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Perception of Small- and Medium-Sized Enterprises in Klang Valley, Malaysia towards Profit and Loss Sharing Mode of Financing

Siti Khadijah Ab. Manan[1]
University Teknologi MARA

Moha Asri Abdullah[2]
International Islamic University Malaysia

Abstract: Equity financing on the basis of profit and loss sharing (PLS) had long been proposed by Muslim scholars to be the prevalent method of funding to businesses. This is so because scholars believe that this particular funding method is able to meet the true spirit of equitable distribution of income and wealth, hence materialising the goals of the *shariah* (*maqasid al-shariah*) in the economy. In addition, they viewed that a balanced proportion of equity and debt in a firm's financial structure would be able to yield a handsome return as the mode promotes participation and hard work while at the same time motivates business expansion and growth. Nevertheless, theoretical perceptions of the scholars on the mode would be less meaningful without ground support from businesses. This study therefore examines the perception of entrepreneurs towards PLS-equity financing. The small and medium-sized enterprises (SMEs) are chosen as samples of the study as these enterprises constitute the majority of business establishments in Malaysia. The study found a favourable finding in support of the scholars' view. The study proposes that PLS equity financing should be given premier attention by the respective bodies and agencies as current practices seldom offer this mode to businesses particularly smaller enterprises.

Keywords: Debt, equity, small and medium-sized enterprises, profit-loss sharing
JEL classification: D22

1. Introduction

Islam, as a complete and comprehensive system, has placed serious emphasis on establishing justice in the economy. This principle of transactions is clearly stated in the Qur'an that "deal not unjustly and ye shall not be dealt with unjustly" (Qur'an, *al-Baqarah*: 279). Therefore, any form of unjust dealing and practice such as *riba* (interest), *ikhtikar* (hoarding) and *maysir* (gambling) are strictly forbidden while fair dealings are advocated and promoted. One form of a fair practice is distribution of profit and loss on shared basis, simply known as PLS (or profit and loss sharing). Scholars in the field of Islamic banking and finance have long been discussing the advantages of PLS equity financing *vis-à-vis* debt-based financing. It has been argued that PLS should be given premier attention in as

[1] Centre for Islamic Thought and Understanding (CITU), Universiti Teknologi MARA Shah Alam, Malaysia. Email: *heyda66@yahoo.com* or *sitik274@salam.uitm.edu.my* (corresponding author)

[2] Kulliyyah of Economics and Management Sciences (KENMS), International Islamic University Malaysia. Email: *mosria@gmail.com* or *mosri@iium.edu.my*

far as its application in financing businesses is concerned. It is thus advocated that financing of businesses should be mainly based on PLS without neglecting interest-free debt-based instruments.

Conventional finance theorists on the other hand emphasise that debt should be a prevalent mode of business financing (Van Auken *et al.* 1996; Forsaith and McMahon 2002; Cassar 2004) as it is a cheaper source of capital compared to equity (Pike and Neale 2003). In addition, interest payment of debt is tax deductible (Myers 2001). Tax deductibility of interest on debt would yield higher income to businesses thereby a higher return to investors. To capital providers, debt-based mode of financing is favourable as this would mean minimum risk to be borne and maximum return to be anticipated. It is therefore not surprising that the existing conventional modes of financing for businesses in Malaysia are mainly on a debt basis. While this scenario could be practically acceptable in view of the conventional theorists, it is not relatively justifiable in Islamic practice. Statistics published by Bank Negara Malaysia (BNM) show that most of the Islamic banking facilities are debt-based and only a very minimal percentage is equity-based. This has stirred constant debates between the scholars and practitioners of Islamic banks (BNM, 2001; 2002; 2003; 2004; 2005). They have every right to argue and indeed they have their very own justifications and reasons to support their views. But one very essential aspect that should not be neglected is the view of the users of the facilities.

This paper therefore attempts to answer the question of whether Malaysian entrepreneurs could accept equity financing via identifying its positive attributes. Specifically, the paper aims to identify the acceptance of SMEs' entrepreneurs on the concept of PLS that would encourage them to opt for such a mode of financing. The organisation of the paper will be as follows: Section 2 provides a brief overview of Muslim scholars on PLS equity financing. Section 3 elaborates the methods employed in the study and data analysis. Findings of the study are discussed in Section 4 while the conclusion is in Section 5.

