THEORETICAL BACKGROUND OF INTERNAL AND EXTERNAL ENVIRONMENT OF NEGOTIATION

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Abstract: *Corporate failures and financial scandals are a phenomenon that emerged long before the 21st century. Different scandals around the globe spread over the last decades, such as Enron, Parmalat and WorldCom have interested the stakeholders to question the implications and efficiency of both management and auditors. To reply this demand, the authors conduct qualitative research: the exposure of theoretical background in the field of audit-auditee relationship in the context of corporate governance. Auditor-auditee negotiation concerning difficult client accounting issues involves not only the auditor and the client, but also various other parties on both sides. Moreover, the implications of such a situation have various ramifications that surpass the boundaries of many regulations. The results show that the auditor-auditee relationship is of key importance for the auditing process, also based on the macro and microenvironment of this relationship and the negotiations model that can also have an influence on the matter.*

Keywords: audit, negotiation, auditor, auditee

Jel classification: M42

Introduction

One of the significant factors for the financial crisis that occurred at the beginning of the preceding century was either the failure of corporate governance regulations and improper appliance of audit standards and corporate governance codes, or the lack of potential for auditing in reporting problems ahead of the time they go out of auditing process. Analysing how auditing on one hand and corporate governance, on the other hand, failed to play their role is of crucial importance in the pursuit of correcting the flaws as soon as possible.

In consequence of these facts, the main objective of our paper is to draw a theoretical background of the environmental factors that influence the auditor-auditee relationship in the context of corporate governance. The motivation to conduct a research on this subject is triggered by the fact that auditing as a profession relies on the independence principle (Byrne, 2001; Ruddock et al., 2004) reflected, ultimately, in a reliable auditor's report. Nevertheless, the relationship developed between the auditor and the auditee, before and during the auditing process, is very complex, the most significant fragment being the negotiation phase (Antle & Nalebuff, 1991; Kennedy, 1992; Pruitt & Carnevale, 1993; Gibbins et al., 2001; Salterio, 2012).

This paper contributes to the literature in the field of macro and microenvironment of the relationship, taking into consideration first of all, the protectionist relationship, the stewardship

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relationship and finally and yet importantly, the statutory and working relationship. All these contribute to describe the micro and macro environment.

The remainder of this paper exposes the methodological aspects, followed by a disclosure of the most important elements of the auditor-auditee relationship theoretical background and debates concerning the interaction between them. The last part of the paper presents the conclusions, limitations and perspectives for future studies in this challenging and debatable area of knowledge.

Data and Methodology

To achieve the objective of the paper, the research is based on a inductive reasoning (Gray et al., 2007) starting with a collection of data regarding the auditor–auditee relationship, based on relevant international literature, and the development of a theoretical background, as a result of the data analysis. The aim is to illustrate a generalizable conjecture based on observations. The approach is from particular to general and the collection of data leads to the theoretical background (Saunders et al., 2009; Bryman & Bell, 2007). The purpose of this process is to contribute to a better understanding the literature in the field as a mandatory step before performing significant research in an area (Boote & Beile, 2005).

Based on the current published literature, the auditor-auditee relationship can be explained from a micro and macro perspective. The whole phenomenon under study – the auditor-auditee relationship - is viewed as an interrelated structure, consisting of more that the involved parties; there are more than just linear relationships between parts and/or cause/effect interactions; the phenomenon is dynamic, flexible, nonetheless in synergy.

Factors influencing auditor-auditee relationships

The auditor-auditee relationship is a current and very debatable topic of today. Recent, investigations show that there are audit firms that give too much importance to their clients, and rotate the audit partners only before mandatory rotation, due to their commercial interests (Chen et al., 2016; Lennox & Wu, 2016; Stewart et al. 2015). Lennox (2005) recognized that the auditor-auditee relationship, could negatively affect audit quality. Their argumentation considers the reduced probability of the auditor discovering and/or reporting a problem regarding the financial statements, if there is a increased degree of familiarity. In line with this, Bruynseels and Cardinaels (2013) consider auditor independence as indicator of audit quality; the independence will weaken when acquaintance between the audit partner and the firm's executives appears.

