

**FACTORS INFLUENCING THE CAPITAL STRUCTURE OF  
SHARI'AH COMPLIANT PUBLIC LISTED COMPANIES IN THE  
KUALA LUMPUR STOCK EXCHANGE (KLSE).**

by

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# **DEDICATION**

**This dissertation is dedicated to:**

**My Father Ahmed Digale Mire,**

**My Mother Aneb Adan Mohamoud,**

**And also**

**My Brothers**

**And**

**My Sisters**

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Praised be to Allah – The Most Exalted (TME), Creator of the heavens and earth. Peace and blessings be upon His holy prophet Mohammad. Allah (TME) created me with the capacity to persevere and provided the means to complete this study. Unto Him belongs the highest in praise and gratitude. I bear witness that there is no god but Allah and Mohammed is His servant and messenger.

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## **LIST OF ABBREVIATIONS**

AAOIFI: Accounting and Auditing Organization for Islamic Financial Institutions

BCBS: Basel Committee on Banking Supervision

CG: Corporate Governance

CIBAFI: General Council of Islamic Banks and Financial Institutions

FTSE: Financial Times Stock Exchange

FSA: Financial Sector Assessment

Halal: Lawful; permitted by Shari'ah

Haram: Unlawful; prohibited by Shari'ah

ICFS: Institutions offering Conventional Financial Services

IIFS: Institutions offering Islamic Financial Services

IFSB: Islamic Financial Services Board.

IIRA: International Islamic Rating Agency

KLSE: Kuala Lumpur Stock Exchange

IMF: International Monetary Fund

OECD: Organization for Economic Cooperation and Development

PBUH: Peace and Blessings be upon him – generally mentioned along with the holy Prophet Mohammed's name

PLCs: Public Listed Companies

SSB: Shari'ah Supervisory Board

Shari'ah: (or Sharia) Islamic law.

TME: The Most Exalted- generally mentioned with Allah's name

## **APPENDICES**

Appendix A	List of the Companies under the study
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# **FAKTOR-FAKTOR MEMPENGARUHI STRUKTUR MODAL DALAM SYARIKAT-SYARIKAT AWAM MEMATUHI SYARI'AH TERSENARAI DALAM BURSA SAHAM KUALA LUMPUR (KLSE)**

## **ABSTRAK**

Kefahaman mengenai prinsip-prinsip Shari'ah adalah salah satu isu penting yang perlu dipelajari dan diamalkan dengan syarat-syarat dan perundangan dalam amalan Syari'ah. Shari'ah adalah merupakan sesuatu yang sejagat boleh menyelesaikan permasalahan berkaitan dengan perniagaan atau perkara-perkara lain. Syari'ah dibina atas dua prinsip asas, menghindari kepayahan dan menghapuskan yang haram (Rosly, 2005). Ini adalah seperti yang dinyatakan dalam al-Quran bahawa "Tuhan tidak menjadikan agama sesuatu yang menyusahkan" (Surah 22: Ayat 78). Objektif utama kajian ini adalah untuk mengkaji samada syarikat-syarikat yang termasuk dalam kategori mematuhi Shari'ah dan tersenarai mematuhi prinsip-prinsip Shar'iah dengan menganalisis kepatuhan terhadap criteria yang ditetapkan. Ia dilihat samada faktor-faktor seperti kegiatan perniagaan, jenis perniagaan, Pengerusi Syarikat, peratus pemilikan saham oleh golongan Muslim serta kewujudan Majlis Penyeliaan Shari'ah dan mengkaji perbezaan antara syarikat-syarikat ini berhubung dengan kriteria pematuhan. Daripada sebanyak 506 syarikat tersenarai di Papan Utama KLSE, sampel berjumlah 218 dipilih secara strata. Sebanyak 218 laporan tahunan 2007 digunakan dan data dianalisis menggunakan SPSS. Adalah didapati bahawa Pengerusi syarikat mempunyai kesan yang signifikan terhadap pematuhan kriteria yang dikenakan.

# **FACTORS INFLUENCING THE CAPITAL STRUCTURE OF SHARI'AH COMPLIANT PUBLIC LISTED COMPANIES IN THE KUALA LUMPUR STOCK EXCHANGE (KLSE).**

## **ABSTRACT**

The understanding of the Shari'ah principles is one of the most important issues that companies must learn and train their employee to be clear towards the rules and regulations of Shari'ah to practice as its is. Hence the Shari'ah is universal for all humankind, its settles all the issues that human beings face in this world whether its business or other things. The Shari'ah is built on two basic principles, namely: removal of hardship (*ra'f alharaj*) and the prevention of haram (*daf' aldarar*) (Rosly 2005). This has direct bearing to the *Qur'anic* verse that "God never intended to make religion a means of inflicting hardship" (22:78) and "God intends to make easy for you" (4:28). The primary objective of this study is to examine the public listed companies which are under Shari'ah compliance category are fulfilling the Shari'ah principals, by analyzing the difference of compliance Criteria in terms of Business Activities, Type of the Business, President of the Company, The Percentage of Muslim Shareholders and Shari'ah Supervisory Board, and also to investigate the difference between these companies in terms of compliance criteria, and what are the factors affecting the adaptation of Shari'ah compliance? A total of 506 companies listed in the Main Board of KLSE Malaysia were selected a sample of 218 using stratified sampling method. 218 annual repots were collected as cross-sectional year 2007 and analyzed using the SPSS Program. The results revealed that President of the Company (POC) has significant influence on the compliance criteria. Implications, limitations, and recommendations for future research will be presented in this study.

