

Challenges to *Shariah* equity screening, from *Shariah* scholars' perspective

Shariah equity screening

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Received 14 November 2016

Revised 18 February 2017

Accepted 17 March 2017

Abstract

Purpose – This paper aims to examine the challenges of applying *Shariah* law in the equity market by engaging in narratives with *Shariah* screeners and advisors on how they conduct their screening responsibilities despite the low levels of Islamic-related disclosure made by companies in their annual reports. The *Shariah* screening processes in three countries with different Islamic equity markets – Malaysia, Saudi Arabia and the United Kingdom – are examined.

Design/methodology/approach – The authors interview 19 *Shariah* screeners and advisors in three different Islamic equity markets – Malaysia, Saudi Arabia and the United Kingdom.

Findings – Overall, the findings in this study show that despite the differences in the regulatory environment, companies still make Islamic-related disclosures on a voluntary basis. However, the lack of Islamic-related disclosures presents various challenges for *Shariah* screeners, particularly when identifying the operations that constitute the main activity of the company in screening for prohibited activities.

Research limitations/implications – *Shariah* screeners can play an important role in increasing the level of understanding and perhaps increasing Islamic-related disclosures in annual reports by establishing a set of effective guidelines or practices for *Shariah* screeners to use when screening companies for their *Shariah*-compliant status.

Originality/value – The paper identifies a gap in the *Shariah* screening literature and voluntary Islamic disclosures literature. By identifying this gap, the paper highlights the challenges *Shariah* screeners and advisors face because of the low level of Islamic-related disclosures.

Keywords Islam, *Shariah* compliant, Ethical funds, Screening method

Paper type Research paper

Introduction

Encouraging publicly listed companies to become accredited with *Shariah*-compliant status presents unique challenges. These challenges are noticeably different from those of the Islamic finance industry because non-financial publicly listed companies were not set up to offer Islamic finance products and services, nor do they have a separate wing that offers Islamic banking or a financing unit. Most of the literature (Rasul, 2010; Kasim *et al.*, 2013; Van Greuning and Iqbal, 2008) identify the main challenges as the non-existence of standardized *Shariah* rulings embraced by regulators from various geographic locations and an insufficient number of qualified scholars to participate in the administration and rulings of *Shariah* law. Rasul (2010) suggests that



International Journal of Islamic
and Middle Eastern Finance and
Management

Vol. 10 No. 2, 2017

pp. 229-242

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1753-8394

DOI 10.1108/IMEFM-11-2016-0165

This research was supported by the University of Malaya Research Grant (UMRG), RP011C-13SBS.

Shariah interpretations and rulings are becoming more important and sought after, even in a conventional business setting; unfortunately, these interpretations often vary from one scholar to another. [Kasim et al. \(2013\)](#) lament the lack of *Shariah* experts who are not only knowledgeable in the operations of conventional financial markets but also well-versed in *Shariah* law to assist in regulating the Islamic capital market. [Kasim et al. \(2013\)](#) also highlight the importance of disclosing *Shariah*-related information by *Shariah*-compliant companies to increase the confidence of investors, in particular Muslims. However, these researchers find that publicly listed companies from Malaysia, the Gulf Cooperation Council countries and the United Kingdom exhibit low disclosure of this information.

Low levels of *Shariah*- or Islamic-related disclosures in annual reports may present challenges for *Shariah* screeners and advisors because of the lack of information by which the screening can be conducted. *Shariah* screeners and advisors are *Shariah* scholars who are given the responsibility to screen companies for *Shariah*-prohibited activities, the lack of which qualifies them as *Shariah*-compliant companies. Our study examines the roles and experiences of *Shariah* screeners and advisors in Malaysia, Saudi Arabia and the United Kingdom in conducting this screening in their respective equity markets. We choose these three countries because of their strong presence in the Islamic finance market; the Islamic finance market is a crucial influence on expansion of the Islamic equity market ([Abdul Rahman et al., 2010](#); [Ahmed, 2010](#)). Malaysia and Saudi Arabia are among the countries that drive the growth of Islamic finance worldwide, and they have the most developed Islamic finance market in the Muslim world. In the Western world, the United Kingdom has the most developed Islamic finance market and is the leader in supporting the infrastructure of Islamic finance ([Lackmann, 2014](#); [TheCityUK, 2015](#)). Our observations in these three countries can provide an overview of the similarities and differences in the screening process of three well-developed Islamic finance markets in light of the low Islamic-related disclosures.

The next section presents an overview of the different *Shariah* screening levels in the three countries, and this is followed by a review of the literature on *Shariah* screening. Next, the methodology for the research is presented, followed by an analysis of the study's findings. The paper then continues with the implications and conclusion of this study, followed by an outline of limitations and recommendations for future research.

