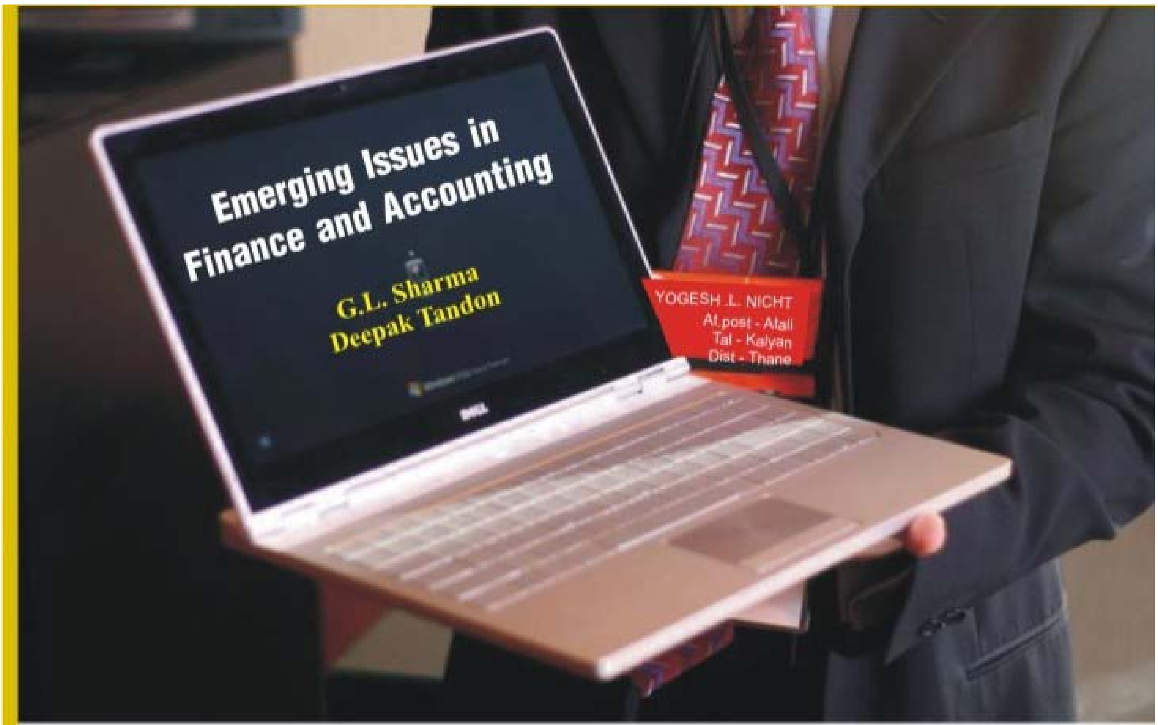

Emerging Issues in Finance and Accounting

G.L. SHARMA
DEEPAK TANDON

Himalaya Publishing House

Emerging Issues
in
Finance and Accounting

Edited by

G.L. Sharma

Deepak Tandon

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Preface

India is at the crossroad of transforming itself into a rapidly developing emerging market economy. The inherent strength of the economy is also reflected by the resolve with which the country was able to come out of recessionary trends, sooner than most other economies. However, this was not without its share of the problems. The country still has a long way to go before its fundamentals are strong enough to resist any kind of economic shocks that the world may go through again. As India expands its role in the global economy, there is an imminent need to strengthen its financial sector further in aiding economic development and facilitate a smoother integration with the global financial markets. India has made a rapid progress in reforming the banking sector and the securities markets. These reforms were undertaken within a comprehensive package involving improved fiscal responsibility and enhanced central bank independence.

With this background, the National Conference on "Emerging Issues in Finance and Accounting" was organized in July 2010 at the Lal Bahadur Shastri Institute of Management, Delhi. The present volume is an outcome of the papers presented at the National Conference. In all, we had received more than two dozens papers out of which 21 papers were selected for presentation at the conference. On the basis of academic content 13 papers, including six invited papers were finally selected for publication in this volume.

