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AFTER ENRON: EMPIRICAL EXAMINATION ON EARNINGS CONSERVATISM IN MALAYSIA

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Abstract

The failure of ENRON and subsequent demise of Arthur Andersen has renewed interest in earnings and audit research. This study examines the impact of ENRON debacle on earnings conservatism in Malaysia. We hypothesised that in the period after ENRON, the auditors and managers of the firms have incentives to report more conservatively to avoid risk of litigation and to protect reputation capital. Based on a sample of 1043 firm-years over the period of 2001 and 2002, we find that, on average, firms do report more conservatively in 2002. In addition, evidence suggests that former Andersen clients report more conservatively in 2002 relatively to non-Andersen clients. Further, we document similar results for firms switching to from another Big 4 to another Big 4 auditing firm in 2002. Finally, we discover firms that did not switch in 2002 do report more conservatively in 2002. We conclude that the ENRON debacle have a profound impact on firms to report more timely earnings.
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Introduction

The level of earnings conservatism on average present in a given economy has been studied extensively in the past (e.g. Basu, 1997; Pope and Walker,

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1999; Ball, Kothari and Robin, 2000; Ball, Robin and Wu, 2003; Watts, 2003a, 2003b; Jain and Rezaee, 2004; Gul, Srinidhi and Shieh, 2001). Basu (1997) defines conservatism - 'reflecting bad news more quickly than good news' as recognising good news requires a higher degree of verification to be recognised in financial statements compared to bad news. This asymmetry in recognition leads to systematic differences between bad news and good news in terms of timeliness. Thus, the long-standing accounting principle of conservatism is operationalised to refer to the asymmetric timeliness of news recognition.

Watts (2003b) lists contracting, litigation, taxation and regulation as the primary factors used in the literature to explain the existence of earnings conservatism. Watts (2003a) argues that the contracting and litigation explanations for the existence of conservatism stem from the fact that the parties to the firm have asymmetric information, asymmetric payoffs, limited liability, and different time horizons. Conservatism produces accounting numbers that can be used in contracts among the parties to reduce these moral hazard problems. It benefits the users of financial statements by constraining managers' opportunistic payments to themselves and to other parties, mitigates agency problems associated with managerial investment decisions, increases debt and other contracts agreement efficiency, facilitates the monitoring of contracts, and reduces litigation costs (Watts 2003a,b; Ball and Shivakumar, 2005).

The episode of ENRON and the demise of Arthur Andersen (hereafter, Andersen) in 2002 highlighted the importance of investigating earnings conservatism, a measure of financial reporting transparency. The importance is driven by the risk of litigation against auditors (Holthausen and Watts, 2001; Krishnan, 2007).[1] In addition, Barton (2005) argues that managers do care about their own reputation and use auditor change to signal their credibility. Therefore, managers and auditors, particularly brand-name auditors, have market-based incentives to enhance earnings conservatism (Krishnan, 2007).

The purpose of this study is to investigate whether earnings conservatism has increased for firms in the period after the ENRON saga or 2002, for both Andersen and non-Andersen clients. As such, we employ the method suggested by Basu (1997) in determining the level of conservatism employed both by the managers and auditors of former Andersen clients. Evidence in relation to earnings conservatism is relatively scarce in Malaysia. Further, no evidence has been documented in relation to the nature of earnings conservatism surrounding the ENRON saga in 2002 in Malaysia. Since Malaysia's institutional settings is different from the U.S, it will be interesting to examine whether the observation is different or similar with other countries.

The need to study earning conservatism in Malaysia also stems from the growing importance of corporate transparency in Malaysia. Aziz (1999) highlighted that one of the concerns of transparency issue in Malaysia is some of the major transactions which involved multi-million dollar contracts are often dealt through the close-negotiations rather than open-bids. Therefore, even though there is an increasing number of recent corporate failures all over the world, less attention is given to Malaysia as some of the cases are put out of sight due to the Malaysia's political economy having surrounded with political connection and cronyism (Johnson and Mitton, 2003; Faccio, 2007). The recent case of state-controlled conglomerate Sime-Darby collapse highlighted this issue more.

Thus, the main motivation of this study is to analyze whether firms in Malaysia are alert to the recent cases of corporate failures and do take a further initiative to be more conservative in their reporting. It is expected that firms will be more conservative as they switch auditors due to the increase in litigation pressure and this switching is important to signal firm's credibility to the investors. As conservatism has been used as a proxy for corporate transparency by previous researchers (Francis et al., 2004; Vichitsarawong et al., 2010), this study contributes in highlighting the issue of corporate transparency in Malaysia and to relate the results of the study with the Malaysian's institutional setting.

This study is more relevant as Malaysia have different institutional backgrounds and this unique feature might contribute to different results compared to the other studies with the same objectives. First, Andersen Malaysia is wholly owned by Malaysians, who are also partners of Hanafiah Raslan and Mohamad (hereafter, HRM), which is the largest local accounting firm. Unlike Andersen Singapore, Andersen Malaysia has a local firm and this local firm, HRM is a strong local brand. Therefore, after the demise of US Andersen, the Malaysia counterpart is under no pressure to merge with its rival (Big 4) although without an international link it may lose some global clients. Andersen Singapore opted to merge with Ernst and Young, as did units in New Zealand and Australia, while Andersen Thailand agreed to form a business alliance with rival KPMG and in Hong Kong and China, Andersen units chose to tie-up with PricewaterhouseCoopers. According to Zainal Abidin Putih, Chairman of both Andersen Malaysia and HRM, the local unit was strong financially and capable of operating independently (Reuters, rediff.com, April 4, 2002). Thus, it is expected that the significance of conservatism might be different compared to other institutional background. In addition, to date 2002 Andersen audits an estimated 153 of the more than 800 companies listed on Bursa Malaysia (formerly known as Kuala Lumpur Stock Exchange), industry estimates give PricewaterhouseCoopers the largest share of clients among the top 100 companies on the KLSE, followed by Ernst and Young, KMPG, Andersen and Deloitte.[2]

