

REVISITING THE AAOIFI SHARIAH STANDARDS' STOCK SCREENING CRITERIA

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ABSTRACT

A vigorous and vibrant equity market being an integral part of a resilient and sustainable Islamic financial system, plays a vital role in the overall economic developments of a country. However, the contribution of Muslim investors to the equity market requires the availability of Shari'ah compliant stocks for them to invest, which must pass a certain set of Shari'ah screening criteria prior to any investment. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) offers a criterion for screening stocks to include them in the Shari'ah compliant list, which consists of total five filters. The objectives of this study are three-fold: 1) critically analyse AAOIFI's criterion and providing the Shari'ah justification behind these filters; 2) develop and introduce a unique filter to be included in the criterion as a replacement of one of the current filters; and 3) suggest to re-examine one of the existing filters, and proposes the removal of two filters from the criterion. To sum up, this paper advocates major changes in AAOIFI's criterion based on stronger Shari'ah justifications. It is expected that the findings of this study would not only provide an efficient and practically sustainable solution, it would also enable more companies to become Shari'ah compliant, and provide Muslim investors a wider universe of Shari'ah compliant stocks to choose from for their investment.

Keywords: Corporation; Company; Islamic Capital Markets; Shari'ah Compliant Shares; Screening Methodology.

1. INTRODUCTION

Shari'ah compliant financial markets are considered part and parcel of the Islamic financial system and of the real economy in many jurisdictions. Above all, the propagation of the Islamic capital market (ICM) tremendously contributed to the much-applauded overall growth of Islamic finance. On the one hand, the ICM has facilitated the investors who were previously searching for Shari'ah compliant projects in finding viable and potentially profitable investment venues for their capital; and it has ensured, on the other hand, that their capital goes into the projects or instruments which are directly related to the real economy, i.e., stocks, *sukuk*, etc. This in turn has been translated into playing a pivotal role in overall economic development.

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Nevertheless, the establishment of the ICM is a recent phenomenon. The Shari`ah did not allow Muslim investors for sometimes to take part in the equity market. It was considered permissible only after the International Islamic Fiqh Academy of the Organization of Islamic Cooperation (IIFA-OIC) had issued a resolution in 1992. The IIFA-OIC allowed participation in joint stock companies whose business activities are completely Shari`ah compliant. Accordingly, it did not allow involvement in the companies whose business activities are either impermissible or a mixture of permissible and impermissible elements (IIFA-OIC, 2000, Resolution # 63/1/7). The Islamic Fiqh Council (IFC) of the Muslim World League (MWL), also seconded the IIFA-OIC's view in its own resolution issued in 1995 (IFC, 2006, Session # 14, Resolution # 4). These Shari`ah resolutions were perceived as a good step towards establishing the ICM; however, what has been proposed in such resolutions may not be congruent with the reality. As a matter of fact, majority of the companies in stock markets, one way or the other, are involved to a certain extent in prohibited activities. It is very hard to find a listed company which is completely Shari`ah compliant. Meaning to say that although one may find companies in the stock markets whose main business activities are Shari`ah compliant, they are usually also involved in some prohibited activities. For example, a supermarket offers many permissible household products, but it also sells liquor and pork. A hotel is another good example which mainly provides accommodation but also serves alcohol to its customers, or operates a casino as a side business. Furthermore, a company that manufactures permissible electronic items may also borrow on interest or place its surplus cash in interest-earning deposits or financial instruments. As per the above resolutions, it is not allowed to participate in or trade shares of such companies. Therefore, those resolutions did not completely remove the hurdle faced by the investors wishing to be compliant with the Shari`ah in the arena of capital markets.

Many Shari`ah scholars recognized this challenging situation and tried to propose practically viable solutions to it. They did not out-rightly reject the mixed activity companies; rather suggested criteria to decide whether a company or stock is Shari`ah compliant. Therefore, the focus was diverted to the companies with a mixture of permissible and impermissible activities. The main objective of the suggested criteria was to include a company with a permissible main business activity and with a minimum level of impermissible elements into the list of Shari`ah compliant companies. The criteria also had to provide maximum flexibility and concession to the companies and investors, so that they could avail the opportunities of financing and investing in permissible businesses. Based on those criteria, many stock index providers started screening stocks to provide a list of Shari`ah compliant stocks for Muslim investors. For example, Dow Jones offers Dow Jones Islamic Market Indices, FTSE has Shari`ah Global Equity Index Series, MSCI provides World Islamic Index, and so on.

