

# **The Impact of Bankruptcy Prediction, Company's Financial Condition, Previous Year Audit Opinion, Firm Size and Audit Tenure Towards Auditor's Going Concern Opinion**

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## **ABSTRACT**

**Objective** – The auditor is responsible for obtaining sufficient audit evidence about the accuracy and proper use of the going concern assumption from the company's management through its financial statements. These evidence are used for the purpose of deciding whether there are material uncertainties about the entity's ability to maintain the continuity of its business. Thus, the objective of this paper is to examine the impact of bankruptcy prediction, company's financial condition, previous year audit opinion, firm size and audit tenure towards Auditor's going concern opinion.

**Methodology/Technique** – The object of this paper is the service companies listed on the Indonesia Stock Exchange for the period of 2011-2014. This paper uses secondary data and samples taken were determined based on the purposive sampling method. The regression logistic is used to analyse data.

**Findings** – The results of this research show that bankruptcy prediction, company's financial condition, previous year audit opinion, firm size, and audit tenure all simultaneously, have a significant impact towards Auditor's going concern opinion, particularly Previous Year Audit Opinion.

**Novelty** – This paper provides insights into the factors affecting auditors in providing a going concern opinion in the case of Indonesian companies.

**Type of Paper:** Empirical

**Keywords:** Bankruptcy Prediction; Company's Financial Condition; Previous Year Audit Opinion, Firm Size; Audit Tenure; Auditor's Going Concern Opinion.

**JEL Classification:** D81, M42.

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## **1. Introduction**

Competition among the business industry can force a company to take the right strategy such as creating innovative products and providing the best services as a means of improving its business performance. This can serve as a competitive advantage to businesses. The purpose of the company is to generate optimal profits, enhance corporate value, satisfy consumer desires, and to maintain the company's going concern.

In this context, the auditor is responsible for obtaining sufficient audit evidence about the accuracy and proper use of the going concern assumption from the management that prepares and presents the financial

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statements. From these documents, the auditor can conclude as to whether there are material uncertainties about the entity's ability to maintain the continuity of its business.

Based on regulation KEP-346 / BL / 2011, Go Public Companies listed on the Indonesia Stock Exchange are required to submit financial statements to the Indonesia Financial Services Authority (OJK). This practice is examined by an independent auditor who acts as an independent third party. According to the Public Accountants Professional Standards (PSA No. 29 SA Section 508), there are five types of audit opinions: unqualified opinion, unqualified opinion with explanatory paragraph, a qualified opinion, disclaimer and adverse opinion. The company that gets an unqualified audit opinion would be a company that provides relevant and reliable information in its financial statements.

Auditors are also required to provide information to users of financial statements regarding the company's sustainability. This is referred to as a going concern. In the proposed going-concern audit opinion, the auditor can analyze the financial or non-financial data.

The purpose of this paper is to obtain empirical evidence that can show the impact of bankruptcy prediction, company's financial condition proxies Return on Assets (ROA) and Debt to Total Assets Ratio (DTAR), previous period audit opinion, firm size and audit tenure towards the Auditor's going concern opinion.

## 2. Literature Review

Agency problem arises because of a conflict of interest between principal and agent. Jensen and Meckling (1976) state that the agency relationship is a contractual relationship between the principal and the agent where the principal (shareholders) delegates responsibility for decision making or specific tasks to agents (managers). Compared to shareholders, managers have more internal information and information leading to the company's future prospects. Therefore, managers are obliged to provide information about the actual condition of the company through the disclosure of information in the financial reports (Dewayanto, 2011).

According to the Auditing Standards Section 508 (PSA No. 29), the auditor's opinion consists of five types: (1) Unqualified Opinion, (2) Unqualified Opinion with Explanatory Paragraph, (3) Qualified Opinion, (4) Adverse Opinion and (5) Disclaimer Opinion. The auditor is responsible for obtaining sufficient audit evidence about the accuracy and proper use of the going concern assumption by the management which prepares and presents the financial statements. From this, the auditor can conclude whether there are material uncertainties about the entity's ability to maintain the continuity of their business or not.

