Because they comply with *shariah* law, Islamic firms – financial as well as non-financial – behave differently from their conventional counterparts. While we know a lot about the structure and operation of Islamic financial institutions, information on Islamic non-financial corporations is very limited. This book combines technical as well as non-technical information on Islamic listed corporations and their structures and strategies, from several dimensions. The contents of this book will be particularly useful for academics to gain an in-depth view of Islamic corporate finance, with evidence garnered from around the globe.

—Professor Dr. Habib Ahmed
*Durham University, UK*

In recent years the Islamic financial services industry has seen astonishing, double-digit global growth, mostly in the form of financial firms (Islamic banks, microcredits, and others). However, the existing literature provides minimal coverage of the underlying corporate finance assumptions and relevant financing strategies of non-financial *shariah*-compliant corporations which engage in *halal* business – that permitted by *shariah* law. This book covers regular topics in corporate finance, such as performance matrix/measures, capital structure, dividend policy, and pertinent corporate finance issues, from the perspective of Islamic corporations. The book will help both corporate leaders and academics to arrive at a deeper understanding of Islamic corporate financing, especially in emerging economies.

—Dr. Syed Musa Bin Syed Jaafar Alhabshi
*Dean, International Islamic University Malaysia (IIUM)*
*Institute of Islamic Banking and Finance, Malaysia*
Most existing texts covering topics in Islamic finance discuss the potential of Islamic banking; very few talk about other forms of financing and the investment activities of Islamic firms from the standpoint of owners and managers. This book fills this gap by looking at the traditional as well as non-traditional financing and investment activities of *shariah*-compliant companies.

The chapters in this edited text offer a full range of topics in corporate finance for Islamic firms, including global comparisons of *shariah* screening, dividend policy and capital structure of Islamic firms, details of global Islamic equity markets, trends and performance of *sukuk* markets, and a brief account of derivative securities that can be used in Islamic finance. This is a useful reference for anyone who wishes to learn more about the performance of *shariah*-compliant companies vis-à-vis conventional firms. The book includes both technical and non-technical information that would be suitable for classroom teaching as well as a reference for postgraduate research students.

**M. Kabir Hassan** is Hibernia Professor of Economics and Finance, and Bank One Professor of Business at the University of New Orleans, Louisiana, USA.

**Mamunur Rashid** is Senior Assistant Professor of Finance at the Universiti Brunei Darussalam.

**Sirajo Aliyu** is Senior Lecturer at the Federal Polytechnic Bauchi-Nigeria, and a certified member of the International Council of Islamic Finance Educators and Chartered Institute of Islamic Finance Professionals.
ISLAMIC CORPORATE FINANCE

Edited by M. Kabir Hassan, Mamunur Rashid and Sirajo Aliyu
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CONTRIBUTORS

Md. Faruk Abdullah is Senior Lecturer at the School of Banking and Finance, Faculty of Economics and Management Sciences, University of Sultan Zainal Abidin, Kuala Terengganu, Terengganu, Malaysia.

Nasiru Abdullahi is Senior Lecturer in the Department of Business Administration, Ahmadu Bello University Business School, Zaria, Nigeria.

Mustapha Abubakar is Senior Lecturer in the Department of Banking and Finance, Ahmadu Bello University Business School, Zaria, Nigeria.

Sirajo Aliyu is Senior Lecturer at the Federal Polytechnic Bauchi, Nigeria and a certified member of the International Council of Islamic Finance Educators and Chartered Institute of Islamic Finance Professionals.

Zaheer Anwer is Director at the Lahore Centre of Excellence in Islamic Banking and Finance, The University of Lahore, Lahore, Pakistan.

Ali Ashraf is a financial economist and Associate Professor of Finance at Frostburg State University, Maryland, USA.

Lim Li Chern is a postgraduate student at the Nottingham University Business School, University of Nottingham Malaysia Campus.

Mohammad Ashraful Ferdous Chowdhury is Assistant Professor at the School of Management and Business Administration, Shahjalal University of Science and Technology, Bangladesh.
M. Kabir Hassan is Hibernia Professor of Economics and Finance, and Bank One
Professor of Business, at the University of New Orleans, Louisiana, USA.

Md. Shafiul Islam is Head of Operations at AM Securities Financial Services
Limited, Bangladesh.

Shamsher Mohamad Ramadili Mohamad is Professor at the International
Centre of Education in Islamic Finance, Kuala Lumpur, Malaysia.

Rasidah Mohd-Rashid is Senior Lecturer at School of Economics, Finance and
Banking, Universiti Utara Malaysia, Kedah, Malaysia.

Andrea Paltrinieri is Associate Professor at the University of Udine, Udine, Italy.

Ahsanur Rahman is Head of International Trade and Sales, BRAC EPL Stock
Brokerage Limited, Dhaka, Bangladesh.

Asmak Ab Rahman is Senior Lecturer at the Department of Shariah and
Economics, Academy of Islamic Studies, University of Malaya, Kuala Lumpur,
Malaysia.

Mamunur Rashid is Senior Assistant Professor of Finance at the Universiti Brunei
Darussalam.

Mohamed Eskandar Shah Mohd Rasid is Associate Professor at the International
Centre of Education in Islamic Finance, Kuala Lumpur, Malaysia.

Varun K. Sibdoyal is Assistant Manager at Deloitte Mauritius.

Ahmad Hakimi Tajuddin is Lecturer at Taylor’s Business School, Taylor’s
University, Selangor, Malaysia.

Andrew Saw Tek Wei is Lecturer of Finance at the Universiti Malaysia Sabah.

Ajim Uddin is PhD Candidate at the Martin Tuchman School of Management,
New Jersey Institute of Technology, USA.

