

THE ENGAGEMENT DECISION IN MEDIUM AUDIT PRACTICE IN SOUTH AFRICA

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ABSTRACT

The decision to accept an appointment as registered external auditor to an audit client (the engagement decision) has in recent years been subject to an increased level of professional care and consideration, mainly as a result of previous experiences of engagement decisions that have led to audit practitioners suffering significant financial losses and litigation exposure, as well as significant amendments to statutory regulation and new International Standards on Auditing. The engagement decision is affected by a number of factors or motivational drivers. The purpose of this article is to discuss some of these factors related to the audit practitioner's business that may be grouped together under the headings of commercial, professional and organisational considerations. The article further reports on the extent to which auditors in medium audit practice in South Africa considers the three groups of considerations during the engagement decision, based on questionnaire results. Lastly, the article comments on the need for a balanced approach to the three groups of considerations to manage the auditor's business risk associated with the engagement decision.

Keywords:

Auditor predisposition, motivational drivers, professional considerations, commercial considerations, organisational considerations, engagement decision, judgment, medium practice, auditor's business risk.

1. INTRODUCTION

The decision by an auditor to accept an appointment as registered external auditor to a client (the engagement decision), has in recent years been subject to an increased level of professional care and consideration by practitioners. This is mainly as a result of previous experiences of engagement decisions that have led to audit practitioners suffering significant financial losses and litigation exposure (Venuti, Holtzman & Basile, 2002), as well as amendments to statutory regulation and new International Auditing Standards.

Engagement risk consists of three components: the prospective client's business risk, audit risk and the auditor's business risk. The consideration of all three components is in fact a first step to ultimately comprehensively managing risk for the audit practitioner (Kerr, Jooste, Grupe & Vreeland, 2007).

The engagement decision, it is argued, is impacted directly and indirectly by the predisposition of an auditor. In respect of the auditor's business risk, this predisposition is imbedded in a number of factors that may be grouped under three distinct headings: commercial, professional and organisational considerations. These considerations, or otherwise put, motivational drivers, impact on the judgment applied during the engagement decision. It is argued that for judgment to be applied responsibly, audit practitioners must use a balanced approach to consider all of the motivational drivers to an equal extent. In order to do this, the audit practitioner should not be predisposed to any one group of considerations.

The purpose of this article is to discuss the commercial, professional and organisational considerations or motivational drivers related to the auditor's business risk that affect the engagement decision. The article further reports on the extent to which auditors in medium audit practice in South Africa consider the three groups of motivational drivers during the engagement decision to determine whether they are predisposed to any one group of factors, based on questionnaire results. Lastly, in conclusion, the article comments on the need for a balanced approach to the three groups of factors to manage the auditor's business risk associated with the engagement decision.

2. DEFINING “PREDISPOSITION” AND THE THREE CATEGORIES OF MOTIVATIONAL DRIVERS

Predisposition is defined as “an inclination or tendency” (Pearsell, 2001:413). Predisposition refers to a particular state of mind. It is submitted that the tendency to accept or decline an audit engagement during the engagement decision is driven by the extent to which an auditor's judgment is affected by or embedded in the three categories of motivational drivers.

When researchers began to study risk and its impact on audit decision-making processes, very little was known about the joint influence that motivational drivers had on these processes (Johnstone, 2000:1). But despite limited studies, the tensions between professional and commercial drivers were present, according to researchers such as Kirkham (1992:301) and Bailey (1995:191-195). The third group of motivational drivers, organisational drivers, were only identified during later studies such as that by Gendron (2002:8). Gendron found that not only do professionalism and commercialism impact the engagement decision, but organisational

factors also influence the way in which practitioners deal with the competitive pressures between commercial and professional drivers during the engagement decision.

