

**AUDITOR REPUTATION, AUDITOR INDEPENDENCE AND LOCAL MARKET
PRICES:
CONTAGIOUS EFFECT ON ANDERSEN'S CLIENTS IN MALAYSIA**

by

Rohami Shafie
Lecturer
Faculty of Accountancy
Universiti Utara Malaysia
06010 Sintok, Kedah, Malaysia.
Phone: 04-9283725
Fax: 04-9285762
Email: rohami@uum.edu.my

Kamil Bin Md Idris
Associate Professor
Faculty of Accountancy
Universiti Utara Malaysia
06010 Sintok, Kedah, Malaysia.
Phone: 04-9283954
Fax: 04-9285762
Email: kamil@uum.edu.my

and

Wan Norhayati Binti Wan Ahmad
Lecturer
Faculty of Accountancy
Universiti Utara Malaysia
06010 Sintok, Kedah, Malaysia.
Phone: 04-9283782
Fax: 04-9285762
Email: wnwa@uum.edu.my

Key Words: Auditor Reputation, Auditor Independence, Market Prices

ABSTRACT

This study examines the impact of Andersen reputation on market prices using the event that Andersen has admitted shredded documents related to the Enron audit in United States. Specifically, in this paper, we extend to the other stock exchange out of United States, namely Bursa Malaysia. Is there any contagious impact on Andersen reputation to the Bursa Malaysia? Since the admitted announcement shows the issue of independence as the main focus in the Andersen case, this study also document the impact of non-audit fees on market reaction surrounding the admitted announcements date. Interestingly, the results prevails a contagious impact on Andersen's Malaysia office. However, Andersen's Malaysia office only suffered a less severe decline compared to Andersen's United States and Houston office. In addition, there is no evidence that Andersen's Malaysia questionable.

Keywords: Auditor Reputation, Auditor Independence, Market Prices

1.0 INTRODUCTION

Studies on auditor reputation have been discussed frequently in the accounting and auditing literatures. Such studies attempted to relate the audit reputation with audit fees, loan pricing and initial public offering (Palmrose, 1986a; Francis and Simon, 1987; Simon and Francis, 1988; Betty, 1989; Butterworth and Houghton, 1995; Blackwell, et al., 1998; Rose, 1999; Hartini, 2003). In addition, it is assumed that a reputable auditor also an independence auditor (De Angelo, 1981b). Many people assume that larger audit firms, especially the Big Five firms, are more credible than the non-Big Five firms. Thus, they are presumed to perform more quality works than the non-Big Five. This phenomenon pretends to give value added to the wealth of companies.

However, recently the Enron scandal in the United States caused the reputation and independence of the Big Five to be questionable. The history event happened when the Enron's auditor, Andersen, was heavily criticized for its collapse. After August 2002, Andersen was barred from conducting and reporting on the audits of SEC-registered companies. This is never happens in the history of auditing profession that such big firms are denied of its quality in that way.

The Enron case caused the auditor's reputation severely tarnish to the extent that many companies' (Andersen's clients) share prices significantly dropped simply because investors loss confidence on the auditor's reports (Chaney and Philipich, 2002). However, Andersen (also known as Arthur Andersen) was a multinational audit firms. The events occurred in the U.S may contagious to other nations. Nevertheless, empirical study has to be carried out to confirm such contention. This paper attempts to carry out such study.

2.0 PROBLEM STATEMENT AND MOTIVATION OF THE STUDY

An interesting issue in this study is the effect of auditor reputation onto investors' decision. In the Enron case, there was empirical evidence that investors reacted negatively when they loss confidence on the quality of audit performed by Andersen (Chaney and Philipich, 2002). However, whether the decline in reputation observed

for Andersen may contagious to other audit firms is yet to be determined. Since the Andersen's case was broadcasted and debated worldwide, many of its associates in other nations have become worried. Thus, the contagious effect is suspected to occur in other regions of the world where Andersen's name is associated.

Since the contagious effect of the Andersen case remains questionable, this study investigates such effect using local setting, namely among Malaysian companies listed in Bursa Malaysia (formerly known as Kuala Lumpur Stock Exchange) of Main Board and Second Board.

3.0 THE SIGNIFICANT OF THE STUDY

Today, auditor reputation has become the focus of many corporations and investors, especially those companies that are listed in the stock exchange. Although Malaysia never experiences any major audit litigation, this study may provide evidence that support the theory of "insurance hypothesis." Under this theory, investors view the audit products as including insurance against potential investment losses (Wallace, 1987; Menon and William, 1994). Auditors provide insurance to investors against losses sustained by their reliance on potentially inaccurate financial statement information. Should the results of this study are in congruence with what has been expected, and then the existing theory on "insurance hypothesis" is expanded to include the contagious effect of auditor reputation. This is a contribution to knowledge.

