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The Possibility of Financial Distress with the Analysis of Corporate Governance Mechanism, Financial Indicators, Inflation and Interest Rate: Case in Indonesia' Basic and Chemical Industry

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Abstract: The ever-changing economic conditions have affected the activities and performance of companies, both small and large companies, that many companies have gone bankrupt, especially several manufacturing companies listed on theIndonesian Stock Exchange. This study aims to examine the affect of board size, agency costs, liquidity, leverage, inflation, and interest rates on the possibility of financial distress. The population in this study are manufacturing companies belonging to the basic and chemical industries listed on the Indonesia Stock Exchange (IDX) for 2019-2021. Sampling is done by purposive sampling methods. The number of samples that meet the requirements in this study amounted to 146 data. Based on the results of the multinomial logistic regression analysis, it can be seen that board size, agency costs, and liquidity affect the possibility of financial distress, while leverage, inflation, and interest rates do notaffect the possibility of financial distress.
Keywords: Board size, agency costs, liquidity, leverage, inflation, interest rates, financial distress.

1. Introduction

Numerous companies, both small and large companies, have folded as a result of the constantly shifting economic conditions, particularly a number of manufacturing firms that are listed on the stock market. The most severe of all them is the basic and chemical sector.Many companies saw their net profit decline due to further increases in production costs, and some companies have negative net income.This is because most companies import raw and auxiliary materials as part of their manufacturing activities, and the cost of selling finished products has increased. Therefore, a model is needed that can predict the financial difficulties of basic and chemical industries. This allows us to assess a company's financial performance and take management action before financial difficulties that can lead to bankruptcy occur in the future.

Companies that are said to be experiencing financial distress can experience de-listing or elimination from the stock market (include listed companies on the Indonesia Stock Exchange - IDX). They are unable to fulfill their obligations because the company experience a decline in the financial performance. Financial distress is the stage when a company's financial condition declines before the company has to be liquidated or declared bankrupt (Platt and Platt, 2002). The condition of financial distress that occurs in a company can be predicted by looking at the company's financial statements. This is done by analyzing the financial statements. Effective corporate governance is one strategy that is thought to be able to minimize financial distress.

According to Sipahutar (2014), corporate governance is the relationship between various stakeholders in a company that determines the direction of company performance. On the other hand, Shleifer and Vishny (1997) define corporate governance as a mechanism that can protect minority parties from takeover by management or controlling shareholders by emphasizing legal mechanisms.One of the corporate governance mechanisms is the size of the board of commissioners. The composition of the board of commissioners must be designed to supportthe decision that can be taken effectively, accurately and promptly and can act independently. Due to the small number of commissioners, the control function carried out in the company is relatively weak and has no financial impact compared to companies without financial pressure (Hanifah and Purwanto, 2013).Wardhani (2006) find that there is a significant correlation between size committee in determining the likelihood that a company will face financial difficulties. In other research by Yudha and Fuad (2014) find that the committee size hasno significant effect on a company's financial difficulties.

Another corporate governance mechanism is agency fees. It defines from agency costs that are incurred by separating management and ownership. Management agency costs can be interpreted as fees paid by the owner to regulate and monitor the performance of managers who work for the benefit of the company (Fadhilah and Syafruddin, 2013). Fadhilah (2013 and Syafruddin, 2013) find that administrative agency costs have a

significant positive impact on financial distress.

The financial indicator used as a predictor of financial distress is liquidity ratio. The liquidity ratio makes it possible to compare the current ratio with the figure 1:1. This means that the company's current assets are able to pay all of its current liabilities. If the liquidity ratio with a comparison value greater than 1 is defined as safe. The company's current assets must be greater than the company's current liabilities because the company needs costs to meet its current obligations and the company is ready to pay them off (Nila, 2021).Another ratio used is leverage. Leverage is a metric used to measure a company's ability to pay debts (short-term and long-term) (HanifahandPurwanto, 2013). This ratio analysis is used to measure a company's ability to pay its debts in short-term and long-term, if the company is liquidated or dissolved (WidarjoandSetiawan, 2009:112).

