ISLAMIC EQUITY FINANCING FOR SMEs DEVELOPMENT

By:

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INTRODUCTION

Following the Asian Financial Crisis 1997-98, the Malaysian government started to focus on the strength of the domestic economic activities rather than reliance on the foreign investment and trade which are subject to volatilities (Fong, 2003). This fact entails efforts to foster the development of small-and-medium scale enterprises (hereafter stated as SMEs) in order to make them as the national backbone for future growth. Considering the significance of SMEs to the national outlook, this humble chapter seeks to discuss the role of Islamic equity financing in developing more and more successful SMEs. The discussion commences with the definition of SMEs in Malaysia and a brief highlight on their needs to equity financing. Then, the authors generally describe the modes of Islamic equity financing available in Islamic jurisprudence. The following chapters briefly discuss on the applicability of the two widely quoted Islamic trading partnerships i.e. Mudarabah and Musharakah in SMEs development. Finally, a bold concluding section wraps up the whole article with several recommendations.

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DEFINITION OF SMEs IN MALAYSIA

In Malaysia, the definitions of SME are based on two criteria i.e. number of employees and annual sales turnover. These two criteria provide broader and wider coverage and applicability of SMEs definitions. The definitions of SMEs apply for the following sectors: primary agriculture; manufacturing (including agro-based); manufacturing related services (MRS); and services (including Information and Communications Technology)[2] (BNM, 2005). Each sector has its own general and specific definitions for micro, small and medium enterprises. However, it is not within the discussion of this chapter. Table 1 and 2 summarize the definition of SMEs in Malaysia based on number of full-time employees and annual sales turnover.

Table 1: Definitions of SMEs Based on Number of Full-Time Employees

Size / Sector	Primary Agriculture	Manufacturing (including Agro-Based) & MRS	Services Sector (including ICT)
Micro	Less than 5 employees	Less than 5 employees	Less than 5 employees
Small	Between 5 & 19 employees	Between 5 & 50 employees	Between 5 & 19 employees
Medium	Between 20 & 50 employees	Between 51 & 150 employees	Between 20 & 50 employees

Source: National SME Development Council, BNM

Table 2: Definitions of SMEs Based on Annual Sales Turnover

Size / Sector	Primary Agriculture	Manufacturing (including Agro-Based) & MRS	Services Sector (including ICT)
Micro	Less than RM200,000	Less than RM250,000	Less than RM200,000
Small	Between RM200,000 & less than RM1 million	Between RM250,000 & less than RM10 million	Between RM200,000 & less than RM1 million
Medium	Between RM1 million & RM5 million	Between RM10 million & RM25 million	Between RM1 million & RM5 million

Source: National SME Development Council, BNM

[2] Services sector also includes mining and quarrying sector and construction sector.

Based on Table 1 and 2, it can be observed that SMEs are small and new in nature. Most of them do not have strong, appealing and convincing financial track records in the eyes of potential lenders and investors. However, it is not a common practice in the real world for SMEs to obtain external equity financing. Hence, this paper insists on the need for the establishment of Islamic equity-based financing for SMEs development programme. In fact, SMEs represent the earlier stages of big businesses and with good monitoring and mentoring processes, they would constitute a vast potential of medium and long-terms investment opportunities.

MODES OF ISLAMIC EQUITY FINANCING (PARTNERSHIP)

