



**AAOIFI**

ACCOUNTING AND AUDITING ORGANIZATION  
FOR ISLAMIC FINANCIAL INSTITUTIONS

# Shari'ah Screening Methodology

**Dr. Hamed Merah – Secretary  
General, AAOIFI**

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# The Agenda

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# The Agenda of the Presentation

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Introduction to  
AAOIFI

Introduction to  
Capital Markets  
and Related Issues

Shari'ah Screening  
at a Glance

Brief on AAOIFI's  
and other Shari'ah  
Screening  
Methodologies



# AAOIFI: An Introduction

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# AAOIFI has 26 years long story...

- 1 Established in 1991, 26 years ago
- 2 Mission is to develop and issue standards for the global Islamic finance industry
- 3 Large base of member institutions from 45 countries, including Central Banks, around 25 regulatory authorities, financial institutions, accounting & auditing firms, legal firms, etc.
- 4 To date, AAOIFI has issued 100 standards
- 5 Standards issued cover 5 disciplines: Shari'ah, accounting, auditing, ethics and governance
- 6 AAOIFI offers contract certification + software certification services

AAOIFI is responsible for developing and issuing standards for international Islamic finance industry.



# AAOIFI at a Glance

## Members

- **Numbers of institutional members from over 45 countries**
  - Central Banks
  - Regulatory authorities
  - Financial institutions
  - Accounting & auditing firms
  - Legal firms

## Status of Adoption

### Regulatory Requirement

- Bahrain
- Qatar
- Oman
- Syria
- Sudan
- Jordan

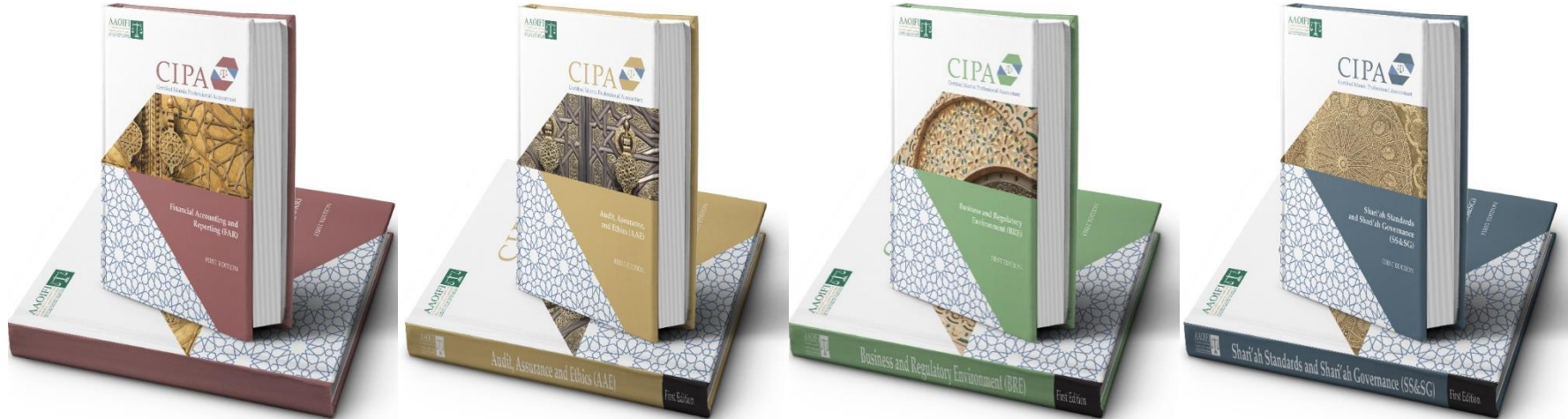
### As Basis for National Standards

- Indonesia
- Pakistan

### Guidelines

- Brunei
- Egypt
- France
- Kuwait
- Lebanon
- South Africa
- Malaysia
- KSA
- UAE
- UK

# The Face of the Revamped CIPA



Financial  
Accounting and  
Reporting (FAR)

Audit, Assurance,  
and Ethics (AAE)

Business and  
Regulatory  
Environment (BRE)

Shari'ah Standards  
and Shari'ah  
Governance  
(SS&SG)