It is inferred from studies by Willmot (1986:576), and Humphrey and Moizer (1990:232) that the driving force behind commercial motivational factors is financial remuneration. Commercial drivers are therefore defined as engagement-specific factors that are financially rewarding to the audit practitioner. Even though this group of drivers is not referred to as a specific consideration when accepting an engagement in *ISQC 1 Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related financial services engagement* (South African Institute of Chartered Accountants (hereafter SAICA), 2006), it is submitted that these considerations must carry weight in the business decisions of the audit practitioner.

Professional drivers are defined by Gendron as (2002:14):

“...a logic based on an idealised, coherent and organisational set of values and ideas centred on the notion of serving the public – and not practitioners’ financial interests.”

Professional drivers refer to engagement-specific considerations based on the audit practitioner’s ethical social responsiveness (Tricker, 1982:36). Compliance with ethical requirements is indeed specifically required during the acceptance of an engagement through the applicable auditing standards referred to above (SAICA, 2006:par 28).

An immediate comparison between commercial and professional drivers reflects on the tension that exists between the two categories. It is argued that this tension may be balanced out to an extent by the existence of strong organisational drivers.

Gendron concluded that organisational drivers (2002:7):

“...assumes that human action and political processes play a key role in organisational life, with activities and decisions within the organisation being subject to the influence of organisational factors having different interests and adhering to different logic.”

Examples of organisational drivers include peer review procedures, the structure of the firm and firm-specific audit programmes. As with professional drivers, organisational drivers such as competence, time and resources to perform an engagement must specifically be considered during the engagement decision in order to comply with the applicable auditing standards (SAICA, 2006:par 28).

3. MOTIVATIONAL DRIVERS THAT AFFECT THE DECISION TO ACCEPT AN APPOINTMENT

3.1 Commercial Drivers

Commercial drivers manifest themselves in a number of ways during the engagement decision.

Marx, Van Der Watt, Bourne and Hamel (2004:8-3) place emphasis on client selection that will limit legal liability and reputational damage to a firm.

Puttick, Van Esch and Kana contend that, as with any other commercial enterprise, the audit practitioner must consider his own business risk and protect himself against financial loss and reputational loss during the engagement decision (2007:236-237).

Asare, Hackenbrack and Knechel (1994:169) found that a practice's development strategy plays a major role in the client-acceptance decision process, as the extent of data collection and analysis in any given situation is closely linked to the way audit practitioners initially perceive the potential client against the firm's practice-development strategy. Data collection and analysis are likely to be more intense for potential clients whose fit with the firm's strategy is initially unknown, than for potential clients that are immediately perceived as fitting into the practice's strategy.

Dirsmith, Heian and Covalesski (1997:12) concluded in their study that the decision to reject a potential client is a difficult decision to make since this decision contradicts the pressures on a practitioner's contribution to the growth of the practice.

Farmer, Rittenberg and Trompeter (1987:11), and Peecher (1996:125-140) studied practitioners' preferences for efficiency or effectiveness in the context of the profitability of the audit practitioner's business and concluded that this may vary depending on a variety of factors. These include the profitability of the client, the percentage of practitioner and practice revenue represented by the client, the practitioner's risk preference, and the practitioner's concerns about litigation. Trompeter (1994:56-58) further concluded that the practitioner compensation schemes that emphasise client retention lead to less conservative judgments.

Practitioner preference has also been studied by Bierstaker and Wright (1999:2), who concluded that audit practitioners may adjust audit programme plans in response to practitioner preference. They found that audit practitioners significantly reduced planned tests and budgeted hours in response to practitioners' preference for efficiency. This has an effect on the profitability of a practice and the commercial success of the auditor's business. Their conclusions suggest that audit practitioners would place a greater weight on commercial considerations than on professional guidance, introducing risk into the engagement decision as audit procedures may be reduced for commercial benefit.

It may therefore be concluded that engagement risk will increase as more attention is given to commercial drivers when making the engagement decision.

