

# Transition to Accrual Accounting: Models and learnings for Urban Local Bodies



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*The financial challenges faced by Indian municipalities and their subsequent impact on municipal governance have been widely discussed. The root cause of the weak financial position primarily stems from two factors: inadequate own-source revenues of municipalities and poor fiscal management, with the latter often exacerbating the former. As urban populations continue to surge, municipalities are*

*under increasing pressure to achieve financial self-sufficiency. They are expected to augment their own-source revenue streams while also raising funds from open markets through mechanisms such as municipal bonds. However, for municipalities to issue bonds, they need to establish their creditworthiness, which is contingent upon obtaining a credit rating. This, in turn, necessitates reliable and accurate financial statements.*

**T**he quality of financial information available to decision-makers plays a pivotal role in shaping fiscal management policies. Accurate financial information hinges on the reliability of the underlying accounting system. Across the globe, governments are transitioning from the traditional “cash” accounting system to the more effective “accrual” accounting system. The accrual system ensures the completeness and accuracy of financial reporting. It is projected that by 2025, over 50% of jurisdictions worldwide will report on an accrual basis. In India, this

shift has been acknowledged by successive Central Finance Commissions (CFCs), beginning with the twelfth, which emphasized the adoption of accrual accounting in government practices.

The journey towards implementing the accrual accounting system in India commenced with urban local bodies (ULBs). The Comptroller and Auditor General, in a report dating back to 2002, recommended the adoption of accrual accounting. However, even after two decades, a substantial number of ULBs in the country continue to

maintain their accounts on a cash basis. In a bid to accelerate the adoption of accrual accounting, the Ministry of Housing and Urban Affairs (MoHUA), Government of India, heeding the recommendations of the 15th CFC, made audited annual accounts a prerequisite for accessing basic grants. These audited annual accounts encompass the Balance Sheet, Income and Expenditure Statement, and Cash Flow Statement, all of which necessitate accrual accounting.

This policy shift has prompted State governments to encourage ULBs to prepare financial

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statements and undergo audits. Nevertheless, the experiences of States that have attempted the transition to accrual accounting in ULBs reveal that these reforms are intricate and carry a significant risk of failure if not executed meticulously. While a few States, including Karnataka, Kerala, and Tamil Nadu, have effectively embraced the change, many others are still in the process of transitioning. In certain instances, the situation has regressed following an initial implementation. Overall, successful adoption of the accrual system has been limited to a few ULBs within most States.

### The study

Irrespective of the outcomes of these transition efforts, States that have taken the lead

in adopting accrual-based accounting have accumulated valuable experiences that can serve as valuable lessons for other States currently embarking on similar reforms. However, the existing literature on this subject is limited and outdated, necessitating the development of a knowledge repository to capture reform insights. To address this gap, a study commissioned by NITI Aayog was conducted by the ICAI (through the Committee on Public & Government Financial Management) and ICAI Accounting Research Foundation. This study aimed to document the reform journeys of select States, distill key learnings, and provided recommendations for more effective future reform endeavours.

The study spanned five months, from November 2021 to March 2022, and focused on States including Odisha, Rajasthan, Tamil Nadu, and Cantonment Boards. These States were chosen based on demographic, geographical, and urbanization factors, as well as their progress in implementing municipal finance reforms. The research

involved interviews using a comprehensive questionnaire covering various dimensions of accrual accounting transition, such as reform planning, policy framework, technological solutions, implementation strategies, human resources, training, and financial statements. In addition to the in-depth study of selected States, desk-based research was conducted on experiences in other Indian States and internationally.

The draft report was shared with the study States for feedback and was further discussed at a consultative workshop in May 2022. This workshop brought together representatives from NITI Aayog, ICAI, Ministry of Housing and Urban Affairs, Government of India, the Comptroller and Auditor General of India, and Urban Development Departments of select States. The feedback collected during these interactions was incorporated into the final report.

The final study report was released in January, 2023.

### The report

The study report is structured into four chapters. Initial chapter lays the groundwork by contextualizing the study and highlighting the importance of sound financial management for effective municipal governance. It provides an overview of the historical evolution of municipal financial reforms in India, outlines the study's objectives, methodology, and inherent limitations. Importantly, the study is not confined to technical aspects of accrual accounting but also emphasizes the importance of effective implementation.



