

How Profit and Loss Sharing System (PLS) Encourage Small & Medium Enterprises Sustainability

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ABSTRACT

The aim of this study is to identify how Profit and Loss Sharing System (PLS) can encourage the sustainability of Small and Medium Enterprise. By using qualitative approach, the results show that Profit and Loss Sharing System has been encouraged the Small and Medium Enterprises to be more sustainable by reducing internal principal-agent problems. There are (1) The employee have a share of the return, then they will work hard to generate the expected return. (2) As a partner, the employee has a sense of belonging. It leads the employee try hard to maintain the (small) corporate to keep running and developing. Then, the expected return and sense of belonging will encourage the sustainability of Small and Medium Enterprise.

Keywords: Profit and Loss Sharing, Principal-Agent, Small Medium Enterprises Sustainability

INTRODUCTION

Small- and medium-sized enterprises (SMEs) in Indonesia play a great role in contributing to the country's economy. Based on the statistics in 2009, 56.72% of the total GDP in the manufacturing sector is earned by the SMEs, which represent 99.96% of total number of manufacturing industries (3.27 million companies) and also absorb employment for 87.47% of the total industry workers [Fatimah *et al.* (2013)].

Related to export performance, SMEs in Indonesia give significant contributions to national export performance. In 2010, SMEs' contribution to national export performance is about IDR 175.894,9 Billion (or equal to 15.81%) and IDR 187.441,82 Billion (equal to 16.44%) in 2011. The flagship export products for SMEs include: 30% of handicraft, 29% of fashion and accessories, 27% of furniture, 10% of food and beverage, and 4% of health and beauty products. These figures prevail despite wide range affirmative policy initiatives in developing SMEs launched by the Government of Indonesia.

There are a few problems facing the development of SMEs. The most common obstacles that hinder the development of SMEs in Indonesia are lack of innovative technology, inefficient production processes, limited skilled workers, insufficient capital investments and lack of standardization products. The Government actually provides assistance to the SMEs, varying from program socializations and workshops to technical guidance and revitalization of equipment, to diminish those obstacles. Those

programs are implemented based on the Government policy on SMEs Development, namely Government Policy Number 17 Year 2013 on Micro, Small and Medium Enterprises. There are also a few Ministry Policies on the related subjects from Ministry of Cooperation and SMEs, Ministry of Industry, Ministry of Trade and Ministry of State-Owned Enterprises.

Even then, the main policy challenge will be to speed up the development of technology based SMEs, preferably in the kind of technology that conforms to the current global discourse on *sustainable development* that embeds with three key domains: i) *Environmental Sustainability*, ii) *Social Sustainability*, and iii) *Economic Sustainability*. In that spirit, the main feature of the development policies for SMEs consists of:

- a. Improvement of access to technology,
- b. Improvement of access to finance,
- c. Improvement of access to market,
- d. Technology diffusion and commercialization scenarios through business incubation, and
- e. Provision and creation of favorable environment to support new business ventures, etc.

Towards those challenges, attention has been paid to support SMEs in many aspects. Encouraging entrepreneurship on SMEs players is put high on the agenda of Government, for entrepreneurs are seen as the catalyst of growth, combining capital, innovation and skills. This agenda recognizes the importance of entrepreneurship that stands out in the time of innovative change, and fostering a favorable climate for SMEs, which is considered as fundamental aspect.

The presence of interest in economic and financial activity showed two sides of the economy, the monetary sector and the productive sector (real). Supposedly the two sides (based on classical economics) is (a) side that produces the same magnitude. The relationship between the monetary sector to the real sector, in classical economic theory, only bridged by the price level. If the money supply is greater than the value of goods and services available, the level of price increases. Conversely, the price level decreases. According to the quantity theory in classical economic theory, any change in the stock of money in circulation will directly affect the level of prices. The magnitude of changes in the level of prices, due to the change in the stock of money in circulation, is proportional to the rate of change in the stock of money circulation.

