Explicating the Interactions between the Auditor and Client Management during the Audit Process: Implications for Corporate Governance

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The paper is a study of the extent, nature, and outcomes of the interactions between auditors and client management during the audit process, and the consequent impact on the effectiveness of corporate governance structures in place. A total of 28 semi-structured interviews were carried out in 8 different sized Egyptian accounting firms. The semi-structured interviews were facilitated by the use of a pre-designed interview schedule using a very broad topic guide with a few direct questions. The interviewees’ responses revealed that it is important for the auditor not only to assess the nature of the given dispute and the stage to which the dispute has evolved, but also to assess the forces and factors affecting the parties involved. Secondly, when resolving audit disputes, interviewees indicated that there is no single negotiation strategy that can be applied in all situations. The findings should be treated with some caution since the interviews were conducted with only one group of subjects, namely 28 Egyptian auditors of Big 4 and other audit firms. Accordingly, the issue remains open as to whether the interviewees’ perceptions can be generalized to the whole population or to other groups (for instance, finance directors or shareholders). Most of the previous studies have been conducted in developed, Anglo-Saxon countries; therefore there is an opportunity for more research to be carried out in other countries, specifically in developing countries, namely Egypt, thus providing additional evidence on this issue.

Field of Research: Auditing, Corporate Governance, Developing economies

1. Introduction

Auditors and their clients often encounter situations in which professional standards allow for different judgements about the appropriate treatment of accounting transactions (Johnstone and Muzatko, 2002). For example, auditors and their clients may disagree on the proper valuation of inventory or accounts receivable, because both parties may make different judgements regarding inventory obsolescence or the allowance for doubtful accounts. In such situations, auditors and their clients generally seek ways to resolve their disagreements. Furthermore, it may be argued that both parties generally benefit from a strong, long-term relationship with the other; auditors gain valuable client-specific knowledge that may aid them to conduct their audits effectively and efficiently, and clients avoid the costs associated with switching auditors. Therefore, it is in both parties’ interests to resolve, via discussion and negotiation, accounting issues, over which they have a dispute, whenever possible. However, it is important to note that in situations where companies issue financial statements that are materially incorrect there could be very significant legal and reputation costs to both client management and the auditor.

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As such, negotiations in order to present a representational faithful view of the client’s financial status would seem to be an important goal for both auditors and client management (Johnstone and Muzatko, 2002). Nonetheless, in the process of expressing an opinion on the client’s financial statements, a certain amount of conflict between the auditor and client management could possibly arise (Gibbins, Salterio, and Webb, 2001; Wright and Wright, 1997). Before the auditor is willing to provide an unqualified audit report, any issues that have arisen throughout the audit process must be resolved. During the resolution process, client management is likely to attempt to persuade the auditor to accept the client management position. The early independence literature (see for e.g. Goldman and Barlev, 1974; Nichols and Price, 1976) modelled the auditor’s ability to withstand pressure from a client when resolving issues as a function of the client’s sources of power relative to the auditor’s sources of power. Thus, as Murnighan and Bazerman (1990) point out, when negotiating with the client, the auditor is faced with incentives to cooperate and incentives to compete. One factor influencing auditor’s ability to resist client management pressure is the strength of the corporate governance structures in place. A corporate governance structure is an institutional mechanism applied at the company level to provide assurance to third-party users that independence is being preserved. Corporate governance mechanisms include board of directors and audit committee involvement in establishing and maintaining the appropriate auditor-client management relationship and in overseeing the conduct of the audit. Appropriately functioning boards of directors and audit committees should provide a neutral, well-informed buffer between auditors and management (Johnstone, Sutton, and Warfield, 2001). One of the benefits of strong corporate governance is the enhancement of auditor independence. A strong and active audit committee comprising independent members can act as an intermediary between the auditor and client management in the event of a dispute. In this sense, the paper is a study of the extent, nature, and outcomes of the interactions between auditors and clients during the audit process, and the consequent impact on the effectiveness of Corporate Governance structures in place. The basic components of the interactions that are investigated are the contextual factors affecting audit disputes, in terms of how they develop, are discussed and negotiated and the impact of these disputes on auditors’ ability to withstand client management pressure, and the negotiation strategies the auditor may adopt when dealing with audit disputes with the ultimate aim of assessing the effectiveness of Corporate Governance structures in place.

