

**THE IMPACT OF MONITORING MECHANISMS AND MANAGEMENT
INCENTIVES ON AUDITOR-CLIENT NEGOTIATIONS AROUND THE TIME OF AN
INITIAL PUBLIC OFFERING**

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The Impact of Monitoring Mechanisms and Management Incentives on Auditor-Client Negotiations around the Time of an Initial Public Offering

Auditor-client negotiations typically arise in the context of the incentives and monitoring of the parties involved (Gibbins et al. 2001; Gibbins et al. 2007), yet we know little about how these contextual factors influence negotiation judgments from the manager's perspective (Brown and Wright 2008; Salterio 2011). We posit that monitoring mechanisms through the negotiations process will affect managerial opportunism. Specifically, we posit that a strong audit committee overseeing financial reporting bolsters the bargaining power of the auditor (Ng and Tan 2003; Brown and Wright 2011) and thereby constrains managerial opportunism. Further, we posit that a contentious past relationship with the auditor results in less opportunistic judgments by managers, who are motivated by a desire to come to a negotiations resolution (Gibbins et al. 2007; Thompson 2009; O'Connor and Arnold 2001; Diekmann et al. 2003). This is in contrast to auditors, who employ more competitive strategies when faced with a contentious client (Brown-Liburd and Wright 2011), which is consistent with the auditors' professional mandate for conservatism in their pre-negotiation judgments (Antle and Nalebuff 1991). In addition, we examine whether greater opportunities to act on managerial incentives or heightened scrutiny from a variety of monitors impact opportunistic behavior in the IPO-year (Lo 2008) relative to the pre-IPO period. To test our hypotheses we use a 2 x 2 x 2 experimental factorial design with audit committee strength (strong or weak) and past auditor relationship (contentious or cooperative) manipulated between subjects, and management incentives (IPO-year) manipulated within subjects. Participants in the experiment are 137 experienced CFO/Controllers who provide pre-negotiation judgments concerning an inventory write-down issue. The findings indicate that participants propose and expect a larger inventory write-down when the audit committee is strong, when faced with a contentious past auditor relationship, and in the presence of both of these conditions. These effects are even more pronounced in the IPO-year. The results are consistent with strong monitoring mechanisms constraining client opportunities to act on their incentives to manage earnings.

Keywords: auditor-client negotiation; management incentives; negotiation strategy; negotiation relationship; audit committee; initial public offering

INTRODUCTION

We examine whether incentives for management and opportunities from monitoring influence managers' judgments in resolving financial reporting issues. Auditor-client negotiations typically arise in the context of both auditor and management incentives (Gibbins et al. 2001; Gibbins et al. 2007), yet prior accounting research has largely focused on the negotiation judgments from the auditor's perspective and less so from the client's perspective (Brown and Wright 2008; Salterio 2011).¹ Examining the manager's perspective is important since they prepare the financial statements and thus essentially make the first offer in audit negotiation. Also, negotiating with auditors is a common and critical part of the CFO function and often results in a material impact not only on financial reports (Gibbins et al. 2007), but also on the CFO's compensation (Antle and Nalebuff 1991).

We focus on the manager's pre-negotiation position in the initial public offering (IPO) setting, when there is arguably greater information asymmetry and thus greater opportunities to act on managerial incentives to present accounting performance that benefits insiders at the expense of IPO subscribers. The IPO setting concomitantly presents more heightened monitoring than is usual from a variety of monitors including regulators, auditors, and audit committees (Lo 2008).² Our research is thus able to speak to the open question of managers' judgments in the audit negotiations process under different managerial incentives and monitoring contexts.

¹ Results are mixed from the few studies examining CFOs in the negotiation process. Gibbins et al. (2005) find that surveyed CFOs focus on accounting issues separately, approach negotiations as a win-lose proposition, and place less emphasis on prior negotiation outcomes and audit committee roles than auditors. Bame-Aldred and Kida (2007) find that relative to auditors, managers are more conceding and trade one issue for another. Gibbins et al. (2007) find that CFOs are prompted by business changes and focus more on form over economic substance. Tan and Trotman (2007) find that the concession strategy of auditors affects the final negotiated offers of financial officers.

² In this study, we do not make any claims as to whether managers should or should not act opportunistically in negotiating with auditors. For example, inflated or smooth earnings can be construed as undesirable earnings management, which implies a motive to mislead users and/or to unduly influence contractual outcomes (Schipper 1989) and thereby extract rents from IPO subscribers. Alternatively, inflated or smooth earnings could represent

Gibbins et al. (2001; 2005) identify internal governance (e.g., the audit committee) and prior relationship with the external auditor as two important and pervasive contextual factors in the auditor-client negotiations process. These two factors likely have a substantial effect on management's expectations going into the negotiation (Brown-Liburd and Wright 2011), particularly in matters involving subjective estimates (Trotman et al. 2005). First, the audit committee oversees the audit process and can play a significant role in helping to mediate disputes between management and the auditor. The passage of Sarbanes-Oxley (2002) placed an even greater emphasis on the role and responsibilities of the audit committee in enhancing financial reporting quality. Post-SOX, audit committees have considerably more authority, which has resulted in notable improvements in the expertise, involvement and thus the strength of audit committees (e.g., Cohen et al. 2010). Thus, if management believes that a strong (weak) audit committee bolsters (diminishes) the auditor's bargaining power (Ng and Tan 2003; Brown-Liburd and Wright 2011), then we expect managers will be less (more) opportunistic in their pre-negotiation positions (Rubin and Brown 1975, Greenhalgh et al. 1985; Gibbins et al. 2001).

Second, prior interactions with a negotiation counterpart can trigger expectations regarding the ease with which an appropriate resolution will be reached and can produce higher levels of cooperative or contentious interactions (e.g., Greenhalgh and Chapman, 1998; Gibbins et al. 2007). Brown-Liburd and Wright (2011) find that auditors take a more competitive approach when faced with a contentious client, consistent with a professional mandate for conservatism in their pre-negotiation judgments (Antle and Nalebuff 1991). In contrast, prior research suggests that managers are motivated by a desire to come to a negotiations resolution (Gibbins et al. 2007; Thompson 2009; O'Connor and Arnold 2001; Diekmann et al. 2003), and

what users (e.g., IPO subscribers and current shareholders) desire and expect, and managers are merely delivering on what is expected of them (Lo 2008).

that managers are more likely to make concessions in response to concessions by auditors (Tan and Trotman 2010; Agoglia et al 2008; Bame-Aldred and Kida 2007), and even more so when faced with a contentious counterpart. Thus, if managers generally take a more cooperative approach to negotiations with auditors, then we expect that managers will take a less opportunistic pre-negotiation position when the past auditor relationship has been contentious rather than cooperative (Bame-Aldred and Kida 2007). Further, we expect that when faced with a strong audit committee **and** a contentious past auditor relationship, managers will make less opportunistic pre-negotiation assessments.

We also focus on the IPO setting where there is an open, empirical question as to whether managers act more or less opportunistically. On one hand, because there is higher information asymmetry due to managers having more access to private information about the firm's prospects than do IPO subscribers, and managers have greater opportunities to act on their incentives to present accounting performance that benefits insiders at the expense of IPO subscribers (Teoh et al. 1998). On the other hand, managers may be less able to act opportunistically because there is heightened monitoring from auditors, boards, analysts, rating agencies, the press, and litigants (Ball and Shivakumar 2008). For example, managers will have less opportunity to engage in detectable earnings management because the resulting accounting reports are subject to audit examination (Lo 2008), and auditors have higher legal liabilities during an IPO (Venkataraman et al. 2008). We assume that like other stages around the IPO, the auditor-client negotiation stage is not transparent to IPO subscribers, since they are not privy to the issues under dispute. If heightened monitoring (greater information asymmetry) explains manager's judgments in auditor-client negotiations around an IPO, then we expect that the

monitoring effects of the strong audit committee and contentious past auditor relationship will be more (less) pronounced in the IPO-year relative to the pre-IPO year.

