DIVIDEND PURIFICATION FOR SHARIAH COMPLIANCE OF INVESTMENTS IN JOINT STOCK COMPANIES

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Riba has been prohibited by the Islamic Shariah and it is clearly stated in the Holy Quran and the Sunnah of the Holy Prophet Muhammad (P.B.U.H.), the 2 major sources of Islamic Law. This research paper discusses a flaw in the current system of income purification for the purpose of eliminating interest factor from income earned from investments in joint stock companies and proposes a new method for calculating the purification rate in order to completely eliminate interest factor from the earnings received by investing in equity securities.

1.0 Introduction

Riba or more commonly known as Interest is prohibited in Islamic Shariah. It is clearly stated in the Islamic jurisprudence that 4 people who are connected with Riba will be treated equally i.e. the person who takes Riba, the person who gives Riba, the person who records Riba and the person who is a witness to a transaction of Riba. Currently Riba has become an integral part of most of the financial transactions taking place in the global economy. It is necessary for Muslims to abstain from Riba and eliminate it from their financial transactions.

The term Shariah Compliant transaction refers to a transaction which conforms to the principles laid down by Islamic law and does not violate any of the laws governing the Islamic Shariah.

Islamic Scholars have laid down detailed guidelines regarding the investment policy in equity securities of joint stock companies. A minority investor in a joint stock company is considered as an owner of that company and he earns his share of profit out of the earnings of the company. It is necessary to keep in mind that a person should invest in only those companies which operate such business which are not unlawful in Islamic Shariah for e.g. the company is not involved into conventional banking or conventional insurance, selling alcoholic drinks, pork or involved in gambling etc.

The income earned from investments in joint stock companies comes from 2 sources i.e. capital gains by purchasing shares and selling them when the price of shares increase and secondly dividends distributed by the companies out of their profits.

The dividend income comes directly out of the earnings of the company. If the company places some of its surplus cash in interest earning deposits (the percentage of cash deposited in interest earning deposits is within the limits specified by the Shariah scholars) than such interest earned also becomes part of the earnings of the company and thus paid out to the shareholders as dividend.

This interest factor becomes haram in Shariah terminology and needs to be eliminated. This elimination should be carried out in such a way that the complete interest factor is eliminated from the earnings earned by the shareholders. Any such amount shall be paid out in charity in order to eliminate the interest factor.

2.0 Current Purification Process

As per the current Shariah guidelines, purification is carried out on any interest income earned and paid to the shareholder through dividends only. The existing mechanism only purifies the dividend income portion of the shareholder and that too on a partial basis. A dividend purification rate is calculated for each company and applied to the dividend income earned from that company.

Currently the formula for calculating dividend purification rate is as follows:

$$\frac{\text{Interest Income}}{\text{Total Revenue}}$$

Where Total Revenue is equal to Gross Sales + Other Income. This is the same formula which is used for screening of companies for eligibility of entering the investable universe.

2.1 Example

We carry on with a hypothetical case of an investor investing in a company and owning 10% of the outstanding shares. A synopsis of the financial statements of the company is as follows:

ABC & Company	**Rs. Mn**
Gross Sales	900
Less: Taxes	100
Net Sales	800
Less: Cost of Goods Sold	500
Gross Profit	300
Less: Administrative Expenses	100
Less: Marketing Expenses	100
Add: Other Income	50
Add: Interest Income	50
Net Profit Before Tax	200
Tax	70
Net Profit After Tax	**130**

It can be noticed that the total non-compliant income earned by the company is Rs. 50 million while the company earned a net income of Rs. 130 million. Other details pertaining to purification process can be deduced as following:

Non-Compliant Income / Gross Revenue	5.00%
Number of Shares (actual)	100,000,000
EPS (Rs.)	1.3
DPS (100% payout) (Rs.)	1.3
Shareholding by Investor	10%
Dividend Received by Investor (Rs. Mn)	13
Purification (Rs. Mn)	0.65
Purification by All Investors (Rs. Mn)	6.50
Remaining Interest Element (Rs. Mn)	43.50

In this example we are assuming a 100% payout by the company which means that a shareholder owning a 10% stake in the company would have earned an interest income of Rs. 5 million of which he purified Rs. 0.65 million or if all investors of the company would have been Shariah conscious investors, they would have collectively earned interest income of Rs. 50 million but collective purification amount would have been Rs. 6.5 million only.

3.0 Flaw in the current system:

According to the current method of calculating purification rate, the interest factor is not completely eliminated from the dividend income. As noticeable from the above example, the interest factor is not completely eliminated from the dividend. In the example provided above an amount equaling to Rs. 43.50 million would have remained part of the company's operations and actual purification would not have taken place at all. The case further worsens if the company decides to reduce its payout ratio. As the dividend payout ratio decreases the interest element remaining in the company's increases. In the worst case if the company doesn't announce any dividend then as per the current purification methodology, no purification would take place although the company would have earned interest income. The current methodology only purifies the dividends and that too leaving behind a considerable amount of interest element in the operations.

4.0 The Proposed System

This paper proposes a new method of calculating the Income purification rate in order to completely purify the income earned from dividends and capital gains of companies where investments have been made. The new system would completely eliminate the interest element irrespective of any dividend payments.

In order to come up with the new methodology, let us first understand the basis of purification. As per Islamic Shariah, all interest income needs to be eliminated from the investor's income and for this purpose all interest income needs to be paid out in charity. No expenses apart from those which have been incurred directly to earn interest income can be set off against interest income. The previous methodology discussed in essence assumes that all expenses including the cost of goods sold are shared pro rata with compliant and non-compliant operations of the business although this is not the case.

At most administrative expenses of the business can be set off against interest expenses because in order to earn that interest income, administrative expenses may have occurred.

Keeping this in mind a new formula can be developed which would help eliminate the interest income completely from the investor's book.

Firstly, we would compute the portion of administrative expenses that is attributable to interest based revenue of the company and that would be computed as follows:

$$\frac{\text{Administrative Expenses}}{\text{Total Revenue}} \times \text{Interest Income}$$

Where total revenue would be gross sales plus other income. The amount computed shall be deducted from the interest revenue and the remaining amount would be called Final Interest Income. This final interest income is then divided by the total number of shares outstanding to compute interest income per share. (IIPS)

$$\text{IIPS} = \frac{\text{Final Interest Income}}{\text{Total No of Shares Outstanding}}$$

IIPS is the basic amount of interest income earned by the investor holding one single share irrespective of the income earned by the company and/or any dividend paid by the company.

In order to completely purify the interest income, an investor should compute IIPS and then prorate it according to the number of shares held and number of days' shares held by the investor to completely purify the interest element from the income.

Expenses for Interest Earnings	5
Final Interest Income	45
IIPS (Rs.)	0.45
Shareholding by investor	10%
No of Shares Held	10,000,000
Purification (Rs. Mn)	4.5
Purification by All Investors (Rs. Mn)	45
Reminaing Interest Element (Rs. Mn)	ZERO

5.0 Conclusion

The table above shows that if the proposed methodology is adopted then complete purification is possible irrespective of the investee company making a profit or a loss as well as irrespective of the investee company paying out dividends or not. An investor who holds the shares is entitled to the interest income earned by the company in that time period. Since purification of all interest based income is necessary, this methodology ensures that full and proper purification is conducted and halal returns are provided to the investor. The currently used methodology presents a major flaw and its usage should be immediately discontinued and the new methodology should be implemented.