Cheong Jiunn Yan is a postgraduate student at the Nottingham University
Business School, University of Nottingham Malaysia Campus.
Introduction to *shariah* screening

According to a Pew Research Centre study published in April 2017 (Lipka & Hackett, 2017), there were approximately 1.8 billion Muslims worldwide as at 2015. With regard to recent growth, Islam is the second largest religion in terms of total size and is often reported to be the fastest-growing religion in terms of its annual percentage growth. With this tremendous population growth follows the potential for more firms to adopt practices that adhere to Islamic *shariah* principles to satisfy this growing market. This is especially the case considering the fact that as more first-time Muslim customers become informed about their choices, they are likely to prefer banking with Islamic banks in addition to maintaining their accounts with conventional banks. This adherence is strictly maintained in some countries, while in others, Muslims still prefer having accounts in Islamic as well as conventional banks (Iqbal et al., 2018).

A key tenet of the Islamic faith is that Islam provides a perfect and all-encompassing guideline and law for all aspects and areas of life. This takes the form of *shariah* law, or Islamic jurisprudence, believed to be divine law revealed by Allah through His messengers and the Holy Book. The last prophet, Mohammad (peace be upon him), was an active businessman. The current day-trading-based banking or profit-and-loss sharing principles in the Islamic world come from the Prophet’s practices from some 1,400 years ago. Consequently, national economic authorities around the world, preferentially in Islamic jurisdictions, have established laws and requirements for companies to conduct business activities in accordance with and in harmony with Islamic law. These guidelines on business activities are well documented, whether codified in national legislation or in other forms, such as interpretations of scripture by *shariah* courts.
Under *shariah* law, Islamic businesses are forbidden from obtaining financing from banks that deal with interest (*riba*), invest despite excessive uncertainty (*gharar*), gamble (*maysir*), or engage in other non-*shariah* compliant activities. Understandably, this will influence the decisions of more religiously concerned Muslim customers to prefer *shariah*-compliant businesses as opposed to conventional businesses, as the former would be less likely to have intentions that would actively violate *shariah* law through their banking choices. Although guidelines on Islamic business activity are well documented, as with any theology and religious law, the interpretation and implementation of *shariah* law differs across different governments and jurisdictions around the world. In order to achieve sustainable growth in Islamic finance, it is necessary to obtain a clear understanding of the differences in *shariah* rulings across these jurisdictions. *Shariah* rulings must be integrated, standardized, and harmonized on an international basis to achieve sustainable growth. The subsequent parts of this chapter will illustrate several similarities and differences between *shariah* rulings across various jurisdictions.

**The start of the Islamic finance standard**

“The truthful and honest merchant is associated with the Prophets, the upright and the martyrs.” This mention by the Prophet (peace be upon him) of the ‘truthful and honest merchant’ in the seventh century, encouraging honesty and kindness when dealing with customers, is the earliest known form of Islamic finance (Haron et al., 2013). However, during its early conception and operation Islamic finance did not perform smoothly, as it met with many challenges at a time when other, mostly Western, countries had colonized Islamic countries. The revival of Islamic finance started sometime between the 1940s and 1950s when Islamic countries began pushing for independence and gaining international recognition. Even so, the establishment of modern Islamic banking, which started in Malaysia during the 1940s, is remembered as being unsuccessful, with a follow-up attempt in the form of the Myt Ghamir bank in Egypt being unfortunately also short-lived. Elsewhere, other oil-rich Islamic Middle Eastern countries started Islamic financial exercises to serve their growing Muslim populations.

Islamic finance gained momentum from 1999 onwards when Dow Jones attempted to create the world’s first Islamic index in Bahrain. This was quickly followed up by other equity providers such as the Shariah Advisory Council (SAC) from Malaysia. From this point onwards, Islamic finance experienced rapid growth and has since been acknowledged as a competitive alternative investment to its counterparts offered by conventional finance institutions. While the supply side – Islamic banking – has been experiencing tremendous growth in the Middle East, South Asia, and Southeast Asian countries, stakeholders have been sharing their sentiments about the need to strengthen the demand side of Islamic finance, i.e. Islamic businesses. The world has yet to witness a global or truly transnational Islamic corporation, as the screening processes involved for such corporations remain highly diverse. Table 1.1 shows that at least six commonly
used screening exercises are available at the present time. Due to limitations of the existing screening exercises, newer screenings are expected to be introduced in the coming years. Even though these screenings show some differences with respect to some individual industries (e.g. weapons and defense), there still exist major gaps in the screening criteria. This chapter hopes to summarize these criteria, to offer a direction towards future screening exercises.

**Shariah screening**

Muslims are prohibited from investing in businesses involved in activities classified as being non-shariah-compliant. It is often difficult to differentiate the compliant set of factors from the non-compliant set, owing to several financial, scientific, and social factors involved. Often, due to social customs, compliance from one factor becomes strongly non-compliant in others. For instance, payment of zakat (the mandatory amount of alms-giving on wealth for Muslims) by corporations is subject to the regulation and accounting practices of their respective legal jurisdictions.
(Rashid et al., 2017). However, when shariah screening is completed, the set of companies are passed based on rigorous procedures to ensure compliance to shariah. Shariah screening, in this respect, is illustrated as also assisting Muslims in their decisions regarding investment in compliant ventures.

Because of the importance of Islamic-compliant businesses to Muslims, the business community has witnessed continuous growth of Islamic funds (Islamic mutual funds, exchange traded funds, unit trusts, and other funds) all over the world (Sanusi, et al., 2015). Muslim investors should not solely prioritize profitability of their investments; the investment must equally be ethical and socially acceptable (Ulrich & Marzban, 2008). Since Islamic screening is based on best Islamic practice, the screening exercises can be employed to identify the best set of investment opportunities for Muslims. The investments are not only compliant in general, but are also said to be socially beneficial and ethically fit to ensure socio-economic justice (Hassan et al., 2019).

The Dow Jones Islamic Market (DJIM) Index was developed in conjunction with the rise of Islamic finance, becoming the world’s first Islamic equity screen provider. Not long after its formation, other equity providers such as the SAC and Standard & Poor’s (S&P) indices were developed to fulfil the growing demand for Islamic finance. Although these equity providers have different opinions on the factors determining good shariah screening criteria, there are several common principles that govern all equity providers engaged in the screening of shariah-compliant companies. Most importantly, the businesses must be permissible (halal) according to shariah (Natarajan & Dharani, 2012), as the prohibition of undesirable activities is believed to ensure social development and economic justice (Ibrahim & Ong, 2012).

