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Professor MURUGESAN SELVAM, M.Com, MBA, Ph.D
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**PRACTITIONERS' VIEW ON THE USE OF DEBT DERIVATIVES IN INDIA
AND JUDGEMENTAL BIAS**

Ganesh R*

*Research Scholar, Department of Commerce, Pondicherry University-Karaikal Campus
E-mail ID: ganeshrppg@gmail.com*

and

Naresh G

*Assistant Professor, Department of Commerce, Pondicherry University-Karaikal Campus
E-mail ID: kгнаresh@gmail.com*

Abstract

Corporates raise their debt capital and equity capital to finance their assets. Whether debt or equity capital, it is subject to market risks like interest rate risks, liquidity risks, Inflation risks, etc., In order to protect their assets against such risks, market participants use derivatives as a hedging instrument. But many investors look upon derivatives as unnecessary, cutting into the profits and sometimes, bringing loss to the company. Many academicians and practitioners professed that investors fear debt instruments, with derivative as more risky than debt instruments, without derivative (Koonce, et al. 2005). In a developing market like India, trading of debt derivatives is still at a nascent stage since the market participants have not gained enough confidence due to the stringent regulations relating to trading of these instruments. Therefore, this research intends to focus on the practitioners' perspective on the use of debt derivatives under Indian capital market conditions. The findings of the study show that majority of practitioners use debt derivative for hedging and found limited usefulness in debt derivative. However, since many managers consider derivatives as a risky asset, their use of derivatives in India is at a low level. Findings of the study also hint at judgmental bias of practitioners against the use of derivatives.

Key Words: *Debt Derivative, Market Participants, Capital Market, Market Risk, Investors Psychology and Judgmental Bias.*

JEL Codes: *H63*

*** Corresponding Author**

1. Introduction

Trading in debt products has become a necessity of the day. In India, debt is said to be a tax shield for the company. But due to many reasons, financial institutions like banks may not be able to provide big amounts as loans, at short notice, to needy firms. Therein lies the crucial role of debt capital in helping the firms to acquire the needed amount on time. In addition to that, debt capital will help for the better financial management of the firm. At the same time, using the debt capital is always vulnerable to risks like market fluctuations. Bonds are, therefore, subject to risks, related to general economy and market conditions in the country. In order to avoid the risk of market fluctuation, financial experts and various authorities advise the use of hedging instruments like derivatives on debt instruments. But firm managers are concerned about the perception of investors on the use of derivatives on debt instruments. Many investors believe that companies can make higher profits if derivatives are not used. If a firm, which uses derivatives, incurs loss due to some other reasons, investors wrongly tend to attribute the loss to the use of derivatives. They may even argue that the loss could have been reduced if derivatives were not used. This ‘blame game’, played by lay investors, criticizing managers for using derivatives after a loss, is what psychologists call as ‘counter factual reasoning’ (Roese, 1997). This forms the basic human psychological reservation against the very concept of derivatives and it is suspected to be one of the causes hindering further growth of these instruments. This aspect has been the subject of study by many like Koonce et al. (2005). The fear of public perception of derivatives also forces some managers to conceal the use of derivatives in the financial reports of their companies. The ‘fear of loss’ and resultant wrath of investors, may then

prevent managers from taking a rational decision on the use of derivatives. Limited cognitive capacities of managers can then result in various judgemental biases, including loss aversion bias, preventing them from using derivatives. In addition to these in India, there is the problem of weak legal protection system, working against the use of novel ideas like derivatives in Indian market (Narayan, 2003).

In developed countries, due to better informed investing community, many of these perceptions have been overcome. Over the last two decades, the developed markets have acquired a lot of experience in the field of debt market. During the period, they have witnessed Over the Counter (OTC) derivatives evolving naturally. They also have good legal protection measures. The derivative market is now booming worldwide and it is said to be worth trillions of dollars. But the picture is different in developing nations like India, which was a rather late starter in the field, beginning with the introduction of interest rate derivatives. However, there had been several ups and downs for various derivative instruments and at times, trading in some class of derivatives trickled to less than 50 trades a month. Even though trading in options and futures in the National Stock Exchange (NSE) has increased in their notional value (Shalini and Raveendra, 2014), on the whole, in our country, derivative market just refuses to surge ahead. Even after about 15 years of derivative business, innovative products like corporate debts and its derivatives are meager, compared to the size of the industry. The market participants feel that the regulating authorities have to do a lot by taking several protection measures to safeguard the industry. Against the present scenario, managers of Corporate India have a lot of reservations in the use of derivatives to cover their risks.

