

Firm Diversification, Profit Management and Capital Structure: An Indonesian Study

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This study aims to identify and analyse the effect of corporate diversification strategies and earnings management on capital structure. In this study, manufacturing companies listed on the Indonesian Stock Exchange during 2012-2016 were examined. Based on the specified population criteria, this study analysed 250 companies through purposive sampling method using the SPSS22 statistic tool. The results of this study concluded that a firm's 'earnings management' has a significant effect on their capital structure.

Key words: *Corporate Diversification, Earnings Management, Capital Structure.*

Introduction

Free trade between countries both within the APEC and MEA regions makes it easier for foreign companies to distribute their products on the Indonesian market. This condition challenges Indonesian companies to compete with international companies in an increasingly competitive business. Companies in Indonesia are generally required to make a significant amount of investment. The investment can come from either capital or debt. Debt is one of the compositions of capital structure. Niu (2008) states that the capital structure is a combination of corporate debt and corporate equity. The decisions taken by using funding sources in the form of debt may have an impact on the principal costs of debt and interest costs that must be borne by the company. If the investment made by the company is not profitable, while the company must pay the loan principal and interest expense in debt, the company will experience financial distress. However, if the company can optimise its debt or can put its debt in the right investment, the company will be more stable and able to compete increasingly competitively. Decision making in the capital structure is essential and very crucial for the company, so the right strategies for investing are needed. One of the strategy is diversification by the company.

Lewellen (1971) argues that product diversification and leverage has a positive effect. Accordingly, Sigh et al. (2003) argue that product diversification is negatively related to firm

leverage. Assuming, diversifying companies make it possible to achieve higher levels of profit. Product diversification can reduce the level of corporate debt. Ajay (2015), in his research, states that between diversification and capital structure, there is a significant relationship. When the company gets high profits from diversification activities, it can control the company's loan capacity or debt capacity. Alonso (2003) found evidence that there was no significant relationship between a company's diversification strategy and a company's capital structure. In Alonso's (2003) research, consideration of the characteristics of company size, profitability, business risk, company growth, and company fixed assets are the control variables.

In addition to the diversification strategy employed by the company, another variable that affects the capital structure is 'earnings management'. This is supported by opinions raised by Trueman and Titman (1988) who say that companies use income equity techniques as an effort to get loans from creditors. The technique is carried out so that the company is assessed in good condition to be given a loan. Earnings equity technique is one of the patterns in earnings management that can affect the company's debt capacity which is the composition of capital structure. Scott (2009: 403), suggests earnings management is the choice of accounting policies made by managers to achieve goals that can later have an impact on the behaviour of looking for profit for the benefit of the company or for themselves. In Statement No. 1 of Financial Accounting Concept (SFAC) earnings information is the main concern and useful for estimating the performance and accountability of management. In order for performance to be assessed in a good position, managers tend to practice earnings management. The effect of earnings management on capital structure can be seen. When a company increases its profit, the level of leverage in the capital structure will increase. One of the motives of companies is to increase profits and so they will want to ensure that they are valued and seen in a good position to gain loans from creditors. Meanwhile, when companies reduce profits, in general, the motive is to avoid high tax burdens.

Some researchers examined the effect of earnings management on capital structure. Dichev et al. (2013) propose companies tend to manage earnings by issuing discretionary expenses. This reduction in discretionary expenses results in higher income. This comparison is considered by the creditors to value a company before issuing debt. The capacity of the debt can affect the company's capital structure. Ghosh and Moon (2010) stated that companies may tend to avoid reporting losses to access higher debt financing. The company must be in good condition to be considered by creditors for funds. Besides, Chung et al. (2005) found a negative relationship between debt and earnings management. When the company receives debt from the creditor, its activities will be controlled by them. This control may reduce the earnings from management practices. Ajay (2015) offers that earnings management has a significant effect on capital structure. The ups and downs of the value of earnings management by the company affect the debt capacity. S. Minabari et al. (2018) said that there was no significant effect

between earnings management on capital structure. This means that earnings management activities do not affect the level of leverage in the company's capital structure.

Previous research conducted by other researchers including Lewellen (1971), Sigh (2003), Ajay (2015), Alonso (2003), Trueman and Titman (1988), Dichev (2013), Ghosh and Moon (2010), Chung (2005), and Minabari (2018), have produced inconclusive results. It is interesting for us, the researchers to re-examine in this study how the influence of diversification is carried out by companies, namely product diversification and earnings management, and how this might have an effect on a company's capital structure. Researchers in this study focus on research on manufacturing companies listed on the Indonesian Stock Exchange as research subjects. The issue of free trade is very influential on the existence of manufacturing companies in Indonesia. In which case, manufacturing companies in Indonesia requires sufficient funds to be able to diversify. On the issue of free trade, the competition will be tighter. Companies should perform well and be in good condition to obtain financing more easily. This condition pushes some companies to do 'earnings management'.

