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Client Acceptance and Continuation Decisions*

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Abstract

This paper presents the results of a study designed to understand how auditors make client acceptance and continuation decisions. Descriptive evidence was gleaned from the professional literature, audit firm materials, and interviews with seven audit partners. Based on the evidence we present a framework that delineates the key activities in this area. Avenues for additional research are presented.

Introduction

Why do auditors accept some companies as audit clients but not others? What types of information do auditors use when making client acceptance decisions? Once a professional relationship has been established, under what circumstances will an auditor terminate the relationship? These and related client acceptance and continuation issues have received limited attention in both the academic and professional literature. The decision to accept an audit client or continue a professional relationship with an existing client is important because an incorrect decision may directly affect the financial viability of an accounting practice.

We interviewed seven practicing audit partners who are responsible for making client acceptance and continuation decisions and reviewed audit firm manuals and professional standards. This paper presents preliminary findings on the task structure, the decision process and its participants, their incentives, and the types and sources of available information that shape such decisions. Our effort is exploratory—to sketch some of the more important issues that are of interest and concern to practitioners and academics alike. Sometimes it will appear that we have raised more questions than we have answered. This is deliberate and follows from our goal of identifying key issues and stimulating further research.

The next section delineates the motivation and presents background information. It is followed by a section that describes the interview method. Then the descriptive information on how auditors make client acceptance and continuation decisions is presented in a framework that emerged as we analyzed the interview results. The final section enumerates some research opportunities.

Motivation and Background Information

Our primary motivation is to understand the client acceptance decision process—in its naturalistic setting—from the perspective of practitioners. The paucity of research

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and the importance of the client acceptance decision, suggested an exploration of that decision environment. The crucial role of such exploration in theory building is aptly demonstrated by work on accountability (Emby and Gibbins 1988; Gibbins and Newton 1993). In this regard, this exploratory study responds to calls to give adequate consideration to the nature of audit tasks, as a prerequisite to evaluating auditors' judgments or formulating theories of audit judgment (Felix and Kinney 1982; Wright 1987; Burgstahler and Sundem 1989; Trotman 1992). Second, we elaborate on the guidance included in the professional standards and academic literature (e.g., Huss and Jacobs 1991; Stice 1991) pertaining to information sources, reliability of evidence, relative importance of different types of evidence, and the extent of information search. We explain why auditors evaluate evidence from various sources differently, and why under certain circumstances (e.g., lapse of time) a discovery of lack of integrity on the part of management will be discounted by an auditor.

Professional guidance on client associations is provided in the Statements on Quality Control Standards (QC) section QC 10 and paragraphs QC 90.23-.24. These standards require that an audit practice establish procedures for evaluating prospective clients and for reviewing the continuation of ongoing relationships. For prospective clients, suggested procedures include (1) obtaining financial statements, (2) performing third-party inquiries, (3) communicating with predecessor auditors, (4) evaluating independence issues, and (5) reviewing pertinent regulatory rules. For existing clients, the emphasis should be on identifying and evaluating significant changes in client circumstances. Examples of significant changes include changes in management, ownership, legal counsel, financial status, litigation status, type of business, and scope of engagement. Whether dealing with prospective or existing clients, the standards require that firms designate a person to be responsible for each decision, inform all personnel of firm policies, and emplace a system for monitoring compliance. Finally, these standards indicate that "the auditor would not necessarily include all the examples or be limited to those illustrated." In effect, the auditor's judgment determines the nature and extent of client acceptance procedures.

Audit firm policies and procedures reviewed tended to restate the professional standards but with emphasis on administration and provision of a paper trail of compliance. At some firms, a lengthy form must be completed, typically consisting of numerous yes/no questions and requiring additional explanation for the no answers. Other firms utilize open-ended questionnaires that allow the auditors to summarize their efforts and findings. Firms differ in the level of approval (e.g., office managing partner or regional partner) that is required for obtaining or continuing any given client relationship. While our initial review of firm manuals indicated firm differences, our interviews suggested that the apparent differences were matters of form rather than substance. Further, procedures that were not explicitly discussed in the manuals were routinely undertaken in the actual decision process depending on the circumstances of the prospective client being evaluated. Therefore, our first proposition is that research on inter-firm differences in client acceptance decisions is not a viable opportunity. As a corollary, we propose that inter-engagement differences are more worthwhile to study.

Interview Method

Seven partners representing four international accounting firms were interviewed in their respective offices located in the same major metropolitan area. Each interview lasted one to two hours. Two of the researchers were present for each interview. The interviews followed a semi-structured format that allowed the interviewee the latitude to convey anecdotal evidence. Prior to the interview, each participant was provided an interview fact sheet that illustrated some of the issues to discuss (see exhibit 1). They were told, however, to add or to delete from the list at their discretion—in effect they described the decision process in whatever way they desired. None of the participants referred to this sheet during the interview. All interviews were taped and transcribed.[1] Partners were chosen because they are responsible for the client acceptance decisions.

