

Regulatory sanction to an audit firm: An analysis of client stock market reaction

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Abstract

Regulatory compliance is a significant element of environmental security, the safeguarding of stable state revenues and the achievement of other key public objectives. Capital market effects of enforcement have received a lot of attention, but it has not been much reviewed and explored within the scope of Indonesian capital market. Specifically, this research aims to provide an in-depth review of the regulatory sanction imposed on a major audit firm in Indonesia and to analyze the impact of investor valuations by looking at the stock prices of each client company of the audit firm. We examine the stock market effects of the regulatory sanction imposed upon one of the Big Four auditors in Indonesia, namely KAP Tanubrata, Sutanto, Fahmi, Bambang & Rekan as a member of BDO International Limited for actions related to its audit of PT Garuda Indonesia (Persero) Tbk (Garuda Indonesia). The shares of 37 BDO auditees and 37 non-BDO auditees are analyzed and their respective cumulative abnormal returns (CAR) are calculated in order to observe their reaction upon the event, i.e. the imposition of sanction by regulator towards BDO. Two event windows are examined in our analysis - April 26th, 2019 is the date on which the issue was informally reported by the media/press and June 28th, 2019 is the date on which the regulator officially imposes its sanction. Using the event study methodology, we calculated the CAR and obtained results that showed significant differences in the CAR figures for BDO and non-BDO clients. Our findings suggest that a significant difference in the CARs of BDO and non-BDO clients only exists over a brief period of time, indicating a lack of major concerns for the case. Therefore, we see that BDO has no reputational loss in relation to the Garuda Indonesia case, both on informal and formal dates.

Keywords stock market reaction, regulatory sanction, audit firm, auditor reputation, audit quality

1. INTRODUCTION

Auditors, notably external auditors, occupies a substantial role in assuring that financial reports of their clients are complete, accurate and are free of material misstatements. They must ensure that every statements of their clients are presented in accordance with the applicable accounting framework and ensure that true and fair results are presented on the record. Furthermore, it is the responsibility of external auditors to certify the financial statements of the firms they audit. Certain investors and lenders required this certification for their analysis. This places immense pressure on auditors because failure in providing their clients with adequate certification may have a detrimental impact on the firms they audit and the surrounding economy. Auditors are demanded to apply adequate skepticism to accounting estimates and treatments and also address every shortcomings detected, so that investors and other interested parties can have confidence in the quality of the information contained in the auditor's report.

An issue that has posed significant concerns about the audit quality of one of the Big Four audit firms in Indonesia has recently occurred. This research raises the issue of sanction imposed by regulator to one of the Big Four auditors in Indonesia, namely KAP Tanubrata, Sutanto, Fahmi, Bambang & Rekan as a member of BDO International in Indonesia. The imposition of sanctions by the regulator is due to the finding of financial statements engineering in Garuda Indonesia's financial statements. BDO Indonesia, as the auditors of Garuda Indonesia in the period, are considered negligent in identifying and detecting misstatements in Garuda Indonesia's financial statements. Consequently, Financial Services Authority (FSA, originally referred to as *Otoritas Jasa Keuangan/OJK*) imposed their sanctions to BDO Indonesia in the form of a written monition to amend its quality

control policies and procedures, and also a one-year suspension on the Notification of Registration to one of the partners at BDO Indonesia.

The exposure of a firm's wrongdoing may cause reputational harm to the firm, which can further impact the firm's operation. The three categories which may indicate that impairment of a firm occurs includes financial strain (monetary sanctions) incurred by the detection of financial infringements, an increase in the cost of capital due to the provisions to do business with a sanctioned firm, and news of firm violations that can reduce the number of existing and future clients (Karpoff, 2012).

