

Audit of Public Sector Undertakings

18.1 Introduction

The public enterprises in India have been assigned a key role in the socio-economic development of the country. These enterprises are industries supplying basic inputs to industry and agriculture, such as coal, oil, steel, minerals and metals, cement, chemicals and fertilizers and heavy equipment. Public utilities like the railways, postal and telecom services, electricity generation and supply, road transport, etc. constitute another class of public enterprises. Thus in India the public sector has achieved a dominant role in the national economy.

Public sector enterprises are organised through any one of the following modes:

- (a) Departmentally managed undertakings which form part and parcel of Government activities, for example Indian Railways, Postal Services, Security Printing Press , Canteen Stores Department ;
- (b) Government companies and deemed Government companies set up under the Companies Act 1956, where Government or Government-owned and controlled institutions own 51 percent or more of the paid up capital;
- (c) Corporations set up under the specific Acts of legislature e.g., Life Insurance Corporation, Unit Trust of India, etc.

18.2 Framework for Government Audit

In India, government audit is performed by an independent constitutional authority, ie. Comptroller and Audit General of India (C&AG), through the Indian Audit and Accounts Department. The Constitution of India gives a special status to the C&AG and contains provisions to safeguard his independence.

Article 148 of the constitution provides that the C&AG shall be appointed by the President and can be removed from the office only in a like manner and on the like grounds as a judge of the Supreme Court. Thus, the C&AG can be removed only on the ground of proven misbehaviors or incapacity and only through an order of the President's after each house of Parliament has recommended the removal by the required majority. The salary and other conditions of service of the C&AG are determined by the Parliament. Article 151 of the Constitution requires that the audit reports of the C&AG relating to the accounts of the Central/State Government should be submitted to the President/Governor of the State who shall cause them to be laid before Parliament/State Legislative.

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The Comptroller and Audit General's (Duties, Power and Conditions of Services) Act, 1971, prescribes that the C&AG shall hold office for a term of six years or upto the age of 65 years, which is earlier. He can resign at any time through a resignation letter addressed to the President. The Act also assigns the duties regarding the audit to be followed by C&AG.

The organisations subject to the audit of the Comptroller and Auditor General of India are:

All the Union and State Government departments and offices including the Indian Railways and Posts and Telecommunications.

About 1200 public commercial enterprises controlled by the Union and State governments, i.e. government companies and corporations.

Around 400 non-commercial autonomous bodies and authorities owned or controlled by the Union or the States.

Over 4400 authorities and bodies substantially financed from Union or State revenues.

Audit of Government Companies (Commercial Audit) - There is a special arrangement for the audit of companies where the equity participation by Government is 51 percent or more. The primary auditors of these companies are Chartered Accountants, appointed by the Union Government on the advice of the Comptroller & Auditor General, who gives the auditors directions on the manner in which the audit should be conducted by them. He is also empowered to comment upon the audit reports of the primary auditors. In addition, he conducts a supplementary audit of such companies and reports the results of his audit to Parliament and State Legislatures.

Audit Board Setup in Commercial Audit - A unique feature of the audit conducted by the Indian Audit and Accounts Department is the constitution of Audit Boards for conducting comprehensive audit appraisals of the working of Public Sector Enterprises engaged in diverse sectors of the economy.

These Audit Boards associate with them experts in disciplines relevant to the appraisals. They discuss their findings and conclusions with the managements of the enterprises and their controlling ministries and departments of government to ascertain their view points before finalisation.

The results of such comprehensive appraisals are incorporated by the Comptroller and Auditor General in his reports.

Action on Audit Reports - The scrutiny of the Annual Accounts and the Audit Reports thereon by the Parliament as a whole would be an arduous task, considering their diverse and specialised nature, besides imposing excessive demands on the limited time available to the Parliament for discussion of issues of national importance. Therefore the Parliament and the State Legislatures have, for this purpose, constituted specialized Committees like the Public Accounts Committee (PAC) and the Committee on Public Undertakings (COPU), to which these audit Reports and Annual Accounts automatically stand referred.

Public Accounts Committee - The Public Accounts Committee satisfies itself:

- a. that the moneys (shown in the accounts) were disbursed legally on the service or purpose to which they were applied.

- b. that the expenditure was authorised.
- c. that re-appropriation (i.e. distribution of funds).

It is also the duty of the PAC to examine the statement of accounts of autonomous and semi-autonomous bodies, the audit of which is conducted by the Comptroller & Auditor General either under the directions of the President or by a Statute of Parliament.

Committee on Public Undertakings - The Committee on Public Undertakings exercises the same financial control on the public sector undertakings as the Public Accounts Committee exercises over the functioning of the Government Departments. The functions of the Committee are -

- a. to examine the reports and accounts of public undertakings.
- b. to examine the reports of the Comptroller & Auditor General on public undertakings.
- c. to examine the efficiency of public undertakings and to see whether they are being managed in accordance with sound business principles and prudent commercial practices.

The examination of public enterprises by the Committee takes the form of comprehensive appraisal or evaluation of performance of the undertaking. It involves a thorough examination, including evaluation of the policies, programmes and financial working of the undertaking.

The objective of the Financial Committees, in doing so, is not to focus only on the individual irregularity, but on the defects in the system which led to such irregularity, and the need for correction of such systems and procedures.

C&AG's Role - The Comptroller & Auditor General of India plays a key role in the functioning of the financial committees of Parliament and the State Legislatures. He has come to be recognised as a 'friend, philosopher and guide' of the Committee. His Reports generally form the basis of the Committees' working, although they are not precluded from examining issues not brought out in his Reports. He scrutinises the notes which the Ministries submit to the Committees and helps the Committees to check the correctness of submit to the Committees and facts and figures in their draft reports.

The Financial Committees present their Report to the Parliament/ State Legislature with their observations and recommendations. The various Ministries / Department of the Government are required to inform the Committees of the action taken by them on the recommendations of the Committees (which are generally accepted) and the Committees present Action Taken Reports to Parliament / Legislature.

In respect of those cases in Audit Reports, which could not be discussed in detail by the Committees, written answers are obtained from the Department / Ministry concerned and are sometimes incorporated in the Reports presented to the Parliament / State Legislature. This ensures that the audit Reports are not taken lightly by the Government, even if the entire report is not deliberated upon by the Committee.

