

# Implications of Value Added Tax on Hosiery Industry of Ludhiana

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Value Added Tax (VAT) is an improved form of sales tax levied and collected on consumer expenditure in stages of transactions involving sale of goods. "Value Added" is the difference between sale and purchase of goods. Thus, VAT is nothing but a form of sales tax only and is charged at each stage of sale on the value added to goods and not on the gross turnover of the dealer (Agarwal and Agarwal, 2002). In other words, VAT is a multistage tax levied on the value added at each stage of sale and is equivalent to last point sales tax (Chanchawat, 2004). It also streamlines ills of the earlier prevalent Sales Tax System.

Government's main motive to implement the VAT system is to remove double taxation and multiplicity of taxes of commodities, rationalize the tax structure (Panthaki, 2005), increase tax compliance, curb the tax evasion and widen the tax net. VAT will bring in more discipline in the indirect tax regime with the erosion of cascading effect of taxes (Kumar, 2002). It will help to keep a check on the parallel economy which is putting a lot of pressure on inflation and increasing the gap between rich and poor. All this will finally bring down the prices of the various commodities in the long run. Eighty percent of the world's population is now under a VAT regime covering 120 countries. Where the VAT is perfect, tax evasion is less than 10%. Where VAT is not implemented, tax evasion is more than 40%. By adopting VAT with effect from April 1, 2005, India has joined the majority of the countries which have implemented VAT and hopes to derive the advantages thereof. Dasgupta (2005) pointed that VAT may not boost revenues because of incomplete coverage of goods and services and coverage only of registered dealers or manufacturers and sellers with turnover exceeding a threshold limit of Rs. 5 lakhs in India.

This research will attempt to study the impact of VAT and advantages of this system over the old system on hosiery manufacturers of Ludhiana as three years have passed since VAT was implemented. Ludhiana is the hub of hosiery industry with many large and small-scale manufacturers operating in the city. When VAT was implemented, hosiery industry was the most affected and a lot of resentment came from its constituent units. With this background, the study is being undertaken with the following specific objectives.

- 1) To study and compare the impact of VAT on small-medium (SMEs) and large hosiery manufacturers of Ludhiana.
- 2) To study the problems faced by these hosiery units in implementing VAT in their organizations.

## RESEARCH METHODOLOGY

The basic research design was exploratory in nature. There are about 4800 hosiery units in Ludhiana. Most of them i.e., about 4000, are in the unorganized sector. Remaining about 800 are in the organized sector, operating on small-medium and large scale. List of these units was obtained from the District Industries Centre (DIC), Ludhiana. These 800 units formed the population of the study. These units were classified into small-medium and large hosiery units on the basis of capital investment in plant and machinery. Hosiery units with the investment of upto Rs.10 crores were covered under Small and Medium Enterprises (SMEs). There are approximately 750 such units in Ludhiana. Units with the investment of more than Rs.10 crores in plant and machinery are called large enterprises. There are approximately 50 such units in Ludhiana. Proportionate and Simple Random Sampling was done to draw the sample. Out of 800 hosiery manufacturers, a sample of 80 units was selected through the lottery method in proportion to their ratio in the total population. The sample size of 80 units has been divided into 75 small-medium hosiery manufacturers and 5 large hosiery manufacturers. The data was collected through a structured questionnaire and by personally interviewing the respondents.

## FINDINGS

The information collected from the hosiery units with respect to VAT has been studied and analyzed deeply to understand the impact of VAT on these units and problems faced by the hosiery manufacturers.

### 1. ETHICS IN BUSINESS

Business Ethics refers to the system of moral principles and rules of conduct applied to business. Ethics helps the market to do its best. The perception regarding ethics in business was seen to affect the inclination of respondents towards ethical practices.