Another area of debate for researchers is auditor independence and its influence upon audit quality, taking into consideration the relationship between audit failures and audit-auditee tenure (Sikka *et al.* 2009; Li, 2009; Daniels & Booker, 2011; Joe *et al.*, 2011; Al-Thundeibat *et al.*, 2011; Gonthier-Besacier *et al.*, 2016). Nevertheless, consistent proof regarding the concerns of reduced independence actually gives legitimacy to criticism of the manner in which the accounting profession has developed over time, into firms providing broad-based services (Ruddock et al., 2004).

In this part, the aim is to offer context on the interaction between the auditor and the auditee. In this, two dimensions are identified: the internal environment and external environment. Based on the literature, the following variables that influence the internal environment are acknowledged: the auditor's opinion, the working procedures, the degree of self-interest, the accounting methods, the presence of the expectation gap, the following of ethical guidelines. The identified external variables are as follows: audit regulations, the competition, self-regulation and other stakeholders such as the banking sector, creditors, investors, the stock exchange, the political system/climate, the Academia, financial analysts etc.).

These dimensions influence all the involved parties in a different manner, and these influences decide the outcome of the process. Thus, the relationships among with the way those are structured and process interactions can be synthesized as following:

a) (the) Protectionist Relationship: (Auditor - Shareholders)
b) (the) Stewardship Relationship: (Management - Shareholders)
c) (the) Statutory and Working Relationship: (Auditor - Client)

The structure and process dimensions of interactions

a.) **The protectionist relationship**

This link between the auditor and the shareholders stems from the relationship they have, the auditors being appointed to protect the shareholders' interests in the company. In practice, shareholders have less involvment in the audit engagement than the management of the firm, so they are based on the work of the auditor. The protectionist relationship, which is the interaction between auditors and shareholders, has not yet been debated in financial institutions and markets.

Nevertheless, it is a general agreement that all relevant financial information will be made available and be easily accessed through the Stock Exchange and the Internet for the entities listed on the stock exchange. However, a solution for a better communication between the auditors and shareholders has not yet been found. Shareholders demand more information from auditors, apart from what is conveyed within the auditors' report; still, companies are faced with a difficult, if not impossible task of complying with complex reporting rules and the demand of increased disclosure to shareholders.

b.) **The stewardship relationships**

The stewardship theory was developed following criticism of the agency theory (Davis et al., 1997). The stewardship theory contains a complementary system to that of the Agency's Theory as regards to the relationship of the involved parties. The basis for the stewardship theory is the exchange relationship, in this case between a principal (owner) and a steward (administrator). The basic difference between the theory of the agency and the stewardship theory can be seen in the way the administrator/manager behaves. Stewardship theory establishes that managers are merely administrators, hired to work in the interests of their owners. The prospect of promotion, affiliation, achievement and responsibility motivates administrators to focus on long-term collective responsibility, which is why managers will not pursue their own benefits (Fischer 2003).

The premise behind the stewardship theory is that managers are essentially trustworthy in corporate governance. It is very important that managers do not automatically adopt behaviour centred on their own interests but rather focus on the interest of the owners (Solomon, 2007).

The conceptual basis of the theory is related to the elaboration of Theory Y, which was issued by McGregor, which starts from the assumption that managers are hired for their skills and expertise, and, as such, the need for excessive monitoring of their behaviour, as assumed by the Agency Theory, is pointless. (Nicholson & Kiel 2007). This leads to a significant reduction of costs. (Donaldson & Davis, 1994). Management, the user of the property of owners, will protect and maximize their interests by increasing the company's performance. As a result, the utility of the administrator increases if he decides to work for the development of the company and does not adopt a contrary position, focusing solely on his own benefits. This view is also shared by Goldman and Barlev (1974). However, the moral dilemma can be resolved by arraying a management incentive scheme, aligned with the interests of the shareholders: year-end performance bonuses, for instance. Another solution could be for the company to provide an exhaustive public disclosure of information, to assure interested parties that management is not in a better position of knowing more about a company (Shirley-Beaver, 1981).

