and Kida, 2007; Cheng, Tan, Trotman, and Tse, 2017) and auditors' economic motivation such as client retention (e.g., Hackenbrack and Hogan, 2005) prevalent in the current audit-client negotiation environment. This leads to our research question as follows:

What are the independent and joint effects of client attitude (i.e., inflexible vs. flexible) and the use of PES schemes (i.e., firm-wide vs. divisional) on auditors' negotiated judgements?

To address the above research question, we conduct an online experiment that aims to investigate whether the auditors' PES and client flexibility jointly affect auditors' negotiated outcomes in a simulated environment. Although prior research in auditing has separately examined PES and client flexibility on auditors' behaviour, the current auditing literature does not inform us how these two factors interact in the context of the recording of audit adjustments in a negotiation setting. There is an ex-ante expectation that these two factors will interact in the context of proposed audit adjustments in a negotiation setting. Prior research has shown that the role of those audit partners includes the responsibility of developing and maintaining an amicable relationship with the client, namely, keeping the CFO "happy" (McCracken et al. 2008). On the other hand, DeAngelo (1981) argued that the greater the client-specific revenue stream (i.e., the more the auditor loses audit fees by client termination), the lower the chance that the auditor will report a discovered breach. In other words, the greater the observed future economic interest in each client, the lower the chance that the auditor will report a breach of quality of the client's financial statements.

Therefore, audit partners are faced with a dilemma to meet the client's preferred negotiation outcome and keep the clients happy as well as achieve a negotiated outcome that is acceptable to both. Considering DeAngelo's (1981) argument we expect that irrespective of the client's attitude, audit partners in the firm-wide scheme may be less motivated to provide concessions to the client's demands as they are less economically dependent on the revenue stream from a particular client. At the same time, we expect that auditors whose performance bonus is distributed from a divisional scheme will be more concerned about keeping their clients happy as their performance bonus might be adversely affected when they face flexible and inflexible clients. This heightened concern for damaging client relationships may induce auditors to act as motivated reasoners. Therefore, in this study, we argue that based on the theory of motivated reasoning, there is an *apriori* reason to argue that the client's attitude will have a lesser impact on audit partners whose PES compensation is based on a firm-wide scheme as opposed to audit partners whose PES based on the divisional scheme.)

The findings show that auditors' PES schemes and clients' attitudes interact to affect auditors' behaviour in a negotiation setting. The findings exhibit auditors' concessionary behaviour in terms of partially or fully waiving a material audit adjustment. Overall, auditors in the divisional scheme condition provide relatively more concession to auditors in the firm-wide scheme condition when faced with flexible and inflexible clients. Our findings have the following contributions. First, the results of this study extend the contemporary research on auditor-client negotiation literature by providing additional evidence that PES schemes affect the behaviour of auditors in a negotiation setting. The findings suggest that PES schemes induce auditors to act as motivated reasoners. This theoretical discussion on the theory of motivated reasoning explains the findings in prior empirical studies in auditing (Carcello et al. 2000; Dekeyser et al. 2016; Trompeter, 1994). Second, the results also provide evidence against the arguments in prior negotiation literature that auditors are less likely to deviate

from their initial positions compared to other negotiators because of their professional image to the outside world (Bame-Aldred and Kida, 2007; Hatfield et al., 2010; Ng and Tan, 2003).

Our results have implications for audit practice. First, the findings of this paper may alert accounting firms of how contextual factors may differentially impact the behaviour of experienced auditors in negotiation contexts. The findings of this paper provide accounting firms with relevant information to design a formal development program for experienced auditors, especially audit partners to prepare themselves for any future negotiation with client management. Second, the findings of this study may alert regulators and standard setters about the influence of economic (i.e., financial) incentives that impact accounting numbers in negotiation context. This study supports the discussion that financial incentives should not be allowed to impair audit quality (Francis, 2004; Trompeter, 1994; Wyatt, 2004; Zeff, 2003). The Transparency Reports contain details about audit partners' compensation (e.g., fixed salary and variable performance bonus) but information regarding the profit-sharing pool is not mentioned. The regulators and standard-setters may gain insight into how performance-based profit-sharing schemes affect the behaviour of auditors in the negotiation phases. It is known that standard setters are aware of disagreements between auditors and clients, and the related discussions are important in improving audit quality (ISA No. 450).

The remainder of this paper is organised with theoretical discussion and hypotheses development in Section 2, research design, and method in Section 3. Section 4 presents our results. We conclude with a discussion of the results and their implications for audit practice, limitations, and future research in Section 5.