18.3 Objective and Scope of Public Enterprises Audit

Under the Act of 1971, the scope and extent of audit is determined by the Comptroller and Auditor General. Audit of public enterprises in India is not restricted to financial and

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compliance audit; it extends also to efficiency, economy and effectiveness with which these operate and fulfil their objectives and goals. Another aspect of audit relates to questions of propriety; this audit is directed towards an examination of management decisions in sales, purchases, contracts, etc. to see whether these have been taken in the best interests of the undertaking and conform to accepted principles of financial propriety.

In examining the decisions of a management, the auditor examines that these were taken by the competent authority after examination of all aspects (economic, technological, public interest) on the basis of all the relevant information available at that time and taking into consideration the different alternatives available to management and that the decisions were consistent with the aims and objectives of the enterprise. Audit is an instrument of accountability. But an equally important purpose of audit of public enterprises in India is to help the Government and the enterprise managements improve their efficiency and effectiveness. This is achieved by bringing out financial and operational deficiencies, inadequacies or ineffectiveness of systems, shortfalls in performance, etc. and by analysing the causes of shortfall from acceptable standards of performance. Financial performance is linked with physical performance and issues of efficient and economic operations and management of resources are highlighted. There is an increasing emphasis on audit being an instrument of improvement. But the Comptroller and Auditor General does not make specific recommendations for improvement though the areas and needs for improvement are highlighted in his reports. In the broader context, Government audit encompasses two main elements, viz., (a) Fiscal Accountability: It includes audit of provisions of funds, sanctions, compliances and propriety; and (b) Managerial Accountability: It includes audit of efficiency, economy and effectiveness (This is often referred to as efficiency-cum-performance audit).

18.4 Audit of Government Companies

The following steps involved in the audit of government companies

(a) Appointment of Auditors Under Section 619(2) of the Companies Act, 1956 - Statutory auditors of Government Company are appointed or re-appointed by the Comptroller and Auditor General of India. There is thus a departure from the practice in vogue in the case of private sector companies where appointment or re-appointment of the auditors and their remuneration are decided by the members at the annual general meetings.

(b) Supplementary audit under section 619(4) of the Companies Act, 1956 - In the case of a Government company, audit is conducted by professional auditor appointed by the C & AG and the latter is authorised under section 619(4) of the Companies Act, 1956 to conduct supplementary or test audit. He is also empowered to comment upon or supplement the report submitted by the professional auditors. The C & AG may also issue directives to the auditors in regard to the performance of their function.

The C & AG has power to conduct a supplementary or test audit of the company's accounts by such person as he may authorise in this behalf and for the purposes of such audit require information or additional information to be furnished to any person or persons so authorised on such matters by such person or persons and in such form as the C & AG may by general or special order, direct.

The question is whether C & AG can call for a supplemental or special audit report under section 619 of the Companies Act. Under clause (b) of sub-section (3) of that section, the C & AG has the power to conduct a supplementary or test audit of the company's accounts by such person or persons as he may authorise in this behalf. The person to be so authorised may well be the auditors appointed under sub-section (2) of that section. It is not necessary to rely on the powers of the C & AG under clause (a) of sub-section (3) for the purpose in view.

(c) Right to comment on Auditors' Report - The statutory auditors shall submit a copy of their audit report to the C & AG who shall have a right to comment upon or supplement the audit report submitted by the statutory auditors in such manner as he may think fit.

Section 217(3) of the Companies Act, 1956 imposes a duty on the Board of Directors of a company to give the fullest information and explanations in the Directors' Report regarding every reservation, qualification or adverse remarks contained in the auditors' report. The Board's remarks on the auditors' report are to be given as an addendum to the report and are to form part of the main body of the report as per Section 217(3). In the absence of similar provisions requiring the company to give their reply on the reservations made by the C & AG, the board of directors of such a company is not bound to give information or explanation in respect of such comments.

Even the C & AG's comments would not have been required to be placed before the annual general meeting of a Government company but for the express provisions contained in Section 619(5) of the Act. Similar express provision would be necessary in the Act if it were intended that the provisions of Section 217(3) should also apply in the case of a Government company.

18.5 Comprehensive Audit of Public Enterprises

The areas covered by comprehensive audit are those of investment decisions, project formulation and management, organisation, delegation of powers and management information systems, organisational effectiveness, capacity utilisation, management of equipment, plant and machinery, production performance, use of materials, productivity of labour, idle capacity, costs and prices, development of complementary ancillary small scale industries, materials management, sales and credit control, budgetary and internal control systems, etc. The areas covered in comprehensive audit will naturally vary from enterprise to enterprise depending on the nature of the enterprise, its objectives and operations.

Some of the issues examined in comprehensive audit are:

- (a) How does the overall capital cost of the project compare with the approved planned costs? Were there any substantial increases and, if so, what are these and whether there is evidence of extravagance or unnecessary expenditure?
- (b) Have the accepted production or operational outputs been achieved? Has there been under-utilisation of installed capacity or shortfall in performance and, if so, what has caused it?
- (c) Has the planned rate of return been achieved?
- (d) Are the systems of project formulation and execution sound? Are there inadequacies? What has been the effect on the gestation period and capital cost?

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- (e) Are cost control measures adequate and are there inefficiencies, wastages in raw materials consumption, etc.?
- (f) Are the purchase policies adequate? Or have they led to piling up of inventory resulting in redundancy in stores and spares?
- (g) Does the enterprise have research and development programmes? What has been the performance in adopting new processes, technologies, improving profits and in reducing costs through technological progress?
- (h) If the enterprise has an adequate system of repairs and maintenance?
- (i) Are procedures effective and economical?
- (j) Is there any poor or insufficient or inefficient project planning?
- (k) Has there been undue waste, unproductive time for men and machines, wasteful utilisation or even non-utilisation of resources? If so, why?

