

Accrual Accounting For Local Bodies:

ELECTED REPRESENTATIVES & STAKEHOLDERS



The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)

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Foreword

The system of Governance in India has many constituents, one of which is the local bodies such as Municipal Corporation, Municipalities, Panchayats etc. In a changing environment, attempts are being made to make the local bodies accountable for their actions. Proper financial reporting by local body is perhaps the most important means to achieve the objectives of accountability and transparency. Traditionally, the local bodies have been following cash basis of accounting for financial reporting since their budgets, which are prepared on the cash basis, have been the principle means of financial control.

In today's scenario, the local bodies are a paradigm shift with regard to their financial reporting system. Some of the local bodies have made sincere efforts to shift from the existing cash basis of accounting to variants of accrual system of accounting. This is a welcome step by such bodies towards a more accountable and transparent financial reporting system. The Government of India has taken number of initiatives particularly Jawaharlal Nehru National Urban Renewal Mission (JNNURM) to bring the accounting reforms in the local bodies in India.

The local bodies in India, especially in view of the accounting reforms, are changing rapidly, with more and more such bodies wishing to change over to accounting systems and practices which would noticeably improved their levels of financial transparency and provide all of them with a much clearer picture of their financial position. This booklet titled 'Accrual Accounting for Local Bodies: Elected Representatives & Stakeholders' seeks to provide introductory information to the elected representatives and stakeholders about the accrual accounting benefits. I thank CA. Jayant Gokhale and the Technical Directorate for visualizing and bringing out this booklet.

I sincerely hope that this booklet would be useful to the elected representatives and stakeholders of the local bodies as well as other concerned.

New Delhi
January 30, 2009

CA. Ved Jain
President

Preface

In the nation's journey towards becoming an economic power, local bodies are going to be key players in making available the best of infrastructure to the country citizens. The Jawaharlal Nehru Urban Renewal Mission (JNNURM) has made funds to the extent of Rs. 50,000 crores for supporting urban reforms and after adding the contribution of states and municipalities the funding would be about Rs.126000 crores over a period of seven years. Accounting reforms and change to an accrual accounting system is a vital ingredient of the reform process. The accounting reform is intended for providing financial information to various users such as, citizens, elected representatives, administrators, investors, creditors, executives, legislatures, State Audit Departments, and State Urban Development and Panchayati Raj Departments in a timely and organised manner. The Committee on Accounting Standards for Local bodies has recognised the need for creating awareness amongst various stakeholders about the benefits of the accounting reform process in local bodies.

The purpose of this booklet is to present the salient features of the accrual accounting system for those who are charged with the governance of the local bodies in India. It brings out the distinguishing features of the two systems of accounting: the traditional cash accounting system and modern accrual accounting system, and the manner in which they impact income, expenses, assets and liabilities of a local body. It also discusses how double entry accrual accounting can prove beneficial for local bodies. Some misconceptions about accrual accounting have also been clarified, to reduce the perceived information gap about the system and its use. It is hoped that this booklet will give a clear picture of the role of the accrual accounting in effecting financial reforms and remove all apprehensions about it. To enable this potential to be fully realised, the said booklet will also be released shortly in various regional languages so that the benefits are appreciated by the grass-root level administrators, corporators and councillors and citizens at large.

I sincerely appreciate the efforts put in by Dr. Avinash Chander and CA. Keshav Datt, Secretary to the Committee on Accounting Standards for Local Bodies, of the Institute of Chartered Accountants of India, in preparing the draft of the Booklet.

I firmly believe that this booklet would be immensely helpful to the elected representatives and stakeholders of the local bodies in India and others concerned.

New Delhi
January 30, 2009

CA. Jayant Gokhale
Chairman
Committee on Accounting Standards for Local Bodies

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- **INTRODUCTION**

- What is the amount of property tax to be received from the citizens of a particular area?
- What is the total value of the land, buildings, roads, bridges, etc. under the control of a local body?
- What is the cost of supplying water to the citizens of the area?
- What is the amount of subsidy for providing services such as water, electricity, education, health, etc. to the citizens of the area?
- How much is the liability of the local body towards its creditors?
- What is the efficiency level of financial performance of a local body and how can it be improved?