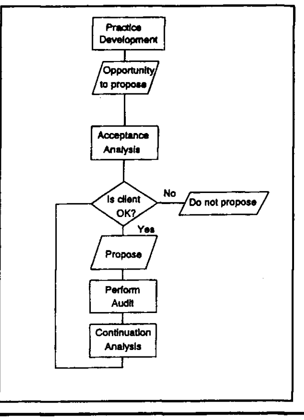
Interview Results

Overview

A content analysis of the interview transcripts suggests that there are four distinct phases—practice development, acceptance analysis, acceptance decision, continuation analysis—of the client acceptance and continuation decision process. Figure 1 is a framework based on this finding. It takes the form of a flow chart.[2] The process starts with *practice development.* The purpose of practice development is to disseminate information about the services provided by the firm and thereby cultivate potential clients. Practice development is usually continuous and low-profile, although it may be aggressive at times when specific target companies are identified and actively cultivated.[3] Typical avenues for practice development include involvement in civic, business, charitable, and social organizations; advertising; high-profile engagements and personal contacts. Size of company, audit fee, prestige, exposure, opportunity for consulting, and timing of the work are among the engagement attributes that accounting firms consider when targeting prospective clients. Successful practice development provides opportunities for auditors to offer their services to prospective clients, often in the form of a proposal.[4]

Figure 1

Flowchart Of The Client Acceptance And Continuation Decision Process



[1] Transcripts of the interviews are available upon request.

[2] The relationship between practice development, acceptance analysis, and acceptance decisions may not be strictly temporal as implied by Figure 1.

[3] Cultivation of prospective clients must be done within the limitations imposed by the Code of Professional Conduct and the applicable state laws.

[4] A proposal is not an engagement letter. We use the term "proposal" to indicate the process by which auditors inform a potential client that they would like to make their services available. An engagement letter is a contract between the parties listing the duties and responsibilities of each. It is completed during the planning phase of an audit.

Exhibit 1

Interview Fact Sheet

The AICPA Quality Control Standards Committee is responsible for developing the profession's quality control standards. It has identified nine elements of quality control for a professional practice. One of these standards pertains to the acceptance and continuance of clients. The purpose of this interview is to gather general information on (1) the guidance the AICPA provides CPA firms on the client acceptance decision, (2) your firm's client acceptance policies and procedures, and (3) the application of these policies and procedures to individual engagements.

For the purpose of this interview, the term business risk refers to the probability that your firm will suffer loss or injury to its practice as a result of providing professional audit services to a particular company. Examples of loss or injury include litigation, tarnished reputation, sanctions imposed by regulatory bodies, lack of profit, etc.

1. We would like to begin the interview by having you describe the process that led to you, as the partner-of-record (partner-in-charge), to accept your newest audit client. It may help to review the client acceptance documents in that company's permanent file as you reflect on the process. This walk-though should include a rather specific description of how the firm's formal (as documented in the audit manual) and informal policies and procedures were applied.
   a. What types of information and evidence did you gather in order to make the decision?
   b. How did you document your reasoning?
   c. Who participated in the process besides yourself? What role did each play?
2. Assume for the moment that a prospective client had approached you about providing audit services.
   a. In general, what characteristics of a prospective client would indicate that it should be accepted?
   b. What characteristics would make you hesitate or think twice about accepting it?
   c. What types of audit engagements would your firm not accept or would be accepted only under special circumstances? What are those special circumstances?
   d. What would be the most likely reasons that you would ultimately decide not to accept a prospective client?
   e. If during an engagement you become aware of facts or circumstances that would have caused you not to accept the prospective client, what would you do?
3. One of the procedures suggested by the Special Committee on Proposed Standards for Quality Control Policies and Procedures was to consider the "riskiness" of the engagement in *accepting* and *planning* an audit engagement (guidelines attached). Is the Committee referring to business risk as defined earlier in the interview? (use revised definition of business risk through the rest of the interview)
   a. How does your firm assess business risk?
   b. What types of evidence is used to assess the riskiness of a prospective client?
   c. How reliable is each type of evidence?
4. Describe an engagement you would consider to have a "high" business risk.
5. Describe an engagement you would consider to have a "low" business risk.
6. In what ways is audit planning affected by these initial assessments of business risk? Is the planning or conduct of the audit any different for those engagements that are judged to have a "high" business risk as opposed to those that are judged to have a "low" business risk?
7. To this point in the interview, we have discussed only client acceptance decisions. The quality control standards also apply to client continuation decisions. How does the client continuation decision differ from the client acceptance decision?
8. In your opinion, does the "Statement on Quality Control Standards No. 1 — System of Quality Control for a CPA Firm" and the "Quality Control Policies and Procedures for CPA Firms" (both are attached) provide sufficient guidance in the area of client acceptance? Explain.
9. Are your firm policies more strict, equally as strict, or less strict than those embodied in "Statement on Quality Control Standards No. 1 — System of Quality Control for a CPA Firm" and the "Quality Control Policies and Procedures for CPA Firms"?
10. Are there any other issues related to the client acceptance decision that we have failed to address or that you would like to clarify or discuss further?