In order to neutralize this trend in India and to boost our economy in line with that of the developed nations, it is imperative to quickly identify the problems that still persist in our country and try to rectify them as quickly as possible. This paper is a modest attempt to examine the attitude of practitioners in India towards the use of debt derivative in the country.

2. Literature Review

Debt Derivative is a financial innovation in derivatives market, which is used to hedge the risk in debt instruments like corporate bonds. There have been several studies on the importance, scope and need of the debt derivatives in the capital market. The Ninth Annual OECD Bond Market Forum which took place in Paris on May 22-23, 2007, reports the use of derivatives, on debt instruments, as a protection measure against the escalation of interest rates (**Ninth Annual OECD Bond Market Forum, 2007**). The study also points to the lack of clear legal framework and restrictions on the use of derivatives as the reasons for the poor response to derivatives by corporate and institutional investors. In the last two decades, developed nations have enacted suitable laws to protect the practitioners of derivatives and as a result, these countries experience extensive use of derivatives in various forms of options, so that trading in debts is more popular in those countries than in equities. In all these countries, derivatives quickly rose into prominence because they were mainly used for socially useful purposes such as end users hedging business risk. Studies show that the notional value of global derivatives, that was only two and half times GDP in 2008, have grown to twelve times GDP by 2011 (**Blundell-Wignall, 2012**). There are several studies which stress the positive aspects and need for a well developed derivative marker. Debt markets are important in improving the growth of economy

and therefore, the Central Bank has to play a lead role in the development of debt market (**Khan, 2012**). Study, on the impact of financial derivatives on spot market, has shown that derivatives help in enhancing the liquidity, marketability and efficiency of stock market in India (**Nayak, 2008**). A recent study has further confirmed that derivatives have brought about positive changes in the credit market and substantially helped corporates in raising huge credits for their projects, especially those with long gestation periods. But at the same time, the study hints at embedded risk in such instruments due to poor regulatory mechanism in the country (**Dey and Dey, 2014**). In spite of good prospects of derivatives, the market just refuses to take off in India. There are several studies on the lack of good response in India. One study attributes this dismal performance to the dominance of Government securities in the debt market and practice of passive internal debt management policy (**Ngiam & Loh, 2002**). This calls for active support on the part of the Government to promote use of derivatives in Indian market. There should be a close collaboration between Government and industry in building successful debt market.

Developing a thriving debt market requires hard work and lot of patience. The practices and key issues of corporate debt market in India have been studied by exploring the present structure of debt market, along with the current policies, initiated by the Securities Exchange Board of India (SEBI) (**Subramanian, 2008**). Factors like a well developed yield curve, a liquid market, existence of sufficient volatility, an unambiguous way of determining term structure of volatility, mechanisms for hedging the product and clarity in legal accounting and tax provisions need to be considered for the development of Interest Rate Derivatives (IRD) in India (**Narayan,**

2003). The problems in India are also common to other Asian countries. Poor credit rating of majority of firms in Asian countries, problems like legal hurdles for borrowers and lenders, insufficient liquidity providers and lack of support from Government policies and regulations, which is common to all Asian countries, are cited as reason for the reluctance to invest by potential investors, (Goswami and Sharma, 2011). Another major problem, affecting the growth of derivatives, is human judgemental biases, leading to judgemental errors. When faced with complex problems, people resort to mental short cuts for taking decisions. Even though, generally, they achieve good outcomes, at times, the outcome may be completely wrong. Such decisional shortcuts, taken by decision makers, are called judgemental biases and they are susceptible to systematic inconsistencies (Nisbett & Ross, 1980). When managers are faced with the prospect of using risky derivatives, one can expect judgemental biases influencing their decisions. A behavioral problem known as counter factual reasoning, in which investors blame company managers for incurring additional expenditure on derivatives after a poor outcome is known, may also discourage the use of derivatives. But contrary to popular belief, it has been found that once investors are aware of the use of derivative on debt instruments, they actually give more credit to firms that use derivatives, even after a poor outcome (Koonce et al. 2008).