Similarly, AAOIFI¹ allows investment in companies with mixed activities with certain conditions. It justifies its opinion based on the Shari`ah principle of removal of hardship from the public and the principle of absolute need (AAOIFI, 2015). Accordingly, it has

¹ AAOIFI stands for Accounting and Auditing Organization for Islamic Financial Institutions, a leading international standard setting body which serves the global Islamic finance industry. Although its standards are generally non-binding they have been accepted by many Islamic financial institutions and jurisdictions either on a compulsory or voluntary basis.

issued standards or criteria for screening stocks to decide whether or not a stock is Shari`ah compliant. AAOIFI's criterion has been adopted by regulatory bodies and other financial institutions in several jurisdictions. Due to the significant role of AAOIFI and the wide acceptance of its standards, this paper attempts to explain its Shari`ah screening criterion for stocks and the Islamic jurisprudential rationale behind it. Alongside, it aims at furnishing a critical analysis of the criterion and its Shari`ah justifications, while making recommendations about how it can be improved. Above all, this paper suggests the inclusion of a new filter in AAOIFI's criterion which is more robust and appropriate, and proposes to remove the unnecessary ones. It is expected that the propositions of this paper would not only make the criterion theoretically more vigorous and rationally sound, it would also promote harmonization among various Shari`ah screening criteria adopted by different jurisdictions, individual institutions or index providers across the globe.

2. THE IMPORTANCE OF SHARI`AH SCREENING AND AAOIFI'S STANDARDS

The investors, both individual and institutional, who were interested in investing Shari`ah compliant venues had been averting capital markets for a very long time. They had been avoiding participation in those markets since the markets and their operations were considered as against the rulings of Islamic commercial law. Consequently, such markets remained underdeveloped in most of the Muslim countries. Although, IIFA-OIC (2000), in 1992, allowed Muslim investors to participate in such markets with some strict conditions, and that was followed by the IFC (2006) in 1995. Even then very few Muslim investors started participating in capital markets. The real proliferation and establishment of ICM activities were only observed at the emergence of Shari`ah compliant stock market indexes which facilitated them in allocating capital to listed stocks across various global equity markets. Obviously, for any index provider to create a universe of Shari`ah compliant stocks, it was necessary to develop theoretically robust screening criteria. Without a clear Shari`ah screening process, it was impossible to filter out Shari`ah non-compliant stocks from the universe of Shari`ah compliant stocks. Due to this significant role, Shari`ah screening criterion can be laid to rest at the heart of Islamic capital markets. The screening criterion or process comprises of various filters that identify and exclude companies that do not subscribe to the principles of Islamic commercial law via the use of customized financial ratios (DeLorenzo, 2004).

The AAOIFI was established in 1990 with the aim of preparing accounting, auditing, governance, ethics and other Shari`ah standards for the Islamic financial institutions. It plays a vital role in harmonizing and standardizing the theoretical basis and practices of Islamic financial institutions at a global level. Its standards have gained acceptance across many jurisdictions on either mandatory or recommended basis, including Saudi Arabia, Bahrain, UAE, Jordan, Lebanon, Qatar, Sudan and Syria (ISRA, 2016). Even in countries where they have not been fully adopted, like Malaysia and Pakistan, they are still heavily relied upon. Its standards also discuss Shari`ah screening criteria for stocks. Due to the AAOIF's worldwide acceptance of its standards, its Shari`ah screening criterion is crucially important for many index providers. Many stock exchanges, like Oman, Maldives, Philippines, and institutions, like Azzad, Alfa Bank have adopted AAOIFI's Shari`ah screening criteria for developing index or investing in stocks.

The implications of this paper hold significant impact on not only the AAOIFI, also those countries or institutions which have adopted AAOIFI's Shari'ah screening criteria. The effect of the implications of this paper is manifold. It is believed that it would make the screening process much simpler, because the suggested criterion has lesser filters. The calculation of those filters is more straightforward as it is free of unnecessary sophistication. This would make the task of maintaining a Shari'ah compliant index more efficient and less cumbersome for index providers. From investors' perspective, the proposed criterion would be greatly beneficial because it would make the pool of Shari'ah compliant stocks much larger. They would be able to maintain diversification at a greater level in their portfolio by choosing stocks from a greater number of available Shari'ah compliant companies. From companies' aspect, it would be easier for them to qualify for the Shari'ah compliant list, and maintain their status with an ease. Ultimately, the implications of this paper are believed to be instrumental in the proliferation of the growth and development of Islamic capital markets at domestic as well as international level.

3. AAOIFI'S CRITERION EXPLAINED

Table 1 below summarizes the components/filters of AAOIFI's criterion for screening stocks which are mainly derived from AAOIFI's Shari'ah standard # 21 on financial papers (shares and bonds). For the sake of clarity, we have categorized and named the filters accordingly.

