

# The effect of financial performance on the profit growth of banks listed on the Indonesia Stock Exchange

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## Abstract

*This study aims to provide empirical evidence showing how financial performance affects the profit growth of public sector banks. The sample comprises companies in the banking industry listed on the Indonesia Stock Exchange from 2018–2021. The research considers quantitative data from annual reports produced from 2018–2021 using purposive sampling. This research evaluated financial performance as measured by two proxies: CFROA was found to not affect bank profit growth, while ROE did have an effect. This research is expected to contribute to the development of new proxies for measuring banking financial performance. This research will also help banks focus on maintaining financial ratios according to regulations, such as net profit margin, operating costs and operating income, and non-performing loans. Furthermore, profit growth, as a factor that increases credibility, needs to be considered to maintain banking viability and customer and investor trust.*

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## 1. Introduction

The progress of a country's banking sector can be used as a benchmark for that country's progress. The more developed a country, the greater the governing role of banks because banks, as intermediaries, drive economic movement in all sectors. There is increasing demand for bank credit, including consumer credit, working capital, and investment, as well as increased purchasing power and business growth. According to Law No. 10 of 1998, banking aids the implementation of national development, thereby increasing justice, economic growth, and national stability to improve people's welfare. To achieve these goals, banks must have good financial performance that is, they must be able to carry out all their business activities effectively.

However, at the beginning of 2020, the Covid-19 pandemic affected the world, including Indonesia, and severely impacted the growth of banking profits. This is evidenced by the amount of net profit generated by state-owned banks such as Bank Mandiri. This bank experienced a decrease in net profits of 37.71 percent (to IDR 17.71 trillion) in 2020, whereas it generated a net profit of IDR 27.48 trillion in 2019 (liputan6.com, February 4, 2021). Owing to the alleviated conditions of the Covid-19 pandemic in early 2022, the net profits generated by banks slowly grew in line with the improvement in Indonesia's economic conditions. Evidence shows that the interim net profit obtained by Bank Mandiri by the end of June 2022 exceeded its net profits at the end of June 2021. This indicates an increase in banking financial performance as represented by Bank Mandiri.

Profits are calculated by subtracting the costs incurred by a bank from the income earned during a period, though a bank that earns large profits cannot necessarily be said to be working efficiently. Rather, comparing the profits obtained with the wealth or capital used to obtain maximum profits determines whether banks operate efficiently. Internal and external parties with a stake in a company need to know the company's profit growth because it signals that the company's finances are improving, which will affect the company's value. When predicting future profit growth, it is necessary to analyze financial statements through financial ratios (Harahap et al., 2020) based on accounting information about the company's operations and financial condition, which is available in its financial statements. Financial ratios are useful for analyzing a company's performance and financial condition (Harahap et al., 2020). Financial performance is an analytical measure of the extent to which a company carries out its operations and deals with changes in resources (Irham, 2014). Financial performance is also interpreted as a tool that measures company development (Kim et al., 2021). That is, the growth of companies and banks is determined by the profit earned over a year as recorded in financial statements.

Profit growth cannot be separated from financial performance. Ndubuisi et al. (2018) showed that financial performance, as measured using leverage ratios, had a significant effect on profit growth in 80 companies in Nigeria. These results support the findings of Heikal et al. (2014), who reported that financial ratios such as ROA, ROE, net profit margin, DER, and CR simultaneously affect the profit growth of automotive companies listed on the IDX. Different results were shown by Khaldun and Muda (2014) and Nikmah and Wahyuningrum (2020), who found that financial performance proxied by ROE does not affect the profit growth of the consumer goods industry. Meanwhile, the results provided by Umobong (2015) and Sokang and Ratanak (2018) indicate that financial performance has a negative effect on profit growth.

The phenomenon of interest to this research is the condition of the Covid-19 pandemic that affected the world and caused a decline in banking net profits in Indonesia, thus disrupting the Indonesian economy. This topic is important because banking supports the implementation of national development by increasing the distribution of development, economic growth, and national stability, ultimately increasing people's standard of living.

Based on evidence linking financial performance to predictions of profit growth and considering the conflicting results of previous studies, the current research re-examines how financial performance influences banking profit growth. This is done by using the cash flow return on assets (CFROA) ratio and ROE as proxies for banking performance.

## 2. Hypotheses development

The results presented by Heikal et al. (2014) and Anggani et al. (2017) show that financial performance proxied by ROE has a positive impact on profit growth. This is because when ROE is high, more capital can be used to finance business operations and, in turn, generate profits. Based on this, the following hypothesis is proposed:

H1: Financial performance proxied by return on equity (ROE) has a positive effect on profit growth.

