

**ANALYSIS OF FINANCIAL PERFORMANCE IN PUBLIC SECTOR  
(A Case Study in Lamongan, East Java - Indonesia)**

**Rida Perwita Sari<sup>1</sup>, Hurip Tjahjono<sup>2</sup>, Turino<sup>3</sup>**

<sup>1</sup>Accounting Department, Faculty of Economics and Business, Universitas Pembangunan Nasional Veteran Jawa Timur, Raya Rungkut Madya, Jawa Timur 60294, Indonesia.

<sup>2,3</sup>Research and Development Council, Lamongan, Indonesia

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**Abstract**

*The study aims to examine the effect of Regional Original Income (PAD) on the financial performance of the Lamongan Regency (local government in East Java Province, Indonesia). The research was conducted in Lamongan using panel data 2010-2017 (eight years) to promote empirical facts. This study uses the Agency Theory and Fiscal Federalism Theory which are designed in the form of quantitative research approaches. The analysis technique in this study uses Structural Equation Modeling (SEM) with a variance based or component-based approach with Partial Least Square (PLS). The results of this study are the Regional Original Revenue (PAD) effect on three components of regional financial performance as measured by the degree of decentralization, regional financial dependency ratio, and local financial independence ratio. These results indicate that that financial performance of local government is influenced by the PAD. The average value of 20% government of Lamongan can maintain and improve the success achieved and have been effective in doing excavation source - a source of local revenue.*

**Keywords:** *Regional Original Revenue (PAD), Financial Performance, degree of decentralization, financial dependency ratio, financial independency ratio, Lamongan .*

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**INTRODUCTION**

The implementation of decentralization is related to the central government and local governments, one of which is the establishment of autonomous regions and the transfer of legal powers from the central government to local governments to manage their respective governments. Law No. 32 of 2004 concerning Local Government and Law No. 33 of 2004 concerning Financial Balance between the Central and Local Governments as the basis for the implementation of local autonomy. Mission the two primary laws are decentralization. Decentralization does not only mean delegation the authority of the central government to the government is lower, but also the transfer of some power from the government to the private sector in the form of privatization (Mardiasmo, 2013).

Local Original Revenue (PAD) is the income derived from the economic activity itself. Local Original Revenue (PAD) is one of the pillars of local independence. Law Number 33 of 2004 concerning financial balance between central and local governments, the source of PAD consists of taxes regions, local retribution, results of local wealth management, and other legitimate local income. Because that, the ability of an area to dig up PAD will affect the development and development of the city. Besides, the more significant the contribution of PAD to the APBD, the

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<sup>1</sup>Rida Perwita Sari  
Email: [ridaps.ak@upnjatim.ac.id](mailto:ridaps.ak@upnjatim.ac.id)

smaller it will be dependence on central government assistance. The demand for an increase in PAD is mainly in line with the increasing number of government authorities delegated to the regions with the transfer of personnel, equipment, financing, and documentation to the areas in large numbers. PAD can be used according to the will and initiative of the local government for the smooth running of local affairs (Bastian, 2012).

The development of Lamongan Regency in the 2016-2021 period entered the third stage in the Local Long Term Development Plan (RPJPD). The RPJPD aims to further strengthen overall development in various fields. The strengthening of development is focused on increasing the competitiveness of the economy based on the advantages of natural resources and human resources. Lamongan's economic growth in 2016 was 5.86 percent, increase compared to the year 2015 which reached 5.77 percent. Many factors influence Lamongan's economic growth, both internal and external factors. Externally, the global economic conditions have not improved, and international commodities are still stagnant at a low level. Some indicators that influence Lamongan's economic growth include the success of the government in maintaining inflation at a low level (National inflation in 2016 at the level of 2.74 percent; more moderate than in 2015 which was 3.08 percent).

The business field structure of some of the Lamongan people is still dominated by the fields of agriculture, forestry, and fisheries rather than other economic business fields. The most significant contribution in 2016 as in previous years was generated by the business field in the category of agriculture, welfare, and fisheries by 38.87 percent. Then the business sector in the class of Large and Retail Trade, Car and Motorcycle Repair amounted to 18.98 percent; eight categories Construction business amounted to 10.77 percent; the field of business in the Manufacturing Industry category is 8.08 percent, and the area of business in the information and communication category was 5.97 percent. While the role of other business categories in the group contributes below 5 percent, this can be seen in the table below regarding a large proportion of the role of each business field towards the total GRDP.

