The Influence of Islamic Financing on SMEs Performance in Nigeria

Sa'adatu B. Adam

Islamic Business School, Universiti Utara Malaysia, Kedah, Malaysia

Abstract: **With emerging literature on Islamic finance and Islamic modes of financing, a number of research studies were conducted to analyze and look at the role of Islamic modes of financing for the growth of several sectors of economy. But few studies have been attempted to consider the influence of Islamic financing on SMEs performance in Nigeria. SMEs are the important determinants of economic growth; they contribute and enhance the general productivity and employment opportunities. Therefore, the purpose of this study is to examine the influence of Islamic financing on SMEs performance in Nigeria. This is cross sectional research using 354 owner/managers of SMEs in Kano, Kaduna and Sokoto State in north-western Nigeria. Regression analysis was used for the data analysis. It has found that Islamic financing (IF) has positive influence on SMEs' performance. Theoretically the study provides additional understanding on the importance of Islamic financing in predicting SMEs' performance. Consequently, the present study is useful to the government and its agencies, financial practitioners, as well as business and academic researchers, in furthering understanding of how the tangible resources in this model influence SMEs' performance in Nigeria. This study recommends for the future empirical studies on this relationship should be replicated to cover the entire six geo-political regions of Nigeria if the findings are to be generalised to the whole country.**

***Keywords*: Islamic financing; Islamic modes of financing; SMEs performance**

I. INTRODUCTION

Small and medium enterprises (SMEs) have been extensively recognised as a catalyst supporting economic development. They assume a crucial role in the advancement of any country's economy (Babajide, 2011). Therefore, the SME sector serves as an instrument for economic recovery and is among the important areas of economic proliferation in both developed and developing countries (Herath & Mahmood, 2013, 2014; Oduyoye, Adebola, & Binuyo, 2013). SMEs constitute the greater part of business enterprises, are responsible for most job creation and are considered to be the major driving force and contributor to economic growth in most economies (Akingunola, 2011). Thus, the impact of SMEs on the growth and development of any country's economy cannot be over emphasised (Aminu & Shariff, 2014).

Considering the potential and prospects of SMEs, there is an urgent need to improve the performance of the SME sector (Lawson, 2012). Nowadays, the performance of SMEs is becoming an important area of concern among business researchers, practitioners, governments and international organisations (Akingunola, 2011). SMEs are considered the major contributors to exports and to the generation of employment, and are unarguably accountable for most of the business- related activities in many countries (Akingunola, 2011). Unfortunately, SMEs contribute only a small proportion of Nigeria's GDP (Bello, 2014; Gbandi & Amissah, 2014).

Thus, the poor performance of SMEs in Nigeria is a serious issue that affects all stakeholders, particularly as the country aims to be among the biggest 20 economies worldwide by the year 2020 (Thomas & Brycz, 2014). Indeed, to achieve this dream SMEs need to play a much more significant role (Bello, 2014) in Nigeria's economic development.

Against the backdrop of SMEs' contribution to the countries mentioned above, it is safe to assume that the Nigerian government is critically concerned about transforming, promoting and supporting SME Sector (Hassan & Olaniran, 2011). For instance, since 1970 the Nigerian government has introduced various schemes, programmes, policies and institutions for promoting SMEs. These includes the Small Scale Industries Credit Guarantee Scheme (1971); Rural Banking Scheme (1977); Peoples Bank (1989); Bank of Industry (BOI); Nigerian Industrial Development Bank (NIDB); Small and Medium Enterprises Equity Investment Scheme (SMEEIS); Industrial Development Centre (IDC); Microfinance Bank Institutions (MFBIs) and finally, in 2004 Small and Medium Enterprises Development Agency of Nigeria (SMEDAN) (Babajide, 2012; Babajide, 2011). In addition, the Nigerian government recently introduced other programmes such as the Subsidy Re-investment and Empowerment Programme (Sure-P) in 2012; You Win in 2012; N-power in 2016 and Youth Entrepreneurship Support (YES) in 2016 (Akande, 2016; Enelamah, 2016; Odia & Odia, 2013).

Although Nigerian SMEs are motivated by the opportunities offered by these schemes (SMEDAN, 2012, 2013), their performance remains unimpressive for a number of reasons, including inadequate poor funding, poor and weak linkage between different segments of operations in the sector, low operating capacities in terms of skills, knowledge and enterprises attitudes, inadequate viable business plans, insufficient government financial support and inadequate infrastructure (Mohammed & Obeleagu-Nzelibe, 2014;

National Implementation Plan, 2010; Oluboba, 2002; SMEDAN, 2012).

