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Challenges Faced in Implementing Objective Accounting for Sustainable Financial Reporting - Evidence from Selected Indian Municipalities

With the vision of Viksit Bharat 2047 and the growing need for improved urbanization, states and cities need additional funds to access capital markets, which requires strong financial discipline through standardized financial reporting as per applicable guidelines. Despite the introduction of the National Municipal Accounts Manual (NMAM) in 2004, many municipalities still struggle with adopting accrual accounting, leading to inconsistencies with NMAM guidance. This article highlights the need for objective accounting over selective accounting to ensure transparency, accuracy, and financial integrity in municipal reporting. It emphasizes the challenges posed by inconsistent accounting practices in Indian municipalities and advocates for a standardized and objective approach to financial reporting.

Introduction

The Chintan Shivir on “Reimagining Urban Governance and Urban Spaces,” organized by MoHUA on May 29-30, 2024, fostered insightful discussions and meaningful knowledge exchange. The event focused on key thematic sessions that addressed urban challenges, promoted inclusive development and economic growth, and envisioned cities as economic powerhouses. To achieve this, cities must be prepared to raise funds whenever required, with robust financial reports and sound credit ratings.

At present, municipalities serve 377 million people, representing 31% of India's population, while contributing

63% to the national GDP. By 2050, this urban population is projected to rise to 800 million, with every second Indian living in a city. Despite SEBI's 2015 municipal bond guidelines, only 23 municipalities have accessed these bonds, accounting for less than 1% of India's 4,000+ cities.¹ This highlights a significant concern, as access to capital markets hinges on several factors, particularly the availability of high-quality, objectively prepared Annual Financial Statements (AFS).

Many municipalities still follow the cash-based accounting system at the local level, whereas worldwide, the Urban Local Bodies are shifting to an “accrual-based accounting system.”² In Kautilya's Arthashastra, there is evidence of the accrual concept,

1 <https://www.sebi.gov.in/statistics/municipalbonds.html>

2 ICAI - ICAI ARF (2023). Transition to accrual accounting: Models and learnings for urban local bodies. January, 611–614.

with revenue being recognized in a manner similar to the modern revenue recognition principle. Yet, even after so many centuries, a lot of municipalities in India still struggle to migrate from cash to accrual accounting. (Tulsyan, 2021)

More than 30 years have passed since autonomy was provided to Urban Local Bodies (ULBs) through the 74th Constitutional Amendment Act (CAA), and still, financial reporting is restricted to the preparation and uploading of Annual Financial Statements (AFS), and that too with the assistance of third-party professionals with the limited capacity of Municipal Accountant. Now, the time has come for these selective accounting practices of ULBs to be tested and validated on many parameters to migrate to objectivity in accounting. This examination is essential because if India aims to achieve the Sustainable Development Goals (SDGs) and transform by 2030, it must prioritize SDG 11—Sustainable Cities. By 2030, over 60% of India's population will reside in urban areas, making the attainment of sustainable cities crucial. Achieving this goal requires sustainable financing strategies supported by objective municipal financial reporting

Broad Objectives of the study:

The objectives of this study, therefore, are as follows:

- a) To identify key challenges to objective accounting through the assessment of current financial reporting practices in selected municipalities by examining annual financial statements available on the City Finance Portal.
- b) To recommend strategies for strengthening objective accounting practices in municipalities.

Each section of this article has been designed to flow logically from the previous one, building a cohesive argument for addressing selective accounting practices in municipalities. The structure of the article is as follows: after the introductory section, which outlines the background of the study, Section 2 examines the

rationale of objectivity in accounting as prescribed by commissions/guidelines/standards. Section 3 details the data collection and methodology employed in the study. Section 4 explores selective accounting practices in various municipalities, supported by practical examples from their published Annual Financial Statements (AFS). Finally, Section 5 presents the conclusions and implications of the study.

