

# INVESTIGATING THE FACTORS OF SELECTING AUDIT CLIENTS: EVIDENCE FROM AN EMERGING MARKET

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## Abstract

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This study investigates the insights and criteria audit partners use to select prospective clients in an emerging market. We use questionnaires to solicit responses from a sample of auditors at the partner/manager level in Big and non-Big 4 audit firms with international affiliations in an emerging economy. Descriptive statistical tools including the chi-square test and multiple logistic regression analysis are used for the analysis. This study finds that auditor reputation enhancement and corporate governance effectiveness are significantly associated with the acceptance of listed companies and that the higher financial reporting quality of listed companies and the need to promote audit and assurance services are significant factors affecting such decisions. Audit firms tend to select parents or subsidiaries because of the expected effective audits and reduced misstatement and litigation risks and audit firm industry expertise is needed to mitigate expected client risks to significantly affect the selection of clients with prior-year audit qualifications. Fraud is significantly associated with the selection of clients with prior violations reported by government monitoring bodies. This study is among the few empirical studies in emerging economies that provide insights from practicing auditors on a set of comprehensive attributes that affect the selection of audit clients. The findings have implications for audit partners and firms, auditees, and the audit profession in selecting clients that fit the firm's and profession's vision of audit branding and reputation.

**Keywords:** Audit, Client Selection, Emerging Market, Audit Qualification, Regression Analysis

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## 1. INTRODUCTION

Corporate scandals affect the reputation of the accounting and auditing profession, the quality of financial reporting, and firms' internal control systems (Soltani, 2014; Ha et al., 2019). These

scandals also have a negative impact on the loss of confidence in the profession, reputation, and branding of individual firms, eventually leading to greater failure and non-compliance (Huang & Chong, 2016). Continuing fee pressure, the intensity of competition among audit firms, and increasing

litigation risk require an assessment of how audit partners determine the continuity of their existing clients and how they select their prospective clients. Prior studies tend to focus on the selection of clients based on pricing (Gerakos & Syverson, 2015), expertise (Bleibtreu & Stefani, 2018), location, interpersonal associations, audit firm size (Landsman et al., 2009) and degree of industry specialization (Knechel et al., 2008). Using post-SOX era data, Hsieh et al. (2022) conclude that the Big 4 generally avoids risky clients to avoid potential litigation and loss of reputation. There is no known study on how Big 4 and their non-Big 4 counterparts select their clients in emerging economies compared to developed ones (Hsieh & Lin, 2016). Moreover, the research findings on such selection decisions are inconclusive. In some cases, the criteria tend to focus on screening for clients' engagement risks (Hogan & Martin, 2009; Dickins et al., 2018), while others have focused on clients' inherent and control risks during engagements. Partners use proactive or initiative-taking risk-adaptation strategies that include adjusting audit fees or audit procedures (Dodgson et al., 2019, 2020) or risk management strategies to assess acceptability (Hogan & Martin, 2009). Cook, Kowaleski, et al. (2020) conclude that reputation may affect audit relationships and that the consequences of clients' behavior may affect auditors' reputations. They argue that auditors adjust their portfolios when presented with new information about client behavior. In addition, auditors who are most concerned about their reputation are least likely to deal with clients with high misconduct. Ruan and Zhang (2021) found that top-tier audit firms are more reluctant to accept non-state-owned enterprises in China that are engaged in alleged bribery and corruption. Nevertheless, there remains scant literature on the process and criteria of how auditors select prospective clients and review their relationships with existing clients.

This study provides evidence on how auditors in an emerging economy select their clients, particularly variations in regulatory and jurisdictional enforcement on firms' corporate governance (CG) structures, training of employees within audit firms, level of competition among audit firms, nature, and operational characteristics of audit clients, local versus transnational companies, and investor-driven environments in developed countries. In view of ownership structure differences, a lack of enforceable guidelines, non-availability of liquid assets and finances from banks and institutions, underdeveloped financial markets where generational ties and family involvement often entangle governance and relationships, less-qualified accountants and auditors in business enterprises, and auditing firms presented the current research question of exploring how auditors select their clients in emerging markets by investigating the factors considered in such selection. The findings from this research will have ramifications for the audit profession, regulators, and users of financial statements.

A questionnaire was designed to collect data from audit partners/managers and identify the factors that influence client selection. Our findings reveal that audit firms prefer assignments from listed firms to non-listed firms because of the perception of higher-quality financial reports and reliable internal control systems in

listed companies. In addition, the audit firm's image is enhanced, providing adequate resources to provide the expected level of quality audit services, and complying with local and international auditing guidelines and other regulatory requirements. Moreover, audited financial reports of listed firms have a wider circulation than those of non-listed firms because of the sheer volume of financial statement users and the range of stakeholders. A firm's reputation depends on its number of users. These findings also reveal that audit firms tend to opt for clients who do not receive qualified reports or adverse citations from monitoring bodies or regulators. In addition, audit firms tend to select a parent or subsidiary being audited because of the expected effective audits, and reduced misstatement and litigation risks are significantly associated with such selection. More specifically, the results indicate that the level of an audit firm's industry expertise needed to mitigate risks, including fraud, is the most significant factor affecting the selection of clients with prior-year audit qualifications.

This study adds to our understanding of clients' acceptance decisions and their implications for auditor quality in several ways. First, it provides empirical evidence on a set of comprehensive attributes that link auditors' decisions to select their clients based on ownership structures, group audits, listed versus unlisted firms, types of audit reports, and oversight boards' unfavourable reports. Second, it provides insights from practicing auditors regarding the most significant factors driving the selection of listed companies in an emerging market. Third, it sheds light on the importance of industry specialization based on partners' years of experience as well as clients' ownership structure in the selection process in an emerging market (Basioudis, 2007; Guan et al., 2016). Fourth, this study is the first to examine auditors' perceptions of the factors affecting the selection of clients engaged in prior violations detected by monitoring bodies. Finally, this study is relevant to both regulators and users because of the proximity of auditor-client relationships in promoting audit quality and stakeholders' confidence and images, whereby auditors need to build their reputations while clients need to provide a reliable governance structure to secure confidence from fund providers. Without a constant flow of financial support, clients may face ongoing concerns, regulatory punishments, and adverse reputations and brandings.

The remainder of this paper is organized as follows. In the next two sections, we describe the institutional setting of corporate governance in Egypt, followed by a discussion of the theoretical framework associated with the clients' selection process and research question development. The fourth section describes the research methodology, followed by descriptive statistics and an analysis of the results. In the final section, we provide the summary and conclusions of our study.

## 2. BACKGROUND ON THE EGYPTIAN AUDIT ENVIRONMENT

Egypt is an emerging economy that has experienced radical change throughout its history. The Egyptian setting is dynamic, and its governmental interventions have impacted professional, economic,

financial, legal, cultural, political, accounting, and auditing frameworks (Hassan, 2008). Egypt is one of the few emerging economies that has transformed from a capitalist economy to a planned economy and returned to a capitalist economy. The full cycle witnessed the Egyptian legal structure, initially embraced by French civil law, with a lack of investor protection, legal inefficiencies, and weak enforcement mechanisms for openness and transparency in its economic prowess. Firms are mainly financed by banks that have access to financial and nonfinancial information with stringent audit and accounting regulations (Elbayoumi et al., 2019). Major economic contributions come from banking, financial and investment institutions, insurance and pensions and other finance funds, tourism, revenues from the Suez Canal, telecommunications, and, more recently, the energy sector. Being the largest country in the MENA region in terms of its population and among the largest in Africa, Egypt has become the most appealing investment hub in the region to attract foreign investments, has the most diversified stock market in terms of the range of listed firms and market capitalizations, and is the most active in liquidity in terms of trading volumes. Moreover, the privatization of many state-owned enterprises has stimulated competition and volume of trade, which influences the accounting and auditing professions, firms' governance, disclosure regulatory reforms, and the demand for effective assurance services.

