

# **IMPROVING AUDIT EFFECTIVENESS**

## **Introduction**

11 CAG is the sole and statutory auditor of the union and state government finances, their departmental undertakings, authorities substantially financed from the union and the state governments' funds, government companies and the transactions relating to the consolidated, contingency and public account funds of both the union and the state governments. In addition to audit responsibilities, CAG also sets standards of accounts and compiles accounts for all states except Goa. Besides the formal discharge of its audit responsibilities as Supreme Auditor, CAG provides other value-added services, including effectiveness of Government interventions, propriety of expenditure and transparent reporting on the state of fiscal health of government entities and its parastatals. CAG's audit has a very wide perspective and is not only concerned with aspects like fidelity of accounts, conformity of expenditure to the provision of funds and regularity of transactions but also extends to questions of propriety, efficiency, overall performance and adequacy of systems.

12 Under the DPC Act, the CAG has access to all records and documents relating to the accounts of the Govt. offices and organisations audited by him, and has the power to inspect any concerned office, to scrutinise records relevant to his audit, to raise questions in the context of any account or report he has to prepare and to make audit observations.

## **What determines Audit Effectiveness ?**

21 The effectiveness of the CAG audit would lie not only in its ability to perform these statutory functions effectively, but also in it being perceived as an agency improving the effectiveness of union and state governments interventions for the common good. In an ideal system, even if there is no identification of under assessment of revenue, in-appropriate expenditure and violation of the propriety rules for expenditure, CAG audit would still be considered quite effective if it successfully prevents the recurrence of such happenings and improves the over all credibility of government finances and transparency of its operations. It is, however, quite difficult to conceive of objective performance parameters for assessing effectiveness of such qualitative changes and economy, efficiency and effectiveness of government finances.

2.2 The effectiveness of audit could be viewed from the point of view of the volumes involved, underassessment of revenue, excess expenditure and system improvements, which may act as a deterrent. Perceived usefulness of audit by the auditee organisations, as reflected in their level of compliance and implementation of recommendations, improvement in the overall accountability mechanism and transparency, etc. have generally been considered as the parameters of assessing audit effectiveness by Supreme Audit Institutions.

**Box 2.1**  
**Parameters of Audit effectiveness**

| <b>Effectiveness Parameters</b>  | <b>How could these be measured?</b>  |
|--|--|
| Effective performance of statutory functions   | Timely completion of Reports   |
| Perceived as an agency improving the effectiveness of public funding and government interventions  | Specific, implementable recommendations which are accepted by planning/authorising and implementing agencies |
| To successfully prevent recurrence of underassessment/shortfalls in revenue, inappropriate/wasteful/infructuous/impropriety expenditure to improve credibility and transparency of government operations | Develop scientific and consistent methods of identifying these shortcomings                                  |
| Foster qualitative improvement in government interface with people   | Provide required information at a time and in formats/frequencies for remedial action/systemic improvements  |
| Perceived as useful by auditee institutions  | Level of acceptance and compliance   |

**Audit Effectiveness Assessment: Parameters Adopted by SAIs**

31 General Accounting Office (GAO) of the United States uses seven annual measures, (financial benefits, other benefits, implementation of the past recommendations, new recommendations, new and innovative products, testimonies and timeliness in submission of Reports) to assess its performance in meeting its strategic goals and objectives. These measures indicate the degree to which the GAO's work benefits Congress by providing the Congress:

- Most eminent and high profile information;
- Developing ways to improve the Government and tracking whether these improvements are, in effect, made.

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**Box 3.1**  
**GAO's Annual Performance Measures**

| <b>Measure</b>                    | <b>An Indicator of</b>  |
|-----------------------------------|---|
| Financial benefits                | Has our work provided financial benefits for the American people in term of reduced costs or high revenues?   |
| Other benefits                    | Has our work produced tangible benefits for the American people in the term of better government operation or service?  |
| Past recommendation implemented   | Are most of our recommendations implemented?  |
| New recommendations made          | Do we develop ways of improving the conditions in our works?  |
| New products with recommendations | Do about half of our products provide recommendations for improvements while we continue to meet our congressional clients' requests for purely informational products?           |
| Testimonies                       | Are we in touch with our congressional clients' information needs and can we fill requests for what typically is high profile, fast turnaround, explicitly distilled information? |
| Timeliness                        | Do we deliver most of our products to our requesters when agreed?   |

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3.2 The financial benefits of GAO Reports are generated when agencies act on the GAO's findings and recommendations to make government services more efficient; improve its budgeting and spending of tax revenue and to strengthen the management of federal resources. Other benefits that flow to the people from the GAO's work are in the form of information, which may result in statutory and regulatory changes. Tracking the implementation of past recommendations and the extent of such implementation is another

measure of assessing its performance. These are tracked for upto a period of five years. Since the GAO has both the information and the expertise, it provides value-added services to the Government by analysing the long term fiscal position and structure, information on budgetary choices and reliability of financial information on the Government's fiscal position. Its findings and sources contribute to the Parliament deliberations. GAO, as a legislative branch agency, also testifies at congressional hearings covering a wide range of complex issues. Finally, GAO measures its performance in terms of the timeliness of submission of its Reports as against preset targets. The seven measures and what they indicate are summarised in box 3.1 above.

3.3 The Canadian SAI uses a results chain mechanism with defined immediate, intermediate and end outcomes to assess its effectiveness. Most of these are, however, qualitative in nature and may not be generally amenable to quantification and inter-country or inter-temporal comparison. The long-term results relate to public confidence and good governance, which are considered critical for credibility of information and efficacy of programmes.

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**Box 3.2 Results Chain Matrix**  
**Long-term End Outcomes**

|   |  |
|---|--|
| <p>We contribute to better managed government programs and better accountability to Parliament and the public</p> | <ul style="list-style-type: none"> <li>• Public has confidence in government institutions.</li> <li>• Good governance and an accountable government.</li> <li>• There is progress towards sustainable development.</li> <li>• Programs are effective and efficient.</li> <li>• Departments report to Parliament on their performance with credible financial and non-financial information.</li> </ul> |
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3.4 Medium term objectives, under the results chain mechanism, relate to relevance of the audit reports for the federal government and the parliamentarians.

**Box 3.3**  
**Intermediate outcomes (medium term)**

|   |  |
|---|--|
| <p>Audits and studies are relevant to and result in a better informed Parliament, our client</p>                      | <ul style="list-style-type: none"> <li>● Parliamentarians consider accountability, value-for-money, compliance with authorities, and environmental and sustainable development consequences in their legislative and oversight work.</li> <li>● Parliamentary committees endorse Office recommendations.</li> <li>● Parliament appropriately reflects the intended messages in debates.</li> <li>● Organisations we audit implement our recommendations and use best practices.</li> <li>● Organisations we audit integrate environmental and sustainable development considerations into decision-making</li> <li>● Organisations we audit comply with authorities and adhere to financial reporting standards.</li> <li>● Our presence has a deterrence effect.</li> <li>● Organisations we audit appropriately reflect the intended messages in their responses to our recommendations.</li> <li>● The public and media appropriately reflect the intended messages.</li> </ul> |
| <p>Audits and studies are relevant to federal departments, agencies, Crown corporations- who are our stakeholders</p> |  |
| <p>Audits and studies results in a better informed media and public</p>   |  |

3.5 The immediate outcomes in the result chain of the Canadian SAI relate to the support to the auditee institutions and how they perceive the audit findings.

