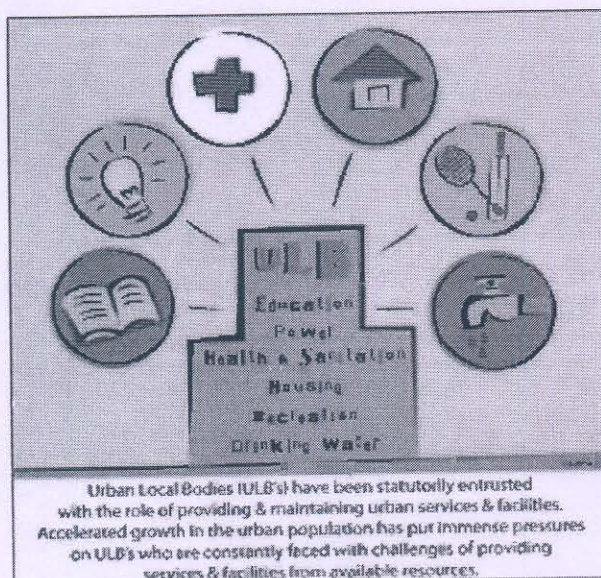


ULBs: Vibrant Institutions of Self-Government – The Role of PFMA



It is imperative for ULB's to have an improved Public Financial Management (PFM) for better urban governance and performance. In the last decade or so, there seems to be a competition going on amongst the ULB's across India to improve their financial management systems. This article seeks to explain the reasons for such spurt change in the PFMS of ULB's and the benefits thereof.



– CA. Pankaj Goel and CA. Aseem Bhargava

(The authors are members of the Institute. They can be reached at pgoel@ipeglobal.com)

India has undergone an eloquent demographic revolution over last few decades. Since independence, country's population has grown almost three times from 361.09 million as per 1951 census to 1027.02 million as per 2001 census. During this period, the urban population has grown nearly five times from 62.44 million to 285.35 million. The number of metropolitan cities has also grown from 23 to 35 during this period. This rapid rise in urban population has taken a heavy toll of the civic infrastructure in the urban areas consequently leading to widening of gap between demand and supply factors leading to further deterioration in the quality of life.

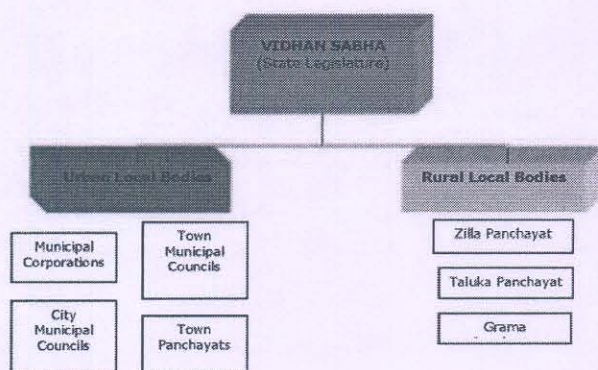
Urban Local Bodies (ULB's) have been statutorily entrusted with the role of providing and maintaining urban services and facilities like education,

power, health and sanitation, housing, recreation, drinking water etc. Such accelerated growth in the urban population has put immense pressures on ULB's who are constantly faced with challenges of providing services and facilities from available resources. The vision of several investment programmes is to optimise social and economic development in urban areas. The vision will be achieved through policy reforms to strengthen urban management and support for priority investments in urban infrastructure and services required to meet basic human needs, improve quality of life, and stimulate sustainable economic development. To cater to the needs of this ever growing population in urban centers, a revamp is required in the management and functioning of these local bodies involving provision of adequate funds at their disposal, bring accountability and transparency in their duties and endow them with such power and responsibilities so as to enable them function as vibrant institutions of self-government.

Background

India has a federal system of government governed by the Constitution of India. There are three tiers of government viz. the Union or Central government, the State government and the Local government bodies. There are two types of local governments: Urban local government and Rural local government. Urban local government is manifested in Municipal Corporations, Municipal Councils and Town Panchayats. Rural local government operates through Zilla Panchayats (Parishads), Taluka Panchayats and Grama Panchayats.

Exhibit 1.1: General Structure of Local Bodies



The number of urban local bodies in different tiers is as per Table 1 below:

Table 1	
Tiers of Local Bodies	Numbers
Municipal Corporations	109
Municipalities	1432
Nagar Panchayats	2182
Total	3723

Source: Twelfth Finance Commission Report

The areas under local government are categorised into different tiers depending upon factors such as population of the area, the density of population therein, the revenue generated for local administration, the percentage of employment in non-agricultural activities and such other factors.