All the screen providers follow a common two-stage method: qualitative followed by quantitative screening (Htay et al., 2013) (Figure 1.1). The qualitative

<table>
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<tr>
<th>Qualitative/activity screening</th>
<th>Quantitative/financial screening</th>
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<td>Qualitative screening is a process of screening out companies and business activities involved in prohibited activities. According to Standard &amp; Poor’s (2009), business activities which involve advertising and media, food and drinks containing alcohol, stem cell research, or financial services (except shariah-compliant financial services on deferred basis) are screened out because these business activities are deemed inappropriate to Muslim investors.</td>
<td>After selection of companies based on qualitative screening, quantitative screening is carried out on the companies’ audited annual reports. In quantitative screening, three aspects will be considered: leverage compliance, cash compliance, and the percentage of non-permissible revenue from non-compliant activities (Standard &amp; Poor’s, 2009).</td>
</tr>
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**FIGURE 1.1** Definition of qualitative and quantitative screening

*Source: Standard and Poor’s (2009).*
stage screens companies based on their core business activities (Ulrich & Marzban, 2009). Hence, the first stage of the qualitative screen is often called the “activity screen”. The quantitative stage involves financial ratio benchmarks, i.e. cash and debt ratios (Securities Commission Malaysia, 2017). These financial ratios typically identify the extent of involvement of Islamic corporations with traditional financing, interest, and their investment in interest income. The primary sources of this information are updates shown by the stock market and annual reports.

Across several national jurisdictions, the Shariah Supervisory Board (SSB) of each country reserves full rights to issue different screening criteria. Certain index providers such as the Financial Times Stock Exchange (FTSE), Morgan Stanley Capital International (MSCI), S&P, and Dow Jones have developed their own screening processes to screen and determine which companies and businesses are shariah-compliant for investment. One such example developed by Malaysia’s SAC is said to be an inappropriate model in Bosnia and Herzegovina because of its lack of consideration of companies’ liquidity of assets and indebtedness (Meskovic et al., 2012). On a similar note, the Dow Jones’s screening criteria utilizing market capitalization in the screening processes, which was meant to be replaced by balance sheet items, has instead attracted considerable scholarly criticism (Meskovic et al., 2012).

In this context, there are two major differences between existing screenings. Firstly, the classification of activities as compliant or not, in the first stage, is subject to expert opinion. Often, it is difficult to identify a core business activity, especially in cases where the company is highly diversified. Therefore, benchmarking is complex. Secondly, the threshold levels used for the financial ratios are subject to shariah explanations that are often criticized by several groups on at least two grounds. The first is that the one-third maximum debt level is not based on enough grounds for clear justification. The second is that the use of market capitalization, as opposed to total assets, to calculate some of the ratios has been criticised by experts (for this differentiation, see Table 1.2). It is important to note that unless they are listed on the stock market, according to some screen providers (e.g. AAOIFI, S&P, and DJIM), firms cannot be screened as they do not have market capitalization. This may limit the promotion of small non-listed firms that are being screened according to the shariah guidelines in place. This is particularly dangerous for countries like Bangladesh or Malaysia, where a major portion of manufacturing output is attributable to small and medium enterprises (SMEs).

Another major hurdle present in current screening exercises stems from the various accounting standards employed in different countries. While it is important to acknowledge the effort that Islamic countries put in to establish and comply with Islamic accounting practices, for the sake of maintaining greater harmonization in corporate reporting, the necessity for Islamic firms across the board to adopt common reporting formats, such as those in use by conventional firms, is non-negotiable. This lack of a common format has resulted in inconsistency in various stages in the aforementioned screening processes between different countries. Added to this is possible unreliability stemming from the fact that the SSB will only use the available audited statements as provided by the company (Hashim et al., 2017).
<table>
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<th>Screens</th>
<th>DJIM</th>
<th>S&amp;P</th>
<th>SAC</th>
<th>FTSE</th>
<th>MSCI</th>
<th>AAOIFI</th>
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<td>Leverage compliance</td>
<td>Total debt/12-month average market capitalization ≤33%</td>
<td>Debt/36 months average market capitalization ≤33%</td>
<td>Debt/total assets ≤33%</td>
<td>Debt/total assets ≤33%</td>
<td>Debt/total assets ≤33%</td>
<td>Interest bearing debt/ average market capitalization ≤30%</td>
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<td>Cash compliance</td>
<td>Account receivable/12-months average market capitalization ≤33%</td>
<td>Account receivable + cash/36-month average market capitalization ≤49%</td>
<td>-</td>
<td>Account receivable + cash/total assets ≤50%</td>
<td>Account receivable + cash/total assets ≤70%</td>
<td>Cash + deposits + account receivable/ market capitalization ≤67%</td>
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<td>Revenue from non-compliant activities and total interest</td>
<td>Revenue from haram+ total interest/36-month average market capitalization ≤5%</td>
<td>Revenue from haram+ total interest/total assets ≤5%</td>
<td>Revenue from haram+ total interest/total assets ≤5%</td>
<td>Revenue from haram+ total interest/total assets ≤5%</td>
<td>Revenue from haram+ total interest/total assets ≤5%</td>
<td>Revenue from haram+ total interest/total assets ≤5%</td>
</tr>
<tr>
<td>Cash and interest-bearing items</td>
<td>Cash + interest bearing items/12-months average market capitalization ≤33%</td>
<td>Cash + interest bearing items/36-month average market capitalization ≤33%</td>
<td>Cash (excluding Islamic account)/total assets ≤33%</td>
<td>Cash + interest bearing items/ total assets ≤33%</td>
<td>Cash + interest bearing items/ total assets ≤33%</td>
<td>Cash + deposit + interest bearing items/ total assets ≤30%</td>
</tr>
</tbody>
</table>

Table 1.2 shows in greater detail the differing quantitative screening criteria from six providers of equity indices. For instance, according to the AAOIFI interest-based debt must be less than 30%, but the DJIM, FTSE, S&P, and MSCI allow up to 33% or 33.33% of interest-rate-based debt. While the DJIM makes it compulsory to review companies based on the level of debt, liquidity, and interest income, the SAC only focuses on reviewing the core activities and the level of interest-based income of a company. However, the SAC has recently updated its quantitative screening processes, in which financial ratios such as cash over total assets and debt over total assets are made compulsory for all shariah-compliant companies (Securities Commission Malaysia, 2017).