The remainder of this paper is structured as follows: Section 2 develops the research hypotheses, Section 3 describes the sample and variables, Section 4 specifies the empirical result, and finally Section 5 summarises the paper and presents our concluding remarks.

Theoretical Base and Hypothesis Development

Corporate Diversification and Capital Structure

Niu (2008) defines a capital structure as a combination of debt and equity in a business' financing. Decision-making in the capital structure is essential and very crucial for the company, therefore effective investing strategies are needed. One of these strategies is the diversification of the company. Harto (2005) explained that diversification is a business development strategy carried out by developing the number of segments to be more diverse in at least two business segments. Another variable that affects capital structure is earnings management. Scott (2009: 403) argues that earnings management is the choice of accounting policies made by managers to achieve their specific earnings objectives. This decision will later have an impact on firm profit behaviour. The effect between firm diversification and capital structure can be seen through the pecking order theory. Companies tend to choose internal funding sources rather than external funding sources. In this research, companies that carry out diversification strategies require a large amount of capital. If internal funding is not enough, the most important source of external financing is debt. Debt carries a lower risk or flotation cost than other external funding sources. The size of the level of debt (leverage) will affect the company's capital structure.

Based on agency theory, there is a conflict of interest between the principal and the agent. When a company gets a high profit, the management will use the profit to invest in activities that benefit the company, for example, diversification. While the principals in high-profit conditions expect the return of resources that have been issued, adjusting the interests of the principal and the agent requires proper contract planning. So that the agent acts according to or by considering the interests of the principal. Ajay (2015) said that company diversification has a significant effect on the capital structure in relation to controlling the company's debt capacity. When the company gets high profits from diversification activities carried out by the company, this will affect the company's debt capacity on the company's capital structure. Based on the explanation above, the hypothesis proposed is as follows:

H1: There is a relationship between firm diversification and capital structure.

Earnings Management and Capital Structure

Based on the pecking order theory, there are two sources of funding, namely internal funding sources and external funding sources. The most used external funding source is debt. Debt carries a smaller risk or flotation cost compared to other external funding sources. When companies want to use debt, the management will try as much as possible to manage their earnings. Decisions in earnings management will affect the company's capital structure. Earnings management is very vulnerable to manipulation actions carried out by agents (management). This manipulation may lead to agency problems. A contract can be made between the agent and the principal to minimise agency problems. The agent will act under the interests of the principal. Based on research conducted by Ajay (2015), earnings management has a significant effect on capital structure. This statement means that the activities of earnings management will affect the capacity of the company's debt in the capital structure. Based on the explanation above, the hypothesis proposed is as follows:

H2: There is a relationship between earnings management and capital structure

Research Methodology

Independent Variables

Firm Diversification

In this research, firm diversification is measured using the Herfindahl Index method, which refers to measurements made by Jacquemin and Berry (1979). The measurement method used is as follows:

$$H = 1 - \sum_{i=1}^n P_i^2$$

Description

P_i = Segment sales
 n = Number of segmen

A value of 1 (one) on the results of the Herfindahl Index calculation indicates that the company runs a not diversified business segment. However, if the results of the calculation produce a number <1 or 0, it indicates that the company runs two or more business segments or it can be said that the company is diversified.

Earnings Management

In this study, earnings management is measured using a formula by Jones (1991) and Dechow et al (1995). Jones (1991) explains the accrual-based model is one model that uses discretionary accruals to measure the earnings management.

The steps taken to measure earnings management are as follows:

1. Calculate total accruals using the cash flow approach, using the following formula:

$$TA^{it} = NI^{it} - CFO^{it}$$

2. Determine the coefficient of total accrual regression.

Discretionary accruals represent the difference between total accruals (TA) and non-discretionary accruals (NDA). The initial step to determine non-discretionary accruals is to regress the following equation:

$$TA^{it}/A^{it-1} = \alpha(1/A^{it-1}) + \beta_1((\Delta REV^{it}/A^{it-1}) + \beta_2(PPE^{it}/A^{it-1}) + e$$

3. Determine the *non-discretionary accrual*.

The regression performed in (2) produces the coefficients α , β_1 , and β_2 . The coefficients α , β_1 , and β_2 are then used to measure nondiscretionary accruals through the following equation:

$$NDA^{it} = \alpha'(1/A^{it-1}) + \beta_1'((\Delta REV^{it}-\Delta REC^{it})/A^{it-1}) + \beta_2'(PPE^{it}/A^{it-1}) + e$$