Since liberalisation of the economy in 1991, urban sectors have become core generators of national wealth. Presently, urban India accounts for more than 50% of GDP of the country. It is estimated that by 2011, urban areas would contribute about 65% of the total Gross Domestic Product of India. A strong and comprehensive legislative framework is essential for effective functioning of ULB's for improved governance and service delivery.

The 7th five year plan in 1985 laid out recommendations for revitalising civic bodies, reforms for municipal administration, constitution of state finance commissions and providing constitutional status for local governments.

This was further strengthened by a more explicit report by National Commission on Urbanisation in 1988 recognising a link between urbanisation and economic development. The report laid special emphasis on role of local governments in urban development.

New economic policy in 1991-92 emphasised on providing autonomy to local governments. But the major changes were brought by enactment of 73rd and 74th Constitutional Amendment Acts (CAA) in 1991 and 1992 respectively. The provisions related to Urban Local Bodies were incorporated in the constitution and ULB's were formally recognised. The ULB's were entrusted with the following functions and responsibilities under the 74th CAA:

- Urban planning including town planning.
- Regulation of land-use and construction of buildings.
- Planning for economic and social development.
- Roads and bridges.
- Water supply for domestic, industrial and commercial purposes.
- Public health, sanitation conservancy and solid waste management.
- Fire services.
- Urban forestry, protection of the environment and promotion of ecological aspects.
- Safeguarding the interests of weaker sections of society, including the handicapped and mentally retarded.
- Slum improvement and upgradation.
- Urban poverty alleviation.
- Provision of urban amenities and facilities such as parks, gardens, playgrounds.
- Promotion of cultural, educational and aesthetic aspects.
- Burials and burial grounds; cremations, cremation grounds and electric crematoriums.
- Cattle pounds; prevention of cruelty to animals.
- Vital statistics including registration of births and deaths.
- Public amenities including street lighting, parking lots, bus stops and public conveniences.
- Regulation of slaughter houses and tanneries.

The 74th CAA endowed municipalities with powers to collect taxes and states were required to set up State Finance Commission (SFCs) to review and make recommendations on distribution of taxes, revenue-sharing, grant-in-aid system etc.

The INDO-USAID FIRE (D) project acknowl-

edged the need for an improved accounting system and the Institute of Chartered Accountants of India (ICAI) in consultation with FIRE project personnel issued a *Technical Guide on Accounting and Financial Reporting by Urban Local Bodies in India* in October 2000. This guide is an important tool for urban reforms in India and provides a broad framework and direction to ULB's, state governments, etc. for movement towards improved urban accounting and financial reporting.

The implementation of 74th CAA was further facilitated by government of India with the introduction of 'Modern Municipal Law' in 2003. This law was designed to serve as a template for states to revise their municipal legal framework and to bring improvement and transparency in functioning of local bodies. But since the recommendations of this municipal law were only recommendatory in nature, their compliance was not strictly adhered to.

Introduction of Right to Information (RTI) Act in 2005 and Urban Local Government Disclosure Bill in 2006 further emphasised the need for bringing in transparency and accountability in functioning

JNNURM REFORMS

- Modern and transparent budgeting systems and controls;
- Improved framework for city-wide planning and governance;
- Easy access to basic level of urban services;
- Financial self sustainability of agencies for urban governance and service delivery;
- Transparency and accountability in local governance and service delivery;
- Process reengineering through introduction of e-governance applications to reduce cost and time of service delivery process.

of municipalities along with adequate information sharing with public at regular intervals.

The Jawaharlal Nehru National Urban Renewal Mission (JNNURM)¹ was designed as a fast track mission for encouraging reforms and planned development in 63 identified cities. The mission focused on asset creation and management, efficiency in urban infrastructure, meeting fund requirements, community participation and accountability. The mission had Rs 50,000 crores outlay for a period of 7 years starting 2005-06.

Conversion to accrual accounting basis has been identified as a mandatory reform under the Jawaharlal Nehru National Urban Renewal Mission. The seven-year mission, which was introduced in 2005 with a Central aid of Rs. 50000 crore, seeks to implement reforms in 63 cities of the country.

System of Accounting

System of Accounting refers to the manner in which financial records shall be maintained. Under the cash basis single entry accounting system being followed presently by ULB's, the financial transactions are reflected in various registers prescribed under the rules. Thus, recording of transaction is mainly register based. Financial reporting information is not generated at the point of incurrence of the transaction or the event in a particular department.