2. View of Scholars on PLS Financing Mode

In Islam, financing on the basis of PLS could take the form of *mudarabah* (profit sharing) or *shirkah* (profit-loss sharing). The proponents of PLS equity financing instruments view that the application of *mudarabah* and *shirkah* in financing should be given greater emphasis owing to fact that these modes of finance conform to the true spirit of the Islamic principle of risk sharing (*al-ghurm bi al ghunmi* or no sharing without risk bearing). The principle implies that any business undertaking must assume loss or risk (*ghurm*) (Saiful Azhar 2005). This means that man cannot expect to make profit without assuming any risk as such a practice violates the principle of justice (*al-adalah*). The PLS equity contracts entitle the participating parties to share the profit/loss in accordance to the actual outcomes of the business venture. Any predetermined profit distribution on an absolute or lump sum amount is not allowed as this is tantamount to the prohibited *riba* (interest). What Islam allows is predetermined profit ratios not profit amount. The underlying reason is very clear that there is no certainty of profit in business and placing the suffering of loss on the shoulder of one party (as in interest based transactions) is clear cut injustice (*zulm*).

Apart from the criteria of justice in the mode, equity financing is participatory in nature. The equity holders invest their money, share the risks and receive dividends only when profit is earned. They share the success and failure of the enterprises. Through equity financing, just and equitable distribution of income and wealth can be preserved as the capital owners (equity holders) receive what they deserve. It is therefore justified that the implementation of PLS mode of financing will be able to assure the realisation of distributive justice in the economy (Al-Omar and Abdel Haq 1996; Siddiqui 2006).

In fact, the spirit of sharing the ups and downs of the business would promote greater motivation on the part of the capital owners as well as the entrepreneurs to put greater effort and hard work so as to reap larger profits. Indeed, the spirit of brotherhood (*ukhuwah*) inculcated in a partnership system would allow for one partner to help the other (*ta'awun*) which subsequently contributes positively to the growth and performance of the firm. Besides, this brotherhood spirit will be able to mitigate agency problems among partners when one is able to trust (*amanah*) the other. In addition, the participatory nature of equity financing, coupled with the learning capacity among the capital market participants could necessarily reduce risk, mobilise resources and promote production and innovation (Choudhury and Al-Sakran 2001).

As far as Islamic financial institutions are concerned, shying away from applying equity financing would mean that they are not fulfilling their corporate social responsibility (CSR) of promoting socio-economic growth (Habib, 2005) and distributive justice (Ahmad Siddiqui 2007) as well as contributing to nation building in the form of job creation, help start up businesses, increase productivity, sustain economic growth, maintain price level and help reduce income disparities (Saiful Azhar, 2005: 37). Some even view the marginal use of equity financing as a serious operational deficiency (Dar *et al.* 1991). Others view the dominant use of fixed mark-up modes of financing as not beeen able to realise the objectives of *shari'ah* (*maqasid al- shari'ah*) in uplifting the social and economic position of the *ummah* (Abdulazeem and Asyraf 2007). The non-profit sharing system is promoting short-term and trade transactions and it is meant primarily for non-productive consumer financing. These short-comings of the system may hamper the process of capital accumulation and thereby affect economic growth and development (Mirakhor 1997). In addition, the abundance of consumer financing as opposed to investment financing may lead to inflation as the creation of money is not linked to productive investment. As a consequence, stability in the value of money and hence the economy may not be maintained (Al-Omar *et al.* 1996).

3. Method and Data

The research is designed to be both descriptive and analytical. The descriptive study was undertaken to describe the characteristics of the sample, namely small and medium sized enterprises inclusive of the owner's background and general information of the enterprise. The analytical study was conducted to identify the entrepreneurs' perception towards the attributes of debt *vis-à-vis* equity financing.

The population of this study comprised the small and medium-sized enterprises that received Islamic financing extended by the government to the SMEs through Perbadanan Usahawan Nasional Berhad (PUNB) as well as other SMEs receiving funds from other institutions. The population of the SMEs was derived from the list of SMEs available in *http://www.smeinfo.com.my*. The population frame of the study was the listing of SMEs which operate their businesses in the area of Klang Valley (Selangor, Kuala Lumpur and Putrajaya).