***Shariah* screening levels in the Islamic equity funds in Malaysia, Saudi Arabia and United Kingdom**

[Table I](#) presents a summary of the different levels of Islamic equity screening in Malaysia, Saudi Arabia and the United Kingdom. Based on our preliminary observations, the three countries share a similarity: Index providers, *Shariah* service providers and fund managers such as the FTSE *Shariah* Global Equity Index Series, Morgan Stanley Capital International (MSCI) Global Islamic Indices and Dow Jones Islamic Market Indices conduct *Shariah* screening on their equity market. Among the three countries, Malaysia's unique aspect is that it has a regulatory body which conducts the *Shariah* screening on the equity market. Saudi Arabia is unique in that, despite a lack of screening activity by the regulatory body, individual companies (financial and non-financial companies) may choose to elect a *Shariah* supervisory board to provide guidelines and advice on all *Shariah*-related matters. The United Kingdom has neither a regulatory body nor a *Shariah* supervisory body at the company level that performs the screening for non-financial companies. [Table I](#) provides an overview of these unique aspects of the *Shariah* screening levels in the three countries.

Malaysia

The screening body in Malaysia that is responsible for governance of *Shariah*-compliant companies at the national level is the Securities Commission Malaysia (SCM). The SCM

operates under supervision of the Ministry of Finance and is responsible for the regulation of matters pertaining to the capital markets within its jurisdiction. The SCM oversees matters related to the issuance of securities, futures contracts and unit trusts. It also regulates the process of business mergers and take-overs and monitors the activities of the exchanges, clearinghouses and central depository. Malaysia is unique in that it has a dedicated regulatory body, the SCM, that is responsible for screening companies for compliance with *Shariah* law.

To ensure the proper coordination of activities related to securities trading in the Islamic capital market, the *Shariah* Advisory Council (SAC) was established in 1996 as a unit under the SCM in accordance with the Securities Commission Act 1993. The SAC acts as the main point of reference for the SCM in handling matters related to *Shariah* law. The SAC administers the *Shariah* screening process and applications for compliance status. It provides advisory services, analyzes conventional and Islamic products in the capital market, and introduces new products. It also issues *Shariah* rulings on matters related to the Islamic capital market (Securities Commission Malaysia, 2007). Hence, the SAC plays a crucial role in these screening bodies.

The SAC of the SCM published the first list of companies accredited with *Shariah*-compliant status in June 1997. The list has continued to be published on a semi-annual basis and has become an important point of reference for investors and analysts. To date, the companies listed on the Malaysian stock exchange (Bursa Malaysia) that are *Shariah*-compliant comprise two-thirds of the listed companies. The capability of these securities to be traded simultaneously in both the Islamic capital market and conventional capital markets provides a broader platform upon which the companies can compete in the capital markets and also offers greater opportunities for financing and investment activities (Securities Commission Malaysia, 2008). Financial reports are the most commonly used source of screening by the SCM, and it uses these reports as their main source of reference. Other sources include correspondence with the companies. Bursa Malaysia, another regulatory body in Malaysia, provides a trading platform for *Shariah*-compliant products in the capital market.

Level of screening	Malaysia	Saudi Arabia	United Kingdom
Country (Regulators)	SAC, SCM	None	None
Index providers ^a	Various index providers, local (i.e. Bursa Malaysia Hijrah <i>Shariah</i> Indices) and international (e.g. FTSE <i>Shariah</i> Global Equity Index Series, MSCI Global Islamic Indices, Dow Jones Islamic Market Indices)	Various international index providers (e.g. FTSE <i>Shariah</i> Global Equity Index Series, MSCI Global Islamic Indices, Dow Jones Islamic Market Indices)	Various index providers, local (i.e., FTSE <i>Shariah</i> Global Equity Index Series) and international (e.g. MSCI Global Islamic Indices, Dow Jones Islamic Market Indices)
Companies	None, except for Islamic financial institutions	Appointed by individual <i>Shariah</i> -compliant listed company	None, except for Islamic financial institutions

Table I.
Different levels of *Shariah* screening in Malaysia, Saudi Arabia and United Kingdom

Note: ^a*Shariah* screening is also conducted by *Shariah* service providers and fund managers such as Amanie Business Solution, Saudi Arabia National Commercial Bank, and Yasaar Limited

Saudi Arabia

The Saudi Government was determined to improve and strengthen its stock market and, therefore, established the Saudi securities commission, also referred to as the Capital Market Authority (CMA), in 2003 with the objectives of encouraging investment trading, providing investor protection and ensuring transparency as part of the whole agenda. The CMA reports directly to the prime minister who, in this case, is also the king of Saudi Arabia. It also works hand in hand with other government agencies such as the Ministry of Finance and the Ministry of Commerce, which are also appointed by the king. In Saudi Arabia, the official religion is Islam, and the source of law is *Shariah* law, which is promulgated by royal decree. *Shariah* law encompasses all aspects of life, including matters related to society and the conduct of business (*muamalat*). As a result, Saudi Arabia does not need any screening process to grant a *Shariah*-compliant status to its publicly listed companies trading on the Saudi Stock Exchange (Tadawul).

