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ISRA-Bloomberg Sharī'ah stock screening and income cleansing methodologies: a conceptual paper

Income
cleansing
methodologies

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Abstract

Purpose – The purpose of this paper is to explain and critically analyse the Sharī'ah screening criteria and cleansing process for income generated from stocks with a special focus on a newly developed ISRA-Bloomberg methodology.

Design/methodology/approach – The paper focuses on the methodology of ISRA-Bloomberg in terms of Sharī'ah screening of stocks and the income cleansing process. To achieve this objective, this paper adopts a descriptive approach.

Findings – The methodology of ISRA-Bloomberg is unique in terms of its criterion for screening stocks, the cleansing process and coverage of the universe of stocks. It facilitates the investors by offering a novel colour-coding scheme to indicate the Sharī'ah compliance of a stock. It also provides the exact ratios of the Sharī'ah-compliance criteria to the investors so they can closely observe changes in the trend of ratios and decide beforehand whether or not a company is likely to remain within the Sharī'ah-compliant list. The paper further discusses the issues in the screening and cleansing practices faced by the industry.

Research limitations/implications – This research is limited to the criteria of screening and income purification of stocks which have been used by ISRA-Bloomberg from a Sharī'ah perspective.

Practical/implications – The robust screening criteria and comprehensive analysis of the stocks will enhance the confidence of Islamic capital market participants. The investors, regulators and index providers will be equally able to benefit from this initiative.

Originality/value – The paper focuses on the recently established methodology of ISRA-Bloomberg, which has not been discussed in the literature until now. The methodology, because of its exceptionality, may add a new dimension to Sharī'ah screening and cleansing of stocks.

Keywords Islamic finance, Sharī'ah-compliant shares, Islamic equity, Screening criteria, Income purification

Paper type Research paper



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Introduction

A vibrant equity market is one of the most crucial elements of a market economy. It offers a dynamic and efficient platform to companies to gain easy access to capital and to investors to acquire ownership of a company with promising future performance. In this way, it contributes to the growth of real economic activity and development.

An Islamic equity market is also an essential element of the Islamic financial system. However, to develop a comprehensive Islamic equity market, a robust supporting infrastructure is needed. Keeping this in view, it is important, on the one hand, to have devout Muslim investors who are keen on investing in Sharī'ah-compliant stocks and, on the other hand, to make available a large group of Sharī'ah-compliant stocks to them. It is important that they know about any stock if it is Sharī'ah-compliant and how much of the income generated from a Sharī'ah-compliant stock is actually Sharī'ah-compliant. This is to ensure that they can avoid Sharī'ah non-compliant stocks and avoid the impermissible portion of the income from those that pass the Sharī'ah-compliance screening. The issues here are how a stock can be determined to be Sharī'ah-compliant; how much income is permissible from it; and how the impermissible income is treated.

Many regulatory and Sharī'ah authorities, standard-setting bodies, Islamic financial organisations and individual scholars have deliberated on these issues and proposed viable solutions. Based on those solutions, various equity index providers such as Dow Jones, FTSE, MSCI and S&P have developed their own criteria for determining the Sharī'ah compliance of a company's shares. They also offer a complete list of Sharī'ah-compliant shares based on their own databases.

This paper explains the Sharī'ah screening criteria of stocks in general, with a special focus on the newly developed ISRA-Bloomberg Sharī'ah screening methodology. In addition, it discusses in detail the cleansing methodology proposed by ISRA-Bloomberg for the income generated from stocks. The methodology proposed by ISRA-Bloomberg is unique from many aspects that will be made clearer in the following sections of this paper. In doing so, Sharī'ah justifications and rationale of the methodology are also discussed, and comparison of the methodology with other criteria is furnished wherever needed.

After the introduction, the paper explains the concept of Sharī'ah-compliant shares and the need for them. Following this discussion, the importance of screening stocks is highlighted. It explains the criteria of Sharī'ah screening of stocks and the rationale behind such criteria and then discusses the screening methodology of ISRA-Bloomberg. After that, it furnishes the cleansing methodology for the income generated from stocks. It delves into the problems faced in the screening and cleansing processes in the subsequent section, followed by the conclusion.

Investing in common shares

The common stock of a company represents ownership interest in the company apportioned to the number of stocks bought by an investor ([Investopedia, 2016](#)). Therefore, investors essentially own a part of the company that is equivalent to the number of stocks owned from the total number of the company's shares. By increasing the number of shares held by investors in the company, they assist in the positive growth of that company, and, in return, they are rewarded through dividends, warrants, appreciation of the value of shares and other benefits.

The companies which offer their shares in a stock exchange can be divided into three main categories as per their business and operations:

- (1) companies with business and operations which are impermissible from the Sharī'ah perspective;
- (2) companies with permissible business and operations; and
- (3) companies with mixed business and operations or companies involved in both permissible and impermissible business and operations.

