1999

Attitudes of Australian small business firms and financial institutions towards the profit/loss sharing method of finance

Abul Jalaluddin

University of Wollongong

Follow this and additional works at: https://ro.uow.edu.au/theses

Copyright Warning

You may print or download ONE copy of this document for the purpose of your own research or study. The University does not authorise you to copy, communicate or otherwise make available electronically to any other person any copyright material contained on this site.

You are reminded of the following: This work is copyright. Apart from any use permitted under the Copyright Act 1968, no part of this work may be reproduced by any process, nor may any other exclusive right be exercised, without the permission of the author. Copyright owners are entitled to take legal action against persons who infringe their copyright. A reproduction of material that is protected by copyright may be a copyright infringement. A court may impose penalties and award damages in relation to offences and infringements relating to copyright material. Higher penalties may apply, and higher damages may be awarded, for offences and infringements involving the conversion of material into digital or electronic form.

Unless otherwise indicated, the views expressed in this thesis are those of the author and do not necessarily represent the views of the University of Wollongong.

Recommended Citation


Research Online is the open access institutional repository for the University of Wollongong. For further information contact the UOW Library: research-pubs@uow.edu.au
Attitudes of Australian small business firms and financial institutions towards the profit/loss sharing method of finance

Abul Jalaluddin
University of Wollongong


This paper is posted at Research Online.
NOTE
This online version of the thesis may have different page formatting and pagination from the paper copy held in the University of Wollongong Library.

UNIVERSITY OF WOLLONGONG

COPYRIGHT WARNING
You may print or download ONE copy of this document for the purpose of your own research or study. The University does not authorise you to copy, communicate or otherwise make available electronically to any other person any copyright material contained on this site. You are reminded of the following:

Copyright owners are entitled to take legal action against persons who infringe their copyright. A reproduction of material that is protected by copyright may be a copyright infringement. A court may impose penalties and award damages in relation to offences and infringements relating to copyright material. Higher penalties may apply, and higher damages may be awarded, for offences and infringements involving the conversion of material into digital or electronic form.
ATTITUDES OF AUSTRALIAN SMALL BUSINESS FIRMS AND FINANCIAL INSTITUTIONS TOWARDS THE PROFIT/LOSS SHARING METHOD OF FINANCE

A Thesis Submitted in Fulfilment of the Requirements for the Award of the Degree

DOCTOR OF PHILOSOPHY

from

UNIVERSITY OF WOLLONGONG
New South Wales
Australia

by

Abul Jalaluddin
B.Ec. Honours (Malaysia)
M.Ec. Honours (Malaysia)

DEPARTMENT OF ECONOMICS
1999
DECLARATION

I hereby certify that this thesis has not been submitted previously as part of the requirements of another degree and that it is the result of my own independent research.

--- Abul Jalaluddin
ACKNOWLEDGEMENTS

I would like to express my profound thanks to my supervisor, Professor M.M. Metwally, whose guidance, penetrating comments, helpful criticism and constructive suggestions have been instrumental to the completion of this thesis. I highly appreciate the considerable time he spent on my work.

I also wish to record my thanks to Professor Robert Castle, Professor Donald Lewis, Associate Professor Charles Harvie, Associate Professor D.P. Chaudhuri, Senior Lecturer Ed Wilson, Senior Lecturer Tony Webber, Senior Lecturer Nelson Perara and Senior Lecturer Di Kelly, all of the Department of Economics, University of Wollongong, who provided constant encouragement and valuable comments during the course of this research.

I am grateful to Mr. Wolfgang Brodesser, Mr. Robert Hood, Ms Julie Chin and Ms Sophie Abercrombie of the Department of Economics, University of Wollongong for their great assistance in computation and administration.

I whole-heartedly acknowledge the enormous support provided by the Sydney small business community and financial institutions who responded to my lengthy questionnaires requiring information not readily available from any published source. Their friendly discussions also gave me significant insights into the Australian small business finances. Despite heavy workload and business commitments, they provided me with the core data for the research which are vital for my thesis.
I also acknowledge the contributions made by different libraries and organisations to my research. I would specially mention the staff of the Wollongong University library, Sydney University library, New South Wales University library, Macquarie University library, Office of the Inspector-General in Bankruptcy, Small Business Section of the Australian Bureau of Statistics, New South Wales Office of Small Business and the Office of Small Business at the Bureau of Consumer Affairs.