To boost market performance, the CMA opened its doors to foreign entities as a way to broaden institutional participation globally. In July 2009, Tadawul emerged on the US Dow Jones Index, and this move prompted other international indices such as Bloomberg and Standard & Poor's to also consider the same move (Ramady, 2010). In the same year, *Shariah*-compliant companies could be tracked on the Islamic indices on Tadawul. In the absence of a screening process, some publicly listed companies have voluntarily appointed *Shariah* supervisory boards to ensure that their transactions and activities are compliant with *Shariah* principles.

The United Kingdom

The United Kingdom currently does not have a specific governmental body recognizing the *Shariah*-compliant status of listed companies; instead, this status is filtered by global index providers adhering to their own qualitative and quantitative *Shariah* screening criteria. For example, Dow Jones and MSCI conduct their own screening endorsed by the appointed *Shariah* advisors, whereas the FTSE outsources these responsibilities to Yasaar Limited as its *Shariah* advisor.

Challenges of *Shariah* screening

Ho (2015, pp. 227-278) identifies two types of *Shariah* screening methods: qualitative and quantitative:

Qualitative screening method is used to screen non-permissible business activities according to *Shari'ah* principles. Quantitative screening method involves the numerical calculation of ratios of the non-permissible activities in accordance to some maximum allowable threshold.

Ho (2015, p. 228) categorizes the former method into five groups, "*riba* and *gharar*, non-*halal* products, gambling and gaming, immoral activities and other impermissible activities", while the latter is categorized into four categories, debt, liquidity, interest and non-permissible income screens (Ho, 2015, p. 236). The qualitative screening process and the criteria used by *Shariah* screeners and advisors are largely similar, with few significant differences (Derigs and Marzban, 2008; Abdul Rahman *et al.*, 2010; Khatkhatay and Nisar, 2007). However, there are differences in the quantitative screening in terms of the formula, the denominator being used and the threshold limit granted to the companies. The literature (Khatkhatay and Nisar, 2007; Wee, 2012; Abdul Rahman *et al.*, 2010; Ho, 2015) that addresses the screening methodology finds that the differences in the quantitative ratios can be caused by different objectives among the *Shariah* screeners, whether country-specific, regulation-oriented or globally business-oriented. All *Shariah* screeners carry out

assessments of annual reports, particularly financial statements, and available market data based on each index's criteria.

However, the strong dependence of *Shariah* screeners on information in annual reports and financial statements does not seem to have any effect on the number of Islamic-related disclosures. Studies on voluntary Islamic-related disclosures such as Al-Shammari (2013) and Ousama and Fatima (2010) find low levels of disclosures, 13 and 17 per cent, respectively, for Islamic dimension items by *Shariah*-compliant companies. These studies report that the type of information that is lacking in these financial statements is related to information on activities prohibited under *Shariah* law, such as *riba* and *gharar*.

Further comparison between the *Shariah* screening literature (Khatkhatay and Nisar, 2007; Wee, 2012; Rahman *et al.*, 2010; Ho, 2015) and studies on voluntary Islamic-related disclosures (Al-Shammari, 2013; Ousama and Fatima, 2010) shows a significantly higher number of Islamic-related disclosures identified in the voluntary disclosures literature than in the *Shariah* screening literature. For example, as Ho (2015) indicates, *Shariah* screeners examine the annual reports for only nine types of information to perform the *Shariah* screening; however, Ousama and Fatima (2010) and Al-Shammari (2013) propose 48 items for Islamic-related disclosures. Al-Shammari's (2013) Islamic-related disclosures include all of the items mentioned by Ho (2015) except for liquidity. The inconsistencies in these two strands of literature justify the need for a framework that provides a better overview of Islamic-related disclosures. For this purpose, we illustrate the Islamic framework proposed by Ullah *et al.* (2014).

