

# **The Effect of Business Diversification on Financial Performance with Business Risk as an Intervening Variable in Manufacturing Companies for the 2014-2018 Period**

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## **Abstract**

*We can see that the significant economic development from time to time is from the number of companies that are increasing in number. Based on Schumpeter's theory of economic growth regarding innovation that causes the economy to develop, this study examines the effect of business diversification on financial performance mediated by business risk.*

*The sample used is manufacturing companies that carry out business diversification strategies during the 2014-2018 period on the IDX, amounting to 33 companies, with purposive sampling technique. The method of analysis in this study is experimental, which uses Size and Leverage as control variables. Data analysis in this study uses Path Analysis to see the direct or indirect effect of business diversification on financial performance mediated by business risk.*

*The results of the analysis prove that business diversification has a positive and significant effect on financial performance, and business diversification has a positive and significant effect on business risk. However, business risk is unable to mediate the effect of business diversification on financial performance.*

**Keywords:** Business diversification, financial performance, and business risk

## **Introduction**

In entering into increasingly rapid technological developments and the existence of free markets resulting in intense business competition between companies. With the current conditions, the company is required to be able to survive and further develop its business. A growing company must always strive to maintain the quality and excellence of its business to increase the value of the company concerned. Developing companies are also required to develop an appropriate strategy to maintain their existence and improve their performance. (Turiastini and Darmayanti, 2018)

When the 1998 economic crisis that hit Indonesia had a negative impact on domestic business economic activities, economic activity was paralyzed due to the number of companies that closed down and even suffered losses. (Sumendap, et.al., 2018).

Based on several studies regarding business diversification strategies that have an impact on financial performance, such as research by Turiastini and Darmayanti (2018) as well as research conducted by Vidyanata, et al., (2016) states that there is a positive effect of diversification on the company's financial performance. Contrary to the results of Ariani's research (2018) which explains that the diversification

strategy does not affect company performance. The differences in the results of these studies indicate different effects of business diversification on the company's financial performance, thus indicating that other factors influence this relationship. The current condition is where the government has begun to implement a lot of diversification strategies in certain regions in Indonesia,

The diversification strategy has several objectives, one of which is to minimize the overall risk by dividing it. Companies that diversify their business have less risk of bankruptcy because if one business experiences difficulties, other businesses can cover it with the returns they get. Research conducted by Sun and Govind (2017) found that the risk, in this case, is the investment risk that will be reduced if it diversifies when the market is in low volatility. On the other hand, if the market is in high turmoil, diversifying the business will increase the company's investment risk. In the portfolio theory, there is a proverb expressed by Harry Markowitz, namely "Don't put all your eggs in one basket", This means that if it is associated with a business diversification strategy, there are still other businesses that can cover the losses suffered. Research conducted by Wahyuni (2019) on the banking sector in Indonesia states that the diversification strategy has a positive effect on banking risk, which is marked by the more bank assets, better performance, and reducing risk. This is also in line with research conducted by Hendiono (2016) on manufacturing companies, where the results of this study indicate that diversification has a negative and significant effect on business risk, which means that the more diversified a company is, the lower the risk. This is because the losses incurred will be covered by the profits of other business segments so that the risk will decrease.

However, contrary to research conducted by Lucyanda and Wardhani (2016), it is stated that most diversified manufacturing companies in Indonesia have a very dominant sales value in one of their business segments, the results of this study also indicate that the more company segments are added, the lower the company's performance. Research conducted by Nuraini (2017) suggests that diversification can increase business risk, but if diversification works well, it will improve company performance. Due to the differences from previous research results, it is necessary to conduct further research on the role of diversification in risk, especially business risk.

This study focuses more on measuring the role of business diversification on financial performance with business risk as an intervening variable incorporated in the manufacturing industry on the Indonesia Stock Exchange, this reason is that this sector is a relatively large number of companies that diversify well by increasing the number of segments in the Indonesian Stock Exchange. companies or increasing the number of subsidiaries through acquisitions or mergers. This study adds a control variable using size and leverage.

