EMERGING AREAS IN AUDIT

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Introduction

1. Government activities drive Government Audit. Over the last two decades there have been significant changes in the manner in which Government delivers public services. Government has been receding from actual delivery of public services and involving private entities to fill the gap. Public private partnership (PPP) is being used extensively in infrastructure creation and maintenance. Simultaneously, natural resources are being licensed to private entities for development (e.g., oil and gas exploration under NELP) or service provision (e.g., allocation of spectrum for wireless telecom services). A corollary to private partnership in delivery of monopolistic services has been the growth of regulatory agencies to ensure transparency and fair play in actual implementation. In the social sector, too, traditional mode of delivery in beneficiary oriented schemes through the State Governments, district administrations and local bodies has given way to non-government entities in the nature of special purpose vehicles constituted for implementation of such schemes (e.g., the Health & Family Welfare societies created at the State and district level for implementation of NRHM). Along with transfer of responsibility for implementing these schemes, funds for such implementation are also being directly transferred to these entities. Government receding from directly delivering public service and the structures created in its wake raise concerns of accountability and delineate a significant emerging interest area of Government Audit.

2. Two other emerging areas of audit interest have been highlighted in the paper - transfer pricing by multinational companies which is often used as an instrument to evade taxation, and the burgeoning public debt with its attendant risks. While these are relatively newer areas, they are highly significant to both the Government and citizens and hence demand audit attention.

3. While these relatively newer areas trigger an increasingly varied and complex set of audit interests, we need to acknowledge our constraints which challenge our capacity to deal with them. Some of these concerns along with few thoughts on addressing them are also presented at the conclusion.

Public Private Partnerships in exploitation of natural resources and infrastructure

4. **Allocation/ licensing of national resources**: Natural resources are the real wealth of the nation and their optimum utilization is essential for sustained economic improvement. Traditionally, development of these resources (be it air waves/spectrum or coal and minerals or oil and gas), have been done by Government or Government owned entities (BSNL, CIL, ONGC, etc.). As the capacities and investment potential of the private sector improved, policies were formulated for allocating such resources to private entities to harness their highest economic potential and ensure optimum utilization/ exploitation. As the natural resources so allocated are scarce, monopolistic and often irreplaceable, the mechanism for such allocation needs to be transparent and demonstrably fair ensuring the best value to the Government and citizen.

5. **Public Private Partnership (PPP) in infrastructure**: United Nations defines PPP as '*innovative methods used by the public sector to contract with the private sector who bring their capital and their ability to deliver projects on time and to budget, while the public sector retains the responsibility to provide these services to the public in a way that benefits the public and delivers economic development and improvement in the quality of life*'. PPP projects are characterized by long term of contract and transfer of risks to the private sector.

The private partner brings in the required finance either fully or substantially (in case of a viability gap, Government may provide funds to bridge the gap) and implements the project while Government assigns the right to collect revenues arising out of the project to the private partner for a defined period or assures a return (in some cases through payment of annuity). PPP projects may also involve a financial return to Government as license fee, royalty, pre-determined revenue or profit share. Typically the project is bid out transparently to find the most suitable partner. The key to the success of the arrangement in all cases is a balanced sharing of risks and gains.

6. **Public private partnership in electricity sector:** Privatization in electricity sector has happened in generation, transmission and distribution of electricity. In Delhi transmission and distribution was unbundled and privatized in a phased manner. In the larger public interest and with a view to possible reduction of electricity tariff in Delhi a request was received from the then CM Delhi to explore the possibility of C&AG audit of Discoms. In this model also the entire documents would be in the control of private entities.

Audit of PPP arrangements

7. The key motivation for Government entering into PPP arrangements in infrastructure is economic; better efficiency and risk sharing along with budget neutrality. There is, however, a loss of direct control in the arrangement which raises concerns on accountability of Government. Accountability of Government does not, however, get altered in any way because the mode of delivery has changed. Government continues to be responsible for ensuring that public services are delivered adequately and properly and that State property where transferred temporarily to private concessionaire is used as intended. Thus the onus on Government Audit to assure accountability remains. The challenge of Audit is to determine the terms of its engagement vis-à-vis the altered scenario and chart the degree of Audit necessary and desirable to provide this assurance.

8. In traditional execution of projects, whether exploitation of natural resources or development of infrastructure, the entire process of planning, execution and monitoring lay within the Government ambit (directly or through a public sector enterprise/ body or authority owned by Government). As auditors of Government, full access to the audit trail was available while reviewing the project. With significant risks and responsibilities having been placed on the private partner in the PPP model, the access to Audit is now fractured. The degree of loss of access depends on the degree of loss of control on part of the Government which in turn varies with the model of PPP employed. For e.g., in service contracts and management contracts (typically not very long term contracts), the implementation/ execution risk alone is transferred and thus loss of Government control and therefore Audit access is limited to implementation of the contract alone while for a DBFOT (design build finance operate transfer) model, the plan and design risk, financing risk, revenue risk are all transferred to the private partner along with the risk of execution and operation of the project leading to very significant loss of control of Government and consequent limitation of Audit access.

