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Primer on Municipal Accounting Reform JNNURM City-Level Reform

Final Report

Indo-USAID Financial Institutions Reform and Expansion Project—
Debt & Infrastructure Component (FIRE-D Project)

USAID-TCGI Contract No. 386-C-00-04-00119-00

March 2010

This publication was produced for review by the United States Agency for International Development. It was prepared by The Communities Group International (TCGI), in partnership with AECOM.

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Municipal Accounting

ULB Level Reform

1. The Reform

In terms of the recommendations of the National Municipal Accounts Manual (NMAM) released by the Ministry of Urban Development MoUD, Government of India decided to introduce accrual-based double entry system and improved financial management systems in all ULBs in India (Annexure I). Taking this further and for achieving various objectives, JNNURM reform conditionalities call for “improved municipal accounting, with the objective of having a modern accounting system based on double entry and accrual principles, leading to better financial management, transparency and self reliance”, as a mandatory reform for local bodies.

The outcomes to be achieved by states and ULBs that participate in the JNNURM and implement financial management reforms are:

- Increased access to resources for urban services.
- Improved financial management, accountability, transparency of management and improved governance.
- Accurate costing for all urban civic services.
- Timely and better MIS for decision-making,
- Accurate reporting of subsidies for better management and targeting.
- Better control and utilization of assets.
- Publishing of audited financial statements on a timely basis.
- Better management of resources and risks.
- Responsible civil society that is prepared to partner with local government.

2. Rationale for the reform

The importance of reliable information on municipal finances has come to the fore as cities in India develop infrastructure projects that reflect principles of commercial viability and private sector participation. Better financial management is essential.

Currently, due to a lack of good financial management and expenditure management ULBs are wasting scarce resources and are not able to hold municipal staff accountable. Most ULBs currently follow a cash basis of accounting, which provides inadequate information. Since, a statement of assets and liabilities is usually not prepared; a full picture of assets and liabilities is not readily available for appropriate financial management. There is inadequate cash management and timely quality information for planning, decision-making and financial control. As apposed to cash basis, accrual basis is a superior method of accounting of the economic resources of urban local bodies. Under accrual accounting, recording of transactions and events takes place whenever a transaction occurs. Even if no cash is received or disbursed, the relevance, objectivity, timeliness, completeness and comparability of the accounting records and statements are much enhanced. Accrual basis clearly distinguishes between items of a revenue nature and items of a capital nature. This helps in correct presentation of financial statements through an income and expenditure account, a balance sheet, and a statement of cash flows (Annexure II).

ULB budgets do not reflect citizen priorities as the development and consultation process does not include them. Budgeting is not done in a scientific manner; multi-year, flexible and performance-based budgets are not prepared. There is no system of reporting back to the citizens on actual performance compared to budget priorities. Financial audits in many ULBs are pending

for many years. Inadequate internal control systems and absence of an internal audit system hinder risk mitigation and management.

A financial management system for ULBs has to be transparent to be able to take into account citizen inputs and priorities and to be able to share information with the citizens. Users expect that ULB financial reports will help them to assess the use of resources and ensure their economic impact on the economy of the ULB; evaluate ULB spending options and priorities; and assess whether resources were used in accordance with legally mandated requirements. Finally, an appropriate financial management system will permit ULBs to assess their long-term ability to meet financial obligations and their overall financial condition.

3. Reform components

Under the JNNURM, MoUD will provide financial resources to states and ULBs that agree to undertake the following modern accounting reforms:

- Budgeting, accounting, internal controls and auditing.
- Reengineer business processes to align with accrual-based accounting system.
- Integrate financial management systems with financial accounting system.
- Staff training and building financial management capacity.

Roadmap for Implementation

Better financial reporting shall help ULBs be more accountable by assessing the effectiveness of programs and levels of services, and providing information about the financial condition of the ULB and its ability to raise resources to finance the delivery of improved services, and to meet its actual and contingent liabilities. To enable ULBs to implement improved financial management, state governments shall develop the following based on NMAM:

- State-level accounting manual.
- State-level manuals on expenditure management and performance-based budgets.
- State-level policies and guidelines on training and handholding.
- State-level accounting software integrating financial management systems with the financial accounting system.