2. Literature Review

Disputes between auditor and client management that may arise in the course of an audit regarding proper accounting treatment, presentation, disclosure, etc., are often resolved by referring to appropriate accounting rules or guidelines. However, because each disputable situation often involves unique circumstances, the resolution of such conflicts may also be affected by several factors that affect the relative negotiating power of the two parties. Two groups of factors may affect auditors’ decisions in such situations – those factors from which the client derives power (such as the ability to negotiate the auditor/client contract in a market characterized by the presence of competing audit firms) and those from which the auditor may derive power (such as the strength of the corporate governance structure in place, transaction costs to replace the incumbent auditor, start-up costs for a new auditor and loss of the expertise of the incumbent auditor).
Nonetheless, auditors’ ability to withstand client pressure is a function, among other things, of the relative power of the client management and the auditor who are parties to the disagreement. Compared to many other professional groups, Goldman and Barlev (1974) argue that auditors are in a relatively weak position in disputes with their clients because they operate usually in a very competitive market and produce a product (i.e., the audit opinion) that is perceived as being basically homogeneous. The existence of competing audit firms who are ready to replace them provides a major source of the clients’ power – the threat, supported by the ability, to replace auditors with a competitor if a disagreement occurs over either a professional matter or a fee dispute (see for e.g. Goldman and Barlev, 1974; Gul, 1991; Knapp, 1985). Furthermore, audit firm size is also believed to affect auditors’ ability to resist management pressure. Gul (1991) found that bankers expected that large auditing firms would have greater ability to withstand management pressure compared to small audit firms.

Nevertheless, sources of negotiating power may not rest solely with the client. Most audit firms also provide additional non-audit services to many clients, including their audit clients. Although the client may be able to obtain the additional services elsewhere, the client may be reluctant to seek a replacement if the additional services are specialized in nature because of the transactions costs involved both in searching for the replacement and in the replacement’s learning their particular norms, systems and needs.

Another factor influencing auditor’s ability to resist client management pressure is the strength of the corporate governance structures in place. One of the benefits of strong corporate governance is the enhancement of auditor independence. A strong and active audit committee comprising independent members can act as an intermediary between the auditor and client management in the event of a dispute.

Yet, if auditors were, beyond doubt, independent of their client this debate would end here, but, apparently, they are not. The researcher argues that client management effectively influence, in an indirect way, the appointment of the company’s auditors and also effectively influence, indirectly, the determination of the size of the audit fee. Thus, if the auditors conclude that the financial statements do not show a true and fair view and qualify their audit opinion, they know that there is a possibility either of losing the audit or of having their fee reduced. On the other hand, there is also a sense of loyalty that is built up between an auditor and the managers being audited (Moizer, 1997).

Despite the vast amount of research (see for e.g. Awadallah, 2006; Knapp, 1985; Lindsay, 1990; Shockley, 1981) that is concerned with the theoretical identification and empirical testing of variables affecting auditors’ ability to withstand pressure from client management, few studies (see for e.g. Beattie, Brandt, and Fearnley, 2004; Gibbins, Salterio, and Webb, 2001) have focused on the negotiation process that takes place between the auditor and client management in order to reach an outcome. Research on negotiation is increasing in recent years. The increased interest has arisen because of such negotiations’ impact on information released to capital markets and other users, and because of recent concerns about the auditors’ independence and ability to withstand client management pressure (see for e.g. Beattie, Fearnley, and Brandt, 2000; Gibbins, Salterio, and Webb, 2001). Fundamentally, accounting studies concerning interactions between auditors and client management have used a variety of different methods, have focused upon
different interaction stages, and have investigated interactions between staff at different levels on both sides of the relationship. The review of previous relevant literature revealed a lack in studies addressing the effect of the factors affecting auditor's independence on the chosen negotiation strategy. Most of the previous auditing studies were either concerned with the factors that may impair auditor's independence or with the negotiation process per se. Furthermore, most of the previous studies have been conducted in developed, Anglo-Saxon countries leading to the notion that there is much room for more research to be carried out in other countries, specifically in developing countries, to explore any cross-cultural similarities or differences that might exist; thus providing additional evidence on this issue in order to reduce the frequency of conflict in the audit context as well as how to manage this phenomenon in a constructive manner, which, in turn, could benefit all parties with a stake in ensuring effective corporate governance.