Ebaid (2011) observes that the main difference between the Egyptian CG environment and developed markets is that the former was not based on a mandatory basis, such as in the US, or on a comply-or-explain basis, such as in the UK. Instead, on a voluntary basis firms are under no obligation to follow or offer explanations for failing to comply, except for listed companies with limited penalties from the Egyptian Financial Reporting Authority (FRA). In an institutional setting, where the adoption and monitoring of CG practices are not mandatory, it is unclear how auditors could react to clients' voluntary adoption of CG practices (Sharma et al., 2008). A CG code is used by firms to project positive images of their implementation of reliable internal control systems in pursuit of continuing waves of international trade, funds, and cash flows. Without a clear set of criteria, audit committees nominate external auditors based on their networks, relationships, referrals, past experiences, and connections with external auditors (Chong, 2015). Although all the Big 4 and most of the other remaining global audit networks are present in Egypt, they are affiliated with local Egyptian firms to reduce costs in soliciting local clients and complying with the Egyptian Standards on Auditing (ESA), which is a translated version of the International Standards on Auditing (ISA). Local firms, particularly those without international affiliation, are deprived of serving listed firms because their staff do not have sufficient knowledge of ESA or ISA and remain out of the Big 4s' networks and auditees' nominations. Furthermore, consistent with Egyptian law, only Egyptian citizens are permitted to practice the auditing profession and are qualified members of the Egyptian Society of Accountants and Auditors (ESAA) or members of international professional bodies, such as the Association of Chartered

Certified Accountants (ACCA) and the Institute of Chartered Accountants in England and Wales (ICAEW) (Samaha & Hegazy, 2010). The Egyptian environment is also characterized by weak, untrusted, and inefficient legal justice and related enforcement mechanisms (Elbayoumi et al., 2019). Even with the establishment of an oversight board for audit firms in Egypt, Eldaly and Abdel-Kader (2017) showed that the board faces several challenges that hinder its ability to achieve its objectives. Thus, this study examines the criteria that auditors use when assessing prospective clients from an emerging economy perspective characterized by a lack of resources to provide assurances to investors and other stakeholders (Pattnaik et al., 2018), knowledge gaps in a structured continuous education system, and a platform for practitioners to interact and generate ideas on how to exercise high-quality assurance services and reporting by selecting the right clients for their portfolios.

### 3. LITERATURE REVIEW

Professionalism and commercialism are two conflicting forces that affect auditor client selection. Professionalism arises from agency theory, which requires auditors to add assurance to financial statements prepared by management and reduce information asymmetry (Gendron, 2001). Beattie and Fearnley (1995) identify two primary but interlinked sources of demand for audit quality. These are agency and information demands. Agency costs arise from the separation of ownership and management because an agent will not always act in the best interest of a principal (Jensen & Meckling, 1976). Audits help increase the credibility of financial statements by mitigating costs, including potential litigation and negligence. However, factors such as geographic dispersion, cultural and language differences, and differing legal systems make monitoring difficult (Shroff et al., 2014). In addition, information demand for audit quality reflects the presence of information asymmetry between management and market participants. Selecting credible auditors signals the quality of management's representation of firm financial performance. Chong (2015) stipulated that auditors are expected to express independent opinions and serve their clients in a professional and ethical manner to preserve the integrity of individuals and the profession. Professionalism is counterbalanced by commercialism. Thus, when auditors select their clients, potential, or renewal, they may investigate short-term financial returns and opportunities to provide non-audit services, long-term brand buildings, and reputations. Audit firms need to balance these two forces to ensure that they provide ethical services to clients, whether private or listed (Chen et al., 2019). Private firms with concentrated ownership structures and less asymmetric information tend to have fewer reporting incentives to demand high-quality audit reports on their economic performance because such reports address a handful of stockholders and stakeholders, such as lenders and government agencies (Burgstahler et al., 2006). Unlike small- and medium-sized firms, listed firms have a larger and wider range of financial statement users that require audit firms with adequate resources for services.

Professionalism stipulates that auditors sacrifice opportunities while providing services to maintain their reputations and remain independent (Gendron, 2001). Commercialism forces firms to focus on short-term gains and, in some cases, long-term gains and continue the flow of revenue (Watts & Zimmerman, 1981). Between these two, Big 4 auditors tend to focus on professionalism with weaker incentives for short-term returns than their non-Big 4 counterparts do. The Big 4 firms ensure the allocation of adequate resources for listed-firm audits to ensure quality and reliability in earnings reports (Park et al., 2017), and to protect their reputational capital (Ittonen et al., 2014). Thus, professionalism and commercialism are two key conflicting forces that affect audit partners' selection of audit clients: long-term investment and short-term returns.

At the same time, the auditor-client relationship is a unique setting within a business environment, whereby two parties must balance their desires to maintain a close relationship while exercising independence. Professional standards, including Quality Control (QC) Standards (Association of International Certified Professional Accountants [AICPA], 2014) and Statement on Auditing Standards No. 84 (International Auditing and Assurance Standards Board [IAASB], 2013), require auditors to communicate with preceding auditors inquiring about any significant disagreements with management, fraud, illegal acts, and internal control deficiencies before accepting new clients. QC Standards Section 10 (AICPA, 2014) expects auditors to acquire an acceptable level of understanding of the client's industry or the type of business, audit firms' competence and capabilities, including time and resources, willingness to comply with legal and relevant ethical requirements, and integrity and independence of clients before accepting any assurance assignments. Auditors should conduct clients' background checks including civil or criminal litigations, bankruptcies, and any other violations before engaging in an audit. However, none of these standards offers guidance on how auditors should select their clients. Cook, Kim, and Omer (2020) argue that reputation plays a significant role in financial markets because of the information asymmetry between clients and auditors. Auditors with a high reputation tend to have incentives to deliver a sufficiently high level of audit quality to avoid fraud or misreporting incidents that may harm their reputation and eventually jeopardize their recruitment exercise for clients. Auditors will exert additional effort to prevent their clients from making false or erroneous statements that may mislead investors and hurt their reputations (Coffee, 2019) and constantly review their clientele to screen and eliminate those with high engagement and business risks. However, there is no known template that audit partners can access in their clients' evaluation and selection process.

### 3.1. Audit quality

Some studies have examined the alignment between clients and certain types of auditors based on the size of the audit firm, degree of industry specialization, and criteria for selecting auditees (Landsman et al., 2009). In addition to audit fees,

auditors assess the availability of resources, such as the availability of expertise and a good understanding of clients' nature of businesses, auditees' locations, and the extent of agency problems in the client organizational structure in selecting their audit clients (Knechel et al., 2008). Lennox and Wu (2018) find that a company is more likely to engage a particular auditor if the auditee is an alumni of the audit firm and on the management team, whereas Guan et al. (2016) show evidence that audit quality is negatively correlated with the appointment of an auditor when he/she and the CEO are connected through their educational ties. Brown and Knechel (2016) find that clients' geographic proximity or auditor locality has a positive impact on audit quality by constraining opportunistic earnings management or improving accrual quality. Ettredge et al. (2007) find that the Big 4 tends to accept clients who switch from non-industry specialists to industry specialists and clients that have large boards, large audit committees, and a large percentage of independent directors. This suggests that larger clients are perceived as having adequate internal resources for designing, implementing, and reviewing their control systems. However, given the closeness of auditor-client relationships and the potentially high costs of changing auditors, a shift in relationships arises because of compliance with CG quality (Bell et al., 2015). Audit quality will improve if there is a better fit between auditors and clients in terms of expertise in the industry, an understanding of complicated regulatory requirements, and the client's existing policies on complying with external pressure and demands. Francis et al. (2014) found that higher-level audit quality is associated with the use of a specialist auditor.