## The Numbers Behind the Effort

No. of  
Work Hours  
~ **29,000**

No. of Days  
**1200**

Team Size  
**47**

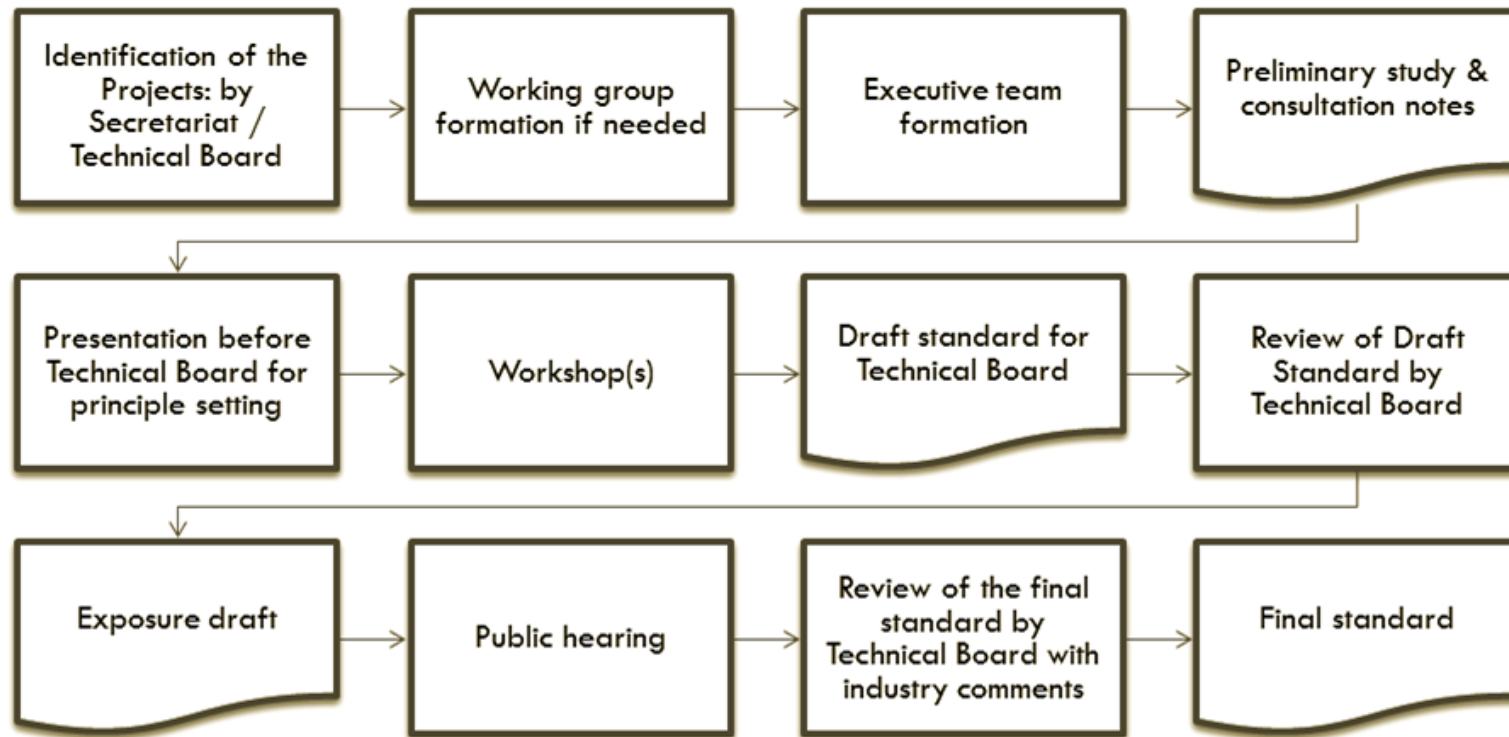
No. of  
Meetings  
**200+**



No. of Pages  
Edited from **3,000** → **1,600**

Question Bank  
**2,000+ questions**

## Development & Revision Cycle



# The Agenda of the Presentation

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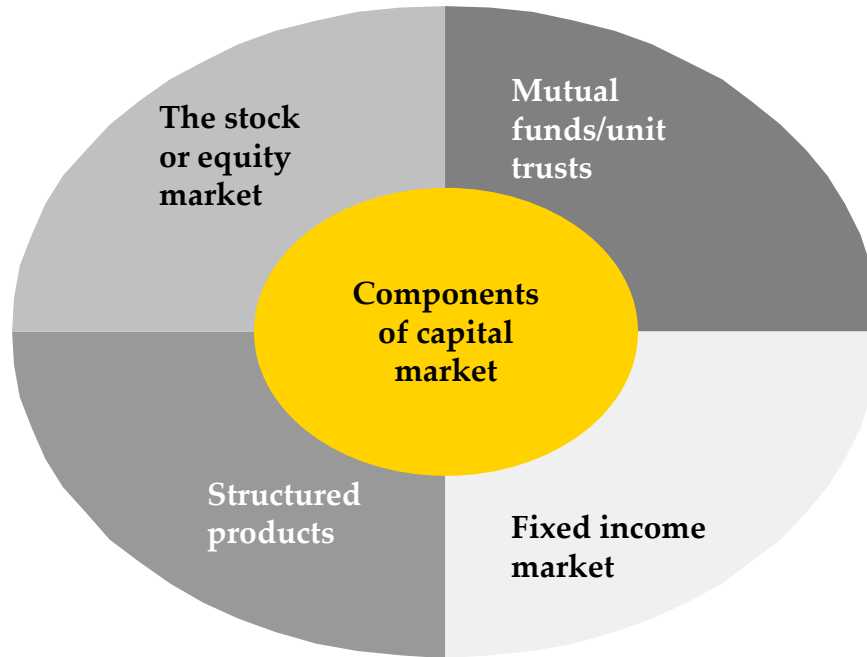
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# Components of Capital Markets: Conventional vs. Islamic



Is this Shari'ah Complaint ?

The components are similar to the conventional capital market components, i.e. Fixed income, equity and structured products, mutual funds/unit trust

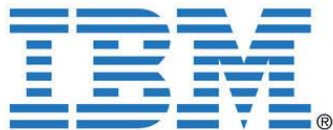
**But**

the features of those components are different from the conventional components.

# Shari'ah Compliant Investor



Can a Shari'ah Compliant Investor buy shares from IBM, Google, Apple, Dell?



Yes, only if the share passes the Shari'ah Screening Criteria



# Islamic Equity Market

**Shares in Shari'ah  
Compliance Companies**

**Screening shares**

According to Shari'ah, it is not allowed to invest in companies that undertake non halal activities such as dealing with conventional banks, pork, alcohol and gambling.

In order to achieve that Shari'ah stock screening is required.

# Islamic Equity Market

**Shares in Shari'ah  
Compliance Companies**

**Screening shares**

There are multiple levels of shar'iah screening:

**Industry screening:** eliminate companies that invest in non halal activities such as dealing with conventional banks, pork, alcohol and gambling.

**Debt and Investments ratios screening:** eliminate companies with financial ratios exceeding the limits agreed by the Shar'iah board.