Thereafter, the study delves into the transition experiences of the selected States, offering a detailed account of their reform journeys including summaries of reforms in each State, case studies of specific ULBs, and a tabular presentation of key transition highlights across all study States. Moreover, it touches upon the transition experiences of other States beyond the study's focus. Cross-cutting developments with relevance to accrual accounting reforms, such as the role of Central Finance Commissions and State Finance Commissions, the National Urban Digital Mission, and initiatives by various entities, are also discussed.

Thereafter, the study covered lessons from the experiences of States engaged in municipal financial reforms. It provides recommendations structured around policy, process, people, and technology dimensions. These recommendations encompass reform design and planning, reform implementation strategies, resource allocation and capacity-building, and technology solution implementation. Two valuable

checklists—one at the State level and another at the ULB level—are introduced, focusing on key success factors for a seamless implementation process, culminating in proposing an indicative 18-month timeline for the transition, complete with key milestones.

Lastly, the study transcends the immediate outcomes of accrual accounting—namely, the production of audited financial statements—and underscores the broader significance of municipal financial reforms. It posits that the ultimate goal of these reforms is to enhance municipal governance. This argument is supported by anecdotes and evidence from international cases in seven countries. It outlines a vision for a finance-integrated municipal e-Governance system and outlines a path forward for municipal finance reforms in India.

### Findings: Concerns of reality

Key findings from the study underscore a concerning reality: aside from a few exceptions

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such as Karnataka, Tamil Nadu, and select Cantonment Boards, most study States have not fully transitioned to accrual accounting in ULBs. This trend is mirrored in the desk-based research across other States, with Kerala standing as a noteworthy exception. The report identifies two major roadblocks: lack of capacities at the ULB level and the absence of integration between financial statement audits and statutory audits. To ensure sustainable change, these challenges need to be addressed promptly, as mere incentives and grants may not lead to enduring transformation.

The report proffers a series of recommendations to structure municipal accounting reform initiatives. In the realm of policy, the report underscores the effectiveness of State-wide implementation, the importance of a collaborative approach involving various departments, and the role of specialized State institutions. The process-related recommendations advocate for informed implementation based on past experiences, decentralized management, clear mandates, and a mix of incentives and disincentives. The significance of integrating financial statement audits into external audits is emphasized, along with the imperative of a





complete transition away from legacy systems.

In terms of resourcing and capacities, the report recognizes the technical nature of accounting and suggests engaging external expertise for project management and assistance. It stresses the need for a balance between external and internal expertise to ensure long-term sustainability. Building in-house capabilities is crucial, requiring adjustments to municipal cadre and service rules. Continuous support arrangements post-implementation are also highlighted.

Technology-related recommendations underscore the importance of adopting a “digital first” approach, integrating technology within a municipal e-Governance framework. However, the report cautions against viewing technology as a panacea, emphasizing that it should complement rather than substitute accounting practices.

### Road ahead

Moving beyond the immediate outputs of accrual accounting, the study posits that the true measure of success lies in the improvement of municipal governance. Audited financial

statements are not an end in themselves; they are a means to enhance accountability, fiscal responsibility, budget management, and risk management. Moreover, they enable efficient resource allocation and facilitate service delivery costing. When combined with non-financial parameters, financial indicators serve as effective tools for performance management at both the ULB and State levels. This argument has been reinforced with examples from seven countries, demonstrating how accrual accounting has been leveraged to achieve better governance outcomes. It envisions a finance-integrated municipal e-Governance system as the cornerstone of successful municipal finance reforms. The study culminates in proposing a holistic approach for municipal financial reforms in India. This approach is marked by outcome-driven design, data-centricity, process reengineering, stakeholder engagement, capacity-building, transparency, and accountability considerations. Additionally, it underscores the growing relevance of environmental, social, and governance (ESG) considerations in the reform landscape.

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In conclusion, the study sheds light on the critical issue of weak financial positions of Indian municipalities and its implications for effective governance. It highlights the importance of adopting the accrual accounting system and documents the reform journeys of select States. The study distills essential lessons and presents a comprehensive set of recommendations for more effective future reform initiatives. It underscores that the ultimate goal of these reforms is to enhance municipal governance and outlines a pathway toward achieving this goal. As India continues to undergo rapid urbanization, the findings and insights from this study can play a pivotal role in shaping the future trajectory of municipal finance reforms, ultimately leading to more efficient and effective municipal governance.

The complete study is available at <https://resource.cdn.icai.org/72746cpfgm58672.pdf> and <https://www.niti.gov.in/sites/default/files/2023-03/Transition-toAccrualAccounting.pdf>.

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