Previous research in many countries have discussed capital market effects to regulatory action/enforcement, some of which are research in United States (Pacini & Hillison, 2003), France (Kirat & Rezaee, 2019), United Kingdom (Armour, Mayer, & Polo, 2017), Germany (Weber, Willenborg, & Zhang, 2008), Japan (Numata & Takeda, 2010), and China (Chen, Firth, Gao, & Rui, 2005). However, this discussion has not been much reviewed and explored within the scope of the Indonesian capital market. Specifically, this research aims to evaluate the regulatory sanctions levied on a major audit firm in Indonesia by looking at the investor valuations through the stock prices of client of the firm.

The article proceeds as follows: The next section offers a brief overview of stock market reaction and audit quality. Section 3 presents data and methodology. Section 4 presents and discusses the empirical results and discusses them. Section 5 provides conclusion and recommendation.

2. LITERATURE REVIEW

2.1. Stock Market Reaction

The absorption of information in the market is based on the signaling theory and the concept of the efficient marketing hypothesis. Signaling theory demonstrates the value of information issued by a firm for the purpose of investment decisions. Information is a prominent element for investors as it provides notes and descriptions of the past, present and future for firms and the capital market. Information may provide a signal for investors in making investment decisions. Market is expected to react to certain information with value, where market participants will then interpret and analyze the information as a good signal or a bad signal. Investors, in this case, may immediately capture any signal that tends to increase their knowledge of a firm and adjust the share price immediately thereafter (Kirat & Rezaee, 2019).

On the other hand, Efficient Market Hypothesis (EMH) states that financial markets provide efficient information (Fama, 1970). This means that investors value the share price of a firm according to available public financial information (Wetterlind Dörner, 2005). Thus, it is impossible to consistently outperform the market, unless someone may have the same information as the market or there is a luck factor. This is because the efficiency created by 'core work' in the stock market means that the current stock price may invariably reflect and include all relevant and practical information (Azzam & Karlquist, 2008).

Market reaction of a firm to any information is indicated by a change in the share price of the firm itself. This reaction can be measured by using return as the value of price changes or by abnormal returns. Through abnormal return, any event that contains information may provide abnormal return to the market. Conversely, those that do not contain information may not provide an abnormal return to the market (Hartono, 2010). Abnormal return is highly necessary in determining performance according to portfolio risk when compared to the reference index or the market as a whole. Abnormal return can also describe whether investors receive adequate compensation for the assumed investment risk. Studies based on abnormal returns have been applied in an effort to verify various events in many studies in the field of corporate finance or financial economics (Jeng, 2015). Further information regarding the observation of market reaction using (cumulative) abnormal return is presented in the next section (see section 3.2 Cumulative Abnormal Return).

2.2. Audit Quality: Reputation Rationale and Insurance Rationale

Audit quality is essential to the acceptance of a firm's audit services and its reputation in the market. Recent research on accounting/auditing domain has therefore discussed audit quality through two primary motivations, i.e. "reputation rationale" and "insurance rationale" (Dee, Lulseged, & Zhang, 2011; Frendy & Hu, 2014; Skinner & Srinivasan, 2012; Weber et al., 2008).

Reputation rationale is related to the prominent role of auditors in alleviating agency problems among managers, owners and creditors of enterprises due to the presence of information asymmetries. To reduce costly decision-making problems and reduce agency costs, managers need to subject to monitoring by auditors and/or financial institutions to obtain their certification (Numata & Takeda, 2010). Therefore, hiring auditors with excellent reputations may assist the firm, notably management, to ensure that all reports published by the firm are accurate and reliable (Dee et al., 2011).

Insurance rationale, on the other hand, linked to the role of the auditor to provide insurance to investors when there is a loss due to the misrepresentation of financial statements (Numata & Takeda, 2010). Auditors are also required to become the 'insurance' in the case when a firm is involved in a litigation. Auditors are considered more capable of identifying material misstatements and are professionally more impeccable, so that they can mitigate any conditions required to achieve a successful litigation (Weber et al., 2008). Larger audit firms tend to set higher fees for their services. Larger firm size and the "deeper pockets" of a firm are associated with greater incentives to provide high quality audit services (Weber et al., 2008).

