



Challenging the Current *Shariah* Screening Methodology Assessments in Kuala Lumpur *Shariah* Index (KLSI)

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Abstract

The purpose of this study is to explain the justification behind the current *Shariah* screening methodology assessments used by KLSI, which differs from other major *Shariah* screening methodology around the world. Besides, this study is also attempts to investigate on the intention to entitle *Shariah*-compliant status by Public Listed Companies (PLCs) in Malaysia. This study employed a series of interviews with five individuals who are involves with KLSI *Shariah* screening methodology as data collection procedure. Thus, this study found a number of justifications on the reasons behind the current *Shariah* screening methodology assessments used by KLSI. This includes reasons on the adoption of additional 20% tolerable percentage, additional criteria on corporate image and *maslaha* (public benefits) and also views on the leniency of current KLSI *Shariah* screening methodology assessments. Besides, this study also identified several measures to identify the intention to entitle *Shariah*-compliant status by PLCs. This includes voluntary application, effort of de-listed PLCs to be listed as *Shariah*-compliant for the following year, impact of *Shariah*-compliant status especially on the share prices and potential investors, good corporate image on maintaining *Shariah*-compliant status and the core value of the business. Then, this study also provide several recommendations to be considered for future improvement especially on *Shariah* screening methodology assessment.

Key words

Shariah Screening Methodology, *Shariah*-Compliant Status, Kuala Lumpur *Shariah* Index (KLSI), Islamic Accounting

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1. Introduction

Shariah screening methodology is a process to exclude companies with unacceptable levels of conventional debt, liquidity, interest-based investment and/or impure income (Ayedh *et al.*, 2019). It was initiated by a team of scholars consist of Muhammad Taqi Usmani (Pakistan), Saleh Tug (Turkey) and Sheikh Mohammad Al Tayyeb Al Najar (Egypt) in 1987 with the objective of finding a solution that would allow Muslim investor to own shares of listed joint stock companies (Mian, 2008; Adam and Abu Bakar, 2014). Then, a *fatwa* of stocks screening was initiated in the 1990s as there is no such guideline to determine the *Shariah*-compliant companies during that time. Therefore, in order to recognize *Shariah*-compliant companies, Sheikh Nizam Yaqoubi proposed general criteria to be applied for identifying *Shariah*-compliant

companies. Later, group of scholars adopted similar stand and participated in *Shariah*-committee in different financial institutions (Gamalalden, 2015).

In Malaysia context, the first Islamic equity index was introduced in Malaysia by RHB Unit Trust Management Bhd in 1996. Later, Kuala Lumpur *Shariah* Index (KLSI) was launched on 17 April 1999 to cater for increasing demand by local and foreign investors who seek to invest in securities and instruments which are in line with *Shariah* principles (Ahmad and Ibrahim, 2002). KLSI was initially comprised of 279 companies as of 17 April 1999. However, it has grown to 696 companies as of 29 November 2019, comprising 77% of the total listed companies on Bursa Malaysia (SC, 2019).

Securities Commission of Malaysia (SC) was established the *Shariah* Advisory Council (SAC-SC) with the duty to formulate *Shariah* screening methodology to assist investors to identify *Shariah*-compliant securities (Zainudin *et al.*, 2014). The main objective of the SAC-SC is to advise SC on *Shariah* matters and *Shariah* guidance for Islamic capital market in Malaysia (Fazilah *et al.*, 2006). It is directly responsible for the regulation and supervision of the activities of the market institutions, including the stock exchanges, clearing house, and monitoring of licenses under the Capital Markets Service Act 2007. SAC-SC will be responsible in determining the status of the securities traded in Bursa Malaysia whether they can be considered as *Shariah* approved which means that the securities are considered as a *halal* company for investment or vice versa (Jamal *et al.*, 2010).

However, current *Shariah* screening methodology assessments used by authorities around the world including SAC-SC is different for each other. This led to inconsistencies in recognition of *Shariah*-compliant companies among major *Shariah* screening methodology. Moreover, arguments on the sources of law (*hukum*) used in the setting of *Shariah* screening methodology assessments become another issues that required for further investigation. Besides, other issues and challenges on *Shariah* screening methodology such as *Shariah* non-compliant on global financial framework, low levels of Islamic-related disclosures, cost for diversification on *Shariah* methodology, cost borne by Muslim investors, earning purification process and effect of on the investment return are resulted due to the implementation of *Shariah* screening methodology.

Therefore, there is a need to understand the justification on the different *Shariah* screening methodology assessments used by KLSI to tolerate the non-permissible activities and also the impact of such non-unification of *Shariah* screening methodology used around the world. This is important as Muslim investors are sensitive to seek for *Shariah*-compliant in investment activities. Besides, inconsistencies in *Shariah*-compliant status by public listed companies also should be examined in order to identify whether the company undertakes its activities according to *Shariah* principles or not (Mohd Sanusi *et al.*, 2015).

In addition, there is also a need to identify the intention to entitle *Shariah*-compliant status by companies. This is because in Islam, all action is judged based on their underlying motives or intention (Alserhan, 2010). In this case, to ensure that Muslim investors have a choice to invest on companies that are aims to operate in *Shariah*-compliant and not just because they are simply passed all *Shariah* screening methodology assessments set up by authorities is becomes another issues to be highlighted.

To answer such issues, this study is divided into several sections. The following Section 2 discusses on the issues in *Shariah* screening methodology practiced around the world. Next, Section 3 is explains on the research methodology used for this study. While, Section 4 is the findings and discussions on such justification of the *Shariah* screening methodology assessments used by KLSI and also intention to entitle *Shariah*-compliant status by companies in Bursa Malaysia. Finally, Section 5 provides a summary and recommendations for this study.

2. Literature review

2.1. Inconsistencies on *Shariah* Screening Methodology Assessments around the World

There are many issues derived from inconsistencies of *Shariah* screening assessments among major *Shariah* screening methodology across the world including KLSI. Although most of the *Shariah* advisory bodies and agencies concerning the *Shariah* screening assessment applied both qualitative and quantitative screening assessment, approaches used for each assessment are slightly different from one to another *Shariah* screening methodology.