It can be observed from Table 1 that AAOIFI's criterion consists of five filters. The first four filters may be called "compliance filters", while the fifth filter as "tradability filter". As the key objective of AAOIFI's criterion is to ensure that any company whose shares are considered Shari'ah compliant should not be mainly involved in any impermissible business activities, including receiving or paying interest, this is taken care of by compliance filters. On the other hand, the tradability filter protects against the trading of a company's shares in the Shari'ah compliant list becoming a currency exchange (*bay' al-sarf*) or sale of debt (*bay' al-dayn*); otherwise, such trading would be subject to the Shari'ah rulings of *bay' al-sarf* and *bay' al-dayn*, which are employed to avoid any interest (*riba*) element in such transactions. This will be elucidated further in the following section, as it will look into each filter mentioned in Table 1, and critically analyze it. Moreover, a new filter is also introduced which is recommended to replace a filter in the current criterion.

3.1. Filter of Main Business of the Company

The filter of main business of the company is quite straight forward, and the rationale behind it is also obvious. The Qur'an says: "O you who believe, do not wrongfully consume each other's wealth" (4:29, Trans. Abdul Haleem, 2004). Al-Mazhari (1991) explains that here 'wrongfully consuming' wealth means acquiring wealth through the means which are prohibited in Shari'ah. Therefore, Shari'ah does not allow to participate in an impermissible business, because it also falls under consuming other's wealth wrongfully. Moreover, the income generated from an impermissible business is also impermissible as stated in an Islamic legal maxim: "Whatever is impermissible in itself, its price [or income] is also impermissible." (Al-Zuhayli, 2006, vol.1, p. 632). The

AAOIFI (2015), in Shari`ah standard # 21, also states the requirement that the company should not have decided its objective in its memorandum of association as to deal in interest or other prohibited products or services.

Table 1: Shari`ah Screening Criterion of AAOIFI

Categories of Filters	Names of Filters	Purposes of Filters	Benchmarks of Filters
Compliance Filters	Main business of the company	To exclude companies with impermissible core businesses	Impermissible core business may include activities based on <i>riba</i> or interest/usury (like conventional banks), trading in uncertainty/risk (<i>gharar</i>) (like insurance companies), gambling/games of chance (<i>maysir</i>) (like casinos), manufacturers or traders of impermissible products or services (like liquor, pork, prostitution, etc.)
	Non-compliant income to total income	To control interest and other types of impermissible income	Impermissible + interest income < 5% of total income of the company
	Interest taking deposits to market capitalization of total equity	To control interest income	Interest taking deposits < 30% of the market capitalization of total equity
	Interest bearing debt to market capitalization	To control the involvement of the company in paying interest	Interest bearing debt < 30% of the market capitalization of the corporation
Tradability Filter	Illiquid assets to total assets	To ensure that illiquid assets do not become small in amount	Total market value of illiquid assets \geq 30% of the market value of the total assets

Source: authors' own

3.2. Filter of Non-Compliant Income to Total Income

This filter in AAOIFI's criterion is applied with the aim of controlling and keeping interest income or any other type of impermissible income within a minimum or tolerable percentage. Consequently, this filter also restricts a company's involvement in impermissible activities. It ascertains that the impermissible income of a company, including interest income, should not exceed 5% of the company's total income. Although the filter seems quite logical, however, the 5% benchmark is questionable. Unfortunately, AAOIFI (2015) does not provide any specific Shari`ah justification for proposing this percentage. So, it is not clear as to why less than 5% impermissible income (including interest) be allowed, and more than 5% is not allowed.

We argue that ideally it should be zero percent, because this is the issue of prohibition. Particularly, both paying and receiving interest (*riba*) are categorically prohibited in the Shari'ah. The Qur'an says:

"But those who take usury will rise up on the Day of Resurrection like someone tormented by Satan's touch. That is because they say, 'Trade and usury are the same,' but God has allowed trade and forbidden usury. Whoever, on receiving God's warning, stops taking usury may keep his past gains— God will be his judge—but whoever goes back to usury will be an inhabitant of the Fire, there to remain. God blights usury, but blesses charitable deeds with multiple increase: He does not love the ungrateful sinner." (2:275-276, Trans. Abdul Haleem, 2004).

Therefore, zero percent for this filter is the desirable benchmark. However, due to the nature of the contemporary economic and financial system, most of the companies one way or the other are deeply involved in interest-based transactions. Moreover, some companies tend to have both permissible and impermissible lines of businesses. Prohibiting participation in such companies would inflict harm and hardship on the Muslim investors. A legal maxim requires: "Harm must be eliminated." (Al-Zuhayli, 2006, vol.1, p. 210). Another maxim states: "Hardship begets facility." (Al-Zuhayli, 2006, vol. 1, p. 257). While another one reads: "Necessities make forbidden things permissible." (Al-Zuhayli, 2006, vol. 1, p. 276).