2. BACKGROUND AND HYPOTHESIS

The extant literature on auditor-client negotiation has established the notion that financial statements can be characterised as an outcome of negotiations between an auditor and client management (Antle and Nalebuff, 1991; Gibbins et al. 2001; Gibbins et al. 2005; Trotman, Wright, and Wright, 2005). The professional pronouncements (AICPA 1984; ACIPA 1997; SAS No. 99 and AICPA, 2002) recognise an auditor's responsibility to detect material misstatements and then ensure appropriate resolution of them. If those disagreements are not appropriately resolved, and the auditor believes the financial statements are materially misstated, the auditor is required to issue a modified (e.g., qualified, or adverse) opinion. A modified audit opinion reduces an auditor's implicit assessment of costs associated with litigation risks, regulatory sanctions, and loss of reputation (Carcello and Palmrose, 1994). On the other hand, clients may switch auditors after having received a modified audit opinion (Chow and Rice, 1982; Lennox 2000; Krishnan 1994; Krishnan and Krishnan, 1996; Carey, Geiger, and Connell 2008) because they are dissatisfied with the outcome of a negotiation with the auditor (Sanchez, Agoglia and Hatfield, 2007, Tan and Trotman, 2010). Both audit research and deficiencies in regulatory inspection reports provide evidence that auditors often adopt self-interested goals to acquiesce to the client's preferred position (Blay, 2005; Hackenbrack and Nelson, 1996; PCAOB 2017, 2014, 2012; Kadous, Kennedy, and Peecher, 2003; Koch and Salterio, 2017; Ng and Tan, 2003).

This tendency to waive audit adjustments may lead to financial statements remaining materially misstated after negotiation. This inclination towards accepting the client's preferred position is troubling because it is detrimental to audit quality and protecting the public interest (Koch and Salterio, 2017). In the social psychology literature, Kunda (1990) suggests motivated reasoning occurs when an individual is motivated to arrive at a particular conclusion. However, Kunda (1990, pp 482-483) also suggests that individuals are motivated to arrive at a goal, attempt to be rational, and try to find justifiable reasons for those conclusions to persuade a "dispassionate observer." Prior auditing studies have shown that auditors act as motivated reasoners (Blay 2005, Kadous et al. 2003, Peecher et al. 2010, Hackenbrack 1992, Koch & Salterio, 2017). Kunda (1990 493) states that "directional goals have been shown to affect people's attitudes, beliefs, and inferential strategies in a variety of domains and studies conducted by numerous researchers in many paradigms."

For example, purely financial considerations may motivate auditors to act as motivated reasoners and adopt directional goals that are consistent with client preferences. Bazerman and colleagues (Bazerman et al. 2002; Bazerman et al. 1997; Bazerman and Moore, 2011; Moore et al. 2010; Bazerman et al. 2006) argue that as long auditors are hired and paid by the client it enhances the willingness of an auditor to adopt a self-interested directional goal of "to see the world through the eyes of client management" (Koch and Salterio 2017 p 118). Auditors have a strong incentive to remain in the client's good graces and are thus highly motivated to accept their client preferred accounting treatments. Expressing the arguments proposed by Bazerman and his colleagues in terms of motivated reasoning theory (Kunda 1990), it can be argued that an auditor might adopt a self-interested goal to acquiesce to the client's preferable reporting choices because the client hires and fires the auditor.

2.1 Performance-based profit-sharing scheme (PES)

The central theme of this paper is to examine whether the PES scheme variable (i.e., economic motivation) affects experienced auditors' concession-making behaviour (i.e., waive material audit adjustment) in a negotiation setting. The dominant organisational form for audit firms is a partnership structure (Kandel and Lazear 1992; Greenwood, Hinings, and Brown 1990; Huddart and Liang 2003, 2005; Liu and Simunic 2005). Audits are administered by engagement partners based in a specific practice office who are remunerated using a performance evaluation-based profit-sharing scheme (Burrows and Black 1998; Coram and Robinson 2017; Trompeter 1994; Wyatt 2004). Consistent with the theory of motivated reasoning, it can be argued financial considerations may induce auditors to act as motivated reasoners and reach client preferred outcomes. The reason is that an individual partner obtains a significant portion of the expected benefits from accepting client demands while passing the expected cost to the partnership (Trompeter 1994).

The author suggests if accounting firms use a small profit pool (i.e., divisional profits) in determining partner compensation, then it is more likely an individual audit partner will acquiesce to client preferences as he/she may become financially dependent on the client. In contrast, when accounting firms use a large profit pool (i.e., firm-wide profits) to compensate for an audit partner, each partner has less stake in a particular engagement. It can be argued that an individual partner will be less financially dependent on a particular client. Hence, the individual partner will be less motivated to accept the client preferred treatments as the client is much less important to the partner's income. Prior empirical research shows audit quality improves when audit partners' compensation is based on a large profit pool (Carcello, Hermanson, and Huss 2000; Dekeyser, Gaeremynck, Knechel, & Willekens 2016; Hay, Baskerville, and Qui 2007). This is because when audit firms share profits across a larger pool, the partners from other offices have a stake in a particular engagement. It is hypothesised that divisional (firm-wide) schemes will motivate auditors to be more (less) accommodating in meeting client demands. Therefore, we argue that irrespective of client conditions, a firm-wide scheme will have a lesser impact on concession-making behaviour as compared to a divisional scheme because of less economic dependency on a particular client. Accordingly, Hypothesis 1 is stated as follows:

H1: *Ceteris paribus, auditors in the divisional PES condition will record a smaller allowance for obsolete inventory than auditors in the firm-wide PES condition in a negotiation setting.*

2.2 Client flexibility

Prior qualitative studies in auditing provide evidence that audit partners encounter clients who are unwilling to accept and strongly oppose recording income-decreasing audit adjustments (Beattie, Fearnley, and Brandt, 2004; Gibbins, Salterio, and Webb, 2001; McCracken, Salterio, and Gibbins, 2008). Beattie, Fearnley, and Brandt (2001) provide an example where the client management did not want to accept the proposed change in accounting treatment for goodwill by the auditor. The audit partner did not see any other option other than to stay firm in their position considering the standards for goodwill accounting. Hence, the negotiation became hostile and difficult to resolve. Beattie et al. (2001) also describe a case where the auditor-client negotiates over the fair value assessment of a property. Contrarily, in that scenario, both the auditor and client management moved from their positions, easing the negotiated outcomes. When negotiating parties are firmly committed (i.e., inflexible) to their position, an agreeable outcome is difficult to achieve, and the relationship starts to worsen (Greenhalgh and Chapman, 1998). A prior auditing study by McCracken et al. (2008) has shown that the role of the audit partner includes the responsibility to maintain a cordial relationship with client management.

In an experimental setting with 140 audit partners, Gibbins et al. (2010) examine the joint effect between the flexibility of the client's initial accounting position and the nature of the client relationship on audit partners' selection of negotiation strategies with client management. The study by Gibbins, McCracken, and Salterio (2010) investigates two hypotheses relating to client inflexibility in a pre-negotiation setting. Their first hypothesis states an audit partner negotiating with an inflexible client may adopt integrative strategies to resolve negotiation issues. Based on the evidence in the negotiation literature that negotiating parties do not employ integrative strategies, the authors formulate the second hypothesis that auditors will be more likely to adopt a contending strategy when facing an inflexible client. For the first hypothesis, the results show that there is only a marginally significant relationship between client inflexibility and an expanding agenda strategy. The problem-solving strategy did not show any significant relationship with client inflexibility. The authors formulate the third hypothesis that when an audit partner is facing a flexible client, there is a higher possibility of adopting either a compromising or a concession-making strategy. They report there is a significant relationship between client flexibility and both the compromising and concession-making strategies. Overall, their results show that there is an undifferentiated emphasis to adopt integrative strategies across all the experimental conditions by

audit partners (Gibbins et al. 2010). They argue that this undifferentiated emphasis on integrative strategies may be troublesome because it shows audit partners will always look for "wins" for client management during negotiations. The findings by Gibbins et. al (2010) suggest that audit partners resort to a contending strategy and concession-making or compromising strategy, for inflexible and flexible clients, respectively. The findings imply audit partners may provide less (more) concessions to the inflexible client (flexible clients). Accordingly, Hypothesis 2 is stated as follows:

H2: *Ceteris paribus, auditors in the flexible client condition will record a smaller allowance for obsolete inventory than auditors in the inflexible client condition in a negotiation setting.*

2.3 Interaction between PES and Client flexibility

In this study, we investigate whether there is an interaction between the PES and the client flexibility variables. Based on the earlier discussion on the theory of motivated reasoning it is known auditors, particularly audit partners are motivated to reach a client's preferred treatment. This motivation stems from whether the audit partner is economically dependent on the specific client engagement. From an economic perspective, audit partners in firm-wide schemes will be less economically dependent on revenue generated by an individual client as compared to divisional schemes, although losing a publicly listed client may affect the audit partners' future career prospects. From the perspective of motivated reasoning theory, there is an expectation that audit partners in divisional schemes are likely to be more susceptible to giving into the wishes of inflexible clients as compared to the flexible clients to keep the inflexible client "happy". However, there could be two arguments that counter this expectation.

First, when PES is based on the divisional scheme, auditors especially, audit partners mind and feel that they are involved in the negotiation such that, if an audit partner in a divisional scheme feels that termination of the relationship is inevitable and sees no way to convince the inflexible client to record the audit adjustment, then the concerned audit partner will adopt a hard stance and offer fewer concessions to that inflexible client. The plausible reason is the audit partner is certain that there will be no future revenue generated from that client engagement. Even though audit partners in the divisional scheme are economically dependent on the revenue generated from a specific client engagement in that instance, audit partners will take conservative positions and offer fewer concessions in recording audit adjustments to the inflexible client.

