# Strengthening Financial Management Systems

**Amiya Kumar Ghosh**
**Pratap Ranjan Jena**

**National Institute of Public Finance and Policy**
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# Executive Summary

## Chapter 1
## Basic Steps towards Better Financial Management

1. Good financial management includes both collection of sufficient resources from the economy in an appropriate manner as also allocating and use of these resources efficiently and effectively, which calls for good expenditure management.
2. As policy goals are required to be met within resources likely to be available in medium term, multi-year programme bringing out the cost implications, is required. It is now universally accepted that multi-year perspective is very important for good budgeting.
3. Reforms in the budgetary process should be the key element in the efficient and effective public expenditure management process, and not just another element in the reform process.
4. A programme based budgeting with a top down approach helps in this process, when focus is on identification of planning and spending objectives, and treating budget as a means of attaining the policy goals.
5. There are various problems in introducing outcome based budgeting as outcomes are often confused with outputs and outputs with inputs. It is difficult to make performance targets as part of the budget formulation process.
6. Public Expenditure Survey (PES) system of U.K. which was introduced in 1960s after the Plowden Committee Report offers good model for expenditure control and management.
7. The need for such public expenditure surveys has an acceptable universality about them. It enables better planning of expenditure, as it leads to improved decision making. It provides a common base for weighing the cost of both new proposals and continuing policies, and it minimizes the element of 'game planning' strategies … Most important is the inherent ability of expenditure plans to reflect the concerns of government and these of community at large.
8. In view of challenges to bring about reforms in public expenditure management reforms in a time bound manner, it is necessary to consider whether restructuring of Ministry of Finance is necessary.

## Chapter 2
## Reforming the Budgetary Process

1. Budgeting system both at Centre and state level continues to be conventional input based, concerned mainly with compliance with budgetary provisions. It is not in conformity with the present aim of making budget output/outcome oriented.
2. The weak linkage between policy making, planning and budgeting often associated with traditional line item budgeting invariably results in poor budgetary performance.
3. Because the present budget is input based, the process of budgeting follows a bottom-up approach while an output oriented budget has to have a top-down approach for policy inputs towards programme formulation complemented by bottom-up approach of working out the input costs of various programmes.
4. In the present budgetary process the ceilings are imposed late in the process after the initial estimates have been prepared by various departments. Overall budget

constraints are not transmitted to departments in terms of ceilings early in the budget process facilitating the departments to plan in advance under a resource constraint.

5. There is a phenomenon of large-scale surrender of funds from the approved budget as also asking for unnecessary supplementary grants. The reasons for inability to spend the budgeted amount and asking for supplementary grants could be found in the lacunae in financial management system itself. Absence of programme based approach to budgeting is the basic problem, as it leads to piece-meal approach to sanction of schemes leading to delay in finalization of schemes and non approval of projects leading to surrender of funds.
6. There is also phenomenon of March Rush which we have not been able to control inspite of several instructions from the Ministry of Finance and introduction Monthly Exchequer Control system. The absence of multi-year budgeting with programme based approach in our budgeting leads to this phenomenon of March rush.
7. The government had made several efforts in the past to revitalize the system; major among them are the introduction of performance budgeting and zero based budgeting (ZBB). While ZBB was not used and remained at a conceptual level, the performance budgets for all these years remained supplementary to the main budget with very little impact on budget planning and resource allocation decisions. The main reason for their failure is non-adoption of programme based approach towards budgeting as also absence efforts towards management reforms.
8. A point can easily be made relating to performance targets. The performance measures should not be used for ex-post analysis of budgetary outcome. Rather, performance targets should be set as goals. Thus, no difference needs to be made between outcome and performance.
9. The latest in the budgetary reforms is the introduction of outcome budget in 2005-06, claimed to have been designed to move beyond the traditional line item system to clearly defined outcomes of all government programmes. In practice the basic elements of outcome budget, such as, measurement of outputs and outcomes, specification of benchmarks, costing of programmes, monitoring and evaluation system and the institutional aspects are still emerging. The outcome budget, like its predecessor – performance budget, is viewed as supplemental device rather than an effective system to influence budget policy and decision making.
10. While the outputs are basically the goods and services produced that can be measured physically and quantitatively, the outcomes are impacts in terms of achieving the goals. The actual outcomes of a programme may be known only after several years and the outcome mentioned in the budgets are merely intents.
11. Keeping these broad themes in view the major steps towards outcome oriented budget formulation are indicated here.
    a. Preparing a macroeconomic framework to ensure that budget follows broad macroeconomic polices and remain well within the resource constraint. In that fiscal targets to be adhered are set up and levels of expenditure compatible to the fiscal targets are determined.
    b. Spending limits are communicated to administrative departments at an early stage of budget preparation to establish a hard budget constraint and improve budget planning. The departments require comprehensive view of resources while formulating their budgets. The finance department, following a top-down approach should determine the availability of aggregate resources for the budget as derived from the macroeconomic framework and establish departmental expenditure limits consistent with government priorities. The

expenditure ceilings should be transmitted to the departments early in the budget formulation stage including both plan and non-plan expenditures.

c. Preparation of expenditure policies for various sectors that fits the aggregate expenditure levels indicated in the macroeconomic framework. In the expenditure planning primary factor for resource allocation should be at the programme level. Policy relevant programme classification for government spending provides link between the budget and the overall strategic planning.
d. Preparation of multi-year expenditure planning by estimating forward costs of programmes within the spending limits already made known. The multi-year expenditure profile of the programmes should be utilized by the finance ministry to anticipate the magnitude of expenditure demands and more important formulate the ceilings on the allocation for each ministry.
e. Strengthening performance budgeting by infusing performance orientation to address for better budget outcomes. The formulation of performance budget should revolve round a multi-year framework and improved expenditure planning, as suggested, keeping department programmes at the core.
f. Allocation of resources consistent with government policies and already agreed upon fiscal targets.

12. The above suggested budgetary system changes should be introduced as part of a Budget Law. The introduction of such a Budget Law will provide a legal backing to some of the initiatives already started and budgetary reform suggested here.
13. The performance budgeting initiatives are acknowledged to be part of broader set of reforms that influence the management of public sector. The PES system that has been recommended for adoption (chapter 1) would provide such an initiative for wider management reforms by focusing on policy issues and costs of programmes.

## Chapter 3
## Role of Integrated Financial Advisor in Financial Management

1. Under the existing scheme of budgetary and financial control and delegation of powers, the Ministries have a Financial Adviser (FA), who plays a pivotal role in the Ministry's financial management. With his assistance, administrative ministries exercise the enhanced powers delegated to them.
2. The net effect of the integrated financial advice system as it was not accompanied by programme planning and evaluation of programmes for budgetary allocation, has been gradual erosion of the position of Financial Adviser in the role of giving objective financial advice for achieving 'value for money' in government expenditure.
3. One of the adverse effects of the Integrated Financial Advisor Scheme has been on budget formulation and budgetary control which is the core of financial management as seen from the appropriation account.
4. An internal review has been made by Ministry of Finance and an office Memorandum of F(5)/L&C/2006 dated 1.6.2006 has been issued. Recognizing that the institution of Financial Adviser occupies a unique position in the functioning of the Government of India and considering changing scenario, it felt that it was necessary to redefine the role, authority as well as accountability of the Financial Advisers.
5. Redefining the role and charter of Financial Advisers, unilaterally by addressing the issue to FAs would not help, as effectiveness of his role would be circumscribed by the management framework within which he functions, where he is only one of the players. The letter dt. 1.6.2006 also indicates that FAs should function like CFOs.

6. In this context attention gets drawn to the provisions of the Chief Financial Officers Act, enacted by the U.S. Government in November 1990, which gives a legislative mandate to CFO. Similar acts have been passed in other countries
7. The designation of the Secretary of a Ministry/Department as the Chief Accounting Authority (under Government Accounting Rules 1990) and laying down his specific role in this regard in General Financial Rules, Rule 64, should be regarded as major milestone in securing accountability of public money. Unfortunately, this very major event in the conception of financial management system in the Government of India has gone without a major discussion on how this role would be given effect to, what would be its institutional implications, and how in particular, it would affect the role of Financial Adviser.
8. To make an impact of the concept of Chief Accounting Authority and his role should be incorporated in an Act called Public Financial Management Act. In other countries also such important changes in financial management are given effect to by enactment. Changing of rules does not have much impact as these are ignored.
9. There is also a realization that without establishing a central authority for giving basic guidance and setting up norms for better financial management, and guide the CFOs, reforms for better financial management would loose its focus and peter out. The establishment office of Comptroller General (OCG) in Government of Canada within Treasury Board Secretariat for government-wide comptrollership and oversight, particularly the areas of financial management is the step in right direction.
10. To provide a central leadership to improve financial management system in India what is, required is creation of a separate Wing in the Ministry of Finance, for overseeing government’s financial management practices and strengthening internal audit. This wing could be called Financial Management Wing. It should be headed by a person who could be designated as Controller General (Financial Management and Internal Audit). He should be a professional expert.
11. There should be a specific Act establishing this post and creation of the financial management wing in the MoF, indicating its functions relating to financial management and internal audit. The same Act should give statutory mandate for the functioning of the Financial Adviser, enhancing his role emphasizing the controllership function.
12. The multi-year programme-wise budgeting can by itself transform the financial management system into an effective instrument for rational allocation of resources, and thereby revolutionize the entire financial planning process. This would strengthen the role of FAs in expenditure management as no other measure can.
13. Organizations and managers are to be given greater freedom in operational decisions. In return, organizations and managers are more directly accountable for results. In this context reference can be made to attempts to give management orientation to defence budgeting in India in the 1990s, with its objective of achieving enhanced accountability and transparency. The concepts like Authority-cum-Responsibility centers (ARC), budget centers and budget holders were introduced for decentralized management of budget with performance orientation.
14. The same compulsion that made the Central Government implement the scheme of Integrated Financial Adviser for assisting administrative ministries in planning, programming and budgeting should now be the reason for State Governments to introduce the system of FA scheme in various departments where FAs would be the representatives of the Finance Department.

15. It is, therefore, necessary that state governments shifts to multi-year budgeting and give the estimates of revenue and expenditure for a period of four years in addition to the year which the budget pertains.
16. Reduction in number of grants; formulation of demands as per functions and as per controlling officers, would lead to better sense of accountability in the execution of budget. Very often the budgets are prepared on a very unrealistic basis. It is necessary to bring out the assumptions underlying the estimation of revenues and expenditure in the budget document.
17. Internal control and internal audit are weak areas in the financial management in the departments of the states. The proposed IFA should be made responsible for both internal audit as well as accounting in their respective departments, as is the practice in the central government.

## Chapter 4
## Internal Audit and Internal Control

1. One of the main weaknesses of the financial management in Government of India, emanates from the fact that the system of internal audit and internal control in financial management of the government has not been given due importance for securing 'value for money' and accountability.
2. In the context of public expenditure management, internal audit should be viewed as a tool of management and the basic purpose of internal audit should be to review and appraise on the soundness and adequacy of internal controls.
3. Internal audit in central government today is basically a regularity audit, conducted in a routine manner, and the result of this audit on improving the financial management is insignificant. The present position of internal audit in central government is so much in disharmony with international standards and practice that unless urgent steps are taken to rectify the situation, the financial management of the government will remain much below the desired international standards.
4. That the present role and function of internal audit has been the cause of concern to the Government of India is brought out by the fact that at the request of the Ministry of Finance, Department of Expenditure, the Comptroller and Auditor General of India, constituted a Task Force on 17 July, 2006 for benchmarking the status of internal audit in the Central Government and determination of roadmap for its improvement.
5. The Task Force, it is understood, after detailed deliberation came to the conclusion that due to severely restricted mandate and lack of interest of the management, the internal audit has not been able to systematically evaluate the risks associated with various activities of the ministry/department for determining their audit strategies and thrust areas
6. After considering various models that are internationally, the Task Force is stated to have felt that while the Inspector General model of the U.S.A., with appropriate modifications—as the one most suited for effective internal audit, but it might not be possible for implementing that model immediately, reasons for which are not spelt out.
7. The Task Force is stated to have recommended that in the interest of independence of internal audit and its more effective functioning, the ultimate objective of the Government should be to appoint Chief Internal Auditor (CIA), professionally trained in auditing.

8. In the interim period, it recommended that to facilitate moving towards legislated internal audit, a Board of Internal Audit (BIA) might be constituted.
9. The most important feature of Inspector General Act of 1978 in USA was to combine internal audit and investigations into programmes and activities under one authority that of IG.
10. To detect fraud and misuse of public money, there would be need for forensic audit. Internal audit teams placed within the departments should be suitably empowered to investigate cases where initial audit findings indicate fraud or corruption.
11. CAG's audit observations indicate several deficiencies in internal control and internal audit which needs to be rectified by installing appropriate systems and institutional mechanism.
12. The State AG need to be given greater authority relating to audit matters of the State by appropriate legal recognition.
13. Suitable provisions could be incorporated in the proposed Public Financial Management Act (Chapter 3) for appointment of a Chief Internal Auditor (CIA) in each ministry/department in the rank of Addl. Secretary. He should be entrusted with responsibilities of both audit and investigation. The proposed Controller General (Financial Management and Internal Audit) to be located at Ministry of Finance could provide the necessary leadership and coordinate the functioning of CIAs. In consultation with CAG, he should also be responsible for laying down the norms of conducting internal audit.
14. There should be Audit Committees in each ministry/department. It should be headed by the secretary of the ministry/department. This committee should also consist of Chief Internal Auditor, Financial Adviser, CGA/CGDA/Financial Controller (Railways), as the case may be and the head of the concerned unit or division of the ministry. Subject experts may be associated wherever necessary. The Audit Committee would give concurrence to audit plan covering various activities of the ministry/department on a quarterly basis, as also for reviewing the actions taken on the earlier recommendations of the internal audit report. The audit committee should be sub-committee of the Financial Management Board. The Board should also decide on the action to be taken on the internal audit reports, as also that of the external audit.
15. In consonance with the principles of decentralized model of resource management, we have recommended adoption of model of Integrated Financial Adviser system in the state governments for moving towards outcome-oriented and performance budgeting. As in the central government model the integrated financial advisor should be monitoring the functioning of the internal audit wing of the department to which he is attached, while being responsible to the department of finance of the state government. This point requires careful pondering over. In this model, the financial adviser will also function as the chief internal auditor and report to the secretary of the department.

## Chapter 5
## Accrual Accounting for Better Accountability

1. It has often been argued by financial management experts that for large number of developing countries, moving to accrual accounting is of dubious advantage.
2. In this context, three things should be kept in view. First, undertaking any major reform is really a journey not an end state. Systematic efforts would have to be made over a number of years to implement it. In this process many of the hurdles mentioned, may be successfully overcome. Second, the effect of any such major

reform process on the mindset of the management should not be ignored. Third, in India, some of the municipalities have successfully switched over to accrual based accounting system.

3. We should aim at modified accrual basis for accounting.
4. For introducing accrual accounting it is often felt that adopting an accrual classification structure that facilitates the recording of revenues, expenditure, assets, liabilities, and cash flows should be considered as the first major step. The next step logically should be, introduction of general ledger based double entry system. Considering the expertise available in government sector in accounting, this step could be quite difficult to implement. This hurdle can only be removed in medium term by initiating intensive training of accounts staff and accountants.
5. As recommended by the Twelfth Finance Commission, considering the need for qualified and professional accounts staff and training for capacity building particularly in the context of our recommendation for changeover to the accrual based system of accounting, we recommend that a National Institute of Public Financial Accounts be set up by the government of India and its charter be decided in consultation with C&AG.
6. For developing a proper implementation strategy the earlier reservations of C&AG and CGA regarding introduction of accrual accounting have to be kept in view.
7. Establishment of a Steering Committee at an appropriate level for implementation of the project accrual accounting should be regarded as the most important step. Considering the challenges involved and hesitations mentioned earlier, it should be headed by no less than the Finance Minister.
8. There should also be an Executive Committee headed by Finance Secretary, among other things, for appointment of technical advisors, setting up consultation groups, project managers, team leaders, project quality assurance and audit.
9. For setting up accounting standards the Comptroller and Auditor General of India has set up Standards setting body, the GASAB. It is for consideration whether the government dominated composition of GASAB will enable it to function as an independent body,
10. From the experience of introduction of accrual accounting in selected municipalities of the country appropriate lessons can be derived for drawing up an implementing strategy. For example, the preparation of accounting manual is very important stage of the reform implementation process. It served as the foundation on which the entire edifice of the improved accounting system will stand. Therefore, utmost care must be taken for its preparation and it should be given utmost priority.
11. Introduction of accrual base double entry accounting system is greatly aided by the application of computer technology.
12. Accrual accounting assists in re-focusing public attention on state of long term community and infrastructure assets (such as hospitals, school, roads, bridges) and the linkage between assets and service delivery objectives.
13. Accrual based reporting gives decision maker broader range of options in managing assets. Assets information disclosed in the balance sheet together with depreciation charges and maintenance costs in the operating statement would be extremely useful in financial planning and decision making over time.
14. The primary advantage of an accrual system is that it permits an explicit recognition of the full extent of the liability and the relationship of the annual budget provision to the full liability.
15. The value of any accounting system would be judged by the use to which it is put. The aim should be to bring about total financial management reform, not just

accounting reform. The implementing agencies for accrual accounting should therefore review the entire accounting and financial reporting system with a view to make it more efficient. Then only the true benefit of introducing accrual accounting system would then be achieved.

## Chapter 6
## Computerization of Treasuries and Flow of Funds in States

1. Treasury system being the core of the state finance management system, emphasis should be given for its computerization. A computerized treasury system facilitates, (i) better cash flow management, (ii) effective monitoring of budget execution, (iii) better accounting of receipts and expenditures and reporting thereon, and (iv) pre audit of government bills. It can provide timely and accurate receipt and expenditure reports.
2. The computerized treasury will bring in more transparency and accountability.
3. Immediate attention should be paid to comprehensively computerize all departmental financial activities, establishing a central database, improve connectivity with finance department and treasury system, and training of officials to handle the computerized activities
4. In the computerized environment it is possible to ensure the pre audit of the bills. With the provisions for budget monitoring, the system will automatically check for the genuineness of the drawing authority and the claim, budget availability, and arithmetical accuracy.
5. The level of computerization across states is not uniform and in many cases comprehensive computerization of financial activities of various departments has not been carried out.
6. There are problems with regard to developing appropriate software for this purpose and availability of networking facility to connect all the treasuries in the state. The states which have not yet started computerization of their treasuries need not go for development of new application software. They can replicate the software already used by other states where the computerized system has shown good results.
7. After establishing online computerized treasury system, other important modules such as pension, Human Resource Management System (HRMS), debt management etc should be integrated with the computerized treasury sequentially depending upon the computerization of individual databases.
8. The present treasury system in the states, does not capture many transaction that are in the nature of transactions between central and state governments and transactions of some departments that lie out of the treasury system like Letter of Credit (LOC) transactions, inter state adjustment done at Accountant General’s level, adjustment of Government of India Receipts to the states and repayment of loans by the state to the Government of India which are adjusted at central accounting system (CAS) at Nagpur. To overcome these problems following recommendations are made;
    a. The CAS Nagpur should publish in their website the complete information on fund released from government of India and the state treasuries may be given permission to access this website
    b. Government of India should release all CSS funds through the State budget so that expenditure tracking and monitoring of financial progress relating to CSS and generation of detailed expenditure reports can be done by the state treasuries.

c. The charter of accounts providing standardization of accounting structure across the states would enable the GOI to monitor the actual expenditure in different schemes at national level on real time basis.
d. Accountant General of the State should inform the treasury department of receipt and adjustment of various grant-in-aids, loans, and pensions etc. on day to day base in a detailed manner, which will facilitate generation of real time receipt and expenditure reports.
e. The database of Agency Banks should be linked with the treasury
f. To get the real expenditure reports the drawal through payees receipts should be abolished by amending the financial code.
g. The LOC system needs to be abolished and the financial transaction of departments Public Works, Irrigation and Forest Departments should be carried out through the treasury.

