ATLANTIS PRESS
Advances in Economics, Business and Management Research, volume 169
Proceedings of the 3rd International Conference of Banking, Accounting, Management and Economics (ICOBAME 2020)

Financial Distress A Case Study of Indonesia

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Abstract: **This study aimed to examine and analyze the influence of manajerial ownership, leverage and profitability on financial distress. The population of this study are manufacturing companies which were listed in Indonesia stock exchange. The sample selection using purposive sampling method. The data will be analysed using logistic regression. The result of this study showed that managerial ownership has not significant impact on financial distress, but profitability and leverage have a negative impact on financial distress. This research contributed to development of science, especially in the field of financial accounting The results of this study were also expected to be used by company managers to always maintain performance so that they avoid financial distress.**

Keywords: managerial ownership, leverage, profitability, financial distress

I. INTRODUCTION

The company was founded with the aim of making a profit, which would later be used to sustain their business. Each company issues a financial report containing information that will be used by information users, particularly stakeholders. Information, especially about profit, is used to measure the success or failure of a business that is being carried out in achieving the operational objectives set by the business management [1]. The Statement of Financial Accounting Concepts (SFAC) suggests that earnings information is a major concern in assessing performance or management accountability. Earnings information also helps owners or other parties in estimating the company's future earnings power [2].

One of the systems that can affect the condition of a company to be good is good corporate governance [3]. The implementation of good corporate governance mechanisms will minimize the risk of a company experiencing a decline in financial condition (financial distress). Difficulty the company's financial condition is characterized by continuous losses, unsold sales, natural disasters that damage company assets, poor corporate governance system or due to unstable state economic conditions that trigger a financial crisis [4].

Financial distress is a condition in which the company experienced financial difficulties before the bankruptcy. Meanwhile, bankruptcy can be interpreted as a condition when a company experiences insufficient funds to run its business. The occurrence of financial distress is due to the fact that the company experiences funding difficulties to cover its obligations and liquidation which begins with a mild to severe level of difficulty, such as the size of the company's debt that exceeds its assets, this will certainly have an impact on managers, shareholders, and creditors [5]. Knowledge of financial distress needs to be implemented as best as possible from an early age so that measures to prevent financial distress can be developed, and bankruptcy can be minimized.

The success and failure of a company is caused by the strategy adopted by the company, such as the implementation of a corporate governance strategy. Corporate governance aims to ensure that company managers always take appropriate and selfless actions, and aim to protect company stakeholders [6]. The corporate governance mechanisms examined in this study are managerial ownership

Managerial ownership is ownership of company shares by the management or managers of the company. Managerial ownership is able to reduce agency problems that arise in a company [7]. The greater the proportion of company ownership by management (directors or commissioners), the greater the management's responsibility in managing the company. Research conducted by [5] proves that managerial ownership has no significant positive effect on financial distress, in line with research conducted by [8]. However, this study is different from the research of [7] which states that managerial ownership has a significant positive effect on the condition of financial distress.

A part from corporate governance, there are internal company factors that can influence financial distress, namely leverage and profitability. Leverage arises from activities using funds originating from third parties in the form of debt [9]. The use of this source of funds will result in an obligation for the company to return the loan along with the loan interest. Leverage tends to reduce the company's assets in the form of cash to pay for expenses arising from leverage which has an impact on the decrease in company cash. Research conducted by [10] states that leverage has a significant negative effect on financial distress.

Profitability is a ratio to assess the company's ability to seek profit. This ratio also provides a measure of the level of management effectiveness of a company. This is shown by the profit generated from sales and investment income [11]. Research conducted by [16] states that profitability has a significant negative effect on financial distress, this research is in line with [9] and [10], but the results of this study are different from research conducted by [12] and [13] which state that profitability has a positive and insignificant effect on financial distress.

Based on the research gap above, this research is very important. Companies certainly don't want to be in financial distress, let alone lead to bankruptcy. Therefore, this study is needed to analyze managerial ownership, leverage and profitability in predicting financial distress by looking at the company's financial statements. So that with this research the company can take strategies or corrective actions for the company in order to maintain its business continuity.

