

CORPORATE GOVERNANCE AND AUDIT DECISION MAKING

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Abstract

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The purpose of this study is to investigate the factors that affect qualified opinion. This study use earnings management, audit quality, audit tenure, firm size, leverage, liquidity, inventories, and losses to predict qualified opinion. The qualified opinion was measured using dummy variables, value 0 for unqualified opinion, 1 other unqualified opinion (Blandón & Bosch, 2013). If the auditor provides an unqualified opinion then the audit opinion is clear. Conversely, if the auditor provides qualified opinion such as going concern, litigation, asset realizing then the audit opinion is unclear (Dopuch *et al.*, 1987). The study uses purposive sampling from financial statement of manufacturing company in Indonesia Stock Exchange for period 2011-2015. This study uses binary logistic regression to test the hypothesis. The result of the research showed that earnings management, audit quality, and tenure can increase the probability of the unqualified opinion. Firm size and losses can increase the probability of the qualified opinion. Meanwhile, leverage, liquidity, and inventories didn't have statistically significant to predict qualified opinion. Companies that make earnings management, auditors rarely provide a qualified opinion. This is due to the behavior of auditors who are less independent in auditing the financial statements. It is proven that the auditor is likely to give an unqualified opinion to a company that has long been a client. British Telcom conducts Accounting Fraud by making an unfair increase in corporate earnings. For 33 years British Telcom obtained an unqualified opinion from the Public Accounting Firm Price Waterhouse Coopers (PWC). This suggests that the higher the earnings management, audit quality and tenure the higher the likelihood of obtaining an unqualified opinion.

Keywords: Qualified Opinion, Earnings Management, Audit Quality, Audit Tenure, Firm Size, Leverage, Liquidity, Inventories, Losses

1. INTRODUCTION

One means that can convince the public is through the company's audited financial statements. The results of the audit report will underlie public support to the company. To obtain good audit report results, many factors influence. Companies need to know the level of significance of these factors. Indonesia is a developing country with moderate economic growth; this causes the need for support for economic growth in Indonesia by the public in this era of globalization. Such support is needed by Indonesia to compete with other developed and developing countries. Support is certainly not in the can easily because it concerns

public trust to the company, especially in the company's performance that can be seen from the audited financial statements.

The company's financial statements with material misleading may result in the company receiving an adverse opinion (Arens *et al.*, 2014). Companies that get unqualified opinion despite the practice of earnings management such as British Telcom. In 2017, the largest British Telcom Company conducted Accounting Fraud by making unfair earnings increases, the increase in earnings in cooperation with corporate clients and financial services for several years. British Telcom is audited Price Waterhouse Coopers (PWC) for 33 years since

British Telcom privatized and got an unqualified opinion.

The purpose of this study is to obtain empirical evidence that earnings management, audit quality, tenure, firm size, leverage, liquidity, inventory, and losses can predict a qualified opinion. The remainder of this paper is organised as follows. First, literature review including hypothesis development. Second, the research method is discussed. Third, the research result and discussion, and Final, the research conclusions.

2. LITERATURE REVIEW

2.1. Public interest theory

Public interest theory states that the main economic reasons for government intervention in various business operations are public interest (Godfrey *et al.*, 2010). Regulations are set up by the government to safeguard the interests of consumers by monitoring the progress of economic performance. In this case, the regulation is about audit standards. Where audit standards are structured to be the main guidelines governing audit activities. So by these standards, there is government intervention as a regulator. The result of the audit activity is the audit opinion that will be used by the company and affect the public interest.

2.2. Audit opinion

Audit opinion according to the accounting dictionary (Ardiyos, 2007) is a report given by a registered public accountant as a result of its assessment of the fairness of the financial statements presented by the company. The audit opinion is the result of the auditor's evaluation of the performance of the company assessed through its financial statements. The quality of audit Opinions is usually influenced by the level of performance, competence, objectivity, and scepticism held by the auditor (Rusmanto *et al.*, 2014).