Audit experiences in PPP so far

9. Recognizing these challenges, a set of auditing guidelines '*Public Auditing Guidelines for PPP in infrastructure projects'* were issued by the Department in 2009 which details the scope, objectives and process of PPP audit while also discussing issues of audit mandate and audit access.

10. Viewing the allocation of natural resources for a specific term to a private licensee as a project, the project life cycle would have the following segments:

(i) Pre-project strategic analysis to decide the specific deliverables of the project, the mode of implementation and the specific model of PPP to be employed.

(ii) Selection of the private partner for the PPP project.

(iii) Implementation of the project by the private partner.

(iv) Completion of the project and its transfer back to the public authority.

11. Given that the PPP experience in this country is two decades old, the relevant accountability concerns at present are regarding stages (i), (ii) and (iii). The accountability concerns would be different for these different stages. While full audit access is available at stages (i) and (ii), access for stage (iii) would generally be limited to the information available with the public partner. Over the recent years, we have touched upon all the three stages (i), (ii) and (iii) in audit, some of these experiences are briefly indicated below.

12. **Strategic analysis:** Different models have been followed for allocation of natural resources by the Government. These models usually entail payment of an upfront amount by the licensee to Government (3 G auctions) or a sharing of revenue/ profit during the lifetime of the allocation with Government (PSCs signed under the NELP regime) or a mixture of the two. The model chosen largely depends on the sector and the terms of allocation. The suitability of the chosen model in maximizing value to Government has been an area of concern. This aspect has been addressed in the performance audit of hydrocarbon production sharing contracts (PSC). As per the New Exploration Licensing Policy (NELP), blocks are allocated to the eligible licensee for hydrocarbon exploration and production through a bidding mechanism, the bid criteria being the profit petroleum share offered to Government. The bidder that offers higher profit share wins the bid. However profit petroleum is arrived at only after allowing the licensee to recover costs incurred (either wholly or partially). The model, thus, provides a perverse incentive to the licensee to inflate costs to the detriment of Government's share in profit petroleum. This has been highlighted in the PA report no. 19 of 2011-12.

13. **Selection of private partner and agreement:** The procedure followed for allocation has also varied from a *first come first served* basis (as in allocation of 2G spectrum) to selection of licensee on the basis of pre-determined parameters (as in the case of coal mine allocation) to bidding (as in NELP for exploration and production of hydrocarbon reserves or the allocation of the 3G spectrum). There have been serious doubts on the transparency and probity of some of these procedures, particularly in case of allocation of 2G spectrum and coal blocks which have been strongly commented upon by Audit. The questions addressed by Audit in these cases were whether limited natural resources have been allocated objectively ensuring optimal utilization and whether the tendering process was competitive and transparent affording the best value to the Government (*PA onallocation of coal blocks*, report no. 7 of 2012-13; *PA on allocation of 2G spectrum by DoT*, report no. 19 of 2010-11). Besides the allocation process, the agreements signed also need review to assure that they have allocated the risks appropriately among the public and private partners and ensure the best value to Government by design. The transaction documents of the PPP arrangements entered for re-development and modernization of Delhi and Mumbai airports have been scrutinized in Audit vis-à-vis their outcome and commented upon.

14. **Implementation:** The implementation of the PPP arrangement and its impact on the Government as well as the citizen are significant areas of concern.

15. A modus operandi adopted by the private companies is to resort to procurements from the related companies or by resorting to multiple mechanisms of visible and invisible payments to and fro the entities. Unlike the PSUs, the private companies' procurements policies and norms are not necessarily L1 - based and not necessarily through open competitive tenders. The procurements questioned by CAG may be justified by the company as something to maintain long term relations or quality or timely completion of job or accepted practice in private companies.

16. Some of the assurances sought in this regard would be compliance to the terms of the agreement, impact of changes made subsequently in the terms of the agreement, achievement of the anticipated value through actual operation of the licensee, correctness of revenue shared by licensee with Government. Though these accountability concerns are relevant, Government audit may be faced with mandate as well as access issues for an in-depth study as operation is largely in the domain of the private sector.

17. The performance audit of hydrocarbon production sharing contracts (PA on hydrocarbon production sharing contracts, report no. 19 of 2011-12; the follow up audit on which has also been finalized and sent to the President) was conducted to address the concern regarding implementation. The objective of the audit exercise was to determine whether effective mechanisms are available with Government to monitor compliance of the private partner with the terms of the contract and to verify that the revenue interests of the Government are protected. A meaningful audit to address these concerns necessitated access to the records of the private licensee. In this case, such access was afforded to the audit team as the audit was conducted at the request of the Government. The agreement (Production Sharing Contract) signed between the Government and the private partner(s) provided for audit and inspection rights of the Government:

"*Without prejudice to statutory rights, the Government, upon at least fifteen days advance written notice to the Contractor shall have the right to inspect and audit, during normal business hours, all records and documents supporting costs, expenditures, expenses, receipts and income, such as Contractor's accounts, books, records, invoices, cash vouchers, debit notes, price lists or similar documentation with respect to Petroleum Operations….*". It was under this provision that audit of private operator's documents was conducted at the request of Government. The extent of access, however, continued to be debated by the private partner throughout the audit exercise (2010-11) and has persisted even in the follow up audit (2013-14) which has prolonged the audit schedule and added to the audit effort.