In addition, publicly held clients hold more audit risk than closely held private clients do because the greater scope of investors and stakeholders depends on audit reports (Decker et al., 2016). Although auditing private companies have less reputational capital at risk, and the risk of litigation is also lower (Vanstraelen & Schelleman, 2017), auditors may still prefer auditing publicly listed companies. Listed firms tend to portray a relatively high level of internal control systems because of the availability of resources in compliance with regulatory rules and policies, which is an incentive for their acceptance by audit firms. This means that listed firms have higher financial reporting quality and report more conservative accounting than do unlisted firms (Park et al., 2017). Nam (2010) also shows that listed small businesses have a higher persistence of accounting information than unlisted firms do because of the high demand for accounting information by their stakeholders and regulators, and client acceptance decisions are affected by whether a client has a regular listing status. Moreover, financial reporting quality in developing countries is significantly less developed than in developed countries. Wadesango et al. (2016) find a negative association between International Financial Reporting Standards (IFRS) adoption and the earnings management of listed firms in Zimbabwe, indicating an increase in the quality of financial reporting for such companies. However, Kamolsakulchai (2015) provides evidence that quality CG practices and audit committee effectiveness among listed firms in emerging economies contribute to positive improvements in firm performance and

financial reporting quality. It remains unclear how auditors determine the quality of their clients' reporting and the processes that may influence selection criteria. Based on the above discussion, we formulate the following research question:

*RQ1: What are the factors considered by auditors to prefer selecting a publicly listed company for audit compared to a privately held company?*

Audit theory and standards link the scope of audit work to financial reporting quality. Sharing similar audit networks could potentially impair auditors' independence due to client pressures, as group-affiliated firms are unlikely to relinquish their internal measurements and determinations of adjustments, including materiality thresholds, audit samples, and cycles of audits. Audit firms may impair their independence in exchange for retaining the group's audits because of the group's capitalization, size, presence, audit fee generation, and reputation building. Chen et al. (2016) support the notion that group auditors tend to compromise their objectivity by willingly adjusting their audit approaches and conceding to client pressure. Group auditors constantly struggle with materiality allocations among subsidiaries when determining the scope of their audit work (Chong, 2015). Parent auditors may have different materiality thresholds among subsidiaries because they are likely to negotiate a lower materiality threshold to ensure higher financial reporting quality (Glover & Wood, 2014). Moreover, subsidiary auditors may retain the group's audits for strategic market niches, particularly if they have the power to justify their opinions and adjustments (Chong, 2015). Management at the parent level will pressure the group's auditors for audit adjustments and modify audit approaches, forcing parent auditors to compromise their independence to avoid the risk of losing significant engagement and related revenues or worsening their reputations for not continuing their services for incumbent clients. On the other hand, Glover and Wood (2014) provide evidence that subsidiary auditors tend to exercise a higher level of reporting quality for these group accounts than nonconsolidated ones, implying that auditors may perform extensive audit tests and assessments for individual subsidiaries to ensure high-quality consolidated results. There is also the perspective that sharing the same network auditor among group-affiliated firms is likely to enhance audit quality because of potentially increased knowledge about the client. Sharing the same network auditor decreases information asymmetry between the client firm and the auditor, leading to better risk assessment and timely detection of critical accounting issues (such as related party transactions) relative to using unaffiliated auditors (Sun et al., 2020). From this perspective, we expect that increased audit quality resulting from auditing a client with an existing parent or subsidiary could motivate auditors to accept such clients. Thus, we developed the second research question as follows:

*RQ2: What are the factors considered by auditors to prefer selecting a client with an existing parent or subsidiary compared to an unaffiliated company?*

### 3.2. Audit risk

Auditors are sensitive to risks and avoidance. A large accounting firm is highly unlikely to accept new auditing engagements that switch auditors

during the term, especially if the switch occurs without stockholders' approval at annual general meetings (Chong, 2015). Further, large audit firms are concerned with their brands and reputations, memberships in global audit networks, and the ramifications of audit failures. This impacts ongoing and ultimate trust and confidence between clients and stakeholders. Audit partners are more inclined to manage clients' risk by avoiding risky clients but by adapting to clients' present and perceived risks. Previous research indicates that smaller audit firms strategically accept new clients and make both pricing and personnel resource allocation decisions to penetrate the audit market niche and yield a deliberate client portfolio (Cook, Kowaleski, et al., 2020). In addition, some audit firms take the calculated risk of litigation and engagement risk and use representation letters and extensive substantive tests as leverage to minimize risk and increase audit fees. Iriving and Walker (2012) find that large audit firms are likely to avoid clients' high-risk comments arising from Form 8-K filings, clients with complicated operations, and clients with modified audit opinions. Similarly, Cassell et al. (2012) find that clients with lower corporate governance switch from a Big 4 to a non-Big 4, although no significant difference exists between firms' resignations and dismissal. Ghosh and Tang (2015) indicate that the odds of future adverse outcomes are higher when a Big 4 firm resigns from engagements, regardless of the successor. In addition, firms that receive a qualified opinion will face a loss of confidence among investors and fund providers, thereby jeopardizing their financial situation and eventually business risk (Li et al., 2018). As stated previously, professionalism and commercialism are conflicting notions auditors face when selecting a new client or continuing with an existing one. Papadopoulou's (2021) study showed that even though audit firms present a tendency towards "professionalism", auditors tend to deviate from this, turning towards the "commercialism" of the auditing services they provide. However, commercialism can undermine audit quality and increase reputational risk (Papadopoulou, 2021). In emerging economies, Sori and Karbhari (2006) find that audit firms, especially the Big 4, are risk-averse to litigation arising from irregularities and are unwilling to associate themselves with public scandals or audit failures, particularly in emerging economies, including Egypt, where there is weak, untrusted, and inefficient legal justice and related enforcement mechanisms (Elbayoumi et al., 2019). Fadaly (2018) concludes that audit firm reputation is the key variable that significantly affects the client selection process in emerging markets. Thus, we expect auditors to be cautious when they are ready to accept clients with unfavorable opinions. This leads to the third research question:

*RQ3: What are the factors that affect the selection of clients with prior year audit qualifications?*

Effective monitoring of the securities market and investigations by the Securities and Exchange Commission (SEC) help enhance investors' confidence in the market. Firms' past behavior is a good predictor of their future behavioural patterns. Interested parties can access a firm's past violations to predict financial misreporting and asset concealment. Decker et al. (2016) argue that before accepting a client, auditors need to search for the client's civil litigation, criminal litigation, and

SEC violation and assess the significance of such matters. Past noncompliance records indicate a firm's future financial reporting risk (Kedia et al., 2017). Choi et al. (2019) observe that when a firm violates non-accounting securities regulations, it violates generally accepted accounting principles (GAAPs). Restatements in the previous period reflect a firm's severe control system failure. Since audit firms in emerging economies are risk-averse to litigation arising from irregularities and are willing to protect their reputations (Fadaly, 2018), we expect these audit firms to consider clients' prior violations based on citation issues by oversight boards. The above discussion led us to answer the fourth research question.

*RQ4: What are the factors that affect the selection of clients with unfavourable reports issued by monitoring government boards?*

### 3.3. Clients' organizational structure

Auditors charge fees according to the time and effort spent on a task. The task itself depends on the complexity and volume of the transactions, the complexity of the client's organizational structure, and the reliability of internal control systems (Adelopo et al., 2012). Variant ownership structures give rise to different control mechanisms used by shareholders to monitor a firm's daily business affairs, including its financial reporting processes. Khan et al. (2011) argued that ownership is a dominant governance mechanism in emerging economies that is likely to influence the financial reporting process, which might affect the auditor's risk assessment process. Prior research shows that audit fees are positively related to client size, complexity, and business risk (Ashbaugh et al., 2003), and the amount of audit work, time, and effort provided by auditors. Nelson and Mohamed-Rusdi (2015) concluded that firms with diverse ownership types, such as government ownership and foreign ownership, have a lower control level on business risks because shareholders lack incentives to monitor management activities and decrease auditors' reliance on clients' internal controls. Furthermore, audit firms may not have the resources, skills, or knowledge to understand the policies and control structures implemented by local governments and foreign firms. Concentrated management ownership tends to have a strong control mechanism because of joint efforts to ensure proper control systems compared to government ownership, whereby each shareholder has small investments and fewer incentives to monitor the organization's activities and operations. Agency theory stipulates that management incentives, costs, exposure to disciplinary and market forces, and complexity of ownership structures could contribute toward the economic performance of the state versus private ownership, and thus, the extent of audit risk and fees (Goldeng et al., 2008). Alhababsah (2019) shows evidence of the importance of family ownership in ensuring high-quality audits in Jordan. Harahap and Prasetyo (2018) report a significant positive relationship between audit fees and firms with greater foreign ownership (high complexity of financial reporting and geographical differences) or government ownership (low interest in control) and a significant negative relationship with firms with higher managerial ownership in an emerging setting.