Accounting Information is compiled at different levels in the organisation. Due to different information at different levels, it has become important to reconcile the information generated in the accounting system. Thus, gaps present in the existing system can be summed up as follows:

- a) Recording of transaction is mainly register based;
- b) There is no clear demarcation of capital and revenue transactions;
- c) Absence of any type of reconciliation

- d) Lack of MIS reporting.

Thus, cash system of accounting though keeps a control on funds actually spent by ULB's and compliance with expenditure limits specified in the budget but does not, however, provide information about the financial position and performance of the ULB's. The records are, thus, maintained on single entry accounting system. This system is non-transparent and traditional.

Need for Change in Accounting System

In a landmark judgment in the case of *Almitra Patel Vs Union of India* (2002), the honorable Supreme Court of India showed concern over the weak system of financial reporting in the ULB's and directed the government to develop guidelines for moving towards full cost based accrual accounting system in ULB's. Moreover, the 2002-03 Union Budget called for setting up of an Urban Reforms Incentive Fund (URIF) with an initial outlay of Rs 5 million to provide reform linked assistance to states. Apart from carrying out reforms in other areas, URIF aimed at introduction of *Double Entry System of Accounting* (DEAS) in Urban Local Bodies.

A task force was, therefore, constituted and on its recommendations the government of India developed a 'National Municipal Accounting Manual' (NMAM) with double entry accounting system as the basis and issued the same in 2005. This manual is a collaborative effort of Ministry of Urban Development, National Institute of Urban Affairs, Comptroller & Auditor General and United States Agency for International Development (USAID). States like Andhra Pradesh, Karnataka, Gujarat and West Bengal have already adopted the recommendations of NMAM in their manuals.

Though the accrual basis of accounting is yet to be fully adopted by all the states, it is pertinent to note that Tamil Nadu was the first state to adopt accrual basis of accounting w.e.f. April 1, 2000 thereby posing a practical example for other states to follow. Recently, the Municipal Corporation of Delhi (MCD) has implemented the accrual based double entry accounting system

¹Source: JNNURM overview issued by Ministry of Urban Development and Ministry of Urban Employment and Poverty Alleviation.

through ICAI's Accounting Research Foundation. This system is also under implementation in Kolkata Municipal Corporation on the same lines. The proposed changes, in relation to accounting are twofold:

- Moving away from Cash and adopting Accrual Basis of Accounting; and
- Moving from Single Entry to Double Entry Method of Book-Keeping.

Thus, the change is in respect of deciding:

- i. WHAT to account for (under accrual accounting system); and
- ii. HOW to account for (under double entry method of book-keeping).

Accrual basis of accounting is a scientific system of recording the transactions on double entry basis. This system not only provides complete details of the state of affairs but also facilitates meaningful financial reporting. This system facilitates the preparation of trial balance, ledger accounts and balance sheet along with schedules.

Public Financial Management and Accountability (PFMA)

Public Financial Management and Accountability systems play a significant role in upliftment of urban sectors, their development and poverty alleviation. Today, most of the municipalities are marred by an incomplete and unscientific system of financial management. This not only leads to undesirable performance but also deterioration in the quality of resource management. It is imperative to say that since public money by way of collected taxes and duties is involved, the Urban Local Bodies have a public accountability attached to their performance which should be answered in a transparent and best possible manner.

Some key components of an effective PFMA system are highlighted below:

- Strong Legal Framework should be in existence to support PFMA system;
- Budget planning and execution in line with government policies and objectives;
- Maintaining adequate records, existence of efficient and timely manage-

ment information and reporting system (MIS) and a sound accounting system for a meaningful decision making;

- Efficient management of funds, working capital and available resources to ensure availability at right time and right place;
- Existence and maintaining of database of all the assets and liabilities for assistance in meaningful decision making;
- External & Internal audit and control mechanisms should exist. Adequate follow-up of actions taken on the basis of audit reports should be done.

Role of ICAI in Strengthening PFMA Effectiveness in ULB's

The Accounting Standards Board of the Institute of Chartered Accountants of India constituted a sub-committee for issuing accounting standard for government including Urban Local Bodies in 1999 and issued a *Technical Guide on Accounting and Financial Reporting by Urban Local Bodies* in October 2000. The guide is an important tool in reforming municipal accounting in India. It provides a broad framework and direction to ULB's on improvements in urban accounting and financial reporting systems. The guide contains recommendations relating to application of Accounting Standards issued by the Institute of Chartered Accountants of India.

Recognising the need to harmonise and improve accounting and financial reporting among local bodies, the ICAI constituted a full fledged Committee on Accounting Standards for Local Bodies (CASLB) in March 2005 its main purpose being framing of Accounting Standards for Local Bodies in India².

