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INSIGHT Journal focuses on social science and humanities research. The main aim of INSIGHT Journal is to provide an intellectual forum for the publication and dissemination of original work that contributes to the understanding of the main and related disciplines of the following areas: Accounting, Business Management, Law, Information Management, Administrative Science and Policy Studies, Language Studies, Islamic Studies and Education.

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TABLE OF CONTENTS

Foreword by Deputy Rector of Research, Industrial Linkages & Alumni i

Paper Title	Page
The Usefulness of Action-Oriented Simulation Accounting Package (ASAP) as a Tool to Develop Skills	1
The Influence of Firm-specific Attributes on Corporate Social Responsibility Disclosure	7
An Analysis on Accounting Students Involvement in Education Hub to Community Program: Student Facilitators' Voice	20
Influence of Whistle Blowing on Unethical Behaviour in Jabatan Kastam Diraja Malaysia (JKDM)	27
Influence of Human Resources, Government Internal Control System, And Information Technology Utilization on Financial Statement Quality of Bengkulu City Government's	43
The Impact of Consumption Values towards Intention to visit Green Hotel in Malaysia	50
Beneficial Usage of Social Marketing for Small and Medium-Sized Enterprise (SME) in Johor	61
Factors Affecting Accounting Student's Interest in Pursuing Careers at Sharia Financial Institutions	71
An Integrated Accountability Reporting Model of Non-Profit Organisations (NPOs)	83
Performance in Organisational Behaviour: Strength of Work Discipline and Employee External Motivation	93
Debt Monitoring Mechanism in SOE's: Evidence from Indonesia	105
A Study on Consumer's Attitude Towards Viral Advertising on Social Media: A Case Study in An Ice Cream Manufacturing Company	113
Analysis of Sharia Accounting Implementation in Bmt (Baitul Maal wat Tamwil) Alif Yogyakarta	126
The Impact of Business Ethics Behaviour on the Customers' Loyalty in Beauty Industry among University Students' in Malaysia	138
Fraudulent Financial Reporting Trough Financial Ratios: Case of Banking Sector in Indonesia	143
Cultural Effects, Work Propriety and Values in Perspective Trust Level in The Ministry of Education and Culture	154

Workload, Job Control, Work Relationship, and Work-Related Stress among employees in Sungai Buloh, Malaysia	168
The Impact of Diversification Strategy, Leverage, IOS on Real Earnings Management	177
Driver and Inhibitor of Organic Food Adoption: A Study on Indonesian Consumers	192
Impact of Brand Awareness, Brand Equity and Brand Slogan towards Product Advertisement: A Case Study in Advertising Industry	199
Earning Response Coefficient: The Indonesia Stock Exchange Case	208
Customer Loyalty on Sharia Banking: The Effect of Brand Image and Customer Value	226
Financial Accountability and Budgeting of Waqf Institution in Malaysia	233
Contributing Factors Affecting Job Performance at Private Hospitals in Southern Region of Malaysia	241
Factors Affecting Attitudes towards Fruits and Vegetables Consumption on YouTube: A Conceptual Paper	249
The Effect of Knowledge Management Practices on Employee Well-being in Malaysian Private Universities	258
Analysis of Reputation Effect, Attractiveness of Advertising and Community Effects on Positive Word of Mouth with Variable Intervening Customer Values on Users of GSM-Based Cellular Cards in Palembang City	270
Halal Literacy and Halal Product Purchase Dimension: A Preliminary Study	277

FOREWORD BY DEPUTY RECTOR OF RESEARCH, INDUSTRIAL LINKAGES & ALUMNI



Since 2018, the INSIGHT JOURNAL (IJ) from Universiti Teknologi MARA Cawangan Johor has come up with several biennial publications. Volume 1 and 2 debuted in 2018, followed by Volume 3 this year as well as Volume 4 with 19 published papers due to the great response from authors both in and out of UiTM. Through Insight Journal, lecturers have the ability to publish their research articles and opportunity to share their academic findings. Insight Journal is indexed in MyJurnal MCC and abstracted in Asian Digital Library (ADL). Moreover, it is also an international refereed journal with many international reviewers from prestigious universities appointed as

its editorial review board members.

This Volume 6 is the second special issue for the 6th International Accounting and Business Conference (IABC) 2019 held at Indonesia Banking School, Jakarta. The conference was jointly organized by the Universiti Teknologi MARA Cawangan Johor and the Indonesia Banking School Jakarta. Hence, this volume focuses mainly on the accounting and business research papers compiled from this conference, which was considered a huge success as over 66 full papers were presented.

Lastly, I would like to thank the Rector of UiTM Johor, Associate Professor Dr. Ahmad Naqiyuddin Bakar for his distinctive support, IJ Managing Editor for this issue Dr. Noriah Ismail, IJ Assistant Managing Editor, Fazdillah Md Kassim well as all the reviewers and editors who have contributed in the publication of this special issue.

Thank you.

ASSOCIATE PROFESSOR DR. SAUNAH ZAINON
Deputy Rector of Research, Industrial Linkages & Alumni
Editor-in-Chief for INSIGHT Journal
Universiti Teknologi MARA Cawangan Johor

The Impact of Diversification Strategy, Leverage, IOS on Real Earnings Management

Dr. MF Christiningrum, Ak., CA.