There are five categories of audit opinion in the audit report (Arens *et al.*, 2014) are as follows first, unqualified opinion. The requirement to obtain an unqualified opinion is the completeness of the financial statements and the adequacy of audit evidence and the auditor examining the interrelationships between such evidence used to draw conclusions by the auditor to state that the audit process has been carried out in accordance with the audit standard. In addition, the conditions that must be met are all financial statements prepared using accounting principles in force. Fourth, adverse opinion. The opinion given by the auditor is adverse opinion if the financial statements are not presented fairly. Lastly, a disclaimer. The auditor provides a disclaimer if the auditor is not independent and the scope of the audit is limited when conducting the audit process.

2.3. Earnings management and qualified opinion

Earnings management is done by deliberate management by reporting the amount of assets or liabilities in the financial statements that are not in accordance with accounting principles (Arens *et al.*, 2014). Earnings management is one form of

accounting irregularities (Subramayam, 2014). Financial statements that are misstated and misleading materially so that the report does not indicate the state of the company that is actually categorized into an adverse audit opinion (Arens *et al.*, 2014). The above indicates that earnings management practices affect the qualified opinion.

Johl (2007), Abolverdi & Kheradmand (2017) stated that earnings management is an indicator in providing qualified audit opinion. Audit opinion and the change of registered public accountant (KAP) can be a signal for investors that the company does earnings management (Bradshaw *et al.*, 2001). Companies that make earnings management may receive a going concern opinion (Butler *et al.*, 2004). Earnings management negatively affects audit opinion (Abdoli *et al.*, 2012). Companies that make earnings management are more likely to get unqualified opinions. While different case with Rusmanto *et al.* (2014), Khozein *et al.* (2016) indicates that there is no effect of earnings management on audit opinion. Despite these two contradictory issues, in fact data in Indonesia support the statement of Abdoli *et al.* (2012) because in Indonesia shows that many companies obtain unqualified opinion despite the practice of earnings management. The hypothesis is:

H1: Earnings management increases, the probability of unqualified opinion increases.

2.4. Audit quality and qualified opinion

Audit quality is a factor that influences audit opinion because of its ability to detect and report false financial statements or manipulation of material financial statements. This is supported by previous research put forward by Johl *et al.* (2007), Bartov *et al.* (2000) and Berdchaw *et al.* (2001) that the higher the auditor's quality, the more likely the company will get a qualified opinion than the Non Big Four KAP. It is contradictory that most Big Four KAP provides unqualified opinion on audited firms (Omidfar & Moradi, 2015). This is because big four KAP has made a selection on the company that will become a client. The hypothesis is:

H2: Audit quality increases, the probability of unqualified opinion increases.

2.5. Audit tenure and qualified opinion

Tenure is the length of the auditor and client relationship measured by the number of years (Jennifer *et al.*, 2010). Research in Indonesia related to tenure audit continues to grow one of them Siregar *et al.* (2012) states that the government regulation concerning audit tenure which was originally 5 years and can be extended to no limit. Blandon & Bosch (2013) state that companies with a qualified opinion will have relatively shorter tenure. The longer the company becomes KAP client, the less independence of KAP. This can make KAP more likely to provide unqualified opinion on companies that have long been clients. Audit tenure may result in the auditor failing to provide the required audit opinion (Geigher & Raghunandan, 2002). Audit tenure negatively affects the qualified opinion (Blandon & Bosch, 2013). The hypothesis is:

H3: Audit tenure increases, the probability of unqualified opinion increases.

2.6. Firm size and qualified opinion

Company size is defined as a scale that can classify the size of the company. Companies with a qualified opinion are relatively small companies (Blandon & Bosch 2013). While Abdoli et al. (2012) indicate that firm size has a positive effect on audit opinion. Big companies tend to get a qualified opinion. The hypothesis is:

H4: Firm size increases, the probability of qualified opinion increases.