This study may also provide some useful insights to the policy maker. The utmost concern of the authority is the interests of investors. The interests of the local investors need to be protected whenever events of audit scandals occur abroad and has no connection with the local market. Thus, authority may want to produce some kind of guidelines or rules and regulations that may curb the unnecessary market reaction over events that occurred abroad.

4.0 RESEARCH QUESTIONS

The basic question in this study is to investigate the auditor reputation in Malaysia. For that reasons, the research questions are:

1. Does the auditor reputation affect the market prices?
2. Is there any contagious effect of auditor reputation of Andersen in United States to its branch in Malaysia?
3. Is there any impact of auditor independence to the market prices of their clients?

5.0 THE OBJECTIVES OF THE STUDY

To date, there is no study published on the effect of audit quality of bankruptcy audit firm on market prices in Malaysia. However, there is a study regarding IPO market and audit quality (Hartini, 2003). Thus, the objectives of this study are:

1. To examine whether auditor reputation affect the market prices.
2. To examine whether there is any contagious effect of auditor reputation

namely Andersen in United States to its branch in Malaysia.

3. To examine the effect of auditor independence to the market prices.

6.0 LITERATURE REVIEW

There are a number of previous studies that addressed the issue of audit quality for large audit firms. It is suggested that large audit firms produce higher audit quality than the smaller audit firms (Lennox, 1999). Such qualities are recognized as market react positively when a company switches to a larger audit firms from a smaller one (Nicholas and Smith, 1983). Also, studies by Reed, Trombley, and Dhaliwal (2000) found that Laventhol & Horwarth clients that selected Big Six auditors tended to be more highly leverage, have less management ownership, and issue more securities in the year after selecting the new auditor compared to L&H clients that selected non-Big Six auditors. Therefore it is assumed that the highly risks clients hired Big Six auditors in which presume as a reputable auditors, because they have to reduce those risks.

In addition, it was found that only 3% of the clients of Big Six firms, compared to 5.1% of smaller auditors' clients were involved in auditor lawsuits (Palmrose, 1988). She also found that on average, assurance level of Big Six auditors were 97% compared to those smaller auditors with only 95% assurance. In this study, she used 472 United States legal cases involving publicly held client-companies during 1960-1985. This result shows that Big Firm auditors are more competence in doing their audit and subsequently presumed to have higher reputation than the non Big Firm auditors.

However, this is not true when there are phenomenon occurred such as auditor bankruptcy and audit failure (Menon and William, 1994; and Chaney and Philipich, 2002). Therefore, this research focuses on two aspects regarding the impact of auditor reputation because such phenomenon rarely studied. First is to examine whether there is any contagious impact of Andersen's reputation to the Andersen's clients in Malaysia on market prices. Second is to investigate the effect of non-audit services on market prices.

Menon and Williams (1994) found that the disclosure of L&H's bankruptcy had an adverse effect on market prices of L&H clients. He used seasoned securities and initial public offering (IPO) loss as the determinant of Cumulative Abnormal Return (CAR). In addition, Green and Dawkins (2000) found that there was negative association between bankruptcy outcome and price reaction to bankruptcy filings.

Similarly, Moreland (1995) in his study of the effects of SEC criticisms (sanctions) of auditors on earning response coefficients (ERC) of client firms, found that abnormal security returns is negatively affected by earning prices. This is also supported by study by Firth (1990) who found that United Kingdom of Trade (DOT) investigations into the affairs of a specific company and their criticism on the auditors appear to incur economic losses from the damage of their reputations.

Moreover, Franz, Crawford and Johnson (1998) suggested that the market interprets litigation against an audit firm as a signal of decreased in auditor reputation. They found that the market places a value on auditor reputation. It is also evidence that

market react more negatively to the auditor reputation than the client's bankruptcy. Clients who were not involve in the litigation, however, experience significant negative returns when there is announcement of litigation against their audit firm. Moreover, in the case of Enron, events directly related to Andersen had a larger (negative) impact on stock returns than events directly related to Enron (Callen and Morel, 2002).

