Firm's Diversification Strategy, Risk & Incentives (Viability Study on Indonesian SMEs)

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Abstract

Small and medium enterprises, or referred to herein as "SME", may face possible extinction when falling behind the fierce competition in the marketplaces. Undoubtedly, SMEs business viability is the big question mark. Given the limited current capabilities, SMEs may face substantial hurdles to constantly expand the business scope. Diversifying business activities may well be the option that those SMEs attempt to pursue as a way of breaking-off the limitation wall.

Firms may well use their intangible assets to build a solid ground to leap into the future. Intangible assets can be used to support the organizational diversifications strategy, perhaps. As the actual diversification can certainly take many forms, it is essential to note the common economic implications to any diversification strategies. For sure, uncertainties are always present in the course of actual implementation of diversification strategies. The level of managerial risk-aversion is noted as a reference point to analyze the likelihood of success and failure on any diversification deals, particularly for SMEs. On the other side of the coin, incentive structures are examined to provide necessary grounding on dealing with uncertainties and risk-aversion.

This paper attempts to evaluate the total impact of implementing diversification strategy for SMEs. The resource-based theory of the firm, and the knowledge-based theory of the firm are used as the starting point. The major concentration will be placed on the use of intangible assets, including potential risks and possible incentives on such diversification strategy, and strategic intent for SMEs. Market structure is also used as a reference point on building up arguments toward organization's intent on diversification. This research was conducted in Indonesia (in the cities of Bandung and Jakarta), which focused on young organizations in retail and service industries.

Keywords: diversification, small/medium enterprises, strategy, risk management, incentive management

I. INTRODUCTION

The rise of role on firm's intangible assets has certainly emerged. This applies not only to large firms, but also to smaller organizations. Studies concerning intangible assets have also risen as a way to support organizations on the future likelihood of outcomes, perhaps, including the viability of those intangible assets. The importance of intangible assets for firms in today's business environment toward firm's diversification strategy is used as the base of analysis (Besanko, et al, 2007; Mansi and Reeb, 2002; Thompson, et al, 2004) in trying to achieve value-creation and value-added (Tanaszi and Duffi, 2000), by noting the essential risks and incentive, which are likely entailing such strategic actions (Besanko, et al, 2007; Murthy and Deb, 2008).

Firms may want to use their intangible assets, which this study mainly concerns on human factor, informational factor, and organizational factor, to build the organizational diversification strategy (Garnsey, et al, 2003; Jensen, 2001; Rumelt, 1984). It becomes essential to note the impact of diversification strategy toward the firm's incentives (Besanko, et al, 2007; Thompson, et al, 2004). This is mainly due to the presence of uncertainties in implementing such diversification strategies. Aside from the intangible assets, the level of managerial risk-aversion is also pondered (Thompson, et al, 2004). As another building blocks, this study takes on the perspective on SME's market structure (Besanko, et al, 2007; Eerola and Maattanen, 2004; Thompson, et al, 2004) to build up arguments toward firm's diversification strategy.

As the basic theoretical reference, which rely on the Coasean theory of the firm, this paper begins with the resource-based theory of the firm (Acedo, et al, 2006), and the knowledge-based theory of the firm (Sampurno, 2006; Sangkala, 2006). These pooled theories[1] provide the necessary grounding for the important roles of intangible assets for firms.

II. LITERATURE REVIEW

II.1. RESOURCE-BASED THEORY OF THE FIRM & KNOWLEDGE-BASED THEORY OF THE FIRM

The theory of the firm, the growth theory of the firm, and the entrepreneurship theory of the firm has experienced substantial improvements in their scopes of coverage. By mid 1980's,

[1] The pooled theories, in this context, refer to both the resource-based theory of the firm, and knowledge-based theory of the firm.

there were several writings that introduced a new way of looking into an organization from its resources, both productive and unproductive, to maintain continuous growth. To win competition, and increasing firm's competitive advantange (Sampurno, 2006; Thompson, et al, 2004), speed and flexibility become important (Anantadjaya, 2010; 2011; Foss and Klein, 2004; Morrison, 1996; Thompson, et al, 2004; Venkartraman and Ramanujam, 1986). In fact, flexible responses are crucial in positively affecting the firm's performance (Rigby and Rogers, 2000).

The perspectives of the resource-based theory indicate that firm's resources directly represent capabilities of the firm, which includes the competence level of internal human capital in managing all resources represents the key ingredient to succeed (Anantadjaya, 2009; Berger and Bonaccorsi di Patti, 2003; Nawangwulan, et al, 2006). Resource-based theory points out that firm's performance is not driven by any characteristics of industry settings, but rather firm's performance portrays the unique firm's resources and capabilities of the firm in making a good use of market opportunities and stay ahead of the competition. Technological advancement, capital market pressures, consumers' preferences and tastes, globalization, and innovation, for instance, are all pushing for market opportunities. These revolutionize the competitiveness of product and services in the market by either rapid geographical expansions, or restrictive geographical boundaries (Hamsal, 2006; Yogaswara, et al, 2006b). This is to say that a single resource, though it may be expensive, valuable, and unique, cannot produce firm's competitive advantage by itself. Combination of resources is the key success to achieve the competitive advantage. Another invaluable ingredient is the integration of resources from various business units of a particular firm (Bridoux, 2004; Cardy and Selvarajan, 2006; Carroll and Hunter, 2005; Colombo and Grilli, 2005; Foss and Klein, 2044).

Whenever one refers to firm's resources, it covers all aspects of resources that a particular firm utilizes. This includes assets, capacity, skills, competence, business processes, systems and procedures, and information management, and management of knowledge. Firms are said to have sustainable competitive advantage when firms are practicing continuous value-creation strategy despite what competitors are doing at the time being. To successfully doing this, firms must ensure that all strategic resources are available for use upon which time when the value-creation strategy will be implemented. For sure, value-creation strategy should ensure value-added benefits, unique, rare, relatively difficult to imitate, and relatively difficult to find substitutes (Sampurno, 2006). In a way, those value-creation strategies are saying similar issues as Morrison's second curve[2] in mid-1990's (Anantadjaya, 2011; Morrison, 1996).

To successfully orchestrating the whole situation, knowledge and the management of knowledge certainly play an important role. Knowledge deficiency leads to inability to perform what was already planned and/or targeted. Similarly, absence of knowledge management leads to redundancy in any works performed. This is particularly true in today's environment with huge variations and turbulence. Firms must understand the essence of maintaining and constantly upgrading the intellectual capital (Sangkala, 2006).