For instance, under qualitative screening assessment, the main different between KLSI with other major *Shariah* screening methodology such as by Dow Jones Islamic World Index (DJIMI), Financial Times Stock Exchange *Shariah* Index (FTSE), Standard and Poor's *Shariah* Index (S&P), Morgan Stanley Compliance Islamic Index (MSCI), Thompson Reuters Ideal Ratings Islamic Indices and the STOXX Europe Islamic Index is the allowable percentage on *Shariah* non-compliant incomes from total business revenues. In this case, 5% is used by these major *Shariah* screening methodology including KLSI to assess the level of mixed contributions from activities that are clearly prohibited such as *riba'* based activities, gambling, liquor and pork; interest income from conventional accounts and instruments and tobacco-related activities. However, KLSI have the additional measurement which is 20%, to assess the level of contributions of mixed rentals from *Shariah* non-compliant activities and to assess the level of mixed contributions from activities that are generally permissible according to *Shariah* and have an element of *maslahah* (public interest), but there are other elements that may affect the *Shariah* status of these activities such as hotel and resort operations.

Meanwhile, under quantitative screening assessment, AAOIFI (2015) for example has a benchmark of maximum 70% of the total value of all the assets of a company for cash and debt, whether they are *Shariah*-compliant, *Shariah* non-compliant or a mixture of both. It means that cash and debt of a company in any form should not exceed 70% of the total assets. As for the second approach, AAOIFI (2015) suggests that cash placed in interest-based instruments should not exceed 30% of the market capitalisation of the total equity of a company. And the interest-bearing debt of a company should not exceed 30% of the market capitalisation of the company. In this way, AAOIFI (2015) covers both approaches in its *Shariah* standards. In contrast, the SAC-SC only applies the second approach by having a benchmark of maximum 33% of total assets for cash placed in conventional instruments, excluding deposits in Islamic accounts. The interest-bearing debt of a company also has a benchmark of maximum 33% of total assets, excluding Islamic financing facility. With these filters, SAC-SC opts to observe the second approach only (SC, 2019).

Besides, some quantitative screening assessments use total assets of a company as a measuring tool for their filters. For instance, SAC-SC has adopted total assets to compare interest-earning cash and interest-bearing debt against them. On the contrary, AAOIFI (2015) has suggested market capitalisation of a company to be used for comparison of cash and debt against it. Market capitalisation is the total dollar market value of all outstanding shares of a company. It is calculated by multiplying a company's shares outstanding by the current market price of one share. Investors use this figure to determine a company's size, as opposed to sales or total assets figures. In this case, some scholars argue that market capitalization does not give the true value of the company. It rather reflects, among various other factors, the market sentiments about a company's future performance on a given day. This can change due to factors that are totally unconnected to the company (e.g. the poor performance of another company in the same industry sector) (Mian, 2008).

Apart from qualitative and quantitative screening assessments, there are other two additional criteria for companies with comprising both permissible and non-permissible elements to become a *Shariah*-compliant status by KLSI. First, the public perception of the company must be good and second, the core activities of the company are important and considered *maslaha* (public benefits) to Muslim and non-permissible element is very small and involves matters such as *umum al-balwa* (common plight and difficult to avoid), *urf* (custom) and the rights of the non-Muslim community which are accepted by Islam (Gamalalden, 2015). Different from previous qualitative and quantitative screening assessments, this criteria is quite interesting as there is no specific guideline or approach and its up on SAC-SC decisions to allow a number of companies to obtain *Shariah*-compliant status under these two criteria although these companies might not passed either one or both qualitative and quantitative screening assessments.

Therefore, inconsistencies in the method of classification used by different groups, such that some stocks that are deemed permissible by one group may be non-permissible by other groups (Derigs and Marzban, 2008). This have been proved by several previous studies that compared between *Shariah*-compliant companies in KLSI with MSCI (Sani and Othman, 2013), DJIMI (Abdul Rahman *et al.*, 2010), and FTSE and S&P *Shariah* screening assessments (Zandi *et al.*, 2014). For instance, a study conducted by Sani and Othman (2013) on 300 *Shariah*-compliant companies in KLSI identified that only 39% of the companies

will be entitled for *Shariah* compliant status if the *Shariah* screening methodology of MSCI screening methodology is used.

Previously, similar study conducted by Abdul Rahman *et al.* (2010) on all 565 *Shariah*-compliant companies listed in KLSI also identified that only 198 out of 565 *Shariah*-compliant companies will be entitled for *Shariah* compliant status if the *Shariah* screening methodology of DJIMI is used. Last but not least, a study conducted by Zandi *et al.* (2014) concluded that 68.57% of the companies approved by KLSI have been accepted under MSCI and FTSE screening assessments whereas only 40% of the companies passed DJIMI assessments and 48.57% passed S&P assessments. Therefore, it can be concluded that not all *Shariah*-compliant companies in KLSI are fulfilling other major *Shariah* screening methodology which indirectly shows that KLSI *Shariah* screening methodology assessments can be considered as most lenient as compared to other major *Shariah* screening methodology (Hussin *et al.*, 2015; Kasi and Muhammad, 2016).

These dissimilarities among major *Shariah* screening methodology are based on several reasons. For instance, differences in the quantitative ratios can be caused by different objectives among the *Shariah* screeners, whether country-specific, regulation-oriented or globally business-oriented (Khatkhatay and Nisar, 2007; Abdul Rahman *et al.*, 2010; Pok, 2012; Ho, 2015). Another possibly reason is modern finance and investment is a new phenomenon and hence, the current practice is based on *ijtihad* of contemporary scholars who have different *Shariah* opinions. Besides, there is no higher Islamic authority that is responsible for religious rulings to be followed by all Muslims (Derigs and Marzban, 2008). Last but not least, no uniform *Shariah* investment code of conduct or a universal predetermined fixed set of *Shariah* screening assessments that is agreed upon between Muslim scholars (Hakim and Rashidian, 2004; Mahfouz and Ahmed, 2014).

Arguably, this inconsistency of *Shariah* screening methodologies drives the Muslim investors to think twice before investing in what so call *Shariah*-compliant investment. Therefore, there is a need to harmonise the standards to global expectation and to spur capital inflows, especially from Middle East investors.