We test our predictions using a 2 x 2 x 2 mixed ANOVA with past auditor relationship and audit committee strength as between subject manipulations and management incentives (IPO-year) as a within subject manipulation. One hundred and thirty-seven experienced CFOs participating in an executive training seminar engage in planning for an upcoming negotiation with an auditor involving an accounting issue requiring a subjective estimate for an inventory write-down. Participants identify a preferred position and acceptable range of alternatives, and then anticipate the position of their auditor counterpart. We find that the inventory write-down is significantly larger when the audit committee is strong, larger when the past auditor relationship is contentious, and largest in the presence of both of these conditions. In addition, these effects become significantly more pronounced in the IPO-year relative to pre-IPO year. These results are consistent with strong monitoring mechanisms constraining opportunities to act on managerial incentives around the time of an IPO.

We contribute to two research streams in accounting: auditor-client negotiations and earnings management in IPOs. First, and with respect to the auditor-client negotiations research, we respond to calls to examine key contextual factors in managers' judgments in the audit negotiations process post-SOX (Gibbins et al. 2001; Gibbins et al. 2007; Bame-Aldred and Kida 2007), i.e., the impact of audit committees and past auditor relationship (Gibbins et al. 2001; 2005). To our knowledge, ours is one of the first studies to examine the impact of audit committees on managers' negotiation actions since SOX substantially increased the committee's roles and responsibilities. Prior research focuses on the impact of past client relationship from

the auditors' perspective (Brown and Wright 2008) or provide mixed results with respect to the managers' perspective (e.g., Gibbins et al. 2007; Bame-Aldred and Kida 2007).

Second, we complement surveys describing CFOs' recollections of audit negotiations (Gibbins et al. 2007) since our experiment directly elicits managers' judgments in the presence of the auditor and audit committee. Thus, we are able to circumvent Nelson et al.'s (2002) concern that while field surveys are designed to elicit evidence from auditors about manager's attempts to manage earnings, they "cannot assess the extent to which the presence of auditors deters managers from attempting earnings management" [p. 198].

Third, we extend our understanding of the complex dynamics that influence auditor-client negotiations by focusing on the IPO setting wherein managers arguably have greater opportunities to act on incentives to manage earnings, but also heightened scrutiny from a variety of monitors (Lo 2008). This context mimics what contextually exists in naturally occurring settings and provides opportunities to gain important insights about managers' judgments (Brown and Wright 2008).

We also contribute to research on earnings management in IPOs in three ways. First, we extend prior archival IPO research examining post-audit financial statements by designing an experiment with ex-ante conditions that captures managers' judgments. In their discussion of contrasting research approaches, Nelson et al. (2002) note that post-audit financial statements are the joint output of auditor-client negotiations, and thus cannot be used to disentangle managers' from auditors' actions. In particular, our experiment complements studies of audit-related factors that impact managerial opportunism around IPOs (Venkataraman et al. 2008; Bedard et al. 2008).

Second, we consider Lo's (2008) claim that managers will be less likely to engage in detectable earnings management because the financial statements are subject to audit examination. We focus on an arguably less detectable way to influence earnings (i.e., the auditor-client negotiation phase) and consider an accounting context that entails considerable judgment (i.e., inventory write-down adjustment) to provide insights on the circumstances under which managers will act on their incentives to manage accounting performance around an IPO.

Finally, we extend prior archival studies by looking at another possible mechanism to engage in earnings management, i.e., managers' strategies in negotiations with auditors. For example, Marquardt and Wiedman (2004) find no significant difference in the unexpected inventory for firms issuing equity, including those undertaking IPOs. Similarly, Anarhony et al. (1993) find no preponderance of evidence that managers manipulate earnings prior to the IPO through accounting convention choices. One possibility is that managers use the negotiations process with auditors to arrive at estimates (e.g., bad debts, inventory obsolescence), such that no differences in unexpected inventory or accounting choices would be observable post-audit. Indeed, CFOs in Gibbins et al.'s (2007) survey recall that asset write-downs are one of a few main negotiations issues that materially impact financial reporting outcomes.

The remainder of this paper is divided into four sections. The next section provides a review of the relevant literature and develops the research hypotheses. This section is followed by a description of the method and presentation of the results. The final section is devoted to a discussion of the major findings and their implications for practice and future research.

BACKGROUND LITERATURE AND HYPOTHESES DEVELOPMENT

Auditor-Client Negotiations from the Client's Perspective

Both Brown and Wright's (2008) review of the literature and Salterio's (2011) discussion generally describe auditor-client negotiations as being influenced by the interplay among the characteristics of the parties, the contextual environment, and the accounting issue of interest. While Gibbins et al. (2001) presents an auditor-client negotiations model from the auditor's perspective, Antle and Nalebuff (1991) present a model which considers the manager's payoff as dependent on the firm's reported income. Bame-Aldred and Kida (2007) extends these models by investigating the initial negotiation positions and tactics of both clients and auditors in a pre-negotiation context.³ They report that clients are more flexible, more accurate in predicting their negotiating counterpart's positions, and more concessionary than auditors. Gibbins et al. (2007) interview matched pairs of CFOs and audit partners and finds that CFOs consider it more important for them (rather than the auditors) to reach an agreement, that they had a better analysis of and sensitivity to the issue, but that the auditors had a better understanding of GAAP.

Managers also consider how accounting issues are monitored. Prior research finds that managers take more conservative positions when applying a less precise standard versus a more precise standard because managers perceive that there is greater uncertainty in how regulators will interpret the less precise standard (Nelson et al. 2002), and when a strong audit committee operates in a rules-based (versus a principles-based) environment (Agoglia et al. 2011). Although Wright and Wright (1997) and Braun (2001) find managers to be more opportunistic with less

³ Our study likewise focuses on the pre-negotiation stage when negotiating parties identify their interests, options, alternatives, goals, and initial position, as well as consider those of their counterpart (Brown and Wright 2008). Pre-negotiation judgments are important because they potentially influence negotiation tactics, expectations about the counterpart's position, and the likely outcome. Further, accurate perceptions of the other party's preferences results in the negotiator being better prepared for the negotiation (Bazerman et al. 2000; Fisher et al. 1981; Pruitt and Carnevale 1993; Trotman et al. 2005).

precise standards in light of auditors' greater propensity to waive subjective adjustments, Cohen et al. (2009) find that auditors waive less when applying a less precise standard when managerial incentives are high and with an independent audit committee.

Taken together, managers are motivated to cooperate with auditors to reach a negotiation resolution and to consider the standards being applied to the particular accounting issues in the context of various monitors. The following subsections discuss audit committee strength and past auditor relationship as two important and pervasive contextual identified in the negotiation literature (Gibbins et al. 2001; 2005).

Audit Committee Strength

Auditors and managers remain the primary direct parties engaged in negotiations to resolve an ambiguous reporting issue (Cohen et al. 2010). When the accounting issues are not clearly defined by GAAP, subjectivity and judgment are present, and managers have greater opportunities to persuade auditors to accept their position. As a result, professional standards and regulators direct auditors to discuss the quality of financial reporting alternatives with the audit committee (AICPA SAS 90 2000; Blue Ribbon Committee 1999).

The impact of the audit committee in monitoring auditor-client negotiations depends heavily on the strength of the committee (DeZoort et al. 2003). A strong audit committee will provide oversight over the negotiations process and advocate for proper financial reporting, thus, enhancing the relative bargaining power of the auditor vis-à-vis management by providing the auditor with an important ally when confronting management in resolving a difficult matter. For example, Ng and Tan (2003) find that when authoritative guidance is lacking, auditors perceive that the negotiated outcome will result in the client recording an adjustment when the audit committee is effective but not when it is ineffective. Further, Brown-Liburd and Wright (2011)

find that in the presence of a strong audit committee, auditors were more likely to propose a higher inventory write-off (first and final offers) during negotiations with the client.