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**Table1: Perception regarding place of ethics in business (No. of respondents (%age))**

Place of ethics in business		
Choices	Small-Medium Units	Large Units
Strongly Agree	23	3
Agree	33	2
Indifferent	6	-
Disagree	8	-
Strongly Disagree	5	-
Total	75	5
<b>Mean Score</b>	<b>0.81</b>	<b>1.6</b>
Relationship between ethics and profit		
Responses	Small-Medium Units	Large Units
Yes	62 (83%)	5 (100%)
No	13 (17%)	-
Total	75 (100%)	5 (100%)
Type of relationship between ethics and profit		
Responses	Small-Medium Units	Large Units
Directly Proportional	46 (74%)	5 (100%)
Inversely Proportional	16 (26%)	-
Total	62 (100%)	5 (100%)

All the large scale units (100%) and 56 small-medium units (75%) believe that ethical practices are a must in business. The positive mean scores for both small-medium (0.81) and large scale (1.6) units also indicate that the entrepreneurs do agree that there is a place for ethics in business. However, the large scale units are more forcefully inclined towards ethical practices than small-medium units.

The hosiery units were asked whether there existed any relationship between ethics and profit. All the large hosiery units replied in affirmative and felt that there was a direct relation between ethics and profit, whereas 62 out of 75 i.e. 83% of the small-medium units felt that there is relation between ethics and the profit. Out of the 62 small scale units, 74% felt that there existed a direct relationship; whereas 26% felt that there also exists an inverse relation between ethics and the profit motive.

## 2. TAX EVASION- REASONS AND REMEDIES

The questionnaire contained various questions regarding the perception of respondents towards possibility of complete elimination of tax evasion, whether the business could be continued with unaccounted transactions and whether VAT would help in curbing tax evasion. Then the reasons for tax evasion and remedies for the same were asked to understand their inclination towards tax compliance.

**Table2: Tax Evasion and inclination towards tax compliance (%age of Respondents)**

Complete elimination of tax evasion		
Responses	Small-Medium Units	Large Units
Yes	51 (68%)	4 (80%)
No	24 (32%)	1 (20%)
Total	75 (100%)	5 (100%)
Continuation of business with unaccounted transaction		
Responses	Small-Medium Units	Large Units
Yes	29 (39%)	-
No	46 (61%)	5 (100%)
Total	75 (100%)	5 (100%)
VAT as a remedy to curb tax-evasion		
Responses	Small-Medium Units	Large Units
Yes	46 (61%)	5 (100%)
No	23 (31%)	-
No reply	6 (8%)	-
Total	75 (100%)	5 (100%)

80% of the large-scale manufacturers were of the view that complete elimination of tax evasion is possible, whereas only 51 (68%) small-medium units believed that absolute tax-compliance is possible, though it is subject to certain conditions. Only 39% of the small-medium respondents said that it is possible to continue the business with unaccounted transactions, whereas 61% of small-medium units and all the large units i.e. 100% respondents thought that tax compliance is a must and it is not possible for them to continue the business with unaccounted transactions.

It was found that 46 out of the 75 small-medium respondents and all the large units agreed that VAT will help in curbing tax evasion in the long run.

### REASONS AND REMEDIES OF TAX EVASION

The major reasons quoted by the respondents for tax evasion were corruption and bureaucracy, non-uniform sales tax rates in different Indian states, tough competition, complexity and the paper work, mentality of people and higher taxation rates. Respondents said that corruption can be fed only if they earn for officials also, which is possible only by evading taxes in today's difficult times. Different sales tax is charged by different Indian states and if they were to sell everything by bill, their product will become very costly and the buyers may switch to other states in search of other cheaper substitutes. Competition is growing and taxation rates are very high. They are not able to cover that additional burden in the sale price of the product or pass it on to the buyer, hence affecting the profitability of the concern. Many respondents also felt that the complexity and the paper work involved in keeping everything accounted and up-to-date is a major reason for tax evasion. People are averse to paying taxes because they feel that paying taxes is nothing but wasting money out of which no developmental work will be done. Also many entrepreneurs were of the view that taxation rates are very high in our country and if these were decreased, then tax compliance would be more.

Respondents suggested that some remedial measures like uniformity in sales tax, change of mindset, lower taxes, check on corruption, simplification of procedures, their confusing provisions and numerous interpretations, strict compliance of the rules, stringent punishment to the defaulters, better government policies and incentives for honest tax-payers can solve the problem of tax evasion to a large extent.