Ullah *et al.* (2014) develop three categories of Islamic principles in their study, the *required*, *expected* and *desired* principles, which represent different levels of obligation adopted from the Islamic *Ahkam*[1] concept. These categories are presented in Table II. They are considered important for the socially responsible investment industry, and *Shariah*-compliant companies must conduct their business activities according to the different levels of obligation prescribed by these categories. Ullah *et al.* (2014, p. 222) describe transactions that fall into the *required* category as those that do not involve any interest-bearing transactions, *gharar* activities (excessively risky transactions) and investments in alcohol and pornography. Items under the *required* category are similar to those used in the screening methodology of *Shariah* screening bodies. Meanwhile, the *expected* category includes the practice of engaging in fair and equitable dealings with all stakeholders in accordance with *Shariah* stipulations and of avoiding activities that are censured by *Shariah* law, such as the business of tobacco and any kind of exploitation: child labor, unfavorable treatment of employees or involvement in any kind of illegal activity (Ullah *et al.*, 2014, p. 223). Finally, the *desired* category is defined as optional, socially responsible behavior, including protection of the natural environment and animal welfare (Ullah *et al.*, 2014, p. 223).

Based on the Islamic framework prescribed by Ullah *et al.* (2014), we were able to consolidate the views of the literature on *Shariah* screening methods and the literature on

Type of category	Description
Required category	Represents activities related to obligatory or prohibited business practices, such as interest-bearing transactions and <i>gharar</i> transactions
Expected category	Describes the recommended or disliked practices, such as child labor and unfavorable treatment of employees
Desired category	Signifies the permitted practices, such as protection of the natural environment and animal welfare

Table II. Islamic perspective of socially responsible investment developed by Ullah *et al.* (2014)

voluntary Islamic-related disclosures. We find that the literature on *Shariah* screening methods focuses on information that is in the *required* category, while the literature on the voluntary Islamic-related disclosures focuses on all three categories of this Islamic framework.

Our review of the literature shows the following. The *required* category of information is important for *Shariah* screeners and advisors, but this type of information is lacking in annual reports. This presents a big challenge for *Shariah* screeners and advisors. It also shows a lack of understanding among companies regarding the items considered important to *Shariah* principles. Our study attempts to generate appreciation for how *Shariah* screeners and advisors conduct their responsibilities in light of these challenges.

Methodology

Design and setting

We adopt a qualitative approach in our study because it successfully provides an understanding of how and why something occurs (Freeman and Cavusgil, 2007). It also allows for the selection of specific cases to address the research questions. For the purpose of this study, we use semi-structured, in-depth interviews with key participants to explore their perspectives on a particular idea, program or situation. This method is especially useful when detailed information is required regarding a person's thoughts and behaviors or to explore new issues extensively (Boyce and Neale, 2006). We secure responses from 19 respondents, and this is within the range of responses recommended by Eisenhardt (1989) to ensure sufficient data without creating data overload during analysis. The respondents selected for this research are involved either in the Islamic capital market or the finance capital market sector. Table III presents the key information about our respondents.

Background of respondents

Table III presents the background of the respondents from the three countries: Malaysia, Saudi Arabia and United Kingdom. To ensure that the respondents remain anonymous, we adopt a coding system whereby each interviewee is quoted based on his/her country (M for Malaysia, S for Saudi Arabia and U for United Kingdom) and a randomly allocated number, as indicated in Table III.

Respondents from Malaysia are categorized into two groups: The first group comprises those in the *Shariah* advisory board, while the second group comprises the

Jurisdiction	Responsibility/authority	Position in the organization	No. of interviewees	Code
Malaysia	<i>Shariah</i> advisor	–	2	M1-M2
	Regulators	Manager	2	M3-M4
	Securities Commission Malaysia			
	Bursa Malaysia	Manager	4	M5-M10
Saudi Arabia		Executive	2	
	<i>Shariah</i> advisor	Manager	2	S1-S2
	Regulators			
	Capital Market Authority	Executive	2	S3-S4
United Kingdom	Tadawul	Manager	2	S5-S6
	<i>Shariah</i> Advisor	–	1	U1
	<i>Shariah</i> Consultants	–	2	U2-U3
	Total		19	

Table III.
Background of the respondents

employees of the regulating bodies in Malaysia. The former is responsible for ascertaining the appropriate application of *Shariah* principles and for working hand in hand with regulators on issues related to the Islamic capital market's business and transactions. Members of the *Shariah* advisory board are primarily appointed to facilitate and monitor innovations in Islamic products and to ensure that robust *Shariah* governance is in process, while also providing greater consistency and clarity to issuers, intermediaries and investors. Members of this group hold academic credentials in *fiqh*[2] (Islamic jurisprudence) and also serve as *Shariah* advisors for several financial institutions.