Hypothesis Development

The Effect of Managerial Ownership on Financial Distress

Managerial ownership is one of the factors that can affect the condition of the company in the future [7]. Managerial ownership in the company is expected to reduce agency conflicts, because management ownership shows that the company is owned by the company management itself, in other words, the owners (principals) also function as managers of the company's agents. Conditions like this will certainly add to the effectiveness and clarity of receiving information in the form of work orders and motivation of managers who are concurrently owners in implementing good company management aimed at generating more income so that the company can be safe from the threat of financial distress [3].

Management of companies with good corporate governance proxies that there is a large managerial ownership so that it is the manager's responsibility to manage the company will get biger. Plus external parties who provide evidence that the company with the implementation of quality corporate governance mechanisms will increase public confidence that the company has low financial distress.

Research conducted by [4] states that managerial ownership has a significant negative effect on financial distress. The results of the study are also in accordance with [13] which state that managerial ownership has a negative effect on financial distress. Based on this explanation, the following hypothesis is formed:

H1: Managerial Ownership has a negative effect on financial distress.

The Effect of Leverage on Financial Distress

Leverage ratio that shows the company's ability to fulfill both short-term and long-term obligations. This ratio is also referred to as the ratio that shows how much a company is financed by debt [14]. Based on agency theory, the decision to use third party funds is left to the agent because it has been given authority. If a financing company is to manage and make decisions on the company. The use of large third party funds will result in the emergence of a large amount of liabilities that the company must pay in the future. If this situation is not handled properly, the company will likely experience financial distress will be even greater [13].

The following studies are presented to support the effect of leverage on financial distress. Research conducted by [15] states that the leverage ratio has a significant positive effect in affecting financial distress. Research by [13] shows that leverage has a positive and significant effect on financial distress. Based on this explanation, the following hypothesis is formed:

H2: Levarage has a positive effect on financial distress

The Effect of Profitability on Financial Distress

Profitability or often referred to as the profitability ratio is a ratio that describes the company's ability to generate profits in a certain period. This ratio arises from the company's success in marketing its products so that the company can make a profit. Referring to the agency theory, operational activities are things that must be done by agents, if the agent is right in making decisions so that they can sell many products, the company will get a large profit. Large profits will attract investors to invest in the company, this will reduce the possibility of the company experiencing financial distress.

The following studies are presented to support the effect of profitability on financial distress. Research conducted by [16] states that profitability has a significant negative effect on financial distress, this research is in line with [9] and [10]. Based on this explanation, the following hypothesis is formed:

H3: Profitability has a negative effect on financial distress

II. RESEARCH METHOD

A. *Types of Research*

The type of this study is an explanation research. Explanation research is research that examines the effect of independent variables consisting of managerial ownership, leverage and profitability on financial distress as the dependent variable.

B. *Population and Sample*

The population used in this study are manufacturing companies listed on the Indonesia Stock Exchange (BEI) for the 2016-2019 period. The sampling technique used in this study was purposive sampling technique, which means that in taking samples with certain considerations. The sampling criteria in this study are:

1. Registered as a manufacturing company on the Indonesian stock exchange during the 2016-2019 period.
2. The company publishes annual reports and financial reports for the period 2016-2019.
3. The company provide all the required data abour managerial ownership, liabilities, leverage, and profitability.

C. Source and Data Collection Method

Data sources in this study were obtained from financial report of all manufacturing companies listed on the Indonesia Stock Exchange in 2016-2019 which had been published, while data collection methods used documentation.

D. Operational Definition and Variable Measurement

Financial Distress

Financial distress is a condition that describes the condition of a company that is experiencing financial difficulties. The dependent variable in this study is measured using a dummy variable and proxied by Earning Per Share (EPS), because EPS can describe how much a company is able to generate profits per share to be distributed to shareholders. If the company has positive Earning Per Share (EPS) then it is worth 0 (zero) and if the company has negative Earning Per Share (EPS) then it is worth 1 (one) [1].

