

# Conversion of Municipal Accounts— A strategic Perspective

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**From time immemorial, accounting for governments and government agencies has been on a cash basis. No change was contemplated until the early 1980s when it was considered appropriate that government business enterprises should move closer to commercial accounting principles practiced in the private sector either on a full accrual or a modified accrual basis.**

## Accounting is Changing as the World Changes

The pace of change has accelerated since then as governments around the world are being asked to do more with less and to be fully accountable to the community for resources entrusted to them. As resources become scarcer, governments and public sector managers are more conscious of different ways to deliver services to achieve government policies and desired outcomes. Examples of this are competitive tendering and other forms of contracting out of activities which have traditionally been carried out by governments.

Demands for better accountability by governments and in turn by public sector managers is being heard around the world as the public realizes that living on credit is

not sustainable for individuals and that the same principle applies to governments.

These forces create an environment in which the public demand reforms in the way governments manage their activities and businesses, and reforms in the way governments fulfil their responsibilities without leaving a huge burden on future generations.

It can be argued that these forces are a precondition for governments adopting financial reforms. An environment of reform tends to lead to decision makers demanding more useful information to assist in deciding between competing courses of action and to discharge their accountability in a meaningful way. The move from a cash basis to an accrual basis of accounting would seem to be a progression in keeping with management and financial reforms in the public sector.

## Indian Scenario

Presently, most of the Municipal Bodies in India are following a Single Entry system of accounting. A Single Entry system of book keeping is one, in which as a rule only records of Cash & Personal accounts are maintained and as such is always an incomplete set of records.

A Single Entry System cannot test arithmetical accuracy of itself. This is because no trial balance can be prepared. In the current Single Entry System only Receipts and Payments records are maintained. It does not distinguish between Asset, Liability, Income and Expenditure. As a result, no Income can be determined from the activities of the Municipal body. The balancing figure of Receipts minus



Payments result in a balance, which is actually the Fund Balance (cash and bank balance).

The adoption of the cash basis of accounting by the Municipal Bodies owes its origin to the pre-eminence of the budget as the principal means of financial control for the Municipal body. The pre-eminence of the budget is well enunciated in almost all the Municipal Acts. The purpose is that as the Municipal body is a service organization there is only

a need to expend monies received / raised against planned / non-planned expenditures. The measuring rod is therefore the budget and so cash basis of accounting is implicit to budgetary monitoring and therefore being followed.

An important element that overrides the budgetary principle of accounting of municipalities is that the obligatory function of the municipality which is to expend monies earned is not fully tenable. Municipalities today earn income on business like ventures. This requires the maintenance of separate books between obligatory and business like activities because their purposes are dramatically different.

Today most Municipal bodies are in need of funds – this is because revenue collection system in most Municipal bodies is weak. In the case of municipal organization, as in others, there is a regular shortfall between revenue and expenses and this deficit has to be met through expensive governmental borrowings at high rates of interest. It is imperative for the municipal organizations to issue their own bonds to meet their short-term and long-term funding requirements. This cannot be done unless a proper rating has been obtained and that in turn is dependent upon the presentation of acceptable sets of financial statements prepared on the accrual basis.

Further, the Union of India had itself filed an affidavit (writ petition (CIVIL) No. 888 of 1996 filed by Mrs. Almitra H. Patel against Union of India and others), in which one of the sugges-

tions made was that urban municipal bodies should be persuaded to shift from their existing accounting systems to the double entry accounting system to pave the way for obtaining private funding as well as bilateral/ multilateral funding for their civic services, such as waste disposals etc. While considering the matter, the Hon'ble Supreme Court in its order dated 13th December 2001 has indicated that the Court would proceed on the basis of the contentions in that affidavit, in case no objections are filed. It is also important to note that the affidavit filed by the Union of India contained very specific reference to the Technical Guide on Accounting and Financial Reporting by Urban Local Bodies which was published by the Institute of Chartered Accountants of India.

The Comptroller and Auditor-General of India (C&AG) had also constituted a Group to look into the matter of bringing about improvements in local government bodies. This Group submitted its report to the Government, and the Government thereafter constituted a monitoring group to gauge the extent of implementation of the recommendations contained in that Report. It is important to note that the C&AG group report also was based on a changeover from the cash basis to the accrual basis. The Report contains a number of formats that the local government bodies are exhorted to use.

In 2002, the Government of India through the budgetary pro-

visions for fiscal 2002 recommended that the Development Authorities and Housing Boards be brought under the tax net and therefore, amended Section 10(20A) of the Income tax Act, 1961. This has also given rise to cause for consideration in the large number of such bodies in the country. In order to determine income tax liability, accounting on the accrual system became a pre-requisite. Thus, the need for the conversion of accounts of development authorities and housing boards had been created through a Government diktat.