Increased revenue (PAD) in Lamongan during the period 2015-2017. There is an increase in financial resources owned by the area. So Lamongan Regency can explore PAD that will affect the development and development of its region. However, some anomalies occur in Lamongan during the period 2011 - 2015 in which the average number of local assets decreased. Lamongan District Government multitude of 1.65% annually as well as a decrease in equity funds during the current Lamongan District Government the period of five years also experienced an average decline of 4.30% and equity investment funds also decreased by 22.08% ( Lamongan District Regulation Number 14 of 2017).

The research objective is to determine the effect of PAD on the financial performance of the local government of Lamongan Regency. The benefits of this research are theoretical and practical contributions, namely enriching accounting knowledge, especially in public sector accounting studies related to the influence of PAD on financial performance by adopting agency theory and Fiscal Federalism Theory and will provide additional accounting scholarly discourse especially public sector accounting in particular by making the right public policy.

The implementation of government activities by the local government is required to always be transparent in implementing local autonomy. One form of accountability is by submitting financial statements. The financial statements are prepared to report the financial condition of local governments in a certain period, and there is some information that can be used to assess the performance of local governments. The local financial context with the existence of fiscal decentralization associated with agency theory means that there is a delegation from the central government to the local government where the local government can execute the functions of the central government that has been delegated to the local government acts as the central government agencies. So the relationship between Agency theory in this study is that with the role of local governments as government administrators can provide principled financial performance on value for money will be able to maximize the welfare of its people.

Law No. 32 of 2004 describes the definition of local autonomy, naming rights, authority, and autonomous regions obligation to regulate and manage the care of an administration and public interest following the law. Several vital principles in the local autonomy law need to be under-

stood, including: 1) The principle of decentralization is the transfer of governmental authority by the government to autonomous regions within the framework of the Unitary Republic of Indonesia. 2) The deconcentration principle is the delegation of governmental authority by the government to the governor as a representative of the government and vertical agencies in specific regions. 3) Co-administration tasks are assignments from the central government to regions and villages, from the provincial government to regencies/cities and towns, as well as from district/city governments to villages to carry out specific tasks. 4) The financial balance between the central and local governments is a system of government financing within the framework of a unitary state, which includes the financial divide between the central and local governments and equalization between locally, proportionally, democratically, fairly and transparently by paying attention potential, conditions, and local needs. The condition is in line with the obligations and division of authority and governance on how to exercise such power, including its financial management and supervision.

Tanjung (2012: 89) argues that the budget is a guide to actions that will be implemented. The government includes plans for income, expenditure, transfers, and financing which are measured in units of rupiah in units of rupiah, which are systematically arranged according to specific classifications for a period. Based on Law Number 32 of 2004 the revenue and expenditure budget is a local government annual financial plan stipulated by local regulations. The budget is the meaning of the results of the formulation and strategy and the strategic planning that is made.

Local revenue and expenditure budget based on the Minister of Home Affairs Regulation No. 13 of 2006, concerning local financial management guidelines article 15 paragraph 3 reads AP BD has the functions of authorization, planning, supervision, distribution and stabilization allocation. A PBD describes all forms of local government activities in finding sources of income and then how these funds are used to achieve government goals within one year.

Law Number 17 of 2003, local income is the right of recognized local government as an addition to the value of net worth. Local Original Revenue Revenues (PAD) are all revenues obtained from the regions from sources within their territory which are collected based on local regulations by applicable statutory provisions (Halim, 2013: 96). Pursuant to article 79 of Law Number 22 Year 1999 concerning local government, stated that Local Original Income (PAD) is something that is obtained by the local government that can be booked with money because of the authority given by the community in the form of local taxes and local retribution, the results of locally owned companies and the management of local assets and other legitimate local revenues. PAD components such as local levies and taxes directly or indirectly will populate the people, so the part must receive special attention.

Local revenue is all cash receipts that are local rights and are recognized as additions net worth value in one fiscal year and does not need to be repaid by the government. Getting a clearer understanding of income, several definitions have been proposed local income. Government Accounting Standards (SAP) No. 2 about the Budget Realization Report (LRA) defines that income as all receipts of State and Local General Cash accounts that add equity to current funds within the period of the relevant budget which is the government's right and does not need to be repaid by the government. Whereas according to Law No. 32 of 2004 concerning Local Government and Law No. 33 of 2004 concerning Financial Management between the Central Government and Local Government stated that the source of local income consists of Original Local Revenue, Tax Revenue, and Non-Tax Revenue.