# CHAPTER 1

## INTRODUCTION

### 1.1 Background

One of the most notable developments in the economic of the world is that Islamic finance developing at remarkable pace. Historically Islamic finance began to take shape in the mid 1970s, jurists also considered the more subtle prohibition of *gharar* (excessive risk or uncertainty), which impacts modern forms of insurance, management tools for credit and interest rate (rate of return) risks, derivatives, etc. Islamic finance was mainly envisioned by leaders of Islamist movements, such as Abu Al'la Al'Maududid, Sayid Qutub, and M. Bakar Al- Sadar (Subaida 2005). Islamic finance as practiced today aims to mimic modern financial practices (banking products, insurance products, money and capital market instruments, etc.) with variations on classical (medieval) contract forms that were deemed devoid of forbidden *riba* and *gharar*. The roots of Islamic finance date back to the 1950s and 60s, and the theoretical literature from that period continues to shape the industry's rhetoric to this day (El Qorchi, 2005).

The Islamic finance emerged in the mid 1970s, with funding from the oil-rich GCC region, following the first oil price shock of 1973 (the industry has been booming in recent years, mainly fueled by high oil prices). Among the first Islamic financial institutions were Kuwait Finance House, Dubai Islamic Bank, and Faisal Islamic Banks in Egypt and Sudan. (El Qorchi, 2005). According to the Finance & Development magazine which is published by International Monetary Fund (IMF), the Islamic finance industry is very booming since its inception three decades ago, the number of Islamic financial institutions worldwide has risen from one in 1975 to over 800 today in more

than 50 countries. A recent research conducted by Shari'ah-Fortune screened around 810 companies in 50 countries worldwide offering Shari'ah compliant financial services. The Middle East covers more than half (around 56 percent) of the Islamic Finance market. Around 450 companies are located in this region. Leading countries are the UAE, Bahrain, Kuwait, Iran and Saudi Arabia. Asian companies compound to a market share of about 20 percent. In particular, Malaysia is one of the key players, not only in Asia, but also globally. Some 114 companies have been screened in Europe, which accounts for around 14 percent of the global market share. In addition to that the international market for Islamic finance has grown more than 15% annually in recent years, where total assets worldwide are estimated exceeds 750 billion (cross-border data remain scarce).(El Qorchi, 2005). These developments and achievements of Islamic finance attracted recently huge investors, banks, and many well-known organizations around the globe, which makes that Islamic financial institutions are stable and also profitable. On the other hand the developments in the Islamic finance and banking sector encouraged that many institutions adopted Islamic financial products, and this makes very crucial to build on this great development in order to make the industry prosper and at the same time try to free the *ummah* from *riba*. The wealth of Muslim world is huge, and globally it's the dominant, especially in the gulf areas, where most countries rich in oil, and this gives Islamic financial institutions to be a leader worldwide, while Shari'ah previously based on faith, now its commercially viable . Since Shari'ah is the way of life, people want to practice it, and getting awareness from the developments that the Islamic finance and banking industry made many Muslims promote their knowledge in Shari'ah. In today's economic crisis Shari'ah-compliant banking and finance is being endorsed for its stability

and is evolving as the best choice on the road to economic recovery. Shari'ah-compliant finance helps in filtering funds away from non-social, non-ethical areas, while promoting thrift, for this reason Shari'ah-compliant finance is the best choice for economic crisis, and by implementing Islamic finance and banking based on the Shari'ah will fill the vacuum and give stable and profitable economic to the world.

Understanding Shari'ah fully will give Ummah prosperity and good economic conditions, investigating the Shari'ah compliance issues will enhance the fairness of financial statements, where every thing will be under Shari'ah rules, so addressing Shari'ah compliance and the factors influencing the capital structure of PLCs will definitely strength the understanding of Shari'ah issues related in the Compliance criteria.

## **1.2 Research Problem**

The industry of Islamic Finance and Banking has grown enormously over the last couple of years. It is very crucial to build on this great development in order to make the industry prosper and at the same time try to increase public knowledge in the Shari'ah matters. In order to enhance the industry, the public's confidence towards the industry of Islamic banking is believed to be vital. It's also necessary to eradicate practices based on interest. (El Qorchi, 2005). Hence the Islamic world found itself in the need of an alternative finance model that is Shari'ah compliant and free interest. In the context of Islamic finance the Shari'ah is the legitimacy of all matters of life, therefore Muslim Ummah (nation) must practice Shari'ah rules fully.

As the Shari'ah touches all matters of life, the Shari'ah compliance must also be extended to all aspects of lives and should not just be limited to some areas particularly Islamic banking and finance. In other words, there is still a gap of studying Shari'ah compliance beyond Islamic banking and finance. Thus this research is conducted to fill the gap by studying Shari'ah compliance of public listed companies in KLSE. Many companies in the Muslim world especially in Malaysia using double system i.e. Islamic banking & finance system and the conventional system which is based on interest, there is a lot of doubtful matters and controversial issues particularly those companies using both systems, this phenomenon will affect the Muslim customers whether these firms are complying Shari'ah laws or not. In this study only Shari'ah compliant companies listed in KLSE will be investigated. In a way, the study assumes that the companies are free from the doubtful and the controversial issues. There is still lack of studies conducted on complying to Shari'ah by the PLCs in KLSE especially regarding factors influencing the PLCs' compliance with Shari'ah. Thus, this research can be considered as a pioneer in this regard.

Understandably, there are a host of factors influencing the compliance to Shari'ah. Having taken only the Shari'ah-compliant companies, the study will only look at the relationship between organizational characteristics such as business activities, type of the business, president of the company, percentage of Muslim shareholders, and Shari'ah supervisory board; and Shari'ah compliance. Shari'ah compliance can be measured in variety of ways. The compliant measurement has quantitative and qualitative properties which is called criteria. Each country has its own Shari'ah compliant measurement or Shari'ah screening criteria.