9. The HRMS database should be created with all relevant details of individual employees and linked to the treasury database. This will facilitate the treasuries to generate salary bills automatically and disburse the salaries through employee's bank account. A full fledged HRMS can be of great help in eliminating fraudulent claims, preventing ghost employees and pensioners and excess payment of salary and pension and family pension which are common in any manual system.
10. It is essential to bring in the transactions of PRIs into treasury fold for better financial management.
11. With the computerization of treasuries the payments to the beneficiaries can be made directly by crediting to their bank accounts by the treasuries. Mobile banking will be helpful for the direct payments to the beneficiaries from the treasury.

## Chapter 7
## Strengthening Financial Management through Computerized System

1. Adopting a good financial management information system (FMIS) is widely acknowledged as an important step that contributes to improved governance, by providing real time financial information for effective administration of programmes, development of budget and management of government resources. Computerization of various public expenditure management processes is the core element of FMIS.
2. The FMIS implemented in an integrated manner can also act as a deterrent to corruption by enhancing transparency and accountability.
3. FMIS also leads to better financial control by providing, (a) information relating to various aspects of financial transaction starting from budget releases, commitment, purchase, payment process, reconciliation between various accounts including that of the banks, and accounts could be maintained in an integrated manner, and (b) a complete and up to date picture of expenditures and commitments for expenditure on continuous basis.
4. An IFMIS in the government system basically means integration of core financial management activities carried out by several agencies such as planning, budget formulation and execution, cash management, debt management, treasury systems, accounting and reporting.
5. The first step in this regard is to computerize the treasury operations, which then needs to be integrated with various financial modules used by different departments like planning, budgeting, accounting, works, auditing etc.
6. The basic requirement for a good IFMIS is that all the financial activity of the departments should be fully computerized and integrated with the treasury system.

The departments can have their separate databases and these data bases need to host at the state datacenters.

7. An ideal computerized financial management system for the state should have a common database and application Software which should cater to the needs of the finance department, planning department, treasury department, budget preparation, H.R.M.S., payroll and pension payments, debt management, commitment for Work approval, procurement, accounting, and auditing. In the present scenario building such an ideal system is difficult mainly due to absence of a common platform catering to the needs of all the Government departments and organizations.
8. Given this the next best alternative is to exploit the present computerized systems available with different departments by integrating them using suitable software.
9. Considering the importance of financial management of states government of India should extend full technical and financial assistance to the states. It is, therefore, advisable to set up an apex body at the national level to develop suitable financial management software for establishing IFMIS in the states. The apex body in addition to meeting software requirements should also provide guidance in establishing IFMIS.

## Chapter 8
## Parliamentary Financial Control

1. The appropriation accounts prepared by the CAG indicate that the Ministries/Departments go in for unnecessary supplementary grants. There are also the phenomena of huge amount of unspent grants from the budgetary grants. These indicate that original budget estimates, which are passed by the Parliament has lost its sanctity. What prevails is the soft budget regime, which is inimical to proper expenditure planning.
2. Easy availability of additional funds through supplementary grants leads not only to unrealistic budget estimates but also to subsequent surrender of unspent funds. These phenomena bring out the necessity of amending the Art 115 of the Constitution, pertaining to Supplementary Grants, making it more stringent. Supplementary demands should be considered only when there are exceptional grounds for it, nature of which should be spelt out by suitable amendment of the Art 115 of the Constitution.
3. Public Accounts Committee of parliament have also taken serious view of these unspent balances, which reflected on the injudicious budget estimates/utilization funds. The Ministry of Finance taking note of the PAC’s observations have issued several directives to the ministries and departments to make realistic assessment of funds by strengthening existing mechanism of monitoring and review. But the malady continues.
4. This recurring malady afflicting the budgetary process is really due to systemic fault in budgeting, and unless the budgeting system is changed, these problems would continue to occur, and any amount of monitoring and control would not help.
5. There is therefore a need for enactment of a Budget Law providing for;
    a. Stricter provision for supplementary demands, making it an exception rather than the rule
    b. Introduction of the concept of programmes and sub-programmes in budgeting
    c. detailed costing of programs, on a multi-year basis so that it could provide basis for budgeting keeping in view cost of inputs
    d. multi-year budgeting on the basis of costing of ongoing programmes with carry out of funds which could not be spent from one year to the next

e. detailed review of the programme to examine the results and costing pattern, as part of the budgetary exercise (in fact programme review should preceed the budget exercise)
f. Making Chief Accounting Authority and Financial Adviser responsible for realistic budget formulation and making them accountable, if significant surrenders of budget allocation take place.

6. If parliamentary control over expenditure is to be real, the functioning of PAC has to be more effective. It has been suggested in a Consultation paper on "Efficacy of Public Audit System in India", submitted to "National Commission to Review the Working of the Constitution", that PAC be made a constitutional body by amending the Constitution. The life of the Committee be made five years to co-extensive with the life the life of the Parliament/State Legislature.
7. Making PAC a constitutional body and making its term coterminous with the life of the Parliament/State legislature would help in making this institution play a more effective role in improving the expenditure management of the government.
8. To make Estimates Committee an effective body, it can be assisted by the CAG, in examination of policy related issues in financial management, including budgetary and accounting reforms. The audit reports of the central government as well as states now contain large number of reviews on various development schemes and programmes. Some of them contain very important observations which have bearing on policy issues. But the departments concerned hardly show any interest in them. As a result, much of the work done by the Audit Department goes waste. It is for consideration whether the Estimates Committee could be mandated to go into performance audit reports particularly to look at the policy issues involved.
9. What can straightaway be done is to entrust the Standing Committees of various departments to examine the CAG's reports both relating to department's regulatory audit, as also performance audit. The Standing Committees after examining the reports can make their own recommendation to rectify the deficiencies and ask for action taken notes on the recommendations made within a stipulated period.
10. For establishing parliamentary control over expenditure, Parliament may consider revising CAG (DPC) Act 1971 to remove the limitations of CAG's power of making scrutiny in respect of any body or authority receiving grants or loan if it is less than 75 percent of total expenditure of these bodies. The CAG Act also stipulates that audit should be subject to the "provision of any law", applicable to that body or authority. Thus, an authority, fully funded by the government, can be set up under a statute, which may not provide for CAG's audit. There are also other limitations, which restrict ambit of CAG's audit that needs to be looked into.
11. In this context new connotation of 'public money', which is much wider than before should be kept in view. The interest of Parliament should cover all those cases where public money is spent.
12. There should be a suitable mandate to CAG by a legislative provision to enable audit to investigate cases where there is suspicion of fraud, by in depth examination of relevant documents, putting questions to persons likely to have knowledge about the matter, to enable it to come to a conclusion. It would help in creating a right environment for ensuring probity and accountability.

# Chapter 1
# Introduction

In considering the issues relating to strengthening financial management system in government sector in India, we have concentrated on issues pertaining to expenditure management. This is for two reasons;

- Barring sporadic attempts at improving the system through introduction of some budgetary techniques (which did not succeed), there has been no systemic look at basic issues involved in expenditure management,
- It is only through better expenditure management that 'value for money' for the tax payers' money could be achieved.

In developing our approach we have taken note of initiatives taken by the Ministry of Finance in recent years towards better expenditure management as seen from the steps regarding revising the charter of financial advisors, setting up a task force for improving internal audit, steps taken towards output/outcome budgeting, and decisions regarding introduction of accrual accounting. We have suggested some institutional and organizational changes without which we feel the intended aims of the reforms would not bear fruit. These issues have been covered in separate chapters.

Emboldened by the impact made by the FRBM Act on expenditure control and taking in account of experience of other countries undertaking financial management reforms, we have stressed the necessity of suitable legislations like Public Finance Management Act, a Budget Law, and suitable amendment to CAG (DPC) Act 1971. Some steps also have been suggested for strengthening Parliament's control over financial management.

For ensuring transparency and accountability in the flow of funds, computerization and networking of treasuries in the states have been recommended, which has been covered in a separate chapter. The ultimate goal would be to aim at instituting Integrated Financial Management System in which computerization would be the most important tool.

We have, however, realized that a piecemeal approach to reforms in public expenditure management would be ineffective. What we need is a coherent approach to expenditure management, with a view to bring about systemic change in the process of expenditure decision making and control, so that reforms in various components relating to financial management, fall in place and reinforce each other within an overarching concept and philosophy. Introduction of multi-year budgeting of an appropriate field in expenditure decision making could be a major step in this direction.

Do we have a model to draw appropriate insights, which has proved its efficacy over years in expenditure management and has not lost its relevance? Yes, we have in the Public Expenditure Survey (PES) of UK, which was introduced in the wake of Plowden Committee report of 1961. The Plowden Committee decided that weakness of the traditional system of the decision-making and control was piecemeal handling of public expenditure. They said that the big issues of public expenditure should be looked as a whole over a period of years and in relation to prospective resources. This judgment was based on three propositions. First, if all expenditure decisions are taken independently of each other, there is no reason to believe that it will conform with realistic view of what the nation can afford or correspond to coherent set of priorities. Second, one cannot get grip over expenditure by looking only at next year, for this is wrong time scale. A gradual build up of cost is usual in most programmes. That is why a multi-year approach in computing costs of programmes and resource allocation, for expenditure planning and control. Third, in Plowden Committee's judgment, expenditure decisions cannot be taken realistically unless necessary resources are considered at the same time.

For implementing the approach of Plowden Committee, the Public Expenditure Survey Committee (PESC) was constituted. Several innovations[1] were brought about through PESC system;

a. Classification of all public expenditures as one entity, divided into programmes, which represent coherent subjects for ministerial consideration.
b. Collective decisions by ministers on public expenditure and resource allocation.
c. Inclusion of time beyond two years ahead, in the arrangements of public expenditure planning and control.

[1] Sir Richard Clarke, Public Expenditure Management and Control, (Edited by Sir Alec Cairncross, MCMILLAN Press, 1978, p 151

d. Establishing relationship of future expenditures to future resources.

These ‘innovations’ of 1960’s which have now become quite commonplace, have provided inspiration for reforms in expenditure management in several countries in the endeavour towards planning and control of expenditure and achieving value for money.

What is most surprising is that these ‘innovations’ had not made much impact in our expenditure management system is indicated by the fact that we continue to take a fragmented view of government expenditure, classifying them under plan and non-plan. Classification of expenditure rigidly into revenue and capital which is a hallmark of input oriented budgeting that we follow, does not help in bringing about the programme concept in expenditure management. We continue to follow piecemeal approach to sanction of schemes and in budgeting and we have only the ensuing year to consider. Programme concept is absent in our budgeting and resource allocation process reflects absence of costing of programmes. There is no evidence of collective decisions of ministers regarding allocation to programmes. We have no system of costing of programmes on a multi-year basis, so we are unable to link future expenditure to likely availability of resources.

It is really surprising that though we adopted the Westminster model of public administration, in this very important field of expenditure management, we have virtually chosen to ignore these innovations in UK followed by other Commonwealth countries, in improving the expenditure management system.

The need for closely looking at the experience of PESC and incorporating strong points of that process in our expenditure management system is stressed in the very first chapter. Considering that the PES is an evolving concept, its experience need to be studied at depth to consider which features are to be incorporated in our system

The secretaries of the departments have now been designated as Chief Accounting Authority with extensive responsibilities for ensuring better financial management of their respective departments. This point has to be prominently kept in view in any reform measures that are undertaken for better financial management.

In view of importance of assigning *inter se* priority among programmes and for monitoring of progress of programmes and its impact on budgetary management, a Financial Management Board, headed by the chief accounting authority, should be constituted in each ministry and departments.

Internal audit is the weakest link in the chain, which requires immediate attention by undertaking suitable reform measures. Internal audit should be regarded as an integral part of financial management system.

As per modern conception, proper role of internal audit is to assess and report on internal control system of an organization. It is to be treated as an important tool of the management to remove the weaknesses existing in the control system of the organization. The mandate of internal audit should emanate from the top management. The report of internal audit on assessment of various aspects of internal control system should receive the attention of the top management, to take necessary corrective measures. We are yet to recognize the importance of internal audit in improving the financial management system

The role of Integrated Financial Advisers (IFAs) who are expected to play a pivotal role in the financial management of a ministry/department needs a re-look. Couple of years back Ministry of Finance attempted to redefine the charter of IFAs in view of changed circumstances. But as would be discussed in a separate chapter, the major issues have not been attended to. For example what would be the role of financial advisers, in the scrutiny of proposals and programmes, in the context of budgetary reforms that are being attempted? Can his/her role be confined only to `macro-management'? What would be the role of Ministry of Finance in the scrutiny of proposals and programmes and what would be the mode of interaction between the financial advisers and the expenditure departments of Ministry of Finance? Is not dual loyalty (to the department they belongs and the Ministry of Finance whom they represent) on the part of financial advisers to some extent necessary? Is it not the dual role of financial advisers is an advantage both to the spending departments and the Ministry of Finance? IFAs had earlier acted as a bridge between the departments to which they are attached and the Ministry of Finance. This role seems to have declined to the detriment of better understanding of each others' problems and compulsions. In this regard, the role of secretaries of the ministry/department, who are now designated as the Chief Accounting Authority, and as per General Financial Rules (as amended) and have very important role to play in the financial management of the ministry/department, have not been delineated while redefining charter of duties of the financial advisers in June 2006.

Another important question is, can the integrated financial advisers of different departments be brought together in an institutional sense to have a common understanding and common purpose in bringing about a better financial management.

Many of the issues can be tackled in a meaningful manner with a proper system of expenditure management as happened in UK after introduction of Public Expenditure Survey Committee (PESC) procedure in 1960s.

In 1940s and 1950s, the Principal Finance Officers (PFOs) in UK, who are equivalent to IFAs in Ministry/Department) did not deal very much with each other. The initiatives to get the PFOs together came from Treasury to infuse them with a sense of common purpose. The frequency of contact among them increased through the system, because they constituted the Committee of PESC. The role of PFOs got strengthened by the introduction of the PESC system.[2]

Keeping in view above experience, one can visualize that the IFAs in the Central Government of India, would be able to play a more positive role in the financial management of various organizations, by introduction of a expenditure management system as in the PESC system, which are based on sound principles of public finance and at the same time innovative in outlook.

Merely changing the format of the budget, and/or the budgetary process would not be enough to bring about necessary reforms in financial management if the aim is to achieve the value for money and delivery of service at economical cost. Important institutional changes are required backed up by suitable legislation, if the reforms measures in financial management are to get necessary boost and become self-sustaining. If these measures are not taken, then the result would be as dismal as the past efforts towards reforms. Introduction of 'Agency' system in the delivery of the services as in UK should be one of the key element of reform in public expenditure management in the quest of value for money.

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[2] see Hugh Helco & Aaron Wildawsky, "The Private Government of Public Money", MACMILLAN – 1974, p.127

# Chapter 2
# Basic Steps towards Better Financial Management

## Introduction

Financial management in a developing economy like India has to be seen in the context of fiscal challenges. The revenue generation capacity has to match the enormous sectoral demand for resources for economic and social infrastructural needs. If there are significant fiscal imbalances, then it may lead to inflation and balance of payment crises. There has to be fiscal consolidation through fiscal reform, before budgetary reforms, expenditure planning and other management reforms pertaining to resource management can take roots.

Attempts can no doubt be made to bring some of these reforms, but there cannot be pursued with vigour, because of basic uncertainty of the resource position, leading to adhocism in decision making. Integral relationship between revenue and expenditure is required to be kept in mind, though we will be concentrating on public expenditure management.

Good financial management includes both collection of sufficient resources from the economy in an appropriate manner as also allocating and use of these resources efficiently and effectively. Public expenditure management is only one of the two instruments fiscal policies. The other one being, generating sufficient resources for carrying on the activities of the government without impairing incentive for higher productivity and income generation. Good expenditure management calls for expenditure control, allocation resources according to policy priorities and good operational management. Good operational management in which minimizing cost per unit of output and achieving outcome for which outputs is intended. Optimal resource allocation involves distribution among programmes on the basis of priorities determined at the policy level, which should get reflected in the budget. As policy goals are required to be met within resources likely to be available in medium term, multi-year programme bringing out the cost implications, is required. It is now universally accepted that multi-year perspective is very important for good budgeting. This calls for expenditure plans and linking budgets to expenditure plans.

For a long time financial management in developing countries was viewed as a process that enabled central agencies like Ministry/Department of Finance to keep "spending agencies under control through continuous review and specification of inputs and verification of documents, submitted for payment. As an extension of this approach, financial management was viewed as being restricted to budget implementation, administration of payments systems, accounting and reporting in the states of funds received and spent. This approach with a long lineage continues to be prevalent even now, through declining scale.[3]

Subsequent reforms in financial management concentrated on the use of government budget as a vehicle for economic development, through improved budget classification system. Cost benefit analysis technique was also applied. From the 1970s the need for containment of fiscal deficits through tightened fiscal management, pre occupied the economists. In the 1980s the management approach came to be prevalent which included a corporate type of financial management within an overall framework of accountability. The overall assessment is that system of financial management in developing countries has generally been slow in adopting itself to changing requirements. Basically, there has been a segmented approach at reforms. There is also a perception of considerable waste of public money.

## II

### Recent Initiatives in Expenditure Management

In India, the enactment of the Fiscal Responsibility and Budget Management Act (FRBMA), 2003 provided statutory mandate and lent credibility to fiscal reforms process. Both the fiscal deficit and revenue deficit has came down since then to manageable proportions, opening a great opportunity to bring in much needed reforms in expenditure management by introducing expenditure planning and budget management. These would, however, require practical and institutional support and statutory mandate. If determined efforts are not made now to put these reforms in place, then there may not be optimum utilization of resources and fiscal imbalances may again develop due to profligacy in

[3] A. Premchand (2005), Controlling government spending, the Ethos, Ethics, and Economics of Expenditure Management, Oxford, p.5

expenditure, nullifying the efforts made through the FRBM Act, to improve fiscal management.

States have also joined the process of fiscal consolidation in line with Twelfth Finance Commission recommendations (TFC) and are complementing the efforts of the central government. Following the example of the central government, 26 states have already enacted fiscal responsibility legislations.

To quote from the Economics Survey 2007-08, “The fiscal situation of the States have shown considerable improvement, which is even better relative to the performance of the central government, post-FRBM. As a proportion of GDP, the fiscal deficits of the states declined from 4.4 percent in 2003-04 to 2.3 percent in 2007-08 (BE). The aggregate revenue deficit of the states was 0.1 percent in 2006-07 (RE).”[4] As per the Economic Survey, the states on a consolidated basis were expected to have a revenue surplus of 0.3 percent of GDP in 2007-08. An incentive based fiscal transfer as recommended by TFC, by embedding it in the framework of fiscal consolidation, has played an important role in its success. This opens up the opportunity for bringing in reforms in expenditure management in the states by institutionalizing medium term expenditure planning.

In India, uptil now, there has not been a coordinated effort towards improvement in public expenditure management system. The efforts that have been made by Ministry of Finance, have been mainly confined to issue of circular and memos to the secretaries of the Ministries/Departments and the integrated financial advisers and holding of some workshops. There has been no effort towards institutional reforms or process reforms. Budgetary process remained almost untouched from the reform process. Basic attempts is towards expenditure control, through circular on economy measures and ad hoc cuts; for example imposition of 5 percent mandatory cuts on non-plan expenditure, ban on creation of non-plan posts, and austerity measures like ban on purchase of vehicle restriction on foreign travels etc. The basic aim is stated to be to contain non-development expenditure and thereby releasing additional resources for development expenditure.

[4] Ministry of Finance (2007), Economic Survey 2007-08, Chapter of Fiscal Developments and Public Finance

For better cash management system in central government “a modified exchequer control based expenditure management”[5] has been introduced along with restriction of expenditure during last quarter of the financial year. The aim is to obtain greater evenness in the budgeted expenditure within the financial year, reducing risk of expenditures during last quarter, especially the last month of the financial year, reducing the tendency of parking of funds and monitor the expenditure patterns. The scheme is to apply to 23 demands for grants listed in Department of Economics Affairs (Budget Division)[6]. In respect of each of these demands, monthly expenditures plan (MEP) separately for plan and non-expenditure is required to be worked out. Even in respect of demands for grants not covered in the modified exchequer management system, it has been advised that the expenditure in the last quarter should not exceed 33 percent of the budget allocation for the demand for grants. In the event of revised estimates being fixed lower than the budget estimates, actual expenditure are to be kept within the revised estimates.