The efficiency and effectiveness audit of public enterprises is conducted on the basis of certain standards and criteria. Profit is not the key criterion on performance; management's performance in the economical and efficient use of public funds and in the achievement of objectives is more relevant. Public enterprises have been set up with certain socio-economic purposes and for fulfilment of certain objectives. The objectives vary from enterprise to enterprise. Audit appraisal analyses the performance of an enterprise to bring out the extent to which the objectives for which the enterprise was set up have been served. Admittedly this is a complex task but basic to effectiveness appraisal. The feasibility/detailed project reports give the basis of investment, capacity, costs, time schedules, gestation period, etc. and are built up of capacities, parameters and norms of consumption, yields, productivity, costs, rate of return, etc. These provide yardsticks by which the performance is measured. Some of the parameters may change due to external or internal factors subsequent to the setting up of the enterprise/project. In conducting efficiency audit due account is taken of the changes effected. Then enterprises are required to have their long and short term capital and operational plans and these provide another set of reference points for assessment of performance. Rated capacity of the unit provides an acceptable benchmark against which physical performance is evaluated. However, utilisation of the rated capacity is assessed along with norms for consumption of raw materials and utilities, yields and rejections as well as requirements for proper maintenance and servicing of equipment. Cost efficiency is another important basis in appraising performance. Standard or target costs are determined on the basis of norms of capacity utilisation, consumption, productivity, yield etc. given in the detailed project reports, moderated in many cases by expert studies to take care of later constraints and changes. The Bureau of Public Enterprises has issued guidelines to be followed by the public sector enterprises in respect of general management, financial management, materials management, production management, construction management, etc. and these guidelines provide another basis for appraising enterprise performance and its systems. Another source of criteria is industrial engineering and other technical studies by internal and external experts and the standards given in these. Then there are standards of financial propriety.

This is a broad indication of the criteria and sources of criteria for conducting efficiency and effectiveness audit of public enterprises. A basic task in audit is to carefully identify the

acceptable criteria for assessing the efficiency and effectiveness of an enterprise so that the appraisal by audit is valid and meaningful.

The starting point of a comprehensive appraisal of a public enterprise, which covers aspects of economy, efficiency and effectiveness, is the preparation of an audit programme based on the study of decisions relating to the setting up of the enterprise, its objectives, the areas of operation, organisation, financial and operational details available in the annual reports and accounts, capital and operational budgets, deliberations of the board of directors, material in the earlier audit inspection reports on the enterprise and other relevant available papers. These audit programmes (or guidelines) identify the areas/aspects which require further detailed audit analysis and criteria, the data required for such analysis and the sources of such data, the extent of the audit analysis including the test checks to be applied and the Instructions to the audit parties assigned to the work.

18.6 Audit Report of the Comptroller and Auditor General

For facility of consideration, the reports of the Comptroller and Auditor General on the public sector undertakings of the Central Government are presented to the Parliament in several parts consisting of the following:

- (a) Introduction containing a general review of the working results of Government companies, deemed Government companies and corporations.
- (b) Results of comprehensive appraisals of selected undertakings conducted by the Audit Board.
- (c) Resume of the company auditors' reports submitted by them under the directions issued by the Comptroller and Auditor General and that of comments on the accounts of the Government companies.
- (d) Significant results of audit of the undertakings not taken up for appraisal by the Audit Board.

The Comptroller and Auditor General submits separate audit report (commercial) to the legislature in the case of 13 States. In the case of other States/Union Territories with legislature, there is a commercial chapter in the main audit report. The State audit reports, contains both the results of audit appraisal of performance of selected companies/corporations as well as important individual instances of financial irregularities, wasteful expenditure, system deficiencies noticed by the statutory auditors, comments noticed in Government audit in the audit functions of certification of accounts and a general review of the working results of Government companies and corporations.

18.7 Propriety Audit

Auditing, as a composite concept, looks into accounting and arithmetical accuracy, adherence to rules and regulations, propriety and the end result. According to the varied Requirements, the emphasis on each of the aforesaid factors differs between various types of audit. Students should carefully go through Sections 227 and 227(1A) of the Companies Act. All the requirements of these two Sections are applicable to a Government company and the analysis

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that will follow will show that some of the provisions of Section 227(1A) really are propriety based. Besides, the Companies (Auditor's) Report Order, issued under Section 227(4A) of the Companies Act, is also applicable to a Government Company, provided the Government company belongs to any of the categories of companies to which the Order applies. Finally, the Comptroller and Auditor General has issued a set of detailed directions under authority of Section 619(3)(a) of the Companies Act which are to be complied with by the independent professional auditor in carrying out the audit of Government companies or companies concerned by Section 619B of the Companies Act. Propriety already exists in the audits carried on by the Comptroller and Auditor General of India.

18.7.1 Definition and Principles - Propriety audit stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct. E.L. Kohler has defined the term propriety as "that which meets the tests of public interest, commonly accepted customs, and standards of conduct, and particularly as applied to professional performance, requirements of law, Government regulations and professional codes". On an analysis, the tests boil down to tests on economy, efficiency and faithfulness. Instead of too much dependence on documents, vouchers and evidence, it shifts the emphasis to the substance of transactions and looks into the appropriateness thereof on a consideration of financial prudence, public interest and prevention of wasteful expenditure. Thus, propriety audit is concerned with scrutiny of executive actions and decisions bearing on financial and profit and loss situation of the company, with special regard to public interest and commonly accepted customs and standards of conduct. It is also seen whether every officer has exercised the same vigilance in respect of expenditure incurred from public money, as a person of ordinary prudence would exercise in respect of expenditure of his own money under similar circumstances.

Propriety requires the transactions, and more particularly expenditure, to conform to certain general principles. These principles are:

- (i) that the expenditure is not *prima facie* more than the occasion demands and that every official exercises the same degree of vigilance in respect of expenditure as a person of ordinary prudence would exercise in respect of his own money;
- (ii) that the authority exercises its power of sanctioning expenditure to pass an order which will not directly or indirectly accrue to its own advantage;
- (iii) that funds are not utilised for the benefit of a particular person or group of persons and
- (iv) that, apart from the agreed remuneration or reward, no other avenue is kept open to indirectly benefit the management personnel, employees and others.

18.7.2 Relevant provisions in the Companies Act, 1956 - The Parliament and Government, with a view to knowing the standards of efficiency, propriety, cost consciousness and economy, have already come up with some provisions in the Companies Act, having direct or indirect bearing on propriety; some of these have been referred to earlier. These provisions are:

1. Section 209(1)(d) relating to Cost Accounting Records.

2. Section 227(1A) requiring enquiry into certain specified matters.
3. Section 227(4A) requiring a supplementary statement on matters specified in the Companies (Auditor's) Report Order.
4. Section 233B relating to requirements of Cost Audit.
5. Section 619(3)(a) requiring a supplementary statement in respect of the Government companies on matters specified.
6. Additional information in Schedule VI, Part II.

