

ECONOMIC
RESEARCH
FORUM



منتدى
البحوث
الاقتصادية

2009

working paper series

EFFECT OF AUDITEE BUSINESS RISK,
AUDIT RISK AND AUDITOR BUSINESS RISK
ON AUDITOR AUDITEE NEGOTIATION
OUTCOMES: AN EXPERIMENTAL
STUDY IN TUNISIAN CONTEXT

Manel Hadriche Sahnoun and Mohamed Ali Zarai

Working Paper No. 467

**Effect of Auditee Business Risk, Audit Risk and Auditor
Business Risk on Auditor Auditee Negotiation Outcomes:
An Experimental Study in Tunisian Context**

Manel Hadriche Sahnoun and Mohamed Ali Zarai

Working Paper 467

February 2009

Corresponding Author:

Manel Hadriche Sahnoun, Accounting Department, University of Tunis, Tunis
E-mail : manel.hadriche@yahoo.fr

Abstract

The purpose of this paper is to study the impact of auditee business risk, audit risk and auditor business risk evaluation on auditor-auditee negotiation outcomes. An experimental research was conducted using 200 Tunisian auditors as participants. We have proved the association between audit risk and auditee business risk. Also, our results indicate that auditee business risk has a significant effect on auditor-auditee negotiation outcomes. So, auditors will be less likely to accept an auditee's aggressive reporting practice when the auditee's business risks are high. On the other hand, results shows that audit risk evaluation don't affect auditor auditee negotiation outcomes. Finally and for the effect of auditor business risk on auditor agreement probability with auditee preferences, the result is not significant.

ملخص

تهدف هذه الورقة إلى دراسة تأثير تقويم المخاطر التي تتعرض لها الشركة التي تدقق حساباتها، وخطر التدقيق، ومخاطر شركات التدقيق على نتائج التفاوض بين المدقق والشركة التي يقوم بتدقيق حساباتها. وقد أجرى بحث تجريبي اشترك فيه 200 مدقق تونسي، وأثبتنا وجود ارتباط بين خطر التدقيق والمخاطر التي تتعرض لها الشركة التي تدقق حساباتها، كما تشير نتائجنا إلى أن مخاطر تلك الشركات ذات تأثير ذي بال على نتائج التفاوض بين المدقق والشركة التي يقوم بتدقيق حساباتها. ومن ثم يقل احتمال أن يقبل المدققون ما قد تضمنه تقارير الشركة التي يدققون حساباتها من ميل إلى الحزم والتأكيد، بينما ترتفع معدلات المخاطر التي تتعرض لها تلك الشركة.

ومن ناحية أخرى، تبين النتائج أن تقويم مخاطر التدقيق لا تؤثر على نتائج التفاوض بين المدقق والشركة التي يضطلع بتدقيق حساباتها. وأخيرا نجد أن تأثير مخاطر المدقق على احتمالات موافقة المدقق على خيارات الشركة التي يقوم بتدقيق حساباتها ليس بالأثر ذي البال.

Introduction

Audited financial statements are a joint product of both the auditor and the auditee (Antle and Nalebuff, 1991; Gibbins, McCracken, and Salterio, 2007; McCracken, Salterio and Gibbins, 2008), and auditors sometimes play an active role in managing the auditee's financial reporting choices (Nelson, Elliott and Tarpley, 2002). In the process of financial reporting, circumstances may arise that lead to divergent preferences between auditees and auditors on accounting and reporting issues. The resolution of such financial reporting issues can be especially difficult when generally accepted accounting principles (GAAP) are ambiguous (Nelson and Kinney, 1997; Kadous, 2000; Johnstone, Bedard and Biggs, 2002), since both parties may make different judgments depending on their preferences.

Despite the importance of auditor-auditee negotiations in financial reporting, limited attention has been given to the need for effective negotiations in situations that entail subjective matters (such as accounting estimates, imprecise accounting standards, etc.) (Trotman, Wright and Wright, 2005; Gibbins, McCracken and Salterio, 2005).

As a result of notorious financial scandals such as WorldCom and Enron in the US and, on the European scene, the financial crises at Parmalat in Italy, Ahold in the Netherlands, and Batam and Affes in Tunisia, among others, the reliability of financial reporting and the audit profession have fallen under a shadow of suspicion, and the role of auditor-auditee negotiation has received increased regulatory attention in recent years.

These events have not left Tunisia untouched by international regulatory trends and recommendations aimed at reestablishing users' trust in financial information. The regulatory response in the country is based on the law 2005-96 relating to the security of financial relations, which seeks to achieve greater transparency and improve the credibility of financial information by regulating auditors' independence.

The purpose of this study is to examine how certain environmental factors influence negotiation outcomes. More specifically, we try to study the effect of auditee business risk, audit risk and auditor business risk on auditor-auditee negotiation outcome in Tunisian context.

Developing a framework for understanding effect of risk on negotiation outcome is important because the auditor's independence and ability to resist to auditee pressures is the most fundamental and vital asset possessed by the auditing profession. Auditor-auditee interactions are fundamental to preserving audit quality, as these interactions include negotiations over changes in the financial statements necessary for the auditor to provide an unqualified opinion.

Research demonstrates that environmental conditions (such as financial dependence) potentially lead to judgment-based decisions that affect the content and credibility of financial statements (Goodwin, 2002; Johnstone, Sutton and Warfield, 2001; Hackenbrack and Nelson, 1996). For example, judgmental situations can reduce actual or perceived audit quality via independence risk. However, environmental characteristics possibly mitigate independence-related environmental conditions (Johnstone, Sutton and Warfield, 2001).

This examination is important because negotiations materially affect the financial statements as auditors actively participate in their auditees' financial reporting choices (Antle and Nalebuff, 1991; Nelson and Kinney, 1997; Demski and Frimor, 1999; Nelson, Elliott and Tarpley, 2002; Ng and Tan, 2003; Trotman, Wright and Wright, 2005). However, relatively little is known about how important contextual features such as risk affect auditor-auditee negotiation. Understanding features that affect the negotiation outcome is important because such an understanding provides insight on audit practice interventions that can be employed

to improve audit quality and reduce litigation exposure on the contentious issues generally resolved via auditor-auditee negotiation.

An emerging line of research is investigating how auditors and their auditees interact to resolve disputed financial reporting issues, building on the auditor-auditee negotiation model developed in Gibbins, Salterio and Webb (2001) (“the GSW model”). That model highlights the importance of accounting contextual features that may affect negotiations (e.g., auditee and auditor negotiation capabilities, financial reporting regulation, and risk, among others). Gibbins, Salterio and Webb (2001) validate their model using survey data of auditors’ self reported negotiations, and call for future research that examines negotiation outcomes, and that considers contextual features such as the riskiness of the negotiation context.

We extend this emerging line of research, using an experimental task. We rely on Prospect Theory (Kahneman and Tversky, 1979) and related findings in the negotiation literature (Neale and Bazerman, 1991), which help to link motivations for risk seeking versus risk aversive behavior with negotiation decision making, to motivate our expectation that auditors in the high risk context will exhibit superior performance in terms of negotiation outcome.

All previous research on auditor-auditee negotiation outcome and risk has been focused on one type of risk. Brown and Johnstone (2007) are focused on engagement risk and negotiation outcome, Chang and Hwang (2003) had examine the individual and interactive effects of auditee business risks on auditor’s decisions regarding whether to accept auditees’ aggressive reporting practices. Houston (1999) has paid significant attention to audit risk and auditor decision. We attend in this research to address and to examine the simultaneous effects of all those risks on auditor-auditee negotiation outcome. So we try to answer to the following questions:

What is the relation between auditee business risk evaluation, audit risk evaluation and auditor business risk evaluation?

Once those risks are evaluated, how do auditors adapt to those risks? What are the effects of those risks on auditor-auditee negotiation outcome?

The purpose of this study is to develop and test a model that describes how auditors evaluate relevant risks and how auditors subsequently adapt to those risks when they negotiate with auditees. Researchers can use the model as a framework to begin investigating how to evaluate and improve auditor-auditee negotiation outcome. The model was developed by consulting with practitioners and by considering prior research and professional standards.

This model proposes that auditors will evaluate auditees’ related risks (e.g., the auditee's financial condition, internal control structure, etc.) and use that evaluation to determine the risk that their firm will suffer a loss on the engagement via a lack of engagement profitability or future litigation. The model proposes that auditors will adapt to those risks in making decision.

To test the model, an experimental study was conducted with 200 audit partners. Risks related to the auditee (e.g., company and industry financial trends, management attitude, internal control environment) and the audit firm (e.g., audit firm expertise) were manipulated and partners' evaluations of the risks were measured. Structural equation modeling was used to statistically test the model. This statistical method tests the relative importance of indicators of various risks (e.g., the importance of liquidity as an indicator of the auditee's financial condition) and tests how those risks simultaneously affect each other and the auditor-auditee negotiation outcome.