Wulandari (2014) states that going concern is the ability of business units that continue their survival during a period of time, for example, less than one year from the date of the audited financial statement. Based on PSA No. 30 (IAPI, 2013), it is noted that if the auditor found indications of a going concern problem, the auditor has the choice of giving unqualified opinion with explanatory paragraph, a qualified opinion or a disclaimer and adverse opinion. If there is a doubt as to whether the company can maintain the sustainability of its business and the management has a plan, the auditor has to analyze the effectiveness of the management plan in addressing the going concern problem. If the plan is effective then the auditor can give unqualified opinion with explanatory paragraph. But if the company does not have any management plan or the plan is not effective for resolving the going concern problem, then the auditor can give a disclaimer opinion.

Some of the factors that can lead to uncertainty about the company's sustainability include external problems such as the disaster that is not covered by insurance, for example, earthquakes or floods. The legal process induced may reduce the ability of the entity to operate the business. Another factor is internal problems such as negative key financial ratios, labor difficulties, difficulties to pay dividends, continuous significant losses and the company's inability to repay the debts at maturity

Bankruptcy is a very serious financial difficulty whereby a company is no longer able to keep operations running well. Financial distress is a financial hardship that may initiate bankruptcy (Wibisono, 2013; Kristiana, 2012). Bankruptcy prediction can be measured through a bankruptcy prediction model known as the Altman Z-Score which calculates the ratio that allows the bankruptcy of the company to be working capital to total

assets, retained earnings to total assets, earnings before interest and taxes to total assets, book value of equity to book value of total debts, and sales to total assets.

The company that is experiencing financial difficulties cannot achieve profit as its economic objective. With the unavailability of funds due to continuous losses that are significant and negative working capital which could lead to financial difficulties, the company's business entity can be affected and the company is likely to receive going concern opinion. Thus, the hypothesis developed for this paper is:

**Ha<sub>1</sub>:** Bankruptcy Prediction has an impact towards Auditor's going concern opinion

Financial conditions can be measured by profitability and solvency ratios. Profitability ratios measure the effectiveness of the management based on the returns generated on sales and investment. In this study, the profitability ratio used is Return on Assets (ROA). ROA shows a company's ability to generate profits from assets utilized (Kristiana, 2012; Fathoni, 2012). If the company is able to manage its assets to generate profits, the more effective its performance, the less likely it is to experience disruptions in running its operations. This is because the company did not experience any losses hence, the auditor is likely to be confident about the company's sustainability. In this regard, the company concerned is less likely to receive any going concern opinion. The second hypothesis developed is:

**Ha<sub>2</sub>:** Company's Financial Condition proxies by Return On Assets (ROA) has an impact towards Auditor's going concern opinion

Solvency ratio measures the ability of the company to repay long term debts. According to Weygandt et al., (2013) "the debt to total assets ratio measures the percentage of the total assets that were financed by creditors". If the company is not able to manage its assets or to repay the debts, then the debt to total assets ratio is high. This means that the impact on the financial condition which indicates the company's financial performance is not effective. Here, the auditor tends to doubt the sustainability of the entity because the company is unable to pay its debts at maturity by using existing assets. Thus, the concerned company tends to receive a going concern opinion. The third hypothesis developed is:

**Ha<sub>3</sub>:** Company's Financial Condition proxies by Debt to Total Assets Ratio has an impact towards Auditor's going concern opinion

Previous year audit opinion is the audit opinion received by the auditee in the previous year. If the auditor had issued the going concern audit opinion the previous year, there is a greater possibility that the company will receive a going concern audit opinion in the current year (Setyarno et al., 2006 in Kartika, 2012). If the company had suffered continuous losses which are significant and the company cannot show or realize the efforts that can be achieved at a profit in the next year as well as is unable to show improvements in its management in maintaining the continuity of its business, then the company is more likely to receive a going concern opinion. Hypothesis four is developed as:

**Ha<sub>4</sub>:** Previous year audit opinion has an impact towards Auditor's going concern opinion

According to Wibisono (2013), the size of the company can be seen from the total assets. The higher the assets are, the higher the company's ability to increase the operating activities to generate higher revenues and profits. This, in turn, will make the company able to maintain the sustainability of its business. Therefore, companies that have high total assets are less likely to get going concern opinions. This claim is supported by the results of the study conducted by Arsianto and Rahardjo (2013) who state that the size of the company has a significant impact towards Auditor's going concern opinion. Companies with large assets have a lower probability to get the Auditor's going concern opinion. However, this is refuted by Januarti and Fitrianasari

