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THE EFFECT OF INNOVATION STRATEGY IN THE INFLUENCE OF MANAGERIAL ABILITY ON FIRM PERFORMANCE

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ABSTRACT

Managerial ability collaborates managerial skill and effort to improve firm performance through resources utilization and strategy implementation. This study is aimed to examine the influence of managerial ability on firm performance with the mediation effect of innovation strategy. The final sample is 940 firms from the manufacturing sector listed on the Indonesian Stock Exchange 2012-2019. Analysis techniques use Data Envelopment Analysis (DEA) to measure managerial ability score, cluster analysis to analyze company strategy, and path analysis to test and analyze variables statistically. The result shows that innovation strategy does not mediate the influence of managerial ability on firm performance. Higher managerial ability directly increases the firm performance, but it decreases innovation strategy and innovation strategy does not affect firm performance. In conclusion, managers should choose between efficiency and innovation because it is a trade-off. Therefore, the company must sacrifice one of them.

KEYWORDS: Firm Performance, Innovation Strategy, Managerial Ability.

INTRODUCTION

Managerial ability is a collaboration between managerial skill and effort in utilizing firm resources to improve firm performance. There is a gap in research of managerial ability and firm performance. Several studies showed no influence between managerial ability and firm performance because all managers are considered to have the same ability and behaviour to execute operations and achieve common goals (Bamber et al., 2010; Jimmy et al., 2019; Mori & Munisi, 2014). Other studies concluded that capable managers are better to create higher firm performance, but it is still unclear which skill or strategy factors influence the most (Fainshmidt et al., 2017; Giménez et al., 2019; Kundu & Gahlawat, 2016; Mohsenzadeh & Ahmadian, 2016; Santoro et al., 2019). Therefore, this study will expand the manager's role, which is not limited to skill, but also their effort in managing firm resources efficiently and implementing an innovative strategy to achieve the expected firm performance.

This research topic stems from Nokia's declining performance until Nokia decided to sell its brand to Microsoft in April 2014. That decline was caused by the management's inability to take strategic ways and innovation, so Nokia lags far behind other competitors. Then, in 2016, PT. Astra International Tbk. and PT. Chandra Asri Petrochemical Tbk., two of the nine reputable companies in Indonesia, received an award from SHIFT magazine in the 2016 Operational Excellence and Award (OPEXCON). It was an appreciation for management because of their ability to achieve great productivity and profits through industrial efficiency and continuous improvement. The two companies also won the award at OPEXCON 2018 (http://shiftindonesia.com/tag/opexcon/). This phenomenon shows that managerial ability contributes to managing the company and determining the right strategy to achieve high firm performance.

The influence of managerial ability on firm performance integrates two supportive theories. First, the resource-based view theory explains that a company is seen as a series of resources, namely a set of certain assets and capabilities (Jimmy et al., 2019; Thongsri & Chang, 2019). The capabilities of managers must support assets utilization to utilize and manage it properly and support innovation management. This theory shows the importance of a mechanism that can increase the firm's ability to compete and balance growth and profitability. The resource-based theory views the differences in the resources and capacity of managers as differentiating the company from its competitors (Giménez et al., 2019). An identical industry must have a unique way of managing, so their achievements also vary.

Second, upper echelons theory assumes that managers play an essential role in firm

performance through strategic choices (Mori & Munisi, 2014). This theory proposed by Hambrick and Mason (1984) states that the characteristics of managerial background predict strategic choices and performance levels. This statement supports that managers play a vital role in the company's success by selecting the best strategy. Managerial ability will be used in choosing the right, innovative, and relevant strategy in decision making to increase firm performance (Krismiaji, 2017; Masri, 2016; Yusdita, 2017; Zwageri, 2020). Organizational outputs are seen as values and cognitive behaviour of the actors behind the organization, namely management. Strategic choice is a broad term, includes formal and informal choices, indecision and decisions, general administrative choices, and competitive choices (Hambrick & Mason, 1984). The right strategy for a business is an essential factor to strengthen and maintain firm sustainability in a dynamic and competitive economic

environment (Ernawati, 2016). The innovation strategy is expected to increase the firm's advantages towards higher firm performance.

The influence of managerial ability on firm performance, which has been neglected for a long time, is the motivation of this study. Managers are primarily homogeneous entities that follow the company's main goals, so there is no significant direct influence between managerial ability and firm performance (Bamber et al., 2010; Jimmy et al., 2019; Mori & Munisi, 2014). Mori and Munisi (2014) further reveal a missing variable between those two variables. In line with this motivation, there are some novelties from this research. First, this study will try to develop and prove Mori and Munisi (2014) research concept, which states that strategy is the missing variable in influencing managerial ability and firm performance. Path analysis will include the innovation strategy as a mediating variable between managerial ability and firm performance. Second, this study will find what factor behind managerial ability, skill or effort, is the strongest one to support a manager. Baghdadi et al. (2018) argue that effort is the most substantial factor behind managerial ability.