Negotiation research suggests that individuals generally use their power and as a result have better outcomes than the weaker party (Rubin and Brown 1975, Greenhalgh et al. 1985). Therefore, if managers believe that the strength of the audit committee bolsters the auditor's bargaining power, then they are likely to engage in less opportunistic behavior when negotiating with the auditor. In other words, if the audit committee is strong, managers will be more likely to propose a larger inventory write-down and will likely accept a final reporting position more in line with the auditor's preference. This leads to our first directional hypothesis.

H1: Managers will propose a larger inventory write-down when the audit committee is strong than when the audit committee is weak.

Past Relationship with the Auditor

A negotiation relationship normally continues over time (McGrath 1966) and impacts negotiation judgments (Gruder 1971; Savage et al. 1989) and outcomes (Schei and Rognes 2003; O'Connor et al. 2005). Prior interactions with a negotiation counterpart can trigger expectations regarding the ease with which an appropriate resolution will be reached and can produce higher levels of cooperative or contentious interactions (e.g., Greenhalgh and Chapman, 1998; Gibbins et al. 2007). For example, a negotiator expecting to face a counterpart who has engaged in distributive negotiation (i.e., contending tactics) in the past, forms a negative perception of her counterpart's intentions (Kahan 1968) and thus adopts a more contending strategy (Brett et al. 1998; Weingart et al. 1990), which persists throughout the negotiation (Tinsley et al. 2002).

Prior research suggest that auditors indeed view the negotiations process as a win-lose proposition that is more distributive in nature (Gibbins et al. 2005; 2010). Hatfield et al. (2008) suggest that auditors employ a reciprocity-based strategy when the client's negotiation style is

competitive (i.e., contending); and Brown-Liburd and Wright (2011) find that auditors use more contending tactics when faced with a contending client, and continue to be contending, but to a lesser extent, when faced with a cooperative client.⁴ These findings are consistent with the auditor's professional mandate for skepticism (Braun 2011) and conservatism in pre-negotiation judgments (Antle and Nalebuff 1991) and in financial reporting (Francis and Krishnan 1990).

In contrast, managers are motivated by a desire to come to a negotiations resolution (Gibbins et al. 2007; Thompson 2009; O'Connor and Arnold 2001; Diekmann et al. 2003). Gibbins et al. (2007) finds that CFOs consider it more important for them (rather than the auditors) to reach an agreement. Thompson (2009) describes a manager-negotiator as one who is able to strategically reach a profitable outcome by being flexible and adaptable, which is consistent with an aversion to ending the negotiation in an impasse (O'Connor and Arnold 2001). As a result, negotiators expecting a competitive opponent become less competitive by setting lower reservation prices and making lower counteroffers (Diekmann et al. 2003).

Recent studies find evidence consistent with managers being more willing to compromise than auditors (Bame-Aldred and Kida 2007; Gibbins et al. 2007; Sanchez et al. 2007; Fontaine and Pilote 2011). Bame-Aldred and Kida (2007) find that relative to auditors who employ a contending strategy, managers are more flexible, generate a wider set of solutions and are more likely to trade-off one issue for another. Gibbins et al. (2007) examine CFOs recollections of actual auditor-client negotiation situations and report that CFOs are amenable to finding a common, compromise resolution. Fontaine and Pilote (2011) survey client management and find that clients prefer not to exercise their power to influence their auditor and have a cooperative, trusting, and information sharing relationship with their auditor. Finally, Sanchez et al. (2007)

⁴ A reciprocity-based strategy is one in which one party makes concessions with the hope that the other party will feel the need to also in turn make concessions.

examine the manager's response to auditor concessions and find that managers have more conservative negotiation limits and initial offers, and are more willing to ultimately post significant income-decreasing adjustments when auditors are willing to make even small concessions (i.e., waive inconsequential adjustments). Thus, if managers are more willing to compromise and are motivated by the desire to come to a negotiations resolution, then we expect that managers faced with a contentious auditor will in turn be more cooperative (i.e., propose a larger inventory write-down). This leads to the following hypothesis:

*H2: Managers will propose a larger inventory write-down when the past auditor relationship has been contentious than when the past auditor relationship has been cooperative.*⁵

Taken together, we expect that managers will consider both the monitoring strength of the audit committee and their past relationship with the auditor. Further, we expect an interaction effect in that managers will propose the largest inventory write-down when faced with a strong audit committee and a contentious past auditor relationship. This leads to the following hypothesis:

H3: Managers will propose the largest inventory write-down with a strong audit committee and a contentious past auditor relationship than all other conditions.

Incentives vs. Monitoring around an Initial Public Offering (IPO)

Management Incentives

Several studies provide evidence that economic incentives influence negotiated outcomes (Antle and Nalebuff 1991; Zhang 1999; Church and Zhang 1999; Kadous et al. 2003). Antle and Nalebuff (1991) demonstrate that given the manager's information asymmetry advantage over the auditor regarding the true state of the company's performance, the financial statements do not

⁵ An alternative expectation is that individuals will mirror contentiousness in negotiations, as indicated by other research in the general negotiation literature (e.g., Kahan 1968; Brett et al. 1998; Weingart et al. 1990). Our findings allow us to explore this possibility within the auditor-client negotiation context.

necessarily or solely reflect the auditor's conservative stance. Rather, the extent of compromise on the financial statements amounts is related to the costs of extending the audit when considered appropriate and the cost-sharing arrangement between the auditor and the manager. Additionally, when possible misstatements are more difficult to detect, managers become more aggressive in preparing the financial statements, and auditors become more cautious. This tension leads to more disputes between auditors and clients (Zhang 1999).

The tension between auditors and clients may become more pronounced in an IPO context when there is higher information asymmetry and thus more difficulty in detecting possible misstatements (Teoh et al. 1998a, 1998b). Pre-IPO, managers have an information advantage over potential IPO subscribers, and this provides managers with greater opportunities to inflate earnings through earnings management (Lo 2008), especially if doing so will enable them to meet or exceed earnings, growth or performance expectations. Teo et al. (1998a) find that relative to matched US non-issuers, US IPO-issuers have higher discretionary current accruals and poorer financial performance in the subsequent three years. They interpret this finding as consistent with the view that potential IPO subscribers are fixated with inflated earnings. Further, Teo et al. (1998b) find that abnormal, income-increasing accruals are associated with poorer post-IPO returns and financial performance. They interpret these results as suggestive of opportunistic earnings management during IPOs. Hence, if higher information asymmetry in the IPO-year (versus the pre-IPO year) presents greater opportunities for managers to act on their incentives, then we expect managers to propose a smaller inventory write-down in the IPO-year.

Monitoring Mechanisms

However, the IPO context is also a setting where there is heightened monitoring in response to higher information asymmetry. Ball and Shivakumar (2008) find that IPO firms in the UK report more conservatively, with publicly-listed firms providing higher quality reports than private firms. They attribute this result to financial statement users' demand for higher quality financial reports for firms going public and the consequential increase in monitoring by auditors, board members and other players in producing those financial reports. Supporting this view, Armstrong et al. (2008) find that the accruals in IPO firms are not systematically opportunistic, and Morsfield and Tan (2006) find that abnormal accruals in IPO firms are lower for IPO firms backed by venture capitalists who play an additional monitoring role.

