The Impact of Audit Quality on Stock Prices in Japan: Based on the Cases of Accounting Fraud in Kanebo, Olympus, and Toshiba

by Siti Maghfiroh

The Impact of Audit Quality on Stock Prices in Japan: Based on the Cases of Accounting Fraud in Kanebo, Olympus, and Toshiba

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ABSTRACT

The title of the research is: The Impact of Audit Quality on Stock Prices in Japan: Based on the Case of Accounting Fraud in Kanebo, Olympus, and Toshiba. The research studies the chronologicals of the three major accounting scandals occurred in Japan: Kanebo and ChuoAoyama, Olympus and KPMG Azsa, and Toshiba and Ernst & Young ShinNihon. Which all of the external auditors are part of Big-4 audit company in Japan. This research uses the events as evidence to highlight the importance of audit quality and how it influences the stock prices. The worse the audit quality, the more it is for investors to lose their confidence and trust on the company's financial statements, which would influence the stock price to decline due to investor sentiment caused be loss of confidence in the stock markets. Through analyzing and describing based on each significant event of each scandal, we have a better grasp on the matter. The research uses Case Study Method that helps the author to determine which specific event would cause market reaction in the form of changes in stock prices, with the purpose of providing evidences that support this research. This research tries to explain that audit quality plays crucial role in determining the sentiment of the investors, considering that fraud, misstatement, or error in the financial statements can be detected and prevent providing poor audit quality if the auditors are unable to implement the core functions and understand what are the indicators of audit quality.

Keywords: Audit Quality; Fraud; Stock Market; Case Study; Japan.

1. Introduction

There are 4 existing stock exchanges that are included in Japan's stock exchange (*kabushiki kokan*); Tokyo Stock Exchange (TSE), Sapporo Securities Exchange (SSE), Fukuoka Stock Exchange (FSE), and Nagoya Stock Exchange (NSE). Among those 4 Japanese stock exchanges, Tokyo Stock Exchange (TSE), which has 3,500 listed companies (2016) according to Trading View, is the biggest Japanese stock exchange while also ranked number 4 as the biggest stock exchange worldwide. Nikkei, or short for Nikkei 225 Stock Average, is the leading index of Japanese Stocks. 225 Stock Average indicates that it consists of 225 Japanese companies that trade in Tokyo Stock Exchange (TSE) regardless of their business sectors. Major stock index that is similar to Nikkei is Dow Jones Industrial Average Index from United States which also uses price-weighted index for its weighting method. However, Nikkei is not the only stock index in Japan. Another Japanese stock index is TOPIX (Tokyo Price

Index) which, different from Nikkei, uses capitalization-weighted index as the weighting method. While Nikkei is equivalent to DJIA Index, TOPIX is considered to be equivalent with S&P 500 from United States. However, in order to maintain a well-functioning stock markets investors' confidence must always be maintained, which is driven from investors' need in looking for assurance in companies' financial reports. Auditing the financial reports of the company is fundamental in building confidence in financial information that will be presented to investors by the management, the confidence of investors is one of the main reasons for stock markets to run efficiently.

Audit quality and the factors that could influence have been a fascinating subject in academic studies. There have been few studies and debates that discussed the subject following the collapse of a company. Stated by the previous study by Noor Adwa Sulaiman (2018), some developments regarding auditing and financial reporting conducted by professional bodies and regulators are implemented in order to improve audit quality. Auditing of financial statements caters as a control mechanism for reducing information unevenness while also protecting the interests of the differing claimants by making sure that the audited financial statements are free from misstatements (Macharia and Gatuhi, 2013). The main purpose of the audit itself is to improve the degree of confidence by people who are the users of the company's financial statements. Those users are consisting of shareholders, creditors, or even newcomers who are interested in building a business relationship. When a financial statement has low risk or low perils on misstatements, it would increase confidence in stock markets (Hoti, 2012). For the players in the stock market, it is crucial for a financial statement to be audited by dependable auditors as it indicates to the market that the financial statements are more reliable than those audited by unreliable auditors.