The findings of the study are that there is an association between audit risk and auditee business risk. Also, our results indicate that auditee business risk has a significant effect on

auditor-auditee negotiation outcome. So, auditors will be less likely to accept an auditee's aggressive reporting practice when the auditee's business risks are high. On the other hand, results shows that audit risk evaluation don't affect auditor-auditee negotiation outcome. Finally for the effect of auditor business risk on auditor agreement probability with auditee preferences, the result is not significant.

The remainder of this paper proceeds as follows. The next section provides background on the auditing process and describes model development and hypotheses. We describe the research methods and results in another section. The last section provides a discussion of results and limitations.

Background on the Auditing Process

Negotiation is a process by which a joint decision is made by two or more parties. The parties first verbalize contradictory demands and then move toward agreement by a process of concession making or a search for new alternatives (Pruitt, 1981). The very nature of the audit function can necessitate negotiation between the auditor and the auditee to resolve disputed financial reporting issues. For example, before an auditor is willing to express an unqualified opinion on an auditee's financial statements, any disputed accounting issues must be resolved. The resolution of these issues may result in a negotiation between the auditor and the auditee, where the auditee is likely to attempt to persuade the auditor to accept his/her position and vice versa.

Gibbins, Salterio and Webb (2001) provide a framework for auditor-auditee negotiation. They find that accounting negotiation can affect the financial statements materially, that senior audit practitioners experience negotiations as a normal part of their practice, and that, when negotiations occur they are important to the parties involved. They expand the elements of negotiation examined in the behavioral negotiation literature to include accounting contextual features identified in the accounting literature and features identified by senior audit practitioners. The contextual features that they identify consist of three general groups: the role of external conditions and constraints, the interpersonal auditor-auditee context, and the capabilities of the parties. These features potentially influence the negotiation process and its outcome.

Negotiations may have a variety of outcomes (e.g., impasse or mutual agreement, etc.) (Thompson, 1990). Generally, negotiators reach an agreement with the other party if it is in their best interest to do so (Thompson, 1990). The auditor and the auditee have joint interests; auditors are generally interested in auditee retention, and auditees want to obtain an unqualified audit report (Gibbins, Salterio and Webb, 2001). Therefore, it is likely that auditor-auditee negotiations will result in mutual agreement. The process of reaching a mutual agreement may involve both parties making concessions so that each party gets at least a part of his or her preferred outcome.

Model Development and Hypotheses

Our model includes two phases, a risk evaluation phase and a risk adaptation phase. First, the model characterizes how risks are integrated to form an overall evaluation of the riskiness of the auditee. Second, the model characterizes adaptation strategies in auditor-auditee negotiation that auditors may use in response to the evaluated risks.

Risk Evaluation

The first phase of the model includes the evaluation of relevant risks. These risks include the auditee's business risk, audit risk, and the auditor's business risk (Huss and Jacobs, 1991; Colbert, Luehlhing and Alderman, 1996). Auditee's business risk is the risk that the auditee's economic condition will deteriorate in either the short or long term (e.g., as proxied by profit-

ability and liquidity, etc.) (Huss and Jacobs, 1991; Johnstone, 2000). Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated (e.g., as proxied by inherent risk and control risk) (ISA 200). Auditor's business risk is the risk that the audit firm will suffer a loss resulting from the engagement (e.g., as proxied by engagement profitability and potential litigation).

How are these risks evaluated in conjunction with one another when auditors make the decision?

Some research shows that the auditee's financial condition can affect the evaluation of audit risk, and vice versa (O'Keefe, King and Gaver, 1994; Eilifsen, Knechel and Wallage, 2001; Wu, Roebuck and Summers, 2002; Kotchetova, Kozloski and Messier, 2005, 2006). While those researches were not conducted in the context of the auditor-auditee negotiation, professional standards indicate that auditors should evaluate these risks. It seems logical that auditee's business risk and audit risk, both unique to the auditee, might affect each other as the auditor evaluates the auditee's related risks. For example, an auditee with weak internal controls that operates in an inherently risky industry may have difficulty obtaining debt financing at reasonable interest rates, thereby affecting the auditor's evaluation of the auditee's financial prospects. Alternatively, an auditee in deteriorating financial condition might reduce its administrative staffing, affecting the strength of its internal control systems and the auditor's evaluation of control risk.

This discussion suggests the following hypothesis:

H1a: Partners' evaluations of auditee's business risk will relate positively to partners' evaluations of audit risk and vice versa.

Additional research provides evidence about how the auditee's related risks might affect auditors' evaluations of the risk that the audit firm will suffer a loss on the engagement (auditor's business risk). Prior research focusing on litigation against audit firms demonstrates that as the auditee's financial condition declines, the likelihood that the auditor will suffer a loss related to the engagement increases (Palmrose, 1987; Pratt and Stice, 1994; Schipper, 1991; Stice, 1991; St. Pierre and Anderson, 1984). Increases in audit risk factors also increase the likelihood that the auditor will suffer a loss (Simunic, 1980; Willingham and Wright, 1985; Kruezfeldt and Wallace, 1986). However, certain features of these studies preclude unambiguous application in this study's setting.

First, prior studies have not examined auditee's business risk, audit risk, and auditor's business risk simultaneously. Since auditors' evaluations of auditee's business risk and audit risk could be related (as proposed in H1a), the relative influence of auditee's business risk on auditor's business risk and the relative influence of audit risk on auditor's business risk reported in prior studies might differ when the effects of auditee's business risk and audit risk are measured simultaneously, as is done in this study.

Second, prior studies have measured auditor's business risk as the likelihood of litigation. However, professional standards and interviews with audit partners indicate that auditor's business risk is made up of other indicators of potential loss, including concerns about auditor profitability. As such, indicators of both profitability and litigation are included in this study.

Third, prior studies have not examined the relationships among these variables in the context of auditor-auditee negotiation. Asare, Hackenbrack and Knechel (1994) report that they do consider how an auditee's business risk and audit risk affect their own firm's risk of loss. Given the litigious and highly price-competitive environment in which accounting firms operate, these reports seem logical. For example, an auditee with a higher level of audit risk is more likely to require costly auditing procedures and is more likely to be associated with an audit failure, which results in negative publicity and costly legal judgments against the

accounting firm. Similarly, auditee financial distress can lead to immediate declines in auditor profitability via reduced or unpaid audit fees, and can also result in costly legal judgments against the accounting firm (Johnstone, 2000; Mock and Turner, 2005; Fukukawa, Mock and Wright, 2006).

This discussion suggests the following hypotheses:

H1b: Partners' evaluations of audit risk will relate positively to partners' evaluations of auditor's business risk.

H1c: Partners' evaluations of auditee's business risk will relate positively to partners' evaluations of auditor's business risk.

Adaptation Phase

The second phase of the auditor-auditee negotiation outcome model is an adaptation phase. Drawing from accounting contextual features identified by Gibbins, Salterio and Webb (2001) as important in auditor-auditee negotiations, we examine how risk evaluations influence auditor decision during auditor-auditee negotiations. Research demonstrates that risk influences decision making behavior (e.g., Knapp, 1985; Walo, 1995; Hackenbrack and Nelson, 1996; Johnstone, Bedard and Biggs, 2002; Chang and Hwang, 2003; Blay, 2007; Gibbins, McCracken, and Salterio, 2008) and is an important aspect of the overall audit environment (Bell *et al.*, 2002).

Prospect Theory suggests that people are risk averse in situations where they are confronting potential gains and that they are risk seeking in situations where they are confronting potential losses (Kahneman and Tversky, 1979). The negotiation literature shows that the risk averse course of action is to accept an offered settlement, whereas the risk seeking course of action is to hold out for future, potential concessions (Neale and Bazerman, 1991). This implies that people in riskier situations will adopt a more contending strategy as they hold out for superior negotiated outcomes. This expectation is confirmed in an experiment by Neale and Bazerman (1991) who show that individuals in a negatively framed condition (a situation described as involving serious financial losses) are more contending and achieve superior negotiated outcomes compared to individuals in a more positively framed financial condition.

Building on the predictions from Prospect Theory and related findings in Neale and Bazerman (1991), we expect that auditors in riskier situations will adopt a more contending negotiation strategy, and accordingly will go through more rounds of negotiation with the auditee, and will switch their bargaining position less often as they demonstrate reluctance to acquiesce to the auditee. Building on the findings regarding the role of risk in financial reporting choice, we expect that in riskier situations, auditors will work to achieve a more conservative financial reporting outcome, and since that alternative is more conservative they will be more confident that the final negotiated outcome is acceptable under GAAP.

Auditee Business Risk and Auditor-Auditee Negotiation: Several studies have examined the effect of auditee business risks on audit decisions (Houston, 1999; Johnstone, 2000; Chang and Hwang, 2003; Ballou, Earley and Rich, 2004; O'Donnell and Schultz, 2005; Brandon *et al.*, 2007).