A Muslim investor cannot participate or invest in companies with completely Sharī'ah non-compliant business and operations. The Qur'ān says:

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا أَمْوَالَكُمْ بَيْنَكُمْ بِالْبَاطِلِ

Oh you who believe, do not wrongfully consume each other's wealth, but trade by mutual consent (Qur'ān, 4: 29, Trans. [Abdel Haleem, 2004](#)).

Al-Ṣabūnī (1997) explains that wrongful consumption here includes every manner of acquiring wealth that is not permitted by Sharī'ah, for instance, theft, dishonesty, usurpation, usury (*ribā*), gambling (*qimār*) and similar things. They are all forms of wrongful consumption of wealth.

As for companies that are involved in completely Sharī'ah-compliant business and operations, it is allowed for the Muslim investor to participate in them, according to the Islamic Fiqh Academy of Organization of Islamic Cooperation (IFA-OIC, 2000, Resolution No. 63/1/7) and Islamic Fiqh Council of Muslim World League (IFC-MWL, 2006, Session No. 14, Resolution No. 4). It is, however, generally observed that it is difficult to find such companies. Most companies are involved in activities that are either completely Sharī'ah non-compliant or a mix of compliant and non-compliant ([Hashim and Habib 2017](#)).

The main issue, therefore, concerns investing in companies that are involved in mixed activities. On the one hand, participation in such companies is tantamount to involvement in impermissible business and, on the other hand, prohibiting participation in such companies would inflict harm on the public and cause hardship. That is why many Sharī'ah authorities and committees, standard-setting bodies and individual scholars support the view that participation in such companies should be allowed based on the principle of removal of hardship and harm from Muslim investors, provided that the impermissible business and operations of such companies are restricted to a certain tolerable limit ([SAC-SC, 2006](#); [AAOIFI, 2015](#)).

The requirement for stock screening from Sharī'ah perspective

From the above discussion, it can be construed that most of the companies which are available for Muslim investors are companies with mixed activities. Even the case of companies established in Muslim countries is not much different ([Hashim and Habib 2017](#)). There are many reasons for this situation, such as:

- The global financial framework itself is not Sharī'ah-compliant. Companies usually fulfil their financial requirements through conventional financial institutions and instruments. For example, the non-existence of Islamic banks in many countries to support cross-border transactions is a big issue. Similarly, Islamic capital markets to facilitate trade are underdeveloped in many jurisdictions, and there is little or no Islamic insurance (*takāful*) to cover associated trading risks. There is a particular lack of institutions specialised in absorbing large risk. These gaps leave companies with no choice but to obtain such services from conventional sources.

- In many cases, companies are established or managed by non-Muslims who, although required to fulfil legal and regulatory requirements of specific jurisdictions, are not required to follow Shari'ah rules. Such companies may get involved in impermissible business activities along with permissible ones, for example, borrowing on interest, earning interest on deposits, etc.
- The Shari'ah respects the rights of non-Muslims. Even though some practices are prohibited for Muslims, the same may not be imposed on non-Muslims. This is particular to cases where the prohibition is solely based on religion such as eating pork and drinking liquor. Therefore, to a certain extent, some allowance needs to be made for such practices for non-Muslims.

Given this situation and the reasons behind it, Shari'ah scholars, regulatory authorities and other Islamic finance players recognised the need to have criteria or methodologies for Shari'ah screening of shares. Those criteria were to facilitate Muslim investors in identifying the shares which at least fulfil the conditions set in the criteria. Those conditions mainly focus on the core business of the company with exceptions that include certain Shari'ah non-compliant activities. Hence, they can offer a list of shares of companies which do not have impermissible business and operations as their core activity, and their impermissible secondary activities are restricted or limited to tolerable benchmarks specified within each criterion.

The logic behind having a Shari'ah stock-screening tool is to limit or control the Shari'ah non-compliant activities of a company and, subsequently, restrict the participation of Muslim investors in such activities. This is to limit cooperation in sinful acts, a fundamental requirement imposed by the following verse of the Qur'an:

وَلَا تَعَاوَنُوا عَلَى الْإِثْمِ وَالْعُدْوَانِ

Do not help one another towards sin and hostility (Qur'an, 5: 2, Trans. [Abdel Haleem, 2004](#)).

What should be screened?

The first criterion of all the Shari'ah screening methodologies is to exclude companies whose main business activity is impermissible. If the main business activity is Shari'ah-compliant, whereas some secondary activities are not, examination turns to whether or not those secondary activities are within the tolerable benchmarks. One of the ways to examine those secondary activities is by the percentage of income generated from such activities. This component of the criteria is important because it not only facilitates the measurement of the level of compliance of a company but also indicates how much of the profit needs to be cleansed. The cleansing aspect is also vital for Muslim investors who take a stance that any income generated from a company's Shari'ah non-compliant activities is impure and thus must be cleansed.