A further study by Chaney and Philipich (2002) using Andersen's client shows that the cost of audit failure would affect and impaired audit reputation. The results show that on the three following days after Andersen's admission of a significant number of documents had been shredded; the Andersen's clients experienced a statistically negative market reaction. This suggested that investors downgraded the quality of audits performed by Andersen (Chaney and Philipich, 2002). Besides, they also found that the clients whose audit was performed by Andersen's Houston office suffered a more severe decline in abnormal returns on this date. Similarly Krishnamurthy, Zhou and Zhou (2002) found that the deterioration of Andersen's reputation was the worse after its criminal indictment on March 14, 2002 caused the market to react more negatively to Andersen clients than to clients of the other Big Four auditors.

Besides concentrating and analyzing the effect of auditor reputation on market reaction of Andersen's clients, Chaney and Philipich (2002); Krishnamurthy *et al.* (2002) studied on the impact of non-audit services to the market prices. It is presumed that market react negatively to the larger non-audit services purchased by Andersen's clients, which show that the auditor independence is impaired (Chaney and Philipich, 2002; and Krishnamurthy *et al.*, 2002). However the results are mixed. Krishnamurthy *et al.* (2002) found that the abnormal return is significantly higher when auditor independence is perceived to be high. This is contrast to Chaney and Philipich (2002). The reason why this happens is because Krishnamurthy *et al.* (2002) used the date of Andersen criminal indictment on March 14, 2002 while Chaney and Philipich (2002) focused on the date of Andersen's admission that a significant number of documents had been shredded. Also, Chaney and Philipich (2002) uses sample which consisted relatively larger firms, whereas Krishnamurthy *et al.* (2002) sample consisted of many smaller firms. However, in general, both studies confirm that Andersen reputation was declined even different dates were used in their analysis. Therefore in this study, the date of Andersen's admission that a significant number of documents had been shredded will be analyze using the regression analyses to ensure that the results can be concluded clearly.

6.1 *The Extent of Auditor Reputation's Studies in Malaysia*

Study on auditor reputation in Malaysia began as early as 1990s. However, most of the studies used the 'audit quality' term. In addition, no studies differentiate between both terms. In the present study, the auditor reputation's term is emphasized. According to Simon et al. (1992) the audit quality in Malaysian's Public Listed Companies (PLCs) is lower than Hong Kong and Singapore. Two reasons were suggested. First because of different national regulatory environment existed in Malaysia that limited the involvement of international investors. This might be due to the fact that Malaysia is a developing nation while Hong Kong and Singapore are categorized as

developed nations. The regulations are not welcome the investors to invest in Malaysia. Therefore, the auditors are not given their best quality in auditing their clients as they are all local companies. Second was due to the fact that most of the PLCs are family-owned, therefore there is less needed to differentiate the quality services acquired from the auditors. It was presumed that their shareholders could easily get any information to reduce the agency cost. As a result, there is no need for Big Five firms.

However, lately, the shareholders are becoming emphasized on the audit quality of the auditors and more foreign companies have invested in Malaysia. Study by Rose (1999) shows that multinational firms paid higher audit fees than local firms. Similarly, Ayoib (2001) found that local Chinese controlled and/or owned companies paid less for audits as compared with foreign owned companies. Besides PLCs, Rohami (2003) also found that foreign banks are paid more on audit fees than local banks. Audit fees used as a proxy of auditor reputation. These three previous studies confirmed Eichenseher (1995) study in which the Big Six firms were found to have more involve with foreign-owned firms than non-Big Six firms.

Hartini (2003) found that Big Five audit firms are perceived to be more reliable by investors since they have a significant effect on the market valuation of Initial Public Offering (IPO). Her study is consistent with Datar et al. (1991) that suggested a positive relationship between audit quality and the market valuation of IPO. Thus, she contended that in Malaysia, investors do recognise the audit quality and giving them a signaling mechanism for decision making (Hartini, 2003).

Interestingly, there was an increasing rate of the market share among Big Six audit firms from 1991 to 1996, which shows that the Big Six audit firms dominated about 65% market share in 1996 and only 58.7% in 1991 in Public Listed Companies (PLCs). On the other hand, the non-Big Six dominated less as the market share decrease from 41.3% in 1991 to only 34.9% in 1996 (Takhiah et al., 2000). This indicates that the companies are more concern to hire the auditors based on the audit quality.

Even though there were studies on auditor reputation in Malaysia, which discussed above, yet there is no studies related to the impact of auditor reputation on market prices were carried out.

6.2 *The Extent of Non-audit Services's Studies in Malaysia*

Similarly, to date, there is no study that examines the effect of non-audit services on market prices in Malaysia. However, there were a number of studies carried out that related to the effect of non-audit fees on audit fees (refer to Mohd Atef and Ayoib, 2000; Ayoib, 2001; Rohami, 2003; Ayoib, Rohami and Norzalina, 2004). This adds to motivation to conduct this research.