2.2. Questionable Sources of Hukum on Shariah Screening Methodology

Another issue on *Shariah* screening methodology is the sources of *hukum* (law). In general, there are not much issues regarding qualitative *Shariah* screening. It is noted that the purpose of qualitative *Shariah* screening is to exclude companies with impermissible core businesses activities (Habib & Ahmad, 2016). This justification is based on the following Quranic verse: "*O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent. And do not kill yourselves [or one another]. Indeed, Allah is to you ever Merciful*" (An-Nisa' 4:29).

However, there is a question for allowable percentage on *Shariah* non-compliant incomes from total business revenues. As mentioned earlier in the previous sub-section, most major *Shariah* screening methodology around the world are using 5% as an allowable percentage on *Shariah* non-compliant incomes from total business revenues. While, only KLSI have the additional measurement which is 20%. Although the ideal rate is actually 0% which mean not even a single cent of *Shariah* non-compliant incomes is allowed for a company to entitle *Shariah*-compliant status. This is based on the following Quranic verse: "*Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein. Allah destroys interest and gives increase for charities. And Allah does not like every sinning disbeliever*" (Al-Baqarah 2:275-276).

Therefore, 0% for this filter is the desirable rate. However, due to the nature of the contemporary economic and financial system, most of the companies one way or the other is deeply involved in interest-based transactions. It is almost impossible to find companies which are not dealing with conventional banks and either earn or pay interest (Derigs and Marzban, 2008). Moreover, some companies tend to have both permissible and impermissible lines of businesses. Prohibiting participation in such companies would inflict harm and hardship on the Muslim investors. Thus, the tolerable rate of 5% and 20% were introduced by

Shariah scholars. Several *Shariah* legal maxims such as ‘*harm must be eliminated*’, ‘*hardship begets facility*’ and ‘*necessities make forbidden things permissible*’ are used to justify these tolerable rates. However, the issue is where this 5% or 20% of allowable percentage is derived from? Until present, there is no *Shariah* justification on this matter (Habib and Ahmad, 2016).

Next, under quantitative *Shariah* screening assessment, it is noted that major *Shariah* screening methodology around the world are using different allowable percentages for quantitative ratios. For instance, under interest-bearing asset ratio and debt ratio, KLSI, DJIMI, S&P and ISRA Bloomberg are using 33%, meanwhile AAOIFI, STOXX Europe Islamic Index and Thompson Reuters Ideal Ratings Islamic Indic are using 30%, while FTSE and MSCI are using 33.33% as allowable percentage (Ayedh *et al.*, 2019). Similar argument with previous allowable percentages on *Shariah* non-compliant incomes from total business revenues was made, which is what the basis is for these different allowable percentages are derived from. It is noted that the amount of allowable percentage is proposed by *Shariah* scholars based on the following Hadith narrated by Saad Ibn Waqqas: “*I became seriously ill at Mecca and the Prophet came to visit me. I said, "O Allah's Messenger! I shall leave behind me a good fortune, but my heir is my only daughter; shall I bequeath two third of my property to be spent in charity and leave one third (for my heir)?" He said, "No." I said, "Shall I bequeath half and leave half?" He said, "No." I said, "Shall I bequeath one third and leave two thirds?" He said, "One third is alright, though even one third is too much." Then he placed his hand on his forehead and passed it over my face and `Abdomen and said, "O Allah! Cure Saad and complete his emigration." I feel as if I have been feeling the coldness of his hand on my liver ever since*” (Hadith No.5659, Sahih al-Bukhari).

However, arguments can be made on this matter. First, this Hadith comes in the context of *wasiyyah* (inheritance), by advising Saad to donate only one-third of his wealth and keep two-thirds for his daughter, but not about *Shariah* non-compliant income. Second, this Hadith is clearly stated one-third, which means that 33.33%. Thus, other two amount used by some major *Shariah* screening methodology which is 30% and 33% is not so called accurate if the amount is based on this Hadith. Third, where one-third refer to total equity own by Saad Ibn Waqqas (not include his debt), indirectly it state ‘keep minimum two-third’ rather than ‘give maximum one-third’, which means that the things that need to be focused is the amount of total equity rather than total debt (Yildirim and Ilhan, 2018).

Besides, one of these two ratios which is interest-bearing asset ratio is seems to redundant with previous *Shariah* non-compliant incomes from total business revenues filter. This is because as long as the company is passing *Shariah* non-compliant incomes from total business revenues filter, it means that this ratio also passed as well (Habib and Ahmad, 2016). Besides, giving loans (through depositing cash into deposits instruments) is normally allowed without any restriction on the amount of loans. This is based on the following Hadith narrated by Anas bin Malik: “*On the night on which I was taken on the Night Journey (Isra), I saw written at the gate of Paradise: 'Charity brings a tenfold reward and a loan brings an eighteen fold reward.' I said: 'O Jibril! Why is a loan better than charity?' He said: 'Because the beggar asks when he has something, but the one who asks for loan does so only because he is in need'*” (Hadith No.2431, Book 15, Vol.3, Sunan Ibnu Majah).

Thus, only debt ratio is viewed to have a strong basis to become as part of quantitative *Shariah* screening assessment as it purpose to control the involvement of the company in paying interest. Under this ratio, the ideal tolerable percentage is 0%. However, for the sake of removing hardship and facilitating people in dire need, it is allowed to participate in such companies with the condition that they pass this filter (AAOIFI, 2015). An argument also was made on this ratio that instead of focusing on the impermissible element which is the interest payment, concentrates on a less relevant element which is the amount of borrowed debts. In fact, the amount of borrowed debts cannot be considered as valid and important cause of *Shariah* compliance at all (Habib and Ahmad, 2016).

Another ratio used under quantitative *Shariah* screening assessment is liquidity ratio. Basically, liquidity ratio is aimed to ensure that illiquid assets do not become small in amount (Habib and Ahmad, 2016). This is because if the liquidity limit is imposed on the basis of rules of *bay' al-sarf* (trade of currencies) and *bay' al-dayn* (trade of debts), then it should not be more than 33.33%. This tolerable rate is based on an established *fiqh* rule about a commodity that is part gold and part brass; it qualifies as gold if the percentage of gold is greater than 33.33% for the purposes of applying the rules of *riba'* (Hanif, 2019).

