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SHARIAH SCREENING PROCESS IN MALAYSIA: A CASE STUDY OF CENSOF HOLDINGS

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Abstract

The Shariah Advisory Council (SAC) have introduced the shariah compliant securities in the stock market. These have created the attention among the Muslim investors to invest in the stock market. The shariah listed companies in Malaysia have to review their halal status through shariah screening process ruled by Securities Commission (SC) twice a year. Additionally, the screening process may be different among other countries. However, Malaysia through SC took the opportunity to upgrade the screening process with intention to gear Islamic capital market reach the global standard by introducing the new benchmarking of shariah screening process. The revised screening methodology was implemented to harmonise the local standards to global practices and expectations especially from Middle East investors. Before we go any further, this study purposely interested to investigate the factors that contribute one local company in Malaysia delisted from the shariah list after the new benchmarking introduced in the market. This study assessed the business activities of CENSOF that caused the companies delisted from shariah compliant securities where previously have been known as shariah compliant securities. From the analysis the result showed that the contributions of interest income and debt over total asset ratio are more than benchmarks set by SC are the factors that caused CENSOF delisted from the shariah list. Hence, when we observe the price before and after the delisting status, CENSOF share price showed no significant effects on the price but then they are some selling pressure as expected by the investment analyst.

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Key-words:-Malaysia shariah screening process, new benchmark, screening, interest income

1. Introduction

1.1 Shariah Screening Process in Malaysia

Shariah Advisory Council (SAC) of Securities Commission (SC officially) introduced the shariah screening methodology in June 1997. Due to the developments and growing of the Islamic finance, Shariah Advisory Council (SAC) has revised the methodology by adopting a two-tier quantitative approach which applies the business activity benchmarks and the newly-introduced financial ratio benchmarks. In June 2012, the Securities Commission of Shariah Advisory Council (SAC) had announced the revision to the screening methodology for determining the Shariah compliant securities of companies listed on Bursa Malaysia. By November 2013, SC officially announced the initiatives. The effects of the revised methodology will be reflected in the List of Shariah-compliant Securities issued by the SC. This revision of the changing in the new screening process is to further build scale in the Shariah-compliant equity and investment management segments.

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1.2 Company Background

Censof (formerly known as Century Software Holdings Berhad) was incorporated under its present name as a public company in Malaysia on 8 August 2008, under the Act with the objective of being an investment holding company to facilitate their listing exercise on 31 January 2011. Censof is a specialist for financial management solutions. Today, Censof is at the forefront of the industry in Malaysia and the global business arena. They have established presence in Malaysia, Indonesia and the United States, with financial management solutions, e-payment gateway services, and investment/asset management solutions.

Their primary business operations include system design, development geared towards its implementation in installation, maintenance, and support; certified by the ISO 9001:2008 standards, established by a Bureau Veritas Certification. As a technology group of company to stay innovative, focused and relevant, the Censof community adheres strictly to its strategic goals set out in the Group's Vision and Mission Statement.

The company vision is to be a leading global provider of financial management solutions by 2016. And their mission is to devote their expertise towards excellence by:

- i. Providing innovative business solutions for our customers,
- ii. Instilling a positive corporate culture that motivates our people to deliver excellence,
- iii. Delivering sustainable growth and value for stakeholders,
- iv. Empowering our people to be caring citizens actively contributing to the community.

As at 30 June 2014, the company has authorized share capital of RM100,000,000.00. Their issued and fully paid-up share capital is RM 41,559,838.20. Currently, they have 4,924 shareholders. The Group have changed their financial year end from 31 December to 31 March which has resulted to a fifteen (15) month financial period for financial year 2014 as compared to the twelve (12) month financial year ended 31 December 2012. The Group had made this decision given the corporate activities that were executed during the year.

For the current financial year under review, the Group has reported a revenue of RM80.3 million with a profit after tax of RM4.1 million; translating to basic earnings RM0.31 per share. Censof believes in continuing building shareholders value and in sharing their success while at the same time upholding structural investments funds for the Group's strategic growth. On the 27 September 2013, they issued a first and final single-tier dividend payment of 1.0centper ordinary share of RM0.10 each which amounted to RM3,542,000 for financial year 2012.

1.3 Problem Statement

The new stringent screening methodology by Securities Commission (SC) affects the shariah status some of the listed companies. Muslim investors for example may concern on halal income earned. Thus, the reason of the keep changing status of some company should be identified in order to provide the confidence of the investors.

In Malaysia, Securities Commission (SC) was empowered to implement the shariah-compliant securities for stocks listed on Bursa Malaysia. It is part of SC's initiatives to further build scale in the shariah-compliant equity and investment management segments. Based on list of shariah-compliant securities by the Shariah Advisory Council (SAC) of the SC, Censof has been listed as shariah-compliant securities. The screening process for shariah-compliant securities was conducted twice a year, on May and November. Refer to the announcement by SC on 31 May 2013, 29 November 2013 and 30 May 2014, Censof was successfully listed as shariah-compliant securities. Unfortunately, listing on 28 November 2014, Censof was delisted as shariah-compliant securities.

