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Contents

Young Researcher Award

Indian Accounting Association invites research proposals on research works done during the last five years in the area of Accounting by scholars/ Faculty members of not more than 35 years of age as on 31.12.1999 for the consideration of Young Researcher Award.

Please encourage the IAA members in your University/ College/ area to submit proposals for Young Researcher Award on or before 10th May 2000.

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Chief Ediotor. IJA

EDITORIAL

Globalisation and financial sector reforms have stimulated interest in financial markets and related activities in the country. There appears greater keen-ness to understand, interact and debate on issues such as financial institutions, instruments traded, the prevailing practices, investor protection, code of ethics etc. in academic circles. More and more scholars are researching and writing on these topics. This issue of the Journal covers some such articles.

Dr. V. Rajarajan has presented the results of a survey of investors' life styles and its relationship with investment characteristics in Chennai in the paper 'Investors Life Styles and investment Characteristics'. It is concluded that individual investors can be segmented on the basis of their life style. Dr. Arindam Gupta in his paper 'Towards Global Stock Exchange' has, after describing the important features and developments in Indian stock market since 1990, concluded that Indian stock market is emerging as a global stock market. Carrying the theme further, Dr. H.N. Agrawal has observed that though the capital market infrastructure and efficiency have improved in India without a strong investor movement, Protection of investor & interest is not possible. Capnvestor protection can not be left to government and regulatory bodies exclusively.

The vexed taxation issues related with buyback of securities have been examined by Dr. Mehrotra Dr. Saxena and Verma in their joint paper on 'Buyback of Securities- Vexed Taxation Issues' in the light of existing legal provisions and court decisions. Siddhhartha Banerjee has described the extended concept of budgetary control in his paper 'New Dimensions of Budgetary Control'. It is made out that identification with budgeting goals, participation at all levels, a system of reward and penalities and self- governing character of budgeting are necessary for improved results.

Related with globalisation is the problem of foreign exchange risk management. Dr. Jita Bhattacharyya has discussed the various aspects of foreign exchange risk and its management in her paper on 'Foreign Exchange Risk Management- An Overview'.

Professor B. Banerjee's article on 'Regulation of Corporate Reporting in India: Perception of Users-A Case Study' is based on the survey of selected useres of financial reports in India. After examining various aspects of the issue in depth, the study has produced some very interesting conclusions regarding the perception of the users of financial reports.

There has been some delay in bringing out this issue due to unavoidable reasons. We hope honourable members would please appreciate.

Udaipur
Nav Samvatsar, 5th April 2000

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Investors' Life Styles and Investment Characteristics

Dr.V.Rajarajan*

Introduction :

The investors with investible funds are selective in investing. The investment behaviour of individuals is in fact, very much a direct and systematic function of personal circumstances. Investment attitudes result in portfolio decisions. The investment choices of individuals remain a profound secret. Therefore, the fund managers find it difficult to market their financial products. How an investor tries to balance various considerations in his choice of financial assets will be understood better if empirical data choices are available.

Life Styles Approach : Need, Meaning & Benefits :

An investor-driven marketing strategy necessitates an understanding of the demographic, socio-economic and psychographic characteristics of the investors, to get a sharper picture of financial market segments. Segmentation of individual investors on the basis of demographic characteristics has been attempted by many including Lease[1] and Avery[2]. But in the financial services industry, an acceptance of demographics as the total basis of marketing dictates an acceptance of the fact that affluent individuals, each earning the same Income and living in similar homes in the same area, have the same financial needs, which is not correct. The individuals may be equal in all respects, may even be living next door to one another, but their financial planning needs are very different. In this context, demographics alone may no longer suffice as the basis of segmentation of individual investors. It is by using psychographics, rather than demographics, that synergism between investors can be generated.

Demographics describe who the buyers are. Life style variables provide some of the "casual understanding of why a consumer is a

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buyer"[3]. Psychographics basically is an attempt to classify people by life style, that is by those attitudes and beliefs that frame the way people think about themselves and their world. Consequently, psychographics or 'life style' measures have become popular means of identifying investors and describing their differences along psychological dimensions which supersede traditional demographic variables. The conecpt of life styles was introduced in marketing by Adler[4]. It is part of the continuing efforts by marketers and other communication specialists to learn more about their target audiences.

Life style segmentation begins with people instead of products and classifies them into different life styles, each characterized by a unique style of living based on a wide range of activities, interests and opinions[5]. If we use psychographics as the basis of determining individuals' financial services needs, we will come much closer to the truth from the customers' perspective of need than we will by using demographics to build a marketing program, where results are more dependent on sales skills than on credibility[6]. Life style segmentation provides an overview of the market in a multi-dimensional sense, and one can learn a great deal about the structure of the market. Thus, life style points to a new construct and is a technique to learn about the nature of audiences and audience segments.

Objective of the Study :

The objective of this study is to find out life styles based segmentation of individual investors and to analyse out the investment size, pattern and future investment preference of individual investors on the basis of their life styles.

Methodology :

The study was undertaken in Chennai. A sample of 450 investors was selected covering different occupations, age and income groups using judgement sampling. A structured questionnaire was issued to each of them. Out of this 45 incomplete or otherwise unusable questionnaires were discarded and the data on 405 investors were used for Analysis. The investors were classified into three life style groups using cluster analysis. The association between the life style groups and various investment related characteristics were brought

out using correspondence analysis, and Kruskal Wallis Test.

Previous Studies on Individual Investors :

The demographic characteristics of individual investors have been studied a lot. To quote few, Avery et al[7] and Ronald et al[8] have studied the age of investors along with family Income, networth and composition of balance sheet of high income families. The Indian studies include Survey of Ownership of Shares in Joint Stock Companies by RBI at the end of 1965[9] and 1978[10]. Gupta brought out a great deal of fascinating material on Indian Share Owners[11]. Rajarajan classified individual investors on the basis of their demographic characteristics[12] and investment size based characteristics[13]. Further the association between stage in life cycle of individual investors and the investment related characteristics were also studied[14].

Studies dealing with the life style characteristics of individual investors are very few. Barnewall suggests, the use of psychographics as the basis of determining individuals' financial services needs takes one closer to the truth from the customers' perspective of need[15]. Warren et al. used life style characteristics to differentiate investors by size and nature of their investment holdings. They found that failure to use life style characteristics as segmentation variable omits an opportunity for further segmentation and blurs some real differences between individual investors and their financial services need[16]. However,life style based study of Indian Investors has not been attempted as far.

Profile of Sample Investors :

A cursory view of Table 1 reveals that 9 out of 10 respondents are men, five out of every six are married and nearly one-seventh are above 50 years. A great majority (84.0%)of the sample are in salaried class and working as officers and clerks, and just one-fifth have a monthly Income exceeding Rs.12,000.

TABLE-1

Demographic Characteristics of the Sample

Age (in years)		Marital Status	
Below 35	45.6%	Single	16.8%
35-50	39.8%	Married	83.2%
50 and above	14.6%	**Sex**	
Family Income (per month)		Female	9.6%
<Rs.8,000	58.7%	Male	90.4%
Rs.8000-12,000	21.5%	**Household Size**	
> Rs. 12,000	19.8%	4 members	33.8%
Occupation		<4 members	32.4%
Business	6.9%	>4 members	33.8%
Profession	15.1%	Employment	
Clerical	32.8%	Salaried	84.0%
Officer	45.2%	Self Employed	12.5%
		Retired	3.5%

Measurement of Life Style :

The questionnaire included 16 Likert type statements to study the life style characteristics of individual investors. The variables for the present study were selected on the basis of earlier studies on consumer durables and non-durables and the characteristics of the financial products.

The following life style variables were selected for the present study:

(1) Appearance consciousness -Conformist/Non conformist

(2) Future Expectations-Optimism vs Pessimism

(3) Opinion leadership

(4) Information seeker

(5) Attitude towards credit - User/Non User of Credit.

(6) Attitude towards Risk - Risk Seeker/ Risk Avoider.

These characteristics were measured by using a five point Likert type scale. Cluster analysis was applied to segment sample investors.

Cluster Analysis Approach :

The purpose of cluster analysis is grouping together of objects, which are often measured on several characteristics, so that there is much homogeneity within the group and much heterogeneity among the groups. Cluster analysis is used perticularly in situations where criteria for group membership are not easily specified in advance[17].

The non-hierarchial method of clustering was adopted for this analysis. Quick cluster in the SPSS package was used for clustering investors.

Life Style Cluster Formation :

After some initial exploration ranging between three and six clusters, a three cluster solution was arrived at. The results are given in Table-2

TABLE-2

Life Style Cluser Membership

Cluster No.	No of Members	% to Total
I	276	68.15
II	65	16.05
III	64	15.80
Total	405	100.00

Using Fisher's linear discriminant function,canonical discriminant analysis was applied to find out the reliability of three cluster solutions. The results indicated high level reliabilty of clusters. Further discriminant analysis was carried out to find the extent of misclassification among the clusters.The percentage of "Grouped' cases correctly classified was found to be 92.1%

Reliability of Variables :

The reliability of the variables chosen for life style segmentation

was tested through variance analysis. The univariate F-ratio and levels of significance of all the six variables exhibit significant differences among the clusters.

The clusters identified through cluster analysis are unique and have significant differences among them. The extent of misclassification is also low, indicating the reliability of clustering. The mean scores for the selected variables in each cluster and the ranks assigned to clusters on each variable on the basis of their mean scores help to develop life style profiles of the three groups. The cluster analysis process ends with labeling the groups with a suitable name.

Based on the dominant characteristics, each life style group was labelled in one phrase (Table-3).Considering the strong risk seeking attitude of Group I members, they were named Active Investors and considering the poor risk seeking or otherwise risk avoiding characteristic of Group III, they were named Passive Investors. Group II members being moderate in risk seeking and in other related characteristics were named Individualists.

After indentifying the three life style groups and their life style characteristics, their demographic and investment related characteristics were studied. Correspondence Analysis was used to identify the association between various life style groups and their demographic and investment related characteristics.

Correspondance Analysis has been primarily used to analyse data presented in a two-way contingency table. The objective of the two way Correspondence Analysis is to portray data geometrically as a set of row and column points in two dimensional space for easy visualisation. The evidence of association between rows and columns can be represented in a graph.

Demographic Characteristics - Life Styles and Age of Investors :

Age is an important variable in investor related studies. Studies in consumer life styles usually assume that only one particular age group will be highly related to a particular life style pattern. The Correspondence Analysis(Fig.1) brings out that Active investors are dominated by the age group of below 35 years, Individualists group by above 50 years and passive Investors by the age group 35-50 years.

TABLE-3

Profiles of LIfe Style Clusters

Life Style Group I	Life Style Group II	Life Style Group III
Strong In Appearance Conscious Future Expectation Opinion Leadership Risk Seeking Information Seeking	**Strong In** Credit Usage	**Strong In** Nil
Moderate In Credit usage	**Moderate In** Appearance Conscious Information Seeking Risk Seeking	**Moderate In** Future Expectation Opinion Leadership
Weak In Nil	**Weak In** Opinion Leadership Future Expectation	**Weak In** Appearance Conscious Credit Usage Information Seeking Risk Seeking
Active Investors	**Individualists**	**Passive Investors**

Figure - 1
Association Between Life Style and Age

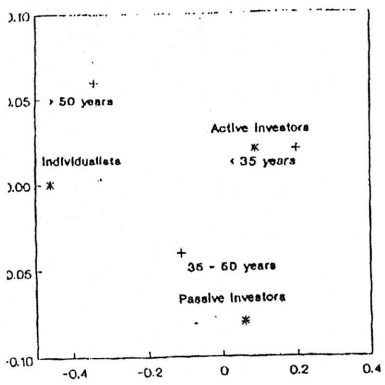


Figure - 2
Association Between Life Style and Income.

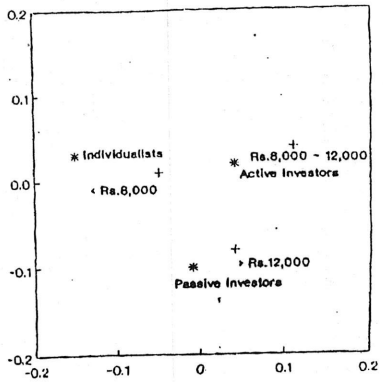


Figure - 3
Association Between Life Style and Household Size

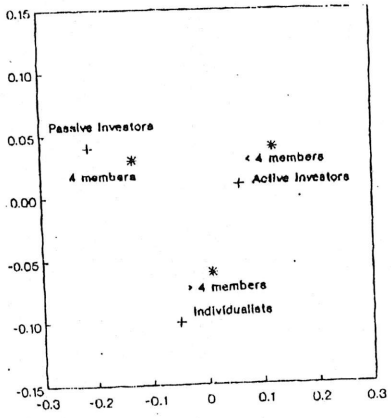


Figure - 4
Association Between Life Style and Occupation

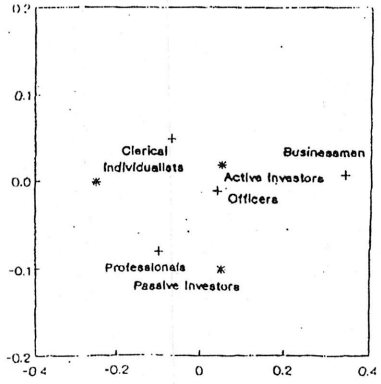


Figure - 5
Association Between Life Style and Investment Size

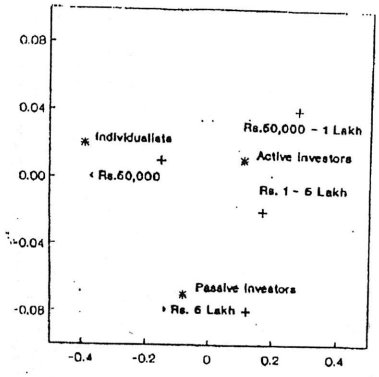


Figure - 6
Association Between Life Style and Expected Return

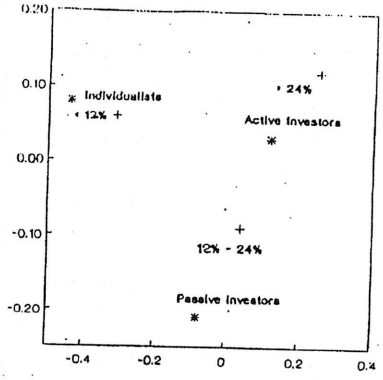


Figure - 7
Association Between Life Style and Portfolio Choice

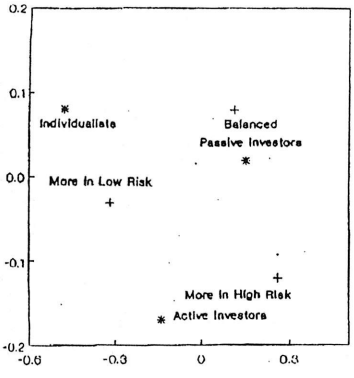
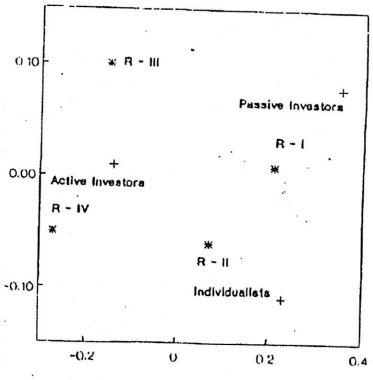


Figure - 8
Association Between Life Style and Risk Categories



Life Style Clusters and Family Income :

Family Income is an important variable in segmenting the market. Based on an exhaustive review of literature, Frank and Frank[18], Massy and Wind[19] concluded that one of the most important demographic variable found to explain ownership of durable products was family Income.Fig 2 depicts that life style clusters happen to be apart from each other in terms of the Income level of its members. It is found that Income level between Rs. 8,000 and Rs. 12,000 is dominated by the Active Investors, Income level above Rs.12,000 is dominated by Passive Investors and Income level below Rs. 8000 is dominated by Individualists Group.