This study is aimed to examine the influence of managerial ability on firm performance and innovation strategy as mediating variables. This research is expected to provide a theoretical contribution to support the resource-based view and upper-echelons theory with evidence that managers are bringing out their ability and implementing appropriate strategies to improve firm performance. This research is also expected to have implications for companies in developing countries. The regulator should monitor and evaluate the competence of managers so they can manage firm resources as efficiently as possible.

Managerial ability is how managers manage firm resources using their capability and effort to improve firm performance. The resource-based view theory underlies the concept of managerial ability that a company is a collection of organizational resources and capabilities (Jimmy et al., 2019; Thongsri & Chang, 2019). Several studies stated that capable and expert managers would deliver managerial ability and contribute to higher firm performance (Baghdadi et al., 2018; Ueki & Martínez, 2019). Not all managers can manage a firm efficiently. Managers must-have skills, expertise, competence, education, and experience in managing a firm. Managerial ability is seen as a skill and an effort to increase efficiency (Edi & Yopie, 2019). Without the manager's effort, the management effectiveness will be unclear.

Managers will carry out their responsibility to achieve outstanding performance as agents with whom the principal agreement binds. Along with the competitive competition, managers become essential players in the company. The same industry with the same resources will have different outcomes as long as management activities are unique. Based on the argument above, the first hypothesis is as follows:

***H_1*: Managerial ability has a positive influence on firm performance**

Capable managers determine how they choose the best strategy by continuously developing innovation to stay competitive in an industry (Giménez et al., 2019; Mohsenzadeh & Ahmadian, 2016). A relevant innovation strategy with a firm's conditions will create a competitive advantage and increase firm performance (Mori & Munisi, 2014; Rundquist, 2012; Xu et al., 2015). The achievement of good firm performance is inseparable from the firm's planning activities, one of them is determining the long-term goals. To achieve this goal, a company needs a strategy determination. A good strategy is in line with the company's goals and strives for new and innovative actions. Without a strategy, no matter

how expert the company's human resources are and abundant inputs, they will not achieve better firm performance.

The contribution of managers in determining the right strategy to generate high firm performance is in line with the upper echelons theory (Mori & Munisi, 2014). Capable managers can achieve the expected firm performance by determining the right strategic choices for company development. Based on the argument above, the second hypothesis is as follows:

***H2*: Managerial ability influence firm performance through innovation strategy**

Based on the research hypotheses that have been compiled above, the research model is shown in the following conceptual framework:

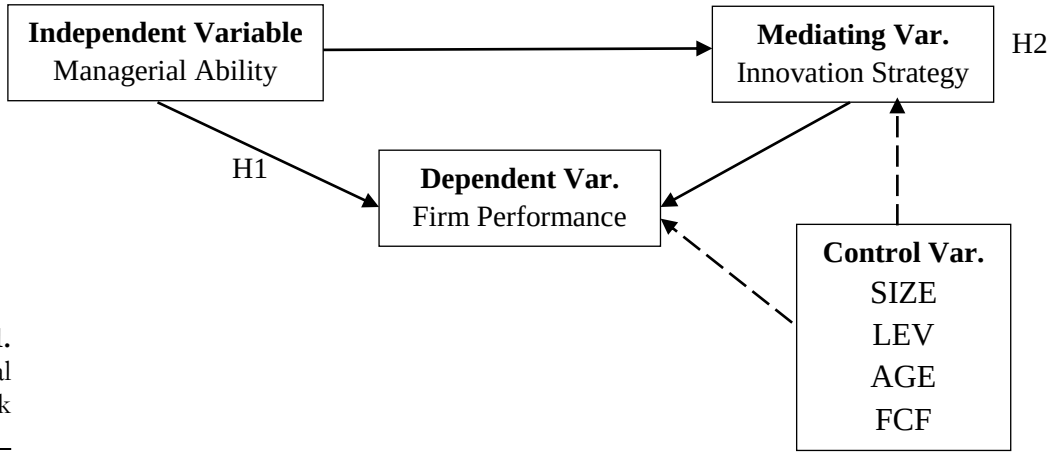

Figure 1. Conceptual Framework

METHOD

This research approach is an explanation. This study is aimed to identify the variables that represent the construct and analyze the statistical correlation between variables. The research population is all companies listed on the Indonesia Stock Exchange (IDX) in 2012-2019, with 1,856. The sample selection uses the purposive sampling technique. The research sample is manufacturing sector companies listed on the Indonesia Stock Exchange from 2012 to 2019 with 940 firms. This period and sector were chosen because Indonesia got into a fourth-generation industrial revolution, which affected some aspects of the industry, especially the manufacturing sector. That sector has the most complex operation and intense competition, so management must be more careful in managing firm resources efficiently, determining the right strategy, and innovating and surviving in the market.