18. In other cases, the audit concern regarding implementation of a project in the PPP mode has been addressed through scrutiny of the records available with the public partner. PPP agreements typically provide for monitoring and submission of periodic project reports (both financial and physical), duly vetted by independent entities to the public partner. Besides, the public entity (either Government or its agency) would have the right to call for information regarding the project from the private partner for monitoring the project as per the agreement. These documents form a rich source for audit of the arrangements. In case of the Delhi airport re-development project, the performance audit conducted addressed the question whether the transaction documents were appropriately structured and the terms of the contract reflected public interest and equity and whether the progress

of the project has been in line with the intended agreed plan (PA on implementation of PPP in Indira Gandhi International Airport, Delhi, report no 5 of 2012-13). The audit was done entirely based on the documents available with and procured through Airports Authority of India (the minority public partner holding 26 percent in the JV constituted for the project).

19. In case of audit at Telecom Private Service Providers (PSPs) as well as in case of audit at Delhi DISCOMs there was vehement opposition to allow C&AG to access their records. The matter was taken by them to the Delhi High Court. In case of Telecom the mandate of C&AG to conduct Audit of PSPs was upheld while in case of DISCOMS the matter is still sub judice.

Recent Supreme Court/ High Court judgments

20. Delhi High Court judgment of 6th January 2014 discussed the principle of 'Res Communes'- which claims that some things are common to mankind like air, water etc. Titles of these resources are vested with the State or Sovereign, in trust for the people. The Court held that Revenue would include any income of the nation derived from any source to be credited to the Consolidated Fund of India.

21. The recent judgment of the Supreme Court (17th April 2014) clarifying the auditability of revenue sharing arrangement of Government with private telecom service providers is a significant boost in asserting the mandate of Government Audit. While detailing the rationale for the decision, the SC has stated:

"Parliament has an obligation to ascertain whether the entire receipts by way of license fee, spectrum charges, have been realized by the Union of India and credited to the Consolidated Fund of India (CFI). CAG's examination of the accounts of the Service Providers in a Revenue Sharing Contract is extremely important to ascertain whether there is an unlawful gain to the Service Provider and an unlawful loss to the Union of India, because the revenue generated out of that has to be credited to the Consolidated Fund of India." The Court has held that section 16 of the CAG(DPC) Act, 1971 read with Article 149 of the Constitution confers on CAG the duty to audit *all receipts* payable into the Consolidated Fund of India and would cover not only the accounts of the Union and of the State and of any other authority or body as may be prescribed or under any law made by the Parliament *"but also to audit all transactions which Union and State have entered into which has a nexus with Consolidated Fund, especially when the receipts have direct connection with Revenue Sharing*".

22. ***Ratio decidendi* and *obiter dicta***: One of the main challenges is "*Whether the recent judgments of High Courts/Supreme courts are to be understood in the context in which they are pronounced or they have a wider framework/application?*"

23. To solve this conundrum we need to introduce the concepts of '*ratio decidendi*' and '*obiter dicta*'. *Ratio decidendi* is a Latin phrase meaning "the reason" or "the rationale for the decision". The *ratio decidendi* is "the point in a case which determines the judgment" or "the principle which the case establishes". *Obiter dicta* are remarks or observations made by a judge that, although included in the body of the court's opinion, do not form a necessary part of the court's decision. A judicial statement can be *ratio decidendi* only if it refers to the crucial facts and law of the case. Statements that are not crucial, or which refer to hypothetical facts or to unrelated law issues, are *obiter dicta*. In other words, *ratio decidendi* is a legal rule derived from, and consistent with, those parts of legal reasoning within a judgment on which the outcome of the case depends. Unlike *obiter dicta*, the *ratio decidendi*

is, as a general rule, binding on courts of lower and later jurisdiction—through the doctrine of *stare decisis*.

24. The process of determining the *ratio decidendi* is a correctly thought analysis of what the court actually decided—essentially, based on the legal points about which the parties in the case actually fought. All other statements about the law in the text of a court opinion—all pronouncements that do not form a part of the court's rulings on the issues actually decided in that particular case (whether they are correct statements of law or not)—are *obiter dicta*, and are not rules for which that particular case stands.

25. The above question arises since the indiscriminate application of such judgments is not prudent. For example: In a particular case, a judgment may be applicable to two organizations but there might be some basic difference between the facts and circumstances of the two organizations. The recent judgments therefore need to be carefully analyzed to ensure that our audit mandate is clearly based on the '*Ratio decidendi*' portion of the judgments and not on the '*obiter dict*a'.

26. Headquarters Office (Professional Practices Group) has duly considered the Court judgments and has issued a Guidance Note defining the protocol for accessing Private Sector records for audit on 4th July 2014. This guidance note provides the IAAD policy on "Direct Access to Private Sector Records for audit by CAG - protocol". According to the guidance note, "Audit of such private sector records is to safeguard the interests of the State or its agencies or its instrumentalities; it is the constitutional mandate of the C&AG and has been upheld in the above said judgments. Therefore, there may be no requirement of specific entrustment of such audits."