2.7. Leverage and qualified opinion

Financial leverage can be regarded as an indication of the comparison between the amounts of capital derived from debt securities with capital derived from the internal company (Subramanyam, 2014). The larger the resulting leverage ratio, indicating that the company has a source of funding through larger bonds than the company's own internal capital. Companies with a qualified opinion have relatively high leverage levels (Blandon & Bosch, 2013). Firms with high leverage can make KAP tend to provide qualified opinion related to risk in paying the debt. The hypothesis is:

H5. Leverage increases, the probability of qualified opinion increases.

2.8. Liquidity and qualified opinion

Liquidity is the ratio used to evaluate a company's ability to meet its short-term obligations (Subramanyam 2014). The lower the liquidity of a company indicates a small opportunity for the company to meet its short-term liabilities. The smaller the company's opportunity to meet its short-term obligations, the greater the chances of the company getting a qualified audit opinion. The higher the liquidity of the company the higher the chances of the company getting an unqualified opinion (Blandon & Bosch, 2013). The hypothesis is:

H6: Liquidity increases, the probability of unqualified opinion increases.

2.9. Inventory and qualified opinion

Inventory is an item owned by the company to be sold as part of the company's business operations (Subramanyam, 2014). The high inventory indicates that the company is less efficient in operational activities. The higher the inventory the higher the possibility of the company receiving a qualified opinion (Blandon & Bosch, 2013). The hypothesis is:

H7: Inventory increases, the probability of qualified opinion increases.

2.10. Losses and qualified opinion

The loss is a decrease in net assets of the company that arose due to unexpected events (Subramanyam, 2014). Losses can be caused by two things, the first because the amount of the load is higher than the income and the second because of the misstatement that causes the company suffered losses in its financial statements. Such misstatements can cause the company to get a qualified opinion (Arens et al., 2014). Audit opinion can be information for investors to know whether the company can be

going concern or bankrupt (Lennox, 1999). Companies that get unqualified opinion, relatively more have higher earnings than companies that get qualified opinion. The higher the loss is the higher the probability of a company receiving a qualified opinion (Blandon & Bosch, 2013). The hypothesis is:

H8: Losses increases, the probability of qualified opinion increases.

3. RESEARCH METHOD

The sample selection in this research is done by using purposive sampling method (Sekaran & Bougie, 2013). From manufacturing companies listed on the Indonesia Stock Exchange period 2011-2015, the sample used by researchers is 82 companies. The sample selection procedure can be seen in Table 1 below:

Table 1. Sample selection procedure

Sample Criteria	Company
Manufacturing companies in Indonesia Stock Exchange during 2011-2015	127
Companies that do not report any financial statements as of December 31	(3)
Companies that do not use Rupiah	(25)
Manufacturing companies that do not have the required data completeness during 2011-2015	(17)
Sample company per year	82
Total data firm	410

Audit opinion according to accounting dictionary (Ardiyos, 2007) is a report given by a registered public accountant as a result of its assessment of the fairness of the financial statements presented by the company. In this study, qualified opinion was measured using dummy variables, value 0 for unqualified opinion, 1 another unqualified opinion (Blandon & Bosch, 2013). If the auditor provides an unqualified opinion then the audit opinion is clear. Conversely, if the auditor provides qualified opinion such as going concern, litigation, asset realizing then the audit opinion is unclear (Dopuch et al., 1987).