To implement the new accounting system in ULBs, it shall be necessary to use the services of local chartered accountants to assist the municipal staff understand and implement the new accounting system. The consultants shall train on the manuals, provide on-the-job training as well as formal training programs¹ on specific elements of the new accounts manuals and on the new double entry accrual accounting transactions. It shall be necessary to use the new system in parallel with the old cash-based system until the municipal staff is proficient in the new system. This is necessary to stabilize the new system and prevent a relapse to the old system.

¹ Based on the NMAM, the MoUD has developed a National Municipal Accounts Training Manual (NMATM), which shall form the basis of preparing state-level municipal accounting training manuals.

4. Steps to implementing the reform

The state governments will have to take the following steps:

- i. Constitute a state-level steering committee with the authority to promulgate accounting standards, formats for budgeting and costing, financial statements and audit reports.
- ii. Pass a resolution expressing commitment to establish modern accounting system.
- iii. Appoint a consultant for development of a state-level municipal financial accounting manual.
- iv. Establish a state-level project management unit under the guidance of the steering committee to oversee implementation and conduct capacity building and training of municipal officials.
- v. Review the legislative framework to identify the changes necessary to implement the improved financial management system. Implementation of the improved financial management system in all ULBs and urban civic service providers may require amendments to relevant legislation, byelaws, rules/regulations, etc.
- vi. Provide guidelines on expenditure management and budgeting to better control expenditures, prepare outcome-based budgets, ensure accountability, and involve stakeholders in setting budget priorities.
- vii. Develop a state-level accrual-based accounting manual detailing the accounting system, policies and procedures, the records and documents to be maintained, and the form, contents and periodicity of various accounting reports.
- viii. Provide guidance on required manpower, training and implementation to switch over to the improved financial management system. Formulate appropriate policies for necessary handholding assistance and internal audit from chartered accounting firms. Based on MoUD's National Municipal Accounts Training Manual, state governments shall prepare a state-level training manual. Further, states shall evolve a suitable recruitment and transfer policy for municipal officials to ensure reasonable stability of tenure of finance personnel.
- ix. Develop/customize accounting software to provide meaningful MIS for managerial decision-making through the new financial management system.

The ULBs governments will have to take the following steps:

- i. Establish a committee to implement improved financial management reforms.
- ii. Appoint chartered accountants for providing handholding support.
- iii. Implement training programs.
- iv. Prepare inventory of assets and liabilities.
- v. Value all assets and liabilities, finalize opening balance sheet.
- vi. Reengineer business processes to align with accrual-based accounting system.
- vii. Adopt and implement an accrual-based accounting system.
- viii. Appoint an external auditor.
- ix. Publish financial statements along with audit reports.
- x. Carry out parallel runs of both existing and new system of accounting till the latter gets stabilized.
- xi. Implement transparent, multi-year budget system with the priorities set by stakeholders.
- xii. Institute internal control procedures and appoint an internal auditor.

- xiii. Undertake credit rating.²
- xiv. Install the selected accounting software, and integrate financial management systems with the financial accounting system.

5. Setting the timeline

Implementation and sequencing of the financial management reforms will have to take into account the administrative capacity, political will and financial constraints of individual states, ULBs and all urban civic service providers.

Steps /Timeline	Y1	Y2	Y3	Y4
State				
Constitute steering committee				
Set up a dedicated project management unit (PMU) to oversee implementation				
Government Resolution expressing commitment to establish modern accounting system				
Appointment of consultant for development of state-level municipal financial accounting manual				
Review the legislative framework				
Develop a state-level accrual-based accounting manual				
Prepare a training manual, formulate policies for appointment of CAs for providing handholding and conducting of internal audit of ULBs				
Develop/customize accounting software integrating financial management systems with financial accounting system, and formulate policies to publish financial statements along with audit reports				
ULBs				
Establish committee to implement improved financial management reforms				
Appoint CAs for providing hand holding support				
Implement training programs				
Prepare inventory of assets and liabilities, value assets & liabilities and finalize opening balance sheet				
Reengineer business processes to align with accrual-based accounting system				
Adopt and implement an accrual-based accounting system				
Appoint an external auditor				
Publish financial statements along with audit reports				
Implement transparent, multi-year budget, commence preparation of outcome budgets				
Institute internal audit, and internal control procedures				

² The identification and valuation of the municipal assets and liabilities, based on the NMAM, to prepare the opening balance sheet shall be an important step for moving towards accrual-based accounting for ULBs (refer chapter 34 of NMAM).

