Towards audited financial statements of urban local bodies in India: Key issues and way forward

CA. Ashok Rao CA. K R Praveena

Authors are members of the Institute. They can be reached at eboard@icai.in

In a recent development, audited financial statements have been made mandatory for urban local bodies (ULBs) across the country to access the 15th Central Finance Commission (CFC) grants. To circumvent capacity gaps in the present statutory audit arrangements (discussed later in this article), State governments are in a rush to get ULB financial statements audited by Chartered Accountants for complying with the grant conditions. This article attempts to highlight certain issues pertaining to the mandate of the financial statements audit and it's scope, and attempts to offer recommendations for addressing the issues. Doing so will help in placing financial statements audit on a firm footing and contribute to better fiscal accountability of ULBs. Read on...

Accrual accounting in ULBs

Although the transition to accrual accounting in ULBs began many years ago, the reforms never took off in the real sense. Even after almost two decades, in states where the transition is supposedly complete, the accrual accounting system is yet to fully stabilize. The transition continues to be plagued by issues that include incomplete or piecemeal information for accounting, underlying business processes not aligned with accrual accounting requirements, low capacities of accounts department personnel, dysfunctional information technology solutions, and a widespread lack of awareness amongst stakeholders on using financial statements for governance. These issues have fostered a tendency to fall back to the legacy system after the initial euphoria of the transition to accrual has died down.

Audited financial statements to access grants

Successive CFCs have highlighted these issues and recommended ways to create better reward mechanisms for states to implement and sustain accounting reforms in ULBs. Several central urban renewal programs such as the Jawaharlal Nehru National Urban Renewal Mission – JNNURM, Urban

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Infrastructure Development Scheme for Small and Medium Towns – UIDSSMT, Atal Mission for Rejuvenation and Urban Transformation – AMRUT, and the 14th CFC grants have touched upon the subject of accrual accounting reforms in ULBs, either encouraging the transition as a soft reform or by directly linking it to grant eligibility. The 15th CFC has gone a step further and made audited annual accounts an entry-level criterion for accessing the grants. The adoption of accrual accounting, which was expected to pick up in response to market forces, is, unfortunately, now having to be forced by the federal government. Policymakers are hoping that this time around, it will work and stir the states and ULBs to action.

Early trends look promising

The initial reaction to the 15th CFC recommendations offers some hope. The recommendations have been accepted by the government. The Ministry of Finance has released the scheme operational guidelines. The Ministry of Housing and Urban Affairs (MoHUA) has released the marking scheme and has set up a web portal for ULBs to upload their audited financial statements[1]. The number of financial statements uploaded on the portal is steadily increasing. There is a buzz around this at the state government levels as well[2]. Many states and/or ULBs that have already transitioned to accrual have floated Requests for Proposals from Chartered Accounts for financial statements audit[3]. Other states, realizing that accrual accounting is the gateway to ULB audited financial statements, are scrambling to quickly implement the reforms.

A few challenges remain though

Notwithstanding the proactiveness within government circles to comply with the entry-level grant conditions, there are increasing signals that the initial enthusiasm will, once again, be relegated to a "tick-in-the-box" exercise, as has been the case with many reform conditions in the past. The underlying reason for this apprehension is that, barring a few exceptions, in most states, financial statement audit is being positioned as an exercise distinct from external audit under the statute governing the ULB (commonly called 'statutory audit'). Thus, the approach to getting annual accounts audited can be compared to the certification of utilization certificates under specific programs/schemes ('UC audit'), where the auditor has a restricted mandate, and the audit serves a limited purpose of opening up access to grants for the ULB.

The authors attempt to highlight two key issues with this approach and provide recommendations for ensuring that efforts behind producing audited annual financial statements of ULBs are properly channelized and result in meeting the objective behind the CFC's recommendations of establishing ULB financial reforms on concrete ground.

Issue 1: Primary audit mandate

www.cityfinance.in, a portal launched by the MoHUA last year carries an interesting comparison of municipal statutes of different states governing accounts, finance, and audit-related matters of ULBs[4]. On reviewing the provisions relating to audit, one can observe that in most states the state audit department (called State Audit Department or Local Fund Audit Department or Examiner of Local Funds) is entrusted with the statutory

1. *http://www.cityfinance.in/fc_grant*
2. *Action at the state level is anchored either in the urban development department or the directorate of municipal administration.*
3. *Karnataka, Odisha, Himachal Pradesh to name a few states.*
4. *Disclaimer: MaGC is the knowledge partner for the portal.*

audit responsibility. Under the Bihar and Jharkhand statutes, a Chartered Accountant (CA) appointed by the State Government may be the statutory auditor of ULBs.