Audit-related factors play an especially important role in firms engaged in an IPO. Venkataraman et al. (2008) find that audit fees are higher in the IPO-year and increasing in IPO size, consistent with higher auditor litigation exposure and thus monitoring vis-à-vis the audit around an IPO. Bedard et al. (2008) find that audit committee effectiveness (i.e., financial expertise and independence) reduces IPO underpricing.⁶ In addition Lo (2008) claims that managers will be less likely to engage in detectable accrual manipulation because the financial statements are subject to audit examination. Arguably, the auditor-client negotiation stage is less transparent to IPO subscribers. Hence, if heightened monitoring constrains the opportunities for

⁶ IPO underpricing is generally defined as setting, for IPO subscribers, an offer price that owner-managers know to be lower than the intrinsic value of the firm. Because owner-managers have private information about the firm's future cash flows and risks, a lower offer price essentially attracts new investors by paying them a premium for investing in a risky firm wherein they have an information disadvantage. As such, IPO underpricing results in a wealth transfer from owner-managers to IPO subscribers (Filatotchev and Bishop, 2002). Although managers have an incentive to attract new investors through IPO underpricing, managers also have an incentive to signal strong financial performance (Brau and Fawcett 2006) and thereby maximize their financing. Bedard et al. (2008) provide evidence consistent with audit committee effectiveness providing a signal of financial reporting quality through the committee's oversight of the firm's IPO prospectus containing the firm's historical financial performance.

managers to act incentive-consistently, then we expect managers to propose a larger inventory write-down in the IPO-year relative to the pre-IPO year.

Taken together, the ultimate impact of an IPO on management reporting opportunism through the negotiations process hinges on the relative impact of the opportunities to act on incentives for misreporting versus the power of monitoring mechanisms to curb such opportunistic behavior. This leads to the following alternative hypotheses, respectively:

H4a: Managers will propose a smaller inventory write-down in the IPO-year than in the pre-IPO year.

H4b: Managers will propose a larger inventory write-down in the IPO-year than in the pre-IPO year.

METHOD

Participants

We recruited CFOs/Controllers attending an executive education training session to participate in the study since these individuals are routinely responsible for negotiating with auditors (Brown and Wright 2008; Gibbins et al. 2001). Table 1 contains demographic information for the sample of 137 CFOs/Controllers and indicates that these participants have sufficient direct task experience in negotiating disputed accounting matters with a mean of 6.7 times in which they have resolved a contentious matter with auditors. These participants also have an average of 13.2 years in their current position and 13.8 years of audit experience. One-hundred and twelve (112 or 81%) had the title of either CFO (56%) or controller (25%). Further, 96% of the participants are CPAs, 65% work for a public company, and 98% work in a company with an audit committee. Of those participants in a company with an audit committee, the participant has had an average of 2.5 instances when they have worked with the audit committee

to resolve an accounting or auditing issue. In all, participants have the requisite task and domain knowledge necessary for the experiment.

Overview

The experiment uses a 2 x 2 x 2 mixed factorial design with two between subjects factors and one within subjects factor. The independent variables are strength of the audit committee (strong or weak) and past auditor negotiation relationship (contentious or cooperative), both of which are manipulated between subjects, and management incentives (pre-IPO year or IPO-year) manipulated within subjects. The experiment was conducted in two phases. In the first phase we examine participants' pre-negotiation judgments during a period in which an IPO is being contemplated, while in the second phase the company has decided to go ahead with the IPO. Participants were randomly assigned to the four between subjects experimental conditions. With the exception of negotiation experience and company type (public vs. private), there were no significant demographic differences ($p > .10$) between the four experimental conditions, suggesting successful random assignment of participants. Negotiation experience and company type were significantly different ($p = .026$ and $.040$, respectively) across conditions, with participants in the strong audit committee/contentious past relationship having the greatest amount of negotiation experience (mean = 7.32) and participants in the weak audit committee/cooperative past relationship having the lowest percentage of participants in publicly held companies (49%). To ensure that our results were not driven by these two variables we conducted the analysis with and without negotiation experience and company type as covariates. The results of both models were qualitatively similar.

Experimental Tasks

Participants received a realistic case adapted from that used by Trotman et al. (2005). Specifically, the case was shortened to focus on the issue at hand (inventory obsolescence) and to introduce the manipulation of the independent variables. The case is based on an actual client situation in which the audit team questioned whether the raw material inventory for a joystick manufacturing company should be written down due to obsolescence given deteriorating aging and a short product life cycle in the industry. Thus, the issue is a subjective matter (i.e. application of a less precise standard) entailing an estimate of the lower-of-cost-or-market for the inventory account. Such subjective matters often entail a negotiation process as opposed to an objective, clear cut issue such as a material recording error where little or no negotiation is required.

Background information was provided about the company (industry, history, overall controls, and summary financial statements) and the issue at hand. Three risk indicators were present in the case. First, the company was planning to go public in the near future such that there were significant pressures to report positive financial performance. Second, the auditor is proposing an inventory write-down that would significantly decrease net income. Third, a number of key performance indicators indicated the inventory situation is of concern (e.g., slower inventory turnover than from the prior year and in comparison to competitors). Following prior research using the experimental task with auditor participants (Brown-Liburd and Wright 2011; Trotman et al. 2005), participants were provided the current inventory write-down already recorded of \$300,000 as well as a \$500,000 inventory write-down for obsolescence proposed by the audit team. Participants were then asked to provide judgments in preparation for discussions

with their counterpart (i.e., the audit partner) regarding their position and that expected of the audit partner (preferred write-down and range).

In phase two of the experiment, participants were told that it is one year later and the company has decided to go ahead with an IPO which will provide for the infusion of capital to fund an increase in research and development and provide them with an expected edge on competitors. Participants are also told that commensurate with similar IPOs, as part of their compensation contract, each member of the management team, including the CFO stand to receive a significant increase in compensation. The inventory situation is again raised as an issue in the current year's audit and the audit partner is recommending an additional write-off. Participants were provided the current year's recorded inventory write-down of \$200,000 as well as the proposed adjustment by the audit team of \$500,000. With respect to the inventory issue from the prior year, participants are told that they were able to resolve the issue with the audit partner last year.⁷ Participants were then asked again to provide judgments in preparation for discussions with their counterpart (the audit partner) regarding their position and that expected of the audit partner (preferred write down and range).

Manipulation of the Independent Variables

As noted, two variables are manipulated between subjects: audit committee strength (*AC*) and past auditor relationship (*PAST*). Exhibit 1 shows the manipulations. Audit committee strength is manipulated as either strong or weak. In a review of the literature, DeZoort et al. (2002) identify four elements that determine audit committee strength: composition (expertise,

⁷ To ensure that the past negotiation relationship manipulation was consistent across phase one and two of the experiment, the experimental materials remains silent with regards to the resolution of the inventory issue. We made this design choice to minimize the possibility that the outcome in the pre-IPO year may drive participants' judgments in the IPO-year. For example, if we told participants that the outcome was a relatively high write-down of \$400,000, then this would signal that the negotiated outcome was consistent with the auditor's desired outcome and may have confounded the manipulation for those participants in the cooperative past relationship condition.

independence, integrity and objectivity), authority, resources and diligence. Consistent with these elements, the strong audit committee condition (*Strong AC*) was described as independent, diligent, and knowledgeable in accounting and auditing. Further, the audit committee was granted sufficient power from the board to achieve its objectives, and the board will side with the audit committee in disputes with management that are contentious.

The weak audit committee condition (*Weak AC*) is one where the audit committee meets minimal regulatory standards in form (e.g., independent members, one financial expert, and all financially literate). However, in substance, the committee is weak, since it meets infrequently, asks few questions, and has limited power from the board to exercise its authority. Further, the board rarely sides with the audit committee when there is a contentious issue involving management. In all, the weak condition is one where it is unlikely the audit committee will or can stand up to management in a dispute with the auditor. Our manipulations are consistent with Institutional Theory (Cohen et al. 2008; Fogarty and Rogers 2005; Gendron et al. 2004; Orton and Weick 1990; Kalbers and Fogarty 1998, 1993), that is, in form an audit committee must meet regulatory requirements while in substance it may not truly be able to fully accomplish its responsibilities.