To measure a company's involvement in impermissible secondary activities, its financial operations need to be scrutinised. For this reason, Muslim investors are required to understand the composition of a company's business conduct from two aspects:

- (1) the company's general business activities; and
- (2) its financial operations.

The first aspect is covered under the "Sector and Activity Based Screening", whereas the second aspect is dealt with under the "Quantitative or Financial Screening".

The quantitative or financial screening involves mainly two approaches:

- (1) Ensuring that a company's main assets are not predominantly cash or cash-related is the first approach. If a company's main assets are cash based, trading of its shares is tantamount to trading of cash for cash at a discount or premium. This will trigger the issue of *ribā* (interest) because, in trading currencies or cash, the Sharī'ah rules of currency exchange (*bay' al-ṣarf*) should be observed. Similarly, a company's main assets should not be in the form of debts (receivables); otherwise, the Sharī'ah rules of debt trading (*bay' al-dayn*) must be observed to avoid any element of *ribā*.
- (2) Next approach is ensuring that a company is not involved directly or indirectly in *ribā*-related activities that exceed the tolerable benchmark specified within the criterion. The *ribā*-related activities of a company can be in two forms:
 - investment and/or placement of cash in conventional or interest-based instruments; and
 - acquiring funds from the capital market or banking sector through interest-based facilities.

It should be observed that the first approach considers all types of cash and debt regardless of whether they are Sharī'ah-compliant or not. If the cash or debt reaches or exceeds a certain threshold, the company will be regarded as a cash-based or debt-based company. Therefore, trading its shares at a discount or premium will trigger the issue of *ribā*. On the contrary, the second approach focuses on the involvement of the companies in *ribā*-related activities such as paying *ribā* in conventional loans or receiving *ribā* from investment activities. This approach, therefore, only takes into account the cash placed or invested in Sharī'ah non-compliant instruments. Similarly, only the conventional debt raised through Sharī'ah non-compliant instruments is taken into consideration in the calculation against a certain base.

It is worth noting that some criteria cater for both approaches, whereas some cater for the second approach only. For example, [AAOIFI \(2015\)](#) has a benchmark of maximum 70 per cent of the total value of all the assets of a company for cash and debt, whether they are Sharī'ah-compliant, Sharī'ah non-compliant or a mixture of both. It means that cash and debt of a company in any form should not exceed 70 per cent of the total assets. As for the second approach, [AAOIFI \(2015\)](#) suggests that cash placed in interest-based instruments should not exceed 30 per cent of the market capitalisation of the total equity of a company. And the interest-bearing debt of a company should not exceed 30 per cent of the market capitalisation of the company. In this way, [AAOIFI \(2015\)](#) covers both approaches in its Sharī'ah standards. In contrast, the Shariah Advisory Council of Securities Commission Malaysia ([SAC-SC, 2017](#)) only applies the second approach by having a benchmark of maximum 33 per cent 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 per cent of total assets, excluding Islamic financing facility. With these filters, [SAC-SC \(2017\)](#) opts to observe the second approach only.

Another point to be noted from the above discussion is that some criteria use total assets of a company as a measuring tool for their filters. For instance, [SAC-SC \(2017\)](#) 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.

ISRA-Bloomberg screening methodology

Similar to other screening criteria, the ISRA-Bloomberg screening methodology also has sector- and activity-based screening. After screening out the companies having impermissible main business activities, it focuses on companies with mixed activities. The sector- and activity-based filter ensures that impermissible secondary activities of companies are within a tolerable benchmark. This is captured by the income generated from such activities. Based on the market norm and established custom, the criterion suggests that the income from such activities should not exceed 5 per cent of the total income of a company, which is termed as revenue. The formula for calculating the ratio is (Table I).

The threshold of 5 per cent is important to indicate that Shari'ah non-compliant activities of a company are minor, and, therefore, the overall investors' participation in the company should not be regarded as assisting in the growth of the impermissible activities of the company. This is in line with the majority of existing Shari'ah stock screening criteria. For example, AAOIFI (2015) Shari'ah Standard No. 21 states:

That the amount of income generated from prohibited component does not exceed 5 per cent of the total income of the corporation irrespective of the income being generated by undertaking a prohibited activity, by ownership of a prohibited asset or in some other way (AAOIFI, 2015, p. 563).

It is also important to highlight here that the basis of this 5 per cent threshold is inferred from the corporate view that below 5 per cent shareholding is still a minor position taken in the company because a shareholding of more than 5 per cent will enable a wider spectrum of rights and more active participation of the shareholder. Therefore, the 5 per cent threshold is considered an insignificant participation in the company's activities and as such the company that has business activities that do not reach this threshold may still be considered Shari'ah-compliant.