Since the study is conducted in Malaysia, the relevant screening criteria used by KLSE will be employed. Difficulties arise as to how to determine the compliance of the listed companies using the data available in the annual reports. Due to insufficient information provided in the reports, out of all the screening criteria only compliant criterion related to financial ratio which is very similar to capital structure will be used and investigated.

The following are some criteria which are common world wide, though there is little bit difference in some regions:

1. Business of the investee company: The basic business of the investee company should be Halal. Accordingly investment in shares of conventional banks, insurance companies, leasing companies, companies dealing in alcohol, tobacco, pornography, etc. are not permissible.
2. Debt to total assets: The total interest bearing debt of the Investee Company should not exceed 40% of the total assets.
3. Illiquid to total assets: The total illiquid assets of the investee company as a percentage of the total assets should be at least 20%.

The relevant parties such as customers, shareholders, regulators and so on are also interested to know the tendency to comply with the Shari'ah with regard to the organizational characteristics investigated. This can be ascertained by studying the differences existed in the factors influencing Shari'ah compliance of those companies.

In conclusion, this study explores the influences of factors that affect the capital structure of Shari'ah compliant PLCs in KLSE, and the relationship between the factors.

The conceptual framework of this study is based on the imam Shatibi theory which based on maqasid al-Shari'ah, and the Shari'ah rules.

In summary, the problem of the research can be stated as follows:

“What are the factors influencing the capital structure of Shari'ah compliant PLCs in KLSE? Secondly what is the relation among those factors? Apart from that the research will study the differences among the factors in complying with Shari'ah among those factors influencing Shari'ah compliance.

### **1.3 Research Objectives**

In line with the problem iterated above, the objectives of this study are as follows:

- 1) To identify the factors influencing the capital structure of Shari'ah compliant PLCs in the KLSE in terms of Business Activities, Type of the Business, President of the Company, The Percentage of Muslim Shareholders and Shari'ah Supervisory Board.
- 2) To analyze differences in complying with Shari'ah (debt) among those factors

### **1.4 Research Questions**

In order to achieve the above objectives, the following questions were formulated:

- 1) What are the factors influencing the capital structure of Shari'ah compliant PLCs in the KLSE?
- 2) Is there any difference in complying with Shari'ah (debt) among these companies with regard to the factors (i.e. Business Activities, Type of the Business, and President of the Company, Percentage of Muslim Shareholders, and Shari'ah Supervisor Board

## **1.5 Significance of the Study**

Firstly, this study will shed a light on some of the important factors that contribute towards Shari'ah compliance.

Secondly, this study will add knowledge of capital structure of Shari'ah compliant companies in KLSE, Malaysia; and factors influencing it.

Thirdly, the study may enrich the understanding of the exact relationships between factors influencing and Shari'ah compliance.

Fourthly, the present study will help PLCs, Bursa Malaysia, Shareholders and investor's provide ways to determine the compliance of particular companies to Shari'ah through examining the factors influencing it. Finally, this study will also contribute to the existing literature by incorporating new variables in to the conceptual frame work to test their impacts on compliance criteria, the difference between these companies & their similarities and to what extent they are being met for the Shari'ah principles.

## **1.6 Scope of the Study**

The Shari'ah compliant companies listed under Main Board of KLSE have been chosen primarily because they are the largest sector which comply Shari'ah in the KLSE. These companies comprises in to eight different industry sectors namely, Consumer Products, Industrial products, Construction, Trading/services, Properties, Plantation, Technology, Infrastructure, in other words these companies play a significant role in the development of the country in general. Globally the Islamic financial institutions offering the Shari'ah compliant product has increased and recently many big organizations in the western world adopted the Shari'ah compliant products.

This research focuses on the relationship between the factors influencing the capital structure of Shari'ah compliant and the Shari'ah compliance. In addition, this research also looks at the differences in complying with Shari'ah (debt) among these companies with regard to factors (i.e. Business Activities, Type of the Business, and President of the Company, Percentage of Muslim Shareholders, and Shari'ah Supervisor Board).

## **1.7 Organization of the Remaining Chapters**

There are five chapters in this study:

### **Chapter One – Introduction**

This is an overview chapter of the study. It begins with a general introduction about the study, the background, research problem, research objectives, research questions, scope and significance of the study are also presented in this chapter. Lastly this chapter ends with the organization of chapters.

### **Chapter Two – Literature Review**

This chapter explores the related and the relevant previous studies conducted in this area. It focuses on what the previous studies have said about the capital structure, Shari'ah compliance matters and factors affecting Shari'ah compliance in PLCs in KLSE Malaysia. It also highlights the theories behind the concepts and the arguments in this study. In this chapter, the theoretical framework and the research hypotheses are also provided.

### **Chapter Three – Research Methodology**

This chapter explains the research methods that were followed in order to conduct this study. It explains the research design, variables, population/sample design, data collection procedures, and selection of measures followed by a brief explanation of the data analysis techniques used.

### **Chapter Four – Research Results**

This chapter presents the overall findings of the study. It summarizes the statistics of the annual report, results of the statistical analysis and it also provides the results of the hypothesis testing.

### **Chapter Five – Conclusion and Recommendations**

This chapter will conclude the study by summarizing the findings. It will also provide the implications of this study for managers in these companies. Recommendations for future research are also suggested in this chapter.