Islam encourages Muslims to participate in a partnership as it is a form of cooperation and collaboration between individuals. Moreover, it leads to more efficient and better use of resources (Al-Masri, 1999). Some individuals only have resources but they do not have the expertise or even the time to manage the resources. Hence, partnership projects are necessary to make use of the resources and put them in more productive and beneficial activities. With the combination of the resources and expertise, the resources would be used more efficiently and not left idle. Therefore, we can see that a number of partnership projects have been established and discussed in the area of Islamic jurisprudence. In general, partnership in Islamic jurisprudence (*fiqh*) is of two types: holding and contract partnerships. A holding partnership refers to the joint ownership by two or more persons of an asset by 'optional' or 'compulsory' means of inheritance or wills or joint purchase or other circumstances. In the other hand, a contract partnership refers to a ‘joint commercial enterprise’ or mutual agreement by two or more persons to contribute to the capital of the partnership and share in its profit or loss. (AAOFI, 1998; Usmani, 2002). Partnership projects for commercial purposes basically can be further divided into two major categories i.e. trading and agricultural partnerships, and can take place in several forms. The divisions can be illustrated by the following points (Al-Masri, 1999; Nyazee, 2002):

1) Agricultural Partnerships (*Al-Sharikat Al-Zira‘iyyah*). This category has three forms:
   a. *Muzara‘ah* (Share-cropping): It is a type of agricultural partnership with land contributed by one party and work by another. The land is cultivated and the yield is shared between them.
   b. *Musaqah* (Share-watering): It is a type of agricultural partnership whereby the trees and land are contributed by one party and their care (watering) is undertaken by another with their fruit being divided between the parties.
   c. *Mugharasah* (Share-planting): It is a type of agricultural partnership where the land and plants are contributed by one party and the work of planting is provided by another party with a portion of plants being given to him.
2) Trading Partnerships (*Al-Sharikat Al-Tijariyyah*). This type of partnership is different from the previous one as the partners share the profit, neither crops

nor plants, between them. This can be further divided into two categories. This category has two forms:

a. *Mudarabah*: It is a type of trading partnership in which capital is contributed by the capital provider (*rabb al-mal*) and labour from the entrepreneur (*mudarib*). The profit is shared between them. In case of loss, it is born by the capital provider. The entrepreneur only suffers from the fruitless efforts.

b. *Shirkah*: It is a profit and loss sharing partnership and takes three major forms.

    i. *Shirkat al-Amwal*: It is a partnership in which participation is based on the contribution of capital by all partners.

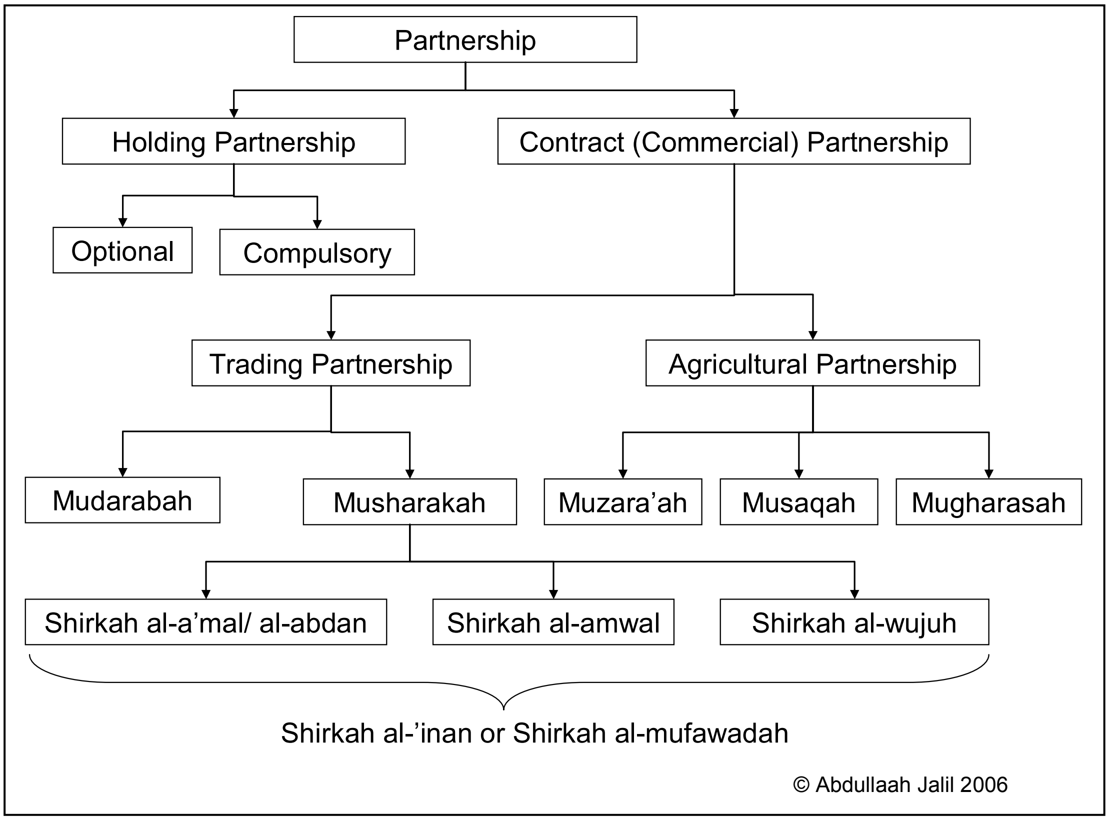
    ii. *Shirkat al-Abdan*: It is a partnership in which participation by the partners is based on labour or skill.