Faculty of Economic, Institut Bisnis Nusantara
Jakarta, Indonesia
christiningrum@ibn.ac.id

Abstract

This study examines the impact of diversification strategies, the level of use of debt (leverage) and the investment opportunity set (IOS) on the performance and earnings quality of diversified firms. Earnings quality is measured by real earnings management. Diversification level is measured by Herfindahl index and number of corporate segments. The diversification strategies in this study are divided into 2 groups, namely related and unrelated diversification. Samples of this study are 120 multi-segment companies (1,320 firm years) listed in Indonesia Stock Exchange for an 11-year period from 2002 to 2012. The results of the study also find that multi-segment strategy affect positively real earnings transactions (via discretionary costs of production and abnormal operating cash flow). The option to perform transactions in real earnings management is significantly influenced by the increase in the number of segments and the level of debts as well as the use of investment opportunities set (IOS).

Keywords: Diversification Strategies, Leverage, Investment Opportunity Set.

1. Introduction

1.1 Background

In Indonesia, there are growing numbers of large corporations that choose to implement multi-segment strategy. This strategy can be executed through internal growth with business expansion and common use of asset, while external growth is executed through merger and acquisition. Xia (2007) reckoned that internal corporate growth can give a more positive impact in comparison to relying on external growth through mergers and acquisitions. Research by Munter (1999), Thomas (2002), Lim (2007) as well as Perez and Hemmen (2010) showed that managers tend to be more aggressive in performing earnings management on diversified companies. It is suspected the aggressiveness was caused by the creation of internal capital market without the obligations to respect debt covenant. Also, resource misallocations and poor selection of investment with positive NPV also triggers earnings management (Stulz, 1990; Matsusaka and Nanda, 2002; McNichols and Stubben, 2008). Earnings management can be performed through accruals and real transactions (Roychowdhury, 2006; Zang 2007 dan Cohen *et al.*, 2008). This research will study earnings management performed through real transactions. Based on the studies above, it is interesting to know further whether multi-segment diversification strategy increase real transactions earnings management.

1.2 Research Questions

Research question that will be studied, based on the background above is as follow: “Is diversification strategy (multi-segment), both related and unrelated, leverage, and companies investment opportunity set affecting on real transactions earnings management on public companies in Indonesia?”

2. Literature Review

2.1 Diversification

Diversification is one of many strategies to compete in business environment. Diversified companies are corporations that has many business segments (multi-segmented) or conglomerations. Business expansion is done through creation of strategic business units (SBU) or subsidiaries, both in similar business line or different line of business with its core. Business line or business segment that are similar with the core business is classified into related segments, and if they are very different from their core business, such segmented are classified into unrelated segments (Palepu, 1985; Mohindru *et al.*, 2007).

2.2 Agency Theory

According to Jensen and Meckling (1976), corporation is a nexus of contract between principals and agents. In the said contract, principals delegated authority of managing the corporation to agents, and agents receive rewards upon their service. The end result expected by the principals is maximisation of corporate values which leads to the ability of companies to maintain their sustainable growth.

2.3 Earnings Management

Earnings management are activities performed by management in choosing transactions recording activities through common accounting treatment for a specific objective (Belkoui *et al.*, 2006). Scott (2012) stated that the objective of earnings management practices are based on bonus motivation, debt covenant, tax, CEO turnover, IPO, and financial statement publication specifically for investors. Based on earlier researches, earnings management can be performed through accrual discretions (Dechow and Skinner, 2000) and real transactions (Roychowdhury, 2006; Cohen *et al.*, 2008; Zang, 2007). This research use one category of earnings management measurement, which is corporates' real transactions activities. Real transactions earnings management are defined by Roychowdhury (2006) as deviation in normal corporate operating activities, performed by management to emit misleading information to various stakeholders, as well as giving the impression that the objective of financial reporting has been achieved through normal corporate operational activities. Real transactions earnings management are performed through real corporation activities manipulation (Roychowdhury, 2006) to alter the reported earnings through time adjustments and corporate scale of operation in their business activities. Manipulations can be performed through sales discounting to achieve annual sales target, overproduction to reduce production cost, as well as

reduction of discretionary expenses such as advertisements and other expenses not directly related to production output.

3. Hypothesis Development

In the recent period, earnings management has developed not only through discretionary accrual but also through real transactions. Accrual earnings management have been a subject of auditor verification, which leads the management to perform earnings management in form of real activities (Ewert and Wagenhofer, 2005). On diversified companies with accelerated business expansion and high demand on third parties financing source are thought to cause earnings management through corporate real activities. Graham et al. (2005) found that earnings management through real activities are harder to detect in comparison with accrual earnings management. Real activities performed by management such as operation expenses reduction, overproduction, or looser sales discount policies are difficult to be distinguished, whether these are earnings management in action or simply considered as optimal business decision. Munter (1999) and Lim (2007) tries to assess the effects of diversification strategy to earnings quality. The results showed that managers are more aggressive in doing earnings management practices on diversified companies in comparison with specialised companies. This research tries to test the relationship between diversification strategy, both related and unrelated, on earnings quality, in which earnings quality are measured through real transactions earnings management. Hypothesis which are to be tested are as follow:

Hypothesis 1a: Diversification strategy positively affect real transactions earnings management through abnormal cash flow from operation in multi-segmented companies.