4. Determine the *discretionary accrual*.

After obtaining nondiscretionary accrual accruals, then discretionary accruals can be calculated by subtracting total accruals (calculation results in number 1) with nondiscretionary accruals (calculation results in number 3). Discretionary accruals (DA) or discretionary accruals can be calculated as follows:

$$DA^{it} = TA^{it} / A^{it-1} - NDA^{it}$$

Description

NI^{it} = *Net Income* of the company *i* in period *t*

CFO^{it} = Cash flows from operating activities of the company *i* in period *t*

TA^{it} = Total accrual of company *i* in period *t*

NDA^{it} = *Nondiscretionary accrual* of company *i* in period *t*

DA^{it} = *Discretionary accrual* of company *i* in period *t*

ΔREV^{it} = Income Changes of company *i* years between *t* and *t-1*

ΔREC^{it} = Change in accounts receivable of company *i* year between *t* and *t-1*

PPE^{it} = PPE of company *i* year between *t* and *t-1*

ROA^{it} = Net income year *t* divided by total assets year *t-1*

A^{it-1} = Total assets of company *i* at the end of year *t-1*

α , β_1 , β_2 = Regression coefficient

Discretionary accruals that produce positive values indicate that the company performs earnings management by increasing its profits. Discretionary accruals that provide negative values indicate that the company conducts earnings management by lowering its earnings. The absolute value of discretionary accruals is used to see overall earnings management in this study (Baccouche et al., 2013).

Dependent Variable

Capital Structure

In this study capital structure is measured by the Leverage Ratio (LEV) which refers to the research conducted by Bhaduri (2002). That is the ratio of the amount of the company's debt to the total assets of the company. Leverage Ratio is measured by the following formula:

$$LEV = \text{Total Debt} / \text{Total Asset}$$



Control variable

Firm Size

Firm size is measured using natural logarithms of total asset. Koh (2003), Harymawan et al. (2019), Haliah (2015), Syarifuddin (2019) use this formula in their research, as follows:

$$\text{Firm Size (I,t)} = \text{Ln (Total Asset)(i,t)}$$

Profitability

This research uses the formula used by Bhaduri (2002) in his research:

$$\text{ROA} = \text{Earning before tax (EBIT)/Total asset}$$

Firm Age

In this study firm age is measured by a formula that refers to research conducted by Plaffermayr et al. (2008), Zulfikar et al. (2019), Sofiyah et al. (2019), and Fawzeeah et al. (2019), as follows:

$$\text{Age(I,t)} = \text{age of the company since operating(I,t)}$$

Tangibility

In this study, tangibility is measured by the formula used by Cakraborty (2010), as follows:

$$\text{Tangibility} = \text{Fixed Asset/total asset}$$

Sample Distribution

Table 1: Firm Sample Characteristics

No	Description	Year				
		2012	2013	2014	2015	2016
1	Manufacturing companies listed on the Indonesia Stock Exchange for the period 2012-2016	128	128	128	128	128
2	Manufacturing companies listed on the Indonesia Stock Exchange that present their financial statements in currencies other than rupiah	(16)	(16)	(16)	(16)	(16)
3	Manufacturing companies listed on the Indonesia Stock Exchange only have one business segment and do not have segment financial statements	(59)	(59)	(59)	(59)	(59)
4	Manufacturing companies listed on the Indonesia Stock Exchange do not present the data needed in research	(3)	(3)	(3)	(3)	(3)
	Total	50	50	50	50	50
	Total Sample	250				

Data Analysis Technique

This study uses multiple linear regression data analysis techniques because there are two independent variables that affect the dependent variable. The aim is to determine the effect of two independent variables, namely company diversification and earnings management, on the dependent variable, namely capital structure. The form of the regression equation in this study is as follows:

$$CS_{it} = \alpha + \beta_1 DIVER_{it} + \beta_2 EARNINGS\ MANAGEMENT_{it} + \beta_3 \ln(SIZE_{it}) + \beta_4 ROA_{it} + \beta_5 USIA_{it} + \beta_6 TANG_{it} + e$$

Description

CS	: Capital Structure
β_1, \dots, β_n	: Regression Coefficient
DIVER	: Firm Diversification
EARNINGS MANAGEMENT	: Earnings Management
Ln	: Firm Size
ROA _{it}	: Profitability
AGE	: Firm Age
TANG	: Tangibility
e	: Residual Error