All these are applicable to Government companies. The requirement of the provisions of section 227(1A) is essentially propriety-oriented as much as some specific dubious practices are required to be looked into by the auditor. Areas of propriety audit under the provisions of Section 227(1A) may be following:

- (a) Whether the terms on which secured loans and secured advances have been made are not prejudicial to the interests of the company or its members.

It may be appreciated that the terms of loans include such matters as security, interest, repayment period and other business considerations. The auditor has to inquire whether the terms are such that they can be adjudged as prejudicial to the legitimate interest of the company or of its shareholders. This is a process of judging a situation by reference to certain objective standards or reasonableness whether the terms entered into are prejudicial or not, not only to the company but also to the shareholders.

- (b) Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company. This proposition has got to be inquired into by reference to the effects of the book entries, unsupported by transactions, on the legitimate interests of the company. The auditor has to exercise his judgment based on certain objective standards. It is also possible that some transactions may not adversely affect the interests of the company. The auditor has to judiciously consider what does and does not constitute the interest of the company.
- (c) Whether investment of companies, other than a banking or an investment company, in the form of shares, debentures and other securities have been sold at a price lower than the cost. Apparently, this is a matter of verification by the auditor. The intention, however, is not know whether loss has occurred due to the sale. The auditor is required to inquire into circumstances of sale of investments that resulted in loss. Obviously, the duty cast on him is propriety based, i.e., reasonableness of the decision to sell at a loss. It involves exercise of judgment having regard to the circumstances in which the company was placed at the time of making the sale.
- (d) Whether loans and advances made by the company have been shown as deposits. Again, considering the propriety element, rationalizing the proper disclosure of loans and advance given by company is made.
- (e) Whether personal expenses have been charged to revenue. It is an accepted principle that expenses which are not business expenses should not be charged to revenue. The effect of charging personal expenses to the business is to distort the profitability of the company and to secure a personal gain at the cost of the company. Obviously, propriety

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is involved in this; charging personal expenses to business account is highly improper and abusive hence this provision.

- (f) In case it is stated in the books and papers of the company that shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash actually received, whether the position in books of account and balance sheet so stated is correct, regular and not misleading. A control has been set up to verify the receipt of cash in case of allotment of shares for cash. Further, if cash is not received, the books of accounts and statement of affairs shows the true picture.

Cost records and the provisions of cost audit are designed to inculcate cost consciousness in the management and to know whether productivity is of acceptable order and whether undue wastage or loss etc. has occurred. It would be useful to go into some of the specific requirement of cost audit report in this context. The cost audit report requires the cost auditors to report, *inter alia* on:

- (a) matters which appear to him to be clearly wrong in principle or apparently unjustifiable;
- (b) cases where the company's funds have been used in a negligent or inefficient manner;
- (c) factors which could have been controlled, but have not been, resulting in increase in the cost of production.

These are clearly enquiries into propriety and the cost accounting records have been prescribed to facilitate these enquiries. Some of the matters in the additional information sought through the Profit and Loss Account (i.e., Part II, Schedule VI) provide a basis for making more searching enquiries into such vital matters as facility utilisation, production, employment of highly paid staff members, inventory, etc.

The implications of the Companies (Auditor's) Report Order 2003, and the provisions of the 619(3) (a) and the directions issued by the Comptroller and Auditor General also contain significant elements of propriety.

18.7.3 Propriety elements in CARO, 2003–

- (a) If the company has given or taken loans, secured or unsecured, to/from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, whether the rate of interest and other terms and conditions of such loans are *prima-facie* prejudicial to the interest of the company. In this case, the auditor will have to look into the reasonableness of the rate of interest and the terms and conditions of such loans. In other words, he will have to see whether the terms and conditions, including the rate of interest are apparently adverse to the interests of the company, having regard to the circumstances of the company at the time of taking the loans and the terms normally available. He is to exercise his judgment based on commercial considerations like urgency, security offered etc.
- (b) If the overdue amount of the loan given to or taken from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act is more than rupees one lakh, what reasonable steps have been taken by the company for recovery/payment of the principal and interest. In making this examination, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that

steps to be taken must necessarily be legal steps. Depending upon the circumstances, period of delay and other similar factors, issue of reminders or sending of advocate's or solicitor's notice may amount to reasonable steps. The auditor should ask the management to give in writing the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management's representations.

- (c) Whether the transactions needed to be entered in a register in pursuance of section 301 of Companies Act have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. Section 301 requires that every company shall keep one or more registers in which it shall be entered separately the particulars of all contracts or arrangements to which sections 297 and 299 of the Companies Act apply. As regards the reasonability of prices, the auditor is not expected to make a roving market inquiry but to examine price lists, quotations, prices for other parties etc. He should also take into account the factors such as delivery period, quality, quantity involved, credit terms etc.
- (d) Is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employee State Insurance, Income-Tax, Sales Tax, Wealth Tax, Custom Duty, Excise Duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the day they became payable, shall be indicated by the auditor.
- (c) Whether the company has made any preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the companies Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company.

From the above analysis, it is somewhat clear that under the Companies Act, we already have tools which bring about a blending of propriety to the professional audit of Government companies. However, a word of caution is necessary in this context. The audit conducted by the Comptroller and Auditor General is a rule, procedure and propriety-based one; and often it is said that the desired flexibility is lacking in the system and this has contributed in a large measure to the lack of rapport between the auditor and the audit-units. Honesty is open to question, if that honesty has deviated from laid down rules and procedures. In turn, this has tended to foster a tendency amongst Government officials to just conform to the rules and provide a show of compliance with the standards of propriety. This is not intended to be little the contribution of this audit in ensuring appropriate use of fund of the Government. In Government, because of the enormous amounts involved and the massive volume of transactions and in view of public interest, it is but necessary that compliance with rules should be insisted upon and non-compliance enquired into. But the benefit derived is at least partly offset by the element of distrust and often the truth remains buried.

One distinguishing feature should be observed; excepting the directions of the Comptroller and Auditor General issued under Section 619 (3)(a) of the Companies Act, the rest of the provisions are applicable equally to government and non- government companies. Whatever elements of propriety are discernible in them are also present in the audit of non-government companies. The directions under Section 619 (3)(a), generally known as Comptroller and

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Auditor General's directions, however, are exclusively applicable to the audit of Government companies and such of the companies in private sector as are covered by Section 619B.