Life Style Clusters and Household Size :

The household size indicates the number of members in the family of the respondent. Larger the size of the household, more the expenses and little the saving and investments. Lewellen et.al found negative influence of family size on direct equity investments.[20]

With the help of Correspondence Analysis (Fig.3) it has been found that the less than 4-member household size dominate Active Investor group, more-that-4-member household size in Individialists group and 4-member-house hold in Passive Investor group.

Life Style Clusters and Occupation :

The sample respondents were classified into four major occupational categories, namely Professionals, Businessmen, Clerical cadre and Officers. On an analysis, the occupation-wise composition of life style clusters were found.

It is clear from Fig.4 that Active Investors group is dominated by officers and Individualists group by clericals and Passive Investors group by professionals.The businessmen respondents are placed away from all the life styles. However, due to their nearness to Active Investors group in comparison to the distance with other two groups, they can be assumed to follow the life style of Active Investors.

Investment Related Characteristics -

Life Style Clusters and Investment Size :

The size of investments was divided into four groups as follows:

(1) Less than Rs. 50,000 (2) Rs. 50,000 to Rs. 1 Lakh, (3) Rs.1 Lakh to Rs. 5 Lakh and (4) above Rs. 5 Lakh.

From Fig.5, it may be seen that the life style groups are relatively far from each other in terms of the investment size of the members that dominate them. It shows that the respondents having an investment of Rs. 1 Lakh to Rs. 5 Lakh dominate the Active Investors group and respondents having investments of less than Rs.50,000 dominate Individualists group and investment size of above Rs. 5 Lakh dominate Passive Investor group. The Rs. 50,000 to Rs. 1,00,000 investment size, due to its nearness to Active Investors group, is assumed to follow their style. It can be said from the above analysis that differences among life style segments on the basis of size of investment are significant and most of the investors in a particular investment size adopt a similar life style.

Life Style Clusters and Expected Rate of Return :

The sample investors identified their expected rate of return on their investments from three choices viz, (a) less than 12 per cent, (b) 12 to 24 per cent, and (c) above 24 per cent per annum.

From Fig.6 it can be observed that life style patterns I,II and III are relatively far from each other, in terms of the expected rate of return. It can be said that the Active Investors group is dominated by members who expect a high rate of above 24 per cent per annum and Individualists group is dominated by members expecting less than 12 per cent and Passive Investors group is dominated by those who expect a moderate rate of 12 to 24 per cent per annum on their investments. Since the 12 to 24 per cent group is equi-distant from Active Investors group and Passive Investors group, some of its members may also be present in Active Investors group.

Life Style Clusters and Portfolio Choice :

The life style clusters were analysed in terms of their preferred portfolio choice. The portfolio choice for this purpose was classified into:(a) Portfolio more in low risk assets, (b) Portfolio more in high risk assets, and (c) a balanced portfolio.

It could be seen from Fig.7 that each of the life style group is

dominated by a particular investment choice to a great extent. The Individualists group is dominated by the investors preferring low risk assets and Active Investors group is dominated by investors preferring high risk assets, and the Passive Investors group is dominated by balanced choice investors.

Life Style Clusters and Risk Bearing Capacity :

Investers' risk bearing capacity can be investigated through a variety of approaches, including the portfolio composition of investors. This study investigated empirically into the issue by enquiring the proportion of investment portfolio allotted to risky assets. Of the sample investors 40 per cent had zero holdings in risky assets, and 36 per cent had only as much as 40 per cent allotted to risky assets. This confirms the highly conservative nature of the sample. Only little less than one-fourth of the respondents had more than 40 per cent of their financial assets in risky class.

From Fig.8 it is clear that the Active Investors, Individualists and Passive Investors groups are far from each other, indicating that there exists significant differences among these life style groups on the basis of investment is risky assets. The Active Investors group is dominated by investors who had more that 40 per cent of their financial assets in risky category and Individualists by investors who had 1 to 20 per cent of financial assets in the risky investments and Passive Investors group dominated by investors who had zero holdings in risky assets. The individuals who had 21 to 40 per cent of assets in risky category are away from all life style groups. However, their proximity to Active Investor group in the figure suggests that they follow Active Investors life style.

Life Style Clusters and Time Perspective :

The investors' responses were classified into (a) short-term perspective group, and (b) long-term perspective group i.e. term orientation while making their investments.

Table-4

Time Perspective	Active Investors		Individualists		Passive Investors		Total	
	No	%	No	%	No	%	No	%
Short-Term	113	40.9	39	60.0	25	39.1	177	43.7
Long-Term	163	59.1	26	40.0	39	60.9	228	56.3.
Total	276 (68.1%)	100.0	65 (16.1%)	100.0	64 (15.8%)	100.0	405 (100%)	100.0

Chi Square	Value	DF	Significance
Pearson	8.43196	2	.01476
Likelihood Ratio	8.37388	2	.01519

Life style clusters were analysed in terms of their time perspective. A close scrutiny of the percentages given in Table -4 reveals that Active Investors group is dominated by long-term perspective investors and Individualists group is dominated by short-term perspective investers.The Passive Invertors group, due to its higher percentage of investors in long-term perspective group, may be said to be dominated by that group. In other words, Active Investors group and Passive Investors group have long-term perspective and Individualists group have short-term perspective, while making their investment decisions.

The Chi-square value is siginificant at 5% level. This strongly confirms the existence of differences among the clusters on the basis of the time perspectives.

Life Style Clusters and Locus of Control :

Locus of control is a specific personality characteristic. It is concerned with, whether an individual sees rewards as contingent upon his own behaviour (Internal control) or as the result of luck, chance etc.,(External control).The locos of control of sample investors was inquired into. On an overall basis 36 per cent investors were internals and 64 percent were externals. The life style clusters were classified on the basis of the locus of control of its members.

Table -5

Locus of Control	Active Investors		Individualists		Passive Investors		Total	
	No	%	No	%	No	%	No	%
Internal	101	36.6	16	24.6	28	43.8	145	35.8
External	175	63.4	49	75.4	36	56.2	260	64.2
Total	276 (68.2%)	100.0	65 (16.0%)	100.0	64 (15.8%)	100.0	405 (100%)	100.0

Chi Square	Value	DF	Significance
Pearson	5.37335	2	.06811
Likelihood Ratio	5.54012	2`	.06266

Table-5 reveals that Individualists group is dominated by Externals and Passive Investors group by Internals. The Active Investors group had more than three fifths of its members as externals. Hence, it may be said that they too are externals. the chi-square vlaue is significant at10% level.

Life Style Clusters and Source of Information for Investment Decisions :

The usefulness of five common sources of information was enquired using Likert type questions, the ratings of which varied from almost always useful to never used. The responses were subjected to Kruskal-Wallis Test. The result is given below in Table-6.

Table-6

Kruskal Wallis Test Resuls

Characteristic	Chi-Square	Significance
Source of Information for Decision	6.3982	0.0408

The Chi square value is significant at 5% level of significance confirming the existence of difference between the clusters on the basis of sources of information for investment decision making.

Active investors group considered the banks to be the primary source of information and investment consultants to be the next, followed by financial periodicals, share brokers and investment research journals. The Individualists group and Passive investors group found investment consultants to be primary source followed by banks, share brokers, investment research journals and financial periodicals.

Life Style Clusters and Future Investment Preference :

The question on future preference of investment choice had eight choices presented in the form of Likert type scale, with ratings ranging from 'certainly yes' to 'certainly no'. To identify the difference in future preferences of investment choice among the life style clusters, Kruskal-Wallis Test was carried out.The results of the test are given in Table-7.

Table- 7

Kruskal Wallis Test Results

Characteristic	Chi-square	Significance
Future Investment Preference	3.2717	0.9148

The Chi-square value is not significant confirming non-existence of differences between the groups on the basis of their future investment preference.

All the three life style groups prefer non-convertible debentures as their first choice for future investment. However, the Active and Passive investors prefer deposits with private companies as their second preference, while Individualists prefer convertible debentures as their second choice.

This way of preferring fixed Income securities with low risk by all investors, irrespective of their characteristics, and particularly even by Active Investors may be because of their recent bad experience with the stock market, which is undergoing a long bear phase extending to more than 4 years.

Conclusions :

The results of the study are summarized in Table-8

Table-8

Probiles of Life Style Clusters

Sl. No.	Characteristics	Life Style Groups		
		Active Investors	Individualists	Passive Investors
	Demographic			
1.	Age (in years)	Below 35	Above 50	35 to 50
2.	Monthly Income Rs.	8,000to12,000	Below 8,000	Above 12,000
3.	Household Size	<4 members	>4 members	4 Members
4.	Occupation	Officers	Clericals	Professionals
	Investment Releated			
5.	Investment Size Rs.	1-5 Lakh	<50,000	>5 Lakh
6.	Expected return	>24%	<12%	12-24%
7.	Portfolio Choice	More in High Risk	More in Low Risk	Balanced
8.	Risk Bearing capacity	>40% in Risky Assets	1 to20%Risky Assets	0% in risky Assets
9.	Time Perspective	Long term	Short term	Long term
10.	Locus of Control	External	External	Internal
11	Source of Information	Banks Investment consultants	Investment consultants Banks	Investment consultants Banks
12.	Future Investment Preference	Non-con Debs. & Company Debentures	Non-con.Debs.& Convertable	Non-conm. Deb. & Company Deposits
	Deposits			

The above analyses clearly brought out the association between life style clusters and investment related characteristics. This underlines the usefulness of life styles to segment individual investors. The results confirm the comments of Warren et. al. that, failure to use life style characteristics as segmentation variables omits an opportunity for further segmentation and blurs some real difference between individual investors and their financial service needs. Thus the financial product designers and marketers and financial service providers would do well by making use of this new basis of segmentation for understanding the individual investors.

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Towards Global Stock Exchange

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In the last week of October, 1997 most of the stock markets the world over have been found to be in a severe crisis following a consistent trend of falling down of prices and consequently, of the index for the last five or six months. When leading bourses like Nikkei, Hang Seng and Singapore got affected from around mid 1997 onwards, this crisis spread to the European and the US markets as well. Along with the world markets, the Indian stock market also responded in the same manner. This is unlike the situation in 1987 when Wall Street plunged sharply but the Indian bourses remained buoyant. Why ?

With globalisation and economic liberalisation of the Indian economy from early 1990's, the Government has liberalised capital market through a series of measures undertaken during 1992-93 to the current financial year. The process of capital market reforms was carried out with an array of reforms encompassing primary and secondary markets, for equity and debt, and for foreign institutional investment. Primary market reforms aimed at greater flexibility to the issues and strengthening the criteria for accessing the securities market. Reforms in secondary market focused on improving market transparency, integrity and infrastructure. Prior to this economic liberalisation, India's economy was more or less closed. This has been the main reason behind Indian bourses remaining buoyant, in spite of Wall Street's falling as in 1987. But now India has also been following open economic system and as a result of this, foreign influence, in whatever form may be, is bound to affect every part of India's economic system. Thus, securities market in India is now susceptible to ongoing reactions in international securities market.

The performance of the Indian stock market, as measured by the size of stock market in relation to the economy and the liquidity of such

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market, is also found to be improving on an average from year to year in the post-liberalisation period. On the assumption that the size of stock market is directly correlated with its ability to raise capital and diversify risk, the ratio of market capitalisation to the gross domestic product (GDP) is used as an indicator of size of market with respect to the economy, which shows a consistent rise up to 1994 and then up to 1997 a consistent fall as well, though even in 1997, it was 33%. Trading value has been found to be in a consistent rising trend from year to year. But liquidity, as measured by the ratio of total value of trade to the GDP, and the turnover ratio, calculated as the ratio of total value traded to market capitalisation, has not been found to have any consistent trend. But it was very good for 1996 and 1997, which has been clearly shown by both the ratios. This performance of Indian stock market is shown in Table I.

Interestingly, from some of the recent important arrangements in Indian stock markets, there is a growing feeling that Indian markets are going to be global. These markets, 23 in total at present including the National Stock Exchange (NSE) and the Over The Counter Exchange of India (OTCEI), and obviously controlled by the Securities and Exchange Board of India (SEBI) from February 1992, have experienced in recent times some such innovations in trading system, automation in trading system, financial instruments, rating of securities, etc. which are simple proof of this so-called globalisation of stock markets. Some such new events are discussed here one by one along with the likely effect of each such event towards creating globalisation of stock exchange in the country.

A. Paper-Less Trading – Dematerialization

The Indian capital market, with the distinction of listing the largest number of companies in the world, has witnessed a huge rise in the volume of transactions in recent years. The passing of the Depositories Act by the Parliament in August, 1996 paved the way for setting up of multiple depositories which would vastly improve the efficiency of the capital market. Under this Act, the SEBI has got the powers to allow registration of depositories and participants and to approve and amend the bye-laws of a depository and allow for dematerialisation (and rematerialisation) of securities in depositories, thereby facilitating the transfer of securities through electronic book entry[1]. This is in keeping

with the world-wide trends.

In this model, when an investor wishes to sell his/her securities, he/she has to hand over the certificates to the broker for de-materialisation. Until the settlement takes place, the scrips continue to stand in the name of the seller. Once 'delivered in', they are dematerialised and cannot be re-converted to physical form ordinarily, except through re-materialisation. After this, when the shares are traded, there is no scrip in the stock exchange at the time of settlement. This facilitates a prompt book entry settlement. Thus, the scrips shall cease to exist in the secondary market. But in respect of new issues, the investors shall retain the option to have the scrips or to participate in the dematerialised model. In this model, the book entry records of the depository are supported by physical scrips held in the depository vaults as well as in the hands of the public. The scrips do not cease to physically exist. Every scrip will only find its way to the depository vaults wherein a regular inventory will be taken. Thus, a depository maintains an electronic record of ownership of shares. A depository will interface with the investors through market intermediaries called depository participants. Market participants such as public financial institutions, scheduled banks, foreign banks in India, state financial corporations, certified custodians of securities, clearing corporations of stock exchanges, registered stock brokers and non-banking financial companies (NBFC) are eligible to become depository participants and the registrars [2]. Through this innovative legislation, many practical major problems of the Indian securities markets, like problems of theft, fake and / or forged shares, share transfer delays, cost of handling, storage and transportation of share certificates will most likely be overcome. Depository also eliminates bad deliveries problem and thus helps to restrict reckless speculation. Besides this, trading in the dematerialised segment does not attract stamp duty on transfer of shares.