## CHAPTER 2

### LITERATURE REVIEW

#### 2.1 Introduction

Shari'ah is the fundamental law of any activity of every Muslim whether an individual or organization, since every Islamic business must comply Shari'ah principles, there is a need to understand and must to be complied with the Shari'ah rules. For this reason Islamic financial framework is governed by Shari'ah. The recent development in the Islamic finance and banking attracted many Muslim customers' as well non-Muslim organizations, as the scale of growth increased a lot comparing to the previous one. Islamic finance is defined as a financial service or product principally implemented to comply with the main tenets of Shari'ah (or Islamic law). The source of guidance for Islamic principles is Shari'ah. Shari'ah is "body of rules deriving its legitimacy from theological premise that is God's law".(Zubaida, 2005). In order to strengthen the Shari'ah compliance mechanism within all companies that offering Shari'ah compliance products and to ensure that they all relevant to Islamic regulations are complied with in letter and spirit, this study will look on the compliance criteria whether and investigate that all public listed companies that are under Shari'ah compliance in KLSE are fulfilling the Shari'ah principles or not. Therefore the present research will focus on Shari'ah compliance criteria as well as the degree acceptance that the public listed companies in KLSE are fulfilling the Shari'ah principles. On the other hand the research will highlight more about Shari'ah principles as well as the concerned principles those relating to the Islamic finance in general in order to understand the common grounds of Shari'ah.

One of the most important issues is the formulation of the capital structure in every company, where the study will investigate the factors influencing the capital structure of Shari'ah compliant of PLCs in KLSE, and also we will indentify those factors. In addition the study will also highlight the relation between the Shari'ah compliance and the factors influencing the Shari'ah compliance. There was a need to study Shari'ah way of business in order to strengthen the Shari'ah compliance mechanism within all companies that offering Shari'ah compliance products and to ensure that they all relevant to Islamic regulations are complied with in letter and spirit (Zubaida, 2005). Since there was a lack of studies with regard to factors influencing Shari'ah compliance, and for the purpose of this study, it's to highlight and study those factors.

As I mentioned in the previous introduction in chapter one that there was little studies regarding public listed companies in KLSE specially those companies who are under Shari'ah rules, so by studying the factors influencing the capital structure of Shari'ah compliant PLCs towards Shari'ah we will discuss in this chapter. This literature review also explores what the previous researches and researchers have said about the Shari'ah compliance criteria, theory behind the study, dependent variable, independent variables, relation between independent variables in this study we'll discuss in the following parts in the literature review.

## 2.2 Review of the literature

### 2.2.1 What is Shari'ah?

In simple words Shari'ah or Shari'ah is the Arabic word for Islamic law and is also known as the 'Law of Allah.' It is important to note that Shari 'ah governs all aspects of life and therefore does not distinguish between secular and religious life. (Subaida 2005).

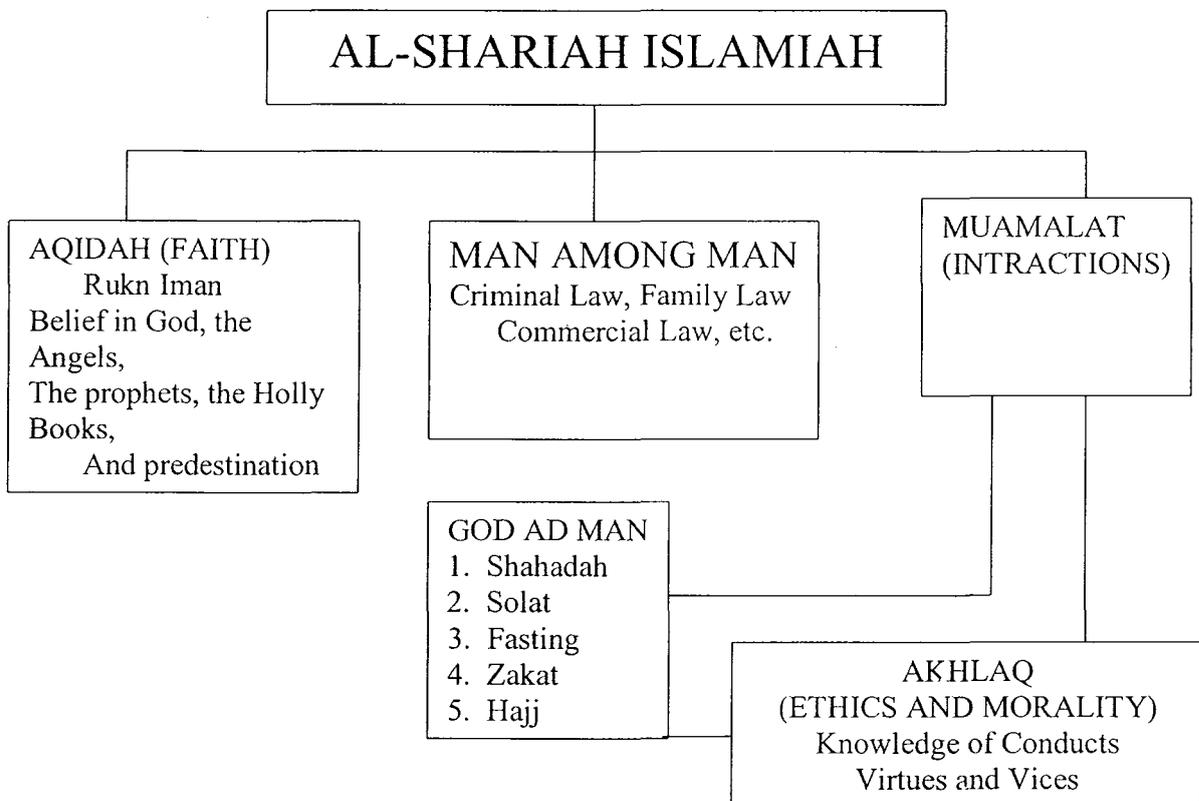


Figure 2.1 The Shari'ah (Rosly 2007)