Different ownership structures affect various levels of clients' financial performance and, thus, the audit process, fees, and quality. This leads to the fifth research question.

*RQ5: What are the ownership structures that are given priority in an audit client selection?*

In summary, the criteria for accepting clients are complex because of the multitude of variables ranging from financial indicators to non-financial indicators, such as engagement risks, internal control risks, and litigation. Any decision, correctly or incorrectly in the appointment decision, may impact auditors' professionalism, reputation, branding, quality of work, and ethics. The literature remains relatively silent on how auditors select their clients, which raises curiosity about understanding the underlying reasons and implications of the process in an emerging economy setting.

## 4. RESEARCH METHODOLOGY

We use questionnaire surveys to gather data from a wide range of professionals in the top 10 audit firms, all with international affiliations with global audit networks, including the Big 4 in Egypt. Thus, this study is based on the collection of primary data. Data was collected over the period from July 2020 to October 2020.

We first piloted our questionnaires by emailing the instrument to three audit partners of international audit firms and two academics for feedback on the clarity of the questionnaire's wording, appropriateness, and completeness. We contacted the technical partners of the targeted firms by phone and followed up with email. Upon receipt of willingness to participate, we attached a copy of the questionnaire with a cover letter explaining the purpose and importance of the responses in helping the audit profession and auditees understand the process of selecting audit assignments. We attest to the confidentiality and anonymity of the participants' responses in our email communication.

Each questionnaire consists of six main sections. The first section asked the participants to indicate their demographic data. For the remaining five sections, we focused on measuring the respondents' perceptions of the variables used in the client selection process based on a five-point Likert scale to assess the respondent level of agreement or disagreement (where 5 = "Strongly agree" and 1 = "Strongly disagree"). The participants' responses to the variables are shown in Table 2. Those variables are based on prior literature (Park et al., 2017) as well as the unique characteristics of the Egyptian setting. The second section examines the factors that affect the selection process of potential clients from listed firms compared with unlisted ones. The third section focuses on the factors that affect the selection of clients with existing parents or subsidiaries. The fourth section asks participants about the factors they would consider when selecting a client with prior-year audit qualifications. The fifth section examines whether respondents consider prospective clients who have received unfavourable reports from oversight boards, and the factors affecting their decisions. Finally, we examine the types of ownership structures that were prioritized in the selection process.

We kept the total number of questionnaires at 200 and allocated them based on the proportionate number of partners and managers. Out of the 200 questionnaires, we received 98 (49%) completed responses. Five questionnaires were excluded due to the respondents failed to complete the instruments and 93 (47%) were useable instruments. Table 1 shows the respondents' background.

## 5. DESCRIPTIVE STATISTICS AND ANALYSIS OF THE RESULTS

### 5.1. Descriptive statistics

We used Cronbach's alpha test to measure the reliability and internal consistency of the responses, with results of 0.875, 0.754, 0.846, 0.889, and 0.809 in the respective sections of the questionnaire. The responses were above the minimum threshold of 0.7 indicating an acceptable level of reliability and consistency among the responses.

**Table 1.** Demographics

| Type of international audit firm | No. | %  |
|----------------------------------|-----|----|
| Big 4                            | 30  | 32 |
| Non-Big 4                        | 63  | 68 |
| Participant's rank               | No. | %  |
| Vice-audit managers              | 17  | 18 |
| Audit managers                   | 41  | 44 |
| Audit partners                   | 35  | 38 |
| Industry specialization          | No. | %  |
| Manufacturing                    | 38  | 40 |
| Services                         | 8   | 9  |
| Manufacturing and services       | 11  | 12 |
| Financial institutions and banks | 9   | 10 |
| Different specializations        | 27  | 29 |

Table 2 provides the means and standard deviations on the percentage of agreements in the variables that auditors apply in their client selection process. The findings show consistency among the responses indicating the reliability of the survey results, with a detailed analysis of the individual variables illustrated below.

#### 5.1.1. Acceptance of listed company audits

Table 2, Panel A, presents the factors most often identified as important when selecting a listed firm. It shows that 80.7% of the participants prefer a listed firm audit. The most agreed upon factor of accepting those firms is enhancing auditor reputation and branding as it gained the highest mean rank of 4.33. The least agreed-upon factors for accepting a listed firm are the high audit fees expected from auditing such firms (mean of 3.89) and the high reputation of the board of directors (BOD) and related committees of those firms (mean of 3.88). Auditors tend to delay benefiting from higher audit fees in later years given the significant effects related to word of mouth about "branding" when accepting listed companies. According to the descriptive statistics, acceptance of listed firms with effective corporate governance systems will enhance the audit firms' reputation, the firms' specific knowledge, and auditor independence thus asserting audit quality and reducing audit risks and litigations. However, we base our results on the multiple logistic regressions that follow.

#### 5.1.2. Acceptance of an existing parent or subsidiary audit client

With the highest mean of 4.01, as shown in Table 2, Panel B, the respondents indicated that the expected effective audit due to sufficient client-specific knowledge is the key factor driving the selection of a client with an existing parent or subsidiary. Other factors cited as important, but with a lower mean rank, are additional negotiation power over the client, low misstatement risk, and low litigation risk. reduced risk of losing existing engagements is the least acceptable factor (64.5% of agreement and mean of 3.67) for accepting those clients. An interpretation of these results is that group audits allow more control and monitoring of the audit performance of all entities and help achieve both audit quality and independence. Acquiring a few groups of audits would reduce the risk of losing existing engagements given the number of entities audited within such groups and the benefits associated with such multiple audit engagements.

#### 5.1.3. Acceptance of audit qualification clients

It was found that 68.9% of the participants preferred accepting audit assignments that had no prior modified audit opinion. However, certain factors must be considered when deciding on the acceptance of clients with prior audit qualifications. The most agreed-upon factors are the level of industry expertise needed to mitigate such risks and the extent of reputational and litigation risks that could result from auditing clients, with mean responses of 4.24, 4.18, and 4.15, respectively. Apart from qualified reports, respondents considered the availability of audit firm resources and effective risk management strategies to be key factors affecting their selection of risky clients. The occurrence of the pandemic as well as the negative economic situation worldwide in recent years has placed more pressure on auditors to accept clients with modified audit opinions and assume possible negative effects on their reputation and litigation risks.

#### 5.1.4. Acceptance of an unfavourable report issued by the monitoring government board

From the survey, many participants (87%) indicated that acceptance decisions were also affected by unfavourable reports issued by the monitoring government board, such as the Egyptian FRA, in the prior year's audit. The extent of fraud cases and accounting violations involved in the report gained the highest percentage of agreement (90% and 87%) and highest mean rank (4.28 and 4.17) among the factors that auditors consider when accepting a client with such unfavourable reports. This is followed by the frequency of receiving such a report (mean of 4.08) and the severity of enforcement actions, that is, penalties or lawsuits (mean of 4.01), as additional attributes.

#### 5.1.5. Acceptance based on ownership structures

According to the survey, 79.6% of the participants preferred accepting a publicly listed firm audit, and about 70% preferred those with large managerial

ownership reflecting on these clients and had stringent internal control systems to meet the regulatory requirements. However, companies that were state-owned enterprises, family companies, and those with high local investments gained

percentages of agreement of only 63.4%, 49.5%, and 48.4%, respectively. The extent of managerial ownership provides stockholders with confidence that management has.

