

## Post-Audit Restatement Risk and Audit Firm Size

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It generally is assumed that audit firm size is a surrogate for audit quality and, therefore, for more reliable audited financial statements. The reliability of audited financial statements, however, is a joint probability distribution resulting from unique audit firm/audit client combinations. This study examines whether a joint probability distribution can be used to provide direct evidence that clients of large audit firms have lower risk of subsequently restating audited financial statements than do clients of smaller audit firms. First, companies having restated prior period financial statements due to error are identified. Selected financial characteristics for these companies and corresponding same-industry medians then are used to create a model for relative restatement risk. The resulting model is applied for an eight year period to individual audit client portfolios for Big 6 (B6) audit firms and to a composite portfolio of Non-Big 6 (NB6) audit firms to identify the mean relative restatement risk for each. We find for the years examined not only did a smaller percentage of B6 audit clients restate, but B6 audit clients were less likely to restate, i.e., had lower mean relative restatement risk than did NB6 clients. Further, no difference in this risk can be found among portfolios of the B6. Although B6 clients were less likely to restate, because restatement risk is a joint probability, it cannot be said this was due exclusively to B6 quality audits.

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### INTRODUCTION

It generally is assumed that audit firm size is a surrogate for audit quality<sup>1</sup> and, therefore for more reliable audited financial statements. A review of the literature, however, fails to support this assumption unambiguously. Audit quality is not observable directly; instead, the reliability of audited financial information depends on a joint probability resulting from unique audit firm/audit client combinations. For example, if an audit firm compiles a portfolio of audit clients presenting only error-free financial statements to be audited, *ex post* observation of those statements cannot provide direct evidence of the quality of the audit provided. The auditor has no audit risk since there are no material misstatements that could be missed – even a low-quality audit should produce the appropriate outcome. Conversely, if an audit portfolio consists of clients with a propensity to produce financial statements containing material errors, audit risk exists and the quality of the audit becomes more mean-

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<sup>1</sup> Audit quality generally is defined as the ability to detect and to require correction of material errors.