Economic conditions (such as inflation and central bank rate) can also be a cause of financial distress.According to Putong (2010), inflation is generally interpreted as an increase in commodity prices. This price increase is due to the procurement system program (production, pricing, printing money, etc.) that is out of sync with income levels in other countries. Rohiman and Damayanti (2019) find that inflation can have a significant impact on financial distress, meanwhileKurniasanti (2018) finds viseversa.

The interest rate is the monetary policy set and announced by the central bank (Bank Indonesia-BI in Indonesia) to the public. BI Letters (SBI) are securities denominated in rupiah issued by Bank Indonesia with recognition of short-term liabilities. The Indonesian interest rate (BI rate) is Bank Indonesia's interest rate (Arifin, 2007).A study by Rohiman and Damayanti (2019) shows that interest rates may not have a significant impact on financial distress. This finding is also supported by Priyatnasari and Hartono (2019); Kumalasari et al.(2014), which state that interest rates do not depend on financial difficulties. The higher the interest rate, the higher the interest expense that must be paid by the company, the more likely it is that the company's profits will decrease and the company will experience financial difficulties.

2. Literature Review and Hypotesis

2.1 Agency Theory

Agency theory is the basis for implementing corporate governance as a monitoring and control mechanism. This is because corporate governance is practiced because each party seeks its own interests due to agency issues between agents and principals. Therefore, by applying the concept of corporate governance, agents (managers) are expected to have confidence in managing the assets of owners (investors), and owners are expected to ensure that agents act in the interests of agents. that agents do not commit fraud (Widyati, 2013). The client authorizes management to make decisions related to the company's business activities. Management is given the responsibility by the principal to manage the company's resources. Managers are given the task of optimizing the entrusted resources for the benefit of their owners in the short and long term.

2.2 Trade-off theory

The trade-off theory, or capital structure theory, states that exchanging the benefits of tax savings by increasing the amount of debt financing is expensive. The tax-saving assumption at issue is that as debt increases, interest expenses also increase, thereby reducing tax payments and putting more net profit into the company's accounts. However, this is also accompanied by the possibility of default due to excess debt (Priyatnasari and Hartono, 2019).Wulandari (2019) shows that in this trade-off theory, companies choose to borrow to a certain extent or level when the tax savings from debt equal the cost of financial distress. Companies that owe debts are subject to fees or interest charges. A company that continues to increase its debt also has to incur more interest costs, and profits will decrease. As a result, the company is approaching financial difficulties, and if this situation continues, the company may go bankrupt.

2.3 Financial Distress

Financial distress or often called financial difficulties, occurs before the company actually goes bankrupt. Financial distress is a condition that reflects the decline in the company's financial position that occurred before bankruptcy or liquidation (Platt and Platt, 2002). Foster (1988) that confirm byRamadhani and Lukviarman(2009) explains that financial distress can occur in various companies and can be a sign or signal of possible company bankruptcy. If the company is in a state of financial distress, management may enter the bankruptcy stage and it is advisable to be careful as steps must be taken to overcome these financial problems and avoid bankruptcy.

2.4 Size of the Board of Commissioners

According to the General Guidelines for Good Corporate Governance in Indonesia, the number of supervisory boards (board of commissioners) must be adjusted to the complexity of the company, taking into account the effectiveness of decision making. Emirzon (2006), the commissioner' size will help increase the

effectiveness of its oversight function and the transparency of its discussions.The size of the board of commissioners is measured by counting the number of commissioners in a company (Wardhani, 2006). The role of the commissioner is expected to minimize agency problems that arise between the board and shareholders. Therefore, the committee have to monitor the performance of thedirectors to ensure that the resulting performance is for the benefit of shareholders (Wardhani, 2006).

The control function carried in the company is relatively weak and less financial impact, if company applysmall number of director(Hanifah and Purwanto, 2013).The composition of the board of commissioners must be able to ensure effective, accurate and fast decisions and they act independently.

H1: The size of the board of commissioners affects the possibility of financial distress.