**Shariah-compliant corporate universe**

Several studies have attempted to find an estimate of the size of the shariah-compliant corporate universe. Derigs and Marzban (2008) considered the S&P 500 index and reported that for 28% of cases (for 387 stocks), screening methodologies are decidedly and significantly diverse. Their study not only illustrates the niche that shariah-compliant corporations inhabit as being miniature in size, but also the lack of harmonization among its screening providers. Using data obtained about Malaysian firms, Abdul Rahman et al. (2010) reported that only 21% of the SAC-screened firms are deemed to be shariah-compliant according to DJIM and SAC guidelines. These results indicate that SAC guidelines may not be compatible with other internationally accepted screening exercises. A study by Adedokun and Rashid in 2019 of compliant firms from Nigeria, using the financial ratios applied by several screen providers, reported significant dissimilarities between Nigerian standards and the standards set by the SAC and DJIM, among others. Using only the financial screening, the study also discovered the Malaysia-based shariah index to be less stringent than the likes of DJIM and FTSE.

Hassan et al. (2019) created an Islamic Business Scorecard and replaced the activity screening by factoring in social and ethical compliances. Their study on Malaysia, Pakistan, and Bangladesh reported around 50% compliance (70% in Malaysia) to shariah rules in these countries. However, after the financial screening was taken into account, compliancy rates dropped to almost 20%. Their study concluded that companies mostly fell short of compliancy primarily due to financial factors. Because Islamic capital market activities and opportunities are limited, Islamic firms are forced to engage with non-Islamic financing, driving them out of the compliancy zone.

**Limitations of existing shariah screening: ethical and social responsibility issues**

Equity index providers around the world provide guidelines for shariah-compliant companies based on shariah principles. However, these authorities only focus on transactions prohibited in shariah law such as the concept of riba
Mamunur Rashid and Andrew Saw Tek Wei

(interest), *gharar* (uncertainty), and *maysir* (gambling), but show limited or no concern towards the ethical and social responsibilities which *shariah*-compliant companies should be engaged. Many Islamic scholars believe that equity index providers should not focus purely on screening *shariah*-compliant companies by means of financial ratios and examining their business activities, but should also include a separate ethical and social responsibility screening stage that strives to encourage companies to comply with this aspect of Islamic law. Priority must be given to how ethical and *shariah*-compliant companies contribute to society. The Ethical Identity Index (EII) by Haniffa and Hudaib (2007) offers a test by which to decide whether or not a company is compliant with Islamic ethical conduct. Adopting EII, several studies have conducted various ethical identity compliancy tests for Islamic firms (Rashid and Hassan, 2014; Hassan et al., 2010).

*Islamic Business Scorecard*

The Islamic Business Scorecard (IBS), proposed by Hassan et al. (2019), combines *shariah* screening processes, ethical identity scores, and corporate social responsibility indices into a single scorecard. The IBS marked the beginning of the introduction of a holistic *shariah* screening process, which can be employed to screen *shariah*-compliant firms. Figure 1.2 shows the components of the IBS.

![Figure 1.2 Components of the Islamic Business Scorecard](source)

**Figure 1.2** Components of the Islamic Business Scorecard

*Source:* See Hassan et al. (2019) for a detailed view of the IBS.

*Ethical Identity Index*

The EII was formulated as a tool to study the differences between the communicated ethical identity and the ideal ethical identity of *shariah*-compliant companies. Communicated ethical identities have a common problem in that absence of communication does not necessarily indicate absence of activity. EII is an ideal ethical identity benchmark that complies with the principles of *shariah*. An ideal ethical identity benchmark must also govern all aspects of Muslims’ lives, promote justice (*al-adl*) and the welfare of society (*al-ihsan*), acquire God’s blessings (*barakah*), and be successful in life (*al-falah*). The EII is founded upon eight dimensions, as follows:

1. Vision and mission statements,
2. Board of directors and top management,
3. Product and services,
4. Zakat,
5. Charity and benevolent loans,
6. Commitments towards debtors,
7. Commitments towards society, and
8. Shariah Supervisory Board (SSB).

**Corporate social responsibility**

Corporate social responsibility (CSR) is an umbrella term that defines and incorporates the tenets of a sustainable environment, ethics in business, corporate governance, public relations, and analysis of stakeholders and relationship marketing. CSR is also viewed as a medium for corporations’ communications with their stakeholders.

Discussions concerning CSR became prominent in the wake of scandals involving major corporations such as Enron and Tyco. The earliest implementation of modern CSR started during the 1920s. However, records from the 1920s show that at the time CSR was limited to the use of personal funds in social responsibility projects and issues, at the discretion of businessmen and in their own private time, usually after working hours. Today, CSR has developed into many categories, including public relations, services, trusteeship, and public welfare. The first known corporation that publicly disclosed its CSR activities was the Hongkong and Shanghai Banking Corporation (HSBC) back in 2003. HSBC disclosed its social initiatives in environmental protection, education support, and development of the arts.

Social ills such as poverty, unemployment, discrimination, and pollution have heightened awareness and public debate on the role of CSR (Barom, 2015). In Western countries, CSR is seen as a means of ingratiating capitalism with a public always suspicious about the overreaching exploitation of their individual interests by large corporations. By contrast, Islamic CSR gravitates towards a more holistic approach, as it is based on the teachings of the Quran and the Sunnah (the practices of the Prophet, peace be upon him) and focuses on human beings’ interaction with nature and their fellow humans. CSR in the Islamic perspective can be traced to the concept of ihsan (benevolence) which requires Muslims to share and promote kindness to other people as part of their responsibility to society.