All the above questions and many more similar questions may be asked by common people, taxpayers, voters, service recipients, NGOs and advocacy groups, especially because of the Right to Information Act, which encourages people to seek information on anything. But answers to these questions are not readily available under the cash basis of accounting system. Even if one tries to go beyond cash accounting records and data, one can only respond by providing approximate estimates, which cannot be certified by the C&AG, Local Fund Auditors, and Chartered Accountants.

Double entry based Accrual accounting is the only system that helps to provide satisfactory answers to the above questions. It also provides financial information characterised by a high degree of transparency and accountability to user groups.

Since the governance of local bodies is by and large in the hands of elected representatives, who have to keep in view the expectations of the citizens of their area, we felt that a booklet on accrual accounting be prepared for their use.

- **USER GROUPS AND THEIR INFORMATION NEEDS**

Key users of the financial information of local bodies are:

- (i) Citizens: They include:
 - Taxpayers
 - Voters
 - Service recipients
 - Members of advocacy groups

- Organisers of NGOs
- Public finance researchers
- Lending Agents
- Investors

All of them are interested in information about the financial position and operational results of a local body, as indicators of increase or decrease in the level of services provided, and future tax burden.

(ii) Elected Representatives

Elected representatives have to work out how much money is available for providing services, and how to optimize services with limited funds, so as to keep the taxes low. They also have to know the amount of money that has been spent in their constituency.

(iii) Government Authorities sanctioning / releasing grants / funds and monitoring their utilization.

(iv) Executive

Executives have to perform the difficult task of managing financial resources. They have to balance the dictates of the legislative intent in the budget, political exigencies of the elected representatives, the need for financial prudence required by creditors, observance of financial discipline and what new projects can be taken up with additional finance etc.

(v) Creditors

Creditors' objective is to ensure the prudent management of resources so as to safeguard their interests in the entity.

(vi) State Audit

State audit is a government department that has to ensure that the subject entities have complied with statutory requirements, contractual obligations, and debt covenants, and conducted all their financial transactions in accordance with relevant rules and regulations. It is also responsible for ensuring that financial

reporting provides a true and fair view of the financial performance and condition of the entity.

(vii) State Urban Development/ Panchayati Raj Departments

These departments represent the state government, which, in some cases, provides nearly 90 percent of the local government resources through grants for general and special purposes. These departments need to know the financial position of a local government to assess its fund requirements for the coming years. The state government also needs to know whether the ULB/ PRI conducts its affairs with financial prudence and within the limits set by its sanctioned budget.

- **BASIS OF ACCOUNTING**

Cash basis and accrual basis are two well known methods of accounting. Local Bodies with their dependence on tax incomes have traditionally relied upon the cash basis financial reporting system.

A. Cash Accounting

The adoption of cash basis of accounting by local bodies owes its origin to the pre-eminence of the budget as the principal means of financial control in the government. In the case of governments, the budget is a formal document that sets forth the objects and purposes for which expenditure is incurred during a period and the sources from which funds are raised to meet this expenditure. The cash basis of accounting measures actual receipts and payments under various budget heads to facilitate a comparison of actual performance vis-à-vis budgeted targets.

In the cash basis method, income is recognised when cash is received and expenditure is recognised when cash is paid, the matching of cash receipts and disbursements serves to determine operating results during an accounting period. This method is simple in its application, but in most cases, it does not fully match all the expenses incurred to the incomes generated in a given period. For example, the purchase of equipment or a building is not depreciated over time, but is fully expensed at the moment of purchase.

Cash basis of accounting fails to achieve most of the financial reporting objectives. It is because the timings of cash receipts and cash payments may not coincide with earning of revenues or incurring of expenses. Furthermore, measurement of performance based on cash basis of accounting is susceptible to manipulation through a variation in the timings of cash receipts or payments. For example, postponing the payment of certain bills by a few days can conceal a budgetary deficit. Another major weakness of cash basis of accounting is that no distinction is made between receipts or payments on capital account and those on revenue account. Thus, no distinction is made between expenditure on construction of infrastructural facilities such as roads, water distribution system, bridges etc. and expenditure on routine items such as salaries, rents etc. Similarly, a substantial expenditure on major changes to a building that result in an increase in its life is treated as no different from the revenue expenditure on normal repairs and maintenance. Similarly, refundable deposits are treated no differently from charges for service rendered.