The Ministry of Communication and Information Technology of the Republic of Indonesia (2006) has already formulated a blue-print toward improving the country's human resources on information and communication technology. From the blue-print, it can be conferred that it is indispensable to upgrade the quality of human resources-dependency on information. As human resources become more aware of various information, the level of awareness is likely to increase as well. As the level of awareness increases, citizens of Indonesia will become more knowledgeable. Advances on human resources knowledge will boost competencies on doing things, thus, developing the quality of human resources in Indonesia. As this progress, Indonesia will also improve its competitiveness in the global market. The cycle continues.

II.2. INTANGIBLE ASSETS

The word "intangible assets" refer to the undefined, undetermined, or non-physical objects with potential to generate future profits (Anantadjaya, 2008; Hamsal, 2006; Sampurno, 2006; Sangkala, 2006). The used of intangible assets[3] is interchangeably with other commonly used terms, such as; knowledge assets[4], and intellectual capital[5] (Anantadjaya, 2008). Looking from the managerial and legal practices, intangible assets, or known in this field of

[2] Morrison's second curve (1996) attempted to differentiate between the traditional and contemporary ways of doing things within firms. In the unstable economy, there are new conditions, new ideas, new technology, and new consumer that are demanding products and services to be delivered faster than ever, better than ever, and cheaper than ever. Also, the new consumer group demands products and services to be available at anytime and anywhere the consumer want them. Any new products and services are basically demanded with a much shorter product life-cycles (Morrison, 1996).

[3] The word "intangible assets" are widely used in accounting.
[4] The word "knowledge assets" are widely used in economics.
[5] The word "intellectual capital" is widely used in managerial and legal practices.

studies as intellectual capital, can be divided into four different forms as the organizational competitive base (Edvinsson and Malone, 1997; Stewart, 2005); (1) human capital[6], which consists of skills, talents, and any types of capabilities in any organizations; (2) structural capital[7], which consists of systems, procedures, policies, and rules in any organizations; (3) customer capital[8], which makes up of customer relationships in any organizations; and (4) partner capital[9], which consists of other individuals and/or other institutions with whom a particular organization is establishing cooperative agreements with.

In contrast to the above segregations on intangible assets, according to Kaplan and Norton (2004), however, intangible assets can also be divided into three different forms as the organizational competitive base; (1) human capital, which[10] consists of skills, talents, and expertise to perform all necessary activities required by the previously set strategy; (2) information capital[11], which consists of the availability of information systems, knowledge application, and infrastructure required to support the execution of strategy; and (3) organizational capital[12], which consists of shared vision and mission, availability of qualified leaders at all levels to mobilize the organizations toward strategies, alignment of goals and incentives with the strategy at all organizational level, and the sharing of knowledge and staff assets with strategic potential.

It is evident that intangible assets should be utilized to support organizational performance, in the actual attempt to boost firm's value. This is simply due to the difficulties of copying or duplicating those intangible assets by competitors.

II.3. STRATEGIC INTENT ON INTANGIBLE ASSETS

[6] Human capital appears to be the main driving force on organizational competitive base since all other types of capitals required the presence of human resources, and thus, human capital as well, prior to the actual start-up and development (Edvinsson and Malone, 1997; Stewart, 2005).

[7] This allows the effective utilization of human capital in creating the organization-wide information systems as well as managerial competences (Edvinsson and Malone, 1997; Stewart, 2005).

[8] This allows the effective utilization of human capital in creating the necessary customers-own-version of structural capital, in the form of database to establish the customer relationship management, while recognizing to whom products and services are sold to. This can take various forms, such as; a complete database to establish customer relationship management, customer research, web sites, and e-commerce, perhaps (Edvinsson and Malone, 1997; Stewart, 2005).

[9] It means that organizations should have strategic partners in dealing with operational activities while maintaining cutting-edge position in the marketplaces (Anantadjaya, 2008; Edvinsson and Malone, 1997; Stewart, 2005). This type of resources denotes strategic value-creation for organizations.

[10] It is referred to as "strategic competencies", and are accounted for about 80% in BSC's objectives (Kaplan and Norton, 2004).

[11] It is referred to as "strategic information", and is accounted for about 80% in BSC's objectives (Kaplan and Norton, 2004).

[12] It is referred to as "culture", which is accounted for about 90% in BSC's objective, "leadership", which is accounted for about 90% in BSC's objectives, "alignment", which is accounted for about 70% in BSC's objectives, and "teamwork", which is accounted for about 60% in BSC's objectives.

To ride the competition wave successfully, intangible assets may have to be sufficiently comprehend by the management. The strategic managerial roles can only be shaped if organizations decide to focus on intangible assets, which consist of human capital, informational capital, and organizational capital. Countries[13] that sufficiently invest in their citizens, may experience more output per person, and faster growth rates as compared to countries, which invest minimally on their people (Anantadjaya, 2008; Mansi and Reeb, 2002). It is apparent evidence that at the macro and micro-economic levels, intangible assets have the ability to shape the long-term value creation, organizational viability, and thus, organizational growth (Kaplan and Norton, 2004).

The impact of intangible assets is certainly different from tangible assets (Kaplan and Norton, 2004). First, intangible assets create indirect value toward any of the organizational financial figures, such as; lower costs, higher revenues and profits. The improvement on the intangible assets affects the financial figures in causal effect. An employees' increase knowledge on quality assurance can influence the quality standard of an organization. Improvements on the quality standard are expected to enhance the overall customer satisfaction, most likely is due to lower numbers of defective products and/or services. As customers are more satisfied, it is expected that those customers will become loyal by returning and make repeat purchases. This inflates firm's revenues. Second, intangible assets create potential value since any investments in intangible assets represent only an unfavorable estimate of its overall impact to the firm's bottom-line. An employee additional knowledge on quality assurance, and the swollen revenues correspond only to the potentials on the likelihood of additional knowledge. Hence, the organizational internal processes[14] must be in-place to ensure that the transformation of the potential value of intangible assets into tangible value can really occur. Third, intangible assets must be bundled. The true value of intangible assets emerges upon combination with other assets, both with other tangible and/or intangible assets. The additional knowledge on quality assurance is only helpful if employees have access to timely data and information. Hence, minimal impact will likely to occur, if the actual handling of finished goods, and delivery of the finished goods remain full of flaws.

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[13] This refers to "resource-poor" countries, such as; Singapore, and Taiwan, where the natural resources are relatively limited and/or otherwise scarce (Kaplan and Norton, 2004). Indonesia's investment in education is 2.8% of its gross domestic product of US$1.03 trillion, or about US$28 billion (www.cia.gov, 2011).

[14] Such internal processes are as follow, but not limited to; order process, negotiation process, approval process, design process, production process, delivery process, customer service process, and many other managerial processes that affect the overall value chain (Anantadjaya, 2007; 2006).