Propriety Audit-Problems - Problems in propriety audit, however, arise mainly because of its distinct nature. The expression "propriety" is a moral term and can be understood by reference to the concept of morality accepted by the society at a given time. In any auditing, the essential test lies in formulation of auditing propositions. In the audit of financial accounts by reference to financial and legal requirements, propositions are built up about happening of events, existence, accuracy, title, ownership, compliance with law and internal regulations etc., which are all verifiable. In propriety audit the formulation of verifiable auditing propositions poses the problem. Propriety audit has an inherent element of subjectivity because it is very difficult to establish standards of public interest, commonly accepted customs, standards for conduct which are not firm basis for audit evaluation. To take care of this situation, the C & AG has developed the norms of propriety for expenditure of public funds in our country and this has been discussed in the study above. By laying down the standards of propriety for Government expenditure the C & AG has really tried to tackle in a practical way the complex problem of subjectivity inherent in a situation calling for propriety consideration.

The norms so developed provide the basis of verifying expenditure incurred by various Government departments. It has also been mentioned that so far as private sector is concerned, limited elements of propriety has been introduced through the provisions of Section 227 (1A) and 227(4A) of the Companies Act, with a verification base. It may, however, be appreciated that the norms of propriety applicable to governmental transactions may not *ipso facto* apply to transactions of private sector which have distinct and more limited, objectives suited to them. Each private sector entity may have its unique objectives related, to its management philosophy and the transactions should be geared to achieve those. For example, a management which is operating for maximization of profits without infringing, any legal regulations may follow certain policies while another management believing in a wider measure of social justice may follow different policies. Despite these clear angularities, certain commonness can also be discerned in the policies and approaches of different managements. They include efficient operations, higher productivity and higher profit, reduction of wasteful expenditure etc. Above all, each entity has its impact on the society and building up propriety audit propositions becomes of paramount importance.

It is felt that if the management of each entity, irrespective of any legal requirements, formulates norms of propriety for the entity, taking full note of wider social repercussions inherent in its operations; a formidable hurdle in the way of wider introduction of propriety audit can be removed. The element of subjectivity in propriety evaluation will get reduced.

Another dimension of the problem noticed in the application of propriety norms in the Government sector needs also to be taken into account. The norms are applied often too mechanically and create problems for expeditious and efficient working. In private sector, this attitude may prove counter-productive. Propriety as a moral element should be a matter of evaluation based on objectives and prevailing circumstances. For example, a travel by air as such should not be

considered wasteful unless it is proved that a travel by rail would have been feasible in the circumstances and would have brought the same results brought by the air travel.

The element of subjectivity has caused proper discharge of duty very delicate and demands discretion, but wisdom of taking commercial decisions under dynamic environment (the economic, social and political) must be evaluated with reference to the circumstances in which these were taken and therefore, the auditor in his field must reconstruct such circumstances. The judgment of the auditor must be objective as otherwise it would dampen the initiative of management and others in taking commercial decisions and propriety audit would prove itself to be counter productive.

18.8 Performance Audit

A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action [Reference : Government Auditing Standards , US , www.gao.gov]

Performance audits include economy and efficiency and program audits:

- a. Economy and efficiency audits include determining (1) whether the entity is acquiring, protecting, and using its resources (such as personnel, property, and space) economically and efficiently, (2) the causes of inefficiencies or uneconomical practices, and (3) whether the entity has complied with laws and regulations on matters of economy and efficiency.
- b. Program audits include determining (1) the extent to which the desired results or benefits established by the legislature or other authorizing body are being achieved, (2) the effectiveness of organizations, programs, activities, or functions, and (3) whether the entity has complied with significant laws and regulations applicable to the program.

Economy and efficiency audits may, for example, consider whether the entity

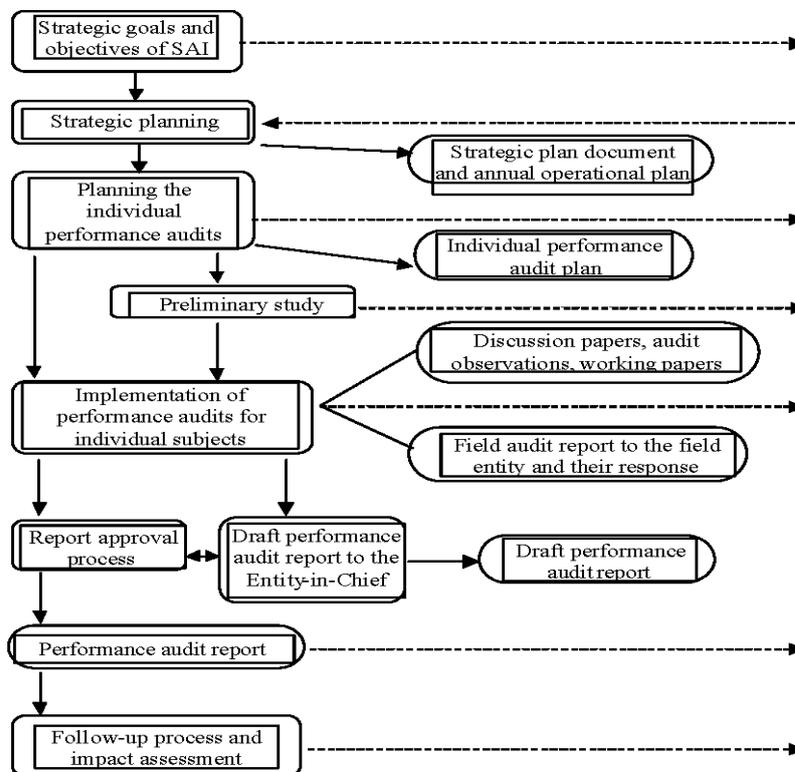
- a. is following sound procurement practices;
- b. is acquiring the appropriate type, quality, and amount of resources at an appropriate cost;
- c. is properly protecting and maintaining its resources;
- d. is avoiding duplication of effort by employees and work that serves little or no purpose;
- e. is avoiding idleness and overstaffing;
- f. is using efficient operating procedures;
- g. is using the optimum amount of resources (staff, equipment, and facilities) in producing or delivering the appropriate quantity and quality of goods or services in a timely manner;
- h. is complying with requirements of laws and regulations that could significantly affect the acquisition, protection, and use of the entity's resources;
- i. has an adequate management control system for measuring, reporting, and monitoring a program's economy and efficiency; and
- j. has reported measures of economy and efficiency that are valid and reliable.