3.2 Professional Drivers

Professional drivers are found on the opposite side of the scale to commercial drivers and refer to the practitioner's sense of professional commitment based on ethical guidance and professional standards. Practitioners have objective frames of reference in applying professional drivers during the engagement decision including codes of ethics and legislation such as the Auditing Profession Act no 26 of 2005. Professional drivers have been impacted significantly by corporate collapses and accounting scandals, leading to regulators and law-makers alike acting promptly with the enactment of several regulatory changes and guidance towards accounting practices and the audit profession itself. This continued change in the audit profession is arguably its only certainty (Terry, 2002:2). Theoretically, the introduction (and application) of more or better legislation and ethical codes should reduce risk in general. In the context of this article specifically, engagement risk related to the audit practitioner's business should also be reduced. In other words, theoretically, a predisposition to professional drivers will reduce the auditor's business risk, which is one of the legs of engagement risk.

Hanlon (1994:339) described the tension between commercial and professional drivers as follows:

“Auditors’ codes of ethics generally emphasise the chief notions upon which the legitimacy of the auditing profession is predicated, namely, public service and independence. Concurrently, auditors are exposed to the commercial logic through several sources, such as the business literature that constantly stresses the importance of the ‘bottom line’, as well as the firm’s performance evaluation reports that typically are based on indicators such as ‘profits per practitioners’. Auditors therefore have to operate and make decisions in the midst of the two logics of action, each of them carrying its own representation of decision-making. These representations oftentimes result in points of tension in day-to-day decision processes.”

3.3 Organisational Drivers

From the discussion in sections 3.1 and 3.2 above, it is clear that tension exists between commercial and professional drivers during the engagement decision. One of the ways in which this tension can be relieved is through the application of organisational drivers or increasing the auditor’s predisposition towards organisational drivers.

Gendron (2002:14) concluded in a study that practitioners may be predisposed towards one of the previously discussed motivational drivers, but may in fact have a balanced approach to these two factors, most often achieved through organisational drivers. Organisational strategies such as peer review procedures, partner remuneration plans, the use of standardised procedures and decision aids can all contribute to the lowering of risk related to a predisposition towards commercial drivers during an engagement decision.

4. THE ROLE THAT JUDGMENT PLAYS IN PREDISPOSITION

Judgment is required to identify and conclude on the presence of risk factors during the engagement decision. The prior experiences of an audit practitioner have a bearing on the judgment exercised (Kerr, et al., 2007). The commercial, professional and organisational drivers discussed above are imbedded in the judgment that practitioners exercise during the engagement decision.

From studies on judgment it may be argued that auditing is a cognitive process that utilises specific paradigms of thought and models. These paradigms and models mainly exist in order to produce certain outcomes and reveal certain audit strategies, mostly focused on reducing risk to the audit practitioner. It is evident that judgment would also be relevant to the engagement decision process, as the impact of risk on the engagement decision would necessitate audit practitioners making judgments in order to produce those outcomes that reflect desired levels of engagement risk to the audit practitioner and his or her business. Again, this judgment is influenced by a predisposition to certain motivational drivers. This predisposition is under continuous tension and this tension itself can expose the audit practitioner to risk if one driver is favoured at the cost of another (Bailey, 1995:191–195).

The immediate question that arises is how audit practitioners in South Africa are affected by judgment that is in fact imbedded in or affected by the three motivational drivers. It is submitted that in the Big Four firms, extensive policies and procedures are in place to ensure strong organisational drivers to balance out tension between commercial and professional drivers. This may not be the case in medium (and smaller) practices as they generally lack the staff, technical expertise and global reach of large firms (United States General Accounting Office, 2003:2).

5. AN INVESTIGATION INTO MEDIUM AUDIT PRACTICE IN SOUTH AFRICA

In order to consider how the three motivational drivers are imbedded in judgment during the engagement decision in medium audit practice in South Africa, an empirical study was designed and conducted in September 2005. It involved the design of a questionnaire encompassing 58 research questions conducted as part of a doctoral thesis at the University of Johannesburg completed by one of the authors and supervised by the remaining authors of this paper.

The questions covered the personal data of respondents, questions on auditor pre-disposition, risk assessment and audit procedures. The questionnaire was accompanied by a letter of support issued by the senior executive for small practices of the SAICA.

