The Influence Of Business Activities And The Aplication Principles On Profit Sharing

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Abstract

The Islamic finance industry has experienced rapid growth in various countries, including Indonesia and Malaysia. Profit sharing is a system of profit sharing between Islamic financial institutions and customers. This study aims to analyze the effect of business activities (such as mudharabah and musyarakah) and the application of sharia principles on profit sharing in Islamic finance institutions in Indonesia and Malaysia. This research uses the Structural Equation Modeling (SEM) method with Smart PLS software. The results of this study are expected to contribute to the development of Islamic finance theory and practice, particularly by providing implications for the design of profit-sharing schemes and the role of sharia principles in Islamic financial institutions.

Keywords : Islamic Finance, Profit Sharing, Sharia Principles, Business Activities
JEL Classification: C01,C15,E01,E02

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Introduction

The Islamic finance sector is experiencing a boom across numerous nations, including Indonesia, Malaysia, and Thailand (Menne, 2023). This surge is fueled by several factors. Firstly, public recognition of the significance of ethical and Islamic finance is on the rise. People increasingly view Islamic finance as an alternative financial system that prioritizes fairness, transparency, and alignment with religious values. Secondly, the Islamic economy's expansion across various sectors, such as banking, insurance, and capital markets, is driving demand for Islamic financial products and services. Thirdly, governments in various countries are actively supporting the development of the Islamic finance industry through favorable regulations and policies (Menne, 2023).

Indonesia's Islamic finance industry is witnessing remarkable growth. Islamic financial assets in Indonesia ballooned from IDR 1,064 trillion in 2014 to IDR 2,171 trillion by 2022 (Abdul, et al., 2022). Several factors are propelling this growth. Firstly, Islamic financial literacy is on the rise within Indonesian society. Indonesians are gaining greater familiarity and understanding of Islamic financial products and services. Secondly, Islamic financial institutions are actively innovating and enhancing their offerings to attract the public. Thirdly, the Indonesian government implements various incentives and policies that support the development of the Islamic finance industry (Abdul, et al., 2022).

Malaysia's Islamic finance industry is also experiencing rapid growth. Islamic finance assets in Malaysia surged from RM 474 billion in 2014 to RM 981 billion by 2022 (Oktavianti & Amsari, 2024). Several factors are driving this growth. Firstly, the Malaysian government has a clear vision to establish Malaysia as the world's leading center for Islamic finance. Secondly, Bank Negara Malaysia (BNM) plays a proactive role in regulating and developing the Islamic finance industry. Thirdly, Islamic financial institutions are actively involved in providing innovative and competitive services (Oktavianti & Amsari, 2024).

While still relatively new, Thailand's Islamic finance industry is demonstrating positive growth. Islamic finance assets in Thailand increased from THB 340 billion in 2014 to THB 530 billion in 2022 (Musyafah, 2019). Several factors are driving this growth. Firstly, the Thai government actively supports the development of the Islamic finance industry. Secondly, cooperation between Thailand and other Muslim-majority countries is on the rise. Thirdly, Thai people's awareness of the importance of Islamic finance is increasing (Musyafah, 2019).

Popular Islamic financial products across Indonesia, Malaysia, and Thailand include Islamic savings, deposits, financing, insurance, and capital markets. A prominent Islamic financial product is profit sharing. This system allows Islamic financial institutions and customers to share profits (Afiah, Muin, & Kadir, 2024). Profit sharing adheres to sharia principles, which prohibit usury and necessitate fair and transparent profit distribution (Afiah, Muin, & Kadir, 2024). This study aims to analyze the impact of business activities and the application of sharia principles on profit sharing practices within Islamic financial institutions across Indonesia, Malaysia, and Thailand. The study's findings are expected to contribute to the advancement of both Islamic finance theory and practice.

Literature Review

Sharia-compliant businesses prioritize transparency in financial management (Suhairi et al., 2023). This principle ensures that financial records and transactions are conducted with honesty and openness. Transparency helps prevent practices that violate sharia principles, such as usury (riba) and excessive uncertainty (gharar). Sharia-based businesses often champion community economic empowerment. Examples include microfinancing and Islamic cooperatives, which foster the development of small and medium-sized enterprises (SMEs) in a fair and sustainable manner. This aligns with sharia's emphasis on fairness and long-term viability (Suhairi et al., 2023).

