CHAPTER 3
AUDITING IN PUBLIC SECTOR UNDERTAKINGS IN INDIA

An evaluation of the audit system in public sector undertakings in India will not be complete and worthwhile without looking into the complexities of public sector auditing. This chapter deals with audit of public sector undertakings and institutional framework of government audit in India.

3.1 Introduction

The system of checking the records of financial transactions existed in ancient civilizations of Egypt, Greece and the Rome. In the Vedas, the *Ramayana* and the *Mahabharata*¹ we can see the earliest evidence of recording of financial transactions in India. But such checking or audit and the maintenance of accounts was confined only to public accounts in these early civilizations. The British introduced auditing in India as an instrument in the extended arm of the Secretary of the State. It was introduced primarily for ensuring the accountability of Indian Administration to the British Government.

Auditing, as it exists today, developed quite late because the development of accounts was slow in comparison to other economic theories, finance and business. It was only during the last part of the 19th century that auditing started taking firm root in the modern sense. The Industrial Revolution and the company form of organization coupled with the publication of several texts on accounting were instrumental in the development of audit practice.

3.2 Audit of Public Sector Undertakings

After independence there was an unprecedented growth in the number of central and state level public sector undertakings in India. From five central government undertakings with an investment of Rs.29 crores in 1950-51, the number increased to 240 with a total investment of Rs. 2,52,554 crores in 2001-2002.\(^2\) Besides manufacturing basic and capital goods they are engaged in a variety of activities employing about 18.54 lakh workers as on 31\(^{st}\) March 2000. In view of the substantial investments and interest involved in the working of the PSUs, the audit of these undertakings is to be carried out independently, objectively, effectively and efficiently in a timely manner.

A proper and nontraditional way of auditing is necessary in the case of PSUs as the funds invested in them does not belong to those whose manage the affairs of the enterprises. That is why they have been made accountable to the public through parliament and controlled by many agencies like C & AG, Bureau of Public Enterprises (BPE), and Committee on Public Undertaking (COPU), etc. In addition to C & AG audit the COPU is authorized to examine the working of the undertaking in detail. Its report is submitted to the parliament and action has to be taken on it within a stipulated period of time. The report on the action taken is also submitted in the parliament. Every undertaking has to submit an annual report in detail to the parliament every year. The BPE publishes a report, named “annual report on the working of commercial and industrial undertakings of the central government” every year. The rigorous controls and strict standards of accountability have encouraged an attitude of playing safe by the officials in many PSUs and, consequently, a large number of procedural requirements have become an integral part of the

organization and management and accounting of such undertakings. In many cases, the executives have to devote considerable attention to comply with procedures.

The audit system of public sector undertaking is not similar to that of commercial concerns. Audit of public undertaking is one of the external controls available to the government to ensure public accountability of these concerns. The auditors of PSUs have to adopt certain techniques of government audit as well as follow standard practices and techniques of private audit also. However, on account of certain distinguishing features like supplementary audit by C&AG, report under section 619(3), etc, the planning and auditing of PSUs is slightly different from that of a private sector enterprise. It is generally an audit against regularity, sanctions, propriety and efficiency. Thus government audit, in effect, is an audit of efficiency. Commercial undertakings of the government of India and the various states can be classified broadly into three categories:

- Departmental Undertakings
- Statutory Corporations
- Government Companies registered under the Companies Act.

3.2.1 Audit of Departmental Commercial Undertakings

Departmental undertakings are established mainly for the purpose of providing certain services. They perform functions which are not necessarily government functions. Their working results are determined through accounts maintained on commercial principles. The statutory basis for the audit of these undertakings is found in Article 149 of the Constitution of India, which empowers the C & AG to undertake the audit of these undertakings.