Based on the Minister of Home Affairs Regulation No. 13 of 2006 states the following meanings of performance is the output/results of activities/programs that will or have been achieved about the use of the budget with measurable quantity and quality. Performance is the achievement of what is planned, both by individuals and organizations (Sularso and Restianto, 2011). Simply put, the performance of a person or organization is said to be good if the results achieved are by the planned target. If the achievement exceeds the goal, then the performance is supposed to be very good, whereas if it is lower than the target, then it can be said that its performance is poor.

Financial performance is a measure of performance that uses financial indicators. The fi-

financial performance analysis is mainly carried out to assess past performance by conducting various analyzes so that financial positions are obtained which represent the reality of the entity and the potential for performance that will continue. So based on these multiple understandings, performance emphasizes what results from the functions of a job. When further listened to what happens in a job is a process that processes input into output.

According to Halim (2008) financial analysis is an attempt to identify financial characteristics based on available reports. In government organizations to measure financial performance, there are several performance measures, including degrees of decentralization, financial dependence, local financial independence ratios, effectiveness ratios, efficiency ratios, harmony ratios, debt service coverage ratios, and growth. The use of ratio analysis as a tool for financial report has been widely applied to commercial institutions, but not in public institutions, especially local governments, which is still very limited. The limited presentation of financial statements to local governments is the nature and scope that are different from the financial statements by commercial companies. Also, the assessment of the success of the APBD as an assessment of the accountability of local financial management is emphasized more on achieving the target, so that it does not pay attention to how changes occur in the composition or structure of the APBD. So, in theory, there is no unanimous agreement on the name and rules of measurement in the ratio analysis of public sector organizations, especially the APBD. This study uses three (3) components of financial performance measurement, namely the degree of decentralization, local financial dependency ratio and the ratio of local financial independency.

Agency theory is used as the primary reference in this study to explain the conflict between the local government and the community represented by the Local Representative Council (DPRD), relating to local financial policies. Due to the different interests of the two parties who are bound in a contract where the government contract in addition to wanting to satisfy the principal also aims to maximize its benefits. The link between agency theory in this study can be seen through the relationship between the central government and local governments, and also the relationship between the community and the local government. The relationship between the community and the government is like the relationship between the principal and agent. The community represented by the DPRD is the principal, and the government is the agent. The agent is expected to take financial policies for the benefit of the principal. The principal has regulatory authority to the agent, and provides resources to agents in the form of taxes, levies, balancing funds, the results of local wealth management and other legitimate local revenues. The conflict of agency theory between principal (central government) and the agent (the local government) can be reduced with the PAD. The degree of decentralization is calculated based on the comparison between the amount of Local Original Revenue (PAD) and total local revenues. This ratio shows the degree of contribution of PAD to total local revenues. The implication is that the higher the contribution of PAD, the higher the capacity of local governments in implementing decentralization. Therefore, the first hypothesis is:

### **H<sub>1</sub>: PAD affects financial performance as measured by the degree of decentralization ratio**

Agency theory as one form of game theory, is a contractual model between two people (parties) or more, which explains the relationship between the agent (management of a business) and the principal (business owner). The principal is defined as the party who gives the mandate to another party called the agent, to be able to act on behalf of the agent. Jensen and Meckling (1976) say that the relationship between managers and owners is within the framework of agency relations. The owner gives trust and can ensure the managers. In maintaining the trust and ensuring the local government, the principle as central government may provide aid to local government in the form of financial grants. With the financial aid, it is expected that local government will perform better and become independent. Due to the gap between principle and agent, the principle will support the agent. It means that the agent may still depend on the principle. Thus, there is a financial dependence between the parties. The financial balance between the central and local governments is a system of government financing within the framework of a unitary state, which includes the financial divide between the central and local governments. Financial Balance between the Central and Local Governments is the basis for the implementation of local autonomy.