27. The guidance has been provided under the following categories:

i. Identification of agreements involving private sector participation

ii. Determination of need to access private sector records

iii. Scope of examination of private sector records

iv. Mode of interaction with private sector

v. Composition of audit parties and capacity building

28. The Supreme Court judgment is a major step forward for PPP audit. The judgment does assert the right of the CAG to audit the PPP arrangements where revenue is being generated which is credited to Consolidated Fund of India. Revenue sharing arrangements exist in many sectors (power generation and transmission, road development and maintenance, setting up and operation of green-field airports or re-development of existing airports, development and operation of new terminals, cargo berths at ports, besides mining for minerals, oil or gas, etc.). In such cases, as clarified by the Supreme Court, Audit can check to assure that the revenues shared by the private concessionaire with Government are indeed appropriate. The revenue sharing model could be an upfront payment or sharing of receipts when they are generated, as per an agreed framework, during the project implementation phase or more commonly, a mix of the two. For example, the Delhi Gurgaon expressway, being a potentially lucrative project, was bid at an upfront premium with the condition that the toll revenue has to be shared with NHAI as per a defined mechanism if more than 1.3 lakh PCUs are tolled on the highway. The nature and extent of audit that would be desirable would depend on the nature of such arrangement. While there is not much scope

in audit of a single transaction up-front payment, more detailed audit involving significant access to the private concessionaire's books and records would be essential for assuring that the correct amount of revenue is being shared by the private partner over the project lifetime.

29. It may, however, need to be kept in view that while the mandate of Audit has been affirmed in PPPs involving a revenue share with Government, its applicability to a particular PPP arrangement and the extent of access it allows to the records of the private concessionaire would need to be confirmed for a smooth implementation of the audit. This is likely to be a contentious matter. Given the constraints of capacity and manpower of the Department, there seems to be a strong case for careful, risk based selection of cases which promise maximum value addition, for attempting such detailed audits.

Issues in audit of PPP arrangements

30. **Explicit mandate**: Involvement of private partners does not diminish the responsibility or accountability of Government in exploitation of natural resources or development of infrastructure. While the audit mandate for PPP projects having revenue share has been upheld by the Supreme Court, there is a case for seeking a more explicit audit oversight for all PPP arrangements.

31. **Primary or supplementary audit**: There are views within IA&AD that before the CAG looks at any private entity's accounts, these accounts have to be primarily scrutinized / accepted by some executive authority within the Government. We need to deliberate whether we agree with the Government exposing the companies directly to the CAG and disassociate itself from assuming any responsibility in the matter.

32. **Scope of Audit**: As spelled out in the PPG guidance note, the decision regarding the scope of PPP audit has to rest with HQ. The note provides that "audit of such records should be limited to compliance audit." The note further states that "only those underlying records are to be examined which are essential to provide assurance for the above." If the Contract/agreement in question entails scrutiny of primary records of private partner whether we can do financial audit (other than certification) or whether we can extend our audit to propriety audit as happened in case of Hydrocarbon PSC audit? When do we confine our scrutiny only to the Balance Sheet and Profit and Loss Account? When do we go into the company's primary books of account tracking particular figures from the annual accounts? What should be the maximum period of audit coverage? So far audit effort on PPP arrangements has been generally limited to the records of the public partner and has been in the nature of performance audit. Whether IA&AD should now restrict itself to only compliance audit?

33. **Mainstreaming PPP audit**: Given the intensive nature of such audits and the resources that need to be deployed on them, these audits have therefore been rather limited in number. As on 31st March 2014, there were 1339 PPP projects at various stages (bidding, construction, operation and maintenance) in various sectors including roads, ports, airports, urban development, tourism, energy, housing, and even in health and education. This includes projects both at Central and State levels as provided on the official website http://www.pppindiadatabase.com. Keeping in view the sheer proliferation of the PPP mode of project implementation, there seems to be a case for mainstreaming this audit. In this regard, the following could be considered:

a. Collection of information on PPP projects entered into by the auditee and creating a database in each office. The format of the database could be standardized and it could be updated during regular audits.
b. The database may clearly indicate the PPP model and particularly the model of revenue share, if any. This would enable an overview regarding the materiality of revenue share as well as inform the risk associated with the revenue share model.
c. Mandating a compulsory check of a small percentage of PPP projects during the course of annual compliance audits of Ministries/Departments of Union and State Governments and other public bodies affiliated to these Governments who enter into concession arrangements. Such a check could cover compliance to procedures laid down for strategic planning and tendering as well as a critical review of the actual contract document vis-à-vis model contract (most areas presently have model contracts and deviations from the terms of such model may need to be critically reviewed). Alongside, the progress of such projects may also be reviewed vis-à-vis expectations from the monitoring reports while the adequacy of monitoring arrangements could be studied. This exercise could be largely compliance based and done entirely through documents available with the authority/ obtained through the authority entering into the concession arrangement. A sector specific audit checklist in this regard could also be considered to assist the exercise. Simultaneous capacity building in the area through training and workshops would be essential. We may consider mandating reporting the results of such limited audit in the respective inspection reports. These, along with the database suggested earlier could form the base for risk analysis to aid in selection of a more detailed exercise of performance audit.
d. While a mandatory audit of all PPP projects is neither feasible (given the limitations of capacity and manpower), nor rewarding (in terms of the value addition that can be provided), there is a need to carefully select projects considered to be high risk and follow through with an in-depth study. It may also be important to keep in view our ability to undertake a credible audit exercise that would stand scrutiny and the result of which will add significant value. Some of the salient capacity concerns have been summarized at para 10 below along with suggested steps to address them.