2.5 Agency Fees

Agency fees occureand increase with the separation of control and ownership. Agency fees generally define from agency costs. Administrative agency costs are costs incurred by the owner to regulate and monitor theperformance of management who work for the benefit of the company (Fadhilah, 2013). Improper implementation of corporate governance can increase administrative costs and cause economic inefficiency for companies.

H2: Agency fee affects the possibility of financial distress.

2.6 Liquidity

The current ratio is part of the liquidity ratio and measures a company's ability to meet its short-term obligations with its current assets (Ardiyanto and Prasetiono, 2011). The liquidity ratio can be compared to the current ratio as a 1:1 number or set as a percentage (100%). In that condition, the company's current assets have the ability to cover all of its current liabilities. The liquidity ratio that greater than 1 is defined as safe from financial difficulties. Working capital must exceed the company's current liabilities, because the company needs funds to fulfill its current obligations and the company is ready to pay them off (Nila, 2021).A low liquidity ratio means that a company has few assets to pay its current liabilities, resulting in a high default risk, and this risk affects the company's potential to grow financially.

H3: Liquidity affects the possibility of financial distress.

2.7 Leverage

Leverage is a metric used to measure a company's ability to pay off its short-term and long-term debts (HanifahdanPurwanto, 2013: 7). Comparison of the amount of capital borrowed by a company to finance its business activities with the assets and capital owned by the company can be shown using the leverage ratio.The leverage ratio, which is the ratio of liabilities to assets, shows the extent to which a company's assets are financed by debt. The total assets of companies financed by high debt indicate that the company has large debts, making it more vulnerable to financial difficulties (Andre and Taqwa, 2013). Most bankruptcies begin when a company fails to pay its creditors. The more debt a company has to bear, the more likely it is to experience financial problems.

H4: Leverage affects the possibility of financial distress.

2.8 Inflation

Inflation is a condition in which overall commodity prices rise. In this case, macroeconomics related to inflation uses Keynesian theory as a basis for analysis to determine its impact on financial distress. In general, an increase in the price of a product will reduce consumer demand for the product and automatically reduce the company's sales (Putong, 2010). If this condition happens permanently, it will reduces the company's revenue and creates a financial emergency.

H5: Inflation affects the possibility of financial distress.

2.9 Interest Rate

The interest rate is the percentage of interest a company has to pay on a series of obligations. According to Sunariyah (2011), high interest rates affect the payment of debts that companies must pay to their creditors, making it difficult for companies to pay their debts and pay off the interest, thereby affecting the company's financial performance. The higher the interest expense, the lower the company's operating profit, and the more likely it is that the company will experience financial difficulties.

H6: Interest rates affects the possibility of financial distress.

3. Methodology

3.1 Population and Sample

The population used in this research is basic industrial and chemical manufacturing companies listed on the Indonesia Stock Exchange during the 2019-2021 period. Sampling in this study is carried out using the purposive sampling method that determining the sample with certain considerations according to the characteristics of the sample and the predetermined sample criteria. The number of samples in this study amounted to 51 companies with 153 data. After seven outlier data, the sample used is 146 data.

3.2 Operational Variable Measurement

Table 1: Variable Measurement

Variables	Measurement	Reference
Financial Distress	Z Score = 1,2 X1 + 1,4 X2 + 3,3 X3 + 0,6 X4 + 1,0 X5 3 = Distress, Z Score < 1.81 2 = Grey Area, Z Score 1.81 ≤ Z ≤ 2.99 1 = Non-distress, Z Score > 2.99	Rudianto(2013: 254)
Size of the Board of Commissioners (UDK)	UDK = the number of company'sboard commissioners.	Wardhani(2006)
Agency Fees (BA)	$BA = \frac{\text{Administration and General Fee}}{\text{Sales or Revenue}}$	Ang et al. (2000)
Liquidity (CR)	$CR = \frac{\text{Current Assets}}{\text{Current Liabilities}}$	Sudana(2011: 21)
Leverage (DAR)	$DAR = \frac{\text{Total Debts}}{\text{Total Assets}}$	Kasmir(2017: 156)
Inflation (Inf)	Inf = Inflation value that obtained from central bank of Indonesia (BI).	Rohiman and Damayanti (2019)
Interest Rate (SB)	SB = Interest rate value that obtained from central bank of Indonesia (BI).	Priyatnasari and Hartono (2019)

