

Report on FAR Masterclass 15 November 2017: “What do we already know about...? Identification and negotiation of audit findings”



Breukelen, 15 November 2017

Direct auditor impact on audit findings

FAR Masterclass on ‘Identification and negotiation of audit findings’

“If we really want to understand audit quality we need to understand where the auditor directly impacts the process.”

- Professor Vanstraelen -

This FAR Masterclass gave a sneak preview into the black box of an auditor’s impact on audit quality through the topic of misstatement and negotiation. How do auditors identify misstatements, and if they do, how do they talk about these misstatements with their clients? Again, the Masterclass provided a platform for mutual knowledge sharing between practitioners and scientists. The four most important take-aways were:

- **Auditors’ impact on client financial statements is non-trivial.**
- **The linking pin between error/accounting issues and outcomes/consequences is the auditor-client negotiation process.**
- **The auditor-client negotiation process is influenced by contextual factors: external conditions, interpersonal context and parties’ characteristics.**
- **The negotiation strategies of both the auditor and the client play an important role during the misstatement evaluation process.**

What is audit quality and what influences it? These questions still echo in the audit field. The research team of Professor Ann Vanstraelen and PhD student Ulrike Thürheimer (Maastricht University) tries to open the black box regarding influences on audit quality by focusing on the direct impact of the auditor on financial statements. According to them the identification of and negotiation about audit findings is one of the main ways in which auditors directly influence audit quality. In this interactive Masterclass Professor Vanstraelen and PhD student Thürheimer shared what is already known about this topic from prior research and stimulated participants to share their knowledge and lessons from practice.

“Audit quality goes to the heart of accountancy. It is fundamental.”

- (Professor Vanstraelen) -

The Masterclass started with Professor Vanstraelen underlining the importance of the topic. Misstatements seem to be a relatively simple topic. However, were you aware that audit-related adjustments reduce pre-audit earnings and assets by an amount exceeding materiality by a factor 2 to 8 (Kinney & Martin, 1994)? Or that adjustments occur in about 70% of audits and have important consequences for the financial reporting quality [FQR], such as smoother and more persistent earnings, and higher accrual quality (Lennox, Wu & Zhang, 2016)? The context highlights the importance and added value of the work of an auditor. After the context was explained a poll was taken amongst the participants. They were asked to give their opinion on topics ranging from the type of procedures that errors are typically detected in to which accounts the detected errors mostly relate to. One of the questions that stirred up a lot of discussion was the question whether the participants consider the financial statement a joint product of management and auditors. In theory, management has the responsibility for the preparation of financial statements and their fair presentation (ISA 210.6b(i)). Nevertheless, fifty percent of the participants answered that they view financial statements as a joint product. An interesting response because it shows the differing views of participants on the auditor’s impact on financial statements.

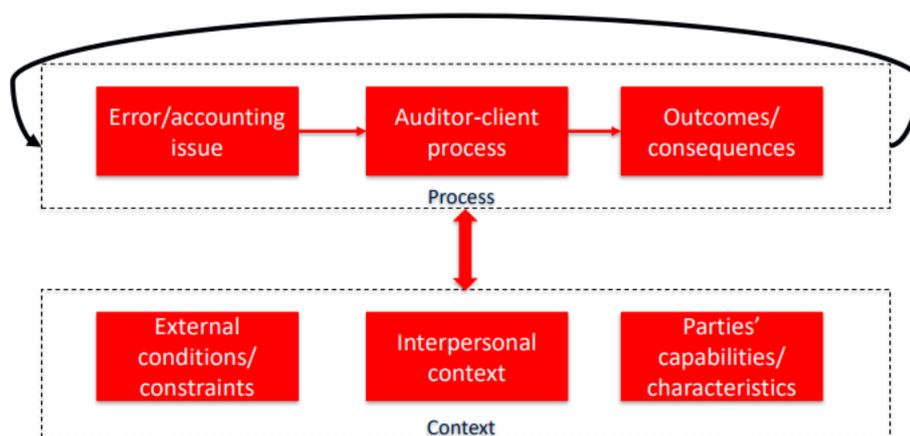
Interesting fact: in the Netherlands listed companies need an auditor’s opinion, whether that opinion is qualified or unqualified. In the USA, however, listed companies need an unqualified auditor’s opinion. Hence, the negotiation process between the client and the auditor after misstatements are found, differs significantly between the USA and the Netherlands.