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The audit of departmental undertakings is carried out on the basis of commercial principles and practices, and the C & AG has the absolute power to extend the audit of such undertakings to conduct an examination of the authority of expenditure as also of the regularity and propriety of financial transactions. In the case of departmental undertakings receipts and expenditure form part of the Consolidated Fund. In general, the auditor follows the same principles and rules, which he normally follows for the government departments for the audit of such undertakings. However, the auditor of these undertakings is expected to go beyond that and see that public money is utilized properly and efficiently. The audit also aims at verifying the correctness of the allocation of expenditure between capital and revenue, the valuation of assets on a reasonable basis and the adequacy of provisions for depreciations and bad debts. The C & AG also analyses the working of the undertakings and points out the weaknesses in various areas of their operations.

Another important feature of departmental audit is that it ensures that accounts are prepared in such a way as to permit a comparative study between different undertakings, and between government and non-government undertakings.

3.2.2 Audit of Statutory Corporations

Statutory corporations are established through the special enactment by the parliament. The provision for their audit is found in the enabling statute. The audit arrangements of statutory corporations differ from one corporation to another. In some cases the C & AG is fully empowered to undertake their audit and in some cases professional chartered accountants are responsible for the audit. In some cases the C & AG performs the “superimposed audit”, in addition to the audit by the professional auditor. In some other cases there are two auditors one of whom is appointed by the
C & AG. There are some statutory corporations in which the C & AG does not possess the right to undertake the audit. The powers and duties of the auditor in most of the corporations are similar to those of company auditors. The forms and the content of the audit report, as furnished by the various corporations, are similar to those prescribed under the Companies Act 1956. They do not differ materially also.

3.2.3 Audit of Government Companies

According to section 617 of the Companies Act, a government company is “a company in which is less than 51% of paid up share capital is held by the central government and/or by any state government or governments or partly by central government and partly by one or more state governments and includes a company which is a subsidiary of the government company.” In India a large number of public sector undertakings are registered as private limited companies under the Companies Act 1956.

Government companies are audited by two external agencies - by a firm of chartered accountants and the C & AG of India. All companies registered under the Indian Companies Act are required to get their accounts audited by a chartered accountant and since government companies are also governed by the general provision of Indian Companies Act. The books of accounts of a government company are required to be audited by a firm of chartered accountants. The C & AG, on the other hand, looks into the propriety, regularity, economy, efficiency and effectiveness of the transactions. This scheme of dual audit is credited with the merit of combining the normal requirement of professional audit and the special check that is imperative to
see that scarce public funds are not wasted or drained away either due to inefficiency or lack of propriety.4

However, the question of audit of government companies by C & AG had been a matter of considerable controversy in the early 1950s when the institution of companies for conducting the government’s industrial and commercial activities were introduced for the first time, as initially these companies were set up under Indian Companies Act 1913 and had no statutory provision for C & AG’s audit. Under Articles 149 to 151 of the Indian Constitution, the C & AG is responsible for the audit of all expenditure and revenue transactions of the central and state governments. However, once a government company is set up as an autonomous entity, its expenditure and revenue transactions do not form part of the Consolidated Fund of union or the state and a question arose regarding the enabling legal provision under which C & AG would have a right to audit their transactions. It was felt that the formation of government companies under the Indian Companies Act tended to whittle away parliamentary control.

3.2.3.1 Appointment of Auditors in Public Sector Undertakings

A firm of professional auditors performs the audit of government companies. Sometimes they are appointed by the company itself, sometimes by the government and at times by the C & AG. Section 619 of the Companies Act 1956 lays down special provisions regarding the audit of government companies and regarding the presentation of audit reports to the legislature. According to section 619(2) of the Companies (Amendment) Act 2000 the auditors of government companies shall be appointed and reappointed by the C & AG from the panel of professional firms of chartered accountants

sent by the company to the government. But in practice, the C & AG maintains a list of firms of chartered accountants out of which he makes the appointment. Thus the auditors are in fact ‘nominees’ of the C & AG who is the appointing authority.

