

Toward a General Theory of Client Acceptance and Continuance Decisions

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This study investigates the theoretical perspectives used in the extant auditing literature on client acceptance and continuance decisions. First, the different client acceptance and continuance decisions are presented. Second, the paper identifies and discusses the single-client approach and introduces "the auditor-client relationship life cycle" as an integrative framework for this perspective commonly used in academia. Third, the audit firm portfolio management perspective is examined. Finally, the apparent incommensurability of the single-client and the clients-portfolio approaches is discussed and the foundation for a general theory of the client acceptance and continuance decisions is developed.

1. Introduction

Since the fifties, auditing research has been constantly growing and evolving, using various theories and methodologies, and addressing ever more varied and complex issues (Krogstad and Smith, 2003). Within this diversity, auditor's judgment and decision making research (J&DM) remains one of the most important investigative areas within the field of auditing (Kotchetova and Salterio, 2007). This is not surprising given that auditor's work is rooted in the exercise of professional judgment to make diverse decisions (Trotman, 1996). This paper contributes to this research stream, discusses the theoretical perspectives used to study auditor's client acceptance and continuance decisions (CACD), and develops the foundation for a general CACD theory.

Client acceptance and continuance decisions are critical and complex decisions, which have significant economic implications for audit firms, their clients, and auditors (Johnstone and Bedard, 2004). For public companies or clients, auditors' CACD may have important consequences such as stock price increase following client acceptance or retention and stock price decline following the auditor's resignation (Beneish et al., 2005). On the supply side, CACD are considered by both professionals and academics as the most important decisions in audit practice (Gendron, 2001; Johnstone and Bedard, 2003). They are frequent and recurrent decisions, which automatically precede every audit engagement. In addition, CACD are critical to the advancement of the auditor's professional career as well as the composition of the audit firm's portfolio of clients and its profitability. This is all the more true that "once formed, the auditor-client relationship for public companies usually extends many years, as those companies rarely switch auditors" (Adams et al., 2005). On the technical side, CACD represent a critical phase in the audit process (IFAC, 2010). The CACD phase includes most of the financial statements audit (or external audit) steps but at a smaller scale. In addition, a careful and extensive assessment of the client during this pre-engagement stage contributes to a better planning and performance of the audit engagement, thereby reducing audit costs and errors.

Considering the theoretical and the practical importance of the CACD stage in the audit process, building a theory of CACD is essential and benefits auditing scholars and practitioners as well. It is also a critical step for developing a general theory of external auditing. In the extant academic literature, two different perspectives have been used to study CACD: the single-client perspective and the clients-portfolio perspective. Under the first perspective, which is by far the dominant approach in the auditing literature, the auditor considers the client-specific factors only when making a client acceptance decision (CAD) or a client continuance decision (CCD), and disregards the potential impact of his decision outcome on the audit firm portfolio of audit clients. The second approach, also called the audit firm portfolio management perspective, considers the set of the audit engagements relating the auditor and his different clients as a portfolio that the audit firm purposefully manages. Under this approach, each audit engagement between the auditor and the client is considered within a broader perspective where the CACD are closely interconnected and directly related to the overall performance of the audit firm.

In our view, these two approaches taken separately provide limited insights on the CACD and the external audit process. This study discusses the apparent incommensurability of the two perspectives to set the foundation for a general theory of the CACD. The rest of the paper is organized as follows: First, the client acceptance and continuance decisions are defined. Second, the single-client perspective as well as the "the auditor-client relationship life cycle" are introduced. Third, the clients-portfolio perspective is discussed. Fourth, the foundation for a general CACD theory is presented. Finally, a conclusion is provided.

2. Client Acceptance and Continuance Decisions

According to Asare et al. (1994) and Johnstone and Bedard (2004), the client acceptance decision (CAD) process consists in attracting desirable or potential clients and deciding whether to submit a bid to perform financial statements audit for those clients who may be interested in the audit firm's services. If the audit firm decides to submit a bid and the potential client retains the offer, the newly accepted client is added to the audit firm's portfolio of clients (Simunic and Stein, 1990; Johnstone and Bedard, 2004). The new client can also initiate the CAD process and approach the audit firm to show his interest in becoming one of its audit clients. In this case, the audit firm assesses the prospective client and either rejects or decides to submit an offer of service that can be ultimately accepted by the new client. In practice, the process can be more complex and iterative as it generally entails several discussions and negotiation rounds.