1.4 Issues Highlighted

We are focusing on Censof Holdings Annual Report 2012 and Annual Report 2013. The shariah status of Censof holding based on the both annual report published. Since the shariah-compliant securities is an optional for company listed in Bursa Malaysia, there are no regulations issues arise from unfulfilled the shariah requirement. However, the Muslim culture and increasing awareness among Muslim investors have encouraged the company to comply this shariah requirement.

The SAC adopts a two-tier quantitative approach, which applies the business activity benchmarks and the financial ratio benchmarks, in determining the shariah status of the listed securities. Hence, the securities will be classified as shariah-compliant if they are within the business activity benchmarks and the financial ratio benchmarks. In addition to the above two-tier quantitative criteria, the SAC also takes into account the qualitative aspect which involves public perception or image of the company's activities from the perspective of Islamic teaching. Censof will be analyzed based on this quantitative and qualitative approach to identify the reason why they delist from shariah-compliant securities on listing on 28 November 2014.

1.5 Research Objective

Basically, the objective of this study is to support SC to continue their initiative to improve the shariah screening process in Malaysia. As the new benchmarking may promote the Islamic capital market industry we believe that the local companies should play the role as well. Thus, specifically this study have been done to identify the factors contribute to the Censof delisting from the latest announcement by the SC.

1.6 Significant Of Study

This project paper contributes to enhance understanding of the main issues relating to the effect of new benchmark of screening process of Censof Holdings. For instance, the new benchmark may encourage the company to fulfil the shariah requirement in expanding Islamic capital market. This will support the development of the Islamic financial market products. The number of companies that fully comply the shariah screening methodology is very significant to the international Muslim investor. Some of the investor may concern on the *halal* status of the stocks. The study may give the perception and positive image of the company.

2. Literature Review

2.1 Concept of Shariah Screening in Malaysia

Muslim investors in the current arena are very much concerned on *halal* income earned. As such, the Islamic finance system should be geared in such a way that could provide confidence towards these investors (Zandi et. al 2014). There are two types of asset which investor can invest in (real asset and financial asset). Muslims investor must always bear in mind that their investments must be in accordance with the Shariah principles which prohibit the elements of *riba*, *maysir* and *gharar*. McGowen & Muhammad (2010) said that Malaysian Muslim investors make up approximately 60 percent of the total population which underlines the high growth potential of the Shariah-based market segment. Hoet. al (2012) stated Shariah screening process will detect prohibited activities if existed and guide investors from embarking onto a non-compliant investment.

Since not all shares of companies are Shariah compliant assets, Shariah scholars and International standard-setting bodies like AAOFI and IFA have laid down the rules and tenets in order to ensure Shariah-complaint investments. Muhammad (2008) thrashes out that criteria for screening could be positive or negative. Positive criteria implies that a corporation may be given important in constructing portfolio universe for reasons such as a good record for quality products, safety and consumer relationship or contribution to environment improvement, pollution control, sustainable woodland management and energy conservation. Negative criteria means to exclude the companies from the portfolio based on certain criteria. For example, leave out the companies producing or supplying *haram* goods like alcohol and pork-related products and so on. (Muhammad 2008).

So, it is necessary to have a proper Shariah screening in the financial market which enables investor to invest companies that operate permissible business activities in Islam.

The major challenge facing the Islamic investment fund industry also comes from its size. Derigs & Marzban (2009) said in the two major markets of Saudi Arabia and Malaysia, Islamic funds account for 55 and 26 percent, respectively of the fund market. Pok (2012) said that there are strong demand for Shariah-compliant financial products from Muslim countries worldwide which also influences non-Muslim investors to invest in the Shariah-compliants products. Therefore, the job of maintaining the quality of screening process becomes more and more challenging.

2.2 Shariah Screening by Securities Commission

Mid 1990s, Shariah screening methodology in Malaysia has been established in accordance with the infancy of the Islamic Capital Market (ICM). Malaysian International Islamic Finance Centre (2013) stated market capitalisation of Shariah-compliant securities was RM254.1 billion in year 2000 and it has increased to RM1.017 trillion in May 2013.