A proper sampling technique is important in order to have a precise and unbiased sample that represents the whole population. As the population of this study consists of two different clusters comprising Islamically financed and conventionally financed enterprises, the sampling technique used was cluster sampling. A total of 600 samples were drawn from the population for use in this study.

A set of questionnaires was personally administered to each of the selected enterprise. Two methods of personally-administration are usually used: drop-off and mail. This study employed both methods to have the bilingual versions of English-Malay questionnaires personally distributed by the researcher and a group of assistant researchers. The approached respondent was given a simple briefing about the study and a time frame for the completion of the questionnaire. A self-addressed envelope was also given to some of the respondents who needed time to fill out the questionnaire. Respondents located in isolated or remote areas were mailed the questionnaire. Follow-up phone calls were conducted to each of the respondents in order to check on receipt of the questionnaire and their response.

The distributed questionnaire elicited information on the (i) owners' demographic background such as gender, ethnic background, education level, age and previous business experience (length of business experience); and (ii) the firm's criteria such as the age of firm, the size (total assets) and nature of operation (types of industry, market product) of the firm, ownership structure and the composition of full time employees. Using the Statistical Package for Social Science (SPSS), the profile of the firms and their owners or managers were analysed to result in frequencies, percentages and means.

In the second part, a set of Likert-scale questionnaires were also posted to the repondents to get their perspectives on debt *vis-à-vis* equity financing. Statements[3] relating to each mode, that is, conventional debt financing, Islamic debt financing and profit-loss sharing (PLS) equity finance were expected to be responded by circling the chosen scale of 1 = Strongly Disagree up to 5 = Strongly Agree. The data were then analysed using factor analysis.

Of the 600 distributed questionnaires, only 124 (or 21%) responded. The low response rate could be attributed to the reluctance of many respondents to spend much time in filling up all the questions. Follow up calls indicated that many had still not filled up the questionnaires. Though they promised to respond, their mails were not received till the end of the data collection period. As the response rate was low and the size of each group within the sample was small, discriminant analysis could not be used to compare the perceptions between the SMEs using the Islamic mode of financing and those using conventional finance.

Nevertheless, the 21 per cent response rate compares favorably with similar studies conducted in this field using similar sample sizes, that is, the SMEs (112 or 22%) response rate yielded in the study of Boocock and Wahab Ismail (2001). Out of the total questionnaires returned, 115 answered all given questions completely and 9 answered only the demographic

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[3] The statements were a modified version of the questionnaire used in an earlier study by Jalaluddin (2001) on SMEs in Australia.

section. The reason given for not answering the other section was that they had no experience or knowledge on financing modes as they had not taken any external financing.

4. Results and Discussion

The following sub-sections discuss the study's findings which comprise the characteristics of the SMEs owner-managers, the characteristics of the SMEs and the perception of the enterprises on the PLS mode of financing.

4.1. Characteristics of SMEs Owner-Managers (OMs)

Most of the respondents (74.2%) were owners of the enterprises with the number of males and females being 62.9 per cent and 37.1 per cent respectively. This finding is relatively consistent with Malaysia's business environment where the number of male business owners exceeds the female numbers though the latter is increasing. The age of OMs was diverse with the youngest being 23 years old and the oldest 62. Nevertheless, many of the OMs were around the age of 40 with the average age being 40.2 years. The business experience of the OMs was relatively in tandem with age as the findings showed that the minimum years of business experience was 1 while the maximum was 37. In general, many of the surveyed OMs had a 10-year business experience.

As far as the ethnic background of the OMs is concerned, most of those who responded were Malays (91.1%) with only a handful being Chinese (8.9%). None of the Indian OMs responded though quite a number of Indian SMEs had been included in the sample.

With regard to educational level, 45.2 per cent of the surveyed OMs had bachelor degree, 32.3 per cent had a professional certificate or diploma and 11.3 per cent had a master's degree. Only a small number of OMs had secondary school level education or had a PhD (10.5% and 0.8% respectively). None of the surveyed OMs had only primary school education.