In general, the term "auditee business risks" refers to the risks that an auditee's economic condition will deteriorate over time (either short or long term); to such an extent that the auditee cannot achieve its earnings targets and/or fulfill its obligations on debt covenants (Pratt and Stice, 1994). As reported by Huss and Jacobs (1991), auditee business risks may affect auditors' decisions on whether to accept or to continue audit engagements, since an auditee's business risks, in turn, affect auditor business risks due to the potential loss of audit fees and litigation should the company become insolvent. For example, in making auditee

acceptance decisions, auditors assess that high auditee business risks could result in high auditor business risks (Johnstone, 2000).

Prior research has also reported that the likelihood of auditor litigation is greatly increased for failing firms, as investors, creditors, and others seek to recoup financial damages (Palmrose, 1987; Stice, 1991; Lys and Watts, 1994). Hackenbrack and Nelson (1996) specifically examine the effect of auditor business risks (engagement risks) on auditors' decisions to permit auditees' aggressive accounting practices. Their results show that auditors are more likely to agree to auditees' aggressive practices when auditor business risks are moderate. On the other hand, when auditor business risks are high, a more conservative financial reporting alternative may become more acceptable to auditors.

Asare, Haynes and Jenkins (2007) studied the impact of auditee business risk and auditor business risk on auditor decision. Their results show that the auditor gives more effort to examine financial statements when auditee business risk is high. In the same way, Chang and Hwang (2003) report that auditee business risk has a significant effect on auditor decision to accept auditee's practices. Joe, Wright and Wright (2006) examine the effect of auditee conditions on auditor-auditee negotiation outcome; their results show that the firms having a good situation end up having an agreement with their auditors. Braun (2001) showed that the auditors are incited to accept auditee's aggressive practice when auditee financial position is good.

Hence, we predict that the likelihood that auditors will accept an auditee's aggressive reporting practices may decrease as the level of the auditee's business risks increases.

H2a: Partners' evaluations of auditee business risk will relate negatively to auditor-auditee negotiation outcome.

Audit Risk and Auditor-Auditee Negotiation: Audit risk is defined as the auditor giving 'an inappropriate audit opinion on financial statements' (ISA 200). This risk has three key components: inherent risk, control risk and detection risk. Inherent risk is defined as 'the susceptibility of an account balance or a class of transactions to material misstatement, either individually or when aggregated with misstatements in other balances or classes irrespective of related internal controls'. Control risk is defined as 'the risk that a misstatement could occur that would not be prevented or detected and corrected on a timely basis by the accounting and internal control system'. Detection risk is defined as 'the risk that the auditors' substantive procedures do not detect a misstatement that could be material'. Inherent and control risk are risks which lie within the company itself. Detection risk lies with the auditors. The extent of substantive testing carried out by an auditor is a function of the assessment of the level of inherent and control risk within the company.

The various types of risk cannot be evaluated with precision; no audit standard makes it possible to determine them in a uniform and precise way. At this point in time the professional judgment will intervene in the various stages of risk estimate. After having to separately determine each risk component, audit risk can be evaluated.

Several studies examined the effect of audit risk or more precisely detection risk on auditor decision (Huston, 1999; Johnstone, 2000). Asare, Hackenbrack and Knechel (1994), Johnstone (2000) reported that a high degree of audit risk decreases the degree of auditee acceptance. Sankaraguruswamy, Raghunandan and Whisenant (2005) studied the factors associated with auditor-auditee negotiation outcome; they found that audit risk affects auditor-auditee negotiation outcome. In the same way, Fukukawa, Mock and Wright (2006) found that audit risk influences auditor judgment and thus its decision making.

Fearnley, Beattie and Brandt (2005) studied the impact of audit risk on auditor independence and his ability to resist to auditee pressure. Thus, if $IR * CR$ is weak, the auditor could, owing

to the fact that the detection risk is weak, reduce his accounts controls (substantive tests), it could in this case accept an auditee's aggressive reporting practice .

On the other hand, if $IR * CR$ is medium or high, the auditor should carry out an important work in the form of substantive tests. In this case, the auditor must be careful and conservative in the examination of the methods practiced by the auditee.

H2b: Partners' evaluations of audit risk will relate positively to auditor-auditee negotiation outcome.

Auditor Business Risk and Auditor-Auditee Negotiation: Engagement risk refers to the risk the audit firm is exposed to, such as loss or injury to the professional practice from litigation, adverse publicity, or other events arising in connection with the audited financial statements (Johnstone, 2000). Engagement risk may exist even if there are no misstatements in the financial statements and the audit is conducted according to professional standards (Rittenberg and Schwieger, 2001); it is an important part of the audit environment (Bell *et al.*, 2002).

Research examining the influence of engagement risk on auditor decision making (e.g., Walo, 1995; Hackenbrack and Nelson, 1996; Johnstone, 2000; Geiger, Raghunandan and Rama, 2006) provides evidence to support the importance of engagement risk in the audit setting. Engagement risk is likely to affect negotiated outcomes because research demonstrates that engagement risk influences auditors' judgment based decisions (e.g., Hackenbrack and Nelson, 1996; Johnstone, Bedard and Biggs, 2002). For example, engagement risk has been shown to affect the generation of alternatives during pre-negotiation. Johnstone, Bedard and Biggs (2002) examine auditors' generation of financial reporting alternatives in a setting in which an audit-auditee proposes an aggressive financial reporting alternative for a complex revenue recognition issue. They find that higher engagement risk is associated with the generation of a greater number and range of financial reporting alternatives, particularly for high knowledge auditors.

In their study of auditor incentives and application of financial reporting standards, Hackenbrack and Nelson (1996) find those auditors' incentives to make aggressive reporting decisions vary as a function of engagement risk. For example, if engagement risk is moderate, auditors prefer an aggressive reporting method. Conversely, if engagement risk is high, auditors prefer a conservative reporting method. In other words, if auditors believe the risk of "getting caught" is low, they may acquiesce to the auditee and allow more aggressive financial reporting positions.

Brown and Johnstone (2007), by using an experimental study with 60 auditors, examined the effect of auditor business risk on auditor-auditee negotiation outcome, they showed that risk degree affects negotiation process, thus auditors will use a concession strategy if the risk is high.

An alternative explanation for the influence of risk on auditor decision making can be drawn from the literature documenting motivated reasoning. Motivated reasoning research demonstrates that judgment is generally influenced by decision makers' motivation to reach a particular conclusion (Kunda, 1990; Boiney, Kennedy and Nye, 1997; Kadous, Kennedy and Peecher, 2003). This type of motive is referred to as directional motivation. Individuals who have directional goals generally search for, interpret, and process information in a manner more likely to yield the desired conclusion (Kunda, 1990). For example, Kadous, Kennedy and Peecher (2003) provide evidence that motivated reasoning significantly decreases an auditor's objectivity. As such, auditors in their study were more likely to identify the auditees preferred method as the most appropriate method when engagement pressure was higher. Engagement pressure was manipulated by varying the timing of when the auditor learned of

the issue and when the interim financial statements containing the accounting method were released to the public. For example, in the high engagement pressure condition, auditors learned of the issue only after the interim financial statements using the accounting method in question had been publicly released.

Johnstone, Sutton and Warfield (2001) argue that costly litigation (e.g., Palmrose, 1988) may serve to mitigate the incentives that lead to concerns about independence. Zhang (1999) presents an analytical model of the auditor's decision to accept an auditee's preferred alternative as a decreasing function of litigation risk. In addition, an experiment by Chang and Hwang (2003) found that risks related to potential litigation resulted in a reduction in auditors' willingness to accept aggressive auditees preferred alternatives. Litigation risk is related to auditee accruals (Lys and Watts, 1994) and is also correlated with auditees' specific factors, such as total assets (Lys and Watts, 1994), as well as financial distress and bankruptcy (St. Pierre and Anderson, 1984; Stice, 1991; Pratt and Stice, 1994). Geiger and Raghunandan (2001) provide evidence that auditors were less likely to modify an audit report for going concern issues subsequent to the Private Securities Litigation Reform Act of 1995. They argue that the reduction in expected litigation costs to auditors accounted for this shift in reporting decisions.

H2c: Partners' evaluations of auditor business risk will relate negatively to auditor-auditee negotiation outcome.

Research Methods

Audit and Tunisian Context

Accounting and audit constitute first and foremost two human activities and therefore, they are affected by the culture of the firm where they are introduced. Every country's socio-economic specificities might have different effects on audit process quality. The examination of the framework administering the auditor's profession in Tunisia can give us a clearer idea about the exploration of the topic studied.