Objectivity in Accounting - Governance effort to date

Municipalities in India face challenges in financial management, with weak fiscal practices and delays in preparing audited annual accounts. The evolution of accounting reforms includes phases of computerization and accrual-based accounting, with guidelines from the Supreme Court and the Ministry of Housing and Urban Affairs. Key developments include the introduction of the National Municipal Accounts Manual (November 2004), the development of State-level municipal accounts manuals, and the commencement of issuance of the Accounting Standards for Local Bodies by ICAI (March 2005). Municipalities are required to adopt an accrual-based double-entry accounting system to qualify for funding under urban reform schemes. Recommendations from the CAG and the 14th and 15th Finance Commissions stress the need for standardized accounting practices and performance-based grants to ensure timely financial reporting. City financial rankings are being used to assess fiscal health based on these reforms. The 15th Finance Commission specifically set deadlines for financial disclosures, requiring unaudited Annual Financial Statements (AFS) for FY 2023-24 to be uploaded by May 15, 2024, and audited AFS for FY 2022-23 by the same date. Looking ahead, the 16th Finance Commission, whose report is expected in October 2025 and will be applicable from April 1, 2026, for five years, may introduce further provisions for enhanced financial reporting, aligning with India's SDG 2030 goals. Various Government policies and guidelines expect

adherence to basic accounting principles and reporting practices by municipalities, as prescribed by the National Municipal Accounts Manual (NMAM), for objective financial reporting. By following standardized accounting principles and reporting guidelines, municipalities can ensure consistency and accuracy in their financial statements to enhance transparency and accountability for better decision-making by stakeholders.

1. Data Collection and Methodology

In this study, secondary sources were explored alongside other relevant materials, as most existing studies are narrative-driven and lack an in-depth analysis using actual Annual Financial Statements (AFS) from municipalities. The majority of research on financial reporting focused on corporate governance in private and public sector enterprises, with limited attention given to municipalities. This gap in the literature forms the foundation for the argument in the present article, highlighting the need for objectivity in financial reporting for enhanced access to capital markets. The data has been collected from the annual financial statements of 30 cities from selected States, covering three zones to highlight the selective accounting practices followed by the selected municipalities, i.e., States of Assam (5), Uttar Pradesh (5), and Jharkhand (20).

2. Evidence of Selective Accounting and Financial Reporting Practices Followed

About Objective 1 of the article, which aims to identify key challenges to objective accounting through an assessment of current financial reporting practices in selected municipalities, the following key issues have been identified. These issues, highlighted by an examination of the annual financial statements available on the City Finance Portal, suggest that selective accounting practices create doubt among analysts

when assessing creditworthiness. This is primarily due to the lack of qualitative characteristics in the financial statements, which undermines their reliability and effectiveness in credit assessments.

i. **Error of Omission: Omission in Reporting (Non-Disclosure of Financial Indicators as per NMAM)**

Chapter 31 of NMAM, specifically Para 31.4, mandates that the Annual Report of Urban Local Bodies (ULBs) should include financial statements such as the Balance Sheet, Income and Expenditure Statement, Statement of Cash Flows, Receipts and Payments Account, Notes to Accounts, and Financial Performance Indicators. *However, an analysis of a selected sample of cities reveals that only Jharkhand consistently includes Financial Performance Indicators in its Annual Financial Statements. Among the 30 cities examined, only 12 in Jharkhand use these indicators, highlighting a gap in standardization and adherence to best practices.* Jharkhand municipalities began incorporating these indicators in the fiscal year 2021-22, following recommendations from their Project Management Unit (PMU),

demonstrating a proactive effort to improve financial management, transparency, and accountability. (Pankaj Goel, 2023)

ii. **Error of Principle: Common Errors in Accounting**

The analysis of annual financial statements from selected cities indicates that many municipal accountants responsible for preparing these statements have a limited understanding of NMAM. As a result, essential accrual accounting principles are often ignored, leading to selective accounting practices that fail to present a true and accurate picture of the municipality's finances. An illustrative example of an error in accounting from Annual Financial Statements is given below.