CSR in Islam follows the concept of khalifah (viceregency) under shariah. Under the concept of khalifah, “a company must act as a steward to its shareholders’ financial resources, and society’s economy, benefiting society and attaining the blessings of God” (Dusuki, 2008). Hence, shariah-compliant companies must achieve good CSR practices to ensure a sustainable environment, health and safety at work, philanthropic contributions, and activities that do not harm society. Figure 1.3 summarizes the concept of CSR in Islam.

Rashid et al. (2013) explain CSR using the model of a two-tiered social and ethical responsibility for Islamic banks, aptly named “customer-centric CSR for banks”. Figure 1.4 shows their ethical efficiency framework. The framework also
functions as a learning ground for shariah-compliant firms and is compatible for integration with the proposed Islamic business scorecard by Hassan et al. (2018).

Summary

Shariah-compliant businesses are important to Muslim investors, since shariah compliance helps Muslims to avoid potential involvement in activities prohibited by Islam, such as riba (interest), gharar (uncertainty), and maysir (gambling). To guide Muslims with decisions relating to shariah-compliant businesses, equity index providers such as Dow Jones and the Shariah Advisory Council provide a set of shariah rules that serve as a guideline for defining shariah-compliant businesses. Shariah screening is the process of screening out shariah-compliant businesses from their conventional counterparts. In practice, however, shariah screening processes may vary depending on the equity index providers and legal jurisdictions involved. These differences result in inconsistencies in the shariah screening processes across countries. Furthermore, while the shariah screening process combines both qualitative and quantitative criteria, it ignores the ethical and social compliancy aspects that shariah-compliant businesses are meant to adhere to, as outlined by scripture. Islamic scholars have commented that ethical and social issues must be addressed by shariah-compliant businesses on top of the basic activity and financial screenings.

Multiple social and ethical models exist that can help to explain the role of ethics and CSR in screening exercises. The Ethical Identity Index (Haniffa and Hudaib, 2007) is a comprehensive ethical screening tool that can be employed for both Islamic and conventional firms to estimate the degree of their respective ethical practices. Several studies (Rashid and Hassan, 2014; Rashid et al., 2017; Hassan et al., 2010) have incorporated the Ethical Identity Index in different contexts, reporting it to have significant implications for Islamic firms. Barom (2015) explained three components of CSR that could be applied on the Islamic
firms. These components are (1) contributions to the eradication of poverty, (2) contributions towards societal development, and (3) contributions to safeguarding the environment. Hassan et al. (2019) combined ethical and social components, as outlined by Haniffa and Hudaib (2007), and the CSR components explained by Barom (2015), alongside the basic activity screen offered by DJIM, to establish the first Islamic “business scorecard” for shariah-compliant firms. Their model not only offers a holistic view of Islamic business activities, but also presents a framework for the comprehensive screening out of shariah-compliant firms from their non-compliant counterparts. The future of Islamic investment largely depends on efforts regarding how these screening exercises are harmonized across disparate legal jurisdictions.

**Performance of shariah-compliant firms**

During the 1990s, Islamic funds experienced a boom due to growing awareness and demand for shariah-compliant capital by Muslims from around the world (Sanusi et al., 2015). For religiously informed Muslims, investment is not solely dependent on profitability; rather, it is understood as a channel to holistic socio-economic development. Hence, the performance of shariah-compliant firms can be imagined as a yardstick of the overall socio-economic performance within a selected country. Shariah-compliant companies are companies compliant with Islamic (shariah) principles and approved by an established advisory board (e.g.
the Shariah Advisory Council of Securities Commission in Malaysia). Shariah-compliant companies rely on the concept of fair profit-and-loss sharing, prohibiting speculation and the involvement of interest payments (riba) (Beck et al., 2013). Because of these attributes, the performance of shariah-compliant companies may vary from the performances achieved by their conventional counterparts. Hence, there exists a need to fully understand the differences between the performances of shariah-compliant and conventional companies.

In this section, a common set of financial ratios will be employed to evaluate and compare the performance of shariah-compliant and conventional companies. A list of selected Malaysian non-financial companies, shariah-compliant and conventional, from the years 2014 to 2016, have been chosen for this evaluation purpose. Based on total assets, the top and bottom five shariah-compliant and the top and bottom five conventional companies are compared. Table 1.3 gives details of the ratios used.

**Liquidity ratios**

Liquidity ratios are an important indication of a company’s ability to meet its debt obligations. These ratios include the current ratio, quick ratio, and cash ratio. Referring to the trade-off hypothesis, firms and financial institutions that hold more in liquid assets will face lower default risk and bankruptcy costs while having higher debt raising capabilities (Bitar et al., 2017).

<table>
<thead>
<tr>
<th>Key financial ratios</th>
<th>Ratio</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liquidity ratios</strong></td>
<td>Current ratio</td>
<td>Current assets/ current liability</td>
</tr>
<tr>
<td></td>
<td>Quick ratio</td>
<td>(Current assets – inventory)/ current liabilities</td>
</tr>
<tr>
<td></td>
<td>Cash ratio</td>
<td>Cash and cash equivalent/ current liabilities</td>
</tr>
<tr>
<td><strong>Efficiency ratios</strong></td>
<td>Inventory turnover ratio</td>
<td>Sales/average inventory</td>
</tr>
<tr>
<td></td>
<td>Receivable turnover ratio</td>
<td>Sales/average receivable</td>
</tr>
<tr>
<td></td>
<td>Asset turnover ratio</td>
<td>Sales/total asset</td>
</tr>
<tr>
<td><strong>Debt management ratio</strong></td>
<td>Debt to asset ratio</td>
<td>Total debt/total assets</td>
</tr>
<tr>
<td><strong>Profitability ratios</strong></td>
<td>Long term debt to asset ratio</td>
<td>Long term debt/total assets</td>
</tr>
<tr>
<td></td>
<td>Profit margin ratio</td>
<td>Net income/sales</td>
</tr>
<tr>
<td></td>
<td>Return on assets</td>
<td>Net income/total assets</td>
</tr>
<tr>
<td></td>
<td>Return on equity</td>
<td>Net income/equity</td>
</tr>
<tr>
<td><strong>Market value ratios</strong></td>
<td>Earnings per share</td>
<td>Net income/common share outstanding</td>
</tr>
<tr>
<td></td>
<td>Price earnings ratio</td>
<td>Market price/earnings per shares</td>
</tr>
<tr>
<td></td>
<td>Market to book ratio</td>
<td>Market price/book value</td>
</tr>
</tbody>
</table>

