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# **TEST OF ACCEPTABILITY OF PROFIT AND LOSS SHARING FINANCING ARRANGEMENTS BY SMALL SCALE BUSINESSES IN AND AROUND KANO CITY IN NORTHERN NIGERIA**

***Suleiman Muhammad Hussaini, PhD***

Department of Business Administration, Ahmadu Bello University, Zaria-Nigeria

***Hussaini Usman Malami, PhD***

Department of Economics, Faculty of Social Sciences, Usmanu Danfodiyo University Sokoto-Nigeria

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## **Abstract**

The persistent lack of or inadequate financing that has bedeviled small scale businesses hampered growth of the sector, hence adversely affects the Nigerian economy. The period of existence and expertise in financial intermediation of conventional interest based banks notwithstanding. They are reluctant in advancing loans to SSBs because of inherent risk in doing so. The objective of this paper is to test whether SSBs in Kano and its environs in Northern part of Nigeria would be prepared to access funds through an alternative profit and loss sharing financing arrangements. Both primary and secondary sources of data were used. Questionnaires' were administered, responses were analysed, and logit regression analysis was utilized to test the acceptability of the PLS financing method. The findings of the study revealed a desire for an alternative PLS financing method

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**Keywords:** Profit, Loss, Small scale businesses

## Introduction

Finance is a necessary factor in all entrepreneurial endeavors. The centrality of finance stem from the dependency of other factors unto it. Apart from the entrepreneurial efforts of the promoter(s) of a business, all other factors require funds. Finance is a cogent requirement not only for start up, but also for the incumbents. It enhances growth in small and large scale businesses.

The need for finance as a precursor for growth and survival is more in the small scale businesses (SSBs). The reason for this is manifold: the ownership structure of SSBs is a limiting factor to the quantum of capital required by SSBs. Also the legal requirement for the formation of SSBs and restrictions in listing on the Nigeria stock exchange affect their funds availability. The financing requirements of SSBs are usually beyond the capability of owner(s) of the businesses. Therefore, recourse would have to be made to other source(s). The available source(s) could be formal or informal. The cost of finance, ease of accessibility and collaterals are some of the major considerations that SSBs have to contend with when deciding where to seek funds. Providers of funds, on their part are concerned more with the safety of their funds, yield thereof and administrative cost of advancing and monitoring loans. A financing need that is categorized as risky would attract higher than normal interest rate, hence cost of advancing loans to SSBs would have to be higher because they are perceived as highly risky.

High cost of funds has its adverse effects on SSBs. It inhibits growth of the sector and by implication growth of the economy. High risk associated with SSBs lending has been the reason for conventional banks' reluctance in lending to the SSBs. On their part, SSBs laments the devastating effects of high interest rate and the stringent conditions that are prerequisite to interest based lending. Though other sources of finance are available, Binks and Ennew(1996) assert that SSBS are the largest clientele of bank. Despite being the largest in terms of number of customers, the actual lending that is channeled to them by the banks is insignificant when compared with funds advanced to large scale business.

SSBs are wary of accessing funds from conventional interest based banks because of the interest rate element (CBN, 2009). The solution to the financing problem might be an alternative financing method that is devoid of interest. The objective of this study is to determine whether SSBs would be prepared to access financing vide the profit and loss sharing (PLS) financing arrangements. To achieve this objective, the paper is divided into

five sections with this section being the first. Section two reviews the concept of PLS as well as empirical studies in the area. The third section presents the methodology adopted for the study. Section four present results and analyses the data .The last section concludes the paper.

## **2- Review of Some Relevant Literature**

The reincarnation of the SSBs that started in the early seventies, emanated from the realization of its economic growth potentials. This phenomenon awakens research efforts in the sector. Prior to this period, the issue of small firms is not a major focus in economics. This lack of interest was buttressed by Acs (2004:8) when he asserts that ‘‘the small firm has for a long time remained a riddle wrapped in a mystery inside an enigma’’. The reason for this neglect was because mass production were thought to be the only route to economic growth and development, and therefore any shift of paradigm was perceived as inefficient. However, redirection of attention from mass to customized production created a niche for the SSBs.

Studies across the globe have identified the indispensability of finance to SSBs as well its constraint to the sector (Beck and Demirgur-Kunt, 2006). The existence of institutional intermediaries that specializes in providing financing at a price, banks could have provided a succor for the financing problem of SSBs, but alas they are reluctant in lending to SSBs because of the risky nature of SSBs lending (Owualah, 2004). The asymmetric information risk of moral hazard and adverse selection inherent in SSBs financing discourages banks from advancing loans to this sector. But being a vital component of the banking public, banks must have to transact business with the SSBs.