The book is organized in three parts:

Part I: Emerging Issues in Finance Area,

Part II: Emerging Issues in Banking Area, and

Part III: Emerging Issues in Accounting Area

It may be mentioned here that these themes are not mutually exclusive; rather, they provide a continuum of facts, observations and ideas on certain aspects of finance, banking and accounting.

The present volume makes comprehensive efforts to only see the emerging issues in areas of finance, banking, and accounting (International Financial Reporting Standards). The volume, in general attempts to identify areas and avenues that can be pursued to find solutions to the problems facing the financial sector. We hope that all those concern with Emerging Issues in Finance and Accounting will find the book interesting and useful.

G.L. Sharma
Deepak Tandon

Contents

Preface

Acknowledgement

List of Contributors

PART I. EMERGING ISSUES IN FINANCE AREA

1	India's Economic Strategy versus Financial *Jugaad* *K.C. Mishra*	3–7
2.	Performance of Initial Public Offerings (IPOs) in Indian Stock Market *Ajay Kumar Chauhan, B. D. Kavidayal*	8–27
3.	Test of Random Walk for Indian Commodity Market *Sanjay Sehgal, Namita Rajput*	28–42
4.	Impact of Increase in Trading Hours on Indian Stock Market *Ashish Garg*	43–51
5.	Microfinance and Accounting Trends *G. L. Sharma*	52–66
6.	Subprime Crisis and Corporate Governance Disclosure in India : An Empirical Study *Neeti Sannan, Pooja Talwar*	67–81

PART II. EMERGING ISSUES IN BANKING AREA

7.	Interest Rate Risk and Asset Liability Management of Banks in India *Madhu Vij*	85–104
8.	Assessment of Forex Markets, Hedging Risk Exposures by the Indian Banks *Deepak Tandon*	105–118

9. Determinants of Capital Structure: An Empirical Study of Indian Commercial Banks — 119–133
Priya Gupta, Divya Jindal

10. Technical Efficiency of Indian Banks Using Nonparametric Frontier Approach – Data Envelopment Analysis (DEA) — 134–142
Neelam Tandon

11. Risk Management in Banks Through Hedging — 143–157
Suresh Chandra Bihari

12. Indian Banking : A Gait Towards Basel III — 158–171
Harish Handa, Meera Mehta

13. Growth of Commercial Banks in India with Special Reference to Priority Sector Lending – A Study of Post-Reforms Era — 172–194
Jasmindeep Kaur, Shilony Gupta

14. Financial Inclusion—*Taking Banking to Masses for Poverty Alleviation* — 195–203
Prem Sibbal

PART III. EMERGING ISSUES IN THE ACCOUNTING AREA

15. Costing Regimes and Managerial Decision-Making — 207–219
G.L. Sharma, P.K. Gupta

16. Effective Cost Management Through Total Cost of Ownership (TCO) — 220–225
Raju Gundala, Ashlesha Dash

17. Analyzing Comparative Financial Performance: Indian GAAPs *vs*. IFRS — 226–233
Monica Singhania, M.K. Mittal

18. Acceptability of Convergence of AS with IFRS and Allied Challenges — 234–245
Ruchi Gupta

19. Challenges in Implementing Indian Accounting Standards (IFRSs) — 246–249
Amarjit Chopra

Index — 250–253

Part I

Emerging Issues in Finance Area

CHAPTER 1

India's Economic Strategy versus Financial *Jugaad**

K.C. Mishra

INDIAN THINK TANK

India is a country known for achievements through fire-fighting and Jugaad. Like many other critical areas, India has no long-term economic strategy. A cursory analysis of post-independence India reveals that the country has a very thin think tank, whether it was Mahalonobis or Gadgil during Nehruvian era or the Yojna Bhavan occupants of current era. Even policy-watchers are unable to discern any clear long-term priorities, based on understanding the strengths India needs to preserve and the weaknesses that threaten India's prosperity the most. Priority addresses not only what to do, but also what not to do. In dealing with a crisis, experience of nineties teaches India that steps to address the immediate problems must support a long-term irreversibility. Yet, it is far from clear that Indian establishment is taking the steps most important to India's long-term economic compulsions. India's best known defence strategist K. Subrahmanyam, who passed away recently on 2nd February 2011, used to opine that strategic naiveté is a national weakness for India.