Table 2. Descriptive statistics

|  | <i>Strongly agree/Agree</i><br>[4-5] (%) | <i>Neutral</i><br>[3] (%) | <i>Strongly disagree/Disagree</i><br>[1-2] (%) | <i>Mean<sup>a</sup></i> | <i>SD</i> |
|--|--|---------------------------|--|-------------------------|-----------|
| <b>Panel A: Selection of listed versus unlisted companies</b>  |  |                           |  |                         |           |
| Priority of selection for listed versus unlisted companies   | 80.7                                     | 16.0                      | 3.3  | 4.04                    | 0.793     |
| <i>Factors that affect selection of listed versus unlisted companies</i>   |  |                           |  |                         |           |
| Enhancing auditor reputation and branding ( <i>REP</i> )   | 88.4                                     | 7.5                       | 1.1  | 4.33                    | 0.665     |
| Auditors enhance their specific knowledge ( <i>KNOW</i> )  | 81.8                                     | 12.0                      | 5.4  | 4.17                    | 0.855     |
| More effective corporate governance ( <i>CG</i> )  | 80.6                                     | 18.3                      | 1.1  | 4.09                    | 0.717     |
| Enhancing auditor independence through restrictions in providing some non-audit services ( <i>IND</i> )            | 82.6                                     | 19.4                      | 1.1  | 4.06                    | 0.719     |
| Demand for high audit quality ( <i>AQ</i> )  | 71                                       | 29                        | 0  | 4.01                    | 0.773     |
| Promoting audit and assurance services within the stock market ( <i>AUDSER</i> )                                   | 78.5                                     | 18.3                      | 3.3  | 3.98                    | 0.737     |
| Management compliance with laws and regulations ( <i>MANGCOMP</i> )  | 74.2                                     | 23.7                      | 2.2  | 3.97                    | 0.758     |
| Higher financial reporting quality ( <i>FRQ</i> )  | 74.2                                     | 22.6                      | 3.2  | 3.96                    | 0.779     |
| Higher audit fees ( <i>FEE</i> )   | 71                                       | 28.0                      | 1.1  | 3.89                    | 0.714     |
| Highly reputable BOD and other related committees ( <i>REPBOD</i> )  | 66.7                                     | 33.3                      | 0  | 3.88                    | 0.735     |
| <b>Panel B: Selection of clients with existing parent or subsidiary</b>  |  |                           |  |                         |           |
| Priority of selection for clients with an existing parent or subsidiary compared to unaffiliated company           | 68.8                                     | 29                        | 2.2  | 3.85                    | 0.736     |
| <i>Factors that affect selection of clients with existing parent or subsidiary</i>                                 |  |                           |  |                         |           |
| Expected effective audit due to sufficient client specific knowledge ( <i>EFFAUD</i> )                             | 76.4                                     | 20.4                      | 3.2  | 4.01                    | 0.787     |
| Additional negotiation power over client ( <i>NEGPWR</i> )   | 81.7                                     | 16.1                      | 2.2  | 3.97                    | 0.650     |
| Low risk of misstatement due to sufficient knowledge about the group ( <i>LOWMISRISK</i> )                         | 67.8                                     | 26.9                      | 5.4  | 3.81                    | 0.798     |
| Low litigation risk due to familiarity with the client's system of control ( <i>LOWLITRISK</i> )                   | 65.6                                     | 20                        | 6.5  | 3.72                    | 0.771     |
| Reduced risk of losing existing engagement ( <i>ENGRISK</i> )  | 64.5                                     | 26.9                      | 8.6  | 3.67                    | 0.825     |
| <b>Panel C: Selection of clients with prior year audit qualifications</b>  |  |                           |  |                         |           |
| Priority is for client that has received unqualified opinion compared to those with prior audit qualifications     | 68.9                                     | 26.9                      | 4.2  | 3.84                    | 0.784     |
| <i>Factors that affect selection of clients with prior year audit qualifications</i>                               |  |                           |  |                         |           |
| Level of audit firm industry expertise needed to mitigate expected client risks ( <i>INDUSTEXP</i> )               | 92.5                                     | 7.5                       | 0  | 4.24                    | 0.579     |
| Extent of reputational risk involved ( <i>REPRISK</i> )  | 88.2                                     | 6.4                       | 5.4  | 4.18                    | 0.820     |
| Extent of litigation risk involved ( <i>LITRISK</i> )  | 85                                       | 9.6                       | 5.4  | 4.15                    | 0.846     |
| Availability of audit firm resources to mitigate expected client risks ( <i>RESOURCES</i> )                        | 83.9                                     | 16.1                      | 0  | 4.11                    | 0.650     |
| Effectiveness of audit firm's risk management strategies to mitigate expected client risks ( <i>RISKMAGSTRAT</i> ) | 79.5                                     | 19.4                      | 1.1  | 4.05                    | 0.713     |
| <b>Panel D: Unfavourable regulatory reports and client acceptance decision</b>                                     |  |                           |  |                         |           |
| Acceptance of an audit client is affected by the unfavourable reports issued by monitoring government board        | 87.1%                                    | 8.6                       | 4.3  | 4.11                    | 0.729     |
| <i>Factors that affect selection of clients with unfavourable reports issued by monitoring government board</i>    |  |                           |  |                         |           |
| Extent of fraud cases involved in the report ( <i>FRAUD</i> )  | 90.3                                     | 7.5                       | 2.2  | 4.28                    | 0.697     |
| Extent of accounting violations involved in the report (GAAP or IFRS) ( <i>GAAPVIO</i> )                           | 87.1                                     | 10.8                      | 2.2  | 4.17                    | 0.701     |
| Frequency of the client receiving reports due to consistent non-compliance to laws and regulations ( <i>FREQ</i> ) | 75.3                                     | 22.6                      | 2.2  | 4.08                    | 0.811     |
| Severity of enforcement actions (penalties/lawsuits) ( <i>PEN</i> )  | 71                                       | 26.8                      | 2.2  | 4.01                    | 0.827     |
| <b>Panel E: Ownership structures and client acceptance decision</b>  |  |                           |  |                         |           |
| Types of ownership structure affect priority in client acceptance decisions  | 66.7                                     | 23.7                      | 9.6  | 3.75                    | 0.868     |
| <i>Audit firms are more likely to accept clients with the following ownership structures</i>                       |  |                           |  |                         |           |
| Company publicly listed ( <i>PUBLIC</i> )  | 79.6                                     | 17.2                      | 3.2  | 3.96                    | 0.706     |
| Company with large managerial ownership ( <i>MANAG</i> )   | 69.9                                     | 25.8                      | 4.3  | 3.82                    | 0.751     |
| The company a state-owned enterprise ( <i>STATEOWNED</i> )   | 63.4                                     | 33.3                      | 3.2  | 3.72                    | 0.713     |
| The company a family company ( <i>FAMILY</i> )   | 49.5                                     | 47.3                      | 3.2  | 3.68                    | 0.849     |
| The company only involves local investments ( <i>LOCAL</i> )   | 48.4                                     | 48.4                      | 3.2  | 3.47                    | 0.601     |

Note: a. Responses are ranked by the mean statistic. Perceived interest in the firm's growth in values and wealth and serving the firms in capacity as both agents and stockholders. Ranges on a Likert scale: "Strongly disagree" = 1, "Disagree" = 2, "Neutral" = 3 "Agree" = 4, "Strongly agree" = 5.

## 5.2. Multiple logistic regression

We proceeded with the logistic regression assessment of the responses to model the probability of a certain class or event existing binary, such as pass or fail. In our study, we assigned each object a yes or no binary client acceptance decision based on the values of a set of independent variables that affect the decisions. We used 0 to denote no agreement, which corresponds to an arithmetic mean of less than 3.4 on a five-point Likert scale, compared to an agreement that takes the value of 1 and corresponds to an arithmetic mean greater than or equal to 3.41. We used the chi-square test to ensure independence and a contingency test to assess the strength of the relationships among variables. Logistic regression uses the stepwise forward method, which retains the predictor/variable with the most significant score statistic. We base our results on these tests.