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Program audits may, for example

- assess whether the objectives of a new, or ongoing program are proper, suitable, or relevant;
- determine the extent to which a program achieves a desired level of program results;
- assess the effectiveness of the program and/or of individual program components;
- identify factors inhibiting satisfactory performance;
- determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;
- determine whether the program complements, duplicates, overlaps, or conflicts with other related programs;
- identify ways of making programs work better;
- assess compliance with laws and regulations applicable to the program;
- assess the adequacy of the management control system for measuring, reporting, and monitoring program's effectiveness; and
- determine whether management has reported measures of program effectiveness that are valid and reliable.

Performance audit cycle



18.9 Performance Audit : Indian Scenario

Performance audit is PSUs in conducted by the Comptroller and Auditor General of India(Supreme Audit Institutions) through various subordinate offices of Indian Audit and Accounts Department (IAAD). In conducting performance audit, the subordinate offices are guided by manual and auditing standards prescribed by CAG.

18.9.1 The mandate and objectives of performance auditing - *According* to Section 19(1) of the Comptroller and Auditor General (Duties, Powers, and Conditions of Service) Act, 1971: "The duties and powers of the Comptroller and Auditor General in relation to the audit of the Accounts of Government companies shall be performed and exercised by him in accordance with the provisions of the Companies Act, 1956".

Section 619(3) of Companies Act empowers Comptroller and Auditor General of India to conduct supplementary audit or test audit of Government companies. Under Section 619(3) (b) of the Companies Act, the CAG shall have power "to conduct supplementary or test audit of the (Govt) company's accounts by such person or persons as he may authorize in this behalf; and for the purposes of such audit to require information or additional information to such person or persons and in such form as the Comptroller and/ Auditor General may, by general or special order, direct."

Section 619 (4) of Companies Act requires the statutory auditor (chartered accountant appointed by CAG under section 619 (2) of the Act) to submit a copy of his audit report on the accounts of the Govt. company to CAG, who shall have the right to comment upon or supplement the audit report in such manner as he may think fit.

Thus while section 619(3) of the Companies Act empowers CAG to conduct test audit (transactions audit) of a Govt. company, section 619(4) empowers CAG to conduct supplementary audit of annual accounts of a Government company.

In so far as statutory corporations are concerned the respective Statutes provide for audit by CAG. The scope includes conducting performance audit of these corporations also though specifically not stated so.

18.9.2 Objectives of performance auditing - The objectives are evaluation of economy, efficiency, and effectiveness of policy, programmes, organization and management. Policy is usually defined as an effort to achieve certain aims with certain resources and perhaps within a certain time. A programme can be described as a set of interrelated means-legal, financial, etc. to implement a given policy. Organisation can be defined in different ways, but mostly it is taken to mean the aggregate of people, structures and processes that have the aim of achieving particular objectives.

In an organized set up or entity, the entity's goal and objectives are governed by its constitution. As well known to us, the Memorandum and Articles of Association of a company forms the constitution of the company as also the basic document for entering into a contract with that entity. Authority is delegated to the management. Management generally refers to a person or group person(s), like Board of Directors in a company, vested with powers to take all decisions, actions and framing rules for the steering, accounting and development of human, financial and material resources.

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Management decisions are mainly internal to the operations of an organization. Policies and programmes decided by the legislature, the executive or executive official, relating to a specific organization (and its internal activities and performance) are the broad guidelines or parameters within which the management is supposed to function. The management is accountable in so far as public sector enterprises are concerned to the legislature and the executives in the Govt. The basic principle of public finance, which not only applies to Govt. expenditure but also forms part of prudential norms of finance in any organization, is that the delegated authority shall observe that care and due diligence in sanctioning of any expenditure as an ordinary man of average prudence of his caliber would have had. Management's action is watched by other statutory authorities like CAG, CVC, etc. as to utilization of the money sanctioned for the purpose of sanction and also within the sanction especially from the angle of reasonability and the benefits flowing from such expenditure. Efficiency is the input-output ratio and in the case of public spending efficiency is achieved when the output is maximized at the minimum of expenditure. These two aspects mainly relates to economy and efficiency while efficacy is measured by the benefits flowing from such spending. Whilst performance auditing does not question political goals, it can point out the consequences of a given policy.

Take for example the audit of performance of enforcement mechanism for administering the provision of Minimum Wages Act which is a social welfare legislation. The auditors, who undertake performance audit of a program or unit, must possess knowledge of the industries or labor contracts where these provisions are applicable and also identify the population thereof before carrying out audit program. The auditor shall evaluate, as part of performance audit, the standard of living before implementation and after implementation of the Act. Further he shall have to evaluate the evidence available before him as to nature of returns prescribed and obtained for taking appropriate action. Auditor shall also have to evaluate the economy, efficiency and effectiveness in the welfare systems to be audited. The performance auditor can then study the shortcomings in the coordination between different agencies like labor department, EPF and ESI organization and the control systems and point out a set of relevant problems. Auditor shall also point out lacuna, if any in the existing legal frame work or enforcement mechanism to strengthen the objective of legislation. Another possible area of critical audit may be to study actual level of compensation required in each area keeping in mind the local living conditions and where the minimum wages prescribed in the statute is demonstrably different from this level he may report the same to the Govt. for taking appropriate action. In this manner, the performance audit can not only examine the reasons for such vagaries but also ensures that the legislation serves the intended purpose. By reporting the same to the legislature, the corrective is made possible.

[Interested students may refer to CPE Background Material on Performance Audit of Public Sector Enterprises in India published by the ICAI for further reference].

18.10 Planning for Performance Audit

The following steps are suggested to the auditors for planning while conducting the performance audit:

(A) Work is to be adequately planned - In planning, auditors should define the audit's objectives and the scope and methodology to achieve those objectives. The objectives are what the audit is to accomplish. They identify the audit subjects and performance aspects to be included, as well as the potential finding and reporting elements that the auditors expect to develop.