2.3. Hypothesis Development

Regulators may issue their enforcement action when a firm commits any violation, including financial statement falsification, overstatement of asset and income, and inadequate disclosure (Rollins & Bremser, 1997). Enforcement actions have the potential to provide new information for auditors and clients, and thus changes their perception on one another. For auditors, this action can be interpreted as a sign that clients carry different business risks than previously expected. For clients, this action requires them to adjust their expectations about the quality of the work of the auditors they use. Enforcement actions increase the likelihood of negative consequences such as lawsuits or reputational damage for auditors and clients (Brocard, Franke, & Voeller, 2018).

Bad news regarding audit firm/auditor may be detrimental to the reputation of the firm, as this may be interpreted by investors as evidence that the firm has conducted a low-quality audit (Dee et al., 2011; Weber et al., 2008). Investors may then question the reliability of audited financial reports issued by other firms (audited by the same audit firm) - including those without any audit failure issue. Investors may instantly revise their view towards the (audit) firm's client. Previous research have shown that enforcement actions to audit firms have negative impact on stock prices, and that it may cause hesitancy towards the accuracy of its client firms' audited financial statements and affects these firms negatively (Chen et al., 2005; Krishnamurthy, Zhou, & Zhou, 2006).

The two interrelated theories of reputation rationale and insurance rationale have been linked to client market reactions when investors are aware of detrimental information about the reputation or sustainability of an audit firm (Dee et al., 2011; Frendy & Hu, 2014; Pacini & Hillison, 2003). News of regulatory actions against audit firms can lead to increased litigation against auditors. Disclosure of negative information about auditors may cause investor to revise their view of the (audit) firm's clients on the basis of (1) reputational motive - loss of confidence in the accuracy of other firm's (auditee) financial statements due to damage to the auditor's reputation or (2) insurance motive - concern about the litigation against auditors originating from the events disclosed (Dee et al., 2011; Numata & Takeda, 2010; Weber et al., 2008).

We thereby hypothesize that the imposition of sanctions by regulators indicates that the audit firm provides its client with poor audit quality and generates doubt as to the quality of the financial reporting. We expect that the share price of the BDO auditees will be/adversely affected. In this research, we examine the shares of BDO auditees (with non-BDO clients as their counterparts) when the media first reported the news about BDO related to the Garuda Indonesia case and when the sanction was officially imposed by the regulator upon BDO, since these events are useful in identifying the economic significance of the auditor's reputation.

HYPOTHESIS. BDO auditees experienced a more adverse, negative abnormal return when compared to non-BDO auditees in both event studied, i.e. when news of BDO Indonesia (associated with the case of Garuda Indonesia) was made public and when the regulator officially imposed its sanction.

3. METHODS

3.1. Event Study Methodology

Event study methodology can be used to identify abnormal returns when an event is occurred. Events can be identified through a newspaper release or the issuance of a notice by an enforcement agency or any other type of

information-providing mechanism (Kirat & Rezaee, 2019). We use event study method to analyze the day-to-day movement of abnormal returns around the period in which the regulator imposes its sanctions on BDO Indonesia. This study examines this through two event windows, i.e. informal date and formal date. The informal date is intended to be the initial date on which cases or news regarding BDO Indonesia (in relation to Garuda Indonesia) are published in the media/press, while the formal date is the date on which the regulator through its official account/channel imposes its sanctions upon BDO Indonesia. The determination of both event windows analyzed in this research is shown in detail in Table 1 below.

Table 1. Event Windows

	t-10	t0	t+10
Informal date	April 9, 2019	April 26, 2019	May 13, 2019
Formal date	June 13, 2019	June 28, 2019	July 12, 2019

The event window studied in this research was 21 days. The event day on each window is represented as t0, the initial date of the observation as t-10, and the end date of the observation as t+ 10. To avoid confounding effects, we decided to analyze the event on this short-length observation.