The results of the above studies suggested that market has a high degree of insight into the auditor reputation.

7.0 HYPOTHESES DEVELOPMENT

The role of an auditor is to monitor a company. The monitoring mechanism is to ensure that managers act in accordance with owners' interests or to reduce agency costs such as increasing rate of managers' honest reporting and reduce the auditing demand by the owner (Chow, 1982; and Finley, Hopwood and Tucker, 1999). In addition, the reputation effect of an auditor will control the opportunistic value-reducing behaviour of the managers (Fama, 1980). This would happen in efficient competitive market (Fama, 1980). Thus, such reputation will protect the share price by adjusting the share prices accordingly (Watts and Zimmerman, 1986). In fact, the managers demand such quality of auditor to signal their honesty to the market (Jensen and Meckling, 1976). Subsequently, the last resort is to protect the shareholder interest. However, when an audit firm is in the case of uncertainty such as bankruptcy or lawsuits, the companies will together bear this uncertainty. As suggested by Menon and Williams (1994), this situation will lead to future monitoring uncertainty and the prospect of a delay in the filing of audited financial statements. Both may create possible losses to the companies such as negative reaction of stock prices.

In light of the Andersen's Malaysia case, the negative market reaction might not be seen before the announcement of Enron's bankruptcy because probably investors in Malaysia still did not know this news. In fact, the contagious effect would not happen before a bad news is announced. The brand name of Andersen was tarnished around the world after Andersen admitted shredded the Enron's documents. Later, such brand name has not been used outside the United States after Andersen United States was barred from auditing the companies. They then tried to find other Big Four for merging and building a reputable brand name. The brand name and audit quality represent the reputation of the auditor and is the most important feature of an audit firm (Dopuch and Simunic, 1982). A repetition story of Andersen failure in the news and press worldwide may also portray an eroded reputation because an action was called to be taken to the Andersen by outsiders such as Securities Commission and public (Peurseem and Hauriasi, 1999). We argue that it may results the investors outside United States to pull out the investment in Andersen clients.

Evidence shows that deterioration in the audit quality of Andersen occurred no later than mid-1990s compared to other Big-Five (Fuerman, 2003). What would happen that Andersen could not protect their liability from any legal regime in the world when the consequence of audit quality and audit failure were severe after they admitted shredded the documents even though Andersen was assumed providing a high audit quality to their clients (Kadous, 2000). Again, we expect that the Andersen United States reputation will also effect the reputation of Andersen worldwide specifically Andersen Malaysia, hence, reflecting negatively in the share prices of its clients.

Study by Callen and Morel (2002) proved that events directly related to Andersen had a larger (negative) impact on stock returns than events directly related to Enron. Therefore, in the case of events directly related to Andersen, it is expected that a negative reaction will be prevailed. In this present study, one event directly related to Andersen' United States that might be effect other Andersen around the world including Malaysia is studied. The date is the announcement of shredding documents,

which Andersen had admitted on Jan 10, 2002. This announcement is the bad news to Andersen's clients. Event on Jan 10, 2002 was unexpected and was met with shock in the business community due to the fact that normally when audit firms paid damages to lawsuit claimants or penalties to the SEC, they are careful not to admit guilt (Chaney and Philipich, 2002). Subsequently, this will tarnish the Andersen reputation. As a result of the bad news, the Andersen's clients also effected. It is argued that the contagious impact will happen in Malaysia due to the fact that Malaysia is an open market nation and Andersen established its branch over here. However, the contagious impact would not spread to other Big Four because it only involved Andersen's reputation (Krishnamurthy *et al.*, 2002). Therefore the following hypotheses are derived as follows (in alternate form):

H1a : Andersen's clients in Malaysia will experience a negative market reaction to the announcement of news that Andersen admitted shredded documents related to the Enron audit, is made public.

H1b : Andersen's clients in Malaysia will experience a negative market reaction to the announcement of news that reflects negatively on the Andersen's reputation.

In addition, the negative abnormal returns could be driven by the Andersen independence. It is argued that audit firms provided other services rather the audits to some extent impair their independence. In the Andersen's case, the event that Andersen admitted shredded documents related to the Enron audit are likely impaired Andersen independence. This will be more prominent if Andersen perform more on other services rather than audit services. As the consequences, the reliability and validity of Andersen audit of their companies could be denied and questionable. Investors will belief that Andersen did not give the best opinion as "true and fair view" to their clients. Thus, the negative abnormal return would be larger if the auditor independence perceived to be impaired.

