

Relationship of Managerial Ability on Going Concern Audit Opinion

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This study aims to determine the relationship between managerial ability on going concern audit opinion. The sample used in this study was 372 observations consisting of all manufacturing companies listed on the Indonesia Stock Exchange (IDX) for the 2014-2016 period. The analysis technique used is logistic regression analysis using SPSS version 20. This research documented that managerial ability had a negative relationship on going concern audit opinion, which showed that the higher the managerial ability of a firm, the firm would likely not get going concern audit opinion. This indicates that managerial ability influences the auditor's judgment in providing an audit opinion on the entity's business continuity. The auditor becomes less sensitive to salient financial distress when managerial skills in the firm are categorised as decent. This research can encourage management to improve their managerial ability in decision making so that the firm can maintain its survival from the perspective of auditor.

Key words: *Managerial ability, audit opinion, going concern.*

Introduction

Financial reports are essential reports that depict the firm condition. Financial reports provide an overview about firm financial structure and how firms attain its financial sources and the firm performance, especially the firm managerial function (Boynton, 2006). Financial reports have crucial role for its users, both for internal parties (management) and external parties (investor). On the one side, investors demand accurate information about the firm conditions. On the other hand, management also wants its financial statements to attain certain targets, so that when the firm's condition cannot reach these targets, management has a tendency to commit fraud, manipulate its financial statements to keep them looking trustworthy (Wahda, 2017).

Cases of fraud on financial statements have occurred. One example is the case of manipulation of financial statements also occurs in large firms in America, such as the Enron and WorldCom cases. After several years of international and domestic expansion, Enron has billions of dollars in debt, but this is hidden from shareholders through partnerships with other firms, accounting fraud, and illegal loans (Widyaningsih et al., 2019). Weiss (2008) found that out of 228 publicly traded firms that went bankrupt, Enron and 95 other firms received unqualified opinions in the year before bankruptcy (Tucker et al., 2003). The fact of the incident raises the question why firms that have unqualified opinions can stop operating. On that basis, the AICPA (1988) requires auditors, in addition to providing an opinion on the firm's financial statements, must state explicitly whether the client firm will be able to maintain its survival until a year later after reporting year (Kartika, 2012). Although the auditor is not responsible for the survival of a firm but in conducting a survival audit it is necessary that auditors consider in providing opinions.

The audit process is a form of validity test of firm financial statement information before the information is disclosed to the public and government (Arens, 2017). In this audit process, the external auditor's role is to ensure that the firm's financial statements have been prepared properly and in accordance with applicable regulations. Auditing is a systematic process for obtaining and evaluating evidence relating to assertions about economic actions and events objectively to determine the level of conformity between these assertions with predetermined criteria and communicating the results to parties interested in an entity (Boynton, 2006).

Financial statements can provide an indication of the going concern of the firm. Going concern is the survival of a business entity and is an assumption in the financial reporting of an entity so that if an entity experiences the opposite condition, that entity has serious problem (Petronela, 2012; Hani et al., 2003). Audit Standard (SA) 570 (IAPI, 2017) explains that the auditor is responsible for evaluating whether there is a material uncertainty about the entity's ability to maintain business sustainability. If the auditor finds material uncertainty about the entity's ability to maintain business sustainability, the auditor will give a going concern audit opinion. Going concern audit opinion is undesirable news for the firm because it can eliminate the confidence of investors and other users of financial statements. The going concern audit opinion gives a signal for investors to pay more attention to the firm's financial condition (Carson et al., 2012). The auditor issues a going concern audit opinion based on several factors such as his managerial ability which is important to be evaluated by the auditor before the auditor issues a going concern audit opinion (Berglund, 2015; Muda et al., 2018).