As mentioned in the above figure, the Shari'ah is the law of almighty Allah to all human kind therefore its all aspects of life in this world and also tells about hereafter as its faith of a Muslim to believe that. Its means that in Islam, the question of right and wrong in resource allocation and the pursuit of economic stability and growth cannot be settled by a mere appeal reason and empirical observation (Rosly, 2005). Man's indebtedness to God for creating him out of nothing is symbolized by his total submission and surrender to His will(i.e. , al-Shari'ah Islamiyah) by the way on which the economic system is built (Rosly, 2005).

The main sources of Shari'ah are Holy Quran, Hadith, Sunna, Ijma, Qiyas and Ijtihad. The Holy Quran is the book of revelation given to the Prophet Muhammad PBUH; Hadith is the narrative relating the deeds and utterances of Muhammad PBUH; Sunna refers to the habitual practice and behaviour of Muhammad PBUH during his lifetime; Ijma is the consensus among religion scholars about specific issues not envisaged in either the Holy Quran or the Sunna; Qiyas is the use of deduction by analogy to provide an opinion on a case not referred to in the Quran or the Sunna in comparison with another case referred to in the Quran and the Sunna; and Ijtihad represents a jurists' independent reasoning relating to the applicability of certain Shari'ah rules on cases not mentioned in either the Quran or the Sunna (El-Gamal, 2000).

The Shari'ah is built on two basic principles, namely: removal of hardship(*raf' alharaj*) and the prevention of haram ( *daf' aldarar*) (Rosly, 2005). This has direct bearing to the *Qur'anic* verse that "God never intended to make religion a means of inflicting hardship" (22:78) and "God intends to make easy for you" (4:28).

In the following figure you will see clear cut picture of Shari'ah namely nature of Shari'ah, sources of Shari'ah, and objectives of Shari'ah.

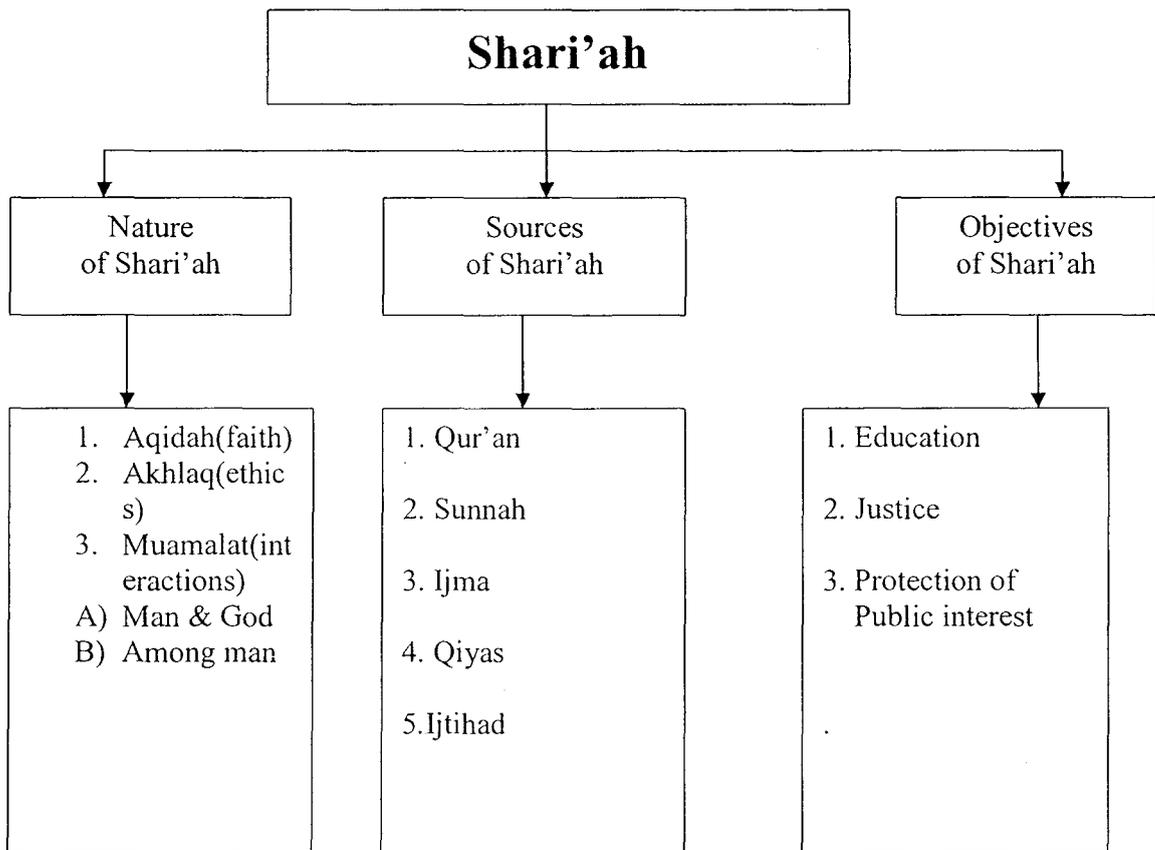


Figure 2.2 The Shari'ah (Rosly 2007)

The Shari'ah categorically outlaws *riba*, translated strictly as usury, but interpreted universally as the prohibition of charging any interest at all on loans. The Qur'an states that: "trading is permitted and usury is forbidden." (Qur'an 2:275-6) The main reason advocated for the abolition of interest in all economic transactions, including bonds, debentures, etc., is that it concentrates wealth and promotes inequality through exploitation. It has been pointed out by Muhammad Siddiqi that: In the case of consumption loans, it violates the basic function for which Allah has created wealth, which envisages that the needy be supported by those who have surplus wealth. In the case of productive loans, guaranteed return to capital is unjust in view of the uncertainty surrounding entrepreneurial profits Muhammad (Siddiqi, 1981).