3. Need of the Study

All previous studies in India highlight the need for derivatives in our growing economy. However, there is a dearth of study on the practitioners' judgemental bias in the Indian capital market. Hence there is a need to look at the perception of market participants in dealing with debt derivatives, along with the impact of judgemental bias on the attitude, towards the use of debt derivatives.

4. Statement of the Problem

Practitioners' perceptions of the use of debt derivatives and counter-factual arguments, which work against derivatives in other countries, can be expected to be much more intense in a more conservative country like India. This paper seeks answers to some of the specific problems, hindering the growth of derivative market in India, such as awareness of derivatives among the stakeholders, managers' awareness and confidence in the use of derivatives and their own trust in investors honestly revealing the use of derivatives. In addition to that, the study also makes an attempt to criticize the effect of judgemental bias on the use of debt derivative.

5. Objectives of the Study

The objectives of the paper can be listed as follows:

- 1) To find out the awareness among practitioners, in the usage of derivatives, to cover debt risks in India.
- 2) To examine the practitioners' opinion about the use of debt derivatives.
- 3) To examine whether practitioners display derivative expenditure and gain/loss they made, in their detailed financial reports
- 4) To find out the practitioners' view on legal protection from possible frauds.
- 5) To examine the effect of judgemental bias on the use of debt derivatives

6. Hypotheses

H_{01} : There is no significant mean difference between the perceptions on the level of usefulness of debt derivative.

H_{02} : There is no significant mean difference between the perceptions on the level of riskiness in the use of debt derivative.

7. Research Methodology

7.1. Source of Data

To study the practitioners' perspective on the development of debt derivatives in Indian market, a structured questionnaire was designed and administered.

7.2. Sample Space

A structured questionnaire was distributed to the practitioners, including Bank Managers, Chartered Accountants, Stock Brokers and Company Managers. The sampling method, employed for the study, was snowball sampling method. The reason for adopting snowball sampling method was to identify the best practitioners who are aware of debt derivatives.

7.3. Sample Size

The sample size consisted of 70 respondents from the States of South India. They were either interviewed directly or contacted by email. Since specialized respondents were considered, the sample was limited to 70.

7.4. Tools for the Analysis

Descriptive Statistics was used for the study, along with ANOVA, to test the hypotheses.

8. Limitations

- Since specialized respondents were considered, the sample was limited to only 70.
- Only the practitioners' sample opinions, from a few selected cities, were taken for the study.

9. Results and Discussion

9.1. Preferred Source for Raising Fund

Finance is the life blood of business. No wonder fund managers look for quick and hassle

free funds, with minimum interest. **Table-1** shows the preferences of source of fund. It is clear from the Table that public sector banks are the most preferred source for raising fund. Issuing bonds does not seem to be a prime source of funding.

9.2. Preference for Bond

Financial institutions like banks may not be able to provide big amounts as loan to needy firms on time due to many reasons. Under such circumstances, issuing bonds can be advantageous. **Table-2** gives the preference of practitioners for using bonds as a source of finance in business and the Table shows that the level of dependence on bonds is less than 25 per cent and ten per cent of respondents did not favor the use of bonds at all.

9.3. Fixed Interest Vs Floating Rate Interest

It is generally expected that people prefer a fixed interest rate to a variable interest on their loans. Therefore, to study the attitude of practitioners towards fixed interest and floating interest loans, they were asked to choose between a loan with a variable interest, with an initial lower rate and a loan with fixed, but higher interest rate. Result, given in **Table-3** shows that even if the interest rate is higher by one percent, a majority preferred fixed interest. It clearly shows the respondents' anxiety towards possible unmanageable escalation in interest rates.

9.4. Calculation of Risk Perception of Debt Derivative

Studies in US and other developed nations have shown that people had initial aversion towards the use of derivatives (**Koonce et al.2005**). In a conservative society like India, this negative perception towards derivatives can be expected to be high.

Table - 4 gives the level of usefulness of debt derivatives. The result shows only a minority of about 13 per cent accepted derivatives to be very useful. At the same time, seven per cent of the respondents found a debt derivative to be not at all useful. Majority of found respondents the usefulness of derivatives as neither *high* nor *low*. This suggests that there is scope for improvement in the near future, on the part of practitioners, with growing awareness in the use of derivatives.