Hypothesis 1b: Diversification strategy positively affect real transactions earnings management through abnormal production costs in multi-segmented companies.

Hypothesis 1c: Diversification strategy positively affect real transactions earnings management through abnormal operation expenses in multi-segmented companies.

Hypothesis 1d: Diversification strategy positively affect total real transactions earnings management in multi-segmented companies.

Researches by Rhouland and Zhou (2005) and Berger and Ofek (1995) showed their support on the hypothesis that on multi-segmented companies, leverage affected earnings quality. Debts are used in financing various investment opportunities and partially used in subsidising weaker segments. This condition tends to trigger earnings management which affects earnings quality, since managements want to look succeeded in managing segments under their ownership. This research tries to test the effect of use of debts on earnings quality measured through real transactions earnings.

Therefore, the hypothesis to be tested:

Hypothesis 2a: Leverage positively affected real transactions earnings management through abnormal cash flow from operation on multi-segmented corporations

Hypothesis 2b: Leverage positively affected real transactions earnings management through abnormal production cost on multi-segmented corporations

Hypothesis 2c: Leverage positively affected real transactions earnings management through abnormal operation expenses on multi-segmented corporations

Hypothesis 2d: Leverage positively affected total real transactions earnings management on multi-segmented corporations

McNichols and Stubben (2008) proved that another reasons corporations manipulate their earnings are so that they can over-invest. Testing was performed using discretionary revenues, which found that there is a relation between earnings management and excess investment. Prior researches by Biddle and Hilary (2006), Verdi (2006), and Bushman et al. (2006) in McNichols and Stubben (2008) also showed that financial report information affects the accounting earnings mentioned. Diversification can also be chosen for opportunistic purposes, which related to agency cost due to available free cash flow or chosen to utilise excess financing by creating internal capital market. According to Krishnan and Kumar (2005) as well as File and Kwak (2006), companies with high IOS are characterised by low contemporaneous earnings, therefore managers in high IOS companies will tend to perform earnings management which aimed to decrease income, so that they can promise earnings to investors in the future. However, there are researches which disagrees with that thesis (Gull et al, 2003), which stated that companies with high IOS will try to deliver credible information upon the condition of the companies, which means that earnings management are driven more by efficiency rather than opportunistic. Based on those arguments, there are more researches which argues that earnings management increase in companies with high investment opportunities. Desire to grow, followed by strict corporate control which mandated management to maintain performance into positive directions, are the reasons that management with high investment opportunity to conduct earnings management. This research aims to test the effect of such investment opportunity on earnings quality measured through real transactions earnings management. Referring to McNichols and Stubben (2008), hypothesis proposed are as follow:

Hypothesis 3a: IOS negatively affecting real transaction earnings management through abnormal cash flow from operations on multi-segmented companies.

Hypothesis 3b: IOS negatively affecting real transaction earnings management through abnormal production cost on multi-segmented companies.

Hypothesis 3c: IOS negatively affecting real transaction earnings management through abnormal operation expenses on multi-segmented companies.

Hypothesis 3d: IOS negatively affecting total real transaction earnings management on multi-segmented companies.

4. Research Method

4.1 Research Population and Samples

This research used companies listed in Indonesia Stock Exchange (IDX) as samples. Samples are taken from all companies in every industry, except financial industries and other industries which does not have minimum 5 specialised companies, referring to Berger and Ofek (1995) Companies must have complete financial report, including segment reporting and its explanations. Observation period as well as data included are from 2002 – 2012 (10 years).

4.2 Empirical Research Model

The models stated below are used to test H1 to H3, which test the earnings quality proxied using earnings management. This research examines the relations between diversification strategy alongside leverage and IOS to real transactions earnings management. Real transaction earnings management are used 3 different measurements, including abnormal cash flow from operation (ABCFO), abnormal production cost (ABPROD), and abnormal discretionary operation expenses (ABDISCEXP).

4.2.1 Hypothesis 1a, 2a, and 3a testing model

$$ABCFO_{it} = \beta_0 + \beta_1 DIVER_{it} + \beta_2 LEV_{it} + \beta_3 IOS_{it} + \beta_4 RISK_{it} + \beta_5 FCF_{it} + \beta_6 SIZE_{it} + \epsilon_{it} \dots \dots \dots (Model 1a)$$

$\epsilon_{it} \dots \dots \dots (Model 1a)$

$$ABCFO_{it} = \beta_0 + \beta_1 DDIVER_{it} + \beta_2 LEV_{it} + \beta_3 IOS_{it} + \beta_4 RISK_{it} + \beta_5 FCF_{it} + \beta_6 SIZE_{it} + \epsilon_{it} \dots \dots \dots (Model 1b)$$

$\epsilon_{it} \dots \dots \dots (Model 1b)$

4.2.2 Hypothesis 1b, 2b, and 3b testing model

$$ABPROD_{it} = \beta_0 + \beta_1 DIVER_{it} + \beta_2 LEV_{it} + \beta_3 IOS_{it} + \beta_4 RISK_{it} + \beta_5 FCF_{it} + \beta_6 SIZE_{it} + \epsilon_{it} \dots \dots \dots (Model 2a)$$