It is indicated that the Financial Advisers (FA) would be responsible for the implementation of modified expenditure management system. This in effect, gives FA a treasury control role which was sought to be removed from FA’s scope of work when the integrated financial adviser scheme was introduced in 1975. Introduction of MEP indicates that there is a basic cash management problem. If this problem of cash management is not overcome it would be difficult to introduce other budgetary reforms aiming towards `output’ oriented budgeting. It is well recognized that input-oriented budgeting is best suited for cash management purposes and for strict budgetary control.

In this background, initiatives taken for improvement in public expenditure management[7] by the Ministry of Finance as indicated in the DO letter of December 2006 by the Secretary, Department of Expenditure to Secretaries of administrative departments need to be mentioned. The nature of initiatives mentioned indicated in the letter, however, keeps one confused about the goal. The most important initiative, which is mentioned, first, is the “Revised Charter for Financial Advisor and Chief Controller of Accounts with a view to redefine their role, responsibilities and accountability, authority and facilitate

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[5] OM. No. 7(2)E/Cord/2007, department of Expenditure, dated 17 September 2007
[6] Memo No. F.No. 21(1)-PD/2005 dated December 27, 2006
[7] D.O. letter Secretary, Department of Expenditure NO.7(3)/2006/E. Coord) dated 21.12.2006

capacity building". While role of the FAs in financial management of the government is very important, it needs to be stressed that improvement in public expenditure management cannot start with redefining the role and charter of financial advisers, who can at best play a supportive role in management of reforms.

The next major point in the DO relates to strengthening of internal audit, reference is made to letter under which C&AG of India was requested to constitute a Task Force to benchmark the status of internal audit and suggest road map for reforms. It also indicates that the report of the Task Force has been received. But the decision in the matter is not indicated. Does it mean that Ministry of Finance is not keen on redefining the role of internal audit giving it a revised mandate and strengthens it institutionally?

The other points mentioned are about the economy instructions issues. It probably need not be pointed out that economy instructions in public expenditures stand on their own, and remain relevant all the time. But economy instructions do not have a direct bearing on public expenditure management which cover *inter alia* policy control and process control measures. Another point relates to manual on 'works' 'Consultancy' and `Goods' which have been circulated to Ministries/Departments. These are unlikely to have much impact on expenditure management.

Among the reforms, mention is made in the DO letter, about the guidelines issued for preparation of Outcome Budget for 2007-08. In the guideline it is indicated that the Performance Budget and Outcome Budget are to be merged into a single document; requiring ministries to link release of funds with progress in achieving monitorable physical progress and putting in place formal monitoring mechanisms to monitor progress against commitment made in the Outcome Budget.

Immediately, after the mentioning about initiatives regarding 'outcome budget', is the concern shown for cash management stressing the need for ceiling of 33 percent (of the budget estimates) in the last quarter of the financial year is mentioned and it is stipulated "that during month of March, the expenditure should be limited to 15 percent of the Budget Estimates". If the cash management is to be the overwhelming concern, then, one wonder how `outcome' budgeting can be given required emphasis.

## III

## The Budgetary Process

Time has come for conception and implementation of a budgetary process, which gets linked to expenditure management process, with the objective of control of expenditure. ‘Control’ has to be conceived of in a wider context, not only in terms of compliance with budgetary provisions, but in terms of achieving value for money in government expenditure and accountability for resources used. Budgetary process should, therefore, be so designed that it enables specification of objectives linked to policy and allocation of resources to achieve the objectives with efficiency and effectiveness while operating within a ‘ceiling’ concept or total spending. **The reforms in the budgeting process should act as a driving force for bringing in other reforms in financial management. Reforms in the budgetary process should therefore be the key element in the efficient and effective public expenditure management process, and not just another element in the reform process. Experience of other countries could usefully be drawn in this regard.**

The concepts of Performance Budgeting, Output Budgeting, and Zero Based Budgeting are not new concepts in Indian public expenditure management. Attempts have been made in the past to introduce them but without success. Among the major reasons for it is non-adoption of step-by-step approach backed up by institutional reforms and not giving adequate attention to budgetary process itself.

A generally accepted first step beyond input based budgeting (line item budget) involves identifying who is spending money and on what. A programme based budgeting helps in this process, when focus is on identification of planning and spending objectives, and treating budget as a means of attaining the policy goals. It helps the departments in conceptualizing its operations in terms of what it does, rather than what input it uses. This helps in linking appropriations with performance and activities. The programme based budgeting approach in the first step towards accountability, as it helps answering basis question about what is being done with the money being allocated to a department/ministries.

As the South African model of budgeting reform (following the Australian model) suggest, in the next step the **key output indicators** and **targets** relating to each programme are stated. "This is an important step towards fulfilling requirement in form of the Public Finance Management Act 1 (of 1999) that measurable objectives for main spending programme be submitted to Parliament".[8]

It needs to be pointed out that while we can be concerned with output/outcome budgeting, we are yet to take steps towards the programme concept in budgeting. Programmes are group of activities that complement each other aiming at a common objective.[9] Allocation of resources on the prioritized programmes should be the first step towards output budgeting, the basic building block for which would be the activities under each programme or sub-programme.

It would, however, be incorrect to say that programme concept is totally absent in budget formulation process. Rather, there is a dichotomy of approach. While formulating the budget, the Departments and Ministries are told, "It is necessary to review the Expenditure Budget in the first instance, to prioritize the activities and schemes, both as the Plan and Non-Plan side and identify these activities and schemes, which can be eliminated or reduced in size or merged with any other scheme. All Ministries and Departments are expected to take up the exercise of reviewing/evaluation of all ongoing schemes/programmes to determine their continued relevance"[10]. But the approach towards formulating the budget is to follow the traditional system of input budgeting. Unless the budgeting process is activity based, where prioritization takes place at various levels of management, it is not possible to schemes at the end of the process.

As it is an input-based budgeting, review of programmes and schemes leading to reduction or elimination of some actions could not help in determining the effect on estimates regarding various inputs like salaries, stores, and maintenance expenditures. That it is essentially an input-based, budgeting is evident from the fact that in formulating the budget, a "bottom-up" approach is to be followed as in the past. To quote from the

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[8] Mathew Andrews (2005), "Performance-Based Budgeting Reforms", Fiscal Management, *ed*. by Anwar Shah. The World Bank, p. 41.

[9] Budget Circular 2008-09 dated 20th September 2007 issued by Budget Division (No.F,2(25-B(D)/2007, para 3.2.1

[10] Ibid

same circular, “Ministries/Departments will, as usual arrange to obtain estimates of expenditure for the current and next year from various organizations and units under their control. The estimates will be securitized by the administrative units of Ministry/Department and forwarded to the Financial Adviser for further examination and processing. The estimates finally recommended by the Financial Adviser will be summarized in the form of statement of Budget Estimates (SBE) and…forwarded to Budget Division of the Ministry of Finance.” (para 3.7)

The fact that it is a bottom-up approach in budgeting that is followed, combined with the point that the final recommendation regarding budgeting estimates is that of the Financial Adviser of the Department/Ministry, leaves no one in doubt that it is totally an input based budget. Programme based budget has to have both a top-down approach for determining the policy objectives and the prioritization of programme, to be supplemented by a bottom-up approach for prioritization of activities for working the costs in terms of inputs to meet the policy objectives embedded in the programme. The top-down approach is totally absent in our budgetary process.

The zero based approach to budgeting, which has been emphasized in the OM dated 1.6.2006 revising the charter of duties of integrated financial advisor (para 9) assumes programme based budgeting. `Decision-packages’ which are the building blocks of zero-based budgeting, are nothing but programmes and sub programmes, on which resources are to be allocated after deciding about the priorities.

In practice ZBB tended to evolve into what has been referred to as “alternative budgeting” which focus not on zero-base but on margins near the current budget base. When zero-based approach is adopted, usually three or more alternative budgets have to be submitted for each programme, one of the alternatives being less than the current budget. That is how marginal approach to budgeting gets introduced. But within the programme concept, the cost and benefit of marginal addition of resources for certain activities cannot be ascertained.

## IV

## Plan and Non-Plan, Capital and Revenue Expenditure: A Fragmented Approach

The budget estimates for Department/Ministries are separately prepared for Non-Plan items and Plan items for various demands for grants. Revenue and capital expenditure has to shown separately. Salary components under any item in the budget have to be shown separately. This kind of classification following the age old tradition creates another kind of dichotomy in approach.

As brought out by the Economic Survey 2007-08, "the distinction between plan and non-plan expenditure is illogical and even dysfunctional. This distinction has led to ever increasing tendency to start new schemes and projects to the utter neglect of maintenance of existing capacity and service levels. The distinction often leads to the misperception that non-plan expenditure is wasteful and should be avoided. This dichotomy has resulted in fragmented view of resource allocation to various sectors.

Apart from the fragmented view of resource allocation, which may lead to wasteful expenditure, this kind of distinction, along with curbing of the salary expenditure, is creating problem of resource allocation in social sector. To quote from Economic Survey, 2007-08, "The problem is assuming greater significance with high priority to social sectors where salary constitutes an important element of the programme. The embargo imposed on recruitment for non-plan posts have caused serious problems of service delivery in health and education sectors. *A need has been felt to draw protocols that will specify the agency for specific function and provide arrangements for coordinate activities* (Page 51 of Economic Survey, Box 3.3).

The last line is clearly a plea for programme based approach to budget allocation, where distinction between plan and non-plan expenditure as also revenue and capital expenditure would not be relevant for determining the priority in allocation as objectives would be the main focus. It is a goal overview approach that is being advocated. But is the Budget Division of the Department of Economic Affairs, listening?

Economic Survey pleads for a re-look at the distinction between revenue and capital expenditure in budget, which leads to another kind of difficulty in the context of

FRBM Act. To quote, "The distinction between revenue and capital expenditure has acquired significance, and needs a re-look, consequent to the situation in the post FRBM period. The FRBM act stipulates that revenue deficit should be eliminated by the end of 2008-09. More than three-fourth of plan expenditure is now revenue expenditures. Strict adherence to FRBM stipulation has a bearing on the ability of the Centre to formulate plan scheme aimed at addressing these new national priorities. Defence expenditure is treated, in national accounts as consumption and then are instances where capital expenditure does not necessarily lead to more investments in the economy" (ibid). These budgeting practices are no more seeking the purpose of achieving national goals. One only hopes that it does not lead to reclassification of expenditure from revenue to capital, to get around the FRBM Act. If the act stands in the way of development goals, the act should be amended.

The basic point is again that there should not be a fragmented view of resource management. And a programme based budgeting with a top down approach would lead to better expenditure management with output orientation.

## V

### Programme Budgeting and Performance Budgeting

Programme budgeting in the shape of planning programming and budgeting system (PPBS) was introduced in the US Federal Government in the mid 1960s. Its core themes were much in common in with earlier strands of performance budgeting.

Programme budgeting aimed at a system in which expenditure would be planned and controlled by objective. The basic building block of the system was classification of expenditure into programme, which meant objective-oriented classification so that programmes with common objectives are considered together.

PPBS went much beyond the core elements of programme budgeting and was much more than the budgeting system. It aimed at integrated expenditure management system, in which systematic policy and expenditure planning would be developed and closely integrated with the budget. Thus, it was too ambitious in scope. Neither adequate preparation time was given nor was stage by stage approach adopted. Therefore, this attempt to introduce PPBS in federal government in USA did not succeed, although the concept of performance budgeting and programme budgeting endured.

Many governments today use “programme budgeting” label for their performance budgeting system. As point out by Marc Robertson the contemporary influence of basic programme budgeting idea, is much wider than continuing use of the label. It is defined in term of its core elements as mentioned above. Programme budgeting is an element of many contemporary budgeting system which aim at linking funding and results. “The extent of ongoing influence of programme budgeting in partly obscured by wide variety of terminology used today to refer to programme such as “outcomes” or output groups (Australia) and ‘Requests for Resource’ (UK)”.[11]

In 1993 USA Congress enacted General Performance Results Act (GPRA) to improve the effectiveness efficiency and accountability of federal programme, where agencies have to focus on programme results. GPRA requires agencies to plan and measure performance using the “program activities” listed in their budget submissions. So it is again performance through programme/activities. GPRA had 7 year implementation time frame, from initial pilot projects to government wide performance reports, incorporating feed-back mechanisms, GPRA’s implementation approach also provided for 2 year pilot project of alternative performance budget approaches in at least five agencies, with regard to spending decision, GPRA aims for a closer linkage before resource and results. As a report of General Accounting Report in Performance Budgeting states “In the sense GPRA can be seen as the most recent event in a almost 50 year cycle of federal government efforts to improve public sector performance and to link resource allocation to performance expectation.”[12]

Bringing out the problem, with past reforms, the GAO Report states GPRA differs from prior initiatives in two important respects. First, past performance budgeting initiatives were typically implemented government wide within a single annual budget cycle; GPRA, in contrast define a multi-year and iterative implementation process that

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[11] Mark Robinson, (2007) “Performance Budgeting Models and Mechanism”, in Marc Robinson (ed) Performance Budgeting, IMF, p 5.

[12] See Report to Congressional Committee, (1997) Performance Budgeting, US General Accounting Office, March

incorporates pilot task and formal evaluations of key concepts. In this manner GPRA increases the potential for integration of planning, budgeting, and performance measure, while guarding against the unreasonably high expectations that plagued earlier initiatives. Second, GPRA will face operating environment unknown to earlier reform processes that is persistent efforts have to be made to constrain spending[13].

But GAO Report on performance budgeting also makes two important points when we talk about outcome oriented budget: (i) past initiatives demonstrate that performance budgeting is an evolving concept that can not be viewed in simple mechanistic terms. It states "The process of budgeting is inherently an exercise in political choice - allocating scarce resources among competing needs and priorities – in which performance information can be one, but not the only factor underlying decision," (ii) GPRA states a preference for outcome measurements while recognizing the need to develop a range of measures, including output and non-quantitative measures. Focusing on outcomes shifts the definition of accountability from the traditional focus on inputs, processes and projects to a perspective centered on the results of federal programs. However, the difficulties associated with selected appropriate measures and establishing relationships between activities and results will continue to make it difficult in many cases to judge whether changes in funding levels will affect the outcomes of federal programmes". [14]

Above points need to be kept in view by our reformers who are attempting to bring in `outcome' budgeting in government budgeting. Since this is a very challenging task, we may look into experience of some other countries in this regard. Let us take the case South Africa, where attempts have been made to introduce outcome budgeting by systematic efforts. In the latter half of the 1990s, with the introduction of the medium-term expenditure framework (MTEF), the South Africa government began restructuring it budget format to show the programmes towards which the departments were allocating funds. The question to be asked is how well have the reforms worked in introducing a

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[13] Ibid
[14] Ibid

result-orientation into budgeting process?. As an informed commentator puts it, the `answer is less than sanguine for the following three reasons[15]:

Firstly, even though performance targets are being developed, they are actually kept separate form the budget not only in South Africa, but also in countries like Malaysia, Singapore, and in most U.S. States, "which undermines their legitimacy,"

Secondly, in South Africa case, for example, as regards performance information, "outputs are confused with inputs and outcomes remain unconsidered." Targets appear to have been technocratically identified which therefore lack real world value. Targets are not spelt out in details making actual measurement unlikely.

Thirdly, and the most important point is that even when effective targets are provided, the budgets in South Africa and many other nations moving toward this kind of system fail to specify who should be accountable for their results, who should hold them accountable. "Very little thought appear to have been given to process of institutionalizing political on marginal accountability for the targets identified in their budget"[16].

So programme budgeting as a top-down objective setting process has failed to bring the outcome-orientation in budgeting as brought out in the above example. It is also difficult to make performance targets as part of the budget formulation process unless managers at various levels get involved in the budgeting process, involving prioritization of activities and resource allocation on that basis.

These experiences make it clear that unless there are institutional reforms, like bringing in the 'agency' concept, where the head of the agencies are treated as CEOs and made accountable for delivery of services in an efficient and effective manner, the reform in budgeting process would be difficult to implement. Only with these institutional changes would there be an inner compulsion within the organization to bring about the changes in the budgetary process.

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[15] Mathew Andrews, (2005), "Performance Based Budgeting Reforms." in Anwar Shah (ed) Fiscal Management, The World Bank, p.32

[16] Ibid

## VI

## Need for Programme Based Budgeting for Output Orientation

Ministry of Finance, as is evident from their recent circulars, keen on introducing output/outcome oriented budgeting. For output orientation in budgeting introduction of programme concept in budgeting is necessary. Programme budgeting, as mentioned above, is top-down approach in budgeting, which emphasizes the planning aspect of budgeting. Programme budgeting involves setting policy level objectives at the top level, and serves as guide for resource allocation decisions on the philosophy that expenditure proposals should be considered in the light of objectives they are intended to serve. Programme categories were to be developed based on objectives to be served. By structuring expenditures so as to juxtapose substitute elements within programme categories and by analyzing costs and benefits of various substitutes, programme budgeting (PPB) opened the door to marginal analysis in budgeting.[17] It was, however, soon realized that, it is not possible to carry out cost-benefit analysis of various substitutes and system analysis as part of the budgeting process. Budgeting process can not bear too much of analyses, as it has to reconcile many competing goals. Further, a purely top-down approach in defining the output/objectives has its own limitation, in that these have to be refined through several levels before they become meaningful for immediate budgeting or operational purpose. These immediate purposes are areas in which decisions are required to be made today.

Proper description of 'output/outcome' or objectives can be done at the agency or organizational unit level, be properly evaluated and measured and can be combined with higher level goals. This should enable a programme to be defined according to the categories and framework within which the agency actually planned its activities. Budget appropriations can be made to carry out these plans. Programme should be defined in such a way as would enable the agency/organization to carry out its operational plans, for it is in their organizational units that details of budget originate. The rationale of programme definition should therefore be, whether it enabled each agency to define its programme according to the categories and framework within which it planned to carry

[17] See Allen Schick (1966), The Road to PPB: The Stages of Budgeting Reforms, Public Administration Review, 26, No.4, December

out its activities. It involves asking questions like **'what should the agency is doing?**' and then the question to be answered is **'for what purpose it is doing it?'** This gives an easy way to follow definition of a programme, which can be used for resource allocation purpose, with which budgeting is concerned.

This is the pragmatic approach towards output/outcome oriented budgeting by basing it on programme concept. This process we call **Programme Based Budgeting,** which is different from Programme Budgeting, which involves a top-down approach to objective setting and resource allocation decision.

A programme in this approach could be defined as broad category of similar services for an identifiable groups of population of a segment of population, for a specific purpose to address the question 'what is to be done and for whom? Sub-programme in this approach can be defined as breakdown of above programme into units which identify more specific services for more specific segment of population. Sub-programmes should be divided into 'activities' which illustrate the way the service is performed for the designated group. These should be the building blocks for the budget.[18]

If we have to bring in output/outcome orientation in budgeting, then a programme based budgeting as briefly described above, is a necessity. This would also help for each levels of management, concerned with budgeting apply zero-based approach, if they are made aware of the resource constraints in specific terms in a multi-year framework.