When presented with an opportunity to propose, the auditor performs a series of procedures that we refer to as acceptance analysis. The acceptance analysis may lead to a decision not to propose, and the process would then stop. Alternatively, if the analysis does not reveal any significant *negative* information about the prospect, the auditor will submit a proposal. Therefore, we propose that a noncompensatory decision is used, and rejection decisions are influenced solely by negative evidence (Beach and Frederickson, 1989; Asare and Knechel, 1992). The proposal is a verbal or written offer to provide services; if accepted by the prospective client, it signifies the "go ahead" to perform the audit.[5]

The final activity incorporated in the framework is the continuation analysis. Once the auditor has completed the audit engagement, a decision must be made whether to continue the relationship with the client. There are a number of reasons why an auditor might choose to discontinue an existing client relationship.[6] Participants indicated that, the decision to disassociate from a client involves consideration of information that becomes available during the course of the audit that would have caused the auditor not to propose in the first place if available at the time of the acceptance analysis.[7] If the auditor (and the client) decide to continue their professional relationship, they will enter into an indefinite cycle of auditing the company and reviewing the relationship. The rest of this section is a detailed discussion of the activities in the four phases: (1) practice development and identification of potential clients, (2) acceptance analysis, (3) acceptance decisions, and (4) continuation analysis.

Practice Development and Identifying Potential Clients

This phase is probably the least discussed in either the professional or academic literature. Nonetheless, all the participants highlighted it as a crucial component of their client acceptance decision process. The main role of practice development is to identify the set of prospective clients available to the firm now and in the future. Participants suggested that not all potential clients are a target of the firms' practice development. Specifically, they identified three constraints that defined which clients to cultivate. The first constraint is imposed by the environment. Firms consider only those engagements that they can service in accordance with professional standards (e.g., independence issues) and regulatory and governmental restrictions (e.g., mandatory auditor switch). The second constraint is firm imposed. Clients must meet certain minimum firm standards before they will be considered worthwhile candidates for acceptance. Some companies may be omitted from consideration because they are in a high risk industry (e.g., casinos, savings and loans), are potentially unlawful (e.g., an importer of cut flowers from Colombia), or of questionable repute (e.g., a 900 telephone service or

[5] A proposal may be either formal or informal. For example, a governmental organization may have a legal obligation to follow a very formal process whereas an owner-managed business may have an informal process.

[6] Clients may also choose to discontinue the professional relationship with a firm on the basis of the *ex post* information that they possess after an engagement is complete. The client may consider the fees unreasonable, may dislike the personnel assigned to the engagement, or feel that quality service was not forthcoming from the auditing firm. Whatever the reason for such a client-firm split, we have omitted this case from our analysis because we are primarily concerned with the factors that affect the *auditor's* decision process.

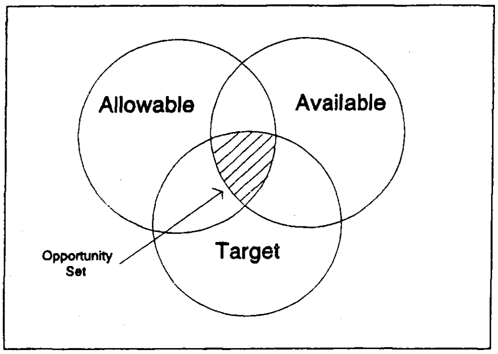
[7] The decision to resign from an engagement can be made at almost any time, even during the course of an unfinished audit. However, withdrawing before completing an audit is obviously an extreme response to extreme conditions, such as discovery of major financial fraud. For the purposes of this paper, we do not exclude those types of events, but we will emphasize the less extreme conditions that would allow the auditor to complete the engagement but then choose to discontinue the relationship.

adult bookstores). The third constraint is auditee imposed. Not only do some clients not solicit bids, but also they are not amenable to the possibility of hiring the firm.

Practice development entails the management and coordination of these constraints. Based on our findings, Figure 2 presents a useful framework for considering firms' practice development efforts. Each point in the Venn diagram is an individual audit engagement. Within the rectangle is every audit engagement to be completed by all audit firms within a specified time period. The area labelled "allowable" represents all audit engagements a particular firm is permitted to serve in the next period. That is the area defined by the environmental constraints. The area labelled "target" represents all engagements that have no obvious disqualifying characteristics. That area is fixed by firm imposed constraints. Finally, the area labelled "available" represents all clients that consider the audit firm a suitable candidate to provide services during the next period—the auditee imposed constraint. This set includes current clients, first-time audit engagements, and companies open to an auditor switch.