II.4. STRATEGIC INTENT OF SMALL AND MEDIUM ENTERPRISES ("SME")

Small and Medium Enterprises ("SME") is commonly referred to as independently owned and operated, without any market dominance in any specific industry (Ebert and Griffin, 2005). Countries across the globe may be dependent on SME for their survival during economic downturn. Indonesia is certainly included. It is a public knowledge that the role of SME is often regarded crucial for the overall economy. It ranges from innovative efforts, opening-up the job market, as well as taking-up an important role for big businesses (Ebert and Griffin, 2005). In particular, the service industry is heavily dominated by SME, as much as 38% (Ebert and Griffin, 2005). One plausible reason is simply the ease on starting-up service establishments. Retail industry follows at about 23%, whereas finance, insurance, and construction industries comprise of 10% each (Ebert and Griffin, 2005).

In this study, SME is a term used initially for firms that fulfill the prescribed criteria set by the Ministry of SME and Cooperatives of the Republic of Indonesia. Some basic criteria for Indonesian SME are as follows; (1) owned by citizens of the Republic of Indonesia, (2) the business is independent and unaffiliated to any medium and large firms, (3) excluding land and buildings, small enterprises have less than Rp. 200 million of net assets, (4) the approximate total in annual sales are less than Rp. 1 billion for small enterprises, or less than Rp. 10 billion for medium enterprises, and (5) regardless of the actual size, and level of sales, such enterprises should be registered formally (Ministry of SME and Cooperatives, 2011). Despite their relatively small in size, it is expected that SME may rely on intangible assets to ride the competitive surge. As previously mentioned, it is expected that SME does not only rely on human factor, but also trying to capitalize from information and organizational capabilities.

II.5. MARKET STRUCTURE

Since this study concerns on SME, the most appropriate market structure is monopolistic competition, perhaps (Besanko, et al, 2007; Ebert and Griffin, 2005). In monopolistic competition, there are many players with differentiated products (Besanko, et al, 2007; Ebert and Griffin, 2005). Any actions of a certain player are doubtful to have impacted other players in the market. Certainly, this is due to the total number of players in the marketplaces, including the players' differentiated products in the marketplaces (Besanko, et al, 2007; Murthy and Deb, 2008). A reduction in price of a particular player may not intrigue reactions from other players in the industry. Not only due to the large numbers of players in the market to be tracked-down, but also due to minimal impacts of such a price reduction into the overall market. Even if other firms experience sales drop, firms may not alter their pricing, just to respond to the price reduction executed by a particular firm. In terms of differentiated products, it is the customers, who are able to distinguish such differences. It means that customers can choose to prefer a certain product than the others. Therefore, firms in the monopolistic competition can increase their prices without losing customers, as in the perfect competition (Besanko, et al, 2007; Murthy and Deb, 2008).

As previously mentioned, to represent the SME competitive condition in the marketplaces, a monopolistic competition is used. Some notable variables to be used as proxies in indicating the general condition of a monopolistic competition include; number of similar products, number of players, number of substitute products, and number of complimentary products. Firms face higher competition as the number of similar products rises, number of players escalates, number of substitutes and complimentary products swells. It is expected that through the questions on product substitutes and complimentary, entrepreneurs may provide illustrations on the potential impact of market structure to any business dealings in diversification and incentives.

II.6. STRATEGIC INTENT TOWARD DIVERSIFICATION

The strategic use of resources and knowledge enable firms to have the competitive edge, which are expected to provide adequate obstacles for other players in the marketplaces. Hence, the reliance on intangible assets allows firms to diversify in such a way, to set themselves different from the crowd. Nonetheless, it remains questionable what kinds of circumstances attract/push firms to diversify? On one side, a popular example of undiversified firm is undoubtedly McDonald’s. Spreading the chain-fast food establishments to countries around the world by just simply offering hamburgers and fries. Hence, there are firms that diversify by producing other products and entering into new marketplaces. Astra group of companies is a classic example of diversified firms in Indonesia. Para Group (CT Group) is yet another example of diversified group of firms in Indonesia, whose operations range from financial services[15], media, lifestyle and entertainment[16], CT Global Resources[17],

[15] The financial services are grouped under Mega Corpora, which houses; PT Bank Mega, PT Bank Mega Syariah, PT Mega Life, PT Mega Insurance, PT Mega Capital Indonesia, PT Mega Central Finance, and PT Para Multi Finance (www.paragroup.com, 2011).

to a philantrophic organization of CT Foundation (www.paragroup.com, 2011). Central Retail Corporation, Dusit International, PTT Exploration and Production, Amari Hotels, Sahaviriya Steel Industries, Banpu, Mitr Phol Sugar Corporation, and Absolute Hotel Services Group are just few examples from Thailand, which are also trying to ride the wave of international diversification (The Nation, 2011). Taiwan-based Asus is also aiming for the top spot in sales across Asian countries (The Nation, 2011). According to Rungfapaisarn (2011), Singha Corp, which is now run by the 4th generation of the Bhirombhakdi family, jumps into fashion industry in Hong Kong, South Korea, Japan, and UK, after years in the beer-making business. In the automotive industry, automakers now diversify into diesel engine and hybrid (The Nation, 2011). Soviet's Lada cars are certainly included (The Nation, 2011). Another unique example is the South African National Taxi Council (Santaco), which will team-up with AirQuarius to fly a budget airline Santaco Express (The Nation, 2011).

By nature, diversification directs firms to produce multiple goods and services, which may be targeted also for multiple marketplaces. When a firm diversifies, it attempts to establish dominant market share within a specific industry[18] (Besanko, et al, 2007). One plausible way of achieving the dominance is through economies of scale and scope (Besanko, et al, 2007). It is, thus, expected that the maximized profits are spilled-over to the maximized shareholders' wealth (Foros, 2003) through the additional distributions of dividends (Jensen, 2001). When a firm decides to diversify, it represents the time that management is started to think about broadening the firm's economies of scale and scope.

If one uses the perspective of Penrosean theory of firm's growth (Penrose, 1959; 1960), it is evident that the concentration of utilization rates on productive and unproductive resources becomes the key ingredient in diversification. During any given time, firms may have resources that cannot be fully utilized on the current production lines. Managers will have to start thinking creatively on increasing the utilization rates on those underutilized resources. Applying those underutilized resources in other marketplaces will improve the economies of scope for the firm (Besanko, et al, 2007). Synergies among firms suggest that firms are

[16] The media, lifestyle, and entertainment services are grouped under Trans Corpora, which operates Trans 7, Trans, Trans Studio, DetkCom, Bandung Super Mall, PT Maha Gaya Perdana, The Coffee Bean & Tea Leaf, Baskin Robbins, Anta Tour, Vaya Tour, Metro Department Store, and Carrefour (www.paragroup.com, 2011).