The CFROA ratio is a proxy for banking financial performance that indicates the ability of banking assets to generate operating profits. CFROA measures current banking performance and is not related to stocks (Cornett et al., 2006). The CFROA ratio is relevant for measuring financial performance because it can describe conditions according to the reality of a bank's financial performance. This is because the CFROA ratio considers depreciation costs for the factors added to the calculation. Depreciation costs can reduce company profits even though cash flow does not change. Thus, the following hypothesis was put forth:

H2: Financial performance proxied by cash flow return on assets (CFROA) has a positive effect on profit growth.

## 3. Research methodology

This research follows a descriptive quantitative approach and uses banking financial report data obtained from the FEB Exchange Corner at Tarumanagara University and the IDX website. This research uses a population of banking companies listed on the IDX from 2018–2021. The research sample was selected using a purposive sampling technique based on the following criteria: First, banks had to be continuously registered on the IDX during the research period. Moreover, their financial reports had to use the IDR currency. Furthermore, there could be no IPO or delisting from the IDX during the research period. The research sample consisted of 33 banks and 132 observational data. This research considered the independent and dependent variables presented in Table 1.

**Table 1. Variable operationalization**

Variables	Proxy
Independent variable	
Profit Growth (Heikal et al., 2014)	$\frac{\text{Profit } t - \text{Profit } t - 1}{\text{Profit } t - 1}$
Dependent variables	
Return on equity (ROE) (Irham, 2014)	$\text{ROE} = \frac{\text{Profit}}{\text{Total equity}}$
Cash flow return on assets (CFROA) (Pancawardani, 2009)	$\text{CFROA} = \frac{\text{Cash flow from operation}}{\text{Total assets}}$
Control variables	
Current ratio (CR) (Irham, 2014)	$\text{CR} = \frac{\text{Current assets}}{\text{Current liabilities}}$
Debt to equity ratio (DER) (Irham, 2014)	$\text{DER} = \frac{\text{Total liabilities}}{\text{Total equity}}$

This research uses a panel data regression analysis with the following estimation model:

$$PG = a + bROE + cCFROA + dCR + eDER + e_{it} \dots\dots\dots (1)$$

Where :

- PG : Profit growth
- ROE : Return on equity
- CFROA : Cash flow return on assets
- CR : Current ratio
- DER : Debt to equity ratio

Three techniques (models) are often employed to estimate the parameters of the panel data model: the common effect, fixed effect, and random effect models. Which model is used depends on the number of individuals, the bank, and the research variables (Widarjono, 2007). Three tests are used to determine panel data estimation techniques. First, the F-statistic is used to choose between a common effect or a fixed effect. Second, the Hausman test is used to choose between a fixed effect or a random effect. Finally, the Lagrange multiplier test is used to choose between the common effect and random effect models (Widarjono, 2007).

#### 4. Results and discussion

The next step was to analyze the descriptive statistics to understand how to determine the characteristics of each variable. The results of the descriptive statistical analysis are shown in Table 2, which contains the mean, median, minimum, maximum, and standard deviation values of the research variables.

**Table 2. Descriptive statistics**

	PL	ROE	CFROA	CR	DER
Mean	0.1831	0.1092	0.0533	0.4843	5.4770
Median	0.0948	0.0700	0.0309	0.2796	5.3550
Maximum	3.4660	0.9300	2.3800	3.9953	16.0800
Minimum	-1.0832	0.0030	-2.3280	0.0188	0.0300
Std. Dev.	0.7250	0.1599	0.3596	0.5788	2.7882
Observations	132	132	132	132	132

The descriptive statistical data for the research model indicate that the value assigned to financial performance, as measured by ROE, is 0.1092. This value means that the amount of company income received by the company is 0.1092 times the profit growth received; thus, this value is quite large.

##### 4.1. Chow and Lagrange tests

Next, the Chow test was carried out to find whether the fixed effect or common effect model should be used in this research. In this test, the null hypothesis and alternative hypothesis are as follows:

H0: The common effect model should be used.

Ha: The fixed effect model should be used.

If the chi-square probability gives a result of < 5%, then H0 is rejected (i.e., the fixed effect model is the most appropriate model).

**Table 3. Results of redundant fixed effect-likelihood ratio**

Effect test	Probability
Cross-section F	0.7601
Cross-section Chi-square	0.4922

The test revealed a probability value of  $> 5\%$ , meaning it was appropriate to use the common effect model. The next step was to run the Lagrange test. The null and alternative hypotheses for this test are as follows:

H0: If the Breusch-Pagan probability  $> 0.05$ , then the common effect model is preferred.

