

**Understanding the Big 4 Effect:  
Clients' Pre-audit Earnings Quality and Audit Adjustments**

Slavko Šodan

University of Split, Faculty of Economics, Business and Tourism, Croatia

Tina Vuko

University of Split, Faculty of Economics, Business and Tourism, Croatia

Željana Aljinović Barać

University of Split, Faculty of Economics, Business and Tourism, Croatia

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**Abstract:**

This paper investigates whether the differences in audit quality between Big 4 and non-Big 4 auditors are mainly driven by the client's pre-audit financial reporting quality or by the differences in audit treatment *via* audit adjustments. Since detailed pre-audit data are not available to the researchers, prior literature could only control the audit effect for different client characteristics, such as size, leverage, profitability etc., between two groups of auditors. However, differences in quality between the Big 4 and the non-Big 4 auditors could still be a reflection of unobservable client characteristics. We use detailed pre-audit/audited financial statement data of Croatian listed companies to develop the quasi-experimental method of pretest-posttest design and control group. By comparing the Big 4 clients and the non-Big 4 clients on audited financial reporting quality while controlling for the pre-audit financial reporting quality, we can directly assess the audit effect and rule out the unobserved firm heterogeneity. Our results indicate that Big 4 and non-Big 4 auditors make similar adjustments to the pre-audit financial statements, but the Big 4 auditors make larger audit adjustments on fixed assets, revaluation reserves, impairment and net income. Also, they more frequently adjust provisions compared to the non-Big 4 auditors. We find, as well, that Big 4 clients have significantly higher pre-audit and audited accrual quality. However, our results indicate that the Big 4 effect is not significant when we control for the pre-audit accrual quality. Our findings remain robust after applying propensity-score matching and difference-in-differences.

**Keywords:** pre-audit financial statements, audit adjustments, earnings quality, audit quality, Big 4 auditors

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