Islamic business ethics hinge on integrity, honesty, and social responsibility (Muzakki, 2023). Businesses that uphold these principles ensure their operations benefit society and the environment. Prudent risk management, founded on fairness, is crucial in Islamic business. Practices that prioritize this principle avoid excessive speculation and harmful activities (Muzakki, 2023).

Sharia-based business activities tend to favor investments that generate positive social and environmental impacts (Budianto & Dewi, 2023). This includes investments in sectors like education, healthcare, and environmental protection. By doing so, these businesses contribute to the application of sharia principles that prioritize the greater good (Budianto & Dewi, 2023). Building on this foundation, our research hypothesis is as follows:

Hypothesis 1: Business Activities have a positive effect on the Application of Sharia Principles.

Profit sharing acts as a cornerstone for transparency and honesty in financial management (Wicaksono, 2020). This system necessitates clear communication regarding profit and loss distribution amongst all parties involved in a transaction. This transparency safeguards against hidden information or misuse of funds, adhering to sharia's principles of openness and integrity. Furthermore, profit sharing fosters community economic empowerment (Zulhikam et al., 2024). By ensuring a fair division of profits among all stakeholders, the system grants everyone a rightful share of the gains. This fosters economic growth and reduces inequality, aligning with sharia's emphasis on fairness and long-term viability.

Profit sharing also strengthens Islamic business ethics (Rustya, 2023). Within this system, all parties have a responsibility to act with integrity and take ownership of their actions. This ensures the business operates in a way that benefits both society and the environment, upholding sharia's principles on ethical conduct.

Profit sharing promotes risk management based on fairness (Munandar & Ridwan, 2023). The system inherently distributes risks proportionally amongst all participants. This discourages excessive speculation and detrimental practices, adhering to sharia's guidelines for responsible risk management. Finally, profit sharing encourages investments driven by ethical considerations (Haerunnisa, Sugitanata, & Karimullah, 2023). Under this system, investments tend to prioritize projects that generate positive social and environmental impacts. This aligns with the sharia principle of prioritizing investments that benefit the greater good. Building upon this foundation, our research hypothesis is as follows:

Hypothesis 2: Profit Sharing has a positive influence on the Application of Sharia Principles.

Sharia-compliant business practices create an environment conducive to the successful application of profit sharing (Mariska & Batubara, 2023). Transparency and honesty in financial management are crucial, ensuring all parties involved in a transaction clearly understand profit and loss distribution. This openness safeguards against hidden information or misuse of funds, adhering to sharia's principles on ethical conduct (Mariska & Batubara, 2023). Furthermore, a core tenet of Sharia-based businesses, community economic empowerment, strengthens the implementation of profit sharing (Munir, 2023). By ensuring a fair division of profits among stakeholders, the system promotes economic growth and reduces inequality, aligning with sharia's emphasis on fairness and sustainability (Munir, 2023).

Similarly, Islamic business ethics, emphasizing integrity, honesty, and social responsibility, further support profit sharing (Djamil, 2023). Businesses guided by these principles inherently operate in a way that benefits both society and the environment, mirroring the focus on fairness and social responsibility within profit sharing (Djamil, 2023). Prudent risk management based on fairness, another cornerstone of Sharia-compliant businesses, aligns with profit sharing (Zulmairoh, Mawati, & Zulfikar, 2024). This focus discourages excessive speculation and harmful practices, adhering to sharia's guidelines for responsible risk management (Zulmairoh, Mawati, & Zulfikar, 2024). Similarly, profit sharing inherently distributes risks proportionally amongst all participants.

Finally, Sharia-based businesses prioritize investments with positive social and environmental impacts, aligning with the concept of profit sharing (Khoiry, Hafiz, & Arianyah, 2023). This focus on public good investments resonates with the emphasis on ethical considerations within profit sharing. Building on this foundation, our research hypothesis is as follows:

Hypothesis 3: Business Activities have a positive effect on Profit Sharing through the Application of Sharia Principles.

Research Method

This research leverages comprehensive and reliable secondary data from the World Bank, encompassing data from various countries to enhance the generalizability of the findings. To analyze the complex relationships between underlying concepts (latent variables) and measurable observations (manifest variables), the Structural Equation Modeling (SEM) method is employed using Smart PLS software.

