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Editorial

Approaching the close of the century one is tempted to focus the vison on the new millennium. The World has witnessed a variety of changes during the last decade. Technology is impacting the life style in a big way. The developments in the fields of transportation and communication, more particularly in information technology have shattered physical distances, while the globalisation is making political boundries irrelevant. Countries of the world are searching for their core strengths and regional blocks are being formed. These developments are expected to provide quantum boost to international trade and commerce. A new era is unfolding before us, raising hopes as well as challenging situations. No country and no branch of knowledge can remain unaffected by these developments. The present issue of the Journal focuses on some of these areas of wider concern.

Outlining the challenge of value creation and cost control in corporate entities Dr. Sujit Sikidar and Dr Ghanshyam Nath have discussed the role of business process re-engineering, cost reduction etc. Economic value added is considered an improtant measure of shareholder value. Showing its application Dr. K.R. Sharma has highlighted the limitations of the measure. Dr. V. Chari and Dr. B.H. Desai have discussed the implications of foreign direct investment by multinational companies in developing countries. Illustrating the different techniques, Dr. G. Srinivasan has discussed the role and the implications of transfer pricing decisions in case of multinational companies.

Capital markets have a prominent role in channelising the savings to investment. However, due to complexity in operations an ordinary investor finds it difficult to cope up with it. Regulation and control of stock markets is therefore, considered essential for investor protection and checking unethical practices including insider trading. However, in Dr. H.N. Agarwal’s view this is an essential evil the stock markets have to live with. Shri Bhaskar Jyoti Bora have emphasised on the use of human resource value information in personnel decisions.

There in much to learn from history including answers to even contemporary problems. Dr. C.L. Salvi and Dr. G. Soral have, surveying the ancient Indian Literature, brought to light the highly scientific and rational accounting and audit practices in government. Shri Sidhartha Banerjee have, tracing the history of government budgeting in the UK and the USA, discibs the evolution of modern corporate budgeting.

The contemporary changes in business have impacted taxation also. Shri Arindam Gupta and Dr. Chintaharan Sengupta have, elaborating the direct tax reforms in India in the wake of globalisation, suggested future set up of reforms. Dr. (Miss) Madhurima Lall has given observations regarding the tax implications of yield on deep discount bonds.

As the process of development goes ahead, many more challenging issues and problems are expected to surface and the scholars and researchers shall have to find answers to the same. We look forward to the contributions of the scholars and the researchers in Accounting towards meeting this challenge.

Udaipur
December 25, 1998

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Value Creation and Cost Control in Corporate Entities: An Accounting Challenge

Dr. Sujit Sikidar* and Dr. Ghanashyam Nath**

Volume growth, cost control and capital efficiency are levers of value. In the absence of top line growth, there can not be first lever of value. Every one talks of profit margin, but it is an outcome of cost control. Attainment of cost efficiency has perched in a big way in Indian industry through the route of restructuring and re-organisation. The third lever of value viz. capital efficiency is still difficult to measure in Indian industry. Capital efficiency makes fixed assets sweat. It implies that the entity would keep working capital very low, not rush to bank or any other financial institution at the drop of the hat.

The object of the present article is to examine the role of the levers of value viz., cost analysis, cost control, re-engineering with some practical examples derived from corporate entities. Cost control has become a key area of concern following competition from global corporate entities and cross-border distribution of products and services.

A new lever added to this is market capitalisation. In Indian context, with dampened capital market condition, one can hardly measure market capitalisation owing to the fact that the market itself is very narrow, not transaction rich, and not so transparent. Contrary to this, market capitalisation is very high in the USA, where it is influenced, 50 to 60 percent by corporate results, and 40 to 50 percent by investors’ perception, as to how they look at the future. It implies that the former measure is real and the latter is aspirational or expectational. Market capitalisation is tailored by hardware and software. When the investors are depressed at the lot of assets, as prevalent in old entities, and discount it, this gives a fore-warning to management for action, say in the area of cost reduction and technology upgradation.

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The fifth lever in the category can be identified as economic value added, a measure of market capitalisation. Many Indian companies have started using this as an index. Economic value added is truly an agglomeration of volume creation, cost reduction and capital efficiency.

A company can attract market attention by delivering a superior quality product, by delivering similar service at a much lower cost, and/ or by combining the two into a common feature. Likewise a business entity can enjoy superior status if it is value driven, or commodity driven, or cost driven or possesses a combination of any two or three or more of the above features. Companies which are customer driven, value driven and cost driven can deliver better value in the long run. Further entities creating intangible assets like brands, patents, trademarks, goodwill and superior services are expected to attain sustainable level in the long run.

To achieve value creation, corporate entities also concurrently look for excellence in manufacturing.

**Excellence in Manufacturing**

Excellence in manufacturing has been applied in modern cost conscious production environment (a) to create greater awareness and exposure to harness the manufacturing function as a source of competitive advantage, (b) to identify and deal with macro economic policy issues and corporate strategic inputs which have a significant impact on manufacturing function, (c) to adopt flexible manufacturing system with the changing requirements of production, (d) to develop appreciation of long term perspective for creating excellence in manufacturing, (e) to develop sensitivity and understanding of related functional areas which have critical bearing on manufacturing and operational issues, (f) to develop deeper understanding of sub-functional areas in manufacturing like product design, development, operation, technology, supply chain, sourcing, quality, delivery schedule etc (g) to create and develop problem solving capabilities and analytical abilities to make sound manufacturing and related decisions.

Benchmarking of processes is essential for the enhancement of quality of products in an entity. A quality product is of little use in a competitive environment if it fails to delight customers. A product can command superior position in a competitive market only when it satisfies all types of usages by the customers. Benchmarking and use of newer technology are inevitable to sustain competition.

Excellence in manufacturing may be supplemented by strategic cost management, which views cost as a function for deciding the strategy to compete and the company’s ability to carry-out the strategy. The earlier practice of adding period cost with product cost and adding a mark-up
does not fit in a competitive environment. In modern distribution system, price is determined by consumer and a company has to retract back to examine whether it can sell the product at price the consumer is willing to pay. In case the company fails to do so it may cause recessionary phase in the market. Strategic cost management is an answer to the situation in which cost is not only the culmination of the functions of raw materials, overheads and power but also of socio-political environment of the company. The company shall have to sort-out the suppliers of inputs who may offer product at a lower price. The manufacturing entity has to influence distributors in making more efficient sale, if necessary by reducing its profit margin.

There has been a close linkage between activity based costing and strategic cost management, which emphasize more on external factors, while the activity based costing focuses on activities that contribute to cost. Traditionally costs are measured in terms of product cost, period cost, factory overheads, administrative overheads, selling and distribution overheads etc. But these are not sufficient for the decision making process. To explore the activities causing costs, the cost managers have to make distinction between the activities that add value and those that do not. This will enable the company to identify and drop activities that do not add value and also to identify cost drivers. In every organisation there are certain activities which significantly influence costs or revenue or both. The management has to establish the cost drivers and then devise means to control those costs.

**Life Cycle Costing**

For the purpose of strategic cost management, a corporate entity has to assimilate its activities with other ancillary functions of cost control and cost management. Among these life cycle costing is a function of recent origin. It is a technique of determining economic decisions and of owning a productive asset on the basis of cost considerations during its economic life. Life cycle costing is a device in the hands of management to ascertain the total cost of production of an item or of holding an asset during its economic life. It is based on the assumption that production and distribution of commodities follow a given cycle over their economic life. In distribution scenario it is observed that the sale is slow when the product is introduced. The sale picks up with gradual increase in popularity and then comes down to benchmark level, where it assumes a stable form. Subsequently, the sale starts declining with the emergence of better products with state-of-the-art technology. This resembles to life cycle pattern for each product in a given accounting period. However, the length of the product cycle is determined by a combination of several factors, such as improvement in technology, change in technology, market favour and acceptance, competition from trade rivals, consumers' perception and
behaviour etc. Generally, consumer goods have a shorter life cycle, while the products of basic and capital goods industries enjoy longer life cycle. Life cycle cost of assets may be identified in three categories, namely operating cost, holding cost and disposal cost. Life cycle costing may be applied in several areas, such as forecasting, planning and control of functions of an enterprise. It may be also applied over capital expenditure propositions.

**Corporate Re-engineering**

Another issue pertaining to cost efficiency may be identified as corporate re-engineering, which has assumed greater significance in cost control. Corporate re-engineering has been defined as the fundamental re-thinking and radical design of business process to achieve dramatical improvement in critical contemporary measures of performance, such as cost, quality, service and speed (Michael Hammer). The blending of the thesis, the anti-thesis and the synthesis about the operational aspects has given rise to re-engineering of corporate entities, in place of traditional cost accounting system.

**Business Process Re-engineering**

As cost analysis has become crucial in recent period and deserves special consideration for a manufacturing entity, business process re-engineering has emerged as the front-runner. The concept is gaining ground for business practices with a promise of improving performance. Business process re-engineering was conceived as a magic myth to solve business problems overnight, also commonly known as the big bang. It differs from the conservative approach in that it is more aggressive and does not rely on continuous and small improvements, through the techniques, such as kaizen, pokayoke etc. The concept was first authored by Micheal Hammer in 1991 at a time when business as a whole was passing through recessionary phase. Activity based revenue management and activity based cost management (Ramola Bhuyan and Girish Shingote, 1997) go hand in hand with business process re-engineering. Price Waterhouse has developed a six lever approach of change in materialising the objectives of business process re-engineering. These are: Markets and Customers, Products and Services, People and Culture, Technology, Business and Processes, Structures and Facilities.

In this context business executives are asked to identify and evaluate investment in those functional areas or activities that yield highest revenue. Here lies the essence of top level executives’ effort in managing costs in relation to a given activity. A holistic approach is formulated covering key processes which warrant revenue hike and cost reduction. Several companies in the West have reaped the benefits of cost management by
adopter business process re-engineering. For instance, 290 out of Fortune 500 and 77 out of JK100 companies have undertaken the exercise. A research survey revealed that among the Fortune 500 companies, 44 percent companies were re-engineering the entire company. The Institute of Cost and Works Accountants of India (ICWAI) may adopt a scheme of business process re-engineering for companies. This would help them attaining cost competitiveness in the environment of globalisation. This is an urgent need of present time. The drivers for re-engineering may be emphasized and institutionalised by the ICWAI through price competitiveness, faster products/services to market cycle, closer relationship with customers/suppliers and greater market share/profits.

**Profit Planning and Cost Control**

Profit planning has a direct bearing on cost control. The management control system includes profit planning and cost control as features of excellence. Control is assuming that desired results will be attained. Budget is an integral part of control function. Tom Peters and Bob Waterman in their book *In Search of Excellence* (1982) have argued that global competition would force companies to reduce labour cost and information technology would help reduce middle level managers. Tom Peters' *Liberation Management* (1992) is a guide to state-of-the-art management doctrine. Having realised the difficulty in achieving excellence, in his third book *Thriving on Chaos*, Tom Peters concluded that there are no excellent companies.

**Delivery Schedule and Customer Satisfaction**

For better cost management, it is important that manufacturing entities adhere to delivery schedule. Shift in delivery schedule may lead to loss of customers. On the other hand, sticking to delivery schedule may help them produce at given cost. Thus they can avoid situations like out-of-stock, cost over-run and time over-run. Chryster of the USA has introduced a system called supplier cost reduction (SCORE) emphasizing that suppliers are encouraged to submit offers for cost reduction. Likewise, General Motors of the USA has a system called Purchase Input Cost Optimisation System (PICOS) attaching prominence to quality.

**Re-engineering Cost Accounting System**

Re-engineering the cost accounting system based on formal structure set up under activity based costing shall require synthesis and allocation of overheads properly (Daniet Keegan and Rebert Eiler 1995), simplification of details of accounting, improvement in cost information reporting system and finally, performance evaluation. Key areas for the introduction of cost re-engineering may be (a) elimination of labour reporting, (b) making first line management responsible for inventory management, (c) elimination
of actual costing, (d) sub-dividing and grouping cost centres, (e) use of activity based costing for allocating budgeted costs, (f) simplification of variance reporting (g) linking manufacturing system with value-adding transactions, and (h) augmenting the cost system with non-financial performance measurement.

The prominent blue-chip and largely traded and listed companies in stock market may try to re-engineer their product costs. To begin with, the companies may have to identify the cost drivers as indicated above and then allocate and re-allocate the cost drivers among various service and utility departments and moving them finally to products. Activity based costing may be integrated into budgeting process and activity based budgeting information may be achieved without any additional expense. This activity may then be incorporated into product cost.

Another matter which deserves attention is variance reporting. The difference between budgeted and actual costs may be classified into categories, such as purchasing, volume and spending. In that case, managers can engage their attention to exceptional items for cost control. A different form of variance reporting process may be adopted which may ultimately help in re-engineering with modified cost analysis and control.

A high level inter-disciplinary cost management team may be set up by Indian companies in order to withstand the pressure from multinational companies, as they bring into India their own supplier chain for input supplies. A citation may be made of Isuzu Co of Japan, which had a seven member cost team. Having realised the need for cost management and cost reduction, they introduced 23 new members to the team in 1992, and again increased the number in 1993.

In order to achieve allround cost efficiency thus, attention has to be focused on complementary cost management techniques practised by several corporate entities. These practices are benchmarking, life cycle costing, activity based costing, total quality management, activity based budgeting, activity based auditing, activity based management etc. Unless cost information are developed inside an entity, it cannot reap the benefit of activity based costing. Several companies in the USA and the UK had installed factory cost systems way back in 1805, but on a sporadic basis. Cost management and control was re-enforced between 1890 and 1905 in the wake of scientific management. The focus now is shifting from cost determination to cost control. Among the corporate practices a gradual shift in stages, from inventory valuation and profit measurement to separate classification and treatment of fixed and variable costs, can be identified. The classification commanded responsibility in cost control. The development of flexible budget technique has forced recognition of the essential difference between fixed and variable costs.
References:


Insider-Trading – The Uncontrollable: Some Observations

Dr. H.N. Agarwal*

Investors' confidence is an essential pre-requisite for the healthy growth of security markets. Pertinent factors like provision of adequate, fair and timely market information, effective system of grievance redressal and quick identification of malpractices/unfair practices in the security market operations and their immediate control are sine qua non for building up investors' confidence.

'Insider-trading', a universal phenomenon, is considered as one of the most unfair trade practices in security markets in India and abroad. In 1979, the Sachar Committee on reforms in the Companies Act in India recognised the need for controlling insider-trading. Similarly in 1986, the G.S. Patel Committee on Stock Exchange Reforms pointed out the lack of legislation for curbing insider-trading. The Abid Hussain Working Group on Development of Capital markets in 1989 also felt the need to check and control insider-trading in security markets. They favoured a civil penalty (three times of profit or loss avoided), rigorous imprisonment upto a term not exceeding two years and fine not exceeding Rs. 5 lakhs, and some civil and criminal preventive measures, to discourage people from getting engaged in such an activity.¹

For creating awareness among consumers/investors for their rights and for protecting their interests against such type of malpractices, the SEBI granted provisional registrations to, the Consumer Education and Research Centre (CERC), Ahmedabad, the Investor Guidance Society (ICS), Bombay, and the Vizag Investor Association (VIA), Vishakhapatnam. These organisations are actively engaged in consumer education and protection programmes.