The above milestone observations started off a new trend in the country with various Urban Local Bodies becoming eager to get their accounts converted. With these winds of change blowing the Chartered Accountants are exposed to new challenges and opportunities in this area.

### Consulting Strategies – Conversion of Accounts

Urban local bodies may vary in size and complexity. Both of these are basically related to the size of the city itself defined in terms of population. However, complexity of operations may arise from other causes also, including patterns of land-use. In India, unfortunately, local bodies have been the victims of unprofessional practices in more ways than one, and this has affected decision-making styles and capabilities across the board. Manpower in urban local bodies, especially at the lower levels, is almost totally unskilled or semi-skilled.

So far as accounting matters are concerned, this state of affairs

severely limits the choice of strategies available to the consultant. Additionally, most local bodies, quite unlike what is expected of them, are anything but transparent in financial matters, and efforts at increasing the levels of transparency and accountability meet with resistance from various levels.

On the brighter side must be seen the generally evolving concern of State Governments as to the financial state of the urban local bodies. This arises from the financial crunch that the State Governments themselves are facing. If the urban local bodies were to become financially viable, or at least if their financial reports were such that one could predicate budgeting exercises based on these financial statements, the State Governments would certainly benefit from that. The problem is that in many such cases there are hidden agendas that are also pursued by the State Governments. Those, however, must be taken as part of the game; especially since the consultant, perforce, must limit his actions to the brief he has been given, and must not extend his own domain of activities to the reasons why one or the other Term of Reference appears on his engagement letter.

Generally speaking, in urban local bodies, three major types of consulting strategies could be adopted:

- Bottom-up
- Organization-wide
- Top-down

Before adopting any consulting strategy it is imperative to get a better overall picture of the administrative structure of the Municipal bodies. This implies understanding

the relevant hierarchies, both at the Headquarter and the district/ward or Sub-headquarter levels. The subdivisions are dependent on the size of the city. Smaller towns may only have wards, while the larger ones may have wards, constituencies or districts and Sub-headquarters.

For this, it is necessary to conduct a study of the administrative structure both at the Headquarters and the Sub-headquarters. These structures as drawn by the advising personnel must be vetted and accepted by the concerned management staff at the Sub-headquarters level and at the Headquarters.

In the case of the Headquarters, most of the information concerning the Organization Structure will be obtained from the contact officer who may be (and should preferably be) a senior officer in the finance and accounts department.

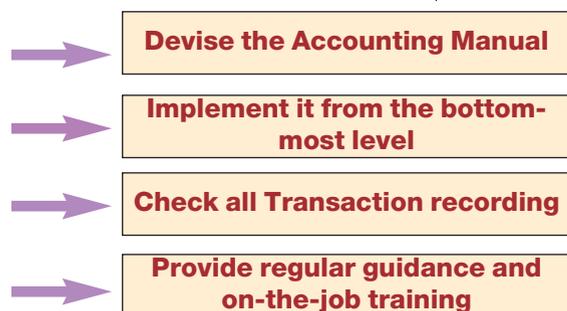
The number of wards, districts etc and their structure has to be carefully noted and incorporated in a proper organizational chart. It is also necessary to note all the functions of the municipal body under the relevant sections of the Municipal Act. This is important because these functions generally get reflected in the Chart of Accounts also. The understanding of these functions and their incorporation is required for MIS requirements that are generally linked to the accounting system through the Chart of Accounts. This can be affected through the computerisation of the basic accounting structure i.e., the Chart of Accounts. If there are redundant account heads in the Chart of Accounts, then the extent of redundancy is found by referring to the

functions as embodied in the Act. And if the Chart of Accounts is deficient in this respect, then that also may be noted from this exercise.

The choice of the consulting strategy in a particular case depends on a number of factors, which are explained below:

**Bottom-up Strategy**

The bottom-up strategy essentially means that the conversion process is initiated from the bottom-most layers of the organization, i.e., the personnel who are tasked with the giving and taking of moneys and the personnel who are tasked with the preparation of basic accounting formats. Essentially



this means that the clerks and lower level officers of the organization are exposed to the new system, to initiate the process of conversion. The system then builds up through the accumulation of transactions recorded on the new formats, which are verified and re-verified by those who are in charge of the conversion process.

This sequence of events requires that there is an Accounting Manual which is prepared prior to the initiation of the implementation process. The adoption of the accounting manual by the lower

level functionaries is the crucial factor. Given that the lower level functionaries in most urban local bodies are at best only semi-skilled in accounting matters, this is the biggest hurdle that the consultant has to face. The accounting manual must be such that it is easy to understand; but more important than that is the designing of the training inputs to these functionaries.