## VII

## Need for a Medium Term Expenditure Framework for Better Budgeting

The task of formulating estimates of expenditure for the next year tends to be easier when a medium term expenditure forecast is available. As Premchand points out, "Given such forecasts, the task of annual budget is to adjust to exogenous factors, such as change in economic climate, change in cost factors (rate of inflation) or change in discographies profits. Attention could then be focused on new proposals. In the absence

[18] See Paul L. Brown (1978), "Establishing a Program Structure", in Frement J. Lyden and Ernest G. Miller (ed), Public Budgeting, Rand McNally College Publishing Co., 3rd Edition,p185-196

of such medium-term expenditure forecasts, the above factors would need to be given detailed consideration in expenditure estimates, involving deeper probe in expenditure categories".[19] The need for medium term expenditure framework on rolling base for proper budgeting in is essential. Absence of such a framework is a great drawback in our budgeting. This issue needs to be addressed on an urgent basis. Summarizing the problems faced in financial management in developing countries, Premchand indicates that "The viability of any budget depends on information available on computing costs of projects and programmes and macro-economic linkages. The budgetary process should be organized to generate such data needed which is not happening". [20]

"The process (budgetary) is also not generating data on the future implications of current policies on operations and expenditure needed to maintain completed projects. Decisions are therefore piecemeal, some as part of formal budget and some outside the process and budget"[21]. Further, the revenue and expenditure process lacks congruence, which frequently contributes to situations in which outlays are determined without considering resources that would be available. "As a result, there has been a shift from strategic management of budget to tactical approaches that imply changes in policy posture".[22]

Commenting in the beginning of nineties on the results of reforms of financial management undertaken in various countries, Premchand observes, 'Recent experience has shown that governments have to some extent got around the allocation issues before public and private sector, *but have yet to achieve balance among and within programmes. The allocation balance appears to have been further skewed in the context of crisis budgeting as a result of arbitrary limits imposed on budgetary inputs'.* As regards the relevance of Programme Budget Structure he stated, 'Budget structures, which were reorganized to conform to programme budgeting and to promote management bias in government, became outmoded owing to lack of periodic update and to rapid changes in government policies and activities", [23]

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[19] A. Premchand (1983), Government Budgeting and Expenditure Control, Theory and Practice, IMF p. 74-75.
[20] A. Premchand (1990), Management of Public Money: Issues in Government Financial Management, IMF, p.33.
[21] Ibid
[22] Ibid
[23] A. Premchand (1990), 'Management of Public Money', Fiscal Management, IMF, p. 33.

In the reform process the lacunae in budgeting process have to be corrected by providing a proper framework in the medium term. This can not be a fixed framework for say, five years, as changes are bound to be there, caused by both internal and external factors, calling for review of the framework. The review would call for looking into changes in programme contents, emerging inflationary factors, prospects of the economy. Assumptions made for putting together the five year expenditure framework are to be reviewed throughout the year and the framework updated every year. Thus, it should be a rolling expenditure framework, with updating it every year.

## VIII

### Need for A Better Model for Expenditure Planning and Control

The basic problem in applying programme budgeting (which can apply to all attempts at output oriented budgeting) in a developing country was summarized (based on experience in Latin American countries) by A Wildavsky as "Programme budgeting involves not only a need to measure the resources used but also a sensible way of relating them to goals. Often such unit cost measurement is out of question in countries when conditions and standards differ widely. Apart from the difficulty of applying standardized measures, programmes themselves may be hard to identify" [24].

The question that then arises is there no successful budgetary reform model which can be adopted? Wildavsky in his well known book, after studying various reform model indicates that there is one successful budgetary reform in Great Britain, which though different from Planning Programming Budgeting System (PPBS), had major consequences for the way resources an allocated[25]. He was referring to the Public Expenditure Survey (PES) system of U.K. which was introduced in 1960s after the Plowden Committee Report. The survey was done by Public Expenditure Survey Committee (PESC). The PES was started in 1963, which was undertaken by the PESC as a forward survey for five year (the budget year and four further years), and was expressed in constant prices. The Plowden Committee recognized the tendency of the Government to lose sight of future costs and of the long term implications of short term decisions.

[24] A. Wildavsky (1975), Budgeting: a comparative theory of budgetary process, Little, Brown & Co., p. 365
[25] Ibid p 277

They demanded, as a basis for action, that explicit and regular surveys of public expenditure be undertaken over a period of years. The basic point of the Plowden Committee Report was that decisions involving substantial future expenditure should always be taken in the light of public expenditure as a whole, over a period of years, in relation to prospective resources. On accepting this recommendation try the U.K. Government, the PESC system was introduced.

"Fortunately, we can learn much from one major reform of modern times in the machinery of resource allocation, the Public Expenditure Survey Committee. Nowhere else in the world, to our knowledge, has the annual budget been replaced with an effective mechanism to control spending several years in the future".[26]

PESC was the committee of principal finance officers of the major spending departments, chaired by a Treasury Deputy Secretary. It considered reports from the Treasury on the forecasts of departmental expenditure. Though spending plans were in existence earlier in some of UK department particularly in Defence, the Plowden Committee the report helped in giving importance to this innovation. The essential difference after the Plowden Report was that the planning approach was regularized as a system, compared with the earlier piecemeal system. More importantly under the PESC system various plans of different departments were brought together and considered against the growth of national income.[27] The yearly PESC report tried to show the future cost of existing government policies, if policies remained unchanged over next five years. Its aim was to provide clearer perspective so that political administrators can weigh firstly total spending implications of present policies against the financial resources likely to be available and secondly, different expenditure against each other.

The purpose of PESC was not to agree to any particular expenditure level or allocation of resources among departments. Its basic aim was to produce agreement among officials on present and future costing of existing policies. The PESC inter-departmental committee concentrated on efforts on the methodology of projection and presentation. No consideration of relative merits of departmental arguments took place in

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[26] Ibid, p 366
[27] Richard A. Chapman (1997), The Treasury in Public Policy-Making Routledge, p.44

PESC. Substantial disagreements were reserved for direct dealings between department and Treasury.

Initially PESC focused on first and fifth year of a programme. Subsequently costs were projected for all the five years. As the White Paper of 1968, indicated, it was planning the path to follow as well as the whole of expenditure in the five year period. It was believed that work along an expenditure path is a superior method of exercising control than to set a distant goal in the fifth year toward which to work.

Indicating the basic strength of the PESC in resolving the disagreements, Wildavsky writes: “A strength of the PESC exercise is that it goes on year after year. Eventually most initial disagreements a negotiated, and differences between Treasury and departments a narrowed down to a more manageable proportions. To be sure, new disagreements surface continually but they are more readily resolved in the context of a pattern of past settlements. A record of understandings about the meaning of existing policy is built up over years. For the departments, this record protects them against cuts in their accustomed income. The Treasury can also be more confident about the foundations of the five year projections on which it has staked so much. For each participant, uncertainty is reduced and security is increased”.[28]

The reformers also recognized the uncertainty of forecasting, over a period of years. They wanted continuous examination and re-examination of assumptions and search for improved techniques for forecasting. The Committee intended these surveys for internal use of government. The PESC documents were never made public.

**The PESC Cycle**

The PESC system will be better understood if a brief outline is given of PESC cycle as it existed in the 1970’s.[29]

Sometime in November the Treasury sent to the departments a statement about the economic assumptions on which to operate in preparing their individual spending forecasts. These assumptions included likely growth of production potential, consumer

[28] A. Wildavsky (1975), Ibid, p 275
[29] Hugh Helco and Aron Wildavsky (1974), The Private Government of Public Money, MACMILLAN, p 200-201

expenditure, industrial outlook and fixed investments. By the end of February, the spending departments submitted preliminary report to the Treasury, *laying down their five years expenditure projections for existing policies*. The Treasury made a computer tabulation and sent the results to its relevant spending divisions. From March until May, the Treasury spending divisions scrutinized and discussed the figures with spending departments in order to reach some agreement on *(i) statistical assumptions, (ii) on what existing policies are, and (iii) on their preferable future costs*. Agreements on these three issues were by no means a bureaucratic formality.

The inter-departmental PESC committee met in May to write a *report projecting cost of present policies specifying remaining areas of disagreement*.

The preliminary report was then sent to the Chancellor in June with copies to all departments. At that time Chancellor and top Treasury officials juxtaposed the PESC report with the assessment of economic prospects.

On the above basis, a decision was taken whether there was, in their view room for this total public expenditure within the limits of economic resources likely to be available.

In June, the UK Cabinet then heard that the prospects were and whether cuts were necessary or whether there was room for greater expenditure. It was usually found that cuts were necessary. These invited further deliberations. Between June & November the cabinet took its decision which later appeared publicly with annual white paper on Public Expenditure in November/December.

The PESC report, as stated above, was mid-year costing of existing policy before the ministries acted. As such it was a secret document and never published. The PESC report was compiled in the General Expenditure Division of the Treasury showed the level of current expenditure, assumptions on which spending prospects are based and proposed expenditure over five year period.

The report was basically a Treasury document, with an appraisal section written by the General Expenditure Division. *The point that needs to be emphasized is that the purpose of PESC was not to agree to any particular expenditure level or allocation of resources among departments. Rather it was supposed to produce agreement among officials on the present and future costing of existing policies.*

It was a fairly sophisticated system which we believe can be installed with suitable modifications in our country, particularly as we had adopted in many respects in our expenditure planning and management of central government a Westminster model of administration, with bureaucracy playing very important role in the process of budget making. IN this context it worth remembering that in programme budgeting political process plays a dominant role in budget making and allocation, which would be less relevant in our situation.

The advantage of PESC process was that it helped in having collective discussion, as it was an organizational expression of the Plowden Committee concept of looking at public expenditure as a whole.

The aim of collective discussion was to seek an agreed statement of the size and composition of departmental programmes which were carried out and to present these in an agreed form to Ministers for review and amendment. It also enabled dialogue of the Treasury with individual department enabled on the size, composition, objectives and management of their programmes. Its outstanding feature that it was continuous, the reason for it is instantly changing situations with which departments and the Treasury have to deal arising from many causes.

Gradually lot of improvement was made in the techniques of analysis employed in the medium-firm assessment itself.

Use of economic analysis appraisal was employed to assess new programme and projects, which helped in sustained dialogue between the Treasury and the departments, where changes were proposed in existing programmes.

This feature of constant dialogue between the Ministry of Finance and the Departments on the programmes being implemented was a very important feature of PESC process which makes it attractive to us for adoption with suitable modification. The advantage of the PESC system was that once it get embedded in minds, every department starts accepting that there is a kind of a medium term ceiling on expenditure of a rolling kind. Thus, ad hoc spending decisions get discouraged.

In its early years the development of PESC got coordinated with the technique of programme analysis and review (PAR). PAR can be traced back to early attempts in UK in 1960s to introduce programme budgeting into the department of Central Government. PAR was intended to ensure that departments had clear objections and statements of priority. These were presented for central consideration before resource allocation began.

During Thatcher Government the PAR was abandoned and subsequently PESC was also abolished as importance was given to efficiency scrutiny and determined effort was made to reduce the scope of Government activity.

However, reduction in the scope of Government activity cannot be our goal. So PESC procedure would continue to be relevant for us.

Any model of output oriented budgeting would involve institution of a budgetary cycle which would call for evaluation of existing programme looking into existing policies, prioritization of the programmes based on sustained dialogue between the spending departments and the Ministry of Finance, and keeping in view medium term ceiling on expenditure, so that what emerged would be the product of collective decision making. A major input in this process would be the costing of existing programmes in the medium term, based on current policies. All these have to take place in keeping the parameters relating to the resources that are likely to be available in the medium term on the basis of economic analysis. The budget cycle has therefore to be sufficiently long, lasting for almost a year, not about 3-4 months as in our case, which is the hall-mark of input based budgeting.

**PSEC: the Annual White Paper & Transparency**

A major question is how to bring about transparency in public expenditure management in India. We seem to be groping from year to year, in search of a strategy. We are not aware what the government is aiming at in the short run and medium term in the public expenditure management. There is no definite statement of the government in the regard. The budget speech of the Finance Minister, indicates what it aims to do in the ensuing financial year in terms of additional funds for various programmes, in that knowing what will happen after that, and what are the medium term objectives. What is needed is a annual white paper on public expenditure.

The PESC procedure in UK helped in bringing out the White Paper on public expenditure. This was a very major achievement. The emergence of the White Paper as a regular annual report to the Parliament setting out in detail the whole of government's strategy for public sectors in the short and medium term, and also containing an account of the plans and objectives of all major programmes, was of great significance. As a state-document it was unique in the world. It was the business of the Treasury to use the PESC machinery to prepare the White Paper and submit it to Ministers for approval. The White Paper had many aspects. It was a major state-document, in which government disclosed its priorities in the public sectors, and had a close link with fiscal policy. Details revealed of individual programme presented to the world an elaborate picture of government's policies in all major parts of the public sector. The political importance of the White Paper was therefore very great. Apart from being a mine of information for Parliament, public, and academic, it displayed commitments on the part of the government, and deviation had to be explained. The material in the White Paper, therefore, played an important role in the thinking and action of responsible departments.

The White Paper centered around the PESC report and by 1970 became a major instrument for public expenditure management. Sir Sammel Goldman could therefore comment, "By the spring of 1970 therefore, the system of public expenditure management and control had become thoroughly familiar both at the centre of the government machine and to responsible spending departments and was fully functioning for planning, programming and monitoring the public sector".[30] He goes on to add that "…Cause of expenditure as a whole had been established, departmental programme consistent with them, covering a five year period had been designed in detail, agreed with the Treasury and confirmed by Ministers and published as open commitment to Parliament and in world".

This is what we should aim at to achieve transparency with clear focus on medium term goals. A procedure like PESC followed by publication of an annual White Paper would enable us to achieve economy, efficiency & transparency in public expenditure decision making.

In mid-seventies, the UK had to adjust to a depressed economy. As government expenditure was growing more than the growth in income, the five year expenditure outlook was no longer considered appropriate particularly as the expenditure figures for last two years became unreliable. Cash limits were introduced in 1976. The duration of PES was progressively reduced from five to three years. The revised PES made extensive

[30] Sir Samuel Goldman (1973),Public Expenditure Management & Control, HMSO, p.12

use of cash programming which led to both better control of expenditure and better link between PES and annual budget. It also succeeded in getting efficiency gains from spending departments.

In eighties and nineties in U.K., public expenditure survey (PES) continued to remain the key element in the system for medium term planning and control of public expenditure. It covered while of public sector, brought figures for expenditure in previous five years up to date and looked ahead for three years. The key procedures for planning and control are cash limits, control of reserve and supply (budget) estimates. From 1992, the government implemented a number of important changes to the system of public expenditure control, so that it became a more explicitly “top down” approach[31].

Since 1998 for planning and control of public expenditure, UK has operated Comprehensive Spending Review (CSR). The framework of public expenditure is divided between Departmental Expenditure Limit (DEL) spending, which is planned and controlled on a three year basis in spending reviews and Annually Managed Expenditures, which can not be reasonably subjected to firm multi-year limits.

In spending reviews, firm DEL plans are set for departments for three years. To encourage departments to plan over medium term, departments are allowed to carry forward unspent DEL provisions from one year to the next. The flexibility removes the incentive for departments to use their provisions as the year end approaches.

Resources and Capital Budgets are set in terms of accrual information. So the resource budget includes a charge for depreciation. As can be well recognized, that this has been possible to achieve because PES is an evolving concept of and it provides the basis for further reforms.

The need for such public expenditure surveys “has an acceptable universality about them”[32]. It enables better planning of expenditure, as it leads to improved decision making. “It provides a common base for weighing the cost of both new proposals and continuing policies, and it minimizes the element of ‘game planning’ strategies … Most

[31] Richard A. Chapman, (1997), The Treasury in Public Policy Making, Routledge, p. 82
[32] A Premchand (1983), Government Budgeting and Expenditure Control, IMF, p. 208

important is the inherent ability of expenditure plans to reflect the concerns of government and these of community at large".[33]

As stated above the problem with PES as it was originally conceived was that they resorted to constant prices in its price surveys (volume basis). This led to inflationary pressures. Other countries that resorted to this method of surveys for expenditure planning, utilized current prices for formulating their forecasts.

The Plowden Report exercised a dominating influence on the development of Public Expenditure Survey, as an executive process independent of budgetary procedures. Although the system was substantially modified in the mid-1970s, with the introduction of cash limits, its objective of establishing a comprehensive planning system remained influential.

But the most important point to note is that, "They detached the planning and control of public expenditure from the cumbersome and inappropriate supply procedures and established many of the necessary features of an effective system"[34]

The PES system adopted a multi-year framework. The reason for it should be obvious to anybody engaged in financial planning. David Heald makes the point cogently, "one year's public expenditure is heavily pre-determined by previous decisions. Change is possible only at the margin. There is time lag before a programme can be expanded or reduced or priorities changed. Consequently, attention must be focused beyond the immediate year, when the room for maneuver is necessarily limited, towards later years in which it is much greater",[35]

The 'forward look' was implicitly linked by Plowden report to medium term assessment of the growth of resources available within the economy, out of which public expenditure growth could be financed. As Heald points out the logic of planning exercise requires time horizons longer than five year, not shorter. "Within the five year plan, the total planning for public expenditure would be determined against resource available. A

[33] Ibid
[34] David Heald, (1983), Public Expenditure, Its Defence and Reform, Martin Robertson, Oxford, p. 174-175.
[35] Ibid p 199-200

new mechanism is required to prevent over-optimistic macroeconomic forecasts validating extra expenditure even when projected extra output fails to materialize. There is no absolute guarantee against such events. The best deterrent is to open up the system so that any further lapses are made fully explicit."[36]

In this regard he proposed that 'Treasury should set three macroeconomic forecast; low, best estimate and high. The overall public expenditure would be set against the best estimate but the total attributed to programmes would be based on low forecast."[37] This would only lead to contingency reserve (introduced in late nineties) being higher for each successive year of survey, which can be distributed on the basis of priorities.

There is urgent necessity of introducing such public expenditure survey system for better expenditure planning, as also for introducing multi-year budgeting on a rolling basis, in the light of surveys. India possesses enough expertise to establish such surveys on scientific basis and introduce cash limits for expenditure planning and a top down approach for expenditure management.

The advantage of PES system is that it is an evolving system. Through providing a control framework for expenditure planning, it allows bilateral relationship to develop between the spending department and the Ministry of Finance. The survey concentrates on costing of existing policies and programmes and techniques of projecting these in future, without getting into merits of the programmes. Contours of existing policy gets clarified while getting into details of programmes, which becomes possible because of intimate bilateral discussions. The process also leads to development of 'trust' between senior officials, which is the key factor for PES system and led to its success. The importance of development of trust among key officials, instituting proper expenditure planning can not be overemphasized. Another implicit point in PES process makes the participants conscious of costs and the implication of costs in medium term while undertaking a programme. Without cost consciousness no public expenditure management system can succeed.

[36] Ibid
[37] Ibid

The important point that comes out of the PES procedure is that Ministry of Finance (Treasury) should be vitally concerned with the departments' calculations of the costs of current programmes as these will be basis for decisions regarding resource allocation. It is therefore essential to see that departments establish and maintain an appropriate system for gathering, analyzing and presenting information of on-going programmes, which would help in accurate monitoring of programmes.[38]

There is also fallacy in the view that public expenditure can be controlled by settling the size of total expenditure as an initial act and allotting shares to individual departments, which could then run their affairs.

This view is erroneous firstly because the total size of the public expenditure can only be determined in the process of settling its components. Secondly because programmes are not interchanging allocations fixed once a year. They are essentially dynamic in nature, subject to many influences. Therefore, alterations in these need to be considered all the time.

For these reasons, the role and involvement of Ministry of Finance in the management control of expenditure from various spending departments, should be continuous.

Programme Analysis & Review (PAR) was one extension of the PESC activity, as it involved development of new techniques of appraisal of programmes of management.

## IX

## Effectiveness and Efficiency in Government Spending

PESC procedure does lead to better planning of expenditure and control by (i) bringing about multi-year outlook (ii) looking into cost implication of present policies involving programme-wise analysis evaluation (iii) relating expenditure to likely

[38] Sir Samuel Goldman (1973), Public Expenditure Management and Control HMSO, p.26, p.29

generation of revenue in medium terms, and thus setting a financial framework leading to economy in government spending and by brining budgeting and planning together lead to better efficiency in government spending. But it may not be enough to achieve effectiveness in government spending i.e. to achieve value for money. The effectiveness in government spending cannot be brought about only by reforming the budgetary system.