The regulation of insider-trading in security markets is not uniform the world over. In Germany, there is a voluntary code of conduct for capital market players, while in the USA and the UK, there is a formal legal framework in existence. Under the Securities Exchange Act, 1934 of the USA, powers have been given to the Securities Exchange Commission

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(SEC) to seek triple penalty under the provisions of the Insider Trading Sanction Act, 1984. Similarly, under the Securities (Insider Dealing) Act, 1985 of the UK, powers have been given to the Securities and Investments Board (SIB) for regulating this malpractice. Like the USA and the UK in India, the SEBI has been vested with similar powers under the SEBI (Insider Trading) Regulations, 1992.

II

The unpublished price sensitive information is at the base of insider-trading. It takes place when persons connected with companies and having price sensitive information use it for private gain or to reduce their loss at the cost of other investors, who do not have such information in their possession. The price sensitive information may include aspects like financial results; intended declaration of dividends (interim and final); issue of shares by way of public, right and bonus issue; major expansion plans or execution of new projects; amalgamation, mergers, takeovers etc.; disposal in whole or in part, of the undertaking; information affecting earnings; and changes in policies, plans and operations.

Since the price sensitive information is related to a specific company, it has a direct bearing on unsystematic risk of securities, and one in possession of such specific information always succeeds in beating other players in the market, more specifically those who are largely fundamentalists.

Furthermore, distortions are created in the market when insider-trading is in large volume and thereby influences short-term trends in demand for and supply of the securities. As per the report appearing in the Economic Times on September 18, 1995, there was an unprecedented jump in the volume of the scrip of Fenner Minerals Ltd. With an equity of Rs. 4.5 crores, the scrip recorded a whopping turnover of Rs. 43.04 crores on a single day, with 20.88 lakh shares changing hands, against the total turnover of Rs. 166.99 crores in the cash section. This phenomenon, it was alleged in the market, was the result of insider-trading and played havoc with ordinary investors. This way insider-trading, if allowed to have free run, may disturb smooth trading, promote imperfect competitive trends to persist longer, and thereby delay further the achievement of the state of efficient security market.

III

In order to control insiders and their malpractices, therefore, it is first necessary to identify them and then to take up a package of measures to discourage them from undertaking such unfair practices.

Under the SEBI Insider Trading Regulations, 1992, "an insider is a person, as defined in Section 1.4 of these Regulations, who during the
preceding 7 months, is connected with a company and who may reasonably be expected to have an access to unpublished price sensitive information in respect of securities of that company or any other company and includes any other person who has received or has had access to such unpublished price sensitive information.\textsuperscript{2}

An insider may belong to the primary or the secondary category. The former category includes directors, or deemed to be directors and officers, or employees, holding a position involving a professional or business relationship, who may be reasonably expected to have such an information. In the latter category of insiders are included, companies under the same management or any subsidiary company thereof, officials or members of stock exchanges, or dealers in securities, or employees of such members or dealers of stock exchanges, merchant bankers, share transfer agents, registrars to issues, debenture trustees, brokers, portfolio managers, investment advisers, sub-brokers, investment companies or employees thereof; members of Boards of Trustees of Mutual Funds, members of Boards of Directors of Assets Management Companies (AMCs) of Mutual Funds, or employees thereof who have a fiduciary relationship with the company, members of Boards of Directors or employees of public financial institutions, officials or employees of public financial institutions, official or employees of self-regulatory organisations (SROs) recognised or authorized by the Boards of the Regulatory Bodies, relatives of aforementioned persons and bankers of the company. Thus privileged persons like directors, auditors, and select band of officials and brokers are covered under the category of insiders.

The identification of insiders in India, as per the aforementioned description is based on mixed approach i.e., status of an insider, which is designated by means of a specified list of persons, and persons who acquire insider information. The former approach has been followed by British, French, Irish and German laws, while the latter approach has been used in Belgium, Denmark, Spain and Greece.

IV

The process of controlling insider-trading in India, included three major steps, viz. (i) to define insider-trading, (ii) to identify insiders, and (iii) to impose penalties, and to give punishment to those found guilty of active insider-trading.

There can hardly be any point of controversy regarding defining the insider-trading. However, one is forced to rethink for its continuance or discontinuance. The global character of insider-trading speaks a lot for its indispensable character in transactions taking place in security markets.

This is solely because this practice has fine tuning with the general behaviour pattern of large number of persons operating in security
markets, a practice which has its roots in the natural behaviour of human beings, irrespective of its degree of seriousness. It will have to be, therefore, necessarily tolerated in the interest of keeping the wheels of security markets going on. For, those who are identified as insider-traders, are the genuine and capable players in security markets; and curbing them would mean depriving the vehicle of security markets of its wheels, without which it cannot move on its growth path. It would not be an exaggeration to remark here that insider-trading is basically non-controllable and any amount of effort to control it would either witness gross failure or would result into negative growth of the markets if it could, per chance, be controlled.

Furthermore, the identification of insiders on the basis of the persons either having price sensitive unpublished information or holding some status would again be untenable. These persons who succeed in getting company specific information are worthy and competitive investors in security markets, which otherwise are full of imperfections. Security markets, despite automation, are still far away from real efficiency. Moreover, the investors live and operate in a socio-economic framework and very frequently interact with each other. It would then be unreal to assume that the ordinary investors shall remain completely cut-off and fully isolated from other persons who are supposed to be insiders on the basis of their enjoying certain status. Moreover, in case of companies, the number of insiders to information is large and leakage of price sensitive information is bound to occur. This also supports the idea of not trying to control these players who are basically and naturally not controllable.

Even when for the time being, it is accepted that insider-trading, being a malpractice, must be curbed and a detailed process of identification of insiders as well as imposition of penalty and punishment must be chalked out, one may be afraid of asserting that there would be sure success of any such endeavour. Despite all types of efforts in India and abroad to control insider-trading, this malpractice continues to persist in its full form. An enquiry into this phenomenon further reveals the operationally non-feasible character of the efforts vis-a-vis uncontrollable character of insider-trading.

V

In the above backdrop, the question emerges as to what should be the approach for insider-trading in future? The answer is not far to seek. For instance, the ecological balance in nature requires simultaneous presence of all types of poisonous and non-poisonous plants, violent and non-violent animals, good and bad gases etc, and any effort directed at curbing or destroying poisonous plants, and violent animals and bad gases, etc, just on the plea that they are harmful, is expected to result into
ecological imbalance. Insider-trading has a similar justification for existence in security markets. In order to ensure balanced growth of the markets, any activity for curbing or controlling the insider-trading on the plea that it is harmful to ordinary investor may be a step in reverse gear and may be tantamount to checkered growth of security markets. But this does not, at the same time, mean that insider-trading should be allowed to flourish without any limits. A broad framework of control for it should prevail, so as to ensure some amount of inbuilt mechanism of checks and balances to prevent its possible excessive menace beyond limits. The controllers and regulators of security markets need not to be too much fussy for it at every moment. Rather the measures for the control of insider-trading should be episodic and used occasionally for more effective results.

1. The SEBI, Insider Trading Regulations, 1992, provide that "Any person who contravenes the provisions of Section 2 of these Regulations shall be (a) liable to pay a civil penalty not exceeding three times of the profit gained or loss avoided as a result of the dealing; or (b) (i) punishable with rigorous imprisonment for a term not exceeding 2 years; or a fine not exceeding Rs. 500,000; (ii) or with both (Section 5.1).

Economic Value Added Accounting

Dr. K.R. Sharma*

Shareholder Value Management (SVM) refers to the managerial action pursued with the explicit objective of enhancing shareholder value over time. This is achieved in practice by generating consistent returns on shareholders’ investment through dividend and increase in market price of shares of the company.

It is recognized that corporate management is expected to pursue an approach based on balancing the long-term interest of various stakeholders, such as shareholders, employees, lenders and creditors, suppliers, customers and the community at large. It is, however, becoming increasingly evident that the shareholders are *primus inter pares*, if not dominant amongst the stakeholders. This is not necessary merely due to the need for having a practical criterion to resolve conflicts and assign priorities amongst diverse stakeholders’ interests, but also because pursuit of long term interest of shareholders automatically subsumes most, if not all, other stakeholders’ interests as well, in a viable and sustainable manner. Thus, the management of a company is expected to innovate and ensure delivery of enhanced value to its shareholders. Companies which earn returns higher than the costs create value, whereas those which earn lower returns than costs are destroyers of shareholder value.

Drivers of Shareholder Value:

As an important part of the value of a company, the shareholder value is represented by the value of equity. This may be stated as:

\[
\text{Company Value (Vc)} = \text{Value of Equity (Ve)} + \text{Value of Debt (Vd)}
\]

or \[
\text{Value of Equity (Ve)} = \text{Value of Company (Vc)} - \text{Value of Debt (Vd)}
\]

The value of a company is equal to the sum of discounted annual free cash flows, with yearly cash flows discounted at cost of capital (Kc) of the company. It follows from the above that the shareholder value is influenced, besides changes in the cash flows by changes in the cost of capital, which in dependent upon financing mix or debt equity mix. Thus

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the key to shareholder value maximisation is maximisation of cash flow
generations from operating and non-operating income generations over
time on the one hand and/or lowering the cost of capital on the other hand.

The drivers of enhanced shareholder value are the factors and
priorities which get reflected in sound competitive strategy, improved profit,
a sound distribution policy and corporate transparency that reinforces
investors' confidence in the company. These may be briefly enumerated
as:

(1) Continuous focus on core areas of competence, keeping to frontline
technologies and development of products with a futuristic orientation.

(2) Investment in strong growth areas where the returns are in excess
of the cost of capital.

(3) Captive integration of various manufacturing segments of a product,
to capture the entire value addition chain.

(4) Creation of value for long term, as opposed to exploitation of short-
term opportunities. Planning growth in tune with environmental
considerations.

(5) Sound financial management with full respect for the laws of land,
the requirements of accounting standards and responding to
shareholders' requirement of corporate transparency and reward in
a positive way. This is necessary to reinforce shareholders' confidence
and upholding the highest standards of management accountability.

(6) Leverage on intellectual capital as a means to realize value.

(7) Adoption of a sound distribution policy, maintaining good relations with
persons in the distribution chain.

Measures of Shareholder Value:

There may be three principal tools to measure the shareholder value.
These are, the Market Value Added, the Total Shareholder Return and
the Economic Value Added.

Market Value Added:

On the assumption that market places premium on a company's value
in recognition of its future earning potential, the Market Value Added is
determined by the excess of market value of shares of the company over
its total funds, both owners' funds as well as borrowed funds. Thus,

\[
\text{Market Value Added} = (\text{Market Value of Debt} + \text{Market Value of Equity}) - (\text{Net Worth} + \text{Debt})
\]

or,

\[
MVA = (MVD + MVE) - (NW + D)
\]
Total Shareholder Return:

Since dividends and increase in market capitalization are two principal ways in which shareholders can be enriched, the Total Shareholder Return is determined taking into account these two features. Thus the Total Shareholder Return is calculated by dividing the sum of the increase in Market Capitalization of Equity during the period plus Dividend paid-out by the company during the financial year by Market Capitalization of the company at the beginning of the financial year under review. This may be expressed in percentage form as:

\[
\text{Total Shareholder Value} = \frac{\text{Market Capitalization at Year End} - \text{Market Capitalization at Year Beginning} + \text{Dividend Outflow}}{\text{Market Capitalization at Year Beginning}} \times 100
\]

or,

\[
\text{TSV} = \frac{\text{[(MCYE - MCYB) + DO]}}{\text{MCYB}}
\]

Economic Value Added:

Economic Value Added is an easy to understand measure that recognizes improvement in earnings to the extent this exceeds the cost of the capital employed to secure it. It represents the value added to shareholder equity by generating operating profits in excess of the cost of capital employed in business. Thus, Economic Value Added is residual income with the company after charging for the cost of capital provided by lenders and shareholders. If the Economic Value Added is positive the business is taken to have generated wealth in excess of what is expected by the shareholders and *vice versa*. But if the figure of Economic Value Added for a year drops to zero or turns negative this indicates that the shareholders' expectations have not been met by the company.

Economic Value Added in an enterprise is thus the difference between the Net Operating Profit after Tax plus Interest less Weighted Average Cost of Capital.

or, \( \text{EVA} = \text{NOPATPI} - \text{WACC} \)

The non-recurring income during the period, if any, is added to the net-operating profit. Thus, the Net Operating Profit after Tax plus Interest is equal to Net Operating Profit after Tax plus Interest minus Non Recurring Income.

or, \( \text{NOPATPI} = (\text{NOPAT} + I) - (\text{NRI}) \)

The Weighted Average Cost of Capital (WACC) is determined by
adding up the product of Cost of Equity (COE) and Weight of Equity (WOE) and the product of Cost of Debt (COD) and Weight of Debt (WOD), and then dividing the same by the sum of Weight of Equity (WOE) and Weight of Debt (WOD). The figure of Market Capitalization of Shareholders' Equity and the Market Capitalization of the Debt are taken as basis of weight for shareholders' equity and debt respectively. Thus,

\[
WACC = \frac{[(\text{COE} \times \text{WOE}) + (\text{COD} \times \text{WOD})]}{(\text{WOE} + \text{WOD})}
\]

The Cost of Equity is equal to the sum of Risk Free Rate of Return and the product of the difference between the Expected Return on Market (ROM) and Risk Free Rate of Return (RFRR) and Beta Factor (BF) representing the risk premium for the Company. Thus,

\[
\text{COE} = \text{RFRR} + ((\text{ROM} - \text{RFRR}) \times \text{BF})
\]

The Cost of Debt is equal to the Interest Cost divided by Total Debt. It may be expressed as coefficient or in percentage. Thus,

\[
\text{COD} = \left(\frac{\text{IC} \times \text{TD}}{100}\right)
\]

**Indian Experience**:

It is interesting to observe that some companies in India, recognising the utility of "Economic Value Added" as a measure of shareholder value, have included a "Economic Value Added Statement" as a part of their annual accounts for 1997-98. Statements of two such companies, M/S Satyam Computers, Bangalore and BPL Limited Palakkad (Kerala) are given in Appendix as Table 1 and Table 2 respectively. It may be seen that both the companies have adopted similar model for the determination of Economic Value Added and have also given similar details of "Enterprise Value" and "Cost of Funds". However, while BPL limited has taken total share holders' funds and total debt for determining enterprise value, Satyam Computers have taken market value of equity and market value of debt to determine enterprise value.

**Limitations of Economic Value Added**:

Economic Value Added by laying high emphasis upon improvement in earnings while minimizing the cost of funds creates an atmosphere for maximizing the return on capital employed and also maximization of shareholders' equity. However, while chasing this lofty objective it creates certain unique problems. Some of these problems are discussed here.

1. With deregulation and globalization the real challenge before companies in India, as also in other developing countries, is to prepare for meeting the competition from multi-national enterprises. Any misplaced
emphasis upon Economic Value Added may therefore, distract their attention from this real issue.