India's coalition politics, especially as it has evolved in recent times, almost enforces an absence of prioritization at the central level. Proverbial Jugaad runs events in piecemeal, rather than developing a strategy that unfolds over years. Political leaders, business leaders, and civil society must begin a respectful, fact-based dialogue about strategic issues. These incumbents

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* Improvisation

need to focus on competitive reality, not defending past moorings. India's success has come with widening disparities and knee-jerk effort for inclusiveness. While the standard of living has risen over the last several years for most income groups, inequality has risen to a proportion that breeds social tension. Any insurance against social tension suffers from non-translational malady in absence of some iconic national message translators, like Lal Bahadur Shastri. Remember his "Jai Jawan, Jai Kissan" and message to ameliorate the problem of food scarcity in the wake of uncalled for war coupled with draught.

INDIA'S READINESS FOR COMPETITION

India has to reconcile these conflicting perspectives and evolve a set of unique competitive strengths; India has to develop an entrepreneurial economy at least for the medium term. India has to move up rapidly in the patent registration market and translating its technology fire power into consumer product and services. Institutions for higher learning should be first centres for excellence in learning and then making money for promoters and not the other way round as it is today. Even Government-run institutions have more revenue concerns than R&D concerns, more concerns to be employment exchanges rather than creating entrepreneurs for startups. Indian business had over-lived an era of protections and licenses. The country requires a stronger commitment to competition and free markets while caring for social inclusion and consumption by masses.

INDIA'S FEDERALISM AND REGIONALISM

India's federalism creates politico-economic regionalism. Economy is decentralized and re-aggregated by intervention of Central Government and centrally mandated institutions, most important of which is Reserve Bank of India. Depending on political vision of local leaders, who govern the states, the resource exploitation shows differential acceleration or deceleration tendencies. Again, the pricing policy is largely determined by political muscle and economic clout of regional leaders. For example, coal becomes a national product with postal stamp type pricing, whereas chemical becomes a regional product with demand and supply driven pricing. The region with abundance of coal lives in a flat economy whereas the region with propensity to produce chemicals tend to determine their level of prosperity through the controlling business leaders. Instead of being the greatest competitive strength of India, this decentralization of the economy creates greatest regional imbalance. Of course, things are changing a bit now.

Reorientation, realignment and structural adjustments are mostly irreversible and often painful. Choosing a right path will not be visible at the starting point. The process becomes easy and pain becomes tolerable, if the strategic direction of the country has a broad consensus. But first it has to be thought, planned, communicated and debated to arrive at a consensus. Once this is done, India will show remarkable dynamism and resilience with willingness to restructure.

India should not overplay demographic dividend as demography has both internal and external relativities. Internal relativity will create regional and social imbalances, resulting in high level of social tension, conflicts and divisive tendencies. External relativity will create global reactions by way of hostile blocs, overt and covert sanctions and in most natural way short-term international adjustments to extinguish any country's specific advantage, unless there is equity in reciprocity.