Practitioners' perception of the level of riskiness, in the use of debt derivative, is shown in **Table-5**. Result shows that only a minority of 37 per cent, considered the derivative instrument as either risky or very risky

To calculate the risk perception of derivative on debt instruments, mean scores of usefulness and riskiness in the use of debt derivatives were calculated. As shown in **Table-6**, mean score of usefulness of debt derivative was 3.11 and mean score of riskiness in the use of debt derivative was 3.24. If mean score of riskiness was subtracted from mean score of usefulness, a value of -0.13 was obtained. This shows that though practitioners perceived debt derivative as a useful tool, they perceived debt derivative to be slightly risky.

To identify the attitude of market participants in India, respondents' preference towards corporate bonds, with and without derivatives, is shown in **Table-7**. The result reveals that 57 per cent of practitioners perceived Corporate Bonds, with derivative, as more risky than corporate bond, without derivative.

Table - 8 gives a deeper understanding about the perception of practitioners. It shows that 58 per cent of the Company Managers perceived debt derivative as risky. In the case of Bank Managers, 56 per cent of them

considered derivative as risky. Only 21 per cent of the Chartered Accountants perceived debt derivative to be risky. Around 65 per cent of Stock Brokers perceived derivative as risky. This result is a strong reminder to the authorities, on the urgent need for educating the practitioners, on the use of Debt Derivatives, especially the managers who are supposed to be the key persons in the decision making of companies.

9.5. Opinion on Audit Disclosure

Even when managers opted for derivatives, they were afraid that investors could negatively assess the managers for using derivatives. This is possible, especially if the company registered a loss or a drop in profit. This negative reaction of investors to the use of derivatives, after a poor economic outcome, prevented managers from being honest in the disclosure of use of derivative in their financial reports. According to another school of thought, bold declarations might actually win a favorable reaction from investors because they would appreciate firm managers, for taking great care of the company.

As per **Table-9**, 87 per cent by opting for derivatives recorded a positive attitude for being transparent in the usage of debt derivative. For a deeper analysis, a cross tabulation is presented in **Table-10**, to evaluate the attitude of firm managers towards transparency. According to the Table, no matter what their profession was, majority of stakeholders believed in honest disclosures of the use of derivatives in their financial report.

9.6. Strength of Present Regulatory System

A study, to assess the strength of present regulatory system toward legal protection against possible frauds, was conducted by interviewing the market participants and their opinion, and the results

are shown in **Table-11**, 61 percent of the practitioners were highly satisfied with the strength of present regulatory system. But still a serious study has to be done to check why the rest were not satisfied with the strength of present regulatory system.

9.7. Redressal of Grievances of Investors

If there is a grievance for investors, there should be a responsible authority to redress their grievances. This study made an attempt to explore whether they were satisfied with the redressal system of their grievances. Practitioners' views on this topic are presented in **Table-12**. The Table reveals that 79 percent of the practitioners opined that they were satisfied with the redressal mechanism of their grievances.

9.8. Purpose of Debt Derivatives

For the study, three options were given to the practitioners, regarding the use of debt derivatives. The options were 1) Hedging, 2) Speculation and 3) Arbitrage. Respondents were then asked to rank them, according to their importance. According to the Tables 1, 3, 2, first rank is given for hedging, second rank for Arbitrage and third for speculation.

Table-13 reveals that 43 per cent of practitioners believed in using derivatives on debt instruments, only for hedging, 30 per cent only for speculation, and six per cent only for arbitrage. Around 21 percent of the practitioners wanted to use all the three options, with different weightages to each one. 13 percent of the total ranked hedging, arbitrage and speculation, in that order.

9.9. Level of Use of Debt Derivatives

Table - 14 displays the practitioners' opinions on the level of the use of debt derivatives. Forty seven per cent of practitioners recorded the level of use of debt derivative in business by them as *very low*. Only three per

cent employed debt derivative at a *very high* level.