The major limitations of cash basis of accounting are:

- Incorrect measurement of income and expenditure
- No statement of assets and liabilities

Because of these limitations, many governments and governmental bodies have switched to the accrual accounting.

B. Accrual Accounting

Accrual accounting recognises financial transactions when they occur, and not when cash is received or disbursed. The accrual method is founded on the principle that all incomes earned during a given period are matched with the expenses incurred for earning those incomes. In other words, incomes are recorded in the period in which they are generated, and expenses are recognised by measuring the goods and services consumed to generate those incomes; and the multi-year benefits associated with long-lasting assets are matched with the time(s) when they are expected to be used.

The accrual method provides a better measurement of net income because it matches expenses incurred with incomes earned for given period and it reflects income in the period to which they belong i.e., the period in which they were earned. Net income is thus, clearly shown as the difference between incomes earned and the expenses incurred for generating those incomes; that is, the difference between the results obtained and the efforts expended to achieve those results. Since accrual accounting provides more complete and useful information than the cash based accounting, most organizations use this form of accounting to support their decision-making and financial reporting.

C Difference between Cash Basis and Accrual Basis Accounting

The major difference between accrual accounting and accounting based on cash receipts and payments is in the timing of recognition of revenues, expenses, gains and losses. It is possible that cash receipts during a particular period largely reflect the effects of activities of the enterprise in the earlier periods, while many of the cash payments may relate to activities and efforts expected in future periods. Thus, an account showing cash receipts and cash payments of an enterprise for a short period cannot indicate how much of the cash received is the return of investment and how much is the return on investment and thus cannot indicate whether or to what extent the enterprise is successful or unsuccessful.

The following examples of ABC Local Body illustrate the difference between cash and accrual methods of determining net income:

Example 1

The ABC Local Body provided services during the month of August for which it charged Rs. 1,000. It received two payments for its services: Rs. 600 on 14 August and Rs. 400 on 10 September. Wages and salaries (the only expense) amounting to Rs. 550 were paid on 31 August. No other services were provided during September.

Accounting basis	Cash Basis		Accrual Basis	
	August	September	August	September
Revenue	Rs. 600	Rs. 400	Rs. 1,000	Rs. 0
Expenditure	Rs. 550	Rs. 0	Rs. 550	Rs. 0
Net Income	Rs. 50	Rs. 400	Rs. 450	Rs. 0

Using the cash basis method, incomes are recorded in the months when cash is received, and expenditures are recorded in the month when cash disbursements occur. Thus, the net income for August stands at Rs. 50 and for September at Rs. 400, *even though no work was done during the latter month*. The accrual basis, after making adjustments, matches all incomes in the period when they are earned against all expenditures incurred to earn that income. The net income now stands at Rs. 450 for August and Rs. 0 for September, reflecting the fact that all the services were provided in August.

Example 2

ABC Local Body supplied following information about the income and expenses for the financial year 2007-08.

	Rs.
Income from property taxes due and received during the year	1,20,000
Property taxes received in advance	15,000
Property taxes due but not received	12,000
Expenses paid for school education during the year	80,000
Expenses paid in advance for school education	20,000
Expenses incurred but not paid for school education	10,000

The income and expenditure accounts of ABC Local Body under (a) Cash basis (b) Accrual Basis of accounting will be as follows:

(a) *Cash Basis*

	Rs.	Rs.
<i>Incomes:</i>		
Income from property taxes due and received during the year	1,20,000	
Property taxes received in advance	<u>15,000</u>	
Total Income (A)		1,35,000

<i>Expenses:</i>		
Expenses paid for school education during the year	80,000	
Expenses paid in advance for school education	20,000	
Total Expenses (B)		<u>1,00,000</u>
Net Income (A - B)		<u><u>35,000</u></u>