It is to be seen whether the civil service who are responsible for financial management system in government is oriented towards achieving efficiency effectiveness. There has to be a management outlook for the civil servants who are responsible for managing government expenditure. Change in budget format or in the budgetary process may induce some changes in outlook and decision making, but may not be adequate to bring about the necessary behavioral changes which would enable achieving value for money.

This point was underlined by the appointment of committee by UK Government in early eighties which reported on “Efficiency and Effectiveness in Civil Service” in 1981.

The committee which concentrated its attention on Civil Service, concluded that “there is no clear orientation towards the achievement of effectiveness and efficiency at the higher level of Civil Service or in the government generally” and that while there was a commendable concern with economy in the use of resources, the Committee observed there was too few attempts to set operational objectives, measure aspects and results, and hence guide proper use of resources.[39]

For this, the committee concluded, government has to have a policy aimed at inculcating a spirit of good management in civil service. This policy, if properly implemented, could be the key to securing efficiency and effectiveness in spending. An environment has to be created which is conducive to good management and to set and attain particular management targets. This demands critical examination of the continuing need for activities, functions and policies as well as their costs.

[39] Third Report from the Treasury & Civil Service Committee on “Efficiency and Effectiveness in Civil Service” Session 1981-82, HC 236

After commending the steps taking by the UK Government towards achieving economy – control of public expenditure, the committee came to the conclusion that the time had come for a general and coordinated drive to improve financial management in government departments. The committee felt that the civil servants, who take decisions about deployment and use of money and staff, should be treated as managers to serve the objectives of good financial management. The main objective was to promote in each department an organisation and system in which managers at all levels should have[40]:

(i) a clear view of the objectives; and assess and wherever possible measure outputs or performance, in relation to these objectives

(ii) a well defined responsibility for making best use of these resources and making critical scrutiny of output and value for money;

(iii) the information particularly about costs, training and access to expert advice which they need to exercise their responsibilities effectively.

This approach to management known as Financial Management Initiative (FMI) was adopted by the government for bringing in better sense of accountability for the civil servants in the management of resources. The above principles were considered by the committee to be fundamental for good management and effective use of resources and should apply to the maximum extent possible.

They felt that the principles set out above, apply to all areas of departmental work, whether it was advice or policy, execution of policy or a specialist or a staff function.

They particularly stressed that in the quest for good financial management, the responsibility for managers should be specified systematically for the control of resources they consume and, wherever feasible, the results they are to achieve. It recommended that each department should therefore examine the scope of breaking down its structure down to cost-centers or responsibility centers to which resource costs can be allocated and for which, where appropriate measures of output can be devised and monitored.

In this context it is worth remembering that the Labour Government set up the Fulton Committee on civil service in 1966. One of the major findings of the Fulton Committee's investigation was that the civil service that too few civil servants who were

[40] Appendix 3, to "Efficiency and Effectiveness in Civil Service" CMND 8616 September 1982

skilled managers. There is a 'tradition of the all-rounder' and the 'cult of amateur'.[41] To overcome the defects Fulton Committee recommended more training in management for scientists and other specialist, and more specialization for managers. It also recommended application of the principles of 'accountable management' in the organisation of executive activities. There is no doubt that many of the points made by the committee of Efficiency & Effectiveness in 1982 were inspired by the Fulton Report of 1968.

The point that comes out is that good financial management is inseparable from good management, and in government sector, civil service has to be motivated and trained to implement well-known management principles.

The Committee on Efficiency and Effectiveness (1982) added that good financial management requires that managers should be concerned with total costs and not simply with annual cost flow. Notional costs, such as accruing liability for superannuation are relevant for decisions which involve a choice before staff and other resources. In some areas managers use resources which include capital item like buildings and stocks acquired in the past and these can be major factor in cost of operation. Therefore, accrual accounting could be more useful for better financial management than cash accounting.

In the context of Financial Management Initiatives (FMI), introduced in eighties in UK, the concept of authority and responsibility and cost centers became very important for effective financial management. The concept of authority and responsibility has wide applicability in the attempts to strengthen financial management in government sector. These responsibility cost-centers should become focal points of responsibility for planning, programming and budgeting for output and cost at the operating and working levels. The budgets could be broken down on the basis of authority & responsibility centres with the aim to achieve value for money.

In USA the Second Hoover Commission (1955) which made a comprehensive analysis of the federal finance management system in its task force report stated among other things;

[41] Quoated by Sir Richard Chapman in "Treasury, in Public Policy", Routledge, 1997, p 46

"The operating budgets should coincide with the organisational pattern by which responsibility has been established within an agency. Operating budgets should disclose the projected programs and workloads, be based on reliable cost information and indicate the funds required to finance operation".[42]

This is the concept of Budget Centre. The concept of authority & responsibility centers, cost centres & budget centres are most important, concepts in financial management of government, which should be adopted for better efficiency & effectiveness in government spending. In India, in Defence these concepts have been applied in a limited way, in the management of the budget of the armed forces. There should be much wider use of these concepts in financial management of the government, along with the development of performance indicators for each of the responsibility centre.

In 1984, following the reforms in UK, in Ireland, the Department of Finance issued 'Guidelines for Financial Management' to all government ministries. In essence the guidelines attempted to fix responsibility for costs and budgets to the lowest possible management level. The guidelines to a large extent echoed the Financial Management Initiatives in UK in emphasizing clarity of objectives, the specification of responsibility and need for greater financial control.[43]

The adoption by the UK of the principles of management recommended by the Committee of an Efficiency & Effectiveness mentioned above, also led to the creation subsequently of Next Step Agencies to carry out execution functions of government, which is considered as "the most significant administration reform of the second half of the twentieth century in British Central Government."[44] It had its immediate origin in the 1988 Report to the UK Prime Minister from the Efficiency Unit entitled "Improving Management in Government: The Next Steps". (Efficiency unit, "Improving Efficiency in Government: The Next Steps", Report to the Prime Minister HMSO, 1988)

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[42] Task Force on Budget & Accounting, Report on Budget & Accounting in the United States Government, June 1955, p-47 quoted by Francis E. McGilvery in "Program & Responsibility Cost Accounting", reprinted from the *Public Administration*, 28, No.2, March/April, 1968 in Fremont, J. Lyden and Ernest G. Miller (1978), Public Budgeting, Rand McNally College Publishing Company, Chicago, (3rd Edition)
[43] Michael Mulreany (1991), "Economy, Efficiency and Effectiveness in Public Sector: Key Issues" in T.P. Hardiman and Michael Mulreany (ed) Economy and Efficiency in Public Domain, Institute of Public Administration, Dublin, Ireland
[44] Richard A. Chapman, (1997), The Treasury in Public Policy Making, Routledge, p. 105

*Next Step project was launched in 1988 with the intention of separating policy advice function of government departments from the service delivery function. By the end of 1990's majority of UK civil servants were working for semi-autonomous executive agencies responsible for service delivery. In India we should carefully study the experiences of Next Step Agencies in UK to bring about suitable reforms, if we want efficient service delivery at an economic cost. Introduction of agencies like the Next Step Agencies, appear to be the way forward for bringing about better financial management in government sector in India.*

The recommendation in the next steps reports might not have been conceived without the Megaw Report on Civil Service Pay, which amended in 1982. "The report made recommendations for performance related pay and introduction of merit scales hand on annual reports."[45]

In 1991, UK Government announced government's intention to introduce more flexible pay regime for the civil services with the aim of bringing about closer link before performance & reward for individual & groups; more delegation to civil service departments and agencies to introduce their own grading structure and do their own pay bargaining.

All these developments would indicate that improvement in financial management is only an aspect of improvement in management of the government and institutional reforms have to play a major role in it, in bringing about better motivation and accountability in government spending.

## X

## Is a Restructuring of Ministry of Finance Necessary?

Ministry of Finance (MoF) has to play a leadership role to bring about reforms in financial management in the government, which would include reforms in budgeting process and budget categorization based on programme concept. In view of new challenges it is necessary for the MoF to have an introspective look at to whether; it is organizationally well structured to bring in reforms in public expenditure management.

[45] Richard A. Chapman, (1997), The Treasury in Public Policy Making, Routledge, p. 112

The MoF should lead by setting an example in organizational reforms, with a view to deliver results. It should be in a position to implement and monitor reform measures in an effective way, and given necessary guidance to various departmentally in –carrying out reforms with to achieve value for money in their spending plan.

The British Treasury had such an introspective look through its *Fundamental Expenditure Review, 1994,* which is accompanied by the mission statement. In March 1994 it had produced a statement of overall aim of the treasury "to be recognized as a professional and effective Finance and Economics Ministry that matches the best in the world".[46]

The working principles on which the review operated were to emphasize that (i) the Treasury should concentrate on *core* activates (i.e. Activities which contributes directly to organizations strategic objections, (ii), the treasury will work best if its staff was clear about they are expected to achieve; (ii) that officials should be encouraged to think in term of outputs they are seeking to deliver, not the inputs they are constituting to the task[47]. The top management structure at the Treasury now consists of the Permanent Secretary and seven directors, with specific responsibilities to achieve treasury objections. These officials are known as Treasury Management Board.

Within the directorate there were in 1995, about sixty standing teams to focus aspects of Treasury's objectives allocated to their directorates. Traditionally the British Treasury has been a small department, with a collegial culture. Arrangement was therefore made to supplement the standing teams with cross-directorate officials, concerned with particular issues. Each of the standing teams was to be managed by an explicit team leader. The key message was that the Treasury of the future must be more managerial and less gradist, and less hierarchical. One particular feature of the new role-based management structure is that the organization has a flatter hierarchy.

For example, the Budget and Public Finances Directorate has eleven standing teams which shares responsibility for the objectives to maintain sound public finances and

[46] David Heald, (1983), Public Expenditure, Its Defence and Reform, Martin Robertson, Oxford, p. 63
[47] Ibid p 66

to keep public expenditure at an affordable level. It also takes lead responsibility for pursing efficient tax policies and for improving the efficiency of government. This directorate is also concerned with new taxation and public expenditure plans, which involves such tasks as producing cash limits consistent with government's overall spending targets and monitoring and controlling expenditure against agreed limits; reviewing plans of future years as part of the information for the current Public Expenditure Survey and keeping under review the systems and procedures to deliver the governments public expenditure objectives[48].

The spending Directorate has thirteen standing teams, which deal with various spending departments. Its task include examining other departments' financial control systems and individual programmes and projects as necessary, with a view to promoting improved value for money; promoting policies and spending priorities, and supporting departments carrying out reviews of senior management structure[49].

The Budget and Public Finances Directorate has lead reasonability for tax policies. It is the directorate with primary responsibility for preparing the budget and handling the subsequent finance bill. Together with Inland Revenue, Customs and Excise, Department of Social Security and the Contributions Agency, it keeps the tax system and benefit systems under review, in relation to their impact of the economy[50].

In India the context of past failure in bringing about basic reforms in financial management system, it is very necessary to consider whether this kind of `Directorate' with managerial outlook will be in a better position to bring in necessary reforms.

**The Multi-year budgeting Techniques: The Commonwealth Approach**

The most important reforms generated by the Plowden Committee Report (1961), as far as budgetary technique is concerned, were the adoption of multi-year budgeting,

[48] Ibid p 75
[49] Ibid p77
[50] Ibid p76

through PES process, which we explained above. PES process in formulating the budget has evolved over years. It made the UK the pioneer in multi-year budgeting.

The prevalent practice as existed in Uk in the beginning of the century is as follows.[51] The formulation of the annual budget proposal and the multi-year strategy starts in early summer, when the Chancellor of Exchequer along with his senior advisors and heads of the Inland revenue Service and Customs and Excise Service, determine the fiscal strategy o be followed for the coming three years. The government's medium term fiscal strategy guides the multi-year budget formulation process. This is formally published at the time of annual presentation of budget to Parliament in November.

After determination of fiscal strategy, the Cabinet Committee on Public expenditure led by the Chancellor and several senior ministers, establishes aggregate and departmental expenditure limits for the multi-year period. This is referred to as 'Control Tools'. When the multi-year Control Tools have been established, the government conducts a review of its existing spending commitments for the next two fiscal years, an d develops a projection as indicated earlier for a third year. The review is known as Public Expenditure Survey (PES).

In UK, the individual spending departments are responsible for determining programme priorities within the limits set by Treasury. This is practice followed in many other Commonwealth nations.

As pointed out by fiscal experts, the central element of UK approach to multi-year budgeting is "the pursuit of budgeting discipline, policy rationalization, and expenditure efficiency by placing the expenditure decisions in a multi-year context.[52]

As a result of historical ties and continued interaction, this practice is also found in other countries of British Commonwealth, such as Australia, Canada, and New Zealand. "Therefore, this approach emphasizing fiscal discipline and expenditure

[51] Boex, L. F. Jamieson et al. (2000), "Multi-year Budgeting: A Review of Internal Practices and Lessons for developing and Transitional Economies", Public Budgeting and Finance, Summer, p 91-98
[52] Ibid

efficiency could be referred to as the Commonwealth approach to multi-year budgeting”.[53]

The multi-year budget approach in UK helps in focusing on the multi-year impact of expenditure commitments and the measures necessary to achieve government’s medium term economic objectives. This, among other things helps in controlling the commitments in expenditure within likely budgetary provisions.

With a single year focus, the budgeting process in India is unable to control the commitments. This is a major weakness in our budgeting process. Since about 98 percent of expenditure is committed (including that in the revenue side), with a single year focus, it is the committed expenditure which determines the budget. In most of the decisions pertaining to expenditure, no matter what the budget provides, commitment of expenditure spreads over more than one fiscal year are made in a given fiscal year without any regard for the consequences. Only a part - often only a token provision – of the commitments is required to be met in the initial year.

If increments in expenditure are to follow a planned pattern, then the only logical course would be to indicate clearly the permissible extent of increase for the next three to four years for any department in advance on the basis of which commitments can be made through a multi-year budget.[54]

There should be no ambiguity in communicating the likely budget figures so that the persons become responsible for containing the expenditures as per the pre-determined pattern. Knowing further spending commitments is important not only for activities that take several years to complete, but also for commitments made in revenue expenditure in terms recruitment of personnel on a scale, which from a long term perspective, may be sustainable.[55] Therefore, unless total commitments both in revenue and capital are kept in view, the expenditure in future years can be predicted nor controlled.

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[53] Ibid

[54] See Ghosh, Amiya Kumar (2000), “Multi-year Budgeting: Key to Fiscal Corrections”, Economic Times, 17 February vol 39, no.300

[55] Ibid

Institution of multi-year budgeting would be most important step towards control of future commitment and it would allow the government to determine annual fiscal policy keeping in view resource constraints of the future years. Thus multi-year budgeting should be treated as the key element in the process of strengthening of financial management in the country.

In this context, a special feature of multi-year budget process in UK is to be noted. It is that multi-year dimension of the budget process is geared towards the expenditure side of the budget. While an expenditure plan is produced for three years, tax policy proposals are only included for the annual budget under consideration. However, the multi-year revenue estimates, are produced for the reminder of the three year period.

**Dislink between Development Plan and Budget**

The practice of making multi-year revenue estimates for future years, while the tax policy proposals are confined to the annual budget under consideration appears to be right model follow for us, in determining the resource constraints relevant for expenditure planning purposes. But, we are also concerned with development plans running for five years. Therefore, the expenditure plan for three years as in UK would not be appropriate in this context. We should have an expenditure plan on a rolling basis for five years as in the original PESC model.

Large number of developing countries has adopted a multi-year development plans like the five year plans practiced in India. It often comprises a deterministic government plan of desired macro-economic objectives. Sometimes the development plans tend to incorporate unrealistic expectations regarding medium-term economic growth and future revenue collections. The five year plans are seldom subject to periodic review and systematic updates. Moreover, the development plans lack specific focus on fiscal policies to be followed. Thus development plans get dislinked from he budget process. As Jamieson Boex et al point out, “In contrast to these conventional development plans, a multi-year budget approach has the advantage of being a more flexible policy tool with much greater focus on fiscal policies and outcomes. A multi-year budget approach can provide a non-deterministic appraisal of economic and fiscal conditions in medium term by placing the government current revenue and expenditure policies in the context of medium term outlook".[56]

With this approach of multi-year budgeting, the link between development plans through programmes and the budgetary process can be firmed up. This will ensure that the fiscal discipline and development planning goes together. Therefore, there is no alternative to adopting multi-year budgeting, if we want better fiscal discipline and strengthening our financial management system.

## XI

We had mentioned that the PES system in UK is designed to control the expenditure. It gradually came to be realized that in controlling the total expenditure, one controls nothing. One has to know much more about the details. Therefore, close association of the spending departments and financial officials, is essential. PES process allows this. But restructuring of the Ministry of Finance into Directorates, apart from bringing in specialization and professionalism, would enable it to have closer association with the spending departments, so that substantial meaning could be given to existing policy, cost projections and improvement factors. This would also enable more determined efforts being undertaken by the departments towards improvement in financial management, through constant interaction with Ministry of Finance officials.

In undertaking budgetary reforms, Ministry of Finance internally has to get convinced about the point that annual budgeting procedure is not the way to control expenditure. If MoF is to control expenditure, then it can not do it by looking at annual estimates when probably ninety eight percent next year's money is already committed. The second point is next year's expenditure is no indication of what would be the real cost at the end. Thirdly, MoF should be aiming establish a process that prevent taking ad hoc spending decisions by asking for financial effects of the new proposals in the years to come. There should be a medium-term expenditure framework to ask for these questions.

[56] Boex, L. F. Jamieson et al. (2000), "Multi-year Budgeting: A Review of Internal Practices and Lessons for developing and Transitional Economies", Public Budgeting and Finance, Summer, p 91-98

PES provides for such a framework, which has evolved over the years, so that one knows about its limitations and how they can be overcome. These are well documented and accessible. The PES process makes it necessary to think in terms of programmes for public expenditure management and stresses the importance of thinking about costs of programmes in the medium term, which is neglected in our expenditure management process.

As explained above, adoption of multi-year budgeting, as prevalent in other commonwealth countries, should be the key element in reform in public administration, with a view to strengthen the financial management of the government. The other major steps should be to creation of agencies in the government sector, for delivery of services, on the pattern of 'Next Steps' agencies in UK. The heads agencies should be designed as Chief Executive Officers (CEOs) with adequate delegation of powers from the parent department leading to authority combined with responsibility to achieve key performance targets. Aim should be to encourage flexibility, initiative and achieving value or money.

There should be a framework document (as in UK) between department (concerned with policy and strategy) and its agencies (concerned with delivery of services), to set out the aims and objectives of agency, the proposed accountability and control arrangements and respective responsibilities of the minister, parent department and the chief executive, which should have approval of Ministry of Finance. Each agency should be required to prepare for each year on a rolling basis, a medium term corporate plan containing detailed performance targets for the years immediately ahead. These plans should be prepared in close cooperation with the department. The agency pattern of functioning for delivery of service would lay the foundation for performance orientation in expenditure management in government.

The main aim of creation of these agencies, as in UK is to change the culture of public administration. Therefore, creation of agencies on the pattern of 'Next Steps' agencies in UK, should be one of the major reforms in public administration.

# Chapter 3

# Reforming the Budgetary Process

## Introduction

The budgeting system in India both at central and state level, despite several reform attempts, continues to be conventional input based more concerned with basic financial compliance. Poor productivity of public expenditure and weak delivery of public services have remained matter of deep concern. In the conventional line item budgeting system the expenditures are listed according to objects of expenditures and often the amounts to be spent on line items such as personnel, travel, fringe benefits, equipments and the like are specified in a detailed manner. The major focus of this type of budgeting is to ensure that agencies do not exceed the specified allocation[57]. The financial compliance is sought to be achieved in this system through detailed budgetary specification of inputs and detailed procedures are designed for expenditure control. The traditional compliance budget, however, does not meet the requirements of allocating resources on accordance with strategic priorities and efficient and effective use of resources in implementation of strategic priorities. The government had made several efforts in the past to revitalize the system; major among them are the introduction of performance budgeting in 1970's and zero based budgeting (ZBB) in 1980's. While ZBB was not used and remained at a conceptual level, the performance budgets continued to be prepared annually. The performance budgets for all these years remained supplementary to the main budget with very little impact on budget planning and resource allocation decisions. The latest in the budgetary reforms is the introduction of outcome budget in 2005-06, claimed to have been designed to move beyond the traditional line item system to clearly defined outcomes of all government programmes. The performance budget has been merged in the outcome budget in 2007-08 and a single document called outcome budget is presented. Although the outcome budget recognizes the principles of programme performance budgeting, its usefulness is limited. In practice the basic elements of outcome budget, such as, measurement of outputs and outcomes, specification of benchmarks, costing of programmes, monitoring and evaluation system and the institutional aspects are still emerging. The outcome budget, like its predecessor

[57] General Financial Rules (GFR) 52(3) stipulates that no disbursements be made which might have the effect of exceeding the total grant or appropriation authorised by Parliament for a financial year except after obtaining a supplementary grant or an advance from the Contingency Fund.