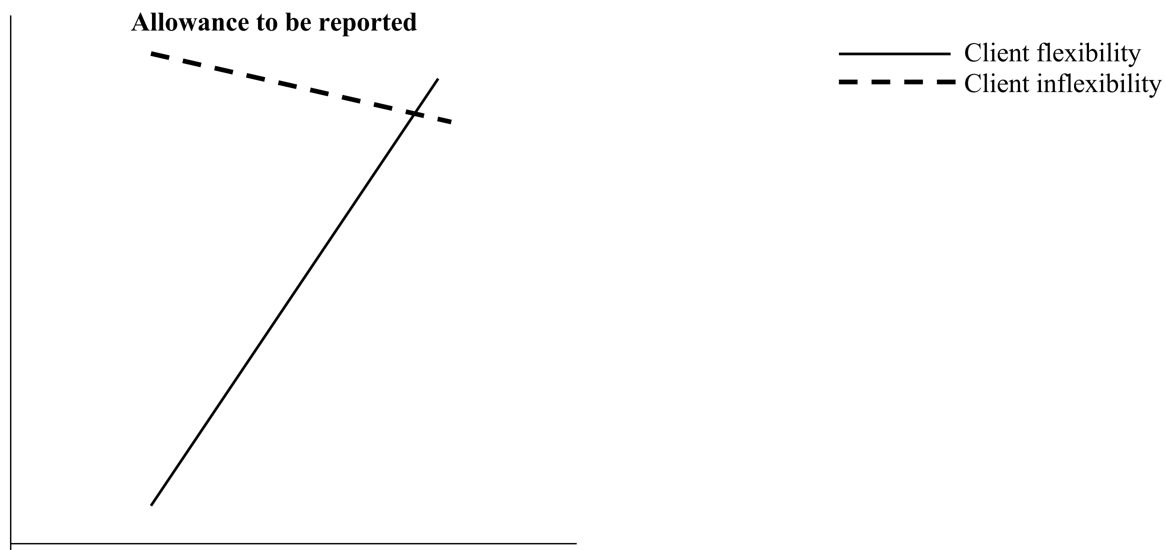

Figure 1. The hypothesised ordinal interaction

Second, the inflexible client may not be very responsive while negotiating with the auditor, this is going to irk the auditor and invoke a tit-for-tat response based on the societal rule of reciprocity (Sanchez, Agoglia, and Hatfield, 2007; Tan and Trotman, 2010). On the other hand, audit partners in firm-wide schemes are less likely to be susceptible to satisfy the needs of client management when they face either flexible or inflexible clients. The reason is that the concerned audit partner is less economically dependent on a specific client engagement. Hence, the audit partner will feel less involved in the negotiation and will show an indifferent attitude while

dealing with either flexible or inflexible clients. Hence, they will take conservative positions and offer fewer concessions in recording audit adjustments to both types of clients. Accordingly, Hypothesis 3 is stated as follows:

H3: Ceteris paribus, client inflexibility will have a smaller downward effect on the magnitude of recording allowance for obsolete inventory when auditors are in the divisional scheme condition than when auditors are in the firm-wide scheme condition in a negotiation setting.

3. RESEARCH DESIGN

3.1 Task and procedure

In this study, we develop our scenarios about Highpoint Electronics based on two published studies (Bennett et al. 2015; Koch and Salterio 2017). The scenario requires participants to assume the role of an audit partner receiving a report from the audit manager about disagreements regarding an estimation for inventory obsolescence resulting in a potential overstatement of pre-tax income. Highpoint Electronics is also involved in a merger discussion with a competitor firm. The client is reluctant to record the income-reducing audit adjustment because it may cancel the merger. Participants were provided with background information regarding the audit firm and the client. Important contextual factors relating to the audit firm were held constant. Specifically, we mentioned that the audit firm is subject to annual review by the regulatory authority, and the firm is also registered for peer review by the professional body every three years. Moreover, the concurrent partner for this engagement is a very senior audit partner and specializes in manufacturing industry audits. Also, we mention “Form AP” must be submitted to the regulatory authority.

The engagement team possesses the sufficient experience to perform this engagement, and the team comprises an audit manager, two audit seniors, and two junior auditors. We also provide information that the client is important from the local office perspective because it contributes significantly to total revenue derived from audit fees. Moreover, the key contextual factors of the client were held constant. Specifically, we mention the CFO is professionally qualified with prior audit experience. The CFO is quite flexible regarding audit adjustments, and in prior years, the CFO agreed to most audit adjustments. Therefore, no qualified audit opinions were issued. In prior years, the CFO and accounting staff cooperated with the audit team. The audit team and client have developed a good working relationship. The Board of Directors takes an active interest in the day-to-day working of the company. The internal controls are sound and can be relied upon. The audit committee is considered strong and asks many probing questions on accounting decisions. After the background information, participants received a simplified comparative income statement along with information on inventory balance (current year unaudited and prior year audited). Participants then considered a situation where a material difference ($5,000,000) arose during the audit between the auditor’s estimate ($7,000,000) and the client's estimate ($2,000,000) for inventory obsolescence. The audit client recorded the allowance for obsolete inventory at $2,000,000 in the unaudited financial statements. The audit team’s initial estimate was their independent estimate for the obsolete inventory allowance.