Considering the issue of participation in stocks in the light of the above Islamic legal maxims, it can be posited that some concession should be made to remove hardship and eliminate general harm from Muslim investors. However, at the same time, the concession should be based on the real and inevitable requirements. In other words, it should be proportionate to the genuine need and actual necessity of the companies and investors. Given that, a permission from the original ruling of prohibition should not be too stringent or insufficient that it could not facilitate the market players in this matter, and fail to remove hardship from them. On the other hand, it should not be too relaxed that it would be abused or it would permit an impermissible thing without any valid justification, since another maxim unequivocally says: "Dispensations given owing to necessities must be limited to the extent of the necessities." (Al-Zuhayli, 2006, vol. 1, p. 281).

Keeping this in view, one must acknowledge the fact that the Shari'ah ruling on participation in the capital markets merits some relaxation, but the relaxation should be confined to its actual need. Khatkhatay & Nisar (2007) conducted a research on the stocks listed on the Bombay Stock Exchange 500 (BSE 500) index. They found that when they applied the 5% benchmark for the impermissible and interest income on those stocks, almost 90% of the stocks passed the filter. When they reduced the benchmark to only 1% for the same filter, still almost 75% of the stocks were able to pass the filter. Based on their empirical study, they suggested that the 5% benchmark, particularly for the stocks on BSE500, is too liberal. Therefore, they proposed to reduce it to 3%, which was sufficient for that particular market. Considering their findings, we argue that the AAOIFI should reconsider the benchmark for this filter. It is appreciated that capital markets in different jurisdictions exhibit different characteristics. Each market is operated in different circumstances and dynamics, and is influenced by different factors. One benchmark may appear to be too relaxed in one market, while a similar benchmark can be too stringent in

another. Hence, instead of having the approach of one size fits all, the benchmark should be allowed to differ from one market to another based on the specific factors and characteristics of each capital market. However, the genuine need is to be recognized by Shari'ah scholars and should be proportionate to its real requirements, which can be determined by regulatory bodies, Shari'ah experts and market players through comprehensive and separate empirical research for each market. Most importantly, the research could be conducted frequently from time to time, and the benchmark could be updated on a regular basis with the aim of reducing it gradually until it reaches to zero percent, which is the desired percentage. In this regard, the question may arise then what if research indicates that a filter of more than 5% is required to give investors a basic universe of say 50% of the stock market? Should there not be a cap? The answer would be: if a valid research indicates that a benchmark of more than 5% is genuinely required, then more than 5% should be allowed. The cap can be determined by the research itself and subject to the unanimous approval of the Shari'ah scholars and regulatory bodies. Since such concession is based on real necessity, there should not be any objection on it. This is supported by the Islamic legal maxim as mentioned above "Dispensations given owing to necessities must be limited to the extent of the necessities.". This maxim works both ways. The concession can be further reduced or increased based on the necessity. In other words, the concession should be equal to the extent of necessity. If the necessity and its extent is justified, the concession could be made accordingly.

Let's say a research indicates that the Muslim investors in London Stock Exchange need at least 50% of the listed stocks for investment, and this has been justified based on the principle of necessity. To make 50% of the stocks available to the Muslim investors, the research indicates that 10% benchmark is required for this filter. The Shari'ah scholars can then decide to allow 10% benchmark, because it has been determined based on necessity. Later the scholars can gradually reduce that 10% benchmark and fix it at zero percent.

3.3. Filter of Interest Taking Deposits to Market Capitalization of Total Equity

This filter focuses on the amount of cash or liquidity a company has in the deposits on which it earns interest. Basically, it is the amount of debt a company extends with the aim of receiving interest on it. The filter ensures that the amount of total deposits on which a company receives interest should not exceed 30% of the market capitalization of the total equity of the company. The purpose of this filter is same as the previous filter, which is to restrict a company's involvement in interest-based transactions. Primarily, involvement with a company that provides loans on interest, notwithstanding the fact that such involvement falls under the category of secondary activity should not be allowed in the least. Nonetheless, holding such opinion would inflict harm to the Muslim investors. Therefore, it is permitted since the amount of interest taking deposits remains within the specified benchmark based on the Shari'ah principles of removal of hardship and dire necessity as has been mentioned above (AAOIFI, 2015).

We argue that this filter seems to be redundant; it is difficult to see any significant requirement from the perspectives of Shari'ah for this filter so long the filter of non-compliant income to total income is in place. In fact, the filter of non-compliant income to total income can serve the purpose of excluding companies with impermissible

activities in a better way than this filter. Additionally, it is hard to justify this filter from the Shari'ah point of view. In the Shari'ah, extending loans is normally allowed without any restriction on the amount of loans. Rather, it is a commendable practice being considered as a form of charity, or even better than that. The Prophet Muhammad (ﷺ) is reported to have said: "On the night on which I was taken on the Night Journey, I saw written at the gate of Paradise: Charity brings a tenfold reward and a loan brings an eighteen-fold reward. I said: O Jibril! Why is a loan better than charity? He said: Because the beggar asks when he has something, but the one who asks for loans does so only because he is in need." (Ibn Majah, n.d., hadith # 2431).