The past relationship is either one in which the counterpart has been contentious or cooperative. The contentious past auditor relationship (*Contentious PAST*) is where past negotiations have been difficult and prolonged, since the audit partner has followed a pattern of adopting a position and then been largely intransigent in revising his position in light of counter-arguments. In contrast, a cooperative past auditor relationship (*Cooperative PAST*) is one where the partner has been willing to accept reasonable counter arguments. These descriptions are

similar to those provided to auditors in prior research (e.g., Brown-Liburd and Wright 2011; Bame-Aldred and Kida 2007).

Dependent Variables

Our first pre-negotiation measure is *PROPOSED RATE* which is a measure of the manager's intended initial response compared to the audit team's proposed write-down amount (Proposed Write-down/\$500,000). A larger initial proposed write-down relative to the audit team's proposed write-down indicates that the manager is beginning the negotiation with a cooperative mindset. For example, if the manager proposes an initial write-down of \$400,000 as compared to \$500,000 proposed by the audit team (i.e., *PROPOSED RATE* =.80), then the manager is entering the negotiation with an opening position that potentially allows for a solution that satisfies both parties since it is close to the auditor's position. However, if the manager proposes a lower write-down, say \$200,000 (i.e., *PROPOSED RATE* = .40), this suggests that the manager is entering the negotiation attempting to reach an agreement closer to her goals by potentially employing a bid high/concede later negotiation tactic. This dependent variable has the important advantage of providing a relative measure of the manager's strategic position, since it is representative of the first offer they would make after learning of the write-down proposed by the audit team.

Our second measure of pre-negotiation judgment is *ULTIMATE W/D*, which represents the manager's perceived final negotiated outcome that will be reflected in the financial statements. This judgment is reflective of the manager's aspiration which is the best outcome that the negotiator can reasonably expect from the negotiation (White et al. 1994; White and Neale 1994). Prior research suggests that the ultimate perceived write-down amount has been

shown to be significantly positively related to the actual negotiated outcome (White and Neale 1994).

RESULTS

Manipulation Checks

We employed two manipulation check questions to determine whether participants encoded the experimental conditions as intended. For the audit committee strength manipulation, we asked: “In the case you just completed how strong do you think the audit committee at VCC is in helping to resolve contentious accounting issues?” The aspect of audit committee strength that goes directly to the focus of the current study is the extent of involvement of the committee in dealing with contentious reporting matters, which enhances the likelihood of the committee’s support for and, hence, the bargaining power of the management. Thus, the manipulation check question focuses specifically on the role of the audit committee in resolving difficult reporting issues. Responses were on a scale from one (very weak) to seven (very strong). The untabulated mean (standard deviation) responses were 1.48 (.504) and 6.41 (.523) for the first phase, and 1.39 (.492) and 6.44 (.527) for the second phase, for participants in the weak audit committee and the strong audit committee conditions, respectively. The difference in means is in the expected direction and significant ($t = -55.98, p = .000$ and $-57.72, p = .000$, for phase 1 and 2, respectively).

For the past relationship manipulation the question stated: “What do you think best describes the past relationship you have had with the audit partner in his approach to dealing with difficult accounting issues?” Responses were on a scale from one (cooperative) to seven (contentious). The untabulated mean (standard deviation) responses were 1.51 (0.837) and 6.91 (1.28) for the first phase and 1.43 (0.498) and 6.46 (0.85) for the second phase, for participants in

the cooperative auditor and the contentious auditor conditions, respectively. The difference in means is again in the expected direction and significant ($t = -25.98$, $p = .000$ and -42.22 , $p = .000$, for the first and second phases, respectively). The difference in means for both questions indicates successful experimental manipulations.

Descriptive Results

PROPOSED RATE

Table 2 provides mean and standard deviations of the participants' pre-negotiation positions for each of the experimental conditions in the pre-IPO year (Panel A) and also in the IPO-year (Panel B). Examining the pre-IPO year assessments (Panel A) and consistent with our expectations, the mean *PROPOSED RATE* is significantly larger in the strong audit committee condition than that in the weak audit committee condition (0.74 versus 0.49, respectively, $t = 13.29$, $p = .000$)⁸; larger in the contentious past auditor relationship condition relative to that in the cooperative past auditor relationship condition (0.70 versus 0.55, respectively, $t = 5.64$, $p = .000$); and largest in the strong audit committee/contentious past auditor relationship condition relative to all other conditions (0.79 versus 0.56, respectively, $t = 17.28$, $p = .000$). Mean comparisons in the IPO-year (Panel B) yield consistent and more pronounced results (all $p = .000$). The results provide initial evidence consistent with participants' willingness to write-down the inventory to an amount acceptable to both parties to the negotiation since the positions of the auditor and management are close in the presence of strong monitoring mechanisms.

ULTIMATE W/D

With respect to the ultimate write-down in the pre-IPO year (Panel A), and also consistent with our expectations, the mean write-down assessments are significantly larger in the presence of a strong versus weak audit committee (\$406,900 versus \$279,300, respectively, $t =$

⁸ All probabilities are two-tailed.

17.90, $p = .000$) and larger when the past auditor relationship is contentious versus cooperative (\$377,300 versus \$316,900, respectively, $t = 5.05$, $p = .000$). In addition, participants' ultimate write-downs are largest when the audit committee is strong AND the past auditor relationship is contentious, relative to all other conditions (\$421,900 versus \$317,000, respectively, $t = 10.51$, $p = .000$). We find consistent results in the IPO-year.

Test of Hypotheses

To investigate the effects of audit committee strength and past auditor relationship on pre-negotiation judgments, we conducted a mixed model MANOVA using participant-provided assessments of inventory write-downs (*PROPOSED RATE* and *ULTIMATE W/D*) in the pre-IPO year (*IPO-YEAR* = 0) and in the IPO-year (*IPO-YEAR* = 1). *Strong AC* is coded 1 for a strong audit committee and 0 otherwise. *Contentious PAST* is coded 1 for a contentious past auditor relationship and 0 otherwise. Untabulated MANOVA results indicate significant main effects for *IPO-YEAR* ($p = .000$); *AC* ($p = .000$); *Contentious PAST* ($p = .000$); and a significant interactive effect of *Strong AC* x *Contentious PAST* ($p = .013$). Given the significant effects of the MANOVA, individual ANOVAs are conducted for each of the dependent variables to test the hypotheses.

Table 3 presents the results of our tests and the following is a discussion of the main and interactive effects for each of the hypothesized relationships. First, we hypothesize that audit committee strength bolsters the auditor's bargaining power to which the manager responds by proposing a larger inventory write-down (H1). Consistent with H1, we find a significant main effect for *Strong AC* for our dependent variables *PROPOSED RATE* ($F = 201.8$, $p = .000$) and *ULTIMATE W/D* ($F = 453.2$, $p = .000$). These results highlight the importance of having a strong

audit committee that provides effective governance and monitoring to mitigate opportunistic behavior by management, which is consistent with regulatory efforts in SOX (Salterio 2011).

Second, we expect that the past relationship with auditors will impact managers' pre-negotiation position. H2 posits that when the past relationship has been contentious managers are motivated to propose a larger inventory write-down in order to reach a negotiation resolution. Consistent with H2, we find a significant main effect for *Contentious PAST* for our dependent variables *PROPOSED RATE* ($F = 102.5, p = .000$) and *ULTIMATE W/D* ($F = 174.9, p = .000$). These results suggest that in contrast to auditors who are more likely to employ a contending strategy when facing a contentious counterpart (Brown-Liburd and Wright 2011; Gibbins et al. 2010; Hatfield et al. 2008), managers are more flexible and adaptive and as such, employ a cooperative approach (Bame-Aldred and Kida 2007; Thompson 2009).

Third, we predict that relative to all other conditions, participants will propose the largest inventory write-down in the presence of a strong audit committee and a contentious past negotiation relationship (H3). Consistent with our hypothesis, we find a significant interaction effect of *Strong AC* x *Contentious PAST* for *PROPOSED RATE* ($F = 7.9, p = .006$) and *ULTIMATE W/D* ($F = 6.7, p = .000$).⁹ These results suggest that incrementally and together, a strong audit committee and a contentious past auditor relationship serve as effective internal and external monitoring mechanisms, resulting in less managerial opportunism.