$\epsilon_{it} \dots \dots \dots (Model 2a)$

$$ABPROD_{it} = \beta_0 + \beta_1 DDIVER_{it} + \beta_2 LEV_{it} + \beta_3 IOS_{it} + \beta_4 RISK_{it} + \beta_5 FCF_{it} + \beta_6 SIZE_{it} + \epsilon_{it} \dots \dots \dots (Model 2b)$$

$\epsilon_{it} \dots \dots \dots (Model 2b)$

4.2.3 Hypothesis 1c, 2c, and 3c testing model

$$ABDISCEXP_{it} = \beta_0 + \beta_1 DIVER_{it} + \beta_2 LEV_{it} + \beta_3 IOS_{it} + \beta_4 RISK_{it} + \beta_5 FCF_{it} + \beta_6 SIZE_{it} + \epsilon_{it} \dots \dots \dots (Model 3a)$$

$\epsilon_{it} \dots \dots \dots (Model 3a)$

$$ABDISCEXP_{it} = \beta_0 + \beta_1 DDIVER_{it} + \beta_2 LEV_{it} + \beta_3 IOS_{it} + \beta_4 RISK_{it} + \beta_5 FCF_{it} + \beta_6 SIZE_{it} + \epsilon_{it} \dots \dots \dots (Model 3b)$$

$\epsilon_{it} \dots \dots \dots (Model 3b)$

4.2.4 Hypothesis 1d, 2d, and 3d testing model

$$REM_{it} = \beta_0 + \beta_1 DIVER_{it} + \beta_2 LEV_{it} + \beta_3 IOS_{it} + \beta_4 RISK_{it} + \beta_5 FCF_{it} + \beta_6 SIZE_{it} + \epsilon_{it} \dots \dots \dots (Model 4a)$$

$\epsilon_{it} \dots \dots \dots (Model 4a)$

$$REM_{it} = \beta_0 + \beta_1 DDIVER_{it} + \beta_2 LEV_{it} + \beta_3 IOS_{it} + \beta_4 RISK_{it} + \beta_5 FCF_{it} + \beta_6 SIZE_{it} + \epsilon_{it} \dots \dots \dots (Model 4b)$$

$\epsilon_{it} \dots \dots \dots (Model 4b)$

Legends:

Independent variable

ABCFO Abnormal cash flow from operation, which are measured:

$$CFO_{it} = K1 \frac{1}{ASSETS_{it-1}} + K2 \frac{SALES_{it}}{ASSETS_{it-1}} + K3 \frac{\Delta SALES_{it}}{ASSETS_{it-1}} + \epsilon_{it}$$

ABPROD Abnormal production expenses, measured:

$$PROD_{it} = K1 \frac{1}{ASSETS_{it-1}} + K2 \frac{SALES_{it}}{ASSETS_{it-1}} + K3 \frac{\Delta SALES_{it}}{ASSETS_{it-1}} + \frac{\Delta SALES_{i,t-1}}{ASSETS_{it-1}} + \epsilon_{it}$$

ABDISCEXP Abnormal discretionary expenses:

$$DISCEXP_{it} = K1 \frac{1}{ASSETS_{it-1}} + K2 \frac{SALES_{i,t-1}}{ASSETS_{it-1}} + \epsilon_{it}$$

REM Total real transactions earnings management, which was formed as sum of ABCFO, ABPROD, and ABDISCEXP; in case of summation between ABCFO and ABDISCEXP, each individual amount was multiplied by -1 to avoid offsetting which may lead to misinterpretation (Zang, 2007), therefore the formula is stated as follow:

$$(-1 * ABCFO) + ABPROD + (-1 * ABDISCEXP)$$

Legends: CFO $_{it}$ (Cash flow from operation on company i, period t); $Assets_{i,t-1}$ (Total asset on company i, period t-1); $\Delta SALES_{i,t}$ (Change of sales between year t and t-1 (t – t-1)); SALES $_{i,t}$ (Total sales of company i, period t); PROD $_{it}$ (Production cost on company i, period t); $\Delta SALES_{i,t-1}$ (changes in sales between year t-1 and t-2 (t-1 – t-2)); DISCEXP $_{it}$ (Discretionary

expenses of company i , period t); **SALES $_{i,t-1}$** (Total sales of company i , period $t-1$); ϵ it (error term)

Dependent variable

DIVER Diversification level of the companies, measured using 1) Herfindahl Index, 2) Number of segments, and 3) dummy variable, 1 if the diversification is related to core business and 0 for other than that, referring to Rhouland and Zhou (2005) and Galvan (2007). Herfindahl Index shows how concentrated a company in their respective business segments. The more concentrated the business, Herfindahl Index will be approaching 1 (Berger and Ofek, 1985; Setionoputri et al., 2009), which indicated that sales is concentrated on specific segments only. Herfindahl Index is calculated using the following formula: **HI = $\Sigma \text{Seg Sales}^2 / [\Sigma \text{sales}]^2$**

Legends: Seg Sales (Sales per individual segment); Sales (Total annual sales)