The stewardship theory considers an important factor in the management structure. The structure must be comprised of internal employees of the company, given their knowledge and familiarity of the entity's problems. If the management of the entity only includes external members, it is more difficult to react to the entity's problems. Members from the outside of the entity can track the maximization of the company's performance in the short run, as their knowledge of the entity's activity is reduced to reports provided by executives coming from within the entity, executives that are experiencing day-to-day problems within the entity (Solomon, 2007).

c.) **The statutory & working relationship**

This is a legal requirement, given the fact that all listed companies are required to perform an audit on their financial statements. If the statements reflect a true and fair view, confirmed through an unqualified auditors' report, the company's stakeholders can trust the financial results and act accordingly.

The Auditor-Management relationships include only individuals involved in the preparation of the accounts, planning the audit task and the timeframe. All listed companies and other types of companies prescribed in national regulations are required, by law, to have their accounts audited. Accounts are presented annually to shareholders and, after their approval, the financial statements and the audit report are publicly available for other parties, like investors and any other stakeholders. It is the management's task to contract auditor services, and, during the audit process, to provide the auditor with required information. This relation should be considered a statutory and, at the same time, a working relationship (between auditors and their clients): there is a legal requirement and it consists of a formal and informal approach regarding to the preparation of accounts, the agreement on deployed accounting techniques and the degree of influence each party has in the process. Furthermore, the relationship also provides a framework for resolving issues, should the formal and informal approach in conflicts fail.

Macro –microenvironment relationship

In accordance with the literature, there are several factors that influence the relation between the auditor and the auditee in addition to other aspects such as independence, the role of regulator's enforcement, voluntary audit partner and audit firm rotation, commercialism, public trust and audit quality. DeAngelo (1981) considers two aspects: perceived auditor competence, which is the detection ability of financial misstatements proved by the auditor; perceived auditor independence, which is the degree of familiarity with the company, which could prevent the auditor from reporting misstatements.

Thus, the first step after discovering a certain issue in the financial statements during the audit process is to disclose it, to fulfill the audit missions' goal. Of course, that disclosure is not sufficient by itself, as the disclosed information must be kept as it is from the moment of its discovery. This is the reason why independence is crucial in the process, and this is the key to making the difference between appearances and reality as Ruddock et al (2004) point out. Nonetheless, "the auditor is the instigator of most negotiations as the easiest path for the auditor, in line with his client retention, sales of other audit services, reputation within firm and other incentives, as it would be easier to accept the client's initial accounting position except when the auditor feels constrained by another important contextual feature (e.g. an accounting standard that the auditor believes applies to the circumstances but the client does not)"(Salterio, 2012).

The auditor-auditee relationship can also be explained at a different level, more than that found in literature. A macro environment relationship and a microenvironment relationship is discovered:

- Macro environment relationship

As shown in the figure below, we identify three major players in audit relationships at the macro environment level.

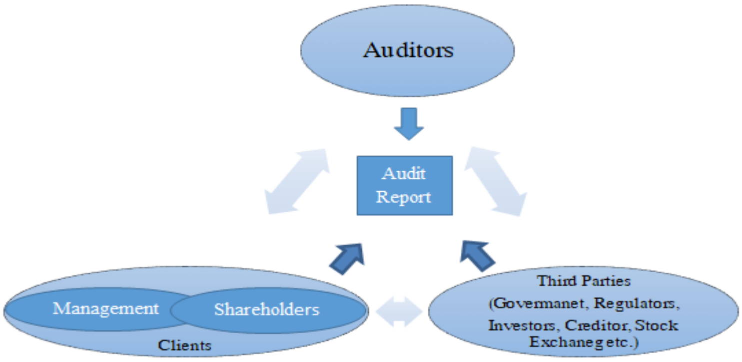

Fig.1. Macro environment level

Source: Based on: Goldman, A and Barlev, B. (1974), "The Auditor-Firm Conflict of interests: Its Implications for Independence" *The Accounting Review,* October, pp. 707-718

As we Shown in the figure below, at the microenvironment relationship there are also three main actors: Auditor, Client and Management.