Figure 2

Determination Of The Opportunity Set



The intersection created by the three constraints is the set of engagements the firm will include in its current acceptance or continuation analysis. We call this the *opportunity set.* Our findings and the framework suggest several interesting propositions. First, both nonclients and current clients are members of the opportunity set. Second, the size and content of the opportunity set changes over time because the number of possible engagements satisfying each of the three constraints changes each period. Third, the firm can influence many of the factors that alter the composition of the opportunity set. For example, it can broaden its allowable set by acquiring the necessary expertise to service specialized industries, firm philosophies and goals can change in such a way as to broaden or narrow the target market, and successful practice development may increase the number of available companies. Finally, based on practice development efforts, potential clients are classified as desirable, undesirable or unknown. Desirable companies are those that the firm is aware of and, unless evidence to the contrary surfaces, would like to serve. These potential clients are cultivated. Undesirable companies are those that the firm is aware of (either individually or as a class) but, for any number of reasons, prefers to avoid (that is, they are not in the target set in Figure 1). Unknown companies are those that the firm is unaware of but that approach the audit firm for possible services. This latter group includes most start-up enterprises and presents the biggest challenge in terms of acceptance decisions. As described in the next section the extent of acceptance analysis is closely linked to this classification.

Acceptance Analysis

This phase is probably the most discussed in the professional literature. Nonetheless, we unearthed several subtle issues. Acceptance analysis includes the activities undertaken by an audit firm to determine whether to submit a proposal. Seven key issues identified are:

1. firm expertise and staffing,
2. firm independence,
3. client effect on firm reputation and image,
4. client integrity,
5. anticipated profitability of engagement,
6. client financial status, and
7. client accounting practices and control structure.

The importance of each issue depends on whether the client is initially classified as, desirable, undesirable, or unknown. Table 1 summarizes some of the differences.

Firm Expertise and Staffing: Professional standards highlight the importance of having the requisite expertise to handle a specific engagement. Presumably, if the expertise is not present, a firm must turn down the prospective client. Many of the interviewees indicated that turning down work because of lack of expertise or adequate staff is rare since most staffing problems can be overcome by transferring personnel from other offices (in the short run) and by expanding recruiting efforts (in the long run). In some cases, the excuse that the accounting firm lacks expertise is offered as an explanation when the firm wants to refuse work for other, more derogatory reasons (e.g., the suspicion that the management lacks integrity).

Firm Independence: GAAS requires that auditors maintain an independent attitude in both fact and appearance. All interviewees indicated that their firms had procedures for identifying potential independence problems. In some firms, independence is verified with a "negative confirmation." With this procedure, a list of clients is periodically distributed to all audit staff, but only those who have a conflict of interest with a client need respond. Other firms use a "positive confirmation;" the client list is made available to appropriate staff, who sign a form indicating that they are independent.[8] Regardless of the system used, the interviewees felt independence problems caused by direct or indirect ownership interests can almost always be resolved.

Client Effect on Firm Reputation and Image: A client can affect a firm's reputation. As one auditor stated, "We wouldn't want to be known as Al Capone's auditor." The issue of reputation goes beyond the possibility of adverse publicity from litigation.[9] In assessing a potential client's effect on firm reputation, participants emphasized the need to evaluate the nature of the client's business or operations as

[8] One firm used a positive confirmation in the local office and a negative confirmation on a national basis.

[9] Wilson and Grimlund (1990), using SEC disciplinary actions as a surrogate for reputation effects, found that firms with bad reputations had their market share erode relative to other firms. Second tier firms (i.e., non-Big Eight) also had difficulty retaining clients when faced with SEC disciplinary action. Surprisingly, the same second-tier firms did not have a significant fall-off in their ability to attract new clients.

well as the reputation of the client's principal owners. For instance, a client may be turned down because the principal owners or managers have a negative reputation in the business community, and the firm may not want to be associated with that reputation. Auditors may also want to avoid companies in certain types of business because the overall reputation of the business is poor, e.g., adult book stores or penny stock schemes.