**Box 3.4**  
**Immediate outcomes (short term)**

|   |  |
|---|--|
| <p>Support for our role and its work is maintained.</p> <p>Clients and stakeholders are engaged in the audit process.</p> | <ul style="list-style-type: none"> <li>• Clients and stakeholders perceive information and audit process as useful.</li> <li>• Organisations we audit accept findings and recommendations.</li> <li>• Financial and value-for-money audits result in increased confidence in information and systems by senior management, boards of directors, and parliamentarians.</li> <li>• Unintended impacts are minimised</li> <li>• Parliamentary committees engage in hearings or briefings on issues reported.</li> <li>• Management, audit committees and boards of directors engage in understanding audit reports and follow up on issues reported.</li> </ul> |
|---|--|

3.6 Other SAIs follow more or less the same kind of approach for measuring audit effectiveness. Two cornerstones for measuring effectiveness have been (i) the ability of the audit to meet the information requirements of the legislature and auditee institutions and (ii) improving the accountability mechanism, resulting in improved outcomes.

**Institutional Mechanisms for Audit Compliance as an aid to audit effectiveness**

4.1 Audit effectiveness usually depends on two factors. Existence of an institutional mechanism of examination of audit compliance greatly enhances audit effectiveness, as it not only ensures action on the recommendations but also encourages audit in improving its apparatus and instruments. The second factor is the quality of observations and their perceived utility by the auditee unit/organisation. SAI-Canada has audit committees, which have an oversight role on key aspects of quality . It adopts internal practice review , professional standards review and external review to maintain its credibility.

4.2 There exists an institutional mechanism to examine the findings of CAG and ensuring an action on these observations by the concerned department/company. The Parliamentary Accounts Committee (PAC) or the Committee on Public Enterprises (COPU) ensure that

the observations are examined at the highest level and acted upon. However, it is felt that there may have been a gradual weakening of these accountability ensuring institutions over time, which may have considerably reduced their impact, particularly at the States' level. It has also been often argued that since observations in the reports pertain to periods, two to three years old, scrutiny by the administrative department and punitive action may become difficult.

4.3 In 1982, CAG had suggested the formation of Audit Committees in each State (with senior representatives of the Administrative and Finance Depts. and the AG), for effective review and settlement of audit objections, inspection reports, etc. which could not be sorted out at lower levels. Though these committees have been formed, improvement in response is only marginal. In August 1992, CAG had appointed a high power committee under the chairmanship of Shri S. L. Shaktihar to report on state responses to audit reports.

4.4 On delay of the CAG's reports, the Committee observed that the "CAG's Audit Reports are only a culmination of process of scrutiny which starts with the initial inspection of records in the various government departments, field offices and organisations. The Inspection Reports issued by the Audit officers call for replies and remedial actions; if these are dealt with promptly and satisfactorily, it would not only reduce the scope for any points mentioned therein developing into unresolved cases which have to be included in the Audit Report, but would also reduce the volume of unsettled audit objections". The Committee also observed that the "CAG's Audit Report on every State contains a Chapter on the Appropriation Accounts of the States which indicate, in a detailed and comprehensive manner, the items of expenditure incurred by government vis-a-vis the grants voted by the Legislature. Excess expenditure over the authorised levels-and the conspicuous surrender of funds arising out of large savings - are commented upon by the CAG in the Appropriation Accounts if they exceed certain limits fixed by the PAC from time to time". The Committee, however, did not make any recommendation on quality *per se* of audit reports and substantiveness of the observations. On the implementation side, it recommended that CAG may consider (in a distinctly visible section of the Audit Report) indicating the current status of some selected important Paragraphs and Reviews relating to his past Audit Reports on which follow-up action has been inadequate. The draft of such a special section may be discussed by the concerned AG with the Chief Secretary and Finance Secretary of the State Government, and their views may be incorporated therein, before it is forwarded to the CAG for consideration.

## CAG's Volume of Work

51 Over all money value of the audit of the CAG has been around 5 percent of the total value of transactions of the union government and around 7 percent in the states. In the last four years, volume parameters are on the increase (as indicated in tables 1 and 2). In both cases, the value of audit as a percentage to total value of transactions involved, comprising of the aggregate revenue and expenditure of the Union and State Government, has also witnessed improvements during the last four years.

**Table 1 - Money value of audit and its percent to total value (Rs.'lp' Crores)  
(Union Government)**

|   | 2000-01 | 1999-2000 | 1998-99 | 1997-98 |
|---|---------|-----------|---------|---------|
| Money value of Audit                              | 37271   | 28982     | 19233   | 13317   |
| Total Value Involved                              | 627214  | 563109    | 506835  | 421739  |
| Audited Value as per cent to Total Value Involved | 5.94    | 5.15      | 3.79    | 3.16    |

**Table 2 - Money value of audit and its percent to total value (Rs.'lp' Crores)  
(State Government)**

|                                    | 2000-01 | 1999-2000 | 1998-99 | 1997-98 |
|------------------------------------|---------|-----------|---------|---------|
| Money value of Audit               | 59712   | 25583     | 18186   | 20962   |
| Total Value Involved               | 483889  | 414602    | 377636  | 336790  |
| Audited Value as per cent to Total | 12.34   | 6.17      | 4.82    | 6.22    |

Note : Money Value of Audit includes the value in local audit and for autonomous institutions, while the total value involved is the total expenditure of the union and state governments. However, since the expenditure includes the charged expenditure as well, the money value of audit net of that will be significantly higher than what has been indicated above.

5.2 In the case of commercial undertakings of the union and the state governments, the money value of audit is roughly of the same order in relation to the total turn over of these corporations. The absolute money value of audit is indicated in table 3.

**Table 3 - Money value of Commercial Audit (Rs. lp'Crores)**

|                  | 2000-01 | 1999-2000 | 1998-99 | 1997-98 | 1996-97 |
|------------------|---------|-----------|---------|---------|---------|
| State Commercial | 14335   | 18809     | 7664    | 3079    | 1782    |
| Union Commercial | 13653   | 7592      | 8190    | 1191    | 8476    |
| Total Commercial | 27989   | 26401     | 15854   | 14990   | 10259   |

5.3 In addition to the money value of the audits involved in commercial units, CAG is also required to certify the accounts of these units. There are instances where the observations made by CAG have resulted in accounts being redrawn.

5.4 Audit impacts could be viewed both through its identification of under-assessment of revenue or excess of expenditure or both. In case of the union and state Governments, the under assessment reported through the test audits by CAG has averaged around 4 per cent of their combined receipts. However, the implementing departments contest many of these under assessment orders/observations of CAG. The acceptance of the observations of the under assessment made by the CAG has been around 0.25 per cent of the combined receipts of the Union and States. Tables 4, 5 and 6 indicate the under assessment observed and accepted as percentage to that reported and to the total receipts.