In regards to the employment, there are two options for business owner in rewarding the employee, which are the payroll system and the profit-loss sharing system. The payroll system suggests the owner to give salary and wages for the employee based on their productivity. There is a difficulty to give rewards for the employee in relation to the profit earned from the business. Meanwhile, profit-loss sharing system allows the owner to give rewards to the employee that depends on the business performance.

THEORETICAL BACKGROUND

Small Medium Enterprises (SMEs)

SMEs are defined as non-subsidary, independent firms, which employ fewer than a given number of employees. This number varies across national and multilateral institutions' statistical systems. World Bank define SMEs as firms with maximum 300 of employees, while UNDP define SMEs as firms with maximum 200 of employees. Financial assets are also used to define SMEs. Based on World Bank's definition, SMEs have maximum revenues/ turnover of \$15,000,000 and maximum assets of \$15,000,000. [Gibson & Van der Vaart (2008)]

While it should be intuitively evident that SMEs are of special importance to private sector growth, there is considerable disagreement within development policy circles as to why, or even whether, this is so. Claims that SMEs are more efficient at creating quality jobs, are more innovative or grow faster than larger firms have been questioned on the basis of large regression analyses or on the basis of examining company registrations and corporate failures. Arguments that the overall business environment in any given country is of greater importance than the development of the SMES sector have apparently caused some in development to question whether taxpayer or foundation moneys should be spent on SMEs initiatives. The result is that the relative priority of SMEs, and therefore SME-related policy, in development is currently unclear. [Gibson and Van der Vaart (2008)]

Indonesia's policy and strategy are geared up to drive SMEs empowerment. The SMEs' empowerment programs are done by empowering the policy directions, as follows: [Indonesian Country Presentation (2013)]

- a. Develop SMEs to support their significant contributions towards economy growth, jobs creation, and increasing competitiveness as well as to support their contribution on increasing people's income, especially to low-income people;
- b. Strengthen the institutions by applying good governance principals;
- c. Expand the bases and opportunities as well as grow the senses of entrepreneurship to drive national growth, to increase export, and to create job employment;
- d. Increase the collaboration of educated labor and skilled labor by adopting technology application;
- e. Develop SMEs to increasingly play its role in the process of industrialization, transfer technology, and capacity building;
- f. Integrate business development in the context of regional improvement, in line with the character of entrepreneur, and business potential in each province;
- g. Develop SMEs to increasingly play a role as products (goods and services) provider to become more competitive than importer's products.

Those strategies are made up to speed up SMEs capacity in line with Indonesian policy direction which focuses on 5 priorities: increase business climate for Cooperative and SMEs, increase access toward productive resources, develop product and market for Cooperatives and SMEs, increase labor competitiveness, and increase Cooperatives as institution.

Indonesia still faces many problems in promoting SMEs export products, which include internal and external problems. Internally, obstacles that face by Indonesian SMEs involve: low commitment to fulfill consumer orders (both domestic and foreign customers); lack of management applied by SMEs, especially in production, administration, and financial aspects; limitation of facilitation for SMEs in order to fulfill orders; low quality of human resources; limitation of capital owned by SMEs; lack of information and communication to stakeholders; and lack of capability in SMEs research and development.

Externally, Indonesia face several problems, such as: instability of supply and price of raw and support materials; high requirements from buyers toward product quality, social environment quality, work environment quality, price competition, and eco-friendly aspects; lack of market access; lack of financial access which includes information, credit skim, and high interest rate; also variation of halal standardization between Indonesia and importing countries.

A general gain of adapting sustainable entrepreneurship in SMEs is the internal dynamics that sustainable approaches introduce in the production process and human resource management. It is likely to lead to a more bold investment policy in both technology and personnel that will yield results in the long run. A direct and obvious gain accrues to those SMEs that supply their products to large companies which themselves are sustainable entrepreneurs and require from their supplier to be so as well in order to be in business. Such large companies may have a direct interest in product- and chain directed environmental care as well as labor conditions.