Managerial ability is something that refers to the particular influence of management on firm performance (Berglund, 2015). Winardi (2000) states that managerial ability is a capability of the actions of planning, organising, implementing, and monitoring carried out to achieve the

set goals (Siagian, 2007; Hersey, 2007; Kim, 2016). According to Harymawan et al. (2019) a managing director needs to have the ability to mobilise resources to achieve firm goals appropriately, which consists of technical expertise, human expertise, and conceptual expertise. High managerial ability will affect the provision of non-going concern audit opinion. Vice versa, if managerial ability is low will have a high likelihood of having a going-concern audit opinion. High managerial ability will have an impact on more accurate information compared to low managerial ability (Demerjian et al., 2012). High managerial ability will increase accuracy in producing financial reports, so that accurate financial statement information can provide assistance to auditors in determining non going concern audit opinion, so that managerial ability is closely related to the issuance of going concern audit opinion (Berglund, 2015).

Prior studies that examined going concern opinion of firms such as Khrisnan and Wang (2014) stated that managerial ability negatively relates to going concern audit opinion given by the auditor. This shows that the auditor's going concern audit opinion is less sensitive to salient financial disturbance signals when managerial ability is high. Berglund (2015) also documented that managerial ability is negatively related to going concern audit opinion. Furthermore, Kim (2016) that low managerial ability and overconfident management will get a going concern audit opinion.

This research specifically tries to examine whether managerial ability has relationship to going concern opinion. The sample in this study consisted of all manufacturing firms listed on the Indonesia Stock Exchange (IDX) for the 2014-2016 period as many as 372 firm-year observations. The analysis technique used is logistic regression analysis. This study found that managerial ability has a significant and negative relationship to going concern audit opinion, which shows that the higher managerial ability of a firm, the firm will not get going concern audit opinion. This indicates that managerial ability influences the auditor's judgment in providing audit opinion on the business sustainability of the entity. The auditor becomes less sensitive to salient financial disturbances when managerial ability is high compared to managerial ability. This research can encourage management to improve their managerial ability in decision making so that the firm can maintain its survival. In addition, this research can enrich the literature on managerial abilities that relates to going-concern audit opinion.

The remainder of this paper is structured as follows. Section 2 reviews the literature and develops the research hypotheses. Section 3 describes the sample, variables, and research design. Section 4 specifies the empirical result. Section 5 summarises the paper and presents concluding remarks.

Literature Review

Theoretical Framework

Auditing is a systematic process for obtaining and evaluating evidence relating to assertions about economic actions and events objectively to determine the level of conformity between these assertions with predetermined criteria and communicating the results to parties interested in an entity (Boynton, 2006; Mulyadi, 2013). Auditing on financial statements aims to determine whether the financial statements as a whole (quantitative information to be examined) are stated in accordance with certain criteria, namely generally accepted accounting principles (Arens, 2017; Whittington, 2012). According to IAPI (2017) in SA 200, the purpose of the audit is to increase the level of confidence of the intended users of the financial statements. This is achieved through the statement of an opinion by the auditor about whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The opinion is about whether the financial statements are presented fairly in all material respects, in accordance with the framework. An audit conducted based on the SA and the relevant ethical provisions enable the auditor to formulate an opinion. IAPI (2017) in SA 700 and 705, there are five types of audit reports issued by auditors, including unqualified opinions, unqualified opinions with explanatory paragraph, qualified opinions, adverse opinions, and disclaimer opinions.

In carrying out the audit process, the auditor is required not only to see limited to information that appear in the financial statements, but the auditor must also be aware of potential issues that can interfere with the continuity of the business of an entity. The current audit requires the auditor to assess going-concern assumptions using information obtained when conducting audit procedures as well as other relevant information obtained from management (IAPI, 2017). According to SA 570 paragraph 17, audit report with going concern modification is an indication that in the assessment conducted by the auditor, there are significant doubts about the auditee's ability to maintain its business continuity, and the auditor is responsible for disclosing the actual state of the client. The going concern audit opinion gives a signal for investors to pay more attention to the firm's financial condition. If the auditor concludes that there are large doubts about the firm's ability to continue as a going concern, they are responsible for expressing these doubts through going concern audit opinions (Santosa & Wedari, 2007).