[17] This firm handles business operations in natural resources (mining and agriculture), such as; PT Para Inti Energy, PT Para Energy Investindo, PT CT Agro, PT Kaltim CT Agro, PT Kalbar CT Agro, PT Kalteng CT Agro, PT Arah Tumata, PT Wahana Kutai Kencana (www.paragroup.com, 2011).

[18] This is in accordance with the cultural school of thought, which states that the pre-existing dominant value affects the ability to adopt, accept and implement necessary changes for the firm (Mintzberg, et al, 1998).

looking for ways to improve their profitability levels by means of working closely together; perhaps, by sharing their available technologies and production process facilities. In essence, the financial synergies may create an immediate boom in market size. This enhances the dominance of firms in a specific industry, at least. Smaller firms can tap into other marketplaces than it otherwise could, alone. Same stories for bigger firms, in fact. Though it may not always be the case, in the longer run, financial synergies are targeted to smooth-out future cash flows (Besanko, et al, 2007). Coordination of various resources, in particular, aims to increase the utility of unproductive resources, firms can now engage in relatively full capacity without reducing the current level of production.

Likewise, if the firms agree to the operational synergies between each other, then the market share of the combined firms should likely to increase. This is logically acceptable since the operational synergies tend to create efficiency in production activities by means of sharing on production processes. This occurrence is evident if positive changes in market share of the combined firms are expected to bring about potential gains. Firms can start engaging in product diversity as well as covering a larger marketplace (Besanko, et al, 2007). On the other side of the coin, through synergies, firms are hoping to excel in minimizing their transaction costs. The strategic deal between Cathay Pacific and China's Dragonair was the evident of increasing economies of scale and scope. Though flying with a different "flag-carrier", Cathay Pacific can now fly direct into China. This enables Cathay Pacific to tap into a much larger market share (CFO Asia, 2006). Such a situation is complimented by Mansi and Reeb (2002) that diversification provides a leverage toward economies of scale since more efficient operations are possible and more profitable business lines are evident for diversified firms than a stand-alone firm.

Considering the above example, managerial reason toward diversification may appear simple. Diversifications seem promising in enhancing efficiency on the internal operational activities. This mirrors to what Besanko, et al (2007) have stated. At least this is true for managers. Managers are attempting to maintain and constantly enhance their position in the hierarchy. This provides a wide avenue toward making diversification decisions. One can easily see that pursuit of growth is prominent in this instance (Mansi and Reeb, 2002).

As stated earlier, from the economics perspective, the key indicator toward diversification is the possibility of increasing efficiency of the diversified firms. This represents the basic preference for firms (Besanko, et al, 2007). Firms try to increase their efficiency via diversification. Economists refer such efficiencies to the concepts of economies of scale and scope. By intensifying the use of underutilize resources, firms can potentially increase their economies of scope (Penrose, 1959; 1960). If at the current period firms cannot optimally utilize their available resources, firms are tempted to seek other opportunities to effectively apply those underutilize resources. Perhaps, firms may want to start producing for other product markets. As the market base expands, firms gain new ground on doing their business activities. Indisputably, this gives rise to the firms' economies of scope. From the point of view on maximizing the utilization of the firm's intangible assets (Garnsey, et al, 2003), firms can gain new ground on doing their business activities whenever managers are able to develop new specific skills, such as; computer science and information systems, for instance. As those skills are specific, firms tend to diversify into unrelated business activities that require the intense use of those specific skills (Besanko, et al, 2007). The concern on economies of scale is very much relevant to reducing costs of production in any given firms. Thus, the rationale behind diversification is undeniably minimizing transaction costs. As the transaction costs are minimized, efficiency increases.

To win more customers, firms must create and deliver economic value. This translates into consumer surplus. Thus, when firms fail to maintain the level of consumer surplus via constant value creation as compared to their rivals, sales will inevitably slip. Since the need to offer consumer surplus are worked together by utilizing capabilities, and resources, it means that constant asymmetries among firms must be persistent. Firms must have different resources, relatively scarce and immobilize (Besanko, et al, 2007; Garnsey, et al, 2003; Jensen, 2001) to be successful in forming and maintaining alliances. To sustain the competitive advantage, firms must have strong resources and capabilities, which are scarce and immobilize easily.

Hence, it is hypothesized that;

H_1 : Market structure strongly influences diversification strategy

II.7. DIVERSIFICATION RISKS & INCENTIVES

As discussed earlier, the underlying issue to start thinking about diversification seems to be the economic drives to constantly maximizing the shareholders' wealth, instead of just maximizing the organizational profitability. To successfully doing this, pricing strategy and quality alone, cannot substantially affect the increment of the firm's bottom-line and/or the firm's overall value. Firm's ability to offer value-added products and services appear to be the key source toward ensuring shareholders' surpluses along the long-run incremental costs, and the general cost structure (Altunbas, et al, 2000; Besanko, et al, 2007; Bloomfied, et al, 2004; Foros, 2003; Larue and Yapo, 2000). It is important to note that although firms are competing fiercely, the willingness to take and assume future uncertainties is not the same. Likewise, assuming that the information is available for firms when they make a decision toward diversification, the perceived risks by management teams cannot be assumed identical. This affects the level of utilization of current profits to boost the expected profits upon diversification (Altunbas, et al, 2000; Gibbons, 1998). As managers are able to gather more information and learn more from such information, it is expected that their levels of confident may increase (Altunbas, et al, 2000; Hirshleifer and Riley, 1979). This results in increased efforts toward maintaining successful diversification[19].

In addition, managerial risk attitudes toward future uncertainties are definitely different across individuals. As this is logically occurring on individuals, firms will behave in such a way conforming to the most common attitudes[20] toward assuming potential risks of diversification. Larue and Yapo (2000) indicated that rationally, risk-averse managers would induce their firms to compete more conservatively. As a result, firms will produce fewer outputs. This is in-line with what the managers perceive; higher uncertainties lead to higher potential losses. As the managers perceive the potential risks of diversification diminishes, even the risk-averse managers will persuade their firms to compete more aggressively by producing more outputs. From the manager's point of view, such conservative actions lead to risk minimization, and thus, securing one's position in the corporate ladder. The studies in electronic capital market by Bloomfield, et al (2004) also confirm the likelihood of engaging

[19] However, it should be noted that though tangibly the firm's economies of scope may seem to be increased following a diversification agreement, it remains uncertain how much the economies of scope has actually been improved. Also, firm's intangible assets may be considered as one potential boost toward economies of scale and scope, it remains uncertain that it may well be the case. The marginal increment on the firm's economies of scale and scope is unclear. It is also uncertain how much the market dominance has been experienced by the firms. In other words, the marginal increment on market dominance is unknown. This is the risk of uncertainties that the diversified firms may encounter (Altunbas, et al, 2000; Larue and Yapo, 2000).