The linking pin between error/accounting issue and outcomes/consequences is the auditor-client negotiation process. This process is a continuum ranging from the client being required to change all issues, to the auditor conceding to all issues, and everything in between these two extremes. A participant points out that the auditor-client negotiation process has changed a lot over the last years. The auditor used to cooperate with the CFO while he/she now works with the audit committee of an organization. The CFO’s motivation is very different from the motivation of the audit committee. This changed the dynamics at the negotiation table. Another participant adds that it used to be that the unadjusted differences were never published but now they can be addressed as part of key audit matters.

After the break Ulrike Thürheimer talked about the evaluation process of misstatements. The participants were asked to discuss amongst themselves about 1) what they considered the most important factors in the auditor-client process on misstatement evaluation and 2) what circumstances influence the auditor-client process on misstatement evaluation. In the first question participants identified factors such as seniority, power-balance, 'need to have' versus 'nice to have' adjustments, type, importance and personal consequences of misstatements as the most important factors in the auditor-client negotiation process on misstatement evaluation. One of the participants shared that he sometimes asked a more senior partner to attend a client meeting if he knew that this specific client was sensitive to such a show of force. As to the second question participants mentioned aspects such as time pressure, relationship with the client, personality of the client and of the auditor, history 'did we see the same mistake last year' and incentive structures on both sides - the client as well as the auditor.

Interesting fact: Prior involvement with the client has a significant negative effect on the size of the proposed audit adjustments (Hatfield, Jackson & Vandervelde, 2011).

Figure 1: Misstatement evaluation model



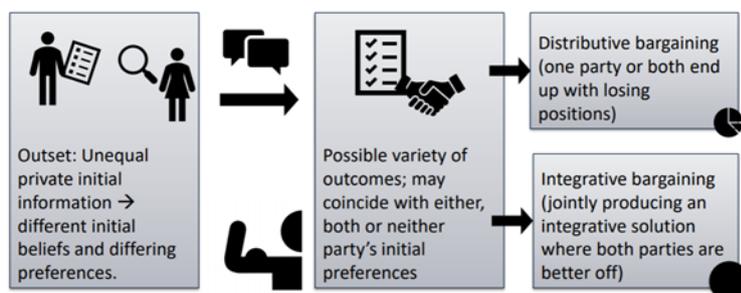
Source: adapted from Gibbins, Salterio & Webb (2001).

The input from the brainstorm was used to compare the opinions of the class with that of the misstatement evaluation model to check the applicability of the model (Gibbins, Salterio & Webb, 2001; see Figure 1). The misstatement evaluation model categorizes the variables that influence auditor misstatement evaluation into three process categories (error/accounting issues, auditor-client process and outcomes/consequences) and three contextual categories (external conditions (constraints), interpersonal context and parties' capabilities (characteristics)). Prior and future interactions influence the relationship between these two different variable categories. The

participants identified many of the same variables as Gibbins, Salterio and Webb identify in their model. It was interesting to see how the large majority of the participants had been in similar situations, hence there was hardly any discussion about which variables needed to be written down. In the discussion of the brainstorm results the auditor-client process was especially debated. In 1991, Antle and Nalebuff were the first ones to point out that the auditor-client process is a negotiation. It seemed as if every participant had a story to tell on this topic. One participant shared: *“It is wheeling and dealing. Do I run the risk of losing a client? If yes, maybe I should choose the middle ground of adding a footnote.”* Research has shown that when the auditor has the option of writing a footnote this acts as a way out to justify wrongdoing (Griffin, 2014).

Professor Vanstraelen linked the ‘wheeling and dealing’ with the circumstances present: *“In situations of high uncertainty auditors seem to shy away from the discussion.”* A risk of writing footnotes is that the auditor counts on the users of the annual report to actually read them. Pressure also influences the negotiation process. A study by Koch and Salterio (2017) showed that in a pressure ‘free’ context auditors are somewhat modest and might even underestimate their power. However, when the pressure from the client rises the auditor will feel the need to rise-up against the client and stand strong. Hence, the negotiation strategies of both the auditor and client play an important role during the misstatement evaluation process (see Figure 2). There are different negotiation strategies and concerns about the clients’ interests or the auditors’ interests influence which negotiation strategy is chosen. Integrative negotiation is often discarded as an option by both auditors and CFOs, while from a stakeholder perspective this negotiation strategy is most beneficial. Interestingly, when the participants were asked to identify their main negotiation strategy, most hands were raised for the integrative negotiation strategy.