**Table 4 - Under Assessment observed and accepted (Rs. in crores)  
(Union Government)**

|                                  | 2000-01 | 1999-2000 | 1998-99 | 1997-98 | 1996-97 |
|----------------------------------|---------|-----------|---------|---------|---------|
| Under Assessment Reported        | 6138    | 13989     | 35949   | 11032   | 6068    |
| Under Assessment Accepted        | 314     | 450       | 1184    | 141     | 88      |
| Accepted as per cent to Reported | 5.11    | 3.22      | 3.29    | 1.27    | 1.45    |

**Table 5 - Under Assessment observed and accepted (Rs. in crores)  
(State Government)**

|                                  | 2000-01 | 1999-2000 | 1998-99 | 1997-96 | 1996-97 |
|----------------------------------|---------|-----------|---------|---------|---------|
| Under Assessment Reported        | 12030   | 4986      | 4476    | 2604    | 2524    |
| Under Assessment Accepted        | 1366    | 628       | 1154    | 1112    | 395     |
| Accepted as per cent to Reported | 1135    | 12.60     | 25.79   | 42.71   | 15.66   |

**Table 6 - Under Assessment observed and accepted as percent to receipts**

|  | 2000-01 | 1999-2000 | 1998-99 | 1997-98 |
|--|---------|-----------|---------|---------|
| Under Assessment as per cent to Total Union Receipts | 2.41    | 6.49      | 18.35   | 6.40    |
| Under Assessment as per cent to Total State Receipts | 5.86    | 2.83      | 2.61    | 1.70    |
| Under Assessment as per cent to Combined Receipts    | 3.95    | 4.84      | 11.01   | 4.19    |
| Acceptance as per cent to Combined Receipts          | 0.37    | 0.28      | 0.64    | 0.39    |

### **Weaknesses of the existing mechanism of indicating audit impacts**

6.1 The test audit results of receipt audit are reported independently and no attempt is made to relate these to the total receipts. Though test audit is generally non-subjective, its being treated as stand alone and independent of the population results in the magnitude becoming less alarming. Since receipt audit involves auditing thousands of vouchers/audit units, it should be possible to assess the total value of under assessment. What probably prevents undertaking such an exercise could be the requirement of documentary evidence of such an under assessment or non-random process of selection.

6.2 In the case of expenditure, while the money value of excess expenditure/impropriety expenditure based on test audit is not readily available, the problems of overall impact assessment are the same. However, in case of expenditure audits, since nearly 75 per cent of total expenditure of the union and the states is in the nature of committed

contractual obligations of interest payments, salary and wages, pensions and assignments to lower tiers of the government, the scope of such audit may also be getting increasingly squeezed. None-the-less, there is a need to link the test audit results to the total value of transactions, so as to indicate the total quantum of under assessment and excess expenditure.

## **Parameters of Audit Effectiveness**

7.1 Parameters for assessing Audit Effectiveness are summarised below in terms of four major activities of CAG. These include:

- (a) The audit of receipt and expenditure on the Civil side,
- (b) Certification of accounts and audit of expenditure on the Commercial side,
- (c) Parameters for Accounts and Entitlement functions; and
- (d) Value for Money Audits partly covered under the Central and State Reviews.

### **A : Receipt Audit**

7.2 The audit of receipts is expected to become the central theme in the medium to long run. With a major segment of expenditure becoming contractual in nature and committed by definition, the scope of expenditure audit is generally getting restricted. Even in the case of capital expenditure or project related expenditure, there has been a tendency of operating through special purpose vehicles (SPVs), particularly in the areas of irrigation, roads and bridges. In the Union Government, the staff expenditure (salary, pensions and other staff related establishments), interest payments and grants-in-aid to States account for nearly 70 per cent of its receipts. On the States side, these may, in fact, account for almost the entire revenue receipts. In view of this, audit of revenue receipts would further gain in importance.

7.3 In Receipt Audit, most audit observations fall in one of these four categories:

- Incorrect classification of commodities, leading to wrong application of the rates:
- Incorrect grant of exemption from taxes, incorrect computation of the taxable turnover/income, resulting in a low tax base for an assessee;
- Non-levy of penalty/interest
- Arithmetical inaccuracy in the calculation of tax liability.

7.4 Of all these observations, the first two i.e. levying of inaccurate rates because of wrong classification of goods/income slab and grant of exemption are non-procedural in nature. In case of the exemption granted, there is an element of revenue foregone. It may be appropriate to look at these exemptions over a longer term because the economic rationale of the grant of exemptions is to increase the tax base in the future. The necessary condition for the exemptions would be the extent of the survival of the units in the post exemption period. The sufficient condition would be whether the net present value of the tax likely to accrue would exceed the net present value of the cost of exemptions. If these conditions were not met, then the fiscal cost of revenue foregone would exceed the future increases in tax collections that may accrue because of these exemptions.

7.5 In a tax structure where there are differential rates for the commodities/income slab, the classification problem is bound to occur. The issue may get further complicated because of the numerous exemptions granted for the computation of the tax bases. There is also a possibility of different rates being applied by different assessing authorities over time and over territorial jurisdiction. In both the Union and State Reports on various taxes, analysis with reference to the tax base has been in vogue. However, this analysis is currently restricted to aggregates like excise collections with reference to a value of manufacturing output, sales tax with reference to States' gross domestic products, custom duties with reference to imports and income and corporate tax with reference to GDP or non-agricultural GDP. In all these taxes, it may be desirable to build a data-base at a reasonably broad disaggregated level, say at a two/three digit level of industrial production, at chapter level of imports and, defined commodity classification level of turnover. It would, then, be possible not only to compare the rates and incidence over time and over commodities but also over geographical territorial jurisdiction. The bulk of tax arrears and the proportion of such arrears under different stages of litigation are also of this category.

7.6 In receipt audit, under-assessment or other parameters of audit as indicated in the report relate generally exclusively to test audits. There has been no attempt to relate to the population (total tax collections). This may, apparently, be due to the apprehensions that, with a test audit sample not drawn in any scientific manner, reporting under-assessment for the population as a whole may not be appropriate. However, this reduces the reported magnitude of the revenue forgone and may have a tendency to generate a kind of complacency. In fact, even in a non-random large sample, if there are no deliberate biases introduced at the selection stage, if the ratio of the test audit cases, likely revenue and the actual revenue, follow a definite trend, then the linking of sample (test audit) results to the population would be largely valid. Further, repeated annual exercises based on the uniform or near uniform method of selection of assessees for audit may track the under-assessment generally accurately. In fact, there have been attempts by

academicians to prepared tax compliance index through such kind of annual exercises.  
(*Arindam Dasgupta and Dilip Mukherjee; Dasgupta, Lahiri & Mukherjee*)

7.7 Effectiveness of the audit of revenue could be significantly enhanced by the following:

- 1) Adopting a more scientific stratified random approach for the test audit and linking the results to population parameters of the receipts.
- 2) Identifying the revenue foregone in various tax exemptions and duty draw back provided by the Governments.
- 3) Linking the revenue receipts with the proxy tax bases at disaggregated Levels.

7.8 Besides random selection of the assessees, to make inferences about population, it may be useful to adopt a simple information matrix, as indicated below. This matrix would have information based upon assessee profiles based on the audit criteria of sample selection (such as 100 per cent above a certain level or less than that), tax liability determined by the department, tax liability as per the audit of cases and based on the ratio of revised liability to the originally assessed liability, the likely yield. However, while preparing this matrix, the audit cases where the originally assessed and audit assessed liability do not differ, should not be excluded. With this kind of complete recording of selected cases, generally reliable estimates of revenue foregone could be made:

(Amount in Rs. Lakhs)

| <b>Assessee Category</b> | <b>Total Number of Assesseees</b> | <b>Total Tax Liability</b> | <b>Test Cheek Assessee Numbers</b> | <b>Originally assessed Tax Liability</b> | <b>Tax Liability based on Audit</b> | <b>Total Tax Liability</b> |
|--------------------------|-----------------------------------|----------------------------|------------------------------------|--|-------------------------------------|----------------------------|
| A                        |                                   |                            |                                    |  |                                     |                            |
| B                        |                                   |                            |                                    |  |                                     |                            |
| C                        |                                   |                            |                                    |  |                                     |                            |
| Total                    |                                   |                            |                                    |  |                                     |                            |

7.9 The possibility of some of the selected records not being produced, requiring either a reduction in the sample size or substitution may not create any insurmountable problem. In fact, this may make non-production of records rather explicit and exert some kind of pressure for the same being avoided.