Since a long time ago, external auditing has been a part of a crucial function of economic activity. Therefore, in order for economic activity to keep on progressing, trust is an important thing to maintain. This is where auditor's independence plays a crucial role in contributing to the confidence of the company's shareholders, by providing them with reliable and unbiased view on company's financial information. Those independent opinion given by the auditor will then become an important portion of an efficient capital markets (The Institute of Chartered Accountants in England and Wales, 2002). In 1949, Japan adopted the Accounting Principles for Business Enterprises, which were the country's first accounting standards. CPAs have been auditing the financial statements of publicly traded firms since 1951, according on these and other criteria, as well as the Securities and Exchange Law of 1948. Stated by Naoki Kasai (2014), since 1948, financial statement audits by certified public accountants have played an important role in Japanese capital markets as they do in markets in other developed countries. Japan has been hit by one of its biggest accounting scandals after Kanebo, who was one of the largest producers of cosmetics in Japan, admitted it had booked 215 billion yen of fictitious profits in its accounts during 2005, with the involvement of ChuoAoyama, who renamed their company to Misuzu in 2006, partook the scandal as Kanebo's auditor, was part of Japan's big 4 accounting company who happened to audit big companies such as Toyota, Sony, and Nippon Steel Corporation as well. The event led to the suspension of ChuoAoyama for two months in 2006 by the Japanese Financial Services Agency (FSA). Few major fraud cases happened in Japan even after Kanebo and ChuoAoyama case such as: Olympus and KPMG AZSA in 2011; and the most recent one was Toshiba and Ernst & Young ShinNihon that happened in 2015.

ChuoAoyama was an affiliation of Price water house Coopers (PwC) in Japan. Before the scandal, it was one of the four biggest accounting firms in Japan. One of ChuoAoyama's clients is Kanebo, whose businesses are in cosmetics, chemicals, foods, and textiles after World War II. Unfortunately, with the fall of the boom economy in the early 1990s, it had managerial problems. Between other departments, the textile department experienced significant losses (Konishi, 2010). However, the bloated numbers in the financial accounts for 5 years—specifically, the fiscal year ending March 2000 up to 2004—reached to 215 billion yen (around US $2 billion) according to the conclusions of their internal investigation are caused by the manipulated firm's books from the 1990s done by the executives of Kanebo. The earnings of Kanebo were manipulated by the company's executives, who deleted 15 unsuccessful Kanebo subsidiaries and linked companies from the list of Kanebo entities that used consolidated accounting to hide losses. They also postponed declaring stock, investment, loan deficits and overstated their sales as well as understated the costs.

The name of Toshiba Corporation was officially made in 1978, after the merger of two firms; Tokyo Denki and Shibaura Seisaku sho in 1938. Toshiba became the 4th largest chipmaker and the 3rd largest laptop computer manufacturer in the world. However, in April of 2014, the Japanese business sector was stunned to learn about Toshiba Corporation's significant accounting fraud. The fraud involved ¥224.8 billion or US $2 billion from 2008 until 2014. Accounting problems that result in financial statement window-dressing are primarily caused by cooperation among management and accountants, as well as professional negligence. Despite the fact that Ernst & Young ShinNihon is one of Japan's largest auditing firms and has been in responsibility of Toshiba's books for sixty years, it failed to do its duty. Since 2008, its audit staff has failed to identify the errors for eight years in a row and proceed to provide no suggestions and advice to the management for improvement.

Meanwhile, the Olympus affair began on October 14 2011, as British-born Michael Woodford was abruptly removed as CEO of Olympus Corporation. Woodford has been the president of Olympus for 6 months when he exposed the fraud inside the company. The fraud itself has been known as "one of the biggest and longest-running loss-hiding arrangements in Japanese corporate history" according to The Wall Street. The use of accounting methods by Olympus to conceal large losses has sparked doubts about whether the company's auditors, the Japanese arm of global powerhouse KPMG Azsa, should have gone more to investigate the red flags. These three big accounting scandals have completely failed in its professional auditing duties and resulted to the public's trust in CPAs being shattered. The accounting fraud practiced by the ChuoAoyama, KPMG Azsa, and Ernst & Young ShinNihon caused auditor switch among its clients. Auditor switching is an alteration of audit firm that is done by the company (the audit firm's client) from its own will or government regulations. When confronted with litigation or criticism, a company is likely to change auditors, either because of discontent with the previous auditor's audit quality or because litigation against the auditor leads in the auditor losing their independence from the company and being unable to do the audit. Identical to what happened in U.S with Enron/Andersen scandal that led to the making of Sarbanes-Oxley Act (SOX), in 2006, Japan also encountered the crash of its Big 4 audit firms which then also led to the making of Japanese Sarbanes-Oxley (J-SOX). Switching auditors does not only mean there is an accounting scandal performed by the auditor that worries its clients, it could also imply that there is an accounting disagreement between clients and auditor, prompting them to seek out another auditor that agree (McConnell, 1983). However, according to Nikkei Asia in 2020, in Japanese cases, almost 70% of listed companies have not switched audit firms in over a decade, believing that a new auditor would not completely understand their business. Due to avoid client-auditor close- relationship that could lead to financial fraud, European Union (EU) policy require listed firms to switch auditors every ten years in principle. Once the audit quality of a company's financial reporting is questioned, it's likely that the company may switch auditors to prevent the capital market implications of potentially incorrect financial reporting (Hennes, et al. 2011).