34. Thus the following Issues are framed for discussion:-

Issue 1*: Whether C&AG should seek explicit mandate for PPP audit in view of the Supreme Court judgment or undertake PPP Audit using the Supreme Court judgment?*

Issue 2: *Whether C&AG audit should be in the nature of primary audit or supplementary audit?*

Issue 3: *If the Contract/agreement in question entails scrutiny of primary records of private partner whether we can do financial audit (other than compliance) or whether we can extend our audit to propriety audit as happened in case of Hydrocarbon PSC audit?*

Issue 4: *Keeping in view the sheer proliferation of the PPP mode of project implementation, is there a case for mainstreaming this audit?*

Regulatory bodies and audit oversight

35. Regulatory bodies are responsible for control over economic activities in the sectors in which they are created to ensure fair play and transparency. Traditionally, there have been regulators in some sectors performing the function of controlling and monitoring the activities in the sector, e.g., Registrar of Companies, Bureau of Indian Standards, Medical council of India, Atomic Energy Regulatory Board etc. These were generally established as autonomous bodies and societies with a statutory backing. The statute under which these were established generally details their audit provisions. Indeed, many of these regulators established till early nineties, are audited by the CAG (as per the statute under which they have been created) in much the same manner as Government Departments, with the audit ambit covering certification, compliance and even performance audits (e.g. PA on AERB, PA on ROC). In case of others, the audit ambit is confined to only to their accounts (e.g., SEBI) and decision making process and its impact remains outside the scope of Audit.

36. As the Government's role changed from being the primary provider of monopolistic services to that of a catalyst for other entities (both public and private) for providing such services, fair, transparent and independent regulation of such economic activities gained prominence. This has led to a proliferation of regulatory bodies in recent times. The regulatory bodies on the one hand protect the consumer from abuse by monopoly service providers (utilities, public transport etc.) both in terms of price and quality and on the other hand ensure that the service providers are able to finance and provide such essential services. The regulators typically price the services, promote competition, monitor service quality and ensure compliance to the terms of the concession arrangement. As Government is a party to the concession arrangement, these regulators are often created as independent authorities, though as is evident from their functions, they exercise the authority of Government. The recent trend is to keep these regulators either fully or significantly outside the scope of Government audit. Most new generation regulatory bodies, such as TRAI, CERC, SERCs, IRDA, have prescribed audit access. While in some cases certifications of their accounts have been assigned to the CAG, their regulatory functions remain outside the scope of audit scrutiny. The justification given is that the regulatory decision of these bodies is appealable to the Appellate Tribunal and hence ought not to be within the purview of Audit.

37. The ISSAI 5230: *Guidelines on best practice for audit of economic regulation* affirms the need of audit oversight over regulators in a global perspective and details some of the important audit concerns regarding impartiality, integrity and competence of regulators, the manner in which regulators ensure access to quality service and the reasonableness of the price of such service fixed by the regulator, steps taken by the regulator to reduce monopoly, promote consumer choice and combat anti-competitive practices.

38. Considering the very significant role of the independent regulators, there is a need for assurance regarding their accountability. Audit ought to have the mandate to review the processes and impact of decisions of the regulators, as these decisions affect the vital interests of the citizens. The draft Regulatory Reform Bill, 2013, however, states that the decisions of the regulator would remain outside the ambit of CAG audit though the accounts of all regulators is intended to be brought under the purview of the CAG Audit.

Issues in audit of Regulators

39. Audit mandate and access issues need to be clarified before actual in-depth audits can be attempted in this area. The impact of regulatory decisions on the citizen could form a part of a broader assessment in a performance audit.

40. While Audit would not like to go into the merits of a Regulator's decision of quasi-judicial nature, Audit should look into the decision making process so as to assure the people and the Parliament about observance of principles of natural justice and the Regulator's own standards or guidelines in this regard and that all the necessary steps have been followed as required for arriving at such a decision.

Issue for discussion

41. ***Issue 5:*** *Should Audit look into the decision making process so as to assure the people and the Parliament about observance of principles of natural justice and the Regulator's own standards or guidelines in this regard and that all the necessary steps have been followed as required for arriving at such a decision?*

Special Purpose Vehicles for implementing beneficiary oriented schemes

42. The trend of direct transfer of funds to special purpose vehicles (SPVs) created for implementation of beneficiary oriented schemes has gained prominence over the last decade. The quantum of such direct transfer has steadily increased reaching Rs.1, 09,173 crore in 2011-12 (a two and a half times increase over 2006-07). These SPVs, societies and trusts had been created to ensure un-interrupted fund flow to the schemes, there being concerns of short release of funds by States (particularly the ones plagued by poor ways and means position) in the traditional treasury mode of fund flow. Though the financial position of the States has improved significantly to avert apprehensions regarding fund flow, the direct fund transfer has continued and proliferated. Till recently, many of the Centrally Sponsored Schemes and most of the flagship schemes of the Government were being implemented by these SPVs which received funds directly.