Second, Malaysia is categorised as common law country which has higher disclosure scores than civil law countries. Ball et al. (2000) stated that the desirable properties of accounting income in common law countries are determined primarily in the disclosure market and therefore, public disclosure becomes a more likely solution for the information asymmetry problem that arise. They find that accounting income in common law countries is more timely and more conservative than in civil law countries. La Porta *et al*. (1998) argue that legal protection of shareholders will be the strongest in common law countries and weakest in French civil law countries. Nevertheless, although the accounting system in this country is derived from common law sources (the United States, United Kingdom, and IASB), Ball *et al*. (2003) conclude that timely recognition of economic losses of this country is not higher than those under code law countries due to lack of enforcement.

Due to these differences of institutional background, it is expected that the significance of conservatism might be different in Malaysia compared to other institutional background such as Singapore which has stricter enforcement (The World Bank, 2005) and Thailand whose practices are ahead of rules (CLSA, 2007).

Since we are interested in examining the impact of ENRON on earnings conservatism in Malaysia, we start our empirical analysis on the directly affected firms which are former Andersen clients. The analysis is important to investigate whether the increase in litigation risk after ENRON demise will influence the firms to report more conservatively compared to non-Andersen clients. We based our analysis on 132 firm-year observations of non-financial Andersen firms listed on both the Main and Second Boards of Kuala Lumpur Stock Exchange.[3]

Similar to Krishnan (2007), we adopt Basu's (1997) conservatism model as our primary mode of empirical analysis. In spite of its limitations that have been voiced out by other researchers (Givoly and Hayn, 2000; La Fond and Watts, 2007), Basu's (1997) model is used as previous studies (Ball *et al*., 2000; Ball *et al*., 2003; Kung *et al*., 2008; Chi *et al*., 2009) have shown that estimated asymmetric timeliness coefficients reveal predictable associations with economic, legal and political institutional variables, at the firm, industry, and jurisdictional levels. Therefore, Ball *et al*. (2009) conclude that the estimated asymmetric timeliness coefficients presented in Basu's model capture a true property of accounting income and not some statistical artefact as claimed. In addition, Ball *et al*. (2009) further state that it has been proved that other models such as Ball and Shivakumar (2005) who use accruals and cash flow and Givoly and Hayn (2000) who use accrual-based proxy also produce the same results as Basu's model.

We find that former Andersen clients do report more conservative earnings in the year 2002. Our further analysis find that if the Andersen clients move to another Big 4, they report more conservatively than the Andersen client move to a non-Big 4. The analysis is important as such to examine whether firm switch their auditors due to the increase in litigation risk or whether they switch to Big 4 auditors to signal its credibility to their investors.

Next, we examine non-Andersen clients who switched either to Big 4 or non-Big 4 auditor during the same period. We find evidence, from a sample of 65 firm-years, that firms switching from another Big 4 to another Big 4 during the debacle, reports more conservatively. Further, our findings indicate that, in general, firms reported more conservatively after the ENRON saga, for either both switching and non-switching firms. In addition, Big 4 firms (non-switching) were more conservative in 2002. Due to their larger size, firms audited by Big 4 auditors have a higher litigation risk than non-Big 4 clients. The result indicates that Big 4 auditors impose greater conservatism on their clients' financial reports to reduce their legal risk and maintain audit quality (Hermann *et al*., 2008).

The paper is organised as follows. The next section describes the institutional settings in Malaysia and gives a brief description of former Andersen clients. Section 3 illustrates prior research on conservatism. Section 4 explains the rationale behind the hypotheses developed for this study while Section 5 describes the research methodology. Findings and discussions of results are detailed in Section 6 and Section 7 concludes.

Institutional Background

ENRON Demise: Malaysia as ex-Andersen Clients

The collapse of ENRON Empire in 2001 shattered the whole nation especially those in the business and accounting area as the company was the largest merchant of natural gas in North America, and the gas trading business became the second largest contributor to ENRON's net income. It was the largest firm's bankruptcy in the U.S history, surpassed seven months later by WorldCom's bankruptcy. The case was a big surprise particularly to the shareholders of ENRON as the financial reporting of the company was 'decorated' with promising profit, lower debt and higher revenues. A combination of aggressive accounting, off-balance-sheet deals and brow-beating of employees and advisers, has allowed ENRON management to create a virtual company with virtual profits.

ENRON bolstered profits by booking income immediately on contracts that would take up to 10 years to complete. It shifted debts into partnerships it created and the entities have been used to manipulate its accounts at the end of each quarter and employed financial derivatives and other complex transactions aggressively to the same end (ENRON: The Collapse, http://specials.ft.com/enron/index.html). The 'aggressive' accounting strategies used by ENRON has successfully disguised the eyes of the ENRON's stakeholders until the scandal was revealed and it was declared bankrupt in late 2001.

The ENRON debacle and the role of Andersen in that context have damaged the reputation of the auditors, and especially that of Big 4 accounting firms. In the aftermath of ENRON, financial statement users place high scrutiny and public distrust in the audit profession which definitely led to the increase in the threat of litigation for alleged audit failures and thus the auditor's business risk. This one strategy for auditors to manage this increased business risk is to report more conservatively.