What needs to be understood is that the lower levels are those that have the highest resistance to change. Also, at these levels, any process of change gets interpreted in terms of addition to job responsibilities, increase in work-load, and, in the more politicized local bodies, as strategies initiated by the top management to control the lower levels. Transparency and accountability are, culturally, anathema to such levels, in most cases.

To be fair, it must also be stated that if the lower levels accept the change, then for the consultant, it is absolutely plain sailing; unfortunately this seldom, if ever, happens. One must also be conscious of the fact that unions are very active at these levels and therefore one must take the unions in confidence, and must work with them, to bring about the necessary attitudinal changes. There are a number of local bodies which have upwards of twenty unions. Obviously, if the consultant tried to win over each union, almost his entire time would be spent on this alone, with no guarantee of success. For that reason, it is necessary to

work with a core group from the local body – whose members are fairly familiar with unions and the way that they would look at things.

It is recommended that the consultant largely confine himself to making presentations and offering comments, leaving the process of ‘buy-in’ to emerge from the series of meetings, which then essentially are between the core group of employees belonging to the urban body and the unions and the opinion makers amongst the lower level functionaries.

Another problem of the bottom-up approach is that the role of the top management becomes severely limited. The top management usually has neither the time nor the inclination to engage in continual dialogues with the lower levels. As such, the consultant cannot approach them every time that he faces a concrete demonstration of the factor of resistance to change. This can create problems, in turn, with the schedule of implementation.

In most local bodies there is a severe problem of manpower in the accounting and finance functions. This can affect the process of implementation because the bottom-up approach demands that for quite some time a parallel process according to the old established system must also run. The results produced by the new system must be checked and re-checked continuously. The net effect is that enhanced manpower must be committed by the organization to the whole conversion process, and this is usually not available. The consultant may certainly bring in his own people to assist the process of adoption of the

new system; but this really is not helpful because finally the employees of the organization must be the ones to own the new process.

Additionally, there is one more, but no less critical, problem. With the existing manpower of the local body committed to their involvement in the changeover process, there is likely to be an effect on the level of service provided to citizens and others who have dealings with the Municipal Body. Getting accustomed to the new formats takes time, and this slows down all activities concerning transactions with outsiders. Therefore, unless carefully planned for, there could be a reaction from the general public also on this whole matter which may have a negative effect on the implementation of the new process.

On the positive side, it is to be stated that if properly implemented, the bottom up approach is the best guarantee of an effectively functioning system. Additionally, since audit trails are built up from the very beginning, major advantages as far as the evaluation of internal controls is concerned, are gained.

**Organization-wide Strategy**

The Organization-wide Strategy is best used when there is reason to believe that all levels of the organization are simultaneously

- ➔ Demands total understanding of initial system across all
- ➔ Demands total commitment of all personnel at all levels
- ➔ Simultaneous introduction of new system together with MIS and budgetary system
- ➔ Comprehensive software may be required for larger entities

and totally committed to the proposed change. In this approach, there is a concurrent introduction of the changed accounting system together with an updated and/or modified Management Information System and Budgetary System.

Clearly then, the adoption of an organization-wide strategy will have as its pre-requisite the condition that there is total understanding of the purpose, the process and the implementation strategy across all levels. This is a condition normally not available. Also because of the substantial nature of changes, mistakes in one sub-system can have a cascading effect, which then becomes very difficult to deal with. The argument given for the Bottom-up Strategy is valid for this strategy also, viz., that a parallel run is required and since we are now talking about a comprehensive change, the total system must run in parallel with the existing on, in order that there is no discontinuity of services to the citizens. This creates pressure on manpower and other resources.

The advantages of the Organization-wide strategy can be briefly stated as –

- One major attempt after careful planning can solve all problems.
- Most outputs can be pre-designed.
- Systemic deficiencies can be pre-iden-

tified and planned for.

- Subsequent changes much easier to follow-up on.

**Top-Down Strategy**

The Top-down approach really begins by implementing changes at the top or the headquarter’s level and then steadily progressing downwards. The main advantage of this approach is that implementation of the changes can be in clearly identified phases, each phase modularly connected to the one preceding it as well as the one succeeding it. The ownership of the project

- ➔ Implementation can be in clearly identified Phases
- ➔ Ownership of the Project proceeds top downwards-once begun, cannot go back
- ➔ Consulting Strategy can be quite flexible
- ➔ No need to make major investments on software initially
- ➔ Can be designed so as not to affect clerical levels in any material way

also proceeds top downwards. This means that once the project begins, there cannot be any retro crate steps. As a result, the consulting strategy can be quite flexible and the total change-over process can be designed so as not to create pressures on the lower levels of the organization.

