

THE IMPACT OF AUDIT FAILURE IN JAPAN

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ABSTRACT

The first part of the lecture investigates the impact of accounting fraud by Kanebo and the resulting penalties on Kanebo and its auditor, ChuoAoyama, on the stock prices of clients of ChuoAoyama and the other Big 4 auditors in Japan. Studying the case of a low-litigation country provides us an opportunity to test whether reputation loss of auditors matters without an insurance rationale. We find that the announcements of poor audit quality significantly decreased the stock prices of clients of both ChuoAoyama and the other Big 4 auditors. Such industry-wide spillover has not been examined using a low-litigation setting in previous studies.

The second part examines whether auditor credibility impairments spill over internationally by examining a unique coincidence of audit scandals on a similar scale in the U.S. and Japan. Since the Japanese Big 4 auditors are members of the global network of the U.S. Big 5 (4 after 2002), audit failure in one country negatively affects stock prices of clients of big auditors in the other country. We find that clients of the Japanese Big 4 auditors experienced negative stock market reactions to events related to the Andersen scandals. Similarly, we find that clients of the U.S. Big 4 auditors experienced negative stock market reactions to events related to the ChuoAoyama scandals. These results confirm a two-way international spillover between Japan and the U.S. We also find that negative stock price reactions are larger for clients of the Big 4 auditors in Japan than in the U.S. market.