Shariah Screening by Securities Commission Malaysia (2013a) stated that SAC has applied a standard criterion to evaluate the business activities of the companies and companies whose activities are not contrary to the Shariah principles will be classified as Shariah-compliant securities. SAC had established this Shariah screening methodology to undertake Shariah screening process for listed companies in Bursa Malaysia with the introduction of four activity-based screening benchmark in 1995 which comprises two assessments which are quantitative and qualitative. Mohd.Hussin & Muhammad (2011) as cited by Zainudinet. al (2012) said that the first List of Shariah-compliant Securities was announced and published in Jun 1997. Securities Commission Malaysia (2013b) stated from 1998, Shariah-compliant securities is made twice a year on April and October but since 2007 till present the announcement was changed to May and November each year.

In France, Peilex&Ureche-Rangau (2013) stated that French companies were screening based on two categories of criteria which is qualitative and quantitative screening. The qualitative screening is basically a negative screening. The negative screening consists in excluding from the index companies that perform Haram activities. Muslim investors are allowed to only invest in clean (Halal) stocks which excludes firms dealing in pork-related products, alcohol, conventional financial services like banking and insurance, casinos/gambling, pornography, gold and silver trade, and hotel industry.

Recently, the screening methodology has been revised by SC by adopting a two-tier approach to the quantitative assessment which applies the business activity benchmarks and the newly-introduced financial ratio benchmark while at the same time maintaining the existing qualitative assessment. This is due to the current development and sophistication of the Islamic finance industry and in line with the SC's initiatives to further enhance the Shariah-compliant equity and investment management segments.

2.3 Revised Shariah Screening 2013

Table 1 Difference between Revised Methodology and Previous Methodology

Differences Between Revised Methodology And Previous Methodology		
Revised Methodology	CHANGES	Previous Methodology
All companies must undergo all screening stages which covers:	Drop	First Stage Screening- focusing on the activities of the company to determine the non-permissible activities if any.
		Second Stage Screening – a mixture activities company should undergo:
1. Quantitative assessment <u>First tier:</u> Compute the contribution of non-permissible activities and compare with the group turnover and group profit before tax. Benchmark used: i. 5% ii. 20% <u>Second tier:</u> Compute the financial ratios: i. Cash/Total Assets ii. Debt/Total Assets Each ratio must be lower than 33%	Reduce benchmark from four to two Newly introduced	1. Quantitative assessment Compute the contribution of non-permissible activities and compare with the group turnover and group profit before tax. Benchmark used: i. 5% ii. 10% iii. 20% iv. 25%
2. Qualitative assessment i. Image of the company ii. Maslahah, 'umumbalwa, 'uruf etc.	Unchanged	2. Qualitative assessment iii. Image of the company iv. Maslahah, 'umumbalwa, 'uruf etc.

The SAC of SC of Malaysia has made an announcement on the adoption of a revised Shariah screening methodology on 18 June 2012 in order to determine the Shariah-compliant status of companies which are listed on Bursa Malaysia. This revised methodology adopts a two-tier quantitative approach which applies the business activity benchmarks and the newly introduced financial ratio benchmarks, while maintaining the existing qualitative assessment. The outcome of the revised methodology is reflected in the List of Shariah-compliant Securities announced and published by the SAC effective from November 2013 (Securities Commission Malaysia, 2012).

Under the revised methodology, all companies listed on Bursa Malaysia are required to undergo the same screening process which covers two-tier quantitative assessment consisting of a reduced business activity benchmarks and the newly-introduced financial ratio, and also qualitative assessment which qualify the company's image and other matters such as *Maslahah*, *'umumbalwa*, *'uruf* and the rights of the non-Muslim community that are accepted by Islam.

However, for the qualitative assessment, there are no changes. Furthermore, with the new screening method, the first stage screening now is for the quantitative assessment and the second stage screening is for the qualitative assessment. All companies who issue the securities must fulfill the requirement in both stages of screening process in order to be certified as Shariah-compliant.

For our case study of Censof, we are using the benchmark for business activities and financial ratio to review the fulfillment of Shariah compliant-securities using previous methodology and revised methodology. The five-per cent benchmark is applicable to the following business activities that Censof involved such as conventional banking, conventional insurance and interest income from conventional accounts and instruments. The contribution of Censof Shariah non-compliant business activities to the Group revenue or Group profit before taxation of the company must be less than five per cent.

Besides that, for the financial ratio benchmarks, we used the cash over total assets and debt over total assets ratio to review the Censof. Each ratio, which is intended to measure *riba* and *riba*-based elements within a Censof company's statements of financial position, must be less than 33 per cent.

In addition to the above two-tier quantitative criteria, we also take into account the qualitative aspect of Censof which involves public perception or image of the company's activities from the perspective of Islamic teaching.

3. Methodology

Our project paper is based on case study methodology. Case studies involve analysis of company annual report and information from the company website. The descriptive analysis was employed to this study.

4. Findings and Analysis

4.1 Quantitative Approach

For business activity benchmarks, the analysis is based on the interest income of the company group. The amount was taken from the company annual reports. The calculation below is to assess the level of interest income contribution to the company. The contribution must be less than 5%. From the analysis, the percentage of interest income to the group's profit before tax is used to analyze the Censof. For 2014, the interest income contribution is 11.29% more than 5% benchmark compared to 2013; the contribution is less than 5% benchmark.

