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Japanese stock market reaction to announcements of news affecting auditors' reputation: The case of the Olympus fraud

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ABSTRACT

The revelation of accounting fraud by the Olympus Corporation gave rise to shareholder allegations of audit failure against Olympus' auditors—Ernst & Young ShinNihon LLC and KPMG AZSA LLC—in 2011. In this study, we investigate whether the auditors' affiliation with Olympus contributes to divergent perceptions of audit quality in the event of news announcements affecting the reputation of Olympus' auditors. First, we use a nonparametric generalized rank event study methodology on 918 sample firms from the First Section of the Tokyo Stock Exchange (TSE) to observe Japanese investors' perceptions of auditor reputation as proxied by abnormal returns. Second, we perform a multivariate linear regression on firms' abnormal returns after controlling for firm-specific variables. We find that Japanese investors do not respond to negative or neutral reputational information arising from news announcements concerning Olympus' auditors for firms affiliated and not affiliated with those auditors. In the absence of legal penalties imposed on Olympus' auditors, we argue that Japanese investors consider the Olympus fraud case as an expected occurrence of audit failure due to a lack of evidence suggesting systematic audit failure on the part of Olympus' auditors and an expectation of lower audit quality in the Japanese capital market. As a result, Japanese investors do not consider news announcements affecting the Olympus auditors' reputation as sufficient evidence to change their prior expectation regarding the reputations of the audit firms affiliated with the Olympus fraud case.

1. Introduction

In the fourth quarter of 2011, Olympus shareholders requested an independent investigation to confirm whether Olympus' independent auditors (Ernst & Young ShinNihon LLC and KPMG AZSA LLC; hereafter referred to as E&Y and KPMG, respectively) were legally responsible for the fraud orchestrated by the company (Olympus, 2011b). Their request signaled that Olympus' auditors had failed to fulfill their duty in issuing a proper audit opinion on Olympus' financial statements. Although no legal penalties were imposed on the auditors, events prior to the conclusion of the investigation in 2012 provide a unique opportunity to assess the impact of news announcements regarding the potential involvement of Olympus' auditors on their reputation. We observe these changes in the auditors' reputation by investigating Japanese investors' abnormal market price reactions surrounding the news announcements.

Two main features differentiate the Olympus fraud case from other major incidents of accounting fraud perpetrated by Japanese companies. First, Olympus represents a very small group of Japanese companies that employ foreign CEOs, a group

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that includes Sony, Nissan, Nippon Sheet Glass, and Shiseido (Nakamoto, 2012). In addition, the Olympus scandal is the first case of major accounting fraud in Japan in which the whistleblower was a non-Japanese, Michael Woodford, who served as Olympus CEO when the fraud was first uncovered in late 2011. Second, the perceived impact of the Olympus fraud case is significant in terms of the relatively strong market position of Olympus among giant Japanese electronics firms,[1] the amount of monetary loss due to the fraud[2] and the extensive media coverage.[3]

The Japanese audit environment is characterized by a lower litigation risk compared with the US, which makes it more appropriate to utilize the auditor reputation hypothesis in examining market reactions following the Olympus fraud case. The ability of Japanese shareholders to successfully indict auditors and demand compensation for audit negligence due to fraud is relatively low (Numata and Takeda, 2010). The reputation hypothesis asserts that the economic value of audit services is derived from the high quality and reliable assurance of financial statements' conformity with GAAP. In the event of audit failure, auditors' reputation will suffer because they are not able to meet stakeholders' expectations of providers of high quality audits. Consequently, Japanese auditors are particularly vulnerable to news or information that might cast doubt on their reputation.

Events surrounding the announcement of the Olympus fraud case provide unique opportunities to test whether news coverage affecting the auditors' reputation had an observable impact on the share prices of other Japanese public firms audited by the auditors affiliated with Olympus. This study aims to provide empirical evidence on the influence of news on auditor reputation for Japanese firms whose auditors were alleged to be involved in the Olympus fraud case. To the best of our knowledge, this paper represents the first attempt to ascertain a change in auditors' reputation resulting from news coverage of their potential involvement in accounting fraud in the Japanese institutional setting.