The dependent variable is firm performance (ROA). Firm performance is a firm's financial condition that describes a firm's success (Scott, 2012). One of the accounting measures for firm performance is Return on Assets, which measures the overall profitability of assets (Baghdadi et al., 2018; Kieso et al., 2015; Yusdita, 2017). ROA is formulated as follows:

$$\text{ROA} = \frac{Earnings\ After\ Tax}{Total\ Assets}$$

The independent variable is a managerial ability (MA_SCORE). Managerial ability is managerial skill, knowledge, and competence in converting firm resources into income

(Demerjian et al., 2012). The measurement is by comparing the output and input used. The output used in this study is sales because it is the primary output and represents the nominal value of the company's products (Demerjian et al., 2012; Demerjian et al., 2013). The inputs used are resource and operational inputs. Resource inputs are total assets and total employee, while operational inputs are Days COGS in Inventory (DCI) and Days Sales Outstanding (DSO). The formula for calculating DCI and DSO is as follows:

$$DCI = \frac{365}{\frac{COGS}{Inventory}} \qquad DSO = \frac{365}{\frac{Sales}{Receivables}}$$

A managerial ability score was calculated using the Data Envelopment Analysis (DEA) technique based on these inputs and output. MA_SCORE will be in the range of 0 to 1, where one reflects the firm's efficiency in managing the resources and vice versa.

The mediating variable used is the innovation strategy (INSTRAT). An innovation strategy is a prospector-type strategy that demands competency, structure, and process that support the company to seek out new products and markets (Hambrick & Mason, 1984). Companies implementing innovation strategy are included in the prospector type as agents of change and superior innovators than competitors (Miles et al., 1978). INSTRAT measurement consists of several aspects, such as: 1) Ratio of market value to book value (PBV); 2) Number of employees compared to sales (EMPSAL); and 3) Capital expenditure compared to total assets (CAPTA) (Ittner et al., 1997). A cluster analysis (K-Means Cluster) was performed from these three aspects. The cluster with the highest score than the total average is the prospector cluster, while the other clusters are non-prospector. Firms included in the prospector cluster are given a score of 1 and 0 for non-prospector (Yusdita, 2017).

The control variables used are firm size, leverage, firm age, and free cash flow (Baghdadi et al., 2018; Thongsri & Chang, 2019; Ueki & Martínez, 2019). Firm size (SIZE) uses the natural logarithm of total assets. Total debt divided by total assets calculates leverage (LEV). The firm age (AGE) is measured by the number of years the firm operates from its establishment to the current year. Free cash flow (FCF) is measured by the difference between net cash flow from operating activities and working capital and the company's capital expenditures divided by total assets.

The type of data research is quantitative data. The data sources used in this study are Osiris and the firm's annual reports. This study's data analysis techniques are Data Envelopment Analysis (DEA), cluster analysis, and path analysis. DEA to calculate managerial ability scores, cluster analysis to classify companies based on firm strategy, and path analysis to test hypotheses using multiple regression through the SPSS program. The regression model of path analysis is as follows:

$$INSTRAT = \beta_1 MA\_SCORE + \beta_2 SIZE + \beta_3 LEV + \beta_4 AGE + \beta_5 FCF + e_1 \quad (1)$$

$$ROA = \beta_6 MA\_SCORE + \beta_7 INSTRAT + \beta_8 SIZE + \beta_9 LEV + \beta_{10} AGE + \beta_{11} FCF + e_2 \quad (2)$$

The magnitude of the direct and indirect effects is analyzed from the two models. The magnitude of the direct effect of the regression model 2 is expressed as standardized coefficients beta (β_6) or p1. Then, the extent of the indirect effect of managerial ability on firm performance through innovation strategy is calculated from the multiplication of path coefficients from model 1 and model 2 (β_1 and β_7) or (p2 and p3).

RESULTS AND DISCUSSION

Table 1. Sample Criteria

No	Criteria	Total
1.	Manufacturing companies listed on the Indonesia Stock Exchange for the period 2012-2019	1,856
2.	Companies do not provide complete data on the variables studied	(357)
3.	Companies have negative firm performance	(559)
4.	Sample of IDX manufacturing companies for the period 2012-2019	940

Table 1 shows the criteria and description of the research samples. This study observes the final samples of 940 firms from a total population of 1,856. Companies that do not provide complete data and have negative performance are excluded from the research samples.