In this experiment, auditor participants were specifically required to answer the question about the allowance of obsolete inventory to be reported in the client’s financial statements, not the adjusting journal entry of $5,000,000 to be recorded in their audit work papers. For that reason, the question did not ask the participants to choose an amount between $0 and $5,000,000. Instead, it is expected that auditor participants will be able to record the required adjusting journal entry (i.e., Dr Cost of Sales and Cr Allowance for obsolete inventory) in hindsight after determining the allowance for the obsolete inventory. For example, if an auditor wants to report $5,500,000 as the allowance for the obsolete inventory on the client’s financial statements, then the following adjustment entry would need to be recorded in the work papers of the auditor:

Dr Cost of Sales $3,500,000
Cr Allowance for obsolete inventory $3,500,000

It is because there is an allowance of $2,000,000 for obsolete inventory recorded by the client in the unaudited financial statements. To report an allowance of $5,500,000 in the client’s financial statements, the auditor needs to record an adjustment entry of $3,500,000 in their work papers.

3.2 Independent variables

To test our hypothesis, we employed a 2X2 between-subjects design where the client flexibility variable (flexibility versus inflexibility) and the PES variable are (divisional scheme versus firm-wide scheme) fully crossed. We adopted the manipulation for the divisional scheme and firm-wide scheme from Chong et. al (2018). For the divisional scheme manipulation, we provided the following information to the subjects, "It is the policy of your firm that all audit partners' bonus is tied to the financial performance of your local office (divisional profits). Your bonus is calculated by the office managing partner from a profit pool based on the divisional profits." Similarly, for the firm-wide scheme manipulation, we provided the following information to the subjects, "It is the policy of your firm that all audit partners' bonus is tied to the financial performance of your audit firm at the national level (firm-wide profits). Your bonus is calculated by the office managing partner from a profit pool based on the overall firm-wide profits."

This study adopts the manipulation statements for the client flexibility and inflexibility conditions from Gibbins et al. (2010). The following information was given to the auditor participants for the manipulation of client flexibility, "You learned from the conversation that the CFO is not fully committed to the unaudited pre-tax income of $49,500,000. You believe that the CFO would accept some adjustments to the pre-tax income of $49,500,000. It seems the CFO is willing to "live with" a range of pre-tax income numbers." Similarly, the following information was given to the auditor participants for the manipulation of client inflexibility, "You learned from the conversation that the CFO is firmly committed to the unaudited net income of $49,500,000. You believe that the CFO would not accept any adjustments to the pre-tax income of $49,500,000. It seems the CFO is not willing to "live with" a range of pre-tax income numbers." Additionally, to the above manipulation, we incorporate the different negotiation logics in the conditions.

3.3. Dependent variable

Prior evidence in the auditing literature suggests, auditors are unwilling to issue qualified audit opinions because it will weaken the relationships with clients. There is a possibility that clients may switch auditors after receiving qualified audit opinions. According to the theory of motivated reasoning, auditors may move toward clients' preferred estimates to satisfy clients' preferences. If clients agree to accept the auditors' proposed estimate, the auditors will issue unqualified audit opinions without jeopardising their relationship with clients. Prior experimental studies also employed a computer-simulated negotiation setting to examine auditors' behaviour (Brown and Johnstone, 2009; Hatfield et al., 2010). The dependent variable in this experiment closely resembles the operationalisation of the auditors' negotiated outcome captured by Hatfield et al. (2010) which is the final allowance the auditor participants want to report. Specifically, this study mentions that "Assume that you are now in the meeting with Highpoint's CFO to resolve the inventory issue. You may choose to agree or disagree with the CFO over a maximum of 5 rounds of interaction. You must now decide how to proceed."

The auditor participants were given three options and they need to choose any one of the options. The three options are mentioned below:

Option 1: Waive Adjustment: Accept the allowance of $2,000,000 currently in the financial statements.
Option 2: Require Full Adjustment: Insist that Highpoint increase the allowance to $7,000,000.
Option 3: Propose New Adjustment: Propose a new allowance somewhere between $2,000,000 and $7,000,000.

By providing three options to participants, this study also captures whether the participants are willing to negotiate with clients or whether the participants already have decided on the allowance to be reported before negotiating with clients.

3.4 Procedure

We used an online method to collect data. Given the seniority of audit practitioners that negotiate with a client, it was difficult to get subjects for this experiment. Hence, we employed a large international online research panel, Qualtrics, to collect data for this study. Qualtrics did a 'soft launch' (i.e., pilot study) to pre-test the instruments for case realism. The pre-test did not highlight the need for any significant changes to the instruments. Recent studies suggested after incorporating adequate screening questions online platforms (e.g., Qualtrics) may be considered as a potential avenue for the recruitment of auditor participants for experimental settings (Leiby, Rennekamp and Trotman 2021; Holt and Loraas 2019; Brandon et al. 2014). External auditors represent a difficult participant group to access for behavioural accounting researchers. Given the seniority of external audit practitioners who usually negotiate with a client, it is even more difficult to get access to