The Indian capital market took a major step in its rapid modernisation when the National Securities Depository Limited (NSDL) was set up as the first depository in India. The NSDL, which commenced its operations in November 1996, has been promoted jointly by the IDBI, the UTI and the NSE. Subsequently, the SBI also became a shareholder by taking 4.76% stake in the NSDL. The NSDL interacts with investors and clearing members through the market intermediaries or depository participants. As on June 08,1998, 57 participants offering

depostiroy services at more than 333 different locations were operational. Trading in dematerialised securities commenced on December 26, 1996 in the NSE. As on June 08,1998,916 out of 1010 active member brokers of the NSE had opened accounts with the NSDL. The total volume transacted in the demat segment during the year, 1997-98 was nearly Rs. 350 crore [3]. The growth in the monthly trading volumes in the dematerialised segment is given in Table II. This clearly shows the increasing popularity of this arrangement. Besides depository participants, other business partners of the NSDL are issuing companies/ their share transfer agents, clearing corporations / houses and clearing members.

The SEBI has initiated a number of changes to promote dematerialised trading. In November 1997, the SEBI specified that w.e.f. January 15,1998, institutional investors having a minimum portfolio of securities of Rs. 10 crore as on the latest balance sheet date will be bound to trade under dematerialised system. In the budget speech of 1999, the Finance Minister had proposed to abolish stamp duty on transfer of debt instruments with in the depository mode, with a view to modernise the debt market and introduce paperless trading in this segment[4].

B. Screen – Based Trading

Till recent times, the physical organisation of stock markets in India experienced "open outcry", which consisted of a pit in which traders shouted and hand- signalled in the process of trading. There are two major alternatives to open outcry through which a market can be organised: using "market makers", or using computer – based order-matching[5]. The latter is called the "open electronic limit order book (ELOB) market". Upto 1994- end, India's market was dominated by the Bombay Stock Exchange (BSE), a monopoly market that did trading by open outcry. But from the middle of 1995 India's market has been dominated by competition between the BSE and the NSE, where both markets have open electronic limit order book markets. The number of shares listed in the BSE has been more than three times of that in the NSE.

Only one attempt has been made in India to build a market using market makers (OTCEI), and it has not been very successful. With market makers, the liquidity of the market is limited by the ability of the

market maker to hold inventory of the security, and the information set of the market maker(s)[6]. One major policy introduced by the SEBI from 1993 onwards, the concerned migration of all exchanges to "screen based trading", motivated primarily by the consideration of transparency. The NSE started first this type of trading in debt instruments in June 1994 and equity in November 1994. In March 1995, the BSE also shifted to ELOB system. This new system has done away with the need for people to gather on the floor of an exchange for trading and has instead made available the exchange floor at the investor's doorstep. The NSE trading software was originally developed by TCAM System, Inc., New York for the Vancouver Stock Exchange[7]. India's CMC (Computer Maintenance Corporation) has developed a Unix-based software system named VECTOR which implements an open ELOB and it has been adopted by eight other markets of the country[8]. This is actually a facility of trading to with automated order matching. The mechanism has an anonymous order driven system, which helps orders, whether large or small, to be placed without any disclosure of idetity and which operates on a strict price – time priority. The system also provides tremendous flexibility to the users in terms of the kinds of orders that can be placed on the system relating to various conditions of time, price and volume. The system also provides complete market information on-line through various inquiry facilities. The best buy order always gets priority for matching against the best sell order. Where an order does not find a suitable match, it remains in the system and is displayed to the whole market until a fresh order comes to match it. Upto September, 1998, there were over 3,000 terminals of NSE using 1789 Very Small Aperture Terminals (VSATS) spread in 220 cities in the country[9].

C. Nationwide Integrated Market

India's stock markets were dominated for a long time by the BSE and this continued upto 1994. Trading orders from outside Bombay would generally involve additional intermediaries as such orders need to be transmitted to a broker there who would carry them to the trading floor. Markets outside Bombay had prices which were found to be significantly different sometimes from prices in Bombay. With the establishment of satellite communications by the NSE, all trading members of the NSE have got equal access to the market, regardless

of their location. The BSE and the Delhi Stock Exchange (DSE) are both in the process of expansion of trading terminals all over the country. This resulted in three major markets, the NSE, the BSE and the DSE, into electronic markets with arbitraged binding prices on all three markets together. Thus the entry of the NSE has not only led to a large increase in the supply of brokerage services but also succeeded to some extent in restricting trading at different prices at different locations, reducing market inefficiency and also succeeded in increasing overall market liquidity. The gradual expansion of modern telecommunication facilities has helped the markets to link up all over the country and thus created the opportunity to develop a nationwide integrated market with the leadership provided by the NSE and the BSE.

D. Change In Trading Methods – from Traditional to Futures:

Securities are traded in three different ways in stock exchanges of India : on spot basis, on cash basis and on settlement basis. Only a few selected frequently traded ordinary shares are eligible for being traded on the settlement (or, badla) basis. All the securities however, may be traded on spot or cash basis. Settlement or badla system of trading, of course, had been suspended by the SEBI for a few months. Again, the SEBI finally agreed to introduce a revised carry-forward or settlement system, the much awaited announcement of which was made by it after a crucial meeting in Bombay on 27th July 1995 to decide on the G.S. Patel Committee Report. As per newspaper reporting, the NSE was supposed to start index-based futures in December 1996, subject to amendments in the Securities and Contracts Act by the Government. The NSE was also supposed to be ready with the software to start futures trading in the NSE-50 index by December 1996, The SEBI has already approved " in principle" the proposal to start futures trading in indices. Dr. R.H. Patil, the NSE Managing Director said once, "if the index-based future could be started, the exchange would introduce other derivatives like index options and futures and options in securities within six months"[10]. The NSE is actually still awaiting the amendments to the Securities and Contract (Regulation) Act (SCRA) of 1956 in this regard. Of course, the Calcutta Stock Exchange (CSE) is going to set up the country's first derivatives stock exchange in association with 19 other regional stock exchanges of the country, with headquarters in Calcutta[11]. There is no formal options market in India. However, there

has been a fairly active options market in the unorgainised sector in the stock exchanges, which speculators have access to. Incidentally, it can be seen that both convertible debentures as well as share warrants have a lot in common with call options. Options on stocks were first traded on the Chicago Board Options Exchange in 1973. Since, then there has been a dramatic growth in options markets. Options are now traded on exchanges through out the world on stock, stock indices, foreign currencies, debt instruments, commodities and future contracts. Thus, it can be said that Indian stock markets are also going to follow the world trend by introducing options trading very shortly as intended by the Government authorities and stock exchange officials, and most importantly, the market participants from time to time.

E. Foreign Investment in Indian Stock Market :

From late 1993 onwards, Indian markets have been flooded by foreign portfolio managers. Over the next three years, roughly $ 11 billion, or Rs. 40,000 crore of Indian securities have been purchased by foreign institutional investors (FIIs). There has been a considerable inflow of capital into the country and constituted roughly 7% of the market capitalisation in the country[12]. Foreign portfolio investment (FPI) may be of four types: investment in Global Depository Receipts (GDRs). [which are basically US dollar-denominated negotiable instruments traded in Europe or the US or both and which are issued by a depository in exchange of rupee-denominated shares in the name of the depository by any Indian company, which can issue such shares after getting approval from the Ministry of Finance and completing other formalities, whereas under instruction from the depository, the custodian bank normally issues share certificates to the GDR-Holders, who purchase the GDRs against payment in US Dollars], investment in Foreign Currency Convertible Bonds (FCCBs) [which are subscribed by a non-resident in foreign currency and convertible into ordinary shares of the issuing company in any manner], FII investments in equity and FII investments in debt instruments (all in the secondary market). Around 60 Indian companies have done issues of either GDRs or FCCBs on what is known as "the euro market"[13]. Besides this, there is also foreign direct investment (FDI) in the primary sector of the capital market in form of contribution in equity of a new Indian company. Investement norms for NRIs have been liberalised and NRIs and overseas corporate

bodies can buy shares and debentures now in Indian market. The increasing trend of FDI in India is due to the existence of higher returns in Indian stocks in comparison to foreign stocks. As a supporting fact of this statement, it can be mentioned that the long-run average rate of return on the Standard & Poor's 500 Index (a market index which reflects the US stock market) is around 0.93% per month whereas the corresponding measure of Indian Market is around 1.6% per month, which also adequately covers the rupee depreciation factor[14]. Total FII net investment for 1993 has been Rs. 25,951 million, which increased to Rs. 67,912 million for 1994 and then reduced for the year 1995 to Rs. 38,537 million and again dramatically rose to Rs. 1,08,035 million in 1996. The figure is Rs. 66,778 million upto October in the year 1997[15]. These figures easily prove the increasing tendency of FII investment in our country.

F. Credit Rating – Introduction in India :

In line with the tradition of developed countries, India also had the introduction of independent credit-rating agencies from the year 1987, when the first rating agency, CRISIL (Credit Rating Information Services of India Ltd.) was promoted by the ICICI. Subsequently, ICRA(Investment Information and Credit Rating Agency of India Ltd.) was promoted by the IFCI in 1991 and CARE (Credit Analysis and Research Ltd.) was jointly promoted by the IDBI, Canara Bank, UTI etc. in 1993. Credit rating has been made mandatory in India for the issuance of debentures and bonds with conversion or redemption period exceeding 18 months, commercial paper, fixed deposit programs of all NBFCs with net owned funds above Rs. 200 lakh and financial instruments in capital market (in which investment will be made from 10% of the annual accretion in the Provident Fund requiring rating from two credit – rating agencies)[16]. Moreover the USA credit rating agency, Standard & Poor's Financial Information Services (S & P), the NSE and the CRISIL have formed a joint venture for launching equity index business in India.

G. Innovation in Financial Instruments :

From the traditional financial instruments like equity shares, preference shares, debentures, bonds, mutual fund units, etc. there has been a growing tendency among the corporate bodies to go for

more innovative financial instruments. These later instruments include Secured Premium Notes with Detachable Warrants, Non-Convertible Debentures, Optional Fully Convertible Debentures with Interest, Partly Convertible Debentures, Fully Convertible Cumulative Preference Shares (Equipref.), Preference Shares with Warrants attached, Secured Zero Interest Partly Convertible Debentures with detachable and separately tradeable warrants, Equity Shares with detachable warrants, Global Depository Receipts, Foreign Currency Convertible Bonds, etc.[17] This trend is also in consonance with that of the developed countries of the world. Convertibles are not less than 15% of the total issues in value in our country in any of the years from 1990 to the current year. Rather it has been nearly 40% of the total issues in value in the year 1990[18]. GDR and FCCB issues are also on the rise. The most important thing lies in the growing diversity of financial instruments. As the securities markets deal with various types of securities this diversity paves the way of qualitative expansion of our capital market.

From the above important features of Indian capital market, which has been emerging mainly during the post 1990 period of liberalisation and globalisation of the economy and corresponding reforms in the Indian capital market. It can rightly be said that due to some significant structural as well as operational reforms, the Indian stock market is slowly but steadily going to become a global stock market in future.

Table I

Performance of Indian Stock Market

Indicators \ Year	1990	1991	1992	1993	1994	1995	1996	1997
Trading Value (Rs. Crore)	38,209	62,681	57,272	67,515	85,414	72,440	3,39,844	57,6483
Market –Capitalisation/GDP	23%	19%	27%	38%	42%	39%	34%	33%
Trading Value/GDP	7%	10%	8%	9%	9%	6%	27%	40%
Trading Value / Market Capitalisation	32%	51%	31%	22%	21%	16%	77%	122%

Source: "Indian Securities Market – A Review", NSEIL, Mumbai, October 1998.

(Originally adapted from "Emerging Stock Market Factbook, 1997," International Finance Corporation).

Table II

Monthly Demat Turnover			
Period	Quantity	Value (Rs. Lakhs)	Trades
April 1997	76,810	2,24.07	373
May 1997	27,938	53.51	308
June 1997	1,29,823	2,53.15	837
July 1997	53,956	1,16.35	410
August 1997	1,13,259	3,67.23	366
September 1997	90,240	2,33.45	493
October 1997	2,26,057	5,69.05	1262
November 1997	7,70,777	4,13.44	597
December 1997	1,19,102	1,85.44	520
January 1998	20,05,093	29,20.64	1394
February 1998	69,41,344	75,21.07	2931
March 1998	209,52,476	22,171.92	8032
April 1998	188,73,170	17,977.00	6148
May 1998	119,62,461	98,37.00	4544
June 1998	103,51,010	14,044.00	6285

Source: "Indian Securities Market – A Review", NSEIL, Mumbai, October 1998.

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Indian Capital Market and Investor Protection

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I

Well- developed and efficient capital market is one of the vital components of basic infrastucture needed for rapid economic development. For its functioning helps directly the process of mobilisation of savings through its key aspects like size transformation, maturity irrelevance and risk-management and channelizes the savings into better productive investment opportunities in the real sector through providing correct signals via efficient security pricing to the market participants[1].

Such a market is characterized mainaly by (i) the availability of complete, consistent, comparable, quick and reliable information equally to all market participants, (ii) the existence of a reasonable level playing field for market participants for fair competition, and (iii) the prudent regulatory mechanism to ensure observance of rules of fair competition; all eventually leading to begetting confidence among market participants, the exclusive and proximate requirement for sound and healthy capital market. The presence of harmonious relationship among market participants and the absence of unfair and manipulative practices, all ensuring protection of investors' interest in the primary and secondary sectors of the market are the other consequent features of such a capital market.

II

Like capital markets of several countries of the world, Indian capital market also grew with the emergence and growth of corporate and business sector in the country; but it remained, by and large, inactive and undeveloped. Of late, particularly during 1980s and onwards, it has witnessed several structularl changes which have brought the market at several crossroads and one such among them may lead to

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more active and efficient capital market in the country. Highlights of the major characteristics of the market are given below:

(1) Indian capital market is a fast, emerging market in Asia. The amount of its market capitalisation increased from $ 13.5 billion in 1986 to $ 183 billion in 1995. It ranked in Asia next to Japan ($ 8.4 trillion), HongKong (3.01 trillion), Malaysia $ 2.23 triltlion and Taiwan ($ 1.87 trillion). The proportion of market capitalisation to the country's GNP increased from 5% in 1980-81 to 40% in 1992-93.

The mobilisation of funds from primary segment increased tremendously from an average of Rs.90 crore[2] in 1970s to staggering figure of Rs.31,014 crore in 1994-95[3]. The funds are being mobilised through common methods, like public issues through prospectus offer for sale, private placement and right issue for both types of instruments, viz., shares and debentures.

(2) Organised trading through stock exchanges is fast growing. The number of stock exchanges which were just nine in1981 have increased to 22 (inculding the Over The Counter Exchange of India OTCEI) in 1992 and to 23 (including the National Stock Exchange NSE) in 1994. Listing of securities at the OTCEI and the NSE is done at national level while at other stock exchanges, it is at regional level only. The OTCEI provides platform for small and medium companies to raise money. The number of listed companies and their paid up capital increased from 2265 and Rs.3972 crores respectively on 1-1-1882 to 8000 and Rs. 24,500 crore respcrtively on 1-1-1994. In terms of the number of listed companies Indian capital market stood second in the world. Moreover, the daily turnover of the exchanges, which was Rs.30 crore in 1981 increased tremendously to Rs.800 crore in 1993-94. As such, the secondary segment of the market is also fast rising.