7.10 In receipt audit, since the bulk of the observations have some kind of regularity, it may be desirable to also have a time series data of such appropriately grouped observations, including their territorial spread to facilitate more focused and better compliance.

7.11 The Indian system is non-compliant with international financial standards with regard to information on tax-expenditure or revenue foregone from various discretionary exemptions/ concessions etc. while some observations have been made in reviews of State and Central taxes, it has not acquired the status of regular reporting. This approach may need further strengthening. The National Institute of Public Finance and Policy has done a study of tax expenditure and implications of tax exemptions for Madhya Pradesh. Audit may sponsor/ outsource such studies and internalize their observations.

7.12 Both, the Receipt and Expenditure Audit Wings, generally perform audit as a stand-alone activity with no coordination with the accounts Wing. There is hardly any institutional system of leads being provided by the Accounts Wing in the process of compilation of accounts, nor is there any coordination between the Central and State audits except for Central Reviews. There has hardly been any use of the VLC data, both for generation of the audit sample and also for actual audit. These may further increase audit effectiveness.

7.13 In receipt audit, so far the observations on user charges and other non-tax revenues have been limited. In the case of most of the economic and social services, audit observations on user charges and cost recovery are marginal. Even in interest receipts and dividends, the implicit subsidies involved therein are rarely indicated/highlighted. It may be worthwhile to look at the ratio of receipts to expenditure for all social and economic services, as that would enable audit to comment on merit/non merit subsidies. Long term analysis and inter state comparisons may further bring home the point of lax compliance and poor administration. In sectors like irrigation, Finance Commissions have been suggesting that states should recover at least 1 per cent return on their total assets at charge after meeting the O&M expenses. In fact, while recommending the deficit grants, the Finance Commission has now been notionally imputing the revenue from user charges, interest receipts, dividend, etc. Audit needs to look at these calculations and make suitable observations, as non-realisation of these targets/assumed returns puts states' finances under strain.

## **B: Commercial Audit**

8.1 In Commercial Audit, the department currently discharges two functions, which are (a) certification of accounts and (b) audit of transactions. In certification of audit, the major area of audit effectiveness would relate to incorporation of the objections made

into the accounts, reduction in the delays in submission of accounts and monitoring of the adverse comments made, if any, on the accounts. However, certification of accounts is a culmination of the process of transaction audit and without the latter being completed, the former may have little significance.

8.2 The CAG's Report on performance of PSUs over the years has become some kind of a statistical reporting and summarization of the data figuring in the annexes at the end. There is a need to look at format of this report by giving emphasis on assessing the performance of the PSUs in the light of the overall economic environment.

Considerable value addition could be made by looking at PSU performance in the light of the overall economic environment, economic value addition by PSU, net draft of the PSUs on Government, etc. A committee, with Mrs. Usha Sankar, MAB, Chennai as its convener, has looked into Report-I (Commercial) and has made significant recommendations on revising the format of Report-I. Adoption of these recommendations may significantly improve not only the contents of the Report but also its usefulness to the understanding of overall government finances and public intervention strategy. The Draft Report of the Committee is at Annex A.

8.3 In the transaction audit of the PSUs, apart from a limited number of observations relating to the receipts, most observations generally fall into these five categories:

- Fraud, misappropriation, embezzlement, etc.
- Infructuous expenditure
- Lax enforcement of contractual obligation in purchases
- Unauthorised expenditure
- Blockage of funds and injudicious purchases
- Non -utilisation of resources provided / allocated

8.4 Such a broad categorization of observations makes it easy to generate a time series and cross section information matrix, which may significantly enhance audit value and help in monitoring audit compliance and systemic improvements. This could be attempted at both, the company and sector / administrative department, level.

(As per cent to total expenditure)

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|           | <b>Fraud, misappropriation, embezzlement etc.</b> | <b>Infructuous Expenditure</b> | <b>Lax enforcement of contracts</b> | <b>Unauthorised expenditure</b> | <b>Blockage of Funds</b> | <b>Non-Utilisation of funds</b> | <b>Others</b> | <b>Total</b> |
|-----------|---|--------------------------------|-------------------------------------|---------------------------------|--------------------------|---------------------------------|---------------|--------------|
| 2002-03   |   |                                |                                     |                                 |                          |                                 |               |              |
| 2001-02   |   |                                |                                     |                                 |                          |                                 |               |              |
| 2000-01   |   |                                |                                     |                                 |                          |                                 |               |              |
| 1999-2000 |   |                                |                                     |                                 |                          |                                 |               |              |
| 1998-1999 |   |                                |                                     |                                 |                          |                                 |               |              |

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8.5 In commercial audit, the observations on receipt side need focused attention. In both the commodity manufacturing and service PSUs, inter company comparisons could provide a clue to the revenue aspect. But this will be commodity specific.

### **C: Works Audit and Expenditure Audit**

9.1 In the less of audit of expenditure also most audit observations can be grouped under five heads as indicated below:

- Fraud, misappropriation, embezzlement etc.
- Infructuous expenditure
- Lax enforcement of contractual obligation in purchases
- Unauthorised expenditure
- Blockage of funds and injudicious purchases
- Non -utilisation of resources provided / allocated

9.2 Since it is possible to categorise the observations into broad categories, it is possible to have time series as well as grant/ department wise comparisons possible. A matrix giving the audit value of these observations in relation to the total value of audit and also in relation to the total value of the expenditure may improve accountability and the audit compliance. The matrix may be as indicated below:

(As per cent to total expenditure)

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|           | <b>Fraud, misappropriation, embezzlement etc.</b> | <b>Infructuous Expenditure</b> | <b>Lax enforcement of contracts</b> | <b>Unauthorised expenditure</b> | <b>Blockage of Funds</b> | <b>Non-Utilisation of funds</b> | <b>Others</b> | <b>Total</b> |
|-----------|---|--------------------------------|-------------------------------------|---------------------------------|--------------------------|---------------------------------|---------------|--------------|
| 2002-03   |   |                                |                                     |                                 |                          |                                 |               |              |
| 2001-02   |   |                                |                                     |                                 |                          |                                 |               |              |
| 2000-01   |   |                                |                                     |                                 |                          |                                 |               |              |
| 1999-2000 |   |                                |                                     |                                 |                          |                                 |               |              |
| 1998-1999 |   |                                |                                     |                                 |                          |                                 |               |              |

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9.3 As in receipt audit, in expenditure audit or transaction audit also, test audit results are not linked to the total expenditure. A representative sample selection is made primarily because having a census or complete enumeration is neither feasible nor desirable. However, if the sample results are treated as being stand-alone and are not linked to population, it would be a reflection on either the objectivity of the sample or its quality or both.

9.4 There currently about a million part II paras in the Inspection Reports pending settlement. Categorisation of these paras in terms of the above-mentioned nature of observations and in relation to the total authorisation for a grant/department may improve compliance. This may provide the risk weights for schemes and departments in addition to facilitating probability proportionate sampling. Another advantage of this kind of documentation is the possibility of panel studies to further strengthen audit observations.