However, both KLSI and ISRA Bloomberg do not adopt this liquidity ratio as part of their quantitative *Shariah* screening methodology assessments.

There is an issue on liquidity ratio especially for services sector companies. Due to the nature of services sector which the core business is on services and involves only little illiquid assets, there is highly possibility for these kind of companies do not passed this filter. Likewise, similar issue also happened in financial sector including Islamic financial institutions where the nature of this sector are dealing much on cash or/and debt basis (liquid asset) (Hanif, 2019). Perhaps these kind of companies need to be exempted from liquidity ratio assessment.

Besides, there is an argument on the needs of this kind of ratio to become as part of quantitative *Shariah* screening methods. First, shares of a company nowadays do not represent the ownership of assets. Previously, owing shares is merely represents the ownership of the assets of the company. However, this concept was changed due to economic and legal evolutions that rather represents as the bundle of right that belong to owners of the shares (Goulding, 1996; Abbasi, 2009; El-Gari, 2015). Shares of a company more importantly represents the company itself, its main business activities, human management, ability to produce and future prospects of generating revenues (Aal Sheikh, 1979; Al-Manea, 1996; Al-Qurahdaghi, 2003). Thus, the rules of *bay' al-ṣarf* and *bay' al-dayn* no longer need to be imposed based on this situation and liquidity ratio will be viewed not important anymore.

Second, another possibility to support the above argument is that this liquidity ratio can be manipulated in order to passed the filter. In this case, a company can manipulate liquidity ratio by artificially introduce illiquid assets among its total assets with the aim of dealing in cash or debt (Habib and Ahmad, 2016). Third, by using *Shariah* legal maxim '*Shariah ruling on primary asset*', quantitative measures are becoming irrelevant. For instance, since cash and receivables are subordinate to a principal asset which is non-cash and non-debt in nature, their amount should not be restricted by any percentage (Habib & Ahmad, 2016). This is based on the following Hadith narrated by Abdullah Ibn Umar: "*If somebody buys date-palms after they have been pollinated, the fruits will belong to the seller unless the buyer stipulates the contrary. If somebody buys a slave having some property, the property will belong to the seller unless the buyer stipulate that it should belong to him*" (Hadith No.2379, Sahih al- Bukhari).

Another issue is the different denominator used in calculating quantitative *Shariah* screening ratios. For instance, KLSI, MSCI, FTSE and STOXX Europe Islamic Index are using total asset, while DJIMI, AAOIFI, S&P, Thompson Reuters Ideal Ratings Islamic Indic and ISRA Bloomberg are using market capitalization as denominator for *Shariah* screening ratios calculations (Ayedh *et al.*, 2019). Several previous scholars argue on the usage of market capitalization as the basis in identifying the degree of *Shariah* non-compliance (Khatkhatay and Nisar, 2007; Obaidullah, 2009; Yildirim and Ilhan, 2018; Hanif, 2019). The major reason is the nature of market capitalization which is out of control as compared to total asset which is within the company's control. Besides, companies may become *Shariah*-compliant or *Shariah* non-complaint due to external market fluctuation, even though their total debts have not been changed (Dar Al-Istithmar, 2009). Another reason that rise up it that market capitalization is driven by sentiments about future cash flows and many factors including past performance, manipulations, government policies, political developments or any other factor, may generate positive/negative sentiments on a particular day (Khatkhatay and Nisar, 2007). In addition, Obaidullah (2009) also point out that current market capitalization implemented is on the average between 24 to 36 months due to severity issue, as compared to total assets who is more reliable and consistence based on historical value. Besides, there is a Quranic verse that inform that Allah will judge every action and will which is within control of each human as follow: "*And, [O Muhammad], you are not [engaged] in any matter or recite any of the Qur'an and you [people] do not do any deed except that We are witness over you when you are involved in it. And not absent from your Lord is any [part] of an atom's weight within the earth or within the heaven or [anything] smaller than that or greater but that it is in a clear register*" (Yunus 10:61).

2.3. Other Issues and Challenges of Shariah Screening Methodology

There a lot of issues and challenges faced by major *Shariah* screening methodology around the world. Basically, *Shariah* screening assessment is made at the first place to classified between *Shariah*-compliant and *Shariah* non-compliant companies especially for Muslim investors. If the company activities

are fully according to *Shariah*-compliant, supposedly there are no issues to be resolved. Same goes to the company which is known to have *Shariah* non-compliant as their core business. However, most of the companies which are available for Muslim investors are companies with mixed activities (Derigs and Marzban, 2008). Therefore, a process to identify which companies can be invested among these mixed activities are needed which make *Shariah* screening assessments was developed.

In fact, the global financial framework itself is not *Shariah*-compliant, which make all businesses may expose with *riba'*. Furthermore, there are lots of companies which are established or managed by non-Muslims who, although required to fulfill legal and regulatory requirements of specific jurisdictions, are not required to follow *Shariah* rules. In this case, Islam respects the rights of non-Muslims. Even though some practices are prohibited for Muslims, the same may not be imposed on non-Muslims. Therefore, some allowance needs to be made for such practices for non-Muslims (Derigs and Marzban, 2008).

Although *Shariah* screening assessment is introduced, it is noted that the low levels of Islamic-related disclosures highlighted present challenges for *Shariah* screeners and advisors especially in identifying any other possible *Shariah* non-compliant activities rather than been highlighted under existing qualitative and quantitative *Shariah* screening assessments (Ousama and Fatima, 2010; Al-Shammari, 2013). For instance, Ullah *et al.* (2014) argues that the current *Shariah* screening assessments are more focused on financial aspects and mislooked other aspects that also can cause *Shariah* non-compliant such as child labor, unfavorable treatment of employees and protection of the natural environment and animal welfare. In fact, even information needed to perform the existing *Shariah* screening assessments is also lacking in the annual report. This indirectly shows that there is a lack of understanding among companies regarding the items considered important to *Shariah* principles (Ullah *et al.*, 2014).

Besides, the current process of *Shariah* screening not only differs by its jurisdictions but also by its different objectives of parties, such as portfolio managers, providers of market intelligence and regulators (Ho *et al.*, 2012). Too much diversity on *Shariah* screening methodology will add cost and requires a larger number of screening processes and in the long run could hamper Islamic finance growth (Derigs and Marzban, 2008). Besides, *Shariah* screening assessments with more strict requirements have affects on the pool of eligible investments for Islamic investments (Engkuchik, 2016). In other word, benefits from diversification of portfolios may not be maximized through *Shariah*-compliant portfolios.