Related and Unrelated diversification are determined using methods previously used by Palepu (1985), in which using Entropy Index (Jacquemin and Berry, 1979) stated in the following formula:

$$\text{RD} = \sum_{j=1}^M \sum_{i=1}^{N_j} s_i^j \ln \frac{s_i^j}{S^j}$$

$$\text{UD} = \sum_{j=1}^M s^j \ln \frac{1}{s^j}$$

Unrelated Diversification (UD):

Legends: M (Number of companies operating within two digits of SIC industry classification, indexed by j); N (Number of companies operating within four digits of SIC industry classification ($N \geq M$), indexed by i); N_j (Number of companies operating in j group); S_i^j (i market capital to j based on total sales); S^j (Market capital of each companies in group j based on total sales)

After RD and UD values are obtained, dummy are determined based on the margin between the two values. If $(RD - UD) > 0$ (positive), dummy value of 1 shall be given, and dummy value of 0 will be given if the margin is negative.

LEV (Leverage of the companies); IOS (Investment opportunity set. The formula for each set are):

MVA : **(asset $_t$ – total equity $_t$) + (shares outstanding $_t$ * share closing price $_t$) / total asset**

Sales Growth : **sales $_t$ – sales $_{t-1}$ / sales $_{t-1}$**

5. Analysis

5.1 Hypothesis Testing result 1a, 2a, and 3a

Empirical evidence on Model 1a and 1b (Table 5.1) concluded that number of segment is significantly and negatively affecting ($\alpha = 10\%$) on ABCFO. This means that the more segment that the companies have, especially when they are related with core business, the number of real transaction earnings management is increased with the decrement of companies operational cash flow. Abnormality of cash flow from operation (ABCFO) is one of real earnings management from by the companies, through sales discount policies and softer loan terms, to increase number of sales. Although sales do increase, since the sales was boosted by softer loan terms, this does not come with appropriate increment of cash flow.

Management of multi-segmented companies' have the ambition to always capable of developing their business through operations segments that they have. The goal of adding new segments, both related and unrelated, are to expand their corporate business empire. The success of segment addition should be proven with creating new sales on those segments. To increase sales per segment, which indicates success and

efficiency, therefore the companies are adopting soft loan policy. Consistent with model 3 testing result, the increase in numbers of segments (QSEG) and numbers of related segments (DQSEG) will increase real transaction earnings management through ABCFO, that comes from abnormal decrease of cash flow from operation, since the increase of sales is not followed with fair increase of cash inflow.

Table 1: Hypothesis 1a, 2a, and 3a testing result

Model 1a: $ABCFO_{it} = \beta_0 + \beta_1 \text{DIVER} + \beta_2 \text{LEVERAGE} + \beta_3 \text{IOS} + \beta_4 \text{RISK} + \beta_5 \text{FCF} + \beta_6 \text{SIZE} + \varepsilon_{it}$											
Model 1b: $ABCFO_{it} = \beta_0 + \beta_1 \text{DDIVER} + \beta_2 \text{LEVERAGE} + \beta_3 \text{IOS} + \beta_4 \text{RISK} + \beta_5 \text{FCF} + \beta_6 \text{SIZE} + \varepsilon_{it}$											
Dependent Variable: ABCFO											
Ind Var	Pre dict	(1)		(2)		(3)		(4)			
		coeff	p-value	coefficien t	p-value	coeff	p-value	coeffi	p-value		
C	+/-	-	0.088887	0.3866	-0.100106	0.3334	-0.098679	0.3304	-	0.096686	0.3327
HI	-	-	0.007172	0.5815							
DHI	+				0.004243	0.6054					
QSEG	+						-0.005016	0.0507*			
DQSEG	-								-	0.003199	0.0663*
LEV	-	-	0.071757	0.0000***	-0.072465	0.0000**	-0.070251	0.0000**	-	0.069903	0.0000***
IOS	-	-	0.008075	0.0180**	-0.008037	0.0215**	-0.007242	0.0366**	-	0.007456	0.0264**
RISK	+	-	0.001412	0.3491	-0.001236	0.4164	-0.001348	0.3692	-	0.001506	0.3159
FCF	+		0.102076	0.0000***	0.103094	0.0000**	0.102271	0.0000**		0.100299	0.0000***
LNTA	+/-		0.005290	0.1496	0.005453	0.1431	0.005967	0.1067		0.005640	0.1193
R-squared			0.684579		0.683859		0.686412			0.685425	
Adj R-sqr			0.651557		0.650762		0.653582			0.652492	

***, **, * is the each level of significance on 1%, 5%, and 10% (two-tailed test)

For debt use and investment opportunity, testing results found that leverage (LEV), at $\alpha=1\%$ and IOS with MVA as proxy ($\alpha=5\%$) is significantly and negatively affecting ABCFO. The aforementioned testing result shows that the larger debt usage and investment opportunity of the company, real transaction earnings management will increase. Companies with multi-segments strategy have high growth opportunity, but often experienced handicap in fund availability (Ferris et al., 2002). Sales growth and investment opportunities in form of NPV-positive projects require massive financing. When internal funding is not sufficient, then the funding source will be seek from external entities, therefore, management is concerned in presenting good level of performance to the creditors. High use of debt, with strict debt covenant monitoring, along with obligation of timely interest and loan principal payment, cause the management to be able to present the creditors that the companies are in healthy sales condition. One of the method is by soften their credit schemes that increase sales, but these are not followed by cash inflow from sales, creating abnormality on cash flow from operations (ABCFO).