### 5.2.1. Acceptance of listed companies

The chi-square test in Table 3a shows whether there is a significant association between the priority of accepting a listed company and an unlisted one (the dependent variable), and the factors perceived by auditors affecting such decisions (independent variables). The test reveals that seven out of ten variables are significantly associated with the decision to accept listed client audits, with

a p-value of < 0.005, although auditors' specific knowledge, independence, and higher audit fees are not significantly associated with such acceptance decisions. The logistic regression in Table 3b also supports correlations between the independent and dependent variables (chi-square value of 56.390 and  $p < 0.01$ ). Hosmer and Lemeshow's test shows that the model adequately fits the data ( $p > 0.05$ ).  $R^2$  shows 73% of the total variation in the log odds ratio, revealing the independent variables are acceptable in the model (*FRQ* and *AUDSER*). According to the Wald statistic, selecting a listed firm audit is the priority among the variables because of its higher financial reporting quality (*FRQ*) and the need to promote audit firms' audit and assurance services within the stock market (*AUDSER*). Positive coefficients of 2.116 and 3.577 support the log odds ratio of the outcome, which is the likelihood of accepting listed firms' audits. The model below (Eq. (1)) shows that stepwise regression retained only two variables (*FRQ* and *AUDSER*) and removed the other variables as they have little impact on how the model fits the data. These two variables have the most significant score statistics and drive listed companies' auditor choices in an emerging setting. These findings are consistent with those of Chow et al. (2006) and Nam (2010) that acceptance decisions are affected by client listing status. They are also consistent with the notion that listed firms have higher financial reporting quality and report more conservative accounting than unlisted firms (Park et al., 2017).

**Table 3a.** Chi-square test and contingency coefficient: Acceptance of listed companies

| Factors affecting the selection of a listed company in its relationship with priority for client selection | Chi-square test |          | Contingency coefficient |
|--|-----------------|----------|-------------------------|
|  | Value           | Sig. (P) |                         |
| REP.   | 5.266           | 0.022    | 0.232                   |
| KNOW   | 0.039           | 0.844    | 0.020                   |
| CG   | 9.001           | 0.003    | 0.297                   |
| IND  | 1.192           | 0.275    | 0.113                   |
| AQ   | 15.343          | 0.000    | 0.376                   |
| AUDSER   | 60.036          | 0.000    | 0.626                   |
| MANGCOMP   | 4.049           | 0.044    | 0.204                   |
| FRQ  | 46.389          | 0.000    | 0.577                   |
| FEE  | 2.573           | 0.109    | 0.164                   |
| REPBOD   | 11.160          | 0.001    | 0.327                   |

**Table 3b.** Results of the logistic regression: Acceptance of listed companies

| Independent variables | Estimated coefficient (b) | Wald test |       | Chi-square test |       | Nagkerke R <sup>2</sup> |
|-----------------------|---------------------------|-----------|-------|-----------------|-------|-------------------------|
|                       |                           | Value     | Sig.  | Value           | Sig.  |                         |
| FRQ                   | 2.116                     | 3.729     | 0.050 | 56.390          | 0.000 | 0.727                   |
| AUDSER                | 3.577                     | 11.178    | 0.001 |                 |       |                         |
| Constant              | -1.695                    | 7.432     | 0.006 |                 |       |                         |

Note: Chi-square Hosmer and Lemeshow test = 2.773 (Sig. > 0.05).

$$\ln\left(\frac{p}{1-p}\right) = -1.695 + 2.116FRQ + 3.577AUDSER \quad (1)$$

### 5.2.2. Acceptance of client with an existing parent or subsidiary

In Table 4a, the chi-square test ( $p < 0.05$ ) shows a significant association between selecting a client with an existing parent or subsidiary and three factors affecting such decisions: expected effective audit (*EFFAUD*), low litigation risk (*LOWLITRISK*), and reduced risk of losing existing engagement (*ENGRISK*). However, the expected additional negotiation power ( $p = 0.862$ ) and low risk of

misstatements ( $p = 0.865$ ) were not significantly associated with the likelihood of accepting those clients ( $p > 0.05$ ). This result may not support that of Sun et al. (2020) that sharing the same network auditor leads to a better assessment of risk and timely detection of critical accounting issues relative to using unaffiliated auditors. The logistic regression models on *EFFAUD*, *LOWLITRISK*, and *ENGRISK* (Table 4b, Eq. (2)) have positive estimated coefficients of 0.642, 1.413, and 0.295, respectively, indicating a high log odds ratio of accepting existing clients

with a parent or subsidiary with a Wald test of  $> 0.05$ . In line with Homser and Lemeshow's specifications, the model has an adequate fit to the data ( $p > 0.05$ ) and an  $R^2$  of 18.2% on the acceptability of the independent variables. In sum, although auditors' decisions to select

a client with an existing parent or subsidiary are significantly associated with expected effective audits due to clients' specific knowledge, reduced litigation, and engagement risk, these set of factors do not sufficiently explain the predictability ( $R^2$  of 18.2%) of such decisions.

**Table 4a.** Chi-square test and contingency coefficient: Acceptance of client with an existing parent or subsidiary

| Factors affecting selection of a client with an existing parent or subsidiary being audited with priority for client selection | Chi-square test |          | Contingency coefficient |
|--|-----------------|----------|-------------------------|
|  | Value           | Sig. (P) |                         |
| EFFAUD   | 4.755           | 0.029    | 0.221                   |
| NEGPWR   | 0.030           | 0.862    | 0.018                   |
| LOW MISRISK  | 0.029           | 0.865    | 0.018                   |
| LOW LITRISK  | 8.050           | 0.005    | 0.282                   |
| ENGRISK  | 7.136           | 0.008    | 0.267                   |

**Table 4b.** Results of the logistic regression: Acceptance of client with an existing parent or subsidiary

| Independent variables | Estimated coefficient (b) | Wald test |       | Chi-square test |       | Nagkerke R <sup>2</sup> |
|-----------------------|---------------------------|-----------|-------|-----------------|-------|-------------------------|
|                       |                           | Value     | Sig.  | Value           | Sig.  |                         |
| EFFAUD                | 0.642                     | 1.224     | 0.269 | 12.918          | 0.024 | 0.182                   |
| NEGPWR                | -0.630                    | 0.873     | 0.350 |                 |       |                         |
| LOWMISRISK            | -0.940                    | 2.378     | 0.123 |                 |       |                         |
| LOWLITRISK            | 1.413                     | 1.811     | 0.178 |                 |       |                         |
| ENGRISK               | 0.295                     | 0.098     | 0.754 |                 |       |                         |
| Constant              | 0.438                     | 0.356     | 0.551 |                 |       |                         |

Note: Chi-square Hosmer and Lemeshow test = 6.140 (Sig.  $> 0.05$ ).

$$\ln\left(\frac{p}{1-p}\right) = 0.438 + 0.642\text{EFFAUD} - 0.630\text{NEGPWR} - 0.940\text{LOWMISRISK} + 1.4133\text{LOWLITRISK} + 0.295\text{ENGRISK} \quad (2)$$

### 5.2.3. Acceptance of clients with prior years' qualified audit opinions

Table 5a reveals that there is no significant association between auditors' decision to accept a client with a modified audit report compared to an unmodified opinion ( $p > 0.05$ ) and the factors affecting such decisions, except for whether auditors have the required level of industry expertise to mitigate the associated audit risks (*INDUSTEXP*) (p-value of 0.017 and contingency coefficient of 0.241). In addition, the regression results support the notion that an auditor's expertise (*INDUSTEXP*) is a crucial factor and the most significant predictor of whether to accept a client with prior audit qualifications, with a p-value (Wald test) of 0.024 and positive *b* of 2.607. Interestingly, the respondents indicated that reputational risk (*REPRISK*) and availability of resources (*RESOURCES*) do not significantly impact accepting such clients

(coefficients of 1.122 and 0.584, respectively), although the chi-square test is 13.095 at a significance level of 0.07. This indicated that the overall independent variables did not statistically affect the likelihood of accepting clients with qualified opinions. The Homser and Lemeshow test showed that the model adequately fit the data ( $p > 0.05$ ).  $R^2$  (18.5%) shows that the overall independent variables included in the model explain 18.5% of the total variation in auditors' decisions to accept clients with prior audit qualifications. The only significant factor that may affect the acceptance of those clients is the level of the audit firm's industry expertise needed to mitigate expected client risks. These results are consistent with the findings of limited studies that audit firm industry specialization enhances the quality of client disclosure and reduces accounting restatements and fraudulent financial reporting (Dunn & Mayhew, 2004; Romanus et al., 2008).