H2 : There is a positive relationship between audit fee ratio and abnormal return for events that perceived Andersen not to be independence.

Consistent with the measurement used by Krishnamurthy *et al.* (2002), the measurement of Andersen independence is the ratio of audit fees to total fees. The reason this measurement is used because low audit fee ratio shows that the auditors provide large amounts of non-audit services, and therefore perceived to be not independent (Krishnamurthy *et al.* 2002).

8.0 RESEARCH DESIGN AND SAMPLE SELECTION

8.1 Sample and Data

The sample comprised of all Andersen's clients in Malaysia in the year of 2000 and the clients must maintain engagement with Andersen until 2002. Total sample is 101 companies. For descriptive analysis, the date that Andersen admitted shredding the documents on January 10, 2002 is used. Ten trading days on stock prices of Bursa Malaysia (Main and Second board) are gathered (see Menon and Williams 1994).

8.2 Explanations of the Model

Fama, Fisher, Jensen and Roll (1969) pioneered the event study. Later, in 1980s, the researchers introduced the cross sectional studies using abnormal returns and firm specific variables of size and leverage (see Leftwich, 1981 and Jain, 1982). Thus, this study replicates the established model of cumulative abnormal return from previous studies in market reaction of audit quality that is used worldwide in auditing literature (see for example, Menon and Williams, 1994; Chaney and Philipich, 2002; Krishnamurthy *et al.*, 2002 in the United States; and in Asia, Gul, Sun and Tsui, 2003) and extended to accommodate the Malaysian environment. Several variables such as size and risk are control in the Ordinary Least Squares regressions, in which possible to influence market returns (see for example Menon and Williams, 1994; Chaney and Philipich, 2002; and Krishnamurthy *et al.*, 2002 in the United States; and in Asia Gul, Sun and Tsui, 2003). Both variables are well specified in the model (Leftwich, 1981). Size and risk are proxied by the natural log of total assets and debt/total assets ratio (debt ratio). Size and risk provide a simple and powerful characterization of abnormal return in finance literature (Banz, 1981; and Fama and French, 1992). Both variables are powerful variables to explain Cumulative Average Return (CARs). Other variables ;sales growth (SALESGROW), Andersen (AA) and financial year-end (FYR) are most likely to attribute the price movements within the window period, thus, affect the market return (Menon and Williams, 1994; Chaney and Philipich, 2002; and Krishnamurthy *et al.*, 2002 in the United States; and in Asia Gul, Sun and Tsui, 2003). Below are the detailed explanations of each variable that likely attribute the price movements within the window period, which may attribute to the contagious effects.

This study uses one sample t-test and the regression analysis (OLS) to analyze the data. The research models are as follows:

Andersen admitted shredding documents

$$\text{CAR} = a + \beta_1\text{FEERATIO} + \beta_2\text{LOGASSETS} + \beta_3\text{SALESGROW} + \beta_4\text{LEV} + \beta_5\text{AA} + \beta_6\text{FYR} + e$$

where,

CAR= The Cumulative Mean Abnormal Return for Andersen client over the two, three and five days around admitted of shredding documents by Andersen.

$$\text{CAR} = \sum_{t=0}^T \text{SAR}_{it}$$

where,

$$AR_{it} = R_{it} - (a + \beta_i R_{mt})$$

AR_{it} = Abnormal Return

R_{it} = Observed return on security I

R_{mt} = Return on the KLSE Composite Index (KLCI) for the t th period

a = Intercept

β_i = Beta for firm I^1

FEERATIO = The ratio of audit fee to total fees paid to Andersen

LOGASSETS = \log_{10} of total assets

SALESGROW = Percentage growth in sales from 1999-2000

LEV = The ratio of long-term debt plus short-term debt to total assets

AA = Indicator variable having a value of 1, if the name of auditor is Andersen and 0, if Hanafiah Raslan Mohamad

FYR = Indicator variable having a value of 1, if the fiscal year-end between December 31 and January 31, and 0, if otherwise

a = constant ($i = 0$)

β = Coefficients = $i = 1, 2, 3, 4, 5$

8.3 Definition

8.3.1 Cumulative Abnormal Return (CAR)

CAR is the dependent variable. CAR is measured by the total of difference between return for client and return on the value-weighted Composite Index of Bursa Malaysia (the expected return).