Undertake credit rating				
Implement accounting software, integrated financial management systems with financial accounting system				

6. Measuring Achievement/Outcomes

Benchmarks of successful implementation are:

State Level

- The state has passed a Government Resolution expressing commitment to establish modern accounting system.
- The state has appointed a consultant for development of a state-level municipal financial accounting manual.
- The state has reviewed the legislative framework for the implementation of improved financial management reforms.
- The state has formulated policies for appointment of CAs for providing handholding and conducting of internal audit of all ULBs and urban civic services providers.
- The state has developed a state-level accounting manual and amended the legislation, as necessary, for adoption of a modern accounting system.
- The state has developed manuals on expenditure management, budgeting, policies on training and handholding and accounting software.
- The state has developed a training manual.
- The state has developed accounting software integrating financial management systems with financial accounting system, and policies to publish financial statements along with audit reports.

ULB Level

- Cities have appointed CAs for providing handholding and implementing training programs.
- Cities have prepared inventory of assets and liabilities and valued assets & liabilities.
- Cities have prepared opening balance sheets.
- Cities have reengineered business processes to align with accrual-based accounting system.
- Cities have adopted and implemented accrual-based accounting system.
- Cities have implemented transparent, multi-year budget, and costing formats.
- Cities have commenced preparation of outcome budgets.
- Cities have appointed an external auditor and adopted an audit cycle.
- Cities have published audited financial statements.
- Cities have instituted internal audit/control procedures.
- Cities have undertaken credit rating.
- Cities have installed accounting software, integrated financial management systems with financial accounting system.

Development of the National Municipal Accounts Manual and the National Municipal Accounts Training Manual

In pursuance of the recommendations of the Eleventh Finance Commission and *Guidelines for the Utilization of Local Bodies Grants* issued by Ministry of Finance, Department of Expenditure, Government of India, the Comptroller and Auditor General (C&AG) of India was to prescribe the accounting and budget formats for urban local bodies (ULBs). Accordingly, C&AG of India constituted a Task Force, which submitted its report on *Accounting and Budget Formats for Urban Local Bodies* to the MoUD. The Task Force noted the urgent need for improved municipal accounting to serve as an effective management tool to document ULB financial activities and financial position, promote more effective and timely decision-making, and facilitate greater accountability and transparency.

The key recommendations of the Task Force were that ULBs:

(i) Introduce an accrual system of accounting; (ii) Implement improved accounting policies; (iii) Use model budgeting and accounting formats, including financial statements and cost sheets for each utility (i.e., water and sanitation, solid waste management, street lights, hospitals, schools); and (iv) Set up required management information systems.

The report also discussed major issues in the transition from cash-based to accrual-based accounting and noted that since municipal law is a state subject, state governments will have to review their respective legislative frameworks to identify the changes to be made in the relevant Municipal Acts and Rules/Codes to implement the recommendations. Each state government will have to constitute a steering committee, develop an accounting manual, and provide training to its municipal staff. The Task Force recommended that ULBs should carry out parallel runs of both the existing and new system of accounting till the latter gets stabilized. Finally, the Task Force suggested that MoUD set up a monitoring unit/committee to ensure effective implementation of its recommendations and help state governments address issues arising during implementation. The report of the Task Force was accepted by the Government of India and forwarded to State Governments for implementation, keeping in view the local requirements.

Subsequently, the MoUD requested the C&AG, based on the Task Force recommendation, to prepare a the National Municipal Accounts Manual (NMAM), and a companion National Municipal Accounts Training Manual (NMATM). These were provided by the MoUD to the state governments. Based on these, the state governments can prepare state-level accounting manuals and state-level training manuals according to their requirements.

Difference between Cash-based Accounting and Accrual-based Accounting

Cash-Based Accounting

Presently, ULBs generally follow the cash basis of accounting reporting against budgetary outlays. Under cash accounting, transactions are recorded when the related cash receipts or cash payments take place. Similarly, expenditure on acquisition and maintenance of assets used in rendering services, as well as on employee remuneration, are recorded when the related payments take place. The end product of the cash basis of accounting is a statement of receipts and payments that classifies cash receipts and cash payments under different headings. It provides readers information about the sources of cash raised during the period, the uses to which cash funds were applied and the cash balance at the reporting date. The measurement focus is cash balances and changes therein. A statement of assets and liabilities may or may not be prepared.