### 3. KNOWLEDGE ABOUT VAT

Before asking about the impact of VAT, it was imperative to know whether the respondents had full knowledge about VAT. It was observed that whereas all large enterprises have full knowledge of the VAT concept, only 64% of the small-medium enterprises knew about it and the remaining 36% did not have full knowledge about the details and intricacies of VAT.

### 4. IMPACT OF VAT

To study the impact of VAT, respondents were asked to indicate the impact on various parameters like Sales, Profitability, Tax liability, Sale price of product, Input cost, Procedural formalities and Paper work by choosing one from the three options viz. increased, decreased and no change.

**Table 3: Impact of VAT on Small-Medium and Large Scale Enterprises (No. of Respondents (%))**

Small-Medium Enterprises							
Impact	Sales	Profit	Tax Liability	Sale Price	Input cost	Procedural Formalities	Paper Work
Increased	44 (59%)	38 (51%)	47 (63%)	20 (27%)	35 (47%)	56 (75%)	62 (83%)
No Change	12 (16%)	19 (25%)	15 (20%)	39 (52%)	18 (24%)	11 (15%)	9 (12%)
Decreased	19 (25%)	18 (24%)	13 (17%)	16 (21%)	22 (29%)	8 (10%)	4 (5%)
Total	75 (100%)	75 (100%)	75 (100%)	75 (100%)	75 (100%)	75 (100%)	75 (100%)
Large scale Enterprises							
Impact	Sales	Profit	Tax Liability	Sale Price	Input cost	Procedural Formalities	Paper Work
Increased	5 (100%)	5 (100%)	5 (100%)	2 (40%)	3 (60%)	5 (100%)	5 (100%)
No Change	-	-	-	3 (60%)	2 (40%)	-	-
Decreased	-	-	-	-	-	-	-
Total	5 (100%)	5 (100%)	5 (100%)	5 (100%)	5 (100%)	5 (100%)	5 (100%)

Table 3 shows that for most of the SMEs, sales (59%), profitability (51%), tax liability (63%), input cost (47%), procedural formalities (75%) and paper work (83%) have increased. 52% of the respondents said that there was no change in the sale price after implementation of VAT. Almost 20-25% of the respondents also experienced a decline in all the parameters except procedural formalities and paper work.

All the 5 large scale units said that their sales, profitability and tax liability, procedural formalities and paper work have increased after the implementation of VAT. Two units had seen increase in the sale price of their products and 3 units observed increase in the input cost.

Further, the respondents were asked to give the percentage (<10% or >10% or no change) with which their Sales, Profit and Tax Liability have increased or decreased. It was found that only 42 out of 75 small-medium respondents replied to this question. Remaining respondents were not willing to disclose the figures. All the large scale units disclosed the information.

**Table 4: Impact of VAT on Small-Medium and Large Enterprises (No. of Respondents (%))**

Parameter	Small-Medium Enterprises					Total
	Increased by		No change	Decreased by		
	0-10%	More than 10%		0-10%	More than 10%	
On Sales	21 (50%)	6 (14%)	5 (12%)	6 (14%)	4 (10%)	42 (100%)
On Profitability	18 (43%)	3 (7%)	9 (21%)	5 (12%)	7 (17%)	42 (100%)
On Tax Liability	24 (57%)	4 (10%)	6 (14%)	6 (14%)	2 (5%)	42 (100%)
Parameter	Large scale Enterprises					Total
	Increased by		No change	Decreased by		
	0-10%	More than 10%		0-10%	More than 10%	
On Sales	2 (40%)	3 (60%)	-	-	-	5 (100%)
On Profitability	2 (40%)	3 (60%)	-	-	-	5 (100%)
On Tax Liability	2 (40%)	3 (60%)	-	-	-	5 (100%)

From Table 4, it can be concluded that for approximately 50% of the SMEs sales, profitability and tax liability have increased by 0-10%. For about 10% of the respondents, all the parameters increased by even more than 10%. Two out of five large scale units said that their sales, profitability and tax liability have increased by less than 10% and the remaining three replied that an increase of more than 10% was seen in all the three parameters. However, no change and decrease in any of the above three parameters were recorded in case of large units, but this change was prominently seen in case of small-medium units. This shows that large scale units have seen a more positive and uniform impact of VAT on their businesses than small-medium units, which have observed a mixed kind of impact on their businesses.