Table 1
Aspects of Acceptance Analysis

	Type of Potential Client		
	Known, Desirable	**Known, Undesirable**	**Unknown**
Expertise/ Staffing	Exists or easily obtained via transfers or recruiting.	Lack of expertise may be used as excuse to avoid undesirable clients.	Will try to obtain if client turns out to be desirable.
Independence	Rarely a problem.	Not pertinent.	Family relationships are more likely to be a problem.
Reputation/ Image	Predetermination usually made that this will be a positive effect which must be rebutted by contrary information.	Predetermination usually made that this will be a negative effect that is difficult to rebut.	Will try to evaluate this with extensive research and investigation. Interpersonal references, media research, review of legal documents and client discussions may all be performed. Key concerns center on nature of business operations and reputation of management.
Integrity	Predetermination usually made that this is unlikely to be a problem. Opinion may be changed by further information received during review but extent of review will be limited.	Typically a major reason why the client is not desirable. Requires extensive rebuttal to overcome preconceptions.	Will try to evaluate with extensive research and investigation. (See "Reputation.") Also concerned with competence of management.
Profitability	Often pro forma consideration, as prospective client is assumed to be willing to pay reasonable fees and business risk is not a major concern. Ex post evaluation is more important.	Not pertinent. No fee is high enough.	Fees may be very important consideration. Can the client afford the work that is necessary to issue an opinion, given their records and control structure? Will the client grow and expand its demands for services? Is engagement timing beneficial to firm? Should fees be paid in advance?
Financial Status	Often pro forma consideration since companies having financial difficulties are easily identified.	May be a major reason why the client is not desirable.	Important consideration since one-year clients are not desirable. Firm often concerned with competence of management, under-capitalization, nature of product and service, and existence of sound business plan.
Accounting Practices	May be a problem in certain industries. Firms may need to discuss their strong opinions with the prospective client. Control structure is rarely a problem.	Not pertinent.	May be a problem in certain industries. Firms may need to discuss their strong opinions with the prospective client. Control structure may be a problem.

To assess possible reputation effects, auditors often search media sources, e.g., LEXIS, for news about the company, its owners, and its managers. Additionally, firms often contact existing clients as a matter of courtesy. This is particularly important if the prospective and existing clients are direct competitors, e.g., Coke and Pepsi. The existing client may object to the prospective client, and most firms are not willing to upset long-standing professional relationships for the sake of obtaining a new client. However, this is not always a problem because companies want to hire the "best" firm for their type of business. This often means that the "best" accounting firm is also auditing one or more of their competitors. The trade-off of confidentiality against industry expertise depends on the number of competitors in an industry or geographic region. Therefore, we propose that, the less concentrated an industry, i.e., the greater the number of direct competitors, the greater the willingness of companies to hire an accounting firm that does work for a competitor.

Management Integrity: Without question, assessing management integrity was the biggest specific concern of the interviewees. In fact, the majority of procedures identified and discussed by the interviewees directly related to assessing management integrity. The focus of most client investigations is to try to determine if the client's management is trustworthy. Assessing management integrity involves communicating with management as well as with those familiar with management. If the auditor feels that the management is less than completely candid, uncomfortable feelings may exist about the accounting practices and procedures of the company. A "hard-nosed but honest businessman" or an "individual with the habit of suing for every imagined slight" would also be difficult to deal with; in these situations, taking on the client may not be worth the trouble.

The interviewees identified many routine sources of references for prospective clients. For example, attorneys are routinely contacted. Information received from the current counsel of the client "must be carefully interpreted, however, since attorneys are hesitant to say anything negative about their clients." Other sources of reference are bankers, stockbrokers, ex-employees of the company, alumni of the accounting firm, business acquaintances of the company's management, other clients, colleagues in the firm (especially tax and consulting personnel), and mutual friends. Bankers are regarded as having a high reputation relative to attorneys. This finding, suggests that holding constant the information content of evidence, information obtained from bankers will be considered more reliable that those from attorneys. Availability of reliable references depend on the business environment. For instance, reliable references are difficult to obtain in a business environment where there are many transient entrepreneurs or much foreign investment.

Where such routine sources are lacking, participants stressed the use of more rigorous and formal investigations. They may review recent financial statements for obvious incongruities,[10] obtain a Dun & Bradstreet report on the company, check with the SEC for complaints, review arrest records, or hire an investigation service. If these investigations reveal anything of importance, management is usually given the opportunity to respond or explain. One participant, recalled an investigation which revealed that a member of top management was a subject of criminal investigations several years ago. As explained by that participant, "transgressions that are ancient history do not help, but they sure are not fatal flaws." One partner indicated that he does not use

[10] One interviewee related a story of a retailer who had an inventory turnover ratio of one. The client was turned away because the auditor felt that there was probably something questionable going on in the business.

investigation services because, if he feels that uncomfortable about the potential client, he would simply choose not to propose. Attitude toward using investigation services, did not seem to be influenced by firm affiliation.

The final source of information that was frequently mentioned was the predecessor auditor (when one existed). Communication between predecessor and successor auditors is required by SAS 7. Auditors are usually fairly forthcoming, even when being replaced by another firm, because they realize that they may someday be on the other side. Contrary to SAS No. 7, however, formal communications may not always occur or may occur after the client has been accepted. SEC Form 8K filings, which detail the circumstances of an auditor change, are not always informative either.