**Table 5a.** Chi-square test and contingency coefficient: Acceptance of clients with prior years' qualified audit opinions

| Relationship between factors affecting the selection of clients with unqualified rather than qualified opinion and the acceptance decision | Chi-square test |          | Contingency coefficient |
|--|-----------------|----------|-------------------------|
|  | Value           | Sig. (P) |                         |
| INDUSTEXP  | 5.714           | 0.017    | 0.241                   |
| REPRISK  | 0.156           | 0.693    | 0.041                   |
| LITRISK  | 0.731           | 0.393    | 0.088                   |
| RESOURCES  | 0.039           | 0.844    | 0.020                   |
| RISKMAGSTRAT   | 0.264           | 0.608    | 0.053                   |

**Table 5b.** Results of the logistic regression: Acceptance of clients with prior years' qualified audit opinions

| Clients with qualified audit report |                           |           |       |                 |       |                          |
|-------------------------------------|---------------------------|-----------|-------|-----------------|-------|--------------------------|
| Independent variables               | Estimated coefficient (b) | Wald test |       | Chi-square test |       | Naglkerke R <sup>2</sup> |
|                                     |                           | Value     | Sig.  | Value           | Sig.  |                          |
| INDUSTEXP                           | 2.607                     | 5.104     | 0.024 | 13.095          | 0.070 | 0.185                    |
| REPRISK                             | 1.122                     | 1.095     | 0.295 |                 |       |                          |
| LITRISK                             | -0.572                    | 0.328     | 0.567 |                 |       |                          |
| RESOURCES                           | 0.584                     | 0.558     | 0.455 |                 |       |                          |
| RISKMAGSTRAT                        | -1.208                    | 1.738     | 0.187 |                 |       |                          |
| Constant                            | -0.560                    | 0.180     | 0.671 |                 |       |                          |

Note: Chi-square Hosmer and Lemeshow test = 3.733 (Sig. > 0.05).

$$\ln\left(\frac{p}{1-p}\right) = -0.560 + 2.607\text{INDUSTEXP} + 1.122\text{REPRISK} - 0.572\text{LITRISK} + 0.584\text{RESOURCES} - 1.208\text{RISKMAGSTRAT} \quad (3)$$

#### 5.2.4. Acceptance of clients with prior year's violations

As shown in Table 6a, the auditor's decision to accept clients who received unfavourable reports from the monitoring body is significantly associated with the extent of fraud cases and accounting violations included in the report ( $p = 0.00$  and  $0.01$ , respectively). Apart from the nature of the cases, the respondents also expressed concerns about the frequency of such cases ( $p < 0.05$ ). However, the respondents paid less attention to the severity of their actions ( $p = 0.086$ ). The logistic regression in Table 6b (Eq. (4)) supports the finding that the nature of *FRAUD* is the most crucial variable when deciding on the acceptance of an audit client (Wald test

$p$ -value of 0.024). However, all variables have a positive impact on the acceptance of clients with unfavourable reports (estimated coefficients ( $b$ ) are positive). The independent variables have a statistically significant impact on the client acceptance decision (Chi-square value 14.499 with a  $p$ -value of 0.006) and  $R^2$  of 27%, indicating fraud is a major concern for auditors in accepting or continuing with the audit assignments. Thus, the extent of fraud cases involved in an unfavourable report is the most significant predictor of the auditor's decision to accept these types of clients. These findings are consistent with the arguments of Fadaly (2018) that audit firms in emerging economies are risk-averse to litigation and are willing to protect their reputation.

**Table 6a.** Chi-square test and contingency coefficient: Acceptance of clients with prior year's violations

| Nature of unfavourable report issued by monitoring government board in its relationship with the client acceptance decision | Chi-square test |          | Contingency coefficient |
|---|-----------------|----------|-------------------------|
|   | Value           | Sig. (P) |                         |
| FRAUD   | 16.130          | 0.000    | 0.384                   |
| GAAPVIO   | 10.143          | 0.001    | 0.314                   |
| FREQ  | 4.726           | 0.030    | 0.220                   |
| PEN.  | 2.940           | 0.086    | 0.175                   |

**Table 6b.** Results of the logistic regression: Acceptance of clients with prior year's violations

| Independent variables | Estimated coefficient (b) | Wald test |       | Chi-square test |       | Naglkerke R <sup>2</sup> |
|-----------------------|---------------------------|-----------|-------|-----------------|-------|--------------------------|
|                       |                           | Value     | Sig.  | Value           | Sig.  |                          |
| FRAUD                 | 1.952                     | 5.088     | 0.024 | 14.499          | 0.006 | 0.269                    |
| GAAPVIO               | 1.074                     | 1.464     | 0.226 |                 |       |                          |
| FREQ                  | 0.757                     | 1.004     | 0.316 |                 |       |                          |
| PEN.                  | 0.223                     | 0.079     | 0.779 |                 |       |                          |
| Constant              | -1.169                    | 1.773     | 0.183 |                 |       |                          |

Note: Chi-square Hosmer and Lemeshow test = 9.332 (Sig. > 0.05).

$$\ln\left(\frac{p}{1-p}\right) = -1.169 + 1.952\text{FRAUD} + 1.074\text{GAAPVIO} + 0.757\text{FRQ} + 0.223\text{PEN} \quad (4)$$

#### 5.2.5. Ownership structure and selection process

Table 7a shows that there is a significant association between client acceptance decisions and type of ownership structure ( $p < 0.05$ ), except for firms that have local investments ( $p = 0.078$ ). This means auditors tend to avoid accepting clients if management is not the owner of the firm unless the firms confine their investments within Egypt and have limited international business risk exposure. Although Nelson et al. (2015) and Harahap and Prasetyo (2018) argue that government ownership is characterized by a complex structure and less control over business risks, there is a significant association between this type of ownership structure

(*STATEOWNED*) and priority in client acceptance decisions ( $p = 0.002$ ). The results of the logistic regression in Table 7b (Eq. (5)) show that family-owned firms tend to be more attractive to auditors ( $p = 0.002$  and coefficient = 1.929) due to management's loyalty to stockholders when it comes to financial returns and performance, indicating that ownership structure affects auditors' decisions to accept those assignments. Finally, the overall ownership structures have a statistically significant impact on the client acceptance decision, with a chi-square test value of 30.130 at a significance level of 0.000. However, the ownership structures of publicly listed companies (*PUBLIC*) and family companies (*FAMILY*) are the most common types of structures that are

given attention by auditors when deciding the priority of client acceptance, with p-values (Wald test) of 0.007 and 0.002, respectively. These

findings support Alhababsah's (2019) study, which shows the importance of family ownership in affecting audit quality.

**Table 7a.** Chi-square test and contingency coefficient: Ownership structure and selection process

| Ownership structures in its relationship with client acceptance decision | Chi-square test |          | Contingency coefficient |
|--|-----------------|----------|-------------------------|
|  | Value           | Sig. (P) |                         |
| PUBLIC   | 17.496          | 0.000    | 0.398                   |
| MANAG  | 10.220          | 0.001    | 0.315                   |
| STATEOWNED   | 9.272           | 0.002    | 0.301                   |
| FAMILY   | 16.862          | 0.000    | 0.392                   |
| LOCAL  | 3.1             | 0.078    | 0.180                   |

**Table 7b.** Results of the logistic regression: Ownership structure and selection process

| Independent variables | Estimated coefficient (b) | Wald test |       | Chi-square test |       | Naglkerke R <sup>2</sup> |
|-----------------------|---------------------------|-----------|-------|-----------------|-------|--------------------------|
|                       |                           | Value     | Sig.  | Value           | Sig.  |                          |
| PUBLIC                | 2.288                     | 7.268     | 0.007 | 30.130          | 0.000 | 0.386                    |
| MANAG                 | 0.809                     | 1.467     | 0.226 |                 |       |                          |
| STATEOWNED            | -1.067                    | 1.940     | 0.164 |                 |       |                          |
| FAMILY                | 1.929                     | 9.390     | 0.002 |                 |       |                          |
| LOCAL                 | -0.093                    | 0.022     | 0.881 |                 |       |                          |
| Constant              | -1.748                    | 7.019     | 0.008 |                 |       |                          |

Note: Chi-square Hosmer and Lemeshow test = 8.594 (Sig. > 0.05).

$$\ln\left(\frac{p}{1-p}\right) = -1.748 + 2.288PUBLIC + 0.809MANAG - 1.067STATEOWNED + 1.929FAMILY - 0.093LOCAL \quad (5)$$

**5.3. Additional analysis: Analysis of demographic data**

While the respondents showed support for some factors affecting the client acceptance decision, we examined any correlations between the participants based on their demographic data and their responses. Using the Mann-Whitney test as a non-parametric test, we compared the mean rank of the responses of the two grouping variables. Table 8 shows that the mean ranks of the Big 4 firms' respondents are significantly higher than the mean ranks of the non-Big 4 firms' when selecting a listed versus unlisted firm and deciding a client with an unmodified rather than a modified opinion ( $p = 0.027$  and  $p = 0.026$ ). The Big 4 is sceptical of accepting a non-listed client that has a prior qualified audit report to avoid audit risks and lower the possibility of litigation and impact on its reputation.