(1)The Auditor-Management relationships include only individuals involved in the preparation of the accounts, planning the audit task and time. The major parties in this relationship are auditors and management. All medium-sized and large limited companies are mandated by law to have their accounts audited by qualified accounting professionals, i.e. auditors. Accounts are presented annually to shareholders, investors and any other party interested in the company activities.

(2)The role of the auditor in the relationship auditor-shareholders is that the shareholders require from the auditor to verify management's actions in order to ensure their protection against wrongdoing and frauds.

(3)Management-Shareholders relationship reflects whether the management is correctly using the company's resources, owned by the shareholders. A general relationship, which has a tendency to embrace all interactions, is the statutory relationships.

- Microenvironment relationship

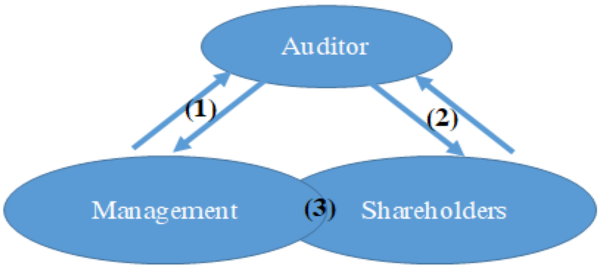

Fig.2. Microenvironment level

Source: Based on: Goldman, A and Barlev, B. (1974), "The Auditor-Firm Conflict of interests: Its Implications for Independence" *The Accounting Review,* October, pp. 707-718

(1) Statutory & working relationship (between auditors and their clients): this is a legal requirement and it relies on the formal and informal aspects of the working relationship between the auditor and the auditee with regards to the preparation of accounts, the agreement on accounting techniques and influence of each party in the process. This study focuses on statutory and working relationships.

(2) Protectionist relationship (between auditors and shareholders) This relationship is developed based on the theory that their shareholders basically appoint (indirectly) the auditors with the aim of protecting their interests in the company, i.e., therefore, auditors are required to verify, on shareholders behalf, whether the management is correctly using the resources the company has

made available to them; these resources are owned by the shareholders. However, the auditors are generally less in contact with the shareholders, their contact is with management.

(3) Stewardship relationship (between management and shareholders) is explained in the literature by the *agency theory*.

Moreover, there are various sources of influence in the audit relationships. Some potential sources of influence factors that are identified and can affect the auditor-client relationships are the audit report, self-interest, audit and accounting regulations, accounting techniques, the providing of non-audit services and, last but not least, the competition between auditing firms.

Conclusion

At the present time, audit has become a complex, interactive and skilful process, which requires a high level of technical knowledge, integrity and interpersonal skills from the audit engagement partners. As a consequence, the audit profession is challenging for all involved parties. However, the profession has the ability to overcome these tests, an aspect agreed upon both the profession and the investors and markets.

The paper reached its objective by outlining the recent developments and academic debates concerning the auditor-auditee relationship. To achieve this, a qualitative research based on a structured literature review was conducted. Our starting point was to set-up the context of audit and auditor-auditee relationship. The corporate governance context highlights the significant responsibilities of an auditor, in protecting the interest of shareholders. The audit serves as a “monitoring device” and is, thus, a crucial part of the corporate governance mosaic (Cohen et all, 2002).

The relation developed among the auditor and auditee, before and throughout the audit process, is very complex, the most significant characteristics showing up during the negotiation phase. For this reason, the study appeals at the classic model of auditor-auditee negotiation, developed by Gibbins et al. (2001) and others. Moreover, the auditor-auditee relationship is then explored at the macro and micro level, the roles of each parties involved develops in time.

Overall, the paper started from the study of literature, being a qualitative theoretical paper that highlights the importance of the relationship auditor-auditee in the context of corporate governance. This topic involves a number of research perspectives, such as a more detailed analysis of the concept of auditor-auditee relationship and the collaboration between these actors at micro and macro level, in the context of corporate governance in different cultural contexts, for example in the case of countries with emerging economies and a centralised economy history,

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