### **2.2.2 Shari'ah and Objectives of Shari'ah**

The Shari'ah is for all human being in this world, and it's the only law that Almighty Allah reveal to Prophet Mohamed PBUH to rule this world. It's relevant all the times and events till the judgment day, it's fair and useful to all mankind in this universe. The Shari'ah is generally predicted on benefits to the individual and the community, and its laws are designed so as to protect these benefits and to facilitate the improvement and perfection of the conditions of human life on earth(Kamali, 2007). The Qur'an is expressive of this when it singles out the most important purpose of the Prophethood of Mohammad PBUH: "We have not sent you but as mercy to the worlds" (al-Anbiya, 21:107).

This can also be seen in the Qur'an's characterization of itself as "a healing to the (spiritual) ailments of the hearts" and "a guidance and mercy" for the believers and

mankind (Yunus, 1057). This very important objective of *rahmah* (mercy or compassion), mentioned in these two verses, is further substantiated by other provision in the Qur'an and Sunnah that seek to eliminate prejudice, alleviate hardship and establish justice. The laws of the Qur'an and the Sunnah also seek to promote co-operation and support within the family and the society at large. The objective of *rahmah* therefore, is most clearly manifested in the realization of *masalahah* in the everyday communal life. (Kamali, 2007). The *ulema* (Islamic scholars) have, thus, generally considered *rahmah* to be the all-pervasive objective of the Shari'ah, and have to all intents and purposes, used its synonymously with *masalahah* (Kamali, 2007).

The primary objectives of Shari'ah are to protect humankind from any problems whether it's financial systems or other aspects of life, the objectives of Shari'ah known in Islamic laws as "Maqasid As-Shari'ah", since organizations operates based on "values", the decisions or actions taken will have to fall back on "Objectives of Shari'ah".

Therefore Shari'ah compliance means within the Muslim context "every action or decision made he/she to refer to the five primary objectives of Shari'ah i.e. "Maqasid As-Shari'ah"

The five primary objectives of Shari'ah are:

1. Preservation of the Religion
2. Preservation of Life
3. Preservation of Intellect
4. Preservation of Property
5. Preservation of Progeny

As we mentioned earlier, these are the primary objectives pursued by Shari'ah can be observed though Islamic rulings revolve around. Shari'ah principles are basic rules of the Islamic way of business, therefore this is very important and essential to every company that comply Shari'ah rules to fulfill as its, for this reason the study will investigate the degree acceptance that these companies are going to the rules and principles of the Shari'ah law, by focusing the capital structure we'll know how they finance their companies, are they in accordance to the Shari'ah laws.

Major principles of Shari'ah that are applicable to finance and that differ from conventional finance are:

- Ban on interest (*riba*): In conventional forms of finance, a distinction is made between acceptable interest and usurious interest. In contrast, under Islamic law, any level of interest is considered to be usurious and is prohibited.
- Ban on uncertainty: Uncertainty in contractual terms and conditions is not allowed, unless all of the terms and conditions of the risk are clearly understood by all parties to a financial transaction.
- Risk-sharing and profit-sharing: Parties involved in a financial transaction must share both the associated risks and profits.
- Ethical investments that enhance society: Investment in industries that are prohibited by the Qur'an, such as alcohol, pornography, gambling, and pork-based products, are discouraged.
- Asset-backing: Each financial transaction must be tied to a "tangible, identifiable underlying asset." Under Shari'ah, money is not considered an asset class because it is not tangible and thus, may not earn a return.

In other words some question how lenders profit from financial transactions under Islamic law.

For instance, in a real estate setting, Shari’ah-compliant financing (SCF) takes the form of leasing, as opposed to loans. Instead of borrowing money, the bank obtains the property and leases it to the Shari’ah compliant investor, who pays rent instead of interest. Earnings of profits or returns from assets are permitted so long as the business risks are shared by the lender and borrower.

For instance the following is figure shows us the compliance framework in Malaysia.