    iii. *Shirkat al-Wujuh*: It is a partnership based on the credit-worthiness of the partners. The ratio of loss is based on the liability borne whereby the ratio of profit could be based on either the liability borne by each partner or mutual agreement between them.

    These three types of trading partnerships could be based on either *'inan* or *mufawadah* partnership.

A *mufawadah* partnership is based on *wakalah* (agency) and *kafalah* (surety) that entails full commitment from the partners. To achieve this purpose, all partners should maintain equality in capital, labour, liability and legal capacity. It declares each partner to be an agent of and surety for the other. In an *'inan* partnership, the equality of legal capacity and contribution by each partner is not necessary (Nyazee, 2002). See Figure 1 for illustration.

Figure 1: Partnership in Islamic Jurisprudence



Based on Figure 1, there are several concepts of Islamic partnership that can be applied for the purpose of Islamic equity financing. However, due to the limitation of this chapter, we will only focus our discussion on the two widely quoted Islamic trading partnership i.e. Mudarabah and Musharakah.

MUDARABAH AS A MODE OF SMEs DEVELOPMENT

Mudarabah is the one of the widely quoted operating principles in Islamic finance for business joint venture. In classical *fiqh* (Islamic jurisprudence) books, *mudarabah* is also named as *qirad* or *muqaradah* or *muamalah*. There are several translations and terminology for *mudarabah* used in English literatures such as trust financing, profit sharing, trustee profit sharing and sleeping partnership with profit sharing.

Theoretically, the definition of *Mudarabah* is a contract in which a party provides capital to the other party who offers his labor with the hopes of getting profits which will be distributed among the parties according to the ratio agreed on between them in the contract.

Classical *mudarabah* refers to a joint venture by two parties in business activities from the inception of the joint venture until the end when all the assets are liquidated (Usmani, n.d.). Today's modern *mudarabah* is very much for the financing purpose where the financier (capital provider) will sell his portion of joint venture to the entrepreneur (*mudarib*) or third party. Mudarabah could be general or specific in nature.