However, the unique element in the ISRA-Bloomberg methodology is that the platform highlights the degree of Shari'ah non-compliant activities of companies. It does not merely list them as Shari'ah-compliant companies. Company ABC, for instance, may be listed as a Shari'ah-compliant company with 4.7 per cent of its income coming from Shari'ah non-compliant activities. This extra feature will bring mainly two benefits to investors:

- Better decisions can be made on whether to buy, hold or sell shares of Shari'ah-compliant companies which are near the 5 per cent threshold.
- The amount of dividend cleansing can easily be done based on the disclosed percentage of income derived from Shari'ah non-compliant activities.

Operationally, activities of companies are categorised in different colours to identify their Shari'ah-compliant status. The different colours shown are the result of a sophisticated consideration process. The companies which are completely Shari'ah non-compliant are highlighted in red; the companies which are completely Shari'ah-compliant are shown in white; and the companies which have mixed activities are shown in blue. The companies in

Table I.
Criterion for Shari'ah
non-compliant
income

Benchmark	Formula
Shari'ah non-compliant income tolerance test	$\frac{\text{Income from prohibited activities}}{\text{Total revenue}} \leq 5\%$

red and the companies which have exceeded the tolerable benchmark in blue are excluded from the Shari'ah-compliant universe. In addition, the system can compute how much income (the exact amount) is from impermissible activities based on the revenue segment, which may be coded either red or blue. This system helps investors in precisely knowing which type of sectors and activities the companies are operating and involved in.

The blue-coding basically indicates the following:

- It is not known if the company's activities in a sector are Shari'ah compliant or not, for example, the category of "Food and Beverages". In this regard, company's activities in the sector are regarded as Shari'ah non-compliant unless declared otherwise by the company. The declaration must fulfil certain criteria including its transparency in Bloomberg's portal. For instance, a company may declare through a supplementary document that it is only involved in *halal* food and beverages. Based on this declaration, the "blue status" may be changed to "white".
- The sector and activity may involve mixed activities. Part of those activities may be regarded as Shari'ah non-compliant. "Hotel" is an example where its activities include accommodation (Shari'ah-compliant) and non-*halal* food and beverages and liquor bar (Shari'ah non-compliant). In this regard, the sector and activity will be regarded as Shari'ah non-compliant except if declared otherwise by the company. Similar to the previous case, in this case as well, the company has to follow the same procedure to be included in the Shari'ah-compliant list.

After the sector screening, the companies are subject to financial screening. There are two financial ratios that need to be met. These are cash-based ratio and debt-based ratio. If a company does not meet the tolerable benchmark of these two ratios, shares of the company will not qualify as Shari'ah-compliant. The ratios and their benchmarks are stated below (Table II).

It should be noted from the above table that the ISRA-Bloomberg screening methodology has adopted the second approach in quantitative or financial screening mentioned previously, which is aligned with the approach of SAC-SC (2006). This is based on the argument that shares actually represent the "business" of the companies regardless of whether assets of the companies are in the form of cash, receivable (debt) or physical assets. Therefore, the issue of debt trading does not arise. It is worth noting here that under this methodology, the shares of Islamic banks can be listed as Shari'ah-compliant stocks and hence can be traded, even though most of their assets are in the form of receivables created by financing activities.

In principle, the methodology uses market capitalisation to compare the benchmarks against whenever the value of the 24-month market average goes above the value of the assets. It is argued that the calculation should be based on market capitalisation because, under this scenario, it represents the true market value of a company, i.e. the real value of a company that the investor is willing to pay for. This is also in line with AAOIFI (2015). This principle is applicable to certain companies that operate without owning many physical assets, for example, Uber and Airbnb, which generate revenue from assets that mostly belong to others.

The 24-month market average is used because it reflects a more stable and reliable figure of the value of the company, particularly, during periods of financial instability or crisis.

The methodology will also use the assets of the companies to compare the benchmark against them under exceptional cases such as for newly listed companies

Table II.
Criteria for cash and
debt based ratios

Benchmark	Formula
Cash-based	$\frac{Cash^1 + Interest\ bearing\ securities^2}{24\ months\ average\ market\ capitalization} \leq 33\%$ <p>(or Total Assets or under exceptional condition)</p>
Debt-based	$\frac{Debt^3}{24\ months\ average\ market\ capitalization} \leq 33\%$ <p>(or Total Assets under exceptional condition)</p>

1: Cash only includes cash placed in conventional accounts and instruments, whereas cash placed in Islamic accounts and instruments is excluded from the calculation. In the case of no information provided by the companies to distinguish whether the cash placed in Islamic accounts and instruments or otherwise, the system will assume that all the cash is placed in conventional accounts and instruments. Hence, the companies are required to provide evidence (i.e. supplementary documents) to show that the cash is placed in Islamic accounts and instruments if they want deduction to be made

2: Interest-bearing securities include both short-term and long-term instruments

3: Debt only includes interest-bearing debt, whereas Islamic financing or *shukūk* are excluded from the calculation. Debt may consist of interest-bearing both short-term and long-term borrowings and finance lease liabilities. The amounts are available from the liability side of the statement of financial position