### 3.2.3.2 Directions by C & AG

According to section 619 (3) of the Companies Act the C & AG is empowered ‘to direct the manner in which the company’s accounts shall be audited’ and ‘to give such auditor instructions in regard to any matter relating to the performance of his functions as such’. The C & AG uses a special questionnaire, which is to be answered by the auditor and to be submitted to the C & AG along with his report within two months of signing of accounts. However, this information is not required to be published with the report under section 227 of the Companies Act.

The directions issued by the C & AG according to the latest section 227(2) of the Companies Act is divided into 8 parts and contains questions relating to system of accounts, internal control, maintenance of production and manufacturing accounts, cost accounts, profit and loss account, the balance sheet and their review, manpower, service units and analysis of accounts to show capital formation, growth and fund flow of the company. Thus it is clear that the scope and duties of government company auditors are very extensive and they are not only to verify the financial statements but also has to undertake propriety-cum-efficiency audit also.

### 3.2.3.3 Supplementary Audit

After the receipt of the audit report by the auditor of the government company the C & AG has the right to comment on it or if he finds some gross
irregularities or mismanagement, to conduct a test audit or supplementary audit. According to section 619 (6) of the Companies Act the C & AG has to conduct a test or supplementary audit of the company’s account by such a person or persons as he may authorize. This audit by the C & AG attempts to examine broadly whether the financial transactions of the enterprise have been conducted with “faithfulness, wisdom and economy” and to present an analysis of the accounts so as to enable the public to see its true financial position. The comments ensure uniformity in accounting and develop healthy practices of appropriate disclosures.\(^5\) The review prepared by the audit party summarises the key data and financial highlights of the enterprise’s operations, indicating the trend for three years. It is generally published as a part of the Directors Report in the Annual Report of the enterprise. But in practice, such supplementary audit is undertaken each year only in the case of a few companies and for the others some comments, termed as audit paras, are given. On an average, each enterprise will get its turn for comprehensive appraisal after 15 years or more. So there is no danger of frequent inquiry by the C & AG in the auditing of PSUs.

### 3.2.3.4 Audit Fees

The remuneration of the auditors of government companies is fixed by Company Law Board on the basis of the recommendations made by the board of directors of the company and on the basis of the factual merits of each case. In recommending the fees the board of directors of the company should take into consideration the affairs of the company so as to see whether there has been a significant growth in the year under review as compared to

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the preceding years. The comparative growth in the activities of the company over the past years shall be taken into consideration while revising the fees.

3.2.3.5 Audit Report

According to sec 619 (5) of the Companies Act, the comments or supplementary audit report of the C & AG shall be placed before the Annual General Meeting of the company along with the audit report. The comment of the C & AG is obligatory and if he has nothing to say, then a “no comment” certificate is to be issued. The annual report of the working of the company along with the copy of the audit report and any comment by the C & AG shall be laid (section 619 (H) of the Companies Act) before the parliament and state legislative accordingly. The audit reports of the PSUs were incorporated in the audit report of the administrative ministries. In 1958, a separate section on PSUs was introduced in the Report on Appropriation Accounts (Civil) submitted by the C & AG of India. In 1965, a separate report on PSUs under the title Audit Report (Commercial) was first produced.

3.3 Institutional Framework of Government Audit in India

The system of parliamentary democracy that India adopted works through checks and balances. Indian constitution provides a mechanism through which the parliament keeps a check on an overzealous executive. The institution of C & AG could thus be regarded as a part of the legislative wing, as it helps in ensuring that public money has been spent with due regard to the legislature’s intention. Under the Constitution of India, all the powers regarding the audit have been vested in a constitutional authority, the C & AG, who is appointed by the President of India, derives his authority from Article 149 to 151 of the Constitution.
A comprehensive Act, namely, C&AG (Powers and Conditions of Service) Act, was passed (in 1971) to regulate the duties and powers of the Auditor-General. Under Article 151 of the Constitution, the reports of the Auditor-General relating to the accounts of the union shall be submitted to the President who shall cause them to be laid before each House of Parliament, and the report on the accounts of a state to the Governor of that state who shall cause them to be laid before the legislature of the state.