It's important for municipalities to record tax revenue accurately, particularly property tax, as outlined in the NMAM. In the recording of Tax Revenue (Code -110 as per NMAM) - Property Tax, a municipality may get some advance amount as a round-off amount, some rebates may be allowed to citizens for digital payment, senior citizens, etc., and due to late deposit, a fine may be



collected. It has been seen that the total collection is recorded as income against Property Tax without taking into account the effect of rebates, advances, and fines. As per NMAM, the effect of rebate and advance shall be accounted for separately, and fines shall be recorded independently.³

Example: Mr. X has a property tax demand of Rs 95 for FY 2023-24; Rs 100 was paid online on 15th June 2023, including a fine of Rs 5. The municipality, in general, allows a rebate of 5% online and 5% for payment up to Quarter 1 of FY.⁴

#	Incorrect Accounting by Municipality	Correct Accounting as per NMAM
	Bank (Code:450) 100 To Property Tax 100 (Code:110 tax Revenue) This shows an inflated figure of Tax revenue, which is not a correct picture	Property Tax Receivables: Code:431 -Dr 95 To Tax Revenue, Code:110 - Cr 95 The municipality must pass Demand Entry as of 1 April, FY
		Bank A/c - Dr 100 Rebate on Property Tax-Dr 9.5 To Property Tax Receivables – Cr 95 To Other Income (Code 180) Fines Cr 5 To Income in Advance Cr 9.5 Note: Current Demand Rs 95 less rebate 10% 9.5= Due is Rs 85.5, Fine Rs 5, The Total Due is Rs 90.5, but what is paid by a citizen is Rs 100. Thus, Rs 9.5 shall be accounted as an advance.

³ Chapter 6 of NMAM

⁴ Jharkhand ULBs provide 5% rebate for online payments and 5% for payment up to 30th June of FY

A significant portion of selected cities (10 out of 30) do not account for property tax correctly, according to the guidelines outlined in the NMAM. Recording the entire collection as tax revenue without accounting for factors like rebates, advances, and fines can indeed distort the true financial position of cities.

iii. Error of Reporting: Financial Statements Formats

Formats of components of Annual Financial Statements (Income & Expenditure Statement, Receipts, and Payments Account, Balance Sheet, and Cash Flow Statements) are presented in Chapter 31 of the

NMAM in vertical format. However, it has been observed during analysis that some smaller cities are still preparing financial Statements in T-shaped formats, which is not in line with NMAM. (Refer to Figure 1)

The below sample from the Annual Financial Statements of the City of Assam shows that the balance sheet of the city of Assam for the financial year 2020-21 was prepared in a T-shaped format, which is not in line with the guidelines outlined in the NMAM, leading to selective financial reporting. *It is good to observe during analysis that there's a significant parity in the preparation of balance sheets among the selected cities, with only 3 out of 30*

following the T-shaped format, which is not recommended by the NMAM.

iv. Error of Reporting: Non-Disclosure of Code of Accounts

Chapter 4 of NMAM, Codification Structure & Chart of Accounts, specifies codes that municipalities must use while recording transactions, and such code of accounts shall be shown during financial reporting of annual financial statements (Refer Figure 2). However, it has been observed in many cities that financial reporting doesn't disclose these codes, though the format is as per NMAM.

Figure 1: Selective Balance Sheet format of Selected Municipality of Assam: (Not in line with NMAM)

**Nalbari Municipal Board,
Assam
Balance Sheet as on 31st March, 2021**

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
Capital Fund		Fixed Assets	10,53,844.00
Opening Balance	7,02,11,147.95	As per Details Annexed	
Add: Excess of Receipt over Expenditure	1,63,57,983.00		
Total Capital Fund	8,65,69,130.95		
Current Liabilities		Current Assets	
Security Deposit	46,30,550.00	Cash-in-Hand	0.00
Add: During the year	6,97,000.00	Cash-at-Bank	8,13,58,236.95
Total Current Liabilities	53,27,550.00	Total Current Assets	8,13,58,236.95
	9,18,96,680.95		9,18,96,680.95

Source: cityfinance.in

Figure 2: Without Code-wise Balance Sheet of the selected Municipality of Assam (Not in line with NMAM)

**Balance Sheet of Digboi Municipal Board
As on 31st March, 2022**

Liabilities	Schedule	Current Year (Rs.) 2021-22	Previous Year (Rs.) 2020-21
RESERVE & SURPLUS			
Municipal (General) Fund	1	11,66,61,453.25	9,37,21,452.86
Earmarked Funds	2	-	-
Reserve & Surplus	3	-	-