(3) Indian capital market now has an organised regulatory framework, wherein the Securities and Exchange Board of India(SEBI) has emerged as a prime regulatory body. The broader regulatory framework consists of (i) the Ministry of Finance, Government of India for implementing the Indian companies Act, 1956, the Control of Capital issues Act, 1947 (repeated in1993), and the Securities Contracts (Regulation) Act,1956 (ii) the RBI, and (iii) the SEBI.

Though the SEBI was initially set up in 1988 as a non-statutory

body to protect the interest of investors and to promote the development of healthy capital market, it was assigned the role of regulatory authority in1992, under the SEBI Act, 1992. Consequently most of the Government powers have been delegated to the SEBI.

Now, the SEBI is to promote Indian capital market by ensuring fairness, efficiency, confidence and flexibility therin and to regulate all pertinent matters to the market. For this, the SEBI is authorised (i) to register and regulate the working of stock brokers, sub-brokers, share transfer agents, bankers to issues, trustees, registrars of issues, under-writers, merchant bankers, portfolio managers, investment advisors other intermediaries including mutual funds who may be associated with securities markets in any manner, and (ii) to prohibit fraudulent practices relating to securities markets and insider trading in securities and substantial acquisition of shares and takeover of companies.

Consequently the SEBI has come out with several guidelines and regulatory measuers, particularly after the abolition of the Office of the Controller of Capital Issues in 1993. The regulatory measures are mainly related to management of stock exchanges, issuance and transfer of securities by companies, functioning of mutual funds and other market participants and entry of FIIs. All these efforts are intended to ensure the establishment of a fair, transparent and efficient capital market.

(4) Equity culture is growing and the market is being globalised. The number of shareholders increased tremendously from 6 million on 1-1-1986 to over 40 million on 1-1-92. Further more the share of securities (shares and debentures including mutual fund investment) to total financial household savings in the country has increased from 3.7% in 1980-81 to 16.3% in 1993-94. With the setting up of mutual funds, both in the public and the private sector, and the permission given to Indian corporate sector to raise funds from foreign market have not only changed the composition of investors of Indian capital market but has also widened its scope to global level. Hence, besides the individual shareholders / investors, the domestic and foreign institutional investors as also foreign private investors (NRIs & OCBs) through GDR and FCCB routes have also joined the investor population of Indian capital market.

(5) Macro level capital market information is now being made

available by way of several indices and quotations. Important among such indices are BSE sensex, BSE National Index, NSE index, CRISIL Index, CMIE Index, DOLLEX, RBI Index, Indices of the Economic Times and the Financial Express, GDR Indices (DSP GDR Valuation Index, 22 Basket SK India GDR Index). Credit Capital's Debt Index and I.Sec's Debt index. Brief details of these indices are given in Table I.

Table I

Important Capital Market Indices in India

Particulars	BSE Sensex	CRISIL Index @@	CMIE Index	BSE Natex	BSE Index	NSE Index @@
i) Base year	1978-79	1994	Nil	1983-84	1984-85	1995
II) Number of companies	30	500	3000@	100	200	50
III) Industries covered	20	97	**	24	NA	20
IV) Basis of calculation	v.w	v.w	v.w&u	v.w	v.w	v.w
V) Volatility	High	Less	Less	Moderate	Moderate	High
VI) Sub-indices Potential	Nil	Yes	Yes	Nil	Yes	Nil
VII) Market capitalisation Represented (%)	33	73	80	40	60	35
VIII) Exchange Represented	BSE	BSE	BSE	4*	BSE	BSE

Note on Symbols :

* Mumbai,Madras, Calcutta and Ahmedabad

@ Approximated

**12 Groups, 40 sub- groups and 52 divisions

V.W. (Value weighted)

V.W.&U (Value weighted and unweighted,)

@ @ New names: S&P, CNX 500 and S& P, CNX nifty & CNX, midcap 200

These indices provide an indication of comparative market movement and help investors in taking up intelligent decisions.

(6) Credit rating agencies have emerged in the market to evaluate and specify the level of risk associated with some specific type of securities. Credit rating gives an indication of safety of principal and ability of the issuer to service it. In a way, it is an information and not an endorsement for investment.

Credit- rating came of age in India in 1991 when the SEBI guidelines made rating of debt instruments mandatory. Three credit rating agencies viz, Credit Rating & Information Services of India Ltd. (CRISIL) promoted by the ICICI in 1988, Investments Information Credit Rating agency (ICRA)promoted by the IFCI in 1990 and Credit Analysis and Research Ltd. (CARE) promoted by the IDBI in 1993, were set up in the country. The CRISIL and the ICRA make distinction between long term and medium term debts, while the CARE clubs them together. Debt instruments of long term and short term maturity are being rated by them.

(7) Newer practices like free pricing of issues, book building and market making are fast emerging in the market. Free- pricing is based on the concept of charging a price that the market can bear.

The latest SEBI guidelines in this connection are as follows.

	Class of Companies	Pricing Pattern
a)	New companies promoted by persons without a track record	Only at par.
b)	New companies set up by existing companies with a five year track record of consistent profitability	Free pricing
c)	Existing private / closely held companies without a three year track record of consistent profitability	Only at par
d)	Companies mentioned under (c) with a three year track record of consistent profitability	Free pricing
e)	Existing public limited companies making further issues	Free pricing

Book- building process is a further step to price the securities in accordance with what the public is willing to pay. In this process, the lead manager for the issue works as a book-runner who, through the

lead manager for the issue works as a book-runner who, through the members of the syndicate created for the purpose, receives the demands from the members together with the prices, they are willing to pay. Keeping in view all such offerings, the ultimate price is fixed by the issuing company in consulation with the book- runner and allotments are made at the price so determined. Recently Nirma Industries has used this method for its issue of Rs.350 crore in the country.

In order to facilitate trading in the scripts of less popular and small sized companies, the market- making activity was encouraged, for it ensures liquidity of listed instruments due to the availability of buy and sell quotations of the instruments by the market- makers. Canbank Financial Services and Credit Capital Finance Corporation were the two initial market-makers at the OTCEI. Now, Citicorp, Birla Global Finance, Infrastructure Leasing and Financial Services have also become active market-makers in the country.

(8) Financial engineering in the shape of innovative capital- market instruments is becoming the order of the day in primary capital market. As such, besides the traditional instruments like ordinary and preference shares and debentures, innovative instruments like FCD/ PCD/ NCD, ZCB, DDB, Ex- interest bonds, Yankee bonds, Euro- bonds, etc, with put and call options suiting to the need of several types of corporate and non- corporate investors with different risk attributes, are being floated in the capital market. Some of the instruments offered tax benefits u /s 10 (23G), 54 EA, 54 EB and 88 of the Income Tax Act. In a way, this type of wider basket of capital market instruments has made the task of risk management much easier for the investors.

(9) Stock exchanges are being equipped with speedy and better infra- structural facilities due to ultra- sophisticated technology. The OTCEI and the NSE started screen-based trading on November 4, 1994 while the BSE introduced on-line screen based Trading System (BOLT) on March 14, 1995, to provide transparent trading facility and improved investor service to the participants. The NSE has also marched ahead in providing investor protection against defaults and clearing house facilities to its brokers across the country. Other stock exchanges in the country are moving towards establishing screen- based trading system as a time bound programme; and now 15 regional stock exchanges have joined the inter-connectivity of stock- exchanges.

(10) The inevitable character of Badla system, i.e. "Teji Mundi" dealings or 'carry forward system' has been a unique feature of Indian capital market. It was banned in December 1992 with the intention of introducing trading in options and futures as and when found convenient. But recently the Parliamentary Committee of Finance did not favour the introduction of option trading. Instead, it recommended the reintroduction of revised Badla (carry forward system) by stock exchanges with SEBI's permission. The new Badla trading finally took off in November,1997 when the SEBI accepted some of the recommendations of the J.R. Verma Committee including the one regarding increase in overall carry forward limit to Rs. 20 crore per stock broker and reduction in daily margin to 10%

(11) Efforts are being made to make the market more efficient and ensure the adoption of investor- friendly trading practices. In order to get better insight and to devise proper guidelines, the SEBI has appointed several committees, like the G.S. Patel Committee to review the carry forward system, the B.D. Shah Committee on short-selling and the L.C. Gupta Committee on options trading.

Use of 'stock-invest' and 'lock in period', provisions was started with some reservations. Free pricing of shares was started with a view to price the equity offerings to public more realistically, according to what market can bear. Thus, the cumbersome procedure of approaching the earstwhile CCI for every small thing was removed, Now, only the SEBI scrutinises and approves issues. If the SEBI is not satisfied with pricing and justification of premium, it does not interfere; instead, it insists that investors should be made aware of this fact, so that they may take their own decisions. In fact, merchant bankers who act as issue managers are expected to take the responsibility of prices so fixed. The investors are again expected to judge the professional competency and honesty of marchant bankers to rely on prices. Thus, this system assumes the existence of intelligent and well informed investors in the market.

(12) Scripless trading, which enables quick transfer of securities through book- entry has been introduced. For this, National Clearing and Settlement System at New Bombay has been set up. Similarly, Central Depository, viz., National Securities Depository Ltd, was set up and it has already strated providing services to the Unit Trust of India

Life Insurence Corporation ((LIC) the General Insurance Corporation (GIC) and few others. The system is further expected to ensure efficient and stricter control over the operations. Now the SEBI has made paper less trading compulsory for certain investors and has increased the number of scrips for compulsory dematerialised trading by institutional investors from 30 to 50, w.e.f. August 10, 1998.

(13) The market is passing through an experimentation stage. For example, the proportional system of allotment was introduced. But it functioned grossly in favour of big players of the market and to the disadvantage of small and retail investors. It was stopped in October 1993 and a provision was made that a minimum of 50 % of the net offer to public out of the public issue amount would be allotted to individual investors applying for shares not exceeding 1,000 in each case. Recently, the Parliamentary Standing Committee on Finance[7] has recommended that small investors should be given firm allotments up to 200 shares.

(14) Active efforts (The Companies Amendment Ordinance 1998) are on to allow companies the facility of buy back of shares. This may bring benefits like returning surplus funds, increasing value of shares, supporting share prices during period of temporary weakness, achieving or maintaining target capital structure, preventing unwelcome take over bids and blocking hostile takeovers of companies and also benefit investors.

(15) The Reserve Bank of India (RBI) is also becoming more active to check certain malpractices. For instance, after the CRB capital market episode and consequent suffering to investors and other market participants, the RBI now requires compulsory registration of non banking financial companies (NBFCs) and has started regulating their quantum of deposits, interest rates, liquidity of deposits, etc. New NBFCs are not allowed to accept public deposits for initial two years. Acceptance of deposits thereafter can be possible with the RBI permission and that too on the basis of their track record.

Furthermore the commercial banks have been allowed to invest in preference shares, debentures and bonds, in capital market and as such they invest in these instruments heavily, mainly through private placements.

(16) On the recommendation of the L.C Gupta Committee, the SEBI had approved on 11th May 1998 in a phased manner the

derivatives trading, beginning with stock Index futures. For this corporates, FIs, FIIs and mutual funds are allowed to trade with certain restricting conditions.

(17) Greater awareness of the welfare of investors by stock exchanges is being witnessed now. For example the BSE had set up a "Stock Exchange Customers Protection Fund" in 1986.

On the basis of the aforementioned highlights it would not be too much of an exaggeration if one remarks that all such changes in the Indian capital market have taken it to several heights and this may lead to healthier and more efficient capital market, crossing the national boundaries to enter and function at global level too.

III

But like capital markets the world over the Indian capital market also suffered from several defects and malpractices detrimental to the interest of investors, which in turn resulted into shattering of investors, confidence in the market. Prominent defects and malpractices are not far to seek.

(1) Though the number of listed companies on stock exchanges has increased tremendously,yet trading in large number of securities is not done frequently. According to a recent report appearing in the Economic Times, trading of listed shares on the BSE was as given in Table-2.

Table-2

Trading of listed shares	No of companies
Daily	207
Weekly	538
Fortnightly	396
Monthly	954
Yearly	959

Besides the shares of the remaining about 2000 listed companies were rarely being traded. As such annual trading in relation to market capitalization is low and investors face the problem of illiquidity of their securities.

(2) "Short- sale" and "long purchase" are normal practices of

speculators. According to the B.D. Shah Committee, a short- sale is defined as "the selling of the shares without having the physical possession of the shares, unless it is either for squaring up of an earlier purchase in the same settlement of the same stock exchange, or against the pending deliveries from the same stock exchange pertaining to previous settlements." Similarly a long -purchase is defined as " the purchase of shares with the intention of not taking the deliveries and squaring off the transaction".

Though these are inevitable practices in capital market, for these practices facilitate liquidity and competitive prices in stock market, yet their excessive use particularly in volatile securities provide a mechanism for bear- hammering and bear-raids bringing further deeper depression in bear-phase in case of short- sale; and produce over heat in the bull phase to produce excessively higher unrealistic expectations in the bull- phase, in the case of long- purchases. Thus these practices give wrong signals to the market and innocent and vulnerable investors may be misled and eventually may suffer huge amount of loss.

(3) Insider- trading means trading in securities done by insiders on the basis of unpublished price sensitive information which is not availabe to other investors. According to the SEBI regulations " An insider, means any person who is or was connected with the company or is deemed to have been connected with the company, who is reasonably expected to have access,by virtue of such connection, to unpublished price sensitive information in respect of securities of the company, or who has received or has had access to such unpublished price sensitive information." The connected person is defined "as a director or an officer or an employee of the company or one who holds a position involving a professional or business relationship between himself and the company and who may reasonably be expected to have an access to such information."

The practice of insider- trading helps insiders to earn excessive profit or to reduce loss at the cost of other investors. Some reported examples of insider- trading are: (I) Purchase of 8 Lakh shares of Brooke Bond Lipton India Ltd. from the UTI at Rs.360 per share against the prevailing price of Rs. 320 per share just two weeks before the merger of BBLIL with Hindustan Lever Ltd. in April 1996 (Merger ratio 9 HLL shares for 20 BBLIL shares). On the eve of merger the share price of

shot up from Rs. 7,550 to Rs. 36,000 in three months just because of the plan of 5:1 bonus issue. (iii) In 1994 the share price of Boots India rose from Rs. 400 to Rs. 850 in a single trading session in February 1994. Next day the company announced the foreign parents intention to raise its stake to 51%, bonus issue 1:1 and rights at a premium of Rs.15 only.

(4) Kerb- trading is one which takes place outside the precincts of stock exchanges beyond office hours of trading. It is done by and large on the basis of rumours, gossips and false or distorted information. Such transactions are generally reported or recommended by members of stock exchanges as the opening price quotations of the scrips next day and are normally accepted by the authorities of stock exchanges. But this practice causes wide fluctuations in security prices, for they are not based on real situations. This encourages excessive speculative practices and is detrimental to the interest of genuine investors.

(5) Grey capital market is an offical capital market where investors who apply for the shares of a company in a public issue sell their shares through forward trading mechanism, even before they are actually allotted to them. Such an activity is carried on after the close of recognised stock exchanges. Gambling instinct of market operators and stock brokers is behind such types of activities and as such, these activities give wrong signals to operators and players of stock exchanges and eventually result into loss to small and innocent investors. For example in 1993, one share of Morgan Stanley was traded at a premium of Rs. 110 in the grey market, but it was listed below par.