Considerable evidence has accumulated regarding the antecedents of SMEs performance. A comprehensive review of literature has identified several factors influencing SMEs performance (Shamsudeen, Keat, & Hassan, 2016). Although these factors have provided important insights into the determinants of SMEs performance, only a limited number of studies, however, investigated the idea that performance of SMEs may be influenced by Islamic financing particularly in Nigeria (Bazza & Daneji, 2014). Among the few available studies on Islamic financing have strongly demonstrated that it is an important determinant of SMEs performance (Batra, Kaufmann, & Stone, 2003; Mazanai & Fatoki, 2012; Kuzilwa, 2005; Gbandi & Amissah, 2014). Despite the fact that access to finance contributes significantly to SMEs' success in Nigeria (Gbandi & Amissah, 2014; Ogujiuba, Ohuche, & Adenuga, 2004). In Nigeria sources of Financing SMEs are obviously inaccessible. Even where it is available you find out that it is not feasible to obtain. This is because of high cost of fund and stringent requirements which must be met. As a result many SMEs failed to meet the requirements hence could not get the needed fund (Bazza & Daneji, 2014).

From the related literature reviewed, there are few studies on Islamic Financing as major drivers of SMEs' performance. In short, most of the previous studies aimed at investigating Islamic Financing differently from the performance aspect of SMEs (Abdesamed & Wahab, 2014; Bazza & Daneji, 2014; Pooe, 2014), thereby neglecting the influence of Islamic Finance on SMEs' performance. This serve as the major important gap in the literature. Therefore, this study extends the existing literature by examining Islamic Financing as a key factor influencing SMEs performance with empirical analysis.

Islamic financing is a mode of financing that emphasized financing as co-owners (equity holders) not financing as creditors. It recognized share of profit and loss as a return for capital does not interest as the case of conventional financing. It does not believe in arriving at a predetermine amount of money as a return to capital owners rather it believed in the amount of money that is realized after executing the business which could be profit or loss (Bazza & Daneji, 2014).

II. LITERATURE REVIEW

2.1 SMES' Performance

The actual outcome of every organisation measured alongside its input makes up the performance of a firm. Performance measurement allows organisations to concentrate on the units needing to be improved, by assessing the degree of progress required, based on quality, cost and time, as well as combining areas with higher yields (Ringim, 2012; Tomlinson, 2011).

According to Dess and Robinson (1984) as cited by Ringim (2012), SMEs' performance is assessed by a number of criteria or indicators for competition, globalisation, long-term survival liquidity, profitability, management performance, human resource management, leverage market share, and quality of goods and services. To Dess and Robinson, these indicators serve as the major elements in measuring SMEs' or organisational performance. Berry, Sweeting and Goto (2006), also relate performance to level of productivity, the optimal utilisation of resources in an effective and efficient way.

Performance is defined by Man (2009) as the result of acclimatising effective management processes; it can be measured by a number of criteria: productivity, growth, efficiency and effectiveness. Kaplan and Norton (1995, 2001) suggested that, a firm's performance should be determined by using a Balanced Scorecard (BSC) which captures both lagging and leading performance measures. BSC examines performance from four different perspectives: financial, customer, the internal business process, and learning and growth. The BSC method was used by Kee-Luen *et al*. (2013) to measure business performance, with the financial perspective as an indicator to measure financial (goals) performance; the customer perspective to measure performance in terms of time, cost, quality and services in relation to customer satisfaction; critical internal operation measured by the internal business perspective; and the learning and growth perspective to measure the emphasis of management on employee capabilities, motivation, available information systems and empowerment. These provide a balanced view of a firm's performance.

Nevertheless, Hudson, Smart and Bourne (2001) identified shortcomings in the BSC approach, even though it cover very good performance dimensions, because no mechanism is provided for maintaining the defined measure. Ballantine and Brignall (1994) identified lack of integration between strategic scorecard, top-level and operational-level measures as an additional deficiency of Kaplan and Norton's model. Hudson *et al*. (2001) proposed six dimensions of performance measurement: flexibility, quality, finance, time, human resources and customer satisfaction.

Murphy, Trailer and Hill (1996) and Suliyanto and Rahab (2012) measured performance using only two dimensions: financial and non-financial measures. Performance is the determination of financial ability of an organisation, such as its investment level and profitability level including growth in sales (Kamyabi & Devi, 2011). However, the performance concept as explained by Olusola (2012) is the ability to measure the level of achievement of a business organisation, whether big or small; SMEs can be assessed in terms of size, employment level, profitability and potency of working capital.

To summarise these concepts and definitions, SMEs' performance refers to organisational successes that cover operational and financial outcomes. Organisational success means achieving the overall objectives in an effective and efficient utilisation of resources. Performance can be measured using objective (financial) and subjective (non-financial) measures.