4. Results and Discussion

4.1 Descriptive Statistical Analysis

Table 2: Results of Descriptive Statistical Analysis

Variable	N	Minimum	Maximum	Mean	Standard Deviation
Size of the Board of Commissioners	146	2.000	9.000	3.950	1.622
Agency Fees	146	0.001	0.983	0.086	0.136
Liquidity	146	0.057	9.457	2.160	1.887
Leverage	146	0.081	2.821	0.494	0.330
Inflation	146	1.680	2.720	2.086	0.452
Interest Rate	146	3.500	5.000	4.077	0.656
Financial Distress	146	1.000	3.000	2.010	0.883

Source: Processed secondary data, 2023

The data in Table 2 shows that there are 146 companies as a sample. The data consists of the dependent variable (financial distress) and six independent variables, namely size of the board of commissioners, agency fees, liquidity, leverage, inflation, and interest rates, with maximum, minimum, mean, and standard deviation value.The size of the board of commissioners shows a minimum value of 2 and a maximum value of 9. Meanwhile, the average value is 3.95 with a standard deviation of 1.622. The agency fee showsa minimum value of 0.001 and a maximum value of 0.983. Meanwhile, the average value is 0.086. The liquidity variable shows a minimum value of 0.057 and a maximum value of 9.457,while the average value is 2.160. The leverage variable shows a minimum value of 0.081 and a maximum value of 2.821. Meanwhile, the average value is 0.494.The inflation variable shows a minimum value of 1.68 and a maximum value of 2.72. Meanwhile, the average value is 2.086 with a standard deviation of 0.452. The interest rate variable shows a minimum value of 3.5 and a maximum value of 5. Meanwhile, the average value is 4.077 with a standard deviation of 0.656. The financial distress variable shows a minimum value of 1 and a maximum value of 3. Meanwhile, the average value is 2.01.

4.2 Multinomial Logistic Regression Analysis

Table 3: Results of Multinimal Logistic Regression Analysis

Effect	Model Fitting Criteria	Likelihood Ratio Tests		
	-2 Log Likelihood of Reduced Model	Chi-Square	df	Significance
Intercept	210.259	2.096	2	0.351
Size of the Board of Commissioners	214.892	6.729	2	0.035
Agency Fees	221.470	13.307	2	0.001
Liquidity	246.818	38.655	2	0.000
Leverage	208.996	0.833	2	0.659
Inflation	208.414	0.251	2	0.882
Interest Rate	208.346	0.183	2	0.913

Source: Processed secondary data, 2023

Based on the data generated by the fit information model, it can be concluded that the inclusion of independent variables into the multinomial regression model shows the best results. The goodness of fit test ofthe model gives the result that the data entered fits or follows the multinominal regression model. This means that the model can describe the data. The feasibility test of the model is seen from the significance value of the Chi-Square (Pearson and Deviance)> 0.05, then the regression model fits or matches the observation data. From the results of the test table, it shows a value of 0.746 and 0.999 which means > 0.05 and it can be concluded that the regression model fits or matches the observation data. The feasibility of the model by looking at Cox and Snell shows a value of 0.511. This value indicates that the diversity of the independent variable data can explain the diversity of the response variable data by 57.9%. Meanwhile 42.1% is explained by other independent variables outside the model.

The results of the multinomial logistic regression test show that the size of the board of commissioners has a significance value of 0.035 and is smaller than the 5% significance level (0.05). This result finds hypothesis one (H1) is accepted which states that the size of the board of commissionersaffects the possibility of financial distress. This shows that regardless of the size of the board of commissioners, it is able to avoid the possibility of the company experiencing financial difficulties. The results of this study are inline with the research conducted by Wardhani (2006) and Parulian (2007) which states that there is a negative effect of board size on financial distress.

