

The Price-Earnings Relation in Troubled Times: The Case of Arthur Andersen

Paul K. Chaney
Vanderbilt University

Kirk L. Philipich
University of Michigan – Dearborn

The purpose of this study is to examine the impact of auditor reputation on the price-earnings relation. More specifically, this study examines annual earnings response coefficients (ERC) before (2001) and after (2002) the Enron events that substantially impaired Arthur Andersen's reputation. Two possibilities exist. First, the market may perceive that Andersen's shredding of audit documents, and its subsequent loss of reputation, may have caused auditors, in general, to take greater care, thus increasing the reliability of the reported earnings numbers. This would manifest itself by stronger reactions to reported earnings. Alternatively, the market's confidence in the reliability of reported earnings may have eroded leading to smaller responses to reported earnings. In addition, any resulting change in the market's response to reported earnings might be even more pronounced for Andersen clients. Our tests revealed a significant decrease in ERCs in the post-period. However, upon further examination, we found that clients of Deloitte and Touche and PriceWaterhouseCoopers exhibited large declines in the market's response to their earnings releases. The clients of KPMG saw declines, but not nearly as dramatic as those of Deloitte and Touche and PriceWaterhouseCoopers. However, the clients of Arthur Andersen and Ernst & Young saw their ERCs rise substantially.