Profit Loss Sharing (PLS)

Profit - loss sharing contract is an agreement between two parties where each party to collect resources, invest in some projects and then share profits and losses. Although profit sharing and loans seem similar, the difference is clear. Based on the definition of Institute of Islamic Banking and Insurance, profit-loss sharing means profits and/ or losses that may arise from economic activities/ business is borne together. In the instrument for the results are not fixed and there is a certain returns as interest, but do profit and loss sharing based on the real productivity of the product. The characteristics of PLS system are equity based, fairness, risk sharing and collateral on character, which enforce a partnership between the owner and the employee.

Factors that affect the amount of profit – loss sharing percentage are determined by parties in agreement, which are influenced by:

- a. The contribution of each party to the partnership (share on partnership)
- b. The prospect of profitability (expected return) and Type of Business
- c. Estimated risks to be faced (expected risk)
- d. Taking into account the costs and BEP
- e. How big assumption that the return will be given to depositors
- f. Market Price

In a profit – loss sharing, the results are not guaranteed. While the loans are applied by conventional banks, the loan does not depend on the outcome of the profit or loss and are usually guaranteed that the debtor must return the borrowed capital plus the amount of interest that is certainly without regard to how the results of the use of the loan capital.

DISCUSSION

Internal Principal-Agent on employment system

- a. Payroll System

Payroll system leads to a principal-agent relationship between business owner and employee. Principal-agent relationship may cause conflicts of interest and moral hazard issues that occur when principal hires agent to perform specific duties that are in the best interest of the principal but may be costly, or not in the best interests of the agent.

- b. PLS System

Profit & Loss Sharing (PLS) suggests an equitable sharing of risks and profits between the parties involved, which are owner and employee. PLS is also called participatory modes, which backed by real assets in utilizing the funds. The concept of profit-and-loss sharing in an enterprise, as a basis of financial transactions is a progressive one as it distinguishes good performance from the bad and the mediocre.

Development of SMEs in Indonesia has become one of the important economic policies to create economic growth. One of the methods used to develop the SMEs is through the implementation of PLS between the owners of capital and workers. During this time, the development of SMEs experience problems due to the imbalance that occurs between the owners of the role of capital to labor. Inequality role that occur not only on revenues, but also there is a difference in productivity will affect the results obtained.

Profit and Loss Sharing System has been encouraged the Small and Medium Enterprises to be more sustainable by reducing internal principal-agent problems.

- a. The employee has a share of the return, and then they will work hard to generate the expected return.

The productivity of a worker can be seen in the number or the results obtained from the work carried out, in other words that the work will continue to follow the level of productivity of a worker.

PLS concept illustrates that there is no imbalance between the rights and obligations of owners of capital and workers. Owners of capital give full credence to the workers to run a business entity providing full authority in terms of management. Likewise with productivity of workers continue to be the main demands of the owners of capital to produce a quality product.

In Indonesia, the cultural community has done well for generations between the owners of capital and workers where workers will get a reward from investors (business entities) that is applicable in general in society. Wages received by workers is not based on the level of productivity of work, but is being implemented at the beginning with the acceptance of the wage agreement.

As we know that running a business entity always has two side surfaces, namely profit and loss; hard workers and idlers; productive and unproductive. If a worker has worked hard certainly have high expectations for the results (return) are equal to the level of productivity. However, the opposite is true, that the results or the wages they get the same wage every month.

PLS concept has looked at changes in the productivity of a worker. PLS concept will provide an opportunity for the owners of capital and labor to get the result (return) to jointly work to improve productivity in order to achieve the desired expected return. Through the concept of PLS, the owners of the business and employees will receive not only for profit alone, but also bear the loss together. In terms of profit sharing, workers will get a big part when carrying out responsibilities well through increased productivity. The result of an increase in the productivity of the workers would also have a direct impact on the yield (revenue to be received). Vice versa, if the worker has decreased productivity in managing the work would also be an effect on the decrease in yield (revenue to be received).