In this study, business activity serves as the independent latent variable, while the dependent latent variables include application of Sharia principles and profit sharing. Consumption, GDP, and work participation act as the measurable indicators for the business activity variable. For the application of Sharia principles, the manifest variables include interest rate, control of corruption, and poverty gap. Finally, profit tax, bank liquid reserves to bank assets ratio, and bank equity to bank assets ratio serve as the measurable indicators for the profit sharing variable. Detailed descriptions of all variables are provided in Table 1.

Table 1. Variable description

Variable Name	Variable Description	Unit of Analysis
Consumption	Total household expenditure on goods and services	Percentage of GDP
GDP	Gross Domestic Product, the total value of goods and services produced in a country	The value of the currency
Work Participation	Labor force participation rate, the percentage of the working age population who are working or looking for work	percentage
Interest Rate	Loan interest rate	Percentage per Year
Control of Corruption	The level of corruption control in a country	Index (0-100)
Poverty Gap	Poverty gap, the percentage of the population living below the poverty line	percentage
Profit Tax	Income tax on company profits	Profit Percentage
Bank Liquid Reserves to Bank Assets Ratio	The ratio of bank liquid reserves to bank assets	Percentage

Partial Least Squares (PLS) is a powerful statistical technique used in social science research, particularly in fields like management, business, and political science, to analyze relationships within complex models known as Structural Equation Models (SEMs). SEM-PLS is a popular choice due to several advantages.

A key benefit of SEM-PLS lies in its ability to assess theoretical frameworks from a predictive standpoint. This method is particularly recommended when the research focuses on making predictions based on the theoretical model. Additionally, SEM-PLS is well-suited for analyzing intricate structural models with numerous variables, indicators, and relationships. In such scenarios, SEM-PLS offers a clearer understanding of the connections between these elements.

Furthermore, SEM-PLS is an appropriate choice when the research objective is to explore theoretical advancements and delve deeper into existing theories. This method empowers researchers to uncover potentially hidden relationships that might not be evident with other techniques. It's also advantageous for path models that include constructs measured formatively, where SEM-PLS can provide more accurate and reliable results.

Financial ratio-based studies or those with similar data types often find SEM-PLS to be a superior method compared to others. In general, SEM-PLS boasts stronger analytical and predictive capabilities than techniques like path analysis and multiple regression. This stems from its ability to analyze variables and models at a deeper level, providing a more comprehensive understanding of the phenomena under investigation.

The research process using SEM-PLS starts with model design. This initial stage involves identifying the variables and the relationships to be explored. Following this, a path diagram visually depicts the connections between these variables. This diagram is then converted into mathematical equations, allowing for further analysis.

Next, researchers define the concepts within the model by assigning operational definitions to each variable. Once the equations and variable definitions are established, an appropriate algorithm is chosen based on the data type and research objectives. Resampling methods are then employed to estimate the sample's distribution within the population, aiding in model validation. The final steps involve inputting the path diagram into the SEM-PLS software and conducting model evaluation. This evaluation assesses the model's fit with the data and its ability to explain the observed variances.

Results and Discussion

We designed the PLS SEM Model based on the hypotheses presented in Figure 1.

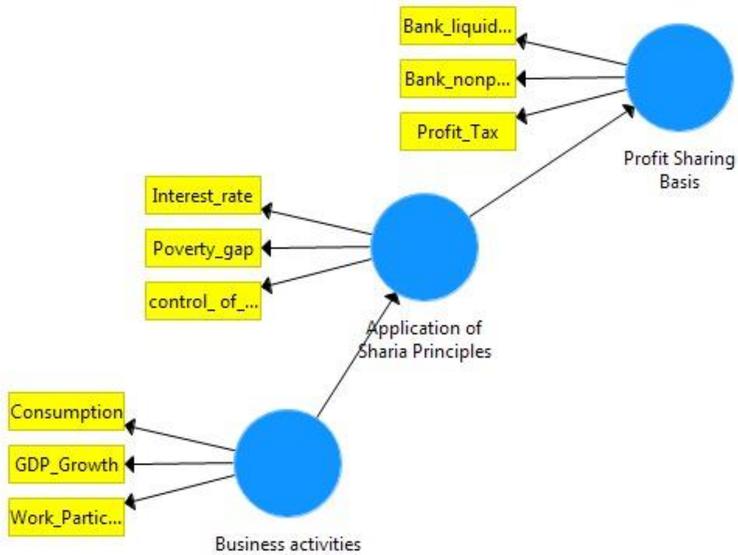

Figure 1.PLS SEM Model

We constructed a path diagram based on the hypothesis presented in Figure 2:

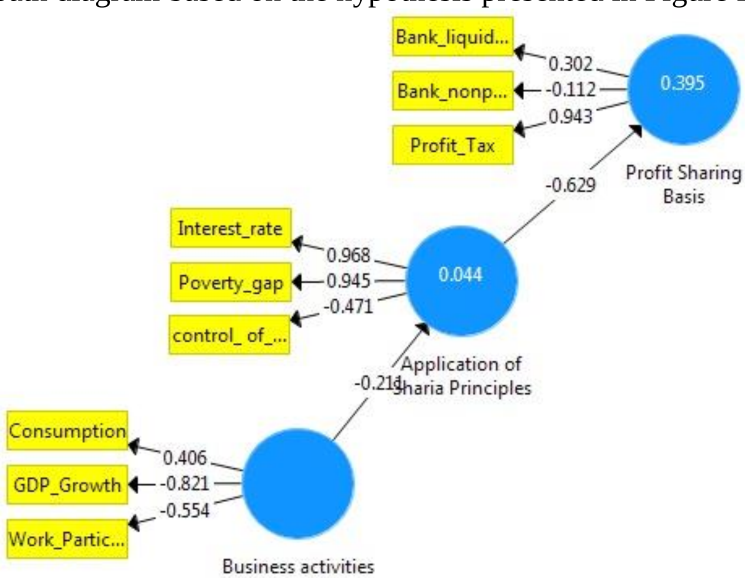

Figure 2. Path Diagram

Table 2. Path Coefficients

	Application of Sharia Principles	Business activities	Profit Sharing Basis
Application of Sharia Principles			-0.629
Business activities	-0.211		
Profit Sharing Basis			

This section clarifies the terminology used in our research model built with SEM-PLS :
Application of Sharia Principles refers to how Islamic principles are implemented within a business or activity. In banking and finance, this translates to how Sharia principles guide operations and transactions. This may include principles like prohibiting usury (interest), promoting fairness and transparency, and utilizing profit sharing.
Business Activities encompass all actions undertaken by an entity or individual related to business operations. This includes production, sales, marketing, management, and other relevant functions. Within the context of SEM-PLS, Business Activities function as a latent variable measured by various indicators.
Profit Sharing Basis refers to the principle where profits from a venture are distributed amongst all parties involved according to a predetermined agreement. In Islamic banking or finance, this translates to the principle of profit sharing, where profits from investments or loans are shared between the bank and the customer based on a mutually agreed-upon ratio.
The process of converting a path diagram into a system of equations within SEM-PLS involves translating the relationships between model variables into mathematical equations. In our specific model, Application of Sharia Principles is the independent variable, while Business Activities
and Profit Sharing Basis are the dependent variables. Values like -0.629 and -0.211 potentially represent the path coefficients within the model, indicating the strength and direction of the relationships between these variables.

Table 3. Specific Inderect Effects

	Specific Indirect Effects
Business activities -> Application of Sharia Principles -> Profit Sharing Basis	0.133

Within our SEM-PLS model, Specific Indirect Effects refer to how one variable influences another indirectly through one or more intermediary variables. In this instance, Business Activities has an indirect effect on Profit Sharing Basis that is channeled through Application of Sharia Principles. The value of 0.133 quantifies the strength and direction of this indirect effect. The positive value signifies that an increase in Business Activities will lead to an increase in Profit Sharing Basis through a corresponding rise in Application of Sharia Principles. This value also suggests that roughly 13.3% of the overall effect of Business Activities on Profit Sharing Basis can be attributed to this indirect influence.

