



## Analysis of the Relationship between Micro, Small and Medium Enterprises Sharia Compliance with Increasing Leverage on the Impact of Covid-19 (Case Study of MSMEs in Bandung City, Indonesia)

### ABSTRACT

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The purpose of this study was to identify the importance of shari'a compliance in the context of MSMEs, MSME's reputation, access to funding, and the impact on the role of shari'a compliance during increased leverage, to determine whether shari'a compliance is associated with increased leverage in MSMEs. is to analyze the impact discussed. This study takes a descriptive-analytical approach to verificative how Shariah compliance affects MSMEs' ability to utilize resources. Primary data sources and the technique for collecting data in this research uses a questionnaire technique. The analysis used in this research is likert scale analysis, hypothesis testing design using confirmatory factor analysis is a method of one of the multivariate analysis methods part of SEM (Structural Equation Modeling) whose function is to confirm or test the model to be hypothesized. To test the hypothesis model, this research uses the outer model for the measurement model and the inner model for the structural model. The Micro, SME population of Islamic Banking customers is his 156 companies and consists of his sample of 50 respondents using non-probability sampling. The study found a correlation and impact between Shariah compliance and leverage in MSMEs in Bandung. Findings from the study highlight the application of Shariah principles in the business activities of MSMEs, in particular the ban on Riba, transparency and fairness, social and environmental responsibility, and resilience to challenges in applying Shariah elements to their business activities. is shown. Shariah compliance impacts MSMEs' reputation, investor confidence, and access to finance.

**Keywords:** Sharia Compliance; Leverage, MSMEs; Financing

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### INTRODUCTION

Micro, Small and Medium Enterprises (MSMEs) are very important for the economy of a nation in this era of globalization (Sedyastuti et al., 2021). MSMEs significantly help create jobs, increase average income, and equitable economic growth (Razak et al., 2018). However, MSMEs often have difficulty obtaining adequate funds for the growth and expansion of their business activities (Ingaldi & Ulewicz, 2019). Insufficient company

resources and their ineffective use are one of the variables that can limit MSMEs' access to funding.

The use of financing funds to finance the operational activities and investments of a business that is right can help MSMEs increase (Cowling et al., 2020) their operational scale, expand markets, increase efficiency, and optimize business growth potential (Zimon, 2018). However, increasing financing funds also carries risks that must be managed properly (Maman & Rosenhek, 2020) so that MSMEs remain sustainable. (Hu & Kee, 2022)

On the other hand, MSMEs must also pay attention to sharia compliance requirements (Pati et al., 2021). Usury, speculation, and other commercial practices that go against sharia law are all prohibited (Lubis, 2020). Sharia-compliant MSMEs can pique the interest of stakeholders including customers, investors, and Islamic finance institutions (Alsharari & Alhmoud, 2019) because they are seen as reliable business organizations (Nahlík & Jackson, 2021). The size of the company, liquidity ratios, and ratios of ownership and disclosure of secrets did not significantly affect profitability, according to prior research, specifically Alshari's study *The determinants of profitability in Sharia-compliant corporations: evidence from Jordan* (Alshaari & Alhmoud, 2019). The ZISWAF Agency serves as the unit of analysis, which is a business that adheres to sharia law (Pati et al., 2021). A Sharia Insurance Company is the Lubis Research Unit of Analysis. While using SMEs as the unit of analysis, this study intends to assess the impact of sharia compliance on raising leverage. The impact of sharia-compliant MSMEs on their level of leverage is also examined in this study. The primary goal of this study is to increase MSMEs' access to financing and help them use healthy leverage, as well as to better understand the significance of sharia compliance in doing so. Since there hasn't been any research on Sharia Compliance using the Islamic MSME analysis unit, this study is novelty in that it examines the Sharia Compliance variable with that unit.

This study intends to examine how Sharia compliance affects SMEs' ability to leverage capital. The impact of sharia-compliant MSMEs on their level of leverage is also examined in this study. The primary goal of this study is to increase MSMEs' access to financing and help them use healthy leverage, as well as to better understand the significance of sharia compliance in doing so.

### **LITERATURE REVIEW**

This chapter will discuss the basic definitions and concepts that are relevant in the context of the influence of sharia compliance on increasing the leverage of MSMEs. In this chapter, it will be explained in detail regarding sharia compliance and MSME leverage (Hassan et al., 2021).