The audit function was first established and regulated by the 1959 trade code which remained valid in terms of corporate law until 2000. The accounting occupation consists mainly of four professional bodies: the chartered accountants, the accountants, the fiscal consultants and the offices of fiscal supervision and assistance. The accountants and chartered accountants are solely responsible for the jobs of accounting control and assistance as well as auditorship. For many years, the professional system of auditorship was under the monopoly of the chartered accountants and controlled by an institution that comes under the authority of the ministry of finance, that is the Association of Tunisian Chartered Accountants. It is only with the promulgation of the law n°2002-16 that auditorship was extended to the accounting technicians brought together under a second professional corporation called the Company of Tunisian Accountants.

Whether accounting technicians or chartered accountants, the auditors do their job either individually or within a company. However, the examination of the table of the association proves that most of the professionals are individual offices and that a minority consists of big offices which are essentially either representatives of the Big Four or chartered accountancy firms. Following the example of other countries around the world, the large international audit offices have been represented and leading the Tunisian audit market since they were the Big Eight. The rest of the market is shared among large national audit offices which employ a number of collaborators ranging between 10 and 19 and small structures of accounting professionals most of whom work as sole traders.

On the juridical level, the legal control of accounts witnessed mainly two recent reforms: the appearance of the code of commercial companies in 2000 and the promulgation of the law

2005-96 relating to the security of financial relations. The auditors' role has just been reinforced at two levels: From now on the legal control of accounts is extended to the Liability Limited Companies of a certain size while formerly the auditor's interference was limited to the Public Limited Companies. Moreover, the Tunisian auditor, by virtue of the law of 17 April 1995 related to the recovery of firms in difficulties and following the amendment of 29 December 2003, is in charge of warning about the first signs of difficulties. Finally, he has become a support for justice to disclose crimes as part of the activities undertaken. With these new attributes, the auditor is expected to cooperate and interact increasingly with the statutory control organs, such as the board of directors, the supervisory board and the audit committee.

The Tunisian economic fabric industry consists of two types of firms. The listed companies which are a minority and generally have the juridical form of a Public Limited Company and the non listed companies, most of which make up the fabric of the Small and Medium Firms. Thus, 83% of the firms are of a small size, of a family type and a fairly high level of banking loans. The share capital is less open to the public, and the stock market plays a limited role in financing firms compared with banks, which remain the first source for financing the economic activity. Along with family property and the participation of financial institutions, the State still plays an essential role in the companies' shareholding despite the privatization process initiated in 1987. The most common company management is of a monistic type. The first person in charge of a company combines the two functions of management and control. This management structure involves a strong power concentration in the hands of a single person, that is to say the Managing Director.

Thus, directors can exert a strong influence on auditor behavior in favor of their own interests with the result that attention frequently focuses on conflicts between large and minority shareholders. In this regard, the archival literature shows that management concentration may have relevant corporate governance implications (Shabou, 2003; Omri, 2001). Indeed, management concentration is one of the features that make Tunisian corporate governance different from countries such as the US, Germany and Japan as well as the underdeveloped capital markets that focus largely on financial institutions and banks.

The Tunisian society is at the junction of two extremely divergent civilizations. It is both imbued with the principles of the Arab-Islamic civilization and marked with some values of the French society for historical reasons. Moreover, in the juridical field, Tunisia is closer to the countries originating from the Euro-continental model characterized by a state control, uniformity, conservatism and a dislike to risks. It is a country of written law, widely dominated by Roman law. The weight of cultural heritage derived from the period of the French protectorate as well as the economic links that bring Tunisia and France together have made the civil rights and commercial law in this country inspired by the French regulations.

The institutional, legal and corporate governance peculiarities that make Tunisia so different from the circumstances of the Anglo-Saxon and US, the countries to which most of the existing negotiation literature refers, may affect auditor evaluation of risk and its impact on auditor-auditee negotiation outcome. Consequently, the Tunisian case seemed to us an interesting field of investigation because of its socio-cultural specificities and its institutional environment, which represents the typical features of the countries with emerging markets that differ widely from those of the developed countries.

Participants

Partners and managers were recruited from audit firms. The number of audit firms and auditors in Tunisia is about 500. In order to facilitate information collect, participants were selected from two regions Sfax and Tunis; the two biggest regions. Participants belong to the same culture. A total of 300 copies of instruments were delivered. 200 auditors participated in

the study, representing a response rate of 66.6 percent. The average age of participants was 41 (standard deviation=4.31). Participants had an average of 10 years (standard deviation=5) of audit experience.

Experimental Design and Procedures

The experiment is a 2 x 2 x 2 factorial design, yielding eight case versions that range from relatively low to relatively high levels of risk. Each participant was assured of confidentiality and was requested to complete the questionnaire in a timely manner. The completed questionnaires were collected within a five month period.

The research instruments were developed based on Johnstone's (2000) study. Each participant choice in hazard two cases and completed them. The cases were constructed with the assistance of two partners' auditors, one of whom is from the Big Four audit firm. The cases were pilot tested on five experienced managers. Each case began with a description of the company, including information about growth prospects, reasons for switching auditors, and fiscal year end information. A description of the company's management followed, including information about their relationship with the prior auditor. The level of industry competition was also described.

Financial information was presented next. This information included a summary of sales, net income, and financial ratios, including industry comparison information. Following the financial information was information about the company's internal control structure, the degree of judgment required to value significant company assets, the audit firm's expertise and expected competition from other audit firms. After reading each case, partners evaluated risks and then made decision. Finally, participants complete a debriefing questionnaire.

Independent Variables

The independent variables include auditee's business risk (high, low), audit risk (high, low), and auditor's business risk (high, low) (see Table 1). Information used to manipulate auditee's business risk and audit risk was developed based on prior studies and professional standards. The auditee's business risk manipulation includes information about financial ratios and trends (Chen and Church, 1992; Pratt and Stice, 1994; Dutta and Graham, 1999; Johnstone, 2000), management's long term planning activities (Ponemon and Schick, 1991), and industry competition (Huss and Jacobs, 1991). The audit risk manipulation includes information about the auditee's industry (Maletta and Kida, 1993), the past auditee-auditor relationship (Johnstone, 2000), the degree of judgment required to value significant accounts (Pratt and Stice, 1994), management's attitude toward internal controls and the internal audit department (Maletta and Kida, 1993).

Prior research has provided limited evidence on features of auditor's business risk. Manipulation of this variable is based on Johnstone (2000) which reports that information including the timing of the potential engagement, relative auditor expertise each affect auditor's business risk.

Dependent Variables

After partners received the above manipulations within the case, partners' evaluations of the three risks were measured, yielding the following latent constructs: auditee's business risk evaluation, audit risk evaluation, and auditor's business risk evaluation (see Table 2).

Measuring a partner's evaluation of each risk is important from both theoretical and experimental design standpoints. Theoretically it is important to measure partners' evaluations of the risks because, while an "objective" level of risk may exist, it is the partner's evaluation of that risk that affects decisions (Ponemon and Schick, 1991). From an experimental design standpoint, measuring partners' evaluations of the manipulated risks (and

using those evaluations as the basis for hypothesis testing) controls for the possibility that an indicator variable intended to manipulate a certain variable could, in fact, affect another variable (Baron and Kenny, 1986).

Indicators of the auditee's business risk evaluation and the audit risk evaluation constructs were developed based on prior studies that have made these constructs operational (Ponemon and Schick, 1991; Pratt and Stice, 1994). Indicators of the auditee's business risk evaluation include partners' assessments of the company's short term liquidity, short term profitability, and long term financial viability. Indicators of the audit risk evaluation include partners' assessments of the likelihood of material misstatement, the company's inherent risk, and the company's control risk.

As compared to auditee's business risk and audit risk evaluations, fewer studies have explored auditor's business risk evaluations. Pratt and Stice (1994) utilize the construct by asking auditors to evaluate the likelihood of litigation arising from the engagement. Three other studies, Asare *et al.* (1994), Huss and Jacobs (1991) and Johnstone (2000), describe auditor's business risk as involving both litigation and profitability concerns.

Auditor-auditee negotiation outcome was measured by one indicator. Windsor and Rasmussen (2007) operationalize the construct by asking auditors to evaluate the likelihood of accepting practices of auditees. A scale at 7 points will be used to specify negotiation outcomes.

Statistical Method

Structural equation modeling (SEM) is a statistical method that simultaneously estimates both the association between observed indicators and their underlying latent constructs (the measurement model) and the association between latent constructs (the structural model) (Kenny, 1979; Bollen, 1989; Loehlin, 1992). The maximum likelihood procedure in AMOS 7 is used to test the model in Figure 1. All reported results are standardized.

Model fit is assessed upon the simultaneous estimation of the measurement model and the structural model. The Tucker Lewis Index and the Comparative Fit Index are used to evaluate model fit (Bentler, 1990; Tucker and Lewis, 1973).