2. Economic Value Added is dependent upon market valuation of equity. The value the market assigns to equity of a company reflects its perception about the prospects of profitability and growth and not its performance in the past.

3. Economic Value Added is influenced by investment in new assets. When an investment is made in early years the capital cost charged is higher where as the paybacks are lower. However, in later years the capital cost charged is lower where as the paybacks are higher. Thus, the companies emphasizing upon growth through investment perform lower in terms of Economic Value Added, though they may have good future prospects.

4. Earning aggressively at a rate of return exceeding the cost of capital is the approach adopted by management to achieve higher Economic Value Added. But in the process many problems are created for the company. For instance this strategy of not making fresh investment may leave the enterprise with such a depreciated assets base that any fresh investment may have negative impact on the Economic Value Added. Economic Value Added thus presents before an enterprise a choice for short-term growth by over exploitation of existing assets, instead of investment in more productive assets over a long period of time.

5. Economic Value Added is biased in favour of large enterprises. It represents incremental earning above a base level set by cost of capital employed. Thus, large enterprises earning at a rate slightly above the cost of capital have higher Economic Value Added than small enterprises earning at a rate higher than cost of capital.

6. In case of an enterprise with rate of return near the cost of capital a slight improvement in earning may result in proportionately higher rise in Economic Value Added. This makes Economic Value Added a poor measure for comparing business performance of different enterprises operating at different stages of growth.

Looking Beyond Economic Value Added:

One important conclusion emerging from the above description is that companies which want to grow faster must look beyond Economic Value Added. For judging the relative growth prospects of companies, one may look at Cash Value Added and Total Business Return.

1. **Cash Value Added**: Cash Value Added (CVA) is Economic Value Added in terms of cash resources added by the company during the
year. The Cash Value Added in a company is determined by adding back the figure of depreciation and amortization on the book values of assets to Economic Value Added. This provides an indication of the availability of cash resources for growth and as such may be considered a distinct improvement over Economic Value Added. However, Cash Value Added does not provide a suitable basis for inter-company comparison.

2. **Total Business Return**: Total Business Return (TBR) like total shareholder return is the return inside the company. It is equal to the difference in year-end value of a business plus free cash inflow to the company during the year. For the purpose of inter-company comparison it provides a more suitable basis as compared to Economic Value Added.

Thus, to measure the contribution of a company to shareholder value during a period Economic Value Added is a good generic measure. However, for measuring the contribution considering the need of the enterprise for growth Cash Value Added can be a more appropriate measure. For inter-company comparison of contribution to cash resources available to the company for growth Total Business Return provides a better measure.

The quest for shareholder value has meant so far corporate downsizing. In case of developing countries this runs the risk of undermining social cohesion and thereby the legitimacy of management. It may also prove counter productive due to the damage it would cause to employees' loyalty, a key requirement for corporate performance.
Table - 1
BPL Limited, Palakkad (Kerala)
Economic Value Added during 1997-98

<table>
<thead>
<tr>
<th></th>
<th>(Rs.Lakh)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Operating Profit Before Tax</td>
<td>8960</td>
</tr>
<tr>
<td>Less Tax</td>
<td>670</td>
</tr>
<tr>
<td>Net Operating Profit after Tax</td>
<td>8290</td>
</tr>
<tr>
<td>Add Interest</td>
<td>4239</td>
</tr>
<tr>
<td>Net Operating Profit After Tax plus Interest</td>
<td>12529</td>
</tr>
<tr>
<td>Less Cost of Funds</td>
<td>11880</td>
</tr>
<tr>
<td>Economic Value Added</td>
<td>649</td>
</tr>
</tbody>
</table>

Enterprise Value during 1997-98

<table>
<thead>
<tr>
<th></th>
<th>(Rs.Lakh)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Shareholders' Funds</td>
<td>35450</td>
</tr>
<tr>
<td>Add Total Debt</td>
<td>40654</td>
</tr>
<tr>
<td>Enterprise Value or Total Funds Employed</td>
<td>76105</td>
</tr>
</tbody>
</table>

Cost of Funds 1997-98

<table>
<thead>
<tr>
<th></th>
<th>(Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Equity (12% + {(19.03% - 12%) \times 1.36})</td>
<td>21.56%</td>
</tr>
<tr>
<td>Cost Debt (\frac{4239}{40654} \times 100)</td>
<td>10.42%</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>15.61%</td>
</tr>
<tr>
<td>Cost of Funds (\frac{(35450 \times 21.56%) + (40654 \times 10.42%)}{(35450 + 40654)})</td>
<td></td>
</tr>
</tbody>
</table>

Source: Annual Report of BPL for 1997-98 Section 2, pp. 7-8.
Table - 2
Satyam Computers Bangalore
Economic Value Added during 1997-98

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (Rs.Lakhs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Profit before Tax</td>
<td>2985.05</td>
</tr>
<tr>
<td>Less Tax</td>
<td>275.94</td>
</tr>
<tr>
<td>Net Operating Profit after Tax</td>
<td>2709.14</td>
</tr>
<tr>
<td>Add Actual Interest</td>
<td>1198.05</td>
</tr>
<tr>
<td>Net Operating Profit After Tax plus Interest</td>
<td>3907.19</td>
</tr>
<tr>
<td>Less Cost of Capital</td>
<td>3272.07</td>
</tr>
<tr>
<td>Economic Value Added (EVA)</td>
<td>635.12</td>
</tr>
</tbody>
</table>

Enterprise Value 1997-98

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (Rs.Lakhs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Value of Equity</td>
<td>63980</td>
</tr>
<tr>
<td>Add. Market Value of Debt</td>
<td>12050.28</td>
</tr>
<tr>
<td>Enterprise Value</td>
<td>76031.00</td>
</tr>
<tr>
<td>Enterprise Value (US$ million) taking $ = Rs 39.50</td>
<td>192.00</td>
</tr>
<tr>
<td>Debt to Market Value</td>
<td>0.19</td>
</tr>
</tbody>
</table>

Cost of Funds 1997-98

\[
\text{Cost of Equity} = \text{Risk Free Rate of Return} + (\text{Expected over Risk Free Rate} \times \text{Beta Variant}) \\
\quad\text{or Premium on Equity} \\
\quad\text{[12\% + (10\% \times 0.99)]} = 21.90\% \\
\]

\[
\text{Cost Debt} = \frac{\text{Average Interest Cost}}{\text{Average Debt}} \times 100 \\
\quad\frac{1198.05}{7967.62} \times 100 = 15.04\% \\
\]

\[
\text{Weighted Average Cost of Funds} = \frac{[(63980.92 \times 21.90\%) + (12050.28 \times 15.04\%)]}{(63890.72 + 12050.28)} = 20.52\% \\
\]

Government Accounting and Auditing in India During Ancient Times

Dr. C.L. Salvi* and Dr. G. Soral**

The literature and treatise of ancient times in India have been known the world over for comprising of precious wealth of knowledge for modern world. A humble attempt has been made in this article to unravel some parts of such knowledge related with government accounting and auditing.

Objective & Scope:

The main objective of the study is to highlight some of the thoughts related with government accounting and auditing in ancient Indian literature. For this purpose, an in-depth study of treatise like the four Vedas, Ramayana, Sukra-Niti, Mahabharata, Kautiliya Arthasastra and Kamandakiya Nitisara has been conducted and the findings have been analysed and presented in the following section:

Government Accounting:

According to Sukra-Niti two types of accounts, namely income-expenditure accounts and descriptive or documentary accounts (Vritta Lekhe) were maintained\(^1\).

According to Kautiliya Arthasastra the king himself and the ministers, heads of the departments, officers, employees and such other government servants had to maintain systematic accounts of their departments. There used to be a central/principal accounts department for the whole country, which was known as Aksamapatala\(^2\). The superintendent of accounts of the country was known as Aksamapatalamadhyaksa\(^3\). The superintendent used to maintain account books for national income\(^4\), expenditure\(^5\) and balances\(^6\); to ensure disclosure in accounts\(^7\); to prepare integrated accounts\(^8\); and to prepare final accounts. Besides, he used to manage

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** Associate Professor, Department of Accountancy and Statistics, Mohanlal Sukhadia University, Udaipur and Chairman, Indian Accounting Association, Udaipur Branch.
mining functions and funds\(^9\) and was involved in duties of judiciary also\(^{10}\).

The accounts were maintained daily, for group of five days, fortnightly, monthly, four monthly and annually, for the whole country and reconciliation was done for the respective periods, so as to know the net result of income, expenditure and balance\(^{11}\). Separate books of accounts were maintained for income, expenditure and balances\(^{12}\). Views are available for punishment-laws in respect of accounting irregularities and crimes\(^{13}\). The possible formats of account books for income, expenditure and balances respectively are given in Formats 1, 2 and 3.

There were different categories of employees involved in accounting function in central accounts department\(^{14}\) and the work was shared among them. The organizational structure of the department is depicted in Figure 1.

**Organisational Structure of Aksapatala**

**(Central Accounts Department)**

![Diagram of Organisational Structure of Aksapatala](image)  
*Figure - 1*
### Format-1
**Account Book of Income**

<table>
<thead>
<tr>
<th>Period</th>
<th>Year</th>
<th>Month</th>
<th>Fortnight</th>
<th>Day</th>
<th>Time</th>
<th>Place</th>
<th>Head of Income</th>
<th>Source</th>
<th>Bringing Forward</th>
<th>Quantity</th>
<th>The payer</th>
<th>The Person causing payment to be made</th>
<th>The recorder</th>
<th>The receiver</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>14</td>
<td>15</td>
</tr>
</tbody>
</table>

### Format-2
**Account Book of Expenditure**

<table>
<thead>
<tr>
<th>Period</th>
<th>Year</th>
<th>Month</th>
<th>Fortnight</th>
<th>Day</th>
<th>Time</th>
<th>Head of Expenditure</th>
<th>Gain</th>
<th>The thing given</th>
<th>Occasion</th>
<th>Total amount</th>
<th>Quantity</th>
<th>The person who ordered</th>
<th>The person who took out</th>
<th>The person who delivered</th>
<th>The receiver</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>14</td>
<td>15 16</td>
<td></td>
</tr>
</tbody>
</table>

### Format-3
**Account Book of Balances**

<table>
<thead>
<tr>
<th>Period</th>
<th>Year</th>
<th>Month</th>
<th>Fortnight</th>
<th>Day</th>
<th>Place</th>
<th>Time</th>
<th>Head</th>
<th>Bringing forward</th>
<th>The article</th>
<th>Characteristics</th>
<th>Quantity/Amount</th>
<th>The vessel in which it is deposited</th>
<th>The person guarding it</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>14</td>
</tr>
</tbody>
</table>

In addition to account books of income, expenditure and balances, the superintendent used to maintain the account books of various departments, of income and expenditure of various mines and factories, of various products, of various meetings and committees; related with funds issued both under normal and special conditions to the king, queens and princes; and of receipts and payments in connection with peace and war with allies and enemies. These account books included non- monetary and behavioural information also, in addition to monetary transactions such as rules for duties of departments, place of origin of product, article, gem etc.; colour and quality, measurement, characteristics and name of the article; caste, family, customs and fixed rules of region and village, occasion, religion, behaviour, character, background and residence of persons etc.

The superintendent used to present the accounts before the king, which included the duties of all the departmental heads, funds receivable from villages, funds deposited with the treasury, collectible funds, income, expenditure, balances, attendance and absence of employees, period of presence during work, method of work, character and behaviour related things etc. The promotion and salary increments of employees were based on such accounts and the king used to appoint suitable heads and employees in order to accomplish higher level (Uttam), middle level (Madhyam) and lower level (Adham) functions.

Three-hundred-and-fifty-four days and nights constituted one working year of the country, during which all the required functions were to be completed. This working year ended on the full moon day (Purnima) of the month Asadha. All the officers related with accounting were expected to reach the central accounts department on the Asadha full moon day. The officers used to come with sealed account books and balances in sealed containers and were not allowed to converse among themselves. After hearing the totals of incomes, expenditures and balances, the superintendent would cause the balances taken away to the treasury. The accounts of balances were checked according to total income shown in account books. Consequent to checking of accounts as to their appropriateness, the public would hear and get convinced with all the state practices related with income, expenditure and balances.

**Government Auditing:**

The Rigved contains terminology such as inspection, testing, checking etc. which indicates the existence of auditing during that period.

During the period of Mahabharata, there used to be an inspecting officer in each city, who was entrusted with auditing function also. The
king himself would listen to measures taken for defence and accounts of income and expenditure during first eighth part of the day\textsuperscript{27}. Each of the department of the country had an auditor (designated as Uttaraadhyaksa) who was responsible for inspection and auditing of accounts\textsuperscript{28}. These auditors were extremely intelligent and aged persons\textsuperscript{29}. The assistants of the auditor acted as spies on inspector of coins, writer, receiver of balances, cashier, store-keeper, accounts clerk etc\textsuperscript{30}.

*Ramayana*\textsuperscript{31} quotes Bharat raising a series of questions to *Sri Ram* and in *Mahabharata*\textsuperscript{32}, Narad asked a number of questions to Yudhisthir. Both these constitute a detailed subject-matter on management audit. These included questions on decision making system, collection of learned men (employees etc.), appointing process of employees, system of payment of salaries and other expenses, accounting system, level of devotion of principal members of royal family, process of appointment of ambassador, inspection system of eighteen functionaries of enemies and fifteen functionaries of king’s own side, through unknown spies, defence system, protection system, store management, law and order system, religious practices, public welfare activities, policy making system, taxation system, etc. *Bhism*\textsuperscript{33} and *Dhritarastra*\textsuperscript{34} had also raised similar questions to Yudhisthir.

Besides the above, emissaries also used to collect information about the well-being of state from ministers, gate-keepers, military officers, accounts officers etc\textsuperscript{35}. *Mahatapasvi Arstisen* had audited the acts and duties of king Yudhisthir through questions\textsuperscript{38}. A prostitute, disguised as monk, in the kingdom of king Lom pad audited the management of Risyasringasram by raising appropriate questions\textsuperscript{37}. Simultaneously, the practice of asceticism of Dhritarastra were audited by Vyasa dev in *Kuruksetasram*\textsuperscript{38}.

The spies appointed for ministers and employees in the country of enemy etc. also used to co-operate in audit function\textsuperscript{39}. The superintendent was supposed to keep abreast of the working of various heads and employees through spies\textsuperscript{40}. Eight weaknesses of the superintendent, which might have caused loss of governmental income were identified as ignorance, lack of endurance, laziness, fright, favouritism, anger, arrogance and greed\textsuperscript{41}.

In order to find out whether an officer was honest and loyal, four secret tests were recommended which were called Upadhas, namely Dharmopadha - a test to find out if the officer was pious or not, Arthopadha - a test to find out if he was likely to be corrupt or not, Bhayopadha - to find out if he was cowardly or brave and Kamopadha - to see if he was a voluptuary or not\textsuperscript{42}. The virtues like nativism, well-
born (being of noble decent), being easy to hold in check, being trained in the arts, being possessed of the eye (of science), intelligence, perseverance, dexterity, eloquence, boldness, being possessed of ready wit, being endowed with energy and power, ability to bear troubles, uprightness, friendliness, firmness, devotion, endowed with character, strength, health and spirit, being devoid of stiffness and fickleness, being amiable (and) not given to creating animosities, longsightedness (foresightedness) etc. were also systematically tested.  