The CASLB shall examine the possibility of bringing about global harmonisation and integration of Indian Accounting Standards for Local Bodies with International Public Sector Accounting Standards (IPSAS). The board shall review the accounting standards so framed from time to time and also provide guidance and interpretation of accounting standards (ASI) as and when required. After preparation, ICAI shall send these ASLB to the Technical Com-

²Source: ICAI Journal "The Chartered Accountant" March 2007 issue.

mittee on Budget and Accounting Standards for ULB's constituted by Ministry of Urban Development for recommending the same for implementation by various state governments. This accounting standard shall be mandatory in nature with effect from the date specified by the state governments in this behalf.

Key Issues and Way Forward

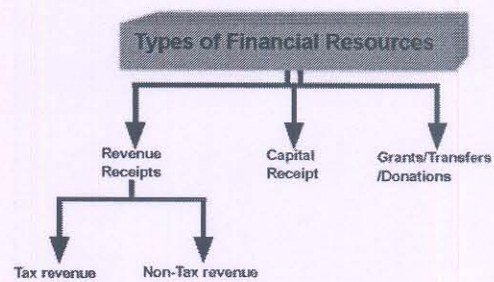
The extant municipal laws for ULB's are inadequate to enable them in discharging responsibilities delegated to them as per 74th CAA. The quest for making ULB's self-reliant and vibrant institutions of self governance requires much more effort at a faster pace both from the ULB's as well as state government. Although various state governments have amended their municipal acts yet some of the most important functions such as planning have not been specifically assigned to the ULB's.

The following key issues are involved in effectiveness of PFMA and making ULB's the institutions of self-government:

- a) **Strict legal framework:** A strong and comprehensive legal framework is a prerequisite for effective PFMA in ULB's. Though a legislative framework does exist for the ULB's for guidance and adherence, most of the provisions are only recommendatory in nature thereby leaving ample scope for by-passing the provisions. The implementation of these legal provisions is as important as their existence.
- b) **Funds Availability and Financial Independence:** ULB's have always been suffering from shortage of funds. As per report submitted by the Twelfth Finance Commission, the total expenditure by 14 out of the 26 states analysed was more than their revenue generation compared over a period of 5 years (1998-99 to 2002-03). This clearly suggests the paucity of funds with ULB's.

Some of the major avenues of revenue generation presently available to ULB's are as per Exhibit 1.2 below:

Exhibit 1.2: Source of ULB's Finances



This is high time now for ULB's to break the shackles of conventional sources and look for new and better avenues of financing their fund requirements. A new avenue for raising funds for ULB's is the capital market through bonds issue. Few municipal corporations such as Bangalore Municipal Corporation and Ahmedabad Municipal Corporation have raised funds through issue of bonds. Even the Government of India offers tax exemptions to investors on the bonds floated by the ULB's but since some smaller ULB's find it difficult to access the capital market, a concept of pooled finance under Pooled Finance Development Facility (PFDF) is under final stages of formulation whereby a group of ULB's, not necessarily comprising of the same state, may join hands to access capital market through a special purpose vehicle. This will help in enhancing the financial independence of the local bodies.

- c) **Effective Accounting Systems and PF-MIS:** Apart from strict legal framework, comprehensive and realistic planning and budgeting is also essential. Once drawn, the plans and budget execution form an equally important stage. This stage is followed by the system of accounting and MIS reporting. Adoption of accrual basis of accounting is of apex importance in this process. The Management Information System should provide timely, accurate and meaningful information keeping in mind the interests of different user groups. Since interest of citizens is involved, significant reports on functioning of ULB's such as Balance sheet and supporting schedules should be made available for public scrutiny.