2.2 The Concept of Islamic Financing

Islamic finance has grow to be a part of the financial sector all over the world and is getting popularity as a promising financial device in an effort to serve as a panacea to the recurrent economic instability in general and the financing desires of SMEs in specific (Bazza & Daneji, 2014; Lawson, 2012).

Its starting place can be traced to Muslim international locations however spread over Europe, the United States, the Middle East and Africa (S Shtayyeh and W Piot, 2008). As a concept Iqbal (1997), expressed himself that the Islamic Finance is founded at the absolute prohibition of the fee or receipt of any predetermined, guaranteed charge of go back. This closes the door to the idea of hobby and precludes the usage of debt-primarily based instruments. The system encourages risk-sharing, promotes entrepreneurship, discourages speculative behavior, and emphasizes the sanctity of contractors. Islamic finance based its structure on risk sharing and promotes profit and loss sharing at the same time prohibits debt financing (leveraging). This is because debt financing transfer the entire risk of the transaction to the borrower. Islamic finance championed the alternative to debt based financing by allowing both parties to share production, transportation, and marketing risks (Bazza & Daneji, 2014).

Islamic financing system comprises in its principles the prohibition of interest, investment in certain sectors such as pig related industry, alcohol or drugs business, interest related business and any transaction that has to do with unseen (Shtayyeh & Piot, 2008). In addition, Iqbal (1997), mentioned risk sharing, money as potential capital, and sanctity of contract as part of the principles. He explained that suppliers of funds should be regarded as investors not creditors. Money becomes capital only when it is combined with other resources in productive activity, and upholding contractual obligation as a sacred duty to minimize the risk of asymmetric information and moral hazard. Sanusi (2011), concurred with the above scholars on the principles of Islamic finance where he noted, under the principles lending is not a business. Investments are to be only in morally and legally approved causes the same thing with the western concept of socially responsible or ethical investing.

Furthermore, in respect to the Islamic mode of financing, Abdulgafoor (1995) categorized mode of Islamic financing into areas like:

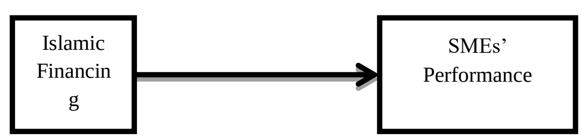
1. Investment Financing: this comprises Mudarabah "where a bank agreed to finance a business proposal of a skilled entrepreneur but not having capital after which the profit resulted will be shared according to agreed ratio. If loss results the financier or the bank will take it and the entrepreneur will lose his managerial efforts. Assuming the loss was due to entrepreneur‘s negligence he will be forced to pay" (Bazza & Daneji, 2014, pp438), Musharakah (active partnership) where both the entrepreneur and the bank contribute to the finance needed in equal or varying degrees at the same time participate in the running of the enterprises after which the profit or loss realized will be shared according to the prior agreed ratio. Lastly, the Estimated Rate of Return.
2. Trade Financing this comprises Murabah (mark up), Ijara (leasing), Hire purchase, Sell-and-buy-back, Letters of credit, Salam (forward trade contract) and Istisna (partnership in manufacturing).
3. Lending this is another mode of Islamic financing that involved Loan with a service charge, No cost loan and Overdraft.
4. Services this involved other banking services like bill collection, money transfers among others.

Meanwhile, looking at the Islamic mode of financing above its identified the financier as a stakeholder in the business. The income of the financier‘s depends on the outcome of the business operation (Bazza & Daneji, 2014; Syauki & Purnamasari, 2011). Added that, when business operation is successful both the financier and the entrepreneur will benefit according to the predetermined ratio as agreed upon. "This justifies the need for the financier to partake in the management of the business concern" (Bazza & Daneji, 2014 pp441).

Empirically, studies reviled that Islamic financing has a strong influence on small and medium enterprises' performance (Bazza & Daneji, 2014; Shtayyeh & Piot, 2008; Sanusi, 2011; Syauki & Purnamasari, 2011). Therefore, in line with the above, this study proposes the following proposition:

H1: Islamic Financing significantly influence the performance of small and medium enterprises.

In line with the above discussion, the focus of this study is to examine the influence of Islamic Financing on SMEs' performance. Figure 1 shows the proposed theoretical framework for this study.



Figure, 1: Research (Conceptual) Framework

III. METHODOLOGY

This is quantitative research design and cross-sectional in nature where the data were collected only in a given point in time (Kumar, Talib, & Ramayah, 2013; Zikmund, Babin, Carr, & Griffin, 2012). A total of 559 questionnaires were distributed using face to face contact to SMEs owner/managers in Kano, Kaduna and Sokoto states in north-western Nigeria, 354 questionnaires were retuned and useable for the purpose of this study. Variables under study were measured using the adapted items from the prior literature. Six items on SMEs performance were adapted from Suliyanto and Rahab (2012) and eight items for Islamic financing are from Martin, Cullen, Johnson, and Parboteeah (2007). All questions were using a 7-point Likert scale where ‘1’ denotes ‘strongly disagree’ and ‘7’ denotes ‘strongly agree’. Finally, the data were analysed using statistical package for social science (SPSS 22vn).