(6) The free pricing of securities allowed by the government and the SEBI without understanding the ground realities by issues proved detrimental to the interest of investors for the issues as the fixed prices of their securities with unreasonably high premiums could not be sustained when such issues were listed at stock exchanges.The investors as such suffered huge loss in terms of total market value of issue in comparision to what the investor paid for it. An illustrative example[8] stating pertinent aspects in some cases is given in Table-3.

Table-3

High Premium Mega Issues and Losses (Between October 1994 and September 1995)

Name of company	Premium Per Share (Rs.)	Present Price (Rs.)	Total Loss as Compared to Total Subscription price paid (Rs. crore)
i) IDBI	120	92.5	684.1
ii) Reliance Capital Ltd.	130	65.0	321.4
iii) Hindustan Petroleum	330	279.0	82.6
iv) Mc Cleod Russel	180	136.3	76.5
v) VLS Finance	390	180.0	80.7
vi) Punjab Communication Ltd.	240	101.0	63.3
vii) Sipla Ltd.	660	297.5	55.6
viii) Jindal Photo Films Ltd.	185	114.0	41.0
ix) Essol Packaging Ltd.	215	158.0	25.9
x) Jindal Drugs ltd.	465	107.0	55.5

The practice of free pricing coupled with the practice of misusing the availability of bank finance through buy- back arrangement have also helped the unscrupulous to do price- rigging so as to enable them to (i) make public issue at un- reasonably high premiums, (ii) create artificial demand to ensure success of the issue,(iii) mobilise no- cost funds, and(iv) maximize earnings to promoters; all to dupe innocent investors.

(7) Functional duality among brokers and jobbers has provided an inbuilt latitude to deceive customers by the unscrupulous and less upright behaviour in terms of less transparent deals and their consequent likely adverse implications. This practice enables them to flourish at the cost of innocent investors.

(8) Though credit- rating agencies rated several issues, it could not protect

the interest of investors. There are several reasons for this state of affairs, like rating done at the initiative of issuers, no compulsion for publication of details, inconsistent rating by different rating agencies, not updating and revision of earlier rating. Consequently, innocent investors are not able to make out the reality and get intangled ultimately to suffer loss.

(9) The mandatory listing of close-ended schemes of mutual funds, particularly under the depressed market conditions, has proved harmful, for they showed dismal performance. Of the 50 closed-ended schemes of mutual funds listed and quoted on 30 th September 1995, 23 were traded at discount to NAV ranging from 5% to 35%, 18 below the issue price quoted at Rs.5 or Rs. 6. As a result, investors' confidence in such type of schemes has been shattered.

(10) The prevalence of bad deliveries, due to difference in signatures and duplicate share certificates put the investors into disadvantageous position, due to funds remaining un- necessarily blocked for long period. About 20% of the deliveries are bad in the BSE Further, delayed settlements and transfers also result into losses. The fiasco of M.S. Shoes with regard to delayed settlement had resulted into short payment of about Rs. 18 crore by a BSE broker.

(11) The practices of proportional and preferential allotment and private placement have deprived small investors of access to blue- chip issues and benefits attached to them.

IV

The questionable and unfair practices used by issuing companies and capital market intermediaries like brokers and jobbers, mutual funds, NBFCs and speculators give a wrong signal to the capital market and thereby mislead genuine investors, create different types of problems and ultimately affect adversely their interest. In other words, interest of genuine investors is at a stake and the investors start feeling unsafe, become hesitant to continue in the market and ultimately suffer huge amount of loss, eventually leading to shattering of confidence in the market. In a way, investor -protection which includes not only the protection against loss arising out of frauds by market participants but also against all unfair and undesirable practices in a broader sense becomes conspicuous by its absence.

It is a paradox that while the Indian capital market has undergone several structural changes leading to more efficient and healthier growth and yet investors interest is not fully protected. In the situation, one has to find appropriate answers to pertinent questions like:

i) Is investor protection fully feasible?

ii) Is the interest of all investors being adversely affected equally?

iii) Is investor protection a responsibility of investor themselves or of the government?

iv) Can investor protection be fully ensured by the government?

v) What type of role is the government expected to play for investor-protection?

A deeper and objective analysis of the practices like insider- trading, speculative and grey capital market activities and kerb trading shows that these practices are inevitable and partly uncontrollable in capital markets the world over[10]. As such, the evil effects of these practices cannot be completely eliminated, though adequate regulatory framework and its proper monitoring can put effective check on these to some extent.

Adverse consequences of proportional and preferential allotment, private placement, free pricing and mandatory listing of closed ended schems of mutual funds can be largely reduced by revising guidelines and framing rules on the basis of ground realities. Similarly, the evil of bad delivery, delayed transfer and refund etc., can be reduced largely by improving infrastructural facilities in the capital market. But, availability of better and detailed disclosure as a part of better infra-structure can-not guarantee investor protection, for these things cannot supplant fully intelligent investment decisions by investors. Thus, despite the existence of more efficient and healthy capital market conditions, there always remains the possibility of lack of investor protection.

Moreover, no amount of regulatory framework can protect investors fully against questionable and unfair practices used by unscrupulous market participants, unless the investors themselves are capable of protecting their own interest. The problem of investor protection had become more prominent during 1990s when every ordinary person, irrespective of his possessing skill and expertise of dealing in capital market, jumped into it just to turn his fate to become rich overnight. In fact, it was this group of investors who suffered most and contributed to further deterioration of the market situation. The intelligent individuals and institutional investors could protect their interest more effectively than their small and ignorant counterparts.

Considering these facts, it becomes obvious that investors' interest cannot be fully protected due to lack of effective regulatory framework and overall public integrity. Moreover, all the investors are not adversely affected equally.

While the prime responsibility of investor protection lies on investors themselves, for the principle of *caveat emptor* cannot be ignored altogether, but this does not imply that there should be no efforts towards the protection of investors interest by the government. In fact, the infrastructural facilities should be developed and effective regulatory framework should be evolved by government to create such an environment which may discourage unscruplous market participants to indulge in fraud etc., and at the same time encourage and ensure smooth and efficient functioning of the market.

V

To conclude it may be observed that Indian capital market has been undergoing several structural changes particularly during 1990s, all leading the market to more efficient and healthier capital market. The changes have been mainly directed towards improving infra-structural facilities and evolving more comprehensive and realistic regulatory framework, aware of investor protection. But the process is still on and hence there is along way to go for investor protection, particularly when large number of ignorant and incapable investors and unscruplous market participants exist.Since the inevitable principle of *caveat emptor* cannot be ignored, no investor protection is possible exclusively by government and other regulatory bodies as a third party.

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Buy Back of Securities : Vexed Taxation Issues

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Introduction

Buyback of shares and securities is related to buying of shares of a company by itself i.e. "buying of own shares". Buyback in the normal terms, is a method of cancellation of its share capital. It leads to reduction in the share capital of a company.

It was in 1877 that the House of Lords in England, Trevor vs. Whitworth had laid down that a company should not purchase its own shares. The reason for the restriction was that such a purchase would result in un-healthy practice of influencing either the market price of its shares or to reducing its share capital without complying with the procedure laid down by the law for the purpose.

On the same ground a provision was included under section 77 of the Companies Act, 1956 which imposed a blanket ban on companies buying their own shares, whether private or public.

Buy back of shares and securities was popular in countries like the USA and the UK. However, with the passage of time various rules that governed the buyback of shares were gradually diluted in many developed countries. However, the British Companies Act, 1985 still debars the companies from purchasing their own shares as it amounts to reduction of capital. Over the years, the situation has changed and the companies now have to work in an entirely new economic environment. Around the globe, companies are facing adapted challenges due to the changes in society, market volatility, customer

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behaviour,competition and technological advancement. There has been a major shift in the approach.

In India the concept of "Buyback of Shares " has been discussed during the last few years. The corporate sector in india was demanding necessary changes to be incorporated in the Act. Thus, in the matter of buyback of shares, Indian corporate was suffering one degree less freedom than its counter parts in the west. In many developed capital markets of the western countries, the law permitted buyback of shares, whereas in India anybody could buy the shares but not the company that issued those shares.

The Central Government had promulgated an ordinance to amend further the Companies Act 1956 on 31st October, 1998 (the Companies Ordinance,1998 No.19 of 1998). Provision have been iniserted under section 77 of the Companies Act, from the date buyback of shares was implemented in the country.

Buyback of Shares by Companies (Amendment) Ordinance, 1998 :

After section 77 of the Companies Act, two sub- sections 77A and 77B were inserted which empowered the companies to purchase their own shares, Such a purchase is termed as "Buyback" and may be made out of :

(i) its free reserves, or (ii) the proceeds of an earlier issue other than the fresh issue of shares made specifically for buyback purposes vide section 77A (1); and (iii) Securities Premium Account.

Under section 77A (2) no company shall purchase its own shares or other specified securities unless (a) Articles of Association authorise, (b) special resolution is passed, (c) the buyback does not exceed 25% of the total paid up capital and free reserves of the company purchasing its own shares or other specified securities, (d) the debt equity ratio must be 2: 1 after such buyback, (e) all the shares or securities are fully paid up, (f) the buyback is in accordance with regulations made by the SEBI. Under section 77A(3), the notice of the meeting at which special resolution is proposed to be passed shall be accompanied by an explanatory statement stating a full and complete disclosure of all material facts, the necessity for buyback, the class of security intended to be purchased under the buyback and the time limit for the completion of buyback. Section 77A(4) states that every buyback shall be completed

within 12 months from the date of passing the special resolution. According to section 77A(5) the buyback of shares may be from the existing securities holders on proportionate basis, or from the open market, or from odd lots, that means where the lot of securities in a listed company is smaller than such market lot may be specified by the stock exchange, or by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity. Under section 77A(6), before buyback the company must file a declaration of solvency to the Registrar and the SEBI in the prescribed form and verified by an affidavit that the Board has made a full inquiry into the affairs of the company that is capable of meeting its liabilities and will not be rendered insolvent with in a period of one year from the date of declaration. Under section 77A (7), where a company buys back its own shares the same have to be extinguished and physically destroyed within seven days of the buyback. According to sertion 77A(8), no company can issue further securities within 24 months from the date of buyback except by way of bonus issue, conversion of warrants, preference shares and debentures. Under section 77A (9), a register containing information about the securites so bought, the consideration paid, the date of cancellation and such other particulars as prescribed, shall be maintained. Under section 77A(10), after completion of buyback the company shall file with the Registrar of Companies and the SEBI a return containing the prescribed particulars within 30 days of such completion. According to section 77A (11), in case of default the company or any officer of the company who is found responsible for default shall be punishable with imprisonment for a term which may extend to two years or with fine which may extend to Rs. 50,000 or both.

According to section 77B no company shall purchase its own shares or other specified securities:

- Through any subsidiary company including its own subsidiary companies, or
- Through any investment company or group of investment companies, or
- If default in repayment of deposit, redemption of debentures or preference shares or repayment of a term loan to any financial institution or bank is subsisting.

Whether Dividend or Capital Gain

The recent debate among tax experts as regards buyback of shares lies on tax implications, as it has become contentious one since the introduction of the new section 77A in the companies Act. Similarly, the same problem disturbs, the shareholders and raise a question as regards taxation, whether the realised amount through buyback should be deemed as dividend or capital gain. Companies are also equally concerned with the issue, since in case of dividend, they are also liable to tax authorities, as they have to pay tax on distributed profits.

In order to have a correct assessment on the debated topic, it is necessary to throw light on the legal provisions as regards dividend and capital gains.

Deemed Dividend :

The term "dividend" has been defined under section 2(22) of the Income Tax Act 1961. This section contemplates five sub clauses from 'a' to 'e' in which certain amount received by a shareholder from a company can be termed as dividend.

Section 2 (22) reads that any:

(a) Distribution entailing release of any part of the assets of the company is deemed as dividend, if the distribution is out of accumulated profits.

(b) Distribution of debentures and bonus shares to preference shareholders will be deemed as dividend.

(c) Distribution made to shareholders on the liquidation of the company, to the extent of accumulated profits available with the company.

(d) Distribution to shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits, which arose after the end of previous year ending next before the 1st day of April 1933, whether such profits have been capitalised or not.

(e) Loans or advances made to certain type of shareholders out of accumulated profits, in which the public are not substantially

interested.

Going through the above sub-clauses of section 2(22), one should be especially concerned with the sub-clause 'd' as only this clause has relevance in respect of buyback of shares. On considering the provision inserted in the new section 77A. one finds that buyback of shares financed by (2) & (3) of section 77A, will not attract tax under section 2(22) of Income Tax Act, 1961. But what concerns most is buyback financed out of company's free reserves.

Capital Gain :

Under section 45 (1) of Income Tax Act, 1961 any profit or gain arising from the transfer of a capital asset is taxable under the head capital gain. Thus, capital gain arises where a person "transfers" any capital asset. Transfer is defined in an inclusive manner under section 2(47) as follows:-

(a) The sale, exchange or relinquishment of the asset, or

(b) Extinguishment of any right therein, or

(c) Its compulsory acquisition under any law, or

(d) Where asset is converted by the owner into stock in trade of a business carried by him.

(e) Any transaction involving allowing of possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in the Transfer of Property Act, 1982, or

(f) Any transaction which has the effect of transferring the enjoyment of any immovable property.

Thus, as regards buyback of shares, transfer of shares by the shareholders to the company are covered under 'a & b'.

Tax Implication on Consideration Received on Buyback of Shares :

From taxation point of view, buyback of shares leads to a question for shareholders and companies whether the amount distributed should be treated as "Dividend or Capital Gain".

Treatment of the consideration on buyback of shares as capital gain is based on the Supreme Court decision in the case of Kartikeya

V. Sarabhai vs CIT 1997, (228 ITR 422) and in Anarkali Sarabhai vs CIT (228 ITR 163), where the Court had held that on the reduction of share capital even though the shareholder remains a shareholder, his right as a holder of those shares stands reduced and there is an extinguishment of right amouting to transfer. Hence, the money received, from the company on the reduction in the face-value of shares is a capital receipt and is subject to capital gain tax under section 45 of Income Tax Act 1961. However, in the case of Kartikeya V Sarabhai vs CIT the Court did not consider the provisions of section 2(22)(d) in the context of capital gain arising on reduction of share capital. To arrive at the amount of capital gain on buyback of shares the difference between the consideration accrued or received and the cost of acquisition of shares by the shareholder, subject to indexation of the cost of the shares, if they have been held for more then 12 months (section 48 related to long-term financial capital asset) should be taken into account. If there has been a capital loss, it can be set off as per the provisions provided in Income tax Act,1961.

It is also contended by some assessees that when money is received representing the shares on distribution of asset which belonged to him by virtue of his holding shares, there is no "transfer", as held by Supreme Court in case of CIT Vs R.M.Amin (106 ATR 368). It was held in the Supreme Court decision in the case of Vania Silk Mills Pvt. Ltd. Vs CIT (191 ITR 647), that the particular asset concerned (shares) has got distracted, thus there can not be transfer and question of capital gain does not arise. Hence, it was contended by the assessees that in case of buyback, there is a reduction in capital due to the shares bought back and cancelled and payment of purchase consideration involving distribution of the accumulated profit of the company to the shareholders and hence should be treated as dividend.