3.4 Objectives and Scope of C&AG Audit in Public Sector Undertakings

Audit of PSUs in India is not restricted to finance and compliance audit; it extends also to efficiency, economy and effectiveness with which these operate. It also relates to questions of propriety, directed towards an examination of management decision in sales, purchases contracts, etc., to see whether these have been taken in the best interest of the enterprise and whether they conform to accepted principles of financial propriety. Being an ex-post facto activity, the competency of the authority which took the decisions is also examined by the C & AG. The C & AG audit is expected to bring out the financial and operational deficiencies, inadequacies or ineffectiveness of systems, and the shortfalls from acceptable standards of performance of PSUs. Audit by the Comptroller and Auditor General of India (CAG) as an instrument of public accountability is considered under the following heads:

- Financial Audit
- Efficiency Audit
- Propriety Audit
3.4.1 Financial Audit

The financial audit of the government companies is carried out by the chartered accountants appointed on the advice of the CAG, and of the statutory corporations by the staff of the CAG. The financial audit of government companies is more rigorous because, firstly, the chartered accountants (CAs) being nominees of the C & AG are not dependent for their continuance on the top management of the company. Secondly, the C & AG has a right to issue directions to the chartered accountants of government companies under section 619 (3) of the Companies Act. Thirdly, the audit report prepared by the chartered accountants in government companies is vetted again by the C & AG, who under section 619(4) has a right to “comment upon or supplement” these reports. The government companies are unhappy about the double audit as it adds to their work, but the C & AG feels that it improves the quality of audit by the chartered accountants who know that their certification could be reviewed by a higher authority.

3.4.2 Efficiency Audit

This audit considers the overall objectives for which an enterprise was set up and the extent to which such objectives have been achieved. This audit reports are meant to help the Committee on public undertakings (COPU), which is expected to judge the efficiency and performance of PSUs. A limitation of audit of efficiency is that it evaluates performances in different areas in a compartmental way, without attempting an overall appraisal. Further, very rarely does it make suggestions for improvement. It analyses an area of operation, gives necessary facts, and leaves it at that.
3.4.3 Propriety Audit

This audit extends beyond the formality of expenditure to its wisdom, faithfulness, and economy. The audit investigates the necessity for the expenditure incurred, and seeks whether the rate and scale of expenditure were justified in the circumstances. The propriety audit is also directed towards a review of the decisions taken by the board of directors or similar authorities to ascertain to what extent their powers have been exercised in the best interest of the undertaking and in accordance with the accepted principles of financial propriety. The propriety audit is based on the assumption that the managers of PSUs have no direct personal interest in the gainfulness or otherwise of their decisions, and that either due to their indifference or inefficiency, the best decisions may not be taken.

The C & AG audit suffers from certain limitations. The audit essentially conducts a test review of accounts and sometimes many cases of major irregularities and financial mismanagement are never unearthed and brought to light. There is considerable time lag in reporting cases by auditor and thus the audit loses much of its relevance. The cases dealt within the reports presented to the parliament last year were from one to six years old. Generally the officials who are supposed to answer the questions were not the persons who handled the case. In this way, this system lacks an effective co-ordination. Auditors of the C & AG office are not professionally trained. They are trained only in procedural audit, which is not sufficient as per the commercial character of PSUs. In India to get a certificate from the C & AG that ‘the C & AG has no comments on the account’ is a cumbersome process. The PSUs have to strain every nerve to complete the entire process (including corrections and modifications to the accounts) and submit the accounts to in
the annual general meeting (AGM) within the deadline prescribed under the Act. In the process, the management does not always have adequate time to hold discussion with the Director of Commercial Audit, provide suitable explanations and persuade him to see its point of view in at least some of the points raised. In this way, the additional certificate given by the C & AG is generally treated as superfluous.