Another issue derived from the introduction of *Shariah* screening is the cost that need to be borne by Muslim investors (Engkuchik, 2016). Inconsistencies of *Shariah*-compliant status by companies had made Muslim investors need to sell their shares once the company has been delisted from *Shariah*-compliant status. In this case, any capital gains arising from the disposal of the *Shariah* non-compliant securities made at the time of the announcement can be kept by the investors. However, any excess capital gains derived from the disposal after the announcement day at a market price that is higher than the closing price on the announcement day should be channeled to charitable bodies or *baitulmal* (Mohamad and Razif, 2013).

Similarly in the earning purification process, purifying capital gains also remains a controversial issue. Some scholars argue that capital gains' purification is not necessary, since the change in the stock price does not reflect the interest income, while others advocate capital gains purification (Obaidullah, 2005). Moreover, quantifying the impermissible income portion that needs to be purified, other than interest income, is a challenging task (El-Gari, 2000). Besides, although the interest-earning portion can be eliminated through earning purification process, interest paid to the lenders, which is also prohibited, cannot be avoided (Mahfouz and Ahmed, 2014).

Furthermore, another question arise whether *Shariah* screening give an effect especially on the return. To answer this question, the returns by *Shariah*-compliant companies and *Shariah* non-compliant companies need to be compared. By referring to a study on the risk and return performance of the *Shariah*-compliant portfolios in five *Shariah* screening methodology which are FTSE, MSCI, DJIMI and AAOIFI, it is found that *Shariah*-compliant portfolios have a low risk as compared to *Shariah* non-compliant portfolios, and there is no significant effect on the *Shariah*-compliant status with the return performance (Ashraf and Khawaja, 2016).

In addition, several studies on the effect of *Shariah* screening on the initial public offering (IPO) of a company also found that there is no significant different between *Shariah* and non-*Shariah* IPOs (Sulong *et al.*, 2017). For instance, based on study on 168 *Shariah* IPOs and 125 non-*Shariah* IPOs issued by Malaysian

companies from January 2005 until December 2014, it found that there is no significant different between these two types of IPOs (Sulong *et al.*, 2017). This result is similar with previous study conducted between January 1999 to December 2008 on 347 *Shariah* IPOs and 37 non-*Shariah* IPOs in Malaysia that found the same insignificant results between *Shariah* IPOs and non-*Shariah* IPOs (Abdul-Rahim and Che-Embi, 2013). Therefore, what is the need to invest in *Shariah*-compliant companies if the return is similar to *Shariah* non-compliant companies? One thing for sure, *Shariah* screening is used for avoiding explicit and major violations of legal prohibition as stated by El-Gamal (2006). Moreover, *Shariah* screening assessments have not been approved by a credible, independent and universal *Shariah* authority, such as the International Islamic *Fiqh* Academy or Islamic Financial Services Board (IFSB). For the *Shariah* screening assessments issued by AAOIFI, it can be argued that members of its *Shariah* boards are also members of *Shariah* boards in Islamic financial institutions and hence, they are not entirely independent from the industry (Mahfouz and Ahmed, 2014). Besides, changes in *Shariah* screening methods will make some companies that are considered as *Shariah*-compliant might become *Shariah* non-compliant, by the same board members who allowed them earlier and vice versa. This will lead to the potential to damage the reputation of the *Shariah* standards and the *Shariah* boards (Mahfouz and Ahmed, 2014).

Last but not least, the intention to entitle *Shariah*-compliant status by companies is becoming another concern especially by Muslim investors. Although the real intention is left to Allah and there is no way for us to uncover it, expression on action taken to entitle *Shariah*-compliant status can be recognized and measured as their intention (Bilal and Mydin Meera, 2015). Besides, there is lot of companies who tried to gain *Shariah*-compliant status with the intention to exploiting Muslim investors' funds to compete with *Shariah*-compliant companies (Qureshi, 2011). This is because religiosity becoming one of the main factors that influencing Muslim investors to invest in *Shariah*-compliant status companies (Abduh and Hussin, 2018). Therefore, intention to entitle *Shariah*-compliant status by companies must be identified and observed in order to ensure that Muslim investors have a choice to invest on companies that are aims to operate in *Shariah*-compliant and not just because they are simply passed all *Shariah* screening methodology assessments set up by authorities.

Based on the above discussion, it could be argued that the objective of *Shariah* screening is to ensure the *Shariah*-compliant of the business of company whom claiming it is *Shariah*-compliant aiming at achieving spiritual objective (satisfying Allah S.W.T) and economic objective by attracting Muslim capital for *halal* investment. However, there is a crucial issue concerning about the *Shariah* screening methodology process. This concern would be categorized into two parts. First, they bases and the underlying evidences of the process of *Shariah* screening. Second is derived from the first one, which is about the variance of the process of *Shariah* screening; this drive the motive of this study to quest deep into this issue.

3. Methodology of research

This research aims to explain the justification behind the current *Shariah* screening methodology assessments used by KLSI. Besides, this study intends to investigate on the intention to entitle *Shariah*-compliant status by Public Listed Companies (PLCs) in Malaysia. Moreover, this study is also attempts to challenges this current *Shariah* screening methodology and recommends several improvements for consideration in the future. This study is the extension of a study by Ayedh *et al.* (2019) on comparison between major *Shariah* screening methodologies around the world with KLSI.