The auditor can identify information about certain conditions or events that indicate there is great doubt about the ability of the entity in maintaining its survival. The conditions and events are as follows:

1. Negative trends, for example, recurring operating losses and lack of working capital,

2. Work strikes or other labour relations difficulties, heavy dependence on the success of certain projects, loss of key customers, occurrence of uninsured disasters, inability to pay short-term obligations,
3. External problems that have occurred, such as, complaints from court proceedings, passage of laws or other problems that might jeopardise the entity's ability to operate.

Relationship between Managerial Ability to Going Concern Audit Opinion

A manager is required to have the ability to manage the resources that exist in his firm in terms of managing the business of a firm, especially the ability to combine human and natural resources is realised by carrying out management functions within the firm (Wang, 2013). Winardi (2000) states that managerial ability is a capability of the actions of planning, organising, implementing, and monitoring carried out to achieve the set goals. Demerjian et al. (2012) explain that good managerial skills are based on the level of efficiency of a manager who changes the firm's resources to generate revenue. On the other hand, Siagian (2007) states that managerial ability is the ability to manage businesses such as taking action in planning, organising, motivating, monitoring and evaluating. Hersey (2007) states that managerial ability is the ability to move resources in order to achieve their goals appropriately. In the auditor and management relationship, the auditor has the opportunity to observe management's actions and evaluate their ability to determine an acceptable level of risk (Larasati et al., 2019).

One of the factors that influence going concern audit opinion is managerial ability as along with business development that is getting more advanced, managerial ability refers to the impact of managerial function on firm performance in managing firm resources. The auditor can give a going concern opinion when there is a material uncertainty in the financial statements that causes significant doubts about the entity's ability to maintain the viability of its business (Triani et al., 2012; Lie et al., 2016). According to Kim (2016) and Larasati et al. (2019) that in the auditor and management relationship, auditors have the opportunity to observe management actions and evaluate their capabilities. The auditor has the authority to evaluate managerial ability as primary evidence in audit evidence as the basis for providing going concern audits. Therefore, managerial ability is very important for auditors to assess the firm's future conditions, whether the firm can maintain its survival in the next few years (Krishnan & Wang, 2014).

Demerjian et al. (2012) stated that good managerial skills are based on the level of efficiency of a manager who utilise the firm's resources so it generates revenue. High managerial ability will not get going concern audit opinion or have a positive impact in providing non going concern opinion (Arens, 2017). Vice versa, if managerial ability is low it will have a high likelihood of having a going-concern audit opinion. High managerial ability will also have an



impact on more accurate information compared to low managerial ability (Demerjian & McVay, 2012). High managerial ability will also increase accuracy in producing financial statements, so that accurate financial statement information can help auditors help the accuracy of audits in determining non going concern audit opinions, so that managerial ability is closely related to the issuance of going concern audit opinions (Berglund, 2015).

In prior studies, it documented that managerial ability negatively relates the going concern audit opinion given by the auditor (Khrisnan & Wang, 2014). The auditor's going concern audit opinion is less sensitive to salient financial disturbance signals when managerial ability is high. Berglund (2015) shows that managerial ability is negatively related to going concern audit opinion. Therefore, if managerial ability is low then going concern audit opinion will be given by the auditor, and vice versa (Berglund, 2015). While Kim's (2016) research shows that low managerial ability and overconfident management will get a going concern audit opinion. It can be concluded that high managerial ability has a negative relationship on going concern audit opinion compared with low managerial ability. Based on this, the hypotheses proposed in this study are as follows:

Hypothesis: Higher managerial ability of the firms will less likely have going concern opinion

Research Methodology

Sample and Data Sources

The sample used in this study were all manufacturing firms listed on the Indonesia Stock Exchange (IDX) during the study period, 2014-2016. The manufacturing industry was chosen because it is an industry that has good prospects for growth and is also the most widely listed on the IDX and obtains an unqualified opinion. The data used in this study was obtained through the firm's financial statements which can be accessed through the official website of the IDX. The number of samples in this study was 372 firm-year observations. This study uses a purposive sampling method in determining the research sample, the sampling method which is based on certain considerations in selecting research objects. The criteria used in sampling the research are provided in Table 1.