This study is intended to provide additional empirical evidence on the impact of announcement of an audit firm that fails to provide good audit quality and detect fraud on their client's financial reports. And what performing poor audit quality and accounting scandal could render to stock markets' doubts. So, The research questions below represent the research problems:

- Due to Japan as a low-litigation setting, how does audit failures affect reputation loss in each case? And how does it affect auditor switch too?
- What are the things that caused the deterioration of audit quality performed by ChuoAoyama, Ernst & Young ShinNihon, and KPMG Azsa during the period of the accounting fraud?
- What is the stock market reaction following the scandal of each case?

2. Literature Review & Theoritical Framework

2.1 Agency Theory

According to Agency Theory, agency relationship is when one or morestakeholders engage another as their agent for the purpose of performing a service on their account. As a result of providing the service, the agent is given some decision-making responsibility (Jensen and Meckling, 1976). Simple agency model indicates that stakeholders lack motives to rely their agents as a result of information asymmetries and self-interest, and that they will strive to address these concerns through implementing procedures that align agents' objectives with stakeholders and decrease the potential for information asymmetries and opportunistic behavior. Different incentives and information asymmetries could cause concern about the accuracy of the information which has an influence on stakeholders' faith in their agents. There are a variety of strategies that can be employed to try to balance the interests of agents with the goals of the organization. An audit helps preserve confidence and trust by providing an independent audit on the activity of agents and the information they offer (The Institute of Chartered Accountants in England & Wales, 2005). Simplest agency model implies that no agents are reliable, and that if an agent can profit at the cost of a principal, they will do so. Auditors are hired as contract agents, regardless, they are required to be independent from the agents that are in charge of the business. In this setting, the major aim is accountability of the audited accounts, as audits serve to maintain confidence and transparency. In a simple agency audit approach in which a professional independent auditor is brought in and a statutory audit is conducted to help resolve a simple agency issue between directors and shareholders. However, there are additional variables involved, such as the connection between auditors and other stakeholders that have interest in the audit's outcome.

2.2 Audit Quality

According to De Angelo (1981), she defined audit quality services as "the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system and (b) report the breach.". Based on the previous study conducted by De Angelo she made a theory that says big companies would have a good quality auditor to assess their financial statements because big companies have bigger reputation at stakes compared to smaller companies. And big companies also possess more resources to hire professional auditors with good performance. Palmrose (1988) argues that higher level of assurance means higher quality of audit services. Which means negligence and misstatement, or an audit failure, have a low possibility to be found in a high quality of audit services. Auditors who are known or have the reputation for their ability in discovering and reporting misstatements in a financial statement, have more reasons or incentives to maintain their good reputation by making sure that they always provide a high- quality audit service. That argument can be justified because according to Davidson, Stening, and Wai (1984), "Audit quality is the accuracy of auditor's information reporting." Based on the arguments presented by several authors on their research regarding audit quality, it can be said that audit quality is not defined by law or regulations (Institute of Chartered Accountants in England and Wales, 2002). Eventually auditors should be able to present high-quality audit reports to the shareholders, in a sense that the information presented in the reports are independent; unbiased; and supported by sufficient evidence. According to IAASB (International Auditing and Assurance Standards Board) audit quality has four basic aspects.

Figure 1: The Four Basic Aspects of Audit Quality

2.2.1 Auditor's Independence

Auditor independence plays a very crucial role in measuring audit quality according to Arens, Elder, Randal, Beasley, and Mark (2014). Auditor independence can be defined as an auditor's unbiased mental attitude during the process of auditing a company's financial statements. An auditor can be perceived as not being objective or biased when they show their lack of independence throughout the financial reporting process, which also indicates the possibility of the auditor to not report detected breach (DeAngelo, 1981). Although auditor independence plays a significant role in audit quality, some companies seem to ignore the importance of auditor independence in determining the quality of their financial statement as those companies whose financial statements were audited with unqualified auditor fell apart shortly after the public knew about the misstated financial statements (Deirdre, 2010). The role that auditor independence plays in audit quality is very fundamental because it helps to determine it. Thus, when the auditor is not independent it will cause the collapse of a company as it decreases the confidence of investors on that particular company's financial statements.