3.2. Cumulative Abnormal Return (CAR)

We employ the standard event study methodology to evaluate the stock price reaction with regard to the public announcement of misconduct by an audit firm and sanctions imposed by regulators for such errors.

Ordinary Least Squares (OLS) regression model is the most popular approach used to estimate the relationship between stock price and market return. The relationship is then used to estimate expected returns. The so-called market model is calculated by this formula:

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it} \quad (1)$$

We then calculate the abnormal return around both events of informal and formal date. We used a traditional market model to see the effect of these events on the stock return of the sampled firms. The following equation defined the measurement of abnormal return for firm i at day t.

$$AR_{it} = R_{it} - (\hat{\alpha}_i + \hat{\beta}_i R_{mt}) \quad (2)$$

Where R_{it} are the returns on the stock of firm i on day t and R_{mt} are the index of market returns on day t. The coefficient α_i and β_i are estimated from an ordinary least squares (OLS) regression of R_{it} on R_{mt} using a 21-day period consisting of days -10 to +10 relative to both event date.

Lastly, cumulative abnormal returns (CAR) for each firm is also calculated by summing up the abnormal returns of respective firm within the event window. 'N' in the following equation represent the number of days in the event window.

$$CAR_{it} = \frac{1}{N} \sum_{t=1}^{t=N} \varepsilon_{it} \quad (3)$$

3.3. Sample Selection

The population in this study are the stocks of firms from all sectors listed on the Indonesia Stock Exchange (IDX). We applied purposive sampling method to obtain the research sample. The sampling criteria are presented in detail through Table 2.

Table 2. Sample Selection Criteria

	No. of Firms
BDO Indonesia clients (source: IDX)	42
Firms with insufficient or missing return data on IDX	(5)
Sample with available returns	37
Non-BDO clients (comparative firms)	37
Final sample	74

Our sample consist of 74 firms in total. We have ensured that the 2018-2019 financial statements of each firms are available to obtain information about external auditors who carry out audit work. Financial reports are also used to identify the industry and firm size of each company. We have also ensured that each of client (BDO auditees) and their comparative firms (non-BDO auditees) are of the same size and classified in the same industry. Financial reports and share prices are obtained from the Indonesia Stock Exchange website. Firms must have return data for the period of the event and at least 21 days during the event window.

4. FINDINGS

4.1. Descriptive Statistics

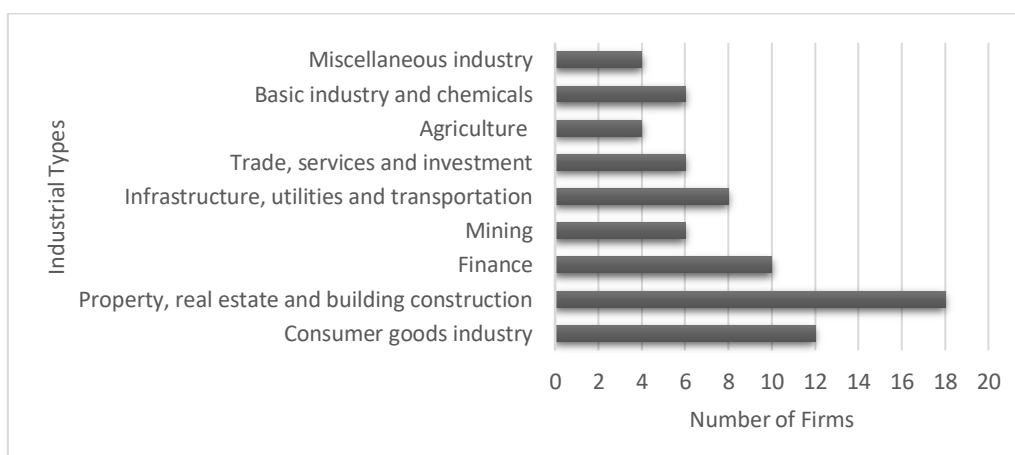
Descriptive statistics is reported in Table 3. As shown in the table, the mean CAR of BDO auditees before the date of media publication was -0.0011, increasing in the period after the date of media publication at 0.0005. However, it again shows a decrease in the mean CAR on the period before and after the date of the official regulatory sanction from 0.0009 to -0.0004. The minimum CAR of BDO auditees before the date of media publication is -0.013, while the maximum value is 0.010. Within the period before the date of the imposition of sanctions by the regulator, the minimum and maximum CAR values of BDO auditees are -0.008 and 0.020, respectively. Whereas in non-BDO auditees, the minimum and maximum CAR values are -0.010 and 0.018, respectively. The mean of non-BDO auditees are 0.0009 before the regulatory sanction was officially issued and decreased to -0.0004 after the sanction was issued.