In fact most of Andersen's non-U.S members, including Malaysia, defected from Andersen before the US arm was convicted on June 15, 2002 (Cahan *et al*., 2005). Therefore, this study is appealing as Malaysia is one of the ex-Andersen clients that suffer from the demise of Andersen. Andersen's name was an international brand and thus it is expected that by some means the events involving Andersen's U.S arm, Arthur Andersen event gave a negative reaction to the Malaysia capital market.

At the same time, even though auditors in Malaysia were required by the Companies Act to report in writing where a breach of the Act has occurred and where he or she has no confidence that the directors will deal adequately with his task, on a practical level breaches of the law in this country are hard to detect and even harder to prove, especially in cases of fraud, forgery, collusion or management override of control systems. Some of the cases are even carried out or hindered by political figures. Besides, the Companies Act does not require an auditor to give an opinion as to whether the information given in the directors' report is consistent with the audited accounts and there are no KLSE rules requiring directors to agree with auditors on the content of preliminary announcement of financial results (The World Bank, 2005).

Favere-Marchesi (2000) analyses audit quality in ASEAN countries based on the legal environment faced by auditors in those countries. The study notes that auditor independence was seriously compromised in some countries (eg. in Brunei, Vietnam and Philippines) and the lack of a liability regime faced by auditors. Therefore, he suggests that Malaysia needs improvements for statutory auditors mandating a proficiency examination and the expansion of civil liability. Hence, reputational damage resulting from publicity with respect to either litigation or unprofessional conduct is not of the same importance in Malaysia as in Western countries. Given this lower external discipline and monitoring of auditors, it is expected that the significance of conservatism might descend a little bit.

In spite of that, Malaysian public listed companies are typically characterised with high levels of ownership concentration (Abdul Samad, 2004; Claessens *et al*., 2000). Therefore, the agency problem in Malaysia exists between minority shareholders and the majority shareholders (not between shareholders and management) who often have effective control over the managers (Morck and Yeung, 2003; Hanazaki and Liu, 2003; Claessens and Fan, 2002). This high control concentration and a large separation of control and ownership are more likely to led the firms to hire Big 4 auditors than non-Big N firms subject to agency problem. In order to mitigate agency costs, firms are likely to hire larger expert auditors that can enhance the quality of financial reporting after the downturn of Andersen. Yatim *et al*. (2006) find that larger audit committee expertise reduces auditors' risk assessments associated with the financial reporting process. As auditors face less risk of making errors, the reduction of the risk will then enhance the quality of financial reporting.

Former Andersen Clients: Where are they After ENRON

After the ENRON saga in 2001-2002, the clients of Arthur Andersen were forced to switch to another auditor. Although most of them switched to Ernst and Young, there were some clients who moved to a transitional auditing firm in 2002. The transition to Ernst & Young is probably due to the effort that has been done by the firm to pick up most of Andersen's affiliates in Southeast Asia after losing out to rivals in Hong Kong, China and Taiwan (Taipei Times, 2002). Table 1 tabulates the descriptive statistics on former Andersen clients. As at 2001, they are 66 non-financial firms audited by Arthur Andersen.[4]

Table 1: Switching Analysis on Former Andersen Clients (2001-2002)

Switching Movement	Sum	Percentage
AA_TO_OTHERS	20	30.303
AA_TO_HRM	25	37.879
AA_TO_EY	19	28.788
AA_TO_BIGN	2	3.030
	66	100.000

AA_to_OTHERS is former Andersen clients switched to Non-Big N auditing firms. *AA_to_HRM* is former Andersen clients switched to Hanafiah, Raslan and Mohammad. *AA_to_EY* is former Andersen clients switched to Ernst and Young and *AA_to_BIGN* is former Andersen clients switched to the remaining Big N auditing firms other than Ernst and Young.

Twenty-five of the former Andersen clients switched to Hanafiah, Raslan and Mohammad, a local partner for Andersen. Further, twenty (20) former Andersen clients switched to non-Big 4 auditing firms.[5] Nineteen (19) former clients switched to Ernst and Young while only two moved to another Big 4 auditing firm.

Prior research

Earnings Conservatism

The concept of conservatism has been discussed extensively in the prior literatures with Basu's (1997) paper as the core reference. Basu defines conservatism as reflecting bad news more quickly than good news. Traditionally, conservatism can also be defined as "capturing accountants' tendency to require a higher degree of verification for recognizing good news than bad news in financial statements." These accountants' tendency has resulted in two important reporting features of conservative accounting which are asymmetric timeliness recognition of accounting gains versus losses and systematic understatement of net assets (Watts, 2003a).

Conservatism is said to play an ex-ante efficient role in contracting between parties constituting the firm such as managers, debtholders, shareholders, regulators, legal and policy makers and tax authority (Watts and Zimmerman, 1986 and Basu, 1995). Earnings conservatism is widely held to be a function of the legal infrastructure in place (common-law versus code-law), the propensity of disputes to be resolved by common law legal action against managers and auditors, rather than through informal channels, the efficiency of the securities markets, and the strength and depth of the public accounting profession. Where the accounting profession is stronger, trained accountants are better able to make the informed professional judgements needed to implement and enforce conservatism in practice.

