

A technical analysis to ascertain levels of Halaal income on Equity

Are you satisfied with portfolio performance while you and the Portfolio managers disregard the Shariah requirements pertaining to the evaluation of the shares you buy and sell or which are bought and sold on your behalf by Unit trusts' managers

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Introduction

Shares or stocks of diverse natures form significant or predominant investment avenues for banks, investment companies, insurance companies, private individuals and certain government divisions which require investing state and private capital.

Various financial intermediaries are inter-dependent due to the nature of their operations which demand constant investment and re-allocation of capital from lower income producing areas to areas of higher returns. The existence of Stock exchanges and other financial institutions for the purpose of investment and trading in shares highlights the role of shares and the companies which form the economic driving force behind such shares.

Shares are basically rights of ownership in business entities or companies.

Non-Muslim companies are not bound by Shariah regulations. Therefore their operations include Islamically prohibited forms of earnings (e.g. production and sales of Islamically prohibited items – wine, musical instruments, purchases and sales of Islamically prohibited items – porn films, Haraam meats, Islamically Haraam income – interest and dividends from Haraam sources, etc.). Likewise, they would also trade their shares in formats allowed under the financial regulations of the economies within which they operate. Some of these trading formats are Islamically prohibited. Thus, although you have shares with underlying assets that can be classified as Halaal or Halaal to particular levels, the income derived from trading in a non-Islamic format would classify the income as Haraam (Islamically prohibited).

The fact that shares form the components of unit trusts, investment pools of insurance companies and investment instruments of private individuals, three significant Islamic issues require to be initially noted:

1. Which companies do the shares represent?
2. What is the nature of the operations of the specific companies in order to ascertain the degree of Halaal income per share?
3. How are the shares traded? Does the trading format conflict with rules of the Shariah?

The above requirements become more complex when these shares are traded by fund managers without

1. ascertaining the actual Halaal returns per share
2. consideration of the values at which shares can be Islamically purchased or traded.

Unfortunately there is no international consensus of Muslim scholars in regard to many issues pertaining to some of the critical issues in this regard.

However, as an introductory first step in this analysis, a company, from a Shariah or Islamic legal perspective, should be attributed by the following four attributes:

1. It should be producing or manufacturing Islamically Halaal products, free of any Haraam ingredient or Haraam component, or should be selling only items that are considered as Islamically allowable for the purposes of sale.
2. providing Halaal services
3. having external earnings (dividends etc) from Halaal avenues.
4. not generating Haraam earnings through charging clients interest or earning interest from any external avenues.

Furthermore, although, no ahadith have been located to state that income earned on capital borrowed on an interest basis is Haraam, yet borrowing on interest is declared Haraam. Some jurists give an allowance to borrow on this basis in dire circumstances. However, the truth of the matter is that Islam prohibits financing production and business on the basis as well since it generates interest income for the providers of capital as well as imposes an interest debt on the borrowers of capital. Thus, as a precautionary note, some panels of jurists have advocated that companies whose capital is financed by more than one-third through interest based loans should not be invested into because of the interest debt created. However, they have not regarded earnings earned through the employment of interest-based capital as Haraam. Thus, depending on the nature of the concern, the nature of their capital employed will either be interest-free or interest-related to some degree

Unfortunately, the reality on the ground, especially in regard to companies in the non-Muslim world, is that companies often produce Islamically prohibited services or products, or generate income from Islamically allowed avenues as well as from Haraam sources. The incomes from the diverse sectors (Halaal/Haraam) require to be separated as an essential element for ascertaining Halaal earnings.

Haraam income can be fully recognized if proper computer or other controls are in place. Alternatively, conservative approximations or estimates can help us to measure such income in specific enterprises. Where such income is not annually segregated or removed from the business, it is an economic fact that it is subsequently employed as part of capital to generate revenue or perpetuate a business concern.

General investment factors considered when investing in the shares of a company.