Table 3. Descriptive Statistics

		Event I: Media Publication (Informal Date)		Event II: Official Sanction Issued By Regulator (Formal Date)	
		Pre-event	Post-event	Pre-event	Post-event
BDO	N	37 [37]			
[Non-BDO] auditees	Min	-0.013 [-0.013]	-0.010 [-0.014]	-0.008 [-0.010]	-0.015 [-0.039]
	Max	0.010 [0.013]	0.012 [0.020]	0.020 [0.018]	0.014 [0.009]
	Mean	-0.0011 [0.0001]	0.0005 [0.0014]	0.0009 [0.0013]	-0.0004 [-0.0024]
	SD	0.0049 [0.0065]	0.0050 [0.0072]	0.0063 [0.0047]	0.0054 [0.0077]

Figure 1 shows the number of firms sampled for this research. The majority of firms are firms categorized in the property, real estate and building construction industry, of which 9 are BDO auditees and 9 are non-BDO auditees. This number is then followed by the consumer goods industry with a total of 12 firms. Industries with the least number of firms are miscellaneous industry and agriculture with a total of 4 firms, respectively.

Figure 1. Sampled Firms by Industry



4.2. Discussion

We begin this part by presenting the non-parametric Wilcoxon rank sum test of BDO auditees' abnormal returns before and after the informal and formal date. Informal date is the date on which the first case regarding BDO and Garuda Indonesia was reported in the media/press. It can be seen in Table 4 below, that there is a decrease in negative CAR numbers on the pre-event to the post-event of the informal date. There is also no difference on the median CAR for the two periods before and after the informal date. The p-value obtained through the Wilcoxon sum rank test of 0.729 indicates that there is no difference in the CAR of BDO auditees before and after the publication of news regarding BDO's role in the Garuda Indonesia case. The formal date is intended as the date on which sanction are formally enforced by the regulator through its official account/channel/website. Table 4 also shows that there is no significant change in the percentage of negative CAR figures. The mean CAR of BDO auditees has decreased from 0.0009 at the time before the imposition of sanctions by regulators to -0.0004 at the time after the imposition of sanctions by the regulator. The p-value of 0.757 indicates that there is no significant difference in the CAR of BDO auditees before and after the sanction imposed by the regulator.

Table 4. CAR – Pre vs. Post-event [BDO Auditees only]

	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation	Wilcoxon sum rank test p value
Informal Date						
Pre-event	37	54.59	-0.0011	-0.0010	0.0314	0.729
Post-event	37	51.08	0.0005	-0.0010	0.0269	
Formal Date						
Pre-event	37	49.19	0.0009	0.0003	0.0330	0.757
Post-event	37	49.46	-0.0004	0.0002	0.0298	

Table 5 and 6 presents mean and median CAR for BDO and non-BDO auditee around the informal (April 26, 2019) and formal date (June 28, 2019). We report the results in seven different windows. Panels A, B, C, D, E, F and G are the results of calculating the comparison of CAR (BDO vs. non-BDO auditee) on one-day (day 0, the event day), two-day (day -1, 0), two-day (day 0, +1), three-day (day -1, +1), four-day (day -3,0), four-day (day 0, +3) and six-day (day 0, +5) windows, respectively. The mean and median CARs for BDO and non-BDO auditees are significantly different in two windows (Panel A with p-value of 0.001 and Panel B with p-value of 0.007). However, in these two windows, the CAR for BDO auditees are significantly bigger in value than those of the non-BDO auditees.