The client continuance decision (CCD) applies to existing audit clients only and does not apply to the new ones. It consists in evaluating ongoing audit clients and deciding whether to continue offering audit services to them. Depending on the outcome of the client continuance evaluation, two types of decisions are distinguished: the retention decision and the resignation decision. The retention decision is the auditor's decision to continue the audit engagement with the client for the subsequent year. The resignation decision is the auditor's decision to discontinue the audit services relationship with the existing client. Accordingly, resignation implies the elimination of undesirable clients, including those who are evaluated as excessively risky and those that no longer fit the audit firm targeted clientele, for example in terms of the industries privileged by the firm (Johnstone and Bedard, 2004; Shu, 2000).

Resignation and retention decisions are the two sides of a coin. They are the two mutually exclusive outcomes of a same decision process resulting either in keeping the client (client retention) or not (auditor resignation). Nonetheless, a critical difference between the two decisions lies in their respective drivers. Resignation is generally caused by several events that are unfavorable to the client-auditor relationship, bringing the auditor to end the audit relationship. Conversely, the retention decision is taken not only after major facts have come to light, but also, systematically and periodically, generally on an annual basis, even in the absence of trigger events (Stanley, 1999).

Proposition 1: A successful CACD theory should integrate all the three client acceptance and continuance decisions, i.e., the client acceptance decision, the client retention decision, and the auditor's resignation decision.

Obviously, CAD and CCD are similar. Both require the auditor to evaluate the audit client and then decide whether to provide audit services for him. For instance, Stanley (1999) argues that the risks as well as the profitability related to an audit engagement must be considered within the decision to accept a new client or to pursue a relationship with an existing client. In the extant auditing literature, the CAD and the CCD are seldom differentiated (e.g., Schroeder and Verrault, 1987; Huss and Jacobs, 1991). Some authors maintain that "the decision to continue or terminate a professional relationship is similar to the decision to accept a client" (Asare et al., 1994). As a result, the CCD is commonly viewed as a "mechanical" replication of the CAD (Colbert, 1996; Goldwasser, 1988). In other words, the auditor decides to continue the engagement for an additional year whenever the client continues to meet the acceptance criteria. As for regulation, the two decisions are also not differentiated by Canadian and American regulatory bodies (e.g., Statement on Quality Control, standard 2 and 4 in USA and CSQC-1, Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and other Assurance Engagements, in Canada).

Although the two decisions have some commonalities, to treat them the same way is simplistic as this omits the professional and relational variables characterizing a continuing audit engagement. CADs involve new clients whereas CCDs involve existing clients. As a result, the main difference between the two decisions lies in the CCD being "informed by knowledge of the client deriving from conducting the audit in the prior period" (Johnstone and Bedard, 2004). Therefore, ceteris paribus, auditing an existing client is easier and less costly than auditing a new one as the auditor already knows client's business, management, internal controls, etc. (Johnstone and Bedard, 2004). Moreover, an incumbent client has a closer relationship with the auditor based on mutual trust and cooperation (Rennie et al. 2010). Greenstein and Hamilton (1997) supports this important distinction and documents that in certain circumstances, it is possible for the auditor to decide to continue an audit engagement with a somewhat risky client that he would not have accepted if he was a new client. This can be explained by greater tolerance due to familiarity (Greenstein and Hamilton, 1997) or a more accurate assessment of client's riskiness due to improved knowledge (Johnstone and Bedard, 2004).

Accordingly, a successful CACD theory should take into consideration the potential relationships, the similarities, and the disparities between all the audit engagement decisions. Most importantly, future research needs to investigate links, similitude, and differences between CACD both theoretically and empirically, in order to enhance our understanding of and help build a coherent general theory of CACD.

Proposition 2: A successful CACD theory should integrate the potential relationships, the similarities, and the differences between all the three client acceptance and continuance decisions.