INDIA'S CAPITAL MARKET

A mature capital market is the greatest secondary wealth creator of a country under various parametric conditions. For one, there must be a strong real sector underlying generating continuous quarterly results and propelling vision for growth. Secondly, country should have currency stability and there should be continuous movement towards hard currency zone. Thirdly, interest rates and inflation targeting should be in sync. Lastly, world should believe in the growth story of the country arising out of its geo-political coherence and discernible policy interventions. Capital market should be so regulated that a startup entrepreneur can raise capital, lose it if macro and micro parameters become adverse but the entrepreneur does not die economically; the market again allows the individual to start another company. On the investor side, there should not be a Mumbai club to determine the market. Capital market is speculative anywhere but it should not be a casino joint. Indian capital market has shown signs of some maturity and holding power in the teeth of crisis, but it has not yet crystallized as a net wealth earner for the country from global investors. To some, it works like a siphon of retail investor's wealth to foreign investors and ringside investors. India has to invent an optimum strategy in this respect as yet.

Capital market is most efficient when underlying enterprises are capable of passing off their increase in cost to selling price, which consumer accepts with full understanding. There are direct capital market instruments for costs arising out of commodities, currencies or interest rates but there are no such direct instruments for strategic mistakes or inefficiencies. Such costs are internalized in the price adjustments of existing instruments till the instruments become irrevocably junk. Forwards and options are designed to mitigate market risk when current prices cannot be adjusted for instruments which are likely to be affected by future cost consequences. This is the basis for capital market introducing derivatives for its wealth management efficiencies. There cannot be a dogmatic policy to have or not to have some globally accepted strategies to deepen or widen the capital market.

For example, forward contract is good enough to mitigate market risk but it introduces counterparty default risk. Counterparty default risk can be mitigated by converting Over the Counter (OTC) forward contracts into exchange traded futures, but it introduces operational risk of daily cash inflow or outflow arrangements on the basis of which counterparty risk is mitigated. This gave rise to trade on options. While mitigating operational hassles arising out of daily cash flows, options introduce cost consequences in the short run. All such capital market instruments have their uses and cost as also operational consequences. Indian capital market strategy should be one to replicate global scene with full understanding of the impact of the instruments *on the underlying* and the purpose for which they are supposed to be utilized and to what extent. Escaping from an idea in currency is an improper strategy.

INDIA'S MONETARY POLICY TRANSMISSION

Reserve Bank of India is synonymous with monetary confidence of Indian citizens with

Government of India. Monetary policy stance of RBI reaches the citizens through a transmission process. There is a perceived gap in the procedure to transmit RBI policies, particularly if it is intended to positively affect the common man.

For monetary policy transmission, RBI operates a liquidity adjustment facility (LAF). It primarily consists of two monetary instruments Repo and Reverse Repo. Banks borrow from RBI for one day at overnight Repo rate. Banks lend to RBI for one day at overnight Reverse Repo rate. This system seeks to equilibrate cash inflows and outflows of banking system. While it does a short term liquidity adjustment, it does not operate as a strategic liquidity management system. This is one of the prime reasons for policy transmission snag. Only when RBI policy rate instantaneously impacts banks' cost of liquidity or lack of it, the policy transmission will be strategically oriented. For this to happen, RBI should become a non-competing supplier of structural liquidity.

One interesting paradox in India is in RBI's role as a banker to the Government. When advance tax is collected, Government has cash inflow which improves liquidity of RBI but depletes liquidity of banking industry. Then there is a stampede for liquidity gap management. It happens every time and the system seems to have resigned itself to short-term arrangements during such paradoxical periods. RBI and Government must have identified such parametric situations from years of operations. This experience can be translated into a policy stance so that instead of developing counterparty liquidity mismatch situation, there should be only book entries and liquidity of the system remains intact.