Figure 2: Negotiation process

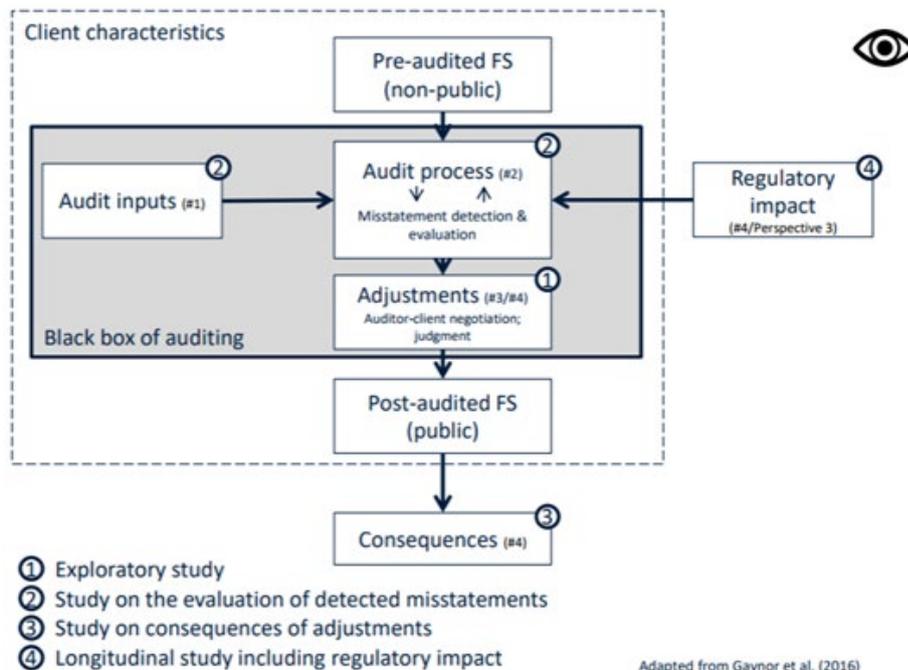


Source: Adapted from Gibbins, Salterio & Webb (2001).

At the end of the masterclass the research team presented the outline of the FAR research project that consists of four studies (see Figure 3). The participants were invited by the research team to give

feedback and/or add important variables. Their invitation still holds, so, if you have questions about or additions to the model, please feel free to contact Ann Vanstraelen (a.vanstraelen@maastrichtuniversity.nl) and/or Ulrike Thürheimer (u.thurheimer@maastrichtuniversity.nl).

Figure 3: Outline FAR research project



Source: Adapted from Gaynor et al. (2016)

References:

- Antle, R., & Nalebuff, B. (1991). Conservatism and auditor-client negotiations. *Journal of Accounting Research*, 31-54.
- Gaynor, L. M., Kelton, A. S., Merer, M. & Yohn, T. L. (2016). Understanding the relation between financial reporting quality and audit quality. *Auditing: A Journal of Practice & Theory*, 35(4), 1-22.
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- Koch, C., & Salterio, S.E. (2017). The Effects of Auditor Affinity for Client and Perceived Client Pressure on Auditor Proposed Adjustments. *The Accounting Review*.
- Lennox, C., Wu, X., & Zhang, T. (2016). The effect of audit adjustments on earnings quality: Evidence from China. *Journal of Accounting and Economics*, 61(2), 545-562.

In addition, to read more about this subject the following books/articles are suggested by the research team:

- Durney, M., Elder, R. J., & Glover, S. M. (2014). Field data on accounting error rates and audit sampling. *Auditing: A Journal of Practice & Theory*, 33(2), 79–110.
- Malhotra, D & Bazerman, M. H. (2008). *Negotiation Genius: How to overcome obstacles and achieve brilliant results at the bargaining table and beyond*. Bantam Books.
- Messier, W. F. J., Eilifsen, A., & Austen, L. a. (2004). Auditor Detected Misstatements and the Effect of Information Technology. *International Journal of Auditing*, 8(3), 223–235.
- Salterio, S. (2012). Fifteen years in the trenches: auditor-client negotiations exposed and explored. *Accounting and Finance*, 52 (Suppl.), 233-286.

***“We need to pay more attention to the role of negotiations
 in the curriculum of our summerschool.”***

- participant from a big four company -