Table 2. Descriptive Statistics

Variable	N	Min	Max	Mean	Std. Dev
MA_SCORE	940	0.008	1.000	0.333	0.256
INSTRAT	940	0.000	1.000	0.340	0.474
ROA	940	0.000	0.459	0.078	0.067
SIZE	940	23.928	33.495	28.479	1.649
LEV	940	0.000	2.492	0.446	0.230
AGE	940	2.000	118.000	36.018	18.011
FCF	940	-0.695	1.299	0.079	0.148

The descriptive statistics of the research data are presented in table 2. The level of variation MA_SCORE is 76.57%. It means the managerial ability of the firm observations is relatively uniform and close to the average value, so it can be said the sample companies are still not efficient (mean <50%). The INSTRAT distribution level has a varying level of 139.41%, which indicates the innovation strategy of the sample firms is relatively diverse and deviates from the average value. The level of variation ROA is 84.61%, so the performance of the sample firms is relatively uniform and close to the average value. Table 3 shows that MA_SCORE, LEV, and FCF correlate with ROA at the 1% level. Then, MA_SCORE and FCF variables correlate with INSTRAT.

Table 3. Pearson Correlations

Variable	MA_SCORE	INSTRAT	ROA	SIZE	LEV	AGE	FCF
MA_SCORE	1						
INSTRAT	-0.187***	1					
ROA	0.099***	-0.023	1				
SIZE	0.396***	-0.014	0.023	1			
LEV	0.157***	-0.044	-0.375***	0.125***	1		
AGE	-0.049	-0.064	-0.019	0.027	0.057	1	
FCF	0.086***	-0.179***	0.335***	.068**	-0.094***	0.087***	1

***, **,* Significant correlation at 0.01, 0.05, 0.1 levels

Efficiency Score	Classification	Number of Companies
1	Efficient	67
< 1	Not Efficient	873

Table 4. DEA Results

The DEA results in table 4 show that 873 companies are inefficient in managing company resources with an efficiency score of less than one. The remaining 67 companies can manage resources efficiently with a score of 1 (100%).

The cluster analysis results in table 5 show that cluster 1 has a higher PBV, EMPSAL, and CAPTA Zscore value than the total average value. A higher PBV reflects that the company is developing new product innovations to achieve excellence. A large EMPSAL indicates an increase in employees to support continuous innovation. A high CAPTA suggests the company is doing a lot of development and innovation enhancement. Thus, cluster 1 of 320 companies is included as the prospector, and cluster 2 of 620 companies is non-prospector.

Cluster	Zscore			Number of Companies
	PBV	EMPSAL	CAPTA	
1	0.08384	0.82433	0.78918	320
2	-0.04327	-0.42546	-0.40732	620

Table 5. Cluster Analysis Results

Path analysis was performed by regression analysis for the two regression equation models. The regression results are shown in Table 6.

Variable	Model 1 (INSTRAT)		Model 2 (ROA)	
	Without Control	With Control	Without Control	With Control
	Coef (sig)	Coef (sig)	Coef (sig)	Coef (sig)
MA_SCORE	-0.187***	-0.203***	0.098**	0.139***
	(0.000)	(0.000)	(0.003)	(0.000)
INSTRAT			-0.005	0.039
			(0.884)	(0.183)
SIZE		0.084**		-0.006
		(0.015)		(0.837)
LEV		-0.034		-0.365***
		(0.289)		(0.000)
AGE		-0.060*		-0.014
		(0.062)		(0.617)
FCF		-0.165***		0.297***
		(0.000)		(0.000)
Adjusted R^2	0.034	0.067	0.008	0.245

Table 6. Regression Results

***, **,* significant at 0.01, 0.05, 0.1 level

Variable definition: MA_SCORE (Managerial Ability) = comparison between input and output

using DEA analysis, INSTRAT (Innovation Strategy) = dummy variable from cluster analysis,

SIZE (Company Size) = natural logarithm of total assets, LEV (Leverage) = total debt/total assets,

AGE (Company Age) = number of years the company was established, and FCF (Free Cash Flow)

= (operating cash flow – capital expenditure)/total assets

The regression equations of the two models are as follows

1) INSTRAT = -0.203 MA_SCORE + 0.084 SIZE – 0.034 LEV – 0.060 AGE – 0.165 FCF + e1

2) ROA = 0.139 MA_SCORE + 0.039 INSTRAT – 0.006 SIZE – 0.365 LEV – 0.014 AGE + 0.297 FCF + e2

Model 2 shows MA_SCORE variable has a significant positive effect on ROA with a p-value of 0.000 (<0.01) so that Hypothesis 1 is accepted. Models 1 and 2 show MA_SCORE has a significant negative effect on INSTRAT with a p-value of 0.000 (<0.01), but INSTRAT has no significant effect on ROA with a p-value of 0.183 (>0.1). Therefore, the innovation strategy does not qualify as a mediating variable, and Hypothesis 2 is rejected.