A 'financial audit' is widely understood to result in attestation of the financial statements[5]. However, barring certain exceptions, in most states, the state audit department, which is the primary auditor, does not undertake attestation of financial statements since there is no such requirement under the governing Acts[6]. In Tamil Nadu, the Local Fund Audit Department undertakes certification of financial statements as part of its audit of ULBs. In Karnataka, by statute, the Financial Statements Auditor – a CA firm engaged by the Urban Development Department (UDD) – is required to submit the audit report to the state audit department, which relies on this report in its audit.

Most state audit departments are beset with their own set of problems which include a backlog of audit arrears running into several years, acute staff shortages, and archaic audit processes. More importantly, they lack internal capabilities to be able to audit financial statements produced by the accrual accounting system[7]. The gap in legal mandate coupled with these problems has ensured that audit of financial statements has hitherto remained untouched.

To meet the grant eligibility conditions, State UDDs have charted workarounds to produce audited financial statements of ULBs. The usual *modus operandi* is to engage CA firms to undertake financial statements audit. Such audited financial statements serve the limited purpose of satisfying the grant eligibility criteria and are forgotten after that. The state audit department (the primary auditor) does its audit in due course and its report has the legal sanctity of statutory audit. This has, at times, resulted in instances where ULBs have ended up with two sets of audited financial statements for the same financial year – one audited by the CA firm and another audited by the state audit department.

Unless this anomaly in audit mandates is addressed, it is evident that the financial statement auditor's report would never be accorded the importance of the primary auditor's report and will continue to be an additional exercise to the primary audit. There are multiple ways to address this:

a) Introduce necessary amendments in the state municipal Acts to recognize a CA firm appointed by the state government as the primary auditor – this would preclude the need for the state audit department to separately undertake ULB audit[8]. Apart from addressing the issue of lack of clarity in the mandate, it would help lessen the workload of state audit departments, which are reeling under staff shortages on one hand and an increasing number of auditee institutions on the other;

b) Retain the state audit department as the primary auditor, specifically include certification of financial statements in the mandate, and establish a mechanism for the outsourcing of audit work by the department to CA firms – this would help enhance internal resources and capacities of the state audit department[9];

c) Delineate the role of the financial statement auditor and the primary auditor in the statute, clearly specifying how the financial statement auditor's work fits into the primary auditor's work – this would avoid overlap in mandates[10].

Issue 2: Scope of audit

"Audit of accounts"[11], as generally practiced by state audit departments, goes beyond financial audit. It includes a large

[5] The definition of Financial Audit used in the C&AG Auditing Standards is aligned to the definition adopted by INTOSAI, It focuses on determining whether an entity's financial information is presented in accordance with the applicable financial reporting and regulatory framework. This is accomplished by obtaining sufficient and appropriate audit evidence to enable the auditor to express an opinion as to whether the financial information is free from material misstatement due to fraud or error.

[6] Namely, the Acts governing municipal corporations and municipalities and the Local Fund Audit Acts.

[7] The 15th CFC report in Para 7.95, states that audited accounts shall include a minimum of: a) balance sheet; b) income and expenditure statement; c) cash flow statement; and d) schedules to balance sheet, income and expenditure statement and cash flow statement.

[8] As in the case of Bihar and Jharkhand.

[9] Presently followed in Odisha, although it still does not include audit of financial statements.

[10] Followed in Karnataka.

[11] This is term generally used in the governing municipal Acts and Local Fund Audit Acts.

element of compliance audit[12] and covers propriety aspects as well. The strong focus on compliance and propriety stems from the fact that there is no system of independent internal audit[13] in ULBs which would have addressed these aspects. Moreover, the audit by the state audit department is based on a hundred per cent check of transactions[14]. The financial audit, in this case, does not include within its ambit a certification of the full set of financial statements[15], even in cases where the definition of "annual accounts" under the applicable statutes covers them.

Contrary to this, an **audit of financial statements** is understood by CAs as an opinion on the true and fair representation of the auditee's financial affairs. Although compliance and propriety aspects are important considerations, these are not the primary focus of a financial statements audit. These aspects are reviewed as part of forming the audit opinion on the adequacy and satisfactory functioning of the internal control system of the auditee-ULB. Furthermore, the audit opinion is arrived at adopting a risk-based approach using sampling techniques and does not involve a hundred per cent check of all transactions. Unlike traditional audit by the state audit department, the financial statements auditor certifies the full set of financial statements and not just the closing cash balance.

Differences in scope and approaches in the two audits discussed above give rise to certain legitimate concerns, making "audit of accounts", in its traditional avatar, seemingly appear indispensable. One concern is that certain areas of compliance and propriety may be omitted in financial statements audit[16]. Another concern is that, given the involvement of public money, a sample-based audit may omit to catch irregular transactions when they fall below the sampling threshold, and therefore, a more detailed audit is called for. Lastly, the perception that accountability of the state audit department is higher compared to a CA firm, and hence the primary audit responsibility cannot be delegated.