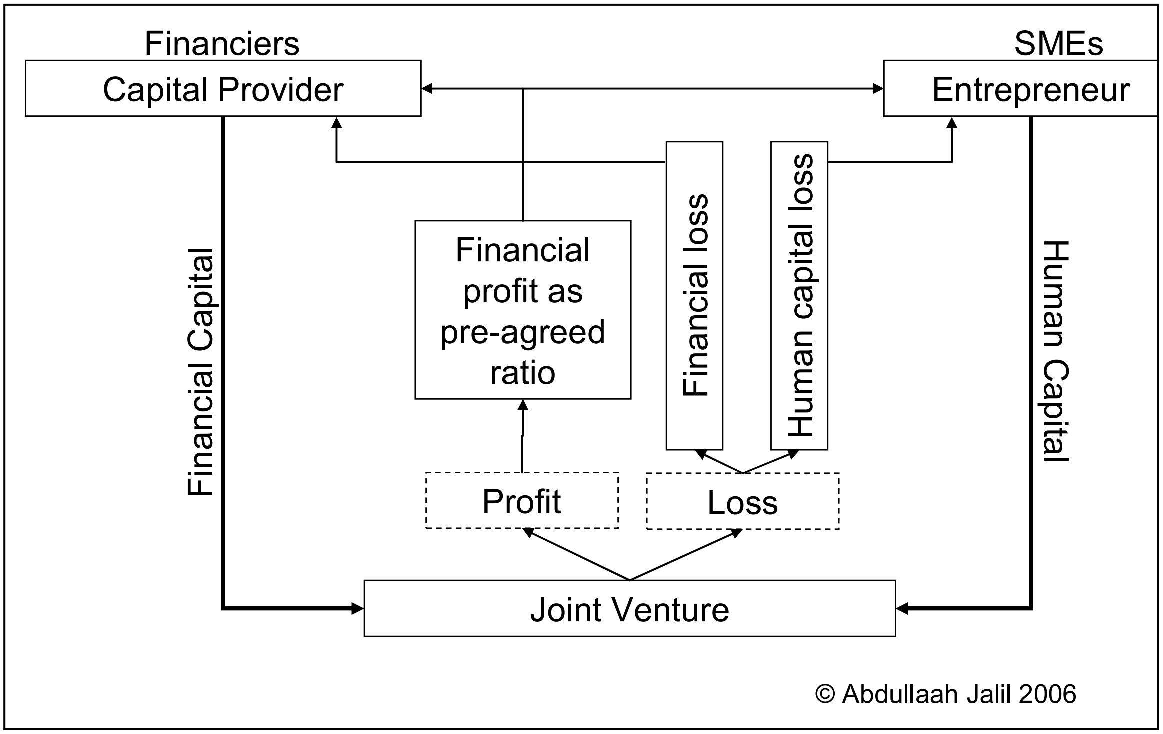
With regard to the application of mudarabah for SMEs development, specific/restricted *mudarabah* is more appropriate to take place as the conditions and stipulations laid down by the financier could safeguard their capital outlay. In Islamic jurisprudence discipline, the financier is termed as the *sahib al-mal* or *rabb al-mal* or *muqarid* (capital provider) as he is the party who provides a specific amount of capital to the SMEs. SMEs provide –

acting as *mudarib* or *'amil* - entrepreneurship and management expertise for carrying out the specified business venture, trade, industry or services. Profit will be divided between as pre-determined ratio.

In today's dynamic world, *mudarabah* can take place in various forms and it is flexible in nature. For example, the capital provider could place his representative in the company's BOD (Board of Director) to monitor their investment and involve in the company's decision making. In the other hand, the enterprise and its staff could claim wages (*al-ujrah*) in advance prior to the finalized profit calculation. As trustee, the enterprise acts as an agent of business. It is assumed to act with prudence and in good faith. It is responsible for looses incurred due to his full negligence and breach of contract. It is also expected to employ and manage the capital in such manner as to generate optimum profits for the business without violating the value of Islam.

In the case of loss (without negligence or misconduct), the financial loss will be incurred by the financier and the entrepreneur will suffer a fruitless effort. The enterprise will have a bad track record which would lead to bad reputation of the company. This is indeed a fair division of profit and loss.