Based on the contracting theory, investors and creditors demand conservatism to monitor their contracts with the firm efficiently. Investors demand conservatism so that it can verify reported performance 'independently' from managers and ensure that their contracts are monitored efficiently. Debtholders and other creditors also demand timely information about bad news because the option value of their claims is more sensitive to a decline than an increase in firm value (Basu, 1997). Watts (2003a) argues that conservatism facilitates effective monitoring of managers and contracts by constraining overpayments to managers and other parties. It reduces the manager's incentives and ability to manipulate accounting number and hence, reduce aggressive accounting. Watts (2003b) argues that conservatism reduces managers' ability and incentives to overstate earnings and net assets by requiring higher verification standards for gain recognition and reduces managers' ability to withhold information on expected losses. Managers usually possess valuable private knowledge about firm's operation and asset values, thus managers have incentives to withhold from reported earnings any information that would adversely affect their compensation if managerial compensation is linked to reported earnings.

In addition to that, the characteristic of conservatism of deferring earnings and generating lower net assets reduces litigation costs that may faced by the managers and auditors. Managers may be conservative to avoid conflicts and to avoid any disputable contracts by refraining themselves from undertaking innovative investment in order to deter any entry competition in their firms' products or to signal their quality. It also provides early warning signals to governance bodies such as the board of directors to do early investigation into the reasons for bad news. Auditors may demand conservatism to limit their liability exposure arising from overstating revenue and profit. Basu (1997) in his study finds that during the increased auditor liability regime, the increase in the difference in sensitivity to good and bad is statistically significant by showing that the slope coefficient on 'good news' doubles while the coefficient on 'bad news' increases six-fold.

Hypotheses Development

The demise of Arthur Andersen has renewed auditors' concern for litigation risk and appreciation of preserving reputation capital, particularly for the Big 4 auditors. An audit firm's reputation capital represents its expertise and commitment to a high level of audit quality. A high level of reputation is a competitive advantage – the auditor can attract talented employees, recruit clients away from other auditors, and even charge a premium for services. Conversely, as Arthur Andersen has learned the hard way, impairments to reputation are often associated with litigation and can be costly for the audit partners (Krishnan, 2007).

Investors' concern over the quality of financial reporting and auditor credibility has increased another cost for auditors—that is, the cost of professional liability insurance. Thus, the combination of greater scrutiny by regulators and investors and lower liability coverage underscores the need to manage litigation risk, particularly for the Big 4 auditors. One strategy that is likely to mitigate the business risk is to prevail on clients to recognise bad news about future cash flows in a timely fashion, that is, enhance earnings conservatism. This scheme could be viewed as the first line of defence to ward off potential litigation. Other strategies, such as seeking an increase or premium in audit fees to compensate for the increasing risk of litigation or issuing modified opinions or even resigning from risky engagements, may be more costly, not viable, or simply less effective. In the wake of the ENRON-Andersen affair, the risk of potential judicial proceeding is likely to be high for former clients of Arthur Andersen. These clients are perceived to be more risky relative to clients of other auditors.

Thus, the current auditors, particularly the Big 4, are expected to enforce a higher level of earnings conservatism to mitigate potential litigation risk. Similar to Big 4 auditors, managers of firms formerly served by Arthur Andersen also have incentives to protect their reputation and mitigate the risk of litigation. This is particularly true for managers of firms served by Andersen's Houston office. For instance, Barton (2005) examines how managers react if the reputation of their auditor becomes tarnished and finds that clients with more visibility in the capital markets (more analyst and press coverage and institutional ownership) defected from Arthur Andersen for another Big 4 auditor. This finding is consistent with the notion that managers are concerned about their own and the firm's reputation and use auditor change to signal their credibility. In summary, both managers and auditors of firms formerly served by Andersen have incentives to increase these firms' earnings conservatism to protect their reputation and mitigate the risk of litigation.

In a related study, Krishnan (2005) noted that in the post-Andersen world, Big 4 auditors and managers use earning conservatism as a risk management strategy, that is protecting reputation capital and mitigating the risk of litigation. In an earlier study, Schwartz and Menon (1985) find that failing firms are the firms that have a greater propensity to switch auditors, while Williams (1988) argues that the failing firms tend to switch auditors to portray a good image of the company. Hamilton *et al*. (2005) show that auditor rotation can promote greater independence and consequently, higher quality of auditing.

In view of the fact that the auditors' legal liability exposure increase in the ENRON post-period, combined with the motive of the firm to retain their financial statements credibility in the eyes of their stakeholders, this study hypothesizes that (in alternative form):

H_1: Earning conservatism is higher for former clients of Arthur Andersen in the period after ENRON saga

Basu (1997) in his study, stresses on the effect of conservatism with respect to increase in auditors' legal liability exposure. Basu (1997) divided the auditors' legal liability exposure into four sub-periods which are the period before 1966 which has low expected damages, the period of 1966-1975 which is the period of increased auditor damages, the period of 1975-1982 in which auditor liability was lower than in preceding 10 years and lastly the period of 1983 – 1986 in which auditors' liability increased again. The result shows that the sensitivity of earnings to bad news increased six-fold during the increased auditor liability regime of 1967-1975 while sensitivity of earnings to good news doubles, indicating that conservatism increases as the auditors' liability exposure increased. The sensitivity of earnings to good news and bad news is insignificant during the initial low auditor liability regime. The final high auditor liability regime of 1983-90 sees no increase in sensitivity to 'good news', but a large and increased in the sensitivity to 'bad news'.