[20] This conforms to the cultural school of thought (Mintzberg, et al, 1998).

in limit orders[21] when information becomes uncertain. When information is considered adequate, the frequency of engaging in limit orders fades over time. At the same time those risk-averse managers inducing lower output, the riskier-taker managers will tempt their firms toward competing more aggressively. Thus, firms produce more. Again, this difference is mainly due to the overall perception of managers toward potential risk in the future states. Hence, sufficient level of information and attitude advantages can potentially allow firms to produce more under uncertainty than others. Firms run into a major issue when they are not getting all the required information on diversification strategies and action plans to make such a diversification agreement workable. Firms also run into a major issue when they believe that they have gathered all the required information on diversification. This is another type of risk that managers should be concerned with (Larue and Yapo, 2000).

In order to ensure the likelihood of success (Beasley, et al, 2007), it is necessary for managers to note the following key factors; growth, intangible assets, cash ratio, earnings volatility, leverage, firm size, and market risk (or otherwise financially termed as beta). This is particularly true for firms with extensive growth options (Garnsey, et al, 2004; Holmstrom and Roberts, 1998). Diversified firms are unquestionably included in this category.

From the perspective of intangible assets, for instance, the economics of risk should be taken into consideration most during distress periods. Goodwill is definitely one of many firms' intangible assets. During times of downturns, firm's goodwill tends to be undervalued. In other words, the situation of economic slump leads to lower level of firm's goodwill. The lower level of firm's goodwill should directly benefit debt-holders. Nonetheless, stockholders are often forgotten. Stockholders should have been indirectly benefited as well via a lower interest rate charged by debt-holders. This translates into a lower interest expense. Firms with a relatively high degree of concentration toward research and development, will likely to incur high expenses on research and development. Though incurring high expenses, this is transformed into the creation of intangible assets (Sampurno, 2006). Such research and development activities are prominent in the education industry, by sending-off lecturers for advanced studies, for instance. In such a situation, universities face substantial risks of returns on investment, which may lead to both success and failure states

[21] Limit orders means that "*a trader makes an order by placing a limit order to buy or sell the asset at a specific price*". If a particular order is actually falls within the existing limited boundaries, "*a trader takes an order by agreeing to trade*" (Bloomfield, et al, 2004).

toward future teaching methods and transfers of knowledge. Hence, bulkier institutions face lower risk toward survivability into years to come (Besanko, et al, 2007; Gugler, et al, 2002; Hirshleifer and Riley, 1979).

Firm's leverage amount is yet another factor to ponder on the likelihood of success in diversification. From the analysis of ratio, leverage is beneficial to elevate firm's performance via the use of other sources. Nevertheless, it is also widely understood that the higher the scale of leverage, the higher the odds on firm's financial distress. Under the condition of financial mishap, firms are likely to start experiencing reduction in debt ratings. The lower debt ratings lead to higher borrowing cost. Undoubtedly, diversified firms are also experiencing leverage in their course of doing business activities. Once firms enter into diversification agreements, they experience various types of leverage. Financial leverage and operation leverage are indeed two most popular types of leverage for diversified firms (Beasley, et al, 2007; Besanko, et al, 2007; Mansi and Reeb, 2002). When the level of financial leverage heightens, diversified firms are able to enjoy the benefits of working tightly with other firms in producing more goods and services. When the level of operational leverage intensifies, diversified firms also enjoy the similar benefits of ability to produce more goods and services. Thus, a good risk management will likely to lower the chances of financial misfortune, which boosts the debt ratings and lower the firm's borrowing costs (Beasley, et al, 2007).

Market risk may contribute to the success or failure of diversification. As the country's economy stabilizes, market risk decreases. As the market risk falls, firms may be forced to re-price the existing stocks using lower cost of capital. Ceteris paribus, a lower cost of capital is only possible given the fulfillment of other conditions, both internally and externally. The lower cost of capital can also be achieved via establishing synergy. If the synergy works well, a lower cost of capital is not impossible. This affects the possibility of re-pricing stocks at more attractive price level. If this holds up, diversified firms have the ability to control the possibility of price reactions by means of lowering the firm's beta (Beasley, et al, 2007).

In addition to the previously mentioned factors on likelihood of success and failure above, it is necessary to document managerial characteristics since risks are mostly associated with the managerial overall attitudes toward future unknown states. It is logical that for salary-based managers that they disfavor more volatility. These types of manager favors the smoother the expected and actual returns. For sure, this type of manager tends to favor organizational risk management to minimize the volatility of the expected returns. In essence, this framework of thinking safeguards the salary-based compensation. For a commission-based manager[22], however, the story is different. Managers may hold diversified portfolio to favor risk management to reduce the overall portfolio risk. Thus, the more volatility on future states, the better. This type of manager favors an aggressive risk management to maximize the uncertainties of the expected returns. Certainly, the underlying issue behind managerial compensation is further complicated by board and ownership structure in any given firm.

Hence, it is hypothesized that;

H_2 : Market structure strongly influences incentives

H_3 : Market structure strongly influences risk attitudes, and vice versa

H_4 : Risk attitudes strongly influences diversification strategy

H_5 : Risk attitudes strongly influences incentives

H_6 : Diversification strategy strongly influences incentives

III. RESEARCH METHOD

A non-probability cluster convenience sampling method is used in this study to note the characteristics of those SME in certain locations, and industries. The non-probability cluster convenience sampling method is used to segregate SME in Jakarta and Bandung. Research is conducted by gathering data from primary and secondary sources in service industries in Jakarta and Bandung.

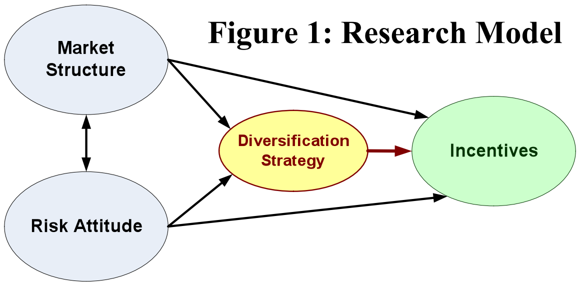
Though there are some quantitative data, this study is also used a qualitative method by incorporating focus group discussion ("FGD") that consists of entrepreneurs from various retail and service industries in Bandung and Jakarta. Those entrepreneurs are relatively mixed in terms of their ages, years of experience in the business, market exposures, market structure, market risks, size of the firm, and level of competition. Nonetheless, all participants of FGD have similar characteristics in terms of years of actual operations in the business. They are entrepreneurs of young organizations in retail and service establishments.