The latter group belongs to two different organizations that have different roles and responsibilities in ensuring that the Islamic capital market operates and functions efficiently and effectively: the SCM and Bursa Malaysia (formerly known as the Kuala Lumpur Stock Exchange). Respondents from the SCM are chosen because they are directly responsible for providing a supportive infrastructure, particularly because SCM is responsible for the screening of *Shariah*-compliant companies. Respondents from Bursa Malaysia, on the other hand, are selected because they provide the trading platform for *Shariah*-compliant investments to be traded in the market. Hence, they can provide a fuller picture of the role of the SCM in the *Shariah* screening process. Overall, two respondents hold managerial positions, and the remaining six hold general and senior management positions; two are executives. We contacted the respondents through telephone calls and followed up with emails to secure an interview with them.

The first group of respondents representing Saudi Arabia serves on the country's securities commission, the CMA, attached to the Inspection and Compliance Department, and directly examines issues of non-compliance in publicly listed companies trading on the Tadawul. This organization provides a trustworthy trading platform for all listed companies; regulates and monitors the capital market; and protects investors from unethical and illegal investment activities. The CMA is also responsible for supervising the Tadawul. Owing to the important role it plays, we secure another two respondents from Tadawul for interviews. Both respondents are managers in the compliance department. Finally, we seek expert opinion from the managers of the Islamic Research and Training Institute (IRTI) who deal with vast research activities; advisory services; and the delivery of training and workshops related to Islamic economics, banking and finance throughout the Kingdom. IRTI, as an affiliate of the Islamic Development Bank, is considered an important organization in Saudi Arabia that contributes actively to knowledge development pertaining to *maqasid al-Shariah* (objectives of Islamic law).

We secure three respondents from the United Kingdom; one is a *Shariah* advisor for financial institutions and the other two are *Shariah* consultants from private consultancy bodies. The former is a member of the *Shariah* supervisory board for banking, mutual funds, *takaful* and *retakaful* companies in different jurisdictions worldwide. This advisor possesses qualifications in Islamic finance, *Shariah* law and secular law. One of the *Shariah* consultants works for a private consultancy firm, where he specializes in *Shariah* governance and private equity, having experience in advising governments and conducting training related to the areas of interest. Our last respondent is a renowned Islamic banker who currently advises on Islamic financing, corporate finance, project finance, trade finance and consumer banking management.

Research process and analysis

All respondents agreed to be interviewed either in person or over the telephone. The respondents were instructed to allow for at least a 45-minute interview session. All but

two of the interviews were taped with the permission of the interviewee and transcribed by an independent transcription professional. Some of these interviews were recorded, transcribed and translated into English. The respondents were assured of their confidentiality and anonymity. In most cases, the interviews lasted between 45 minutes and 1 hour. The average duration was 48 minutes. This is in line with guidance from [Jacob and Furgerson \(2012\)](#), suggesting that lengthy interviews be avoided so that respondents do not lose interest and stray from the questions being asked. Interviewers encouraged further explanations from the respondents, but still followed the interview guideline.

An interview guide was developed from prior discussions with an Islamic capital market scholar and sent to the interviewees before the interview sessions. The interview started with a brief description of our study and its purpose. All questions were open-ended and expansive to assist and encourage the respondents to elaborate on the issues based on their viewpoints and experiences in different directions but within the same context ([Jacob and Furgerson, 2012](#); [Turner, 2010](#)). Our primary intention during the interviews was to probe interesting avenues for investigation regarding the challenges faced in conducting *Shariah* screening in light of the low number of Islamic-related disclosures in annual reports. Questions posed to the *Shariah* screeners and advisors focused on the various *Shariah* interpretations applied in a conventional equity market. Additional questions were presented to the regulator groups to probe on monitoring and enforcing issues related to the *Shariah* screening process. The interviews were then analyzed and summarized independently by two researchers. This was done to identify similar patterns and themes in the respondents' answers ([Boyce and Neale, 2006](#)). Thus, this study fulfilled the credibility and integrity criteria. The coding revealed two main themes, discussed in the next section.

Findings and discussions

The analysis provided in this section offers insights into how the existing *Shariah* screening practices are conducted despite the low number of Islamic-related disclosures in annual reports. We divide our findings into two main themes. The first theme examines the *Shariah* screeners and advisors' view of the disclosure practices of companies in relation to Islamic-related disclosures of the three countries. Understanding this is important because, as highlighted earlier, these disclosures help *Shariah* screeners determine the *Shariah* status of the company. Next, we observe the impact of the first theme on the screening process by *Shariah* scholars. Within this theme, we highlight issues faced by *Shariah* scholars when applying the screening process. A summary of our findings, categorized by themes and sub-themes, is presented in [Table IV](#).

Islamic disclosures made by companies

In this theme, we find that none of the countries regulates Islamic-related disclosures for non-financial companies, and this has different effects on companies' practices in making such disclosures. We identify two sub-themes from our interviews.