(b) *Accrual Basis*

	Rs.	Rs.
<i>Incomes:</i>		
Income from property taxes due and received during the year	1,20,000	
Property taxes due but not received	12,000	
Property taxes received in advance	<u>(15,000)</u>	
Total Income (A)		1,17,000
<i>Expenses:</i>		
Expenses paid for school education during the year	80,000	
Expenses incurred but not paid for school education	10,000	
Expenses paid in advance for school education	<u>(20,000)</u>	
Total Expenses (B)		70,000
Net Income (A - B)		<u><u>47,000</u></u>

The above illustration clearly brings out the difference between the two bases of accounting. The Net Income of Rs. 47,000 under accrual basis of accounting reflects the true income of the ABC Local Body during the year whereas under cash basis, the Net Income of Rs. 35,000 is the difference between the receipts and disbursements during the year. Thus, accrual basis of accounting is a scientific method for measuring accounting transactions, which is being accepted globally by governments for reporting their financial transactions.

A comparative analysis of the basis of accounting is described in the table given below:

Distinction between cash basis and accrual basis of Accounting

Elements	Cash Basis	Accrual Basis
Incomes	<p>When cash is received.</p> <p>Examples:</p> <ul style="list-style-type: none"> • On collection of property taxes • On collection of fees and fines • On transfer of grant money to the bank account 	<p>When the incomes are earned.</p> <p>Examples:</p> <ul style="list-style-type: none"> • On property taxes becoming receivable- on issuance of demand note • On receipt of sanction letter for grant • In case of revenue sharing agreement with other agencies, as in case of utilities, when the other entity has earned the revenue of which a part is to be shared with the ULB/ PRI
Expenditures	<p>When cash is paid out.</p> <p>Examples:</p> <ul style="list-style-type: none"> • When salaries are paid • When supplier bills are paid 	<p>When the expense is incurred and a liability arises.</p> <p>Examples:</p> <ul style="list-style-type: none"> • When at month end, salaries become payable to employees • When on receipt of supplies payment becomes due to a supplier

The cash collections / cash payments vis- a- vis revenue/ expense recognition under accrual basis are further illustrated below:

Cash Collection vs Revenue Recognition

Cash Collection	Prior Period	Current Period	Subsequent Period
Cash received in current period concurrent with earning of income		<ol style="list-style-type: none"> 1. Income earned 2. Cash increased 	
Cash received in prior period before earning of income	<ol style="list-style-type: none"> 1. Obligation to provide goods or render services increased 2. Cash increased 	<ol style="list-style-type: none"> 1. Income earned 2. Obligation to provide goods or render services decreased 	
Cash received in subsequent period after earning of income		<ol style="list-style-type: none"> 1. Income earned 2. Debtors increased 	<ol style="list-style-type: none"> 1. Cash increased 2. Debtors decreased

Cash Payment vs Expense Recognition

Cash Payment	Prior Period	Current Period	Subsequent Period
Cash paid in current period concurrent with using resource to generate		<ol style="list-style-type: none"> 1. Expense incurred 2. Cash decreased 	

Cash paid in prior period before using resource to generate income	1. Cash decreased 2. Prepayment increased	1. Expense incurred 2. Prepayment decreased	
Cash paid in subsequent period after using resource to generate income		1. Expense incurred 2. Liability to pay for resources used increased	1. Cash decreased 2. Liability to pay for resources used decreased

- **SUBSTANTIAL IMPACT OF ACCRUAL ACCOUNTING**

The accrual accounting impacts assets, liabilities, incomes and expenses, but the major impact is on:

1. **Fixed Assets**

By using cash accounting, the value of local body's fixed assets, such as a building or buildings, vehicles and equipment, is not shown in the local body's balance sheet. The purchase price of a fixed asset is fully expensed in the year of purchase and therefore the transaction has an immediate impact on the annual budgetary balance. In the accrual method, these capital expenditures are recorded as assets on the local body's balance sheet. The annual cost of using the asset is reported as the estimated annual depreciation on the value of the fixed assets, plus outlays for operation and maintenance.