Sumawan and Sukartha (2016) argued that the increase in revenue from high local revenue each year also showed the top financial resources owned by the region. If the financial resources held can be utilized and managed optimally, they will reflect the performance of the local government. Government financial performance can be measured by how much the ability of local governments to explore the potential of the potential region to contribute to the growth of local revenue each year. The financial performance of local governments in this study was measured using the local income growth ratio. According to Halim (2008: 241), the proportion of income growth can show how much capacity the government has in the region to maintain or increase the growth of its opinions from one period to the next. The higher growth of local views and positive value each year indicates that the local government has been able to increase regional revenue growth. Local revenue growth has grown every year causing the local government to be able to meet all the needs of the region and give an indication that local finance has been able to be adequately managed by the local government. The financial dependence is calculated by comparing the amount of transfer income with total local revenue. The higher this ratio, the greater the local reliance on the central/provincial government. Therefore, the second hypothesis is:

**H<sub>2</sub>: PAD affects financial performance as measured by the ratio of the financial dependency ratio**

Many countries have adopted fiscal decentralization to improve their public sector performance. Fiscal policy making from centralization to decentralization make different consequences, per speed and to pursue reforms of economic, political and social goals in a country (Moges, 2013). Fiscal federalism presents a normative model that describes the central government as a wise interpreter of community aspirations, which provides direction in intergovernmental institutional rules to ensure that local government institutions act according to the wishes of the center assuming the intentions of all people). So the theory of fiscal federalism states that economic growth will be achieved by fiscal decentralization through the implementation of local autonomy where fiscal decentralization is the transfer of authority related to decision making to low-level governments (Akai and Sakata, 2002) which serves to improve the efficiency of the long-term public sector (Faridi, 2011). By implementing a decentralized government system, local governments will be pursued to increase their efforts to provide better public services in their regions (Suhardjanto et al., 2009).

Fiscal decentralization allows regions to be able to manage their financial capacity to develop in their area. The construction of various public sector facilities will lead to an increase in local income that has an impact on local economic growth (Suwandi & Tahar, 2015; Utomo, 2012). It is reflected in the implementation of decentralization /autonomy in this country which has entered the second decade. However, in general, economic development has not been able to improve the quality of life and elevate the level of welfare of local communities. The higher the local government generate local revenue, the higher the fiscal decentralization or financial independence.

The ratio of local financial independence (fiscal autonomy) shows the ability of the region to self-finance the activities of government, development, and service to the people who have paid taxes and retributions as a source of income needed by the district. The ratio of local financial independence reflects the dependence of the region on external funding sources. The higher the independence ratio means that the level of local reliance on external assistance. The independence ratio also illustrates the level of community participation in regional development. The higher the independence ratio, the higher community participation in paying local taxes and levies which are the main components of PAD. Therefore, the third hypothesis is:

**H<sub>3</sub>: PAD affects financial performance as measured by the ratio of the financial independency ratio**

## **RESEARCH METHODS**

This research is a quantitative approach. Partial Least Square (PLS) used to analyze data because the measurement scale is different. The descriptive qualitative approach in this study provides complete information so that it is useful for the development of science and more can be applied

to various problems. A descriptive qualitative approach in this study is to provide complete information on the results of research models that have not been answered statistically. The variables that will be used in this study consist of one independent variables, namely PAD and one dependent variable, namely financial performance. PAD is all revenues obtained from the region from sources within its territory which are collected based on local regulations by applicable statutory regulations.

The PAD formula is as follows:

$$\text{PAD} = \text{Local Tax} + \text{local Retribution} + \text{Results of Local Wealth Management Separated} + \text{Other Legitimate PAD} \dots\dots\dots (1)$$

The financial performance is measured with three components of local financial performance namely degrees of decentralization, local financial dependency ratios, and local financial independence ratios. Degree of decentralization shows the degree of PAD's contribution to total local revenues. The implication is that the higher the contribution of PAD, the higher the capacity of local governments in implementing decentralization. This ratio is calculated based on the comparison between the number of Original Local Revenues (PAD) and total local revenues. This ratio is formulated as follows:

$$\text{Degree of decentralization} = (\text{Local Original Revenue}) / (\text{Total Local Revenue}) \times 100\% \dots\dots (2)$$

Financial Dependency is the dependence of a region that shows local dependence on the central/provincial government. This ratio is calculated by comparing the amount of transfer income with total local income. The higher this ratio, the greater the local dependence on the central/provincial government. The following formula calculates financial dependency:

$$\text{Financial Dependency} = (\text{Transfer Revenue}) / (\text{Total Local Revenue}) \times 100\% \dots\dots\dots (3)$$