Short-Term Debt:
Short-term debt includes bank overdrafts, short-term debts and borrowings, repurchase agreements (repos) and reverse repos, the short-term portion of long-term borrowings, current obligations under capital (finance) leases, current portion of hire-purchase debt, trust receipts, bills payable, bills of exchange, bankers' acceptances, interest-bearing loans and short-term mandatory redeemable preferred stock. It also involves short-term debt netted with unamortised premium or discount on debt, and may include fair value adjustments of embedded derivatives. The category of "banks and financials" includes call money, bills discounted, federal funds purchased and what is because of other banks or financial institutions

Long-Term Debt:
Long-term debt includes:

- A. All interest-bearing financial obligations that are not due within a year
- B. Convertible, redeemable, retractable debentures, bonds, loans, mortgage debts, sinking funds and long-term bank overdrafts
- C. Long-term portion of long-term debt, pension obligations
- D. Subordinated capital notes
- E. Long-term hire purchase and finance lease obligations
- F. Long-term bills of exchange and bankers' acceptances
- G. Mandatory redeemable preferred and trust preferred securities
- H. Other debt which is interest bearing

Calculation of Interest-Bearing Debt:

Borrowings	X
Finance lease liabilities	X
Bank Overdraft	X
Other interest-bearing debt	X
Total interest-bearing debt	X*

* Debt based on Islamic financing or *shukūk* to be deducted from the total if these amounts are included in the calculation. Similarly, in case no information is provided by a company to distinguish whether the debt is based on Islamic financing/ *shukūk* or interest-bearing debts, the system assumes that all the debts are interest- bearing debts. Hence, companies are required to provide evidence (i.e. supplementary documents) to show their debts are based on Islamic financing or *shukūk* if they want the deduction to be made

where the market capitalisation is unknown or under bad economy situation where the market is considered as “too much under value”. These exceptional situations shall be determined in a clear manner to avoid manipulation by any party. The justification to revert to the assets under the said situation is because of the fact that it represents the tangible value of the companies.

It can be observed from the above explanation that ISRA-Bloomberg Methodology is unique in the sense that it relies on both 24-month market average and total assets under certain conditions to compare the benchmark against.

Cleansing methodology for stocks

If a company passes the above proposed criteria, its shares will be considered Sharī'ah compliant for investment purposes. Despite that, because such companies are involved in some impermissible secondary activities, part of the income generated from them is impermissible for Muslim investors to retain. The Qur'ān states:

وَأِنْ تَبَيَّنَ فَلَكُمْ رُءُوسُ أَمْوَالِكُمْ لَا تَظْلِمُونَ وَلَا تُظْلَمُونَ

You shall have your capital if you repent, and without suffering loss or causing others to suffer loss (Qur'ān, 2: 279, Trans. [Abdel Haleem, 2004](#)).

This verse discusses the effects of the prohibition of *ribā* in loans. It indicates clearly that the lender is entitled only to the loan principal and not to the interest portion. The principal is the permissible portion here, and the interest is the prohibited portion. In other words, a Muslim should not recognise any income that originated from interest or other impermissible activities. The Prophet (ﷺ) mentions:

There is no flesh nourished by the unlawful except that the fire is more appropriate for it ([Al-Tirmidhi, 1975](#), Vol. 2, p. 512, *ḥadīth* no. 614).

This *ḥadīth* has established a very important principle that the source of wealth or income should be permissible. The consumption of wealth or income that originated from impermissible sources may lead a person to the fire in the hereafter.

Therefore, it is important for Muslim investors to avoid the income generated from the impermissible activities of the company whose shares they hold. In other words, such income requires special treatment, known as cleansing or purification, which will be discussed in the following section.

Cleansing of stocks can be defined as:

The process of identifying, separating and channelling the impermissible income of the stocks to charity ([Hashim and Habib 2017](#), p. 66).

The cleansing methodology basically focuses on what needs to be cleansed from the income of the stocks and how it is cleansed. There are a number of scenarios in the context of stock trading that require cleansing of income. The first scenario involves cleansing the Sharī'ah non-compliant portion of income from Sharī'ah-compliant shares while an investor continues to hold the shares. The second scenario involves cleansing capital gains realised from selling Sharī'ah-compliant shares. The third scenario involves the cleansing of any income generated during the process of disposing of shares that have been excluded from the Sharī'ah-compliant list after the latest periodic review. The fourth scenario involves the cleansing of any Sharī'ah non-compliant income from shares excluded from the Sharī'ah-compliant list that an investor continues to hold. Each scenario has its specific Sharī'ah rulings, which are discussed below.