participants for this experiment. Hence, this study employs a reputed international online research panel, Qualtrics to collect data for this experiment. Other published accounting studies (Long and Basoglu, 2016; Nelson and Rupar, 2015) also used the Qualtrics panel to recruit tax accountants and MBA graduates (Study 2), respectively. The recruitment of tax accountants indicates it is not uncommon to use Qualtrics Panel to recruit hard-to-reach participants. Qualtrics Panel provides participant recruitment services for a fee. The researcher of this study did not have direct contact with participants, who were compensated for completing the study instruments by Qualtrics. Qualtrics does not divulge participant compensation information. There is considerable debate among academic researchers regarding using online platforms (e.g., Qualtrics) for the recruitment of participants with specialised knowledge, skill, and experience (e.g., external auditors, and tax accountants). Nevertheless, recent studies suggest after incorporating adequate screening questions, online platforms may be considered as a potential avenue for the recruitment of external auditor participants for research purposes (Brandon, Long, Loraas, Mueller-Phillips, and Vansant, 2014; Holt and Loraas, 2019; Leiby et al. 2021).

The two appealing aspects of the Qualtrics Panel are that participation is truly voluntary and participants are truly anonymous to the researcher (Holt and Loraas, 2019). Voluntary participation implies participants recruited through Qualtrics Panel are true "pull" participants as they willingly decide to volunteer to participate in surveys or experiments. Similarly, a potential benefit of the true anonymity of participants to the researcher is that participants feel no demand effects as they know their responses cannot be tied to themselves or their firm and they can, therefore, answer freely. Based on their findings Holt and Loraas (2019) commented, "Qualtrics Panels present a promising avenue for obtaining external auditor participants when the research context applies to a broad spectrum of auditors." Furthermore, in the article by Leiby et al. (2021, p. 65), the authors mentioned that critics of online platforms often point to participant anonymity and low wages as red flags for inattention or low effort (Clifford and Jerit 2014) but there is no evidence to support these criticisms. Moreover, Hauser and Schwarz (2016) found that online participants are more sensitive to subtle, yet meaningful changes in the wording of questions. Qualtrics randomly distributed four condition-based research instruments to its community panel members along with invitation letters stating the purpose of the study.

We recruited experienced audit practitioners (e.g., audit partners, directors, senior managers, and managers) from the US. We incorporated three screening questions to filter out participants who did not meet our criteria. We used the following criteria for sample inclusion. The first screening question was about the current profession of the participant. If participants selected a profession other than "External Auditor," the survey would terminate. The second screening question was about the actual external audit position of the participant. If participants selected "Junior Auditor," the survey would terminate. The last screening question was related to participants' experience (i.e., number of years) as an external auditor. If participants selected "0-3" years' experience as an external auditor, the survey would terminate. Then, we examined the respondents' identification (ID) numbers and internet protocol (IP) addresses, which revealed no similar ID numbers or IP addresses. This examination of IP addresses suggested that there were not multiple responses from the same respondents. This examination of IP addresses suggests that there were no multiple responses from the same respondents. The quality check protocol (e.g., Prevent Ballot Box Stuffing) option prevents participants from taking a survey more than once. The preventive option places a cookie option on participants' browsers when they submit a response. If a participant clicks on the survey link for a second time, Qualtrics will detect this cookie and not permit the participant to retake the survey. Participants responded to comprehension and manipulation check questions. Next, subjects responded to two questions regarding the minimum allowance they would accept and their chosen materiality level. Finally, participants responded to a series of demographic questions.

4. DATA ANALYSIS AND RESULTS

We collected a total of 43 responses for this study. The demographic information for this study is summarised below:

Out of 43 participants, 32 are male and 11 are female participants. Out of the total participants, 6, 8, and 13 participants are audit partners, directors, and senior audit managers, respectively. The remaining 16 are audit managers. In terms of audit experience, 17 participants have more than 10 years of experience. 19 participants reported they have audit experience between 7 to 9 years whereas 7 participants mentioned their audit experience falls between 4 to 6 years. Out of the total participants, nine participants reported that they work in Big 4 firms, six and five participants reported that they work in non-Big 4 firms with international presence and non-Big 4 firms with a national presence, respectively. The remaining 17 and six participants work in regional and local firms. Lastly, the participants were asked how often they resolve audit differences with clients. 15 and

19 participants reported they resolve audit differences very frequently and frequently, respectively while six participants reported they occasionally resolve audit differences. One and two participants mentioned they resolve audit differences rarely and very rarely. The below Table I shows negotiation behaviour of auditors. It can be said that out of 43 participants, 14 participants (i.e., 33%) chose to waive the audit adjustment, and another 10 participants (i.e., 23%) insisted the client fully record the audit adjustment. The remaining 19 participants chose to negotiate with the client.