3. Single-Client Approach

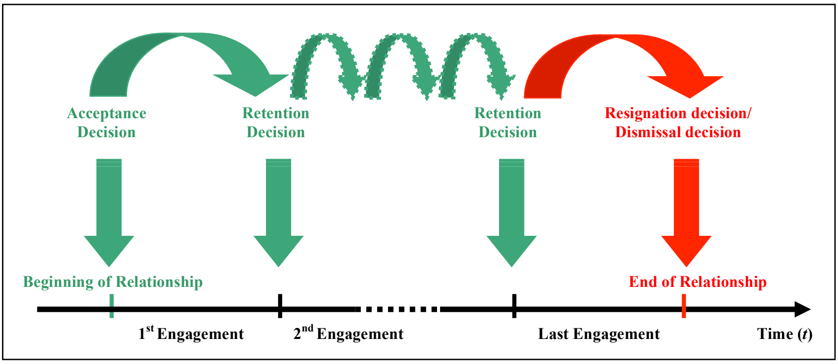
The single-client approach to client acceptance and continuance decisions arises from our examination of the extant literature as it has not been explicitly identified nor studied in prior research. Most of the previous audit studies examined CACD, also called auditor or audit engagement decisions under this approach, on a single client basis and have overlooked any audit firm clients-portfolio dimension. This approach assumes that the auditor considers only client specific factors when assessing the audit engagement risk/reward trade-off and that he disregards the potential impact of his ultimate CACD on the audit firm portfolio of clients. For example, before accepting or rejecting a new audit client, the auditor will certainly assess the client's riskiness on an individual basis. However, the auditor will not appraise the potential impact of the client's acceptance on the overall riskiness of the audit firm clients-portfolio.

Previous research shows that CACD are made in accordance with the risk avoidance theory, which suggests that audit firms reject risky clients (Johnstone and Bedard, 2004). Additionally, the literature documents that the CACD process involves two key phases: the risk/return evaluation phase and the risk/return management strategies phase (Johnstone, 2000; Gendron, 2001; Johnstone and Bedard, 2003). During the first stage, the auditor appraises the client's riskiness and the anticipated yields from the audit engagement and checks whether the expected risk/return ratio meets the audit firm requirements. In the second stage, non-acceptable engagements are reconsidered before final refusal in order to ensure that risk management strategies such as personnel-related policies, pricing strategies, differential audit activities, and monitoring policies, cannot bring the prospective relationship to an acceptable risk/return level. Although few studies have investigated the risk management factors, risk assessment factors such as management integrity, corporate governance system, business risk, non-audit services opportunities, and audit risk, have been the most frequently studied in the CACD literature[1]. This is mainly explained by the availability of data.

The main limitation of the single-client perspective as used in the extant literature is that it considers the client acceptance decision, the auditor resignation decision, and the client retention decision as three totally separate decisions. This explains why very few studies have addressed more than one decision concurrently (e.g. Beneish et al., 2005; Johnstone and Bedard, 2004). Nonetheless, these decisions are closely related as described in the previous section and a successful CACD theory should integrate the three audit engagement decisions in a global decision process relating acceptance, retention, and resignation (propositions 1 and 2).

To address this problem, we introduce the "auditor-client relationship life cycle" framework depicted in Figure 1. This framework applies the "life cycle" concept to the CACD stage and shows the respective roles of the different audit engagement decisions in the auditor-client relationship. First, client's acceptance starts the auditor-client relationship. Afterwards, the audit relationship may be continued through the client retention decision or can be terminated by one of the parties. The auditor can decide to stop auditing the financial statements of the existing client (auditor resignation). Alternatively, the client can initiate the termination of the audit relationship and decide to dismiss the incumbent auditor. Consequently, the "auditor-client relationship life cycle" meets propositions 1 and 2 and may therefore be considered as a successful CACD theory as it integrates in a coherent framework all the client acceptance and continuance decisions as well as the interconnectedness between these decisions. Despite these essential merits, the "auditor-client relationship life cycle" framework remains a single-client based approach and overlooks any audit firm clients-portfolio dimension to the CACD stage.