**Shari’ah Compliance Framework in Malaysia\***

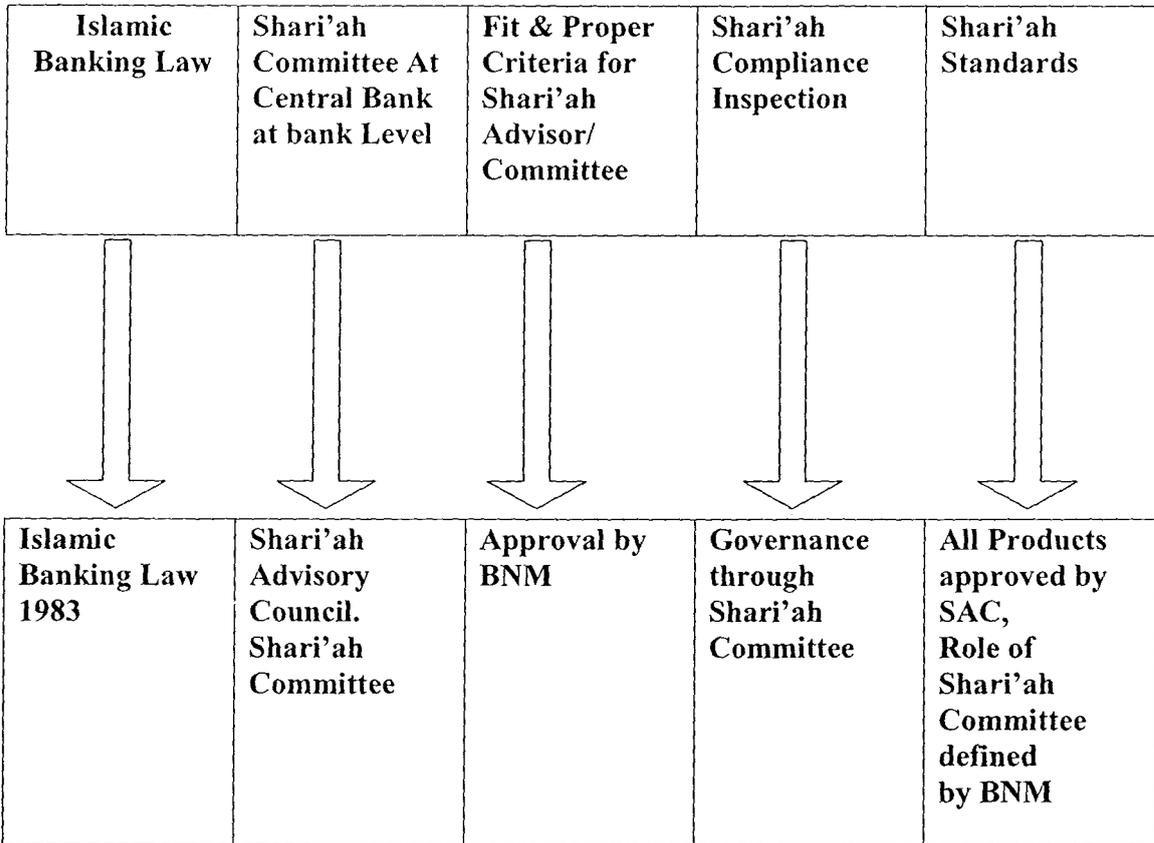


Figure 2.3 Shari’ah Compliance Framework in Malaysia

*\*Shamshad Akhtar: Shariah compliant corporate governance  
Keynote address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the  
Annual Corporate Governance Conference, Dubai, 27 November 2006*

Shariah Compliance Framework –Country wise

Country	Islamic Banking Law	Shariah Committee		Fit & Proper Criteria for Shariah Advisor/ Committee	Shariah Compliance Inspection	Shariah Standards	Accounting Standard
		At Central Bank	at bank Level				
Malaysia	Islamic Banking Law 1993	Shariah Advisory Council	Shariah Committee	Approval by BNM	Governance through Shariah Committee	All Products approved by SAC, Role of Shariah Committee defined by BNM	Accounting Standards developed by MASB
Bahrain	Regulations for Islamic Banks	Shariah Supervisory Committee	Shariah Supervisory Board	N.A	Internal and External Shariah Audit as per AACIFI standards	AACIFI	AACIFI
Indonesia	Laws for Islamic Banking Introduced in 1992 & Amended in 1999	National Shariah Board	Shariah Supervisory Board	NSB approves appointment of SSB members	Internal and External Shariah Audit	Fatwa on products issued by NSB	AACIFI
Iran	Usury free Banking Act 1983	Council of Guardian	N.A	N.A	No	Guidelines provided by Council of Guardians	Not Known
Brunei	Islamic Banking Act Cap. 168	Shariah financial supervisory Board (SFSB)	Shariah Advisory Board	SFSB approves appointment of Shariah Advisory Board members	No	SFSB Approves Islamic products introduced by Financial Institutions	Not Known
Pakistan	Banking Companies Ordinance, 1962 and Policies for Islamic Banking in 2001 & 2003	Shariah Board	Shariah Advisor	Fit & Proper Criteria by SBP	Manual developed in 2004, now being implemented	Essentials for Islamic modes	AACIFI standards are being adapted by a committee of ICAP

Figure 2.4 Shari'ah Compliance Framework country-wise

*\*Shamshad Akhtar: Shariah compliant corporate governance  
Keynote address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the  
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In the above figures its clear that Shari'ah compliance is almost same in the above mentioned countries only they got different name boards or authorities who are rule and make the regulations of the subject matter, though they use their own regulation but in Islam the primary sources is the Qur'an and Sunnah.

### 2.2.3 Consequences if not fulfilled Shari'ah

Almighty Allah give Muslim *Umah (nation)* Qur'an in which they will fine every matter they need in this world , and make them easy to practice his religion Islam, and the Prophet PBUH said in Hadith narrated by Abu Muhammad 'Abdullah bin Amr bin al-'As, radiyallahu 'anhu, reported that the Messenger of Allah, PBUH, said: "None of you (truly) believes until his desire or inclination is in accordance with what I have brought or subservient to what I came with." [ A fine and genuine hadith which was related by al-Maqdidsi in his Book of Hujjah].

Al-Imam Al-Shatibi, in his book *Al-Muwafaqat*, volume number 2, p. 168, mentions that the objective of Shari'ah is to keep Muslims away from desires so that the believer will be a servant to Allah willingly and become an honest servant of Allah. He also states that following one's desires with regard to the rulings of Shari'ah is a problematic issue where a person might use tricks to fulfill his desires, using deception in order to evade the rulings of Shari'ah.