A loan transaction only becomes usually impermissible when the lender asks for interest on it, because interest is impermissible, and in this case, the charity aspect of the loan is compromised (Al-Zuhayli, 2001). So, it is the interest factor which makes it impermissible, not the amount of loans *per se*. In addition, AAOIFI's whole criterion is about deciding on which stock is Shari'ah compliant or otherwise. In the light of the above discussion, this filter does not seem to play a vital role in deciding Shari'ah compliance of a stock. However, one may argue that the special purpose of this filter is to limit companies from extending loans on interest, and consequently controlling them from indulging in impermissible activities. This can be answered by the fact that the filter of main business activity is already in place to ensure that the main business activity of a company should not be interest-based. As for the involvement in interest-based transactions as a secondary activity, it is already taken care of by the previous filter, which ensures that the interest received by a company should be within the tolerable limit, if not zero. As long as the interest income remains within the tolerable limit, the amount of loan does not seem to be a valid and important cause for deciding Shari'ah compliance of a stock. Moreover, it is of concern that the existence of such filter would negatively impact the efficiency and focus of the whole criterion. Hence, the AAOIFI should reconsider the presence of this filter in its criterion.

3.4. Filter of Interest Bearing Debt to Market Capitalization

This filter takes into account the debt which is borrowed by a company, and the company pays interest on it. It ascertains that the interest-bearing debt of a company should not exceed 30% of the market capitalization of the company. The Shari'ah justification and rationale behind this filter is based on the prohibition of paying interest. It is reported that the Messenger of Allah (ﷺ) cursed the devourer of interest and its payer, and one who records it, and the two witnesses, and he said: they are all equal (in guilt). (Muslim, n.d., hadith # 1598) it can be construed that just as receiving interest is impermissible, paying interest is also impermissible. Therefore, a company ideally should not borrow on interest at all. Nevertheless, for the sake of removing hardship and facilitating people in dire need, it is allowed to participate in such companies with the condition that they pass this filter (AAOIFI, 2015).

There is no objection on the aim of this filter which is to restrict a company from being involved in interest-based transactions by borrowing on interest; because consequently, the company in this way engages in impermissible transactions, and pays interest. However, we argue that this filter, instead of focusing on the impermissible element which is the interest payment, concentrates on a less relevant element which is the amount of

borrowed debts. In fact, the amount of borrowed debts cannot be considered as valid and important cause of Shari`ah compliance at all. A company can run its business and operations through getting financing completely in the form of debts. There should not be any Shari`ah objection on it as long as the company does not pay any interest on it. Thus, the factor which affects Shari`ah compliance of a stock is interest payment, not the amount of debts it borrows; hence, the factor of interest payment should be controlled and restricted by the filter, not the amount of debts itself. In order to control the interest payment of a company, we introduce an entirely new filter which is explained in the next sub-section.

3.5. *Introducing a New Filter*

The current filter gauges the interest payment in an indirect way. In order to be efficient, robust and theoretically sound, the filter should directly capture the interest payment. Therefore, we suggest that total interest expense of a company against its total income should be taken into consideration. It should not exceed a certain benchmark. The formula to calculate it would be:

$$\frac{\text{Total Interest Expense}}{\text{Total Income}} < X\%$$

The rationale behind taking interest expense is that it represents the total interest payment of a company. The justification for taking total income in the denominator is that it would measure the interest payment in comparison with the total revenue generated by a company. As expenses are directly related to the total income because they are paid out of the total income, it seems quite logical. Hence, it is appropriate to measure the interest payment against the total income. On the other hand, it is noteworthy that we have not proposed any specific percentage as a benchmark of the filter, and that has been done intentionally. We propose that similar to the benchmark of non-compliant income to total income, the benchmark of this filter should also be determined on the basis of the exact dire need of the market players of each capital market. The benchmark should reflect the proportion of the genuine requirements. The regulatory bodies, Shari`ah scholars and market players of each capital market can collectively determine a benchmark based on a comprehensive empirical research specific to each market on a case by case basis. It goes without saying that the benchmark of this filter, similar to the benchmark of the non-compliant income to total income, should be regularly adjusted and gradually decreased in order to reduce the amount of interest payment of the Shari`ah compliant companies to zero per cent.

This proposed filter seems to be more logical, efficient, direct and theoretically robust than the current filter introduced by the AAOIFI. Therefore, it is suggested that the AAOIFI should consider including this filter in the criterion. Besides, other regulatory bodies and index providers may also look into this filter and include it in their own criteria.