Figure 1: Auditor-Client Relationship Life Cycle

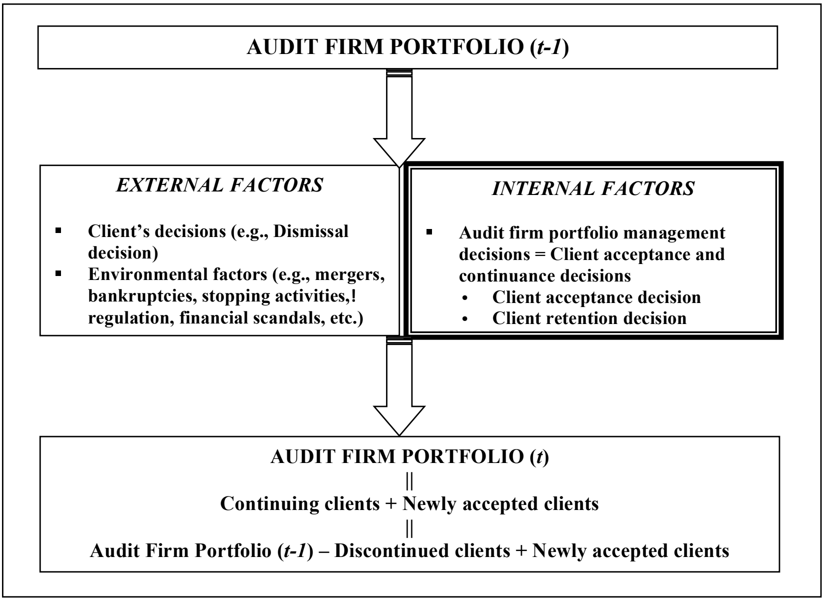


4. Clients-Portfolio Approach

The clients-portfolio perspective, also called the audit firm portfolio management perspective, considers the set of the audit engagements relating the auditor and his (or her) clients as a portfolio that the audit firm purposefully manages. This approach introduced more than twenty years ago by two seminal auditing scholars in Simunic and Stein (1990) and adopted subsequently by other researchers (e.g. Johnstone and Bedard, 2004, 2005) is still embryonic and consists in transposing the portfolio theory in finance to the audit context[2]. According to Simunic and Stein (1990) "the riskiness of an audit engagement is properly defined and measured within a portfolio context"[3] since the outcome of every client acceptance or continuance decision has an impact on the riskiness of the audit firm clients' portfolio en bloc (Huss and Jacobs, 1991). Similar to portfolio optimization in finance, auditors deal with the selection and management of optimal portfolios of audit clients. Consequently, each audit engagement should be considered within a broader slant where the CACD (also called audit firm portfolio management decisions (AFPMD) under this approach) drivers are closely related and contribute directly to the overall performance of the audit firm.

Johnstone and Bedard (2004) considers the clients-portfolio as a result of "a complex interplay between purposeful management decisions of the audit firm" and other external forces. As depicted in Figure 2 below, the authors distinguish between the changes that occur in the clients-portfolio's composition as a result of the CACD or the AFPMD and those deriving from other factors beyond auditor's control such as client-initiated auditor changes (dismissal decision) and general economic circumstances (e.g., mergers, bankruptcies, etc.). In other words, those external forces affect the audit firm's clients-portfolio in a manner that can be totally out of its control whereas the AFPMD are "purposeful" decisions taken deliberately by the auditor in order to manage the audit firm portfolio of clients. As shown in Figure 2, an audit firm portfolio of clients at the beginning of the current period (*t*) is composed of continuing clients (retention decision) and newly accepted clients (client acceptance decision). In addition, existing or continuing clients can be derived from the audit firm portfolio of clients at the beginning of the previous period (*t-1*) after excluding the set of discontinued clients (resignation decision).