With regards to how one can control and deal with one's desires, firstly Al-Imam Al-Shatibi says that the main thing is to make the law of Shari'ah and its rulings as a judging authority that every Muslim should respect, appreciate, and comply with. Secondly, some other scholars mention feeling Allah's presence, seeking knowledge, and the continuance remembrance of Allah are the ways of controlling self-desires. Thirdly, Imam Ibn Qayyim mentions about 50 ways of dealing with self-desires. Even those who are already influenced by self-desire can use any of these ways to get rid of their Self-desires.

He mentions this in his book *Rawdat al-Muhebin* (Garden of Lovers). The following are 15 selected ways:

1. Strong resolution.
2. Patience.
3. Self-courage.
4. Considering consequences.
5. Reflecting that Muslims have been created for a great mission which cannot be fulfilled except by controlling one's desires.
6. Not to be enslaved by self-desires.
7. To know that Satan is the enemy that gets through the servants of Allah. Satan uses desires to influence people.
8. To know that following self-desires will lead to someone's destruction and punishment by Allah.
9. To know that fighting desires by making an effort in order not to be influenced by the desires is one of the greatest forms of *jihad*. Fighting desires is the essential message of Islam. Muslims are required to make every effort to adhere to the teachings of the Qur'an and Sunnah.
10. To know that the one who lets the desires take over and lead him will spoil his intellectual opinion.
11. To know that following desires will weaken the eagerness for performing good deeds. The opposite is also true in this case - that is, not following desires leads to strengthening one's motivation to perform good deeds.

12. To know that not being misled by desires will lead to the honor in this life and the Hereafter.
13. To know that following desires is the main cause of the spiritual heart disease and the remedy of the disease is to not follow desires. We have to make *jihad* to fight desires otherwise we will not be able to fight our enemies.
14. To know that seeking knowledge and feeding it by performing the preferable acts will strengthen one's faith.
15. To know that we need to be enlightened by the Qur'an and Sunnah. This requires us to make the effort to recite the Qur'an in order to know the meaning and the wisdom behind the *ayahs*.

We should make the Shari'ah as the judging authority for everything we do. Before we do something, we should ask ourselves: Is this act based on a sound reason? If the answer is not, then we are following the desires. This is why Allah labels the Qur'an as Al-Furqan or as the criterion that distinguishes what is right and what is wrong.

Therefore every Muslim, whether individual or Organization must fulfill the Shari'ah as its other wise Allah will punish him in this world and here after, so we must fear ALLAH and see our business transactions and do only if they are on the righteousness way and ask scholars to give us the best answers before we do our own.

In other words these issues are very complex and need always knowledge so in this study at end we will provide a suggestions and recommendation in this regard.

As there are no previous studies in regard whether these companies are comply Shari'ah rules, so what I'll emphasize is to know how these companies are practicing the principles of Shari'ah, by knowing this it will give us a clear cut that these companies are

under the principles of the Shari'ah, in which they'll get a lot of Muslim customers. On the other hand Islam principles constitute a love of nature, and of people: the self and others, and an awareness of the importance of balance and the need to take reasoned actions to preserve this balance. Maybe this is the real threat of Islam: is it too much for those who may be termed corrupted by the socio-political order and its rhetoric, including accountants? Those whose perceived interests fuse with problematic hegemonic forces suffer from an obsessive irrationalism manifest in a tendency to destroy and reconstruct rather than engage in rational progressive development.(Kamla et al., 2006).

### **2.3 Shari'ah Compliant**

The Islamic finance is based on the principles of Shari'ah law, which prohibits certain types of investing activities commonly found in non-Islamic capitalization transactions such as the use of debt instruments or use of preferred shares providing higher returns than common shares. The compliance criteria measurement varies in different regions in the Islamic world, though the difference is not that much and its related to principles of Shari'ah understanding in general. In this research, the KLSE criteria will be used as standard criteria; since the companies under this research are listed in the Main Board of KLSE. For instance criteria for screening of stocks to be included in the universe could be positive or negative. Positive criteria imply that a company may be given greater weight in portfolio construction for factors, such as, a good record for quality products, safety, staff management and customer relations; involvement in environment improvement, pollution control, sustainable woodland management and energy conservation and the like.

Negative criteria mean the exclusion of companies from the universe based on certain criteria. Islamic funds have generally used negative criteria and exclude producers of alcohol and pork-related products, providers of conventional financial services (banking, insurance, etc.) and providers of entertainment services (hotels, casinos /gambling, cinema, pornography, music, etc.). Tobacco manufacturers and defense and weapons companies although not strictly forbidden for investment under Islamic Law are excluded as well. Apart from the main line of activity that must not be forbidden in the eyes of *Shari'ah*, Islamic funds have also been using a financial screen to exclude company that rely on excessive interest-based debt and derive a significant portion of their income from interest. However, the nature of such screens has also undergone changes over time and the criteria used in such screens are often not free from controversy.(Obaid, 2005).

On the other hand some Shari'ah scholars would like to offer these as “interim” solutions. We would like to add a qualifier to these. The “interim” solutions must not be “arbitrary” solutions involving a great degree of “subjectivity.” For example, consider the subjectivity involved in the screen prescribed the Malaysian Securities Commission Shari'ah Council. The screen requires inclusion when;

1. Public perception or the image of the company must be good; and
2. The core activities of the company have importance and mash-Allah to the Muslim Ummah and the country, and the haram element is very small and involves matters such as uruf and the rights of the non-Muslim community which are accepted by Islam.

There fore the compliance criterion are very important and essential to all companies under Shari'ah rules. Based on the following criteria we'll examine that the above mentioned companies are under Shari'ah compliance, the compliance criterion are many