Anticipated Profitability of Engagement: The interviewees suggested that virtually all engagements result in little or no profit in the first year (i.e., lowballing). In submitting a proposal, firms focus not on first-year profits but rather on the prospect for future profits from repeat engagements and on opportunities for spin-off work, such as tax or consulting. Alternatively, if most of the work can be performed at a time when staff are unassigned, the fees from the engagement may help cover some of the firm's fixed costs.

Client Financial Status: The participants indicated that they are not interested in accepting a client who is on the verge of bankruptcy since such cases tend to end up in costly litigation and high up-front costs cannot be recouped. Accordingly, the client's financial status is thoroughly assessed prior to proposing. This does not mean that companies in financial difficulty are totally avoided. Auditors also evaluate management plans for dealing with the identified difficulties. In such situations, the key questions become: Is the business legitimate and does the product or service make sense? Is management competent and honest? Does the company have a reasonable business plan? Is undercapitalization the main cause of the company's difficulties? Although not interested in short-term clients, accounting firms stand to gain much from start-up companies with a reasonable plan because these may eventually require more accounting services.

Client Accounting Practices and Control Structure: A key concern that auditors often address early in the decision process is whether the prospective client is auditable. As used here, auditability refers to whether the client's accounting practices and control structure are conducive to accurate and complete record-keeping. The interviewees indicated that they would be wary about submitting a proposal to management that had disagreed with its previous auditors on questions of accounting principles. This is especially true if the previous auditor was a "Big 6".

Acceptance Decisions

"Most of the (acceptance) decisions are fairly easy" and "95 percent (of the time we) are going to accept the client—it's a matter of documenting what we are doing" were comments made by audit partners interviewed. Auditors want to "get to yes." Turning away a client is a difficult choice for many to make since successful recruiting of clients is one criterion often used to judge the promotability of a manager to partner or to determine a partner's share of profits. But even the most aggressive auditor realizes that there are significant risks associated with accepting some companies as clients. Consequently, little negative evidence is needed to reject the client. This suggests that auditors can be characterized as "hungry" yet cautious. Being hungry, the auditor adopts the operating hypothesis that all prospective clients are acceptable. However, because the auditor is cautious, very little negative evidence is required for this hypothesis to be abandoned. Asare and Knechel (1992) have tested and found support for this proposition.

Continuation Analysis

The decision to continue or terminate a professional relationship is similar to the decision to accept a client, but the sources of information for the decisions differ. After completing an engagement, the accounting firm has more information upon which to base its decision. This suggests that external sources of information, such as business or legal references, are less important when the firm has extensive first-hand information. The three key issues that auditors consider when deciding to continue a professional relationship are:

1. Changes in client circumstances that are related to issues considered during the acceptance analysis,
2. Audit results and status of client relations,
3. Actual profitability.

The interviewees indicated that a problem would need to be significant before most firms would resign.

Significant Changes in Client Characteristics: Auditors cannot accept a client and then close their eyes to circumstances that might have caused rejection if previously known. Many of the interviewees indicated that the criteria they use for deciding to continue a client are the same as for accepting a client. The instances of disassociating from a client for reasons of reputation, financial status, expertise, or lack of independence are fairly rare; firms do a good job with their acceptance analysis in these areas. Issues related to management integrity are more likely to pose a problem since the auditor now has inside information about key management. For example, one interviewee related a case where he resigned because the president had been convicted of tax fraud even though the case did not involve the company.

Audit Results and Client Relations: The performance of the audit will reveal information that is relevant to the continuation decision and may lead to conflict between the auditor and the firm personnel or management. Situations involving voluminous related-party transactions, client-imposed scope limitations, and accounting disagreements that cannot be satisfactorily or amicably resolved may lead auditors to conclude that they should withdraw from the client. Other situations may be more subtle, such as when management ignores management letter comments or when the control structure is deteriorating. The interviewees indicated that they would withdraw from an engagement if they are frequently at loggerheads with management, which may occur even if the engagement is an otherwise profitable endeavor.

Profitability: After an audit has been performed, the firm is able to analyze whether the engagement was profitable. Fees, costs, and expenses are all known with relative certainty at that point. The mechanism for determining profitability is the realization rate, computed by dividing the total fees collected for the job by the man-hours employed. This rate is then compared to the "official" billing rates of the audit team. A job that is operating at less than 80 percent realization is being billed at a substantial discount. Realization rates in the first, and even second, year of an engagement may be relatively low. The consensus of the interviewees was that realization should be close to 100 percent by the fourth year. Otherwise, the relationship will be terminated unless there are extenuating circumstances for continuing to discount the job.[11]

Research Opportunities

Throughout the paper, we have identified testable propositions. In this section we will link some of our findings to the academic literature with a view to identifying more research issues. The unifying theme of this section is business risk. Business risk is the likelihood that an accounting firm will suffer a loss due to its association with an audit client in spite of complying with professional standards.[12] Such losses include lawsuits, inadequate profits, and damage to a firm's reputation. Business risk may be best controlled by careful selection of the firm's clients.[13] The interview results indicate that the purpose of the acceptance or continuation analysis is to assess the business risk associated with a current or prospective client. The purpose of this section is to illustrate how the client acceptance framework developed in this paper can be used to generate research questions. Table 2 presents a sample of specific questions.