Model Evaluation

Table 4. Outer VIF Values

	VIF
Bank_liquid_ reserves	1.014

Bank_nonperforming_loans	1.085
Consumption	1.061
GDP_Growth	1.058
Interest_rate	3.687
Poverty_gap	3.769
Profit_Tax	1.070
Work_Participation	1.055
control_ of_corruption	1.172

This section addresses a potential issue called multicollinearity in our regression model. Multicollinearity occurs when explanatory variables (independent variables) are highly correlated with each other. This can make it difficult to interpret the individual effects of these variables on the dependent variable.

The Variance Inflation Factor (VIF) is a measure used to detect multicollinearity. In our model, variables like Bank liquid reserves, Bank non-performing loans, Consumption, GDP Growth, Profit Tax, Work Participation, and control of corruption all have low VIF values. This indicates that these variables are not significantly correlated with other explanatory variables in the model.

However, Interest rate and Poverty gap have slightly higher VIF values, suggesting a moderate degree of multicollinearity. This means they share a stronger correlation with one or more other explanatory variables.

While VIF values above 5 or 10 are typically considered indicative of high multicollinearity, neither Interest rate nor Poverty gap reaches this threshold in our model. Therefore, while some moderate multicollinearity exists, it is not a major concern.

Table 5.Inner VIF Values

	Application of Sharia Principles	Business activities	Profit Sharing Basis
Application of Sharia Principles			1.000
Business activities	1.000		
Profit Sharing Basis			

This section focuses on multicollinearity within the core model (inner model) of our PLS SEM analysis. Multicollinearity refers to a situation where constructs (latent variables) in the model exhibit high correlations with each other. In our case, we have three constructs: "Application of Sharia Principles", "Business Activities", and "Profit Sharing Basis".

The VIF (Variance Inflation Factor) value of 1.000 for both "Application of Sharia Principles" and "Business Activities" indicates an absence of significant multicollinearity between these two constructs and the remaining constructs in the model. This signifies that "Application of Sharia Principles" and "Business Activities" can be adequately explained by the other constructs without any significant redundancy of information.

Table 6. Fit Summary

	Saturated Model	Estimated Model
SRMR	0.195	0.197
d_ULS	1.706	1.740

d_G	1.085	1.096
Chi-Square	59.189	59.421
NFI	0.266	0.263

This section evaluates how well our estimated model fits the data compared to a perfect-fit model (saturated model). The Fit Summary provides various metrics for this assessment. One measure is the SRMR (Standardized Root Mean Square Residual). This absolute fit measure indicates the average discrepancy between the actual data and the model's predictions. While our model's SRMR is slightly higher than the saturated model, it remains acceptable as it falls below the 0.08 threshold.

Additionally, ULS (Unweighted Least Squares Discrepancy) and GD (Geodesic Discrepancy) assess fit based on the difference between the observed data and the model's predictions. Similar to SRMR, both ULS and GD values are slightly higher for our model compared to the saturated model, suggesting a slightly better fit for the saturated model. The Chi-Square test also evaluates fit based on these discrepancies. Again, the Chi-Square value leans towards a slightly better fit for the saturated model.

Finally, the NFI (Normed Fit Index) is a relative fit measure that compares the improvement of our model over a baseline model with no relationships. In this case, the NFI for our model is slightly lower than the saturated model, indicating a slightly better fit for the saturated model. Overall, while the saturated model shows a marginally better fit in some measures, our estimated model still demonstrates an acceptable fit to the data based on the SRMR value staying below the 0.08 threshold.

Conclusion

In the context of SEM PLS, the term "Application of Sharia Principles" refers to applying Sharia principles in an entity or activity. Specifically in banking or finance, this pertains to how Sharia principles are implemented in business operations and activities, including the prohibition of usury (interest), fairness, transparency, and profit sharing. "Business activities" encompass all actions related to business operations such as production, sales, marketing, management, and others. In SEM PLS, Business activities can be a latent variable measured through various indicators. Meanwhile, "Profit Sharing Basis" is the principle where business profits are distributed among involved parties based on an agreed ratio. In Islamic banking or finance, this refers to sharing profits from investments or loans between the bank and customers. "Conversion of Path Diagram into System of Equations in SEM PLS" is the process of translating relationships between variables in the model into mathematical equations. In this context, researchers may have a model with "Application of Sharia Principles" as an exogenous variable, and "Business activities" and "Profit Sharing Basis" as endogenous variables. Values like -0.629 and -0.211 represent path coefficients, indicating the strength and direction of relationships between variables.

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