A major difference found in the responses of the small-medium and a large unit was that none of the large hosiery unit respondents said that VAT has had a decreasing impact on any of the parameters under consideration. However, the increasing impact on sales, profitability and tax liability is a good and healthy sign as it shows the growth in industry while the increasing impact on sale price, input cost, procedural formalities and paper work calls for a serious and immediate attention of the authorities.

## 5. IMPACT OF INTER-STATE DISPARITIES IN VAT

There are many inter-state disparities under VAT system that have not been solved and removed till yet. One of the main disparities is that VAT has not been implemented by all states. Also, the input tax credit is not given to the manufacturer on the purchase of raw material from outside their own states. In other words, the tax paid on inputs procured from other states through inter-state sale or stock transfer will not be eligible for credit.

All those respondents who purchase their raw materials from the other states replied in affirmative to this question. There were 41 (55%) respondents from the small-medium segment and 4 (80%) of the large-scale enterprises. The remaining 34 (45%) small and medium enterprises and 1(20%) of large scale units which did not buy raw materials from other states said that inter state disparities did not have any impact on their organization.

## 6. IMPACT OF VAT ON COMPLIANCE COST

It was observed that 58 out of 75 i.e. 77% of small-medium enterprises and 4 out of 5 i.e. 80% of large enterprises replied that their compliance cost has increased after the implementation of VAT mainly due to increase in procedural formalities to be complied with and paper work to be done.

## 7. PERCEPTION ABOUT VAT

Respondents were also asked what they felt about VAT in general and whether it will be helpful in fulfilling the objectives of its implementation.

### *VAT as a solution to reduce cascading effect of taxes i.e. tax on taxes*

VAT ensures that the raw material and manufactured goods are not taxed repeatedly as they pass through various stages of manufacturing or distribution and there is no cascading effect. All the large enterprises were confident that introduction of VAT would certainly help in reducing the cascading effect of taxes. Whereas small-medium enterprises were somewhat equally divided, as 39 out of 75 i.e. 52% respondents said that VAT will act as a solution to reducing the cascading effect of taxes, the remaining 48% replied in the negative.

### *VAT as a taxation system*

Respondents were also asked whether VAT is a uniform, simple and transparent taxation system. Whereas the entire large-scale i.e. 100% large scale respondents and 45% of the small-medium enterprises felt that VAT is a simple and transparent taxation system, the remaining 55% of the respondents said that they were not clear about the details and intricacies of VAT. They attributed their responses to complex and some unclear rules and regulations in the VAT.

## **8. VAT AND COMPETITIVENESS**

The respondents were asked whether VAT would bring in more competitiveness by providing a level playing field to all the manufacturers.

**Table 5: VAT and competitiveness**

Choices	No. of respondents	
	Small-Medium Units	Large Units
Strongly Agree	11	3
Agree	26	2
Indifferent	19	-
Disagree	15	-
Strongly Disagree	4	-
Total	75	5
<b>Mean Score</b>	<b>0.33</b>	<b>1.6</b>

The positive mean score for both the segments indicates that the entrepreneurs do agree that VAT will help in bringing more competitiveness by reducing the cascading effect of taxes and thus providing level playing field to all players operating in the industry. Large scale units had more conviction (1.6), whereas, small-medium units (0.33) though positive, were less convinced about this fact.

## **9. EFFECTIVENESS OF VAT IN WIDENING THE TAX BASE**

Respondents were also asked whether VAT would help in widening the tax net by increasing tax compliance and by bringing the unorganized sector under its purview.