Results and Discussion

Description of Research Results

Of the variables used in this study, the independent variables are company diversification (DIVER), and earnings management (EARNINGS MANAGEMENT). The control variables are company size (SIZE), profitability (ROA), company age (AGES), and tangibility (TANG). The dependent variable is the capital structure (CS). Based on the results of the study, it can be seen that the minimum, maximum, the average values of each variable, and the standard deviation of the companies sampled from 2012 to 2016 are presented in Table 4.1 as follows:

Table 4.1: Descriptive Test Result

	N	Min	Max	Mean	Std. Deviation
CS	250	.0786	1.5711	.478702	.2223244
DIVER	250	.0000	.7106	.425869	.2004276
EARNINGS MANAGEMENT	250	.0001	.4385	.056338	.0573295
SIZE	250	25.2767	33.1988	28.419345	1.6491607
ROA	250	-.2456	.5635	.080343	.1125807
AGE	250	3	83	34.08	13.598
TANG	250	.0115	.8431	.372162	.1924394
Valid N (listwise)	250				

Analysis of Multiple Linear Regression Models

The multiple linear regression analysis model aims to examine the effect of the independent variables, namely company diversification and earnings management, and the control variables, namely company size, profitability, company age and tangibility to the dependent variable, that is capital structure measured using leverage ratios. The following table is the result of the multiple linear regression analysis model:

Table 4.2: Multiple linear regression analysis results

Model		Unstandardized Coefficients		T	Sig.	Conclusion
		B	Std. Error			
1	(Constant)	-.298	.224	-1.332	.184	
	Diver	-.048	.063	-.761	.448	Not Significant
	Earnings Management	.866	.222	3.909	.000	Significant
	Size	.025	.008	3.059	.002	Significant
	ROA	-.822	.121	-6.803	.000	Significant
	Age	.002	.001	1.827	.069	Significant
	Tang	.121	.068	1.780	.076	Significant

Note: a significance level of 10%

Table 4.2 is based on the summary results of the multiple linear regression analysis models in Table 4.5. It shows the relationship between each independent variable on the company's capital structure. Following is the interpretation of the table above:

1. The value of the constant (intercept) of -0.298, means that if all the independent variables used do not change (constant), then the company's capital structure will decrease by -0.298 due to other variables outside this study.
2. The firm diversification variable has a regression coefficient of -0.048, which means that if the diversification of the company increases by one unit, the capital structure variable will decrease by -0.048 and vice versa, assuming other variables are constant.
3. Variable earnings management with a regression coefficient of 0.866 can be interpreted if the value of earnings management increases by one unit. The amount of capital structure will also increase by 0.866 assuming other variables are constant.
4. The company size variable has a regression coefficient of 0.025, which means that if the firm size variable increases by one unit, the capital structure variable will increase by 0.025 and vice versa, assuming the other variables are constant.
5. The profitability variable (ROA) has a regression coefficient of -0.822. This means that if the profitability variable increases by one unit, then the capital structure will decrease by -0.822 and vice versa, assuming the other variables are constant.
6. The age variable of the company (AGES) has a regression coefficient of 0.002. This means that if the company's age variable increases by one unit, the capital structure will increase by 0.002 and vice versa assuming other variables are constant.
7. The tangibility variable has a regression coefficient of 0.121, which means that if the tangibility variable increases by one unit, the capital structure variable will increase by 0.121 and vice versa assuming other variables are constant.

After interpreting the regression coefficient, hypothesis testing can then be performed. Hypothesis testing is done by looking at the value of the t-test that aims to determine the effect of independent variables on the dependent variable partially. The following interpretations of the t-test value are as follows:

1. The t-test value of the company's diversification variable is -0.761 with a significance level of 0.448. This significance value is higher than 0.10, so it can be concluded that company diversification has no effect on capital structure. Thus, the hypothesis in this study was not accepted.
2. The t-value of the earnings management variable is 3.909, with a significance level of 0.000. This significance value is smaller than 0.10, so it can be concluded that earnings management affects the capital structure. Thus the hypothesis in this study is accepted.
3. The t-test value of the firm size variable (SIZE) is 3.059, with a significance level of 0.002. This significance value is smaller than 0.10, so it can be concluded that the size of the company affects the capital structure.
4. The value of the t-test of profitability variable (ROA) is -6.803, with a significance level of 0.000. This significance value is smaller than 0.10 so it can be concluded that profitability affects the capital structure.
5. The value of the t-test for the age variable of the company (AGES) is 1.827 with a significance level of 0.069. This significance value is smaller than 0.10 so it can be concluded that the age of the company affects the capital structure.
6. The T-value of the variable tangibility test (TANG) is 1.780, with a significance level of 0.076. This significance value is smaller than 0.10, so it can be concluded that tangibility affects the capital structure.

