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# The Impact of a Going-Concern Audit Opinion on Board of Directors

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**A B S T R A C T**

Paper examines the impact of a going-concern audit opinion on the corporate governance, measured by the changes in board of directors' composition. External auditor's opinion is used as a measure to address agency problems in companies. We examine this impact on sample of 55 companies listed on the Banja Luka Stock Exchange which have received going-concern audit opinion for 2013 financial reports. In this paper, the relationship between going-concern audit opinion and the corporate governance is investigated observing changes in board of director composition and additional requests for rigorous board performance evaluation after the shareholder's assembly have received external auditor's report. Results show that board of directors of companies that received going-concern audit opinions have not suffered serious consequences such as rigorous board performance evaluation, reduction of board size or changes of board members. This highlights the importance of measures that need to be put in place in order to increase of external auditor's role in corporate governance.

**A R T I C L E I N F O**

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Audit, Board of Directors, Corporate Governance, Going-Concern Opinion

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## 1. INTRODUCTION AND LITERATURE REVIEW

According to agency theory, agency problems arise as a result of the divergence of interests among agents and principals (Jensen and Meckling, 1976; Shleifer and Vishny, 1997; Miller, 2002), that is managers and shareholders. The agency problem of information asymmetry arises because managers have superior information about the company's business and financial situation than the stakeholders.
Klein et. al. (2002) observe that "*in corporate finance, asymmetric information refers to the nation that firm insiders, typically the managers, have better information that do market participants on the value of their firm's assets and investment opportunities*".

Voluntary disclosures by managers and Board of Directors prevent information asymmetry between shareholders and management to a certain extent (Karamanou and Vafeas, 2005). One of the most important corporate governance principle of transparency and public disclosure is aimed at reducing information asymmetry in companies (Todorovic et. al., 2013).

Regulatory changes and improvements in corporate governance principles, financial reporting and auditing standards and enforcements of these regulations by shareholders, investors and other players in capital markets support the agency theory problem and confirm the importance of external auditing and corporate governance in financial reporting (Cadburry, 1992; Hampel, 1998; Blue Ribbon, 1998; SOX, 2002).