The agency fee variable has a significance value of 0.001 and is smaller than the 5% significance level (0.05). This study accepts the second hypothesis (H2) which states that agency fee affectsthe possibility of financial distress. This study supports research conducted by Safitri (2021) which states that agency fees have a significant positive effect on the possibility of financial distress. When linked to the principles of corporate governance, managerial agency costs must be in accordance with the principle of accountability,in which the useof supervisory costs carried out by managers must be reasonable and properly managed in accordance with the interests of the company. This illustrates that if a company has large managerial agency costs, there are company managers who tend to use company resources exploitatively to fulfill their goals, if this happens continuously it can cause instability of company resources and can cause a decline in financial conditions and increase the occurrence of financial distress.

The liquidity has a significance value of 0.000 and is smaller than 0.05 significance level. This study accepts hypothesis three (H3) which states that liquidity affects the possibility of financial distress. This result supports research conducted by Nila (2021) which states that liquidity has a positive effect on the possibility of financial distress. The results of this study support the trade off theory which states that companies will try to increase their debt ratios to gain tax advantages. A high debt ratio for companies will increase payment defaults for companies and will further trigger the possibility of a company experiencing financial distress.

The leverage variable has a significance value of 0.659 and is greater than the 5% significance level. This study rejects the fourth hypothesis (H4) which states that leverage doesn’taffectthe possibility of financial distress. This research is inline with the results of research conducted byPertiwi (2018) which shows that leverage has no effect on financial distress. The higher of leverage ratio, the higher the risk the company will bear as a result of the company's assets not being able to cover its debts. The high leverageratio indicates thata company is in bad condition because the costs borne by the company are getting bigger. That condition is triggering the potential for financial distress. However, a high DAR -as the leverage ratio- does not necessarily mean that the company has low profits due to high expenses. However, it is possible if a high DAR value is not followed by a high burden, that make the company can avoid the potential for financial distress (Marlin, 2017).

The inflation variable has a significance value of 0.882 and is greater than 0.05 significance level. This study rejects the fifth hypothesis (H5) which states that inflation doesn’t affectthe possibility of financial

distress. This can happen because the inflation that occurred during the study period is not too high or tended to be stable with an average inflation rate in the descriptive analysis of 2.086 during the 2019-2021 period and the company could still control and anticipate these conditions. The results of this study support research from Rahmidani (2013) which states that inflation has no effect on the possibility of companies experiencing financial distress.

The interest rate has a significance value of 0.913 and is greater than the 5% significance level (0.05). This study rejects hypothesis six (H6) which states that interest rates doesn't affect the possibility of financial distress. The results of this study are inline with the research of Priyatnasari and Hartono (2019) which states that interest rates have no effect on the possibility of a company experiencing financial distress. This result is not in accordance with the trade off theory, this theory explains that companies can reduce tax payments because of corporate debt. It is possible for a company to increase its profit and it is not in a state of financial distress. The use of debt as a way to reduce taxes can increase the interest expense for the company. Increased interest rates will also increase interest costs and companies will pay more debt because interest rates have increased and can result in companies experiencing financial distress.

5. Conclusion

Based on the test results and previous discussion, this study finds that the size of the board of commissioners, agency fee, and liquidity affect the possibility of financial distress. Meanwhile, leverage, inflation, and interest rates do notaffect the possibility of financial distressin manufacturing companies classified as basic and chemical industries listed on the Indonesia Stock Exchange (IDX) in 2019-2021.The sample in this study is only the scope of manufacturing companies on the Indonesia Stock Exchange (IDX) and carried out for short-term periods (2019-2021). Further research can expand the object of research based on the index that represent the specific classification in the stock market (instead of Indonesia Stock Exchange). Future researchcan be extended the period of research years into medium or long-term period that can provide an overview of the company's condition to minimize the possibility of financial distress. This study finds the variables that determine the possibility of financial distress in a specific classificatiob of Z Score Altman and future research can pay attention to the three variables and use financial distress measurement models.

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