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Dividend Purification Process Adopted by Investors in Mixed Company

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***Abstract*— *Shariah* compliant capital market instruments has emerge and keep develop and innovate in order to fulfill current investor demands. Nowadays, the investors does not only concern about the rate of return that they will receive at the end of the year, but also they are concern about the cleanness and purity of the dividend that they get especially for Muslim investors. The evolvement of *Shariah* compliant index will attract more investor either from local or international to invest in our country. This paper presents the definition of dividend purification, the process and the implication towards Islamic capital market. Next, the paper will review the importance of dividend purification and the method of dividend purification that have been used. Lastly, the paper will review the impact if dividend purification process are not implemented and concluded with further suggestion.**

Keywords*— *dividend; dividend purification; Shariah compliant fund, Islamic capital market

I. Introduction

Shariah-compliant funds are investment funds governed by the requirements of *Shariah* law and the principles of the Muslim religion. *Shariah*-compliant funds are considered to be a type of socially responsible investing. Nowadays, the demand for Islamic equity market instrument are increases, not only in Muslim majority country but also at non-Muslim country as well. One of the key aspects of regulating Islamic equity market is related to guidelines on regulations of *Shariah* compliant stock indices. *Shariah*-compliant indexes differ from their conventional counterparts in at least three ways; *Shariah* supervisory boards establish investibility guidelines and monitor the process; the guidelines are then applied to the universe of securities, and finally, purification rules are set to "cleanse" any impure profits from securities-paying dividends [1].

Malaysia has been widely recognised as the world leader in Islamic capital market (ICM) with a market size of RM1.7 trillion on 2017, which has more than doubled over the last decade [2]. As the only country in the world with a framework for Islamic fund management companies, it now houses 20 full-fledged Islamic fund managers including large international firms. Combined with other fund management companies operating Islamic windows, Malaysia has RM149.6 billion worth of Islamic assets under management (AUM) end of 2016, which is among the largest in the world [2].

The *Shariah* Advisory Council (SAC) of the Securities Commission Malaysia (SC) continuously plays its crucial role in providing guidance as a reference centre for *Shariah* matters in ICM-related issues. In line with the positive growth of ICM in Malaysia, the SAC has discussed and resolved several issues pertaining to investors, agent, broker and also issuers of Islamic capital market instrument [2].

The purpose of this article are to know in detail what are the method that have been used by different index provider to determine the investment instrument status either it *Shariah* compliant or not. Second objective is to know the method that have been used to purify dividend income. The methodology that have been used is qualitative method which review of report and previous literature. Lastly, this paper will give futher suggestion in order to enhance and encourage investor to purify their dividend income.

II. Dividend Purification Definition

Recently, although there are no accurate data, it can be estimated that there are around 200 index providers in the world today [3]. Index providers also have different approaches to dividend purification, a ratio that has developed over time in which a certain proportion of the profits earned through dividends (which corresponds to the proportion of interest earned by the company), must be given to charity. Each index provider have their own screening criteria. For the Dow Jones Islamic Market Indexes, dividend purification is not an issue because the indexes do not allow non- compliant companies to be included from earlier. For Financial Times Stock Exchange (FTSE), appropriate ratios stand at 5%, while Morgan Stanley Capital International (MSCI) Barra applies a "dividend adjustment factor" to all reinvested dividends [1].

According to [4], 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. [5] identified majority scholars agree to the need for a purification process for the investment funds. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (2010) in *Shariah* Standard 5/1/4/3 stipulates that *zakat* need to be paid from investment funds in their different forms. They, however, have different views on determining the elements that need to be purified in the process of purification. To the question of what needs to be purified in the context of

Islamic unit trust funds, as well as other investment funds, three elements are involved. They are namely; dividend, capital gain, assets or liabilities.

[6] defined purification is the process of identifying part of the income coming from impermissible activities and donating that income. According to AAOIFI *Shariah* Standard No. 21, earning purification is obligatory for one who owns the shares at the end of the financial period, whether or not the profit was distributed and whether the company made a profit or suffered a loss (AAOIFI, 2010). However, purification is not obligatory for an investor selling shares before the end of the financial period. According to [7], there are two methods of purification – income purification and dividend purification. The income purification method appears to be more sensible than the dividend purification method. Dividend purification cleans only that part of income which is distributed as dividend. Unlike in the income purification method, the impure income portion will not be purified in the dividend purification method if the company does not pay dividend or suffers a loss, but still generates some impure revenue. Logically, it is unpractical to ask the investors to purify the prohibited income portion from their own pockets if the company does not pay dividend or suffered a loss [8].