**Table 6: Effectiveness of VAT in widening the tax base**

Choices	No. of respondents	
	Small-Medium Units	Large Units
Strongly Agree	13	3
Agree	28	2
Indifferent	16	-
Disagree	12	-
Strongly Disagree	6	-
Total	75	5
<b>Mean Score</b>	<b>0.40</b>	<b>1.6</b>

The positive mean score for both the segments indicates that the entrepreneurs do agree to the fact that VAT will help in widening the tax base and increasing tax compliance. In reply to this question also, large scale units (1.6) showed more conviction than small-medium units (0.4).

## **10. SUCCESSFUL IMPLEMENTATION OF VAT**

Respondents were asked whether successful implementation of VAT had been done. 25% of small-medium enterprises did face some problems and were not able to implement it properly. All large hosiery units replied that they were able to implement VAT successfully in their organization.

### ***Changes made in the organization in order to implement VAT***

Respondents who replied in affirmative to the previous question (61) were then asked to describe the changes which they made in any of the functional area in order to implement VAT successfully in their organization. Only 38 respondents i.e. 33 small-medium and 5 large units said that they made some changes in accounting and billing department. Few said that increase in the input cost was passed on to the buyer by increasing the sale price of the product. This also affected their sales to some extent. They also said that now most of the sales were against bills and VAT could be charged on these. Respondents further said that they had applied for registration under VAT to avail the VAT number. Few respondents also said that training was given to the concerned employees. Other respondents said that not many changes were required to be made.

### ***Gearing up before implementation of VAT***

These 38 respondents were then asked about the preparations made by them before VAT was implemented. All the respondents i.e. 33 small-medium and 5 large units said that they started gearing up one-two months before the implementation of VAT and also that early gearing up proved to be very helpful in smooth and easy implementation of VAT.

### **11. PROBLEMS FACED IN IMPLEMENTING VAT**

VAT was implemented with effect from April 1, 2005 in Punjab along with many other states. Respondents were asked to explain various reasons for the strikes and lockouts and what were the operational and functional difficulties they faced and are still facing while implementing VAT.

Both small-medium and large hosiery units replied that inter state disparities and implementation of VAT in some states were the major reasons of their problems. Non-availability of input tax credit on the raw materials purchased from the other states, less knowledge about the whole VAT concept, non-availability of C-forms, lack of proper training, increase in procedural formalities, compliance costs and paper work, no bills on purchases, less jurisdiction, problem in attainment of VAT number, presence of many other taxes like octroi, central sales tax, etc. are among the various other problems faced by entrepreneurs.

### **12. REASONS FOR OPPOSITION OF VAT**

Those respondents who had knowledge about VAT said that the opposition came from those hosiery units that did not have knowledge of VAT. Also, no proper groundwork was prepared by the government to train people and create awareness about the concept of VAT. Since people did not know about the benefits of VAT, they thought that VAT would be an impediment in the growth of their trade and industry. Few respondents said that they were not able to adapt to a sudden change, while some said that everything new is opposed first and after sometime it is accepted when people get used to it. However, the lack of knowledge and awareness about VAT was reported as the major reason for the hue and cry among the hosiery manufacturers at the time of implementation of VAT.

### **13. ADEQUATE TIME GIVEN TO ADOPT VAT**

Fifty nine percent of the small-medium enterprises were of the view that they were not given adequate time to adapt to the new VAT regime. On the contrary, 100% of large enterprises replied that they had sufficient time to make the required changes in the organization and fulfill various formalities required to get a VAT number.

### **14. CONCERNS RESOLVED**

The respondents said that they did have some concerns after the first draft paper on VAT was out for consideration. Some of those concerns were taken care of while some were not, like abolishing the CST, availability of C-forms, input tax credit on purchases made from outside. 49 out of the 75 i.e. 65% of the small-medium enterprises and 3 out of 5 i.e. 60% of the large hosiery units said that their concerns were not taken care of by the authorities. They said that this was one of the major reasons for so much of agitation, protests, strikes, bandhs and processional marching at the time of implementation of VAT.

### **15. TRAINING PROVIDED BY THE AUTHORITIES**

All the small-medium as well as large enterprises replied that no training was given by the government. They attributed that this was rather one of the reasons for less knowledge and awareness of VAT among the general public.