Since litigation carries a great amount of risk to auditors, we argue that the ENRON debacle influences the level of earnings conservatism for both non-Andersen clients that switched or did not switch during the ENRON period. Therefore, we posit the following hypotheses:

H_2: Earnings conservatism is higher for non-Andersen clients that switched auditors in the period after ENRON saga

H_3: Earnings conservatism is higher for non-switching firms in the period after ENRON saga

Research Methods

The data for this study consists of 1034 firm-years observations for year 2001 and 2002. The data distribution, based on the research objectives are presented in Table 2. There are only 197 firm-years observations for switching firms which consist of 132 observations for Andersen clients, presented in Panel A of Table 2. Panel B of Table 2 tabulates the observations for non-switching firms which consist of 513 Big 4 and 333 non-Big 4 observations. All data used for this study are collected from the Compustat Global database, Stock Performance Guide Handbook and published annual reports. The main measure of conservatism is Basu' (1997) asymmetric timeliness of earnings where:

$$X_{it} / P_{it-1} = \alpha_0 + \alpha_1 DR_{it} + \beta_0 R_{it} + \beta_1 R_{it} \; x \; DR_{it}$$

Where X_{it} is net income per share for firm I in fiscal year t, P_{it-1} is the price per share at the beginning of the fiscal year. R_{it} is the fiscal year continuously compounded return. DR_{it} takes the value of 1 if $R_{it} < 0$ and 0 otherwise. Similar to Krishnan (2007), we employ fiscal year returns because auditors will have access to stock return information at the time of the audit. In the particular model, β_1 (the incremental bad news coefficient) is expected to be greater than β_0 (the good news coefficient), that is, earnings is more sensitive to bad news that good news. Thus, an increase in β_1 following the auditor switch would be consistent with an increase in earnings conservatism. We estimate the above model for year 2001 (the last year as client of Arthur Andersen) and year 2002 (the first fiscal year under a new auditor) and the sample only consists of Andersen clients and compare the coefficients for the interaction variable *R x DR*.

A second model pools client-observations from both years and adds an additional indicator variable, *SWITCH* that takes the value of 1 for year 2002 and 0 for year 2001. We interact *SWITCH* with R_{it}, DR_{it} and $R_{it} \; x \; DR_{it}$. This directly examines whether the contemporaneous association between earning and negative returns is statistically different in year 2002 compared with year 2001.

$$X_{it} / P_{it-1} = \alpha_0 + \alpha_1 DR_{it} + \alpha_2 SWITCH_{it} + \alpha_3 DR_{it} \: x \: SWITCH_{it} + \beta_0 R_{it} + \beta_1 R_{it} \: x \: DR_{it} + \beta_2 R_{it} \: x \: SWITCH_{it} + \beta_3 R_{it} \: x \: DR_{it} \: x \: SWITCH_{it}$$

The variable of interest in Model 2 is *R x DR x SWITCH*. Thus observing $\beta_3 > 0$ is consistent with greater asymmetric timeliness of earnings associated with former clients of Arthur Andersen following the switch to a Big 4 auditor. All tests are one-tailed tests.

We employ both models for the following control samples, namely the remaining Big 4 clients which did not change the auditors, Big 4 clients which change auditor within Big 4 and non-Big 4 auditors. Further, we also controlled for former Andersen clients that switched to Ernst and Young in 2002. Examining earnings conservatism of non-Andersen clients that switched within Big 4 auditors is motivated by the following reason. A comparison of earnings conservatism of two groups concurrently switching auditors former Andersen clients that were forced to switch to other Big 4 auditors and non-Andersen clients voluntarily switching within Big 4, can shed the light whether the Big 4 auditors treat the two groups of clients differently or whether managers face different incentives in the post-Andersen period (Krishnan, 2007).

Next, we examine whether earnings conservatism has increased for those former Andersen clients that switched to non-Big 4 auditors. Prior research finds that Big 6 auditors constrain accruals-based earnings management more than non-Big 6 auditors (Becker et al., 1998**;** Francis, Maydew, and Sparks, 1999). Similarly, Basu, Hwang, and Jan (2000) find that the asymmetric timeliness of earnings is greater for clients of Big 8 auditors than for clients of non-Big 8 auditors. These findings are consistent with the notion that brand-name auditors have more incentives and expertise than non-brand-name auditors in protecting their reputation capital and, therefore, prevail on their clients to recognize bad news in a timely fashion or, alternatively, face greater liability exposure, ceteris paribus. Thus, it will be interesting to examine whether earnings conservatism has increased for clients of non-Big 4 auditors as well.

Table 2: Data Distribution of Sample Firms (2001-2002)

			# of observations		
Panel A: Switching Firms					197
	Arthur Andersen			132	
		To Big 4	42		
		To non-Big 4	90		
	Big 4			41	
		To Big 4	17		
		To non-Big 4	24		
	Non-Big 4		24		
		To Big 4	24		
Panel B: Non-switching firms					846
	Big 4			513	
	Non-Big 4		333		
Total observations			1043	1043	

Data Description

Descriptive statistics and test of differences in mean and median values for year 2001 and 2002 for former Andersen clients are presented in Table 3. Mean and median earnings (X_{it} / P_{it-1}) are lower for former Andersen clients for year 2001 relative to 2001, although the differences are insignificant. The returns, however are higher in the year 2001 and 2002 and the differences are significant, consistent with the U.S findings by Krishnan (2007).

Table 3: Descriptive Statistics for a Sample of Former Clients of Arthur Andersen (2001-2002, n = 66

	n	Mean 2001	n	Mean 2002	t-test	Median 2001	Median 2002	Mann Whitney
% of loss	29	0.4394	21	0.3182	1.073			-
% of negative returns	37	0.5606	45	0.7121	**-1.818***			-
Earnings (X_{it} / P_{it-1})		-2.427		0.650	-1.576	0.021	0.055	0.913
Annual Returns (R_{it})		-0.114		-0.337	**3.085*****	-0.029	-0.310	**3.432*****
Firm Size ('000)		1013000		763800	1.018	241000	278000	0.071

The total number of clients equals 66 for both 2001 and 2002. Earnings (X_{it} / P_{it-1}) is net income per share, deflated by price per share at the beginning of the fiscal year. Annual returns are continuously compounded returns for the fiscal year. Firm size is the total assets. *, ** and *** indicate significance level at 10, 5 and 1 percent for a two-tailed test respectively.