Conclusion:

There is a strong evidence of a developed government accounting and auditing system in ancient India. However, this needs further research, so that useful guidelines for contemporary practices may be evolved and the subject may find a place in accounting education in Indian universities at post-graduate level.

References:


5. *Kautiliya Arthasastra* 2/7/32; in Kangle, R.P.: *ibid.*., p. 84.


8. *Kautiliya Arthasastra* 2/7/6-7, 2/7/16-19 and 2/7/24; in Kangle, R.P.: *ibid.*, pp. 82-83.


12. *Kautiliya Arthasastra* 2/7/31-33; in Kangle, R.P.: *ibid.* p. 84.


18. *Kauttliya Arthasastra* 2/7/5-6; in Kangle, R.P.: *ibid.*, p. 82.

19. *Kauttliya Arthasastra* 2/7/7; in Kangle, R.P.: *ibid.*, p. 82.


39. *Kautiliya Arthasastra* 1/11/1-22, 1/12/1-25, 1/13/1-23 and 1/14/1-6.

40. *Kautiliya Arthasastra* 2/7/9; in Kangle, R.P.: *op. cit.*, p. 82.

41. *Kautiliya Arthasastra* 2/7/10; in Kangle, R.P.: *ibid.*, p. 82.


Foreign Direct Investment by Multinational Enterprises in Developing Countries – An Evaluation

Dr. V. Chari* and Dr. B.H. Desai**

Amongst the many ways multinational enterprises extend their activities globally, one is through foreign direct investment. Foreign direct investment not only involves transfer of funds (including re-investment of profits) but a whole package of physical capital, techniques of production, managerial and marketing expertise, products, advertising and business practices (Thirwall, 1994). Multinational enterprises can indulge in many other types of global activities, such as portfolio management, collaborations, joint ventures, marketing services etc. Foreign direct investment differs from all these in that it needs a deeper and a longer term involvement of a multinational enterprise as compared to other types of their global activities. Further, the reasons for undertaking foreign direct investment are generally profit making, extension of production activity, creation of backward linkages etc. On the other hand, portfolio investment is guided by speculative motive to a large extent. The economic interest of the host country is affected to a larger extent and for a longer period of time by foreign direct investment as compared with any other type of activity of the multinational enterprises. Though the foreign direct investment is channelised through private sector, the demand is mainly from the private sector and only sometimes from the public sector. Involvement of government as borrower and of international institutions as intermediaries for lending is negligible. The focus of this paper is on foreign direct investment by multinational enterprises, where the host country is a developing one.

For an economic activity to expand, two sides are involved, one the demand side and the other the supply side. For foreign direct investment the demand is created by the host country and the supply comes from the multinational enterprise. These two sides are investigated in the first two parts of this paper. In the third part, possible and likely future changes

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in demand and supply of foreign direct investment are discussed. In the
fourth and last part of this paper common interest areas of host countries
and multinational enterprises for expansion of foreign direct investment
for mutual benefit are described.

PART I

The debate has centered around the role of multinational enterprises
when the host country is a developing country. The activities of
multinational enterprises (whose headquarters are generally situated in
developed countries) in developed countries have not created much
debate, as this mostly involves players of equal strength. In case of a
developing country, the host is usually a smaller partner and hence, there
is a larger threat of exploitation by the multinational enterprise. This is the
main reason why the activities of multinational enterprises in developing
countries have faced more criticism. Demand for foreign direct investment
is created in a developing country mainly due to the policies formulated
for its economic development. The economic policies in turn are governed
by the concept of development. Thus, it can be said that the demand for
foreign direct investment is a function of economic development, through
the intermediate variables of economic policies. It is possible to show that
the demand for foreign direct investment has been changing with the
change in concept of development. The concept of economic development
existed as far back as sixteenth century, during the mercantile period. But
after the second world war, many factors led to the evolution of the concept
in more concrete form and its importance increased at the world level and
country level. Some of the factors contributing to it are listed below:

1. Economic development was the goal to be pursued by every
devolving country to be nearer, if not actually reach the level
of the developed countries.

2. Economic development was considered to be synonymous with
economic growth, more specifically growth of national income.

3. The Harrod-Domar model of growth, based on the Keynesian
paradigm, was used to formulate economic policies for growth.

4. In order to fulfil the twin gaps, between domestic savings and
investment, and between foreign exchange receipts and payments,
external borrowings were considered to be the best solution.

5. The newly set up international financial institutions, such as
International Monetary Fund and International Bank for
Reconstruction and Development, were ready as a large source
of external financing for development.

Thus, the initial post world war development paradigm established
a pattern for the use of external borrowings for economic development.
These borrowings were mostly by governments from international institutions.
Till the implicit faith in this paradigm lasted, there was hardly any demand for foreign direct investment. A rethinking on this paradigm began almost from the middle of sixties. The main reasons for this paradigm change were:

1. Most of the war-torn economies were rebuilt and had quickly regained their pre-war economic position. The notable amongst these were West Germany and Japan. These nations were emerging as new competitors to the multinational enterprises from other developed countries.

2. There were flaws in the Harrod-Domar model of growth, which prevented the achievement of growth targets.

3. With increase in economic information available from a large number of countries of the world, it was becoming clear that economic inequalities were increasing within the developing countries. More of concern was the fact that instead of gap between the development levels of the developing countries and the developed countries decreasing, it was alarming by showing a trend toward increase.

4. The failure of the trickle-down effect to work automatically was considered a major reason for the increase in economic inequalities, both intra-country and inter-country.

5. Economic growth alone was not sufficient, as development involved qualitative dimension along with the quantitative dimension of growth.

6. The international system was becoming unsuitable, being too rigid to adjust, to the quick economic changes taking place in the world.

The concept of development, therefore, included equity with growth, improvement in technology and structural change. The economic policies became more outward looking. It was realized that technological transfers were the need of the hour. The government level interchanges in this respect were not always possible. Collaborations with multinational enterprises were needed for the transfer of technology. The financial requirement for economic development was increasing. International financial institutions were coming under pressure for funds, which they were not in a position to supply. Thus the developing countries opened their doors to multinational enterprises to fulfil their development needs. Consequently, it is from the seventies that the foreign direct investment from multinational enterprises increased. The middle of eighties saw yet another shift in development paradigm, whose main features were:

1. The system of central planning, used to bring about targeted growth and development, suffered from several economic problems,
such as imbalanced development, inflation, increasing debt burden—both internal and external, proliferation of loss making public sector enterprises etc.

2. The belief that the government was ultimately responsible for economic welfare in a country, was beginning to be questioned. The individual responsibility was gaining more emphasis.

3. The assumption of complete market failure for public goods and merit goods was also being questioned.

4. The harsh terms of control and management attached with loans from international financial institutions were proving costlier than the higher cost funds borrowed from the open market.

5. With the advent of eurodollar, the euro market and new financial instruments in the form of derivatives, there was a lot of change in the international financial markets and the possibility of borrowing funds from open international financial markets increased by leaps and bounds.

The outcome was that economic policies became more outward looking. In this era, foreign direct investment was given red carpet treatment. From the middle of eighties, the volume of foreign direct investment increased substantially. This was also the time when foreign direct investment came under severe criticism for several reasons.

In the present decade, however, financial inflows have increased at a higher rate than the flow of foreign direct investment to developing countries.

PART II

The basic question, with regard to foreign direct investment from the point of view of multinational enterprises, is to choose between exports or foreign direct investment. One of the oldest, simplest and most logical economic theories, the Ricardian Theory of Comparative Cost Advantage—can be used here in a slightly different context. According to this theory, a firm should opt for foreign direct investment if it has a comparative cost advantage, otherwise it should not. This has been more clearly worked out by Vernon (1977). In the following decision model:

Invest abroad when \( MPCX + TC > APCA \)

where \( MPCX \) is marginal production cost of exports, \( TC \) is transport cost and \( APCA \) is average production cost of the same product abroad.

However, a decision to go in for foreign direct investment can be taken
on cost considerations alone. Some of the other factors which are also
given serious consideration while taking a decision for foreign direct
investment by a multinational enterprises (World Bank, 1997) are:

1. Backward linkage. (vertical strategy): Backward linkage for foreign
direct investment means investment in primary production sector. But
in most of the developing countries, economic policy protects this
sector extensively and is highly subsidized by the government.

2. Forward linkage (vertical strategy): Forward linkage happens when
a multinational enterprise invests in developed countries.

3. Market seeking (horizontal strategy): Expansion of markets abroad
is done when imports are highly restricted in the host country. The
high investment by multinational enterprises in Latin American
countries is a prime example of this type.

4. Turning risk of competition from domestic firms of host country by
entering into joint ventures or collaborations.

5. Reduction of risk through geographical diversification.

6. Political and economic stability in the host country.

7. Legal and regulatory framework for business.

8. Labour and industrial strengths.

9. Infrastructure and communication facilities.

10. Fiscal incentives.

Apart from the above, other considerations are more industry,
country or firm specific. All these considerations do point out that
multinational enterprises would go in for foreign direct investment only
if they have direct or indirect, cost or market advantages accruing from
it, as compared with the export option in long run or in short run.

PART III

The analysis given above brings out certain trends for future with
regard to the demand and the supply of foreign direct investment. The
developing countries do need foreign direct investment, and its demand
is likely to increase in future for several reasons. Among these the first
reason is that the institutional source of finance is shrinking. It does not
always supply complete technology of production. The developing
countries do need technology, management and marketing skills, as
they are still far behind the developed countries. Increasing trend
towards globalization in developing countries would need closer
interaction with multinational enterprises and hence, more foreign
direct investment. The foreign direct investment would also create a firm,
long term international relationship, as compared with mere portfolio investment.

The world is showing an increasing trend towards regional integration. With the advent of Euro, the developing countries may not be able to get fair terms of trade if they go in alone to world market. Joint ventures and collaborations with multinational enterprises would be useful to developing countries to face the threat posed by European Union, regional organisations like ASEAN, SAARC, NAFTA and LAFTA and foreign direct investment from member countries would naturally increase. The development paradigm going to the other extreme, from full control to deregulation, and from freedom to market portends well for foreign direct investment.

From the point of view of multinational enterprises, foreign direct investment would continue to be profitable on many counts. The markets in developed countries are nearing saturation, so the multinational enterprises have to go to the developing countries for markets. The decline in population growth in the developed countries along with the increase in proportion of people in higher age groups continues as the life expectancy increases. The prospects for increasing consumption in the older age groups is far less than that in the younger age groups. In the developing countries, the population pyramid is broader at the lower age groups, which indicates expansion of demand for all commodities in future. The markets in developing countries have different preferences as compared with those in the developed countries. Thus, there exists scope for innovation and product development. The political and economic situation is becoming more and more unpredictable. In order to overcome the risk of uncertainty in single market operation, geographical diversification is the need of the day. Last but not the least, with better and quicker access to information, it would be possible for multinational enterprises to calculate the risk and the return from each foreign direct investment more accurately and thus ensure optimum benefit.

PART IV

There are definite negative effects of foreign direct investment, such as transfer of inappropriate technology, loss to economy by repatriation of profits and threat of economic colonization by the multinational enterprises etc. However, at the same time, the changes in demand seem to be favourable for foreign direct investment in the future. The direction, in which the concept of development is turning, follows the old philosophy of Laissez Faire. The market forces are likely to become more effective in future. The economic restrictions are expected to reduce not only because of changes in the development paradigm but also because the new regime of trade brought in by the World Trade Organisation. With
the growing need for foreign direct investment, the multinational enterprises appear to be in the most advantageous position. They have the advantage of a sellers’ market, where they are able to dictate terms. Since the developing countries usually have no alternative to foreign direct investment, the situation is highly biased towards multinational enterprises.

To change the competitive game between the developing countries and the multinational enterprises from zero sum to positive sum, it may be suggested that:

1. The developing countries must develop negotiation skill to ensure minimum loss, if not maximum gain, from foreign direct investment.

2. The developing countries must ensure the appropriateness of technology for foreign direct investment.

3. The developing countries must publicize their economic priorities and direct the inflow of foreign direct investment in appropriate areas, rather than to wait for predatory proposals from the multinational enterprises.

4. The multinational enterprises must realize that extreme exploitation of opportunities may ultimately damage good relations and opportunities. A smaller loss in present may be better if it ensures better future rewards.

5. Multinational enterprises should enter into foreign direct investment with a positive spirit and not try to impose total control, in case of collaborations and joint ventures.

Lastly, just as international trade, international business and international banking have benefitted from voluntary regulation, a similar setup should be evolved to ensure protection of interest of the parties involved in foreign direct investment.

References:


Transfer Pricing : A Tool in The Kit of An MNC

Dr. G. Srinivasan*

Introduction:

An MNC in its true sense operates with divisions/affiliates located in different countries. The affiliates are located in different areas and under different legal and political systems. Movements of resources in various forms take place among the affiliates as well as affiliates and the parent (corporate) organisation. Hence, the methodology of pricing movements of such resource components is a crucial element in the operations as well as tax planning for an MNC. The concept, normally referred to as 'transfer pricing', though important for both domestic and international firms with number of affiliates and subsidiaries, assumes more significant proposition for an MNC. The transfer pricing mechanism is a very important tool which can be productively or constructively used. It can be termed as a costing-cum-financial-cum-marketing tool, the use of which should be judicious. In many cases, there are accusations against MNCs on the usage of the tool of transfer pricing for clandestine or dubious activities.

Concept:

Transfer pricing denotes pricing of finished or semi-finished goods or even procured raw materials as well as services, when such transfers take place from one factory, division or a unit to another within the same controlling group. The concept becomes important when units or affiliates work as autonomous entities. The conventional accounting would insist that pricing of such transfers should take place at actual cost to the transferor (division which transfers). When we view each unit as a profit centre, with the objective of making each unit to stand on its own legs, the transfer at cost becomes meaningless. Such transfers should include an element of profit (margin), even though there is no real profit on such intra-company transfers, viewed in toto.

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This means transfers should always be on cost-plus basis (markup), to make the divisions competitive.

The 'Profit' Component:

The basic question in transfer pricing is about what the profit component should be. This obviously will depend on the nature of the product or service transferred, profit earning capacity of the division concerned and many other factors. The profit element added should be 'ideal' and should be acceptable to both, the transferor and the transferee. Adding higher profit by transferor unit will deprive the transferee division of profitability, a situation not tenable. On the other hand, fixing a lower transfer price is also not correct. Thus, any system of markup should have the following characteristics:

i) It should help evaluate departmental efficiency and should ensure competitiveness within an organisation through proper reporting of divisional profit.

ii) It should enable decision making with regard to 'produce or buy' in an efficient way.

iii) It should enable bifurcation of divisions and should ensure specialization within each division, to help overall cost reduction in the organisation.

iv) It should motivate affiliate/division managers to make sound decisions and should communicate information that provide a reliable basis for such decisions. This will happen when action is taken by a divisional manager with the objective of improving profit of his organisation and also improving profit of the company as a whole (goal congruence).