The rationale behind charging amount paid out of accumulated profits as dividend has been highlighted in the case, Punjab Distilleries Ltd. V/s CIT (Supra), where it was held that a company may, on the pretext of reducing its capital, utilise its accumulated profits to pay back to the shareholders the whole or part of the paid up amount on the shares. Thus the form in which shareholders get back the whole or part of the capital contributed by them in effect is a share of accumulated profits, which, if a straight forward course was followed, should have been received as dividend. This is a division of profits under the guise

of division of capital, a distribution of profits under the colour of reduction of capital.

The treatment of the money received on buyback of shares as dividend by the assessees is guided by following the provision with effect from 1-6-1997 in the Finance Act, 1997 which was introduced in the Income Tax Act, 1961, Chapter XII-D (comprising of sections 115-O to 115-Q) which have provisions relating to tax on distributed profits by domestic companies in terms of section 115-0 any amount declared, distrebuted or paid by domestic company by way of dividend (whether interim or otherwise) on or after 1-6-97, whether out of current or accumulated profits, shall be charged to additional Income-tax referred to as tax on distributed profits at the rate of 10% and paid to the Central Government within 14 days of the declaration, distribution or payment whichever is earlier of the dividend. Thus, the purchase consideration for the buyback of shares being treated as dividend will be exempt in the hands of the shareholder under section 10(33) having already attracted additional tax on distributed profits at 10% in the hands of the company under section 115-0.

The latest ruling of the Supreme Court in the case of CIT Vs G Narasimhan (1999) 151 CTR 94, has considered all these arguments and resolved this controversial issue. The Supreme Court has held on this contentious issue that any distribution to its shareholders by a company on the reduction of its capital is deemed to be a distribution in the form of dividend to the extent that the company possesses accumulated profits, whether such profits have been capitalised or not under section 2(22)(d), and any distribution which is made over and above the accumulated profits of the company (capitalised or otherwise) will be treated as capital receipt in the hands of the shareholders, under section 45. The original cost of acquisition to the shareholder of that right in shares, which stands extinguished as a result of the reduction in share capital, will be deducted from the capital receipt. Only when the capital receipt is in excess of the original cost of the acquisition of the interest which stands extinguished will give rise to captial gain.

The above discussion brings out that on buyback the companies would be at a disadvantage since they would be required to pay 10% tax on dividend distributed. The shareholders, however, will gain because, (a) the dividend, even deemed dividend, is not taxable in the

hands of the shareholder, and (b) the balance of consideration generally would represent capital loss, which can be set off against capital gains or carried forward profits.

However, the real threat arises when a company opts buy-back through open market. Here the person to whom "dividend" is being paid can not be determined. It may be possible that the seller of shares may not be the registered owner of the shares, as these may not have been sent for transfer by the new owner. Can the owner be said to have received "dividend" and not made capital gain or loss? Can the same transaction be taxed in two different ways, dividend in the hands of the company and capital gain/loss in the hands of the seller? In this case, the company opting for buyback does not know the identity of the seller (payment being done through clearing house) and hence, to whom it is paying dividend cannot be ascertained.

Conclusions :

To conclude buyback of shares by a company results into distribution of dividend to the shareholders, to the extent the amount comes from accumulated profits (whether capitalised or not) and the balance gives rise to capital gain. The shareholders will not be required to pay tax on dividends as it is exempt u/s 10(33), However, they will be liable to pay tax on capital gain, The company will be liable to pay tax on distributed profits u/s 115-0, as the amount paid off is taken as distribution of dividend.

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New Dimension of Budgetary Control

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Introduction :

Budgetary Control may be defined as a system of management control and accounting wherein all operations are forecast and planned and actual results compared with forecast and planned results[1]. Budgetary control aims at comparing results with desired standards of performance and taking necessary action in relation to significant deviations[2]. Thus, budgetary control provides a system of control which is concerned with comparing actual performance with budget and taking corrective action when actual performance falls short of the budget significantly. The objective of this paper is to show how the system of budgetary control has deviated from the conventional concept and captured a new dimension.

Budgetary Control Function

Hanson[3] has described the budgetary control function in details specifying its expanded concept.

Budgets and Control : Conventional Concept

A budget is a formal statement of management plan for a given time period which will be used for control. It is treated as a 'yardstick' aganist which the performance is measured. The evaluation of this measurement actually states what corrective action is necessary.

This conventional concept of control is incomplete, since it denotes control through budgeting as a mechanistic and responsive action without considering that it is to some degree a self-governing action. Responding to measured differences between actual and budgeted performances, corrective actions are always taken after the performance

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creating the differences takes place.

Budgets and Control : Expanded Concept

The additonal areas of control under the expanded concept may be categorised as, (a) The nature of authority and the budget, (b) the degree of identification with budget goals, and (c) The degree of attainability of budget goals.

The above attributes explicitly recognise the self- governing character of control through budgeting. These may help in reducing the divergence between actual performance and budget continuously. In fact, the above intangible aspect of control takes place before the process of measuring and evaluation starts. They are also complementary to the responsive and corrective action as highlighted in the conventional model.

a- The Nature of Authority and the Budget :

In an authoritative relationship, the decisions made by superiors are communicated to subordinates. A budget gets an authoritative character when it is communicated to the concerned person. It is a customary practice in authoritative relationship that the person to whom a budget is communicated will take action to meet the budget requirement. Authority is, therefore, a major source of control. As a budget acquires authoritative character, it acts as an effective control mechanism.

b- The Degree of Identification with Budget Goals :

Communication of budget to concerned person does not state that his response will be entirely as per the budget requirement. The reciprocal aspect to authority indicates that a subordinate may not abide by the communicated budget. There is a continuum of responses, some of which may be more appropriate than others in meeting the budget. The more closely an individual identifies himself with the budget goals, the more appropriate will be his budget response. The degree of identification with budget goals is, therefore, a significant aspect of the control function. The participative budgeting is an example to be drawn as to increase individuals' identification with budget goals. The persons responsible for performances of cost and profit centres should therefore,

participate in the planning of expected performance.

The members of the organization once involved in the preparation of budget become aware of the budget goals more easily. Thus, the participative process acts as a control mechanism, since it encourages identification with budget goals.

Another procedure influencing identification with budget goals is the existence of a system of evaluating performance. Under the conventional concept of control function, the measurement and evaluation of performance provides the basis for formulating corrective action. Inherent in this process, there is an element of control influencing the action of persons as they perform. For example, a report on performance may be an important stimulus to good performance on the part of the person whose performance will be judged.

Moreover, there are some procedures which may lead to individuals' identification with budget goals and goals of the organization as well. These may include recruitment and training programmes, involvement in extra-organizational activities and a scheme of reward and penalty. A company's selective recruitment and hiring policy may help to achieve the organization's needs and objectives by means of potential interest and motivations of the individuals. Training programmes whether of the formally structured type or of the continuous on-the-job type, must be designed as per the organization's values.

The involvement of individuals in the company's extra-organizational activities, like participation in the company's recreational functions, may help to strengthen the identification process. A system of reward and penalty may serve to maintain an individual's identification with company goals more directly. The examples of a reward system may include periodic pay raises, commissions, pensions, stock options, promotions and bonuses. Penalties may consist of pay cut or no increase, demotion or no advancement and possibility of loosing the job.

c- The Degree of Attainability of Budget Goals :

The third critical area involves the degree of attainability of budget goals. In some situations, budget standard may not be reasonably attainable. As a result, the performance of individuals will be found to

be inefficient. It will be impractical if the budget standards are too easily attainable. For efficient and productive performance, it is necessary to prepare budgets which are attainable and at the same time challenging.

In view of attainability of budget goals, it is desirable to design a control mechanism to prevent too unfavourable deviations. One such control mechanism is participative budgeting discussed earlier. Apart from it, there are two other control techniques viz, flexible budgeting and establishing a range of performance levels for each budget goal.

A flexible budget is intended to provide attainable goals regardless of the operating level. A range of expected performances is prepared for each budget goal. Some times, a gradation in expected levels of performances is made on the basis of excellent, good, fair and poor. It is preferable to accept some performances within this range than others.

Responsibility accounting is a concept related to attainability of budget goals. An individual will achieve a budget goal only when he has the responsibility for whatever performance to reach the goal. In the absence of such responsibility, the budget will be unattainable. For an effective budgetary control function, it is desirable to formulate budgets in terms of responsibility centres.

Besides, comparison of actual with budgeted performance should be made more frequently and communicated to persons concerned. The objective of such a recommendation is that budget goals may be adjusted, if necessary, in order to keep them rigorous yet attainable.

Conclusion :

The discussion above brings out that the expanded concept of budgetary control has added a new horizon to management control system. The conventional concept of budgetary control is mechanistic and as such not expected to arouse responsive action. It does not consider the fact that it is to some degree a self-goverming action. The expanded concept of budgetary control is recognized by its self-governing character. It is complementary to responsive and corrective action of the conventional concept. The first attribute of the expanded concept of budgetary control is that a budget gets sn authoritative character by way of communication process. The second attribute is

the degree of identification with budget goals. The identification process is made possible through participative budgeting, a system of evaluating performance, a suitable recruitment and training programme, involvement in extra-organizational activities and a policy of reward and penalties. The third essential attribute is the degree of attainablity of budget goals. A budget becomes attainable through flexible budgeting, establishing a range of performance levels for each budget goal, responsibility accounting and frequent comparison of actual with budgeted performance. These three attributes of the expanded concept of budgetary control establish an effective control mechanism.

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Foreign Exchange Risk Management-An overview

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The Concept of Foreign Exchange Risk

Corporate foreign exchange risk refers to the adverse effects that unanticipated exchange rate changes can have on the value of the firm. Foreign exchange risk originates from the randon fluctuations of foreign exchange rates. It can be measured by the variance in the value of monetary as well as real assets and liabilities and the operating income of a company that is caused by unanticipated changes in the exchange rates (Dufey and Giddy, 1997). In other words, foreign exchange risk is measured by the variance in the domestic currency value of an asset, liability or operating income that is attributable to unanticipated changes in exhange rates (Levi, 1996). According to this definition, volatility in exchange rates is responsible for exchange rate risk only if it results in volatility in the real domestic currency values of assets, liabilities or operating Income. This makes exchange rate risk dependent on exposure as well as exchange rate fluctuations. Exposure by itself does not mean exchange rate risk if exchange rates are perfectly predictable. Again, unpredictability of exchange rates does not mean exchange rate risk for items that are not exposed.

Exposure

It is apparent that exchange rate volatility is by itself a necessary but not sufficient condition for foreign exchange risk- some firms may not be affected by foreign exchange rate changes at all. Hence, what is required is to assess the foreign exchange exposure that quantifies the sensitivity of the value of assets, liabilities and operating income with respect to exchange rate variations. The concept of exposure describes the effect that exchange rate changes have on these values; it is the value which is at risk.

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Exposure is conventionally seen as those elements of a firm's physical and financial position which are generally located outside the relatively safe home base and which are denominated in foreign currencies. It is. therefore, necessary to identify exactly which assets, liabilities, income flows and cash flows are denominated in currencies other than that of the parent and where these are located (Holland, 1993). There are three conventional classes of exposure, viz. (a) economic exposure, (b) transaction exposure, and (c) translation exposure.

Economic exposure is concerned with the impact of exchange rate changes on the uncertain foreign currency stream of corporate cash flows and ultimately with the impact on the value of the firm. There are two aspects of economic exposure- the competitive or operating aspect and the transaction aspect.

Transaction exposure is the uncertain domestic currency value of an open position denominated in a foreign currency with respect to a known transaction. Transaction exposure is, therefore, the relatively short-term subset of economic exposure (Wihlborg. 1980).

Alder and Dumas (1984) are of the view that exposure is a correlation coefficeint. If home currency returns are regressed on foreign exchange rates, then the correlation coefficient will measure the sensitivity of these returns to foreign exchange rate changes. Exposure is therefore reflected by the sensitivity of these cash flows and returns of exchange rate changes. Even a wholly domestic firm with little importing and exporting business can be exposed to currency risk. If a company's customer base is dominated by importing and exporting firms whose ectivities are influenced by exchange rate changes, then the firm's operations will be exposed to exchange rate risk. As a result, there are very few firms which are free from currency risk (Alder and Dumas, 1984).

The concept of exposure, therefore, applies equally to the wholly domestic firm, the domestic firm engaged in export and import, and the full MNC.

Unanticipated Changes in Foreign Exchange Rates :

Unanticipated changes in the foreign exchange rates are a source

of foreign excange risk. The emphasis here is on unanticipated changes, as anticipated changes in the foreign exchange rates as well as other available information are already reflected in market prices.

Fluctutions in the exchange rates that cause deviations from purchasing power parity (PPP) constitute a risk specific to foreign investments which is called exchange risk. Exchange rate changes only cause exchange risk to the extent that they represent deviations from PPP. If exchange rate changes ensure that PPP holds,then they do not constitute exchange risk (Pillbeam, 1994). Thus, if inflation changes and exchange rate changes do not completely offset each other over a short term period, then only firms may be exposed to exchange rate risk. In other words, only unanticipated changes in the real exchange rates are a source of foreign exchange risk. It would be useful at this stage to consider the distinction between nominal and real changes in the exchange rate (Holland, 1993).

The nominal exchange rate may be expressed as:

$$St = So \frac{1+FIt}{1+DIt}$$

where St = Nominal Exchange Rate in Period t

So = Nominal Exchange Rate in Period o

FIt = Expected Foreign Inflation Rate in Period t

DIt = Expected Domestic Inflation Rate in Period t

The real exchange rate may be expressed as :

$$RSt = St\ (Actual) \frac{1+DIt}{1+FIt}$$

where RSt =Real Exchange Rate in Period t

It is apparent that the concept of real exchange rate takes into account the joint effect of inflation changes and nominal exchange rate changes. If the real exchange rate at the end of the period is the same as the nominal exchange rate at the beginning of the period, then the firm does not face any foreign exchange risk.Thus unanticipated changes in the real exchange rate are a major source of foreign exchange risk.

FOREIGN EXCHANGE RISK MANAGEMENT (FERM)

A pertinent question at the very outset is 'should firms manage foreign exchange risk?'. The modern principles of the theory of finance suggest *prima facie* that management of corporate foreign exchange exposure may not be either an important or a legitimate concern for managers. Modigliani and Millar have shown that, in the absence of taxes, transaction costs, asymmetries in information and other market imperfections, a company's investment and financing decisions are independent of each other. Again, creation of value is dependent on investment decisions. Hence, the risk management aspect of a firm's financing decision cannot create value.This only suggests that corporate management of foreign exchange risk is of no value to a firm. Hence, FERM should be accomplished by an individual investor through proper diversification of his/her investment portfolio. However, Dufey and Srinivasulu (1983) have identified several obstacles to investor hedging, viz.,size of transaction, structural barriers and availability of information.

Another argument put forward is that FERM may simply be considered irrelevant if equilibrium conditions exist in international markets for both financial and real assets. However, Alder and Dumas(1983) have disagreed with this view and have identified conditions in which FERM may be of value to shareholders, creditors and managers, even when foreign exchange markets are efficient. They have pointed out that there may be situations when the distribution of unanticipated exchange rate gains and losses (relative to the anticipated changes expressed in forward rate) may have wide variances. If large adverse changes in exchange rates coincide with the timing of the receipt of a large foreign currency receivable, the currency changes may lead to liquidity problems for the firm, even though this would correct itself (i.e. equilibrium restored) in the long run.