Cleansing Sharī'ah non-compliant income while holding Sharī'ah-compliant shares

As discussed earlier, there is a maximum threshold of 5 per cent of total revenue for income generated from any Sharī'ah non-compliant activities of a company. In other words, a company may remain in the Sharī'ah-compliant list if its income from Sharī'ah non-compliant activities remains at 5 per cent or below. The question is whether or not that small portion of Sharī'ah non-compliant income must be cleansed.

It is worth noting that while holding shares of a company, investors may earn cash income from the dividends distributed by the company. They may also earn non-cash income such as bonus shares. They might also be awarded with warrants or options to subscribe to preference shares. These warrants or options may be sold to other investors. Hence, the benefits realised from shares of a company can be divided into two main categories:

- (1) cash income from dividends; and
- (2) non-cash benefits such as bonus shares, warrants, options or others.

Cleansing of cash income from dividends. The approach of ISRA-Bloomberg for cleansing cash income is that the cleansing is made in proportion to the percentage of Sharī'ah non-compliant activities of the company. For example, according to the audited financial report of Company A, 3 per cent of the income is generated from Sharī'ah non-compliant activities. Therefore, 3 per cent of the dividend distributed by the company should go to charity as a result of the cleansing process.

Though the above methodology looks simple, it is not easy for investors to know the exact percentage of income generated from Sharī'ah non-compliant activities except by performing a deep analysis and calculation based on the financial audited report of a company. It is observed that almost all index providers or institutions conducting Sharī'ah screening of stocks only provide information on whether or not a company is in the list of Sharī'ah-compliant stocks. It is difficult for investors to find out the exact percentage of impermissible income. On the contrary, the ISRA-Bloomberg platform provides the exact percentage of income generated from Sharī'ah non-compliant activities so that investors can accordingly cleanse the cash income with enhanced reliability and ease.

Cleansing of non-cash benefits. As stated earlier, these benefits can be in the form of bonus shares, warrants, options or others. The approach of ISRA-Bloomberg in this regard is that there is no cleansing required for such benefits, simply because there is no direct cash inflow to the investors. Though on paper it is recorded that the investors will have more shares, the cash income from those additional shares will only flow in through the next cycle of dividend distribution.

No cleansing is needed for warrants and options for the same reason: no income is received by the investors in these cases. Instead, the investors' money flows out when they exercise warrants and options. The cash income flows in through the next cycle of dividend distribution; hence, the cleansing exercise will then be performed at that particular point of time. Nevertheless, if the investors choose to sell their rights in the form of warrants and options, then cleansing of the income received from them is required. This is because of the fact that the investors, in this case, have converted the "dividend" in the form of warrants and options into cash income. Therefore, the same rule of cash dividends is applied here.

Cleansing of capital gains received from selling Sharī'ah-compliant shares

The treatment of capital gains from the cleansing perspective remains under debate. Some scholars such as Sheikh Taqi Usmani suggest that it is a safe approach to cleanse capital gains from selling shares. It is based on the understanding that the market price might

reflect an element of interest or impermissible income (Usmani, 2002). On the contrary, ISRA-Bloomberg opines that there is no need to cleanse capital gains. It is argued that the change in the stock price does not directly reflect interest or other income generated from Sharī'ah non-compliant activities of a company. In reality, the changes in stock price in the market comprise a complex phenomenon that is attributed to multifarious factors, including supply and demand. Therefore, capital gain is not direct income from Sharī'ah non-compliant activities. Moreover, the stock price in the market basically reflects the price that the buyer is willing to pay to acquire those shares. It would be far from reality to think that the investors consider interest or impermissible income during trading shares as the principal factor or objective of the transaction, especially when it is in a negligible amount (less than 5 per cent of the total revenue in this case). This opinion is based on the Islamic legal maxim stating:

يَغْفَرُ فِي التَّابِعِ مَا لَا يَغْفَرُ فِي الْمَتَّبِعِ

Something can be forgiven as the subsidiary which cannot be forgiven as the principal (Al-Zuhayli, 2006, vol. 1, p. 447).

The above maxim proposes that when a factor or element is subsidiary to a principal factor or element, it might be overlooked in issuing the Sharī'ah ruling for the whole case, whereas that element cannot be overlooked otherwise. Putting it in the context of cleansing capital gains, it can be said that the interest or impermissible income is definitely a subsidiary factor. Therefore, it seems more appropriate to exclude capital gains from the income cleansing process.

Cleansing of income generated during the process of disposing the shares that have been excluded from the Sharī'ah-compliant list

In principle, investors are not supposed to hold any share that has been excluded from the Sharī'ah-compliant list. In other words, investors should dispose of it by selling it in the market. The reason for this requirement is to stop investors from helping or contributing in impermissible activities, as per the previously mentioned *Qur'ānic* verse:

وَلَا تَعَاوَنُوا عَلَى الْإِثْمِ وَالْعُدْوَانِ

Do not help one another towards sin and hostility (Qur'ān, 5: 2, Trans. Abdel Haleem, 2004).