2.2.2 Auditor's Competence

Professional capacity is considered as an important factor affecting the quality of technique, as well as the satisfaction of subjects using audit results (Boon, 2007). And according to Kharismatuti and Hadiprajitno (2012), competencies can be defined as a personal aspect of a worker that allows them to attain greater performance. Several of previous empirical studies explained that competence has two elements which consist of experience and knowledge and these elements help to contribute to the auditor's ability in performing good audit quality. Based on the research study about the effect of competence on audit quality done by Ramlah, Syah, and Dara (2018), they explained that the most important thing in establishing auditor's competence is through training. They argued that by giving extensive training to auditors will form higher skills on them from more and more courses that the auditors took.

2.2.3 Auditor's Skepticism

Concerns regarding situations in which auditors did not adhere professional skepticism effectively in their audits are a common thing in audit evaluation results around the world, and have been a hot topic in terms of audit quality. The word 'professional' in professional skepticism refers to the fact that auditors have been, and continue to be educated and improve to apply their expertise in making decisions according to professional standards (Quadackers, 2009). In the context of audit, professional skepticism is an approach in auditing that involves a critical evaluation of evidence, the ability to observe and detect fraud, becoming more conservative in audit judgement, and keeping skepticism on evidence presented by clients (Hurtt et al., 2013). According to Professional Standards of Public Accountant (2011), professional skepticism is being defined as "an approach that involves a questioning mind, being alert to conditions which may signal possible misrepresentation caused by error or fraud, and a critical examination of audit evidence." With professional skepticism, auditors will have a way of thinking in which they don't take audit evidence without questioning them. Instead, the auditor conducts the audit with a reasonable amount of caution degree through asking investigative questions, critically analyzing answers, and carefully compare the results of the analysis with the obtained evidence.

2.2.4 Forces That Influence Audit Quality

In a well-functioning capital market, high-quality auditing plays a fundamental part. According to the prior research conducted by Douglas J. Skinner and Suraj Srinivasan (2012), there are two forces that influence auditors to perform high quality audit; litigation incentive and reputation incentive. Audit quality function includes auditor's reputation thus the announcement of new corporate financial information will influence economic value of auditors. The insurance/litigation and the reputation are two opposing concepts in accounting literature that characterize the relationship between audit quality and its economic value (Frendy and Hu, 2014).

- Litigation Incentive
  Litigation risk often occurs in audit companies since their duty is to provide assurance by reviewing and evaluating the company that hires them to detect any inefficiencies in the company's internal control, to investigate potential theft and fraud, to help the company in achieving their objectives, and to company whether or not the financial report of the company is accurate and comply to the regulations. Therefore, there will always be a possibility of litigation coming from stakeholders if they think there has been some negligence done by the auditor. The process of a lawsuit takes a lot of expenses and time, which is why avoiding litigation is an incentive for an auditor to perform a high-quality audit. However, because shareholders and other third parties have had trouble obtaining cases against auditors, Japan has been viewed as a low-litigation country (Numata and Takeda, 2010).
- Reputation incentive

Good reputation is essential for an auditor, and in order to achieve that auditor must avoid audit failure to indicate their quality in audit. Since the capital markets depend on the accuracy and reliability of audited financial statements for consideration when making decisions (Kronenberger and Pietzsch, 2017), the need for auditor with lack of audit failure in their past performance is needed to show that the auditor who assess the financial statements has a good reputation. The urge for audit companies to have bigger and better reputation incentivize them to provide credible financial statements by changing their auditors in order to avoid the declining of their audit quality. Based on the previous studies done by Skinner and Srinivasan in 2012 as well as Kronenberger and Plietzsch in 2017, the evidence in their arguments point out that litigation and reputation give incentive for audit quality. A litigation against an audit company gives a negative impact on client's equity securities prices (Franz, Crawford, and Johnson, 1998) because when a lawsuit against an audit company happens, it indicates that there have been audit failures and carelessness in their assessment. Thus, related to the indicators that define the quality of an audit mentioned before, the value in the opinion of the auditor on audited financial reports will be reduced as well as their reputation. When auditor's opinions' value has decreased and their competencies are questionable, the confidence of shareholders and investors on the accuracy of the company's financial report will also decline and result in the fall in company's security prices.