Moreover, there are other possible market imperfections which may make foreign exchange risk management relevant. Thus, equilibrium relationship may hold between economies but not necessarily at the level of a particular firm. Again, major imperfections may exist,e.g., segmentation of world capital markets and major deviations in the parity relationships. These minor and major imperfections and various combinations of them may attach risk to a

company's exposure and may make FERM necessary. Shapiro and Titman(1985) point out that unsystematic risk like exchange rate risk, if left unmanaged, increase the probability of a firm getting into financial distress.

There are,however, some firms which refrain from active management of foreign exchange risk even though they are fully aware of the fact that exchange rate fluctuations may affect their earnings and value. The major reasons for this type of attitude (Dufey and Giddy,1997) are discussed, in brief,below.

(1) They think that the use of risk management tools, like forwards, futures and options are speculative. And, gambling in currencies is outside the scope of their business. They are,perhaps, right to fear the abuse of hedging techniques but refusing to use these risk management instruments may expose the firm to considerable speculative risk.

(2) Managers point out that exposure cannot be measured. However, imprecision should not be an excuse for not taking decisions in the matter of risk management.

(3) Managers agree that a firm should hedge the foreign exchange risk. All transactions like imports and exports should be covered with forward contracts and foreign subsidiaries are financed in local currencies. However, they fail to realise that much of the firm's value comes from transactions which are yet to be completed. This means that, although transaction hedging may cover transaction exposure, the economic exposure is left uncovered.

(4) Some managers argue that the firm does all its business in home currency and hence there is no foreign exchange risk. But, a moment's thought will reveal that invoicing a foreign customer in the home currency may fail to make the price competitive if the value of the foreign currency falls. In this case, the firm's revenue may be influenced by currency changes.

(5) Some firms argue that doing business is risky and the firm is rewarded for bearing risk,both business and financial. But this argument overlooks the fact that investors may reward a firm for risk where the outcome,though uncertain,is expected to be positive. However, this is rarely the case in financial market bets where the

outcome tends to reflect odds that are 50/50.

Foreign Exchange Risk Management (Ferm) The Goal :

From the aforesaid discussion it is,thus, clear that a firm may be exposed to foreign exchange risk under certain circumstances. Hence, the need arises to manage such foreign exchange risk. At this stage, the appropriate question would be what should be the FERM goal of the firm? The answer is not easy to find. But as a practical alternative, managers should aim to minimise the impact of unexpected real exchange rate variations on the cash flows and earnings of the firm measured in relevant currency. This requires application of certain techniques of FERM.

Techniques of Ferm :

The major techniques of FERM include (a) strategic and operational responses,(b) various internal financial techniques, and (c) external risk management techniques like forward market hedging, money market hedging and currency options.

Strategic and Operational Respones :

These are primarily aimed at handling the economic exposure of a firm.

(1) Strategic Responses :

A firm should not structure or change its strategic decisions solely on the basis of FERM considerations. But foreign exchange risk may have major strategic implications for the firm and strategic decisions can play a significant role in FERM (Holland, 1993). Consequently, the goals of FERM relative to strategy include (i) taking currency volatility into consideration at an early stage in strategic decision making, (ii) identifying existing strategic flexibility relative to potential new changes in the real exchange rate, and (iii) creating new levels of strategic flexibility relative to such changes.

Action at the strategic level usually takes the form of alteration to known levels of exposure or to potentially new levels of exposure

to foreign exchange risk as well as attempts to alter the sensitivity of exposures to exchange rate changes. One reason for doing this is to tackle those actions of competitors which may have an indirect and unanticipated effect on long -term foreign currency cash flows of the firm. A second reason is to handle the general vulnerability of the firm to changes in exchange rates. The numerous decisions which alter exposure or reduce sensitivity to currency risk include: (a) the diversification of the location of production and sales and sources of raw materials in many countries for long-term strategic reasons;(b) avoiding inflexible currency zones and locating production and sales in many currency zones with high currency diversification benefit;(c) the creation of flexible manufacturing systems that allow rapid product differentiation for acquiring greater control over foreign currency prices and faster introduction of new products in overseas markets;(d) developing production systems that can promptly respond to product changes and can be used to tailor products to unique niches in the market place and also reduce the sensitivity of products to foreign currency price changes as well as provide the means to exploit exchange rate changes; (e) investing large sums of money in research and development with a view to creating unique knowledge and technological advantages for the firm; (f) converting the long-term economic exposure into a competitive advantage,e.g., firm A having a long term exposure in firm B's currency, may choose firm B having similarx exposure in firm A's currency as its trading partner for the purpose of long -term swap with B.

(2) Operational Responses :

Operational decisions are a further means by which a firm can alter exposure to risk and adjust its internal demand for FERM services (Booth and Rotenberg,1990). Decisions relating to production levels, pricing, sourcing, etc., can have an important effect on the economic exposure position of the firm and may also help reduce the scale of economic exposure. It is sometimes difficult to distinguish between strategic and operational decisions. Decisions in some areas may be strategic for one firm and tactical for another; the distinction often lies in the time horizon and degree of significance for the firm. However, it must be pointed out that the strategic and operational decisions together would best combat foreign exchange risk. Strategic decisions

often take priority, with operational decisions providing an important support capability when responding to currency risk. Any remaining lack of currency flexibility in real business of the firm can be compensated for by imaginative manipulation of the internal financial system, the currency mix for financing and various risk management instruments supplied by financial markets(Holland,1993).

Internal Financial Techniques :

Internal techniques may be distinguished from external financial Internal Financial techniques by their use of a variety of internal corporate means to alter financial exposure to currency risk. They include methods like netting, matching, leading and lagging. An MNC's capability to employ these internal techniques depends on the existence of a sophisticated internal financial system within the firm. An MNCs internal financial system is diagrammatically presented in Fig-1 (adapted from Lessard,1979).

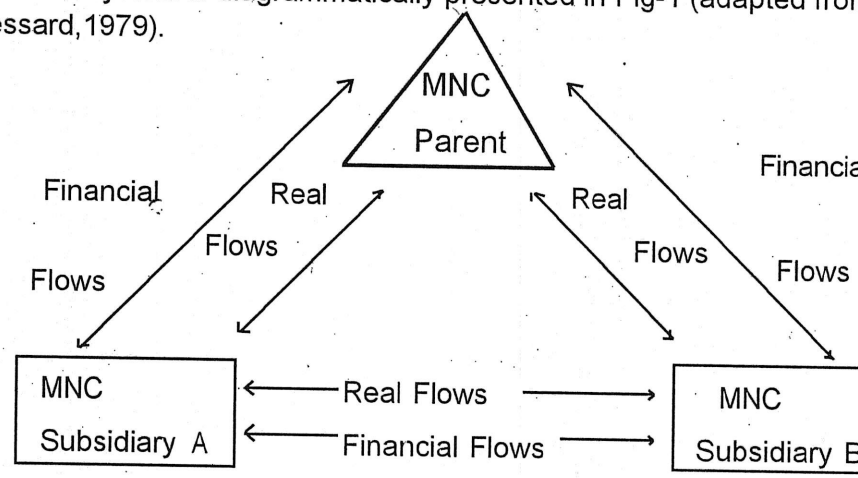

Fig. 1.

The real flows include flow of goods, materials and technology, while finanacial flows include equity investment, loan, interest and loan repayment, devidends and payment for goods and services. Real flows give rise to bulk of the financial flows. Consequently, greater the real flows, greater is the capacity of an MNC to control internal financial transfers and greater is the scope for the use of internal financial techniques. In case of FERM decision, the choice of the channel and the timing possibilities give rise to a range of internal currency risk management techniques. The techniques which may be used to alter considerably the overall exposed position of an MNC as also the liquidity

position of each of its subsidiaries are stated below.

(a) speeding up (i.e.,leading) and delaying (i.e., lagging) payments of accoumts between the subsidiaries- modification in the terms of credit between the subsidiaries can substantially alter the exposed positions of not only such subsidiaries but also of the MNC group as a whole.

(b) Altering the terms of loans between subsidiaries can have an effect similar to (a) above.

(c) Choice of the invoicing currency between subsidiaries may also be very useful in altering exposure to currency risk.

(d) matching in terms of currecy, size and timing of cash inflows and outflows, to the extent possible, may be useful in minimising expoure to currency risk.

(e) payables and receivables within the MNC group can be netted off. Netting refers to the parent company and its subsidiaries periodically 'setting up" the net amounts owed or owing as a result of trade within the firm. Netting reduces the number of payments and the overall volume of transfers and is, therefore, useful in reducing both transaction costs and exposure.

External Risk Management Instruments :

When strategic and operational decisions and internal financial tectniques are not enough to deal with a firm's exposure to currency risk, external risk management instruments have to be used. Fortunately, foreign exchange and credit markets and other outside agents offer to firms a wide range of services designed to insure firms against these risky exposures. The most important of these external risk management instruments include forward contracts, currency futures, currency options, currency swaps, etc. All of these instruments are some form of contractual arrangements which make the firm liable to fully discharge it's side of the contract. These instruments generally fall into two classes: (a) those which are customised or tailored according to the requirement of the firm, and (b) those which are standardised and available through exchanges. These external techniques are generally used by firms to insure against a possible loss on known transactions' exposures. But some of these techniques may also be used to manage translation exposure.

The choice of a particular extermal risk management instrument would depend upon the circumstances of the case. The classical extermal risk management techniques employed by firms are the forward market hedge and money market hedge which share the same objective of insuring the firm against any change in the full home currency value of foreign currency transaction exposure. But the money market hedge does offer some additional advantage over the forward market hedge. It offers immediate liquidity for the firm which can borrow foreign currency on the strength of the foreign currency receivable and immediately change it into the home currency and use it more productively. These two techniques may, however, become disadvamtageous if the firm fails to get its foreign currency receivable on due date. The firm may also have to forego the opportunity to gain from favourable exchange rate changes. These disadvntages may be over come by entering into a currency option contract but the amount of the option premium may make the option contract expensive. Currency swaps may be useful when different firms have exposure in different currencies which they may set off for mutual benefit.

Thus there exists good scope for foreign exchange risk management. A variety of options in terms of policy, timing and technique are available. However, the choice of the FERM technique would certainly depend on the attitude of the firm towards risk management, the type of exposure and the availability of risk management instruments.

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Regulation of Corporate Reporting in India : Perceptions of Users - A Case Study

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Introduction:

Regulation of accounting is an age-old phenomenon. The extent of regulation may vary from country to country. It does not enjoy unmixed blessings and suffers from certain limitations also. The nature of regulation in India has undergone many changes over time with a view to reducing its shortcomings, on the one hand, and making it in tune with the changing socio-economic environment, on the other.

In this paper, an attempt is made to ascertain users perceptions with respect to regulation of corporate accounting and reporting in India. For this purpose, a questionnaire was prepared and sent to the users of accounts – both of accounting academy and profession – at different parts of country. The whole process thereof is discussed below.

Design of Questionnaire:

The questionnaire contained only sixteen questions, which were meant to get users perception on:

i) The present system of regulation of accounting;

ii) Desirability or otherwise of the regulation;

iii) The role of Companies Act and professional bodies in this respect ;

iv) Desired improvement in regulation, etc.

Against each question, two answers (like Yes/no) were suggested and the respondents were asked to answer the question by giving tick mark at the appropriate place. This yes/no type of answering has its

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own limitation, as there may be questions where none of the suggested answers is appropriate or there may be multiple answers of a question. But still we have adopted this method because it has some relative advantages also over other methods of study (Saravanavel, 1987)

Profile of the Respondents :

In order to make the study a broad-based and of all-India character, the copies of questionnaire were sent to the selected users throughout the country. The initial sample size was 200 comprising members of Indian Accounting Association (IAA) and IAA Research Foundation. While all the life members (157) of IAA Research Foundation were selected from the membership register, only 43 members comprising office bearers (present and immediate past office bearers) were selected from the IAA member's register. The reason for selection of all members of the IAA Research Foundation is not difficult to comprehend. Research Foundation is the only platform where professional accountants and accounting academics get together having interest in promoting accounting, accounting education and research, both nationally and internationally. Many of them use corporate financial reports not only for their research but also for investment decision making. Similarly, to keep the number of members from IAA limited, only office bearers, both immediate past and present, were taken out of a total number of 1000 members. Democratically speaking, these 43 members may be said to be representing the views of rest of the members of the Association. The selected persons were again a cross-section of people (academics, professionals and shareholders) so that the study can reflect an unbiased and complete picture of the issues in question. Among the persons so selected, 50 were professionals and 150 were academics. Many of them are the direct users of accounting information either as investors in shares or bonds of Indian companies or as researchers.

In all 53 responses were received (Table 1). Out of 53 responses, 14 completed questionnaires (28%) were received from professionals and 39 (26%), from academics.The rate of response is undoubtedly low.

Table 1

Statewise Distribution of Respondents

Name of State	No. of Respondents	Percentage
West Bengal	33	62.2
Bihar	1	1.9
Assam	1	1.9
Orissa	1	1.9
Himachal Pradesh	1	1.9
Uttar Pradesh	2	3.8
Delhi	5	9.3
Punjab	1	1.9
Rajasthan	2	3.8
Mumbai	2	3.8
Andhra Pradesh	3	5.7
Karnataka	1	1.9
Total	53	100.00

But going by the general experience of data collection in India (Roy 1991, Porwal 1994) this may be considered satisfactory. Of the total responses received, 73.6 % are from academics and 26.4 % are from professionals (Table 2). Table 1 shows that responses were received from 12 states of all the four zones (east, west, north, and south) of the country. East zone, however, represents the lion's share. It is expected that the analysis made therefrom will result in an overall view of users' perception on accounting regulation in India.

Table 2

Profile of Respondents

	No.	Percentage
Academics (College & University Teachers)	39	73.6
Professionals (Members of ICWAI & ICAI)	14	26.4
Total	53	100.0

Analysis of Responses :

For the last 150 years, the company law has been at the center of framework of accounting regulation in India. Contribution of professional bodies in this regard is not also less important. While the Companies Act has provided a general legal framework for regulation of accounting, the profession has added thereto the objective specifications and required clarifications. Still, since the inception of regulation of accounting, a debate has been continuing as to the desirability or otherwise of regulation through Companies Act and professional or other bodies. An analysis of the responses to such questions (Table 3), however, shows that the present system of regulation of accounting through Companies Act and professional bodies is liked by most of the academics (77%) and professionals (71%).

Table 3

Regulation Through Companies Act or Professional Bodies

Nature of	Academics		Professionals	
Responses	No.	Percentage	No.	Percentage
Yes	30	76.9	10	71.4
No	9	23.1	4	28.6
Total	39	100.0	14	100.0

Next comes the desirability of 'self-regulation'. Self-regulation usually involves an organisation or association developing a system of rules that it monitors and enforces against its own members or,in some cases a large community (Baldwin and Cave, 1999). The Institute of Chartered Accountants of India (ICAI) may be one of the choices to play this role. Self-regulation may again be a substitute for regulation through Companies Act or complimentary to it. On the question of self-regulation, (Table 4), only 18 % academics and 14 % professionals feel that self-regulation, instead of regulation by bodies other than the preparers, may serve the purpose better. 15% of the academics and 21% of the professionals do not favour self-regulation. Majority (67% in case of academics and 64 % in case of professionals) does not, however, make any remark. Does this mean that they favour present practice of regulation through Companies Act ? In that case, the desirability of self-regulation is rejected outright.