Model for Empirical Estimation

PER= $\beta_0 + \beta_1$ IF + E

Where: β_0 = Constant (Intercept)

B_1 = Coefficient of IF

E = Standard error of estimate

IV. ANALYSIS AND RESULT

The questionnaire collected were coded into SPSS version22 and screened accordingly ready for further analysis. The data analysis and result of the findings presented in the following sections.

4.1 Demographic Profile of Respondents

In this section, the respondents were asked to indicate a number of characteristics relating to their firms as well as other demographic variable, such as their job position, line of business, business type, location of the business, age of the firm, number of employees and estimated total assets. It was revealed that:

- ✓ 54.8% of the firms in the sample are managed by the owners, 34.7% by managers and 10.5% by both owner and manager. This indicates that more than half the SMEs in Nigeria are managed by the owners.
- ✓ 90.4% of SMEs operating in Nigeria are small, with the remaining 9.6% medium.
- ✓ Most of the firms in this study had existed for 1-5 years at the time of data collection: 153 respondents representing 43.2%. 99 firms (28.0%) had been in business for 11-15 years, 79 firms (22.3%) for 5-10 years, and only 23 respondents (6.5%) for more than 15 years.
- ✓ 62.7% of the respondents estimated the total assets of their firms as a minimum of NGN5 million, 32.8% NGN5-50 million 2.3% each with total assets between NGN50-500 million or NGN500 million and above.

4.2 Hypothesis Testing

Having achieved all the assumptions of statistical analysis, the data of the study were analysed using zero-order correlation. Therefore, the Pearson zero-order correlations between the study variables were obtained at 1% level of significance. From the result of the analysis of the bivariate correlation, it is established that, significant positive relationship exists between Islamic financing and SMEs' performance.

4.2.1 Relationship between IF and Smes’ Performance

The result of the analysis indicates that, higher Islamic financing is positively associated with SMEs’ performance in Nigeria ($r = 0.316$, $P < 0.01$). Therefore, the alternative hypothesis is accepted which states that, there is significant positive association between IF and SMEs’ performance. This relationship has been tested and confirmed. Therefore, the finding is in line with theoretical postulation of RBV and POT that strongly claimed that SMEs’ performance is likely to be stronger for firms with high Financing (tangible resources) than those with lower financing. Similarly, this result also confirmed the findings of some earlier studies (e.g. Beck & Demirguc-Kunt, 2006; Demir & Caglayan, 2012; Fonseka et al., 2013; Krishnan et al., 2014; Kuzilwa, 2005; Rahaman, 2011; Rogerson, 2008; Xavier et al., 2013; Zou et al., 2010) that reported positive and strong relationship between Islamic financing and performance. Table 1 present the Pearson’s correlation results for Islamic financing and SMEs' performance.

Table I: Pearson’s Correlation: Islamic Financing and Smes' Performance

		SMEs’ Performance
Islamic financing	Pearson’s correlation Sig. (2 tailed)	0.316** 0.00

** Correlation is significant at the 0.01 level.

V. CONCLUSIONS, IMPLICATIONS, LIMITATION AND SUGGESTION FOR FUTURE RESEARCH

The objective of this study was to prove the need and significance of the access to Islamic finance as predictor towards achieving higher level of SMEs' performance. It is of the interest of this study to establish an attempt to investigate the relevance of the antecedents of the SME performance which likely will continue to generate research interest from the researchers and will certainly produce several empirical evidences. Thus, this study tested the hypothesis that were carefully developed from the related literatures reviewed. Hence, the statistical finding indicates that, Islamic finance is positively associated with SMEs’ performance in Nigeria.

By implication, this study provides empirical evidence for the theoretical association hypothesised from the literature. Therefore, this study suggests that SMEs may need to obtain better financial capital to improve their performance. The findings make another expected contribution to RBV, POT and the entrepreneurship literature by clarifying the role played by IF in organisational performance. Similarly, the Central Bank of Nigeria would benefit from the findings of the present study, as they will serve as a guide in resource allocation and offer a formula to commercial banks and establish more Islamic banking windows in assisting SMEs in Nigeria. However, one of the short coming of this study is, the study limited itself by conducting only correlation analysis to establish the strength and the direction of the relationship. Therefore, future study should investigate the holistic causal nature of the relationship between these variables. Additionally, regression analysis may be conducted further to establish the cause and effect of this hypothesized relationship.

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