43. The funds once released by the Union Government used to go out of the ambit of Government accounts and Government audit. This mechanism of transfer, where the trail of fund flow was so dispersed and which was beyond traditional accounting, auditing and hence parliamentary oversight, had raised serious accountability concerns.

44. The drawbacks of the direct transfer of funds have been commented upon by the High Level Expert Committee on efficient management of public expenditure (2011). The non-uniform accounting framework of implementing agencies, lack of centralized data on expenditure incurred by the implementing agencies, lack of assurance and accounting regarding the assets created, doubts on the integrity of the utilization certificates and the large un-spent balances remaining as float outside the Government accounts have come in for criticism. The Committee had recommended a switch over to the treasury mode for transfer of funds from the 12th Plan onwards. The 13th Finance Commission had also stated that the optimal solution is to route funds through the State budgets so that the treasury system could report utilization of funds and State Governments could monitor implementation of the schemes.

45. HQrs in May, 2012 issued a guidance note on "Audit of Flagship Programmes". It acknowledged the challenges of conducting audit of implementing agencies responsible for

implementation of the programmes, the sheer number of these IAs, confusion about direct audit mandate and the resource availability of the Department. The guidance note stated: "*Provisions for audit by the CAG as contained in the programme guidelines or as communicated in the sanction letters may be treated as deemed entrustment of audit to the CAG under the relevant section of CAG's (DPC) Act, 1971 and a formal entrustment need not be insisted upon. Only supplementary audit of such implementing agencies has to be taken up to ensure the integrity and effectiveness of the Plan funds being transferred to them for achieving various programme objectives.*"

46. Over the recent years, CAG has conducted performance audits on beneficiary oriented schemes where the fund transfer and implementation has been done through such SPVs. Some of the prominent efforts in this regard include PA on National Rural Health Mission (NRHM), Mahatma Gandhi Rural Employment Guarantee Scheme (MNREGS), and Pradhan Mantri Gram Sadak Yojna (PMGSY). During conduct of these audits, the documents of the SPVs have been accessed through the implementing Ministry/ Department both at the level of Union and State Governments. However, the nature of implementing agency (SPV) has precluded regular compliance audit by CAG so far.

47. In July 2013, the Planning commission decided as follows:

"The existing CSS/ACA Schemes in the Twelfth Five-Year Plan have been restructured into 66 Schemes, including Flagship Programmes. All Plan schemes under which Central Assistance is provided to the States are to be classified and budgeted together as Central Assistance to State Plans with effect from 2014-15 (BE) onwards.For all CSS/ACA schemes funds will be placed with the Administrative Ministries for transfer to the States through the Consolidated Fund of the States concerned. This mode of transfer may be implemented in a phased manner in BE 2014-2015.These arrangements shall come into force for the remaining years of the Twelfth Five Year Plan"

48. Thus the Central Government would now transfer funds under restructured CSS through the State Treasuries. However, most of the State governments still lack sound delivery machinery and may continue to rely upon the network of NGOs/ Societies etc. at the cutting edge level. The audit concerns as discussed above therefore remain.

Issues in audit in beneficiary oriented schemes implemented through SPVs

49. While performance audits of some of the social sector schemes have been taken up with significant value additions, such audits being resource intensive are few and far between. While it is important to continue efforts in PAs, considering the accountability concerns of direct fund flow, we may consider mainstreaming the audit of IAs and incorporating these concerns in regular compliance audits.

50. Some suggestions in this regard are for consideration:

i. We may consider building up a database in field audit offices based on the information available:

ii. The Central Plan Scheme Monitoring System (CPSMS) has been designed by the CGA to provide online, real time MIS regarding transfer of plan funds from Central Government to the final Implementing Agency (IAs). Though the system is expected to provide information regarding release as well as expenditure details, the module regarding expenditure

information is yet to be functional. However, the information regarding release of funds to IAs has been traced in the system.

iii. Most of the CSS schemes have a MIS (often an online, real time, MIS like MNREGS) detailing the physical as well as the financial progress of the scheme.

iv. Information regarding the utilization certificates (as well as the lack of them) is usually collected by the field audit offices.

v. Such a compilation may provide indications regarding materiality (the quantum of releases should be a guide) and risk (lack of UCs or mismatch in figures quoted in the UCs and MIS for example) for further probe of IAs.

vi. During the course of regular compliance audit of the respective Ministries/ Departments in the Central and State Governments, a small sample of IAs considered high risk (as seen from the database) could be looked at in greater detail. The accounts of these IAs (as certified by the statutory auditors) as well as supporting documentation could be called for through the implementing Government Ministries/ Departments and scrutinized. As part of the guidelines of the CSS schemes involving SPVs for implementation, access is generally allowed for accessing all records in this regard. (The guidelines for implementation of Right to Education (RTE), for example states regarding records at the IA level, *'….these records and receipts/ invoices shall be available for inspection by the Auditors, State Implementing Society, State Government and Government of India*'). A sector/ scheme specific audit checklist could be considered for assistance of the audit party. Capacity building of the audit parties for being able to detect red flags for fraud related concerns could also be considered in this regard.

vii. An IT audit of CPSMS implemented by CGA and of selected MIS mechanism maintained for specific schemes in the Ministry/ Department levels could also be considered. This might give better insight to the integrity of such publicly available information and suggest the way forward for improving their quality.