– performance budget, is viewed as supplemental device rather than an effective system to influence budget policy and decision making. However, the introduction of outcome budget underlines the effort to improve the budgetary system and needs to be strengthened further to make it a potent force to influence budget policy and decision making. The gender budgeting introduced by the central government to identify the resources utilized for addressing the problem of women, is mostly a compilation of the programmes and schemes in this area. The gender budget is still to emerge as a compelling basis to influence the budget making.

The weak linkage between policy making, planning and budgeting often associated with traditional line item budgeting invariably results in poor budgetary performance. In the Indian context the factors that contribute to this inherent problem needs to be analysed to make systemic and institutional changes to strengthen the budgetary process. The reform should aim at strengthening the basic budget management system and incorporate performance orientation to the budget to link the public spending with achievements. The adoption of fiscal responsibility and budget management act (FRBM) by the central government and state government has initiated profound changes in the fiscal management. The FRBM provides opportunities for looking beyond a single year for fiscal management thus influencing the budget management.

## II

### Evaluating the Existing Compliance Budgeting System

The budgetary practice both at Central and state government level is more or less similar. There are two major aspects in the centre-state relations that merit a mention in the context of budget. First, the state governments, as demarcated by the Constitutional provisions, play large role in providing basic services in the field of health, education, water supply and sanitary services, electricity, transport and communication, agriculture, maintenance of law and order, provision of judicial services and bear major portion of expenditure responsibilities. The functional responsibilities and consequent expenditure requirements of states far outweigh their revenue sources for which their dependence on central transfers is large. This has wider repercussion in the budgeting practice and public expenditure management design depending upon the flow of funds. Second, many programmes included in the central government budget, known as centrally sponsored schemes (CSS), are implemented by the state governments or state level autonomous agencies and local governments (both rural and urban). Both from the point of view of wide ranging responsibilities of the state governments and long performance chain due to involvement of many levels in implementation of central programmes, the productivity and efficiency of public expenditure is important.

Under the provision of the Constitution, the government presents annual financial statement (AFS), showing annual receipts and expenditures, both under current and capital heads of account to the Parliament. Each department present a demand for grant containing the estimates of expenditures for the year with details of estimates divided into items. The annual budget estimates are prepared on cash basis and the amounts voted lapse at the end of the financial year. After the passage of the demand for grants by the legislature, a bill is introduced to provide for appropriation out of the consolidated fund. The tax proposals are contained in the finance bill, which is passed by the parliament after the demand for grants are voted. With the adoption of Fiscal Responsibility and Budget Management Act (FRBM) by the central and the state governments, the medium term fiscal framework (MTFF) and fiscal policy documents are presented along with the budget.

The budget is developed primarily following a bottom-up approach from estimates of individual departments. The departments frame their estimates after taking into account plan schemes approved by the Planning Commission. Apart from allocations for continuing plan programmes initiated in earlier fiscal year, the Planning Commission decides on the new programmes that can be undertaken on the basis of estimate of resources available for plan expenditure that is provided to it by the finance ministry. The departmental estimates, in addition to plan schemes, includes assessment of non-plan expenditures in which committed expenditures such as interest payments, staff salaries and pensions, and subsidies are the major items. The finance ministry prepares the final budget after consolidating the departmental estimates keeping in view the available resources. All the departmental estimates, after being consolidated, are matched with revenue estimate to arrive at first estimate of deficits. The optimum level of borrowing both from external and internal sources decided that would be used to finance the deficits. However, after the enactment of FRBM in 2004, the targets for fiscal and revenue deficits are fixed in accordance with the provisions of the act. Given the targets of fiscal deficits, the revenue shortfalls are filled either through tax measures or through adjustments in expenditures. Given the rigidity in non-plan expenditures as large percent of non-plan expenditure being accounted for by committed expenditures, adjustments are usually made on plan sides, i.e., capital investments.

The legislature exercises control over the budget process by approving the departmental demands, allowing expenditures and approving the tax proposals. However, the scope of financial control by Parliament is limited as large percentage of the total disbursement of the civil ministries are 'charged' on the consolidated fund of India that are not subject to voting in the parliament. The major items under charged disbursements are interest payments, repayment of debt, transfers to states and Union Territories on account of grants under the proviso to Article 275(1) of the Constitution, block grants, loans for State plan schemes etc. During the period 1994-2006, 70 to 81 percent of the total disbursements for the civil ministries, in the case of central government, were charged on the Consolidated Fund of India. In 2005-06 effectively the scope of financial control by Parliament was limited to about 19 percent of the total disbursement in the civil ministries[58]. Although the members of the parliament get ample opportunity to discuss the budget proposals, this control over public expenditure has been diluted in recent times due to reduced parliamentary debate over the budget proposals. The Constitution also provides for post budget, evaluation by various parliamentary committees, the Public Accounts Committee, the Estimates Committee, and the Committee of Public Undertaking.

The preparation of budget primarily following a bottom-up approach from the estimates of individual departments is often incremental in nature. Overall budget constraints are not transmitted to departments in terms of ceilings early in the budget process facilitating the departments to plan in advance under a resource constraint. This weakens the linkage between planning and budgeting with regard to resource allocation based on government priorities and costing of programmes and activities.

[58] Audit reports of Appropriation Accounts of Union Government, 2007-08, Chapter 6, pg 83, C&AG

The budget implementation in terms of realizing revenues and expenditures as envisioned in the budget passed in the legislature brings out certain crucial issues. The percentage change of realized revenue receipts and expenditures over budget estimates for the central government and state governments are shown in table 1 and 2 respectively. In the case of central government, the realized gross tax revenues have shown wide fluctuation and are mostly lower than that of the budget estimates. The non-tax revenues, however, seem to have been exceeded the budget estimates. Revenue expenditures, although more or less conformed to the budget estimates up to 2004-05, have exceeded the budget estimates in 2005-06. Capital expenditures have shown large reductions as compared to the budget estimates.

**Table 1 Central Government: Percentage Change of Actual Over Budget Estimates**

| | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 |
|---|---|---|---|---|---|
| Gross Tax Revenue | -17.47 | -8.28 | 1.12 | -4.02 | -1.05 |
| Non-tax revenue | 2.53 | 0.06 | 10.35 | 3.92 | 4.47 |
| Revenue Expenditure | 1.05 | -0.32 | -0.13 | -0.25 | 3.42 |
| Capital Expenditure | -23.01 | -27.87 | -17.57 | -11.63 | -10.26 |

Source: Budget Documents, Government of India

The variation in realized revenues and expenditure as against the budget estimates for the state governments has recently been narrowed down. The realized revenue receipts were less by 10 percent of the budgeted receipts in 2001-02; the gap since then has narrowed down to 0.3 percent in 2004-05 and in 2005-06, the realized revenues have exceeded the budget estimates. The budget implementation performance relating to states' own revenues containing their own taxes and non-taxes shows early breakthrough as the actual receipts have exceeded their budgeted amount in 2004-05. In the case of revenue expenditures the actual expenditures have remained less than the budgeted amount during the entire period, although the variation has declined. The capital expenditures have suffered most during the period 2001-02 to 2003-04 as they were reduced by more than 15 percent, after which it seems to have been converged to the budget estimates.

**Table 2 Percentage Change of Actual over Budget Estimates**

| Percentage | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 |
|---|---|---|---|---|---|
| Own Revenues | -9.41 | -4.61 | -1.56 | 2.65 | 2.45 |
| Revenue Receipts | -9.88 | -7.81 | -4.70 | -0.30 | 2.41 |
| Revenue Expenditure | -5.56 | -5.59 | -1.26 | -2.75 | -2.42 |
| Capital Outlay | -18.68 | -15.98 | -15.76 | 1.73 | 3.11 |

Source: State Finances – A study of Budgets, RBI, Relevant Issues

The budget realization of state governments shown in the table 2 at an aggregate level, however, hides the performance of individual states. There are 10 states out of total of 28, which have failed to realize the budgeted estimates of total revenues and 9 states which have failed to realize their own tax estimates as budgeted in 2005-06 (annexure 2.1, 2.2 ). The failure to realize the budget estimates for these states is a result of volatility witnessed both in their own revenues and central devolution. A Large number of states, however, have shown higher realization of revenues receipts, as also the own tax revenues, as compared to the budget estimates. The flow of share in central taxes, which is formula driven as recommended by the central Finance Commission, riding on buoyant central taxes in recent years has helped in surpassing the revenue targets.

The volatility in the revenue realization both in terms falling short and exceeding the budget estimates indicate unsatisfactory fiscal marksmanship. The projection of revenue receipts should be carried out in an unbiased manner that would result in convergence of realized revenues to the budgeted level. The overestimation and underestimation in revenue projections are a matter of concern as it results in unrealistic budget. The overoptimistic projections in revenue receipts help in accommodating inflated expenditure allocation. When reduction in revenue expenditures is difficult due to committed nature of major items, the capital expenditure becomes the targets of adjustment. Being in conservative side, i.e., underestimating revenue potential also does not help. Both scenarios depict absence of unbiased projection methodology and distort the expenditure priorities.

The manner in which the budget is being executed seems to have been defeating the vary objective of budget controls over spending and has bearing on preparation of budget estimates. The audit of appropriations accounts by the CAG has pointed out that there are evidences of both excess spending and under spending by various departments[59]. The excess expenditures require reappropriation of such expenditures following proper procedures with the sanction of the competent authorities, which were not forthcoming indicating laxity of budget control. In the context of budget implementation to achieve results, authority to reappropriate funds gives flexibility to departments in budget execution. However, in the line item budgeting system, where allocation of funds are according to detailed object heads, the excess expenditures requiring reappropriations, which are not done following proper procedures, is considered to be going against the original purposes as authorized by the parliament.

Devolution of greater financial powers to the administrative ministries is the corner stone of the effective implementation of the budget. Excessive concentration of financial authority with the finance ministry was stated to have been decentralized to administrative ministries by following the 'delegation of financial powers[60]. However, the delegation of financial powers has not provided required flexibility to the administrative ministries as the budget execution is marked by control of actual spending through layers of decision makers with the ostensible objective of expenditure control. The departments have to seek authorization to spend beyond a specified limit separately for plan and non-plan expenditures. In the case of non-plan expenditures the proposals exceeding a specified limit require initial clearance from a appraisal forum called Committee on Non-plan Expenditures (CNE) and sanctions by the minister in charge and the Cabinet Committee on Economic Affairs (CCEA). While outlays for plan schemes are in principle approved by the Planning Commission, actual expenditures require formulation of detailed schemes and approval of prescribed authority. The plan schemes exceeding specified amount needs clearance from Expenditure Finance Committee (EFC) headed by the secretary expenditure and approval from Minister Finance or from CCEA[61].

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[59] For instance, during the year 2005-06 there are 46 cases (Civil and Defence Services) in which there was an excess expenditure of Rs.101786.70 crores as against the available provisions.

[60] Delegation of financial power rules 1978 and amendments thereafter deals with non-plan expenditures and delegation financial powers for plan schemes through guidelines issued by Ministry of Finance (Plan Finance Division II) for formulation, appraisal and approval of plan schemes from time to time.

[61] In the case non-plan expenditures, the administrative departments have the authority to spend up to Rs.5 crore and amounts between Rs.5 to Rs.15 crore with the sanction of the Minister in charge of the department. All non-plan proposals exceeding Rs.15 crore require approval of the Committee on Non-plan Expenditures (CNE) and sanction of the Minster up to the amount of Rs.50 crores and sanction of the Cabinet Committee on Economic Affairs (CCEA) for amounts exceeding Rs.100 crores. In the case plan

While efficient use of public money is the major theme of any budgeting system, large amount of unspent money have been surrendered every year at the lapse of the financial year as has been shown in table 3 and 4. In table 3 the unspent provisions of the central government civil ministries as reported by the CAG in their audit reports of appropriation accounts are shown. In 2005-06, the gross unspent provision for central government civil ministries was Rs.29756 crore. In table 4 state wise unspent provisions for the year 2005-06 is reported. Barring two states, all other states have shown unspent amounts. The difference between budgeted and actual expenditures called 'savings' are as high as 33 percent in Assam, 29 percent in Madhya Pradesh, 25 percent in Punjab, 26 percent in Goa, and 22 percent Goa and more than 10 percent in many other states. In many cases the unspent amounts are higher that the supplementary estimates that were presented during the year.

Large-scale unspent provisions are indicative of lack of efficiency in programme management at departmental level in an annual budget cycle. Excessive provision under various sub-heads during the budget preparation stage due to lack of a realistic assessment of departmental requirements is the major reason for this. Absence of indication of budget ceilings at an early stage of budget formulation and lack of resource trade-offs across the departments fuels the practice of excessive departmental demands. To compound the matter proper forecasting methods are not used to estimate expenditure demands for various items. The plan and non-plan distinction in budgets, practiced both at central and state levels, introduces unnecessary complexities to the budget planning. There is a tendency to inflate the plan size every year thus spreading the resources thinly across many projects. Although the plan and non-plan concepts are not clear, the plan expenditures are regarded as developmental and provide popularity to budget proposals.

The reasons for inability to spend the budgeted amount could also be found in the financial management system itself. Absence of programme based approach to budgeting

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expenditures administrative ministries have the power to authorize spending up to Rs.15 crores and proposals between Rs15 to Rs.75 crore with the approval of the Minister in charge after the proposals are cleared through the Standing Finance Committees (SFC). Expenditures proposals between Rs.75 crore to Rs150 crores needs approval of Minister of charge and Minister of Finance after being cleared through Expenditure Finance Committee (EFC) headed by the secretary expenditure. Expenditure proposals above Rs.150 crores need initial approval of EFC and final approval from the Cabinet Committee on Economic Affairs (CCEA).

is he basic problem, as it leads to piece-meal approach to sanction of schemes leading to delay in finalization of schemes, non approval projects, non-receipts of utilization certificates from implementing agencies, slow disbursal of funds, time overruns in project implementation, shortage of personnel are some other factors attributed to unspent provisions.

Various economy measures to be implemented by the departments as instructed by the Ministry of Finance (MOF) are also cited as one of the reasons for departmental savings. However, adherence to such official memoranda is not a common practice.

At the central level the Department of Expenditure, MOF, through its instructions, emphasized upon the need for effective mechanism for realistically assessing the requirements of funds by the departments to avoid savings and surrender of funds. The financial advisors (FA) are given the responsibility of bringing in more analytical inputs into budget formulation process through programme prioritization and allocation within budget ceilings[62]. However, this is not sufficient to ensure realistic and efficient deployment of resources. The problems associated with the present integrated financial advisor (IFA) scheme is discussed in a subsequent chapter that points out that the scope of FAs is limited to bring in such changes.

**Table 3 Central Government: Unspent Amounts of Civil Ministries**

Rs. Crore

| | **Unspent Amount** |
|---|---|
| 2005-06 | 29756 |
| 2004-05 | 38642 |
| 2003-04 | 29619 |
| 2002-03 | 59473 |
| 2001-02 | 20237 |
| 2000-01 | 64883 |

Source: Audit reports of appropriation accounts of civil ministries, CAG

[62] See office memorandum issued by the Department of Economic Affairs (Budget Division) 31 July 2006

**Table 4 State Governments: Actual Expenditures against grants/appropriations - 2005-06**

Rs. Crore

| States | Original Grants/Appropriations | Supplementary Grants/ Appropriations | Total | Supplementary % to Original Grants | Actual Expenditures | Savings (+)/ Excess (-) | Savings % to Grants |
|---|---|---|---|---|---|---|---|
| Andhra Pradesh | 55442.0 | 3163.5 | 58605.5 | 5.4 | 49305.8 | 9299.7 | 15.9 |
| Arunachal Pradesh | 2080.9 | 684.4 | 2765.3 | 24.7 | 2441.9 | 323.4 | 11.7 |
| Assam | 20123.3 | 1327.8 | 21451.1 | 6.2 | 14286.3 | 7164.8 | 33.4 |
| Bihar | 26328.7 | 2647.7 | 28976.4 | 9.1 | 22568.5 | 6407.9 | 22.1 |
| Chhattisgarh | 11242.6 | 1294.3 | 12536.9 | 10.3 | 9850.7 | 2686.2 | 21.4 |
| Goa | 3725.7 | 200.6 | 3926.4 | 5.1 | 2891.3 | 1035.1 | 26.4 |
| Gujarat | 36465.0 | 3418.1 | 39883.1 | 8.6 | 35150.3 | 4732.8 | 11.9 |
| Haryana | 17625.7 | 644.5 | 18270.3 | 3.5 | 17071.5 | 1198.8 | 6.6 |
| Himachal Pradesh | 7760.9 | 1431.4 | 9192.2 | 15.6 | 9443.0 | -250.7 | -2.7 |
| Jammu & Kashmir | 13600.7 | 1044.0 | 14644.6 | 7.1 | 25792.0 | -11147.4 | -76.1 |
| Jharkhand | 12423.3 | 1691.9 | 14115.3 | 12.0 | 14357.8 | -242.5 | -1.7 |
| Karnataka | 37163.4 | 4364.8 | 41528.2 | 10.5 | 36208.7 | 5319.5 | 12.8 |
| Kerala | 28009.1 | 4473.9 | 32483.0 | 13.8 | 28019.3 | 4463.7 | 13.7 |
| Madhya Pradesh | 35790.3 | 7883.7 | 43673.9 | 18.1 | 31220.8 | 12453.1 | 28.5 |
| Maharashtra | 72216.9 | 19714.1 | 91931.1 | 21.4 | 82972.5 | 8958.6 | 9.7 |
| Manipur | 3227.1 | 539.3 | 3766.4 | 14.3 | 2917.4 | 849.0 | 22.5 |
| Meghalaya | 2351.0 | 176.9 | 2527.9 | 7.0 | 2101.0 | 426.9 | 16.9 |
| Mizoram | 1802.1 | 756.7 | 2558.8 | 29.6 | 2307.5 | 251.3 | 9.8 |
| Nagaland | 3310.9 | 427.4 | 3738.2 | 11.4 | 2981.0 | 757.3 | 20.3 |
| Orissa | 19012.7 | 2020.3 | 21033.0 | 9.6 | 16053.2 | 4979.8 | 23.7 |
| Rajasthan | 32935.6 | 743.4 | 33679.0 | 2.2 | 28503.2 | 5175.7 | 15.4 |
| Punjab | 27552.2 | 1448.7 | 29000.9 | 5.0 | 21881.3 | 7119.6 | 24.5 |
| Sikkim | 2246.8 | 183.4 | 2430.2 | 7.5 | 2160.4 | 269.8 | 11.1 |
| Tamil Nadu | 41202.0 | 5615.8 | 46817.8 | 12.0 | 41737.6 | 5080.1 | 10.9 |
| Tripura | 3864.4 | 534.8 | 4399.2 | 12.2 | 3420.1 | 979.2 | 22.3 |
| Uttar Pradesh | 75731.9 | 8233.1 | 83965.0 | 9.8 | 70646.4 | 13318.6 | 15.9 |
| Uttarakhand | 8706.5 | 858.0 | 9564.5 | 9.0 | 8579.7 | 984.8 | 10.3 |
| West Bengal | 42207.8 | 2731.4 | 44939.2 | 6.1 | 41766.8 | 3172.4 | 7.1 |

Source: Audit Reports of State Governments – 2005-06, Comptroller and Auditor General, GOI

During the implementation of the budget rush of expenditure in the last quarter of the financial year and more specifically in the month of March has remained a persistent problem. In the case of central government, during the year 2005-06, under 180 major heads pertaining to 105 demands of civil ministries and one major head in defense services, major part of expenditures including disbursements on grants-in-aid to states, capital outlay and investments were made in the Month of March[63]. In some cases the

[63] See Appendix VI-D, Rush of Expenditure during the month of March 2006 and last quarter of 2005-06, Report of CAG on Union Government Accounts, pg 146-156

whole amount was spent in March only. The problem of rush of expenditures towards end of the financial year in states is shown in table 5. Table 5 shows percentage of expenditures pertaining to different grants during the last quarter of the financial year and during the month of March for some of the major states. More than 80 percent of expenditures under various grants are incurred only in the fourth quarter of the financial year in the case of states like Gujarat, Karnataka, Rajasthan and West Bengal. In other states also large amount of funds are spent in the last quarter and in general expenditures during the month of March is very substantial.