Financial Independence. The ratio of local financial independence (fiscal autonomy) shows the ability of the region to self-finance the activities of government, development, and service to the people who have paid taxes and retributions as a source of income needed by the region. The following formula calculates local financial independence:

$$\text{Financial Independency} = (\text{Local Original Revenue}) / (\text{Central} + \text{Provincial} + \text{Loan}) \times 100\% \dots\dots (4)$$

The population of this study is the PAD and financial performance of Lamongan Regency, ie all the data comprising the Local Financial Statements are budget, and the budget calculations and other supporting data from Lamongan District Government in 2010 until 2017. All populations were used as research samples. The type of data used is secondary data. Secondary data is a source of research data obtained by researchers indirectly through intermediary media in the form of evidence, records or historical reports arranged in published archives. The type and contribution of this study data are financial report data including Lapora and realization of the 2010-2015 APBD in Lamongan Regency so that the kind of data used is panel data. The data panel is a combination of time series data and cross-section data.

Data collection procedures are documentation/literature review methods. Documentation is a method of collecting data based on documents, literature studies, scientific journals, and other written reports that have to do with research variables, as well as references to literature related to the themes being researched and the nature of the data is quantitative data, namely data in the form of a number, and is objective.

The analysis technique in this study uses Structural Equation Modeling (SEM) with a variance based or component-based approach with Partial Least Square (PLS). According to Ghozali (2014: 7), PLS is an alternative approach that shifts from a covariance-based SEM approach to variance-based. Covariance-based SEM generally tests causality/theory while PLS is a more predictive model. Testing of the structural model (Inner Model) is done by looking at the R-square value which is a goodness-fit model test and the magnitude of the structure path coefficient.

The research model that will be used in the study is Partial Least Square (PLS). Analysis of this research data using Partial Least Square (PLS), assisted by SmartPLS software. Partial Least Square is structural equation analysis (SEM) which has a variant basis, and together can test measurement models and test structural models or predict a model (Jogiyanto, 2011). The path

analysis model of all latent variables in PLS consists of two stages, namely, describing the measurement model / outer model and the Goodness of fit. The measurement model shows the relationship of the latent variable with the indicator. The measurement model is measured by Convergent validity: describes the correlation between the construct and the indicator. The higher the construct, the better. Convergent validity is seen from the value of the outer loadings. The correlation is considered reasonable if the value of outer loadings is greater than 0.5.

Discriminant validity: describes the validity of the construct used in the study. The construct is considered valid if the AVE value is greater than 0.5.

Composite reliability: describes the feasibility of the construct used in the study. A good value of composite reliability has a value of 0.70. The goodness of fit describes the variability of the latent variables in the research model. The goodness of fit value is obtained from the coefficient of determination ( $R^2$ ).  $R^2$  is a measure of the degree of variability in changes in exogenous variables to endogenous variables.

## RESULTS AND DISCUSSION

### Results

#### Data Analysis Results

Figure 1 shows that first, PAD has a direct effect on the degree of decentralization is 0.98 and is significant with a significance value of  $p = 0.01$ .  $R^2$  value of 0.96 shows the PAD variable can explain a decentralized degree ratio variable of 96%. Second, PAD directly affects the financial dependency ratio is 0.87 and is significant with a significance value of  $p = 0.01$ .  $R^2$  value of 0.96 shows the PAD variable can explain the variable financial dependency ratio of 76%. Third, PAD directly influence the independence ratio 0.98 and significant with significance value  $p = 0.01$ .  $R^2$  value of 0.97 shows the PAD variable can explain the independence ratio variable of 97%. Thus, PAD affects the three components of the financial performance of which is measured by the degree of decentralization, the ratio of local financial dependency and ratio of local financial independence in the framework of financial management transparent, effective, efficient and accountable.