Figure 2: Audit Firm Portfolio Management



The clientele adjustment strategy frequently used by audit firms is a good illustration of the practical relevance of the clients-portfolio perspective. According to the clientele-adjustment argument, audit firms, especially those of a certain size, target specific niches in the market for audit services. The niche choice depends on several factors related principally to the audit firm including the structures of its audit and other costs as well as the set of its potential clients (Shu, 2000). Over time, targeted clientele of the audit firm may change due to changes in the firm characteristics and/or the client characteristics, and continuing the audit of misaligned clients will be not profitable. Consequently, the audit firm may be interested in adjusting its clients-portfolio by resigning from existing clients who no longer match the audit firm targets. Testing empirically the clientele-adjustment argument, Shu (2000) documents that auditor's resignation is positively related to the occurrence of clientele mismatch caused by changes in auditor's characteristics, especially the structure of auditor's costs.

The audit firm portfolio management perspective provides an integrative framework in which the three acceptance, retention, and resignation decisions are interrelated since each decision affects the composition of the audit portfolio of clients as shown in Figure 2. However, as argued by Jonhstone and Bedard (2004), the unconditional transfer of portfolio theory from finance to auditing is marred with several difficulties. First, the composition of the audit firm portfolio is the result of both the auditor's decision to accept or retain clients, and the latter's decision to hire the auditor. On the contrary, the composition of the investor's stock portfolio is the result of his unilateral investment decisions. Second, estimating the return and the standard deviation of the market is critical in the financial portfolio theory whereas estimating these parameters for all audit firms' portfolios of clients would not be practically possible. Third, many audit clients, even large ones, are not publicly traded. Finally and most importantly, the maximum loss a stock portfolio holder can experience is limited to his initial investment. On the contrary, the auditor's loss may be far higher than the original audit investment. Some efforts have nevertheless been done relating to portfolio optimization with uncertain liabilities in finance (e.g., Elton and Gruber (1992). This work may be inspiring for audit researchers since the audit engagement can be considered as an asset or a liability depending on whether it is profitable or not. Nonetheless, in Elton and Gruber's model, liabilities are known at the time of the portfolio selection. In the audit context, the liability arises normally at some point in the future and the auditor is generally not aware of it at the CACD stage.

These theoretical issues explain why this innovative and interesting approach never took-off, despite the fact that, in practice, auditors are used to think of their clients as a portfolio (especially before the scandals of the beginning of the century). This raises the following questions: *is the "audit firm portfolio management perspective" useless and irrelevant, at least theoretically? Is the "auditor-client relationship life cycle" framework a better alternative? Were practitioners completely wrong when they used the portfolio approach for many years?*

5. Toward a General Theory of Client Acceptance and Continuance Decisions

Even though the portfolio approach may not be directly applicable to the audit firm context, it provides an essential complement to the more widely used single-client approach. When dealing with CACD, both the single client specific factors and the audit firm portfolio attributes should be considered. Client's characteristics are fundamental for the assessment of both the riskiness and the profitability of any audit engagement. At the same time, the characteristics of the audit firm clients' portfolio could not be totally ignored due to their important role in the overall performance of the audit firm. Therefore, there is no doubt about the usefulness of the portfolio approach in the CACD setting. However, the challenge is how to use both approaches at the same time in practice, since the portfolio perspective cannot substitute the single-client approach. This debate has been avoided for decades by scholars and our position in this paper is that the single and the portfolio perspectives are complementary and that a successful CACD theory should be a mix of both approaches.

Proposition 3: A successful CACD theory should integrate both the single-client and the clients-portfolio approaches.

Contrary to the field of finance, we believe that portfolio theory cannot be used in external auditing to reduce the riskiness of the audit firm clients' portfolio by the mechanism of diversification as suggested by Simunic and Stein (1990). More specifically, the impact of a particular client on the audit firm portfolio riskiness and profitability cannot be used as an acceptance/retention criterion, especially in the current audit market characterized by growing litigation risk and where an audit firm may collapse following the failure of one single audit engagement (e.g., the audit engagement of Arthur Andersen with Enron). To be accepted or retained, the client should indeed meet the acceptance/retention criteria on a single basis. If the client is not acceptable using the single based approach, then the client should be rejected even if he (or she) fits well into the audit firm clients' portfolio (i.e., even if the auditor can reduce the audit costs associated with the engagement and obtain an acceptable risk-reward trade-off for the audit because the client matches the audit firm targeted clientele). Accordingly, the single client approach should remain the fundamental approach for CACD as it depicts not only the most fundamental and significant decision factors, but also due to a "catastrophic" risk which may arise from a single client.