2. **Liabilities**

In the cash accounting system, liabilities and provisions, such as outstanding expenses, creditors, tax refunds, incomes received in advance and unpaid bills of works contractors are not shown in a local body's balance sheet. Accrual accounting includes a more comprehensive list of liabilities in the balance sheet. These include outstanding expenses, creditors, provisions for tax refunds, incomes received in advance, the value of liabilities related to claims to other parties, to the extent payment is likely

and estimable and increased liabilities for employee retirement benefits etc.

3 Income from taxes

In cash basis of accounting, tax incomes are recorded on a cash basis in the year in which they are received. Refunds are charged against incomes in the year in which they are paid. In accrual accounting, tax receipts and refunds are generally recorded in the year in which the taxable activity takes place. Accordingly, a receivable account is established for taxes still owing to the local body and a payable account is established for tax refunds owing to taxpayers.

- **BENEFITS OF ACCRUAL ACCOUNTING**

The availability of complete information to all the stakeholders enables them to hold a local body accountable for the stewardship of public resources. It also improves the local body's ability to meet its short-term and long-term financial obligations.

- The local body's balance sheet provides a comprehensive picture of its assets and liabilities.
- The annual budgetary balance reflects the impact of economic events during the given fiscal year. In particular, year-to-year changes in recorded tax incomes reflect accurately year-to-year changes in the tax base and tax rates, as these changes are not affected by lags in tax collection and the payment of refunds.
- The annual budgetary balance reflects the impact of local body's decisions during the fiscal year. In particular, the decisions that result in increase in its liabilities, for resources received are recorded in the year in which the economic event takes place. Under cash accounting, the full cost of some of those decisions would not be shown in the local body's financial statements until all of the resulting cash payments were made many years later.

It is expected that the use of accrual accounting will also help local body managers and decision-makers to manage the tasks of resource allocation and take sound risk assessment decisions.

- Since all assets (financial and non-financial) are recorded in local body's financial accounts, managers will become more careful about the management of assets under their control and pay proper attention to issues such as maintenance requirements, replacement policies, identification and disposal of excess assets, loss caused by theft or damage and the full impact of assets on services delivery.
- Because the method recognises existing and potential liabilities, managers will pay greater attention to the management of liabilities under their control and become aware of their responsibility for those liabilities, and the need to develop plans for managing them, including identifying the impact of existing liabilities on future resources.
- Since all operational costs are recorded in local body's accounts, managers get a complete picture of its financial performance (all costs and incomes). This will help them to consider all the costs in making decisions, such as the evaluation of the cost-effectiveness of in-house delivery versus contracting out of services, the appropriateness of a cost-recovery policy or the amount to charge other agencies for services provided.
- Local Bodies will be able to leverage their assets better and borrow at competitive rates.

• **ACCRUAL ACCOUNTING SYSTEM IN LOCAL BODIES: SOME MYTHS**

There is a misconception among some functionaries of local bodies with respect to the accrual accounting system. The misconceptions vis-à-vis the facts are given below:

Myths	Reality
Cash accounting is time-tested and the change to accrual system is unwarranted.	Cash basis of accounting fails to meet several financial reporting objectives. It is because the timing of cash receipts and cash payments may not coincide with earning of revenues or incurring of expenses. Furthermore, measures of performance based on cash basis of accounting are susceptible to

	manipulation through a variation in the timings of cash receipts or payments.
Accrual accounting system favours Chartered Accountants.	Local bodies are subjected to audit by the State Local Fund Auditors and/or Technical Guidance and Supervision of CAG. Chartered Accountants only help in accounting issues.
The system requires huge investment in computers and expensive accounting software.	Local bodies do not require high-end computer systems. Depending upon the body's size and volume of work, computer costs will range between Rs. 1,00,000 and Rs. 2,00,000. More than 90% of local bodies will require an outlay of less than Rs. 3,00,000 on computer hardware and less than Rs. 50,000 on packaged software.
Accrual accounting will lead to staff redundancy.	In most local bodies, the accounts section is understaffed. The staff requirement will remain more or less the same.
Double entry accrual accounting system means double workload.	In the existing cash accounting system too, municipal bodies maintain a second set of records for cross checking, though these records are disjointed. In the double entry accrual accounting system, the second set of records becomes a meaningful part of the accounting system. Even in manual form, the double entry accounting system does not double the workload. Its computerised form reduces and simplifies the workload.
The adoption of accrual accounting implies that a local body is in a position to borrow from the market.	Borrowing from the market depends on a local body's overall financial position and the bankability of its projects. Mere accounting reforms cannot help it to borrow from the market. Accounting reforms help it to