3.6. *Filter of Illiquid Assets to Total Assets*

Unlike all previous filters, this filter does not principally focus on the Shari`ah compliance of a stock, rather it has been created for the tradability feature of a stock. In fact, AAOIFI (2015) defines a stock or share as:

“A share represents an undivided share in the capital of a corporation, just as it represents an undivided share in its assets and the rights associated with it upon conversion of the capital into tangible things, benefits, debts and so on. The subject-matter of the contract at the time of trading of shares is this undivided share.” (AAOIFI, 2015, p. 562)

It can be construed from the above definition that AAOIFI (2015) perceives that a stock represents “ownership of the shareholder for his undivided share in the assets of the company” (p. 562). Furthermore, when a stock is traded, the subject matter of the transaction becomes the assets of the company. Given that, the AAOIFI (2015) views that the composition of the assets of a company is important and directly affects the tradability feature of a stock. Thus, it holds that when a company’s assets are only in the form of cash, or liquid assets, trading of the company’s stock is only permissible with two conditions: 1) the stock should be traded at the nominal value; and 2) the delivery of the price and stock should be on spot basis. So, the trading of such stock falls under the Shari`ah rules of currency exchange (*bay` al-sarf*). Likewise, when a company’s entire assets are in the form of receivables (debts), trading of the stocks of such company falls under sale of debt (*bay` al-dayn*). Hence, the Shari`ah rulings of sale of debt should be observed in trading of such stocks (AAOIFI, 2015). Since this filter is not about Shari`ah compliance, rather about tradability of a stock, it does not differentiate between permissible and impermissible cash and debt. It only considers whether an asset is illiquid and non-debt or otherwise.

However, to the AAOIFI (2015) if the assets of a company consist of a mixture of cash (liquid assets), receivables or debts, fixed or tangible assets, benefits and rights, then the Shari`ah ruling for the tradability of the stocks of such company would depend on the primary asset. If the primary asset is cash, the Shari`ah ruling of *bay` al-sarf* will be applied. If the primary asset is receivables, the Shari`ah ruling of *bay` al-dayn* will be applied. If the primary asset is other than those two types of asset, then the Shari`ah ruling will follow general conditions of the subject matter of sale. The AAOIFI (2015) defines the primary asset as the one which conforms to the objective and main business activity of a company. Additionally, to avoid falling under the Shari`ah rulings of *bay` al-sarf* or *bay` al-dayn* in trading stocks of a company, the AAOIFI (2015) also puts a condition that the total market value of non-cash and non-debt assets should be at least 30% of the total value of all the assets. Thus, if the primary asset of a company is neither cash nor debt, and the total market value of all non-cash and non-debt assets is at least 30% then the stocks of such company can be freely traded at any price. The AAOIFI (2015), as a precautionary measure, also states that this permission should not be used as a way for dealing in cash or debt. For instance, a company should not artificially introduce illiquid assets among its total assets with the aim of dealing in cash or debt.

As the Shari`ah justification for the opinion about trading of stocks representing mixed assets, the AAOIFI (2015) mentions that primarily the cash and receivables in a stock should follow their own Shari`ah ruling, but if they are subordinate to a principal asset which is other than cash and receivables, then they will follow the Shari`ah ruling of the principal asset. To support this argument, the AAOIFI (2015) mentions a few *ahadith* and legal maxims as follows: “When a person buys a slave, who has wealth, then the wealth is for the seller, unless the buyer stipulates this too.” (Bukhari, 2001, hadith # 2379).

The AAOIFI (2015) argues that there is no condition for the price of the slave, it can be anything. Conversely, the slave's wealth may include cash, receivables, fixed assets, etc. in any amount. Even with the probability of the presence of cash or debt in the possession of the slave, the cash and debts are not considered because the slave is the principal asset in this case and his wealth is subordinate to him. Another *hadith* referred to by the AAOIFI (2015) is: "When a person buys a palm-grove after pollination, then the fruit is for the seller, unless the buyer stipulates this too." (Bukhari, 2001, *hadith* # 2204).

AAOIFI (2015) elucidates that the sale of fruit before it starts ripening is generally prohibited in Shari'ah, but in the above *hadith* it is allowed, because in this case, the unripe fruits are subordinate to the palm-grove. Given that, Shari'ah scholars have established a few principles of Islamic jurisprudence, such as "A subsidiary cannot be subject to different Shari'ah rules [than its parent]." (Al-Zuhayli, 2006, vol. 1, p. 441); and "A subsidiary follows the Shari'ah rules applicable to its parent." (Al-Zuhayli, 2006, vol. 1, p. 434).

As for the justification of the benchmark of 30% for this filter, the AAOIFI (2015) mentions that although cash and receivables are allowed in the criterion to be more than 50% of the total assets in value, as they may reach up to 70%, still they would remain subordinate to the non-cash and non-debt assets since the non-cash and non-debt assets are at least one third in value. Nonetheless, if these are reduced to less than one third, they would become meagre and would not be eligible to be considered as the principal asset against cash and debt which would be more than one third in such case.