Cash Reserve Ratio or CRR is a direct liquidity intervention tool. Banks maintain CRR as a ratio of their statutory liabilities, which are mostly of the nature of demand and time liabilities (DTL) of the nature of deposits or a few floats. But purchased funds of the nature of borrowings from RBI are not part of this DTL. Banks have learnt this trick and a major part of their liability can be purchased funds on which they need not bother for CRR. This is a seeming strategic lapse in the policy for CRR. A policy sensitive CRR alone can dictate banks to equilibrate their marginal cost of funds to RBI borrowing interest rates. CRR is maintained with a tenor window of a fortnight average daily balance. Like all other methods of window dressing smartness, this also provides a policy compatible window dressing corridor. Banks make the overnight rates violent during this policy mandated tenor without having to develop internal expertise to manage the liquidity as per the spirit of the policy. It would be a prudent strategy to shift the overnight rate intervention to a pointer policy rate targeted for this mandated tenor of a fortnight bid rate with a declared threshold. In such case banks learn to manage their liquidity better and RBI gets discovery driven rate for cost of liquidity at the moment with a fortnightly rest. Overnight Repo rate should be logically at a defined premium over this fortnight auction bid rate maintaining a symmetrical corridor for Reverse Repo rate of same tenor.

Corporate Bond Market in India is languishing in the absence of liquidity. Even the best rated corporate bonds cannot be a match to Government securities. It is largely an outcome of collateral policy stance rather than risk perception or demand and supply situation. Sub-sovereign or non-sovereign interest rates are not properly discovered in India as yet due to this policy snag. Firstly, RBI should explore to accept highly rated corporate and sub-sovereign bonds in the Repo and Reverse Repo corridor alongside Sovereign Securities. This will bring a metamorphosis in the corporate bond market. Policy intention transmission to business world will become more direct. Secondly, RBI should discover the cost of liquidity and not dictate the cost of liquidity. This is best done by creating a 90 day money market in India and throwing a floating rate corridor for that period to serve as a benchmark for the term structure of interest rates. Without any rate range spelt out, RBI 90 day liquidity auction will discover market appetite and benchmark rate to which corporate bond yields will quickly adjust depending on the unit level risk assessment.

INDIA'S STANCE FOR FINANCE OF ENTREPRENEURSHIP

RBI and Government policies have direct and indirect impact on entrepreneurial strength of India at dispersed level. Individuals and small enterprises cannot read the slow moving policy lips. Due to lack of policy transmission, understanding is needlessly driving up the cost and complexity of doing business for these thinly manned entities. Larger corporates have their economic intelligence and outsourced research experience to somewhat do the impact study and take pre-emptive or reactive operative measures.

Indian documentation system is very robust, but it is more oriented towards past achievements, stock and transaction flow than capturing the future where all the new money of the country lies. Past achievements bring to the fore embedded value of the country. Stock provides clue for infrastructural preparedness. Transactional flow indicates the level of activation of the infrastructure as against perceived current needs of the country. All money lies in future; only a rational current strategy can provide present value of the country's future, which makes the country more valuable in the global analysis – much more than its embedded value and value arising out of the stock and flow. Financial strategy of the country is discerned from its financial institutions, financial policy, financial regulations, taxation and investment incentives, financial markets and financial techniques in managing short-term financing; medium- and long-term financing; cash management; trade financing and insurance of risks.

INDIA AS A FUNCTIONING DEMOCRACY SHOULD MAKE A DIFFERENCE

Despite temporary aberrations arising out of coalition politics, India's bottom line is a functioning democracy. The political system is supple with the built-in democratic processes needed to defuse systemic stresses. The urban middle class is likely to allow itself to be co-opted by the democratic polity and participate in the income transfers to the poor as a premium they have to pay by way of insurance against social tension. The democratic federalism endures an extended period of implosion that would have otherwise created a catastrophic impact on regional stability. India's democratic process has a built-in capacity to rectify structural imbalances. As Masahiro Matsumura, Professor of International Politics, St. Andrew's University in Osaka (2007) says, even the poorest and socially challenged make their voices heard in domestic politics and policymaking. In India's democratic context, its middle class is less able to reject fair reallocation of wealth and socioeconomic opportunities that benefit the rural poor majority. Democracy is a crucial element of economic development that India enjoys. India's economic order will shine with a little more value added thinking and strategic underpinning of its public finances as also private investments.