In case of loss, PLS concept has its suitability in the loss-sharing procedures in a business entity. If the loss or damage occurred is not the direct fault of the workers, if any, will be borne entirely by the owners of capital (business entity) without prejudice to the final income of workers. Vice versa, if the damage or loss occurs due to the fault of the workers, then the loss will be borne jointly between workers and owners of capital (business entities).

- b. As a partner, the employee has a sense of belonging. It leads the employee to try hard in maintaining the (small) corporate to keep running and developing. Then, the expected return and sense of belonging will encourage the sustainability of Small and Medium Enterprise.

Harmonious and balanced cooperation between the owners of a business entity with the workers will certainly create beautiful harmonies. Alignment and in determining the suitability of a particular strategy in describing the outlook for developing SMEs will be very big influence on the level of income or receipts.

Workers alignment with the business entity owners will appears on the execution of the work being done in the field. Suitability of the work is not only about the means, methods, strategies but also the suitability as a partner. Suitability and harmony in developing SMEs will certainly bring a feeling of comfort in the SMEs area. Convenience course will also create a sense of ownership (self - belonging), which are realized in the form of loyalty and also the increasing productivity.

When ownership / self - belonging of workers appear, the increase in the productivity of the workers will come by itself. This is because the workers were already able to feel that the success of SMEs is also contributed by the hard work of the workers.

Ownership or self-belonging in the beginning of the emergence of a sense of family arise between the owners of capital (business entities) with the workers. Workers will also feel the desire of the owner of the business entity to participate and work hard to develop the SMEs.

Ownership or self-belonging that exists within the workers would have to be the main thing that was addressed by the owner of the business entity. Family relationships that appear in the form of co-operation to improve productivity, will certainly have an impact on the sustainability of SMEs in the future. It takes encouragement, cooperation slick, and harmony in developing SMEs into a business entity that is more advanced and able to compete to develop community level of economy.

Basically the production-sharing contract (profit-loss sharing) provides flexibility for *mudharib* (managers, users of funds, and the borrower) to determine the level of optimization effort will do. Under ideal conditions in which each party to gain access to the full information (symmetric informational) concept for the result is an optimal choice (first best solution). But of course there will be no ideal conditions for each of the parties, in which is not possible to get perfect information. These imperfections will increase the level of risk of the parties who perform the contract. For example, *shahibul maal* (creditors) make loans to *mudharib* (debtors). However, due to lack of information relating to the rate of return (expected return) of a business, then the possibility of capital owners is potentially going to lose. There are times in investment financing in Islamic banking, production-sharing contracts (profit-loss sharing) often fail to apply because of some potential problems encountered.

An example is the implementation of the PLS through land management ponds in Pati, Central Java Province. Sharing agreements made orally, in accordance with local

customs without intending to violate Islamic law. The division of the ponds is done with a percentage of 50 % or 1/10.

In addition, the application of PLS is in Padang food restaurant. The restaurant management fields have a business model based on sharia Islamic economics or the conventional economics. However, there are several models. The typical system is the *mato* system, which applies to the portion of the results of the various components involved in the restaurant business. Everyone has the right and obligation in their respective duties.

Mato system will be divided within 100 days. Division occurs three times a year. In the process of distribution, each party has to agree before running the restaurant business. In the process of division is usually all the components come together, do the study and calculate the number of transactions. This amount consists of the purchase of raw materials, rent and operating costs of labor that is often referred as money soap. Then it is also calculated the sales revenue for 100 days. The difference in income minus expenses will be resulted in either profit or loss.

PLS encourage SMEs sustainability by creating partnership between principal and agent, which contribute to productive use of assets. Equity participation using PLS will provide a sharing system of risk and reward. The possibility of reward and risk enhance the activities of the SMEs, improve outputs and ensure prudent financial management.

CONCLUSION

It is expected that in the end, the financing transactions of profit loss sharing contract can achieve the contract that produces the best quality (the best solution). Of course, with fixed bases on Islamic principles that parties to a contract can obtain optimal revenue without one of the injured party in the presence of asymmetric information.

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