There is no universally accepted definition of small-scale business, because the classification of business into large or small scale is relative. Bandar and Presley (1992) observe that the different socio-economic structures of each country are the reasons for non-uniformity in definition of SSBs. Therefore, the definition adopted for this study is the ‘‘Small and Medium Enterprises Development Agency of Nigeria’’ (SMEDAN) definition of SSB, but devoid of the labour requirement. The reason for this is twofold. Firstly, SMEDAN is the organ of the Nigerian government that is vested with activities of SSBs. Secondly , since the emphasis of this study is on the financing aspect of SSBs , we belief that relaxing the labour requirement of the SMEDANs’ definition will not significantly affect result of this work. Hence, we define a SSB as an Enterprise whose assets is up to 0.5 million Naira, and not

more than 50 million Naira (3120 Dollars), excluding cost of land and employing not more than one hundred people.

## 2.1 Profit and loss sharing (PLS) mode of financing

PLS is a contractual arrangement between two or more transacting parties, which allows them to pool their resources together to invest in a project for the purpose of sharing profit and loss (Usmani, 1999). The idea of PLS gain prominence with the advent of the Islamic banking. Most Islamic economists contend that PLS is based on two major modes of financing, namely; *Musharaka* and *Mudarabah* (Jalaluddin, 1999).

*Musharaka* simply means partnership. It is a kind of partnership between two or more people, whereby each one of the contracting parties makes a certain contribution for the generation of capital. All the contracting parties have full right in the management and administration of the capital, but it is not necessary required of them to do so. *Mudarabah* on the other hand, is a contract where one party provides capital and the other party goes into the business by the provision of his expertise, who consequently turned out to be an entrepreneur.

The emphasis of these modes of financing is that reward –sharing is related to risk-sharing, risk sharing and not risk transfer. The main distinguishing features of PLS includes; Return Sharing Method (RSM), which is agreed upon before commencement of the business. Principal and return are not guaranteed in the event of loss, except where it is established that the loss is as a result of negligence on the part of the active partner. Thus, it is based on trust and does not necessarily require any collateral.

There are very few empirical studies that seek to determine whether or not, SSBs would be willing to access funds through the PLS financing arrangements. Surprisingly, majority of these are from Australia. Dar and Presley (2000) and Gait and Worthington (2007) analysed the persistence of Murabaha (cost-plus) financing in most Islamic banks. They posit the need for Islamic banks to enhance financing via PLS. Dar and Presley (2000) identified ignorance and lack of adequate awareness as the major impediments to acceptability of the PLS. In addition, the two studies posited that monitoring can reduce the information asymmetry inherent in PLS, but that it will tend to reduce profit share of SSBs. Jalaluddin (1999) study the attitudes towards the probability of using PLS financing by Australian SSBs. He identified five independent variables that may entice SSBs to prefer the PLS, but did not justify selection of these variables against others. The major finding of the

study was that about 60% of Australian SSBs were prepared to try the use of PLS financing arrangement. The risk sharing between financier and financee, together with linkage of costs of financing to profitability were the benefits the SSBs envisaged to be derived from this financing mode. Management interference was the reason that was likely to prevent those who are not prepared to try the PLS.

Bandar and Presley (1992) studied the behavior of small scale manufacturing businesses in Saudi Arabia towards the Islamic modes of finance in general and PLS in particular. Surprisingly, the study revealed that about 85% of the sampled SSBs rejected the proposal for accessing funds through the PLS. The reason for the mass rejection was twofold; the perception that PLS automatically warrants dilution of ownership of the business and, since the bulk of Saudi Arabian banks are interest based, they are apprehensive that accessing funds from them may indirectly mean dealing in interest. The former was however the main reason for the rejection. They concluded that the PLS is not a reliable source of financing SSBs, because of the ignorance of the workings of PLS, that was probably caused by the lapse of time between when it was last truly practiced and the influence of the intrusion of colonizers (Aliyu, 2000).

Al-Satti (1992) cited in Aliero (2002) fault Bandar and Presley (1992) on the ground that since PLS shares risks, it should logically be the preference of SSBs in less developed countries. The linkage of cost of finance to outcome of the business eliminates the obnoxious effects of interest rate, pooling experience together enhance success of SSBs and that religion would influence acceptance of PLS. Al-Saati assumes other factors to be constant. His envision is a society that is enlightened and insulated from the influence of crusaders. Al-Saati also observed the inadequacy of the statistical technique used to analyse the data, but he did not suggest the appropriate statistical tool that could have been employed. Aliero (2002) flawed Al-satti's assertions because it lack empirical prove. We concurred with Aliero's observation.

Aliero (2004) studied the possibility of using Rotating Savings and Credit Associations (ROSCAS) to finance SSBs in the Northern Nigerian city of Sokoto. He opined that Roscas can be an alternative interest free means of financing SSBs. Though Roscas is a non interest mode of financing, but pooling SSBs together for the purpose of operating a Roscas may be cumbersome and impracticable.