Table 5. CAR – BDO vs. Non-BDO Auditees [Informal Date]

Panel A: Day 0					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	32.43	0.0066	0.0051	0.0200
Non-BDO	37	72.97	-0.0149	-0.0036	0.0439
Wilcoxon sum rank test p value			0.001*		
Panel B: Day -1, 0					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	47.30	0.0023	0.0018	0.0196
Non-BDO	37	63.51	-0.0099	-0.0024	0.0367
Wilcoxon sum rank test p value			0.007*		
Panel C: Day 0, +1					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	41.89	0.0006	0.0019	0.0238
Non-BDO	37	55.41	-0.0009	-0.0010	0.0420
Wilcoxon sum rank test p value			0.145		

Panel D: Day -1, +1					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	48.65	-0.0003	0.0011	0.0221
Non-BDO	37	54.95	-0.0023	-0.0009	0.0376
Wilcoxon sum rank test p value			0.361		
Panel E: Day -3, 0					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	50.68	-0.0000	-0.0000	0.0253
Non-BDO	37	56.76	-0.0035	-0.0015	0.0390
Wilcoxon sum rank test p value			0.323		
Panel F: Day 0, +3					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	44.59	0.0013	0.0017	0.0245
Non-BDO	37	52.03	0.0018	-0.0005	0.0486
Wilcoxon sum rank test p value			0.982		
Panel G: Day 0, +5					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	46.85	0.0007	0.0011	0.0253
Non-BDO	37	55.41	0.0005	-0.0012	0.0441
Wilcoxon sum rank test p value			0.734		

Table 6 below shows the non-parametric Wilcoxon rank sum test of BDO and non-BDO auditees' abnormal returns before and after the imposition of sanction by regulator. The only significant difference was found on Panel E (Day -3, 0), which is significant at a 5 per cent level. We also discovered that the mean CARs of BDO auditees are lower in number and negative than CARs of non-BDO clients across all the windows in Table 6. Within the formal date, the mean CAR values for BDO (non-BDO) auditees across all the windows were -0.0050 (0.0103), -0.0035 (0.0012), -0.0039 (0.0070), -0.0032 (0.0020), -0.0017 (0.0041), -0.0012 (0.0017), and -0.0016 (0.0023).

Table 6. CAR – BDO vs. Non-BDO Auditees [Formal Date]

Panel A: Day 0					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	48.65	-0.0050	0.0019	0.0316
Non-BDO	37	48.65	0.0103	0.0005	0.0464
Wilcoxon sum rank test p value			0.769		
Panel B: Day -1, 0					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	55.41	-0.0035	-0.0010	0.0274
Non-BDO	37	52.70	0.0012	-0.0011	0.0376
Wilcoxon sum rank test p value			0.874		
Panel C: Day 0, +1					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	50.00	-0.0039	0.0001	0.0350
Non-BDO	37	54.05	0.0070	-0.0009	0.0478

Wilcoxon sum rank			0.455		
test p value					
Panel D: Day -1, +1					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	54.05	-0.0032	-0.0013	0.0314
Non-BDO	37	54.95	0.0020	-0.0012	0.0417
Wilcoxon sum rank			0.982		
test p value					
Panel E: Day -3, 0					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	50.68	-0.0017	-0.0001	0.0307
Non-BDO	37	49.32	0.0041	0.0002	0.0382
Wilcoxon sum rank			0.028*		
test p value					
Panel F: Day 0, +3					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	52.03	-0.0012	-0.0002	0.0346
Non-BDO	37	53.38	0.0017	-0.0009	0.0560
Wilcoxon sum rank			0.645		
test p value					
Panel G: Day 0, +5					
Clients of:	N	Negative (%)	Mean CAR	Median CAR	Standard Deviation
BDO	37	52.25	-0.0016	-0.0003	0.0312
Non-BDO	37	51.80	0.0023	-0.0002	0.0481
Wilcoxon sum rank			0.122		
test p value					

The result in Table 5 may imply that investors react rationally due to several reasons. Investors do not seem to consider the news disclosing BDO's misconduct as negative news. There is a possibility that investors perceive this as a good signal that, as a result of the misconduct, BDO may need to strengthen and improve their internal control.