The research population was audit firms per the Public Accountants' and Auditors' Board database that had more than five, but fewer than sixty partners and that operated in South Africa. This population selection criterion was designed to exclude Big Four firms. The population existed of the following firms:

- Fisher Hoffman PKF
- Moores Rowland
- Grant Thornton Kessel Feinstein
- BDO Spencer Steward
- SAB&T Inc.
- RSM Inc.
- Gobodo Inc.
- SizweNtsaluba VSP Inc.
- Lloyd Viljoen
- BGR Inc.
- Theron du Plessis
- Enslins
- Ngubane & Co.
- Nexia Levit Kirson, and
- Vos, Steyn and Van Zyl Inc.

The Cronbach Alpha Coefficient for the research was calculated by the Statistical Consultation services of the University of Johannesburg (STATKON) at 98.9%.

It is argued that due to the importance of ethical behaviour of the research population in general, the responses would generally be credible. The research response rates are depicted in **TABLE 1**. It is important to note that as a census was conducted, the overall response rate of 28% is very high as it does not relate to a sample, but to the entire population.

TABLE 1: Research response rates of the empirical research

<i>Size of practice</i>	<i>Total practitioner population</i>		<i>Submissions received</i>		<i>Response rate</i>
	<i>No.</i>	<i>%</i>	<i>No.</i>	<i>%</i>	<i>%</i>
Zero returns	0	0	8	12	0
6 to 10 practitioners	29	10	19	24	66
11 to 20 practitioners	29	10	12	15	41
21 to 30 practitioners	42	15	12	15	29
31 to 40 practitioners	79	28	6	8	8
41 to 50 practitioners	43	15	6	8	14
51 to 59 practitioners	59	21	14	18	24
Total	281	100	77	100	28

Source: Steyn (2006:143)

The response categories allowed for in the research questionnaire are depicted in **TABLE 2**.

TABLE 2: Response categories of the questionnaire

<i>Response category</i>	<i>Meaning</i>
No extent	The motivational factor does not impact the engagement decision of the practitioner at all
Small extent	The motivational factor does impact the engagement decision of the practitioner to some extent, but less than to a moderate extent
Moderate extent	The motivational factor does impact the engagement decision of the practitioner more than to a small extent, but less than to a large extent
Large extent	The motivational factor does impact the engagement decision of the practitioner more than moderately

Source: Steyn (2006:148)

It is impossible to reflect on all of the questions in the questionnaire in this article. However, to illustrate the tension between the three motivational drivers, three of the research questions will be presented below so as to report on research done in these areas.

6. QUESTION 1: THE COMMERCIAL DRIVER RELATED TO THE PROFITABILITY OF THE ASSIGNMENT

Studies such as those conducted by Asare, et al. (1994:169), Dirsmith, et al. (1997:12) and Cohen and Trompeter (1998:481-504) found that practitioners are under significant pressure to increase revenue and accept new clients in order to increase the revenue base of their practices and the overall profitability of their assignments.

The research question that arises from this evidence is to what extent the decision of the audit partner to accept a new client is impacted by commercial considerations such as the profitability of an assignment. The research results to this question are shown in **TABLE 3**.

TABLE 3: Research results for question 1

<i>Question 1</i>								
<i>To what extent is your decision to accept a new client impacted by commercial considerations such as the profitability of the assignment?</i>								
<i>No. of practitioners</i>	<i>0</i>	<i>6-10</i>	<i>11-20</i>	<i>21-30</i>	<i>31-40</i>	<i>41-50</i>	<i>51-59</i>	<i>Total</i>
0 response	8		1					9
	88.9%		11.1%					100%
	100%		8.3%					11.7%
Not at all				1				1
				100%				100%
				8.3%				8.3%
To a small extent	3		2	1	1	3		10
	30.0%		20.0%	10.0%	10.0%	30.0%		100%
	15.8%		16.7%	16.7%	16.7%	21.4%		13.0%
To a moderate extent	7	5	7	3	2	6		30
	23.3%	16.7%	23.3%	10.0%	6.7%	20.0%		100%
	36.8%	41.7%	58.3%	50.0%	33.3%	42.9%		39.0%
To a large extent	9	6	2	2	3	5		27
	33.3%	22.2%	7.4%	7.4%	11.1%	18.5%		100%
	47.4%	50.0%	16.7%	33.3%	50.0%	35.7%		35.1%
Total	8	19	12	12	6	6	14	77