Figure 2: Division of Profit and Loss in *Mudarabah* Model



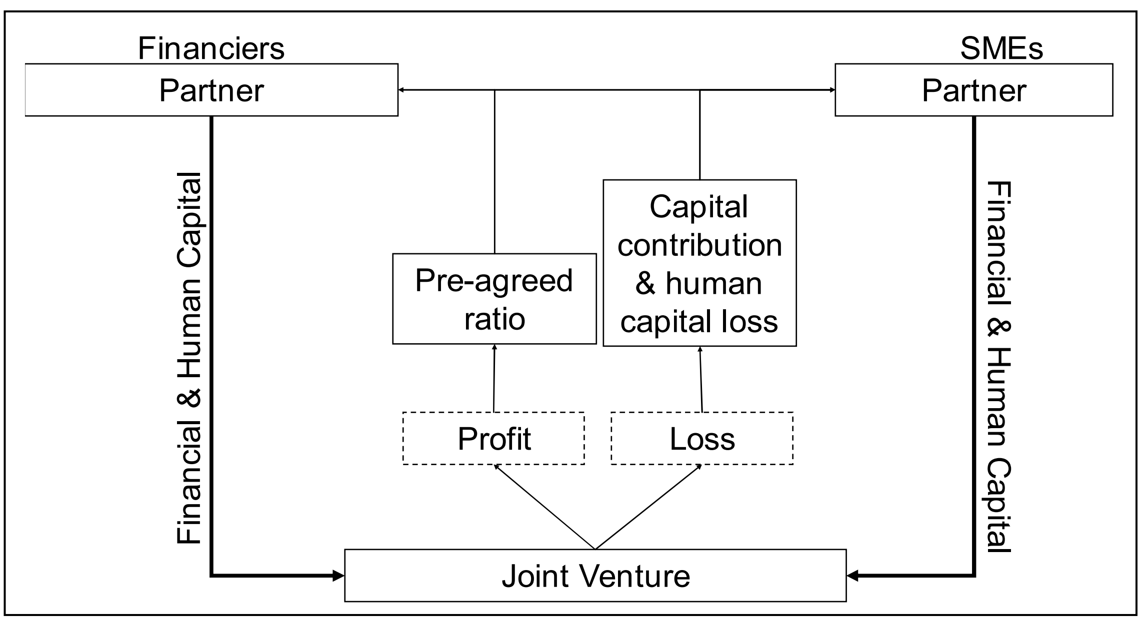
MUSHARAKAH AS A MODE OF SMEs DEVELOPMENT

Musharakah is another potential model for SMEs development. Perhaps, it is more practicable and realistic compared to *mudarabah* where total financial capital is contributed by only one party. In *musharakah* model, both financier and SMEs contribute to the capital of the joint venture and participates in work. The relationship between the financier and SMEs in a contract of *musharakah* from the *fiqh* viewpoint is a partner-to-partner relationship.

In a real situation, the financier could contribute e.g. 90% of the total capital outlay while the rest is contributed by the enterprise. However, the enterprise may carry out 90% of the labor and management aspects in the joint venture. In other words, the financier contributes most of the financial capital while the enterprise contributes most of the human capital.