Regulatory requirements for disclosures. Our interviewees from all three countries agree that any disclosures related to Islamic-related disclosures are made voluntarily; no regulations require such disclosures in any of the three countries:

There is no disclosure requirement; there is no practice as such anywhere in the world that I am aware of. Non-financial service companies do not disclose anything meaningful and have no formal structure with regard to *Shariah* compliance (U1).

Table IV.
Summary of interview findings

Theme	Sub-theme	Malaysia	Saudi Arabia	United Kingdom
Islamic disclosures made by companies	Regulatory requirements for disclosures	None because regulator can make enquiries	None because country is based on <i>Shariah</i> law	None because of secular country
	Effect on companies	Indirect regulation	Self-regulation	Self-regulation
<i>Shariah</i> screening of required elements	Interest	Not problematic	Not problematic	Not problematic
	Other required items	Problems related to non-permissible income screen	Not problematic	Problems related to non-permissible income screen

[...] the prerogative to make additional disclosures is left to the company (M3).

Despite these similarities, regulators have different motivations for making such disclosures voluntary. In Saudi Arabia, these types of disclosures are not important for regulators because they assume that all companies are *Shariah*-compliant:

It is not part of the responsibility or rights of the CMA to ensure that PLCs [publicly listed companies] comply with *Shariah* law. As mentioned earlier, the CMA assumes that all PLCs are *Shariah*-compliant companies (S3).

In the UK, the motivation not to regulate such disclosures is based on the country's secular environment:

That is their own [companies'] initiative; they technically voluntarily disclose that, and the regulator is not in a position to test or confirm whether the company is *Shariah* compliant or not and the regulator refuses to go there because the company is in a secular environment [...] (U1).

In Malaysia, companies also have no motivation to make such disclosures because regulators of the Islamic equity market use their authoritative power to obtain *Shariah*-related information directly from companies. The SCM:

[...] seeks direct engagement with the PLC to obtain that particular [*Shariah*-related information] (M5).

One interviewee elaborated on the practicalities of such an engagement:

[...] they have to answer any inquiries from us, so there is no problem. We just state when we need the reply, how many days (normally, we give a week). There is no problem. We will get a reply because they are obliged to answer us. (M3)

Effect on companies. The effect of the lack of regulations in Saudi Arabia and the United Kingdom is that the companies that are in the Islamic equity market are self-regulated. In the United Kingdom, self-regulation of Islamic disclosures is practiced by only Islamic banks:

Here in the UK, we absolutely do endorse and encourage self-regulation from Islamic banks. Yes, the self-regulators are secular, and that's good, that's fine to remain there. It does create some problems or leave some gaps and some grey areas, and the only way to address that is self-regulation by the industry to collectively state that this is the way we want to do things. Because you know you can't have problems, right? We have had in the past examples where people have tried to sell products as *Shariah* compliant, but they're not *Shariah* compliant at all. If you take *Shariah* compliance as a measure of international Islamic banking standards by Malaysia, Bahrain, or wherever, it's easy for

that industry to collaborate and coordinate to ensure that we take on the best practices in line with international standards. (U1)

In Saudi Arabia, self-regulation of Islamic-related disclosures is practiced not only by Islamic banks but also by other types of companies:

[...] the approach is that they allow the industry to be self-regulated [...], for example, an Islamic bank or even a company [...] has to decide on the *Shariah* committee, the number and so on. It's not being forced, in that sense. If you look into the context of, well, all banks, by definition they cannot charge interest and they cannot pay interest, so, you can say that, by definition, they are *Shariah*-compliant, and they also pay zakat [...] but, taking steps forward, you take the case of companies; it depends on the company. Some companies have it, some companies don't, so this allows [for] self-regulation by the industry. (S1)

For Malaysian companies, the effect of more active involvement by the SCM in the *Shariah* status of companies means that companies, apart from the Islamic finance industry, need not elect a *Shariah* committee, but instead can rely only on communication with the SCM. In addition, the SCM does not require that these companies understand *Shariah* concepts or what it means to be *Shariah*-compliant, nor are they required to disclose additional *Shariah*-related information to the public. The present role of the SCM results in minimal demands on companies.

However, some companies do seriously consider *Shariah* compliance because they actively seek *Shariah*-compliant status because they see that the market can play a significant role in creating awareness among companies of this *Shariah*-compliant status, as indicated by the interviewees cited below:

[...] some negative impact to their share performance (M5).

This happens when their investors are big Islamic institutions that have a significant impact on the company if their shares are sold (M1).

In these instances:

[...] sometimes, a company falls off the list [the *Shariah*-compliant list], and then the restructuring will take two to three months. After they restructure from conventional to Islamic practices, they will then ask to be placed on the list again. Some companies do make an effort to be on the list (M1).