(2008) cited in Arsianto and Rahardjo (2013) who claim with empirical evidence that Firm Size has no significant impact towards Auditor's going concern opinion. Thus, hypothesis five is developed as:

**Ha<sub>5</sub>:** Firm Size has an impact towards Auditor's going concern opinion

Audit tenure which can be defined as the relationship between the auditor and the client is measured by the number of years (Arsianto and Rahardjo, 2013). The Ministry of Finance set Regulation No. 17 / PMK.01 / 2008 for Public Accounting Firms. It explains that the maximum audit tenure for Public Accounting Firm is six years and the longest by an auditor, is three years. Audit tenure may affect the auditor's independency in doing the audit and giving an opinion, so the possibility of getting the Auditor's going concern opinion would be low. Hypothesis six is thus developed as:

**Ha<sub>6</sub>:** Audit Tenure has an impact towards Auditor's Going Concern Opinion

### 3. Research Method and Data Analysis

This study uses secondary data sourced from samples that were taken based on the purposive sampling method. The criteria set is that samples must be service companies listed on the Indonesia Stock Exchange for the period of 2011-2014. They must also have published financial statements for the period of 2011-2014 and these financial statements must have been audited by external auditors. The financial statements must end on December 31 and are denominated in the Rupiah currency. The samples must also experience a negative net income for at least 2 year and the financial statements must be respectively done between 2011-2014. The samples used in this research comprise 14 companies for the four year period so the total observation is 56 observations. This research uses regression logistics since the dependent variable is measured by the nominal scale.

#### Independent Variables

##### 1. Bankruptcy Prediction

The calculation of the bankruptcy prediction is as follows Wibisono (2013):

$$Z = 0.717Z_1 + 0.847Z_2 + 3.107Z_3 + 0.420Z_4 + 0.998Z_5$$

$Z$  = Z-Score

$$Z_1 = \frac{\text{Working Capital}}{\text{Total Assets}}$$

$$Z_2 = \frac{\text{Retained Earnings}}{\text{Total Assets}}$$

$$Z_3 = \frac{\text{Earnings Before Interest and Taxes}}{\text{Total Assets}}$$

$$Z_4 = \frac{\text{Book Value of Equity}}{\text{Book Value of Debt}}$$

$$Z_5 = \frac{\text{Sales}}{\text{Book Value of Debt}}$$

2. Return on Assets

The calculation of the ratio ROA is as follows (Weygandt et al., 2013):

$$ROA = \frac{Net\ Income}{Average\ Assets}$$

3. Debt to Total Assets Ratio

The calculation of the DTAR is as follows (Weygandt et al., 2013):

$$DATR = \frac{Total\ Debt}{Total\ Assets}$$

4. Previous year audit opinion

The category of Previous year audit opinion is as follows (Arsianto & Rahardjo, 2013):

- a. For companies in the previous year that received the Auditor's going concern opinion, the code is - 1.
- b. For companies in the previous year that did not receive the Auditor's going concern opinion, the code is 0.

5. Firm Size

The calculation of the firm size is as follows (Arsianto and Rahardjo (2013):

$$Firm\ Size = Ln (Total\ Assets)$$

6. Audit Tenure

According to the research of Arsianto and Rahardjo (2013), audit tenure can be measured by using a ratio scale according to the KAP relationship with the auditee. Tenure is measured by the number of years involved. The first year of the engagement begins with the number 1 and this increases by one for the subsequent years. The calculation of tenure audit companies to be affiliated with Big Four Public Accounting Firm focused on client engagements with local affiliates. If the affiliation is changed, then the calculation will start from 1.

The overall fit model data show that the decreasing amount of 2LogL (76.988) and -2 LogL final (21.008) is at iteration 9. This means that the hypothesized model fits.

Table 1. Cox Snell's R Square and Nagelkerke's R Square test,

Model Summary			
Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	21.008 <sup>a</sup>	.632	.846
a. Estimation terminated at iteration number 9 because parameter estimates changed by less than .001.			

The independent variables comprising bankruptcy prediction, company's financial condition, previous year audit opinion, firm size and audit tenure can be explained for 84.6% of the auditor's going concern opinion.