Source: Steyn (2006:149)

From the research results it is concluded that practitioners consider commercial motivational drivers from a moderate to a large extent (39.0% and 35.1%). In each firm size category, the highest response was either to a moderate or to a large extent, from which it is deduced that commercial considerations such as the profitability of an assignment are a significant factor in the engagement decision of practitioners in medium audit practice.

This result provides evidence that practitioners in medium audit practice in South Africa are predisposed towards commercial considerations from a moderate to a large extent.

7. QUESTION 2: THE PROFESSIONAL DRIVER RELATED TO COMPLIANCE WITH STATUTORY REGULATIONS

The Auditing Profession Act no 26 of 2005 is the primary legislation that regulates the audit industry. In addition, auditors must consider and comply with the Companies Act and the Public Audit Act (if they are exposed to subcontracting to the Auditor General).

Compliance with these acts is compulsory, but not guaranteed. The question then arises to what extent auditors consider compliance with statutory requirements when deciding to accept a new client. The research results to this question are shown in **TABLE 4**, which follows.

TABLE 4: Research results for question 2

<i>Question 2</i>							
<i>To what extent is your decision to accept a new client impacted by compliance with statutory regulations?</i>							
<i>No. of practitioners</i>	<i>6-10</i>	<i>11-20</i>	<i>21-30</i>	<i>31-40</i>	<i>41-50</i>	<i>51-59</i>	<i>Total</i>
To a small extent		1			1	1	3
		33.3%			33.3%	33.3%	100%
		8.3%			16.7%	7.1%	3.9%
To a moderate extent	10	3	5	2	1	3	24
	41.7%	12.5%	20.8%	8.3%	4.2%	12.5%	100%
	52.6%	25.0%	41.7%	33.3%	16.7%	21.4%	31.2%
To a large extent	9	8	7	4	4	10	42
	21.4%	19.0%	16.7%	9.5%	9.5%	23.8%	100%
	47.4%	66.7%	58.3%	66.7%	66.7%	71.4%	54.5%
Total	19	12	12	6	6	14	77*

Source: Steyn (2006:169)

**Zero responses included in cross-tabulation*

Registered auditors in medium practice consider statutory compliance to a large extent (54.5% of respondents) during the engagement decision. Most respondents from all the firm size categories indicated a response of at least approximately 60% when considering statutory compliance to a large extent, except 47.4% of respondents from firms with 6 to 10 practitioners, suggesting that smaller firms give less consideration to such statutory compliance.

It is a further matter of concern that 3.9% of respondents do not consider statutory regulations and these practitioners are likely to expose themselves and their audit practices to significant risk during their engagement decisions.

Indeed, the results are very concerning given the contention that commercial drivers and professional drivers are at opposite ends of the scale. If an engagement decision is driven by commercial factors and compliance with legislation, being a professional driver, is not assured,

the risk of accepting a particular engagement can become unacceptably high.

8. QUESTION 3: THE ORGANISATIONAL DRIVER RELATED TO CLIENT TARGETING

Studies by Solomon (1987:1-25), Libby and Luft (1993:425-450) and Gendron (2002:2) all concluded on the influence that the partnership as organisation has on practitioners when considering matters such as targeting strategies for specific clients in certain industries. These strategies serve as organisational motivators to achieve in many instances a balance between commercial and professional drivers (Gendron, 2002:8). The question then arises as to what extent audit practitioners in medium practice in South Africa consider the impact of such organisational motivational drivers during their engagement decision processes, such as client targeting strategies. The research results to this question are shown in **TABLE 5**.