The authors believe that there are ways to systemically address the above concerns without necessarily having to commission two parallel sets of audits towards the same objective. These are outlined below.

> An audit of financial statements is understood by CAs as an opinion on the true and fair representation of the auditee's financial affairs. Although compliance and propriety aspects are important considerations, these are not the primary focus of a financial statements audit.

a) Compliance and propriety largely fall within the remit of internal audit. The concept of internal audit, in its true sense, is slowly finding takers within government circles in recent years. While larger ULBs can have exclusive internal audit arrangements, for a majority of ULBs, a pooled internal audit arrangement at the state level would be cost-effective. The primary audit (which should encompass financial statement audit), in such cases, would be required to evaluate and comment upon the effectiveness of internal controls and internal audit rather than having to undertake a cent per cent check of all transactions.

b) A system of pre-audit[17] or concurrent audit[18] can ensure a near 100% coverage of transactions and ensure basic correctness and completeness. Such checks would then be an integral part of the ULB's internal control

12. Compliance Audit definition under the C&AG Auditing Standards focuses on whether a particular subject matter is in compliance with the criteria. Compliance auditing is performed by assessing whether activities, financial transactions and information are, in all material aspects, in compliance with the applicable authorities which include the Constitution, Acts, Laws, rules and regulations, budgetary resolutions, policy, contracts, agreements, established codes, sanctions, supply orders, agreed terms or the general principles governing sound public sector financial management and the conduct of public officials.

13. Internal audit here should not be confused with "pre-audit" which is an additional layer of internal control nor with "resident audit" which is a method of audit execution and not internal audit per se.

14. A few state audit departments are in the process of moving to risk-based sampling.

15. The practice of certifying the closing cash balance is followed in some states.

16. For instance, non-compliance with procurement laws and guidelines, non-adherence to delegation of powers, procedural irregularities, lapses in service matters and so on.

17. Pre-audit is a system followed in certain ULBs, under which, every payment is checked by an independent official from outside the ULB before it is made. The pre-audit responsibility is generally assigned to personnel from the State Audit Department.

18. Concurrent audit is a common practice in the banking and financial services industry where the number of transactions is large and correctness of individual transactions assumes high importance.

system rather than being part of the external audit mandate. With the increasing digitalization of ULB functions, a large part of such checks can be automated, which can, over time generate significant cost benefits.

c) All CAs are bound by the auditing standards, code of ethics, and disciplinary arrangements of the Institute of Chartered Accountants of India (ICAI). This serves as an additional recourse for ensuring accountability of a CA firm discharging the primary auditor role over and above audit accountability aspects covered in the municipal statutes of the state. Further, the audit firm selection criteria can be tailored to ensure that credible firms get selected[19], which serves as an additional assurance on the audit quality and accountability aspects.

d) The Comptroller and Auditor General of India (C&AG), working with the World Bank and the Asian Development Bank, has formulated standard terms of reference for the audit of externally aided projects. On similar lines, it would be advisable for the C&AG, ICAI, and the MoHUA to jointly come out with standard terms of reference for financial statements audit of ULBs. Such terms of reference must elaborate the mandate, scope of work, applicable auditing standards, audit in a computerized environment, and reporting requirements amongst other things. This would ensure uniformity in ULB audit across the country and establish uniform expectations on the content and quality of ULB audit reports. It would also help in undertaking auditor capacity development efforts.

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Conclusion

The 15th CFC has set the ball rolling towards institutionalizing accrual accounting reforms in ULBs in the country and ensuring their long-term sustainability.
It is now up to the MoHUA and the state governments to ensure that, quick-fix solutions don't proliferate merely to satisfy the grant eligibility, leaving the larger systemic issues relating to audit mandate, legal backing, scope of audit, and capacity of auditors unresolved. Arriving at an acceptable solution would benefit from the active involvement of state audit departments in their capacity as the statutory auditors of ULBs, the ICAI as the premier professional body governing the audit landscape in the country, and the C&AG as the Supreme Audit Institution of India.
The 15th CFC has introduced relaxations in eligibility conditions for financial years 2021-22 and 2022-23 by requiring only 25% of ULBs in a state to submit audited annual accounts. The relaxations provide ample time and opportunity to engage with key stakeholders and plug the loopholes. Doing so would ensure that audits of financial statements are not viewed as a ritual for accessing grants but become a means for increased public accountability and better fiscal management of ULBs.

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7. *Comparison of municipal finance provisions – http://www.cityfinance.in/municipal-law*

[19] *It is common to include empanelment with the C&AG as an eligibility criterion while selecting CA firms for ULB audit.*