4.2. Characteristics of Enterprises

The majority of enterprises surveyed were engaged in the service sector (72.6%), some were engaged in manufacturing (21.8%) and only a small number were in agriculture or agriculture-related businesses (2.4%). A detailed break-down of service businesses indicate that many were engaged in retailing (19.4%), construction (8.1%) and wholesale (4.8%). The remaining were in other service businesses such as restaurants, consultancy, hotel, education and ICT (39.5%). This finding is consistent with the overall profile of small and medium-sized businesses in Malaysia.

In terms of ownership structure, the survey disclosed that about 70 per cent of the enterprises were private limited while the rest were sole proprietorships (17.7%), partnerships (7.3%) and family-owned businesses (4.8%). Consistent with their structure as small and medium-sized, the majority of the enterprises were managed by their owners (86.3%) and only some were managed by managers (13.7%).

In terms of age of the enterprises surveyed, it was diverse, ranging from as young as one year up to 40 years of operation. The average age of enterprises was 7 while the dominant age was 4. This indicates that many enterprises are still in the early stage of development. Further details on the age of enterprises revealed that 74.2 per cent of the enterprises had been in operation for 10 years or less.

The surveyed enterprises employed quite a significant number of employees as the average size of employment was 21. The maximum number of employees employed by an enterprise in this study was 147. An analysis of the employees based on their ethnic background indicates that the majority of them were Malays (72.9%) while Chinese and Indians constituted only a small percentage (6.07% and 2.5% respectively). Not surprisingly, quite a significant number of foreign workers (immigrants) were employed (18.9%) and this number surpassed the total sum of Chinese and Indians employed by the enterprises. Interviews with several employers disclosed that the main reason for the significant number of foreign workers was their willingness to work hard at reasonable (or sometimes cheaper) wages.

The products sold by the surveyed enterprises were diverse, ranging from a minimum of one product up to more than twenty products, with the average for each enterprise being three products. These products were mainly sold in the local market (54.8%) and regional (18.6%) as well as the national market (22.6%). Only a small percentage (4.03%) of the products was marketed internationally. This finding is consistent with the data reported by the Department of Statistics Malaysia and SMIDEC in 2005 where the SMEs in Malaysia contributed not more than 20 per cent of outputs for export (SMIDEC, 2006).

In terms of assets, the study identified that the enterprises had an even size of assets across the range. Almost one-third (29.8%) had assets valued at less than RM200,000, approximately one-third (28.2%) had assets valued at more than RM1 million and another 25 per cent had assets valued between RM200,000 to RM400,000. The remaining enterprises (16.9%) operated with assets valued between RM400,000 and RM1 million.

4.3. Financing Received

On sources of start-up financing and financing of their on-going businesses, the finding is consistent with many previous studies as 75.8 per cent of the surveyed enterprises utilised their own funds or funds from their family for start-up. Those who sought external equity obtained their funds mainly from partners or development institutions. Approximately 12 per cent of the enterprises obtained start-up funds from development institutions and 10.5 per cent acquired funds from their business partners. Only 1.6 per cent received start-up funds from other sources such as banks or government grants.

The SMEs were asked on their sources of external equity and debt to finance of their on-going business. The study revealed that 56.5 per cent of the enterprises still prefer internal funds as the main source of funding. With regard to external equity sources, government-backed development institutions such as PUNB became the next source of funds (27.5%) while partners (8.1%) and other sources (8.1%) served as alternative financing to the enterprises. This finding contradicts the earlier finding of Boocock and Wahab Ismail (2001) where partners were found to be the main source of external equity.

As for external debt sources, the study revealed that 75.8 per cent of the surveyed enterprises borrowed funds from various sources particularly financial institutions using a number of financing methods. Similar to other previous studies in other countries, enterprises in Malaysia preferred banks and finance companies (57.5%) to be the main sources of loans while development institutions such as PUNB served as another source of loans (35.1%).

Other sources such as MARA, MIDF or business partners were also sought after by the enterprises to seek loans. This finding indicates that banks play an important role as loan providers to SMEs.