Liabilities	Schedule	Current Year (Rs.) 2021-22	Previous Year (Rs.) 2020-21
Total Reserve & Surplus (A)		11,66,61,453.25	9,37,21,452.86
GRANT/CONTRIBUTION FOR SPECIFIC PURPOSE (B)	4	52,51,486.25	52,51,486.25
LOANS			
Secured Loans	5	2,18,869.00	1,71,300.00
Unsecured Loans	6	-	-
Total Loans (C)		2,18,869.00	1,71,300.00
CURRENT LIABILITIES & PROVISIONS (D)			
Deposits received	7	8,11,495.00	11,07,275.09
Deposit works	8	-	-
Other Liabilities	9	14,38,781.00	6,83,940.00
Provisions	10	-	-
Total Current Liabilities & Provisions (D)		22,50,276.00	17,91,215.09
TOTAL LIABILITIES (A+B+C+D)		12,43,82,084.50	10,09,35,454.20

Source: cityfinance.in

The analysis indicates a positive trend, as most of the selected cities disclose codes of account, with only 4 out of 30 cities failing to do so in their financial reporting.

v. Error of Commission: Non-Disclosure of Code 260

Revenue Grants, Contributions, and Subsidies, as per Codes 160

and 260 of the National Municipal Accounts Manual (NMAM), require municipalities to book revenue grants received and expenses incurred out of such grants under these codes. For example, under the Smart City Mission, funds for Administrative and Office Expenses (A&OE) are provided to states/ULBs for the

preparation of Smart City Proposals (SCPs) and Project Management Consultants (PMCs), in addition to capital grants. However, some cities may be incorrectly recording receipts under code 160 without booking the corresponding revenue expenses under code 260, resulting in an overstatement of receipts and an inaccurate surplus position.

Figure 3: Without Code 260 accounting Income and Expenditure of selected Municipality of Uttar Pradesh (Not in line with NMAM)

Nagar Nigam Prayagraj

Provisional Income & Expenditure Statement

For the year ended 31st March 2022

Code No.	Item / Head of Account	Schedule No.	Amount (₹) 2021-22	Amount (₹) 2020-21
INCOME				
I-10	Tax Revenue	I-1	739,101,912.75	684,003,677.84
I-20	Assigned Revenues & Compensation	I-2	-	-
I-30	Rental Income from Municipal Properties	I-3	15,182,346.00	15,571,073.50
I-40	Fees & User Charges	I-4	77,581,400.00	56,081,111.42
I-50	Sale & Hire Charges	I-5	13,321,981.00	6,917,367.00

Code No.	Item / Head of Account	Schedule No.	Amount (₹) 2021-22	Amount (₹) 2020-21
I-60	Revenue Grants, Contributions & Subsidies	I-6	4,052,349,718.00	4,035,151,660.25
I-70	Income from Investments	I-7	9,145,800.00	9,143,924.00
I-71	Interest Earned	I-8	3,696,960.00	4,864,248.00
I-80	Other Income	I-9	104,798,984.86	1,004,424.50
A:	Total – INCOME		5,015,179,102.61	4,812,737,486.51
EXPENDITURE				
2-10	Establishment Expenses	I-10	3,280,182,205.00	2,422,507,636.00
2-20	Administrative Expenses	I-11	53,259,502.00	40,070,307.00
2-30	Operations & Maintenance	I-12	931,128,716.00	1,320,085,778.61
2-40	Interest & Finance Expenses	I-13	115,823.62	200,331.68
2-50	Programme Expenses	I-14	485,636.00	1,157,701.00
2-60	Revenue Grants, Contributions & Subsidies	I-15	–	–
2-70	Provisions & Write off – Property Tax	I-16	–	–
2-80	Miscellaneous Expenses	I-17	284,510.00	14,750,926.00
2-72	Depreciation	B-11	727,726,551.56	716,928,660.00
4-30	Consumption of Stock	B-14	52,928,300.00	16,194,200.01
B:	Total – EXPENDITURE		5,046,111,444.18	4,531,895,540.30

Source: cityfinance.in

3. Suggested Interventions for Transition to Objectivity in Accounting

The NMAM (2004), AMRUT guidelines (2015), and recommendations from various finance commissions in the past all advocated for better accounting and reporting practices. However, the above section analysis reveals that the actual accounting practices in selected cities remain far from achieving objectivity in accounting and reporting, which is essential for a true and fair view of financial statements. It is essential to move beyond selective accounting and reporting by actively implementing the frequent guidelines and recommendations provided by various stakeholders over the past two decades. Strengthening

adherence to standardized practices will enhance transparency and financial discipline. Thus, the time has come for a smooth transition from selective accounting to objective accounting, with cities now assessing capital markets for funds through Municipal Bonds.