## **D : Project Performance Audit/Reviews**

10.1 Pursuant to the changes in government policies and the nature of public expenditure, auditing practices and techniques have been evolving over the time and with a greater speed since late 90s. This natural development has opened before us new frontiers of audit and exposed us to the challenges, not so common in our not so exciting (!) profession.

102 From transaction audit to efficiency-cum-performance audit/Value for Money Audit and IT Audit, the department has come a long way in developing and polishing new tools and techniques of audit. However, whether there has been a commensurate development on the structural and organisational issues is a matter for deliberation. If we accept that we have not succeeded in effective macro-level analysis of sectoral development and reform issues covering policy framework, intervention instruments, networking arrangements and so on, the most probable reasons are the way we are organized and the way we relate ourselves to the Government and to each other.

103 The government's development policies and initiatives undertaken for translating those policies into programmes and regulations on a sectoral basis have largely missed the audit eye and have often not found mention in our Audit Plans. The consequential impact of audit at macro-level has also, therefore, not been much. We can't claim that we have, at the right time, given the right input through our reports, for a particular policy to be more effective. Even Performance Reviews are mainly restricted to a specific programme or scheme or organization and do not take into account several initiatives and interventions designed to influence/influencing that area/sector. The holistic approach cutting across the three tiers of Government is missing.

104 Sectoral studies are particularly important in the fast changing environment where the Government's role is shifting from that of an implementer to that of a facilitator/regulator. Instances of funds not getting spent through government agencies but following the route of SPVs and NGOs instead, have become the rule of the day, putting pressure on us to change our approach towards audit. We would have to necessarily concentrate on the end use and outcome of expenditure, rather than on spending methods and propriety.

105 Any attempt to carry out a sectoral study would necessarily involve a detailed appreciation of the issues indicated below and the role of the government at its different tiers:

- Developments in the sector over the successive plans,
- Lessons derived, if any
- Remedial actions taken, if any,
- Planning future direction, if done,
- Intervention instruments and suitability thereof for proceeding in that direction,
- Final outcome and
- Recommendations.

10.6 It has been observed that policy reviews are more focused and generate greater curiosity and interest. They track performance and are amenable for the kind of outcomes audit. In economic or infrastructure projects, say in the case of power, audit may cover planning or power demand surveys to generation, distribution, pricing and other issues, currently in the jurisdiction of PSU audit, central sector and state audits. This would make observations much more meaningful and constructive. Similarly, in the auditing of social sector programmes or programmes relating to poverty alleviation, there may, in addition, be a need to have beneficiary perception, if need be outsourced. In these cases, audit also needs to get into some kind of performance evaluation parameters. Problems that could be encountered in the audit of such programmes, like education, are indicated in Annex B on issues in the Audit of Education.

## **E: Parameters for evaluating status of work of an A&E office**

### **(a) Entitlement functions**

111 Two major entitlement functions performed by the A&E office are (a) maintenance of Provident Fund Accounts of State Government employees and (b) authorisation of retirement benefits to State Government employees. Both these functions involve an interface with the public and are of the nature where the department performs a "service" to the employees of the State Government. Therefore, the degree of satisfaction of the "service" and the efficiency of performance of the service are of paramount importance.

#### **i) Provident Fund**

112 The performance parameters could include:

- Authorisation of the final payment cases to the total cases.
- Reduction of residual balance cases.
- Non accumulation of final payment cases, as indicated by the percentage of final payment cases pending up to one year for authorization to the total final payment cases to be authorized and pending as closing balance.
- Clearance of unposted debits, as indicated by percentage of unposted debits to total number of unposted debits.
- Clearance of unposted credits, as indicated by percentage of unposted credits cleared to the total number of unposted credits.

## **(ii) Pension related functions**

113 The major activity of the pension wing is issue of CPO, GPO and PPO. Some of the key performance parameters could be:

- Disposal of pension cases as indicated by percentage of pension cases authorized to the total cases (opening balance + fresh receipts).
- Disposal of family pension cases as indicated by percentage of family pension cases authorized to the total cases (opening balance + fresh receipts).
- Disposal of pension revision cases as indicated by percentage of pension revision cases authorized to the total cases (opening balance + fresh receipts).
- Non-accumulation of pension cases as indicated by the percentage of pension cases pending upto one year for authorization to the total cases to be authorized and shown as pending.
- Non-accumulation of family pension cases as indicated by percentage of family pension cases pending upto one year for authorization to the total family pension cases.

## **(b) Accounts Wing**

- Number of correction entries occasioned due to reconciliation with department.
- Number of suspense/remittance items that could not be cleared during current year.
- Number of RBD discrepancies that could not get settled during the year . (Quarterly meetings, holding of)
- Number of 'A' category TE's made.
- Adherence to date of issue of Monthly Civil Accounts.
- Number of adverse balance cases in Finance Accounts.

## **Measuring Audit Effectiveness**

121 Constant improvement in audit effectiveness may require development of indicators, which are amenable for quantification for comparison over time and across auditee units. In Audit, one can also consider desirability of observations and their acceptability. A committee constituted by CAG on May 7, 2003 has developed such desirability-acceptability matrix for revenue and expenditure audit. In these matrices, observations have been arranged hierarchically, giving greater emphasis on audit findings that would

lead to an enhanced impact. Adoption of these matrices as indicated by the Committee (Report of the Committee is at annex 'C') may result in audit planning corresponding to the desirability-acceptability matrix leading to an overall improvement in the Audit Reports.

12.2 The Committee has adopted differential weighting pattern based on hierarchy of observations and their acceptability . Highest weights have been accorded to the observations, leading to defined savings/revenue gains.

**Ezr gpf kwg Awf kwRgr qt w**

| <i>Acceptability Index\ Para Desirability Index</i>                | <i>Recovered</i> | <i>Accepted</i> | <i>Rebutted</i> | <i>No reply</i> |
|--|------------------|-----------------|-----------------|-----------------|
| Fraud/misappropriation/ embezzlement/losses detected in audit      | A1<br>(5)        | A2<br>(4)       | A3<br>(2)       | A4<br>(1)       |
| Recoveries at the instance of audit                                | B1<br>(5)        |                 |                 |                 |
| Over payments detected in audit                                    | C1<br>(4)        | C2<br>(3)       | C3<br>(2)       | C4<br>(1)       |
| Wasteful / infructuous expenditure                                 |                  | D2<br>(2)       | D3<br>(1)       | D4<br>(0.75)    |
| Violation of contractual obligations, undue favours to Contractors | H<br>(2)         | F2<br>(1.50)    | F3<br>(1)       | F4<br>(0.75)    |
| Regularity issues  | G<br>(2)         | G2<br>(1.50)    | G3<br>(1)       | G4<br>(0.75)    |
| Idle investments / Idle establishment / Blockade of funds          |                  | H2<br>(1)       | H3<br>(0.75)    | H4<br>(0.50)    |
| Delays in Commissioning equipment                                  |                  | I2<br>(1)       | I3<br>(0.75)    | I4<br>(0.50)    |
| Non achievement of objectives                                      |                  | J2<br>(1)       | J3<br>(0.50)    | J4<br>(0.25)    |
| Miscellaneous  |                  | K2<br>(1)       | K3<br>(0.50)    | K4<br>(0.25)    |