2.3 Theoritical FrameWork

A good framework will explain theoretically the relationship between the variables to be studied. According to Uma Sekaran (Sugiyono, 2017), framework is a conceptual model concerning about how the theory correlates to variety of factors that have been defined as fundamental problem. Meanwhile, according to Suriasumantri (Sugiyono, 2017) framework is a temporary explanation of the symptoms that are the object of the problem. Based on the discussion, it can be concluded that the framework is a conceptual temporary explanation of the relationship between each object of the problem based on the theory. Audits play a critical role in building assurance and establishing trust in financial data. Understanding how the audit quality has progressed requires an understanding of the principal-agent relationship, as portrayed in agency theory. The knowledge asymmetry among principals (shareholders) and agents has been studied extensively using agency theory (management). The agency theory is used in this research to examine the impact of audit quality on the stock prices. This research aims to establish the context for that development, with a particular focus on shareholder-director agency relationships in understanding the significance of audit quality for investors. Understanding how the function of an auditor has evolved requires an understanding of the principal-agent relationship as portrayed in agency theory. Agents are appointed by the principals, who delegate certain decision-making authority to them. By doing so, the principals are putting their faith in their agents to operate in their collective interest. Principals may lack faith in their agents as a consequence of information asymmetries among principals and agents' differing motives, and may need to put in place mechanisms, such as audit, for strengthen this trust. As a result, agency theory provides a valuable economic theory of accountability for explaining the growth of audit quality. Concerns about financial information's trustworthiness serve to explain why the audit is considered as a crucial method for shareholders to assure that the directors are managing the firm in the best interests of the shareholders, thus as an external auditor, auditor must perform good audit quality in making sure that the financial reports they are auditing are reliable for the shareholders to use. To measure if an auditor is able to perform good audit quality, there are three indicators to acknowledge; independence, competence, and skepticism. In order for auditor to provide reliable audited financial reports, they must possess all those three indicators. There are consequences if unfortunately the auditor fails to provide reliable audited financial reports to shareholders. Those consequences can come from litigation risks and reputation risks. However, this research is using Japan as the background setting due to its low-litigation settings. With the minimal litigation risks of auditing, Japan is rather strong for identifying the value of reputation for auditing which will be useful in examining the risks of audit failure to investors through reputation loss in a country where litigation incentives is lacking.

In order to study the impact of audit failures to the stock prices through the loss of the external auditor's reputation, this research is using Case Study Analysis with the purpose of observing and analyzing how companies who conducted accounting fraud with external auditors who fails to identify the misconduct in their clients' financial reports could affect the state of stock markets' effectiveness and influence the stock prices of such companies.

3. Research Methodology And Data Analysis Technique

3.1 Research Method

Correlating to the purpose of the research mentioned in Chapter I: Introduction, this research is categorized as basic research that aims to expand theories, and knowledge of scientific understanding. The nature of this research is qualitative descriptive which is a method of research that explains the characteristics of the phenomenon studied. This methodology pays attention to the "what" of the research subject rather than the "why". With the use of literature review in Chapter II, gathered from the previous research, this research adopts secondary data, the data that has already been obtained through primary sources and made available for other researchers to use for their own research. The data obtained for this research are collected from books, reports from official accounting institutions, and academic journals from ScienceDirect, Google Scholar, and other trusted journals. The object of this research is the impact that comes from audit quality. In this research, audit quality and reputation incentives are the x variable in this research which indicates that it stands as the independent variable affecting the dependent variable (y). Thus, making stock markets' performance and auditor switch as the dependent variables in this research. Subjects are the parties that are the target for data collection in the research study. Therefore, the subject of this research are the stock prices as well as auditor switch that are being affected by the audit quality of a company's financial statements in Japan. In this research, stock prices and auditor switch can be classified as the y variable which means it stands as the dependent variable.

3.2 Data Analysis Technique

To analyze the impact of audit quality in Kanebo, Olympus, and Toshiba's financial reports on the stock prices of those Japanese companies, this research is adopting Case Study analysis where it is designed to inspect the effect of an event on a specific dependent variable, commonly used dependent variable in event studies is the stock price of the company. Researchers can use qualitative case study methods to perform in-depth investigations of complex phenomena in a specific environment. According to Baskarada (2014), in academics, the case study approach is the most commonly utilized method for qualitative researcher. However, there has been a limitation in obtaining data for Kanebo stock price since the company itself had been delisted by Tokyo Stock Exchange since 2006. Therefore, in order to fill the gap, this research choose to analyze based on the stock prices of companies audited by ChuoAoyama instead to support the research.

4. Result And Discussion

Kanebo/ChuoAoyama, Olympus/KPMG AZSA and Ernst & Young, and Toshiba/Ernst & Young ShinNihon in order to explain the influence of poor audit quality in their companies' financial reports on the stock market prices. To better analyze the case, that are part of the Big 4 Auditors, presented poor audit quality of financial statements which later on triggered reactions from the stock market players. The following discussions in each of the table are arranged chronologically.