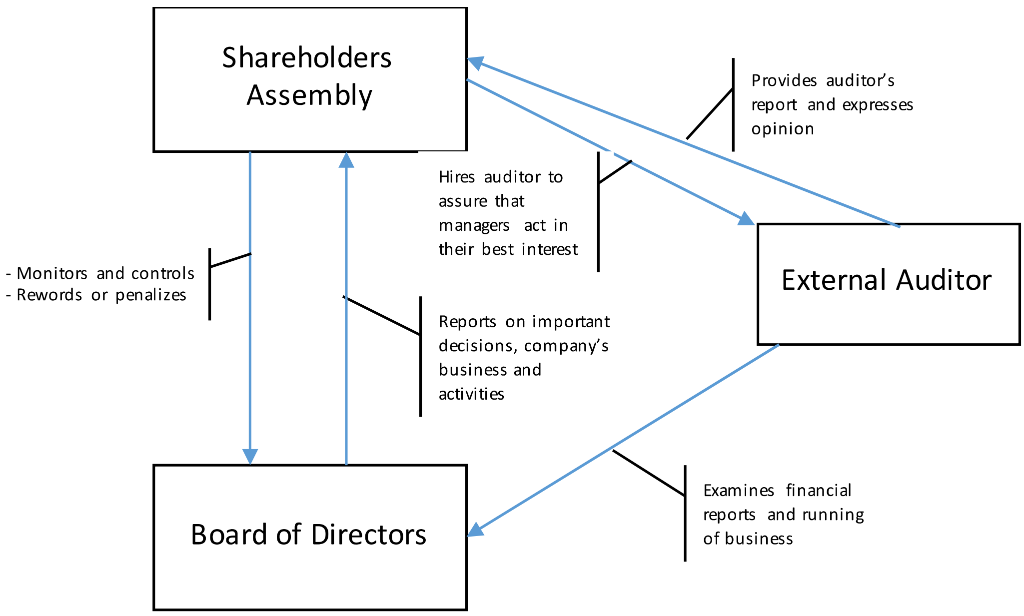


**Figure 1:** Role of external auditor between owners and managers

As shown in Figure 1. the existence of an external audit reviews is one of the important factors decreasing information asymmetry. Auditor's opinion plays an important role in mitigating agency problems in company between shareholders and managers (Jensen and Meckling, 1976). Audit review and report is an important mechanism for reducing information asymmetry (Beatty, 1989; Willenborg, 1999). Therefore, shareholders hire external auditors to assure that managers act in their best interest (Antle, 1982; Watts and Zimmerman, 1986).

Studies show that audit reports signal increased reliability of financial statements (Coram, Mock, Turner and Gray, 2011) and that the auditor's going-concern modified report communicates valuable information about risk to investors (Blay, Geiger and North, 2011) and shareholders. As a result, market responds adversely to a going-concern report (Blay and Geiger, 2001; Menon and Williams, 2010).

In paper we examine the relationship between and impact of an external auditor's going-concern opinion on the corporate governance. We use external auditor's opinion as a measure to address agency problems in sample companies. When external auditor expresses report with going-concern suspect or opinion, it means that the auditors raise doubts of the company's ongoing ability (Casterlla, Lewis and Walker, 2001), practices of corporate governance and Board of Directors' ability to govern company well. As external auditor has indicated and raise doubt about running the company Board of Directors of these companies should suffer serious consequences such as rigorous board performance evaluation, reduction of board size or changes of board members.

## 2. METHODOLOGY AND RESEARCH HYPOTHESIS

Paper examines the impact of a going-concern audit opinion on the corporate governance, measured by the changes in board of directors' composition. External auditor's opinion is used as a measure to address principal agent problems in companies.

Out of 269 companies which have received and disclosed auditor's report for FY 2013 we have selected sample of 55 companies listed on the Banja Luka Stock Exchange which have received going-concern audit opinion for FY 2013 financial reports. Therefore, we examine this impact on a full population of companies which have received going-concern audit opinion.

In this paper, the relationship between going-concern audit opinion and the corporate governance is investigated observing changes in board of director composition after the shareholder's assembly have received external auditor's report. Moreover, to further understand monitoring and control practices we investigate whether shareholder's assembly requested additional and rigorous board performance evaluation.

To offer useful answers to the research problem and realize the objectives, the following hypotheses were tested:

**H1.** External auditor's going-concern opinion has impact on Corporate Governance practices of companies.

**H2.** External auditor's going-concern opinion leads to consequence to the Board of Directors.

> **H2.1.** External auditor's going-concern opinion leads to changes in Board of Directors' composition.
>
> **H2.2.** External auditor's going-concern opinion leads to additional and rigorous Board performance evaluation.

To test research hypotheses, we have collected data from the Banja Luka Stock Exchange database, annual reports and companies' web pages regarding:

- auditor's reports for FY 2013,
- shareholders assembly meetings,
- shareholders assembly meetings decisions,
- changes in Board of Directors structure, and
- board performance reports.

## 3. RESEARCH RESULTS AND DISCUSSION

Research data collected on companies which have received going-concern audit opinion for FY 2013 financial reports from different sources was analysed and presented in Table 1. (by number of companies) and Figures 2 to 5. (in percentage of total observed companies).

**Table 1:** Impact of auditor's going-concern opinion

| | Yes | No | Total |
|---|---|---|---|
| Discussed Auditors Report on Shareholders Assembly Meeting | 50 | 5 | 55 |
| Changes in Board of Directors Composition | 13 | 42 | 55 |
| Requested Additional Board Performance Evaluation | 1 | 54 | 55 |

Source: Authors' research

Table 2. shows reasons for expressing going-concern opinion at sample companies from the Banja Luka Stock Exchange and that main reason for expressing going-concern opinion is significantly higher short-term debt than current assents. These reasons indicate problems in practices of corporate governance and Board of Directors' ability to govern company well.