The portion of the structural equation model that examines the association between an observed indicator and its underlying latent construct is called the "measurement model". For example, in this study auditee's business risk was manipulated and partners' evaluations of auditee's business risk were subsequently measured via questions about short term liquidity, short term profitability, and long term financial viability. The answers to these questions represent three indicators of the underlying latent construct "auditee's business risk evaluation". The measurement model provides evidence, for example, about whether the variable "short term liquidity" is a significant indicator of the auditee's business risk evaluation.

A measurement model with a good fit to the data must be estimated before the structural model can be tested. The fit of the measurement model is evaluated based on "factor loadings". The standardized factor loading of an indicator variable is considered acceptable if it is above about 0.60 (where 1.00 is maximum) (Bagozzi and Yi, 1988). An indicator variable with a factor loading of about 0.60 or below may be removed from the model. However, "re-specification decisions should not be based on statistical considerations alone but rather in conjunction with theory and content considerations" (Anderson and Gerbing, 1988).

The portion of the structural equation model that examines the association between latent constructs is called the "structural model". The structural model depicts the hypothesized

relationships between latent constructs. The relationship between these constructs is evaluated by examining the direction and strength of the path. The path coefficient is the statistic used to evaluate the degree and direction of association between the latent constructs. The path coefficients in structural equation modeling are interpreted analogous to regression coefficients.

Results

Measurement Model and Descriptive Statistics

The results of evaluating the measurement model are described below. The descriptive statistics, correlation matrix and standardized factor loadings for the indicators are provided in Tables 3, 4 and 5.

The examination of Table 3 shows that the means of the three indicators of auditee business risk (aubr 1, aubr 2, aubr 3) are close to one another is 4.31, 4.24, 4.47; this proves the bond between different items relative to auditee business risk. In the same way, for the others items of the others variables which have averages of 3.92, 4.07, 4.09 for audit risk and 3.39 and 3.87 for auditor business risk. For the negotiation variable, the mean is about 3.98, signifying a medium degree of agreement between auditors and auditees.

With regards to the standard deviation, we notice that our built varies slightly inside our sample. Indeed, more the degree of fluctuation measured by the standard deviation is weak; more the estimate quality is good.

Examination of the correlation matrix reveals that partners viewed the auditee's business risk evaluation, the audit risk evaluation, and the auditor's business risk evaluation as distinct constructs. For example, the indicators of the auditee's business risk evaluation, aubr1 (short term liquidity), aubr2 (short term profitability), and aubr3 (long term financial viability), are highly correlated to each other (correlations of 0.73, 0.68 and 0.79, respectively) and are less highly correlated to the audit risk evaluation or auditor's business risk evaluation indicators.

Similarly, the indicators of the audit risk evaluation, ar1 (material misstatement), ar2 (inherent risk), and ar3 (control risk), are highly correlated to each other (correlations of 0.89, 0.81 and 0.87, respectively) and are less highly correlated to the auditee's business risk evaluation or auditor's business risk evaluation indicators. The indicator of auditor-auditee negotiation outcomes are highly correlated to auditee business risk.

The indicators of the auditee's business risk, audit risk evaluations and auditor business risk have standardized factor loadings that are well above the 0.60 benchmark (see Table 5). As such, no modifications were required to achieve a good fitting measurement model for these constructs.

Structural Model

Results of testing the structural model provide evidence about whether the auditor-auditee negotiation outcomes model in Figure 1 is consistent with the experimental data. The overall model goodness of fit measures (Tucker Lewis index = 0.90, comparative fit index = 0.94) indicate that the auditor-auditee negotiation outcomes model fits well and is consistent with the experimental data.

Hypothesis 1 tests the risk evaluation phase of the model. Hypothesis 1a proposes that partner's evaluations of auditee's business risk and audit risk will affect each other. The path from the audit risk evaluation to the auditee's business risk evaluation is significant ($P = +0.33$, $p < 0.05$), providing partial support for the hypothesis. The reciprocal path, from the auditee's business risk evaluation to the audit risk evaluation, is also significant, so hypothesis 1a is supported. Hypotheses 1b and 1c propose that partner's evaluations of auditee's business

risk and audit risk will affect partners' evaluations of auditor's business risk. The significance of the paths from the audit risk evaluation to the auditor's business risk evaluation ($P = +0.78$, $p < 0.05$) support H1c. But the paths from the auditee's business risk evaluation to the auditor's business risk evaluation are not significant.

Hypotheses 2 test the adaptation phase of the model. Hypotheses 2 tests whether partners' evaluations of risks directly affect the auditor-auditee negotiation outcomes. H2a predicts that the auditee's business risk evaluation (i.e., partners' assessments of the auditee's profitability, liquidity, and financial viability) will relate negatively to the decision.

H 2a is supported, since the path from the auditee's business risk evaluation to auditor-auditee negotiation outcomes ($p < 0.05$) is significant.

H2b predicts that the audit risk evaluation (i.e., partners' assessments of the auditee's inherent and control risk) will relate negatively to the negotiation. The path from the audit risk evaluation to auditor-auditee negotiation (H2b) is not significant.

H2c tests whether auditors' evaluations of their own firm's risk of loss (auditor's business risk) affect the auditor-auditee negotiation. The result shows that the auditor's business risk evaluations don't affect auditor-auditee negotiation.

Conclusion and Limitations

This study develops and experimentally tests a risk based model of the outcome of auditor-auditee negotiation. Auditee's business risk, audit risk, and auditor's business risk are manipulated and the relationships between partners' evaluations of these risks and the auditee- auditor negotiation outcome are measured. The findings show that partners evaluated the auditee's risks substantially as expected and adapt to those risks in making negotiation with auditees.

The results relating to the risk evaluation phase of the model show that partners' evaluations of audit risk affect their evaluations of the auditee's business risk and that both of these auditee related risk evaluations did not affect partners' evaluations of auditor's business risk (i.e., the risk of loss due to a lack of engagement profitability or potential litigation).

The finding related to the risk adaptation phase of the model concerns the relative influence of the auditee's business risk on auditor-auditee negotiation outcomes. This result confirms the expectation of prospect theory, so auditors in riskier situations will adopt a more contending negotiation strategy, and accordingly will go through more rounds of negotiation with the auditee, and will switch their bargaining position less often as they demonstrate reluctance to acquiesce to the auditee. In riskier situations, auditors will work to achieve a more conservative financial reporting outcome. So, when auditee business risk is high, Tunisian auditors became more conservative in order to preserve his reputation and reduce litigation risk. The Tunisian example that can be cited at this level is Batam. Thus, we have seen (late 2002) the bankruptcy of the company. This is a major distribution firm listed in the Tunis Stock Exchange and with a great local reputation. The company went bankrupt without any prevention on the part of the auditor. The government and small shareholders who criticized the external auditors did not adequately support claims audited, and certifying a false balance sheet, have turned against him and the courts which have decided his imprisonment for two years. The Tunisian audit market is very competitive and every auditor seeks to preserve his reputation, his auditees and consequently his financial conditions.

The measurement model results provide new evidence about important variables to auditor-auditee negotiation outcomes; they confirm the usefulness of indicators that have been utilized in prior studies in other decision contexts.

The conclusions based on the findings of this study are limited by the study's design. First, since each participant completed two cases, the potential for demand effects is increased. However, this feature of the design allows for control of individual differences in risk preference and sensitivity analyses reveal no evidence of demand effects. Second, generalization of the results regarding the evaluated risks is limited to the indicator variables measured in the study. Future research would benefit by using the indicator variables found to be significant in the measurement model and by experimenting with indicator variables not included in this study. Also, our method tests the simultaneous effect of all risks on auditor-auditee negotiation outcome. It ignores the individual effect of each risk on negotiation outcome. Third, generalization to auditing firms other than those included in the study is limited.

Also, generalization of our study to others governance environments is limited because of the influence of the social-psychological factors and legal environments. The Tunisian audit market is different from any other audit market. Additional environmental factors, such as audit firm culture, possibly influence judgment and decision making. For example, audit firm culture influences an auditor's socialization process. In a negotiation context, if the audit firm culture is risk averse an auditor's judgment may be influenced by firm culture and s/he may be unwilling to accept an auditee's aggressive reporting position.

This study provides evidence on how risk evaluation affects auditor-auditee negotiation outcomes. This study makes several significant contributions. First, we respond to calls for negotiation research that investigates the role of risk, which is particularly relevant today as auditors operate in a highly litigious political environment where negotiation between auditees and their auditors is viewed as a potentially problematic aspect of the dual role of both parties in the financial reporting process. Second, understanding how auditors respond to risky versus less risky auditees during auditor-auditee negotiation is important and has important audit quality and public policy implications. Third, despite the expectation of conservatism required by GAAP, the findings suggest that certain environmental factors may cause auditors to acquiesce to auditee preferences and allow more aggressive reporting. From a stakeholders' (e.g., investors, regulators, etc.) perspective this is not necessarily an optimal criterion for decisions that impact the financial statements. The expectations of stakeholders are that auditors will select the most informative alternative. The implication for practice is that accounting firms may need to strengthen their internal oversight mechanisms (e.g., peer reviews, concurring partner reviews, etc.) to ensure that auditors decisions are aligned with the firm's, as well as stakeholders', expectations of audit quality. Also, understanding features that affect the negotiation outcome provides insight on audit practice interventions that can be employed to improve audit quality and reduce litigation exposure on the contentious issues generally resolved via auditor-auditee negotiation.