- d) **Accounting Standard for ULB's:** Presently ULB's are following diverse accounting policies and practices in preparation of their financial statements. Moreover, being pushed by the requirement of funds, local bodies are approaching capital markets for raising funds through bonds issue. A need is, therefore, felt for formulation of standards for financial reporting which shall make the results of ULB's more meaningful. Constitution of CASLB by ICAI for formulation of Accounting Standard for Local Bodies is a step in this direction. Once formulated and issued, this accounting standard will not only improve the quality of financial reporting but also act as a benchmark guidance tool for comparable financial reporting of local bodies.
- e) **Audit and Internal Control Mechanism:** For any organisation, internal control and audit mechanisms need to be timely and effective. So is the case with ULB's. Presently, in many ULB's, internal audit systems are highly conventional and inadequate. There is a need for separate Internal Audit Department. An independent assessment by an audit committee should also be undertaken with the involvement of external auditors. The role of C&AG audit should also be enhanced so as to improve audit quality and compliance reporting by ULB's. ICAI may also look into the possibilities of formulating a separate audit standard for ULB's covering the key areas of concern requiring special attention.
- f) **Fixed Assets and Inventory Management:** Most of the fixed assets and inventories of ULB's are not being properly accounted for in the books of account since accounts are maintained on cash basis. A change from cash to accrual basis would require a proper record of fixed assets and inventories. Inadequate controls may lead to locking of excess funds in fixed assets and inventories and may also increase the inventory carrying costs. The other disadvantages include inefficient usage of available resources, obsolescence of existing assets without use, high risk of abnormal capital and revenue losses, misappropriation of assets, etc. Physical verification of these assets at periodical intervals is also essential.
- g) **IT Implementation:** E-governance being the need of the hour, the ULB's require implementation of information technology. This involves computerisation of all or major systems such as accounting, public service records, online database development, online redressal of public grievances, e-tendering, e-procurement, networking with international public agencies etc. For this purpose, sufficient training programmes, workshops and seminars need to be conducted for ULB's personnel thereby imparting sufficient knowledge about use and benefits of e-governance.
- Apart from above, personnel's training is also required in other areas such as accounting, service delivery, etc. for improvement in the manner of functioning of ULB's. For this purpose, a training manual is also under preparation.
- h) **Capacity Building:** As most of the ULB's are functioning for more than three decades and during this period they have followed single entry accounting and are not fully aware of latest IT tools and accounting provisions, building on the capacity of staff of ULB's is of critical importance and significance for an effective PFMA.
- i) **Public-Private Partnership (PPP) Approach:** The scope for public-private partnership in functioning of ULB's is yet

to be fully explored. Outsourcing of services such as power distribution, telecom, sanitation, solid waste management, construction of roads & bridges, street lights, parking lots and public conveniences management, etc can be considered. The power and telecom sectors have seen a tremendous rise in the entry of private players and efforts of government have proved fruitful and services provided by these sectors have improved.

In this connection, the Municipal Corporation of Delhi has recently taken steps specially in the field of solid waste management and involved few private operators in different zones of Delhi to carry out the activities of collection and transportation of municipal solid waste.

- j) **Use of Services of Chartered Accountants in ULB's:** Following the direction given by ICAI, services of Chartered Accountants can be used in implementation of new systems. CA's can be engaged internal or external auditors or as a consultant and can be well utilised in ensuring compliance to the legal framework and proper presentation of accounts for end users. Services of chartered accountants can also be taken for ensuring a smooth switchover from cash to accrual basis of accounting. Other areas where CA's services can be considered are improvement in tax collection procedures, physical verification of inventories, fixed assets etc.

Conclusion

The main purpose of Urban Local Bodies is to maximise the provision of urban services within the available resources. At the same time, urban bodies are accountable to citizens, investors and other stakeholders. It is expected of ULB's to comply with the laws, rules and regulations by which they are governed. With the introduction of PFMA framework and 74th Constitutional Amendment Act, changes required in system

of accounting and financial reporting are to be strictly adhered to in order to bring about a qualitative improvement in the presentation of financial statements and the method of governance and functioning of ULB's and make them institutions of self-government.

An improved Public Financial Management and Accountability will in turn improve the service delivery by ULB's. For this purpose, technical, managerial, financial and administrative capacities of ULB's are required to be strengthened.

The impetus provided by the reforms such as Jawaharlal Nehru National Renewal Mission needs to be carried on with full commitment. An equal support in this regard is required from the staff and other personnel of municipalities so that an easy switchover from old systems to new ones can be achieved without interruptions. Similarly, municipalities should also take its personnel in full confidence while implementing any reform measures and ensure that any such measures are not detrimental to the interest of the personnel. Adequate training and frequent interactions can make the task easy and enhance their adaptability to change.

Though the ULB's have made a remarkable progress during the last five years or so at a much faster pace than last two decades, a lot is still to be achieved. There does exist a sound legal framework, nationally sponsored reform initiatives such as JNNURM, Modern Municipal Law, National Municipal Accounting Manual, instances of best practices in ULB's both at national and international levels, there is a requirement of strict adherence to these initiatives.

Urban Local Bodies play a crucial role in providing valuable services to the society. Improvement in functioning, management and accountability of ULB's through the use of PFMA measures will bring in more transparency and better service delivery. Improved service delivery will certainly help in improving standards of living and in turn contribute to economic growth of the country. Full support in this regard is expected from the state and the central government. □