Findings

Panel A and B of Table 4 presents the results for Model 1 for years 2001 and 2002 respectively. Panel C presents the results of Model 2 that pools client observations for both years. In Model 2, *SWITCH* is an indicator variable that takes the value of 1 for year 2002 and 0 for year 2001. In year 2002, the good news coefficient (R) has become more negative and the bad news coefficient has increased significantly, from 1.779 to 3.996. The result is consistent with Krishnan (2005) who found that earnings of former Andersen clients have become more sensitive to bad news, showing greater concern on litigation risk during post-ENRON scandal.

However, based on Panel A and Panel B of Table 4, earnings of former Andersen clients based in Malaysia are only a fraction more sensitive (0.27 times) in 2002 than earnings in 2001. Further, the results in Panel C of Table 4, shows that the increases in asymmetric timeliness of earnings, captured by β_3 is positive, but not significant, even at the 10 percent level. The results may be influenced by the size of the firms as ex-Andersen clients in Malaysia is smaller in size compared to ex-Andersen clients' in US and smaller firm usually display greater conservatism even in the pre-ENRON decade compared to other ex-Andersen clients (Krishnan, 2005) and the smaller size has enabled the firms to switch auditors at a lower cost (De Angelo, 1981). Additionally, the result may also be influenced by the ex-Andersen clients' risk factors in Malaysia. As illustrated in Table 1, about 70% of ex-Andersen clients in Malaysia switch to lateral Big 4 auditors which are HRM, Ernst and Young and other Big 4 auditors. It shows that ex-Andersen clients in Malaysia pose less risk due to its smaller size and due to that, it make possible for other Big-4 auditors to accept these less risky clients. This result is consistent with prior literatures (Hindo, 2003 and Landsman et al., 2006) who suggested that Big 4 auditors may have become more sensitive to risky clients in the increment of litigation costs during post-ENRON decade. Other than that the result may be influenced by Malaysia's institutional setting which lacks of enforcement and has less stricter regulations. Due to these factors, the result of conservatism measured by β_3 is not significant.

Nevertheless, the results indicate that following the forced auditor switch in 2002, earnings of former Andersen clients have become more sensitive to bad news, as such more conservative earnings. All tests are one-tailed with White-corrected t-statistics.

Table 4: Coefficients and Adjusted R^2 from Regressions of Earnings on Returns for Former Clients of Arthur Andersen for Years 2001 and 2002

$$X_{it} / P_{it-1} = \alpha_0 + \alpha_1 DR_{it} + \beta_0 R_{it} + \beta_1 R_{it} \; x \; DR_{it}$$

Panel A : 2001 (n = 66)		
Variable	Coefficient	t-Statistic
INTERCEPT	-1.054	-0.547
DR	-1.853	-0.502
R	-0.794	-0.319
DR X R	1.779	0.509
Adjusted R^2	0.041	

Panel B: 2002 (n = 66)		
Variable	Coefficient	t-Statistic
INTERCEPT	5.616	1.853**
DR	-6.584	2.000**
R	-3.728	-1.322*
DR X R	3.996	1.297*
Adjusted R^2	0.076	

(*Continued*)

(Con't Table 4)

Panel C: Both years (n = 132)

$$X_{it} / P_{it-1} = \alpha_0 + \alpha_1 DR_{it} + \alpha_2 SWITCH_{it} + \alpha_3 DR_{it} \ x \ SWITCH_{it} + \beta_0 R_{it} + \beta_1 R_{it} \ x \ DR_{it} + \beta_2 R_{it} \ x \ SWITCH_{it} + \beta_3 R_{it} \ x \ DR_{it} \ x \ SWITCH_{it}$$

Variable	Coefficient	t-Statistic
INTERCEPT	-1.234	-0.783
DR	-1.626	-0.468
SWITCH	7.668	2.240**
DR X SWITCH	-5.748	-1.174
R	-0.004	-0.003
DR X R	1.222	0.255
SWITCH X R	-14.064	-0.967
R X DR X SWITCH	13.116	0.857
Adjusted R^2	0.003	

X_{it} is net income per share for firm i in the fiscal year t, P_{it-1} is price per share at the beginning of the fiscal year. Annual returns (R_{it}) are continuously compounded returns. DR_{it} takes the value of 1 if $R_{it} < 0$, and 0 otherwise. *SWITCH* takes the value of 1 for year 2002 and 0 for year 2001. *, ** and *** indicate significance level at 10, 5 and 1 percent for a one-tailed test respectively.

Further Analysis

We extend our analysis by segregating Andersen clients switch either to another Big N or non-Big N auditing firm. Panel A of Table 5 presents Model 2 result when Andersen clients switched to another Big N auditor, while Panel B of Table 5 tabulates Model 2 results when Andersen clients that switched to non-Big N auditing firms. We find, Andersen clients that switched to another Big 4 report more conservatively in the year 2002 (70.924, $t = 1.356$, $p<0.10$) than former Andersen clients employing non-Big 4 auditing firms. This further supports that Big 4 auditing firms have more reputation costs to protect than the non-Big 4 auditors. With such prospect for litigation after the ENRON saga, it is not surprising for remaining Big 4 auditing firms to be more conservative.