## **Literature Review**

### **Market Power Theory**

Market power theory is the ability to influence market prices or even turn off competitors. Every company may have this capability but it is not necessarily used, this capability will be used when the company feels that a competitor has caused a loss (Dewi and Atiningsih, 2019)

### **Schumpeter's Theory of Economic Growth**

Schumpeter's theory assumes that an economy is in a steady equilibrium. According to Schumpeter, the

process of economic development is the main factor that causes economic development to be the process of innovation and the perpetrators are innovators or entrepreneurs (entrepreneurs). The economic progress of a society can only be applied by the presence of innovation by entrepreneurs. These innovations include the introduction of new products, the introduction of new products, the opening of new markets, mastering new supply sources of raw materials or semi-manufactured goods, and the formation of new organizations in each industry such as the creation of a monopoly. In this theory, it emphasizes that innovation can pound and develop an economy. Diversification itself is part of innovation.

### **Business Diversification**

According to Tjiptono (2008), diversification is an effort to seek and develop new products or markets, or fulfill the ambitions of managerial personnel.

both, to pursue growth, increase sales and profitability.

Harberd and Rieple also stated that diversification was carried out with several objectives, including:

- a. Value-Added Growth
- b. Even out the risks
- c. Achieving Synergy
- d. Control Suppliers And Distributors

### **Financial performance**

Financial performance appraisal is one way that management can fulfill its obligations to funders and for the purposes set by the company (Rani, 2015).

Shareholders need information about the company's financial performance to avoid the risk of loss in the stock portfolio. Creditors need this information to assess whether or not a credit provider is appropriate based on company performance, while management makes various decisions by looking at the company's financial performance in the previous period (Vidyanata, et.al., 2016)

ROA is one of the profitability ratios that can be used to assess the company's performance in generating profits at certain levels of sales, assets and share capital. In analyzing the financial statements of the company's financial performance reports, ROA shows the company's ability and efficiency of the capital invested in all its assets to generate profits. ROA can be used as an indicator to determine how well a company is able to obtain optimal profit from its asset position (Turiastini and Darmayanti, 2018).

### **Business Risk**

According to Horne and Wachowicz (2005) in the research of Valentina and Kuzikna (2017), business risk is the uncertainty that a company faces in running its business, can be measured by the variable operating profit (EBIT) generated by the company's asset portfolio and product market activities.

### **Effect of Business Diversification on Financial Performance**

Several studies mention the effect of business diversification on financial performance including: research Turiastini and Darmayanti (2018), Vidyanata, et.al. (2016), and Chen and Yu (2012) stated that the diversification strategy has an effect on the company's financial performance. And also research conducted

by Iskandar, et al., (2017) where the results of their research show that diversification strategies have a positive effect on the company's financial performance.

H1 = business diversification has an effect on financial performance.

### **The Effect of Business Diversification on Business Risk**

Lestari and Sari (2014) stated that the diversification variable has an effect on total risk and systematic risk, but does not affect the company's unsystematic risk. Company diversification can reduce business risk by staying provide a sufficient potential level of profit, supported by research conducted by Wahyuni (2019), and Shabrina (2020).

H2 = Business Diversification has an effect on Business Risk

### **Effect of Business Diversification through Business Risk on Financial Performance**

Hanafi (2014) explains that there is a positive relationship between risk and profitability. This means that the higher the risk, the higher the profit level expected by the company. This positive relationship shows that if the business risk is high, financial performance can improve. Turiastini and Darmayanti (2018) show that business risk has a significant and negative relationship to financial performance. The negative relationship shows that diversification only has a direct effect on financial performance.

H3 = Business Diversification has an indirect effect through Business Risk on Financial Performance.

## **Conclusion**

This study discusses the effect of business diversification on financial performance mediated by business risk with the following conclusions: (1) Business diversification has a positive effect on financial performance, meaning that if the company is increasingly diversified, financial performance will increase. (2) Business Diversification has a negative effect on Business Risk, that if the company becomes more diversified, the business risk experienced by the company will be smaller. Because if in an unstable condition one segment of the company experiences a loss, it can be covered with other segments. (3) Business Diversification does not have an indirect effect through Business Risk on Financial Performance. The suggestions that can be given are for companies to improve the company's financial performance by choosing to implement a diversification strategy. The choice of this strategy also aims to increase the competitive advantage between other business competitors.

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