Issue for discussion

51. ***Issue 6:*** *While it is important to continue efforts in performance audits of the social sector schemes, considering the accountability concerns of direct fund flow, should IA&AD consider mainstreaming the audit of IAs by doing compliance audits of IAs on a regular basis?*

Other significant areas

Transfer pricing

52. Transfer pricing refers to pricing of cross border transactions between two related parties. It is the price attached to transfer of goods, services and intangibles within a corporate group. Such intra-group transactions are not governed by market conditions but are driven by common interest of the group. It is frequently used for tax avoidance and

evasion by large MNEs as artificial transfer prices are fixed in a way to suit the varying tax rates in countries where the MNE operates, for maximum benefit of the group. Taxable profits can be artificially shifted out of one tax jurisdiction to another using transfer pricing which would have a detrimental effect on Governments. A similar transfer of taxable profits is also possible within a country when a corporate entity has units in SEZs having tax immunity.

53. The Transfer Pricing Regulations were introduced in the Finance Act 2001 which provide that any income arising from an international transaction shall be computed having regard to the arms' length price. Various methods of arriving at the arms' length price and applicability of these methods have been stipulated. Considering the increase in transfer pricing litigation, a set of measures like *Safe Harbour Rules, Advance Pricing Agreement, Specified Domestic Transactions* have been introduced.

54. While mandate and access issues are not relevant here, there is a need to define the scope of audit of transfer pricing. The Income Tax Department computes an 'arms' length price' for international and certain domestic transactions in case of doubt regarding the transfer pricing employed by corporate body. This price then, becomes the base for tax assessment and demand. It is possible to arrive at different prices based on different methodologies. Adherence to a particular methodology would largely be a matter of technical judgment. Considering the complexity of the matter and the technicality of the judgment, Audit may not consider providing alternate valuation in the course of audit.

Issue for discussion

55. ***Issue 7****: Whether a systems audit of transfer pricing could be attempted to assess the appropriateness of the mechanism employed by the Income Tax Department in this area?*

Public Debt

56. Most governments have large financial needs as they seek to grow their economies and provide for social needs of their citizens which are sourced from public borrowing. Public debt can expand the production and consumption choices of current and future generations, allowing governments to increase productive investments and distribute the tax burden more fairly between the current and future generation. However, public borrowing also entails significant risk in the sense that an unsustainable public debt can impair the government's ability to reduce unemployment and poverty levels. The objective of debt management should then be to mobilize borrowings with long term cost efficiency subject to prudent levels of risk in the debt portfolio and also to develop a liquid and well - functioning domestic debt market.

57. The Public Debt Offices are under the audit jurisdiction of the CAG and the inspection of the Public Debt Offices is being done in line with the provision of the 1994 Manual. As per the said manual, the audit of permanent debt offices consists of seeing whether

i. The PDO maintains correct and accurate records of all the securities or bonds issued or discharged or cancelled and these are correctly accounted for in the books of the PDO.

ii. The PDO has submitted the quarterly statement of balances to the Central Debt Section which has agreed debt figures with the figures as per the accounting authorities.

iii. Payment of interest or repayment of principal has been made correctly and only once on proper authority.

iv. PDO has adequate checks to ensure that RBIs guidelines are being duly observed.

v. From the above, it can be seen that the audit of the PDOs is only envisaged as an administrative check to ensure that the payments made by the PDO are correct and are properly accounted and recorded in the books. The audit will not look into the operational aspects of the functioning of the PDOs.

58. However, public debt management is a critical issue for governments world-over and the public debt managers (Government / RBI in the case of India) are responsible for obtaining the necessary funds at a low cost over time while at the same time ensuring that the quantum of borrowing does not increase substantially to expose the country to potentially significant risks and challenges.

59. Given the limited ability of the citizens to monitor the actions of the policy makers and hold them accountable, there is a need for an effective management system to ensure sustainable public debt in the country. Internationally, it has been recognized that Supreme Audit Institutions (SAIs) can play a significant role in improving public debt management and prevent public debt from reaching unsustainable levels through a system of regular financial audits and periodical performance audits which can enhance the transparency and accountability, strengthen internal controls and provide an independent perspective to stakeholders regarding the risks and benefits of public debt. Regular financial audits of public debt are essential elements to guarantee public debt managers are held accountable for their public debt actions. Performance audits of public debt can contribute to enhancing the effectiveness, efficiency and economy of debt management. Such audit can bring an independent perspective to stakeholders regarding the risks and benefits of public debt and may help to strengthen internal control in public debt programs to reduce risks of fraud and corruption. Audit may assist in efforts to modernize public debt's legal framework by examining best practices identified in ISSAI's public debt audit guidelines.

60. While audit mandate and jurisdiction is un-disputed, capacity remains a concern. Besides, as benchmarks are not readily available delivery of the audit assignment poses a challenge. Decisions under this audit have a long gestation which adds to its complexity.