Earnings management is defined as a management disclosure with full intervention to the financial reporting process to external parties, with the intent of obtaining personal benefits (Subramanyam, 2014). Earnings management is measured by Discretionary Accruals. Audit quality (AQ) is measured using dummy variables (Adeyemi et al., 2012). Score 1 represents KAP Big Four, while score 0 represents other than Big Four KAP; where the Big Four KAP is Deloitte Touche Tomatsu, PricewaterhouseCoopers, Ernst & Young, KPMG. Tenure audit is the length of the auditor and client relationship measured by the number of years (Jennifer et al., 2010). Tenure audits are measured using a log of the number of years in which the company has been audited by the same registered public accountant. Discretionary accruals were calculated using the following formula:

$$TA_t/A_{t-1} = \alpha(1/A_{t-1}) + \beta_1((\Delta REV_t - \Delta REC_t)/A_{t-1}) + \beta_2(PPE_t/A_{t-1}) + v_t \quad (1)$$

Where TA, total accruals (Inc, - OCF), A_{t-1} prior total assets, ΔREV_t change in net operating revenues, ΔREC_t change in net receivables, PPE, gross property, plant and equipment, v_t error term also known as

discretionary or abnormal accruals, Inc, income before extraordinary items and discontinued operations, OCF, operating cash flows.

Firm size is a scale that can classify the size of the company in various ways including total assets, log size, or stock market value. In this study, firm size is measured from the average log of total asset value at the end of the year (Abdoli *et al.*, 2012). Leverage is the use of debt financing to increase revenue (Subramanyam, 2014). Leverage is measured from total liabilities divided by total equity which are both based on book value. Liquidity is the ratio used to evaluate a company's ability to meet its short-term capability (Subramanyam, 2014). Liquidity is measured by dividing the company's total cash by the total liabilities of the company. Inventories are goods owned by the company for sale as part of the company's business operations (Subramanyam, 2014). Inventories are measured by dividing the company's inventory at the end of the period by the total assets of the company at the end of the period. The loss is a decrease in net assets of a company that arises from circumstances or unexpected events (Subramanyam, 2014). In this study, losses using dummy variables, value 1 representing companies that suffered losses and 0 others.

4. RESULTS AND DISCUSSIONS

Test results of descriptive statistics and hypothesis testing can be seen in the following Table 2 and 3:

Table 2. Descriptive statistics

Variable	Minimum	Maximum	Mean	Std. Deviation
QO	0	1	0.5243	0.5000
DA	-1.7846	0.7621	0.0000	0.1653
AQ	0	1	0.3731	0.4842
AT	1	4	1.5658	0.7379
SIZE	10.9379	14.3815	12.1688	0.6961
LEV	-31.1754	70.8314	1.4135	5.4183
LIQ	-0.4231	6.0928	0.4178	0.8180
INV	0.0001	0.7168	0.2132	0.1364
LOSSES	0	1	0.1609	0.3679

Table 3. Hypothesis testing

Variable	Expected Sign	B	Sig.
Constant		-3.0552	0.1599
DA	-	-1.3685	0.0838
AQ	-	-0.8785	0.0007
AT	-	-0.3141	0.0298
SIZE	+	0.3440	0.0564
LEV	+	-0.0216	0.3093
LIQ	-	-0.1042	0.1197
INV	+	-1.0267	0.1989
LOSSES	+	0.8754	0.0059

Note: n 410

Chi-Square 7.7454 Sig. 0.4587

Nagelkerke R2 11.8%

% correctly predicted 62.2

The test results show that earnings management (DA) has a significance value of 0.0838 and coefficient -1.3685, then *H1* is accepted. This shows that earnings management negatively affects the qualified opinion. In accordance with previous research conducted by Abdoli *et al.* (2012) that earnings management is negative to audit opinion. Earnings management increases, the probability of unqualified opinion increases. Earnings management increases the likelihood that a company will get

unqualified opinion. A number of companies that get unqualified opinion despite the practice of earnings management are companies, such as Enron, Worldcom, and British Telcom. In 2017, the largest British Telcom Company conducted Accounting Fraud by making unfair earnings increases. For 33 years British Telcom gained an unqualified opinion. This shows that companies that make earnings management tend to get an unqualified opinion.