Sharia compliance refers to adherence to Sharia principles and values in business activities (Ayub, 2013) (Nuralam, 2017). These principles are based on Islamic religious

teachings and include usury (interest), garar (uncertainty), maisir (speculation), and the prohibition of commercial practices contrary to Islamic principles of justice and ethics (Hussain et al., 2015). Shariah compliance includes adherence to Islamic law and business practices that are legal (allowed) and avoidance of those that are illegal (prohibited) (Ayub, 2013).

MSME leverage is the use of borrowed funds to fund MSME operational and investment activities (Nur Wahyuni & Ak, 2022). Leverage helps MSMEs expand their business reach, expand their market and drive business growth. From a financial perspective, leverage is measured by the ratio of debt to equity or total assets (Haque & Varghese, 2021).

When managing leverage, MSMEs must carefully weigh the risks and benefits. Too much debt can increase the risk of bankruptcy and debt dependence, and too little debt can limit business growth. Therefore, it is important for MSMEs to use leverage wisely and within manageable limits.

### ***Relationship between Sharia Compliance and MSME Leverage***

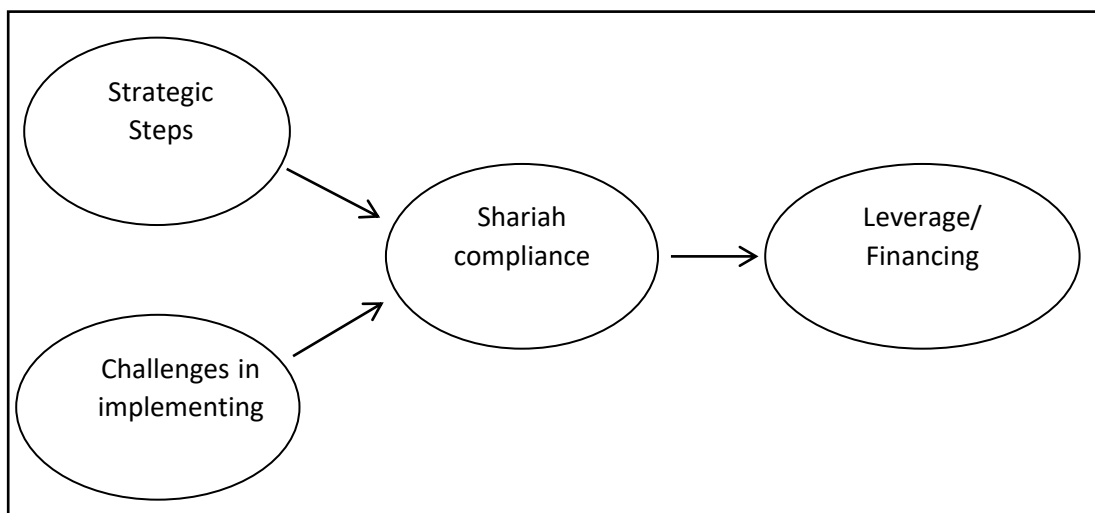
The relationship between sharia compliance and MSME leverage can have significant implications (Shahar & Shahar, 2015). Sharia compliance can affect MSME leverage in several ways: (1). Banking Access: Sharia-compliant MSMEs can obtain funding from Islamic banking institutions more easily (Shinozaki & Asian Development Bank, 2015). Islamic financial institutions frequently offer financing that complies with sharia principles, giving sharia-compliant MSMEs a better chance to get the funding they need to expand their businesses (Fernández, 2021). (2). Related Parties Can Be Trusted: Sharia-compliant MSMEs are viewed as being trustworthy by customers, investors, and business partners (Hurriyati et al., 2020). Sharia compliance is a sign of moral rectitude, integrity, and dedication to Islam's moral principles. Due to stronger commercial linkages and increased confidence among associated parties, MSMEs may be more able to take advantage of new opportunities (Hilb, 2012). (3). Sound financial management: Using sharia-compliant financial instruments, such as mudharabah, musyarakah, or murabaha finance, is a requirement for sharia compliance (Hussain et al., 2015). Sharia-compliant MSMEs can avoid dangers and shady business practices by practicing effective financial management and ensuring the responsible use of borrowing (Nemoto & Yoshino, 2020).