Out of the 70 practitioners, 38 favored the *low* or *very low* level of use of debt derivatives. As shown in **Table-15**, among the 38 respondents, 27 of them highlighted to the lack of awareness in the use of derivatives as the main reason. One person who answered, 'None of the above', was a company manager and that respondent gave the opinion that debt derivative was risky. Only 13 practitioners preferred to use derivatives at *high* level or *very high* level, in their business. Nine out of these thirteen indicated good awareness as the reason for their use of debt derivative in business. Four of them preferred derivatives only because of lack of other better options.

To check whether there was significance in the mean difference between practitioners on the usefulness of debt derivatives, ANOVA Test was carried out.

H_{01} : There is no significant mean difference between the practitioners in the usefulness of debt derivative.

As P-value was 0.671, which was less than 0.05, null hypothesis is accepted.

H_{02} : There is no significant mean difference between the practitioners in the riskiness in the use of debt derivative.

As P-value was 0.619 which was less than 0.05, null hypothesis is accepted.

This shows that the difference in the perception of practitioners towards the use and perception of riskiness in the use of debt derivative was not significant.

9.10. Awareness on the usage of Debt Derivative

Out of 70 practitioners, who were interviewed, 19 of them were unaware of the usage of debt derivative. This comes to around 27 per cent of the population.

9.11. Attitude of Different Age Groups Towards Debt Derivatives

To check whether the inclination to use and perception of riskiness, in the use of debt derivative, differed for different age groups, descriptive analysis of different age group was applied. Results are given in the **Table - 16**. The study shows that except in the age group 50-65, all other age groups perceived debt derivatives as slightly risky. As two respondents did not fill the age, only 68 were taken for the analysis.

10. Findings

The study shows that public sector banks were the first preferred source for raising funds and the level of dependence on bonds was less than 25 per cent. The study also sheds light on the fear of practitioners towards possible unmanageable escalation in interest rates. These findings seem to be a clear indication of judgmental biases at work, hampering the growth of derivatives in India.

The findings show that a significant number of practitioners used debt derivative for hedging. Though many of the market participants found some usefulness in debt derivative, due to the riskiness in its use, the level of use in their business was *low*. Majority of practitioners perceived bonds, with derivative, as more risky than bonds, without derivative. At the same time, a large majority were bold enough to reveal the expenditure and net profit or gain acquired through debt derivative. Majority of them were satisfied with the strength of present regulatory system for protection from possible frauds and the redressal of grievances. If the above said issues could be solved, then it would lead to the development of a robust debt derivative market in India.

11. Conclusion

Use of derivatives on debt instruments is well established in US and other developed nations. In the beginning, even in these countries, market participants and practitioners had initial reservation about the use of derivatives. Problems, which confronted the development of debt derivatives in developed nations initially, are found to exist in India also and that too on a much larger scale. The low use of derivatives can be taken as an indication of judgmental bias of practitioners in India against the use of derivatives in their firms. This bias is basically a loss aversion bias which managers in India seem to suffer from. Thus the very instrument, which is designed to reduce the loss on debt repayments, is looked upon as an additional burden for their firms, either enhancing their loss or eating into their hard earned profits.

The present study also brings to light the inertia of Indian market participants to change with time and adopt new practices used successfully elsewhere. Practitioners in India, including managers, still depend on public sector banks for servicing their debt requirements. In addition to this, only fewer practitioners had a positive approach towards the derivatives. All these points reveal that there is a need for proper education for all practitioners on the use of derivatives. But one encouraging result of the study was that managers were very forthright in the need to declare everything before the shareholders, including the use of derivatives. Hence it may be concluded that the negative perception on debt derivatives, which is now found in India, may be overcome with time and growing awareness. The growth of derivatives is essential for the benefit of all stakeholders. Benefits derived by the firm, will ultimately boost the economy.

12. Scope for Further Research

- Investors' perception on the use of derivatives is an unexplored area.
- Use of debt derivatives by market participants can be examined.