[22] This includes managers with stock-based compensation and/or share-ownership compensation (Beasley, et al, 2007).

Leveraging on previous acquaintances, the selection process on those entrepreneurs is merely convenience-based (Anantadjaya, et al, 2011a; 2011b; Anantadjaya, 2007; Yogaswara, et al, 2005; 2006; 2010). A total of 50 invitations were sent out to prospective participants. Out of those 50 invitees, there were only 9 invitees to participate in the FGD. Though the response rate was only 18%, the participants were actively and positively contributed. As the purpose of FGD in this study is to provide qualitative analysis, it is expected that the result on FGD would actually conform to the statistical findings.

III.1. RESEARCH MODEL

Figure 1: Research Model



The following illustration shows the research model in this study. As previously noted, the market structure and risk attitudes are used as the foundation in building arguments toward diversification strategy. The notions on market structure and risk attitudes are developed based on the resource-based theory of the firm and knowledge-based theory of the firm. The relationship between market structure and risk attitudes represents the asymmetric information that may exist in the marketplaces among players.

III.2. FGD PROCESS

The total of 9 participants in FGD are distributed a series of questions, as discussed below. Prior to the day of the meeting, participants are also requested to submit their financial records, particularly sales, expenses, product mix, and product lines. From these figures, growth rates can be calculated.

In the first session, individually, all participants are asked to respond to the series of questions on market structure, risk attitude, and diversification strategic intent. Once individual responses are submitted, participants are put into group discussion to share their responses. Following the group discussion, a short presentation on averages of their financial performance are shown. The first session is concluded by asking participants to respond to the same series of questions again in market structure, risk attitude, and diversification strategic intent. Since all participants have been in business for some time, it is expected that their responses are similar, before and after the group discussion. However, variations that may occur provide illustration that risk attitude and diversification strategic intent may be modified once personal influences are introduced. Such introduction of personal influences may portray the level of competition in the marketplaces in terms of information sharing.

In the second session, individually, all participants are asked to provide explanations to the variations in their financial performance. It is expected that their responses may provide link between what those entrepreneurs may have planned in the beginning, and the actual performance of the firm. Of course, this takes into account the level of market risk.

III.3. VARIABLES

To represent market structure, as previously mentioned, questions are formulated based on the monopolistic competition. Aside from inquiring similar products, and numbers of players in the marketplaces, questions also cover substitute products, and complimentary products. As the numbers of substitutes and complimentary products increase, this condition confirms the market structure of monopolistic competition. It is expected that through the questions on product substitutes and complimentary, entrepreneurs may provide illustration on the potential impact of market structure to any business dealings in diversification and incentives.

To represent risk attitude, the labels of risk-averse and risk-lover are used. Questions are formulated based on the willingness on assuming risks, particularly for entrepreneurial business risks. Questions are mainly covered innovation risks, and investment risk. It is expected that through the questions on innovation risks, and investment risks, entrepreneurs may provide picture on the level of risk-aversion. As the level of risk-aversion increases, it is expected that entrepreneurs may likely to engage in diversification strategy, and vice versa, as an illustration that diversification strategy may entail incentives.

To represent the diversification[23], this study incorporates a managerial strategic directional scheme for years to come. Hence, variables chosen to approximate diversification follows the growth strategy, and concentration strategy (Anantadjaya, et al, 2011a; Noe, et al, 2008). Concentration strategy focuses on increasing market share, creating market niche, and cost efficiency. Internal growth strategy emphasizes on product/service development, including innovation and potential ventures with other businesses. Questions used in the FGD are formulated around those chosen variables. As stated, it is expected that such variables would

[23] In this study, the term "diversification" is also used to note the diversification intentions of entrepreneurs.

reveal the diversification strategy of entrepreneurs of young organizations.

To represent diversification risks, this study focuses on financial performance of the firms. Some selected variables to note the diversification risks are; sales, expenses, growth rate[24], product mix, and product lines. It is expected to experience a lower diversification risk when sales increase, growth rate rises, product mix multiplies, and product lines enlarge. On the contrary, when expenses rise, a higher diversification risk is expected. In addition, some proxies as commonly noted as indicators of the macro economic condition; gross domestic product[25] ("GDP"), interest rates[26], foreign exchange[27], and inflation[28] (Besanko, et al, 2007; Ebert and Griffin, 2005; Soekasah, 2009), are also used. When GDP rises, and foreign exchange strengthens, a lower diversification risk is expected. Consequently, a higher diversification risk is expected when interest rates escalate, and inflation swells.

IV. ANALYSIS

In this study, questionnaires were distributed via online to SME's entrepreneurs. The list of entrepreneurs was previously compiled during the most recent studies in the first semester of 2011 (Anantadjaya, et al, 2011a; 2011b). With a total of 155 respondents, about 61% of those respondents are located in Jakarta, and the remaining 39% is in Bandung. Since there were no significant differences in the demographic, their responses were combined.

The respondents' financial characteristics, as dimensions of incentives, over the 18-month period, up to June 2011, were as follows;

- The average daily sales were Rp. 320,910, with a standard deviation of Rp. 299,821.
- The average daily expenses were Rp. 98,297, with a standard deviation of Rp. 121,388.
- The average growth rate was 0.69%, with a standard deviation of 0.12%.

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[24] In this study, the term "growth rate" represents growth in firm's sales, firm's assets, and firm's size (Anantadjaya, et al, 2011a).

[25] In this study, the term "GDP" is used as a proxy to approximate the risk level in the country. As GDP rises, the general economy appears booming (Besanko, et al, 2007; Ebert and Griffin, 2005; Soekasah, 2009). This may intrigue firms to increase inventory for higher sales, and/or enticing firms to start engaging into diversification intentions since it contains incentives for firms to do so.

[26] According to Besanko, et al (2007), Ebert and Griffin (2005), and Soekasah (2009), in this study, the term "interest rates" is used as a proxy to approximate the risk level in the country. As interest rates rise, the general economy may experience slowdowns. This may intrigue firms to reduce inventory for lower sales. At this time, diversification intentions become unattractive since it does not contain any incentives to do so.

[27] According to Ebert and Griffin (2005), and Soekasah (2009), in this study, the term "foreign exchange" is used as a proxy to approximate the risk level in the country. It represents the exchange rate between US dollar and Rupiah. As foreign exchange strengthens, Indonesian products become more expensive for foreigners. At this time, diversification intentions become attractive since the chances of accumulating incentives as enormous.