# The Agenda of the Presentation

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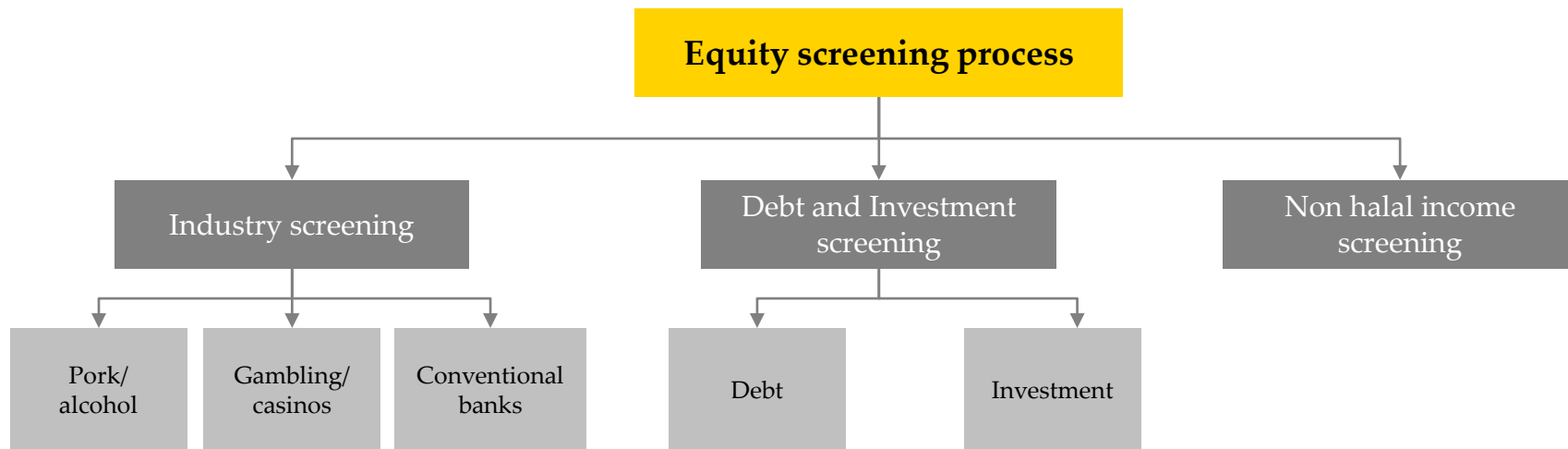
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# Overview of Equity Screening Criteria



# First Level of Equity Screening Process

According to the industry screening, if a company's core business is related to one of the following area , this company will be considered non Shari'ah **Compliance** and therefore it will not be permissible according to Shari'ah to invest in it.

No.	Prohibited activity
1	Conventional financial institutions
2	Conventional insurance companies
3	Alcoholic beverages
4	Gambling
5	Pork and Non-Halal food
6	Non-Halal food
7	Tobacco-related Products
8	Any activities deemed unlawful

## Second Level of Screening

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There are minor differences in the first level of screening. However, there are more differences when it comes to the second and third level of screenings (Debt and Investment ratios and Non-Halal Income).

Different Institutions (AAOIFI, S&P, Dow Jones, etc) offer various solutions. The criteria used by AAOIFI as well as other Institutions are provided in the following slides

# The Shari'ah Screening Process



Extraction of relevant financial information from audited financial report and other material information



Compile the result and issue list of Shari'ah-compliant securities



Undertaking Shari'ah compliance review process to identify contribution from non-permissible activities



Compare with Shari'ah financial benchmark



# Types of Companies of Investments

## Non Shari'ah Compliance

- with Non-Halal activity as its core source of income and if debt and investment ratios exceed the allowed thresholds

## Mixed

- Shari'ah complaint core business and financial ratios that do not exceed the thresholds