Holding shares of companies that are deeply involved (beyond the threshold) in Sharī'ah non-compliant activities could be considered as "helping" those companies in their prohibited activities. Therefore, those shares should be disposed of.

In disposing of such shares, the main issue to be clarified is the price of such shares that can be considered as the baseline (principal), which investors would be allowed to keep as their capital. In other words, the following should be decided: how much of the capital gains from selling such shares can be retained by the investors and how much should be cleansed. This is in line with the verse of the Qur'ān (2: 279) cited above where investors are eligible to receive their capital without suffering loss or causing others to suffer loss.

In the methodology of ISRA-Bloomberg, the baseline or principal is the acquisition price or the price of shares on the pronouncement date, whichever is higher. It is logical to see the acquisition price as the principal amount because this is the actual price paid by the investors when they acquired such shares.

For example, an investor has acquired a particular Sharī'ah-compliant share on 1 November 2000 at US\$1.00 per share. On 1 November 2016, the price of the said share has increased to US\$15.00 per share. On the same date, the share was declared Sharī'ah non-

compliant. On 2 November 2016, the investor sold the share at US\$15.50 per share. Under this scenario, the principal is the share price on the day of pronouncement (US\$15.00). The investor is entitled to retain the price on the pronouncement date because such increase in value occurred while the share was regarded as Sharī'ah-compliant. Any price increment thereafter (in this example, it is 50 cents) should be channelled to charity and should not be recognised as income.

In another scenario, let us assume that price on the pronouncement date (1 November 2016) fell below the acquisition price at US\$0.95 per share. Under this scenario, the principal should be US\$1.00 per share which is the acquisition price. However, it should be noticed that, in this case, if the investor decides to sell the share on the same date, he would not be able to receive back his principal (US\$1.00 per share), as the price is US\$0.95 per share. Therefore, the investor can hold the share and wait until either the price of the share goes back to US\$1.00 or the company pays dividends which can compensate for the loss incurred by the investor because of cleansing. In other words, the investor can receive back his principal through capital gains and dividends both.

Cleansing of income generated during the process of holding shares that have been excluded from the Sharī'ah-compliant list

It is understood that once a share is declared as Sharī'ah non-compliant, investors need, on the one hand, to dispose of that share as soon as possible and, on the other hand, to get back their principal amount. However, it is possible that an investor, particularly an institutional investor, sometimes holds a very large number of shares. To dispose of such a number at a price that enables recovery of the principal amount requires a very long period. It is possible that during this period, the share is included again in the Sharī'ah-compliant list. It is likely to happen in the case of companies whose activities or financial ratios marginally exceed the threshold.

In the methodology of ISRA-Bloomberg, it is allowed for the investors to hold such shares, and they do not need to dispose of them. However, the issue here is how to decide whether or not a difference of ratio is marginally above the threshold. For instance, if a company's debt ratio exceeds 33 per cent of its 24-month average market capitalisation, how can it be decided whether or not the difference is marginal? According to the methodology of ISRA-Bloomberg, a difference of 5 per cent can be tolerated. Nevertheless, it is important to be clear that the original benchmarks of the ratios remain as they are and continue to apply in general and that this extra 5 per cent is tolerated only for this particular scenario. In this scenario, investors do not need to immediately dispose of the shares which have been excluded from the Sharī'ah-compliant list because of a marginal difference of only 5 per cent. Moreover, there are three main requirements which need to be fulfilled in this scenario:

- Any impermissible income received in the form of dividends should be channelled to charity. This is to ensure that only cleansed income is realised by Muslim investors.
- Investors need to continuously monitor the trend of the ratios specified in the criterion by taking into account interim financial reports of the company. Most publicly listed companies issue their interim financial reports on a quarterly basis or any other intervals. While holding shares under this scenario, investors must be more sensitive towards the movements in the trends or ratios of the company. Through interim financial reports, investors can get an indication of whether or not the company is likely to make its way back to the Sharī'ah-

compliant list. Investors may continue to hold the shares if the company is moving towards greater Sharī'ah compliance. On the contrary, investors should dispose of the shares if the company is heading in the wrong direction.

- If investors decide to sell the shares of such a company, any capital gains above the acquisition price or the price on the pronouncement date, whichever is higher, should be channelled to charity. In this case, the same principle of disposing of Sharī'ah non-compliant shares is applicable. This condition is applied to avoid any exploitation by investors through "arbitrage", whereby investors may benefit from the price movement during the holding period.

Limitations in the screening and cleansing processes and some recommendations

It is generally observed that many index providers and organisations performing Sharī'ah screening of stocks carry out stock screening and cleansing with due diligence. Similarly, the ISRA-Bloomberg methodology is also used with the best efforts to ascertain that the screening and cleansing processes are as accurate and thorough as possible. The accuracy and thoroughness of these processes are crucial in maintaining reliability of the output and market confidence. However, there are many limitations and major hurdles in performing these processes with precision. Some of them are highlighted in this section, along with some suggestions on how to minimise their negative effects.