The AAOIFI's explanation for the benchmark does not seem adequate, nonetheless, it seems that the one-third measurement has been derived from a *hadith* where Sa'ad Bin Abi Waqas (R) narrates:

"I became seriously ill at Mecca and the Prophet (ﷺ) came to visit me. I said, "O Allah's Messenger (ﷺ)! I shall leave behind me a good fortune, but my heir is my only daughter; shall I bequeath two third of my property to be spent in charity and leave one third (for my heir)?" He said, "No." I said, "Shall I bequeath half and leave half?" He said, "No." I said, "Shall I bequeath one third and leave two thirds?" He said, "One third, and one third is much." (Al-Bukhari, 2001, *hadith* # 5659).

From the above *hadith*, some scholars have derived the principle that one-third amount is substantial for anything in issuing a Shari'ah ruling (Al-Qurahdaghi, 2003). So, if the non-cash and non-debt assets are found to be one-third in value, they would be considered as substantial or significant.

We argue that this filter is debatable from numerous aspects. First, the perception that a stock merely represents the ownership of the assets of a company, confined to cash, receivables and tangible assets, is a controversial concept. In fact, some studies even do not recognize the shareholders' ownership on the underlying assets of a company. For instance, Manjoo (n.d.) mentions that this concept might have been valid based on the old legal structure of companies. Nevertheless, due to the great historical evolution in the legal concept of companies and stocks, a stock no longer represents ownership of the assets of a company, rather it represents a bundle of rights that belong to the owner of that

stock. He argued that some real cases from the court, like *Macaura v. Northern Assurance Co. Ltd* (1925) and *R v. Philippou* (1989) where it was clearly stated that a shareholder does not own the assets of a company. Goulding (1996) also supports that a stock does not entitle ownership of underlying assets of the company to its holder. A company's property, according to him, is legally owned by the company itself. Likewise, Abbasi (2009) and El-Gari (n.d.; 2015) reiterated the same argument by mentioning that the property of a company cannot be attributed as the property of its shareholders in legal theory. In the light of those studies, the issue of the shareholders' ownership on the underlying assets demands an in-depth scrutiny from Shari'ah perspectives, which needs an independent research. Whether a share represents a bundle of control ownership of underlying assets in conventional legal system, the contemporary Muslim jurists need to settle it if there is sufficient evidence of ownership of shareholders from Shari'ah point of view or otherwise.

Besides, many Shari'ah scholars, like Aal Sheikh (1979), Al-Manea (1996), Al-Qurahdaghi (2003), and many others opine that other than cash, receivables and tangible assets, a stock of a company more importantly represents the company itself, its main business activities, human management, ability to produce and future prospects of generating revenues. Instead of merely considering cash, receivables and tangible assets of a company, these significant factors should also be considered.

One may argue on whether these opinions should be accepted as they are, but at least, they adequately prove that the concept of stocks being evidence of ownership of underlying assets of the company is indeed a controversial concept. In addition, other scholars have opined that a stock also represents elements which are other than cash, receivables and tangible assets of a company. Therefore, it may not be accurate to establish a filter solely on the concept of a share representing merely the ownership of cash, receivables and tangible assets of a company, rather the intangible assets or factors, which are arguably more important, should also be considered.

Second, deriving the principle of one-third being substantial from the aforementioned *hadith* of Sa'ad Bin Abi Waqas is also a controversial matter in Shari'ah. It can be observed that the *hadith* is about bequest, and as such setting the benchmark for the filter based on this *hadith* seems to be interpreting it out of the context. In fact, the majority of scholars do not accept the principle of one-third. For instance, Hanafi scholars do not give credence to this principle. The view that the criterion of majority is more than half (>50%), and minority is less than half (<50%). The criterion of something that is exactly half (=50%) should be decided on the basis of custom (Al-Kasani, 1986). Maliki scholars also differ on this issue; some hold that half (50%) is the measurement of substantial quantity, while others hold that it is one-third, and some hold that it is less than one-third. Hanbali and Shafi'i scholars prefer in some cases custom to decide the benchmark for substantial quantity, while in some cases, they rely on the principle of one-third (Al-Nadwi, 2006; Al-Hababisah, 2013). Thus, it is safe to say that the principle of one-third is not a well-accepted principle.

Third, the 30% benchmark for the filter is counter-logical. Let us suppose that a company has 70% of liquid assets and 30% illiquid assets. Since the illiquid assets are up to the benchmark, the company would pass the filter, and its stocks would be tradable without

the application of the Shari`ah rulings of *bay` al-sarf*. It is interesting that the liquid assets are not only more than the illiquid asset in this case, but also, they are even more than two-third (70%); and yet they would be ignored in issuing the Shari`ah ruling and would be treated as meagre. By virtue of the same one-third principle, liquid assets would also be significant. Furthermore, the AAOIFI's opinion goes against the legal maxim which states: "The majority takes on the Shariah ruling of the whole." (Al-Zuhayli, 2006, vol. 1, p. 601). As per this maxim, 70% of liquid assets should definitely be considered as the whole against 30% illiquid assets in issuing Shari`ah rulings. Therefore, such stocks should be subject to the Shari`ah ruling of *bay` al-sarf*.

