CHAPTER II

THEORETICAL FRAMEWORK AND THE HYPOTHESIS DEVELOPMENT

2.1. Theoretical Framework

2.1.1. *Managerial Ability*

Managerial ability is a skill or personal characteristics that help the achievement of the performance in management duty (Sulastri, 2009). There are some additional skills and personal characteristics suggested by *the American Assembly of Collegiate Schools of Business* for college students in developing the managerial skills (Sulastri, 2009), *leadership, self-objectivity, analytic thinking, behavioral flexibility, oral communication, written communication, personal impact, resistance to stress, and tolerance of uncertainty.*

Manager performs critical functions and has responsibility towards company performance (Wagner, 2008). Bertrand and Schoar (2003) said that managerial ability is reflected in the underlying decisions of the company (e.g., aggressive R&D investment or merger and acquisition activity). Demerjian et al (2008) said that manager specific features (ability, talent, reputation, or style) affect economic outcomes and are therefore important to economics, finance, accounting, and management research as well as to practice.

From the explanation above, it can be concluded that the capable manager is manager who has broad knowledge in businesses, having the ability of making effective and efficient decision, as well as an expert in the field of his/her responsibilities. The impact of those skills owned by a manager is to create firm value.

Research on managerial ability in the field of financial accounting is something new. Difficulties in measuring managerial ability make a lot of research has not yet be done. Demerjian et al (2012) uses data envelopment analysis (DEA) for measuring managerial ability by using data from the financial report.

2.1.2. *Data Envelopment Analysis (DEA)*

Data Envelopment Analysis is a linear programming-based technique for evaluating the efficiency of a Decision Making Units (DMU) (Mantri, 2008). The performance of a unit is evaluated by comparing its performance with the best performing units of the sample. In the population all DMU should have a set of data consisting of the same input and output.

Any DMU wants to meet the efficiency, which makes maximum output by using minimal input. Measurement of efficiency is usually measured by a ratio which compares level output produced with an input used. The higher the ratio is, the more efficient a DMU. For example, Return on Asset (ROA), which compares net income and total assets. The higher net income is, the higher the usage of assets.

The measurement of efficiency by the usage of single output and input as known above is known as a traditional analysis of efficiency (Isnugrahadi and Kusuma, 2009). Different with the traditional analysis, DEA can handle multiple inputs and outputs for measuring efficiency. For example from ROA, input (assets) is composed from a wide variety of components. In traditional methods, every other component assets are regarded to have the same contribution and to have equal weight. In fact, the component of the fixed asset and an intangible asset has distinct contributions in generating net income. DEA uses certain weights to the input and output in measuring the degree of DMU efficiency.

According to Demerjian et al. (2012) weights of a component input and output are resulted from a DMU with another DMU in a unity samples. The usage of weights is used because of the relation of inputs to produce some of the output. The weighing will determine how efficient a company uses input to produce the output.

According to DEA, company can be said to be efficient if the ratio between output and inputs is equal to 1 or 100 %. This is indicated that the company is no longer do extravagance in the usage of input. The company is said to be less efficient if the ratio of between outputs and inputs is less than 100 %. This is indicated that the company does not use the inputs efficiently. This level of efficiency is used as a measurement of managerial ability.

2.1.3. Signalling Theory

Signalling theory is used to explain that a company uses the information to give a positive or negative signal to the investor. Leland and Pyle in Scott (2012: 475) explain that signaling theory is that company's executives who have better information about the company are encouraged to provide this information to prospective investors in which the company can enhance corporate value through its reporting by sending a signal through its annual report.

Management does not fully submit all the information which will increase the firm value to the capital market, so if any information is submitted to the market by management, the market will react to the information as a signal (Listiana, 2009).

The information submitted by the manager about the good condition of the company through the financial reports is a signal that the company has done its operations well. Good signal will either be responded well by other parties or not.

2.1.4. Firm Market Value

The management of a company by the manager must be based on an objective which is going to be achieved. The objective is usually related to the decision making on financial field, which is used to maximize firm value. Firm value is the size of the success of company in improving the prosperity of the owners or shareholders (Suyono, 2011).

One form to describe the prosperity of the owners or shareholders is stock price. Firm value can be seen from stock price and the number of shares outstanding at the end of period. For companies that have gone public, the price of stock of a company is determined by supply and demand on the market. The market price is a reflection various-made decisions and management policy (Meryati, 2011). The higher the stock price of a company is, the higher firm value of a company. A company that has good management and always grow, will have the number of outstanding shares and the stock price is getting higher (Suyono, 2011).