The Kruskal-Wallis test was used to rank the nonparametric test for any statistically significant differences between two or more groups of independent variables. Table 9 shows that the mean ranks across the different levels of respondents' ranks differ significantly in the priority of selecting listed firms and clients with unmodified rather than modified opinions (p-values of 0.015 and 0.012), indicating that audit partners (based on their higher level of experience) compared to managers tend to lower their risk appetite to avoid accepting clients that have a higher exposure to business risks, as they focus more on the long-term growth and reputation of audit practices. In addition, respondents with different industry specializations differed significantly for items related to the selection of listed companies and tended to focus on selecting audit clients with lower audit risk exposure ( $p < 0.05$ ).

**Table 8.** Mann-Whitney test — Analysis of variance based on type of audit firm

| Priority of client selection                                     | Mean rank      |                    | P-value |
|--|----------------|--------------------|---------|
|  | Big 4 (n = 30) | Non-Big 4 (n = 63) |         |
| Listed versus unlisted companies — A                             | 55.17          | 43.11              | 0.027   |
| Clients with an existing parent or subsidiary being audited — B  | 48.73          | 46.17              | 0.641   |
| Client with unqualified than qualified audit opinion — C         | 55.33          | 43.03              | 0.026   |
| Client with unfavourable reports issued by monitoring board — D  | 52.75          | 44.26              | 0.106   |
| Ownership structures will affect client acceptance decisions — E | 44.73          | 48.08              | 0.548   |

**Table 9.** Kruskal-Wallis tests — Analysis of variance based on respondent's rank and industry specialization

| Priority of client selection | Respondent's rank            |                   |                   |         | Industry specialization |                  |                          |                                |                                    | P-value |
|------------------------------|------------------------------|-------------------|-------------------|---------|-------------------------|------------------|--------------------------|--------------------------------|------------------------------------|---------|
|                              | Mean rank                    |                   |                   | P-value | Mean rank               |                  |                          |                                |                                    |         |
|                              | Vice audit managers (n = 17) | Managers (n = 41) | Partners (n = 35) |         | Man. (n = 38)           | Services (n = 8) | Man. & Services (n = 11) | Financial institutions (n = 9) | Different specializations (n = 27) |         |
| A                            | 33.32                        | 46.40             | 54.34             | 0.015   | 43.09                   | 35.31            | 66.86                    | 40.06                          | 50.19                              | 0.025   |
| B                            | 51.82                        | 46.73             | 44.97             | 0.642   | 37.37                   | 65.00            | 57.91                    | 43.67                          | 51.89                              | 0.010   |
| C                            | 30.76                        | 50.51             | 50.77             | 0.012   | 45.95                   | 55.63            | 64.14                    | 35.11                          | 42.91                              | 0.061   |
| D                            | 38.85                        | 45.60             | 52.60             | 0.128   | 41.50                   | 70.38            | 58.41                    | 45.50                          | 43.67                              | 0.012   |
| E                            | 37.47                        | 50.74             | 47.24             | 0.186   | 43.50                   | 65.63            | 44.64                    | 47.72                          | 47.13                              | 0.264   |

## 6. CONCLUSION

While the auditing literature provides limited results on the criteria that audit firms use in the selection of audit clients in developed economies, prior research lacks evidence from an emerging market perspective. This study provides empirical findings on how auditors select their recurring and prospective clients in emerging markets such as Egypt. The use of Egypt in our laboratory study was due to its vibrant economy, a hub for international trade and businesses in the MENA region, and extension of the existing literature. The findings provide evidence that audit firms tend to select clients that have a good and reliable internal control system, those who do not have prior years' qualified reports, prefer publicly listed clients, do not receive unfavourable reports from the government or oversight boards, and clients whose management teams are also the owners of the firm. These findings are consistent with the results of prior studies and have direct implications, including clients' CG practices and prior years' qualifications (Harahap & Prasetyo, 2018; Alhababsah, 2019) including ownership structure, extent of audit risk, fees, and quality. The findings of this study also support the notion provided by Kedia et al. (2017) that clients' prior violations of monitoring bodies' rules are indications of the future in their financial reporting risks and weaknesses in the control systems.

The results illustrate the importance of auditors' need to balance professionalism and commercialism in selecting their clients and not merely focus on clients' internal control quality and financial reporting systems and the number of clients to sustain the fee revenue of an audit practice. Auditors tend to select listed firms, especially transnational companies with high financial reporting quality, which could help promote their branding and reputation and audit and assurance services within the stock market. Furthermore, an effective audit and relatively low reputational and litigation risks are significantly associated with the acceptance of an existing parent or subsidiary audit client. The level of industry expertise needed to mitigate clients' expected risk and clients with a modified audit opinion is an additional variable auditors would consider. Auditors avoid clients with unfavourable reports from monitoring bodies, violations due to fraud, and accounting standards. Finally, auditing firms prefer publicly listed firms, family-owned firms, and clients with high managerial ownership. Collectively, these results indicate that audit firms attempt to avoid audit risk and litigation, and non-Big 4 auditors are more willing to accept clients with higher audit risk. The key reason is to penetrate the market niche, generate revenue, and obtain non-auditing services.

This study contributes to the literature in several ways. It is among the few studies that

provide empirical evidence from an emerging market that links auditors' selection of clients based on attributes such as ownership structures and types of reports issued from monitoring bodies and group audits. It contributes to the auditing literature, provides additional evidence, and confirms previous findings (Guan et al., 2016; He et al., 2017) on the significance of industry specialization based on partners' years of experience in the selection norm. The study also sheds light on how larger audit firms remain under pressure to maintain their reputations and expand their market niche, using stringent audit procedures to reduce audit risks. Moreover, this study is relevant to regulators because of the proximity of auditor-client relationships in promoting high audit quality and reputation. The findings enrich the existing literature on the preferences of audit partners and managers in selecting their prospective clients and deciding the continuity of existing principal-agent-auditor relationships. More importantly, these findings could initiate further research on other emerging markets and, instead of using one methodology, researchers may consider using multiple methodologies to underpin the findings. Multiple approaches could help strengthen the underlying results and explore areas requiring further research. Finally, the findings of this research further highlight the importance of having a reliable CG code that helps strengthen the reliability, transparency, accountability, and quality of internal control; increases the effectiveness of corporate ethical practices; and reduces financial reporting risks. Effective CG is closely associated with the quality of the financial reporting process and may affect auditors' assessments of client-related risks in the selection process. In screening, partners are more (less) likely to accept a prospective client or continue a contract with an existing client in the presence of stronger (weaker) CG practices.

This study has several limitations that could serve as avenues for future research owing to the relatively small sample size. Moving forward, researchers could use their own country as the base to compare with ours, particularly countries with similar cultural and geopolitical backgrounds. Apart from using questionnaires, follow-up forum discussions and phone calls with selected respondents could help understand and appreciate the underlying rationale for the selection process that might not have been included in the questionnaires. Continuing conversations with partners will help to reveal personal and psychological variables, including networking and work or social experiences with existing and potential clients. Future research could investigate other factors that audit firms would consider when selecting a client, so the quest for insights continues.

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