4.1 Kanebo and ChuoAoyama Case and Reputation Loss

The case of Kanebo/ChuoAoyama was significant in the history of accounting fraud because it represents the biggest amount of manipulation in Japan. Event 1 took place when the fraud was first exposed for their fraud which later on would create mistrust and doubt among investors on Kanebo's audit quality. The Japanese company that manufactures cosmetics, skincare, makeup and hair care was in the middle of an in-house investigation or arestructuring operation with the Industrial Revitalization Corporation of Japan (IRCJ) when they detected accounting fraud in Kanebo's operation. Few months after Event 1 happened, Kanebo decided to fire their auditor for helping and giving their approval to their previous financial statements in the fiscal year 1999-2003 that were overstated by the executives in Kanebo, former President Takashi Hoashi and former Vice President Takashi Miyahara, in order to hid their losses which reached the amount of ¥81.9 billion in 2001 and ¥80.6 billion in 2002 alone. And since a deceptive financial statement is harming investors' confidence, Tokyo Stock Exchange (TSE) decided to delist Kanebo from the capital market. Maintaining investors' confidence and convincing them their interests are fully prioritized are necessary to create an efficient and organized market. Another reason is because capital markets go together with civilizations seeing that capital markets have been contributing in development and expansion such as helping in financing the railroads and warranting capital for companies that are in need. Accordingly, the significant need for reassurance and security of capital market players is "*as old as the markets itself*". Prior to their decision in delisting Kanebo, Tokyo Stock Exchange had delisted Seibu Railway in December 2004 after they were proven to forge fraudulent reports for more than 40 years. The similarity between Kanebo and Seibu Railway can be located in their illegal actions of hiding the company's losses and overstating their earnings in order to present their financial statements as healthy to the investors, which violated the rules regulated by Tokyo Stock Exchange. A stock can be delisted if it meets any of the criteria for delisting stocks mentioned above, and with Kanebo's fraudulent action in manipulating their financial statements with the help of their three external auditors from ChuoAoyama to cover the liabilities that exceed their assets, they had met one of the criteria for delisting stock from Tokyo Stock Exchange. After the announcement of Kanebo's delisting from the stock list in Tokyo Stock Exchange, in September 13th 2005, the three external auditors from ChuoAoyama were being arrested for cooperating with the former executives in forging the financial statements, following the arrestment of the three former executives that were arrested in July 2005. Prior to the arrestment of the three auditors, Tokyo District Public Prosecutor's special investigation department had the authorization to search ChuoAoyama's offices to obtain sufficient evidence. The prosecutors deemed that the auditors were acknowledging the fraud in the company's book but they still approved them anyway. The three auditors were also deemed to be highly immoral by the prosecutors for suggesting on how to falsify the financial statements to the former managers. After the arrestment of the three auditors, in May 2006, Financial Services Agency (FSA) deregistered them and command the suspension of ChuoAoyama, from their core business, which is auditing service, in the course of two months starting from July. FSA's settlement to suspend ChuoAoyama marked as the first major audit company to get suspended in Japan.

4.2 Toshiba and Ernst & Young ShinNihon Case and Reputation Loss

Event 1 started in April 2015 when Toshiba was suspected for doing improper recordings for 7 years on their financial statements that later exposed Toshiba's executives. The accounting irregularities in Toshiba came to SESC's attention after there had been an anonymous tip that the company had been inflating their profits for $1.2 billion. The news of Toshiba's accounting scandal expanded internationally, and seeing that Toshiba's scandal happened after Kanebo and Olympus, it provoked a question among investors about which Japanese major company will be disclosed with fraud next. Given thought to the magnitude of the scandal and its impact on the view of Japanese corporate governance, SESC announced to impose fine to Toshiba with the amount of ¥7.37 billion ($60 million) and to put them under surveillance which means they had to hand over report about their internal controls' improvements, in order to regain the market's confidence, in December 7th 2015. In Event 3, just like its client, Ernst & Young ShinNihon was imposed with fine by the Financial Services Agency (FSA) with the total of ¥2.1 billion ($17.4 million) and a suspension from doing their audit services for three months long. Just like the case of ChuoAoyama, the suspension of Ernst & Young ShinNihon was part of a disciplinary action against an audit company and CPA who were providing poor audit quality. The updated outline of audited financial result of Toshiba by Ernst & Young ShinNihon under the supervision from Independent Investigation Committee. Toshiba conducted accounting fraud by overstating their number of profits for ¥152 billion and also understating the costs within their numerous of business units through the period of 2008 until 2014. Toshiba had been audited by Ernst & Young ShinNihon for sixty years. The company implemented U.S. GAAP for financial reporting and was audited according to Japanese auditing standards for the relevant years.