*Source: Based on Singh and Schmidgall (2002) and Linares-Mustarós et al. (2018).*
Screening of *shariah*-compliant companies

The current ratio is used to measure the ability of a company to pay its short-term obligations and is measured by dividing its current assets by its current liabilities (Linares-Mustarós et al., 2018). When the current ratio is below 1, it indicates that a company’s liabilities are greater than what the company holds in assets, thus suggesting that the company in question could have difficulty in meeting its short-term obligations. As can be seen from Figure 1.5, the current ratios for the top five conventional firms remained above 1 throughout the three years in question, while the current ratios for the top five *shariah*-compliant firms fell below 1 for the same period. The results indicate that the top five *shariah*-compliant firms were relatively less healthy in terms of meeting their short-term obligations compared to their conventional counterparts. Like the top five conventional firms, the lowest five conventional firms all had a current ratio above 1, indicating that the current assets of those firms were able to match the obligations of their current liabilities. However, unlike the top five *shariah*-compliant firms, the lowest five *shariah*-compliant firms had a current ratio above 1, indicating that the lowest five *shariah*-compliant firms were better able to meet their short obligations. Overall, the conventional firms are shown to have been more liquid than the selected Islamic firms.

**Quick ratio**

The quick ratio (also known as the acid test ratio) is a similar measure but based on the immediate liquid position of a company (Atieh, 2014). Unlike the current ratio, the quick ratio compares the most liquid assets to the company’s current liabilities. The quick ratio is taken by dividing the company’s current assets (excluding inventory) by its current liabilities (Linares-Mustarós et al., 2018). Figure 1.6 shows that the quick ratio of the top five conventional firms remained above 1 for
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all three years, indicating that the proceeds from their most liquid current assets would be able to satisfy their short-term obligations. As before, compared to the *shariah* firms, the conventional firms enjoyed better quick liquidity.

**Cash ratio**

The cash ratio measures the extreme conservative point of a company’s liquidity (Atieh, 2014). Unlike the current and quick ratios, the cash ratio only takes cash into account, omitting other current assets as used in calculating current and quick ratios, under the assumption that the cash held by the company represents the most liquid asset held relative to its other current assets. The cash ratio is measured by dividing cash and cash equivalents by the company’s current liabilities. Figure 1.7 shows the cash ratios of the top five conventional firms to have been above 1 in 2014 and 2016, although dipping to slightly below 1 during the year, 2015. On the other hand, the results from the top five *shariah*-compliant firms indicate a poor cash ratio, below 0.3 in all three years. To compare, the lowest five conventional firms all have a cash ratio above 1 for the years 2015 and 2016, only falling slightly below 1 in 2014. While the lowest five *shariah*-compliant firms fared better than the top five *shariah*-compliant firms, their cash ratio remained below 1 in all three years.

The poor liquidity ratios of the top five *shariah*-compliant firms could be a result of the revised *shariah* screening methodology that was introduced in Malaysia, commencing on the 18 June 2012 (Zainudin et al., 2014). The revised *shariah* screening issued by the Shariah Advisory Council (SAC) of the Securities Commission (SC) of Malaysia is intended to measure *riba*-based elements by restricting the ratio of cash to total assets ratio to less than 33%. This restricts the amount of cash available to *shariah*-compliant companies. Although the top five *shariah*-compliant firms performed poorly in terms of liquidity ratios, as
stated above, the revised *shariah* screening requirement for the debt over total assets ratio of *shariah*-compliant companies to not exceed 33% still stands. This ensures that the debt obligations of *shariah*-compliant companies are sustainable (Zainudin et al., 2014).

**Efficiency ratios**

Efficiency ratios measure a company’s ability to utilize its assets and liabilities efficiently. Efficiency ratios include the inventory turnover ratio, the receivables turnover ratio, and the asset turnover ratio.

**Inventory turnover ratio**

The inventory turnover ratio shows how many times a company has sold and replaced its inventory in a given period. The inventory turnover ratio is measured by dividing the cost of goods sold by its average inventory. Figure 1.8 shows that the top five conventional firms reported inventory turnover ratios of 4.10, 3.58, and 3.27 for the years 2014, 2015, and 2016 respectively. In comparison, the top five *shariah*-compliant firms performed better in terms of their inventory ratios, with ratios of 11.78, 7.49 and 7.41 for the years 2014, 2015, and 2016 respectively. Similarly, the lowest five *shariah*-compliant firms outperformed the lowest five conventional firms in terms of their inventory turnover ratios.

**Receivables turnover ratio**

The receivables turnover ratio is a measure of a firm’s efficiency in collecting debts on credit. A high receivables ratio indicates greater efficiency in a company’s ability to collect receivables and suggests a high chance that the firm in question
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is operating on a cash basis. Receivables turnover is measured by dividing sales by average receivables. Figure 1.9 shows that the receivables turnover ratios of the top five *shariah*-compliant firms exceeded those of the top five conventional firms, while the lowest five *shariah*-compliant firms outperformed the lowest five conventional firms.

**Total asset turnover ratio**

The asset turnover ratio measures how efficiently a company deploys its assets to generate sales. Asset turnover ratio is measured by dividing sales by total assets. As can be seen from Figure 1.10, the total asset turnover ratio of both the top
five conventional and the top five shariah-compliant companies were similar throughout the three years. Besides this, Figure 1.10 also shows that the lowest five shariah-compliant companies outperformed the lowest five conventional firms; the latter performed poorly, with lower reported values for their asset turnover ratios.