### 3- Methodology

Data for this study were obtained from both primary and secondary sources. Questionnaires were administered on 350 sampled SSBS. The questionnaire was structured using predominantly close-ended and five point Likert-type questions. Stratified random sampling was used to generate the sample size of 350. The population of registered and operational SSBS in Kano and its environs during the study period was 2029. Sample size of 350 was selected from the total number. The sample was determined using Yamane's (1968) formula as expressed by Israel (1992) thus;

$$n = \frac{N}{1 + N(e)^2}$$

Where,

n = Sample size

N = total population

e = Level of significance (95%)

The total number of small scale businesses obtained from Kano State Ministry of Commerce and industry as at 2010, was two thousand and twenty- nine (2029), out of which, commerce constituted 46%, service related 35%, manufacturing 17% and finally, processing that stood at 2%.

The unequal numbers of the respective business lines made us represent each business line to be sampled on the basis of its proportion in the total number of businesses. We thus, determined the number of the SSBS to be sampled; viz;

$$r = \frac{X}{\text{Number of registered businesses}} \times \frac{350}{1}$$

Where;

r = number of businesses to be chosen from each line of business, and

x = total number of a particular business line, as appeared in the list

In this way, we got the following sample size for each line of business; commerce - 162, service related - 123, manufacturing - 60 and processing - 5.

Simple random sampling was afterward used to choose the small businesses to be included in the sample. Three hundred and sixteen (316) questionnaires were returned, but five were invalidated (illegible) and thus, cannot be used. Therefore, three hundred and eleven (311) questionnaires were available for use, representing 88.85% response rate.

The logistic and probit regression were used to test the acceptability or otherwise of the Profit and loss sharing financing arrangement. Jalaluddin (1999) used the Logit and Probit to predict the preparedness of Australian SSBs to access finance vide the PLS. Logistic and Probit regression are used when the dependent variable is a categorical variable and the independent variables are metric variables (Anderson, 2007). The dependent variable usually consists of two groups or classifications, for example, good or bad, accept or reject, male versus female or high versus low. Other instances are where more than two groups are involved, such as low, medium and high classifications.

For the purpose of this study respondents were asked to use a scale of 5 – 1 vides; strongly agree, agree, undecided, disagree, and strongly disagree to indicate their degree of acceptance with the following statements;

Var 001: The PLS financing arrangement allows the sharing of risk between financier and financee;

Var 002: PLS intervenes with the management of the business, hence may dilute ownership;

Var 003: In PLS, cost of financing is dependent on profit;

Var 004: In PLS, tangible collateral is not a necessary condition;

Var 005: PLS would motivate business expansion as the future risk associated with the expansion could be shared with financiers.

These Statements were the features of the PLS, thus represented by the following variables:

Variables: r001=  $X_1$ , Variables 002 =  $X_2$ , variable 003 =  $X_3$ , variable 004 =  $X_4$ , and variable 005 =  $X_5$ . The criterion variable was “Y” where,  $Y = 1$ , stands for businesses that were ready to seek financing through the PLS arrangement, and  $Y = 0$  for businesses that won’t seek

financing through the PLS, otherwise Group N. The dependent variable is therefore, the two groups of small businesses (Group Y and Group N), and the independent variables were the variables outlined above.

#### 4-Data analysis

We used the probit and logistic regression to test the acceptability or otherwise of the PLS amongst SSBs, particularly in Kano and its environments.

##### 4.1-Result of logit and probit analysis

Table below provides result of probit and logistic regressions.

**Table 1: Attitudes of SSBs in Kano metropolis towards PLS financing**

	INDEPENDENT VALUE	LOGIT	PROBIT
Variables	Constant	2.090 (4.9292)	1.9987 (4.9455)
Var001	The PLS financing arrangement allows the sharing of risk between financier and financee,	-0.656 (4.6197) *	-0.675 (4.6321) *
Var002	PLS intervenes with the management of the business, hence may dilute ownership	-0.246 (-2.2162) *	-0.254 (-2.223) *
Var003	In PLS, cost of financing is dependant on profit	-0.255 (2.1567) *	-0.2157 (2.1641) *
Var004	In PLS, Tangible collateral not a necessary condition,	0.372 (2.755) *	0.375 (2.776) *
Var005	PLS would motivate business expansion as the future risk associated with the expansion could be shared with	0.073	0.056



	financiers	(0.6348)	(0.612)
	Log of likelihood function	-320.582	-174.633
	R – Square	0.193	0.198
	% Correct Prediction	71.9	73.8

### Logit and probit analysis Output, 2011

\*significant at 0.05

The Criterion variable was the type of preference (x),

Where;

X = 1, if the business was prepared to apply PLS

X = 0, if the business was not prepared to apply PLS

The critical t - value is 1.96, hence Variables 1, 2, 3 and 4 are statistically significant. The first, third and fourth variables are statistically significant and positive, while the second variable is significant and negative. This suggests that the higher the degree of risk borne by a financier, the more he shares in the profit, and the less intervention in management, the higher the probability that SSBs will use the PLS as a financing option, the better. The second variable suggests that SSBs would not mind intervention in management of their businesses by fund provider(s), but less of it can make them prefer PLS. The fourth variable is statistically significant and positive meaning that SSBs would accept PLS because of non imposition of collateral as a necessary condition for accessing funds.