However, the SCM also faces problems when companies do not understand the importance of meeting the *required* category, compared with the other categories (*expected* and *desired*). Some companies request *Shariah*-compliant status based on their activities that fall under the *desired* or *expected* categories and not under the *required* category. One interviewee states that:

[...] a cigarette company had applied to be *Shariah*-compliant because of its contribution to the nation [i.e. its contribution in terms of tax payments]. (M3)

However, this company's application was rejected because:

[...] it manufactures a product that is *haram*, and it makes people unhealthy (M4).

The main activity of the company is the focal point of the SCM's assessment of whether the company meets the required category:

For example, a palm oil factory that produces a lot of smoke will remain compliant as long as its main activity is compliant (M3).

In the next section, we highlight *Shariah* issues that arise from companies' main activity.

Shariah screening for required elements

Under this theme, interviewees are consistent and highlight that screening for *Shariah* companies is direct and uses just the figures in the financial statements. An example of one interview illustrates this:

I don't think the screening is rocket science. I don't think it is a big deal. I mean, it is very straightforward. You just get the audited account, and you apply the ratios (U2).

However, under jurisdictions such as Malaysia and the UK, *Shariah* scholars are at times required to conduct other tests related to companies' operations. We highlight two sub-themes in this area related to identifying the required elements of *Shariah* screening.

Interest. As discussed earlier, the practices in the *required* category dictate that any *haram* activities, such as involvement of interest elements in business operations, are to be avoided. Nevertheless, companies are often unable to fully meet the requirements stipulated in this category, particularly on the interest element. This is evidenced in the following extract from interviews:

Most companies have a mixture of *halal* and *haram* elements. It is not very often that we can find a company that is 100 per cent *Shariah* compliant. Even in the list of *Shariah*-compliant companies, we can still see that there are elements of interest, at least in their current accounts or savings accounts (M1).

[...] possibly the issue of interest payment would arise [...] that would be an issue [...] that would be the only, I would say, issue involved, but again, for interest payments subject to a certain percentage, then you can still do the purification; here it goes with the percentage (S1).

For example, you may have a company, a shipping company which is *halal*, and you can invest in it. But the directors are telling you, we are going to open a financing department. Shipping companies do all of that. Now the financing department exceeds the 5 per cent ratio (U2).

The interest portion of companies can be largely captured through the ratios used for screening. One interviewee indicates this:

[...] we decided that when we observe the financial ratio, we are [only] detecting *riba* (M3).

In Saudi Arabia, this part of the screening is not important:

Okay, but looking at the operational side, they [the companies] are all *Shariah* compliant [...] so, in the context of overall operations, here, if they are doing domestic operations, then they don't have issue with operations, since all of them are *Shariah* compliant (S1).

For example, hotels; our hotels are all *Shariah* compliant here, so are other activities. You don't see that component of screening being that important here (S1).

Unlike in Saudi Arabia, in Malaysia and the United Kingdom, *Shariah* screeners need to do more than just rely on ratios. Other elements in the screening are indicated below.

Other required items. The issue of identifying required items not only revolves around the involvement of interest elements arising from debt or savings, but it is also found in other business activities that may not fulfill the *required* category. *Shariah* screening looks at how much of the present revenue from the companies' main activities comes from *haram* elements. The problem with this area is that disclosures are not provided by the company. One interviewee highlights the *Shariah* issues that may arise in the retail and services industry:

Just take the case of a company like Tesco. So, the core business for Tesco is to sell electronics, food, and clothing which are *halal*. But the food portion of it, which is maybe alcohol, is less than 5 per cent,

so you screen it. You can invest and then you are going to do the justification. Now, what are you going to reveal there? You cannot get information from Tesco besides the balance sheet (U2).

I remember I was developing an index for company, and it just so happened that it was a country where tourism was flourishing and the stock market has a lot of hotels. When you looked at the AAOIFI [Accounting and Auditing Organization for Islamic Financial Institutions] ratio, it was fantastic. You can put those hotels [in the Islamic index]. Then I told them, look, I want the breakdown of income, which was not in the accounts. So, because they were listed companies, they had these big hotels, and about 10 per cent of the income is from alcohol. 10 per cent. This is not revealed in the accounts. So, we cannot invest. [...] So, you need to go the extra mile (U2).

One interviewee illustrates this with an example of a glass manufacturer and a description of *Shariah* information that was needed:

[...] in detail, what type of glass they manufacture, and whether their orders or contracts are with liquor companies. We need to know that proportion (M3).

Even for companies that produce bar codes, this can be a problem.