The control variable in the regression model makes the Adjusted R square value increase. Models 1 and 2 have Adjusted R square values of 6.7% and 24.5%. Changes in the dependent variable, firm performance, can be explained by variables in this study as big as that value, while the rest is explained by other variables not included in this study. Furthermore, table 7 shows the direct and indirect effect of MA_SCORE on ROA.

Table 7. Direct and Indirect Effect

Direct Effect			Indirect Effect	Total Effect
p1	**p2**	**p3**	**(p1 x p2 x p3)**	**p1 and indirect effect**
0.139 (0.000)			0.007917	0.146917
	-0.203 (0.000)	0.039 (0.183)		

Based on table 7, the direct effect between MA_SCORE and ROA is 0.139 greater than the indirect effect through INSTRAT, which is 0.007917, so the innovation strategy variable can not mediate the influence of managerial ability on firm performance.

The Positive Influence of Managerial Ability on Firm Performance

The more capable managers are, the higher firm's performance is. Managerial ability is proven to have a significant favourable influence on firm performance. This study demonstrates that managers who are proficient in managing operational activities will improve the firm performance and benefit investors and other stakeholders. A capable manager is a valuable asset for the company, following the resource-based view theory that the company is a collection of resources that support each other to achieve the target and

improve firm performance. High firm performance verifies that a company has successfully utilized human resources and the shareholder's capital.

Managers in every company must have various qualities in their competence to operate firms. This study does not support the statement of Mori and Munisi (2014), competence and expertise of each manager are considered the same on the assumption that they work for the company. This research concludes that there are still many companies in Indonesia that have not yet achieved management efficiency. Behind efficiency, many managerial factors become a concern, such as effort and skill. High-skilled managers will open up vast opportunities to grow and develop then compete competitively with other companies. The decisions taken by a capable manager reflect the manager's professional judgment.

This result is in line with research conducted by Baghdadi et al. (2018), Ueki and Martínez (2019), dan Chang et al. (2010), showing that managers' ability to understand and effectively utilize firm resources is an essential input that can generate competitive advantage. Managerial ability is resource management and will influence the manager's decisions. Therefore, a company must choose the best, expert, and highly competent manager in carrying out the firm's operational activities to reach good performance.

The Effect of Innovation Strategy in the Influence of Managerial Ability on Firm Performance

The influence of managerial ability on firm performance is not through an innovation strategy. The innovation strategy can not play as mediating variable. The results of this study have answered research conducted by Mori and Munisi (2014) that strategy can not intervene managerial ability on firm performance. Capable managers have improved firm performance without selecting an innovation strategy. The strategic choice of each company must be adjusted to the firm's character and conditions (Arianwuri et al., 2017). The focus of manufacturing sector companies in Indonesia is still on managing complex operations, so innovation is limited. Innovation requires many research and development costs and causes higher risk uncertainty (Arianwuri et al., 2017). So, innovation is dangerous for the manufacturing sector, which has to survive and run complex operations in intense competition.

In line with Edi and Yopie (2019) research, managerial ability shows that a highly competent manager in operational decisions will add value and lead the company to a high-efficiency level. Their strategic choices to improve firm performance focus on efficiency, not innovation. These results follow the upper echelon theory that firm executives have the authority to determine their strategic decisions. Of course, the strategy must follow the company's character and condition to maintain sustainability.

CONCLUSION

This study concludes that managerial ability has a significant positive influence on firm performance. Capable managers have high competence to operate operations efficiently and provide high firm performance. Second, the innovation strategy can not mediate the impact of managerial ability on firm performance. Managerial ability shows high managerial competence in making operational efficiency decisions to add value to the company and enhance firm performance without going through an innovation strategy.

The limitation of this study is using COGS data as input to measure managerial ability scores so that the sample of companies is limited to the manufacturing sector. Future researchers can find other measurements to calculate managerial ability scores. Second,

most companies in Indonesia are still focused on operational efficiency and cause an imbalance in the number of efficient companies in the variables related to managerial ability, which is only 7% of the research samples. Further researchers can use several indicators to measure managerial ability, not only viewed from the firm's efficiency.

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