Business Risk: How Is It Assessed?

The discussion of acceptance analysis indicates that auditors use many types and sources of information to assess business risk. No prescriptive or descriptive research has directly addressed the selection, weighing, or integration of the information available to assess business risk. However, several observations on how business risk is assessed and issues for further research are evident from the interview results. Table 2 enumerates six questions related to this topic.

First, the relative importance of cues and the information evaluation strategies of auditors when assessing business risk are areas amenable to research. Auditors weigh differently the relative importance of the seven types of information discussed in Section 4.2 when assessing business risk. For instance, the interview results suggest that auditor independence and firm expertise and staffing are directly controllable by the audit firm and should play only a limited role when auditors assess business risk. Of the factors that are not directly controllable by the auditor, management integrity and the client's financial status are the most important in the business risk decision. Further, these two factors may be evaluated configurally. If management integrity is low, the assessed level of business risk is likely to be high regardless of the client's financial status. But if management integrity is high, the assessed level of business risk is directly related to the client's financial status.

The information used to assess business risk comes from many sources, particularly in acceptance analysis situations. The interview results indicate that information from current counsel is scrutinized closely, while information from bankers is considered very reliable. The credence attached to the predecessor auditor's communication appears to be affected by the reasons for the auditor switch. Thus, issues related to the

[11] Simon and Francis (1988) reported evidence that indicated fee cutting amounted to 24% in a new engagement and 15% in years 2 and 3 of an engagement, with full fees being received by the fourth year of an engagement.

[12] Section AU 312.02, footnote 2, acknowledges the existence of this risk without giving it a specific name.

[13] Business risk is different from, and subsumes, the concept of audit risk (which represents the likelihood that the auditor will issue an incorrect audit report). Audit risk is controllable by the auditor via proper audit planning and compliance with professional standards.

effect of source reliability on business risk assessments is an area with research opportunities.

Information search strategy is an important facet of the client acceptance analysis. The process can be quite costly, and investigation costs cannot be passed on to the client if the latter is not accepted. Many factors can be expected to influence the information search process, e.g., the economic outlook or whether the client is planning an initial public offering. The interview results indicate that the amount of information gathered varies considerably across engagements. The acceptance/continuation decision process is a context in which research on information search strategies is needed.

Table 2
Research Opportunities

Business Risk: How is it Assessed?

1. To what extent does the relative importance of the seven acceptance analysis issues vary with the classification of the prospective client in the practice development phase?
2. Are business risk assessments influenced by auditor-specific factors such as a sense of professional responsibility and individual motivations?
3. Given the same facts and circumstances, will the business risk assessment differ depending upon whether the potential auditee is a prospective or continuing client?
4. What is the relationship between audit risk and business risk? How does information obtained during the screening of clients affect audit planning?
5. To what extent does a Firm's audit technology influence the assessment and minimization of business risk?
6. Are auditors well calibrated as to their ability to assess and control business risk?

Business Risk: Whose Preferences Prevail?

1. How effective are firm policies (or the partnership agreement) in providing efficient risk sharing among auditor partners?
2. Should firms allocate a greater portion of insurance liability premiums to higher risk clients? If so, how?
3. How is the business risk of a firm affected by clients inherited through firm merger activities?
4. Are auditors on repeat engagements willing to accept a higher (lower) level of business risk than would be accepted on a new engagement?
5. To what extent does the possibility of spin-off work (e.g., consulting and tax) affect an auditor's tolerance of business risk?

Business Risk: How is Audit Pricing Affected?

1. How do business risk assessments affect pricing decisions?
2. Does the classification of a prospective client during the practice development phase affect the extent of lowballing?
3. Does a firm's tolerances of business risk affect their market position?
4. Under what conditions should auditors use fixed fee versus cost plus contracts for pricing audit engagements?
5. What influence do restrictions on practice development (e.g., advertising and soliciting) have on the opportunity set of potential clients and, ultimately the pricing of audit services?

Finally, the relationship among business risk, audit risk and audit planning needs to be unravelled. Preliminary evidence suggests that evidence obtained during the client acceptance process is used to reduce audit testing (Huss and Jacobs 1991; Hackenbrack and Knechel 1994). The pervasiveness and the appropriateness of such a strategy remains unknown.

Business Risk: Whose Preferences Prevail?