An error that has been commonly made by practitioners for many years consisted in using the portfolio approach to distinguish between acceptable and not acceptable clients. This practice has been, undoubtedly, one of the main causes of audit scandals at the beginning of the century and the ensuing dramatic increase of auditor litigation risk. Previous studies documented that accepting highly risky client has been the main reason behind the major auditing scandals (Ethridge et al., 2007). However, auditing literature did not extensively investigate why audit firms did so at the first place. Some scholars argue that audit firms' greediness is the source of all the problems (Toffler, 2003). While this argument cannot be completely discarded, it is worthwhile to note that all major audit firms, especially Big4, have been accustomed to use well developed and complex expert systems to assist engagement partners in their CACD (e.g., KRisk by KPMG and FRisk by PricewaterhouseCoopers). In addition, audit quality controls such as peer reviews are well developed in those audit firms which limits perverse effects of greediness (Bedard et al., 2008). Interestingly, some CACD expert systems include audit firm portfolio factors though they are used on a single client basis (Bell et al., 2002). This suggests that besides greediness, a myopic decision making process may have contributed to making highly risky clients looking acceptable.

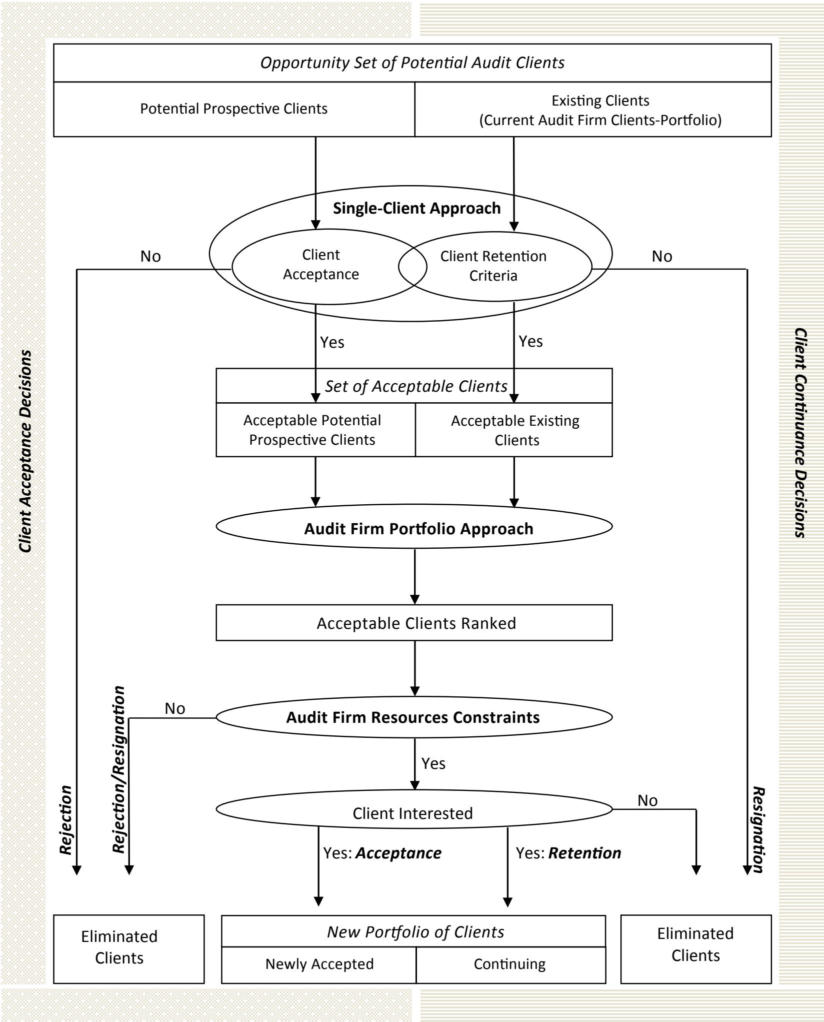
Proposition 4: A successful CACD theory should consider the single-client approach as fundamental.