Managerial ownership

Managerial ownership is ownership of company shares owned by management. Share ownership by company management makes management have a dual function, namely as the owner of the company as well as the manager of the company [17]. The greater the managerial ownership will be able to unite the interests of shareholders and managers because it is related to a high sense of ownership of these shares, so that it is expected to reduce the potential for financial distress. Based on research conducted by [4] managerial ownership in this study is formulated as follows:

$$MO = \frac{\text{Total ownership of managerial shares}}{\text{Number of shares outstanding}}$$

Leverage

Leverage is a ratio that shows how much debt is used to finance the company's assets. The use of the amount owed by the company depends on the success of the company in generating revenue and the availability of assets that can be used as collateral for this debt. As for this study, the leverage ratio is measured using the total debt to assets ratio [10]

$$DR = \frac{\textit{Total liabilities}}{\textit{Total assets}}$$

Profitability

Profitability is the ratio used to measure the company's ability to earn profits or profits. In this study, profitability is proxied by Return on Assets (ROA) [18]. ROA shows how much net income can be obtained from all the wealth owned by the company. This ratio relates the profits derived from the company's operations with the amount of investment or assets used to generate operating profits. The profitability in this study is formulated as follows:

$$ROA = \frac{\textit{NetProfit}}{\textit{TotalAssets}}$$

E. Data analysis Method

Data in this study were analyzed using logistic regression analysis. The research model is as follows:

$$\text{Ln}\ \frac{FD}{1\text{-FD}} = \alpha + \beta1\ MO + \beta2\ DR + \beta3\ ROA + \varepsilon$$

Where:

$\text{Ln}\ \frac{FD}{1\text{-}FD}$	= Probability Financial distress
α	= Constant
β1-β4	= Regression Coefficient
MO	= Managerial Ownership
LEV	= Leverage
DR	= Profitability
ε	= Error Term

Research Model Figure

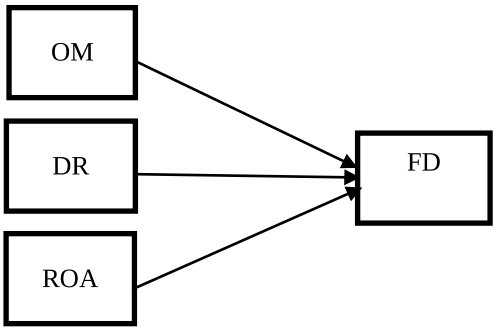

Fig. 1 Research Model

III. RESULTS AND DISCUSSION

A. Descriptive Statistic

Descriptive statistical analysis in table 1 in this study provides an overview or description of data that is seen from the mean, standard deviation, maximum, and minimum values

	N	Minimum	Maximum	Mean	Std. Deviation
OM	303	,000	10,333	,16736	,375860
DR	303	,002	317,190	1,59544	18,20169
ROA	303	-56,959	117,201	,89409	9,42905
Valid N (listwise)	303				

TABLE I. THE DESCRIPTIVE STATISTICS

Based on table 1 can be seen that the minimum value of MO (managerial ownership) was ,000, the maximum value was 10,333, value of mean was ,16736 and value of standard deviation was ,375860. The description of DR (leverage) show the minimum value was ,002, while the maximum value was 317,190, the value of mean was 1,59544 and value of standard deviation was 18,20169. The next description was ROA (profitability) show the minimum value was -56,959, the maximum value was 117, 201, the value of mean was ,89409 and value of standard deviation was 9,42905.