According to *Shariah* Advisory Council of Securities Commission, the purification of dividends received and excess capital gained from the disposal of *Shariah* non-compliant securities after the date of announcement, as well as capital gained and dividends received from the disposal of *Shariah* noncompliant securities which were mistakenly invested (Tainted Income) to be undertaken by the investors themselves instead of the fund manager of the Islamic funds is permissible subject to the following conditions:

i. Upon receipt of the Tainted Income, the fund manager shall deposit the Tainted Income into a separate account which is segregated from the account of the Islamic fund;

ii. The fund manager shall distribute the Tainted Income to the investors as soon as practically possible which shall be advised by the *Shariah* adviser of the Islamic fund;

iii. The fund manager shall inform/notify the investors of their obligations to purify the Tainted Income in accordance with the *Shariah* principles upon the distribution of the Tainted Income to the investors; and

iv. The processes and procedures for the purification of the Tainted Income by the investors shall be clearly disclosed in the prospectus/offering document.

The SAC also resolved that it had no objection for the fund manager to utilise a portion of the Tainted Income to pay all cost associated with the distribution of the Tainted Income.

III. Shariah Screening Methodology

The screening process is important as according to the Securities Commission Malaysia (SC) because more than 60% of all companies listed on Bursa Malaysia are considered to be "mixed companies" where their business activities comprise both *Shariah* compliant and non-compliant transactions. *Shariah* compliant instruments, and *Shariah* indexes, generally prohibit investment in alcohol, pork, tobacco, weapons, gambling, pornography, certain leisure and entertainment businesses, as well as conventional financial systems.

In Malaysia, we are adopting a Two-Tier Quantitative Approach. The two tier quantitative approach which applies the business activity benchmarks and the financial ratio benchmarks. The business activity benchmark are divided into two types of benchmark which are the 5% benchmark and the 20% benchmark. The 5% benchmark is applicable to the conventional banking; conventional insurance; gambling; liquor and liquor-related activities; pork and pork-related activities; non-halal food and beverages; *Shariah* non-compliant entertainment; tobacco and tobacco-related activities; interest income from conventional accounts and instruments (including interest income awarded arising from a court judgment or arbitrator and dividends from *Shariah* non-compliant investments); and other activities deemed non-compliant according to *Shariah* principles. The contribution of *Shariah* non-compliant businesses/ activities to the Group revenue or Group profit before taxation of the company must be less than 5% (<5%).

The 20% benchmark is applicable to hotel and resort operations; share trading; stockbroking business; rental received from *Shariah* non-compliant activities; and other activities deemed non-compliant according to *Shariah* principles. The contribution of *Shariah* non-compliant businesses/ activities to the Group revenue or Group profit before taxation of the company must be less than 20% (<20%).

According to [9], The Dow Jones Islamic Market filters a prospective company's eligibility (after removing companies with unacceptable primary business activities) based on compliance with three financial ratios, namely: (1) Companies must have a debt to equity ratio equal to or less than 33%. (2) Companies must have an accounts receivable to total asset ratio equal to or less than 47%. (3) Companies must not receive more than 9%of total income from non-operating interest activities.

For FTSE *Shariah* Indexes, the *Shariah* screening is undertaken by Yasaar Research Inc. with FTSE then calculating and disseminating the indexes. FTSE and Yasaar Research Inc.'s screening process is managed in accordance with written guidelines relating to the *Shariah*. These guidelines have been set by Yasaar's *Shariah* Board who also monitor compliance. The *Shariah* guidelines can be grouped into two separate components – business activity and financial ratios. However, this is only part of the picture. The Dow

Jones Islamic market Indexes prohibit any involvement in the activities mentioned, while the FTSE *Shariah* Global Equity Index Series allows companies to be included if the income on their total interest and noncompliant activities does not exceed 5% of the company's total revenue. Similarly, the MSCI Islamic Index Series only prohibits companies who derive more than 5% of their revenues (cumulatively) from any prohibited activities, as does S&P. Like Dow Jones Indexes, the Russell-Jadwa *Shariah* Index prohibits non-compliant companies from inclusion.

Basically, the *Shariah* screening process have to be review from time to time. So, its means that the number of securities that classified as *Shariah* compliant securities instrument are keep changes. The changes may be due to current capital market situations, current policy and guidelines as well.

IV. Dividend Purification Methods

Generally, there are two means of purification of property in Islam, they are; *zakat* and charity. According to Investopedia, *zakat* is an Islamic finance term referring to the obligation that an individual has to donate a certain proportion of wealth each year to charitable causes. *Zakat* is a mandatory process for Muslims and is regarded as a form of worship. Giving away money to the poor is said to purify yearly earnings that are over and above what is required to provide the essential needs of a person or family.

M. Rodzi et. al (2013) defined *zakat* as 'purification' or 'growth'. *Zakat* enables the wealthy or rich people to purify their hearts from greed by giving a part of their wealth to the needy. The needy who receive the *zakat* are then able to fulfil their needs, and, thus, the economic wealth bestowed by Allah s.w.t is spread to all the people and real economic growth is achieved [10]. *Zakat* have positive impact especially to the *zakat* recipient as they can get benefit and also improve their lifestyle if they used the *zakat* given wisely.

Zakat (Almsgiving) is one of the most important instruments in the Islamic economic system, and it plays a significant role in eliminating inequalities in society. Muslims who possess surplus wealth are obligated to pay *zakat*, and this fund will be distributed to prescribed eight beneficiaries known as *zakat* recipient (*asnaf*) group with the priority given to the poor and needy [11]. *Zakat* given also reduce the greedily of the payer and reduce the envy and jealous feeling of the *zakat* recipient.