I am thankful to the University of Wollongong for granting me a scholarship to pursue my doctoral degree and to the Department of Economics for supporting my two surveys in the Sydney metropolitan area.

I would also like to thank my wife, Rahazimah, and our two sweet little daughters, Nabila and Nadra, who smilingly sacrificed my company and waited for me till late at night. I can never repay my wife for her unceasing support, endless supply of love and encouragement during the difficult times of my survey and thesis writing. To them I say—

I love you.
DEDICATION

To my mother, Mrs. Najma Begum- a living courage to my life and my wife, Tengku Rahazimah Binti Tengku Mahmud- a partner in heart and intellect.
ABSTRACT

Small business firms usually obtain finance from commercial lenders on fixed or variable rates of interest. These businesses, or any other borrower for that matter, will have to pay back the principal borrowed along with its stipulated interest at the end of the specified period. They are willing to pay the interest on the loan over and above the principal borrowed because they expect the borrowed amount of capital would make a marginal contribution in their profit at least equal to the total interest paid. They are legally liable for the payment of the interest and the principal regardless of their actual level of earnings. They must make these payments as per contract even if they suffer heavy losses in the project. This arrangement, which is common in most, if not all, countries of the world, may cause a great deal of hardship on the part of the borrowers, especially at times of economic slowdown.

There is a method of finance called profit/loss sharing practiced in some South-East Asian and Middle Eastern countries. A number of financial institutions in the Western countries including UK, Denmark, Luxembourg and Switzerland has been applying this method since the early 1980s.

The main objective of this thesis is to find out the attitudes towards, motivations for and probability of using the profit/loss sharing principle of finance by the Australian small businesses and financial institutions. Two surveys were conducted to achieve this objective. Multivariate statistical analysis, especially factor analysis, discriminant analysis and logit and probit regressions, was applied to the survey results.

Factor analysis identified five factors which may explain why small businesses are motivated to borrow funds using the profit/loss sharing method of finance. These factors are business support, risk sharing, risk of default in the traditional system, cost of borrowing and suitability of the profit/loss sharing method. Another three factors were identified to provide reasons why small businesses would not borrow funds using this new principle namely, terms of borrowing, management intervention and high cost of borrowing.

Discriminant analysis indicates that risk sharing between borrowers and lenders is the most important predictor in discriminating between the two groups of small businesses—those who would and those who would not like to borrow funds using this method. The other discriminating variables include motivation for business expansion, cost of borrowing and management intervention.

The logit and probit models show that the higher the degree of risk sharing, the lesser the cost of borrowing and the greater the motivation to business expansion, the higher the probability that the small businesses would apply the profit/loss sharing method. The respondents also indicated that the lower the degree of management intervention, the higher the likelihood that the small businesses would be prepared to apply this method of finance.

A large number of variables determining the motives of financial institutions to lend funds on the basis of the profit/loss sharing method were reduced to four factors namely, business support, growth in demand for funds, risk of default under the traditional system and potential higher return to lenders. At least three underlying factors may
explain why some financial institutions would not like to lend funds on this basis namely, management complication, unfamiliarity of the profit/loss sharing method and risk sharing with borrowers.

Discriminant analysis applied to financial institutions suggests that the growth in demand for funds is the most important predictor in discriminating between the financial institutions who are prepared to lend money on the basis of the profit/loss sharing method and those who are not. The other significantly discriminating variables include the potential higher return on funds, depositors' concern, monetary regulation, management complexity and risk sharing with borrowers.

As a majority of the responding small businesses (59.5%) are willing to borrow and a sizeable percentage of the financial institutions (41.2%) are willing to lend funds on the principle of the profit/loss sharing, the Australian monetary authority could consider offering this new method of finance as an integral part of the Australian financial system.

The financial institutions may introduce the new method on a trial basis to selected customers. The financial institutions should find some mechanisms to minimise the concerns of depositors for lending their money using this principle, perhaps through obtaining prior consent of depositors in this regard. They should also conduct serious research in the areas of simplified business performance monitoring, auditing and record keeping to minimise the cost of lending and secure a greater share of the market.
## CONTENTS

Declaration .......................... ii  
Acknowledgments ....................... iii  
Dedication ............................ v  
Abstract .............................. vi  
Contents .............................. viii  

CHAPTER ONE: INTRODUCTION

1. Introduction ........................ 14  
2. Problem Statement .................... 15  
3. Objectives of the Study ............... 16  
4. Methodology .......................... 17  
5. Organisation of the Thesis .......... 18  