Table 5: Coefficients and Adjusted R^2 from Regressions of Earnings on Returns for Former Andersen Clients that Switched to Either a Big N or Non-Big N Auditor

$$X_{it} / P_{it-1} = \alpha_0 + \alpha_1 DR_{it} + \alpha_2 SWITCH_{it} + \alpha_3 DR_{it} \ x \ SWITCH_{it} + \beta_0 R_{it} + \beta_1 R_{it} \ x \ DR_{it} + \beta_2 R_{it} \ x \ SWITCH_{it} + \beta_3 R_{it} \ x \ DR_{it} \ x \ SWITCH_{it}$$

Panel A: AA to Big 4 (n = 42)

Variable	Coefficient	t-Statistic
INTERCEPT	-13.328	-1.373*
DR	7.700	0.575
SWITCH	27.002	1.984**
DR X SWITCH	-21.560	-1.269
R	15.495	0.920

(*Continued*)

(Con't Table 5)

DR X R	-12.279	-0.658
SWITCH X R	-74.819	-1.451*
R X DR X SWITCH	70.924	1.356*
Adjusted R^2	0.017	

Panel B: AA to Non Big 4 (n = 90)

Variable	Coefficient	t-Statistic
INTERCEPT	1.119	1.144
DR	-2.429	-1.387*
SWITCH	2.865	1.121
DR X SWITCH	-2.695	-0.857
R	-0.357	-0.349
DR X R	0.536	0.095
SWITCH X R	0.002	0.000
R X DR X SWITCH	1.045	0.082
Adjusted R^2	0.025	

X_{it} is net income per share for firm i in the fiscal year t, P_{it-1} is price per share at the beginning of the fiscal year. Annual returns (R_{it}) are continuously compounded returns. DR_{it} takes the value of 1 if $R_{it} < 0$, and 0 otherwise. *SWITCH* takes the value of 1 for year 2002 and 0 for year 2001. *, ** and *** indicate significance level at 10, 5 and 1 percent for a one-tailed test respectively.

Non-Andersen Clients

We extend our analysis by examining the impact on earnings conservatism to non-Andersen clients during the ENRON saga. We divide the analysis into parts. The first is in examining non-Andersen clients that switched to another auditing firm in 2002 presented in Table 6, whilst the second, tabulated in Table 7, examines non-Andersen clients that did not switch in 2002.

Switching Firms

There are 65 observations pool over the two-year period. Panel A of Table 6 presents the results for Model 2 for non-Andersen clients audited by another Big 4 switched to another Big N in 2002. The coefficient for β_3 is positive and significant (57.148, $t = 1.642$, $p < 0.10$) suggesting that non-Andersen clients switching to Big 4 auditing firms are more conservative in 2002. Similarly, we find non-Andersen client audited by a Big N in 2001 and switched to a non-Big N in 2002 reports more conservatively, although the result is insignificant. The result supports hypothesis H_2.

In contrast, we find that non-Andersen clients previously audited by a non-Big 4 and moved to a Big 4 in 2002 are less conservative. This interesting result of upward switching could provide opportunities for future research. Nonetheless, our overall findings, shown in Panel D of Table 6 suggest that non-Andersen clients that switched to another auditing firm report more conservatively in 2002.

Table 6: Coefficients and Adjusted R^2 from Regressions of Earnings on Returns for Non-Andersen Clients that Switched to Either a Big N or Non-Big N Auditor

$$X_{it} / P_{it-1} = \alpha_0 + \alpha_1 DR_{it} + \alpha_2 SWITCH_{it} + \alpha_3 DR_{it} \ x \ SWITCH_{it} + \beta_0 R_{it} + \beta_1 R_{it} \ x \ DR_{it} + \beta_2 R_{it} \ x \ SWITCH_{it} + \beta_3 R_{it} \ x \ DR_{it} \ x \ SWITCH_{it}$$

Panel A: Big 4 to Big 4
Total panel (unbalanced) observations: 17

Variable	Coefficient	t-Statistic
INTERCEPT	3.463	0.802
DR	-3.601	-0.772
SWITCH	22.212	1.394*
DR X SWITCH	-19.695	-1.195
R	1.594	0.235
DR X R	-1.579	-0.221
SWITCH X R	-55.761	-1.620*
R X DR X SWITCH	57.148	1.642*
Adjusted R^2	0.220	

Panel B: Big 4 to Non Big 4
Total panel (unbalanced) observations: 24

Variable	Coefficient	t-Statistic
INTERCEPT	-1.955	-0.808
DR	-5.341	-0.608
SWITCH	3.262	1.140
DR X SWITCH	0.365	0.038
R	-4.588	-0.528
DR X R	-28.117	-0.873
SWITCH X R	-4.078	-0.309
R X DR X SWITCH	36.999	1.096
Adjusted R^2	0.105	

X_{it} is net income per share for firm i in the fiscal year t, P_{it-1} is price per share at the beginning of the fiscal year. Annual returns (R_{it}) are continuously compounded returns. DR_{it} takes the value of 1 if $R_{it} < 0$, and 0 otherwise. *SWITCH* takes the value of 1 for year 2002 and 0 for year 2001. *, ** and *** indicate significance level at 10, 5 and 1 percent for a one-tailed test respectively.