[28] According to Ebert and Griffin (2005), and Soekasah (2009), in this study, the term "inflation" is used as a proxy to approximate the risk level in the country. It represents the overall movement of price levels on various products and services.

In addition to the above respondents' financial characteristics, some selected indicators on the Indonesia's macro economic condition are also noted.

Table 1: Reliability Statistics

Cronbach's Alpha	**Cronbach's Alpha Based on Standardized Items**	N of Items
.457	**.881**	12

Source: SPSS

The reliability statistics indicated that the data are considered 88% reliable. The reliability statistics appeared to indicate an acceptable degree of reliability. This means that the data set used in this study can be analyzed further. Nevertheless, since the descriptive statistics indicated that there was variability in terms of the scaling on the original data, a standardization process on scaling is deemed necessary. Standardized Z-scores are used in further analysis.

From the validity statistics table, it is apparent that the results of path analysis were considerably valid. The measurement on model fit Root-Mean-Square Residual ("RMR") indicates 0.412. Any values smaller than 0.05 are considered valid (Ghozali, 2004; Santoso, 2009; Schumacker dan Lomax, 2004; Wijaya, 2009). Other supporting measurements on Normed Chi Square ("CMIN/DF") of 1.364, Goodness of Fit Index ("GFI") of 0.891, Adjusted Goodness Fit Index ("AGFI") of 0.871, and Parsimonious Goodness of Fit Index ("PGFI") of 0.888, indicate that the model meets the standard validity criteria (Ghozali, 2004; Santoso, 2009; Schumacker dan Lomax, 2004; Wijaya, 2009).

Table 2: Validity Statistics

Model	**RMR**	**CMIN/DF**	**GFI**	**AGFI**	**PGFI**
Default model	**0.412**	**1. 364**	**0.891**	**0.871**	**0.888**
Saturated model		1.000		1.000	0.000
Independence model	0.331	0.000	0.000	0.000	0.000

Source: AMOS

Referring to the structural model in the diagram, the following can be analyzed;

- At 95% confidence, the correlations on all dimensions used to indicate the market structure show considerable strengths. Though numbers of players appear to have the lowest level of correlation, it signifies that numbers of players, similar products, substitute products, and complimentary products, have satisfactory power to explain the market structure. These empirical evidences do not seem to conform to the underlying theory used in this study.

It should be noted that, respondents' responses show that similar products appear to be the dominant factor of market structure. This shows that the market structure is likely to be set by similar product availability in the marketplaces, instead of numbers of players, as commonly referred to in economics references. Also, it should be noted that substitutes and complimentary products show strong correlations in explaining the market structure. Hence, it appears that regardless of the actual numbers of players in the marketplaces, the actual conditions of the playing field in the market structure is set by other dimensions. These statistical findings are confirmed by the results of FGD. Participants in FGD unanimously agreed that the numerous variability of products, including substitutes and complimentary, is the driver for the market structure.

- At 99% confidence, the correlations on all dimensions used to indicate the risk attitude shows satisfactory strengths. At 84% correlation, investment risk appears to be leading in explaining entrepreneurs' risk attitudes. Though the innovation risk is a mere 55%, it also shows a an acceptable level of correlation. This is logically acceptable since SME's entrepreneurs may have to continuously invest in the business, and to constantly innovate to maintain existence. The statistics indicate that SME's entrepreneurs tend to be tolerant to risks. These empirical evidences seem to conform to the underlying theory used in this study. Fortunately, these statistical findings are also confirmed by the results of FGD. Though the results of FGD do not show the same percentages, 67%[29] of participants in FGD, agree that investment risk is the driver for the risk attitude.

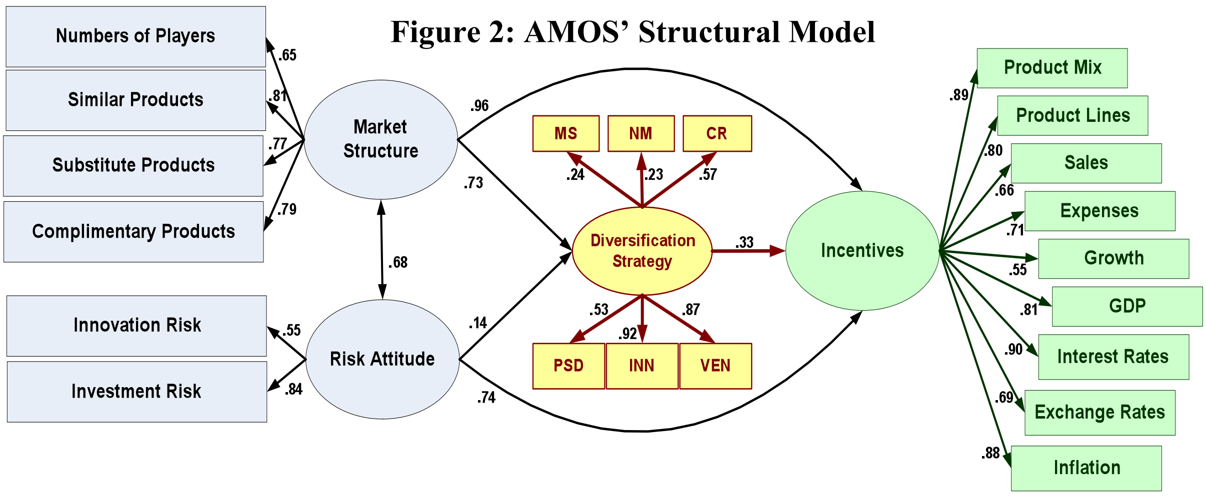
- At 95% confidence, the correlation between market structure and risk attitude show a marginally strong relationship. This shows that market structure influences risk attitudes, and vice versa. The product availability forms the condition of the market structure. This shapes the risk attitudes. Similarly, entrepreneurs' risk tolerance toward innovation and investment risks form the risk attitude. This directs the market structure. Just as the underlying theory does not conform to the empirical evidence, the results of FGD appear to be in contradiction as well. Participants in FGD state that the market structure directs

[29] In this study, there were 6 participants, out of a total of 9 participants, who indicated an agreement that investment risk is the major element in shaping the risk attitudes of entrepreneurs.

the level of risk tolerance.