Table 1: Descriptive: Auditors' Negotiation Behaviour

Conditions	**Cell size**	**Waive adjustment**	**Require full adjustment**	**Propose New adjustment**
Divisional scheme Flexible client	13	9	0	4
Divisional scheme Inflexible client	09	1	3	5
Firm-wide scheme Flexible client	09	2	3	4
Firm-wide scheme Inflexible client	12	2	4	6
Total	43	14	10	19

4.1 Comprehension and Manipulation check

4.1.1 Comprehension check

After reading the case materials, participants responded to two comprehension questions. The first comprehension question was related to divisional and firm-wide schemes. Specifically, the participants were asked to "Indicate to what extent you agree or disagree that your performance bonus depends on the divisional (firm-wide) profits" for the divisional (firm-wide) conditions, respectively, on a 7-point Likert scale (7 – Strongly Agree and 1 – Strongly Disagree). We noted that 90% of the participants were in the divisional scheme. Similarly, we noted 86% of the participants in the firm-wide scheme conditions answered in the right direction. The results show that the majority of the participants in this study read the case with reasonable attention.

4.1.2 Manipulation check

We also included a manipulation check question on client flexibility, "Indicate how difficult it will be to move the CFO from his/her initial position of reportable pre-tax income of $49,500,000" on a 7-point Likert scale (7 – Extremely difficult and 1- Extremely Easy). We find the responses of participants are directionally consistent with our manipulation and statistically significant (t= 1.858, p=0.035, one-tailed).

4.2 Results

We conducted an ANOVA to test whether the difference is significant (see Table 2). The results showed that the mean allowance for obsolete inventory auditors willing to accept two conditions: divisional scheme flexibility (inflexibility) client is $2,165,812 ($4,193,179), whereas the mean allowance for firm-wide scheme flexible (inflexible) client conditions are $4,157,778 ($3,975,849). H1 predicts that audit partners in the divisional PES condition will record a smaller allowance for obsolete inventory than auditors in the firm-wide PES condition in a negotiation setting. The results in Table II show that the average mean allowances for the divisional scheme and firm-wide scheme are $3,179,496 and $4,066,814, respectively which is consistent with our prediction. However, The ANOVA[1] result shows a marginal effect for the PES variable (F=2.125, p=0.077, one-tailed) on the allowance for obsolete inventory.

To a certain extent, this finding provides support to the arguments put forward by researchers (Trompeter, 1994; Wyatt, 2004; Zeff, 2003) as well as to the cautionary advice that financial considerations provided to audit partners should not hinder the quality of financial statements in the current regulatory regime (IAASB, 2014). H2 predicts that auditors in the flexible client condition will record a smaller allowance for obsolete inventory than auditors in the inflexible client condition in a negotiation setting. The results in Table II shows that the average mean allowances for flexible client and inflexible client are $3,161,795 and $4,084,514, respectively which is consistent with our prediction. However, the ANOVA result shows a marginal effect for the client

[1] As the sample size is small a non-parametric (e.g., Kruskal Wallis H test) to further validate the ANOVA result reported in the paper. The mean rank for flexibility and divisional condition (n=13) is 12.81, inflexibility and divisional condition (n=9) is 27.44, flexibility and firm-wide condition (n=9) is 26.72 and inflexibility firm-wide condition flexibility and firm-wide condition (n=9) is 26.72 and inflexibility firm-wide condition (n=12) is 24.33. The test statistics showed a significant result H (3) =10.856, p=0.013.

flexibility variable (F= 2.298, p-value=0.069, one-tailed) on the allowance for obsolete inventory. This result complements the results reported by Gibbins et al. (2010). The result implies that if audit partners face inflexible clients, they are more committed to taking a tougher stance to reduce the client's pre-tax income. However, at the same time, those audit partners tend to move toward the client's preferred accounting choice. Gibbins et al. (2010) reported that audit partners have a greater intention to use integrative strategies when they face inflexible clients. It is to be noted that in that study, Gibbins et al. (2010) predicted and found support that auditors will adopt a concession-making strategy when they face flexible clients but not inflexible clients. Our results also point in that direction. It seems auditors would concede more when faced with flexible clients than inflexible clients. H3 predicts whether an interaction between PES and client flexibility exists. The prediction is that the inflexible client will have a smaller downward effect on the magnitude of the proposed allowance when auditors are in the divisional scheme conditions than when auditors are in the firm-wide scheme.

The ANOVA result shows the interaction effect between profit-sharing schemes and client flexibility is statistically significant (F=3.293, p=0.039, one-tailed). The simple main effects analysis shows the client flexibility variable affects the divisional scheme variable (F=5.640, p= 0.023, two-tailed) whereas the client flexibility variable did not affect the firm-wide scheme variable (F=0.044, p=0.835, two-tailed). Similarly, the profit-sharing scheme variable affects the client flexibility variable (F=5.445, p=0.025, two-tailed) whereas the profit-sharing variable did not affect the client inflexibility variable (F=0.063, p=0.804, two-tailed). Therefore, the result finds support for H3. The reason is that the inflexible client was not very responsive in a multiple-round experiment, which irked the auditor in the divisional scheme and invoked a tit-for-tat response based on the societal rule of reciprocity (Sanchez et al. 2007; Tan and Trotman, 2010). Hence, inflexible clients in the divisional scheme received less concession that is, a higher mean allowance of $4,193,179 compared to a mean allowance of $3,975,849 for the inflexible client in the firm-wide scheme. The descriptive statistics for the dependent variable in the four experimental conditions and the ANOVA results are shown in Table 2.

