



## DO FINANCIAL RATIO PREDICTING FINANCIAL DISTRESS IN LOCAL GOVERNMENT

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### Abstract

This study was conducted with the aim of testing and analyzing the effect of financial independence and the degree of decentralization on financial distress in districts and cities in West Java province for the 2015-2019 period. The sampling technique used is non-probability sampling with sampling the sample is saturated sampling. The method used in this research is descriptive and verification method. The data collection technique used was secondary data obtained from the Supreme Audit Agency (BPK). The population of this study is all districts and cities in West Java Province in the 2015-2019 Fiscal Year. The number of regencies and cities in West Java Province in the 2015-2019 Fiscal Year is 27. The results of data analysis show that financial independence has a negative effect on financial distress and the degree of decentralization has a positive effect on financial distress.

**Keywords:** financial independence, degree of decentralization, financial distress, government

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### INTRODUCTION

Agency theory explains the relationship between the principal (society) and the agent (government)(Jensen and Meckling, 1976). The government as an agent for the community will carry out activities in order to fulfill services for the community. Implementation of services to the community through the stages of preparing the right policies, appropriate budgets, and good allocation of capital expenditures in building infrastructure, development in accordance with what is needed by the community (Halim, 2001). Based on agency theory, conflicts that arise are due to the lack of responsibility for budget management by the government as an agent to the board as the principal, so that the board feels that the government is not carrying out its responsibilities in accordance with applicable regulations. Therefore, the government must improve the management of its budget, in accordance with applicable regulations and provisions so that it is efficient and effective and prevents the occurrence of Financial Distress.

Financial distress in the government sector is the inability of the government to provide public services according to the service quality standards set (Jones and Walker, 2007). The inability of the government is because the government does not have the availability of funds to invest in the infrastructure used in providing services to the public. Financial distress has an impact on the welfare of people who cannot enjoy the facilities that should be provided by the government (Sutaryo, 2012). The inability of the government will lead to the failure of the government to provide standard services or facilities for public compliance due to insufficient

funds to invest in public infrastructure due to the lack of capital expenditure allocation resulting in more spending being inefficient. Based on Figure 1, the regional government expenditure budget in the West Java Province during the 2015-2019 fiscal year was not fully absorbed in connection with the administration of the government in order to provide services to the community through planned programs and activities (Ditjen, 2020). This has the potential to experience financial distress, because the realization of expenditure intended for program and activity financing is not allocated or not optimal.

In addition, 60% of local governments in the West Java Province experienced Financial Distress in 2019, namely, West Bandung Regency, Bekasi Regency, Bogor Regency, Ciamis Regency, Garut Regency, Kuningan Regency, Pangandaran Regency, Purwakarta Regency, Sukabumi Regency, Tasikmalaya Regency, Bandung City, Bekasi City, Bogor City, Cimahi City, Depok City, and Sukabumi City (BPK, 2020). These problems, among others, are related to poor Budget Absorption due to several agencies due to failed auctions, as well as the minimal allocation of Capital Expenditures because capital expenditures are closely related to the interests of the community. and most governments are more concerned with Personnel Expenditures.

Capital expenditure is one of the most important factors in encouraging regional development, if a larger capital expenditure budget is used for personnel expenditure, it will affect regional development needs. Local government revenue is not only obtained from the APBD, but also from local revenue. Regional original income can be used to assist APBD in funding all regional government affairs, especially regional development, therefore regional governments must increase the value of regional original income and manage APBD in accordance with applicable regulations. APBD management can assess a regional government in terms of regional financial independence and the degree of decentralization. In general, it can be interpreted that financial independence is the ability or contribution of regional original income in meeting their needs in an effort to run the government system, provide services to the community and carry out regional development (Rukaman, 2013). Financial independence describes an area that can show a large community contribution in paying regional taxes and levies. Local governments should be able to manage their regional revenue sources. However, there are still many local governments that have not been able to manage it, financial independence in Indonesia is almost entirely low in financial independence which is considered not yet independent, including in West Java, almost all districts/cities in the province of West Java have experienced not yet independent as many as 27 districts/cities and the most The lowest is Tasikmalaya Regency, which is getting 7.52% where the government is still dependent on other funds. As for the Pangandaran Regency which is still not independent, namely getting 7.79%, and the Regency/City that is already quite independent, namely the Bekasi Regency which gets 43% (BPK, 2020).