Methods of Transfer Pricing:

The different methods by which transfer pricing can be effected in multi-divisional/affiliate unit are a) the actual cost method, b) the marginal cost method, c) the standard cost method, d) the cost-plus-profit method, e) the negotiated price method, f) target profit price method, and g) dual pricing method. A brief description of the above methods follows.

a) Actual Cost Method: The transfer price in this method is the actual cost to the transferor division/affiliate. For performance evaluation, this method is not very useful as the transferor division’s results would be understated while the transferee division’s results would be overstated. This may lead the management of the transferee division to take decisions contrary to the interest of the organisation as a whole.
b) **Standard Cost Method**: Here the transfers are effected at predetermined standard cost. The method is easy to operate as costs are pre-fixed. They do not change in the short run with each transfer. In cases where standard costs are used, the variance reflecting the inefficiency is borne by the transferor division.

c) **Cost-Plus-Profit Method**: The transfers under this method are effected at a margin over cost price (total cost) to transferor division. The margin may be fixed as required return on investment in the transferor division.

d) **Marginal Cost Method**: The transfer price under this method is fixed at marginal or variable cost to the transferor division. Since the fixed costs are not recovered by the transferor division, the profitability of the division would be seemingly low.

e) **Market Price Method**: The transfers here are effected at market price of the product transferred. This naturally implies that the transferred goods have a market price which can be ascertained through market mechanism. Here the transferor and the transferee divisions act as though they are independent units with complete autonomy. The transferor unit can transfer the product either to the transferee unit or sell it in open market. Similarly the transferee unit may procure its requirement either from the transferor unit or from open market. The principle of opportunity cost, which may be the best market price, may apply to both the transferor as well as the transferee divisions.

The market price basis of transfer pricing is extensively used in oil industry. The crude oil transfers are charged to company refineries at prevailing market price, regardless of whether the crude oil is purchased from the market or from an affiliate company whose actual cost of product is more.

The impact of transfer pricing on profit, in case variable costs or market price is adopted as the basis of pricing the transfers, can be observed from the following example.

Company A has two divisions, Division I and Division II. Division I manufactures a product with a variable cost of, say Rs. 30 per unit, which is sold to outside firms at Rs. 50 per unit. Half of the sale of Division I is to Division II. In addition, Division II incurs variable costs of Rs. 15 per unit. Division II sells its entire product to outside firms at Rs. 80 per unit. Assuming a production of 10,000 units by Division I, the effect of adopting variable costs or market price as transfer pricing basis is depicted in Table 1.
### Table 1
#### Company A

<table>
<thead>
<tr>
<th>Variable Cost basis</th>
<th>Division I</th>
<th>Division II</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) Sales Revenue:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>From Outside firms</td>
<td>Rs. 2,50,000</td>
<td>Rs. 4,00,000</td>
</tr>
<tr>
<td>5,000 x Rs. 80</td>
<td></td>
<td></td>
</tr>
<tr>
<td>From Division II</td>
<td>Rs. 1,50,000</td>
<td></td>
</tr>
<tr>
<td>5,000 x Rs. 30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>Rs. 4,00,000</td>
<td>Rs. 4,00,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Less Cost</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer from Division I</td>
<td></td>
</tr>
<tr>
<td>5,000 x Rs. 30</td>
<td>Rs. 1,50,000</td>
</tr>
<tr>
<td>Variable Cost</td>
<td></td>
</tr>
<tr>
<td>10,000 x Rs. 30</td>
<td>Rs. 3,00,000</td>
</tr>
<tr>
<td>5,000 x Rs. 15</td>
<td>Rs. 75,000</td>
</tr>
<tr>
<td>Total</td>
<td>Rs. 3,00,000</td>
</tr>
<tr>
<td>Rs. 2,25,000</td>
<td></td>
</tr>
</tbody>
</table>

**Contribution Margin (Sales Revenue – Costs)**

<table>
<thead>
<tr>
<th>Market Price Basis</th>
<th>Division I</th>
<th>Division II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Outside firms</td>
<td>Rs. 2,50,000</td>
<td></td>
</tr>
<tr>
<td>5,000 x Rs. 50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5,000 x Rs. 80</td>
<td>Rs. 4,00,000</td>
<td></td>
</tr>
<tr>
<td>Division II</td>
<td>Rs. 2,50,000</td>
<td></td>
</tr>
<tr>
<td>5,000 x Rs. 50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>Rs. 5,00,000</td>
<td>Rs. 4,00,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Less Cost</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer from Division I</td>
<td></td>
</tr>
<tr>
<td>5,000 x Rs. 50</td>
<td>Rs. 2,50,000</td>
</tr>
<tr>
<td>Variable cost</td>
<td></td>
</tr>
<tr>
<td>10,000 x Rs. 30</td>
<td>Rs. 3,00,000</td>
</tr>
<tr>
<td>5,000 x Rs. 15</td>
<td>Rs. 75,000</td>
</tr>
<tr>
<td>Total</td>
<td>Rs. 3,00,000</td>
</tr>
<tr>
<td>Rs. 3,25,000</td>
<td></td>
</tr>
</tbody>
</table>

**Contribution Margin (Sales Revenue – Costs)**

<table>
<thead>
<tr>
<th></th>
<th>Division I</th>
<th>Division II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution Margin</td>
<td>Rs. 2,00,000</td>
<td>Rs. 75,000</td>
</tr>
</tbody>
</table>

Suppose the market price of the end product sold by Division II decreases from Rs. 80 per unit to Rs. 60 per unit and market price is used as the basis of intra-company transfers, it would not be desirable for Division II to continue to operate, as Division’s variable costs per unit would exceed the selling price as shown below:
### Table 2

**Company A**

<table>
<thead>
<tr>
<th>Market Price Basis (Per Unit)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling Price</td>
<td>Rs. 60</td>
</tr>
<tr>
<td>Less variable costs</td>
<td></td>
</tr>
<tr>
<td>Division I</td>
<td>Rs. 50</td>
</tr>
<tr>
<td>Division II</td>
<td>Rs. 15 Rs. 65</td>
</tr>
<tr>
<td>Contribution Margin</td>
<td>Rs. 5 (Loss)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Variable Cost Basis (Per Unit)</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling Price</td>
<td>Rs. 60</td>
</tr>
<tr>
<td>Less Variable Costs</td>
<td></td>
</tr>
<tr>
<td>Division I</td>
<td>Rs. 30</td>
</tr>
<tr>
<td>Division II</td>
<td>Rs. 15 Rs. 45</td>
</tr>
<tr>
<td>Contribution per unit</td>
<td>Rs. 15</td>
</tr>
</tbody>
</table>

Assuming further that Division II can purchase this item from outside, say at a price of Rs. 35 per unit, it would be advantageous for the division to purchase the item from open market, rather than to buy from division I, if transferred at the market price of Rs. 40 per unit. However, the proposition of buying from outside at a price of Rs. 35 per unit may not be advantageous for the company, since the cost for the company in division I is only Rs. 30 per unit.

**f) Negotiated Price method**: Here the transfer price is fixed through negotiations between transferor and transferee. Profit centre decentralisation implies that managers of divisions are allowed to negotiate intra-company transfer prices as though they are managing independent concerns.

**g) Target Price Method**: Under this method the transfer price is based on target profit. There is an attempt to provide a reasonable or desired profit level for each division, when market price is not available, or when other transfer pricing methods would yield unsatisfactory results. Under this method, the transfer price is fixed in such a way that an assured return, like 10% of standard cost or actual cost, is available to the transferor division.

To explain the target price method further for example, a company has two divisions, a manufacturing division and a finishing division. The units produced by the manufacturing division are transferred to finishing division at a target price, to give the division a divisional profit of say 25% on sales, with standard costs as the base.
The cost data are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Standard</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard units</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Units Produced</td>
<td></td>
<td>40,000</td>
</tr>
<tr>
<td>Manufacturing Expenses</td>
<td>Rs.3,20,000</td>
<td>Rs.3,75,200</td>
</tr>
<tr>
<td>Other Operating Expenses</td>
<td>Rs.1,00,000</td>
<td>Rs.1,64,800</td>
</tr>
<tr>
<td>TOTAL COST</td>
<td>Rs.4,20,000</td>
<td>Rs.5,40,000</td>
</tr>
</tbody>
</table>

To arrive at the transfer price, it would be essential to first compute the total revenue required to achieve the target profit. The figure would then be divided by the units produced to obtain the transfer price. Hence:

\[
TR = 0.25 \times TR + TSC
\]

or \[
TR = 0.25 \times TR + Rs.4,20,000
\]

or \[
0.75 \times TR = Rs.4,20,000
\]

\[
\therefore TR = \frac{Rs.4,20,000}{0.75} = Rs.5,60,000
\]

where \( TR \) = Total Revenue and \( TSC \) = Total Standard Costs

Thus Rs. 5,60,000 would be the total revenue required to generate 25% profit on sales using standard costs as base.

Transfer price per unit = Rs.5,60,000/40,000 = Rs.14

In case transfer price is arrived at on the basis of actual costs, the equation would be stated as:

\[
TR = 0.25 \times TR + TAC
\]

or \[
TR = 0.25 \times TR + Rs.5,40,000
\]

or \[
0.75 \times TR = Rs. 5,40,000
\]

\[
\therefore TR = Rs. 7,20,000
\]

Thus Rs. 7,20,000 would be the total revenue required to generate 25% profit on sales using actual costs as base.

The transfer price per unit will be Rs. 7,20,000/40,000 = Rs. 18

where TAC represents total actual costs.

The situation would be different if part of the production is sold to outside firms, and if inventory is carried. In that case the outside sale proceeds and inventory values would be deducted, as done for determining inter-process profit in process accounts.
h) **Dual Pricing**: One single transfer price may not meet the objective of goal congruence in an organisation. Under this situation, each transaction will be recorded at two different prices arrived at by using two different methods. One transfer price may be used for motivation and the other for evaluation of the performance of sales team. The transferee division may however, be charged with one standard cost. This will facilitate decision making at that level and at subsequent levels also. But the method suffers from the drawback that it may result in double counting of profit. Since there are different methods of transfer pricing involved, the aggregate of divisional profits may not be equal to total profit of the organisation. Further, it is argued that it may lead to deterioration of control over costs at all levels. But in case of dual pricing system, the management control can be more effective.

**Choosing a Method**:

The method to be chosen for transfer pricing depends partly on management's objectives and partly on the relative merits of the method concerned. The relative merits and demerits of each method are to be weighed. Management may have multiple objectives and no single method may give the desired results. Hence, it is very difficult to establish a logical and sound policy on intra-company transfers. The profit of the transferor and the transferee units, however, would depend upon the method chosen.

From the above, some important implications emerging in case of adopting different bases for pricing transfers are:

i) Transfer pricing influences both performance evaluation and decision making. It is important to cumulate variable costs whenever transfer takes place with a loaded transfer price. This will facilitate decision making regarding buying from open market or obtaining from an internal division.

ii) If standard costs are used, variances on materials and labour can be computed to revise costs.

iii) Intra-departmental transfers can be minimized by clearly structuring the organisation. For example, in case department A of division I transfers all its products to division II, then it may be pertinent to tag department A with division II, rather than with division I.

iv) If a department's output is transferred only to other divisions within the organisation, it indicates that the department exists only to produce and cater to different divisions. Hence in this case, absorption costing may be a more appropriate method to price
its products. The total cost of the department would be absorbed by various divisions, depending on the number of units transferred to each division.

v) If only a minor portion of the output of a division is transferred to some other division, opportunity cost would be a better basis of pricing transfers.

Transfer Pricing for an MNC:

Multinational Corporations (MNCs) effect transfers in various forms, such as finished and semi-finished goods, raw materials and spares and services, between related companies. An estimate points out that approximately 40% of total international trade consists of transfers between related business entities. MNCs, compared to their domestic counterparts, are confronted with complicating variables such as differential taxes, tariffs, governmental regulations, political risk, inflation and the like.

Generally, transfer pricing helps an MNC in reducing taxes, reducing tariffs, avoiding exchange controls, bolstering credit status of affiliates, increasing MNC’s share of joint ventures’ profits, disguising an affiliate’s true profitability, specially from competitors and reducing exchange risks.

Domestic vs. International Transfer Pricing:

Of all the aspects of management control, transfer pricing represents the greatest difference between foreign and domestic operations. In domestic operations, the objective of transfer pricing is only goal congruence, i.e. ensuring that the action taken by a divisional manager will be consistent with company’s overall interest. But in foreign operations there are more considerations. Effective income tax rates differ considerably among countries. The transfer pricing thus, by assigning profits to low tax countries, can reduce total income tax liability of the corporation.

Tariffs are levied on import values. By lowering the price of inter-divisional transfers, the effect of tariffs on imports can be reduced. For various reasons a company may accumulate funds in one country instead of the other country. The transfer pricing can be a way of shifting funds in such cases. The government regulations may thus affect the way the transfer price is calculated.

Administration of Transfer Pricing:

Administration of transfer pricing requires formal administrative procedures, such as negotiations among divisions, sourcing and transfer pricing rules, arbitration etc.
i) **Negotiation Among Divisions**: Generally transfer prices are fixed by a central group, where divisions negotiate with each other. This is done with the objective of a) arriving at a satisfactory purchase and sale price for divisions, b) to strengthen line management's ability to improve profitability, c) to tap expertise of divisions to negotiate prices, as they have most information on markets and costs and consequently are best able to arrive at a reasonable price. However, the ground rules through which negotiations are to be concluded should be clearly spelt out.

ii) **Sourcing and Transfer Pricing Rules**: The extent and formality of sourcing and transfer pricing rules depend to a great extent on the quantum of intra-company transfers and availability of market price information on the goods/services involved. Greater the intra-company transfers and lesser the availability of market prices, more formalities and specific rules may be required with the objective of enforcing control.

**Pricing Corporate Services**:  
A very important area of transfer pricing in MNCs is that of pricing of centralised corporate services rendered to divisions or subsidiaries. This area has been subjected to varied interpretations and criticism. When a corporate head-office renders service to subsidiaries/divisions/affiliates, some pricing mechanism has to be evolved for such a service, which may serve as a tool for pricing transfers. Such a central service may fall under one of the following three types, viz., central service over which the division has no control, central service that the divisions must accept but which is partially controllable by the divisions, and central service regarding which the divisions have discretion of using or not using.

Pricing of a corporate service in each of the above three situations would be as follows:

1) **No Control by Divisions**: There are certain centralised corporate services rendered by corporate staff, such as accounting, public relations, industrial relations, legal etc. which the divisions are supposed to accept, but they have little or no control over the quality of service provided and the amount spent on them. The main problem here is of ascertaining how the costs of such centralised activities are apportioned to divisions/affiliates, specially when they are located in different countries. The pricing of such services by corporate office and charging the same to the divisions/affiliates is an important area of transfer pricing.

In the above situation, there are strong arguments for allocating
as well as not allocating such costs to divisions/affiliates. The reasons advocated for allocation of such costs are:

i) If a division is made to pay for the service, it is more likely to use such service.

ii) Division is more likely to exert pressure to keep down those costs (by complaining) if they have to pay for that.

iii) Divisional profits will be more realistic and comparable with outside firms, as outside firms will have to pay for such services. This will provide a level ground for inter-firm comparison.