In spite of all these limitations, C & AG audit is very essential. It is an important instrument for the enforcement of the accountability of PSUs because these enterprises have been financed out of public funds. It need to be appreciated that the C & AG’s audit is largely responsible for maintaining transparency in the accounts of PSUs, which can be said to represent the “true and fair state of the company”. The same cannot be said about the private corporate sector, where there are numerous instances of accounts being manipulated, often with the connivance of their auditors. However, instead of duplicating the kind of audit which the chartered accountant does, the C & AG should play a wider, higher and more positive role of making periodical overall appraisals.

3.5 Audit Board in India

Traditional audit suffers from certain deficiencies and is not found suitable for government commercial enterprises. Noticing these deficiencies, the Administrative Reforms Committee (ARC), suggested reorientation in the method and outlook of audit and adopted the system prevailing in France. As a result of the ARC recommendations, the Audit Board was constituted in April 1969 with technical experts as members, under the supervision and control of the C & AG.
The Audit Board is headed by the chairman, and has about ten members stationed at different places like New Delhi, Mumbai, Kolkata and Chennai. Each member of the audit board is responsible for a select number of undertakings depending on functional requirements and geographical convenience. When a company is selected, a five-member board is nominated with the chairman and two officers of the Indian Audit and Accounts Department and two part-time members. The part-time members are appointed by the Administrative Ministry responsible for the enterprise to be reviewed in consultation with and with the concurrence of the C & AG. The part-time members are technical experts who have considerable experience of the industry whose performance is being evaluated and are appointed in consultation with the ministry concerned. They are closely associated with the appraisal at various stages and help the Audit Board in analyzing areas where technical expertise is needed. The Audit Board undertakes comprehensive appraisals in the form of audit reviews of a few selected undertakings every year. These appraisals are incorporated in the C & AG’s commercial audit reports and are finally presented to parliament and become an objective, balanced and constructive appraisal of the performance of the enterprises.

3.6 Audit Report and the Committee on Public Undertakings

Public enterprises were set up as part of country’s development planning process. Recognizing the special character of PSUs, based on the recommendation of the parliamentary committee headed by V.K. Krishna Menon, the parliament constituted a Committee on Public Undertakings (1964)
to examine the efficiency and to see that the PSUs are being managed in accordance with the sound business principles.\textsuperscript{6}

The C & AG reports, after they are submitted to parliament, are required to be examined by the Committee on Public Undertakings (COPU). Unfortunately, due to the heavy pressure on the COPU’s time it is not able to examine a large number of audit reports. A study by R.K. Chandrasekhar shows that the backlog in the committee’s examination of C & AG reports presented up to the year 1986 was 91, which included 48 appraisal reports, 15 introductory reports, and 25 reports on individual irregularities (containing 785 audit paras). The committee had examined only about 50 percent of the comprehensive appraisals prepared under the Audit Board system and just 3 audit paras out of the 800 paras included in the audit reports. Report of the C & AG, Government of Kerala (Commercial) for the year 2002-2003 reveals that three reviews and 21 paragraphs are pending for discussion by Committee on Public undertakings. K.Chandrasekhar, a former Deputy Comptroller and Auditor General points out that the mismatch between the rate of presentation of reports and their examination by the committee has created an anomalous situation, of increasing the volume of unexamined reports. In effect, the procedure for selection has eroded the procedure of accountability enshrined in the system of parliamentary control, since it tended to become discriminatory, which not only enabled several chief executives and management to escape any examination by the committee on C & AG’s reports but also affected substantially the utility and effectiveness.

of the audit reports, as tools to enforce accountability by the COPU and parliament.

The review of the audit system in PSUs reveals that there is a pressing need for a thorough change in the existing system of audit in PSUs. The deficiency lies not only in the system but also in the people and the professional bodies associated with the audit of PSUs. While admittedly there is considerable scope for improving the working of the office of the C & AG, we cannot do away with its audit. It is time for the institution of C & AG to change its style of functioning and take into consideration the special requirement of PSUs which face tough challenges while operating in a highly competitive global environment.