It is intended that by thoroughly comprehending the fundamental ideas behind sharia compliance and MSME leverage, it will be possible to describe the impact of sharia compliance on raising MSME leverage (SME Policy Index: ASEAN 2018: Boosting Competitiveness and Inclusive Growth, 2018). The development of the hypothesis in this study is by adding the variables of strategic steps and the challenges of implementing sharia compliance with sharia financing.

Based on the preceding description, the hypotheses of this study are:

1. There is a correlation between the level of Shariah compliance and the increase in Islamic funding.
2. Strategic Steps influence the development of Shari'a compliance.
3. Challenges in implementing Shariah compliance affect access to Shariah finance.

***Hypotheses of the research***



**Figure 1.** Proposed Conceptual Framework

**METHODOLOGY**

This study takes a descriptive analytical approach to investigate how Shariah compliance affects MSMEs' ability to utilize resources. This approach is used to present a holistic view of the research object and to examine the relationships between the variables under investigation. Primary data sources and techniques for collecting survey data. The Micro, SME population of Islamic Banking customers is his 156 MSMEs and consists of his sample of 50 MSMEs using non-probability sampling. Using this method will produce research results with a thorough explanation and understanding of what was found in this study. as well as being able to link findings to existing literature, build coherent stories, and identify interesting patterns.

The technique for collecting data in this research uses a questionnaire technique, By testing research instruments using validity and reliability tests. Sampling techniques include targeted Non probability sampling. The analysis used in this research is Likert scale analysis, Hypothesis Testing Design using Confirmatory Factor Analysis is a method of one of the multivariate analysis methods part of SEM (Structural Equation Modeling) whose function is to confirm or test the model to be hypothesized. To test the hypothesis model, this research uses the Outer model for the measurement model and the Inner model for the structural model.

The reason for collecting data from 50 MSMEs is due to the cost and time-effectiveness of the study and the researchers argue that this is more cost and time-saving than collecting data from the 50 MSMEs. a larger sample. In addition to more focused research analysis with a more limited sample size, researchers can focus more on high-quality data collection and in-depth analysis.

**RESULTS**

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**Table 1.** Validity and Reliability Test

	<b>Cronbach's Alpha</b>	<b>rho_A</b>	<b>Composite Reliability</b>	<b>Average Variance Extracted (AVE)</b>
Strategic Steps	0.933	1.078	0.905	0.626
Challenges in implementing	0.923	0.965	0.943	0.735
Shariah compliance	0.878	0.898	0.956	0.575
Leverage/ Financing	0.942	0.965	0.951	0.827

Source: SEM PLS 2023 Processing Data

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Explanation of reliability according to Hair et al. (2021), stated that the alpha value is  $>0.7$  ( $>$  of  $0.70$ ) it means good reliability. Explanation of validity according to Hair et al. (2021) the minimum provisions stipulated for valid instrument items, namely the validity index  $> 0.5$ . Meanwhile, the correlation level  $< 0.5$  means it is invalid. Based on the Table 1, all data variables has a good reliability estimate because all reliability measures are less than  $0.7$ . Likewise with its validity because the AVE value is  $>5$ .

### F Square Test

The higher the value, the stronger the description. F-squared values between  $0.67$  and  $1.00$  are considered strong,  $0.20$  and  $0.33$  are considered moderate, and  $0$  and  $0.19$  are considered weak (Vincenzo et al., 2010). Based on the r-squared test results in the table, the combined influence of Strategic Steps, Challenges in implementing and Shariah compliance on Leverage/ Financing is  $0.423$ , which means the r-squared value is reported to be moderate.

Table 2. R Square Value

	R Square	R Square Adjusted
Leverage/ Financing	0.423	0.334

Source: SEM PLS 2023 Processing Data

### R Squared Test

The R-squared value is intended to determine the magnitude of the influence between variables. The f-square value is divided into three parts. That is,  $0.02$  means a small influence,  $0.15$  means a medium influence, and  $0.35$  means a large influence (Hair et al., 2021).

Based on the Table 3, it shows that the results of the F square test on variable Next, variable X2, , Challenges in implementing on Leverage/ Financing, has a value of  $0.458$ , which means it is included in the large category because it is more than  $0.35$ . And finally, variable X1, namely Shariah compliance, has a value of  $0.223$ , which means it is in the medium category because it is less than  $0.15$  Strategic Steps x3.