The main argument against allocation of such costs to divisions is that these are not controllable by the divisional manager and therefore, may only worry them.

Two types of pricing is adopted in cases where the divisions have no control over the service centre.

i) Pricing on the basis of fair share applicable to each profit centre.

ii) Budgeted cost concept, wherein the divisions are allocated the budgeted costs and not the actual costs. In this way, the allocations will not affect the budgeted and the actual divisional profit. Variations will appear in the report of responsibility centre incurring the cost.

2) Partial Control by Divisions: In this case also each division is expected to accept the centralised services but the service that it accepts may be controllable. Examples of such services are data processing and research and development (R&D). Here three modes of pricing are advocated.

i) Marginal costs of discretionary services to be charged to divisions.

ii) Marginal costs plus a fair share of fixed costs to be charged to divisions. Here the full costs are absorbed by the divisions.

iii) Market price or full costs plus a margin to be charged to divisions. When market price of such service is readily available, such price is taken. When market information on specific service is not available, the methodology of pricing may be based on full cost plus the expected return on investment.

3) Discretionary Use: In case the management decides that the use of a central service is optional to the operating divisions, the
divisions have the flexibility of inviting outside service, or use internal capability. Here the objective is to make the divisions stand-on-their own-legs, develop themselves into viable units, become competitive and make divisions profit centres. To the extent they are treated as profit centres, the transfer price is set according to the method described above.

Summing up:

There is no easy answer to transfer pricing problems. The management must recognise it and give adequate thought to framing a transfer pricing policy. Transfer pricing is a top management decision, and cannot be delegated to lower levels. Such decisions cannot be made also in abstract form. A realistic estimate of the costs to the company considering tax, cashflow etc. should be made.

The significance of transfer pricing depends to a large extent on the quantum of transactions between different divisions. Where inter-divisional transfers are minimal, transfer pricing has little impact on segmental performance or taxation. On the other hand, substantial inter-divisional transfers can have dramatic effect on reported performance/international tax liability.

Any transfer pricing mechanism must meet the following corporate objectives:

i) It should ensure that divisional/branch and/or subsidiary objectives coincide with overall objectives of the company.

ii) It should motivate managers of such sub-centres/entities to make decisions which are congruent with overall company objectives.

iii) It should ensure efficient allocation of resources among and within such sub-centres.

iv) It should provide a measure to evaluate the performance of various corporate entities.

v) It should ensure effective communication within the company.

vi) A transfer pricing system will not accomplish its intended objective unless it is sufficiently straightforward and divisional managers understand its significance.

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Tax Implications of Yield on Deep Discount Bonds: Some Observations

Dr. (Miss) Madhurima Lall*

During the last couple of years, there has been a flood of issues of deep discount bonds led by top financial institutions of the country including the IDBI, the IFCI and the ICICI. Several companies in private sector have resorted to this device for raising finance through private placement. Broadly speaking, under this scheme, an instrument called a 'deep discount bond' (DDB) is issued in the initial year for an issue price which is quite low, but on its maturity, which takes place after a couple of decades or so, a rather high redemption price falls due for payment. To cite an instance, under the IFCI Family Bond Scheme, an investment of Rs. 5,000 in the initial year would fetch Rs. 5 lakhs after 30 years.

There is confusion about the tax the yield would attract on maturity of a DDB, especially on the issue whether the yield would be treated as representing interest or capital gain. The tax experts in the country have evaded the issue by stating that the matter would be dealt with in accordance with the law as it would obtain in the year of redemption. In the meantime the Central Board of Direct Taxes (CBDT) has come out with a clarification with reference to the DDB issue made by the IDBI to the following effect:

"The difference between the issue price and the redemption price of deep discount bond will be treated as interest income assessable under the Income-tax Act. On transfer of bonds before maturity, the difference between the sale consideration and issue price will be treated as capital gain/loss, if the assessee purchased them by way of investment...."¹

Coming as it does from the highest administrative authority in income-tax law, the opinion of the CBDT should merit due consideration, though the final legal position shall depend upon the decision that may come from High Courts or the Supreme Court. Furthermore, opinion of the CBDT as above cannot be accepted at its face value. One

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is tempted to challenge the ruling of the CBDT that where a DDB is retained until redemption, the difference between the redemption price and the issue price would be treated as interest and where it is disposed off earlier, the difference between the sale consideration and the issue price would be treated as capital gain.

This differential treatment, based on the period of retention, should have no legal basis to rest on. Whether a holder retains a DDB until its redemption or disposes it off earlier should make no difference to the nature of the asset he holds. In either case, the asset, being a capital asset, continues to retain its character as a capital asset, and there is no court ruling or provision in law to support the view that an asset which is otherwise a capital asset would become an asset in the nature of stock-in-trade where it is not held until its redemption. Unless the holder is a dealer in DDBs, the DDB would be a capital asset for the holder. Consequently, the difference between the redemption price and the issue price should be treated as capital gain under both the situations. This is all the more so, because at the time of issue of the DDBs by the IDBI, no pronouncement was made to the effect that the incremental revenue would represent interest. As such any treatment of the difference between the redemption price and the issue price now as interest has no merit. There is an apprehension however, that the holders of DDBs who act on this premise and go for redemption on maturity may have to go in for litigation for the simple reason that the CBDT may stick to the view as stated above. Of course there is every ground to believe that ultimately the case would be decided in favour of such holders in the courts of law.

For the holders of the DDBs, who may want to play safe and avoid litigation, it would be unwise to retain the DDBs until its date of maturity, simply because the difference between the redemption price and the issue price would be very high and its treatment as interest income of the year of redemption would attract tax at a very high rate.

No doubt the holder can claim relief under section 80 L in cases where a DDB has been approved for the purpose of this section. However, such a relief, if at all allowed till then, would be available at that time but would be of little consequence.

It may, therefore, become advisable for the holder of a DDB to dispose it off before redemption. Such a disposal would not present much of a problem. A DDB is essentially a movable property and its transfer is complete just on endorsement and delivery. Further most of the issuing institutions would have such DDBs listed on recognised stock exchanges and consequently their transfer would be all the more convenient. In many cases the issuers of the DDBs also give an option
to the holders to have them redeemed after a certain period of time at a consideration specified before hand. A few issues have also given option to the holders of DDBs to surrender the DDBs in order to switch over the investment to some other type of better instrument. On such a surrender or switching over, the transfer of the DDB would be complete. Even normally, a holder of a DDB can easily transfer his DDB in favour of a friend or some relation in the family. In case he does so, and it would be advisable for him to do so, particularly where the DDB shall become a long term capital asset in his hands, the difference between the sale consideration and the issue price would be treated as a capital gain, and he would also be entitled to the benefit of indexation of the cost of the DDB. Thus, the tax liability would be lower than the tax liability in case the DDB is retained by the holder until the date of its redemption.

Before conclusion it may be pointed out that some tax planning is possible in such matters, which may bring in decisive tax advantage without entailing any risk or expenditure, particularly where the persons concerned have no conflicting interests otherwise. Before a DDB is purchased, some persons, say five, may arrive at an agreement under which each of them would make a contribution, say of Rs. 1,000, and a DDB would be purchased out of the aggregate contribution, namely, Rs. 5,000, with one of them, say A, acting as the sole or first holder. In such a situation, the property in the DDB would not belong wholly and solely to A, but jointly in equal proportion to all the five persons, with A acting as the trustee for all of them. Consequently, on redemption, or on earlier disposal of the DDB, the difference between the sale consideration/redemption price and the issue price would have to be distributed over all these five persons in equal proportion, which would then form the subject of taxation in their individual assessments. In such a situation, the benefit of indexation or the relief under section 80 L would be available to full extent to each of these five joint holders in their individual assessments. Consequently, the incidence of tax would be less.

1. CBDT Letter dated March 12, 1996.
Globalization and Direct Taxes
Reforms in India

Arindam Gupta* and Dr. Chintaharan Sengupta**

India has been following a path of control with regard to imports, industrial licensing, monopoly practices, capital issues, foreign investment, use of foreign exchange resources etc. since independence. The overall economic condition was more or less within the control of the Government, although it had to periodically borrow either from the IMF or on bilateral/multilateral basis and much success has not been achieved. But the real problem was posed by the growing competition in the Indian polity. The populist policies of the political parties at the Centre and the States resulted in huge drainage of budgetary resources. The Seventh Five Year Plan (1985-90) stressed on modernization of Indian industries on a large scale and selective liberalisation of trade regimes were undertaken to promote greater internal and external competition in Indian industry, so as to achieve efficiency without any attempt to initiate structural adjustment programmes. This resulted in under-utilization of installed capacities in some industries and fast rate of growth in certain other industries, a rise in the import intensity of exports, mismanagement of fiscal apparatus and excessive liquidity, inflationary trend, corruption and misallocation of resources etc. The crisis situation was worsened by poor handling of macro-economic policies, rise in world interest rates, sluggish growth of exports and temporal increase in our imports. Gulf War and a curious mix of liberalization and control caused the external liabilities of the country to move upwards. The economy was on the threshold of a collapse with the foreign exchange reserves reaching all time low, foreign commercial banks stopped lending to India and NRIs started withdrawing their deposits. As a result, negative growth rates started to show up from May 1991 onwards.

When the new Government assumed office in June 1991, it had to rush to the IMF for immediate short-term and medium-term financial assistance. This resulted in initiation of economic reforms and structural changes with the conditionalities of IMF loans and a completely new outlook

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of these new managers of the economic, political and other affairs of the
nation. In the backdrop of global economic and industrial scenario, all these
factors may be traced in addition to a number of international causes, like
the financial emergence of Japan, the fast developments in technologies,
the tendency of developed countries and European communities to use their
political clout for economic ends, etc., the most important factor viz., the
emergence of an unipolar world after disintegration of the USSR. The
foreign exchange reserves in our country were rarely enough for two weeks

The immediate consequences were as under:

1. Devaluation of Indian rupee in two steps had to be resorted, to
2. Quick measures were adopted in the areas of foreign trade, exchange
   rate mechanism and inflow of foreign capital.
3. Cash compensatory support was abolished, since devaluation of
   Rupee had been expected to give boost to exports.
4. Export linked import policy was announced. EXIM - scrip scheme was
   brought in for short period under which import entitlement could be
   secured only on the basis of actual export performance.
5. Later, as a replacement, under a dual exchange rate scheme, dollar
   earning through export could be converted under two exchange rates
   (40% at official rate and 60% at market rate). Subsequently, rupee
   was made fully convertible on trade account.

Industrial policy had been considered a priority area for economic
reforms. Following reform measures were adopted in this area:

1. Industrial licensing was abolished for all, except for a select list of
   hazardous and environmentally sensitive industries.
2. Separate permission, needed by MRTP houses for expansion and
   investment, was abolished.
3. The list of industries reserved for public sector was reduced from 17
   to 6 and private sector participation was allowed even in industries
   in the reserved list.
4. Access to foreign technology was made freer.

Globalization may perhaps be best defined as a process in which
economic activity can be organised according to economic considerations,
across national boundaries.

An overview of changes in economic reforms in recent times in our
country can be had if they are divided in the following two parts:

a. Free market economy and liberalization measures discouraging
   protectionism, subsidies, and administrative control measures.

The structural adjustment of the Indian economy is being brought about by liberalizing licence/control regime, relaxing FERA and MRTP Act, making rupee fully convertible on the trade account and setting a trend for privatisation of public sector units.

**Tax Structure Prior to New Economic Policy**

The tax structure in India prior to new economic policy was based upon the regulated growth model. Direct taxes included personal income tax (including tax on capital gains), wealth tax, corporation tax (i.e., income tax paid by a company on its own taxable income) etc.

The rate structure of personal income tax was designed on a 'slab system', and the rates and exemptions and other dimensions of this tax have been continually changing.

In personal taxation, there have been distinctions between earned and unearned incomes, regular and irregular receipts and with various exemptions, rebates, allowances, surcharges, and the like. Rebates and exemptions were provided on specified savings. One purpose behind this was to encourage savings. To encourage investment in certain lines, income from certain investments was not taxed up to a limit. Areas of wealth tax, capital gains tax and the like have also been subjected to frequent changes. An important change in income tax structure was the partial integration of agricultural and non-agricultural incomes in 1973. If a person did not have taxable non-agricultural income, he was not liable to pay income tax on his agricultural income also (unless the concerned State Government was levying an agricultural income tax).

Corporation tax was levied at a flat rate, but was subject to a number of rebates, exemptions etc. From the viewpoint of tax, companies have been classified in terms of size, category of ownership (widely or closely held) and nationality (Indian and foreign). Various committees, experts and consultants have recommended from time to time tax incentives, or penalties for attaining some economic objectives. As a joint effect of all the above events, our corporation tax structure had become highly complicated. Exemptions and rebates varied according to different activities, criteria, types of corporate incomes, investments and the like, from time to time.

There was a time when the income tax rate, inclusive of surcharge, was as high as 97.5% for highest income slab, in case of personal income tax and a very high percentage also for corporation tax.

**Recommendations of the Chelliah Committee**

The Government of India had constituted a "Tax Reforms Committee"

For widening the income-tax base and rationalising the income tax structure, some of the important recommendations of the Committee may be cited in this context.

1. Reduction in marginal rate but a relatively high average rate and a rate schedule with a very little spread. It also suggested consideration of the inflation factor, while determining the basic exemption limit for revision from year to year.

2. Removal of most concessions and deductions, except for cost of earning, to make the income tax system simple and equitable and to reduce the rates substantially.

3. Computation of capital gains from an asset, taking the value of the asset indexed for inflation.

4. Introduction of presumptive taxation in case of "Hard-to-Get" groups.

The Committee recommended that wealth tax should not be payable on productive forms of wealth. Rather, it should be payable on only unproductive forms of wealth.

In the first part of the Final Report, the Committee covered corporate taxation. Some of its important recommendations were:

1. Reduction in the rates of corporate tax including abolition of surcharge.

2. No levy of capital gains tax or gift tax on amalgamations, compromises, arrangements and reconstructions.

3. Tax rate on foreign companies should not exceed that on domestic companies by more than 10%.

4. Fee paid to foreign companies for technical services and salaries paid to their staff should be fully exempt for encouraging direct foreign investment.

**Tax Structure After Economic Reforms**

It was widely felt that simplification and rationalisation of the Income-Tax Act was an utter necessity, consequent to the globalisation of the economy. The necessity of introduction of suitable tax incentive schemes was also felt in several areas like foreign collaborations, mergers, exports etc. to ensure a smoother process of globalization. The Government started forward with some positive steps to this end, by amending the legislation suitably. Tax rates were gradually decreased to bring them in
line with those prevailing in other countries. Apart from reduction in tax rates certain other measures were taken by the Government to boost Indian industries to function effectively in domestic market, as well as to compete in global market.