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## RECEIPT AUDIT REPORTS

| <i>Acceptability Index \<br/>Para Desirability Index</i> | <i>Recovered</i> | <i>Accepted</i> | <i>Rebutted</i> | <i>No reply</i> |
|--|------------------|-----------------|-----------------|-----------------|
| Non compliance to law, rules etc.                        | R1<br>(5)        | R2<br>(4)       | R3<br>(2)       | R4<br>(1)       |
| Lacuna in Law / procedure, policy                        |                  | S2<br>(2)       | S3<br>(1)       | S4<br>(0.75)    |
| Reviews  | T1<br>(1.5)      | T2<br>(1)       | T3<br>(0.75)    | T4<br>(0.50)    |

Note : Weights in brackets

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### **Need for having strategic goals for audit effectiveness**

131 Audit effectiveness cannot be looked at in isolation of the strategic goals of institutions. For the strategic plan 2002-2008, strategic goals of CAG are indicated below:

- Endeavoring to assess government performance, promote accountability and inform and assist Parliament;
- Assessing the progress in implementation of critical programmes aimed at enhancing the quality of the life of the people;
- Reviewing the measures taken to deepen the process of economic reforms and to optimise resource usage;
- Evaluating steps taken to ensure quality infrastructure in support of greater economic growth and international competitiveness.
- Reviewing the integration of science and technology in harmony with the environment to meet the challenges of a changing world.
- Studying the initiatives undertaken to meet the demands of the changing security environment.

132 These strategic goals also require gearing audit to macro issues. However, in these areas also, the parameters for assessing audit effectiveness may not change materially.

## **Other issues in Audit effectiveness**

14.1 Other than the observations on under assessment of revenue and excess expenditure, value judgements on audit effectiveness require different kinds of parameters. Even in cases of under assessment of revenue or excess of expenditure, a decline in the ratio could be due to the systems improvements suggested by audit, strengthening of internal checks, which again could originate because of audit findings or due to the deterrence effects, which in turn, indicates quality audit. In view of this, the effectiveness assessment of audit really needs to look beyond the traditional parameters. Though these parameters would differ according to the major mandated and non-mandated activities of CAG, the basic underlying criteria could be the system improvements, reduction in number of cases of recurring nature, improvement in credibility and transparency of the government accounting and general perception about the same and the impact that it would make on attitude of the operating departments towards audit, in its being viewed not as fault finding but as a constructive critic.

## **Transaction Cost of CAG's Audit**

15.1 Effectiveness of CAG's audit needs to be looked in the light of the transaction costs that it imposes on the system, directly and indirectly. The direct cost of the audit and entitlement functions of CAG is the expenditure incurred on the establishment of this institution. Indirect costs include the costs at the level of departments and parastatals in compliance of the audit observations, preparing action taken notes and in maintaining an establishment to ensure such compliance. Indirect costs need also to include the delays and operational constraints imposed by the audit requirements and other incidental costs perceived by the auditee institutions. The perceived costs, though never assessed in notional terms, are considered high enough by the auditee institutions. But this may be because the money value of the under assessment as indicated by CAG based on its test check report, is particularly insignificant in relation to the total value involved. The total transaction cost for CAG audit may, therefore, appear to exceed such reported under assessment. Further, there is no probability proportionate sampling based on the risk perception of different kind of transactions or different kind of auditee units. A switch over to such an arrangement could further improve audit impact.

## **Value Added Services**

16.1 CAG provides value-added services, which are part of its reporting programme. The most important of these value added services relate to the fiscal health of the union and the states and the commercial undertakings/parastatals. However, even though these

reports contain CAG's observations on the fiscal health of these entities, there is limited evidence of these being taken seriously. Further strengthening of this sphere of work may not only improve corrective role of audit and its use as management aid, but may also lead to better interface with auditee institutions.

## **Extracts from Draft Report of the Committee for improvement in the content and presentation of Report No.1 (Commercial) and Review of Accounts**

### **Recommendations**

#### **Chapter 1 -Government Investments, Loans & Liabilities**

Chapter 1 of the Report gives an overview of the total investment by way of equity and loans by Central Government and other Governmental agencies in the Central Government companies and deemed Government companies. The annual budgetary outgo in the form of equity, loans and subsidy is also given. The chapter also gives an overview of the disinvestment policy of the Government and amount realised during the year from the disinvestment process.

- The amount of equity and loan investments -sector wise during the year may be given.
- The equity investment in the PSUs whose networth is negative may also be given as a list.
- The rate of return to GOI on equity investment in PSUs may be compared with the rates of interest on government securities.
- The Committee felt that it is important to give figures relating to grants released by the Government during the year. The figures relating to equity, loans, subsidy and grants should be linkable to the figures in the Central Government accounts.
- While the figure on loans released to the companies during the year is available, there is no indication of material defaulters in respect of loans. Also, inter corporate loans given by PSUs at the instance of various ministries and the position of repayments may also be included.
- An important form of financial support given by the Government of India is in the form of guarantees. The details of guarantees are also available in introduction to Chapter 1. The said amount should be compared with the total loans raised by the companies during the year.

- Since this Chapter indicates the transfer of resources from the Union Government to its parastatals, it is also important to relate these as part of overall government receipts. Resources for both equity participation and loans are raised by Government and transferred to these PSUs. Similarly, total cumulative investment and loans to these entities is part of the Government's cumulative capital expenditure and outstanding loan receivables. It may also be necessary to look at the investment and advances relative to Government's capital expenditure and outstanding loans.
- With these changes, the Chapter would capture fully the PSUs draft on government and the existing position of this cumulative draft relative to its capital expenditure and loans. This indirectly will also indicate the relative importance of this investment as an intervention tool.
- Adding a section on sources and uses of funds could further enrich this Chapter by PSUs, because that would indicate the share of Government in their total resource availability. A longer-term analysis of these parameters would indicate shifting importance of relative sources of funds for PSUs and their applications.

## **Chapter 2 -Accounts in Arrears**

- (i) A new Chapter 2 on companies whose accounts are in arrears should be included. This chapter should also contain details of Food Corporation of India till it is in arrears. The reasons for arrears may have to be detailed. The action taken by the Ministry concerned and Department of Company Affairs to pull up the arrears or to wind up the company, if any, should be mentioned.
- (ii) Currently only FCI figures in analysis of the companies whose accounts are in arrears. This gives a lopsided and incomplete picture. Inclusions of a separate chapter will not only fill in this vacuum, but would add more value. Since it will explicitly indicate such companies, which are in arrears, it may have some impact on compliances.

## **Chapter 3 -Return on Investment.**

This chapter deals with profit earning PSUs, loss making PSUs, capital erosion and profitability analysis. The chapter is quite comprehensive. The Committee recommends the following additions.

- (i) The dividend policy of the Government of India (para 2.3 (i)) should figure in the introduction to the chapter.
- (ii) In respect of dividend declared by Oil Sector PSUs (para 2.3(iv)), details of those Oil PSUs which have not declared dividend at 20% paid up capital and 30% post tax profit alone should be given in the text.
- (iii) So far as dividend to equity ratio (para 2.3(vi)) is concerned, the same should be given by indicating the amount of dividend settled by drawings from reserves.
- (iv) In the Profitability Analysis (para 2.7), data should be exhibited separately in respect of profit making and loss making companies. The para relating to loss making companies should be linked with capital erosion.
- (v) The ranking in terms of ratio of net profit to capital employed and to net worth should contain details relating to profit before depreciation, interest and tax (para 2.8) in both the tables. Also a few more parameters should be added before the ranking is decided. The details of the parameters will have to be arrived at.
- (vi) In return on investment, so far only the equity has been considered, which ignores the accumulated reserves, also a part of the shareholders fund. Reserves also arise because of retention of the profit by the PSUs rather than its distribution amongst shareholders.
- (vii) Further by taking the shareholders fund as the investment, comparison across companies would be more meaningful. It will also take care of high dividends declared by some companies drawing from the reserves.
- (viii) Ideally, one would like to have profitability done sector wise because in some cases the profit could be monopoly rent as these sectors are reserved for public sector.
- (ix) It may also be desirably to look at the profitability in terms of PSUs as new and nationalised (acquired).