Table 3. R Square Value

	Leverage/ Financing
Strategic Steps	0.027
Challenges in implementing	0.458
Shariah compliance	0.223

Source: SEM PLS 2023 Processing Data

**Hypothesis Testing Results**

**Table 4.** Path Coefficient for hypothesis testing results

	<b>Original sample</b>	<b>Sample Mean</b>	<b>Standar Deviation</b>	<b>T statistics (Io/STDEVI)</b>	<b>P Value</b>	<b>Hypothesis</b>
Strategic Steps to Leverage/ Financing	0.122	0.085	0.098	2.423	0.033	Hypothesis is Accepted
Challenges in implementing to Leverage/ Financing	0.523	0.436	0.123	3.664	0.000	Hypothesis is Accepted
Shariah compliance to Leverage/ Financing	0.324	0.232	0.388	2.608	0.048	Hypothesis is Accepted

Source: SEM PLS 2023 Processing Data

**DISCUSSION**

***The Relationship between Sharia Compliance and Raising MSME Leverage***

The application of sharia principles in MSME business, the effect of sharia compliance on MSMEs' reputation, the function of sharia compliance in gaining access to capital, and how sharia compliance can help MSMEs leverage themselves will all be covered in the study's findings.

Riba is forbidden: MSMEs should refrain from using and paying interest in their commercial dealings. Instead, they can make use of Islamic financial tools that abide with Islamic law, including mudharabah or musyarakah financing. Transparency and Fairness: MSMEs must use honest and ethical business practices in their interactions with clients, customers, and other stakeholders. MSMEs are expected to take into account the social and environmental implications of their operations and assume responsibility for engaging in sustainable business practices.

***Impact of Sharia Compliance on MSME Reputation***

Compliance with sharia law may enhance MSMEs' reputations. Sharia-compliant MSMEs are seen as being morally upright, upholding the highest standards of business conduct, and dedicated to adhering to sharia principles. This might inspire more trust in customers, investors, and business partners. A solid reputation as a sharia-compliant MSMEs can widen networks, create new opportunities, and boost appeal to connected parties.

### ***Sharia Compliance as a Determinant of Trust in Other Parties***

Building a good business connection requires a lot of trust. MSMEs that adhere to sharia law have an edge when it comes to gaining the trust of relevant parties including customers, investors, and financial institutions. Sharia compliance demonstrates a dedication to the moral principles upheld by Islam, giving associated parties the assurance that MSMEs would do business with honesty and integrity.

### ***Sharia Compliance and Access to Funding Sharia-compliant***

MSMEs that adhere to Sharia law are more likely to be approved for financing by Islamic financial institutions. Islamic financial firms frequently offer funding that complies with sharia law. Sharia-compliant MSMEs have a better chance of securing the funding they need to expand their businesses in this situation. This more convenient access to capital may aid MSMEs in developing healthy operational scales, market expansions, and leverage increases.

### ***Contribution of Sharia Compliance to Increasing MSME Leverage***

Sharia compliance can contribute to greater utilization of MSMEs in a number of ways, including: (1). Improved access to funds, Facilitating access to loans from Islamic financial institutions can help Sharia-compliant MSMEs obtain the capital they need to expand their operations and investments, thereby increasing their leverage (Biancone et al., 2019a). (2). Sound financial management, Shariah compliance includes the use of Islamic financial products that comply with Islamic principles. This tool helps MSMEs manage their finances smarter, avoid unwanted risks, and achieve healthy leverage (Elasrag, 2019). (3). Improved trust and reputation, Sharia compliance enhances credibility and reputation of MSMEs. This will create new opportunities for investors, consumers and business partners to come together to provide additional support and financing to MSMEs (Qoyum & Fauziyyah, 2019).

Understanding the link between Shariah compliance and increased leverage for MSMEs will help MSMEs and other stakeholders recognize the importance of Shariah compliance and take appropriate steps to increase leverage in business situations requiring Shariah. are expected to take The principle of increasing leverage in a healthy way.

### ***Strategies for Increasing Sharia Compliance and MSME Leverage***

This chapter describes strategies and steps that MSMEs can take to improve their Shariah compliance and increase their impact. Improved Shariah compliance may have long-term benefits for MSMEs, such as better access to finance and improved reputations.