The  $R^2$  for both the logit and probit indicates the goodness of fit. The Probit model gives marginally better results than the logit (in terms of  $R^2$  and  $t$  values).

Results for both probit and logit suggest that small businesses are indifferent as to capacity of PLS to motivation expansion. This is probably due to the dearth of practical experience on operation of PLS financing arrangement amongst Nigerians' SSBs.

The response indicated in table (2) below shows preference of SSBs for PLS financing mode. Larger percentage of the surveyed SSBs would prefer the PLS financing arrangement.

**Table 2: Desire for PLS**

Preference for PLS	Frequency	%	Awareness of PLS	Frequency	%
Yes	221	71.06	Yes	253	81.35
No	90	28.94	No	51	16.40
Total	311	100	Others	7	02.25
			Total	311	100.0

Field Study: 17<sup>th</sup> October, 2011

The high preference rate for the PLS by SSBs as shown in the table above is an indication that it will be widely accepted by SSBs in Nigeria. Over 70% of the surveyed SSBs expressed readiness to explore the PLS. The rate of awareness of the PLS also reflects the eagerness to experiment it. Two hundred and twenty-one (221) SSBs or 71.6 % of the surveyed SSBs know about PLS. Conventional banks are perpetually introducing new financial products that are more of trading than interest based. The consistent introduction of these new financial products tailored towards cost-plus financing and equity participation has aroused the inquisitiveness of financees and also superiority of the PLS

## 5- Conclusion

The global recognition of the potential of SSBs in harnessing economic advancements has heightened the need for assisting SSBs to grow and survive. The conventional interest based banking method has to charge interest rate attached with other conditions, both of which are inimical to success of SSBs. The solution to the peculiarity of SSBs financing problem is an alternative financing arrangement devoid of interest payment.

Profit and loss sharing mode of financing alternative would be accepted by SSBs in Nigeria because it allows for sharing of risk as against its total transfer to financee as obtained in the conventional interest based financing mode. It also relates cost of funds to the accrued profit, and not anticipated earnings, and it does not impose collateral as a necessary condition for the provision of funds. The major snag to acceptability of PLS, according to Nigerias' SSBs is the potential to interfere in the management of the business of financee, as allowed by PLS doctrine. This fear could be allayed by opting for a variant of the PLS that do not allow interference in the management of the business of the financee. Based on the

findings of this study we identify some policy implication issues that require the attention of government.

The resentment of the interest based financing modes and desire for the PLS is a good development. It is an indication of the obsession of the banking public with the exploitative interest based financing. The government should therefore respond to the yearning of the teeming business community that indicated desire for this financing arrangement by ensuring that efforts are intensified towards reorienting Nigerians on the need to imbibe honesty, diligence and transparency in business dealings. This is because PLS can thrive only where honesty and transparency are the dictum of business transactions. The larger society should also be made to develop a mechanism through which dishonest business persons or organizations are ostracized.

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## APPENDIX- QUESTIONNAIRE

NAME OF ENTERPRISE.....

WORKING CAPITAL.....

Please indicate your agreement with the following statements;

Profit loss sharing (PLS) allows sharing of risk between entrepreneur and financier

- a. Strongly agree
- b. Agree
- c. Undecided
- d. Disagree
- e. Strongly disagree

PLS interfere with management of the firm

- a. Strongly agree
- b. Agree
- c. Undecided
- d. Disagree
- e. Strongly disagree

PLS links cost of borrowing to profitability

- a. Strongly agree
- b. Agree
- c. Undecided
- d. Disagree
- e. Strongly disagree

PLS do not strictly impose collateral as a condition

- a. Strongly agree
- b. Agree
- c. Undecided
- d. Disagree
- e. Strongly disagree

PLS would motivate business expansion as the future risk associated with the expansion would be shared with financiers

- a. Strongly agree
- b. Agree
- c. Undecided
- d. Disagree



e. Strongly disagree

PLS would be preferred financing mode than the interest based mode

a. Strongly agree

b. Agree

c. Undecided

d. Disagree

e. Strongly disagree

PLS is a well known financing mode in Nigeria

a. Strongly agree

b. Agree

c. Undecided

d. Disagree

e. Strongly disagree