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Table - 1 : Preferred Source of Funding in India

Source	Frequency	In Percentage	Rank
Public Sector Banks	48	68.6	1
Issue Bonds	14	20	2
Financial Institutions	8	11.4	3
Total	70	100.0	

Source: Computed Data

Table - 2 : Dependence on Bonds

Level of dependence	Frequency	Percent	Rank
Z ero	7	10.0	3
Less than or equal to 25%	40	57.1	1
Greater than 25% but less than or equal to 50%	18	25.7	2
Greater than 50% but less than or equal to 75%	5	7.2	4
Total	70	100.0	

Source: Computed Data

Table - 3 : Preference of Loan Scheme

Loan Scheme	Frequency	Percent	Rank
Fixed Interest Rate 11%	36	51.4	1
Floating Rate (Current Rate 10%)	34	48.6	2
Total	70	100.0	

Source: Computed Data

Table - 4 : Level of Usefulness in use of Debt Derivative

Level of Usefulness	Frequency	Percent
No Use	5	7.1
Level 1	11	15.7
Level 2	34	48.6
Level 3	11	15.7
Very Useful	9	12.9
Total	70	100.0

Source: Computed Data

Table - 5 : Level of Riskiness in use of Debt Derivative

Level of Risk	Frequency	Percent
No Risk	4	5.7
Risk Level 1	10	14.3
Risk Level 2	30	42.9
Risk Level 3	17	24.3
Very High Risk	9	12.9
Total	70	100.0

Source: Computed Data

Table-6 : Statistics of Level of Usefulness and Riskiness of Debt Derivatives

	Usefulness of Derivative	Riskiness of Derivative
Mean Score	3.11	3.24

Source: Computed Data

Table-7 : Risk Perception in using Derivative in Debt Instruments

Risk Perception	Frequency	Percent
Yes	40	57.1
No	30	42.9
Total	70	100.0

Source: Computed Data

Table-8 : Risk Perception in using Debt Derivative (Occupation wise Classification)

Occupation	Risk Perception	Total			
	Yes	Yes (%)	No	No (%)	
Bank Manager	10	55.56	8	44.44	18
Chartered Accountant	4	44.44	5	55.56	9
Stock Broker	15	65.22	8	34.78	23
Company Manager	11	57.89	8	42.11	19
Total	40	57.97	29	42.03	69

Source: Computed Data

Table-9 : Need for Disclosure

Audit disclosure	Frequency	Percent
Yes	61	87.1
No	9	12.9
Total	70	100.0

Source: Computed Data

Table-10 : Importance of Honest Declarations of Use of Debt Derivatives in Audit Reports

Occupation	Importance of honest Audit reports		Total
	Yes	No	
Bank Manager	17	1	18
Chartered Accountant	10	0	10
Stock Broker	17	6	23
Company Manager	17	2	19
Total	61	9	70

Source: Computed Data

Table - 11 : Satisfaction Level of Practitioners about the Present Regulatory System

Satisfaction Level	Frequency	Percent
High	43	61.4
Low	27	38.6
Total	70	100.0

Source: Computed Data

Table - 12 : Satisfaction of Redress for Practitioners' Grievances

Satisfaction with redressal authorities	Frequency	Percent
Yes	55	78.6
No	15	21.4
Total	70	100.0

Source: Computed Data

Table-13 : Reasons for Using Debt Derivative

Preference of usage of debt derivative	Frequency	Percent	Rank
Hedging	30	42.9	1
Speculation	21	30.0	2
Arbitrage	4	5.7	4
1,2,3	2	2.9	5
1,3,2	9	12.9	3
2,1,3	2	2.9	5
2,3,1	1	1.4	6
3,2,1	1	1.4	6
Total	70	100.0	

Source: Computed Data

Table - 14 : The Level of Use of Debt Derivatives in Business

Level of Use	Frequency	Percent
Very Low Level	5	7.1
Low Level	33	47.1
Don' t Know	19	27.1
High Level	11	15.7
Very High Level	2	2.9
Total	70	100.0

Source: Computed Data

Table - 15 : Reason for Low Level of Use of Debt Derivative in Business

Reason for low use of derivatives	Frequency	Percent
Lack of awareness	27	71.1
Alternative product	10	26.3
None of the above please specify	1	2.6
Total	38	100.0

Source: Computed Data

Table - 16 : Results of Descriptive Statistics

Parameter	Age	N	Mean
Usefulness of debt derivative	20-35	38	3.13
	36-50	20	2.95
	50-65	10	3.40
	Total	68	3.12
Riskiness in use of debt derivative	20-35	38	3.29
	36-50	20	3.20
	50-65	10	3.20
	Total	68	3.25

Source: Computed Data