In addition to financial independence which is a source of financial distress, the degree of decentralization is also a source of financial distress. The degree of fiscal decentralization or commonly referred to as the degree of regional fiscal autonomy is a very important aspect in the implementation of regional autonomy as a whole (Sistiana and Makmur, 2014). Decentralization is carried out with the aim of making it easier for regions to carry out government functions, namely, maximizing the potential of their respective regions (Halim et al., 2017). Fiscal decentralization is an obligation that must be carried out by local governments with the aim of developing their local government. The degree of decentralization describes the extent to which local governments increase their own local revenue. Local governments that have a high degree of decentralization indicate that local governments are not dependent on transfers and have implemented fiscal decentralization in accordance with established regulations. In West Bandung Regency, Regional Original Revenue (PAD) has experienced a very drastic decline due to the impact of the Covid-19 pandemic, the degree of decentralization has decreased (Umbara, 2020).

## METHOD

The research method used in this research is quantitative research with a descriptive and verification approach. This study describes financial independence, the degree of decentralization and financial distress and explains the effect of the variables studied. The data used is the financial statements of the district/city governments in the province of West Java as many as 27 cities/districts with a time span of the 2015-2019 fiscal year, for the 2020 fiscal year it was not included in the study due to abnormal conditions of a pandemic that will disrupt regional income levels. . Variable operationalization consists of financial independence which is calculated based on total PAD divided by spending, the degree of decentralization is calculated based on total PAD divided by total income and Financial distress is Capital Expenditure divided by total expenditure, if less than 30% then given a weight of 1 If achieved 30% is given a weight (Sari and Arza, 2019).

### RESULTS

Based on descriptive statistics, the Mean value of financial independence is 0.2377. This shows that the financial independence of the Regency/City Governments in West Java for the 2015-2019 fiscal year is in the low category. The Mean value for the degree of decentralization of 0.2176 indicates that the degree of decentralization of the Regency/City Governments in West Java for the 2015-2019 fiscal year is included in the Enough category. The mean value of financial distress is 21.1915. This shows that the financial distress of the Regency/City Government in West Java for the 2015-2019 fiscal year is included in the distress category.

The data were analyzed using log regression and before carrying out the verification analysis, the data were tested for classical assumptions consisting of normality test, autocorrelation test, multicollinearity test, heteroscedasticity test and model feasibility test (goodness of fit). The results show that the significance value of the Kolmogorov-Smirnov test is 0.121, which is greater than 0.05. Because the significance value of the Kolmogorov-Smirnov test is greater than 0.05, it can be concluded that the regression model has met the assumption of normality. The Durbin-Watson value is 0.867 with 135 observations. The Durbin-Watson value is between -2 to 2, so there is no autocorrelation symptom in the regression model. Tolerance value for all independent variables > 0.1 and VIF (Variance Inflation Factor) value for all independent variables < 10. Thus, it can be concluded that there is no multicollinearity in the data.

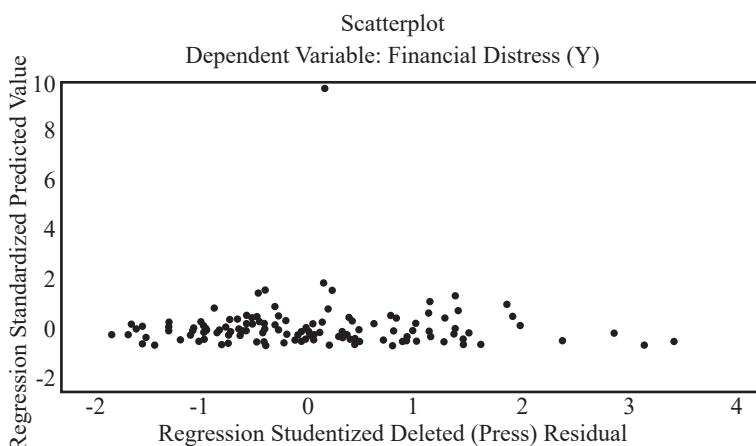


Figure 1 . Graph of Heteroscedasticity Classical Assumption Test

Based on Figure 1 Scatterplot, it can be seen that the points spread randomly and are evenly distributed both above and below the number 0 on the Y axis so it can be concluded that there is no heteroscedasticity in the regression model. The significance value of the Hosmer and Lemeshow test is greater than 0.05, so it can be concluded that the empirical model obtained is in accordance with the theoretical model.