3. Methodology and Research Design

The current research was based on conducting personal semi-structured interviews where an interview schedule has been prepared; however, the questions were left open-ended. This form of interviewing has been chosen for two reasons; first there was a list of issues about the auditor-client negotiation relationship that needed investigation. Second, the questions related to these issues could not be answered in form of ‘yes’ or ‘no’ or any other pre-determined form. Rather, open-ended questions were more relevant to allow the interviewees to express their opinions freely. Moreover, this gave those interviewed the opportunity to discuss the issues in a way they could control. The interview schedule was developed based on audit concepts selected from the literature and previous empirical studies. The basic components of the interactions that are investigated are the contextual factors affecting audit disputes, in terms of how they develop, are discussed and negotiated and the impact of these disputes on auditors’ ability to withstand client management pressure, and the negotiation strategies the auditor may adopt when dealing with audit disputes. A total of 28 semi-structured interviews were carried out in 8 different sized accounting firms. Agreement was obtained from the eight firms of accountants to participate in the study and interviews were conducted with 4 partners and 7 senior managers from two of the ‘Big 4’ accounting firms, 6 partners and 7 senior managers from 4 medium-sized firms of accountants, and, finally, 4 senior managers from 2 small-sized firms of accountants. The level of partners and managers was chosen because the results of the pilot study interviews indicated that if auditors were to choose a certain negotiation strategy during the audit process; this would be selected by the partner or the manager.

4. Discussion of Findings

In explicating the issue of audit disputes and its impact on the effectiveness of Corporate Governance structures in place, the discussion was under three main headings: nature of the audit dispute and the factors underlying it, development stages of the audit dispute, and applied negotiation strategies to deal with the audit dispute. On one hand, when asked about the nature of the audit dispute and what might be the factors that lead to the argument, the interviewees elicited three main factors that cause audit disputes. These include disagreement over informational factors, disagreement over perceptual factors, and disagreement over role factors. The informational factors exert their influences when the various points of view have
developed on the basis of different sets of facts, whereas the perceptual factors exert their influence when the persons have different images of the same stimulus. Finally, the role factors exert their influence because each of the individuals occupies a certain position and status in the relationship between them. The fact that he or she occupies such a position or status may put certain constraints on him or her if the discussion is related to his or her role.

On the other hand, the interviewees’ responses, on aggregate, revealed that the audit dispute passes through five main stages, in the sense that each stage leads either to the conflict being resolved or the conflict being complicated, thus moving to the following stage. In addition, it was deduced that there are some certain forces and factors affecting the auditor’s position in each stage. Those forces and factors determine to a large extent the outcome of the dispute. The forces are mainly represented by the effectiveness of the corporate governance structure’s role in handling the situation, and the factors are represented by the balance of power between the auditor and client management. Hence, it was deducted that it is important for the auditor not only to assess the nature of the given dispute and the stage to which the dispute has evolved, but also to assess the forces and factors surrounding it. Finally, based on the dual concerns model and its associated five strategies, i.e. collaborating, competing, avoiding, accommodating, and compromising, it was concluded from the interviewees’ responses, that there is no single strategy that can be adopted in all situations as this would depend on each case individually and on the factors surrounding it. This was because, as reflected from the interviewees’ responses, the nature of audit disputes is not the same. Consequently, each audit dispute has its unique circumstances; the resolution of such conflicts is affected by several influences that affect the choice of an appropriate negotiation strategy.

5. Conclusion

Conflict between client management and the audit firm is apparently occurring with increasing frequency (Beattie, Fearnley, and Brandt, 2000; Gibbins, Salterio, and Webb, 2001). The central argument here is the way auditors deal with these conflicts and the effect – if any – on their ability to resist client management pressure. Large financial failures and accounting scandals suggest potential conflicts that have reduced the effectiveness of corporate governance, the reliability of financial statements, and, ultimately, investor confidence. Policy makers have responded with unusual speed by passing numerous new regulations. Yet, many of these regulations changes have occurred without much consideration of evidence provided by the extant empirical research literature. Thus, if audit firms are to retain their important role in the financial reporting process, more research needs to be undertaken. The findings and conclusions of the semi-structured interviews should be treated with some caution since the interviews were conducted with only one group of subjects, namely 28 Egyptian auditors of Big 4 and non Big 4 audit firms. Accordingly, the issue remains open as to whether the interviewees’ perceptions can be generalized to the whole population or to other groups (for instance, shareholders). Of more concern, as the population surveyed was exclusively comprised of Egyptian auditors, whose experience would be based on Egyptian rules, practices and procedures, the results and analysis are not necessarily applicable to other jurisdictions. For instance, other factors such as cultural differences of the interviewees’ personal characters and experience may have a significant impact on auditors’ choice of the appropriate negotiation strategy to be applied in audit disputes. In other words, Egyptian auditors may perceive these disputes in a different light from their counterparts in other
countries, suggesting that need for more research. Another primary limitation in the interviews is that the main focus was on factors perceived as impairing auditors’ independence. Future research could be undertaken to identify other factors that may enhance independence. Further, the interviews held, when dealing with the issue of negotiation strategies, focused on the dual concerns model and its associated five strategies. Further research could be undertaken to explore the issue through applying any other relevant models, for instance, the Thomas-Kilmann Instrument.

References