**Table 2:** Reasons for expressing going-concern opinion

| Reason | No. of companies |
|---|---|
| Significantly higher short-term debt than current assents | 26 |
| Significant losses | 9 |
| Loss over the capital | 11 |
| Potential illiquidity or loss | 9 |
| **Total** | **55** |

Source: Kondic and Poljasevic, 2015

Figure 2. shows that majority of companies, 91% or 50 companies discuss auditor's report on shareholder's assembly meeting. However, 9% or 5 companies did not discuss auditor's report on shareholder's assembly meeting, indicating that some companies do not realise importance of external auditor report on company's business specially when external auditor raises doubt of the company's ongoing ability, practices of corporate governance and Board of Directors' ability to govern company well.

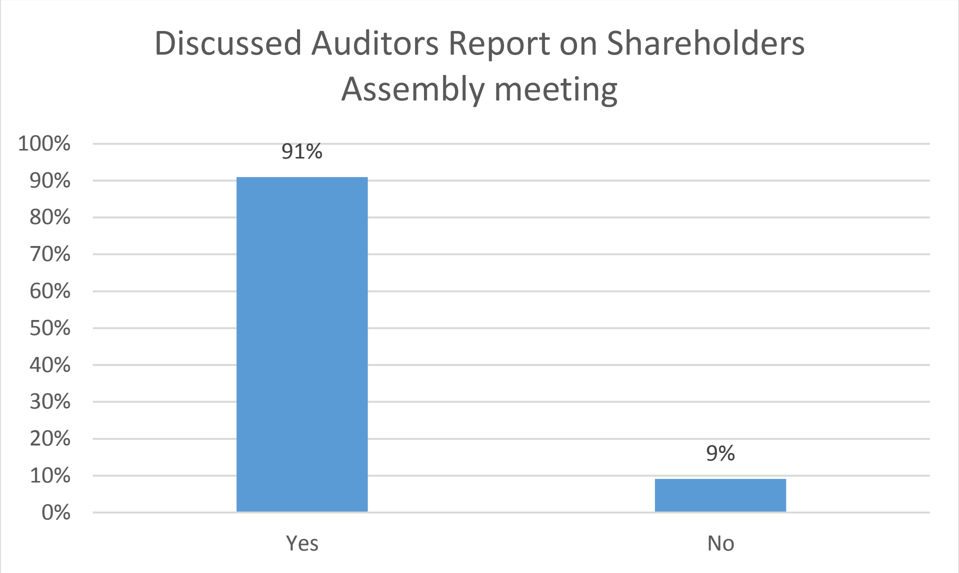


**Figure 2:** Discussed Auditors Report on Shareholders Assembly Meeting

Figure 3. indicated that majority of sample companies, 76% or 42 companies, have not made any changed to Board of Directors composition and changed its members even dough external auditor raised doubts of the company's ongoing ability, practices of corporate governance and Board of Directors' ability to govern company well. Only 24% or 13 companies have made changes to Board of Directors' after the shareholder's assembly have received and discussed external auditor's report.