Table 2 Calculation based on business activity benchmarks

	Calculation	Quantitative Result
Percentage of interest income to the Group's revenue (2014)	RM 658,000 / RM 80,328,000	0.008191 @ 0.8191%
Percentage of interest income to the Group's revenue (2013)	RM 147,000 / RM 44,766,000	0.003284 @ 0.3284%
Percentage of interest income to the Group's profit before tax (2014)	RM 658,000 / RM 5,829,000	0.1129 @ 11.29%
Percentage of interest income to the Group's profit before tax (2013)	RM 147,000 / RM 9,805,000	0.015 @ 1.5 %

For financial ratio benchmarks, the analysis is based on cash over total assets and debt over total assets. The amount was taken from the company annual reports. The calculation below is to assess the ratio percentage and must be less than 33%. From the analysis, the debt over total assets ratio is used to analyze the Censof. For 2014, the ratio is 38.15% more than 33% benchmark compared to 2013; the ratio is less than 33% benchmark.

Table 3 Calculation based on financial ratio benchmarks

	Calculation	Quantitative Result
Cash over total assets (2014)	RM 11,506,000 / RM 319,867,000	0.03597 @ 3.597%
Cash over total assets (2013)	RM 3,247,000 / RM 82,181,000	0.0395 @ 3.95%
Debt over total assets (2014)	(RM 55,490,000 + RM66,547,000) / RM 319,867,000	0.3815 @ 38.15%
Debt over total assets (2013)	(RM 6,968,000 + RM667,000) / RM 82,181,000	0.0929 @ 9.29%

4.2 Qualitative Approach

In addition to the above two-tier quantitative criteria, the SAC also takes into account the qualitative aspect which involves public perception or image of the company's activities from the perspective of Islamic teaching. The principal activities of

Censof are investment holding company. Their subsidiaries activities such as design, development, implementation and marketing of financial and related software and services, providing services for software development, acting as a service provider for financial applications, and electronic payments. Overall, Censof not involved in any shariah non-compliant business activities.

Besides that, Censof has a good image towards public. On the 3rd of September 2013, the Censof family came together as one to celebrate the Censof Hari Raya Open House. The grand event was held at Empire Gallery, Subang. Over 600 people, including clients, business partners and vendors came to take part in the celebration and enjoy fellowship on the auspicious day.

The Group's corporate values of 'Caring, Credible, and Committed' are carried out in partnership with local communities, industries and government and non-governmental organisations. This is in line with their mission to ensure that The Group empowers its people to be caring citizens actively contributing to the community.

In the month of July, The Group had donated RM10,000 and participated in Vistage the 'Stop Hunger Now' program. Stop Hunger Now is an international hunger relief agency that has been fulfilling its commitment to end hunger for more than 15 years. Since 1998, the organization has coordinated the distribution of food and other lifesaving aid to children and families in countries all over the world. The Group alone managed to pack 20,000 packets of food in the given time and these packets were distributed to 600 different homes in Malaysia, Myanmar & Cambodia.

We also found the largest shareholder in Censof as at 30 June 2014 is RHB Nominees (Tempatan) SdnBhd that owned 173,000,000 share or 41.63%.

4.3 Results

From our analysis, we found that Censof was classified as Shariah non-compliant securities as stated by SC on 28 November 2014 because of 2 reason:

- i. Benchmark for interest income is 11.29 % more than 5% benchmark set by SC
- ii. Financial ratio of debt over total asset is 38.15 % more than 33% benchmark set by SC

Through the observation we identified the aggressive investment by the company may contribute to the unfulfilled of the requirement.

5. Policy Implication and Application

The implication of the study will enhance the understanding of the regulator, investor, the company and the public on the main issues relating to the effect of new benchmark of screening process of Censof Holdings. This new benchmark may encourage the company to fulfil the shariah requirement in expanding their company towards international. This shariah requirement is very significant to the international Muslim investor nowadays. Some of the investor may concern on the halal status of the stocks. The study may give the perception and positive image of the company to the public.

6. Conclusion and Future Recommendation

Based on case study, we have better understanding on the shariah screening process in Malaysia. The current practise is not adequate because the screening process is focus only on business activities of the company. There should be another screening process on behalf of the investor and is not bias to company only. The status of shariah compliance of the company should be include in the annual report for public assessment and not rely only on the listing by the SC.

Our case study had limited resources. Due to the time constraint, this study only focus on the analysis of the annual report and the company website. In the future the researcher may include other resources such as interview, the company's responses to the survey and the company management's responses to the inquiries to analyse further regarding the issues.

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