The test results show audit quality (AQ) has a significance value of 0.0007 and coefficient of -0.8785, then *H2* is accepted. This shows that audit quality negatively affects the qualified opinion. Audit quality increases, the probability of unqualified opinion increases. Audit quality increases the likelihood that a company will get an unqualified opinion. Big company British Telcom doing Accounting Fraud. Price Waterhouse Coopers (PWC) audited British Telcom for 33 years since British Telcom privatized. During the PWC client, British Telcom obtained an unqualified opinion.

Audit tenure (TENURE) has a significance value of 0.0298 and a coefficient of -0.3141, then *H3* is accepted. This shows that Audit tenure negatively affects the qualified opinion. Audit of tenure increases, the probability of unqualified opinion increases. Tenure audits increase the likelihood of companies getting unqualified opinion. The longer the KAP relationship with the client, the greater the chance the client gets an unqualified opinion.

Firm size (SIZE) has a significance value of 0.0564 and a coefficient of 0.3440, then *H4* is accepted. This shows that firm size has a positive effect on qualified opinion. Firm size increases, the probability of qualified opinion increases. Large companies tend to get a qualified opinion compared to small companies. This indicates that big companies are more paid attention by various parties especially from shareholders. This causes large companies cannot choose KAP to get an unqualified opinion. KAP that audit large companies can provide a qualified opinion in accordance with the results of the audit without pressure from the management.

Leverage (LEV) has a significance value of 0.3093, then *H5* is not accepted. This shows that leverage does not affect the qualified opinion. Liquidity (LIQ) has a significance value of 0.1197, then *H6* is not accepted. This shows that liquidity does not affect the qualified opinion. If the company presents its financial statements in accordance with applicable financial accounting standards, high or low liquidity does not affect audit opinion. Inventory (INV) has a significance value of 0.1989, then *H7* is not accepted. This shows that inventory has no effect on audit opinion. This is due to an audit opinion issued by the auditor to provide confidence in the presentation of financial statements. Companies that have presented financial statements in accordance with applicable financial accounting standards, high or low inventory will not affect audit opinion.

Losses have a significance value of 0.0059 and a coefficient of 0.8754, then *H8* is accepted. This shows that losses have a positive effect on the qualified opinion. Losses increases, the probability of qualified opinion increases. Companies that experience losses, tend to be difficult to get an unqualified opinion. Losses indicate that the

company is unable to conduct operations efficiently or there is misstatement in the financial statements. Companies that get losses, tend to get a qualified opinion.

5. CONCLUSIONS

Based on the test results can be made the following conclusions companies that make earnings management is likely to get unqualified opinion; Firms that are audited by the big four KAP are likely to get unqualified opinions; Companies that have long been clients are likely to get unqualified opinions; Large companies are likely to get a qualified opinion; Leverage, liquidity, and inventory have no significant effect on qualified opinion; Companies that experience loss are likely to get a qualified opinion. British Telecom conducts Accounting Fraud by making an unfair increase in corporate earnings. For 33 years British Telecom obtained an unqualified opinion from the Public Accounting Firm Price Waterhouse Coopers (PWC). This suggests that the higher the earnings

management, audit quality and tenure the higher the likelihood of obtaining an unqualified opinion.

This study has several limitations of the first, the research period used is limited to a period of 5 years so it is not able to capture a situation that requires a longer observation period. For further research to extend the period of study, a minimum of 10 years so that the data obtained can better describe the actual condition. Second, the sample of companies used only the manufacturing companies listed in Indonesia Stock Exchange, so the lack of research results can be generalized. To further the study sample into non-financial companies listed on the Indonesia Stock Exchange. Third, Nagelkerke R^2 values are small because less than 20%, indicating that the variation of independent variables in this study can only slightly explain the dependent variable. This means that there are many other independent variables that can influence qualified opinions such as audit delay and KAP change. Fourth, auditor of each country is different because the culture of each country is different. The different of the auditor can be used as the development of future research for another country.

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