Traditionally, ULB budgets have been cash-based, and this led to cash-based municipal accounting. Moreover, these systems conform to state and city legislative requirements. The information provided under cash accounting is easy to compile and understand, and historically, met the requirements of users. However, today the users of financial statements are demanding more information on assets and liabilities and the impact of current consumption of assets on the overall financial position.

Cash-based accounting fails to meet many financial reporting objectives. Evaluation of ULB performance requires the measurement of accomplishments and the resources expended on them during a set period. But the timing of cash receipts and payments may not coincide with earning revenues or incurring expenses. Managers can delay receipts or payments until the next reporting period. Another major weakness of cash-based accounting is that no distinction is made between receipts or payments on capital accounts and those on revenue accounts. With cash accounting, spending on the assets used over many years is recorded only when money is spent. No subsequent account is taken of depreciation or whether the asset is still in use. Cash accounting limits the ability of the citizens to hold the ULBs accountable for their use of resources. ULBs can be held accountable only for their use of cash, but not for their management of other assets and liabilities. Consequently, measurement of performance and financial position under the cash accounting is unlikely to yield correct results.

Completeness and accuracy of accounting data are important prerequisites of financial reporting. However, current accounting systems and practices neither record financial information completely nor guarantee the accuracy of this information. Thus, there is an urgent need to improve municipal accounting systems in the country to provide leaders and citizens of local bodies with more accurate and complete financial information. This will help improve governance, transparency, and accountability and facilitate improved service delivery, resource mobilization and utilization of scarce financial resources.

Accrual-Based Accounting

Under accrual accounting, recording of transactions and events takes place whenever a transaction occurs. Even if no cash is received or disbursed, the relevance, objectivity, timeliness, completeness and comparability of the accounting records and statements are much enhanced. Accrual basis clearly distinguishes between items of revenue nature and items of capital nature. This helps in correct presentation of financial statements through an income and expenditure account, a balance sheet, and a statement of cash flows.

It is increasingly accepted that the accrual basis of accounting is more appropriate and suitable for users of ULB financial statements than cash accounting. Accrual accounting recognizes assets, liabilities, net assets/net worth, revenues, and expenses. The focus of accrual accounting is on all assets, and not just cash.

Accrual accounting provides users with information that:

- Helps ULBs to demonstrate accountability for their management of all assets and liabilities recognized in the financial statements. This information is particularly important in relation to infrastructure assets, the replacement of which could strain ULB financial capacity.
- Identifies ongoing costs, such as depreciation and maintenance, of owning and operating assets, which are needed to measure the total cost of goods and services produced. ULBs need this information to determine which goods and services to provide and the most efficient way to provide them.
- Enables users to evaluate a ULB's ongoing ability to finance its activities and to meet its liabilities and commitments. Information on all liabilities forces ULBs to acknowledge and plan for the payment of long-term liabilities, such as pension liabilities. Information on the extent of financial obligations and exposure to contingent liabilities bears directly on future revenue requirements of ULBs and their ability to pay for commitments and obligations and finance their operations.
- Allows users to compare revenues with expenses, enabling them to assess whether current revenues are sufficient to cover the costs of services in the current period.
- Enables ULBs and other users to make rational decisions about the viability and sustainability of their programs, to decide whether to continue them, and to initiate proper budgeting and control of activities.

Accrual accounting does not disregard the usefulness of information available under cash-based accounting. A statement of cash flow is usually an integral part of the financial statements prepared under this basis. This provides better information on cash flow and, therefore, facilitates better cash management.

Conclusion

Most urban officials in India agree with the need to introduce double entry, accrual-based accounting systems. Providing the required capacity building of the municipal accounting and other staff will ensure its long-term sustenance. Now, with the development of NMAM and NMATM, it will be easy for states and cities in India to introduce improved accounting and financial reporting systems. In principle, the benefits to users of the financial statements will exceed the costs of recording, summarizing, reporting and auditing the information. The benefits and costs need to be considered over a reasonable time frame in order to balance the short-term costs of shifting from one basis to another.