In the previous research, the researcher were using Tobin's Q ratio to measure firm market value. Tobin's Q ratio is used as indicators for measuring the firm value, which has been much used in financial research. Tobin's Q Ratio was first introduced in 1969 by James Tobin as a predictor of firm's profitable investment. Tobin (1969) specifies Q as a ratio of firm's market value to its replacement cost. The value of Tobin's Q ratio describes a condition of investment opportunities owned by a company (Lang, et al 1989) or potential growth of a company (Tobin & Brainard, 1968; Tobin, 1969). Therefore, there are some limitations with Tobin's Q:

1. It is difficult to estimate replacement cost of company's assets due to lack of liquidity.
2. Some items (human capital, trade secrets, copyrights and patents) are intangible assets that are often difficult to value.

From the explanation above, the firm market value is measured by using Price to Book Value. Price to Book Value (PBV) describes how much a market value the company shares (Darmadji, 141:2001). PBV is an important indicator in the investment ratio and has already been used in various securities analysis of the world.

Price to Book Value gives a signal to investors whether the price paid to/invested to the company is too high or not if it is assumed the company bankrupt immediately. If the company bankrupts, then the main obligation is to pay off debts first, and the remaining assets (if there are any) will be distributed to all shareholders.

So, the main concept of Price to Book Values (PBV) is, the market capitalization is divided by the book value. The book value can be with the base of all companies or per its shares. This ratio is obviously comparing the market value towards firm value based on financial statements.

It can be interpreted that the higher the value PBV of a share indicates there is an excess on market perception towards firm value and the contrary, if the value PBV of a share is low, then can be interpreted as a signal of good investment opportunity in the long term.

Damoran (2001) in Fitriyadi and Rahardjo (2014), say that Price to Book Value has some advantages as follows:

1. The book value is relatively stable that can be compared with market price. Investors, who have a little faith on discounted cash flow method, can use price book value in comparison.
2. The book value is determined based on accounting standard which is consistent for all company. PBV can be compared among the same companies as the guidelines whether under or overvalued.
3. Companies with negative earnings can be measured by using Price to Book Value.

2.2. Previous Research

The research about the impact of managerial ability towards firm market value has been explored previously. The list of previous research is listed in table below.

Table 2.1

Previous research of Managerial Ability and Firm Market Value

Number of Research	Researcher	Research Title	Result
1	Tita Djuitaningsih, Aulia Rahman	The Impact of Managerial Ability towards Financial Performance	Managerial ability has positive impact towards EPS, ROA, DER, PER and ROE.
2	Alex Johanes Simamora	The Impact of Managerial Ability towards Firm Value with Managers' Ownership as Moderating Variable	• Managerial ability has positive impact towards firm value. • Managers' ownership is strengthening the impact of managerial ability towards firm value
3	Peter R. Demerjian, Baruch Lev, Melissa F.	Managerial Ability	• The researcher found that there's a positive

	Lewis, Sarah E. McVay.	and Earnings Quality	association between managerial ability and earnings quality. • The researcher found that higher quality managers are associated with higher quality earnings. • This finding consistent with the premise that the more capable the manager, the better he or she is to estimate accruals, and it suggests that firms can improve their earnings quality by employing higher ability managers.
4	Indra Isnugrahadi, Indra Wijaya Kusuma	The Impact of Managerial Ability towards Earnings Management with Quality of Auditor as Moderating Variable	• Managerial ability has positive impact on earnings management. • Earnings management has not significant effect towards earnings management.

2.3. The Hypothesis Development

One of the keys of a company's success is the existence of managers who are managed to design the business process that is efficient and effective, and able to make decisions that create value for the company. Besides, managers also have an obligation to communicate the company performance to the outside parties (stakeholders) who are interested with the company and the most appropriate way for manager to communicate the company performance is through financial reports that are reporting on certain period (Isnugrahadi and Kusuma, 2009).

Financial report is a picture of the financial condition of companies that are analyzed using a financial tool analysis, so it is easier to understand whether company is in a good or bad condition in a certain period of time (Ermayanti, 2009). A manager, who is capable, will usually have an accurate judgment. In order to make an accurate judgment, manager is required to have expertise. To get the expertise, a manager usually has a high level of education. Besides, the level of experience of a manager also determines his/her managerial ability. Managerial ability is a skill or personal characteristics that help the achievement of the performance in management duty (Sulastri, 2009).

The more capable manager will result to the efficiency of company performance that can be seen through the financial report. Financial report is important for a company, because information contained in a financial report will be used by investors, as guidelines on making investment decision.

If the information contained in financial report describes the efficiency of company performance, thus, implicitly, it provides positive signals to investors. According to Signalling theory (Leland and Pyle in Scott, 2012:475), the company could raise the value of the company through sending signals through its annual report. Because of that, it is expected that investor will consider information in the company's financial report to make investment in the company.

The more efficient the company performance is, it will increase the level of credibility of investors towards the company. By having this high level of credibility, investors will certainly give a positive response towards the company. If the supply remains the same, the demand of shares of the company will increase, which is resulted with the movement of share prices are likely to rise. These rising of share prices, will increase the company's firm market value.

From the hypothesis development above, the hypothesis of this research is:

H1: Managerial ability has positive impact on firm market value.