The entrepreneurs were asked whether they took conventional loans, Islamic debt financing or both. The study revealed that 62.8 per cent of the enterprises took Islamic debt financing while 31.9 per cent took the conventional loan. Not surprisingly, 5.3 per cent of them took both types of financing. An interview with one of the five revealed that the reason for taking both Islamic and conventional financing is because the two modes offered different advantages to the borrower. The fixed mark-up rate of Islamic debt financing would allow the borrower to have a stable repayment. The fluctuating interest rate of conventional loans on the other hand would give the borrower room for adjustment in repayment.

The SMEs entrepreneurs were also asked to express their readiness to apply profit and loss sharing (PLS) type of equity financing if they were given the opportunity. They were expected to answer 'yes', 'no' or 'not sure'. The 'yes' answer would indicate that they were ready to apply PLS type of equity financing. Initially of course, they were given a brief explanation of PLS equity financing in order for them to have a clearer view on the said mode of finance. The study discovered that 56.5 per cent of the enterprises that responded expressed their readiness to apply PLS method of finance, 14.5 per cent objected to the use of the method while 29 per cent were unsure of applying the method. This could be due to their limited knowledge about PLS. If they had better exposure to the method, the percentage who would agree to try PLS method would probably be much higher.

4.4. Factor Analysis and Scale Reliabilities

A principal component analysis with varimax rotation was conducted to validate the underlying dimensions for the perception towards PLS and debt financing attributes (Table 1).

The results of the varimax rotation analysis indicate the existence of four significant factors with eigenvalues greater than 1 that explained 58.232 per cent of the variance. These factors were identified as advantages of PLS (15 items), disadvantages of interest (5 items), profitable fixed-rate system (3 items) and default risks of the conventional system (2 items). In this study, the four factors were considered adequate to represent the data as the results of the analysis are satisfactory, given that the factors do not exceed 60 per cent of the explained variance recommended in social sciences (Hair *et al.* 1998). The KMO measures of sampling adequacy value for the item was 0.853 (greater than 0.6) and the Bartlett's test was highly significant (Chi-square = 2153.332, $p < 0.001$). Hence, we may therefore conclude that factor analysis is appropriate for the data.

The results of this study seems to reveal that profit and loss sharing method of finance (PLS) is perceived to have lots of business and economic advantages to the SMEs. The interest-based method of finance, on the other hand, is perceived to have lots of disadvantages to the SMEs as its strict criteria of loan disbursement had caused them to have little access to credit. In addition, high interest charges may contribute to the problem of default in the repayment of loans. As for Islamic credit financing, this method is perceived to be profitable due to its fixed nature of repayment.

Table 1. Factor analysis and scale reliability (N = 115)

Variable	Items	Factor Loading	Number of Items	Reliability
Advantages of PLS	The PLS method would motivate business expansion.	.861	15	0.949
	In PLS method of finance, both the capital owner and the entrepreneur would be committed to business success.	.847		
	Sharing of profit would improve business efficiency.	.844		
	The PLS method would provide business support to management at times of economic depression.	.842		
	The PLS method would result in a more effective monitoring of business activities.	.832		
	The capital owner/partner would care more about the business under PLS system because the risks are shared.	.827		
	The PLS method would allow small business to obtain funds on a fair basis.	.792		
	The PLS method would encourage innovation.	.776		
	The PLS method is more flexible than the conventional method of borrowing.	.741		
	The PLS method would mostly suit risky business.	.692		
	The PLS method allows the sharing of risk between capital owner and entrepreneur.	.690		
	In PLS, the costs of capital will not be fixed because they are subject to the outcome of business.	.675		
	The PLS method could reduce bankruptcy caused by failure to service the debt.	.643		
	The PLS method does not place a heavy burden on entrepreneurs at times of business slow down.	.640		
	Profit return to partners could be higher under the PLS system as compared to that of the conventional loan system.	.616		

Table 1. Continued.