To be written

Definition of Equity

The amount of money left in a business entity after liabilities have been deducted from assets is the equity of the owner/shareholders of that entity. This is the

therefore the amount actually owned by the business owner or the amount which reflects the nominal value of the joint claims of the shareholders. Since the assets and liabilities of a going concern constantly change, the nominal equity reflects a time specific amount.

The Equity of a company is sometimes shown on the right hand side of a balance sheet.

The equity constantly increases/decreases in relation to the profits/losses of the entity. Half-yearly or quarterly or periodic equity calculations are done depending on necessity. Financial regulations generally require annual calculations to be made.

Most businesses do not operate at a level where live, real-time data is available at regular intervals on a daily basis. Such data would be ideal for the purposes of Islamic investment or disinvestment decisions.

Actual nominal valuations of shares and the market values at which shares are bought and sold

When companies list their shares on an Exchange (Stock exchange), two prominent values come into play:

1. A real-time market value which differs from the nominal value. The purchasers in the market accept to pay this value even though it may differ from the actual nominal value at that instance.
2. A constantly fluctuating real-time market value which is used as an investment indicator against the diverse prices at which shareholders have actually purchased their shares or subscribed to the shares. In this case, shareholders do not compare the real-time market values at which they purchased their shares against the actual real-time nominal value at the instances at which they purchased their shares, but rather begin to base their decisions to hold or sell the shares on the basis of comparing subsequent real-time market values against the historical real-time prices at which they bought the stock. These two prices are used to determine whether a shareholder is making a profit or loss.

A market allocation of the price of a commodity based on the variables of cost, supply and demand is a valid economic valuation thereof. We therefore acknowledge that the Shariah would also sanction such a pricing mechanism since it is accepted among traders as a fair indication of the value of a commodity at a specific time in a specific location.

The fact that shares do not always represent underlying assets that are Shariah approved, demands that shares have to be categorized in two other divisions:

1. Shares which fully represent Shariah approved assets
2. Shares which entail some underlying assets that are Haraam

This is the fundamental reason why real-time market valuations of the second type of share have to be re-analyzed in respect of

a. & b. Haraam and Halaal assets.

c. & d. Haraam income from internal and external sources

The Assets/liabilities ratio

Although Islamic law allows for the transfer of debt, it does not allow the sale of debts to others, especially when this is at a price higher than the actual amounts of the debt.

For as long as the assets/liabilities ratio represents a positive value, any real-time market value could be acceptable on a Shariah basis immaterial if the Equity/debt ratio is less than 1. Here, again, it would be Shariah compliant to adjust the assets/liabilities ratio to represent Shariah approved assets/liabilities instead of a non-sectoral classification of all assets under a general asset category.

The assets/liabilities ratio can be fundamentally employed to determine, together with other factors, whether the Shariah allows a specific share to be purchased or not.

Unit trusts and private share portfolios

The reality on the ground is that the common private investor is not sophisticated enough to do the technical analysis required for him/her to validly purchase a share on an Islamic basis.

Fund pools'/ Unit trusts's managers also, generally, do not necessarily have all the real-time accounting data required to analyze a share. Let alone, do the analyses on a Shariah basis. They neither comply to stringent Shariah check-lists when making investment decisions pertaining to certain or all shares which they include in specific portfolios or under general investment pools which they classify and claim to be Shariah complaint.

Since the nature of a business's assets and operations could alter in the course of time, it is essential that a Shariah acceptable nominal share value is also ascertained at the instance of a share sale. This would be nudged off by portfolio managers as a cumbersome exercise that has practical constraints and little economic value for their purposes. However, in as much as this may be rejected by those unconcerned of the Shariah implications of a sale, it is essential for a Muslim shareholder to realize actual Shariah approved profit amounts in respect of his historical ownership price (and adjusted Shariah value due to underlying Haraam assets) against the sale price which also requires an adjusted Shariah value due to the same or different underlying assets which may be of a haraam nature.

I, personally, do not recognize real-time market prices of shares as a sufficient basis upon which Shariah sanctioned profitability is to be based.