- *In summary, among the 30 selected cities, those in Jharkhand demonstrate relatively strong adherence to objective accounting and reporting practices compared to cities in Uttar Pradesh and Assam.*
- *Specifically, cities in Jharkhand appear to excel in implementing standardized accounting practices recommended by the National Municipal Accounts Manual (NMAM).*

Against objective 2, interventions that may be adopted by the Centre, State, or City for objective accounting have been detailed below:

- City Finance Portal Improvement:** The City Finance portal still does not allow municipalities to upload all six mandatory components⁵ as per Chapter 31 of the NMAM. It is therefore suggested that the City Finance Portal develop a Management Information System (MIS) in two parts: one for cities that upload all six components as required by NMAM, and another for cities that do not. This would enable comparisons to be made and highlight which cities require support in the automation of financial reporting.

⁵ Chapter 31 covers key financial statements, including the balance sheet, income and expenditure statement, receipts and payments account, notes to accounts, cash flow statement, and financial indicators



ii. Institutionalise Surveillance

Mechanism: Establishing Project Management Units (PMUs) or Municipal Reform Cells (MRCs) at the National Level dedicated to financial reforms, as seen in cities like Patna Municipal Corporation and Guwahati Municipal Corporation, is a proactive approach for improving financial management practices within municipalities. (Abraham, 2013)

iii. Mandate Certificate Course for Accountants:

The Institute of Chartered Accountants of India (ICAI) and the Comptroller and Auditor General of India (CAG) have developed a certificate course for accountants of municipal bodies to improve the quality of financial management and reporting in municipalities. This course shall be considered to be mandated by States or cities for accountants of ULBs and accountants proposed to be hired in ULBs.

iv. Mandatory Enforcement of Accounting Standards for Local Bodies:

2 ASLBs (ASLB 2 & ASLB 5) out of 31 have been mandated by ICAI to be compiled by members of ICAI while auditing the financial statements of Local Bodies w.e.f. April 1, 2022 (Pankaj Goel, 2023). *It is suggested that just as Accounting Standards are made mandatory for companies through amendments in the Companies Act by the Ministry of Corporate Affairs, a similar approach can be taken at the state level for municipalities to make*

the adoption of Accounting Standards for Local Bodies (ASLBs) mandatory through amendments in relevant State Municipal Acts until NMAM has been amended at National level.

v. Resolving Accounting Staff Shortage Issues:

State-imposed restrictions on recruitment to positions and inadequate staffing levels can hamper the efficiency and effectiveness of financial management in ULBs. For example, in Tamil Nadu, due to a Government Order (GO), no fresh vacancies were created, and only people were appointed on a compassionate basis. Recognizing the staffing shortage, the Asian Development Bank (ADB), under its TNUFIP program, provided an incentive of Rs 5,00,000 per vacancy to be filled in selected ULBs covered, as prespecified in the Facility Administration Manual of Tranche 1, as a performance incentive.⁶ Furthermore, the creation of a Municipal Accounts Service cadre was proposed in one of the reports of the Ministry of Housing and Urban Affairs (MoHUA)⁷, may be adopted by the State.

This study highlights a prime issue regarding selective accounting practices in cities, which are meant to be engines of growth and drivers for effective service delivery. States and cities must take proactive steps toward reforming their financial management practices without waiting for advisories from MoHUA. Chartered Accountant

firms responsible for preparing financial statements for cities should ensure compliance with NMAM and other relevant accounting standards. By implementing these interventions, states and cities can overcome the challenges associated with selective accounting practices and strengthen their financial management systems. This, in turn, will contribute to more efficient resource allocation, improved service delivery, and sustainable urban development.

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6 Tamil Nadu Urban Flagship Investment Program, Project Number: 49107-003

7 Approach towards Establishing Municipal Cadres in India, 2014, MoHUA