## **Chapter 4 – Inventory Management and Marketing**

This chapter deals with value of inventories namely raw materials, stores & spares and finished goods. The ratio analysis given in the chapter was thoroughly analysed. The Committee recommends the following.

- i) The chapter should relate only to Inventory Management. The details on sales/marketing may be taken to the next chapter.
- ii) The existing para 3.6 giving the value of surplus, obsolete and non-moving items of stores and spares may be deleted.
- iii) Analysis of percentage of consumption of raw material and stores & spares to value of production over the years may be made to arrive at list of companies showing increasing trend and decreasing trend.
- iv) Another section, which may need to be added in this Chapter, may be the cost of holding excess inventory by the PSUs. This could be implicitly worked out on the basis of average rate of interest. This indication would provide revenue forgone by the PSU s by holding excess inventory.

## **Chapter 5 – Capacity Utilisation**

The company's viability depends on the capacity utilisation. The chapter is the most important indicator of the efficiency of the public sector units. The chapter acquires more importance in view of privatisation and market driven economy. In the light of the same, the Committee recommends the following for improving the quality of the chapter.

### **GENERAL**

#### General recommendations

- i) The Committee recommends that all the tables in the text portion should give the basis of the calculation.
- ii) The committee recommends fixing of certain norms like paid up capital of Rs. 100 crore and above to arrive at the names of companies who have a high ratio of dividend to equity (existing chapter 2); high capacity utilisation (existing chapter 4); vacancies in Audit Committees /Board of Directors (existing chapter 7).
- iii) The Committee deliberated on the present format of the text portion of Report No.1. It is felt that it is summarising the data figuring in the appendices. It may be necessary to have a fresh look at the format by modifying it to assess the performance of PSUs in the light of over all economic environment, impact on Government's over all finances for which purpose a longer time series would be required. The data relating to contributions of PSUs to GDP, sources and utilisation of funds in PSUs, sector wise may have to be collected and included in the report.

## Audit of Education Sector

Education has been recognised as a critical input for investment in human capital and social and economic empowerment. Education is also recognised as one of the three dimensions of Human Development Index, which over time has emerged as the single most important indicator of inter country comparisons of quality of life.

Government of India monitors the progress of the various dimensions of HDI under its Millennium Development Goals based on quantifiable targets/standards set by the international community. The latest Human Development Report (HDI), 2002 of UNDP highlights that India since late 1980s has been able to considerably "catch up" and narrow the gap in HDI. Overall HDI value for India has improved from 0.302 in 1981 to 0.472 in 2001, and some of sub-national entities in India have HDI value close to the advanced economies.

93rd Constitutional amendment in December, 2002 has made education a fundamental right for all children in the age group of 6-14 years. Programmes have been launched to fulfill this constitutional obligation.

Over the years, significant progress has been made in improving literacy levels. The total literacy rate which was only about 18 per cent in 1951 rose to over 65 per cent in 2001. Gross enrollment ratio at primary and upper primary levels increased to nearly 96 per cent and 59 per cent respectively by 2000-01.

The physical progress in enrollment was facilitated by additional allocation of public funds to education sector. Overall government expenditure on education (both the Union Government and the States) as per cent to their revenue receipts and expenditure has remained generally stable. The expenditure as per cent to GDP at 3.12 per cent in 2001-02 continues to be lower than the overall goal of its being raised to 6 per cent.

### Government Expenditure on Education

|   | 1980-81 | 1990-91 | 1995-96 | 2001-02<br>(Budget<br>Estimates) |
|---|---------|---------|---------|----------------------------------|
| Expenditure on Education<br>(In US \$ billions) | 51      | 9.7     | 9.7     | 15.0                             |
| <b>Expenditure on Education as per cent to</b>  |         |         |         |                                  |
| Total Government's Expenditure                  | 11.49   | 11.20   | 11.04   | 10.98                            |
| Total Government's Current revenue              | 17.56   | 17.73   | 15.71   | 16.59                            |
| Gross Domestic Product                          | 2.83    | 3.06    | 2.72    | 3.12                             |

Education policies in India as, in the other developing countries have confronted three basic choices, between access to education and quality of institutions, between basic education and professional job oriented education and between extent of public funding and cost recovery. With in these, there has been a range of options with varying reliance on one or the other. There is no simple trade-off in these choices in terms of either and or. However, assessment of impact of these options on student performance has never been easy and unambiguous. It has, therefore, not been easy to define an optimal combination of these options and decide on policies that would most likely to result in "value for money." Resources are being spent in unproductive ways- ways that do not contribute to improving student performance. But there is no blueprint for a model school as yet which could be universalised and adopted.

Audit of Education sector in India has to deal with both the issues of spread and structure. The total number of educational institutions in 1997-98 was close to about a million and these were geographically well diversified. Government's expenditure on education sector has been over us \$ 15 billion. Sector in itself has been quite complex and reasonably well defined performance parameters indicating some kind of broad input-outcome relationship are missing, making effectiveness or value for money audit rather difficult and objective.

With in this complexity of the sector, Department has, however, been innovative. While procedural and propriety audit had continued to be done in-house, impact assessment and beneficiary perception was out-sourced. Results of this collaborative approach were encouraging and qualitatively more robust. But the differences over cross sections in teacher- pupil ratio, teacher's education, or his experience and salary (incentives), expenditure per pupil and facilities do not fully explain the differences in student performances, drop out rates, repeat classes. This may partly be due to the heterogeneity of the country, but as auditors I think we are still struggling to describe both the education process and what makes a good or bad teacher/school for our value for money audit. May be more repeat/panel studies are necessary. In traditional audit issues of efficiency, economy and propriety , challenges in education sector are the same as in other programmes/projects. But ignoring the effectiveness component would not only be restricting the scope but make it to that extent less constructive.

# **MEASURING AUDIT EFFECTIVENESS**

A Committee was constituted by the Comptroller and Auditor General of India on May 7, 2003 to examine the issue of Audit Effectiveness and develop appropriate criteria for the purpose. The Committee consisted of Shri B.R.Mandal, PD (RS), Shri M.C.Singhi, PD & Economic Adviser, Shri S.K.Bahri, PD (INDT) and Shri H.Pradeep Rao, PD (RC). The Committee worked under the overall supervision of Smt.A.L.Ganapathi, ADAI (RA).

## **The purpose**

2. Measurement of effectiveness of audit could be for two purposes:
  - a) For external dissemination of the contribution made by us towards the larger end of improved governance and to meet public expectations. And
  - b) For internal evaluation so that performance could be assessed and benchmarks. could be set for enhancing results in the future. Such internal evaluation would take into account the different circumstances in which offices function and comparisons of performance would necessarily be inter temporal rather than inter state.