- At 90% confidence, the correlations on all dimensions used to indicate diversification strategy show mixed strengths. There are dimensions with a considerably high correlation (product/service development, innovation, and ventures), but there are also dimensions with a relatively low correlation (market share, niche market, and cost reduction). This indicates that SME's entrepreneurs may not put an emphasis into enlarging market share and focusing on niche market. Likewise, these findings show that SME's entrepreneurs highlight the innovation and ventures activities in trying to diversify. This is also evident by the strongly positive correlation of 0.92 between diversification strategy and innovation, and 0.87 between diversification strategy and ventures.

Figure 2: AMOS' Structural Model



The correlation between market structure and diversification strategy is worth noted. At a correlation value of 0.73, this result shows that such an influence is relatively significant. This shows that market structure dictates the diversification strategy of SME's entrepreneurs. On the contrary, risk attitude and diversification strategy is only 14%. This shows that the implementation of diversification strategy does not rely on the risk attitude of entrepreneurs. In other words, it becomes insignificant whether the entrepreneurs are risk-adverse or risk-lover. These empirical evidences do not seem to conform to the underlying theory used in this study. These statistical findings are also confirmed with the results of FGD. At a similar level, about 78%[30] of participants in FGD agree that risk attitude is not the driver for diversification strategy.

- At 95% confidence, the correlation between diversification strategy and incentives show a relatively weak relationship, at a value of only 0.33. This shows that diversification strategy does not significantly influence incentives. Regardless of the actions that entrepreneurs perform, those sets of actions do not bring about incentives. This empirical evidence does not conform to the underlying theory on the economics of strategy (Besanko, et al, 2007). This statistical finding is also confirmed with the result of FGD. All participants agree that diversification strategy brings about incentives. This means that participants of FGD believe that improvements in incentives are the impact of diversification strategy.

- At 99% confidence, the correlations on all dimensions used to indicate incentives shows satisfactory strengths, with the least strengths on growth (0.55), and sales (0.66). Though growth rate, and sales show the weakest link among all indicators, these indicators display the statistical findings that entrepreneurs' growth rate and sales provide sufficient incentives following the implementation of diversification strategy. This empirical evidence does not fully conform to the underlying theory on the economics of strategy (Besanko, et al, 2007). Nonetheless, these statistics are confirmed with the results of FGD. All participants unanimously agree that product mix, product lines, sales, expenses, growth, GDP, interest rates, exchange rate, and inflation represent the incentives for diversification strategy. This means that such financial performance portray the appealing factors for entrepreneurs to consider. The swelling numbers on product mix, product lines, sales, growth rate, exchange rate[31], and GDP show the positive incentives for entrepreneurs. The diminishing numbers on expenses, interest rates[32], and inflation[33] indicate positive incentives for entrepreneurs.

[30] In this study, there were 7 participants, out of a total of 9 participants, who indicated an agreement that market structure is the major element in shaping the diversification strategy.

[31] As the exchange rate strengthens, local currency becomes stronger as compared to other foreign currencies. This pushes the purchasing power of local residents toward more consumption. As residents increase their consumption toward goods and services, for entrepreneurs, this may be seen as incentives on diversification strategy.

[32] As the interest rate declines, residents may withdraw their savings and put them into some other investment options. This may also include increasing consumption toward any goods and services. For entrepreneurs, the additional consumption may represent as incentives on diversification strategy.

[33] As inflation declines, residents experience lower price level. This induces higher consumption rate. For entrepreneurs, this may be portrayed as incentives on diversification strategy.

- At 90% confidence, the correlation between market structure and incentives shows a strong relationship, at a value of 0.96. This shows that market structure has a significant influence toward incentives. Despite the common threats that may exist in the marketplaces, those sets of conditions used in this study bring about incentives. This empirical evidence conforms to the underlying theory on the economics of strategy (Besanko, et al, 2007). This statistical finding is also confirmed with the result of FGD. All participants agree that market structure strongly influences incentives. This means that participants of FGD believe that incentives are constantly available in the marketplaces that follow the monopolistic competition, regardless of numbers of players, similar products, substitutes and complimentary.

- At 90% confidence, the correlation between risk attitude and incentives shows a relatively strong relationship, at a value of 0.74. This shows that risk attitude influences the generation of incentives. Despite the types of innovation risk or investment risk, the common entrepreneurs' risk attitudes bring about incentives. As the entrepreneurs take on higher risks, the expected returns inflate. This empirical evidence conforms to the economics of strategy, or the risk-aversion theory (Besanko, et al, 2007). This statistical finding is also confirmed with the result of FGD. All participants agree that as people takes on more risks, the chances of experiencing expected higher returns jump. This means that participants of FGD believe that incentives follow the level of risk tolerance, regardless of the actual types of risks that entrepreneurs may decide to engage in.

V. CONCLUDING REMARKS

V.1. CONCLUSION

The linkage from the resource-based and knowledge-based theory of the firm to firms' diversification provides a clear path for future development. The reading suggests that it is now safe to draw a conclusion that knowledge has become the priority for firms to secure their sustainability into the long future. In fact, this is an evident that the importance of intangible assets has emerged. This is particularly true in the diversification agreements. As firms are now challenged with dynamic and heavy turbulence in the economic environment, which is coupled with the intricacies in ensuring the successful diversification, balancing the risks and incentives, creating additional value leads to substantial firms' performance. When firms try to do so, firms must realize the power of information from other firms and marketplaces. Also, firms must now realize the power of intangible assets and incentives on the used of such intangible assets. Continuous interaction with the externalities may proof beneficial for firms in monitoring and updating themselves into the most-current conditions in the marketplaces. This enables firms to formulate steps of actions toward flexibilities and quick responses. Transforming information to knowledge and learn to manage knowledge represent the significant impact to future development of firms worldwide. In short, intelligence level of human capital becomes the foundation for firms in staying ahead the competition.

The statistical findings are able to show the relationship among variables. In fact, the quantitative results point out the most significant variables, and dimensions to focus on SME's entrepreneurs. Based on the data and analysis, it is safe to conclude that;

- Market structure has 0.73 influence toward the implementation of diversification strategy.
- Market structure has 0.96 influence toward the generation of incentive.
- Market structure has 0.68 influence toward the formation of risk attitude
- Risk attitude has only 0.14 influence toward the implementation of diversification strategy
- Risk attitude has 0.74 influence toward the generation of incentives
- Risk attitude has 0.68 influence toward market structure
- Diversification strategy has 0.33 influence toward the generation of incentives

V.2. RECOMMENDATION

In order to maintain existence in the marketplaces, entrepreneurs of SME may have to concentrate on engaging in the similar/complimentary products, investments, coming up with innovation, establishing ventures, and take benefits on the fluctuations on interest rates. Future research may use additional variables and indicators to really note the impact of diversification strategy to firms' risks and incentives. Perhaps, targeting to bigger firms and/or publicly-listed firms may also be beneficial.

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