### **16. ATTITUDE OF TAXATION AUTHORITIES**

The entrepreneurs were concerned about the attitude of the tax personnel towards them. It was found that the officials have a harsh and harassing attitude towards them, and this restrained them from coming forth with their problems regarding VAT. So, they continued operating in parallel economy.

### **17. SUGGESTIONS REGARDING ANY MODIFICATIONS REQUIRED IN CURRENT VAT SYSTEM**

Finally, respondents were asked to suggest some changes or modifications that they would like in the current VAT system. Entrepreneurs felt that VAT should be implemented in its totality with other taxes being waived out. Also, CST should be phased out and C-forms should be made available to the hosiery units. These are the biggest reasons for running a parallel economy. Respondents also replied that certain rules, regulations, laws and procedures related to VAT must be simplified and made clear so that no ambiguity is there in understanding them. Lastly, proper training and knowledge must be imparted to the entrepreneurs as well as the general public to create awareness, so that they understand the rationale behind VAT.

### **CONCLUSION**

There was unrest among the hosiery manufacturers when VAT was implemented because of either some misunderstandings, increase in complexity and ambiguity in laws related to VAT or due to lack of awareness regarding various provisions of the new taxation system. However, the study finds that most of the manufacturers agree that the relevance of VAT in the changed scenario cannot be over emphasized and its introduction shall bring in more discipline in the indirect tax regime. While this change is a welcome measure for the trading community at large, the changeover would be a success only when the same is implemented across the country and not in a fractured way. VAT should be taken to its logical conclusion and linked with the central VAT. Government is further thinking of administering a single unified Goods and Services Tax (GST) from April 1, 2010 through out the country.

*(Cont. on page 42)*

From the above table, it is observed that the EVA of the company is increasing during the study period. The EVA Values are ranging from Rs. -0.57Crs to 0.77 Crs because of increasing of capital employed and NOPAT. In the year 2002 and 2003, the EVA values are negative (-0.57 and -0.316) which indicate that the company did not effectively utilize the share holders funds. From 2004 to 2007, the EVA values are positive, which show the efficient use of share holder's funds.

From the above table, it is also observed that the MVA of the company is fluctuating during the study period. It is ranging from Rs. -3.24 crs to Rs. 106.67 crs because of increase in number of shares of the company and market price during the period of study. The total common equity also increased from the year 2002 to 2007 which acts as a factor to support the increasing of MVA. The negative MVA of 2002, 2003 & 2004 (-3.77, -3.24 & -0.26) indicate that of less investment value as compared with the capital contributed by the investors.

When EVA was compared with MVA, both showed negative values in the year 2002 and 2003. From the year 2004, EVA values were positive because NOPAT was greater than COCE where as MVA values were positive from the year 2005 because of increase in stock price of the company. The share price of the company decreased in the year 2007 and also the total common equity increased and due to that reason, the MVA of the company decreased in 2007.

The calculated co-efficient of correlation between EVA and MVA ( 0.78 ) shows that there is a positive relationship between EVA and MVA .It is inferred that both EVA and MVA were strongly associated with each other during the study period.

Co-efficient of correlation between EVA and Dividend paid is also positive (0.98).This shows a strong association between EVA and Dividend paid.

The co-efficient of correlation between MVA and Dividend paid (0.76) shows a positive association between MVA and Dividend paid.

### **CONCLUSION:**

EVA is the performance measure that is tied most directly to the creation of shareholder wealth but MVA is the difference between current market value of a firm and the capital contributed by the investors. Both EVA and MVA are two financial keys to create shareholders wealth and the true indicator of a company's financial performance.

The calculated co-efficient of correlation are 0.78, 0.98 and 0.76 between EVA and MVA; EVA and Dividend paid, MVA and Dividend paid respectively. It clearly indicates a strong positive association between the variables. Since the year 2005, the positive EVA and MVA values of a company depicts that value is being added to the investors.It is also evident that the dividend paid is also moderate during the study period.

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