Although a firm may have a particular risk tolerance at a conceptual level, the actual business risk assessments are made at the office level and, within an office, at the individual partner level. Partners have different risk tolerances. For instance, newly promoted partners may pursue risky engagements more aggressively than would established partners. Partners who have recently been involved in litigation may be more conservative than they otherwise would be, reducing their risk tolerance. The diversity of such tolerances means that client acceptance decisions made by individuals (or within local offices) may not coincide with the overall objectives of the firm. This observation has important implications for research that assumes a single set of risk preferences for decision making (e.g., Simunic and Stein 1990).

Firms adopt a number of policies and procedures that are intended to reduce such variations in individual risk tolerances and, ultimately, client acceptance decisions. Examples include senior partner reviews and the use of standardized client acceptance checklists. At this point further research is needed to ascertain how effective these techniques are.

Partially tempering these individual differences is the strong sense of partnership responsibility and duty to the accounting profession that was expressed by the partners interviewed for this paper. Personal integrity, professional ethics, and interactions with peers would all contribute to an increase in the effectiveness of firm policies and procedures. The role these intangibles play in the individual partner's risk/return trade-off decisions is an important area for future research. Five questions related to this topic are listed in table 2.

Business Risk: How Is Audit Pricing Affected?

Auditors cannot simply choose companies to add to their client base. They must bid against their competitors for the opportunity to serve a particular company. Consequently, auditors' acceptance/continuation decisions subsume an assessment of the minimum fee they are willing to accept.[14] The interview results indicate that these business risk and bidding decisions are not made in isolation. Rather, they involve comparing the net benefit that can be obtained by adding the company to its current client base. From this "portfolio" perspective, the decision to add a client to the firm's client base is based on the explicit consideration of its riskiness in relation to existing clients. Consequently, business risk plays an important role in an auditor's audit pricing strategy (see also, Simon 1985; Simon and Francis 1988; Simunic 1980).

Prior research indicates that auditors use either a fixed fee or a cost-plus contract to price their audit (Palmrose 1989) and a tendency toward lowballing exists on some initial engagements (DeAngelo 1981; Turpen 1990). The conditions under which

[14] Simunic and Stein (1990) argue that the minimum bid level will include a recovery of direct costs, a recovery of opportunity costs, and a premium based on the perceived risk of the engagement. Simunic and Stein also argue that commonalities such as "client industry, geographic location and types of accounting principles" (p. 332) cause returns across audit engagements to be correlated. We would add the firm's audit technology to this list also. As a result of these commonalities, the decision to add a client to the firm's client base should be based on the explicit consideration of the return, risk, and covariation with existing clients.

either type of contract is used is not well understood, nor is it clear why auditors lowball on some engagements but not others. The interview results indicate that one possible explanation is auditors are more willing to use a fixed fee arrangement or lowball in situations of low business risk. Additional research that examines the relationship between lowballing or bidding strategies and business risk is needed.[15]

Accounting firms will also assess business risk differently in similar situations because they have different cost and revenue functions. The cost of performing an audit can be expected to vary across firms with different audit technologies (Cushing and Loebbecke 1986), industry specialization (Eichenser and Danos 1981) or perceptions of the audit risks of the client at the global, account, or assertion levels. These variations directly affect the extent of audit effort necessary to obtain reasonable assurance that financial statements are free of material misstatements.

The revenue a firm can expect to collect on an engagement will also vary across firms and will depend on such factors as the firm's attitude toward lowballing (DeAngelo 1981; Schatzberg 1990), fee cutting (Simon and Francis 1988; Ettredge and Greenberg 1990; Turpen 1990), and their ability to generate spin-off work in consulting or tax (Simunic 1984; Palmrose 1986; Abdel-Khalik 1990). To the extent that these differences occur, firms will have different assessments of business risk and their bids will differ. The extent to which the cost and revenue functions of firms affect business risk assessments and audit pricing strategies is an important area for future research. We enumerate five research questions related to this topic.

Concluding Remarks

On the basis of a review of the professional literature, audit firm materials, and interviews with audit partners, we presented evidence on how auditors make client acceptance and continuation decisions. Our approach was driven by the lack of prior research, and has identified a number of research issues with practical significance. Auditors' assessments of management integrity is potentially the most rewarding area for further research. The dynamics of the client acceptance process and planning judgments as well as the relative importance of the various information sources identified in professional standards are fertile research avenues. Conversely, inter-firm differences in client acceptance decisions does not appear to be a viable opportunity (cf. Huss and Jacobs 1991).

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[15] Simunic and Stein (1990, 339) conclude that an auditor with a high-risk portfolio of clients will tend to bid low. An earlier attempt to model this decision process is reported in a paper by Scott (1975). His model was based on the assumption that the auditor's loss function (and thus his or her risk) is derived from the utility function (e.g., wealth) of the financial statement user. While interesting, this perspective omits the multi-investment decision problem of the auditor and limits the definition of risk to economic losses by investors that can then be passed on to the auditor (presumably via litigation).

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