Education and Awareness MSMEs need to improve their understanding of Sharia principles and the importance of Sharia compliance (Herry et al., 2019). This can be achieved through education and training programs for MSME owners and employees. A good understanding of Shariah compliance will help MSMEs apply these principles to their daily business practices.

Advice and Support MSMEs may seek assistance from consultants or Shariah financial institutions who can provide guidance and assistance in implementing Shariah compliance (AlMaimani & Johari, 2015a). Advisors can help MSMEs identify areas that need improvement and provide Shariah-compliant solutions.

Integration of Shariah Systems and Procedures MSMEs should integrate Shariah principles into their operational systems and procedures. This includes using Islamic financial tools, increasing transparency and accountability in commerce, and ensuring adherence to Islamic principles throughout supply chains and financial management.

Selection of Appropriate Business Partners MSMEs should select business partners that are Shariah compliant. This also means that our suppliers, customers and other business partners follow the same principles. Choosing a Shariah compliant business partner can help enhance the reputation of MSMEs and build sustainable relationships.

Leveraging Technology and Innovation MSMEs can use technology and innovation to support Shariah compliance and increase their impact. For example, use a Shariah-compliant digital platform to raise capital, manage finances, and expand market reach. Technology and innovation can also help MSMEs improve operational efficiency and reduce risk.

Reporting and Accountability MSMEs must ensure accurate and transparent financial reporting in line with Shariah principles. This will increase trust between parties and help MSMEs get better financing. A good reporting system also facilitates the monitoring and evaluation of MSMEs' financial performance, enabling better decision making.

By implementing the above strategies, it is expected that MSMEs will improve their Shariah compliance and influence. This increase will open up new opportunities, improve access to finance, strengthen reputations and drive sustainable MSME business growth.

### ***Challenges and Efforts to Overcome in Increasing Sharia Compliance and MSME Leverage***

The challenges MSMEs face in improving their Shariah compliance and influence, and the actions that can be taken to address these challenges. Understanding these challenges is critical so that MSMEs can take effective action to improve their Shariah compliance and increase their influence. Some of the most common challenges are: (1). Lack of Understanding and Awareness. One of the major challenges faced by MSMEs is the lack of understanding and awareness of Shariah principles and the benefits of Shariah compliance. Many MSMEs may not have access to appropriate information or may not

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be aware of the importance of implementing Shariah principles in their business. Continuing education efforts and awareness-raising campaigns must be undertaken to meet this challenge. (2). Limited resources MSMEs, Often face limited resources in terms of both financial, human and infrastructure. Implementing Shariah compliance and increasing leverage requires an investment of time, money and other resources. To meet this challenge, MSMEs can raise Shariah-compliant funding, work with like-minded business his partners, and leverage affordable technology. (3). Complexity of Shariah Regulations, Shariah regulations can be complex and vary from country to country. This can be confusing for MSMEs who want to introduce Shariah compliance into their business. To overcome this challenge, MSMEs can seek the help of an experienced Sharia advisor or attend a training course on Sharia rules to increase their understanding. (4). Changing Consumer and Market Behavior, Consumer behavior and market requirements can change over time. MSMEs need to keep up with these developments and be able to adapt their business to meet consumer needs and preferences from a Shariah compliant perspective. This may include product and service innovation, appropriate marketing strategies, meeting consumer needs while maintaining Shariah integrity. (5). Low Trust from Related Parties His MSMEs, Who are just beginning to implement Shariah compliance are likely to have low trust from related parties such as consumers, investors and financial institutions. This is due to ignorance or suspicion about MSME's commitment to Shariah principles. To meet this challenge, MSMEs need to build and maintain their reputation through transparency, honesty and consistency in implementing Shariah principles.

### ***UMKM strives to meet the challenges of dealing with increasing compliance and Shariah use***

Through the following initiatives, MSMEs can overcome the challenges they face in improving Shariah compliance and influence. Increase understanding and awareness of Shariah principles through education and awareness campaigns. Seek funding in line with Shariah principles through Shariah financial institutions or Shariah-based funds. We build partnerships with business partners that align with Shariah principles. Leverage technology and innovation to improve operational efficiency and market access. Maintain transparency, honesty and consistency in the implementation of Shariah principles in order to build a good reputation.