Fourth, we hypothesize that the ultimate impact of an IPO on management reporting opportunism through the negotiations process hinges on the relative impact of the opportunities to act on incentives for misreporting (H4a) versus the power of monitoring mechanisms to curb such opportunistic behavior (H4b). Consistent with H4b, we find that heightened monitoring in the IPO-year dominates greater opportunities to act on management incentives in explaining

⁹ Results using contrast coding yield inferentially similar results.

managers' pre-negotiation judgments. Specifically, we find a significant difference for *IPO-YEAR* for *PROPOSED RATE* ($F = 633.5, p = .000$) and *ULTIMATE W/D* ($F = 378.6, p = .000$).

Taken together, these results suggest that participants are prepared to enter negotiations with auditors with a more cooperative mindset around the time of an IPO. These results are consistent with findings by Ball and Shivakumar (2008) who suggest that IPO firms are less opportunistic because financial statement users demand higher quality financial reports for firms going public and, consequently, increased scrutiny is present from various monitors (Lo 2008).

Additional Findings

Intended Strategy

During the pre-negotiation phase, participants reported in an objective choice question the strategy they would likely use during negotiations with the audit partner (*Reported Strategy*¹⁰). Descriptive results are reported in Table 4, Panel A and complement the main results. In both the pre-IPO year and IPO-year, approximately 86% of the participants reported that they were quite or very likely to use an integrative or cooperative strategy. Compared to those in the other conditions, the participants in the strong audit committee/contentious past relationship condition selected only the integrative or cooperative strategy. Further, in the IPO-year there is a slight increase (43% vs. 35%) in the number of participants reporting that they would use an integrative strategy and an increase in the extent to which they would very likely use the strategy (39% vs. 30%). In the general negotiation literature, the integrative strategy is seen as the preferred approach (the “gold standard”) which results in benefits to both parties

¹⁰ Managers were asked to choose one strategy from a list of strategies ranging from integrative (I would work with the audit partner to solve this issue together in the context of other audit issues) to distributive strategies as follows: [contending (I would be firm in pursuing my position); concessionary (I would accept the audit partner's position); cooperative (I would try to bring all my concerns about this issue out into the open with the audit partner so that the issue could be resolved in the best possible way); and compromising (I would try to find some middle ground to resolve the issue with the audit partner)]. Managers were then asked to indicate the extent to which they would pursue the selected strategy on a Likert scale where 1 = very unlikely and 7 = very likely.

(Pruitt and Lewis 1975; Fisher, et al. 1981; Raiffa 1982; Neale and Bazerman 1991), yet this strategy is rarely employed (Thompson and Hrebeck, 1996). Consistent with findings from prior research on auditor-client negotiations (Gibbins et al. 2005; 2007; Bame-Aldred and Kida 2007), it appears that managers view the audit negotiations process as integrative in nature and intend to utilize a strategy that allows for an optimal solution that benefits both parties.

We also examine additional pre-negotiation judgments that have been found to be indicative of negotiation strategy¹¹ (see Table 4, Panel B). Specifically we examine the participant's *RESERVATION PRICE*, which is the minimal acceptable position, below which settlement is clearly unfavorable. General negotiation research suggests that reservation prices are a manifestation of the negotiator's perceptions, goals and expectations (Krause et al. 2006; White et al. 1994). For example, White et al. (1994) find that in a dyadic distributive negotiation, reservation price was the most important predictor of outcomes, and Pinkley et al. (1994) find that negotiators with higher reservation prices negotiated significantly higher outcomes than negotiators with lower reservation prices. In the context of this study, a higher reservation price would suggest that the manager plans to adopt a cooperative negotiation strategy. Untabulated analysis indicates that the mean *RESERVATION PRICE* in the pre-IPO-year is \$279,740, with the highest reservation price occurring in the *Strong AC/Contentious PAST* condition vs. the *Weak AC/Cooperative PAST* condition (\$367,220 and \$180,380, respectively; $t = 12.25$, $p = .000$). These results suggest that the effect of strong monitoring mechanisms result in the manager adopting a more cooperative negotiation strategy. Additionally, we examine the *PROPOSED W/D* in relation to *RESERVATION PRICE* and *ULTIMATE W/D* (Aspiration price). If the proposed write-down is closer to the reservation price, this would suggest that the manager is employing a bid high/concede later strategy which provides the manager with more

¹¹ Results for the IPO-year are qualitatively similar.

negotiation flexibility in order to achieve an outcome closer to her aspiration price. Alternatively, if the proposed write-down is closer to the aspiration price, this would suggest that the manager is adapting a more competitive stance and will have less flexibility to make concessions to reach her aspiration price. Untabulated mean comparisons of the overall means in the pre-IPO year indicate that the difference between *PROPOSED W/D* and *ULTIMATE W/D* is significantly greater than the difference between *PROPOSED W/D* and *RESERVATION PRICE* (-\$34,350 vs. \$33,211; $t = 12.56$, $p = .000$); suggesting that managers adopted a strategy of bid high/concede later, allowing for greater flexibility to reach a mutually beneficial agreement.

Finally, an untabulated analysis indicates no significant difference in the mean assessments of the manager's *RESERVATION PRICE* (\$279,740) to her perception of the audit partner's *RESERVATION PRICE* (\$279,890). This suggests that the manager believes that an agreement can be reached that is agreeable to both parties. Generally speaking, the manager perceives that the write-down amount that the audit partner will accept is similar to the amount that the manager would more than likely agree to. All these findings hold for the IPO-year.

Taken together, these alternative measures of intended strategy are consistent with the manager's *REPORTED STRATEGY* self-assessments and provide further evidence that managers are motivated to reach agreement rather than end the negotiation in impasse, and they appear more willing to compromise than auditors. Further, managers seem to be more strategic in their approach to negotiations with auditors. Specifically, managers seem to make use of a bid high/concede later tactic that will allow them greater opportunity to reach their desired outcome. This is in contrast to auditors, who generally open negotiations with offers that are reflective of their desired goal (Ng and Tan 2003; Brown and Johnstone 2009), which does not allow them much negotiation flexibility.

CONCLUSIONS

A common and critical part of the CFO's function is to resolve difficult, complex accounting and disclosure issues through auditor-client negotiations. However, there is very little research that investigates the manager's perspective. Thus, it is important to examine factors that drive their pre-negotiation position and negotiation strategies, especially in situations where managerial incentives may lead them to exploit the subjectivity inherent in standards such as accounting estimates. In this study, we conduct a controlled experiment to examine the impact of two pervasive contextual factors [the strength of the audit committee (strong or weak) and the past auditor relationship (cooperative or contentious)] on managers' pre-negotiation planning judgments in both the pre-IPO year and the IPO-year. We posit that managers will propose a larger inventory write-down of inventory when both the audit committee is strong and the auditor has been contentious in the past. Consistent with our expectations, we find the largest inventory write-down occurs when the audit committee is strong and the auditor is contentious. This result is consistent with the view that managers perceive the negotiations process to be integrative in nature and they are willing to cooperate, with respect to their negotiation goals, in order to reach agreement with auditors. In additional analyses we find that managers in the strong audit committee/contentious past auditor relationship condition perceive that they are very likely to adopt an integrative or cooperative negotiation strategy. These results suggest that strong monitoring mechanisms during auditor-client negotiations serve to constrain managerial opportunism.