TABLE II. COX SNELL'S R SQUARE AND NAGELKERKE R SQUARE

Step	-2 Log likelihood	Cox & Snell R Square	Nagelkerke R Square
1	259,842[a]	,221	,285

The next step was model fit testing. Overall fit model test showed that test on block number 0 obtained a value of -2 log likelihood of 295.576, while in block number 1, the value of -2 log likelihood was 259.681. This result showed that there is a decrease in the value of -2 log likelihood which allows the relationship between the dependent variable. Test of Cox Snell's R Square and Nagelkerke R square table 2 showed that value of Cox and Snell's R Square was 0,221 and value of Nagelkerke's R Square was 0,285. These results indicate that variability of financial distress can be explained by managerial ownership, leverage, and profitability of 28.5% and 81.5% can be explained by other variables outside the model.

TABLE III. HOSMER AND LEMESHOW

Step	Chi-square	Df	Sig.
1	21,307	8	,070

Based on model fit test table 3, value of significance hosmer and lemeshow was 0.070. This value is more than 0.05 which means that the model is fit with observation (data).

B. Hypothesis Testing

The result of hypothesis testing in this study is showed at table 4.

TABLE IV. THE RESULT OF HYPOTESIS TESTING

	B	**df**	**Sig.**
MO	0,589	1	0,584
DR	2,279	1	0,000
ROA	-3,336	1	0,036
Constant	-2,436	1	0,000

Based on the test results in table 4 shows that the managerial ownership variable had no effect on financial distress so that H1 was rejected. Managerial ownership does not affect the possibility of financial distress because the health condition of a company is not caused by the size of the shares owned by the management, but rather due to the ability of management to manage the company. In addition, the reason managerial ownership has no effect on financial distress is because the percentage of managerial ownership in manufacturing companies in Indonesia is still very small, and part of the number of shares outstanding in the company is fixed. In fact, there are many manufacturing companies that do not have a managerial proportion of ownership at all. This research is not in accordance with agency theory, which clearly states that the higher the managerial ownership, the smaller the possibility of financial distress. If management owns shares in the company, then the supervision of a company should be higher. The results of this study support the research conducted by [7] which states that managerial ownership has no influence on financial distress.

Leverage shows the company's ability to fulfill all its obligations, both short-term and long-term, so that it can affect the company's condition in experiencing financial distress. The regression test results show that the leverage has a significant positive effect on financial distress. This is in accordance with the second hypothesis which states that leverage has a significant positive effect on financial distress. This result is in accordance with the agency theory which states that the decision to use third party funds is left to the agent because it has been given authority. If a financing company manages and makes decisions on the company using large third party funds, it will result in a large amount of liabilities that the company must pay in the future. If this situation is not handled properly, the company will likely experience financial distress will be even greater [13]. The following results are presented to support the effect of leverage on financial distress. Research conducted by [15] states that the leverage ratio has a significant positive effect in affecting financial distress. The results showed that the profitability variable had a significant negative effect on financial distress. This is in accordance with the second hypothesis which states that liquidity has a negative and significant effect on financial distress. Profitability describes the company's ability to generate profits in a certain period.

The results showed that the profitability variable had a significant negative effect on financial distress. This is in accordance with the third hypothesis which states that liquidity has a negative and significant effect on financial distress. Profitability describes the company's ability to generate profits in a certain period. These results are in line with agency theory which states that operational activities are things that must be done by agents, if the agent is right in making decisions so that they can sell many products, the company will get a large profit. Large profits will attract investors to invest in the company, this will have an impact on the possibility of the company experiencing financial distress is getting smaller. The results of this study support the research conducted by [16] which states that profitability has a significant negative effect on financial distress, this study is in line with [9] and [10]. This shows that the higher the profit will reduce the possibility of experiencing financial distress.

IV. CONCLUSION

Based on the results of data analysis and discussion of the influence of managerial ownership, leverage and profitability on financial distress, it can be concluded that managerial ownership has no effect on financial istress. Leverage has a significant positive effect on financial distress. If a financing company is to manage and make decisions on the company. The use of large third party funds will result in the emergence of a large amount of liabilities that the company must pay in the future. Profitability has a significant negative effect on financial distress, large profits will attract the attention of investors to invest in the company, this will reduce the possibility of the company experiencing financial distress is getting smaller.

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