Table 2. Hosmer and Lemeshow's Goodness of Fit Test

Hosmer and Lemeshow Test		
Chi-square	df	Sig.
4.989	7	.661

*Hosmer and Lemeshow's Test* with the sig 0.661 > 0.05 means that the model are fit

Table 3. Classification Tabel,

Classification Table <sup>a</sup>					
Observed			Predicted		
			OPINI AUDIT GOING CONCERN		Percentage Correct
			0	1	
Step 1	OPINI AUDIT GOING CONCERN	0	30	1	96.8
		1	2	23	92.0
	Overall Percentage				94.6
a. The cut value is .500					

Table 4. The Results of The Test Statistic F

Omnibus Tests of Model Coefficients				
		Chi-square	Df	Sig.
Step 1	Step	55.980	6	.000
	Block	55.980	6	.000
	Model	55.980	6	.000

Source: data processing SPSS 20

Based on Table 2, it can be seen that the chi-square value of 55.980 has a significant value of 0.000 which is smaller than  $\alpha = 0.05$ . This means that bankruptcy prediction, company's financial condition, previous year audit opinion, firm size and audit tenure, all simultaneously, have a significant impact towards Auditor's going concern opinion.

Table 5. The results of statistical tests t

Variables in the Equation							
		B	S.E.	Wald	Df	Sig.	Exp(B)
Step 1 <sup>a</sup>	Z	-.079	.222	.125	1	.723	.924
	ROA	-7.386	5.783	1.631	1	.202	.001
	DTAR	.541	1.529	.125	1	.724	1.717
	OAt1(1)	-4.924	1.748	7.932	1	.005	.007
	SIZE	-.206	.295	.487	1	.485	.814
	TENURE	.747	.557	1.795	1	.180	2.110
	Constant	5.273	7.751	.463	1	.496	195.068
a. Variable(s) entered on step 1: Z, ROA, DTAR, OAt1, SIZE, TENURE.							

Based on table 5. regression equation is:

$$\ln \frac{GC}{1 - GC} = 5.273 - 0.079Z - 7.386ROA + 0.541DTAR - 4.924OA_{t-1} - 0.206SIZE + 0.747TENURE$$

The result of this research implies that bankruptcy prediction, company's financial condition, previous year audit opinion, firm size, and audit tenure simultaneously have a significant impact towards Auditor's going concern opinion. This shows that this model is fit and can be used to predict Auditor's going concern opinion.

Previous year audit opinion shows a significant impact towards Auditor's going concern opinion. In providing current year audit opinion, the auditor can be affected by the previous year audit opinion and this can be used to assess whether the management can successfully execute the management's plan that had been prepared in the previous year

Bankruptcy prediction, debt to total asset ratio, return on asset, size and audit tenure do not have any significant impact towards Auditor's going concern opinion. This is because in predicting going concern opinion, the auditor looks at the overall financial and management plans that a company uses in aiming to overcome the company's problem.

#### 4. Conclusions

Based on what has been mentioned above, it is clear that previous year audit opinion has a significant impact towards Auditor's going concern opinion. When the company has received a going concern opinion in the previous year period, it is more likely to develop plans to maintain its survival. Auditors will analyze whether the management has successfully executed such management plans which have been prepared in the previous period as a means to provide information regarding the company's sustainability, referred to as a going concern, to users of the financial statements.

In predicting the going concern audit opinion, the auditor looks at the overall financial and management plans in overcoming a company's problems and its ability to overcome or delay the payment of debts and other financial ratios such as cash flow. In addressing the debt, the company can offer a number of assets to defer payment. With the debt, the company's cash flow from operating activities can be positive and so increase. There are indications of a going concern problem such as negative working capital, recurring operating losses that cause capital deficiency followed by internal and external problems.

Bankruptcy prediction, company's financial condition proxies Return on Assets (ROA) and Debt to Total Assets Ratio (DTAR), firm size and audit tenure clearly do not have a significant impact towards Auditor's going concern opinion because in predicting the going concern opinion, the auditor looks at the overall financial and management plans to overcome the company's problem.

Audit tenure does not affect the auditor in providing a going concern opinion because the auditor has to follow audit standards such as independency and the auditor must also comply with certain auditing principles in the auditing process.

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