**Table 5 State Governments: March Rush (2005-06)**

Percent

| States | No. of Cases | 4th Quarter | March |
|---|---|---|---|
| Andhra Pradesh | Total Exp. | 41 | 27 |
| Bihar | Total Exp. | 57 | 42 |
| Chhattisgarh | 10 | | 55 |
| Gujarat | 36 | 84 | 69 |
| Karnataka | 21 | 81 | 77 |
| Kerala | 20 | 71 | 66 |
| Madhya Pradesh | 10 | 62 | 34 |
| Orissa | 13 | | 81 |
| Punjab | 25 | 70 | 54 |
| Rajasthan | 10 | 96 | 91 |
| Tamil Nadu | 46 | | 71 |
| Uttar Pradesh | 28 | | 55 |
| West Bengal | 17 | 85 | 76 |

Source: Audit reports CAG

It is therefore difficult to surmise that the funds released in the last month could have been put to use constructively for the purposes for which they were authorized. The release of central funds to the state governments resulted in similar rush of expenditure at their end towards end of the financial year and has contributed to greater prevalence of personal ledger accounts where the funds are parked pending their utilization. There are stipulations in the form of instructions by Department of Expenditure, MOF, not to spend more than one third of the budget estimates during the last quarter of the financial year. It was further refined by stipulating the expenditures during the month of March to be limited to 15 percent[64]. While it underlines the concern that the rush of expenditures during the last quarter has received, the actual practice is yet to be fine tuned.

[64] See D.O. No.7(3)2006/E.Coord, Department of Expenditure, Ministry of Finance

**The absence of multi-year budgeting with programme based approach in our budgeting leads to this phenomena of March rush.**

In addition to the directive to limit the spending during the last quarter, Government has modified the cash management system by introducing a 'exchequer control based expenditure management' in 2006 with the objectives of obtaining greater evenness in spending during the year, reducing rush of expenditure during the last quarter, reducing the tendency of parking of the funds, effective monitoring, and better planning of indicative market borrowing[65]. The scheme was designed to be applied to 23 major demand for grants. Under this scheme the demand for grant has to be accompanied with a monthly expenditure plan (MEP), separately for plan and non-plan expenditures, which will form the basis for quarterly expenditure allocations (QEA). The MEP has to observe the spending limit for the month of March (15 percent) and last quarter limit (33 percent). Further savings in any quarter will not qualify for automatic carry forward to the next quarter and need to be revalidated from the Ministry of Finance by modifying the MEP and QEA. The financial advisor in each department has been given responsibility to implement this cash management system. Such a cash management system, although is designed to strictly control the expenditure and reduce the unevenness in spending during the year, goes against providing flexibility to the managers in implementing their budget to obtain desired results. In the input based budgeting system where basic programmes are not at the core of the budget formulation, the monthly and quarterly spending restrictions compounds the problems faced during budget execution.

The budget presented to the parliament often is not final as it is augmented by supplementary demands for additional expenditures during the year[66]. Although, the objective of presenting supplementary demands is to meet unforeseen factors, in practice, large part of them has become routine affair. This practice has undermined the sanctity of annual budget as a policy instrument and the concept of hard budget constraint thus undermining fiscal discipline. The CAG in their audit of appropriation accounts of Central government for the year 2005-06 have pointed out that the final expenditure was less than the original grants/appropriations thus the entire amount put forth through supplementary demand for the year was unnecessary and is pointer to the obvious fact of

[65] See F.No.21(1)-PD/2006, Department of Economic Affairs (Budget Division), Ministry of Finance
[66] Article 115 of the Constitution of India provides for supplementary demands

deficiencies in budget formulation[67]. State governments also present supplementary budgets during the fiscal year. On an average two supplementary budgets, some time three are presented during the year. Table 2 gives original budget estimates and supplementary estimates presented across the states for the year 2005-06 on the basis of audit of appropriations of state governments by the CAG. From the data presented in table 2 it is clear that the unspent amounts many a times exceeds the supplementary proposals making them redundant.

Budgetary complications arise at state level due to scheme based transfers by the central government, termed as centrally sponsored schemes – CSS. The CSS in terms of their outlay and implementation scheme are designed by the central Ministries where the state governments have very limited autonomy. Many CSS have a requirement of matching contribution from the State Governments putting enormous financial strain. Over the years the CSS has become an important tool of the central Government to influence polices and expenditures on subjects constitutionally allocated to the states. Some of the CSS bypass the state budgets and are routed through implementing agencies such as missions or autonomous societies created under the provision of the specific schemes, DRDAs, and local bodies. The dependence upon the implementing agencies other than the state government has arisen due to the stated delay in flow of funds from the state governments to many of the CSS and diversion of funds by the state governments for other purposes. A comprehensive picture regarding the expenditures in various sectors in states is difficult to be found from the state budgets due to off-budget CSS. The sector expenditure planning operates at various levels depending upon the source of funding and a comprehensive sector plan is absent. Control over implementation of CSS schemes by autonomous agencies is diffused due to the funding pattern and the expenditure tracking is not streamlined. The flow of funds from the central governments to these autonomous agencies is based on the utilization certificates submitted by them that are not based upon any detailed auditing.

Plan and non-plan divide is quite sharp in budgetary process at both central and state levels. While the fresh projects undertaken during the five year plan are termed as plan expenditures, the projects carried forward from the previous plan period are categorized as non-plan expenditures. The maintenance and operation of

[67] C&AG (2007), Audit Report of Appropriation Accounts, chapter 7, pg 92,

projects/schemes created during the previous plan period are financed from non-plan expenditures. Five Year Plans are not always linked to the availability of resources through a macroeconomic framework. Large number of new schemes is added in every new five year plans, which leads to thin spread of resources (Planning Commission, 2003). Moreover, planned goals, objectives, outputs and resource allocations are not adequately integrated into annual budgets. As the plan and non-plan budgets are prepared quite separately, new projects/schemes may be started even when there are insufficient resources operate and maintain the new infrastructure. Thus the budget formulation process suffers due to absence of a comprehensive view of availability of resources and allocations of such resources on the basis of prioritization.

Annual budget cycles with no carry forward provisions, first, necessitate surrender of unspent amounts. The year end savings arise not due to adopting economy measures, rather in most cases due to failure in preparing realistic budgets and institutional bottlenecks in programme management. Second, the expenditure pattern is not evenly balanced during the year, despite repeated official instructions from MOF, and year end lapse provision leads to rush of expenditure at the end of the year. Third, in the annual budget system the future year commitments of the policies undertaken are absent. A single year is not always sufficient to complete any particular project which spread over to future years. Also the new policies undertaken during the year have recurrent expenditure commitments in terms of maintenance and running costs that are not calibrated in the current budget. Inadequate control over departmental commitments; especially on the capital side worsens the gap between liabilities and resource availability. This imposes financial burden in the future year budgets that may be hard pressed for finding resources.

In the traditional line item budgeting system predictability of fund flow is low that affects planning and implementation. As the departments are not informed about the expenditure limits early in the budget cycle, the expenditure planning is not carried out within a budget restraint. There is always a tendency to inflate the expenditures. The budget cuts and imposition of budget ceilings by the Ministry of Finance in a bilateral decision making process at a latter period, when leaves the departments with reduced budget, the reductions are not calibrated on a priority basis. Rather size of various schemes is reduced across the board. On the other hand, when revenue forecasts are overestimated that enables financing inflated expenditure demands; invariably it results in budgets cuts and restrictions on payments at a latter stage. Low predictability of fund flows to the departments due to inflated expenditure budgeting and consequent fund flow restrictions; result in delays, and poor expenditure effectiveness.

**III**

**Past Attempts at Budget Reforms and Outcome Budget**

To provide a link between public spending and physical targets, Government of India introduced performance budget following the recommendations of the Administrative Reform Commission (1968). The performance budgeting was sought to be introduced at federal government level in USA following the recommendations of Hoover Commission. While the budgeting system in USA, since the early performance budgeting following Hoover Commission followed by programme budgeting and budgeting systems in many other countries have undergone qualitative changes, the budgeting system in India has remained more or less input based.

The performance budget at the centre was initially presented for few departments on a supplementary basis in 1968 and latter its scope was enlarged to cover all the ministries. Some state governments also made efforts on their own to prepare performance budgets. But the efforts came to be substantially diluted at the centre, as the scope of the document was limited to plan programmes. The departments continued the practice of preparing performance budget annually in addition to their regular budget. The preparation of performance budget has become a routine affair without any discernible influence on the expenditure management.[68] The performance budgets seem to be the conversion of regular departmental budgets with narrations regarding the various plan programmes run by them and physical achievements. The objective to bring in a system that emphasizes results and making administrators as managers to enhance effectiveness and efficiency of public spending through performance budgeting thus remained unfulfilled. The weaknesses of performance budgeting as practiced all these year in India was highlighted in the guideline issued for preparation of outcome budget 2006-07 and performance budget 2005-06 by the Ministry of Finance (MOF). The guideline pointed out that, "a need has for some time been felt to address certain weaknesses that have crept in the performance budget documents such as lack of clear

[68] A Premchand (2007), Trapped in the Comfort Zone of denial: 50 Years of expenditure management in India, National Institute of Public Finance and Policy, (Mimeo), p 16

one-to-one relationship between the Financial Budget and the Performance Budget and inadequate target-setting in physical terms for the ensuing year. Besides, there is growing concern to track not just the intermediate physical "outputs" that are more readily measurable but the "outcomes", which are the end objectives of State intervention." The introduction of performance budgeting, however, resulted in creation of a new accounting classification system for the budget in mid-seventies which was refined periodically.

The government took initiatives to introduce ZBB in 1987-88 with the objective of comprehensive budgetary review of various programmes run by departments. The objective of ZBB was to improve effectiveness of public expenditure programmes by evaluating alternative ways to achieve the programme objectives through cost effectiveness analysis, prioritization of objectives and allocating resources to programmes with higher priority and eliminating programmes which have outlived their utility. The effort to launch ZBB lost its momentum in latter years. The theme of ZBB was sought to be revived again during 1999-00 although with a limited scope for new outlays only. However, it was not used in the following years. The attempt to introduce ZBB has not received enough support from the executing agencies that resulted in its demise.

The introduction of outcome budget in 2005-06 has revived the themes of obtaining budgetary outcomes as distinct from inputs[69]. The outcome budget, initially limited to plan outlays in the first year of its introduction, subsequently extended to non-plan outlays. The preparation of outcome budget is planned to be a joint effort by the central agencies, viz, finance ministry and planning commission, and the administrative departments. In the guidelines issued for preparation of the outcome budget, broad format has been provided for each programme that includes, the objective or the outcome intended, proposed outlays for the year, quantifiable deliverables/physical outputs, projected outcomes, processes and timeliness and remarks and risk factors. The guideline also defines these performance indicators[70].

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[69] Outcome budget of Ministry of Finance, 2007-08 in its preface indicate that "the Outcome Budget is an endeavour of the Government to convert the "Outlays" into "Outcome" by planning the expenditure, fixing appropriate targets, quantifying the deliverables in each scheme and bring to the knowledge of all, the "Outcomes" of the Budget outlays provided for each scheme/programme. Thus, the "Outcome Budget" is an effort of the Government to be accountable and transparent to the people."

[70] The Guideline for Preparation of Outcome Budget, 2007-08, defines the performance indicators in the following way;

**OUTCOMES:**

Preparation of outcome budget involves the following steps – defining measurable outcomes, standardizing the unit costs of delivery, benchmarking standards, capacity building for attaining the requisite administrative capacity ensuring necessary funding, effective monitoring and evaluation and making the system far more intrusive through the participation of the community and the stakeholders[71]. The outcome budget designed with the objective of bringing in the management concept and also seeks to identify the risk factors that can influence converting intents to outcomes.

The budget reforms over the year emphasized the need for moving beyond the traditional budgeting system where central focus is on inputs to programme performance budget which is output/outcome oriented and establishing organizational and individual accountability framework. In this context it is useful to define the performance indicators that relate to the budgetary process. The inputs refer to the resources used to produce a service, the output is the service itself and outcome is the purpose achieved by producing the service[72]. While the outputs are basically the goods and services produced that can be measured physically and quantitatively, the outcomes are impacts in terms of achieving the goals. The actual outcomes of a programme may be known only after several years and the outcome mentioned in the budgets are merely intents. To that extent the guideline to the outcome budget indicates that the final outcome need not be co-terminus with the annual targets and may span a longer time frame.

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- Improvement in literacy level from --% to ___% by a target year .or bringing ___(no.) of educationally most backward districts (or other administrative unit) to minimum 50% literacy by a target year.
- Similar targets for 'Infant Mortality Rate', 'Minimum employment guaranteed under law: % of population/districts covered', '% of children covered under immunization programme, % of villages provided with access to potable water, % of villages connected to block headquarters by all –weather road; % of villages/blocks/districts certified by Ministry of Labor as "Minimum Wage –compliant" ; % share in total power generating capacity, volume of trade with developing countries; tourist arrivals; etc
- Sub-targets, to the extent feasible, for coverage of women, SC/ST population, Special Category States, North Eastern Region etc may be considered for further value-addition.

**OUTPUTS:**

- Quantity and value goods/services produced or supplied; number of new schools, primary health centres or Anganwadis opened; number of children enrolled, enrollment ratio and retention ratio; number of beneficiaries assisted; amount of (subsidy linked) credit disbursed; number of man days employment generated and value of assets created or incremental value of work in progress

[71] Ministry of Finance, Department of Expenditure (2007), Guideline for Preparation of Outcome Budget 2007-08

[72] Salvatore Schiavo-Campo and Daniel Tommasi (1999), Managing Government Expenditure, p. 26

For the year 2007-08 the Outcome Budget and Performance Budget are merged and placed in one combined document, the latter providing information relating to the preceding year. The objective is to compare the performance of the past year vis-à-vis the performance indicators used for the budget year. The administrative ministries are required to prepare their respective outcome budgets by late March each year on the basis of the Annual Financial Statements presented in the parliament in February. The performance budget, now part of the outcome budget, would indicate the 'outcome' of the outcome budget of the previous fiscal year. Thus, while Annual Financial Statement and outcome budget would be for the ensuing financial year, the performance budget would be present the picture of actual achievement/performance for the financial year gone by.

In practice the measurement of outputs and outcomes, looking at outcome budgets of various departments, seems to have been mixed up. While, the outputs could be measured in quantifiable terms, measuring outcomes is difficult proposition given the fact that proposed outcomes of a specified programme could be influenced by many other extraneous factors. The outcome budgets of many departments merely reproduce the outputs targets to be outcomes and in many other places general intents of the programmes are passed of as outcomes. The outcome budgets in practice do not clearly enunciate the fiscal year goals that would facilitate securing accountability from the implementing agencies in amounts spent and performance measures and in economy in resources use, efficiency in operation and effectiveness in the results. The outcome budget, notwithstanding its objectives, does not seem to have gone beyond the familiar performance budget as practiced all these year since its inception in 1970's.

The budget calendar for preparation of outcome budget and performance budget by the administrative departments raises issues pertinent to formulating outcome measures and their link with resource allocation. First, indication of performance measures in terms of outputs or outcomes, measurable and quantifiable as indicated in the guideline, is being used as an *ex post* exercise by formulating them after the main budget is presented. It would then appear that the outcome measures indicated in outcome budgets of various departments are not derived based on any programmatic and activity analysis using cost information. Second, the performance measures are not being used in the expenditure decision making reflected in the budget as these are formulated taking already presented budget figures. Amounts indicated in the budget are shown as outlays and the general intents and targets of various schemes are shown as output and outcome measures. The physical targets, many a times shown as outcomes, could also be considered as outputs in the programme performance budgeting context.

A point can easily be made relating to performance targets. The performance measures should not be used for ex-post analysis of budgetary outcome as indicated in MoF instructions. Rather, performance targets should be set as goals. Thus, no difference needs to be made between outcome and performance.

In the steps involved in the preparation of outcome budget outlined in guideline, in addition to defining the outcomes in measurable terms, other important elements are standardizing unit costs of delivery and benchmarking the standards/quality of outcomes and services. The objective of these processes is to adapt management process in the public sector management for converting outlays into outputs and outcomes and addressing the value for money concerns. Benchmarking the standards/quality of outcomes and services in terms of target versus actual, or in terms of historical series, or in terms comparable activities needs to be specified and unit cost of delivery to be worked out for budget purpose. Formulation of standards and related unit costs should be specified properly to achieve the programme outcomes efficiently under overall budget constraint. To adapt such management processes a robust financial management system is required and administrative capacity needs to be strengthened to formulate outputs and outcomes. However, these aspects were not given sufficient attention during the all these years when the performance budget was continued to be prepared. The accountability framework needs to be established to make organizations and individuals responsible for the delivery of intended outputs or outcomes, which will contribute to its success.

While the outcome budget as evolved since 2005-06 has not been able to establish an effective system, the efforts are important and shows the direction of further reforms. The concept of presenting outcome budgets are relevant in the present context to evaluate the budgetary spending in terms outcomes rather than only achieving financial compliance under the traditional inputs budgets. The practice needs to be taken further by strengthening the processes and activities to infuse performance orientation in the budgeting system by building a proper performance information system that would influence the expenditure decisions and evaluate performance.

## IV

## Opportunities

There is firm linkage between fiscal policy framework and financial management and the fiscal discipline to a great extent determines the shape of financial management systems. The budgets reflect the overall fiscal policies of the government and the financial management systems are principal instruments for implementation of fiscal policies and provide information that forms the basis for monitoring and reporting the fiscal situation. The fiscal situation both at central and state level have improved upon significantly in recent years as compared to the difficult years in late nineties. The fiscal imbalance necessitated pursuing fiscal correction and consolidation measures. One of the notable improvements in recent times is the enactment of Fiscal Responsibility and Budget management Act (FRBM) by the central government in 2004 and by the states governments during 2005-06 to prune the fiscal and revenue deficit ushered in a rule based fiscal management regime.

The FRBM act, in addition to charting out fiscal reduction path, provides an element of medium term fiscal planning that reinforces fiscal discipline. It stipulates achieving revenue balance and 3 percent fiscal deficit at both level of government by 2008-09 and provides for presentation of medium term fiscal framework (MTFF) and fiscal policy statements along with the budget documents. The MTFF works out forward projection of revenues and expenditures for three years in which the fiscal targets such as revenue and fiscal deficit targets as indicated in the FRA are worked out.

The fiscal policy statement provides broad view of governments strategies relating to revenue generation and expenditure allocation. The preparation of medium term fiscal framework and the fiscal policy statement thus have a legal sanctity that provides a medium term outlook for the fiscal management for the government. These documents have enhanced the transparency level in government fiscal management and are useful for various stakeholders in the economy including general public. Regular availability of fiscal data of central and state governments and easy access to such data and other fiscal management information through departmental websites has improved general awareness and has provided useful inputs for research work.