Table 2 Effects of PES and Client flexibility on Negotiation outcomes

Panel A: Descriptive statistics

PES	**Client**		
Divisional scheme	**Flexibility**	**Inflexibility**	**Average**
Mean	2,165,812	4,193,179	3,179,496
(S.D.)	(351,663)	(2,267,973)	(1,314,318)
Sample size	13	9	11
Firm-wide scheme			
Mean	4,157,778	3,975,849	4,066,814
(S.D.)	(2,312,260)	(2,438,546)	(2,375,403)
Sample size	9	12	11
Average			
Mean	3,161,795	4,084,514	3,623,155
(S.D.)	(1,331,962)	(2,357,760)	(1,844,861)
Sample size	11	11	11

Panel B: ANOVA results

Independent variable	**df**	**F**	**p-value (one-tailed)**
PES	1	2.125	0.077
Client flexibility	1	2.298	0.069
PES X Client flexibility	1	3.293	**0.039**

5. CONCLUSION

This paper consists of an experimental study that examined the concession-making behaviour of experienced US auditors in a simulated negotiation setting. This study relies on a pre-programmed computer to simulate an "actual" negotiation environment to re-examine the impact of PES and client flexibility on auditors' behaviour. In this experiment, auditors negotiate with a pre-programmed client. In addition to the manipulation statements on client flexibility, the program conditions were also incorporated to reflect the client's flexible and inflexible attitude towards the recording of an audit adjustment. The results of this study provide additional evidence that experienced auditors are inclined to satisfy clients' preferred accounting choices. We note certain limitations to this experiment. First, this experiment focuses only on one dimension of profit-sharing schemes, that is, client retention and generation of future revenue. In audit practice, the performance-based profit-sharing schemes of audit partners are based on various parameters, for example, leadership, people development, operational excellence, and client service (Coram and Robinson, 2017). Second, the manipulation for client flexibility may

induce artificial demand effects but an attempt was made to minimise artificial demand effects by emphasising to participants before they commenced their tasks that there was no right or wrong answer. Furthermore, the participants are experienced auditors (i.e., audit managers and above) as Bamber (1983, p. 404) stated "audit managers are experienced and successful professionals who have little motivation for providing misleading responses and are unlikely to be intimidated by the experimental task." Third, experiments are well-suited to test theories, rather than simulate reality. That is why this study follows the *sine qua non* of experimentation to alter two factors at a time while controlling for other factors that could complicate causal inferences. In practice, the decision to waive or record audit adjustments also depends on other factors such as the assessment of engagement risk and the deadline for the engagement. Fourth, this study did not investigate the role of the audit committee in an auditor-client negotiation setting. In the current institutional arrangement, audit committees are entrusted to hire and pay auditors and resolve disputes between auditors and client management.

Future researchers may investigate the role of audit committee members in auditor-client negotiation settings. It will enrich the negotiation literature in auditing if researchers can design experiments that capture triadic interactions between auditors, members of the audit committee, and, client management. Lastly, care should be taken when drawing inferences from the results because of the mechanistic nature of simulated negotiation. This experiment partially captures the richness of auditor-client negotiation in practice. It is because this experiment is limited by the fact that the role of client management is fixed by design. Future research could investigate whether auditors' pre-negotiation behaviour will change in the negotiation phase when auditors negotiate with a real client. The negotiation with a real client may be either face-to-face or through a computer-mediated communication mechanism. Auditors are increasingly relying on computer-mediated communication (CMC) with clients (Baltes, Dickson, Sherman, Bauer, and LaGanke, 2002; Brazel, Agoglia, and Hatfield, 2004).

For example, social presence theory predicts the degree to which the communication mode indicates another person is "present" affects individual behaviour (Short, Williams, and Christie, 1976). It is expected the extent to which the social behaviour (i.e., negotiated outcomes with a simulated CFO) corresponds with actual behaviour depends on whether the environment suppresses or reinforces the social presence necessary to reflect actual behaviour. Future research may specifically design experiments that employ face-to-face interactions between auditors and client management. The reason is prior studies (Bazerman, Curhan, Moore, and Valley, 2000; Bennett and Hatfield, 2018) observed that face-to-face interactions maximise "social presence" more than computer-mediated (e.g., email-based) interactions.

Future studies could employ confederates (representing client management) like prior studies (Bennett and Hatfield, 2013, 2018; Saiewitz and Kida, 2018) to examine auditors' behaviour. However, it is to be acknowledged that confederates act on behalf of researchers, and therefore, the role of confederates is scripted beforehand. Still, the nature of the experiment will be far richer than the experiment involving computer simulation. Another fruitful area of auditor-client negotiation research would be to incorporate experimental economic designs that often examine multiple parties (e.g., auditor, client management) at the same time rather than holding one party constant (Kachelmeier, 2018).

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