After the scandal of Toshiba came to public, Ernst & Young ShinNihon was then given fine for ¥2.1 billion or $17.3 million by JFSA (Japan's Financial Services Agency). due to intentionally ignored the irregularities that occurred in Toshiba's financial reports for more than 6 years. However, this intentional action coming from Toshiba's external auditor can be traced to their long relationship as auditor-client without any audit rotation at least every seven years as it has been regulated in JICPA (Japanese Institute of Certified Public Accountants) to avoid any bias from the auditors in performing their duty. The American Institute of Certified Public Accountants (AICPA) published a paper in 1992 that looked into whether mandatory audit firm rotation could be more effective than compulsory audit partner rotation in terms of improving audit quality and regains the trust of investors. The lack of audit independence between the company and its external auditor led to a poor performance of professional competence from the auditor's part; a serious case of negligence of their duty. This happened due to for many years ShinNihon had been in command of Toshiba, and had developed a false sense of assurance that Toshiba would not do such things. It can be seen that ShinNihon failed to apply accounting principles and auditing standards and using forensic auditing techniques to prevent, deter, and investigate fraud. The level of development of the stock market is influenced by the availability of accurate and reliable corporate financial information about firms' financial performance and financial position, as well as the appropriate legal and regulatory infrastructure, such as an effective Securities Exchange Commission, an active stock exchange market, and the accessibility of accurate and reliable corporate financial information about firms' financial performance and financial position. At the end of 2015, immediately after the announcement of Toshiba's annual record loss, Toshiba's stock price again plunged to 12%, which in total the company's stock price had been decreasing as much as 40% since their fraudulent financial statements scandal in April. Toshiba was declining periodically after the blow-up of the scandal. Investor sentiment can be used as the measurement for the market reaction towards the fraud because when investor sentiment on a company is high it's usually because investors are being optimistic and feel encouraged to buy the stocks, which then lead to the increasing price of the stock of that particular company. In other hand, when investors are being pessimistic toward the company, they would feel reluctant in buying the stocks and instead find other more attractive alternative. After matching the events in Table 6 and the down-shifting of Toshiba stock prices following the scandal, they reflect not only due to the financial loss that Toshiba was facing, but more importantly they reflect the loss of trust and confidence of investors caused by the fraud done by the internal party and the poor audit quality from Ernst & Young ShinNihon.

4.3 Olympus and KPMG AZSA Case and Reputation Loss

Event 1 took place in May 2009, Tsuyoshi Kikukawa, the former CEO of Olympus announced that their contract with its former auditor, KPMG AZSA, had ended. KMPG AZSA has been Olympus' external auditor for several years until 2009. The external auditor of Olympus found some inappropriate transactions in the company's books, this discovery later forced KPMG Azsa to warn the top executives of Olympus to resign if they did not want them to notify the Japanese authorities about the wrongful transactions. After some negotiations, Olympus agreed to wipe out ¥71 billion or $921 million of those transactions. In return, KPMG Azsa had to also agree to sign on Olympus' accounts with their unqualified opinion; addressing that there was not anything irregular with the financial statements of the company. Kikukawa decided not to mention any dispute with KPMG Azsa even though Japan has a strict rule of disclosure that requires companies to inform investors regarding the opinions of their external auditor. The investigation later revealed a confidential internal document written by Kikukawa to Olympus' executives in Europe and the United States saying that there had been disagreement between the company and its external auditor, which he stated that he did not intend to disclose with their investors. After the announcement of their ending contract with KPMG Azsa, the chief executive then had no choice but to open to public through a letter explaining that the dispute with KPMG Azsa was due to the company's acquisition of Gyrus, medical device company in United Kingdom, that costed $2.2 billion in 2008. No mention of KMPG Azsa's discoveries of irregular transactions in Olympus books.

Event 2 covers the affair of *Facta*, a Japanese magazine that discusses the topic of economics, published an article that uncovered questionable transactions during Olympus' 2008 acquisition of Gyrus written by Yamaguchi Yoshimasa[8]. The article contains details of Olympus' involvement in an illegal practice of hiding its financial losses in 2011. The erupted scandal that happened to Olympus brought necessary questions about the importance of transparency in Japanese corporations and ignorance of the mainstream media to disclose more. Event 4 happened as the direct effect of what happened in Event 3. Event 3 explains the affair in which Michael C. Woodford, whose position in Olympus at that time was as chief executive, decided to become the whistleblower. Woodford was the first non-Japanese to run the Japanese company that manufacture optical and reprography products. His suspicion started when a friend of his notified him through email that contains a translation version of an article from *Facta* that Yamaguchi Yoshimasa detailly wrote about Olympus. On October 14 2011, Woodford was then removed from his position after only working as the CEO for only a few weeks at a special meeting board that only lasted a few minutes. His dismissal was mainly because Woodford insisted in pressing questions and investigating the irregular transactions. Woodford's sudden removal drew a lot of attention especially after he decided to make an out-of-court settlement in regards to his dismissal. The news about the fraud in Olympus and Woodford as the whistleblower were covered in western news media such as The Sun, The Sunday Times, and The Independent where they praised him as the "Businessperson of the Year".