Data were collected through a shorter case study interview approach (Yin, 2014). Interviews were conducted on 5 individuals who are involves with KLSI *Shariah* screening including *Shariah* Committee members of Islamic financial institutions (IFIs), *takaful* and Islamic asset management, industrial players and regulators (both SAC-SC member and SC staff). Due to the concept of anonymity and confidentiality, as suggested by Wiles *et al.* (2008), the names of these individuals will not be disclosed. Information obtained was a primary source (from the interviews), it was therefore unethical to reveal the identity of the organizations. The profile of all interviewees is as follows:

Table 1. Profile of Respondents

Interviewee	Gender	Level of Education	Position
1	Female	PhD	Shariah committee member of IFI and <i>takaful</i>
2	Male	PhD	Shariah committee member of IFI and <i>takaful</i>
3	Male	PhD	Shariah committee member of Islamic asset management
4	Male	Bachelor Degree	SC staff
5	Male	PhD	SAC-SC member

The interviews focused on the *Shariah* screening used by KLSI based on interview protocol and lasted around one hour for each session. Interview protocol or known as interview guideline was developed to ensure that data collected can achieve the objectives of study (Mason, 2002). In addition, probing was also adopted to ensure collected data revealed ‘what we think they reveal’ (Treece and Treece, 1986). Interview protocol questions were prepared by focusing on the two aspects. These three aspects are: (i) justification behind current *Shariah* screening assessments; and (ii) intention to entitle *Shariah*-compliant status.

Subsequently, a phenomenological approach to analyse data was adopted, which involves interpreting and reflecting on the data transcript so as to achieve a holistic understanding of the meaning of the participants’ experiences (Alexis and Vydellingum, 2007). In this case, all the interviews were reviewed several times before being transcribed. Meanwhile, for reporting purposes, this study employed a single-case study approach (Yin, 2014). This approach was used by combining all selected individual information into a single writing. Three aspects mentioned earlier were focuses and used as themes in analysing and reporting the findings. To ensure that every statement was documented, the interviews were recorded. The interviews were conducted from the beginning of September 2019 until the end of January 2020 via face-to-face approach.

4. Findings and discussions

4.1. Justification Behind the Current *Shariah* Screening Assessments

In line with the two main objectives of this study abovementioned, interview session was structured and conducted through the discussion of each objective accordingly. It is meant to ease the interviewee to follow the flow of discussion. The first objective of the study is to identify justification behind the current *Shariah* screening methodology assessments used by KLSI. As previously discussed, there are different *Shariah* screening assessments used by major *Shariah* screening methodology around the world including KLSI. Each assessment have it own justification on why such assessment is used to become as part of qualitative or quantitative *Shariah* screening assessments. For instance, under qualitative assessment, KLSI is the only one who have the additional measurement which is 20%, apart from 5% tolerable percentage used by other major *Shariah* screening methodology around the world. One of the reasons is because the tolerable percentage is categorized based on *fiqh al-awlawiyat* (priorities). The interviewee 3 mentioned that: “*Actually, there is not a problem if we have several tolerable percentages under qualitative assessment. This is because each industry has their own culture and nature and it will require different tolerable percentage on impermissible income. In the case of Astro, one of PLCs is classified as Shariah non-compliant as it is under entertainment industry which is classified as prohibited. However, if we look the revenues generated by Astro, most of it comes from channel subscriptions of consumers which there are supposedly not an issue for Shariah non-compliant. Perhaps, qualitative Shariah screening assessment need to be more diversifies and each PLC is screened through case by case.*” (Interviewee 3).

This statement has been supported by Interviewee 2. It says that different tolerable percentage on impermissible income is required based on same concern. Plus, the interviewee 2 mentioned that: “*We cannot say that 100% Shariah-compliant Company is existing in these days. We must treat based on the needs of that particular PLC in the economy. Otherwise, Muslims cannot involve and controlling the economy power*” (Interviewee 2).

Meanwhile, for nominator issue, all interviewees are agreed with the used of total assets by KLSI as the nominator for financial ratios calculations under quantitative *Shariah* screening assessment. For instance, interviewee 2 informed that the adoption of total assets as nominator for financial ratios by SAC-SC is to avoid uncertainty as total assets is more stable because it is based on historical values as compared to market capitalization which is fluctuate in nature. Besides, interviewee 1 also mentioned that by using

total assets would have a more reflection on PLCs' true condition as compared to market capitalization. Thus, this findings support Obaidullah (2009) argument on the nature of total assets which is more reliable and consistence based on historical value.

In term of the decision of SAC-SC for not using liquidity ratio as part of quantitative *Shariah* screening assessment, interviewee 1 argues that if that particular PLCs owns Islamic bank accounts, so what is the point to have liquidity ratio as liquidity ratio is mostly concern on interest that may combined due to the opening conventional bank account. Moreover, interviewee 5 also stated that interest bearing already being calculated in debt ratio and there is no necessary to have redundant calculation. The interviewee 5 mentioned that: "*Normally the purpose of liquidity ratio is due to the concern of interest bearing portion in cash. However, as interest bearing had been included in debt ratio, there is no necessary to have liquidity ratio anymore*" (Interviewee 5).

This redundancy issue is adds to previous arguments on the needs of liquidity ratio as part of quantitative *Shariah* screening assessment. Previously, liquidity ratio is being argued due to the rules of *bay' al-ṣarf* and *bay' al-dayn* are no longer need to be imposed, possibility to be manipulated and irrelevant due to adoption of *Shariah* legal maxim '*Shariah ruling on primary asset*' (Habib and Ahmad, 2016).

For the basis of 'one-third' used as an indicator to calculate quantitative *Shariah* screening ratios, interviewees have different opinion on the use of the *wasiyyah* Hadith (Hadith No.5659, Sahih al-Bukhari). For instance, interviewee 1 stated that the Hadith was partially referred, which is on the figure basis. The interviewee 1 mentioned that: "*This Hadith is only referred for the figure and not overall Hadith. That's why we don't include the illah (tool) referred by this Hadith which is the property (equity)*" (Interviewee 1).

While, interviewee 2 and 3 viewed that the use of the *wasiyyah* Hadith just as a guideline for *Shariah* scholars to propose such allowable percentage. In this case, interviewee 3 stated that: "*The SAC-SC are using this Hadith as a reference for their ijthad in proposing allowable percentage for quantitative Shariah screening calculations. The figure 'one-third' is proposed without being backed-up on this Hadith*" (Interviewee 3).