Table-4

Desirability of Self-regulation

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	7	17.9	2	14.3
No	6	15.4	3	21.4
No remark	26	66.7	9	64.3
Total	39	100.0	14	100.0

Thus, what comes out from the study is that regulation through Companies Act and professional bodies is a necessity, but there is sufficient room for modifications and improvements.

Table 5

General Purpose Financial Statement Serving the Purpose of all User-Groups

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	6	15.4	6	42.9
No	33	84.6	8	57.1
Total	39	100.0	14	100.0

Table 6

Desirability of Different Financial Statements for Different user - groups

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	28	71.8	4	28.6
No	6	15.4	4	28.6
No remark	5	12.8	6	42.8

Does one set of financial statements serve the purposes of all the user-groups ? The majority of the respondents are also of the view that the present reporting system does not provide the creditors and investors with useful information for decision making (Table 7) So that question is the desirability of prepa-ing. "different financial statements

of different user-groups in spite of high cost and time factor" (Table 6). This is a vexed issue, the debate for which has been continuing since long.

Table 7

Does the present reporting system provide the creditors and investors with useful information for decision making ?

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	7	17.9	3	21.4
No	32	82.1	11	78.6
Total	39	100	14	100

Acceptance of the wider view, that preparation of financial reports must proceed from a perception of user-needs, leads to consideration of two subsidiary alternatives (Most 1986) :

*general purpose financial reporting, i.e. providing information for unknown users having multiple decision objectives; or

*specific purpose financial reporting, i.e. providing information for specific user-groups having a known decision objective.

It may be noted that general purpose financial reporting is the objective adopted in the U.S.A by FASB Statement of Financial Accounting, Concept No. 1. This is because the information needs of most of the users are necessarily the same (AICPA, 1973) or issuing multiple reports may create confusion among various user-groups (Lal. 1985). In India too the Companies Act requires for a general purpose reporting rather than a specific purpose reporting.

In a recent article, A. Rashad (1997) highlighted the limitations of a single set of general purpose financial statements to satisfy the information need of absentee investors for evaluating accountability and decision usefulness of managers. He proposed to replace the current system by two sets of financial statement -: realisation- based financial reports to show manager's use of economic resources and valuation-based financial reports that will provide measures of expected

present value of the firm's property rights and contingent claims, respectively. According to him, the dual type of financial reporting is likely to achieve the officially adopted objective of financial statements, namely, to help investors predict future cash flows as to amounts, timing and uncertainty.

In view of the above position, user's perception was sought on the issue whether different financial statements are needed for different user-groups in spite of high cost and time factor. 72% academics feel that a number of mono-purpose reports should be issued which may be tied together fully. Professionals, however, are not in favour of different financial statements. Only 29% professionals favour different financial statements (Table 6)

In India the objectives of financial statements are yet to be clearly defined by any authority. The sole effort was made in the report of Company Law Committee (Bhaba Committee) prior to the enactment of the Companies Act, 1956, in the following words:

> "The form of balance sheet and the contents of profit and loss account should be such as would make available to the shareholders as much information relating to the affairs of the company as it is possible to disclose."

Since the above report, no attempt to define the objectives of financial statements has been made (Banerjee, 1994). Before we come to the results in this respect, a reference to some of the notable international scenario may not be out of context.

In November 1978 the Financial Accounting Standards Board (FASB) of AICPA issued Statement of Financial Accounting Concepts No. 1 entitled "Objective of Financial Reporting by Business Enterprises" which laid down five objectives. These are:

* To provide information which is useful to investors, creditors and others in making rational decisions.
* To assist investors and creditors in assessing future net cash flows to the enterprise in respect of amount, timing and uncertainty.
* To identify entity resources (assets) and claims against resources, both creditor claims (liabilities) and owner claims (owner's equity)
* To provide information about enterprise performance and earnings potentials.

* To show how an enterprise obtains resources and what it uses them for.

Of these five objectives, the second objective, viz. " to assist investors and creditors in assessing future net cash flows to the enterprise in respect of amount, timings and uncertainty" has been most widely quoted as the objective laid down by the FASB (Banerjee,1988). The framework of FASB has been influential around the world. As for example, the IASC's framework and the UK's statement of principles are clearly derived from it (Nobes & Parker, 1989). The International Accounting Standards Committee (IASC) through proposed Statement Framework for the Preparation and Presentation of Financial Statement suggested that :

"The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of potential users in making economic decisions."

About the need for a set of clear objectives of financial reporting, the academics and professionals are more or less unanimous. 97% academics and 100% professionals feel that the objectives should be clearly defined, if the usefulness of financial reporting is to be increased (Table 8).

Table 8

Defining the Objectives of Financial Reporting

Nature of	Academics		Professionals	
Responses	No.	Percentage	No.	Percentage
Yes	38	97.4	14	100
No	1	2.6	-	-
Total	39	100	14	100

Almost all the respondents (both academics and professionals) have suggested further that there should be a conceptual framework of accounting in the line of the exposure draft issued by the Institute of Chartered Accountants of India (Table-9)

Table-9

On having a Conceptual Framework of Accounting

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	38	97.4	14	100
No	-	-	-	-
No remark	1	2.6	-	-

It may be mentioned that in order to provide reliable and timely accounting information which would be useful to the investors and creditors, conceptual framework for accounting be developed. This framework shall provide the overall objective of accounting, define different accounting elements and identify different valuation principles on which the accounting standards can be based. This framework will also define the characteristics of "usefulness" of accounting information (Banerjee & Jaggi, 1997).

Regarding the Balance Sheet, vertical form is perferred to the T. form by majority of the respondents (Table 10). Next comes the question of providing future-oriented information. The need for disclosure of forecast information is important than disclosure of other items because disclosure of such information by security analysts is almost non-existent in India. In the absence of any forecast information, investment decisions are generally made on the basis of incomplete information and unreliable rumours and these environments are not conducive to the development of healthy financial markets. Moreover, disclosure of forecast information may prove useful in attracting foreign capital (Jaggi, B., and Banerjee, B.,1998). On this crucial issue of providing forecast information, 100% academics and 88% professionals perceive that more future-oriented information should be included in the director's report if the annual accounts are to be made useful for decision-making (Table 11). Thus, the mandate that we have got from respondents is that the present system of regulation of accounting through Companies Act and professional bodies may prevail subject to necessary changes from time to time to suit the changing social requirements.

Table-10

Vertical vs. T- form of Balance Sheet

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Vertical	26	66.7	12	85.7
T- Form	12	30.7	2	14.3
No remark	1	2.6	-	-
Total	39	100.0	14	100.0

Note : One respondent has made no remark as he finds no difference between the two formats.

Table 11

Desirability of having more future-oriented information in the director's report

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	39	100	12	85.7
No	-	-	1	7.2
No remark	-	-	1	7.1
Total	39	100	14	100

A study on regulation of accounting cannot avoid discussion on accounting standards. One of the objectives of accounting standards is to provide uniformity in preparation of financial statements. In other words, standards are developed to harmonise the diverse accounting policies and practices adpted by different companies. The harmonisation process makes accounting information comparable across different companies which enables the financial statements users to properly interpret the information contained in the financial statements for their investment decisions. It, however, needs to be pointed out that preparation of annual financial statements by companies can be influenced by the 'subjectivity' factor when diverse accounting policies and practices are used by different companies. As a result, there may be variation in the use of measurement and valuation methods used

for determining income, expenses, assets and liabilities, even though the determination process takes place within the same legal framework of the country. Consequently, the preparation of operating results by different companies may vary. Through the accounting standards, an attempt is made to limit the diversity in accounting policies and practices so that accounting information disclosed by different companies becomes more comparable (Banerjee & Jaggi, 1997).

In view of the above, a few questions were set in the questionnaire in relation to accounting standards. Respondents in a large number have no hesitation to accept that accounting standards play a dominant role in the area of regulation of accounting. 82 % academics and 79%.

Table 12

Has the issuance of accounting standards by the ICAI improved the prospect of comparability of accounting information and its quality ?

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	32	82.1	11	78.6
No	5	12.8	2	14.3
Partial	2	5.1	1	7.1
Total	39	100.0	14	100.0

professionals agree that issuance of standards by the ICAI has improved the prospect of comparability of accounting information and its quality (Table 12). But the prospect is not fully converted into reality because, according to the respondents, there is no effective machinery to enforce the compliance of standards. Standards are of little value unless they are observed. The real challenge, therefore, lies in their adoption. Initially, all standrads issued by the ICAI were recommendatory, which meant that compliance with the standards was optional. Later, compliance with standrds was made mandatory in stages. At this time, of the 15 standards issued by the ICAI, 13 standards have been made mandatory and 2 (AS-2: Valuation of Inventories and AS-3: Cash Flow Statement) are still recommendatory. An interesting feature of the compliance process was that, prior to the Companies (Amendment) Ordinance, 1998, there was no legal provision to ensure compliance

with standards. The only way to ensure compliance was through the audit function by members of the ICAI. At this time also, the authority to monitor the compliance of standards does not rest with any agency which has judicial powers. Instead, information on compliance is provided by the statutory auditors in their annual reports. An overwhelming majority (100% professionals and 95% academics), feel that the compliance should be enforced by the provisions of the Companies Act (Table 13). It is also felt by 90% academics and 71% professionals that compliance with accounting standards may be enforced through an administrative or quasi-judicial body (Table 15).

Table 13
Legal provisions to ensure compliance with Accounting Standards

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	37	94.9	14	100
No	2	5.1	-	
Total	39	100	14	100

In our country, the preparation of standards and their enforcement through auditing function lie. virtually in the hands of ICAI. There is no structural independence in the process and there is no independent government or private agency to monitor the compliance with the standards (Banerjee *et al*, 1998). Thus most of the respondents (75% of the total) think that this practice should be discontinued and the standard-setting body should be given structural independence from the auditing profession in India (Table 14).

Table 14
Is it necessary to ensure structural independence of the Accounting Standard-setting body from the auditing profession in India?

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	28	71.8	11	78.6
No	11	28.2	3	21.4
Total	39	100	14	100

It appears from the study that there are some drawbacks in the organisation of standard-setting and its enforcement. Attempts should, therefore, be made to review the matter without further delay.

Table 15

Enforcing the compliance with Accounting Standards through an administrative or quasi-judicial body

Nature of	Academics		Professionals	
Responses	No.	Percentage	No.	Percentage
Yes	35	89.7	10	71.4
No	4	10.3	4	28.6
Total	39	100	14	100

Cash Flow Statement (CFS) is now considered a necessary addendum to profit statement, in the absence of which a complete picture about the financial health of a firm is not obtained. In fact, there may be substantial book profit year after year, but if it is not associated with liquid position, a company may have to face serious problems (Bhattacharyya, 1987). Thus, CFS is a must. But this is not yet decided whether it is to be prepared according to the SEBI guidelines or as per Accounting Standard No.3 (since revised). The respondents are also in dilemma in this respect. 67% academics and 43 % professionals feel that the SEBI guidelines should not be withdrawn (Table 16).

Table 16

Desirability of withdrawal of SEBI Guidelines on CFS

Nature of	Academics		Professionals	
Responses	No.	Percentage	No.	Percentage
Yes	13	33.3	8	57.1
No	26	66.7	6	42.9
Total	39	100	14	100

That is, round about 50% of the total respondents maintain totally different view. On the question of giving freedom to the reporting enterprises to follow either of them, the same confusion is discernible among respondents (Table 17).

Table 17

Issuance of a directive by the appropriate authority giving freedom to the reporting enterprises to follow either AS-3 or SEBI Guidelines

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	19	48.7	3	21.4
No	8	20.5	4	28.6
No remark	12	30.8	7	50
Total	39	100	14	100

The wave of conglomerate mergers, coupled with growth of multinational companies, both having their origin in 1960, ultimately led to segment reporting. Today, in the USA, Canada, the UK and Australia segment reporting is comonplace in the financial reporting packages of companies that are diversified by product line and geographic area. The present corporate pracitce in India gives only the overall picture through conventional financial statements (Banerjee, 1994, Chakraborty, 1995).Segment reporting has been talked about for long. But the progress in this respect is still very negligible in India. Even in Pakistan, the segment disclosure is required if turnover of segment exceeds 20% of the turnover of the company (Saeed,1989).

Table 18

On Segment Reporting

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	37	94.9	13	92.9
No	2	5.1	1	7.1
Total	39	100	14	100

The last two questions of the questionnaire were eventually relating to the necessity and threshhold of segment reporting. Respondents' response in this case has been in tune with the increasing demand of users for disaggregated information. 95% academics and

93% professionals, i.e., almost all of the respondents are in favour of segment reporting (Table 18). Of them, a large number (74% in case of academics and 79% in case of professionals) are of the opinion that 20% of the turnover of a firm should be taken as a threshold for segment reporting (Table 19).

Table 19

Threshold for Segment Reporting as % of Total Turnover

Nature of Responses	Academics		Professionals	
	No.	Percentage	No.	Percentage
Yes	29	74.4	11	78.6
No	7	17.9	2	14.3
No remark	3	7.7	1	7.1
Total	39	100	14	100

Summary :

We summarise the findings of the study. Only the majority opinion on each issue is stated.

1- The present system of regulation of accounting through Companies Act be continued.

2- On self-regulation, respondents(majority) did not indicate their opinion.

3- General purpose financial statements do not serve the purpose of all users. So, in spite of high cost and time factor, although academics prefer monopurpose reports, professionals are not in favour of different financial statements for different users.

4- The objectives of financial statements should be clearly defined and there should be a conceptual framework of accounting in line with the exposure draft issued by the ICAI.

5- For Balance Sheet, vertical form is preferred to the T-form.

6- In order to facilitate decision-making, future-oriented information should be disclosed in the director's report.

7- Issuance of accounting standards by the ICAI has improved

the prospects of comparability of accounting information and its quality.

8- Compliance with accounting standards should be enforced by legislation in the Companies Act. Also, there shuld be an administrative or quasi-judicial body for enforcement.

9- The present standard- setting process be reviewed to ensure structural independence to the standard-setting body.

10- Professionals are in favour of the SEBI's withdrawl of guidelines on Cash Flow Statement, while academics do not want the SEBI to do the same. On the question of giving freedom to corporate enterprises to follow either AS-3 or the SEBI guidelines, as the case may be, half of the professionals appears undecided, while the majority of the other half is not in favour of giving such an option. Academics, however, are in favour of the option.

11- Respondents are in favour of segment reporting. Twenty per cent of the total turnover of a firm should be taken as a threshold for segment reporting.

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INDIAN ACCOUNTING ASSOCIATION

Annual General Meeting Notice

A Meeting of the IAA General House will be held at the Venue of 23rd Annual Conference, Ajmer with Prof. B. Ramesh in the Chair on Monday, the 22nd May 2000 at 4.00 p.m. to transact the following agenda.

1. Consideration of the minutes of AGM meeting held at Jaipur
2. Consideration of the Accounts of the Association
3. Topics for the next IAA Annual Conference
4. Consideration of proposals for holding next annual conference of IAA
5. Election of Office bearers/ Executive Members as per the Constitution
6. And any other item with the permission of the Chair.

(PROF. D. PRABHAKARA RAO)
APRIL 6, 2000, Vishakhapatnam

All the members are requested to attend the meeting.

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