## Pure

- Shari'ah complaint core business and no interest based deposits or loans

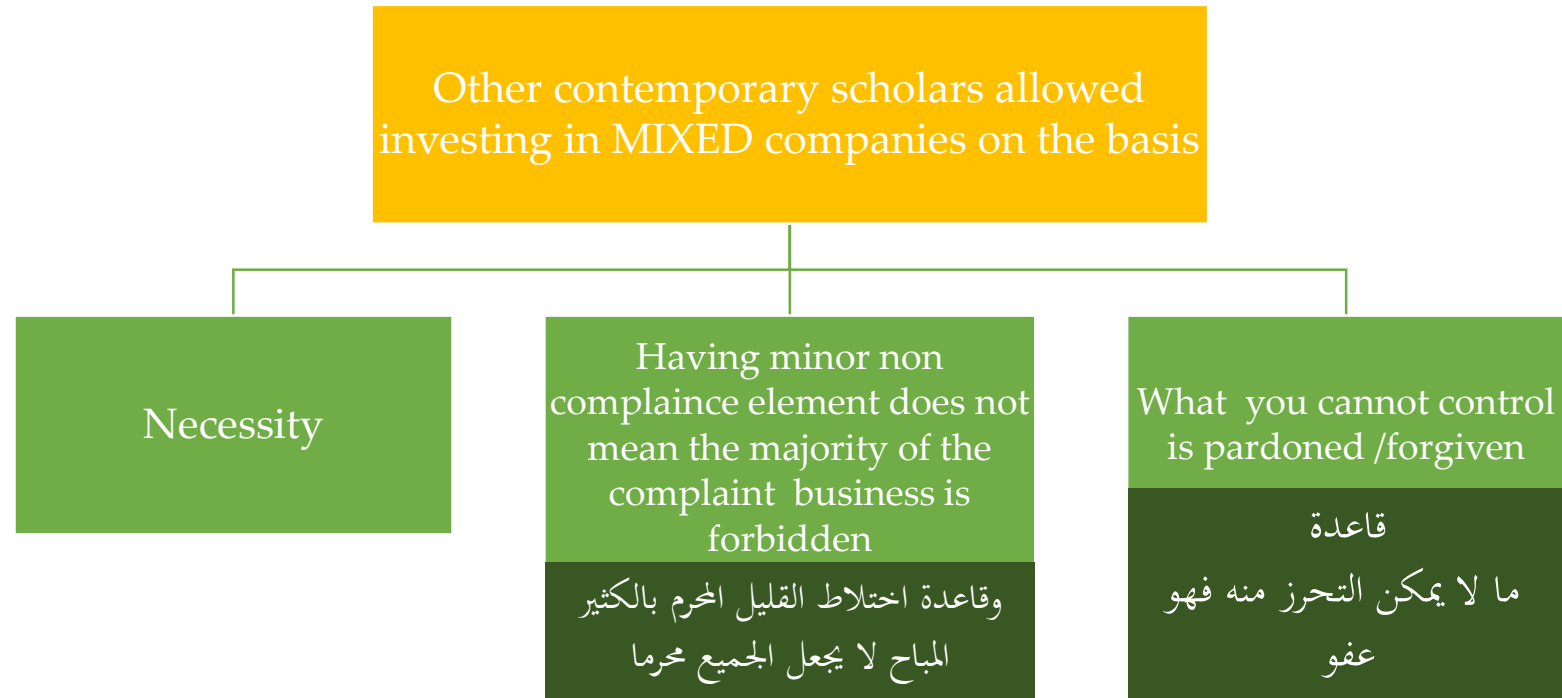
# Types of Companies of Investments - Important Notes

Some scholars only permit investing in PURE companies. This is in accordance with fatwas from :

The Islamic Fiqh Academy : and

The Islamic Fiqh Council of Mecca  
(Affiliate of Muslim World League)

# Types of Companies of Investments - Important Notes



## Note to Consider

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It should be noted that **RIBA is not allowed at any circumstances** (Not even 1%), BUT given that the **investors does not have authority** when it comes to the decisions of the institution, it is allowed to invest in the institution of it passes the Shari'ah thresholds while it's a **must to purify income** through the **Cleansing Process**



A Shari'ah Complaint investor is under a moral obligation to **object in the General Assembly meeting of the company on its non- Shari'ah complaint activities.**



## Cleansing Process

It must be noted that **mixed shares** will have to be cleansed (purified).



Purification means that non Halal Income will have to be donated to Charity and cannot be included in the investors P&L accounts.

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## AAOIFI's Shari'ah Standard No. 21: Financial Paper (Shares and Bonds)

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- In order to provide guidance for the Islamic Capital Markets stakeholders, AAOIFI issued in May 2004, its Shari'ah standard No. 21 on financial papers.
- The following slides shed light on the major guidelines in the standard including mentioning AAOIFI's Shari'ah Screening Methodology.

# Rules for Issuance of Shares

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**2/1 The issuance of shares is permissible** if the **objectives** for which the corporation was established are permissible according to the Shari'ah, thus, the objectives of its formation should not be transactions that are prohibited, like the manufacturing of liquor, trading in swine or transactions in Riba.

**2/4 It is permissible to underwrite the issue** when this is done without compensation in lieu of underwriting.

**2/5 It is permissible to split the value of the share into instalments** at the time of subscription so that one instalment is paid and the remaining instalments are deferred.

**2/6 It is not permissible to issue preference shares** that have special financial features leading to the granting of priority to these shares at the time of liquidation or the distribution of profits. It is permitted to grant certain shares features related to procedural or administration matters, in addition to the rights attached to ordinary shares, like voting rights.