8.3.2 Audit Fee Ratios

This is the first hypothesis variable, which defined as the total audit fee to total fees paid to Andersen. The objective to include this variable is to see whether the auditor independence affect the market return. Both Chaney and Philipich (2002); and Krishnamurthy *et al.* (2002) predicted a positive relationship between audit fee ratios and market return if the auditor independence is perceived to be impaired by investors. The Company Act 1965 required every company to disclose the amount of audit fees paid to their auditors in the annual reports. Audit fees are measured by the dollar value of audit fees paid by the companies to the Andersen. The total fees are the total of audit fees plus non-audit fees. Beginning 1 June 2001, the companies listed in Bursa Malaysia are required to disclose the amount of non-audit fees.

8.3.3 Assets

This variable is defined as total assets. One effect that the size variable should pick up is the increase in audit costs, given that previous studies shows that audit fees are a function of size (Menon and Williams, 1994). This will lead to the negative relationship between size and return. The market may react negatively to the large clients of Andersen because they downgraded the audit quality of Andersen

¹ Betas were estimated using a 100-day estimation period that ended December 31, 2001 (refer to Menon and Williams, 1994). Composite Index of Bursa Malaysia was used to compute market returns.

when audit the large clients in Bursa Malaysia. This may due to the market sentiments in Bursa Malaysia (Noor and Wan, 2004). In addition, large Andersen clients are often viewed as having the ability and the incentive to manage earnings, more complex, less transparent, thus the market may discount the quality of their reports (Chaney and Philipich, 2002). Similarly, large clients also have a large information asymmetry between managers and investors when market participants generate and disseminate less predisclosure information of the companies (Ho, Liu and Ramanan, 1997). In fact, the negative relation between size and market return is robust in various finance literature such as Banz (1981); and Fama and French (1992). This is confirmed by Gul et al. (2003). However, it will not prevail due to size surrogate for other effect as well (Menon and Williams, 1994). For example, Krishnamurthy *et al.* (2002) found no relationship between size and return.

8.3.4 Sales Growth

This is one of the control variables, which defined as percentage growth in sales from 1999-2000. Sales growth is between 1999 and 2000 used to capture potential aggressive revenue recognition procedures by companies (Chaney and Philipich, 2002). Sales growth is an indicator of future profitability. The announcement of Andersen audit failure by themselves shows that unclear reliability of the financial statements audited by Andersen. Hence, the investors will react negatively when Andersen clients sales growth increase dramatically because it can be said that the financial statement audited by Andersen were not reliable due to the audit failure of Andersen. Investors may assume that Andersen did not control the earning managements of their clients. In addition, the market will downgrade Andersen clients with high growth in sales because these companies might be using aggressive revenue-recognition strategies that could not be sustained in the future (Chaney and Philipich, 2002). Moreover, in general, the managers have an incentive to be bias and distort the figures for their self interest. Hence, this would not resolve if low quality auditor audited the figures (Healy and Palepu, 1993). Andersen may not increase the credibility of financial statements by verifying the management estimation. But, what would happen is that, the information asymmetry would be greater between managers and investors. This will lead to the negative relationship between sales growth and return. Chaney and Philipich (2002) found a significant negatively relationship between this two variables. However, Krishnamurthy *et al.* (2002) found no significant relationship between sales growth and return although the sign was negative.

8.3.5 Leverage

The other control variable is leverage. It is argued that firms with high leverage may be more likely to use inadequately disclosed off- balance sheet transactions that may hide the firm's true financial condition (Krishnamurthy *et al.*, 2002). Also, a high leverage will cause the

market judges the prospects of Andersen clients to be poor (Fama and French, 1992). Thus, market will react negatively with Andersen clients with high leverage. For example, Gul et al. (2003) found a statistically significant negative relationship between CARs and leverage. Therefore it assumed that a larger negative reaction would be seen for companies that have higher leverage than lower leverage.

8.3.6 AA

Since 1990, Andersen worldwide was team up with the first and largest local audit firm in Malaysia namely Hanafiah Raslan Mohamad. The purpose of the team was to use the name of Andersen in the global market. However, there are clients who like to use local brand name of Hanafiah Raslan Mohamed. Thus, it may provide different effect on market prices. Due to the Andersen reputation tarnish in the global market, the effect will be more severe when the clients using the Andersen's name compare to local brand name. For example, Gul et al. (2003) found that market responds positively to the companies that audited by well-established auditor with high reputation. Hence, the market is expected to react negatively with Andersen reputation compare to local brand name.

8.3.7 Financial Year-End (FYR)

Financial year-end controls for monitoring uncertainties resulting from the possibility of lengthy delays before audited statements for the period were issued (Menon and Williams, 1994). Besides, the financial year-end controls the uncertainty of clients that just ended their fiscal year before audited by Andersen. The investors will react negatively for the clients that have fiscal year end within the event date of Andersen admitted shredded the document. This might be because the market judges these clients as poor company in the sense that their financial statements will be audited by low reputation auditor. Therefore, FYR is expected to have a negative relationship with CAR.