5.2 Hypothesis 1b, 2b, and 3b testing results

Model 2a and 2b (table 5.2) testing shows that HI and DHI variables are significantly and negatively ($\alpha=5\%$) affecting ABPROD, whilst QSEG and DQSEG are significantly and positively ($\alpha=1\%$) affecting ABPROD. HI and DHI negative coefficients indicate that as companies are diversing through the number of segments that they have (although related with their core business), this will increase ABPROD. Cohen and Zarowin (2010) found that companies will try to look efficient through increasing their production volume up to more than their supposed level, so that cost of goods sold will decrease due to factory overhead that looks more efficient from what it should be due to pseudo-efficiency scale of production. The result which looks contradictory at a glance indicates that diversification with dispersed sales in multiple segments (decreasing HI), will increase ABPROD. On diversification strategy, not all segments are performing positively, therefore managers tend to cover the set backs from less productive segments through abnormal volume of production. This practice can be surpressed by implementing diversification strategy which are focused and related to their core business, and not dispersing on many segments, as well as concentrated sales which was shown by high value on HI will decrease ABPROD. Leverage (LEV), investment opportunity (IOS) and companies' size (LNTA) showed significant effects on ABPROD. Usage of debt (LEV) is significantly and positively, at $\alpha=1\%$, affecting ABPROD. This finding can be interpreted that massive financing needs on multi-segment companies are mostly met using external financial sources when internal financing is not anymore sufficient. To smoothen the process of earning debts, management will try to create a positive impression on the creditors. Using abnormal level of production (overproduction), management wants to show that companies as debtors have good capability in fulfilling their obligations as stated in debt covenant, assuming that the products can be sold. This result is inline with Roychowdhury (2006) that stated that companies with high debt level will manipulate their real activities through abnormal cost of production.

Table 2: Hypothesis 1b, 2b, and 3b testing result

Model 2a : $ABPROD_{it} = \beta_0 + \beta_1 \text{ DIVER} + \beta_2 \text{ LEVERAGE} + \beta_3 \text{ IOS} + \beta_4 \text{ RISK} + \beta_5 \text{ FCF} + \beta_6 \text{ SIZE} + \varepsilon_{it}$									
Model 2b: $ABPROD_{it} = \beta_0 + \beta_1 \text{ DDIVER} + \beta_2 \text{ LEVERAGE} + \beta_3 \text{ IOS} + \beta_4 \text{ RISK} + \beta_5 \text{ FCF} + \beta_6 \text{ SIZE} + \varepsilon_{it}$									
Dependent Variable: ABPROD									
Ind Var	Pre dict	(1)		(2)		(3)		(4)	
		coeff	p-value	coeff	p-value	coeff	p-value	coeff	p-value
C	+/-	0.692170	0.0005** *	0.663941	0.0011** *	0.680795	0.0005***	0.651409	0.0005** *
HI	-	0.061660	0.0108**						
DHI	-			-0.038224	0.0262**				
QSEG	+					0.011910	0.0083***		
DQSEG	+							0.006935	0.0075** *
LEV	+	0.039278	0.0047** *	0.032475	0.0194**	0.038761	0.0064***	0.044340	0.0011** *
IOS	-	0.017763	0.0020** *	-0.017440	0.0031** *	0.017607	0.0021***	0.010907	0.0355
RISK	+	0.001246	0.6337	0.000639	0.8102	0.001701	0.5326	0.000286	0.9138

FCF	-	-	0.010787	0.2824	-0.014196	0.1642	0.017482	0.0930*	-	0.013553	0.1740
LNTA	+/-	-	0.019519	0.0064**	-0.019061	0.0097**	-	0.021863	0.0022***	-	0.0029**
R-squared			0.718882		0.711509		0.712744			0.713843	
Adj R-squared			0.689451		0.681306		0.682671			0.683885	
***, **, * is the each level of significance on 1%, 5%, and 10% (two-tailed test)											

IOS variable testing result shows significant and negative effect upon ABPROD on $\alpha = 1\%$. Diversification strategy creates high growth opportunity, thus creating investment demand to increase production capacity. Use of fund are more focused on investment financing in the future. Companies' commitment to allocate fund for increasing production capacity discourage management to conduct real transaction earnings management through overproduction since this action will disrupt the companies' cash flow. Therefore, ABPROD will decrease accordingly to the increase of IOS. This result contradicts with Roychowdhury (2006) which stated that growth opportunities will encourage the increase of abnormal cost of production. Overall, from model 2a and 2b testing, it can be concluded that in diversified companies, there are factors that can trigger cost of production discretion (ABPROD) through real transactions practices. Those factors included diversification strategy concentration level (HI) and its relation with core business (DHI), number of segments (QSEG) and related segments (DQSEG), and debt usage (LEV). Factors which can discourage cost of production discretion included investment opportunities (IOS) proxied with MVA, free cash flows (FCF), as well as companies' size (LNTA). This means that increase of IOS, FCF and SIZE of the companies will lower abnormal cost of production (ABPROD).