From a research perspective, the findings of this study should motivate further inquiry into how business risks affect auditor-auditee negotiation outcomes. Research suggests that a more detailed and global evaluation of business risk is needed. Specifically, international research is needed to analyze the risk/negotiation relationship outcome in other countries where different standards, structures, cultures and legal environments prevail.

Figure 1: Auditor-Auditee Negotiation Model

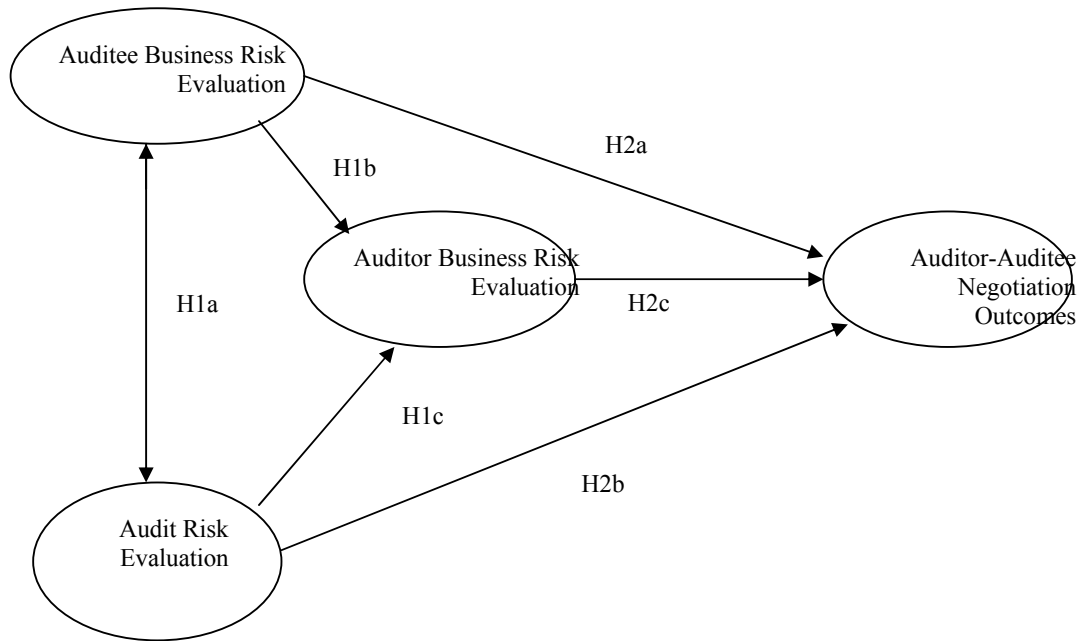


Figure 2: Experimental Design

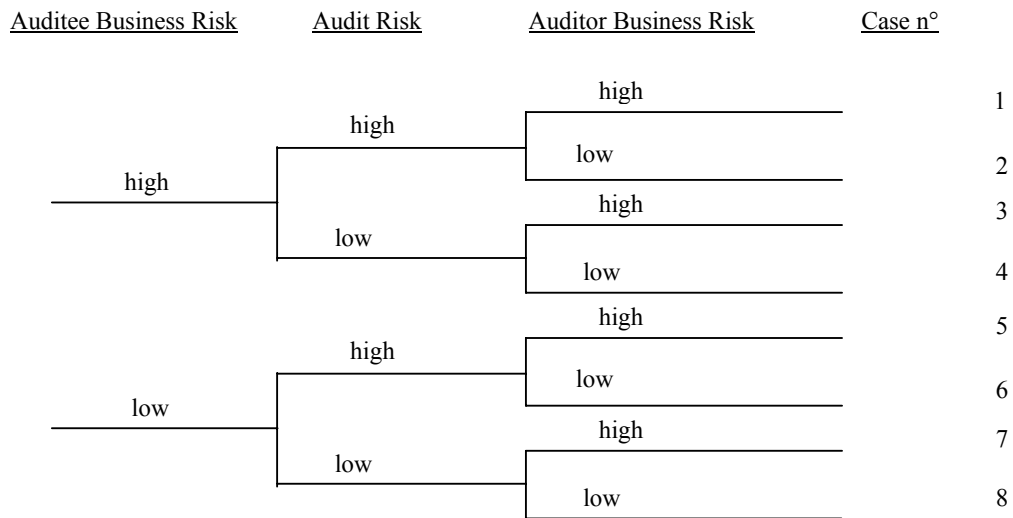
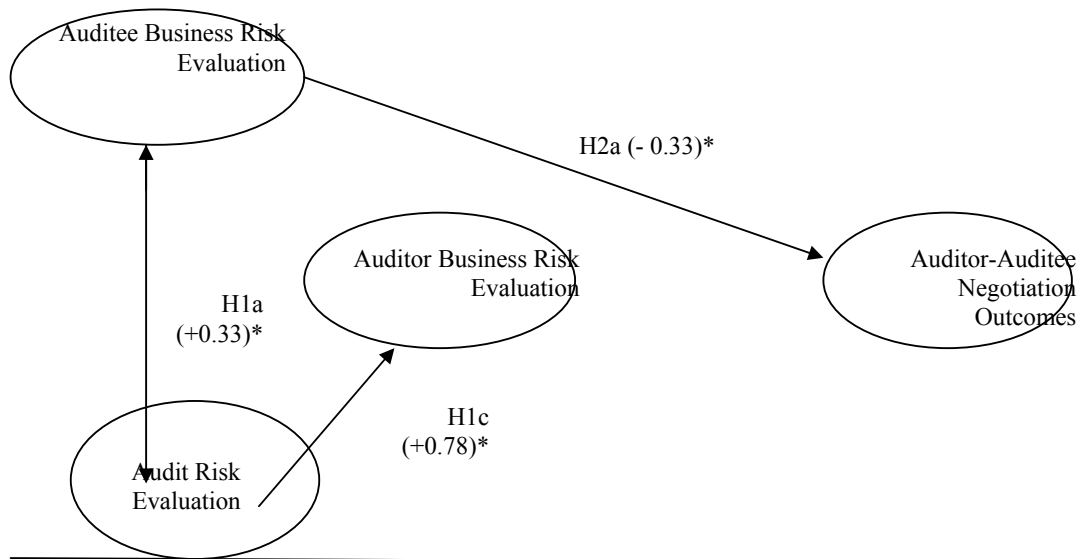


Figure 3: Tests of Hypotheses



Path coefficients appear in parentheses. The significance of each path is denoted as * $p < 0.05$. Paths that are not significant at $p < 0.05$ are not included. Overall model significance is as follows: Tucker Lewis index = 0.90, comparative fit index = 0.94.

Table 1: Description of Independents Variables

Industry average	<u>Auditee's Business Risk (variable name: mabr)</u>
Financial trends	<ul style="list-style-type: none">• Various account balances and financial ratios for several years indicate that the company is performing 35 percent worse (better)* than the industry average.
Long term planning	<ul style="list-style-type: none">• Various account balances and financial ratios for several years indicate that trends are declining (improving).• A limited (significant) amount of long term planning for the future direction of the company has occurred.
Industry competition	<ul style="list-style-type: none">• A relatively large (small) number of companies make up the industry in which this company operates. Competition between the companies is high (low).
Nature of the industry	<u>Audit Risk (variable name: mar)</u>
Management attitude	<ul style="list-style-type: none">• The company is a manufacturer and distributor of equipment and supplies in an industry characterized by an unstable (a stable) growth pattern.
Internal audit department	<ul style="list-style-type: none">• Top management does not (does) strongly endorse a high level of internal control.• The company does not (does) have an internal audit department.
Engagement timing	<u>Auditor's Business Risk (variable name: mabr)</u>
Audit firm expertise	<ul style="list-style-type: none">• The fiscal year end for the company is December 31 (June 30).• Relative to other Big Four accounting firms, your firm has a fairly low (high) level of expertise in the industry in which the company operates.

*Low-risk manipulations appear in parentheses.