Table 1: Sampling Selection Criteria

| No | Identification | 2014 | 2015 | 2016 | Observations |
|----|---|------|------|------|--------------|
| 1. | Manufacturing firms in IDX 2014-2016 | 141 | 144 | 147 | 432 |
| 2 | Manufacturing firms that listed after 2014 | | 3 | 3 | 6 |
| 2. | Manufacturing firms that not publish its financial reports consistently in IDX for period 2014-2016 and does not have sufficient data | (13) | (13) | (16) | (42) |
| 3. | Manufacturing firms that has negative efficiency value | (2) | (4) | (6) | (12) |
| 4. | Final sample | 126 | 124 | 122 | 372 |

Variable Operationalisation

Independent Variable

The independent variable in this study is managerial ability as measured by the level of management efficiency in managing firm resources. Managerial ability is measured through two stages according to Demerjian & McVay (2012) research. In the first stage, the firm's efficiency is calculated. The efficiency of this first stage of the firm is calculated using the Stochastic Frontier Analysis (SFA) method using the Fixed Effect Model (FEM) regression model and using Eviews software. From the processing results, residual values will be obtained. Efficiency values are calculated from 1 minus absolute value of residual. The following formula for calculating firm efficiency in the first stage:

$$Sales_{it} = \alpha + \beta_1 PPE_{it} + \beta_2 RnD_{it} + \beta_3 Goodwill_{it} + \beta_4 IA_{it} + \beta_5 COGS_{it} + \beta_6 SG\&A_{it} + e_{it}$$

Where, PPE is net property, plant & equipment, RnD is net research and development, IA is intangible assets, COGS is cost of goods sold, and SG&A is selling, general, and administrative expense.

In the second stage, the efficiency value obtained from the previous stage as a dependent variable is processed by four firm characteristics and total assets, market share, free cash flow, and firm age as independent variables. Total assets (TA) are measured by the number of assets owned by the firm. Market share (Ms) is measured by the number of shares outstanding multiplied by the share price. Free cash flow (FCF) is measured by a dummy variable, 0 when free cash flow is negative and 1 when free cash flow is positive. Firm age (Age) is measured by the differences of Intial Public Offering (IPO) year to observation year. After determining the proxy value, the efficiency value in the previous stage is regressed with total assets, market share, free cash flow, and firm age with multiple linear regression methods and SPSS 20. The results of this processing produce residual values. If the residual

value is high, then managerial ability is high, and in contrast, if the residual value is low then, managerial ability is low. The following formula for calculating managerial ability in the second stage:

$$FE_{it} = \alpha + \beta_1 TA_{it} + \beta_2 MS_{it} + \beta_3 FCF_{it} + \beta_4 Age_{it} + e_{it}$$

The independent variable is tested in two stages with the aim of ensuring that the value of efficiency in the first stage can describe managerial capabilities rigidly. In the first phase of testing the value of efficiency can describe managerial ability. However, it is necessary to validate the efficiency values so that the efficiency values are rigid for the managerial capabilities of the firm and are not influenced by firm characteristics. Thus the second stage of testing is needed. In the second stage of testing, the value of efficiency in the previous stage was regressed with total assets, market share, free cash flow, and firm age. The results of this processing give rise to residual values. The higher the residual value, the managerial ability is also higher because the influence of the total assets, market share, free cash flow, and firm age is getting smaller, and vice versa.

Dependent Variable

The dependent variable in this study is going concern audit opinion. A going concern audit opinion is an opinion in which there is an auditor's consideration of a significant inability to the firm's survival in carrying out operations. According to SA 570 paragraph 17 (IAPI, 2017) it is stated that the going concern audit opinion is that there is material or significant uncertainty related to conditions or events that cause significant doubt over the entity's ability to carry out its business activities. A going concern audit opinion is stated if there is a sentence "significant doubt over the ability of an entity to carry out its business activities" which refers to SA 570 (2017). Going concern audit opinion is measured using a dummy variable, which is when a firm gets a going concern audit opinion, it is given code 1 and when the firm gets a non-going concern audit opinion, code 0 is given.