Overall, Figure 1.10 shows Islamic firms to be more efficient than their conventional counterparts in inventory, receivables, and total asset management.

**Debt management ratio**

Debt management ratios are an important indication of how efficiently a company manages its debts, and include the total debt ratio and the long-term debt ratio.

**Debt-to-asset ratio**

The debt-to-asset ratio measures the amount of assets a company holds against its debt and serves as an indicator of financial risk in a firm; a higher debt-to-asset ratio indicates a higher financial risk. From Figure 1.11, conventional firms seem to have higher debt-to-asset ratios compared with shariah-compliant firms, illustrating this higher financial risk. As a consequence of the obligatory screening processes to which shariah-compliant companies in Malaysia are subjected (the debt-to-asset ratio of these firms must be below 33%), the debt-to-asset ratios of shariah-compliant firms are reported to be lower than those of conventional firms.

**Long-term debt ratio**

The long-term debt ratio measures the amount of assets held by a company that are being financed with long-term debt; as before, a higher long-term debt ratio indicates greater financial risk. As shown by Figure 1.12, conventional firms have
higher long-term debt ratios than shariah-compliant firms, indicating the higher financial risks of conventional firms. The long-term debt ratios for the top five shariah-compliant firms are reported to be around 20%, indicating 10% of short-term debt for these firms (assuming a maximum of 30% total debt).

**Profitability ratios**

Profitability ratios are a measure of a company’s ability to generate earnings to pay for their running expenses within a specific time-frame. Profitability ratios include the profit margin ratio, the return on assets, and the return on equity.
Screening of *shariah*-compliant companies

**Profit margin**

The profit margin measures the income earned by a company as a percentage of its sales figures; a higher profit margin indicates a higher income per unit of sale. It is calculated by dividing net profit over sales. Figure 1.13 shows the profit margin of the top five conventional firms remaining steady over the period, with each year achieving profit margin figures above 10%. While the profit margin of the top five *shariah*-compliant firms were reported to be higher than the top five conventional firms for 2014 and 2015, their profit margin fell considerably from 12% in 2015 to 5% in 2016. The lowest five *shariah*-compliant firms underperformed compared to the lowest five conventional firms, with negative profit margins for both 2014 and 2015, meaning that costs incurred exceeded revenue earned.

**Return on assets**

The return on assets measures income earned as a percentage of what a company holds in assets; a higher return on assets indicates a higher income per asset used in the running of a company. The return on assets is calculated by dividing net income by average total assets (Singh & Schmidgall, 2002). As Figure 1.14 shows, the return on assets of the top five conventional firms remained steady over the period between 2014 to 2016. While the return on assets of the top five *shariah*-compliant firms outperformed that of the top five conventional firms for both 2014 and 2015, the top five conventional firms outperformed the top five *shariah*-compliant firms in 2016. The lowest five conventional firms’ value of return on assets for the three years stood at zero, while the lowest five *shariah*-compliant firms achieved negative values during for both 2014 and 2015, before subsequently achieving 8% of return on assets during the year 2016.

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**TABLE 1.1** Profit margins for top five conventional and *shariah*-compliant firms, and lowest five conventional and *shariah*-compliant firms, 2014–2016 (in %)

<table>
<thead>
<tr>
<th>Year</th>
<th>Top 5 conventional firms</th>
<th>Top 5 <em>shariah</em>-compliant firms</th>
<th>Lowest 5 conventional firms</th>
<th>Lowest 5 <em>shariah</em>-compliant firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>11.29</td>
<td>12.77</td>
<td>0.84</td>
<td>-12.73</td>
</tr>
<tr>
<td>2015</td>
<td>10.14</td>
<td>11.87</td>
<td>1.22</td>
<td>-8.90</td>
</tr>
<tr>
<td>2016</td>
<td>11.59</td>
<td>4.76</td>
<td>2.37</td>
<td>14.07</td>
</tr>
</tbody>
</table>

**FIGURE 1.13** Conventional vs *shariah*-compliant firms, 2014–2016: Profit margin

*Source:* Authors’ own.
Return on equity

Return on equity measures the percentage of income derived from equity, with a higher return on equity indicating higher income per equity; it is calculated by dividing the net income of a company over its equity. The return on equity of the top five conventional firms remained steady over the three-year period from 2014 to 2016. While the return on equity of the top five shariah-compliant firms outperformed that of the top five conventional firms for both 2014 and 2015, the situation was reversed in 2016. The lowest five conventional firms achieved a value of return on equity of zero in all three years, while the lowest five shariah-compliant firms reported negative values for both 2014 and 2015 before reaching a 12% of return on equity in 2016.

Overall, Islamic firms are reported to be more profitable than their conventional counterparts. This is true for almost all the compared ratios.
Screening of shariah-compliant companies

Market value ratios evaluate the value of a company’s stock price and include the earnings per share, price–earnings ratio, and market-to-book ratio.

Earnings per share

Earnings per share measures the portion of firm’s profit allocated to each common share held in a company and is measured by dividing net income by the number of common shares outstanding (Singh & Schmidgall, 2002). Earnings per share is an important indicator of a share’s price. Since conventional firms dominate the Kuala Lumpur Stock Exchange (KLSE), the top five conventional firms had higher earnings per share throughout the three years compared to the top five shariah-compliant firms. Due to their reported negative earnings, the lowest five shariah-compliant firms similarly showed negative earnings per share for both 2014 and 2015 (Figure 1.16). This changed in 2016 when the lowest five shariah-compliant firms reported positive and higher earnings per share than the lowest five conventional firms. Although the shariah-compliant firms reported higher incomes for the period, their earnings per share may have been balanced out by their holding a higher level of shares outstanding.