Therefore, issues on the use of the *wasiyyah* Hadith is not referring to the property (equity) condition (Yildirim and Ilhan, 2018), is become irrelevant. On the additional criteria set by KLSI apart from qualitative and quantitative *Shariah* screening assessments, it is notified that the using public perception and *maslaha* (public benefits) due to *umum al-balwa* (common plight and difficult to avoid), *urf* (custom) and the rights of the non-Muslim community which are accepted by Islam are based on several rationales. First, this additional criteria was used if the company's activities cannot be separated between *halal* and *haram* elements or *haram* element is untraceable. This had been stated by interviewee 4 as follow: "*The use of umum al-balwa is necessary in the situation where haram activities of the company are untraceable, or when halal and haram elements are inseparable because of the nature of the business of the company*" (Interviewee 4).

Second, under the case of *umum al-balwa*, few companies with the huge impact on the economy will be considered to be entitled with *Shariah*-compliant status. This is to ensure that Muslims' ownership on those particular companies is significant to the benefit of *ummah* economy as whole. In this case, interviewee 5 stated that: "*Certain companies such as Permodalan Nasional Berhad (PNB), a Bumiputera asset management company (depositors are mostly Malay Muslim) needs to be entitled with Shariah-compliant status. It is noted that the major reason on why PNB is not passing the Shariah screening assessment is due to its investment in Malayan Banking Berhad, the biggest banking in Malaysia. As Maybank becomes among the strategic asset in Malaysia, it will be not a good move for PNB to let go such acquisition on Maybank in order to fulfill current Shariah screening assessments*" (Interviewee 5).

In addition, under the case of *maslaha* (public benefits), interviewee 4 have an opinion that there is a needs to acquire shares in certain companies where their products are being used widely including by Muslims. In this case, interviewee 4 stated that: "*We also need to look at certain companies where their products are widely used by Muslims and Muslim cannot run from using their products. Therefore, to have such shares in these kinds of companies is important for me*" (Interviewee 4).

Last but not least, although with additional criteria set by KLSI is seen that KLSI becoming the most lenient as compared to other major *Shariah* screening methodology (Hussin *et al.*, 2015; Kasi and Muhammad, 2016), this statement have a mixed reaction by interviewees. For instance, interviewee 2

mentioned that: *"Although Malaysia is known with its leniency, actually Malaysia is taking a moderate step. Based on wasatiyyah (moderate) concept, it is noted that KLSI still have Shariah screening methodology assessments to be conducted thoroughly"* (Interviewee 2).

On the other hand, interviewee 5 stated that KLSI *Shariah* screening methodology assessment still can be considered strict as there are still hundreds of companies who not been entitled with *Shariah*-compliant status. In this case, interviewee 5 stated: *"Based on the latest Shariah-compliant securities list, from 900 PLCs only 693 are entitled with Shariah-compliant status. There are about 204 PLCs which are not entitled with Shariah-compliant status. So, this can be looked as one of the indicators that KLSI Shariah-screening assessment is still can be considered as strict"* (Interviewee 5).

Meanwhile, interviewee 1 stated that KLSI *Shariah* screening methodology assessment is not totally lenient. In this case, interviewee 1 stated: *"Actually we can say that our Shariah screening methodology assessment is in neutral. There is a part where our Shariah screening assessment is lenient and there is another part where our Shariah screening assessment is conservative"* (Interviewee 1).

4.2. Intention to Entitle Shariah-Compliant Status

Next, in order to answer the second objective of this study, interviewees were asked on the intention to entitle *Shariah*-compliant status by public listed companies (PLCs). In the first and third interview sessions, this study found that current approach of *Shariah* screening process adopted by KLSI will eventually shows PLCs intention to entitle *Shariah*-compliant status. The interviewee 3 mentioned that: *"Unlike before this, the current Shariah screening process is a voluntary screening process. Therefore, PLCs now need to apply if they want the Shariah-compliant status. So we can figured that the one who entitle Shariah-compliant status at present are eager to get the status and not just because they passed the Shariah screening criteria"* (Interviewee 3).

Besides, Interviewee 1 also mentioned that the effort of the de-listed PLCs to be listed as *Shariah*-compliant for the following year as part of their intention to entitle *Shariah*-compliant status. The interviewee 1 mentioned that: *"We can see the effort of PLCs who being de-listed from Shariah-compliant status and for the next year they entitle back the Shariah-compliant status as part of their eagerness to entitle Shariah-compliant status"* (Interviewee 1).

These actions by PLCs are in line with Bilal and Mydin Meera (2015) suggestion that actions by PLCs becomes as an expression on their intention to entitle *Shariah*-compliant status. Moreover, *Shariah*-compliant status have big impact especially in getting more capital from Muslim investors especially from the Middle-East. In this case, Muslim investors are looking for *Shariah*-compliant status to invest their funds. This further would lead to effect the market price of the PLCs. The interviewee 4 mentioned that: *"As we know, there are lots of funds from Muslim investors especially who came from Middle-East. They will look potential PLCs with Shariah-compliant status for them to invest. Therefore, we can see that the important to have such Shariah-compliant status by PLCs as it not only will bring potential investors, but it also will effect on market price of PLCs"* (Interviewee 4).

Furthermore, certain PLCs with inconsistent *Shariah*-compliant status will eventually make their investors need to face some losses from disposal and later buy back the shares. Therefore, to ensure that their investors do not have such losses or need to dispose their shares, this will make PLCs are struggling to fulfill all *Shariah* screening criteria and maintain their *Shariah*-compliant status. The interviewee 5 mentioned that: *"It will be cost for investors if PLCs are keep changing their Shariah-compliant status. Therefore, to overcome this matter, several de-listed PLCs will counter this issue by making a press statement and stated their commitment to be listed again in the future. This process also can be viewed as part of the effort and eagerness of PLCs to entitle Shariah-compliant status"* (Interviewee 5).

In addition, changing in the *Shariah*-compliant status is indirectly will shows that the *Shariah* governance on Islamic capital market is soundly function and in a good practices. This will eventually leads to investors and public confidents with PLCs who is able to maintain their *Shariah*-compliant status. The interviewee 2 mentioned that: *"Inconsistent Shariah-compliant status by PLCs is actually shows that we have good Shariah governance practices by SC. Although investors will face some losses when the market price is down and they need to dispose their shares, it actually give a picture that investors are confidents with our SC and Shariah screening process"* (Interviewee 2).