Audit objectives can be thought of as questions about the program that auditors seek to answer. Scope is the boundary of the audit. It addresses such things as the period and number of locations to be covered. The methodology comprises the work in data gathering and in analytical methods auditors will do to achieve the objectives.

Auditors should design the methodology to provide sufficient, competent, and relevant evidence to achieve the objectives of the audit. Methodology includes not only the nature of the auditors' procedures, but also their extent (for example, sample size).

In planning a performance audit, auditors should:

- a. Consider significance and the needs of potential users of the audit report.
- b. Obtain an understanding of the program to be audited.
- c. Consider legal and regulatory requirements.
- d. Consider management controls.
- e. Identify criteria needed to evaluate matters subject to audit.
- f. Identify significant findings and recommendations from previous audits that could affect the current audit objectives. Auditors should determine if management has corrected the conditions causing those findings and implemented those recommendations.
- g. Identify potential sources of data that could be used as audit evidence and consider the validity and reliability of these data, including data collected by the audited entity, data generated by the auditors, or data provided by third parties.
- h. Consider whether the work of other auditors and experts may be used to satisfy some of the auditors' objectives.
- i. Provide sufficient staff and other resources to do the audit.
- j. Prepare a written audit plan.

Planning should continue throughout the audit. Audit objectives, scope, and methodologies are not determined in isolation. Auditors determine these three elements of the audit plan together, as the considerations in determining each often overlap.

(B) Significance and User Needs - Auditors should consider significance in planning, performing, and reporting on performance audits. The significance of a matter is its relative importance to the audit objectives and potential users of the audit report. Qualitative, as well as quantitative, factors are important in determining significance. Qualitative factors can include:

- a. visibility and sensitivity of the program under audit,
- b. newness of the program or changes in its conditions,

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- c. role of the audit in providing information that can improve public accountability and decision-making, and
- d. level and extent of review or other forms of independent oversight.

One group of users of the auditors' report is government officials who may have authorized or requested the audit. Another important user of the auditors' report is the auditee, which is responsible for acting on the auditors' recommendations. Other potential users of the auditors' report include government officials (other than those who may have authorized or requested the audit), the media, interest groups, and individual citizens. These other potential users may have, in addition to an interest in the program, an ability to influence the conduct of the program. Thus, an awareness of these potential users' interests and influence can help auditors understand why the program operates the way it does. This awareness can also help auditors judge whether possible findings could be significant to these other users.

(C) Understanding the Program - Auditors should obtain an understanding of the program to be audited to help assess, among other matters, the significance of possible audit objectives and the feasibility of achieving them. The auditors' understanding may come from knowledge they already have about the program and knowledge they gain from inquiries and observations they make in planning the audit. The extent and breadth of those inquiries and observations will vary among audits, as will the need to understand individual aspects of the program, Government Auditing Standards such as the following.

- a. **Laws and regulations** - Government programs usually are created by law and are subject to more specific laws and regulations than the private sector. For example, laws and regulations usually set forth what is to be done, who is to do it, the purpose to be achieved, the population to be served, and how much can be spent on what. Thus, understanding the laws establishing a program can be essential to understanding the program itself. Obtaining that understanding may also be a necessary step in identifying provisions of laws and regulations significant to audit objectives.
- b. **Purpose and goals** - Purpose is the result or effect that is intended or desired, and can exist without being expressly stated. Goals quantify the level of performance intended or desired. Legislatures set the program purpose when they establish a program; however, management is expected to set goals for program efforts, operations, outputs, and outcomes. Auditors may use the purpose and goals as criteria for assessing program performance.
- c. **Efforts** - Efforts are the amount of resources (in terms of money, material, personnel, and so forth) that are put into a program. These resources may come from within or outside the entity operating the program. Measures of efforts can have a number of dimensions, such as cost, timing, and quality. Examples of measures of efforts are dollars, employee-hours, and square feet of building space.
- d. **Program operations** - Program operations are the strategies, processes, and activities the auditee uses to convert efforts into outputs. Program operations are subject to management controls.
- e. **Outputs** - Outputs are the quantity of goods and services provided. Examples of measures of output are tons of solid waste processed, number of students graduated, and number of students graduated who have met a specified standard of achievement.

- f. **Outcome** - Outcomes are accomplishments or results that occur (at least partially) because of services provided. Outcomes can be viewed as ranging from immediate outcomes to long-term outcomes. For example, an immediate outcome of a job training program and an indicator of its effectiveness might be the number of program graduates placed in jobs. That program's ultimate outcome and test of its effectiveness depends on whether program graduates are more likely to remain employed than similar persons not in the program. Outcomes may be intended or unintended, and they may be influenced by cultural, economic, physical, or technological factors external to the program. Auditors may use approaches drawn from the field of program evaluation to isolate the effects of the program from those of other influences.

One approach to setting audit objectives is to relate the elements of a program to the types of performance audits. For example, audits concerned with economy could focus on efforts: Were resources obtained at an optimal cost and at an appropriate level of quality? Audits concerned with efficiency could focus on the program operations or the relationship between efforts (resources used) and either outputs or outcomes to determine the cost per unit of output or outcome. Program audits could be concerned with determining whether program outcomes met specified goals or whether outcomes were better than they would have been without the program. Any type of performance audit could encompass program operations if auditors are looking for reasons why the program was successful or not.

(D) Criteria - Criteria are the standards used to determine whether a program meets or exceeds expectations. Criteria provide a context for understanding the results of the audit. The audit plan, where possible, should state the Government Auditing Standards criteria to be used. In selecting criteria, auditors have a responsibility to use criteria that are reasonable, attainable, and relevant to the matters being audited. The following are some examples of possible criteria:

- a. purpose or goals prescribed by law or regulation or set by management,
- b. technically developed standards or norms,
- c. expert opinions,
- d. prior years' performance,
- e. performance of similar entities, and
- f. performance in the private sector.