(*Continued*)

(Con't Table 6)

Panel C: Non-Big 4 to Big 4
Total panel (unbalanced) observations: 24

	Coefficient	t-Statistic
INTERCEPT	2.547	0.339
DR	-2.503	-0.278
SWITCH	-24.523	-2.077**
DR X SWITCH	27.023	1.822**
R	-2.148	0.114
DR X R	2.192	0.112
SWITCH X R	63.885	1.673*
R X DR X SWITCH	-60.774	-1.731*
Adjusted R^2	0.063	

Panel D: total
Total panel (unbalanced) observations: 65

	Coefficient	t-Statistic
INTERCEPT	0.751	1.026
DR	-2.555	-0.882
SWITCH	2.067	1.021
DR X SWITCH	0.212	0.075
R	2.564	2.292
DR X R	-4.150	-1.149
SWITCH X R	-15.846	-1.316*
R X DR X SWITCH	19.187	1.354*
Adjusted R^2	0.074	

X_{it} is net income per share for firm i in the fiscal year t, P_{it-1} is price per share at the beginning of the fiscal year. Annual returns (R_{it}) are continuously compounded returns. DR_{it} takes the value of 1 if $R_{it} < 0$, and 0 otherwise. *SWITCH* takes the value of 1 for year 2002 and 0 for year 2001. *, ** and *** indicate significance level at 10, 5 and 1 percent for a one-tailed test respectively.

Non-switching Firms

Table 7 presents the results for non-switching firms. Panel A tabulate the results for Big 4 clients that did not switch during the ENRON saga. We observed that Big 4 clients report more conservatively in 2002 (9.128, t = *1.904, p<0.05*). However, we find that non-Big 4 clients report less conservatively, but the result is insignificant, even at the 10 percent level. Nevertheless, we find, non-switching firms do report more conservative earnings in 2002.

Table 7: Coefficients and Adjusted R^2 from Regressions of Earnings on Returns for Non-switching Firms for Years 2001 and 2002

$$X_{it} / P_{it-1} = \alpha_0 + \alpha_1 DR_{it} + \alpha_2 SWITCH_{it} + \alpha_3 DR_{it} \text{ x } SWITCH_{it} + \beta_0 R_{it} + \beta_1 R_{it} \text{ x } DR_{it} + \beta_2 R_{it} \text{ x } SWITCH_{it} + \beta_3 R_{it} \text{ x } DR_{it} \text{ x } SWITCH_{it}$$

Big N (n=513)		
	Coefficient	t-Statistic
INTERCEPT	0.411	.411
DR	-1.932	-1.363*
SWITCH	1.164	0.764
DR X SWITCH	0.896	0.431
R	7.622	4.379***
DR X R	-8.041	3.238***
SWITCH X R	-6.939	-1.706**
R X DR X SWITCH	9.128	1.904**
Adjusted R^2	0.064	
Non Big N (n=333)		
	Coefficient	t-Statistic
INTERCEPT	2.053	1.341*
DR	-0.472	-0.231
SWITCH	1.773	0.695
DR X SWITCH	-4.019	-1.200
R	1.645	.451
DR X R	-0.048	-0.011
SWITCH X R	6.762	0.923
R X DR X SWITCH	-9.383	-1.145
Adjusted R^2	0.017	
Total (n=846)		
	Coefficient	t-Statistic
INTERCEPT	0.793	0.890
DR	-1.098	-0.931
SWITCH	1.543	1.221
DR X SWITCH	-1.185	-0.898
R	6.401	17.555***
DR X R	-6.121	-4.584***
SWITCH X R	-3.900	-1.263
R X DR X SWITCH	4.080	1.281*
Adjusted R^2	0.037	

X_{it} is net income per share for firm i in the fiscal year t, P_{it-1} is price per share at the beginning of the fiscal year. Annual returns (R_{it}) are continuously compounded returns. DR_{it} takes the value of 1 if $R_{it} < 0$, and 0 otherwise. *SWITCH* takes the value of 1 for year 2002 and 0 for year 2001. *, ** and *** indicate significance level at 10, 5 and 1 percent for a one-tailed test respectively.

Conclusion

The demise of Arthur Andersen provides an opportunity to investigate the nature of earnings conservatism in Malaysia. We examine whether former Andersen clients report more conservatively in 2002, and we investigate whether the ENRON debacle has an impact on the remaining Big 4 and non-Big 4 auditors. Based on a sample 132 observations of Andersen clients over the two-years period, we find that clients do report more conservatively in 2002. Our further analysis discovers that Andersen clients switched to another Big N report more conservatively as relative to those switching to the non-Big N auditing firms. The result supported the view that although auditors in Malaysia has less litigation and lack enforcement, firms become more conservative when the litigation risk increases and use Big 4 auditors to signal its credibility to the investors. The result also reveals that firms in Malaysia are alert to the recent corporate failure and are more transparent to avoid public scrutiny.

In addition, we investigate the nature of earnings conservative for non-Andersen firms that switched during the same period. Our result indicates that firms audited by the Big 4 auditing firm switched to another Big 4 auditor, report more conservatively relative to former Big 4 client that switched to a non-Big 4 auditor. However, we find that non-Big 4 clients moved to Big N report less conservative earnings in 2002. In general, our findings support the notion that litigation risk faced by auditors increases the incentive to report more conservative earnings. The findings are consistent with the notion that increasing earnings conservatism is one option for both Big 4 auditors and managers to mitigate the litigation risk and preserve reputation capital.

Notes

1. The U.S. Supreme Court unanimously threw out the conviction in May 2005.
2. Although 153 firms are audited by Arthur Andersen, we could not gather all the relevant information due to limited resources.
3. As at 2004, Kuala Lumpur Stock Exchange is known as Bursa Malaysia.
4. The total observations for Arthur Andersen is 97, but only 66 data are available for analysis purposes.
5. Unfortunately, Compustat Global did not provide the names of non-Big N auditing firms.

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