PART ONE: PROFIT/LOSS SHARING METHOD OF FINANCE VIS-A-VIS TRADITIONAL METHODS OF FINANCE

CHAPTER TWO: CURRENT METHODS OF FINANCING SMALL BUSINESS FIRMS IN AUSTRALIA

1. Introduction ........................ 21  
2. Commercial Loan Providers to Small Businesses in Australia ................. 22  
3. Current Methods of Financing Small Businesses in Australia ................ 23
### CHAPTER THREE: THE IMPACT OF HIGH INTEREST RATES ON BANKRUPTCIES OF SMALL BUSINESS FIRMS IN AUSTRALIA

1. Introduction 30  
2. Interest Rates and Bankruptcies of Small Business Firms in Australia: 1975-1995 31

### CHAPTER FOUR: PROFIT/LOSS SHARING METHOD OF FINANCE

1. Introduction 40  
2. A Historical Background of the Profit/loss Sharing Method of Finance 42  
3. Profit/loss Sharing System as Practiced in the Western Societies 45  
4. Models of Profit/loss Sharing Method of finance for Western Societies 50
PART TWO: VIEWS OF SMALL BUSINESS FIRMS

CHAPTER FIVE: SALIENT CHARACTERISTICS OF THE SAMPLE

1. Introduction 53
2. Sample Size 54
3. Definition of Small Business Firm and the Selection of the Sample 54
4. Main Characteristics of the Sample 55

Appendix 5: Small Business Survey Questionnaire 64

CHAPTER SIX: ATTITUDES OF SMALL BUSINESS FIRMS TOWARDS THE PROFIT/LOSS SHARING METHOD OF FINANCE: FACTOR ANALYSIS

1. Introduction 76
2. Factor Analysis: A Brief Exposition 76
3. Mathematical Model for Factor Analysis 79
4. Main Factors Favoring the Profit/loss Sharing Method of Finance 81
5. Factors Responsible for the Rejection of the Profit/loss Sharing Method of Finance 89

Appendix 6A: Statistical Results for the Main Factors Favoring the Profit/loss Sharing Method of Finance 95

Appendix 6B: Statistical Results for the Factors Responsible for the Rejection of the Profit/loss Sharing Method of Finance 113
CHAPTER SEVEN: ATTITUDES OF SMALL BUSINESS FIRMS TOWARDS THE PROFIT/LOSS SHARING METHOD OF FINANCE: DISCRIMINANT ANALYSIS

1. Introduction 123
2. Discriminant Analysis: Some Theoretical Discussions 123
3. Discriminant Analysis Model 126
4. Discriminant Analysis of the Survey Results 127

Appendix 7: Statistical Results 133

CHAPTER EIGHT: PROBABILITY OF APPLYING THE PROFIT/LOSS SHARING METHOD OF FINANCE BY AUSTRALIAN SMALL BUSINESS FIRMS: LOGIT AND PROBIT ANALYSES

1. Introduction 138
2. A Brief Review of the Logit and Probit Methods 138
3. Logit and Probit Models 140
4. Data 141
5. Statistical Results of the Logit and Probit Models 142

Appendix 8A: Statistical Results of the Logit Model 145
Appendix 8B: Statistical Results of the Probit Model 148
PART THREE: VIEWS OF FINANCIAL INSTITUTIONS

CHAPTER NINE: SALIENT CHARACTERISTICS OF THE SAMPLE

1. Introduction 152
2. Selection of the Sample 153
3. Main Characteristics of the Sample 153

Appendix 9: Financial Institutions Survey Questionnaire 159

CHAPTER TEN: FACTORS DETERMINING THE ATTITUDES OF AUSTRALIAN FINANCIAL INSTITUTIONS TOWARDS THE PROFIT/LOSS SHARING METHOD OF FINANCE: FACTOR ANALYSIS

1. Introduction 169
2. Main Factors Favoring Lending of Funds on the Basis of the Profit/loss Sharing Method of Finance 169
3. Factors Against Lending on the Basis of the Profit/loss Sharing Method of Finance 175

Appendix 10A: Statistical Results for the Main Factors Favoring Lending of Funds on the Basis of the Profit/loss Sharing Method of Finance 181

Appendix 10B: Statistical Results for the Factors Against Lending on the Basis of the Profit/loss Sharing Method of Finance 193