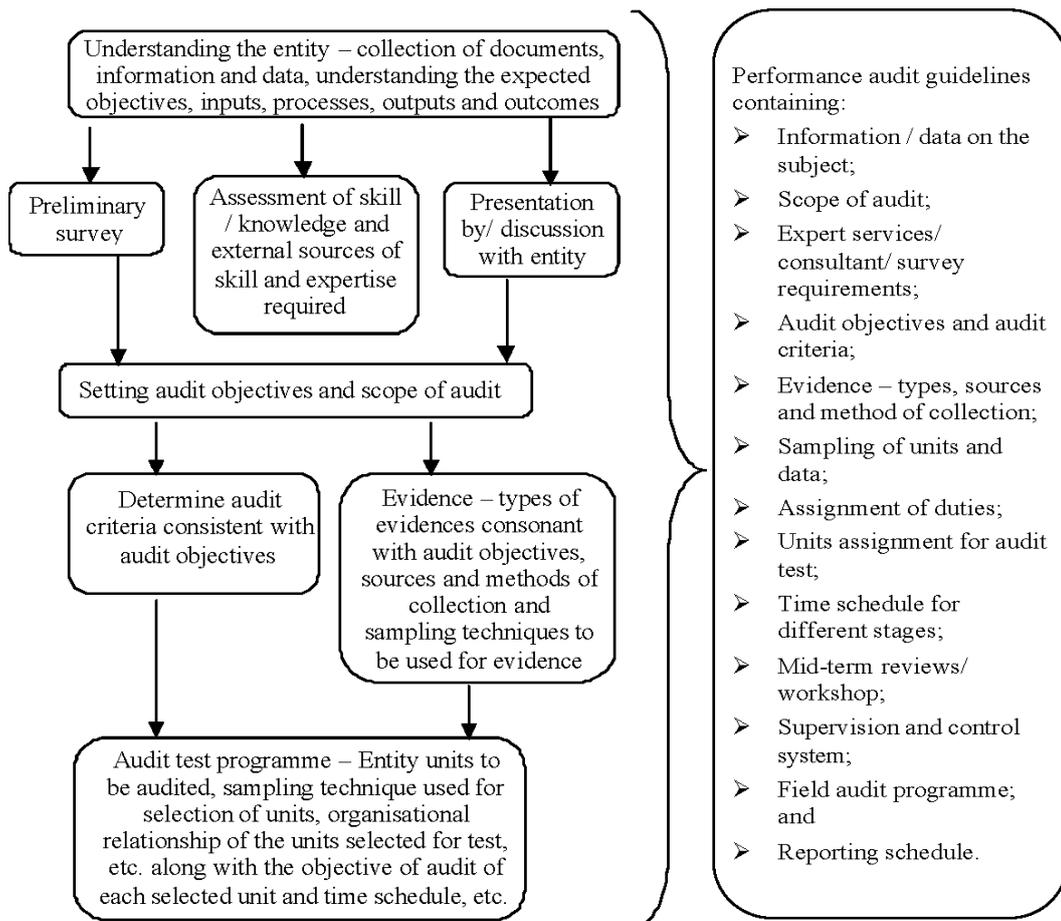
(E) Audit Follow-Up - *Auditors* should follow up on significant findings and recommendations from previous audits that could affect the audit objectives. They should do this to determine whether timely and appropriate corrective actions have been taken by auditee officials. The audit report should disclose the status of uncorrected significant findings and recommendations from prior audits that affect the audit objectives.

Much of the benefit from audit work is not in the findings reported or the recommendations made, but in their effective resolution. Auditee management is responsible for resolving audit findings and recommendations, and having a process to track their status can help it fulfill this responsibility. If management does not have such a process, auditors may wish to establish their own. Continued attention to significant findings and recommendations can help auditors assure that the benefits of their work are realized.

(F) **Considering Others' Work** - Auditors should determine if other auditors have previously done, or are doing, audits of the program or the entity that operates it. Whether other auditors have done performance audits or financial audits, they may be useful sources of information for planning and performing the audit. If other auditors have identified areas that warrant further study, their work may influence the auditors' selection of objectives. The availability of other auditors' work may also influence the selection of methodology, as the auditors may be able to rely on that work to limit the extent of their own testing.

If auditors intend to rely on the work of other auditors, they should perform procedures that provide a sufficient basis for that reliance. Auditors can obtain evidence of other auditors' qualifications and independence through prior experience, inquiry, and/or review of the other auditors' external quality control review report. Auditors can determine the sufficiency, relevance, and competence of other auditors' evidence by reviewing their report, audit program, or working papers, and/or making supplemental tests of their work. The nature and extent of evidence needed will depend on the significance of the other auditors' work and on whether the auditors will refer to that work in their report.

Performance audit planning



Annexure I

Specimen Performance Audit Report issued by the Comptroller and Auditor
General of India

[Source : www.cag.gov.in]

Performance Audit Report on Sale of Sugar Mills of Uttar Pradesh State Sugar
Corporation Limited for the Year 2010-11

Uttar Pradesh State Sugar Corporation Limited (UPSSCL) was established in the year 1971 as a wholly owned undertaking of Government of Uttar Pradesh (GoUP) under the Companies Act, 1956 to run private sugar mills acquired by the State Government under the Uttar Pradesh Sugar Undertaking Acquisition Act, 1971.

In June 2007, Govt. UP decided to privatise/ sell sugar mills of UPSSCL. The sale of 10 operating mills was executed during July 2010 to October 2010 and that of 11 closed mills in January 2011 to March 2011. The Comptroller and Auditor General of India decided to conduct an audit scrutiny of the Disinvestment Process in UPSSCL to present an independent and objective assessment of Disinvestment Process to the State Legislature and further to provide an aid to Administration for monitoring the Disinvestment Process of other Companies in future.

This Report contains the results of the audit covering the period from June 2007, when the initial decision for disinvestment was made, to March 2011 when the sale process of these mills was completed. There was complete lack of competition as two out of three competing Companies were related to each other in sale of ten operating mills of UPSSCL. In case of UPRCGVNL, all the bidding Companies bid in a concerted manner and unusual withdrawal of bids by the original highest bidders in favour of challengers indicated the cartelization / concerted bid by a group of related Companies affected the realization of fair value of sugar mills. In respect of three mills of UPSSCL, only ₹ 166.85 crore could be realised against Expected Price of ₹ 291.55 crore. In case of 11 closed mills of UPRCGVNL, ₹ 91.65 crore was realised against total Expected Price of ₹ 173.63 crore. Management and CGD failed to detect these issues as they did not insist on submission of the requisite documentation by bidders.

This Audit Report, covering the process of disinvestment up to March 2011, was prepared for submission to the Governor under Article 151 of the Constitution of India.