5.3 Hypotheses 1c, 2c, and 3c testing results

Testing result on model 3a and 3b showed in table 5.3 indicates significant and negative effect ($\alpha = 1\%$) between numbers of segment (QSEG) and operating expense discretion. This implies that with increasing number of segment, number of real transaction earnings management done by companies will also increase. This finding is inline with Graham et al. (2005) and Rowchowdhury (2006), which stated that with larger number of segments, companies will manipulate production volume to create sense of efficiency through decrease of COGS, yet abnormal cost of production (ABPROD) will remain due to the increase of production volume. This condition encourages companies to streamline operation expenses by cutting promotional expenses, general and administrative expenses, as well as other expenses related to research and development, and this will be visible from the amount of operation expenses discretion. From leverage variable testing, the result finds a significant and negative ($\alpha=5\%$ dan $\alpha=10\%$) connection between leverage and ABDISCEXP. Increasing use of debt from external parties obliged the companies to show performance improvement from each of their operation segment. To create the necessary accounting performance, which later will be reviewed and appraised by creditors, management will undertake operation expenses discretion, which include cut in promotion expenses, general and administrative expenses, R&D expenses as well as other operation expenses, since this practice can improve current year corporate performance (contemporaneous earnings). Holding back operation expenses which are not directly linked to production output is

necessary in order to support companies' performance so that they can fulfill the terms and conditions stated by the creditor in the debt covenant. Investment opportunity is significantly and positively affecting ABDISCEXP ($\alpha=1\%$), showing that the larger the investment opportunity for the company, they will experience less real transaction earnings management due to the decrease of operation expenses abnormality. Companies with high IOS tend to allocate their fund on capital expenditure and aggressively opening more segments while hoping for better profit stature in the future. In this condition, companies will require more operation expenses such as advertising expenses and new market/products promotions expenses, general and administrative expenses to serve new segments, R&D expenses, as well as other operation expenses. Therefore, it can be understood that on the researched companies, when IOS increase, the tendencies are operation expenses will also increase and real transactions earnings management through operating expenses abnormalities are not generally happening.

Table 3: Hypothesis 1c, 2c, and 3c testing result

Model 3a: $ABDISCEXP_{it} = \beta_0 + \beta_1 DIVER + \beta_2 LEVERAGE + \beta_3 IOS + \beta_4 RISK + \beta_5 FCF + \beta_6 SIZE + \varepsilon_{it}$									
Model 3b: $ABDISCEXP_{it} = \beta_0 + \beta_1 DDIVER + \beta_2 LEVERAGE + \beta_3 IOS + \beta_4 RISK + \beta_5 FCF + \beta_6 SIZE + \varepsilon_{it}$									
Dependent Variable: ABDISCEXP									
Ind Var	Pre dict	(1)		(2)		(3)		(4)	
		coeff	p-value	coeff	p-value	coeff	p-value	coeff	p-value
C	+/-	0.079374	0.0552*	0.080094	0.0551*	0.110141	0.0098** *	0.083765	0.0424**
HI	-	0.005894	0.2652						
DHI	+			0.005287	0.1717				
QSEG	+					- 0.002924	0.0017** *		
DQSEG	-							- 0.000860	0.1591
LEVERAG E	-	- 0.005556	0.0679*	- 0.005157	0.0940*	- 0.006982	0.0225**	- 0.006322	0.0376**
IOS	+	0.005224	0.0001** *	0.005402	0.0000***	0.006039	0.0000** *	0.005190	0.0001***
RISK	+	- 0.001965	0.0001** *	- 0.001938	0.0002***	- 0.001883	0.0003** *	- 0.001994	0.0001***
FCF	-	- 0.000569	0.7608	- 0.000562	0.7635	-1.08E-05	0.9955	- 0.000562	0.7651
LNTA	+/-	- 0.003793	0.0119**	- 0.003801	0.0128**	- 0.004467	0.0044** *	- 0.003722	0.0139**
R-squared		0.994135		0.993988		0.993976		0.994119	
Adj R-squared		0.993521		0.993359		0.993346		0.993503	
N		1320		1320		1320		1320	

***, **, * is the each level of significance on 1%, 5%, and 10% (two-tailed test)

5.4. Hypothesis 1d, 2d, and 3d testing result

Model 4a and 4b, as shown in table 5.4 test the effect of diversification strategy, leverage, and IOS on total Real Earnings Management (REM). REM value is the sum of ABCFO, ABPROD, and ABDISCEXP, after multiplying ABCFO and ABDISCEXP with -1 (minus one) to avoid misinterpretation when summed with ABPROD (Zang, 2007). REM can be undertaken through sales management, cost of production, as well as discretionary decrease of expenses. All three activities can be executed simultaneously or partially by management.