Based on these findings, we assume several matters about the rational actions of investors towards the events we studied. First, investors did not perceived the news of BDO (in connection with the Garuda Indonesia case) as bad news. With the disclosure of this case, investors expect BDO to have higher quality as regulators/law enforcers requires the firm to improve its internal control. Second, the possibility of a larger event is present in both event date, which may reduce investors' attention to the issues we pose in this research. Thirdly, certain investors are likely to have an unreasonable mindset where their investment practices are conducted at random and uncorrelated. Fourth, investors consider the limitations of financial statement audit in the light of audit failure. Audit procedures require a significant level of materiality and a substantial risk assessment with respect to management assertions. In a large and complex firm, it is likely that certain immaterial accounts are missed. For this reason, investors act rationally by understanding the circumstances that audit failure issue may likely occur at a low frequency in a long run (Chen et al., 2005).

Meanwhile, the only significant, negative difference on day (-3, 0) on the abnormal returns of BDO and non-BDO auditees indicates a lack of major concern to the case. Hence, we may conclude that BDO has no reputational loss in relation to the Garuda Indonesia case, both on informal and formal dates.

Previous research has proven that reputational losses due to errors impacting clients, suppliers, or investors of a firm have a large and significant impact, while reputational losses related to errors involving third parties (such as market participants in general or society in general) have little impact and not significant (Armour et al., 2017; Murphy, Shrieves, & Tibbs, 2009). The finding of this research complements previous empirical studies that have shown market non-reaction to other events associated with regulatory sanction and auditor reputational loss (Barbera & Martinez, 2006; Frendy & Hu, 2014; Kirat & Rezaee, 2019; Soepriyanto & Zudana, 2020).

5. CONCLUDING REMARKS

We investigated the impact of regulatory sanction and the subsequent decline on auditees' stock prices and contrasted with those of non-auditees, using events related to the BDO-Garuda Indonesia case. We have collected stock market prices of the sampled firms during two events: the announcement of misconduct on media/press and official imposition of sanction from the regulator. Through an event study approach, we assess the impact of these events on the stock prices of BDO auditees and non-auditees. The event study enables us to isolate abnormal returns which are resulted from the events around the two events (t-10 to t+10).

The result indicate a significant difference on the stock prices of BDO and non-BDO auditees only in a brief of time around the two event date. Within the period when BDO-Garuda Indonesia case was announced in the media/press, the CAR of BDO auditees were significantly bigger in value than those of the non-BDO auditees. This result suggest that investors do not value the announcement of misconduct as a negative news.

However, a distinct fact occurred within the period when regulator imposed their sanction on BDO, in which the mean CAR of BDO auditees were more adversely affected than those of the non-BDO auditees. We observe a decrease in BDO auditees' stock prices only in a brief period of time around the period of event (days -3 to 0), indicating a lack of major concern for the case. Hence, we may conclude that no reputational loss on BDO in relation to the Garuda Indonesia case, both on informal and formal dates.

We only analyze 10 days before and 10 days after the event date for the estimation period. Further research is expected to extend this window to capture the possibility of major unpredictable investor reactions. Future studies is also expected to further examine this topic with a more comprehensive discussion, for example by using control variables to support the empirical analysis that have been carried out. This research can be an evaluation for regulators to consider the types or forms of sanctions imposed on firms/business actors that breach the laws. A number of audit firms in Indonesia have recently been subject to enforcement action by regulators, therefore it is best that these audit firms concentrate more on improving the quality of their audit services.

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