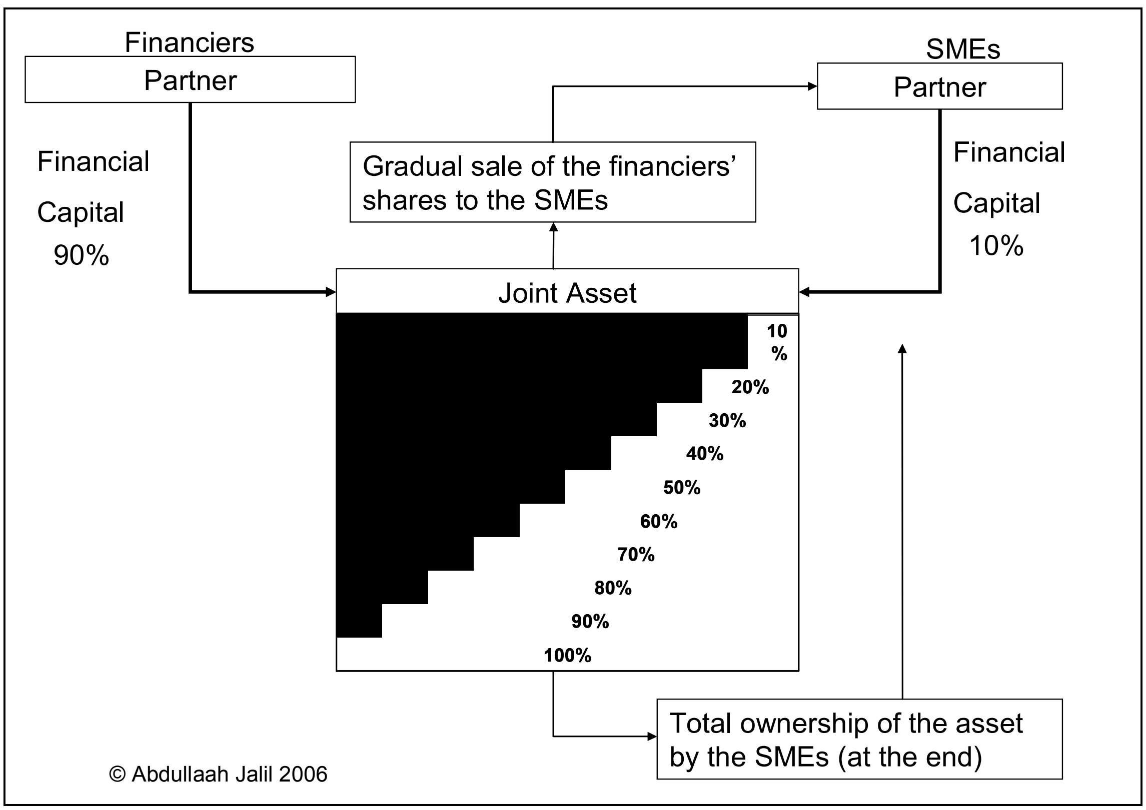
According to Hanafis and Hanbalis, profit can be divided in proportion to capital contribution; or equally divided even the capital contributions are different; and unequally divided even the capital contributions are equal. However, Malikis and Shafi'is state that profit should be in proportionate to the size of capital contribution. In the case of loss (without negligence or misconduct), the scholars agree that the loss should be divided in proportion to their respective shares in the capital. This is based on principle of "Profit should according to what they (partners) stipulated, and the loss should be proportionate to both funds (AAOIFI, 1998).

Figure 2: Division of Profit and Loss in Musharakah Model



Diminishing *musharakah* could be applied in a joint venture between the financier and SMEs. Based on the concept, the financier and enterprise will participate in the joint ownership of a commercial property or equipment, or in a joint commercial enterprise. The share of the financier will be divided into units and they will be sold to the enterprise gradually, thus increasing the enterprise's own share until all the units are purchased by him. At the end of the contract, the entrepreneur will be the sole owner of the commercial property or equipment or commercial enterprise (Usmani, 2002).

Figure 3: Diminishing Musharakah Model of a Joint Asset



CONCLUSION

Based on the previous discussions, it is observed that *mudarabah* and *musharakah* could be viably applied in the process of SMEs development. In addition, there are several numbers of Islamic modes for equity financing that are underutilized in the real worl. Financial institutions and government sectors that are heavily involved with SMEs should include Islamic equity financing into their various financing scheme. SMEs need further risk sharing instrument to be more innovative, creative and independent entity. It is highly regrettable if our Malaysian Muslim entrepreneurs have to adopt for conventional equity financing due to the absence or small-size of Islamic equity financing. Conventional equity financiers may include certain conditions and stipulations that are not Shariah-compliant in their financing scheme. Additionally, they may overlook certain Shariah criteria for decision making. The authors strongly believe that Islamic modes of equity financing could promote entrepreneurship as enterprises could obtain financial resources at the minimum price with less risk. However, these modes of financing require robust trust (*amanah*) and full of transparency between the parties involved.

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