By addressing these challenges and taking appropriate measures, MSMEs can improve their Shariah compliance, leverage it step by step, and contribute to the growth and sustainability of their business.

### ***Benefits and Impact of Increasing Sharia Compliance on MSME Leverage***

Enhancing Shariah compliance will provide MSMEs with a number of significant benefits, both financial and non-financial. Some of the benefits and impacts that can be achieved are listed below.

Easier access to finance By improving Shariah compliance. MSMEs will have easier access to finance from Islamic financial institutions. Islamic financial institutions tend to be interested in lending to SMEs that operate under Shariah principles. In this way, MSMEs can obtain the funds they need to expand their business, make investments, or overcome liquidity problems.

Improving Reputation and Trust Improving Shariah compliance. MSMEs build a good reputation in the eyes of consumers, business partners and society. A Shariah-friendly consumer tends to prefer doing business with his MSMEs who adhere to Shariah principles. With a good reputation, MSMEs can increase customer trust and achieve higher loyalty.

Increased Competitiveness Enforcing Shariah compliance. Increased Competitiveness Enforcing Shariah compliance can help MSMEs differentiate themselves from their competitors. This can provide a significant competitive advantage in an increasingly competitive market. MSMEs that are able to meet the demands of more Sharia-conscious consumers are more likely to increase their market share, win new customers and retain existing customers.

Sounder Financial Management. Shariah principles prohibiting usury (interest) and speculation promote wise and sustainable financial management. Shariah-compliant MSMEs tend to manage their finances more carefully, avoid unwanted risks, and prioritize more sustainable and productive investments. This could lead to financial consolidation and strengthen the overall debt of MSMEs.

Improving Relationships. With Related Parties Improving Shariah compliance will also help MSMEs to develop better relationships with related parties such as Islamic financial institutions, investors, suppliers and other business partners. Related parties are more likely to trust and support MSMEs that work more closely with Shariah principles, opening up opportunities for better cooperation and long-term growth.

Considering these benefits and impacts, improving Shariah compliance could be a key factor in increasing the influence of MSMEs (Biancone et al., 2019b), (AlMaimani & Johari, 2015b), (Alharbi et al., 2022). Through proper awareness, education and enforcement, MSMEs can realize their full potential of Shariah compliance and achieve sustainable business success (Wahga et al., 2017).

## CONCLUSION

This study investigated the impact of Sharia compliance on the increased influence of MSMEs. Based on the analysis and discussion so far, we can draw the following conclusions: there is a correlation between the level of Sharia compliance and the increase in Islamic funding. Enhanced Shariah compliance could bring many benefits to MSMEs such as easier access to finance, improved reputation and credibility, improved competitiveness, sound financial management and improved relationships with related

parties. Strategic measures influence the development of Shariah compliance. When promoting Shariah compliance, MSMEs need the following strategic steps: B. Increase understanding and awareness, integrate Shariah systems and procedures, select business partners that meet requirements, adopt technology and innovation, and be consistent. Challenges in implementing Shariah compliance affect access to Shariah finance. When implementing Shariah compliance, there are challenges to be addressed, including: Limited Understanding, Access to Shariah Funds, Intense Competition, Adherence to Shariah Standards, Changing Business Environment.

### *Limitations of this study*

This study does not take into account non-Sharia factors that may also influence the level of indebtedness of MSMEs. External factors such as economic conditions, regulations and industry factors can also play a role in increasing leverage. This study also only involved MSMEs that had been in business for at least two years. This may ignore the impact of Shariah compliance on new or less permanent MSMEs.

### *Recommendations for future research*

Conduct comparative studies between MSMEs applying Sharia principles and conventional MSMEs in terms of leverage and overall financial performance. This can provide insight into how Shariah compliance affects leverage and business performance. Conduct longitudinal research to examine changes in leverage over time and how Shariah compliance affects these long-term trends.

The results of this study can be used to develop Islamic financial education and training programs for MSME owners. With a better understanding of the relationship between Shariah compliance and leverage, MSMEs can make smarter financial decisions. Islamic financial institutions and organizations that support MSMEs can use the results of this study to design training programs specifically to help MSMEs optimize their use of leverage based on principles Sharia.

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