Table 2: Description of Dependent Variables

	<u>Auditee's Business Risk Evaluation</u>
<u>Indicator 1 (aubr1)</u>	What is your assessment of the company's short term financial liquidity?*
<u>Indicator 2 (aubr2)</u>	What is your assessment of the company's short term financial profitability?
<u>Indicator 3 (aubr3)</u>	What is your assessment of the company's long term financial viability?
	<u>Audit Risk Evaluation</u>
<u>Indicator 1 (arl)</u>	What is your assessment of the likelihood that the company's financial statements might contain a material misstatement?
<u>Indicator 2 (ar2)</u>	What is your assessment of the company's inherent risk (i.e., the susceptibility of the financial statements to material error, assuming minimal internal controls)?
<u>Indicator 3 (ar3)</u>	What is your assessment of the company's control risk (i.e., the risk that the auditee's internal control structure might not be effective at preventing or detecting errors)?
	<u>Auditor's Business Risk Evaluation</u>
<u>Indicator 1 (abr1)</u>	What is the likelihood that litigation might be brought against your firm as the auditor of the company?
<u>Indicator 2 (abr2)</u>	What is the likelihood that performance of services for the company will be profitable for your firm?
	<u>Auditor-Auditee Negotiation Outcomes</u>
<u>Indicator 1 (decide 1)</u>	What is the likelihood that you would recommend accepting practices of auditees?

* Seven point scales (where 1 equals "very low" and 7 equals "very high") were used to measure responses.

Table 3: Descriptive Statistics

	N	MEANS	STANDARD DEVIATION
AUBR1	200	4.31	1.76
AUBR 2	200	4.24	1.59
AUBR 3	200	4.47	1.75
AR1	200	3.92	1.69
AR2	200	4.07	1.77
AR3	200	4.09	1.77
ABR1	200	3.39	1.95
ABR2	200	3.87	1.56
NEG	200	3.98	1.87

Table 4: Correlation Matrix

	<i>aubr1</i>	<i>Aubr2</i>	<i>Aubr3</i>	<i>ar1</i>	<i>ar2</i>	<i>ar3</i>	<i>abr1</i>	abr2
Aubr1								
Aubr2	0.73†							
Aubr3	0.68†	0.79†						
Ar1	0.07	0.06	0.03					
Ar2	0.05	0.01	-0.01	0.89†				
Ar 3	-0.01	-0.01	-0.02	0.81†	0.87†			
Abr1	0.17*	0.05	0.12	0.60†	0.59†	0.58†		
Abr2	0.35†	0.36†	0.42†	-0.05	-0.01	-0.04	0.12	
Decide	0.18†	0.27†	0.13	0.14*	0.06	0.06	-0.01	0.09

Aubr: Auditee business risk

Ar: Audit risk

Abr: Auditor business risk

Decide: Auditor-auditee negotiation outcomes

Table 5: Loading

<i>ITEMS</i>	AUBR1	AUBR2	AUBR3	AR1	AR2	AR3	ABR1	ABR2
<i>Loading</i>	0.83	0.83	0.83	0.89	0.89	0.89	0.89	0.89

References

- Anderson, J. C and Gerbing, D. W. (1988). Structural Equation Modeling in Practice: A Review and Recommended Two-step Approach, *Psychological Bulletin*, 103, 411-423.
- Antle, R, Nalebuff, B. (1991). Conservatism and Auditor-Client Negotiations, *Journal of Accounting Research*, 29, 31-54.
- Asare, S, Hackenbrack, K and Knechel, W R. (1994). Client Acceptance and Continuation Decisions Proceedings of the 1994 Deloitte & Touche/University of Kansas Symposium on Auditing Problems, edited by R P Srivastava, 163-178 Lawrence, KS: University of Kansas .
- Asare, S. K., Haynes, C. M. and Jenkins, G. (2007). The Effects of Client and Preparer Risk Factors on Workpaper Review Effectiveness, *Behavioural Research in Accounting*, 19, 1-17.
- Bagozzi, R. P. and Yi, Y. (1988). On the Evaluation of Structural Equation Models. *Academy of Marketing Science*, 16, 74-94.
- Ballou, B., Earley, C. E. and Rich, J. (2004). The Impact of Strategic Positioning Information on Auditor Judgments about Business Process Performance, *Auditing: A Journal of Practice and Theory*, 23, 71-88.
- Baron, R M, and Kenny, D A. (1986). The Moderator-Mediator Variable Distinction in Social Psychological Research: Conceptual, Strategy, and Statistical Considerations, *Journal of Personality and Social Psychology*, 51, 1173-1182.
- Bell, T B, Bedard, J C, Johnstone, K M and Smith, E F. (2002). KRisksm: A Computerized Decision Aid for client Acceptance and Continuance Risk Assessments, *Auditing: A Journal of Practice and Theory*, 97-114.
- Bentler, C. (1990). Comparative Fit Indexes in Structural Models, *Psychological Bulletin*, 107, 238-246.
- Blay, A.D. (2007). Independence Threats, Litigation Risk, and the Auditor's Decision Process, *Contemporary Accounting Research*, 22, 4, 759-89.
- Boiney, L G, Kennedy, J and Nye P. (1997). Instrumental Bias in Motivated Reasoning: More When More Is Needed, *Organizational Behaviour and Human Decision Processes*, 72, 1, 1-24.
- Bollen, K. A. (1989). *Structural Equations with Latent Variables*, New York, NY: John Wiley & Sons.
- Brandon, D.M., Kerler, W. A., Killough, L. N. and Mueller, J M. (2007). The Joint Influence of Client Attributes and Cognitive Moral Development on Students' Ethical Judgments, *Journal of Accounting*, 25, 59-73.
- Braun, K. W. (2001). The Disposition of Audit-detected Misstatements: An Examination of Risk and Reward Factors and Aggregation Effects, *Contemporary Accounting Research*, 18, 71- 99.

- Brown, HL and Johnstone, K. (2007). Effects of Engagement Risk and Auditor Negotiation Experience on the Process and Outcomes of Client-Auditor Negotiations, Working Paper, Boston College.
- Chang ,C J and Hwang, NC R.(2003). The Impact of Retention Incentives and Client Business Risks on Auditors' Decisions Involving Aggressive Reporting Practices, *Auditing: A Journal of Practice and Theory*, 22, 2, 207-218.
- Chen, KCW and Church, BK. (1992). Default on Debt Obligations and the Issuance of Going-concern Opinions, *Auditing: A Journal of Practice and Theory*, 30-49.
- Colbert J. L., Luehlfig M. S., and Alderman C. W. (1996). Engagement Risk, *The CPA Journal*, 66 (March), 54-56.
- Demski J. and Frimor H. (1999). Performance Measure Garbling under Renegotiation in Multi-period Agencies, *Journal of Accounting Research*, 37, 187-214.
- Dutta, S, and Graham, L E. (1999). Business Viability Risk Assessment Modelled through a Bayesian Network Approach, *Advances in Quantitative Analysis of Finance and Accounting*, 7, 97-130.
- Eilifsen, A., Knechel, W.R. and Wallage, P. (2001). Application of the Business Risk Audit Model: A Field Study, *Accounting Horizons*, 15, 3, 193-207.
- Fearnley, S., Beattie, V. and Brandt, R. (2005). Auditor Independence and Audit Risk: A Reconceptualization, *Journal of International Accounting Research*, 4, 1, 39-71.
- Fukukawa, H., Mock, T. J. and Wright, A. M. (2006). Audit Program Plans and Audit Risk: A Study of Japanese Practice, *International Journal of Auditing*, 10, 1, 41-65.
- Geiger, M. and Raghunandan, K. (2001). Auditor Tenure and Audit Quality, *Auditing: A Journal of Practice and Theory*, 21, 187-196.
- Geiger, M. A., Raghunandan, K. and Rama, D. V. (2006). Auditor Decision-making in Different Litigation Environments: The Private Securities Litigation Reform Act, Audit Reports and Audit Firm Size, *Journal of Accounting and Public Policy*, 25, 332-353.
- Gibbins, M., McCracken, S. and Salterio, S. (2005). Negotiations over Accounting Issues: The Congruency of Audit Partner and Chief Financial Officer Recalls, *Auditing: A Journal of Practice and Theory*, 24, 171-193.
- Gibbins, M., McCracken, S. and Salterio, S. (2007). The Chief Financial Officer's Perspective on Auditor-client Negotiations, *Contemporary Accounting Research*, 24, 2, 387-422.
- Gibbins, M., McCracken, S. and Salterio, S. (2008). Auditor- client Management Negotiation Concerning Client's Financial Reporting: Evidence from the Client's Side, *Accounting, Organizations and Society*, 33, 4/5, 362-390.
- Gibbins, M, Salterio, S. and Webb, A. (2001). Evidence about Auditor-Client Management Negotiation Concerning Clients Financial Reporting, *Journal of Accounting Research*, 39, 535-563.