Discussion and Analysis

The Effect of Corporate Diversification on Capital Structure

Corporate diversification is a strategy carried out by a company by expanding business segments that are managed and owned. To be able to carry out this strategy, the company generally requires funds that are not small. The size of these funds affect the company's capital structure. The Herfindahl Index method is used to find out how big the company is diversified, then measures the company's capital structure by using leverage ratios to see how much the company's debt is financing investments in company assets.

Based on the agency theory between management and the principal, there is a conflict of interest that affects the formation of the company's capital structure. When a company gets a high profit, the management will use the profit to invest in activities that are beneficial to the company, including the diversification strategy. Besides, the principals tend to expect higher profit sharing when the company gets profits under the assumptions of human nature described

by Einsenhart (1989), namely self-interest. Based on the pecking order theory, if the company wants to carry out a diversification strategy, the company generally requires a lot of funds. When the company is in a less profitable condition, the company uses an external funding source, namely debt first, where debt is one of the compositions of the company's capital structure.

The results of this study indicate that there is no relationship between a company's diversification strategy on the firm's capital structure. Firms which do finance diversification tend to use internal funding sources rather than external funding sources. This is because the company's profits are sufficient to diversify using internal funding sources. The results of this study are in line with the results of research conducted by Alonso (2003) who found evidence that there was no significant relationship between company diversification and capital structure. However, this research contradicts the research conducted by Ajay (2015). The research he conducted provided evidence that company diversification has a significant effect on capital structure.

Earnings Management and Capital Structure

Earnings management is one kind of accounting policy chosen by managers to achieve goals that can later have an impact on self-seeking behaviour (Nimisha, 2019; Agustia et al., 2020; Agustia et al., 2019). To see the effect of earnings management on the company's capital structure the modified Jones formula is used to measure earnings management carried out by the company. Then use the leverage ratio to see the effect of earnings management on the company's capital structure.

Based on agency theory, agency conflicts arise as a result of earnings management actions that are generally carried out by management. The size of the earnings management carried out by the management affects the firm's capital structure. In this study, earnings management has a significantly positive effect on capital structure. It can be concluded that the size of earnings management carried out by management affects the debt and principal capital which is the composition of the capital structure.

Based on the pecking order theory, the ups and downs of earnings management carried out by the company affect the debt received by the company where the debt is a composition of the capital structure. If the company increases the intensity of its earnings management, the creditors assume the company is in a safe position to be given a loan because with the profit the company can return the investment. But when the company decreases the intensity of its earnings management, the creditors assume that the company is in a precarious position to be given a loan.

The results show the relationship between earnings management and the firm's capital structure. The ups and downs of profits due to earnings management affect the level of corporate debt, which is the composition of the capital structure. These results are consistent with research conducted by Ajay (2015) who found that earnings management has a significant influence on capital structure.

Research Limitation

In conducting research, researchers experience several limitations. This limitation can be used as a consideration in subsequent research. Limitations in this study are as follows:

1. This research focuses on product diversification and does not consider market diversification. That is because researchers want to know the effect of the company's diversification strategy on capital structure carried out with the diversification strategy in product segments not in geographical segments.
2. This research in measuring its diversification does not distinguish between related and unrelated diversification. This is because in distinguishing between related and unrelated, the evidence is not concrete if it is done by looking at segment information only. So that the evidence is obtained concretely, researchers are advised to go directly to the relevant company.
3. There is quite a lot of data released in this study because the criteria are determined based on the purposive sampling method. This research determines the research data by balancing the research data, meaning that the research data must be available throughout the observation year. If in one year of observations the data is not found then the data is not included in the research data.

Conclusion

Based on the formulation of the problems and discussions in previous chapters, it can be concluded that company diversification does not significantly affect the company's capital structure. This is because the sample companies generally finance their diversification activities, not using external funding sources in the form of debt which is a composition of the capital structure, but rather through profits or internal funding sources, while the earnings management has a significant effect on the company's capital structure. The ups and downs of earnings management intensity carried out by management affect a company's capital structure. Based on the research results obtained, the suggestion for future research is that given this study does not consider the variability of market diversification as an observation variable, future research do so. It is expected that in future research, the market diversification variable be considered. For future research, another measurement method that is different from this study can be used. This research does not examine the effect of corporate diversification strategy and earnings management on the company's capital structure simultaneously. It is



expected that future research can test the variable of corporate diversification and earnings management on the company's capital structure simultaneously. In this study, the capital structure variable is more focussed on the composition of debt. It is expected that future research on capital structure variables analyse throughout its composition.

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