**Convincing the Management - Arguments**

In all the three strategies, a major factor is the commitment of the top management itself. It is rec-

ommended that the consultant should carefully consider the argument that would be particularly applicable to the situation at hand. Some general arguments however, can be stated as follows:

- Yesterday’s effect on today and today’s effect on tomorrow – financially speaking this is something that is not possible to determine on Cash Basis and since most Urban Local Body top managements are concerned with the short-term immediate future, this kind of an argument, when presented in the context of a specific city or town, with examples, accelerates the process of the top management by-in.
- The change-over process helps to present the financial condition of the Urban Local Body rather than the financial position only. This means that the total work of the Urban Local Body is presented, which normally is a brighter picture than its cash worth.
- The Accrual System also helps to present the segments and the consolidated picture in a format i.e. relatively easily understood by the citizen as well as opinion-makers and influence groups.

It must be noted that the arguments which are valid for the top management are not necessarily the ones which make sense to other levels in the organization. For the lower levels, the primary concern is whether the whole process is going to add to their work load. Thus, in making presentations for these lev-

els or in meetings with them, arguments based on the advantages of computerized accounting may be used in addition to such others as may be considered necessary in an organization-specific and situation-specific context.

**Financial Information**

Basically, financial information can be classified as *Financial Information on Transactions*, and *Financial Information on Events and Processes*. *Financial Information on Transactions*, for example, can be information on Receipts and Payments, and Financial information on Events and Processes can be those pertaining to creation of Assets, maintenance work in progress, etc. The important point here is that the information system in local bodies captures part of this information, and does not capture the whole. Obviously, when financial information is captured by the accounting system, it enters the accounting process. If financial information is captured by other systems, then this is a ‘red flag’ situation, and the organization must sit up and take notice. Carried to its extreme, when information pertaining to events and processes is captured not by the financial system, but by others, then dysfuntionalities are introduced in the organization. This basic concept is shown in the diagram below:

**Captured By**

The consultant must see the extent of information which is not being captured by the accounting system. A very useful example here is the case of current liabilities in respect of engineering contracts. On the cash basis, and as per the practices current in most local bod-

Accounting System	Others
Functional	Red Flag
Value-adding	Dysfunctional

ies, this information is not captured by the accounting system. Funds are released on demand by the engineering department as long as these are within budget. As a result, contract-wise data is not available with the accounts department. At the end of the year the engineering department supplies – if asked for- their ‘estimate’ of outstanding liabilities on account of contracts. Usually, this is an omnibus figure and does not give details.

The consultant must try and institute systems to see that such data are included in the accounting information system, and design appropriate formats for this. Contrary-wise, information on capital work-in-progress, including comparisons of physical and financial progress is also available with the engineering department. If it is already included in the financial

**Information From financial System**

	Available	Not Available
Available	Cross-check and Revalidate	Capture And integrate
<b>Information from Systems other Than Accounting</b>		
Not Available	Analyze and consolidate	Define and Import

accounting system then the Group belonging to the organization must help to capture the data which is then appropriately integrated with other financial data by the consulting team. When the data is not at all available within the

information system, it adds value, and if it is not, then the same information gives rise to anomalies in financial planning and other dys-functionalities.

Thus the accounting reform strategy can be seen in terms of four strategic quadrants, as below:

When data is available from both origins, the appropriate consulting strategy is to cross-check and revalidate the data. The cross-checking should be done by the Group which is part of the organization, and the revalidation is to be done by the Consultant. If the financial data is not available with the

organization then the consulting team must define it, and the group belonging to the organization must participate in the process of importing it into the accounting system. Thus the above schematic also helps to define the responsibilities of the Group from the organization and the consulting team:

The way forward at the ground level is then seen in terms of the following steps:

- List Total information needed
- Locate source of information within the organization and

- classify in terms of the schematic as given
- Generate formats to capture information not currently available within the accounting system
- Evaluate necessity, sufficiency and reliability of data
- Integrate with proposed accounting system

**Corrigendum**

Clause (b) of paragraph 24 (page 9) of the Statement on Companies (Auditor’s Report) Order, 2003 states as follows:

“(b) its turnover exceeds rupees fifty crores; or”

There is an inadvertent printing error in the clause. The word “fifty” appearing in the clause should be read as “five”.

**Information From Financial System**

	Available			Not Available
Available	Cross Check	Re-validate	Capture	Integrate
<b>Information from systems other than Financial</b>				
Not Available	Analyze	Consolidate	Import	Define

Consulting Team’s Responsibilities   
 Organization Team’s responsibilities

**ANNOUNCEMENT**

SEBI has prepared a standardized format of documentary requirements (KYC, Members Clients agreements, Tripartite agreement, Risk Disclosure documents) for trading on stock exchanges. These documents are uploaded on SEBI website [www.sebi.gov.in](http://www.sebi.gov.in) for public comments.