Fourth, the benchmark of the filter in AAOIFI's criterion is 30% which is less than one-third, while according to the principle of one-third, it should be 33.33%. Thus, it is evident that the principle of one-third has not been correctly applied in the criterion.

Fifth, as was mentioned earlier, the AAOIFI (2015) also applies the maxim of principal and subordinate in this regard. The maxim of principal and subordinate is a qualitative measure, and hence it does not accept any quantitative benchmark. The AAOIFI (2015) itself mentions in the interpretation of the *hadith* of the slave possessing wealth (mentioned above) that:

"[The hadith] indicates that debts or cash, **less or more**, in comparison with the price of the slave are not taken into account in the Hukm [Shari`ah ruling], because they are in this case secondary and are not the primary purpose of the contract. Imam Malik relates this Hadith in Al-Muwatta' and then says: "The matter is settled unanimously in our view that if the buyer stipulates the wealth of the slave then it belongs to him, whether this is cash or debt or goods, **known or unknown**. This applies even if the wealth owned by the slave is **more than that with which he is purchased**, and irrespective of whether the price is cash debts or goods." [emphasis added] (AAOIFI, 2015, p. 577)

It is clearly indicated in the above statement that the amount of cash or debt possessed by the slave is irrelevant in this case. It does not matter whether it is less or more than the price, known or unknown, because in this case it is subordinate to the slave (the primary element). Similarly, we argue that since cash and receivables are subordinate to a principal asset which is non-cash and non-debt in nature, their amount should not be restricted by any percentage. Therefore, it is proposed that the AAOIFI should reconsider the presence of this filter in the current criterion based on its role in Shari`ah ruling and logical justifications.

4. CONCLUSION

Shari`ah screening of stocks is the backbone of Islamic capital market. An efficient and practical Shari`ah screening methodology is the key for having a robust criterion for stocks, because based on this criterion the fate of stocks, in terms of being Shari`ah compliant or non-compliant, is decided. The more the criterion of Shari`ah screening is theoretically strong and practically viable, the more the investors, companies, regulators and other players of the Islamic capital market have confidence in the market. The Shari`ah standards of the AAOIFI, among other index providers, propose its own Shari`ah

screening criteria. Due to the well-reputed position of the AAOIFI and worldwide acceptance of its standards, its Shari`ah screening criteria hold unique significance. This paper thoroughly analyses the AAOIFI's criteria and strongly recommends for making substantial changes to the same. The AAOIFI should reconsider the benchmark of the filter of non-compliant income to total income. Also, it should re-evaluate the presence of the filters of interest taking deposits to market capitalization of total equity and illiquid assets to total assets. Lastly, the AAOIFI should deliberate on replacing the filter of interest bearing debt to market capitalization with interest expense to total income of the company. The proposed criterion is summarized in Table 2 below:

Table 2: Proposed Shari`ah Screening Criterion

Categories of Filters	Names of Filters	Purposes of Filters	Benchmarks of Filters
Compliance Filters	Main Business of the Company	To exclude companies with impermissible core businesses	Impermissible core business may include activities based on interest (like conventional banks), uncertainty (like Insurance companies), gambling (like casinos), manufacturers or traders of impermissible products or services (like liquor, pork, prostitution, etc.)
	Non-Compliant Income to Total Income	To control interest and other types of impermissible income	Impermissible + Interest Income < X% Of Total Income of the Company
	Interest Expense to Total Income	To control the involvement of the company in paying interest	Interest Expense < X% of the Total Income of the Company

Source: Authors' own

4.1. Implications of the Proposed Shari`ah Screening Criterion

The implications of the criterion proposed in this paper would have great impact on the current understanding and practices of Shari`ah screening of stocks. The proposed criterion is founded on stronger Shari`ah justification and logical basis, as it directly relies on the sources of Shari`ah. It is favourable for the index providers because it provides not only less complicated, also an efficient and practically more viable solution for it does not consist of any unnecessary filter. The calculation of the ratios is also straightforward. Furthermore, it is beneficial for the companies because it would make it easier for them to become Shari`ah compliant as there are fewer filters and those too are straightforward. Besides, it would facilitate investors interested in investing in the companies which are permissible from Shari`ah point of view by offering them a larger pool of Shari`ah compliant stocks. This pool would provide greater opportunities of portfolio diversification and more effective risk management strategies. Overall, the implications

of this paper play a pivotal role in further progress of Islamic capital market at both domestic and international level.

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