AAIOFI indicates that the responsibility of the purification falls upon the institution, in case it is trading for itself or managing the operations. According to DeLorenzo (2000), the matter of dividend purification for Islamic mutual funds is best left to the investors themselves, since it depends on the circumstances of each investor [12]. When the flexibility are given to the investors, it could be some of them will negligent or just take this for granted and does not think it is an importance matter. So, it is important for unit trust managers or SAC of SC to produce a guideline or regulation pertaining this matter in order to make sure that those that eligible to pay *zakat* are not miss it.

There are a lot of opinion about dividend purification methods. According to AAOIFI standards, in order for investors to calculate the impure income that should be purified per share, the total impure income should be divided by the total number of shares of the corporation [13]. However the standard does not tell how the calculation will be done in detail. This is regardless of whether the company declared a profit or suffered a loss and whether the profit is distributed or not. However, some scholars require that the impermissible income portion is purified only from the dividends distributed (DeLorenzo, 2000) [12]. However, some scholars require purifying interest income only (Dar Al Istithmar, 2009) [14], whereas others such as Dow Jones and S&P do not require interest rate income purification (Khatkhatay and Nisar, 2006) [15]. Clearly, the way of purifying the impure income portion is controversial and subjective. Different index provider having their own method. It's happened due to different inconsistencies in *Shariah* screening criteria among Islamic investment institutions, especially in terms of the tolerance level. This is because there is no universal consensus on a predetermined fixed set of *Shariah* screening criteria and hence, each Islamic investment institution has its own *Shariah* board or a *Shariah* consultant firm in order to set *Shariah* guidelines for its operations (Saeed and Habib, 2014) [8].

The second method for dividend purification is *Sadaqah*. *Sadaqah* or charity is the other means of purification of property is Islam. While the *zakat* is made compulsory to the Muslim who possesses the nisab, the *sadaqah* on the other hand is optional to them (A.Z. Salleh and M.Z. Zakaria, 2015) [5]. *Sadaqah* is an optional not an obligation. So, it's mean the investor having bigger flexibility and choice either to purify their dividend income or not. Nobody can argue and tell it a sin, but it depends on the Barakah of the income. If the investors know that the income is come from prohibit or haram sources, so in order to get barakah in their daily life, they should give *sadaqah*.

Sadaqah can be given during any period of happiness or sadness or as a sign of gratitude to Allah. *Sadaqah* comes in many forms, whether in monetary or non-monetary. Inviting people to do kindness, giving a smile, giving *sadaqah* or food to street beggars is also a charity. As long as, it give benefits to others and it is done with sincerity, it is considered a *sadaqah*. However, for the process of dividend purification, it would be unpractical if there is no rate or percentage of dividend should be given as charity. It is important to have a guideline for investors to clean up the dividend earned.

In Malaysia, the dividend purification process is fully handed over to the investors. They are responsible for knowing the status of their investment instrument and taking their own initiative to purify it. The method of purification is also up to the investor himself. Compared to countries like Singapore, the fund manager is responsible for the dividend purification process. According to Saw, S.H. & Karyn W., in Singapore, the fund manager is responsible for taking out the

tainted portion of the returns and giving it away to charity before an Islamic unit trust fund, as well as other Islamic equity funds, are made available to the public [16].

V. Conclusion

Dividend purification is important things especially in Islamic unit trust funds investment activities. As we know unit trust fund is a diversification portfolio investment. So, the fund cannot run from invested in non-compliant *Shariah*'s elements, especially when invested in mixed business activity. Besides that, it also shown that the dividend purification process also have different methods for different country. When comparing between Malaysia and Singapore practices, in Malaysia, the purification process is voluntarily done by the investor themselves. However, there is no specification on how much or the calculation of the purification process will be done.

The impact of not purify our income or dividend will affected the country as well the economy. As we know, it is important and become an obligation for those having property or wealth that reach nisab or exceed it, they must pay *zakat*. *Zakat* is the right of poor and needy. So, the economic cannot develop and expand if those are suppose to give *zakat* are denying the *asnaf*'s right. When *asnaf* not receive *zakat*, they cannot improve their life. As a consequence, the objective of *zakat* institutions to eliminate the poverty cannot be accomplish. For *sadaqah*, it is subjective seen it fully depends on the investors willingly either to give it or not. If they choose to give *sadaqah*, it is good, but if they not, nobody can say anyting because it is voluntary not obligatory.

Hopefully, there will be research conducted to evaluate the percentage of *zakat* taken out from the dividend for the purification process. In case the investor choose to give *sadaqah* as method to purify their income, SAC of SC should provide a clear guideline to the investors on how the process will be done.

On the other hand, in Singapore, the purification process will be done by the fund manager. Therefore, the amounts are taken out before the returns are distributed to the investors. It will make the investors clearer and know that the returns that they receives are clean and pure from haram element.

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