	<p>translate its financial results into a language or format with which the market is conversant and comfortable. Accounting reforms only lend reliability and credibility to the financial statements submitted by a local body for borrowing.</p>
<p>Accrual accounting implies a better financial position of a local body.</p>	<p>Accounting reforms are not a magic wand, and may not improve a local body's financial position. Accrual accounting can improve the financial position of local bodies by making available qualitative data to take appropriate financial decisions.</p>

About the Committee on Accounting Standards for Local Bodies

Recognising the need for a single set of high quality Financial Reporting Standards, more and more local bodies are shifting from cash basis to accrual basis of accounting. The Council of the Institute of Chartered Accountants of India (ICAI) constituted an independent Committee on Accounting Standards for Local Bodies (CASLB) in March 2005 with the main objective of formulating Accounting Standards for Local Bodies on accrual basis.

The composition of the CASLB is fairly broad-based and ensures participation of all interest-groups in the standard-setting process. Apart from the members of the Council of the ICAI, the CASLB comprises the representatives of the Ministry of Urban Development, Comptroller and Auditor General of India, Controller General of Accounts, National Institute of Urban Affairs, Ministry of Panchayati Raj, Directorates of major Local Bodies, Directorates of Local Fund Audit Departments, Academic Institutions and eminent professionals co-opted by the ICAI.

Apart from formulating Accounting Standards for Local Bodies, the Committee also takes steps for facilitating improvement in accounting methodology and systems of local bodies and acts as a forum to receive feedback from Local Bodies regarding problems faced by them in the adoption of accrual accounting and in application of the Accounting Standards set out in its Preface to the Accounting Standards for Local Bodies.

While formulating Accounting Standards for Local Bodies, the CASLB gives due consideration to the International Public Sector Accounting Standards (IPSASs) prepared by the International Public Sector Accounting Standards Board (IPSASB) of the International Federation of Accountants (IFAC) and tries to integrate them, to the extent possible, to facilitate global harmonization.

About the Institute of Chartered Accountants of India

The Institute of Chartered Accountants of India (ICAI) is a statutory body established under the Chartered Accountants Act, 1949 (Act No. XXXVIII of 1949) for the regulation of the profession of Chartered Accountants in India. During its nearly six decades of existence, ICAI has achieved recognition as a premier accounting body not only in the country but also globally, for its contribution in the fields of education, professional development, maintenance of high accounting, auditing and ethical standards. ICAI now is the second largest accounting body in the whole world.

ICAI has its Headquarters at New Delhi with five Regional Offices at Mumbai, Chennai, Kanpur, Kolkata, New Delhi and 117 branches spread all over the country. In addition, it has also set up 19 chapters outside India and an office in Dubai.

The affairs of ICAI are managed by the Council in accordance with the provisions of the Chartered Accountants Act, 1949 and the Chartered Accountants Regulations, 1988. The Council consists of 40 members of whom 32 are elected by the members and remaining eight are nominated by the Central Government to represent the Comptroller and Auditor General of India, Ministry of Corporate Affairs, Ministry of Finance and other stakeholders.

In terms of the Chartered Accountants Act, 1949, the President is the Chief Executive Authority of the Council. The Secretariat of ICAI is headed by the Secretary who is in-charge of the office of ICAI as its Executive Head. The activities of ICAI can be broadly divided into four parts comprising of Technical Directorate, CPE Directorate, Board of Studies and the Administration, each one headed by a separate head. Other important wings of ICAI are the Examination Department, Disciplinary Cell, Legal Department, Members and Students Services, International Affairs, Research etc. ICAI has also set up the ICAI Accounting Research Foundation under Section 25 of the Companies Act, 1956.