1. Income breakdown

1.1 Conventional income breakdown

	Net profit before tax	XXX-xx
Less:	Tax on Taxable income	_____
	Net profit to shareholders	

Taxable income has to be separated from Non-taxable income in order to ascertain the tax value

	Taxable income	Non-taxable income		
	xx	xx	Taxable + Non-taxable income	Net income before tax

1.2 Islamic Income breakdown

Since conventional companies often have a component of Haraam income we have to segregate the two forms of income.

1.2.1 Income from Islamically approved contracts, sales and services

	Taxable Islamic Income	
Plus	Non-Taxable Islamic income	_____
Equals	Total Islamic income	
Less	tax	_____
Equals	Net Islamic profit to shareholders	

1.2.2 Income from Islamically prohibited contracts, sales and services

	Taxable non-Islamic income	
Plus	Non-Taxable non-Islamic income	_____
Equals	Total non-Islamic income	

e.g. Interest received from short-term or long-term deposits and interest charged on overdue accounts.

1.2.3 Income from Grey-Areas that require analysis to be fully or partially categorized as Halaal income

a. Taxable grey-area earnings from external investments

b. Non-Taxable grey-area earnings

1. Dividends from shares held in external investments¹

2. Segregation of Halaal income in the Income Statement

2.1 Conventional Income Statement

	Revenue	1600
Less	Cost of Sales	<u>960</u>
	Gross Profit	640
Other income		
	Income from investments	15
		<u>655</u>
Less operating	Expenses	<u>545</u>
		110
Less interest paid on	debt	<u>25</u>
		85
Tax	Paid/Due	<u>30</u>
	Net profit to Shareholders	55

2.2 Islamically Adjusted Income Statement

Using the above data, we re-adjust some of the main sectors

2.2.1 Cost of Halaal sales

	Cost of sales	960
Less	<u>Cost of Haraam Sales</u>	<u>160</u>
	Cost of Halaal Sales	800

2.2.2 Total revenue on Halaal Sales

	Total Revenue on Halaal and Haraam Sales	1600
Less	<u>Revenue on Haraam</u>	<u>230</u>
Equals	Halaal Revenue	1370

Notes:

Revenue on Haraam

This can only be truly ascertained if all items were marked with a consistent profit mark up and all discounts on Halaal and Haraam sales were recorded.

¹ Tax is not due on such earnings since it is generally already paid by the company in which the shares are held.

Alternatively, if all haraam sales are computerized and income earned on these sales is likewise ascertainable through the formulae inserted in the spreadsheets or accounting programs which record the differences between the cost and sale prices of these items.

2.2.3 Total Halaal income

	Halaal Revenue	1370
Less	Cost of Halaal Sales	<u>800</u>
	Halaal income	570

2.2.4 Halaal income as a percentage of gross profit

$$570 / 640 = 89,1 \%$$

2.2.5 Percentage of Total Operating Expenses on Halaal and Haraam income

	Total operating expenses	545
Less:	89,1 % of 545 <u>Amount of operating expenses Halaal income</u>	<u>485,6</u>
	Amount of operating expenses on haraam income	59,4

2.2.6 Percentage of interest paid loans to generate Halaal income

$$89,1 \% \text{ of total interest paid (25)} = 22,275$$

2.2.7 Percentage of tax on Halaal income

$$89,1 \% \text{ of total tax paid/due (30)} = 26,73$$

2.2.8. Net profit to Shareholders

	Total Halaal Income	570
Less:	Operating expenses on Halaal income	<u>485,6</u>
Equals		84,4
Less:	Percentage of interest paid on Halaal <u>income</u>	<u>22,275</u>
Equals		62,125
Less	Taxes <u>paid/due on Halaal income</u>	<u>26,73</u>
Equals	Net Halaal profit due to Shareholders	35,395

2.2.9 Nominal Islamic Share Value

	shareholders' Equity
less:	Islamically prohibited income (for the year)
equals:	Islamically Adjusted Shareholders' Equity Value

Islamically Adjusted Shareholders' Equity Value
 Divided by the number of shares
 Equals: Nominal Islamic Share Value.

The "Nominal Islamic Share Value" can only be valid if the "Islamically prohibited income" is annually deducted.