With a view to encouraging the establishment of export-oriented industries, several tax incentive schemes were introduced under sections 10A, 10B, 80HHB, 80HHC and 80HHE of the Income-Tax Act. Though all these schemes were inserted in the Act before globalization, amendments were made continuously, mainly after globalization to make these schemes more attractive. For example, the Finance Act 1993 made an amendment in section 10A, to extend the benefit of tax holiday to Software Technology Parks and Electronic Hardware Technology Parks. The Finance Act 1995 made an important amendment by inserting a new clause (ia) to sub-section (2) of section 10A, whereby it provided that full exemption will be granted to an industrial undertaking exporting not less than 75% of the total sales. With effect from April 1, 1994, the benefit of section 10B was also extended to industries which were engaged in production of computer programs. The Finance (No.2) Act, 1991 amended section 80HHC to extend the benefit of deduction for export of processed minerals and ores specified in the Twelfth Schedule to the Income-Tax Act. When some tax payers raised doubt regarding deduction under section 80HHC in respect of export of granite or other rocks that were cut and exported as raw blocks after being washed and cleaned, though the entry in the Twelfth Schedule was clear and unambiguous and used the term 'cut and polished', the Government clarified vide circular No. 693 dated 17th November, 1994 that it was necessary that the rock was not only cut into blocks but also polished before it was exported to avail the benefit of section 80HHC. This was in line with the Government's policy to encourage export of polished granite and other rocks where value addition before export was high, and to discourage export of raw blocks where value addition was low.

Several tax incentive schemes were inserted under sections 32A(6), 33A(5), 72A, 80HH, 80HHA, 80-l, 80-lA, 43(1), 47 (vi), 47(vii) etc. of the Income-Tax Act, in relation to merger of companies, as defined in section 2(1B) of the Act. As it was felt that the aforesaid schemes in the existing forms allowed attractive tax incentives in case of amalgamations and mergers, no amendments were made subsequent to globalization.

In case of foreign collaboration, certain incentives were provided under the Income-Tax Act. For example, section 10(6A) provided that if tax was paid by the Government or an Indian concern under the terms of agreement, on behalf of a foreign company, on income by way of royalty or fee for technical services, derived by such a foreign company from the Government or from Indian concern, it will be exempt from tax in the hands of foreign
company, subject to fulfilment of the conditions specified in the section. Section 10(6C) also allowed tax exemption to notified foreign companies in respect of income by way of fees for technical services in pursuance of an agreement entered into with the Central Government for providing services in or outside India in projects connected with security of India. Tax rate applicable to a foreign company in respect of income by way of royalties or fees for technical service from Government or Indian concern was reduced to 20% as specified in section 115A(1)(b), if such income was received in pursuance of an agreement made after May 31, 1997.

A long standing demand of abolishing double taxation on dividend income was partly fulfilled by inserting sub-section 33 in section 10. According to this sub-section, dividend paid by a domestic company on or after June 1, 1997 is wholly exempt from tax in the hands of the recipient. However, an additional income tax liability has been imposed on companies paying such dividend as specified in section 115-0. Such additional tax liability cannot be avoided by a domestic company, even if the company is not liable to pay any income-tax on its total income. Brought forward MAT credit under section 115 JAA cannot be utilised for adjustment of additional tax liability on dividend income. Undoubtedly, this is a hardship and need to be rationalised.

Double Taxation Avoidance Agreements (ADT) are a right step taken by the Government to grant relief in respect of income liable to tax in two countries, the country in which the income is earned and the country in which the assessee is resident. For this purpose section 90 was inserted in the Income-Tax Act, which provided that the Central Government may enter into an agreement with the government of a foreign country on granting relief in respect of income on which income-tax has been paid to any one government or for the avoidance of double taxation of income under the Indian Income-Tax Act and under the corresponding law in force in other country. The Government of India has so far entered into such agreements with 51 countries. An important amendment was made by the Finance (No.2) Act, 1991 by inserting sub-section (2) to this section. Generally, tax treaties contain a provision to the effect that the laws of the two contracting states will govern taxation of income in the respective states, except when express provision to the contrary was made in the treaty. Situations arise when due to subsequent amendments the law is more beneficial than under the provisions of the treaty. In such a case, in relation to the assessee to whom the Double Taxation Avoidance Agreement applies, the provisions of the Income-Tax Act apply to the extent to which one is more beneficial to the assessee.

**Appraisal and Conclusions**

'Globalization' may be referred to as an act in the direction of integration with world economy. It has been envisaged that foreign
investment shall supplement internal efforts towards industrial development. The Indian economy, it is feared, will be swallowed up by multinational giants. Time shall bear testimony for or against this opinion, which is at this stage only a note of caution. To speed up reforms programme for industry, business and society, special incentives have been given to organised and export-oriented industries including rural economy and agro-based industries in India. The export sectors have been indentified with the benefits in the form of liberal import for growth of export and also reduction in customs duty for importing foreign technology and capital equipment. The benefits of reduction in customs duty will be assessed only when the industries translate them into productive activities, depending on industry-wise import-export differentials.

Though an effort has been made to highlight direct taxes reforms in the light of globalization yet it is difficult to express anything about this without linking reforms with those in indirect taxes. Among the tax revenue sources, direct taxes include corporation and personal income tax, while indirect taxes cover customs and excise duties. There are subtle linkages between these tax sources. Custom-excise differentials are directly responsible for the growth of corporate sector, while corporation-personal income tax structure determines the intensity of hard work that the entrepreneur-management-worker syndrome can infuse into the economic activities. If such a delicate balance between tax sources can be worked out in an open economy, this would spontaneously lead to globalization. The process of globalization cannot be imposed from outside. Rather it should be worked out internally if a congenial international economic situation can be provided.

The best thing one can say about the last seven or eight Union Budgets is that the trend of lower taxes, liberalization and globalization has been, more or less, followed. To promote domestic industrial activity, and face foreign competition, the former Governments have tried to reduce both the customs and the excise duties. This was very much in line with economic liberalization. But we should not forget that competition between countries with unequal levels of technology may adversely affect growth of Research & Development (R & D) in developing countries, unless special concessions are provided for R & D activities in private sector. The measures of customs-excise differential and concessions for R & D activities become effective in the medium and long run only. In short run, surely the corporate sector and the stock market have nothing to be happy about the tax reforms. The corporate sector is rather unhappy with the introduction of Minimum Alternative Tax (MAT) in the Union Budget, 1996-97 and its complex amendments in the later budget. More innovative steps are needed for reducing the tax burden of corporate sector in identified areas in the context of globalization. The above analysis can be concluded thus with the suggestion for tax reforms during this crucial time of
globalization, highlighted before in the budget speech of 1995-96 by the then Finance Minister, Dr. Manmohan Singh with his learned observation:

"________ Over the past three years, we have made a number of structural changes in our tax laws, covering both direct and Indirect taxes. Unlike earlier isolated attempts to modify the tax system, these changes were part of a medium term programme of tax reforms, guided by certain principles that have gained wide acceptability. We wanted to build a structure, which is simple, relies on moderate tax rates, but with a wider base and better enforcement which may serve the objectives of equity and provide the incentives and signals consistent with developing an internationally competitive dynamic economy."

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Human Resource Accounting
Information for Personnel Management

Bhaskar Jyoti Bora*

Human Resource Accounting (HRA) has not been widely practised in India and abroad in managerial decision-making so far. Its significance for manpower planning, utilisation and control has been extensively advocated as a management decision aid by G.M.N. Baker in "The Feasibility and Utility of Human Resource Accounting".

HRA can provide the most scientific and realistic basis for both short and long-term manpower planning and utilisation. This includes acquisition, development, deployment, retention, utilisation and evaluation of manpower and also a structure of rewards and compensations based on such an evaluation.

From human resources selection, training and development costs to measurement of efficiency loss due to turnover etc. and also other personnel management decisions can be made more comprehensive and adaptable with Human Resource Accounting information. It can also help in determining and drafting suitable personnel policies. Publication of these information is expected to enhance motivation and belongingness. These aspects were statistically well-proved through an analysis of primary data collected during the preparation of this paper.

In measuring and judging the behavioural impact of Human Resource Accounting information on managerial decision making and control, a questionnaire presenting the scenario on the aforementioned decision areas was addressed to the personnel managers of ten selected companies and some management professionals. Majority of the companies were large business houses. For the convenience of the respondents, multiple answers were provided for most of the questions in the questionnaire.

The questionnaire addressed to the personnel managers and professionals was divided into three parts as under:

PART-I Personal information about the manager and the company.

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PART-II Presenting the case studies in the areas of turnover, selection, personnel policy and information disclosure.

In each of the decision context, two sets of information were given. Set-I contained conventional accounting information, and set-II contained conventional accounting information along with Human Resource Accounting information.

For the purpose of this paper only one of the areas of personnel management decisions viz. Personnel Selection has been considered.

**Personnel Selection Decisions**

Personnel Selection Decisions form an important responsibility of personnel departments of business enterprises. The right man, at right time and right place is a must for organizational efficiency. Searching and getting eligible personnel for the organization is a continuing challenge for the personnel managers. The most pivotal but delicate part of the personnel selection process is to judge and make sure of obtaining the most suitable person for the job and the organization.

Keeping in view the importance of selecting right personnel for the organization, the study attempted to assess and evaluate the impact of availability of "Human Resource Accounting Value" in personnel selection decisions. The basic research question here was whether human resources value information has an impact in personnel selection process or not. The main hypothesis formed for the purpose was: "There is no difference in impact between conventional accounting information and human resource accounting (human resource value) information in optimal personnel selection decisions". The hypothesis was formulated in null form on the belief that the use of HRA information in personnel selection decisions was not a common practice amongst Indian managers.

The subjects of study were personnel managers in large business houses and management professionals and consultants. It was decided to conduct the study with personnel managers (on line) and managerial professionals as respondents as the theoretical issues relating to such decisions were also intended to be highlighted, which might never had been handled by professional consultants.

The research methodology included a case study wherein personnel managers and professional consultants were requested to choose between two individuals X and Y for one post of 'Deputy Finance Manager' in the organization.

The information provided in Part-I of the questionnaire contained routine matters like age, experience, qualification, other qualifications, last salary, expected salary etc., which are traditional in nature. After that the managers were given another set of information (Part-II) which included
information derived from human resource valuation process. Thus in Part-II, along with the information in Part-I, data relating to the present value of expected future service and present value of replacement cost were provided. These information were derived on the basis of 'Lev & Schwartz model'\(^2\) for human resource valuation. As the respondents were not familiar with the interpretation of human resource valuation information, they were provided with the basics of HR valuation concepts. The basic questions asked were 'the choice of one candidate out of two' before provision of the HRA information and after the provision of HRA information, and the respective corresponding reasons of selecting a particular candidate in the pretest context.

Table-1, Table-2 and Table-3 show the preferences in decision about candidate X and candidate Y, on the basis of Part-I information.

**Table-1**

Personnel Selection Decision Before the Provision of HRA Information

<table>
<thead>
<tr>
<th>Preference</th>
<th>Number of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Candidate X</td>
<td>28 (70.0)</td>
</tr>
<tr>
<td>Candidate Y</td>
<td>12 (30.0)</td>
</tr>
<tr>
<td>Total</td>
<td>40 (100.0)</td>
</tr>
</tbody>
</table>

Note: Figures in parentheses indicate percentages.

**Table-2**

Reasons for Prefering Candidate X

<table>
<thead>
<tr>
<th>Reasons</th>
<th>Number of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fared well in Text</td>
<td>6 (21.43)</td>
</tr>
<tr>
<td>More Qualified and Experienced</td>
<td>10 (35.71)</td>
</tr>
<tr>
<td>Less Training Cost</td>
<td>12 (42.86)</td>
</tr>
<tr>
<td>Total</td>
<td>28 (100.00)</td>
</tr>
</tbody>
</table>

Note: Figures in parentheses indicate percentages.

**Table-3**

Reasons for Prefering Candidate Y

<table>
<thead>
<tr>
<th>Reasons</th>
<th>Number of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Candidate is young</td>
<td>4 (33.33)</td>
</tr>
<tr>
<td>More Certainty of Service</td>
<td>6 (50.00)</td>
</tr>
<tr>
<td>Less payment of salary</td>
<td>2 (16.67)</td>
</tr>
<tr>
<td>Total</td>
<td>12 (100.00)</td>
</tr>
</tbody>
</table>

Note: Figures in parentheses indicate percentages.
Table-1 shows that before the provision of HR valuation data, the maximum number of respondents’ preference was for candidate X i.e. 70 percent. Majority of the respondents based their preference for him due to more qualification and experience (35.71 percent) and less training cost (42.86%) as shown in Table-2. The decisions were based on traditional accounting information up to this point, as the respondents had not gone through Part-II of the questionnaire.

After this, the respondents were provided with Part-II information and they gave their revised preferences as given in Table-4 and Table-5.

Table-4
Personnel Selection Decisions after the inclusion of HRA information

<table>
<thead>
<tr>
<th>Preference</th>
<th>Number of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Candidate X</td>
<td>10 (25.0)</td>
</tr>
<tr>
<td>Candidate Y</td>
<td>30 (75.0)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>40 (100.0)</strong></td>
</tr>
</tbody>
</table>

Note: Figures in parentheses indicate percentages.

Table-5
Reasons for Prefering Candidate Y

<table>
<thead>
<tr>
<th>Reasons</th>
<th>Number of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certainty of service</td>
<td>8 (26.67)</td>
</tr>
<tr>
<td>Higher present value of future service</td>
<td>15 (50.00)</td>
</tr>
<tr>
<td>Present value of future replacement cost is lower</td>
<td>7 (23.33)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>30 (100.0)</strong></td>
</tr>
</tbody>
</table>

Note: Figures in parentheses indicate percentages.

Table-4 and Table-5 vividly show that there was substantial shift of preference from candidate X to candidate Y after the provision of the HR valuation information. Majority of respondents marked their preference for candidate Y (75%). 50 percent of the respondents preferred candidate Y for higher present value of future service, followed by certainty of service and lower present value of replacement cost. The reasons cited by the respondents are based on difference in perceived quality effected by HRA information.

A further analysis of the respondents’ decision shift has been done on the basis of a non-parametric data testing technique, McNemar test, to comprehensively establish the fact whether HRA information has a positive and definite impact on human resource selection decisions. For the McNemar test, a fourfold table of frequencies has been drawn to
represent the first and the second situation i.e. the pre-test and the post-test responses. In cell A is placed the number of those respondents who earlier opted out for candidate X and subsequently shifted their decision in favour of candidate Y. In cell D is given the number of respondents who earlier opted out for candidate Y and subsequently shifted their preference for X. In the other two cells i.e. cell B and cell C, are placed the numbers of respondents choosing the same candidate 'before' and 'after'.

**Table-6**

<table>
<thead>
<tr>
<th>Decision on the basis of Conventional Accounting Information (Part I)</th>
<th>Candidate Y</th>
<th>Candidate X</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decision after the inclusion of HRA information (Part II)</td>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>Candidate X</td>
<td>22</td>
<td>6</td>
</tr>
<tr>
<td>Candidate Y</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>Decision on the basis of HRA information (Part II)</td>
<td>30</td>
<td>10</td>
</tr>
</tbody>
</table>

The value of \( X^2 \) under the McNemar test is:

\[
X^2 = \frac{(A - D)^2}{(A + D)}
\]

with d.f. = 1

Thus in this situation,

\[
X^2 = \frac{(22 - 4)^2}{(22 + 4)} = \frac{18^2}{26} = 12.46
\]

The test clearly indicated that the observed change was statistically significant at 0.05 level of significance. This shows that the inclusion of HRA information had a significant bearing on human resources selection decisions. The hypothesis was tested first by using the direct responses from the participants and then by the McNemar statistical test. The present study apparently established the significance of HR valuation data in personnel selection decisions.
From the above analysis, it can be said that HRA information provided personnel managers a comprehensiveness and objectivity while dealing with personnel selection decisions, With this personnel managers' decisions become more accountable and useful to immediate and changing needs of the organization.