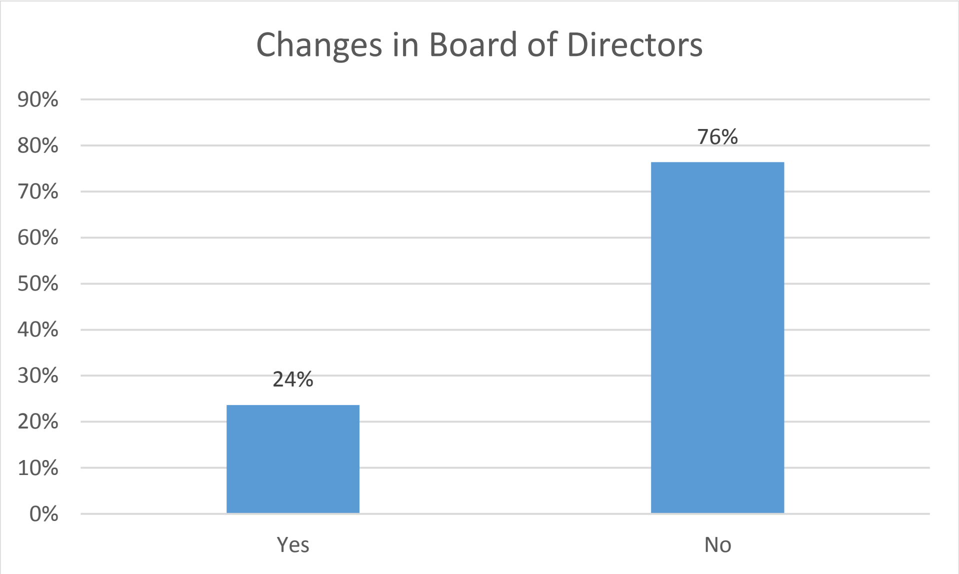


**Figure 3:** Changes in Board of Directors Composition

Data from Figure 4. shows number of changes by 13 companies that have made changes to Board of Directors' after the shareholder's assembly have received and discussed external auditor's report. Most of companies have requested a change of 1 or 2 board members, while there is one company that has changed entire Board after going-concern audit opinion. Also, we have encountered 3 companies which have changed members of Board of Directors but did not disclose number and names of members that have been changed. On average, these 13 companies have made changes to 2 members of Board.

Analysis of data shown in Table 1., Figure 3. and 4. for sample companies from the Banja Luka Stock Exchange indicate that external auditors' going-concern opinion does not lead to changes in Board of Directors' composition, which rejects hypothesis H2.1.

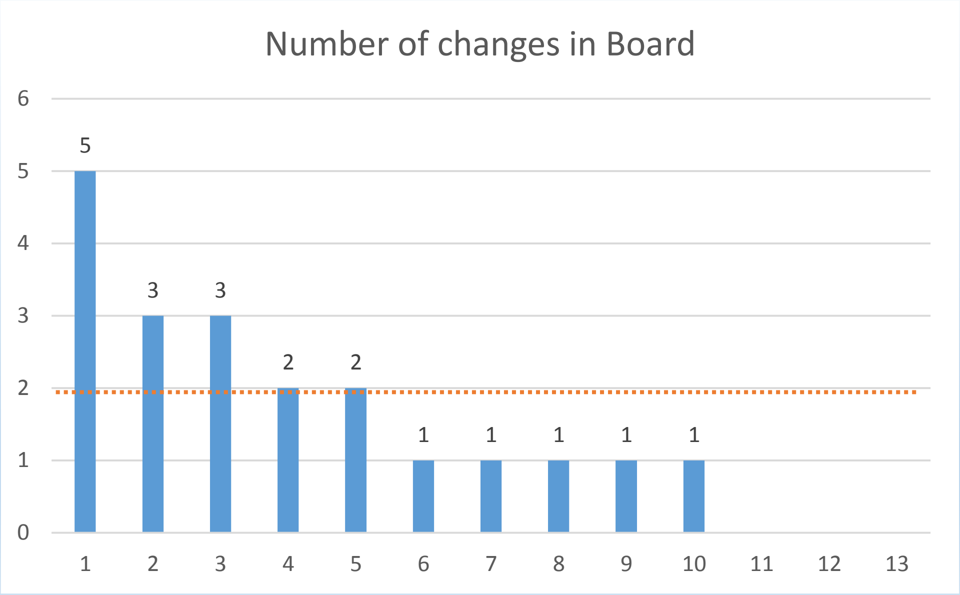


**Figure 4:** Number of Changes in Board of Directors by Company

To further understand monitoring and control practices we investigate whether shareholder's assembly requested additional and rigorous board performance evaluation after receiving going-concern audit opinion. Figure 5. shows that only one company, out of 55 companies, have requested additional and rigorous board performance evaluation. This indicates that shareholders do not perceive external auditor's opinion to play important role as a mechanism for reducing information asymmetry even dough shareholders hire external auditor to assure that managers act in their best interest. Therefore, our analysis of sample companies rejects research hypothesis H2.2.