Ha: If Breusch-Pagan probability  $< 0.05$ , then the random effect model is preferred.

**Table 4. Lagrange multiplier test results**

Test summary	Chi-sq. statistic	Probability
Cross-section random	0.8851	0.3458

The results of the Lagrange test show that it is appropriate to use the common effect model.

#### 4.2. Results

The next step was to test panel data regression with the common effect research model. This was done using EViews 10 software. The results are presented in Table 5.

**Table 5. Results (common effect model)**

Variables	Coefficient	t-stat	Prob.
C	-0.0815	-0.5392	0.5907
ROE	0.8637	2.1617	0.0325
CFROA	0.0034	0.0198	0.9842
CR	0.0867	0.7950	0.4281
DER	0.0234	1.0196	0.3098
R <sup>2</sup>	0.0525	Durbin-Watson stat 2.1151	
F-stats	1.7600		
Prob (F-stats)	0.0140		

Table 5 shows that the F value is 1.7600 and that the probability of F is 0.0140. These values mean that the F test is significant because the probability of F is lower than the 10% significance level previously determined. The F test concludes that the amount of commission received from financial activities has a positive effect on the profit growth of banking companies.

Moreover, the t-value presented in Table 5 has several implications. First, the ROE or returns received by investors can improve banking financial performance with a probability of 0.0325, and this value is below the 10% significance level. Furthermore, the rate of return on changes in cash flows on assets does not affect the company's profit growth, as the probability value of 0.9842 is above the 10% significance level. Moreover, this study used a control variable to reduce external influences other than the independent variables; the specific control variables considered were current ratio and debt ratio. The results presented in Table 5 show that the current ratio and leverage ratio have no effect on the profit growth of banking companies. The value of R<sup>2</sup> is 0.05225 (5.225%). This indicates that the independent variables included in the research model explain 5.225% of the change in the dependent variable, while 94.775% is explained by other independent variables.

### 4.3. Discussion

The results of the panel data regression *common effect model* are presented below:

$$PG = -0,0815 + 0,8637*ROE + 0,0034*CFROA + 0,0857*CR + 0,0234*DER.....(2)$$

The panel data regression equation produced a coefficient value of the ROE research model of 0.8637. Thus, if the independent variable is assigned a value of 0, then the banking financial performance would be 0.8637. Furthermore, the coefficient value of the CFROA research model was 0.0034; thus, if the value assigned to this variable is 0, then the company's financial performance would be 0.0034.

H1: Financial performance proxied by return on equity (ROE) has a positive effect on profit growth.

Banking financial performance, when proxied by ROE, is formulated by dividing net income by total assets. The results show that ROE has a positive impact on profit growth. This outcome supports the research conducted by Haekal et al. (2014) showing that banks generate higher profits when they manage their capital effectively.

H2: Financial performance proxied by cash flow return on assets (CFROA) has a positive effect on profit growth.

Financial performance proxied by CFROA did not have a positive impact on bank profit growth. The average value of cash flow from banking operations was smaller (less than 10%) than total assets owned; thus, this variable does not sufficiently affect the growth of bank profits. In addition, banks failed to show efficiency in proper asset management and did not generate profits, meaning investors did not receive the expected returns (Purwitasari & Soekotjo, 2019).

## 5. Conclusions and suggestions for future research

Financial performance proxied by ROE is positively related to a company's profit growth. This is because additional capital can be used to fund the company's operations, allowing it to generate additional profits. Meanwhile, financial performance proxied by CFROA is not associated with increased bank profit growth. This means that if banks increase their CFROA, their profit growth falls. When banks fail to demonstrate their effectiveness in managing assets, they cannot generate profits. Thus, investors do not receive the returns they expected.

This research used the current ratio as a control variable and showed that this variable does not influence banking financial performance. This confirms that a large current ratio does not indicate large profit growth without the support of good banking resource management. Similarly, the statistical results obtained when debt-to-equity ratio was applied as a control variable show that this ratio does not have a positive effect on bank profit growth. This is because a high liquidity ratio value cannot guarantee the growth of bank profits.

Bank managers could use this research to improve bank performance. Specifically, they should only focus solely on maintaining financial ratios according to regulations, such as net profit margin, operating costs and operating income, and non-performing loans. This is because growing profits must also be considered to maintain bank profitability and credibility. Thus, managers should focus on increasing capital, asset quality, income, and liquidity, as increasing these factors will lead to increased profit growth.

Future research could consider non-banking industries, such as food and beverage or manufacturing industries. In addition, further research can add to the knowledge about which financial performance variables can increase bank profit growth (e.g., the ratio of non-performing loans, operating costs and operating income, and NIM).

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