The main source of information in determining the Sharī'ah non-compliant revenue of a company is its audited financial statements. These statements are not "current"; rather, they reflect the activities of a company that occurred during the previous financial year or period. This poses a great challenge in determining the amount of income to be cleansed. Therefore, the amount may not be an accurate reflection of the company's actual position during the period of dividend calculation, particularly when the dividend is distributed in the middle of the financial year. More accurate data could be supplied by companies if they wanted to do so. However, because this is not a requirement of any accounting standard or relevant regulatory body, the best available data are limited to the audited financial statements of a company. Some companies might provide a few interim statements in between the annual financial audited statements. However, these interim statements are not officially audited and, therefore, are not as reliable as the audited financial statements.

Another obstacle in screening and cleansing exercises is the format of financial audited statements. The statements are prepared in different forms according to regulations and requirements of different jurisdictions. Most jurisdictions have adopted International Financial Reporting Standards as the format for their financial reports. While some other countries use other standards. The point here is that these standards have not been designed to cater for matters related to the Sharī'ah. There is no requirement, for example, to differentiate between income from the sale of permissible and impermissible products or between placing capital in Sharī'ah-compliant or Sharī'ah non-compliant instruments. Therefore, the screening and cleansing methodology is only based on whatever information is available to the index providers or organisations carrying out screening or cleansing exercises.

Another main hurdle facing the screening and cleansing process is that, in most cases, screening and cleansing exercises are done by private organisations or index providers. There are few regulators that perform these exercises. In Malaysia, for example, the Sharī'ah screening of listed stocks is undertaken by the Shariah Advisory Council of the Securities Commission Malaysia (SAC-SCM). The SCM complies with the decision of the

SAC and publishes the list of Shari'ah-compliant stocks twice a year. However, in other countries, screening of stocks is generally performed by private organisations rather than by the regulatory authorities. For instance, both Dow Jones and FTSE have introduced global Islamic indices which track the performance of securities approved by their Shari'ah boards. Some others such as IdealRatings issue the list of Shari'ah-compliant stocks based on the criteria outlined by AAOIFI.

The main issue with private organisations performing screening of stocks is that they solely rely on the financial audited statements of companies. It is difficult for them to obtain more information. Regulators on the other hand, because of their authoritative position, can ask the companies to furnish more information for the purpose of screening their stocks. To elaborate further, let us assume that a company states in its financial audited statement that its income from the sale of food products is ten million. If a regulator is screening the company, it can ask the company to provide a detailed breakdown of impermissible and permissible food items if there is any. The company has to supply the required information. In contrast, private organisations cannot ask the company to provide the required information. Therefore, screening done by regulators is sometimes more accurate because of extra information that they can acquire from the companies.

However, it is also important to highlight here that a regulator's authority is limited to its own jurisdiction only. The authority of the SCM, for example, is limited only to the companies listed on Bursa Malaysia (Malaysian Stock Exchange). It does not have authority to ask a company listed on the Singapore Stock Exchange to provide such information. That is why it can be observed that, in general, regulators only screen companies which are listed on the stock exchange of their own jurisdictions. On the contrary, private organisations screen companies based on their own database without such restriction.

Conclusion

This paper explains the Shari'ah screening and cleansing criteria for shares with particular focus on the ISRA-Bloomberg's methodology in both aspects. The ISRA-Bloomberg methodology is based on the best efforts from ISRA and Bloomberg by combining Shari'ah expertise, market data and analytics. It is not only unique in the sense that its methodology relies on stronger Shari'ah justification and rationale but also exceptional in terms of coverage of stocks as Bloomberg is one of the world's most renowned databases because of its comprehensiveness. Leveraging on such synergy between ISRA and Bloomberg, the methodology may add a new dimension to the Shari'ah screening of stocks and cleansing exercise.

In terms of specific features, the ISRA-Bloomberg platform boasts a novel colour-coding approach which would provide knowledge of the status of a particular share that is easy for the users/investors to interpret. Moreover, it also provides the exact ratios of the Shari'ah compliance criteria to facilitate the investors closely observing changes in the trend of ratios. That would enable investors to decide whether or not a company is likely to remain within the tolerable benchmarks of the Shari'ah-compliance criteria. Finally, the formulas used for the financial ratios in the Shari'ah-compliance criteria are taken based on the best practice approach, which may or may not concur with most of the current leading Shari'ah stock screening providers.

Subsequently, this paper discusses cleansing of the income or profit from the Shari'ah perspective and how it should be applied in the context of stocks. Understanding the cleansing process of the income or profit generated from stocks is pivotal for managing and maintaining a Shari'ah-compliant stock portfolio.

It is believed that the methodology of Shari'ah screening and cleansing of stocks will be well received in the global market and will enhance the Shari'ah screening of shares and income cleansing exercises worldwide.

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