Issue for discussion

61. ***Issue 8:*** *Given the long gestation and lack of benchmarks for audit of Public debt, should IA&AD invest its resources on developing capacity for regular conduct of such an audit?*

Some institutional challenges and suggestions to address them

62. Some institutional challenges: The most significant challenge is of capacity closely followed by the very different business environment particularly for audit of private concessionaires in PPP projects. Summarized below are some of the significant concerns:

(a) **Manpower strength** – Our department is facing acute manpower shortage particularly in the cadre of Assistant Audit Officers (AAOs), who are at the cutting edge of our audit efforts. Audit offices all over India had a combined sanctioned strength of 9400 in the AAOs cadre as on 1 August 2014 out of which 2466 posts were vacant. That works out to more than 26% vacancy. Similarly, the sanctioned strength of AAOs (Comml) is 1514 where vacancies are 407, which also works out to around 26% shortage. Position of vacancy in some of the audit offices is alarming. Fresh recruitment at this level has not taken place for more than 4 years. Added to that is the problem on account of persistently high attrition in this cadre. It is a matter of concern that often AAOs who have acquired *four to five* years of experience leave the department and we are left with either freshly promoted AAOs or very senior AAOs who are on the verge of promotion. Audit teams are often deficient in sheer number of personnel (vis-à-vis the mandated party strength). Add to that the often deficient technical competence of the available manpower, and our capacity to take up complex audits become a major concern.

(b) **Qualifications:** As per our current recruitment rules, directly recruited AAOs in the commercial wing require graduation in commerce as an essential qualification and recruitment in other wings require graduation in any field. An officer without knowledge and understanding of commercial transactions may find it a significant challenge to audit the commercial transactions of private entities that may be necessary in a PPP audit.

(c) **Domain knowledge of the particular area to be audited** – Some emerging areas may require in depth knowledge and understanding to make a credible audit effort in the area (oil and gas, telecom, construction etc.). The lack of technical knowledge may become more apparent with the larger set of auditable entities (including some in the private sector) and the more stringent and complex demands on audit.

(d) **ERP capacity:** Almost all private organizations work in an ERP based environment/IT environment which require familiarity with such systems. Few of our field officers are trained. Even officers trained in IT often hesitate to audit through the computer as their exposure to working in IT environment is limited.

(e) **Paradigm shift in the business environment of the entities to be audited:** The private organizations have a very different business environment and applicable rules and regulations vis-à-vis a Government set up. For a credible audit, the team has to be oriented towards these set of differences. Applying government conditions/rules to the private sector may lead to *perverse* conclusions and even loss of credibility in the long run.

(f) **Resistance to access:** The experience of the ongoing audit of Discoms in Delhi has not been a happy one. After the initial resistance regarding our mandate which was cleared through judicial intervention our efforts are being stymied at every stage by the auditee. We need to be prepared for the tactics of denial, delay, resistance, non-co-operation and outright hostility from such entities. New protocols of interaction may need to be devised to deal with audit in hostile environment.

63. **Some suggestions to address the challenges:** While some of the capacity constraints can be addressed to intensive training and capacity building, there may also be a need to re-define the paradigm of audit to cope with these challenges.

(a) **Shift to assurance based audit:** Given the increasingly complex entities and transactions that we have begun to encounter, a re-thinking of our audit product and audit processes may be in order. A shift from the current 'exception reporting' framework to an

'assurance reporting' framework may safeguard our audit risk by defining the nature and extent of audit**.** Simultaneously the selection of the units audited would need to be demonstrably objective and the scope of audit defined in quantifiable terms. We will have to be explicit, via our working papers of the records examined, audit processes applied and the results thereof. Working papers/documentation may have to be preserved for longer periods than currently prescribed.

(b) **Identification and Creation of Core Teams** – A pool of competent officers from the level of Assistant Audit Officers (AAOs) to the level of Deputy Accountant Generals (DAGs)/Accountant Generals (AGs) having sufficient audit skills, IT skills and domain knowledge should be identified from across all offices. IA&AS officers are usually Audit Managers, while the actual audit work is done by audit teams. This may need to change with provision of GO/AG/PD directly supervising some of the more significant and complex audits. A multi-disciplinary approach may need to be adopted in such cases with the reporting officer and under the overall guidance of the CAG office.

(c) **Training and capacity building, appointment of experts –** Training needs to be targeted ensuring that the officers trained are deployed in the respective domain of expertise. A re-working of necessary skill sets may also be necessary given the broad and complex mix of audits that we intend to attempt. Standardization of programmes to ensure uniformity and quality, and deputation of trained officers to the specific area of capacity to promote training effectiveness is essential. Domain knowledge of the audit subject is a critical element of the audit quality management framework and the skills and experience of the staff deployed on the audit are expected to be commensurate with the requirements of the task. Each office may need to maintain an inventory of skills of its audit personnel which would enable them to match the task with required skills. Gap analysis to determine whether skills required for carrying out the audit are available in-house or can be built up by courses/training programmes in Regional Training Institutes or through outsourcing to professional institutes could be done. Consultation may be sought from experts and specialists with appropriate competence, skill, knowledge, judgment and authority when dealing with unusual, unfamiliar and complex issues.

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