9.0 RESULTS AND DISCUSSIONS

9.1 *Descriptive Analyses*

Table 1 shows that how the sample is gathered. As suggested by Menon and Williams (1994), the companies must meet all the following criteria; first, the companies should have stock return data. Second, additional data in the analyses should be available; third, the trading price should at least RM0.25. Lastly, the companies should not make a dividend or earnings announcement on the ten trading days.

In addition, all Practice Note 4 companies are eliminated to ensure no compounded effect and also meet the Menon and Williams (1994) requirements. After eliminating all insufficient samples, the total sample is 101 companies. These companies are used to see the abnormal return and cumulative abnormal return (refer to Table 2). Out of 101 companies, only 54 companies that disclosed non-audit fees (include companies that did not

purchase non-audit services). Thus, the companies that disclose non-audit fees are used in the regression analyses.

Table 1: Sample Selection: Andersen’s clients in Bursa Malaysia

Total Andersen’s Clients	154
<i>Less</i>	
Delisting companies	3
Practice Note 4 companies	32
Earning Announcement	3
Dividend Announcement	5
No Return Data	6
No Annual Report	1
Trading price below RM0.25	3
Total Sample	101
Companies that purchased Non-Audit Services (NAS)	28
Companies that did not purchase NAS and disclose it in the annual reports	26
Total Sample for regression analyses	54
Companies that are silent on NAS (assumed did not purchase NAS)	47
Total sample	101

Table 2 shows daily excess returns for Andersen over the ten days surrounding the admitted announcement, which is, three trading days preceding the event window and five trading days after it. Overall, it can be said that, the Andersen’s clients stock prices react negatively a day after January 10, which is starting from January 11 until January 16 (weak significantly different from zero at 0.1 level, two-tailed test). The reason might be due to the fact that the news only contagious a day after the admitted announcement. Also, it might due to different time.

Table 3 confirms that CARs for Andersen clients are significantly negative for two and three event windows. However, both abnormal returns and CARs are less severe compare to Andersen’s counterpart in United States and Houston (see Chaney and Philipich, 2002). For example, on January 11 average abnormal returns for Andersen’s clients in Malaysia are only -.3547 % compare to Andersen’s clients in United States with -0.78%. Similarly, in Malaysia, CAR for two event windows (0, +1) is only -.7043%, while United States and Houston office are -1.17% and -3.16% respectively. Again, it is shows that Andersen’s Malaysia office is less severe decline on this date. Overall, the results from Table 2 and Table 3 support Hypothesis 1 (1a and 1b).

Table 2: Effect of Andersen Admitted Announcement of Shredded Documents on Security Prices of Andersen Clients in Malaysia-Abnormal Returns for Ten days Around Disclosure Period

Date	Average Abnormal Return (%)	t-test
Jan 7	-0.3366	-1.593
Jan 8	-0.3603	-1.7*
Jan 9	-0.3148	-1.493
Jan 10	-0.3496	-1.647
Jan 11	-0.3547	-1.676*
Jan 14	-0.3674	-1.730*
Jan 15	-0.3609	-1.704*
Jan 16	-0.3624	-1.711*
Jan 17	-0.3506	-1.654
Jan 18	-0.3516	-1.654

* Significant at 10% (2-tailed)

Table 3: Effect of Andersen Admitted Announcement of Shredded Documents on Security Prices of Andersen Clients in Malaysia-Cumulative Abnormal Returns (CARs)

Event Window	Cumulative Abnormal Return (%)	t-test
(0, +1)	-.7043	-1.664*
(0, +2)	-1.0717	-1.686*

* Significant at 10% (2-tailed)

9.2 Multivariate Regression Analyses

Before using multivariate regression analyses, an analysis on multicollinearity was done. Table 4 shows that only LEV and LOGASSETS is positively associated at 0.01 levels. However, the coefficient between both variables is still acceptable (0.518). To ensure the multicollinearity does not pose serious problem to the multivariate regression analyses, variance inflation factors (VIF) are computed. Evidence exhibits that VIF are under 2. Therefore, it indicates that the multivariate regression analyses can be used to test the Hypothesis 2 with minimal multicollinearity problems

The purpose to use the multivariate regression analyses is to test Hypothesis 2. If Hypothesis 2 is true, the issues of auditor independence, specifically Andersen's Malaysia must be worried. However, the results from Table 5 do not support Hypothesis 2 for both event windows (two-day-window and three-day window). FEERATIO is insignificant although the sign is positive as expected.