KPMG Azsa is another case example of audit failure that directly affected shareholders, investors, creditors, banks, and other entities that require a reliable financial report of businesses. Investors demand auditors to protect their investments from the risk of fraud, despite the fact that financial statements audit is not particularly designed to detect fraud. The failure of KPMG Azsa to uncover Olympus accounting fraud gives a rationale for investors to look down on the financial statement quality of companies examined by KPMG Azsa, as well as the reputation of the auditors. However, very much different with the case of ChuoAoyama and Ernst & Young ShinNihon, KPMG Azsa did not intentionally neglect the irregularities in Olympus' financial reports due to its executives able to keep vital information of their financial positions, keeping them from detecting any red flags. Nevertheless, KPMG Azsa were not doing its duty as they failed to implement auditor's professional competence in exposing the manipulated financial performance of its client and also failed in applying their skepticism that should be critical and questioning every evidence that possibly indicate errors in the statements of Olympus.

As mentioned above, the failure of KPMG Azsa to detect the fraud in Olympus' financial reports thus threatened the external parties such as investors, led to the stock owners to devalue the financial reports of companies that are also audited by KPMG Azsa. What will happen is that KPMG Azsa's clients stock price will turn negative due to investors' lack of trusts. Shortly after the public found out about the scandal, Olympus's stocks market values immediately fell 4.9% which made the total fall reached 45% only on the 5th day after the Japanese camera maker's issued statements with the purpose to ease the fears among their investors, which obviously failed. Even after Olympus has tried in dismissing their malpractice, it did not stop the collapse in its stock market value that finally reached 50% a week after the public announcements, which shows investors and markets' lack of confidence. The reaction of distrust and lack of confidence from investors were expressed through the significant drop on Olympus' stock price.

5. Conclusion And Research Limitation

The first core point of this research is to understand that the level of audit quality performed by the external auditors, which are the third-party hired by the shareholders and are expected to be unbiased or neutral, is able to determine the activity of stock markets. So, in order to have a broader understanding of how one can influence the other, this research uses three majors accounting scandals in Japan; Kanebo and ChuoAoyama in 2004, Olympus and KPMG Azsa in 2011, and Toshiba and Ernst & Young ShinNihon in 2015. Second, through analyzing each event of the accounting scandal being publicized thus deteriorate the reputation of auditors, describing the audit failures based on each case, and analyzing the stock market performance following the scandal, we have a better grasp on the matter of how audit quality also plays a role in sustaining the stock markets' effectiveness. This research uses Case Study Analysis that helps the author to determine which specific event would cause market reaction in the form of shifting in stock prices, with the purpose of providing strong evidences. The common thing between Kanebo, Olympus, and Toshiba is that their malevolence acts in order cover their losses and inflate their earnings to present their financial statements as profitable to the investors. This research tries to explain that audit quality plays crucial role in determining the sentiment of the investors, considering that fraud, misstatement, or error in the financial statements can be detected and prevent providing poor audit quality if the auditors are able to implement the core functions and understand what are the indicators of audit quality.

However, upon writing this research there has been some limitations, such as follows:

- Obtaining data and sample of Kanebo and ChuoAoyama case. there is still unresolved question whether companies who chose to switch auditor from ChuoAoyama were purely because of the audit company's deteriorating reputation caused by poor audit quality or if there is another reason. The author is unable to uncover the full reason of why all 2.300 clients of ChuoAoyama were switching to another external auditors after the accounting fraud because there was not enough data available that studies auditor switch during Kanebo and ChuoAoyama case.
- Some data regarding to the state of Kanebo's stock prices were also unable to obtained due to the fact that they have been delisted from TSE. As explained in Chapter IV, Kanebo's accounting fraud was massive that the regulator had to completely delisted the company from TSE in order to maintain a fair, efficient, and also reliable market.

Several suggestions regarding to the problems presented in this research are as follows:

- The stock exchange regulator must oblige the companies who are listed to disclose the extent of their ties with external auditors. This information is crucial and should be stated in the company's financial statements as a way to assure the shareholders that the reports are reliable with the good opinion of the external auditors.
- To minimize the risks of errors in the financial reports, whether they are intentional or unintentional, auditing should be designed to more properly recognize errors, especially in high-risk areas of fraud.

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