We also find that in the IPO-year managers are willing to take a larger inventory write-down, suggesting less opportunistic behavior due to the demand for higher quality financial reporting from IPO firms. This result is consistent with expectations of the presence of the

auditor and audit committees as well as with other monitoring mechanisms such as regulators. However, a limitation of our study is that we do not explicitly control for these other monitoring mechanisms. Future research can examine whether the presence of other types of monitoring serve to further constrain opportunistic behavior by managers engaged in an IPO. Another interesting avenue for research is the manner in which auditors behave in negotiations with firms undergoing an IPO. We also do not gather information about the manager's satisfaction with regards to the negotiations process, as our focus is on reporting quality as the primary consideration of concern to auditors, audit committees, regulators, and investors. However, since in ongoing relationships it is important to have a good working rapport between the auditor and the manager, we encourage future research that extends our study by examining the impact of managerial satisfaction with regards to the negotiations process.

A final potential avenue for future research relates to the negotiation process and outcome. In our study, the participants report that they are likely to use an integrative strategy. However, we present a context where there is a single subjective issue, which does not completely allow for integrative solutions. For instance, we do not allow managers to trade-off issues. Future research could examine whether managers employ integrative strategies when presented with multiple issues that are material to the financial statements.

Our findings contribute to the auditor-client negotiations literature by providing greater insight into managers' judgment process in a post-SOX environment where greater accountability is expected from managers, auditors, and the audit committees. We provide evidence that, despite the opportunity to do so, managers appear not to exploit the subjectivity inherent in accounting estimates in the presence of strong monitoring mechanisms. Rather, and in contrast to the distributive view of auditors, managers appear to view audit negotiations as

integrative and as a means for cooperative resolution. Further, we contribute to the research on IPOs in that we provide evidence that in the IPO setting, managers act less opportunistically and appear to respond to the demand for higher financial reporting quality when strong monitoring mechanisms (i.e., audit committee and auditors) are present. Finally, our study examines a two-period negotiation over the same issue which is generally indicative of the multi-period nature of negotiations between auditors and management. As a result we are able to begin to investigate how managers' judgment and negotiation strategies evolve over time.

Table 1
Sample Demographics

| Variables | Weak AC & Cooperative PAST | Strong AC & Cooperative PAST | Weak AC & Contentious PAST | Strong AC & Contentious PAST | Total |
|------------------------------------|---------------------------------------|---|---------------------------------------|---|--------------|
| Audit Experience (years) | 13.1 (3.8) | 13.4 (4.6) | 12.3 (4.2) | 13.7 (4.9) | 13.8 (4.4) |
| Negotiation Experience (times) | 6.1 (1.9) | 6.4 (1.5) | 6.7 (1.7) | 7.3 (1.8) | 6.7 (1.8) |
| Position | | | | | |
| CFO | 25 (78%) | 18 (50%) | 20 (63%) | 14 (38%) | 77 (56%) |
| Controller | 3 (10%) | 9 (25%) | 8 (25%) | 15 (40%) | 35 (25%) |
| Other | 4 (12%) | 9 (25%) | 4 (12%) | 8 (22%) | 25 (19%) |
| Certification | | | | | |
| CPA | 31 (97%) | 35 (97%) | 30 (94%) | 36 (97%) | 132 (96%) |
| Other | 1 (3%) | 1 (3%) | 2 (6%) | 1 (3%) | 5 (4%) |
| Company Type | | | | | |
| Public | 26 (81%) | 24 (64%) | 22 (69%) | 18 (49%) | 89 (65%) |
| Private | 6 (19%) | 12 (36%) | 10 (31%) | 19 (51%) | 48 (35%) |
| Company has Audit Committee | 32 (100%) | 36 (100%) | 31 (97%) | 35 (95%) | 134 (98%) |
| Audit Committee Experience (times) | 2.5 (0.7) | 2.6 (1.0) | 2.3 (1.1) | 2.6 (0.9) | 2.5 (0.9) |
| N | 32 | 36 | 32 | 37 | 137 |

Note: This table presents the by-cell and total mean (standard deviation) for audit experience (in years), negotiation experience (in number of times) and audit committee experience (in number of times), as well as the number of observations. The table also presents the by-cell and frequency breakdown of participants' position in their organization, professional certifications, company type, and whether their company has an audit committee or not. The four cell conditions are weak audit committee and cooperative past auditor relationship (Weak AC & Cooperative PAST), strong audit committee and cooperative past auditor relationship (Strong AC & Cooperative PAST), weak audit committee and contentious past auditor relationship (Weak AC & Contentious PAST) and strong audit committee and contentious past auditor relationship (Strong AC & Contentious PAST).

Table 2
Pre-negotiation Judgments

Panel A: Pre-IPO year

| Variable | | Mean (SD) | Past Auditor Relationship | | |
|--------------------------|--------|---------------|---------------------------|--------------------------------|--------------------------------|
| | | | Cooperative | Contentious | Total |
| Audit Committee Strength | Weak | Proposed Rate | 0.40 (0.07) | 0.59 (0.03) | 0.49 (0.11) |
| | | Ultimate W/D | 241.2 (32.8) | 317.4 (14.6) | 279.3 (45.9) |
| | | N | 32 | 32 | 64 |
| | Strong | Proposed Rate | 0.69 (0.046) | 0.79 ^{^^} (0.13) | 0.74 ^{†††} (0.11) |
| | | Ultimate W/D | 384.1 (21.7) | 429.1 ^{^^} (35.6) | 406.9 ^{†††} (37.1) |
| | | N | 36 | 37 | 73 |
| | Total | Proposed Rate | 0.55 (0.16) | 0.70 ^{***} (0.14) | 0.63 (0.16) |
| | | Ultimate W/D | 316.9 (76.9) | 377.3 ^{***} (62.6) | 347.3 (76.1) |
| | | N | 68 | 69 | 137 |

Panel B: IPO-year

| Variable | | Mean (SD) | Past Auditor Relationship | | |
|--------------------------|--------|---------------|---------------------------|--------------------------------|--------------------------------|
| | | | Cooperative | Contentious | Total |
| Audit Committee Strength | Weak | Proposed Rate | 0.58 (0.04) | 0.74 (0.04) | 0.65 (0.09) |
| | | Ultimate W/D | 325.5 (39.7) | 397.1 (23.0) | 361.3 (48.4) |
| | | N | 32 | 32 | 64 |
| | Strong | Proposed Rate | 0.74 (0.06) | 0.84 ^{^^} (0.14) | 0.79 ^{†††} (0.11) |
| | | Ultimate W/D | 405.8 (30.0) | 460.3 ^{^^} (44.1) | 433.4 ^{†††} (46.5) |
| | | N | 36 | 37 | 73 |
| | Total | Proposed Rate | 0.67 (0.10) | 0.79 ^{***} (0.11) | 0.73 ^{◇◇◇} (0.12) |
| | | Ultimate W/D | 368.0 (53.2) | 431.0 ^{***} (47.7) | 399.7 ^{◇◇◇} (59.4) |
| | | N | 68 | 69 | 137 |

Note: This table presents the by-cell and total mean (standard deviation) and number of observations for the pre-IPO year (Panel A) and the IPO-year (Panel B). Proposed RATE represents the participant's initial pre-negotiation position for inventory write-down scaled by the audit team's proposed write-down amount. Ultimate W/D represents the amount (in thousand dollars) that the participant thinks will ultimately be booked for inventory write-down. Cell conditions are described further in Table 1. *** and ††† represent two-tailed significance at the 0.01 level that the column and row total assessment in the cell condition is larger than that in the corresponding, alternative cell condition, respectively. ^^ represents two-tailed significance at the 0.01 level that the mean assessment in the cell condition is larger than that in the three other cell conditions combined. ◇◇◇ represents two-tailed significance at the 0.01 level that the overall total assessment in the IPO-year is larger than that in the pre-IPO year.