Methodology

This study uses a logistic regression model to examine the relationship between managerial ability on going concern audit opinion using SPSS version 20. The following is the regression equation in this study:

$$\text{Ln [odds (going concern audit opinion)]} = \alpha + \beta_1 MA_{it} + e_{it}$$

The equation can be simplified into:

$$\ln \frac{p}{1-p} = \alpha + \beta_1 MA_{it} + e_{it}$$

$$p \text{ (going concern audit opinion)} = \frac{1}{1 + e^{-(\alpha + \beta_1 MA_{it} + e_{it})}}$$

Result and Discussion

Descriptive Statistic

Table 2: Audit Opinion Frequency Distribution

| Category | Frequency | Percentage |
|--------------------------|-----------|------------|
| <i>Non going concern</i> | 354 | 95.2 |
| <i>Going Concern</i> | 18 | 4.8 |
| Total | 372 | 100.00 |

Table 2 shows the distribution of the sample based on audit opinion. In this research, audit opinion is divided into non-going concern opinion and going concern opinion. Based on table 2 for the period 2014 to 2016, the number of sample firms that received non-going concern audit opinions amounted to more than 354 firm-year observations with a percentage of 95.2%, while those getting a going concern audit opinion amounted to 18 with a percentage of 4.8%.

Table 1: Managerial Ability Frequency Distribution

| Category | Minimum | Maximum | Mean | Std. Deviation |
|--------------------|---------|---------|------|----------------|
| Managerial Ability | -0.721 | 0.170 | 1E-7 | 0.134 |

Table 3 shows the descriptive statistical results of managerial ability. In this study, managerial ability is measured in 2 stages: the first stage uses the Stochastic Frontier Analysis (SFA) method using the Fixed Effect Model (FEM) regression model and using Eviews software to measure the level of efficiency of a firm. Based on table 3 it is known that the managerial ability of 372 sample firms has an average value of 1E-7. The minimum value is -0.726. The maximum value is 0.170. The standard deviation has a value of 0.134.

Odd Ratio Value

Odd Ratio is the probability of a firm getting a going concern or non-going concern audit opinion because of the independent variable. Exp values (β) that are more than one are called risk factors or causal factors. While Exp (β) value less than 1 is called protective factor or inhibiting factor. In table 4, the Odd Ratio of the managerial ability variable is 0.015. This means that the risk comparison of going concern opinion in firms that have higher managerial ability is 0.015 times smaller than the lower managerial ability.

Table 4: Odd Ratio Value

| Variable | Exp (B) |
|--------------------|---------|
| Managerial Ability | 0.015 |
| Constant | 0.042 |

Hosmer and Lomeshow Goodness-of-fit Test

The goodness-of-fit test of this model is done by looking at the value of the Hosmer and Lomeshow Goodness-of-fit statistic test that is greater than 0.05, so the null hypothesis is not rejected and this means that the model is able to predict its observational value or it is said that the model is acceptable. In Table 5 shows the significance value of 0.598 which is more than 0.05, so it can be concluded that the model can be said to be fit and accepted. Chi-Square and Lomeshow test is used to measure the difference between the observed value and the predicted value of the dependent variable. A smaller difference means higher quality. Chi-Square Hosmer and Lomeshow value is 6,441 has a significance of 0.598 which indicates H_0 is accepted because the significance value is above 0.05. This test concludes that the model is feasible and acceptable.

Table 5: Managerial Ability Hosmer and Lomeshow Test Kemampuan Manajerial

| Step | Chi-square | Df | Sig. |
|------|------------|----|-------|
| 1 | 6.441 | 8 | 0.598 |

Accuracy Degree of Model

In table 6 it can be seen that the accuracy of the logistic regression analysis in predicting is 95.2%. The ability of the model in predicting firms that have non-going concern audit opinion to remain have a non-going concern audit opinion is 100%. But for the ability of the model in predicting firms that are have going concern audit opinion to remain have a going concern audit opinion is 0%.