# Rules for Issuance of Shares

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**2/7 It is not permissible to issue Tamattu' shares.** These are shares that grant the participant compensation in lieu of his shares, whose value is redeemed during the existence of the company, and he is granted Tamattu' shares that grant him rights that are available for shares based on capital, except the right to profits and the distribution of assets at the time of winding up, insofar as the Tamattu' shares are entitled to profit lesser than that given to the owner of shares based on capital, just as the owner of Tamattu' shares does not have a share in the assets of the company at the time of winding up until the owners of shares based on capital have been granted the value of their shares.

**2/8** The share certificate – or what stands in its place – is a document that is deemed evidence of ownership of the shareholder for his undivided share in the assets of the company. It is permitted that this document be in the name of the owner, to his order, or for the bearer.

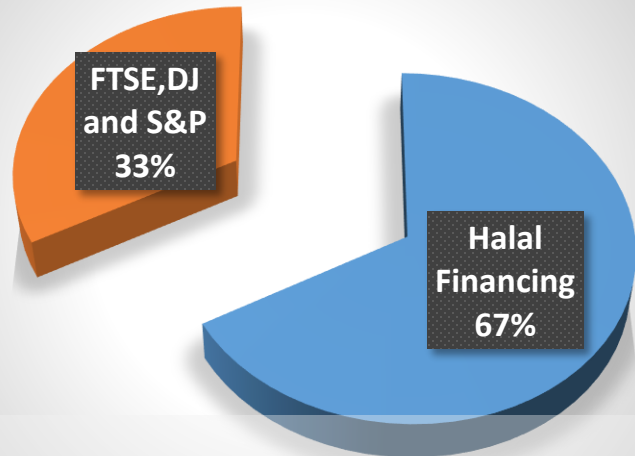
# Rules for Dealing in Shares

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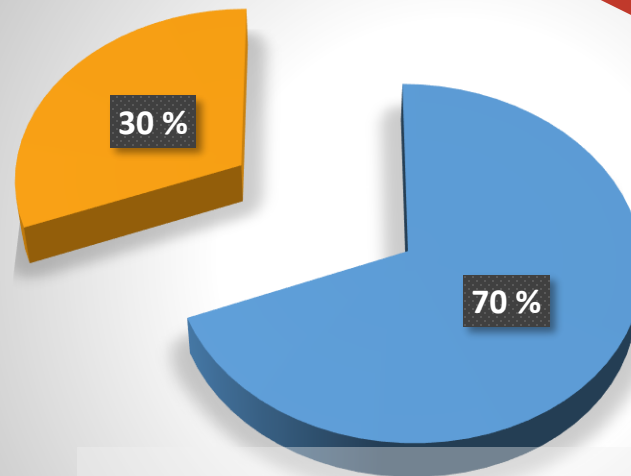
**3/2 It is permissible to buy and sell shares of corporations**, on a spot or deferred basis in which delay is permissible, if the activity of the corporation is permissible irrespective of its being an investment (that is, the share is acquired with the aim of profiting from it) or dealing in it (that is, with the intention of benefiting from the difference in prices).