## **The coverage**

3. The Committee recognised that the impact of audit can not be assessed only from the limited standpoint of Audit Reports placed before the Legislature. A considerable part of the audit effort stands reflected in Inspection Reports that are issued to auditee units. Other SAIs also take into account audit impact generated through management letters i.e. Inspection Reports. Such recommendations / observations included in IRs which have been accepted by auditee units or where remedial action has been taken could also be reported in an omnibus para in the Audit Report. This is suggested since it will not be possible to report all findings contained in Inspection Reports to the Legislature.

## **External dissemination**

4. The Committee considers that it is time that we communicate more effectively with the society at large in order to disseminate knowledge of the impact of audit and the role played by us in promoting effective governance and in improving the management of public finances. Currently, the Audit Reports are perhaps our only instruments of

communication. These are not able to highlight the impact of audit because of the time lag involved in follow up on audit findings/ recommendations.

5. The following could be included in developing a document to be periodically released for external dissemination:

- (a) Recoveries of public monies carried out at the instance of audit;
- (b) Audit observations/recommendations accepted by Government financial implications thereof;
- (c) Changes in law, procedures or schemes attributable to observations by Audit and financial implications thereof;
- (d) Recommendations made by the Public Accounts Committees that are accepted by Government and the financial implication thereof;
- (e) Acceptance of audit observations/details of remedial action taken through Action Taken Notes of audit paras not discussed by the PAC.

6. It is emphasised that the impact of audit, for the purpose of external dissemination, will be reported in a year irrespective of the audit cycle in which the actual observation arose. In order to reflect the results of audit comprehensively findings contained in the Audit Reports presented during the period should also be incorporated in such dissemination. It would be possible to quantify, with a reasonable degree of accuracy, the financial impact of the audit effort in comparison to overall costs of the Department. For the purpose of enhanced readability and professional presentation, it is suggested that the preparation of the document on audit impact be outsourced.

## **Internal evaluation**

7. The Committee also considered the development of appropriate criteria for the purpose of internal evaluation of the audit effort. Separate criteria are suggested for Revenue Audit and Financial Audit (expenditure audit). These criteria are indicative and not exhaustive. They could be developed further if required. Developing criteria for expenditure audit is more complex in comparison to revenue audit. In some cases, like schematic reviews and All India Reviews, it is difficult to quantify impact since such reviews are largely directed towards examining the overall achievement of scheme objectives. Similarly, the audit effort of offices like DGACR and PDAESM which examine Central Ministries has to be viewed in the context of resource transfers to the States (where expenditure is audited by the State Accountant General).

## **Desirability -Acceptability matrix**

8. The criteria developed for revenue and expenditure audit are contained in the enclosed matrices (Annexure I). While developing the criteria, the Committee has taken into account the kind of findings that audit has reported in the past. The findings have been categorised and arranged hierarchically i.e. greater emphasis is placed on audit findings that would lead to enhanced impact. The hierarchy of paras will need to be tempered by an acceptability index since the impact of audit would be greatly enhanced if audit observations were responded to/accepted by the concerned management. This would increase credibility of audit findings. Weights have been assigned relying on both the criteria. Each bond copy will need to be accompanied by a weighted aggregation of money value as shown in Annexure II.

## **Beyond the matrix**

9. Adoption of the matrix will result in the following benefits:
- a) more efforts will be made to obtain Government's responses to audit findings.
  - b) increased emphasis would be placed on raising material issues and making sound recommendations, and
  - c) The focus of audit planning, execution and reporting will correspond to the para hierarchy leading to an overall improvement in the Audit Reports.

## **Caveat**

10. The Committee recognized that the criteria developed could not be uniformly applicable. For example, the audit/certification of the accounts of companies or Autonomous Bodies are a distinctive type of audit. A considerable part of our audit effort is deployed in this area. This effort would need to be separately evaluated. For example, recasting/revision of corporate accounts at our instance/modification of Annual Accounts based on the previous year's audit comment would constitute a significant contribution of audit to the integrity and accuracy of the entity's financial statement. Similarly, there could be other distinctive areas of audit that may need to be separately evaluated.

**ALLOTMENT OF WEIGHTS  
ON THE  
DESIRABILITY - ACCEPTABILITY MATRIX**

**EXPENDITURE AUDIT REPORTS**

| <i>Acceptability Index \<br/>Para Desirability Index</i>               | <i>Recovered</i> | <i>Accepted</i> | <i>Rebutted</i> | <i>No reply</i> |
|--|------------------|-----------------|-----------------|-----------------|
| Fraud / misappropriation /<br>embezzlement/losses detected in<br>audit | A1<br>(5)        | A<br>(4)        | A3<br>(2)       | A4<br>(1)       |
| Recoveries at the instance of audit                                    | B1<br>(5)        |                 |                 |                 |
| Overpayments detected in audit   | C1<br>(4)        | C2<br>(3)       | C3<br>(2)       | C4<br>(1)       |
| Wasteful / infructuous expenditure                                     |                  | D2<br>(2)       | D3<br>(1)       | D4<br>(0.75)    |
| Violation of contractual obligations,<br>undue favours to Contractors  | F1<br>(2)        | F2<br>(1.50)    | F3<br>(1)       | F4<br>(0.75)    |
| Regularity issues  | G1<br>(2)        | G2<br>(1.50)    | G3<br>(1)       | G4<br>(0.75)    |
| Idle investments / Idle establishment/<br>Blockade of funds            |                  | H2<br>(1)       | H3<br>(0.75)    | H4<br>(0.50)    |
| Delays in commissioning equipment                                      |                  | I2<br>(1)       | I3<br>(0.75)    | I4<br>(0.50)    |
| Non achievement of objectives  |                  | J2<br>(1)       | J3<br>(0.50)    | J4<br>(0.25)    |
| Miscellaneous  |                  | K2<br>(1)       | K3<br>(0.50)    | K4<br>(0.25)    |

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### RECEIPT AUDIT REPORTS

| <i>Acceptability Index \<br/>Para Desirability Index</i> | <i>Recovered</i> | <i>Accepted</i> | <i>Rebutted</i> | <i>No reply</i> |
|--|------------------|-----------------|-----------------|-----------------|
| Non compliance to law, rules etc.                        | R1<br>(5)        | R2<br>(4)       | R3<br>(2)       | R4<br>(1)       |
| Lacuna in law / procedure, policy                        |                  | S2<br>(2)       | S3<br>(1)       | S4<br>(0.75)    |
| Reviews  | T1<br>(1.50)     | T2<br>(1)       | T3<br>(0.75)    | T4<br>(0.50)    |

Note : Weights in brackets

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**WEIGHTEDAGGREGATEOFMONEYVALUE**  
**(AUDITREPORT)**  
**(FOR THE YEARENDING)**

| <b>Para No.</b> | <b>Financial period</b> | <b>Crude Money value</b> | <b>Age discounted Money value</b> | <b>Matrix identity</b> | <b>Matrix weight</b> | <b>Weighted money value</b> | <b>Office</b> |
|-----------------|-------------------------|--------------------------|-----------------------------------|------------------------|----------------------|-----------------------------|---------------|
| (4.2)           | (2000-01)               | (50 lakh)                | (40 lakh)                         | (H4)                   | (0.50)               | (20 lakh)                   |               |
| Total           |                         |                          |                                   |                        |                      |                             |               |

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**Signed**  
**Accountant General / PD**

*Note 1 : Money value of paras pertaining to transactions more than two years old will be enhanced by 10 percent*

*Note 2 : The last column needs to be filled up only for the reports for which material is contributed by more than one office*