- Goodwin, J. (2002). Auditors' Conflict Management Styles: An Exploratory Study, *Abacus*, 38, 3, 378-405.
- Hackenbrack, K, and Nelson, M. (1996) Auditors' incentives and their application of financial accounting standards, *The Accounting Review*, 71, 43-59.
- Houston, RW. (1999). The Effects of Fee Pressure and Client Risk on Audit seniors' Time Budget Decisions, *Auditing: A Journal of Practice & Theory*, 18 , 2, 70-86.
- Huss, H F, and Jacobs, F A. (1991). Risk Containment: Exploring Auditor Decisions in the Engagement Process, *Auditing: A Journal of Practice & Theory*, 16-32.
- Joe, J., Wright, A. and Wright, S. (2006). The Impact of Changes in the Reporting Environment, Client Characteristics, and Misstatement Type on the Disposition of Proposed Audit Adjustments, University of Massachusetts Boston.
- Johnstone, K M. (2000). Client Acceptance Decisions: Simultaneous Effects of Client Business Risk, Audit Risk, Auditor Business Risk, and Risk Adaptation, *Auditing: A Journal of Practice & Theory*, 19, 1-25.
- Johnstone, K, Bedard, and Biggs, S. (2002). Generating Financial Reporting Alternatives: Enhancing and Inhibiting Roles of Task Environment and Task Knowledge, *Auditing: A Journal of Practice & Theory*, 21, 1, 47-65.
- Johnstone, K. M., Sutton M. H. and Warfield T. D. (2001) Antecedents and consequences of independence risk: Framework for analysis, *Accounting Horizons*, 15, 1, 1-18.
- Kadous, K, SJ Kenned, Y, and Peecher, ME. (2003). The Effect of Quality Assessment and Directional Goal Commitment on Auditors' Acceptance of Client-preferred Accounting Methods, *The Accounting Review*, 78, 759-778.
- Kadous, K. (2000). The Effects of Audit Quality and Consequence Severity on Juror Evaluation of Auditor Responsibility for Plaintiff Losses, *The Accounting Review*, 75, 327-341.
- Kahneman, D and Tversky, A. (1979). Prospect Theory: An Analysis under Risk, *Econometrica*, 47, 2, 63-291.
- Kenny, D. A. (1979). *Correlation and Causality*, New York, NY: Wiley-Interscience.
- Knapp, M. (1985). Audit Conflict: An Empirical Study of the Perceived Ability of Auditors to Resist Management Pressure, *The Accounting Review*, 60, 202-211.
- Kotchetova, N., Kozloski, T .M. and Messier, W. F. (2006). Linkages between Auditor's Risk Assessments in a Risk Based Audit, Working Paper, Norwegian School of Economics and Business Administration.
- Kotchetova, N., Kozloski, T.M., and Messier, W. (2005). Do Performance and Documentation of Business Process Analysis Influence Auditors' Risk Assessments? Paper presented at the 3rd EARNet symposium, Amsterdam.

- Kruetzfeldt, R W, and Wallace, W A. (1986). Error Characteristics in Audit Populations: Their Profile and Relationship to Environmental Factors, *Auditing: A Journal of Practice & Theory*, 6, 20-13.
- Kunda, Z. (1990). The Case for Motivated Reasoning, *Psychological Bulletin*, 108, 3, 480-498.
- Loehlin, JC. (1992). *Latent Variable Models: An Introduction to Factor, Path and Structural Analysis*. Hillsdale, NJ: Laurence Erlbaum Associates.
- Lys, T. and Watts, R.L. (1994). Lawsuits against Auditors, *Journal of Accounting Research*, 32, 65-93.
- Maletta, M J, and Kida T. (1993). The Effect of Risk Factors on Auditors' Configures Information Processing, *The Accounting Review*, 681-691.
- McCracken, S., Salterio, S. and Gibbins, M. (2008). Auditor-client Management Relationships and Roles in Negotiating Financial Reporting, *Accounting Organizations and Society*, 33, 4-5, 362- 383.
- Mock, T. J. and Turner, J. (2005). Auditor Identification of Fraud Risk Factors and their Impact on Audit Programs, *International Journal of Auditing*, 9, 1, 59-77.
- Neale, MA, and Bazerman, MH. (1991). *Cognition and Rationality in Negotiation*, The Free Press, New York.
- Nelson, M, Elliott, JA and Tarpley, R L. (2002). Evidence from Auditors about Managers' and Auditors' Earnings Management Decisions, *The Accounting Review*, 77, 175-202.
- Nelson, MW, and Kinney, WR. (1997). The Effect of Ambiguity on Loss Contingency Reporting Judgments, *The Accounting Review*, 72, 257-274.
- Ng, T. and Tan, H. (2003). Effects of Authoritative Guidance Availability and Audit Committee Effectiveness on Auditors' Judgments in an Auditor-Client Negotiation Context, *The Accounting Review*, 78, 3, 801-818.
- O'Donnell, E. and Schultz, J. J. (2005). The Halo Effect in Business Risk Audits: Can Strategic Risk Assessment Bias Auditor Judgment about Accounting Details? *The Accounting Review*, 80, 3, 921-940.
- O'Keefe, T.B., King, R.D., Gaver, K.M. (1994). Audit Fees, Industry Specialization and Compliance with GAAS Reporting Standards, *Auditing: A Journal of Practice and Theory*, 13, 41-55.
- Omri, A. (2001). Systèmes de gouvernance et performance des entreprises tunisiennes, *Revue Française de Gestion*, 31, 85-100.
- Palmrose, Z. (1988). An Analysis of Auditor Litigation and Audit Service Quality, *The Accounting Review*, 63, 1, 55-73.
- Palmrose, Z-V. (1987). Litigation and Independent Auditors: The Role of Business Failures and Management Fraud, *Auditing: A Journal of Practice & Theory*, 6, 90-103.

- Ponemon, L A, and Schick, A G. (1991). Financially Distressed Companies and Auditor Perceptions of the Twelve Characteristics of Decline, *Auditing: A Journal of Practice & Theory*, 70-83.
- Pratt, J, and Stice, J D. (1994). The Effects of Client Characteristics on Auditor Litigation Risk Judgments, Required Audit Evidence, and Recommended Audit Fees, *The Accounting Review*, 639-656.
- Private Securities Litigation Reform Act of 1995 (PSLRA) (1995). Pub. L 104-67, 109 Stat. 737.
- Pruitt D. G. (1981). Negotiation Behavior, New York, NY: Academic Press, Inc. *Psychological Review*, 3, 4, 303-311.
- Pittenberg, L E and Schwieger, B J. (2001). *Auditing Concepts for a Changing Environment*. Orlando, FL: Harcourt College Publishers.
- Sankaraguruswamy, S., Raghunandan K. and Whisenant S. (2005). Factors Associated with Long Term Stock Price Performance of Firms Making Disclosures of Auditor-Client Frictions, Working paper, Florida International University.
- Schipper, K. (1991). Discussion of: An Analysis of Auditor Litigation Disclosures, *Auditing: A Journal of Practice & Theory*, 10, 72-76.
- Shabou, R. (2003). Nature des détenteurs de blocs de contrôle, mécanismes de contrôle et performance financière des entreprises tunisiennes, *Revue Gestion 2000* ,125-144.
- Simunic, D. A. (1980). The Pricing of Audit Services: Theory and Evidence, *Journal of Accounting Research*, 18, (Spring), 161-190.
- St Pierre, K, and Anderson, JA. (1984). An Analysis of the Factors Associated with Lawsuits against Public Accountants, *The Accounting Review*, 59, 242-263.
- Stice, JD. (1991). Using Financial and Market Information to Identify Pre-engagement Factors Associated with Lawsuits against Auditors, *The Accounting Review*, 66, 516-553.
- Thompson L. (1990). The Influence of Experience on Negotiation Performance, *Journal of Experimental Social Psychology*, 26, 528-544.
- Trotman, K., Wright A, and Wright S. (2005). Auditor Negotiations: An Examination of the Efficacy of Intervention Methods, *The Accounting Review*, 80, 1, 349-367.
- Tucker, L. R. and Lewis C. (1973). The Reliability Coefficient for Maximum Likelihood Factor Analysis, *Psychometrika*, 38, 1-10.
- Walo, J C. (1995). The Effects of Client Characteristics on Audit Scope, *Auditing: A Journal of Practice & Theory*, 14, 115-124.
- Willingham, J, and Wright, W F. (1985). Financial Statement Errors and Internal Control Judgments, *Auditing: A Journal of Practice & Theory*, 57-70.

- Windsor, C. and Rasmussen, B.W. (2007). The Rise of Regulatory Capitalism and the Decline of Auditor Independence: A Critical and Experimental Examination of Auditors' Conflicts of Interests, *Critical Perspectives on Accounting*
- Wu, B. K., Roebuck, P. and Summers, S. (2002). Financial Statement Transparency and Auditor Responsibility: Enron and Andersen, *International Journal of Auditing*, 6, 287-302.
- Zhang, P. (1999). A Bargaining Model of Auditor Reporting, *Contemporary Accounting Research*, 16, 1, 167-184.