	Dow Jones	FTSE	S&P	Kuala Lumpur Sharia Index2
Core activities (excluding companies involved in the following activities)	<b>Non-permissible activities:</b> <ul style="list-style-type: none"> <li>• Pork Production</li> <li>• Non-Halal food products</li> <li>• Alcohol beverages</li> <li>• Gaming</li> <li>• Interest-based financial institution</li> <li>• Entertainment</li> <li>• arms, defence</li> <li>• Tobacco</li> </ul> <b>Activities deemed to be contrary to Islam</b>	<b>Non-permissible activities:</b> <ul style="list-style-type: none"> <li>• Pork Production</li> <li>• Non-Halal food products</li> <li>• Alcohol beverages</li> <li>• Gaming</li> <li>• Interest-based financial institution</li> <li>• Entertainment</li> <li>• arms, defence</li> <li>• Tobacco</li> </ul> <b>Activities contrary to Islam</b>	<b>Non-permissible activities:</b> <ul style="list-style-type: none"> <li>• Pork Production</li> <li>• Non-Halal food products</li> <li>• Alcohol beverages</li> <li>• Gaming</li> <li>• Interest-based financial institution</li> <li>• Entertainment</li> <li>• arms, defence</li> <li>• Tobacco</li> </ul> <b>Activities contrary to Islam</b>	<b>Non-permissible activities:</b> <ul style="list-style-type: none"> <li>• Pork Production</li> <li>• Non-Halal food products</li> <li>• Alcohol beverages</li> <li>• Gaming</li> <li>• Interest-based financial institution</li> <li>• Entertainment</li> <li>• arms, defence</li> <li>• Tobacco</li> </ul> <b>Activities contrary to Islam</b>
Leverage	Total debt to trailing 12 month moving average market capitalisation < 33%	Total debt to total assets <33%	Total debt to market value of equity (12 month average) < 33%	Not applicable
Receivables	Account receivables to total asset ratio <45%	Account receivables to total asset <45%	Account receivables to market value of equity (12month average) < 49%	Not applicable
Cash	Cash + interest-bearing securities to trailing 12 month moving average market capitalisation < 33%	Cash + interest-bearing securities to assets <33%	Cash + interest-bearing securities to market value of equity (12 month average) < 33%	Not applicable
Non-Halal income	Less than 5%	Less than 5%	Less than 5%	Less than 5% , 10% or 25% as the case may be

## Debt Ratio - Comparison



■ Halal Financing    ■ FTSE, DJ and S&P

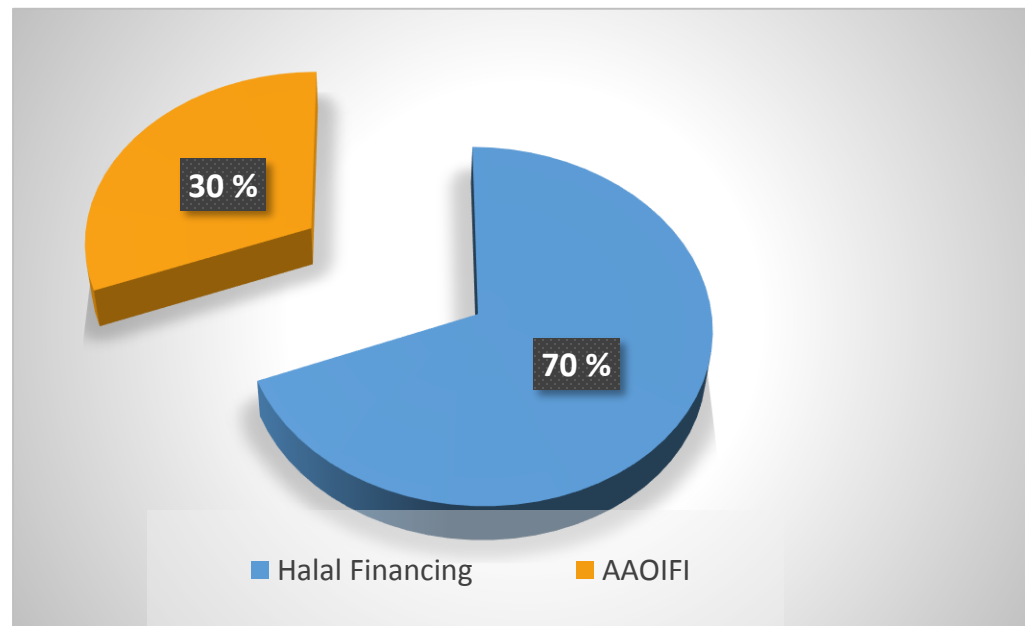
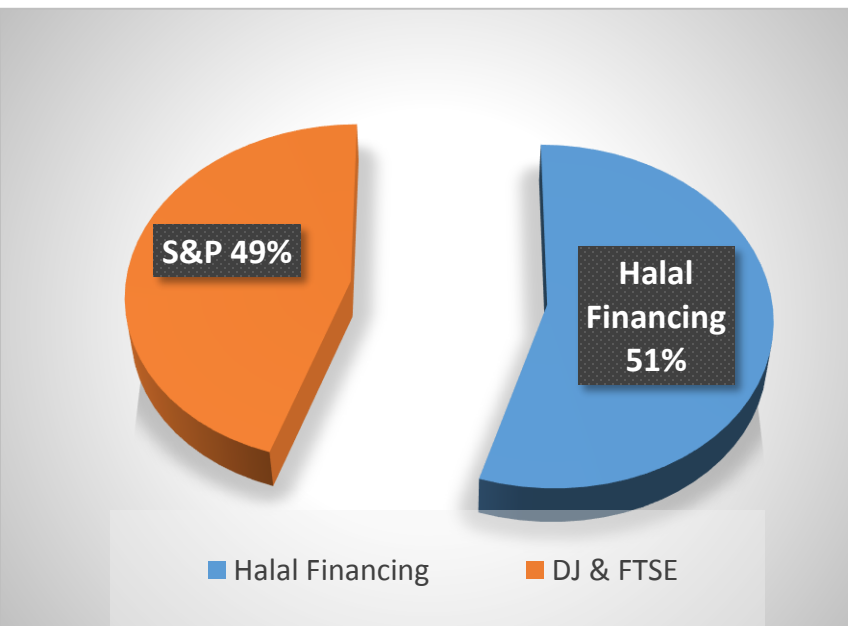