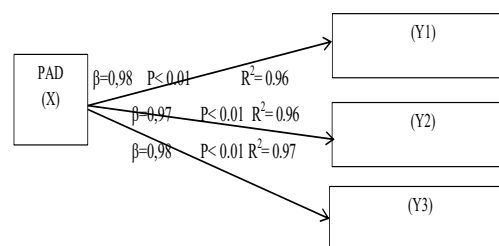


Figure 1. Statistical test results using warpPLS

### Discussion

#### *The effect of PAD on financial performance as measured by the degree of decentralization ratio*

Table 1 shows the financial performance in Lamongan district regency, East Java. The ratio of the degree of decentralization shows the contribution of PAD to total local revenues. In 2010-2015, it was seen that the rate of decentralization degree in Lamongan Regency was still fluctuating where the ratio of the highest degree of decentralization in 2017 was 16%, and the lowest in 2011 was 8%. The implication is that the higher the contribution of PAD, the higher the capacity of local governments in implementing decentralization. Based on the increase in the degree of decentralization ratio over the past 5 (five) years shows that the ability of Lamongan Regency to run local autonomy has decreased with an average rate of 12% which shows the role/contribution of local revenue in financial funding in Lamongan Regency in the aggregate.

As indicated by the agency theory, the relationship between the community and the government is like the relationship between the principal and agent. The community represented by the DPRD is the principal, and the government is the agent. The agent is expected to take financial policies for the benefit of the principal. When the local government as an agent can manage their financial resource for the growth of the local community, then local government has succeeded in managing their local autonomy. Hence, the higher the PAD, the degree of decentralization will be higher too.

**Table 1. Average growth of local financial performance**

Year	Degree of decentralization	Financial dependency ratio	Financial independency	Growth Ratio
2010	0.09	0.70	0.13	0.34
2011	0.08	0.65	0.12	0.04
2012	0.09	0.68	0.13	0.23
2013	0.10	0.68	0.14	0.20
2014	0.14	0.61	0.23	0.41
2015	0.13	0.54	0.24	0.15
2016	0.15	0.63	0.24	0.20
2017	0.16	0.59	0.27	0.06
<b>Mean</b>	<b>0.12</b>	<b>0.64</b>	<b>0,19</b>	<b>0.20</b>

*The effect of PAD on financial performance as measured by the financial dependency ratio*

This Local Dependency Ratio shows local dependence on the central/provincial government. In 2010-2017, the financial dependency ratio in Lamongan was still fluctuating, with the highest financial dependency ratio in 2010 at 70% and the lowest in 2015 at 54%. The implication is that the higher this ratio, the lower the local dependence on the central/provincial government. Based on fluctuations in the financial dependency ratio for eight last years, those who tend to experience association indicate that community participation to actively participate in building their regions is quite good. Even though, the average ratio of financial dependence on the central government is still likely to be high with a value of 64%.

*The effect of PAD on financial performance as measured by the financial independency ratio*

The ratio of local financial independence (fiscal autonomy) shows the ability of the region to self-finance the activities of government, development, and service to the people who have paid taxes and retributions as a source of income needed by the region. In the years 2010-2017 seen the condition of financial independence ratio Lamongan still fluctuated in which the financial independence ratio in 2017 was highest of 27% and the lowest in the year 2011 of 12 %. This means that based on the fluctuations in the financial independence ratio for the last 8 (eight) years which tends to increase indicates that it can continue to improve its ability to self-finance the activities of the Lamongan Regency government, although the average value is still quite low at 19% and the tendency is instructive (the ratio financial independency below 25%).

So the strategy and direction of the policy to achieve the development goals and objectives have been set out in the previous Lamongan District Medium Term Development Plan. This amendment RPJMD continues the strategy and direction of the predetermined policy which in its implementation has just completed the first year of 2016. The RPJMD of this change continues the strategy and policy direction in the following years 2017 to 2021. Policy direction to help District Government Lamongan in choosing the focus of development from time to time over the next five years. The policies include 1) Strengthening basic facilities and infrastructure based on the environment, 2) Enhancing the quality of superior and competent human resources, and 3) Economic

stabilization and local independence through the development of local potential and excellent products

## CONCLUSION

PAD affects the three components of financial performance areas measured by the degree of decentralization, the ratio of financial dependency area and the ratio of local financial independence that is transparent, effective, efficient and accountable in Lamongan. Growth ratio is used to determine the level of PAD growth and local revenue growth. In 2010-2017, it was seen that the Lamongan Regency PAD growth ratio was still fluctuating, with the highest PAD growth ratio in 2014 at 41% and the lowest in 2011 at 4%. That is based on fluctuations in the proportion of revenue growth for 8 (eight) years with an average value of 20% government Lamongan can maintain and improve the success achieved and have been effective in doing excavation source - a source of local revenue. Then hal that needs to be improved is the intensification and extensification of local revenues and the simplification of collection procedures combined with the implementation of effective sanctions and control and supervision.

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