The coefficients for other variables are in the expected directions. However, only two variables are significant. AA and FYR have significantly negative associated to CARs at 0.05 levels (two-tailed test). AA is introduced in the analyses because Andersen was team up with the largest local audit firm of Hanafiah Raslan Mohamad (HRM). The market of audit firm in Malaysia is unique because most of the Big Five team up with local audit firm. Therefore, it is assumed that Andersen is more reputable compared to HRM but not after the shredded document scandal. This might due to the fact that international investors foresee the Andersen quality downgraded after the admitted announcement of shredded document by Andersen. The negative coefficient confirms this contention. The variable FYR has a significantly negative coefficient and consistent with Menon Menon and Williams (1994).

The regression analysis of the two-day window does not much different with the three-day window. Adjusted R^2 for both event windows are 0.129 and 0.129, respectively, which is comparable with other studies (refer to Menon and Williams, 1994; Chaney and Philipich, 2002; Krishnamurthy *et al.*, 2002). Besides, both models are significant at 0.049 and 0.051. Further tests are also employed and the results still hold.²

The results should be interpreted cautiously due to the fact that the declining share prices of Andersen's clients might not be solely necessarily because of the event involved with the shredded reputation of Andersen in United States. The results might be clearer if we include non-Andersen clients as a control sample. However, due to unavoidable constraints, an analysis on the non-Andersen clients could not be conducted.

There are two kinds of results that will be revealed for non-Andersen clients. First if the abnormal return and cumulative abnormal return for their clients are not significant, it shows clearly about the contagious effect. However, if the results are significant and similar with Andersen's clients, it shows that it is congruent with the efficient market hypothesis. Evidence reveals that the investors in Malaysia market follow the market sentiments (Noor and Wan, 2004). Thus, this gives a significant impact on non-Andersen clients because of the investors are so panic about the event happened in United States and the heavily criticisms on the audit quality of auditors including Big Five firms after the scandal involved Andersen.

Although the research design does have such constraints, this study still provides some empirical evidence on insurance hypothesis theory using the

² The non-audit fees ratios are used to replace audit fees ratios and the results still similar.

stock prices. In fact, contagious effects can be expanded to other countries. There is some evidence shows that Andersen Malaysia reputation also affected by the shredded reputation of Andersen US. But, in the case of Andersen Malaysia independence, there is no evidence that investors react negatively when Andersen Malaysia providing large non-audit services to their clients.

Table 4: Correlation Matrix between Independent Variables

	FEERATIO	LOGASSETS	SALESGROW	LEV	AA	FYR
FEERATIO	1	.144	-.161	.041	.027	-.126
LOGASSETS	.144	1	-.056	.518(***)	-.117	-.014
SALESGROW	-.161	-.056	1	-.075	.056	.007
LEV	.041	.518(**)	-.075	1	-.154	.038
AA	.027	-.117	.056	-.154	1	.162
FYR	-.126	-.014	.007	.038	.162	1

*** Correlation is significant at 1% (two-tailed).

Table 5: Effect of Andersen Admitted Announcement of Shredded Documents on Security Prices of Andersen Clients in Malaysia-Regression of Cumulative Abnormal Returns (CARs), N=54

Variables	Expected Sign	Two-day window		Three-day window	
		Coefficient	t-statistic	Coefficient	t-statistic
FEERATIO	+	.123	0.924	.122	0.918
LOGASSETS	-	-.011	-0.073	-.009	-0.061
SALESGROW	-	-.159	-1.217	-.158	-1.211
LEV	-	-.026	-0.169	-.026	-0.171
AA	-	-.266	-2.012**	-.266	-2.013**
FYR	-	-.278	-2.114**	-.276	-2.098**
Constant	+/-		0.122		.1090
Adjusted R ²			0.129		0.128
F ratio			2.310		2.292
Prob > F (Two-tailed test)			0.049		0.051

** Significant at 5% (2-tailed)

Variable description:

- FEERATIO = The ratio of audit fee to total fees paid to Andersen
- LOGASSETS = Log₁₀ of total assets
- SALESGROW = Percentage growth in sales from 1999-2000
- LEV = The ratio of long-term debt plus short-term debt to total assets
- AA = Indicator variable having a value of 1, if the name of auditor is Andersen and 0, if Hanafiah Raslan Mohamad
- FYR = Indicator variable having a value of 1, if the fiscal year-end between December 31 and January 31, and 0, if otherwise