Table 6: Accuracy Classification of Model Prediction

| Observation | | Observation Prediction | | |
|------------------|-------------------|------------------------|---------------|------------------|
| | | Audit Opinion | | Total Percentage |
| | | Non-Going Concern | Going Concern | |
| Audit Opinion | Non-Going Concern | 354 | 0 | 100 |
| | Going Concern | 18 | 0 | 0 |
| Total Percentage | | | | 95.2 |

Main Analysis

Table 7: Logistic Regression Test Result

| Variable | B | Wald | Sign | Hypothesis Result |
|--------------------|----------|-------------|-------------|--------------------------|
| Managerial Ability | -4.174 | 14.461 | 0,000 | Significant |

Logistic regression analysis is carried out to examine the relationship between managerial ability on going concern audit opinion. Table 7 shows the results of the logistic linear regression analysis. In table 7, the logistic regression coefficient of the managerial ability variable (X1) is -4.174 meaning that if the other independent variables are constant, as managerial ability increase, then the possibility of the firm to get a going concern audit opinion is getting lower. Furthermore, the level of significance for managerial ability variables is 0.000 ($p \leq 0.05$) which indicates that managerial ability significantly relates to the going concern audit opinion, so the research hypothesis is accepted. Thus, it can be concluded that the higher the managerial ability, the firm will less likely having a going concern audit opinion.

The results of this study are consistent with previous research which states that there is a negative relationship between managerial ability and going concern audit opinion. Berglund (2015) indicates that the managerial ability variable has a significant and negative relationship to the going concern audit opinion. According to Khrisnan and Wang (2014), managerial ability is negatively relates to the likelihood that the auditor will issue a going concern audit opinion. From this it can be said that managerial ability relates to the auditor's judgment in providing an audit opinion on the entity's business continuity. Auditors are less sensitive to salient financial disturbances when managerial ability is high compared to low managerial ability.

Managerial ability is the ability to combine resources within and outside the firm that is realised by carrying out management functions. Managerial ability comes from good management of fixed assets to produce their products, innovations such as; brands, patents, goodwill and RnD. In addition, managerial ability is also seen in terms of inventory management to generate revenue, and also the expenses incurred by the firm on sales and administration in which there are costs of training and service technology that can improve the ability of resources owned by the firm. Muda et al. (2018) explain that the board's managerial ability and refers to the ability of management to understand the complexity of the firm which will affect corporate governance and performance. Furthermore, if good governance is developed, the firm will not experience doubts in maintaining its survival (Nasution, 2019). In addition, good managerial skills can create competitive advantage for firms (Daeng et al., 2019). Thus, if all organs in the firm are well managed, it can be said that

the firm has high managerial ability. With a high managerial ability, it will likely having a non-going concern audit opinion.

Coefficient of Determination

To find out how much the dependent variable can be explained by the independent variable can be seen from the coefficient of determination Nagelkerke R square. Table 8 shows that the value of Nagelkerke R Square is 0.098, which means the dependent variable that can be explained by the independent variable is 9.8%. While the remaining 90.2% is explained by other variables that excluded in this study.

Table 8: Managerial Ability Coefficient of Determination

| Step | -2 Log likelihood | Nagelkerke R Square |
|-------------|--------------------------|----------------------------|
| 1 | 132.258 | 0.098 |

Conclusion

This study aims to examine whether managerial ability has relationship to going concern opinion in all manufacturing firms listed on the Indonesia Stock Exchange (IDX) for the 2014-2016 period. The results of this study indicate that managerial ability has a significant negative relationship to going concern audit opinion, which indicates that the higher managerial ability, the firm will not get going concern audit opinion. This indicates that managerial ability influences the auditor's judgment in providing audit opinion on the business continuity of the entity.

This research can encourage management to improve their managerial ability in decision making so that the firm can maintain its survival. In addition, this research can enrich the literature on managerial abilities that relates to going concern audit opinion. However, this study has a limitation in that it only uses one proxy to measure managerial ability. Therefore, for further research it is recommended to measure managerial ability with another method, namely the Data Envelopment Analysis (DEA) method.

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