Variable	Items	Factor Loading	Number of Items	Reliability
Disadvantages of interest	Lending criteria of conventional loan places too much emphasis on ability to pay.	.813	5	0.806
	Lending criteria under conventional system do not motivate business expansion.	.767		
	Lending criteria of conventional loan are very strict.	.725		
	Lending criteria of conventional loan places too much emphasis on collateral.	.642		
	Interest system may contribute to the phenomenon of bankruptcy during sluggish economic conditions.			
Profitability of fixed-rate system	The fixed mark-up rates are more profitable.	.846	3	0.848
	The fixed mark-up rates are able to reduce the risk of loss due to economic downturn.	.837		
	The fixed mark-up rates of Islamic financing facilitate future business projection.	.817		
Default risks of the conventional system	Interest payment creates difficulties for business during economic downturn.	.733	2	0.816
	Interest rates on conventional loan are too high.	.631		
Eigenvalues				9.813
Percentage of variance explained				58.232
KMO measure of sampling adequacy				0.853
Chi-square				2153.332

Since the study intended to highlight the positive attributes of the PLS, the 15 items of mode in Factor 1 were then analysed separately from the other three factors (Table 2). The results of the varimax rotation analysis indicate the existence of two significant factors with eigenvalues greater than 1 that explained 66.95 per cent of the variance. These two factors were then identified as the positive contribution of PLS to real business expansion (8 items) and justice in risk sharing (7 items). The KMO measures of sampling adequacy value for the 15 items was 0.935 (greater than 0.6) and the Bartlett's test was highly significant (Chi-square = 1315.547, $p < 0.001$). Hence, we may therefore conclude that factor analysis is appropriate for the data.

The findings of this study indicate that entrepreneurs generally perceived the method to able to contribute to real business expansion as the mode allows small businesses to gain access to capital on a fair basis and it could therefore motivate business expansion and innovation. In addition, the mode could encourage businesses as it takes into account the success and/or failure of the business hence reducing the possibility of business exit.

Table 2. Factor analysis and scale reliabilities of PLS attributes (N = 115)

Variable	Items	Factor Loading	Number of Items	Reliability
Advantages of PLS	The PLS method could reduce bankruptcy caused by failure to service the debt.	.849	8	0.918
	The PLS method does not place a heavy burden on entrepreneurs at times of business slow down.	.804		
	The PLS method allows the sharing of risk between capital owner and entrepreneur.	.711		
	The PLS method would allow a small business to obtain funds on a fair basis.	.661		
	The PLS method would motivate business expansion.	.648		
	The PLS method would encourage innovation.	.630		
	The PLS method would result in more effective monitoring of business activities.	.611		
	The PLS method is more flexible than the conventional method of borrowing.	.565		
Disadvantages of interest	The PLS method would mostly suit risky business.	.777	7	0.904
	In PLS, the costs of capital will not be fixed because they are subject to the outcome of business.	.757		
	Profit return to partners could be higher under the PLS system as compared to that under conventional loan system.	.750		
	The PLS method would provide business support to management at times of economic depression.	.637		
	Sharing of profit would improve business efficiency.	.633		
	In PLS method of finance, both the capital owner and the entrepreneur would be committed to business success.	.619		
	The capital owner/partner would care more about the business under PLS system because the risks are shared.	.611		
Eigenvalues				8.929
Percentage of variance explained				66.957
KMO measure of sampling adequacy				0.935
Chi-square				1315.547

Furthermore, the implementation of PLS promotes justice in the sharing of risk between the capital owners and entrepreneurs. Therefore, a more equitable distribution of income and wealth in the economy could be established.

5. Conclusion

The main objective of this study was to examine the acceptability of entrepreneurs to applying PLS as a method of financing via analysing their perception towards the mode. The study concludes that the PLS method is perceived to have many advantages while the traditional interest-based method is perceived otherwise. Specifically, the PLS mode is perceived to contribute positively to real business expansion and is able to establish justice in risk sharing. The fixed mark-up method of Islamic credit finance is perceived to be better than the traditional method, but its perceived high costs have had led many to believe that the Islamic method is similar to the conventional method. This study's findings show favorable support to the views of Muslim scholars on PLS equity financing.

The positive response and perception of the entrepreneurs towards equity financing, as found in this study, could give a signal to relevant authorities particularly Bank Negara Malaysia (BNM) to consider the need of the entrepreneurs in having other equity modes of financing. In doing so, the existing rules and regulations pertaining to equity participation by banks and non-bank institutions should be reviewed.

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