Most previous research on market reactions to auditors' reputation was conducted on Anglo-American markets, whose results might not be generalizable to the Japanese market. Investors' expectations regarding auditors' reputation for conducting high quality audits rely on the institutional environment where the audits take place. In the US, higher quality audits by the Big 4 auditors have been associated with a stricter US litigation regime against auditors (Khurana and Raman, 2004). However, the Japanese financial reporting environment is characterized by the strong influence of government institutions in shaping accounting policies, a less effective and independent CPA profession, a highly leveraged corporate structure, and a non-litigious audit environment. We argue that these institutional features contribute to weak and lower quality Japanese audit institutions and an environment in which only significant financial reporting fraud can be considered relevant news with a significant effect on auditors' reputation. Consequently, Japanese investors are expected to have a lower quality audit threshold compared with Anglo-American investors. We argue that this lower quality audit expectation diminished the magnitude of Japanese investors' reactions following the news announcements affecting the Olympus auditors' reputation.

Section 2 of the paper reviews the existing literature on audit value, news announcements and market reaction, examines the characteristics of Japanese audit and market institutions, and develops the hypotheses. Section 3 includes a discussion of the research method, the sample selection criteria, and the statistical estimation models used in the paper. Sections 4 and 5 present a quantitative analysis and discussion of the results, respectively. Section 6 concludes.

2. Literature review and hypotheses development

2.1. Value of audit: reputation and insurance hypothesis

The relationship between an audit and its economic value can generally be explained by two hypotheses in the accounting literature: the insurance and reputation hypotheses. The insurance hypothesis assumes that the main role of auditors is taking responsibility in case investors suffer losses from management misrepresentation of financial statements.[4] On the other hand, the reputation hypothesis holds that auditors derive value from providing reliable assurance services by certifying the reasonability of management's assertion of financial information presented to stakeholders.[5]

Both the reputation and insurance hypotheses attempt to explain the audit value and market reaction following audit failure. However, it is difficult to clearly differentiate which hypothesis has better power in explaining the true causal factor of the market reaction from the loss of audit value in previous empirical studies (Ball, 2009). Piot (2005) investigated the determinants of auditors' reputation in three distinct capital markets and legal frameworks: Canada, France, and Germany. The author concluded that evidence for the insurance hypothesis was more salient in Canada (high auditor litigation risk) compared with

[1] Olympus commands 75% of the gastroenterological medical endoscope global market share (Lorsch et al., 2012). Olympus is also a major leader in Japan's high-growth mirrorless consumer camera market with a 30.7% Japanese market share, exceeding rival companies such as Panasonic, Nikon, and Sony (Olympus, 2012).

[2] The total amount of financial losses involved in the Olympus fraud case is estimated to be 252.5 billion yen/2.4 billion USD (Third Party Committee, 2011b). To put this number into perspective, the restated net income of Olympus for fiscal year 2011 was 3.87 billion yen (36.8 million USD), which means that losses were approximately 65 times higher than the 2011 net income.

[3] The scandal attracted a large amount of coverage from both domestic and international media, which is explained, in part, by the factors mentioned above. The media even nicknamed the Olympus scandal "the Enron of Japan" (Armitage, 2012).

[4] In the competitive audit market, the success of audit firms largely depends on maintaining their reputation as providers of high quality auditing. This argument forms the basis of the reputation hypothesis as the main determinant of inherent economic value in audit services.

[5] The value of audit services is mainly derived from the role auditors play in providing their clients with an additional buffer against litigation claims in the event of clients' business failure (Menon and Williams, 1994). Auditors are frequently viewed as a party with "deep pockets" that is able to share the burden of a litigation charge directed against fraudulent companies by affected stakeholders.