Besides, the core value of the business also has an impact to entitle *Shariah*-compliant status. For instance, there are two PLCs in the airlines industry, although both are involves with liquor who is not exceed 5% tolerable percentage on impermissible income, one of them is entitle with the *Shariah*-compliant status and another one is not entitle with *Shariah*-compliant status. The reason is because the one who entitle the *Shariah*-compliant status is selling the liquor and another one who did not entitle *Shariah*-compliant status is serving the liquor as free to their customers. Therefore, it shows that the core value of the business not only plays a significant roles to entitle *Shariah*-compliant status but it also will eventually show the intention of PLCs to entitle *Shariah*-compliant status.

Last but not least, there are certain companies even they are not in KLSI, although they are not passing certain criteria either in qualitative or quantitative assessments, but their effort to obtain *Shariah*-compliant status is make them to be considered as *Shariah*-compliant status especially based on the good public perception of the company and the core activities of the company are important and considered *maslaha* (public benefits) to Muslim. The interviewee 1 mentioned that: "*Permodalan Nasional Berhad (PNB) is the best example for a company who obtain Shariah-compliant status via good public perception and maslaha to Muslim. In this case, we know that PNB is categorized as Shariah-compliant status due to maslaha to Muslim. However, Shariah Department of PNB also have a good effort when they go to every Islamic financial institutions in Malaysia to inform their progress to fulfill all qualitative and quantitative Shariah screening criteria and this we can see as part of their eagerness to entitle Shariah-compliant status*" (Interviewee 1).

5. Conclusions and Recommendations

This study is successfully to justify the reasons behind the current *Shariah* screening methodology assessments used by KLSI. First, under the issue for having additional tolerable percentage which is 20%, it is introduced based on *fiqh al-awlawiyyat* (priorities). Second, on the usage of total asset as nominator in quantitative *Shariah* screening ratios are because to avoid uncertainty and total asset able to give more reflection on PLCs' true condition. Third, issue on not adopting liquidity ratio as part of quantitative *Shariah* screening assessment is answered due to redundancy function with debt ratio. Fourth, on the arguments on the sources of *hukum* based on *wasiyyah* Hadith, it is found that this Hadith is only partially used or it is just been used as a guideline in setting the *Shariah* screening assessment criteria. Next, the reasons behind the additional criteria set by KLSI which are on corporate image and *maslaha* (public interest) are also explained in details. Last but not least, there are mixed opinions on the leniency of current *Shariah* screening methodology where some interviewees stated that KLSI *Shariah* screening methodology is neutral or *wasatiyyah* (moderate), while others stated that it is actually can be considered as strict.

Besides, this study is also successful in identifying the intention to entitled *Shariah*-compliant status by PLCs. There are several ways that can be used to measure such intentions. First, the current approach for applying the *Shariah*-compliant status is changed from mandatory assessed by SAC-SC toward voluntary application by PLCs will show the intention for those PLCs who applied. Second, effort of the de-listed PLCs to be listed as *Shariah*-compliant for the following year can also be regards as part of intention to entitle *Shariah*-compliant status. Third, the impact of *Shariah*-compliant status especially on the share prices and potential investors also plays a significant role for PLCs to entitle such *Shariah*-compliant status. Fourth, PLCs intent to maintain their *Shariah*-compliant status in order to avoid their investors from having a loss due to de-listed status. Next, good corporate image on maintaining *Shariah*-compliant status will give investors and public confidents and will lead to the intention to entitle such *Shariah*-compliant status by PLCs. Furthermore, Moreover, the core value of the business is another reason which can give an impact to entitle *Shariah*-compliant status. Last but not least, effort shows by PLCs to entitle *Shariah*-compliant status by PLCs can be used to measure their intention.

In addition, based on findings from the interview sessions, several recommendations are suggested especially on challenging the current KLSI *Shariah* screening methodology assessments as follow:

1. *Zakat* – it is suggested for KLSI *Shariah* screening methodology to add *zakat* as new criteria in *Shariah* screening assessments. In this case, PLCs with *Shariah*-compliant status must also perform business *zakat* as part of Islamic obligation. As non-Muslim company's way of life can be referred to their corporate social responsibility (CSR), the similar concept can be adopted in performing *zakat* obligation.

2. Income purification – similar to the current practices of Islamic financial institutions (IFIs), any non-permissible incomes generated must be channeled to endowment or charity and this process must be reported as part of income purification process. Therefore, assessment on income purification is suggested as part of *Shariah* screening assessment criteria.

3. *Shariah* reporting – another criteria need to be proposed is *Shariah* reporting. At present, IFIs under the regulation of Bank Negara Malaysia (BNM) are required to issue the *Shariah* Committee report that informs that their operations are according to *Shariah*-compliant. Therefore, there is a need for PLCs with *Shariah*-compliant status to prepare and issues the similar *Shariah* report to shows that their operations are to be in line with *Shariah*-compliant. The report may include such as *Shariah* governance, list of non-permissible incomes or activities and rectification on *Shariah* non-compliant issues.

4. Specific *Shariah* screening assessment – it is also suggested to have specific *Shariah* screening assessment based on industry. This is because different industries have different nature and by understanding the nature of each industry will eventually to set a more suitable *Shariah* screening assessments as compared to current generalise *Shariah* screening assessment.

5. Non-financial *Shariah* screening assessment – apart from current qualitative and quantitative *Shariah* screening assessments that stressed on financial aspect, other non-financial aspects are possibly can be used to indicate the *Shariah*-compliant status. For instance, dress code, place and advertising style also must be referred as these non-financial aspects will effect on the *Shariah* reputational risk if it is not complied according to *Shariah* laws.

6. Legal and moral issues – it is noted that PLCs with *Shariah*-compliant status must eventually following rules and regulations and operates in a good corporate ethics. Any PLCs that have corporate ethics issues such as involving in bribery, damaging environmental and surpress other parties must be considered as *Shariah* non-compliant.

Though the current study provides a number of valuable contributions, the study still have a number of limitations. This includes the scope of the study which is based on the KLSI *Shariah* screening methodology. Hence, future studies are recommended to extend this endeavour to other *Shariah* screening methodology as well. Furthermore, the sample size though covers all related parties who are involved with *Shariah* screening methodology practices; it is still preferable that the future studies can use techniques like focus groups discussion by arranging sessions of several practitioners and scholars to discusses on the similar issues at same time.

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