Price–earnings ratio

The price–earnings ratio measures the share price relative to the earnings of a company. It indicates how much an investor is willing to pay in order to receive one ringgit (or dollar, or other currency) of a company’s earnings and can be calculated by dividing the market price per share by the earnings per share (Singh & Schmidgall,
The price–earnings ratio of the top five conventional firms remained steady throughout the three years, at values from 8.07 to 9.30. The price–earnings ratios for the top five shariah-compliant firms remained steady for both 2014 and 2015, with an increase reported in 2016. Figure 1.17 shows that the lowest five conventional firms achieved significantly higher price–earnings ratios, while the lowest five shariah-compliant firms achieved negative price–earnings ratios in both 2014 and 2015 due to the negative average earnings reported during the period. However, the lowest five shariah-compliant firms achieved positive price–earnings ratios in the following year as their earnings improved compared to the previous two years.

**Market-to-book ratio**

The market-to-book value measures the value of a company as determined by the market relative to the values reported in the published accounts of the company (‘book value’), and is calculated by dividing the market price of a share over the book value per share. When the market-to-book value is above 1, it indicates an overvalue in the company’s shares and vice versa for when the market-to-book value falls below 1. From Figure 1.18 it will be seen that the market-to-book values for the top five conventional firms are slightly below 1, indicating that the conventional firms were slightly undervalued throughout all three years. By comparison, the market-to-book values for the top five shariah-compliant firms are closer to 1, with figures above 1 achieved for both 2014 and 2015, and falling below 1 in 2016. The lowest five conventional and shariah-compliant firms achieved poor market-to-book values in comparison, standing at figures that are far below 1, meaning that their shares are described as undervalued.

In conclusion, the comparison between market value ratios from conventional and shariah-compliant firms yielded mixed results, indicating no clear
Screening of *shariah*-compliant companies

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winner. Conventional firms fared better with higher earnings per share and price–earnings ratios than *shariah*-compliant firms. *Shariah*-compliant firms, however, performed relatively better in terms of market-to-book ratios, indicating a better shares market performance compared to conventional firms.

Summary

The performances of conventional and *shariah*-compliant firms vary in terms of measurements of liquidity, debt management, profitability, and market value. Owing to the more stringent screening criteria of *shariah*-compliant firms, the liquidity ratios and debt management ratios of these companies are also affected indirectly. An example of this exists in the requirement whereby *shariah*-compliant firms in Malaysia are prevented from holding more than 33% debt over total assets and cash over total assets. As the concerns of Muslim investors do not relate solely to the profitability of the companies that they may choose to invest in, they will continue to prefer investments in more *shariah*-compliant companies that will allow them the spiritual peace of mind that they are not indirectly engaging in business practices that contradict Islamic (*shariah*) law, but rather reflect its values.

Notes

Chapter 2


Notes

3 The details of SRI screening methodology can be viewed at http://us.spindices.com/documents/methodologies/methodology-dj-sustainability-indices.pdf

4 The details of shariah screening methodology can be viewed at http://us.spindices.com/documents/methodologies/methodology-dj-islamic-market-indices.pdf


6 This hypothesis states that people shy away from investing in socially controversial stocks that have a negative image attached to them, and as a result these stock carry higher risk due to lesser liquidity.

7 In order to design the shariah and market proxy portfolios, we utilized the constituent lists of the Dow Jones US Index and Dow Jones Islamic Markets Index – US. This data is not publicly available and we purchased it directly from Dow Jones through a research grant extended by BNP Paribas – INCEIF Centre for Islamic Asset and Wealth Management, Malaysia. We are thankful to them for this gesture.

8 The details of these shariah compliance screens are provided in the appendix to this chapter. The complete screening methodology can be viewed at https://us.spindices.com/index-family/Shariah/all.

9 www.nber.org/cycles.html

10 The complete list may be viewed at www.census.gov/eos/www/naics/ (retrieved on 15 May 2017)


Chapter 8

1 Shariah does not allow investment in debt-based instruments like bonds, commercial papers and mortgage-backed securities or instruments based on notional assets or involving high risk, e.g., derivatives, and permissible equity instruments are mutual funds and common stocks (Hayat, Den Butter, & Kock, 2013). Dow Jones and other vendors employ two sets of criteria, namely ‘line-of-business screens’ and ‘financial ratio screens’ when deciding the investment universe. These screens are subsequently used to constitute various shariah indices. These shariah screening results are endorsed by a board of highly renowned independent shariah scholars. The first criterion is qualitative and stipulates exclusion of impermissible businesses like interest (riba), pork, activities involving extreme risk taking (gharar), gambling (maysir), weapons and defence, pornography etc. The second filter excludes companies having

1) Revenues in excess of 5% from the impermissible business activities

2) Total debt and/or monetary assets accounting for 33% or more of market capitalization (24-month average)

3) Account receivable more than 33% of their total assets / market value of equity (24-month average)

4) Cash to market value of equity (24-month average) higher than 33%.

2 Grossman and Hart (1982) and Jensen (1986) propose that high debt can be used to discipline managers.

3 The finance theory discusses, at great length, the role of good governance in addressing agency conflict. Hart (1995) and Shleifer and Vishny (1997) provide with detailed overview of this discussion.
This introductory paragraph has benefited from Allen and Michaely (2003).
It is assumed that they do not intend to sell the stocks merely to meet household needs and instead they wish to keep them for their preferred investment period.
A structure resembling most publicly listed companies.
We are thankful to INCEIF-BNP Paribas Centre for Islamic Asset and Wealth Management, Malaysia for extending research grant for the purchase of this data.
The details of these shariah compliance screens are made available in the appendix and the complete screening methodology can be accessed at https://us.spindices.com/index-family/Shariah/all.

Chapter 9

This article is an extraction of the first author’s doctoral thesis entitled “Application of Wa’d (Promise) in Islamic Banking Products: A Study in Malaysia and Bangladesh” submitted to University of Malaya, Kuala Lumpur in 2016. A significant part of the article is extracted from Chapters 4, 6 and 7 of the thesis.

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Chapter 1


Chapter 2


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Chapter 4


**Chapter 5**


**Chapter 6**


**Chapter 7**


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Chapter 10