Table 3
MANOVA Results

| Variable | Hypothesis | Proposed Rate | Ultimate W/D |
|---|-------------------|----------------------|----------------------|
| Strong AC | + H1 | 2.45 201.8*** | 675637.8 453.2*** |
| Contentious PAST | + H2 | 1.25 102.5*** | 260811.2 174.9*** |
| Strong AC * Contentious PAST | + H3 | 0.09 7.9*** | 9979.3 6.7** |
| IPO-year | - H4a; + H4b | 0.80 633.5*** | 200394.2 378.6*** |
| IPO-year * Strong AC | | 0.22 177.0*** | 52679.8 99.5*** |
| IPO-year * Contentious PAST | | 0.006 4.6** | 106.0 0.2 |
| IPO-year * Strong AC * Contentious PAST | | 0.03 1.2 | 848.9 1.6 |

Note: This table presents the results of mixed model ANOVA. Values in cells represent the mean square and the F-value. ***, **, and * represent two-tailed significance at the 0.01, 0.05, 0.10 level, respectively.

Table 4
Intended Strategies

Panel A: Self-Reported Strategy

| Strategy | Weak AC & Cooperative AR N = 32 | Strong AC & Cooperative AR N = 36 | Weak AC & Contentious AR N = 32 | Strong AC & Contentious AR N = 37 | Total N = 137 |
|------------------------------|--|--|--|--|--------------------------|
| Pre-IPO YEAR | | | | | |
| Integrative | 25 (78%) | 19 (53%) | 18 (56%) | 13 (35%) | 75 (55%) |
| Cooperative | 0 (0%) | 10 (28%) | 9 (28%) | 24 (65%) | 43 (31%) |
| Contending | 5 (16%) | 1 (3%) | 0 (0%) | 0 (0%) | 6 (4%) |
| Concede | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) |
| Compromise | 2 (6%) | 6 (17%) | 4 (12%) | 0 (0%) | 12 (9%) |
| Likelihood of using strategy | | | | | |
| Very Unlikely | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) |
| Quite Unlikely | 5 (16%) | 5 (14%) | 4 (12%) | 3 (8%) | 17 (12%) |
| Slightly Unlikely | 0 (0%) | 1 (3%) | 0 (0%) | 0 (0%) | 1 (0.7%) |
| Neutral | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) |
| Slightly Likely | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) |
| Quite Likely | 17 (53%) | 18 (50%) | 21 (66%) | 23 (62%) | 79 (58%) |
| Very Likely | 10 (31%) | 12 (33%) | 7 (22%) | 11 (30%) | 40 (29%) |
| IPO-YEAR | | | | | |
| Integrative | 12 (37%) | 13 (36%) | 14 (44%) | 16 (43%) | 55 (40%) |
| Cooperative | 18 (56%) | 17 (47%) | 7 (22%) | 21 (57%) | 63 (46%) |
| Contending | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) |
| Concede | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) |
| Compromise | 2 (6%) | 6 (17%) | 11 (34%) | 0 (0%) | 19 (14%) |
| Likelihood of using strategy | | | | | |
| Very Unlikely | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) |
| Quite Unlikely | 6 (19%) | 3 (8%) | 2 (6%) | 1 (3%) | 12 (9%) |
| Slightly Unlikely | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) |
| Neutral | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) |
| Slightly Likely | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) | 0 (0%) |
| Quite Likely | 17 (53%) | 18 (50%) | 18 (56%) | 14 (38%) | 67 (49%) |
| Very Likely | 9 (28%) | 15 (42%) | 12 (37%) | 22 (39%) | 58 (42%) |

Table 4
Intended Strategies, continued

Panel B- Alternative Measures of Intended Strategies

| | Weak AC & Cooperative AR N = 32 | Strong AC & Cooperative AR N = 36 | Weak AC & Contentious AR N = 32 | Strong AC & Contentious AR N = 37 | Total N = 137 |
|--|--|--|--|--|--------------------------|
| Pre-IPO YEAR | | | | | |
| Maximum write-down (Reservation Price) | 180.38 (53.9) | 291.81 (74.9) | 264.41 (10.3) | 367.22 (70.2) | 279.74 (89.1) |
| Assessment of audit partner's minimum write-down (Reservation Price) | 180.28 (23.7) | 301.72 (52.5) | 264.13 (17.6) | 358.43 (65.9) | 279.89 (79.1) |
| Assessment of the write-down that the audit partner will accept | 195.63 (23.2) | 320.56 (20.9) | 275.69 (14.9) | 382.43 (58.1) | 297.61 (76.4) |
| Proposed write-down | 200.09 (33.9) | 345.06 (22.8) | 293.75 (13.3) | 395.95 (65.2) | 312.96 (82.4) |
| Ultimate write-down (Aspiration Price) | 241.19 (32.8) | 384.14 (21.7) | 317.41 (14.6) | 429.11 (35.6) | 347.31 (76.1) |
| IPO-YEAR | | | | | |
| Maximum write-down (Reservation Price) | 260.88 (39.3) | 371.58 (35.9) | 289.06 (59.4) | 432.76 (52.9) | 342.97 (83.1) |
| Assessment of audit partner's minimum write-down (Reservation Price) | 270.13 (20.8) | 345.06 (62.0) | 334.56 (11.8) | 384.11 (69.9) | 335.65 (63.9) |
| Assessment of the write-down that the audit partner will accept | 295.34 (31.8) | 355.56 (26.6) | 349.94 (12.4) | 421.57 (69.9) | 358.01 (61.5) |
| Proposed write-down | 290.41 (22.3) | 372.67 (30.9) | 369.44 (21.3) | 419.51 (69.0) | 365.35 (62.1) |
| Ultimate write-down (Aspiration Price) | 325.47 (39.7) | 405.78 (29.9) | 397.13 (22.9) | 460.3 (44.1) | 399.72 (59.4) |

Note: This table presents participant responses regarding their self-reported intended strategy and the likelihood of using that intended strategy (Panel A), as well as alternative measures of those intended strategies (Panel B). Participants responded to the following questions. "Which of the following types of strategies best describes the one you would predominately plan to use? (Choices consisted of a list of strategies ranging from integrative (I would work with the audit partner to solve this issue together in the context of other audit issues) to distributive strategies as follows: [contending (I would be firm in pursuing my position); concessionary (I would accept the audit partner's position); cooperative (I would try to bring all my concerns about this issue out into the open with the audit partner so that the issue could be resolved in the best possible way); and compromising (I would try to find some middle ground to resolve the issue with the audit partner)]. Managers were then asked to indicate the extent to which they would pursue the selected strategy on a Likert scale where 1 = very unlikely and 7 = very likely".

EXHIBIT 1

Manipulation of Independent Variables

Audit Committee Strength (labeled as “Corporate Governance” in instrument):

Strong Audit Committee Manipulation (Strong AC):

VCC has a board of directors of nine members, three from management (including the president) and six independent, outside individuals. The audit committee is composed of three individuals, who are all independent. Two of the members have extensive experience in public accounting and the third member is financially literate. You have been very impressed with the audit committee’s high level of diligence in representing shareholders’ interests. They ask many probing questions and meet very frequently. Finally, the board has granted the audit committee a high level of power in executing its authority and almost always sides with the audit committee on contentious issues involving management.

Weak Audit Committee Manipulation (Weak AC):

VCC has a board of directors of nine members, three from management (including the president) and six independent, outside individuals. The audit committee is composed of three individuals, who are all independent. One of the members is a CPA and has 5 years of experience in public accounting. The other two members are financially literate. Your experience with the audit committee is that they ask very few questions and meet two times a year. Finally, the board has granted the audit committee limited power in executing its authority and very rarely will the board side with the audit committee on contentious issues involving management.

Past Negotiation Relationship:

Contentious Relationship Manipulation (Contentious PAST):

In the past you have had a difficult relationship with the audit partner in resolving difficult issues. The audit partner tends to stick to his position and be intransigent, failing to listen to counter arguments. As a result, interactions involving contentious issues have been prolonged and difficult.

Cooperative Relationship Manipulation (Cooperative PAST):

In the past you have had a cooperative relationship with the audit partner in resolving difficult issues. He has been willing to accept reasonable counter arguments. As a result, interactions involving contentious issues have not been prolonged or difficult.

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