■ Halal Financing    ■ AAOIFI

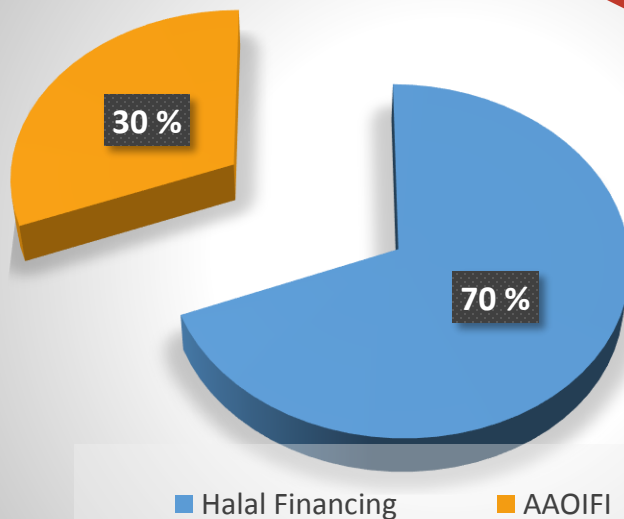
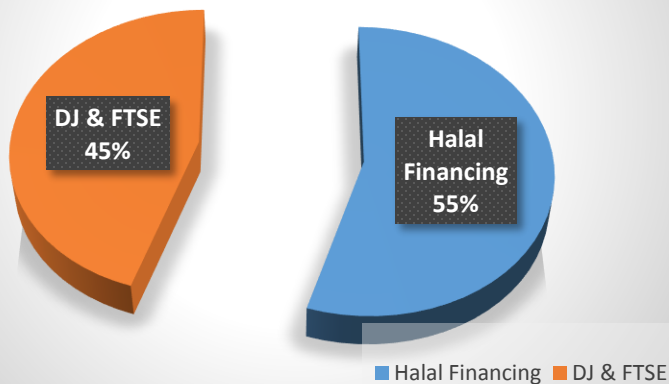
Non Halal  
Income Should  
not Exceed 5%  
of Total Income



## Investment Ratio – Comparison 1/2



## Investment Ratio – Comparison 2/2



Non Halal  
Income Should  
not Exceed 5%  
of Total Income



# CONCLUSION

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## Role of Regulator - Recommendations

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- The Benefits of using Shari'ah Screening are huge for both the investors as well as for the growth and development of the overall Islamic finance industry.
- Having said that, the regulator can help in enhancing the growth of the industry in general and the growth of the capital market in particular through:
  1. *Imposing more Shari'ah related disclosure to ensure transparency and allow the screeners to have access to more accurate data in the financial statements.*
  2. *Making it mandatory to follow AAOIFI's standards to allow harmonization and consistency.*

Thank You  
والحمد لله في الأولى والآخرة