[...] contracts for alcohol or cigarettes and whether the income generated from those activities can be identified separately. (M3)

In other developments, the dilemma involves identifying which of a company's business operations is suitable to be considered its main activity and the one that should meet the *required* category. Two aspects of this are highlighted by one interviewee:

There was a point in time when cinema was an issue. For a shopping complex with a cinema, how are you going to take the cinema into the 5 per cent threshold? [3] Previously, the cinema had a bad image, so regardless of what percentage it is, it will still trigger image issues [...] this dynamism is still under research [...] The issue of image will come in if companies promote liquor to Muslims [...] As long as they are not doing that, and liquor is only for non-Muslim consumption, we allow that [...] In hotels, there are bars and spas, and in some of these, there is no separation of men and women. Considering that the main objective of hotels is to rent rooms, from the *Shariah*-compliance point of view, there is nothing wrong with that, but we have not gotten around to [looking into these details]. We need to look into this issue again. We are not saying that spas where there is no separation of men and women and liquor are *halal*, but maybe certain benchmarks are allowed there (M1).

In addition to the issues discussed above, another area of difficulty is in deciding whether or not certain practices should be included in the *required* category. This task is considered complicated because Malaysian companies operate in a different business environment than companies in other parts of the world. Hence, there are different *Shariah* interpretations, as highlighted by Rasul (2010). This is reflected by one interviewee:

In Malaysia, military equipment is a basic item, so it is not treated as a non-compliant *Shariah* activity. However, at Dow Jones, they treat military activities as a non-compliant activity because companies produce and sell weapons for war, not to defend their countries. [In Malaysia], a few companies are involved in military activities, but they are not listed, so they are not included in our list. (M3)

Implications and conclusion

Overall, the findings in this study indicate that self-regulation of the industry is practiced in Saudi Arabia and the United Kingdom, while regulators of the Islamic capital market in Malaysia exercise their authority indirectly. Despite the differences in the regulatory environment, companies still make Islamic-related disclosures on a voluntary basis. The low levels of Islamic-related disclosures highlighted by literature such as Al-Shammari (2013) and Ousama and Fatima (2010) present challenges for *Shariah* screeners and advisors. These challenges are

mainly centered on identifying prohibited activities indicated in the *required* category, as proposed by Ullah *et al.* (2014), in the main activities of the companies. Another challenging aspect is identifying the operations that constitute the main activity of a company. Interest is the only *required* category item that is easily identifiable by *Shariah* screeners. Our findings support Ho's (2015) suggestion to create a more transparent regulatory environment by establishing a globally acceptable, universal *Shariah* standard for screening.

The findings of our study have two major implications. First, *Shariah* screeners can play an important role in creating an atmosphere of awareness and in increasing the level of understanding and perhaps disclosure related to *Shariah*-compliant status. The collateral effort on the part of these screeners to establish a set of good practices in identifying the challenging aspects of screening for required items is a start toward creating this awareness. This set of good practices can be established through the Accounting and Auditing Organization for Islamic Financial Institutions. Second, Islamic concepts are not easily applied in a conventional setting; this indicates the need for more Muslim scholars to become involved in conventional business practices so that information related to the *required* category can be discernable to them when screening is conducted.

It is necessary to acknowledge some of the limitations of this paper. While we have sought to obtain data from the experiences of *Shariah* screeners and regulators from the perspective of low Islamic-related disclosures, care must be taken in extrapolating these findings to other countries with similar Islamic equity markets. Future research can explore other significant issues faced by these *Shariah* screeners using questionnaire surveys to gain more responses from *Shariah* screeners.

Notes

1. *Ahkam* are Islamic "orders to either perform or not perform certain actions/behaviors while others are strongly recommended courses of action", and these orders are derived from four main sources, namely, "The Quran, the prophetic traditions, Ijma, the consensus of Islamic scholars and Qiyas, that is solving emerging issues by finding their analogies in the first three sources" (Ullah *et al.*, 2014, p. 221).
2. Fiqh is defined as "the body of Islamic law derived from detailed Islamic sources."
3. Companies are classified as *Shariah*-compliant if their ratio of non-*Shariah*-compliant activities against total revenue does not exceed the threshold of 5 or 20 percent (depending on activities) for the business activity benchmark. A 5 percent benchmark is given for the following activities: conventional banking, conventional insurance, gambling, liquor and liquor-related activities, pork and pork-related activities, non-*halal* food and beverages, non-compliant entertainment, interest income from a conventional account and instrument, tobacco and tobacco-related activities and other activities deemed non-compliant with *Shariah*. A 20 percent benchmark is used for the following activities: hotel and resort operations, share trading, stock broking business, rental received from *Shariah* non-compliant activities and other activities deemed non-compliant with *Shariah*.

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