As results show that shareholders do not perceive external auditor's opinion to play important role in reducing agency problem between shareholders and managers (Board of Directors) we also have to reject hypothesis H2. which indicate that external auditor's going-concern opinion leads to consequence to the Board of Directors.

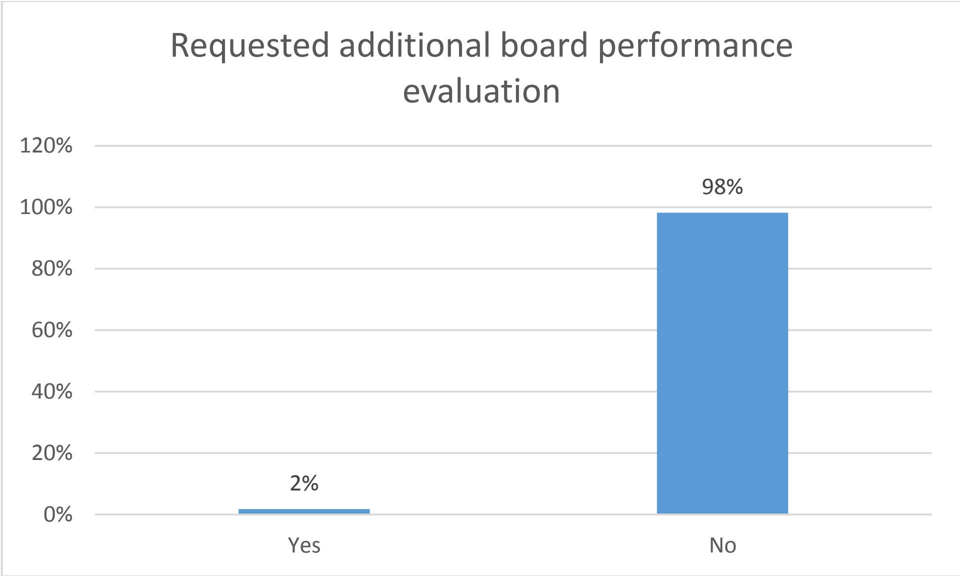


**Figure 5:** Requested Additional Board Performance Evaluation by Shareholder's Assembly

As external auditors have indicated and raise doubt about running the company by expressing going-concern opinion, Board of Directors of sample companies should suffer serious consequences from its shareholders such as rigorous board performance evaluation, reduction of board size or changes of board members.

However, taking into consideration above results and analysis of the relationship between going-concern audit opinion and the corporate governance which was investigated observing changes in board of director composition and requests for additional and rigorous board performance evaluation after the shareholder's assembly have received external auditors report we also reject hypothesis H1. which state that external auditor's going-concern opinion has impact on Corporate Governance practices of companies.

## 4. CONCLUSION

Regulatory changes in corporate governance principles, financial reporting and auditing standards have emphasized importance of external auditor's opinion in corporate governance as auditor's opinion plays important role mitigating agency problems and information asymmetry in company between shareholders and managers.

Therefore, as external auditor expresses going-concern opinion and raise doubt about the company's ongoing ability, practices of corporate governance and Board of Directors' ability to govern company well, Board of Directors should suffer serious consequences.

Results show that Board of Directors of sample companies that received going-concern audit opinions have not suffered serious consequences such as rigorous board performance evaluation, reduction of board size or changes of board members. This highlights the importance of measures that need to be put in place in order to increase of external auditor's role in corporate governance.

Based on results we have rejected all research hypothesis which indicates that in sample companies external auditor's going-concern opinion has no impact on Corporate Governance practices of companies and does not lead to consequence to the Board of Directors. Shareholders of these companies do not use external auditor's opinion to mitigate agency problems and reduce information asymmetry between managers and shareholders.

This implies that shareholders are not active in running a company and controlling do managers act in their best interest. If they want to protect their ownership and interest in company shareholders have to be active in monitoring and control over company's activities. This type of activism focuses on the financial performance of companies and puts pressure on management for an improved of performance and acting in the best interest of company and shareholders.

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