Table 5.4: Hypothesis 1d, 2d, and 3d testing result

Model 4a: $REM_{it} = \beta_0 + \beta_1 \text{ DIVER} + \beta_2 \text{ LEVERAGE} + \beta_3 \text{ IOS} + \beta_4 \text{ RISK} + \beta_5 \text{ FCF} + \beta_6 \text{ SIZE} + \varepsilon_{it}$									
Model 4b: $REM_{it} = \beta_0 + \beta_1 \text{ DDIVER} + \beta_2 \text{ LEVERAGE} + \beta_3 \text{ IOS} + \beta_4 \text{ RISK} + \beta_5 \text{ FCF} + \beta_6 \text{ SIZE} + \varepsilon_{it}$									
Dependent Variable: REM									
Ind Var	Pre dict	(1)		(2)		(3)		(4)	
		coeff	p-value	coeff	p-value	coeff	p-value	Coeff	p-value
C	+/-	8.017842	0.0176**	7.613462	0.0202**	7.136454	0.0241**	7.176590	0.0239**
HI	-	0.744223	0.0922*						
DHI	+			-0.221099	0.4233				
QSEG	+					0.118017	0.0727*		
DQSEG	-							0.101290	0.0607*
LEV	+	1.130115	0.0004**	1.107899	0.0005**	1.110613	0.0005**	1.130330	0.0004***
IOS	+	0.013455	0.8577	0.028173	0.7101	0.022377	0.7680	0.023118	0.7607
RISK	+	0.079778	0.1305	0.080518	0.1318	0.079549	0.1312	0.076196	0.1446
FCF	-	0.194623	0.3141	0.178020	0.3587	0.167730	0.3859	0.201678	0.2974
LNTA	+/-	0.286601	0.0180**	0.285205	0.0185**	0.285007	0.0182**	0.283114	0.0184**
R-squared		0.431336		0.429582		0.430786		0.431670	
Adj R-squared		0.371802		0.369865		0.371195		0.372172	

***, **, * is the each level of significance on 1%, 5%, and 10% (two-tailed test)

Multi-segment strategy implementation tends to increase operational complexity between each segment. Performance result of each segment also greatly varies, which means strong and dominant segment must grow alongside with weaker and less performing segments. The obligation to convince owners that segments are growing well encourage managers to perform real transactions earnings management. Model 6a and 6b testing result finds that real earnings management (REM) will increase together with addition of new business segments whose sales dispersed to many segments. It is found that the more diverse and equal are their sales to multiple segments, which was shown by the decrease of herfindahl index (HI), REM in multi-segment companies will increase as well. This result is also consistent when QSEG and DQSEG is used as proxies for diversification, which showed that the increase of number of segments also significantly and positively encouraging the increase of REM ($\alpha=10\%$). Increase in REM slows down when diversification is related to its core business (related diversification). Else than

creating a more complex operation between individual segments, diversification strategy also increase the needs of third parties financing sources to finance the development of each segment, which encourage to manipulate real transactions to look good in the eyes of the creditors. Testing results find that leverage give significant and positive impact on REM increase ($\alpha=1\%$). Inline with Rhoulard and Zhou (2005); Perez and Hemmen (2010), the result showed that increase in debt within capital structure composition, will increase along with profit manipulation done by managers. Tendencies are that profit discretion happened through increasing income o companies that loan aggressively. Det covenant monitoring from creditors and size of interest expense caused the management to be careful in managing their profit. On all testing related to the effect of debt on abnormality of cash flow from operation, production cost, and operation expense showed significant and positive impact on all testing models. This finding signifies that debt usage dominated real transactions manipulation through sales policy, production cost, and discretion suppression of operating expenses, which also indicates that companies with increasing debt opt to perform real transaction discretion through sales policy and production cost. Difficulties to perform discretion on operation expenses is expected to be caused by needs of operating expenses from multiple division within multi-segment strategy, in comparison with companies which are focused on specific segments only. This finding supports Graham et al. (2005), which stated tht companies prefer to perform earnings management through real transactions to discretionary accrual. The consideration behind companies' favour of performing discretionary through real transactions (especially through discretions on cash flow from operations and production cost) rather than discretionary accrual is that real transaction manipulation are harder to be detected and cannot be differed for various optimal business decision. Meanwhile, discretion through accrual transactions are limited by generally accepted accounting principles as well as obligation to disclose oepartional segments activities on segment reporting.

6. Conclusion

6.1 Research Conclusion

This research is aimed to examine the effect of main variables (diversification strategy, leverage and IOS) on earnings quality of multi-segmented companies. Earnings quality are measured using level of abnormality in cash flow from operation, production cost and operational expenses. From the results above, it is concluded that the research found that diversification strategy affects real transactions earnings management. On companies with various segments, yet sales are concentrated, real transactions earnings management tend to be higher. Such manipulation was performed to improve performance in every segment to make the look efficient. Examination also found that real transactions earnings management are primarily performed through loose sales policy and overproduction policy, which impacted on the cash flow from operation and production cost abnormality in multi-segmented companies. The results also indicated that real transactions earnings management performed better in capturing opportunistic behaviours from managers in multi-segment companies. There is a tendency that management use real transaction earnings management in diversified companies. Also,

it is concluded that real transactions earnings management is more superior in measuring earnings management rather than discretionary accrual.

6.2 Recommendation for further researches

It is recommended for further researches to develop diversification which might lead to geographical segmentation, national and international. Further researches should also include companies from service industry and mining industry, so that all sectors can be represented in the research samples. Also, future researches might consider using other alternatives in measuring IOS which consider macroeconomics condition and impact of financial crisis on testing period. Furthermore, risk can also be measured using other alternatives, such as the use of total risk or cash flow volatility to test the consistency of testing models.

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