On the other hand, the CACD making process should benefit from the portfolio approach and involve factors related to the audit firm portfolio besides client's factors. Although any audit client should necessarily meet the acceptance (retention) criteria on a single basis in order to be accepted (retained), an acceptable client is certainly more attractive to the audit firm if he also enhances the overall profitability of the audit firm clients-portfolio and/or reduces its riskiness. As evidenced by Shu (2000), a client who fits an audit firm's targeted clientele can increase the overall profitability of the firm through reduced audit costs and decrease its riskiness through higher quality audits and lower litigation risk. Combining the single and the portfolio approaches can therefore differentiate between acceptable and more profitable audit engagements, thereby improving auditors' CACD. In other words, the portfolio approach provides auditors with criteria they can use to rank acceptable clients. This responds to a practical problem regularly faced by auditors, as they have to deal with audit firms' limited resources and their inability to accept all interested acceptable audit clients (Boone et al., 2009).

Figure 3 below depicts our CACD theory. This conceptual framework meets all the four propositions developed in this paper. It includes all the three client acceptance and continuance decisions in a unified and coherent setting. In addition, it shows the relationships between the different audit engagement decisions and their impacts on the composition of the audit firm portfolio of audit clients. Consequently, our framework allows the study of the potential relationships, similarities, and differences between the client acceptance, retention, and resignation decisions. It also integrates both the single-client and the clients-portfolio approaches. It recognizes the fundamental role played by the single client decisions factors in the CACD stage while integrating the audit firm portfolio decision factors.

Our conceptual framework starts from the opportunity set of potential audit clients as defined by Asare et al. (1994) and which includes potential prospective audit clients as well as the audit firm current portfolio of clients. This set is assessed periodically through client acceptance decisions for potential prospective clients who are or may be interested in the firm audit services and client continuance decisions for existing clients. As a result, the set of acceptable clients is formed. On one hand, this set includes all the potential clients who successfully meet the audit firm client acceptance criteria on a single basis, and who may therefore be added to its portfolio of audit clients. On the other hand, the set of acceptable clients includes all the existing clients who successfully meet the audit firm client retention criteria on a single basis, and who may therefore continue their audit relationships with the firm. Afterwards, all the clients in the set of acceptable clients are ranked using factors related to the audit firm portfolio. Depending on the audit firm resources limitations and clientele capacity, the firm decides on the new clients who should be accepted/rejected and the existing clients who should be retained/resigned from. As a consequence, the audit firm new portfolio of clients is formed. Obviously, if any of the acceptable clients is not interested in the audit firm services (new client) or decides to dismiss it (existing client), he (or she) is replaced by the next best acceptable client.

Figure 3: Foundation for a General Theory of Client Acceptance & Continuance Decisions



6. Conclusion

The present paper has identified two “poles apart” approaches that emerge from the extant literature to study client acceptance and continuance decisions. The first approach, called the single-client perspective, is frequently used in academia. This approach takes into account the client specific factors only and overlooks the possible impact of the CACD on the audit firm portfolio of clients. The paper has also introduced “the auditor-client relationship life cycle” as a new framework for this perspective, which has the merit of integrating the three audit engagement decisions relating acceptance, retention, and resignation in a coherent setting. The second approach is called the clients-portfolio or also the audit firm portfolio management perspective. This approach considers the set of the audit firm’s clients as a portfolio that the firm purposefully manages.

Additionally, the paper has developed four propositions on the requirements for a successful CACD theory and showed that none of the existing approaches meet all of them. For that reason, the apparent incommensurability of the single-client and the clients-portfolio perspectives has been analysed and the foundation for a general CACD theory that integrates both perspectives and meets the study’s all propositions has been developed. Future research should revisit the client and the audit firm attributes used by auditors during the CACD stage in the light of our CACD framework. A deeper understanding of the single-client and the portfolio perspectives as well as their places, relative importance, and interactions within the auditor’s CACD making process is also necessary to pursue.

Notes:

[1]See Drira (2012) for a detailed review of the literature on client acceptance and continuance decisions.

[2]See Bedard et al. (2008) for more details on this literature.

[3]Note that the authors limited their argument to audit engagement riskiness and ignored the profitability dimension.

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