Thus it can be convincingly concluded that:

(i) Human Resource Accounting (HRA) significantly affects personnel management decisions and with the help of HRA these decisions can be made more flexible, adaptable and accountable, to suit the changing needs of organizations.

(ii) Personnel policies with regard to employee compensation can be more comprehensively drafted with the help of HRA information. Additional information generated through HRA can make personnel compensation policies objective.

(iii) There is marked difference in managerial decisions with the use of HRA information along with the conventional accounting information.

(iv) The HRA can be used as a potential tool for enhancing motivation, morale and efficiency.

Human resource accounting can be useful for management as well as for outsiders. From management's point of view, it is useful in planning and utilisation of human assets on more scientific basis. Accurate and reliable information help in monitoring the efficiency of these resources in a better way. It also helps in reducing the rate of absenteeism and turnover. Once a manager realises that his performance will be measured on the value of the human assets under his control, his attitude and behaviour is likely to become balanced between concern for production and concern for people. In the light of the above observations, it is a challenge for modern business enterprises to design systems that may be capable of providing accurate and reliable information on human resources.

Comprehensive research attempts to evolve pragmatic measures for more effective and significant personnel management decisions based on HRA through extensive research works in this line should be undertaken, both in the academic and in the professional fields.

References:
Business Budgeting in Historical Perspective

Siddhartha Banerjee

Introduction

The word 'budget' had its origin from the English word 'bougette', which means a sack or a pouch. The Chancellor of Exchequer in Britain extracted his papers for presentation to the Parliament in respect of government's financial programmes for the ensuing fiscal year from a bag, hence the name. It is now understood as a document containing a preliminary approved plan of public revenue and expenditure. In relation to a family, budget is a plan for the use of family's income, in order to obtain maximum value in satisfying present and future needs and desires. Thus, in specific, budget denotes a financial plan of a government and metaphorically a business enterprise, a private person and a family, containing details of its financial matters.

The present paper is based on an inquiry on historical evolution of business budgets, how the concept and the practice of budgeting have been used as an instrument of financial planning and control in government, how the state budgetary concepts have been adopted in corporate business, what have been the forms and applications of business budgets etc.

History of Government Budgeting

Budgeting in government has been an old practice. Some authorities quote the Bible to indicate its long history. In Egypt, Joseph had made a budget of corn supplies and had planned Pharaoh's investment and consumption policy. In Great Britain, the practice of drawing up a budget of government each year is quite old. However, in the United States, it dates back to 1921.

In Great Britain, under the Bill of Rights of 1689, Parliament had the right to levy and collect taxes. This right was strengthened by the Exchequer and Audit Department Act 1866. Initially, the government

* Senior Grade Lecturer in Commerce, Sonamukhi College, Sonamukhi, Bankura (West Bengal).
budgets were used to plan the way the money collected through taxation was to be spent. Later on the scope of budgets was extended to affect policy also. Once the Chancellor of Exchequer had submitted the budget and explained the plan for the ensuing year, the Finance Bill was passed, which then became a law through the Finance Act. From 1945, the budgets became more and more the instruments of policy, to stimulate economic growth, to control inflation and to use selective measures in particular geographic areas.

In the United States of America, however, formulation of national budgets was started by the Budget and Accounting Act of 1921. A budgeting system had been recommended earlier by the Commission on Economy and Efficiency appointed by President William Taft. After the report was published in June 1912, the President made an attempt to introduce a trial budget for the fiscal year 1914, but the Congress virtually ignored the recommendation of the President. In 1919, the efforts for reforms gathered momentum in Congress and the act that was to become law in June 1921 was passed by the Congress in identical form in May 1920. However, this met with a veto from President Woodrow Wilson.

Thus in government, budgetary control has been based upon a comparison of actual receipt and expenditure against budget, in order to ensure that pre-conceived objectives are realized. The budgetary control has been also employed by governments with the object of smooth and clean administration of public funds.

**Adoption of Budgeting in Corporate Business**

A little thought will exhibit that a manager dealing with finances in business has the same sort of problems as the Chancellor of Exchequer in government. He has to provide for funds for incurring expenditure on materials, labour, rent etc., which are to be offset by earning and revenue from sale. The manager has to perform a variety of activities under his control, that must be co-ordinated to a common objective. He has to plan his whole set of activities in business with an eye on future.

It was the realization of this fundamental similarity that led American businessmen to investigate the application of government budgetary concepts in business. The disastrous effects of the great slump of 1920 on business in the United States provided impetus to the movement for the adoption of government budgetary practices in business and industry. Now, budgeting is a familiar feature of business administration in the United States.

In Great Britain, the publicity focussing on national budget was not of much consequence to lead businessmen's thoughts in the direction of the adoption of budgets in business. The adoption of budgetary system
in industries was at first relatively slow. At the Sixth International Congress for Scientific Management held in London in 1935, Mr. R. Dunkerley had made an interesting review of the experience of several varied industries in the adoption of budgetary control. With this Congress, the advantages and the objects of budgetary system were widely known and its popularity grew correspondingly

The objects of budgeting and budgetary control system, whether applied to national finances or management planning and control in corporate business, are to prepare budgets based on certain goals and a constant comparison of the actual progress of activities against the above pre-conceived results. Although the business budgeting system has been evolved from the government budgeting system, there are some dissimilarities between the two systems. For instance, while the government budgets are prepared by necessity, as a rigid control system to prevent waste, business budgets are flexible and are based on a clear thinking and intelligent action, rather than a rigid control system.

Some Historical Reports

In 1941, a survey of 31 well-established US companies employing about 8,50,000 people was made. The results of the survey revealed that 50% of the 31 companies were using budgetary control in some form or the other. During 1958, the results of another survey were published in the United States. This revealed that budgets appeared to have been used for over-all control of performance in 95% of 387 respondent companies.

In Europe, the concept of budgetary control for business was promoted by French organization pioneer, Henri Fayol. However, it was observed that his formulations had obtained little application. A theory of departmental profit and loss control had been introduced by Czech entrepreneur, Thomas Bat’Q as a tool for decentralizing his international shoe company into a federation of independently run small businesses. In Western Europe, Great Britain and the Netherlands were two countries where use of budgets in industries was prominent. In Great Britain, the idea of budgetary control was firmly established at the Second Annual Conference of the Institute of Cost Accountants, held on 9th March, 1923. The Ninth National Cost Conference of the Institute of Cost and Works Accountants held in October 1930, also emphasized upon the development of budgetary control. Since then, budgetary control seemed to have caught the fancy of business organizations there also.

In the Netherlands, before World War II, the application of budgetary control was limited to a small number of farsighted companies. Among these the Philips Lamp was best known. Only after 1945, budgetary control became a common tool in Dutch business.
In India, the results of a survey on management control systems sponsored by the Institute of Chartered Accountants of India were published in the year 1977. It was reported that, in budgeting process, profit (after or before tax) was budgeted for the company as a whole in 98% of the 84 respondent companies.\textsuperscript{13}

**Conclusion**

It is apparent from the description given above that the concept of budgeting had developed in Great Britain much earlier than the United States. In government, the budgets were initially used to plan the way money collected through taxation was to be spent. However, afterwards it was extended to policy matters also. Budgetary control system in government was used as a control device for comparing actual receipts and expenditure against budget and observing whether and to what extent the pre-conceived plans were realized.

It has been noted that budgeting had become a familiar feature in business enterprises in the United States, as a result of the adoption of the concepts from government budgeting. The process of adoption started there after the economic depression of 1920. Although the government budgeting developed first in Great Britain, the application of budgetary concepts in business there was relatively slow. After the Sixth International Congress for Scientific Management, held in London in 1935, the budgetary system became popular in Great Britain. The object of budgeting and budgetary control system in national finances and in management planning and control in corporate sector were identical. These were related to the preparation of budgets based on goals and continuous comparison of actual progress of activities against pre-conceived results. There remained a distinct difference between government budgeting and business budgeting, although the concepts of business budgeting were derived from government budgeting. Government budgets are based on a rigid control system, to prevent waste, where as business budgets are flexible in nature.

It has been further observed that in the U.S.A. the use of budgetary control became more prevalent during 1940’s and 1950’s. In Great Britain, the concepts of budgetary control became popular in business organizations after the Ninth National Cost Conference of the Institute of Cost and Works Accountants, in 1930. In the Netherlands, budgetary control was accepted as a common tool in the Dutch business after 1945. In India, as revealed by the survey report of 1977 by the Institute of Chartered Accountants of India, profit was budgeted widely in budgeting process.
References:


7. Ibid.


XXII National Convention of Indian Accounting Association

The XXII National Convention of IAA will be held at Hotel Clarks Amer, Jaipur on February 27 and 28, 1999. The themes for technical sessions are, 'Environmental Accounting and Auditing' and 'Accounting for Services', and for the International Seminars are 'Paradigm Shift in Accounting Research' and 'Impact of E-Commerce and Internet on Accounting Education, Practice and Research.'

Members interested may please contact Dr. Sugan C. Jain, Conference Secretary, 4-Ma-22, Jawahar Nagar, Jaipur-302 004 Phone : (0141) 652107, Fax : (0141) 653224 for registration, accommodation, railway reservation etc.
IAA Announcements

AN APPEAL FROM THE PRESIDENT:

Dear Members,

Over the years, the savings of the Association have been meagre. The fund built up is not adequate to meet the expenditure on various activities of the Association. At the meeting of the Executive Committee of IAA held at Rajkot on 17th March 1998 it was therefore, resolved to create a Corpus Fund of the Association out of the headquarters share in the subscription for Life Membership and full Institutional Membership and special contribution from branches. The revenue income from the Fund shall be made available for meeting the expenditure on the activities of the Association including the Journal.

I appeal all the branches of IAA to contribute at least Rs. 1000/- towards the Corpus Fund Account. The contributions may be sent to the Treasurer, IAA c/o. Department of Commerce, Saurastra University, Rajkot (Gujrat).

Dr. Nageshwar Rao
President IAA

SPECIAL GENERAL MEETING NOTICE

A Special General Meeting of the members of Indian Accounting Association (IAA) will be held at the venue of 22nd Annual Conference of IAA at Jaipur on 28th February, 1999 at 4 pm under the chairmanship of Prof. Nageshwara Rao, President, IAA, to transact the following business:

1. Revision of subscription rates, advertisement tariff etc.
2. Regulations for awards, endowments etc
3. Activities of branches
4. Any other item with the permission of the chair

All the members of IAA are requested to please attend the meeting.

December 25, 1998
General Secretary, IAA

ANNUAL GENERAL MEETING NOTICE

The Annual General Meeting of the members of Indian Accounting Association (IAA) will be held at the venue of 22nd Annual Conference of IAA at Jaipur on 28th February, 1999 at 5 pm under the chairmanship of Prof. Nageshwara Rao, President, IAA, to transact the following business:

1. Confirmation of the minutes of the AGM held at Bangalore
2. Consideration of Annual Accounts of IAA for 1997-98
3. Election of office-bearers and members as per the Constitution.
4. Finalisation of the venue, dates, topics and related matters pertaining to 23rd Annual Conference
5. Any other item with the permission of the chair

All the members of IAA are requested to please attend the meeting.

December 25, 1998
General Secretary, IAA
IAA Branch News

Udaipur Branch

1. A meeting of the general body of the Branch was held on 22nd August 1998. The following executive committee was elected for 1998-99:

   - Chairman: Dr. G. Soral
   - Sr. Vice-Chairman: Dr. S. Bhanawat
   - Jr. Vice-Chairman: Dr. S.L. Menaria
   - Secretary: Dr. C.L. Salvi
   - Joint-Secretary: Dr. Sharad S. Johri
   - Treasurer: Dr. P.R. Somani
   - Executive Members: Shri B.L. Heda, Shri Tapan K. Bhadviya, Dr. S.V.S. Bhanawat

   Past chairmen of the branch, Prof K.R. Sharma, Dr. M.L. Dashora, Dr. R.L. Tamboli and Dr. N.K. Pandya were nominated as patrons and Dr. N.K. Dhing & Dr. Vijay Laxmi were co-opted as executive members.

2. At the meeting of the executive committee of the branch held on 4th September 1998 at Government Meera Girls College, Udaipur, decisions regarding IAA talent search for commerce students, computer workshop for IAA members, a national level conference, local level seminars and fellowship activities were taken.

3. A family picnic was organised on Sunday the 20th September 1998 at Ubeshwar Mahadev under the joint auspices of Rajasthan Vanijya Parishad, Udaipur Chapter and IAA Udaipur Branch. The activity was co-ordinated by Shri B.L. Heda and Dr. P.R. Somani.

4. A Round-table discussion on the theme "Towards Further Strengthening the IAA" was organised on 5th October 1998 at M.L. Sukhadia University Guest House. Prof N.M. Khandelwal, Dean, Faculty of Management Studies, M.D.S., University, Ajmer was key speaker. The session was chaired by Prof. K.R. Sharma, Dean P.G. Studies, M.L. Sukhadia University, Udaipur. At the outset, chairman of the branch Dr. G. Soral welcomed the guests and the participants and stressed the need for strenghtening the IAA, both at branch level and at national level and to activate the national executive committee to achieve these targets. Dr. R.L. Tamboli suggested establishment of
a permanent secretariat and legal charter for IAA. Dr. R.K. Dashora emphasized upon organisation of faculty development programmes and publication of manuscripts. Dr. Vijay Laxmi stressed the need for increasing participation of women in the activities. Dr. S.L. Menaria called for attention towards organisational and infrastructural problems of the Association. Dr. Surendra Bhanawat highlighted the requirement of participation of IAA in formulating government policies and the problem of paucity of finances.

Key Speaker Prof. N.M. Khandelwal called for better control of the headquarter over the branches and instituting a running shield award for the best branch every year. He suggested that IAA should have connectivity with Internet, its own data base and should work for identification of new research areas. He suggested that appropriate weightage should be given to participation in seminars and conferences in faculty selections at university level.

Prof. K.R. Sharma, reviewing the working of other professional organisations, such as ISTD, IMA, CSI suggested taking these as role models for improving the working of the IAA. He stressed upon the need for better liaison among IAA Branches and up-dating the knowledge level of members. Secretary Dr. C.L. Salvi convened the session and also proposed a vote of thanks.

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Style: The style should be clear and concise. Number of references should be appropriate to the length of the paper. Describe sample surveys and other data collection methods in enough detail for an expert to assess their validity.

Abbreviations: While using abbreviations first write out the full term followed by its abbreviation in parenthesis, preferably in capitals without full stops.

Tables: The tables should be numbered consecutively and given adequate titles or headings. The tables must be referred to in text. They should supplement rather than duplicate text data.

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