TABLE 5: Research results for question 3

<i>Question 3</i>							
<i>To what extent is your decision to accept a new client impacted by organisational considerations, such as the strategy adopted by your firms on targeting certain clients in certain industries?</i>							
<i>No. of practitioners</i>	<i>6 to 10</i>	<i>11 to 20</i>	<i>21 to 30</i>	<i>31 to 40</i>	<i>41 to 50</i>	<i>51 to 59</i>	<i>Total</i>
Not at all		1	1	1	1	5	9
		11.10%	11.10%	11.10%	11.10%	55.60%	100.00%
		8.30%	8.30%	16.70%	16.70%	35.70%	11.70%
To a small extent	4	2	4	1		4	15
	26.70%	13.30%	26.70%	6.70%		26.70%	100.00%
	21.10%	16.70%	33.30%	16.70%		28.60%	19.50%
To a moderate extent	11	4	5	2	4	5	31
	35.50%	12.90%	16.10%	6.50%	12.90%	16.10%	100.00%
	57.90%	33.30%	41.70%	33.30%	66.70%	35.70%	40.30%
To a large extent	4	5	2	2	1		14
	28.60%	35.70%	14.30%	14.30%	7.10%		100.00%
	21.10%	41.70%	16.70%	33.30%	16.70%		18.20%
Total	19	12	12	6	6	14	77*

Source: Steyn (2006:154)

**Zero responses included in cross-tabulation*

The results have found that registered auditors in medium practice in South Africa consider organisational motivational drivers to a moderate extent (40.3% of the respondents). Of these, practitioners that consider organisational considerations to a moderate extent, 48.4% (35.5% +

12.9%) are from firms that have 6 to 20 practitioners.

Based on studies by Gendron (2002:8), the impact of organisational factors on auditors in terms of practice development and revenue growth was expected to be significant. The fact that only 18.2% of respondents consider the organisational factor researched in this question to a large extent would therefore suggest that registered auditors in medium practice in South Africa may not be impacted by organisational drivers to the same extent as practitioners in other countries, as suggested in studies by Solomon (1987:1-25), Libby and Luft (1993:425-450) and Gendron (2002:2).

9. CONCLUSIONS DRAWN FROM RESEARCH QUESTIONS PRESENTED

The engagement decision involves professional judgment and “consequent decisions characteristically involve tough tradeoffs” (Bell, Peecher & Solomon, 2005:21). This article reports on evidence obtained regarding the extent to which there is a trade-off between the consideration of commercial, professional and organisational considerations related to the audit practitioner’s business risk during the engagement decision.

The results from the three research questions presented in paragraphs 6, 7 and 8 above, provide evidence, which is supported by the comprehensive research project results, that practitioners in medium audit practice in South Africa are largely commercially predisposed when making an engagement decision. The direct effect of this predisposition is that the engagement risk associated with a particular audit is on the higher side. Theoretically, this increased risk can be balanced by professional drivers such as adherence to statutory requirements. However, again the research has revealed that mandatory compliance with relevant acts is not at the highest level of importance or predisposition for practitioners surveyed. Again, the effect of this is that engagement risk is increased. Theoretically, this increased risk can be balanced out by organisational drivers such as the targeting of lower risk entities in industries with very low risk profiles. Yet the research results have shown that the use of organisational drivers, such as client targeting strategies, is not pervasive among those surveyed.

The net result of all of the above, and indeed the comprehensive research project, is that auditors in medium practice are probably exposed to unacceptably high risk following from their engagement decisions.

The most significant risk exposure identified is that the engagement decision may be significantly impacted by a predisposition towards commercial drivers – to such an extent that auditors in medium practice may not adequately consider professional and organisational drivers during their engagement decisions. This would clearly impact on the risk that these practitioners, their firms and the audit industry in South Africa at large are exposed to.

In the interests of the audit profession in South Africa, greater attention must be paid to balancing the three motivational drivers and the tension between them.

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