Based on the results of data processing, the results of the logistic regression estimation of the effect of Financial Independence and Degree of Decentralization on Financial Distress in Regencies/Cities in West Java Province for the 2015-2019 Fiscal Year.

Table 1. Logit Model Estimation Results for Predicting Financial Distress

		B	S.E	Wald	df	Sig.	Exp(B)
Step 1 <sup>a</sup>	Financial Independence (X <sub>1</sub> )	-38.111	29.016	4.725	1	.009	.000
	Degree of Decentralization (X <sub>2</sub> )	36.652	27.494	4.777	1	.003	8272677278517349.000
	Constant	-2.617	1.138	5.285	1	.022	.073

a. Variable(s) entered on step 1: Financial Independence (X<sub>1</sub>), Degree of Decentralization (X<sub>2</sub>)

The form of the functional equation with the logit model is as follows

$$\text{Log} \frac{P}{1-P} = -2.617 - 38.111X_1 + 36.652X_2$$

Through the logit model, the prediction model can be formed as follows

$$P(Y=1) = \frac{1}{1+e^{-(2.617 - 38.111X_1 + 36.652X_2)}}$$

$P(Y = 1)$  is the probability or opportunity for the government to experience financial distress, the government is predicted to do financial distress if  $P > 0.5$ . based on the table above, it can be concluded that the value of the coefficient of financial independence is negative, indicating that governments with higher financial independence tend not to experience financial distress. and the coefficient value of the Degree of Decentralization is positive indicating that the government with a higher Degree of Decentralization tends to experience financial distress.

## DISCUSSION

Partially, Financial Independence has an effect of 35.9% on financial distress. Based on the theory of resource dependence, explaining that the power of financial resources as reflected in regional income is the strength of financial resources, local governments are required to increase their own regional revenues. The high local revenue is one of the main components in supporting the independence of local government financial resources, this is the power to survive and avoid financial distress. According to research conducted by Dewi Sartika (2016) regional finance has an effect on financial distress, this proves that financial distress is influenced by financial independence. The level of financial independence is a determinant of financial distress. High financial independence tends not to experience financial distress or local governments have sufficient funds to finance these government activities. The results of this study are in line with research which states that financial independence has a negative effect on prediction of financial distress. The higher the financial independence of the regional government, the less dependent on funds from the central or provincial government and less likely to experience financial distress due to the availability of funds. (Luh et al., 2017)

The degree of decentralization has an effect of 40.6% on financial distress. Based on agency theory, agency theory discusses the relationship between agents and principals, with principals trusting agents to manage with the aim of prospering them. Whereas the community has entrusted the local government to manage their area with the aim of improving the welfare of the community, the welfare of the community can be seen in the high and low degrees of decentralization. This will later show the extent to which the local government manages all its regional affairs well, which means that the local government has carried out its obligations as an agent to manage regional finances and improve the welfare of the local community, so the regional government will avoid financial distress. The results of this study are in line with research that the degree of decentralization has a positive effect on financial distress, this occurs where the lower the level of central government intervention in regional development the higher the level of readiness of local governments in implementing regional autonomy (Husniati et al., 2016).

## CONCLUSIONS

Financial Independence in districts/cities in West Java province for the 2015-2019 fiscal year is in the Low category. This shows that there are still many Regional Governments in West Java that have not been independent in financing their programs/activities aimed at providing services to the community. Therefore, local governments must be able to explore the potential sources of regional income. The degree of decentralization in regencies/cities in West Java province for the 2015-2019 fiscal year is in the Enough category. This shows that regencies/cities in the province of West Java are quite capable in implementing their autonomy, although they still have dependence on the central government. Financial Distress is included in the Distress category. This shows that the regions in West Java have not been able to provide maximum service to the community due to the lack of capital expenditure allocation, which is mostly used for relatively less productive expenditures and the local government must be more effective in allocating its expenditures. . Financial Independence has a negative effect on Financial Distress by 35.9%. This shows that local governments that have high financial independence will not experience financial distress. The degree of decentralization partially has a positive effect on Financial Distress of 40.6%. This shows that a high degree of decentralization tends to experience financial distress.

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