The adoption of FRBM provides opportunities for budget management at a macro level. The FRBM act and the policy documents including MTFF have brought about changes in the budget formulation at macro level where the open ended approaches have been avoided by adopting a budget constraint in term of deficit targeting due to its legal sanctity. While the FRBM act and the MTFF have set the macro parameters to be achieved, beyond that its impact on actual budget formulation is not very clear. It is time to look beyond achieving macro fiscal targets and address concerns relating to strengthening financial management systems and consequently productivity of government expenditures.

The introduction of outcome budgets, although the performance budgets are in existence for a long time, emphasizes the importance of performance orientation in the budgets. The ideas inherent in the outcome budget such as linking the level of funding with performance indicators and imbibing management process to ensure accountability are more relevant now. The effort of the government provides opportunity to reassess the budget reforms and needs to be taken further by strengthening the process and procedures and strengthening financial management systems.

The use of information technology (IT) in government has produced significant results. The IT system has increasingly been used to improve payrolls, pension payments, treasury management, tax administration, budget management, accounting and budget reporting. The use of IT provides opportunity to strengthen financial management. The IT will be useful to provide various types of information in a short time that helps financial management and budget formulation. The expenditure tracking on programmes, budget control by gaining mid-course information on progress of programme implementation, information on flow of funds and payments are crucial areas in which IT will be very helpful. The budget reforms will be facilitated with greater use of IT in financial management process.

## V

## Directions of Budget Reforms

Budget formulation should be based on resource trade-offs and prioritization of programmes to ensure that budget conforms to government policies and priorities. The major themes of budget formulation are fiscal discipline, strategic resource allocation and operational efficiency. Budget reforms should proceed to secure economies in expenditure, efficiency in operation and effectiveness in implementation to improve quality of delivery system. The weak link between policy, planning and budgeting has resulted in poor budgetary outcome. Absence of a detailed expenditure planning within a budget constraint contributing to overlapping of programmes, lack of specifications with delivery system and traditional accountability system in a compliance budget framework contributed to weak budget management.

**Keeping these broad themes in view the major steps towards outcome oriented budget formulation are indicated here.**

- Preparing a macroeconomic framework to ensure that budget follows broad macroeconomic polices and remain well within the resource constraint. In that fiscal targets to be adhered are set up and levels of expenditure compatible to the fiscal targets are determined.
- Spending limits are communicated to administrative departments at an early stage of budget preparation to establish a hard budget constraint and improve budget planning
- Preparation of expenditure policies for various sectors that fits the aggregate expenditure levels indicated in the macroeconomic framework.
- Multi-year expenditure planning by estimating forward costs of programmes within the spending limits already made known
- Strengthening performance budgeting by infusing performance orientation to address for better budget outcomes.
- Allocation of resources consistent with government policies and already agreed upon fiscal targets. This is the most important dimension of budget formulation.

**Macroeconomic Framework**

The budget should be framed within a macroeconomic framework that includes fiscal targets and macroeconomic projections with realistic assumptions. Fiscal variables such as revenues and expenditures in the framework should be projected realistically to avoid overestimation and underestimation that would stand the budget implementation. To integrate government policies into the budget and determining matching expenditure levels depends upon the standard of the macroeconomic framework. In this context, the framework is not merely forward projections of economic variables. The fiscal projections in the framework are based upon the fiscal targets to be achieved during the budget cycle and instruments. The projections of real sector variables, monetary variables, exchange rates, external debt, in the framework should be on the basis of economic policy of the government and should be integrated with fiscal management.

The macroeconomic framework provides broad indication of availability of resources to the government within which budget is to be formulated. On the expenditure side the framework provides broad estimates of government expenditure categories such wages, interest payments total transfers, capital outlays. Sectoral allocation of resources relating to expenditure categories, however, is not worked out at this stage. Macroeconomic framework, thus, leads to more specific fiscal framework relating to fiscal targets and composition of expenditures in realistic and sustainable manner and most important, advance ceilings for the departments on the basis of resource availability to facilitate budget planning.

Under the provisions of FRBM act, the medium term fiscal policy statement, otherwise known as medium term fiscal framework (MTFF), sets three year rolling target for prescribed fiscal indicators with specification of underlying assumptions. The fiscal policy strategy statement contains the policies of the government for the ensuing year relating to taxation, expenditure, market borrowing and other liabilities and elements having budgetary implications. It also contains strategic priorities for the ensuing year, rationale for the policy change, provision for mid-year assessment, and policy evaluation. This document is important as it gives details of government policy detailing the fiscal management that government proposes to undertake to achieve the targets outlined in the FRBM act. The macroeconomic framework contains overview of the economy, GDP growth profile, external sector balance, trends in monetary variables, and central government finance.

Thus at the macro level these documents outline government policies and under MTFF, fiscal projections are carried out to indicate broad movements of revenues and expenditure for three years in a rolling manner that is consistent with fiscal targets. These exercises fulfill the initial requirement of budget formulation by indicating the fiscal targets (deficit targets) resource availability and expenditure levels compatible with the targets. The macro framework facilitates provision of expenditure ceilings to all the ministries and departments within the available resource limit.

**Advance Expenditure Ceilings**

The budgetary process in India is initiated in August and September when the budget circular is issued to various departments by the Ministry of Finance. The receipt side of the budget that includes revenues receipts, interest payments, recoveries of loans, and capital receipts is formalized during the months of October and November from the estimates of tax receipts and estimates of receipts by various departments. The first proposals of expenditure budget called statement of budget estimates (SBE) are submitted by the departments by mid November to the budget division (MOF). The departments obtain the estimates of expenditures from various organizations and units under their control and after being scrutinized by the Financial Advisor these are sent to the budget division. The proposed SBEs for the ensuing year contains proposals only relating to non-plan expenditures as the plan proposals are decided by the Planning Commission. On the basis of these proposed SBEs pre-budget discussions are held between expenditure secretary and departments (financial advisors from the departments) in November after which expenditure ceilings are fixed. The departments rework their non-plan budget proposals within the specified ceilings. The budget proposals are finalized after the Planning Commission communicates the annual plan allocations. Subsequently departments prepare the ‘demand for grants’ to be presented in the parliament with accompanying notes and statements.

If spending limits are notified to the departments in timely manner, it leads to better planning of expenditure. infuses hard constraint in the budget preparation. The budgetary calendar indicates that the expenditure ceilings are fixed only after the revenue receipts from all sources are firmed up and first proposals are received from the departments and discussed bilaterally in the pre-budget meetings. The expenditure ceilings, however, are restricted only to the non-plan expenditures and the departments are left to finalize their expenditure proposals after the plan size is decided by the Planning Commission. Such a procedure raises two issues. First, the departments prepare their initial proposals without having any indication on possible budget size. Although, the past trend provides guidance to draw the initial proposals, presenting a bigger budget becomes a normal practice anticipating possible budget cuts. Second, the reduction in proposed expenditures when requires redrafting the proposals by the departments; it may lead to cuts across the board in the programmes of the subordinate units in an arbitrary manner due to paucity of time and inclination to go through the merit of all the programmes again. This affects the programme execution adversely.

The plan and non plan divide runs too deep to give a comprehensive idea about resource availability to the departments at an early stage of budget development. The dichotomy between plan and non-plan in expenditures has been commented upon as unnecessary developments that has adverse effects on the quality of public services.[73] This distinction, however, undermines the budget formulation process of the departments by brining in complexity. The five year plans prepared by the Planning Commission are indicative in nature and are operationalised through annul plans. The schemes/projects to be undertaken in the plan are indicated in the plan documents and resources are made available in the annual budgets. However, if any new scheme/project is proposed by any department, it requires 'in principle' approval from the Planning Commission and then financial resources are tied up in consultation with the Planning Commission. This requires detailed analysis of resource requirements and availability of funds for the existing schemes and if fund requirement exceeds the availability reprioritization exercise needs to be undertaken. The procedures are elaborate and time consuming thus leaving the individuals departments with less flexibility in proposing new schemes. From the budgeting point of view the relevant distinctions are in terms of revenue and capital expenditures with sufficient disclosures relating to new expenditure proposals. The plan non-plan distinction in expenditures needs to be abolished keeping in view its impact on budget development and public service delivery. The departments should have flexibility in developing their budgets with prior indication of resource availability.

[73] Government of India (2000), Report of the Eleventh Finance Commission, p.33

**The departments require comprehensive view of resources while formulating their budgets. The finance department, following a top-down approach should determine the availability of aggregate resources for the budget as derived from the macroeconomic framework and establish departmental expenditure limits consistent with government priorities. The expenditure ceilings should be transmitted to the departments early in the budget formulation stage including both plan and non-plan expenditures.**

In the preparation of advance expenditure ceilings for the departments, important elements that need to be considered are macroeconomic objectives and fiscal targets, review of sectoral programmes, forward estimates for programmes estimated under rolling plans, and government policies relating to sectors. However, expenditure ceilings are to some extent is determined on an incremental basis. Committed expenditures in terms of salary and pension payments, debt servicing, interest payments, running costs of existing schemes, and future year impacts of the ongoing schemes cover major portion of the budget. It is only in respect of the new schemes where longer period perspectives are necessary and proper assessment is needed.

The budget circular issued to the department at the starting of the budgetary process is the convenient document in which the resource availability to the departments may be indicated. The format of the budget circular needs to be improved upon to change it from routine document to a more functional one. The budget circular, in addition regular formats and guidelines should contain information on macroeconomic and financial situation, deficit targets adopted at macro level and government priorities for the ensuing year. In the budget circular the ministry of finance should indicate the sectoral spending limits. Under rolling budgetary procedures (considered in this chapter) it can also include information on allocations for continuing programmes.

**Expenditure Planning**

Improved expenditure planning by the departments forms the core of the budgetary process. Formulation of and costing of departmental spending programmes within the expenditure limits already made know to the departments is the major step in this regard. “Planning, to state the obvious, involves specification of objectives, selection of the organization and financial instruments that enable a fulfillment of the intent, and a detailed blueprint of operations in which tasks, process and responsibilities of every unit engaged in the activity are specified in some detail. In short, before a programme is included in the budget and adequate provision is made for the funding, care needs to be taken to specify the strategy and the managerial and operational aspects."[74] These issues cover vast expanse of expenditure planning and will be elaborated in subsequent sections.

**Preparation of Expenditure Policies for Various Sectors**

In the expenditure planning primary factor for resource allocation should be at the programme level. Policy relevant programme classification for government spending provides link between the budget and the overall strategic planning. If a specified amount is targeted to be allocated to a sector, the decision has to be on the basis of different programmes run by the sector to comply with aggregate targets. The programme based expenditure classification is generally understood to be grouping of expenditures pertaining to activities on services that have common public policy objectives or outcomes. The programme classification of expenditure leads to clarity about the objectives being pursued through public expenditure. Such a classification facilitates decision making on spending upon competing programmes that are most central to allocative efficiency[75]. For instance decision may have to be taken as to how much to allocate to programmes such health treatment vs. health prevention, or elementary education vs. secondary or tertiary education. The programme based expenditure prioritization, however, rests upon robust costing of the programmes. As inputs are basic elements on which the budgetary amounts are spent, the costing of programmes has to be carried out by allocating expenditures on inputs based on the objectives for which the inputs are used.

The departments responsible for preparing their expenditure proposals within the ceilings indicated should clearly distinguish between amounts required to run the existing programmes and amounts required for new programmes. As the spending limits are set in advance comprehensively, the expenditure planning will cover both existing and new

[74] A Premchand (2007), Trapped in the Comfort Zone of denial: 50 Years of expenditure management in India, National Institute of Public Finance and Policy, (Mimeo), p 99

[75] Marc Robinson and Holger van Eden (2007), "Program Classification", in Marc Robinson (ed) Performance Budgeting Linking Funds and Results, IMF

programmes consistent with plan programmes. The launching of new programmes should be accompanied with assessment of its forward budget impact including the project implementation costs and recurring costs to run and maintain the assets created through it. Such an assessment will show the resource requirements for the future budgets and will be handy for the finance departments while determining the budget ceilings. The forward estimates of new programmes should be carried out in a formal multi-year rolling framework.

The practice of presenting multiple supplementary demands for additional expenditures during the year has undermined the sanctity of annual budget. Improved expenditure planning should therefore aim at avoiding this and restore the primacy of the annual budget. The use of supplementary demands should be restricted to the contingent situations and to the regularization of unavoidable excess expenditures. The aggregate expenditures derived from the sector proposals should be considered as firm and deviations should be limited.

Along with the budget proposals the departments should submit statements elaborating the sector polices and expected outcomes. Wherever possible realistic and relevant performance indicators for the proposed programmes should be developed and past results and expected performances for the ensuing year should be provided. The policy statements should also indicate the ways and means of achieving the programme objectives. The economy and efficiency measures that will be part of the implementation process should also be indicated. The outcome budget and performance budget presented provide the quantifiable outcome measures and past performances. However, as discussed, these are developed after the budgets are presented in the parliament and are not part of the budget formulation process. The performance orientation should guide the expenditure planning. These are discussed in a subsequent section.

**Multi-year Perspective**

Multi-year budgeting addresses the basic problem faced in the budgeting, - how to integrate planning and budgeting. The multi-year budget planning is different both in structure and content from the development planning practiced in India and is purely financial in nature. The development planning process is not fully integrated with the budget process and is often optimistic in nature. Multi-year budgeting essentially refers to budgeting in the medium term, i.e., a perspective covering 3 to 5 years including the current year budget. A medium term perspective for budgeting becomes necessary because a single year budget is not sufficient to meet the expenditure priorities. Given the rigidity of committed expenditures and their large share in the budget, success of any new programme and associated adjustments in expenditure priorities require several years beyond the annual budget. The preparation of rolling multi-year expenditure planning leads to improvement in budget preparation by providing advance expenditure ceilings to the departments, increasing predictability of resource availability, and by improving efficiency of public spending. **A realistic multi-year budget framework (medium term) is considered as the cornerstone of performance oriented budgeting, linking resources to policy objectives that defines performance.** For focusing on outcome, a multi-year approach to budgeting is a must, as it takes time for outcome to materialize.

Expenditure planning in a multi-year framework distinguishes between existing and new policies. The existing policies are implemented over several years and in that they need continued outlays in the future. Thus, the outlays needed in the future years are estimated, on a rolling basis, for the next three to five years for each programme. Such estimation in addition to bringing in predictability of resource availability to the line ministries facilitates budget planning and implementation and also helps central agencies in estimating level of aggregate expenditures in the future years. Multi-year budgeting enables better expenditure prioritization and adjustments as and when necessary and becomes immensely helpful for annual budget preparation.

Decomposed rolling expenditure planning requires the mapping of the expenditure profile of each programme. The detailed outlays on line items vary considerably among the programmes that determine the content of expenditure control. In the case of financial planning the multi-year estimations should be carried out in a much compressed form that is different from the detailed minor heads and appropriations used in budget making. Thus the approach to financial planning involves rearrangement of numerous items of expenditures into meaningful categories that provides analytical insight into the functioning of the programme. The expenditure profile of programmes so built forms the core of the data base to be utilized for budget making by line ministries and policy formation by the central agency.

**The multi-year expenditure profile of the programmes should be utilized by the finance ministry to anticipate the magnitude of expenditure demands and more important formulate the ceilings on the allocation for each ministry.** As elaborated earlier, these ceilings should be indicated to the line ministries early in the budget formulation process and instructed to formulate their expenditure proposals within the ceilings indicated. The ceilings are hard budget constraints that will remain valid or the duration of the whole year and supplementary demands considered only in exceptional circumstances. These procedures will lead to greater firmness in taking decisions on requests for new proposals even in the present procedure through the Planning Commission. The multi-year expenditure planning and the programme profile will also enable review of continuing programmes by central agencies to identify programme vulnerability and to discard or modify the programmes that ceased to be effective.

The major focus of multi-year expenditure planning practiced in many other countries is to create a mechanism for better expenditure control and resource allocation by increasing predictability and management responsibility in formulating programmes under hard constraint. Although, budget is prepared in an annual basis, the general view is that annual expenditure budget requires longer term perspective beyond the budget year. The multi-year mechanism provides better information on the medium term cost of current expenditure policies and recurrent costs of capital investment undertaken. Countries like Australia, Canada, Germany, Netherlands, and USA practice multi-year expenditure programming. The United Kingdom has evolved a three year budgeting ceiling under its new public expenditure management system. The multi-year rolling expenditure planning developed in Australia is an example of consistent and disciplined approach that ensures proper linkage with the annual budget. In Australia forward estimates for three years in addition to the budget year is prepared for the existing programmes. The forward estimates are integrated with annual budget to find fiscal space for new programmes. The estimates are reviewed number of times during the year to take into consideration changes in various economic parameters and are made public.

The multi-year expenditure planning starts with initial projections in which medium term expenditure implications of on going programmes are projected. In the next stage these projections are adjusted by incorporating cost impactions of changes in policies (upward or downward adjustments). While carrying out the projections cost estimates of ongoing programmes are prepared before the budget preparation process to assess scope for taking up new programmes. As mentioned earlier, before the budget preparation expenditure ceilings are provided by the ministry of finance over a multi-year period. This will provide indication for required level of savings for the new programmes. During the multi-year phase the projections are updated every year to take into account changes in economic parameters. The preparation of multi-year expenditure planning should be closely coordinated with the annual budget formulation process. The first year of the expenditure planning must be fully consistent with the budget. There should not be separate processes for annual budget and expenditure planning and the budget should emerge from the multi-year expenditure planning process.

**Making Budget more Performance Oriented**

Performance budgeting has the objective of improving allocative and productive efficiency in public expenditure. "Performance budgeting refers to procedures or mechanisms intended to strengthen links between the funds provided to public sector entities and their outcomes and/or outputs through the use of formal performance information in resource allocation decision-making. Formal performance information in this context refers to performance measures, measures of the *costs* to particular parties of outputs and outcomes, and assessments of the effectiveness and efficiency of expenditure obtained through the use of any of a range of analytic tools."[76] Judged from this perspective, major characteristic of performance budgeting is the budgetary use of performance information, both in budget formulation and implementation or in other words in budgetary policy making. Performance budgeting should not be conceived only to establish a mechanism to link funding with the performance measures. Factor like giving responsibility and flexibility to the managers, developing realistic performance indicators for departmental budgets and cost measurements, and improving accounting system in the agencies that deliver services are integral to performance budgeting systems that infuse performance orientation.[77] Introduction of formal performance budgeting without any perceptible impact on performance orientation should not be the direction of reform.

[76] Marc Robinson and Jim Brumby (2005), "Does Performance Budgeting Work? An Analytical Review of the Empirical Literature", Working Paper, WP/05/210, IMF
[77] Salvatore Schiavo-Campo and Daniel Tommasi (1999), Managing Government Expenditure, p. 67

The performance budgeting framework adopted in India, although recognizes the broad principles of budgeting of this genre and provides for measurement of specific outcome, has not been able to foster performance orientation both in budget formulation and implementation. In practice the performance budget and outcome budget that are prepared after the main budget is presented, serves the purpose of merely reporting the performance measures, which are not even derived on the basis of proper programme planning. The performance budgeting as a mechanism of reporting performance measures differs from the conception of performance budgeting that is defined here, which seeks to establish a mechanism for the use of performance measures and other performance information in budget formulation and execution.

The attempts to adopt principles of performance budgeting in USA since 1950 to shift the focus of federal budget process from item based government budgeting to a more result oriented budgeting provides important insights for India. The federal initiatives include budget reforms following the Hoover Commission report during post World War period, Planning-Programming-Budgeting –System (PPBS) in 1965, Management by objectives (MBO) initiated in 1973, and Zero-Base Budgeting (ZBB) initiated in 1977 and Government Performance and Results Act (GPRA) started in 1993. The earlier attempts were formulated mechanistically and ignored the broad political choice involving the budgetary process, i.e., allocating resources among competing needs and priorities. The more recent GPRA was developed as a multi-year government wide implementation process by integrating planning, budgeting and performance measurements. Its basic premise is that the budget decisions should be based on clear information relating expectations about programme performance and use of performance information in the budgetary deliberations. The key elements of GPRA are improved consultation between executive and the legislature relating to agency goals and missions, use of agency programme activities to develop performance planning and measurement, and emphasis on a range of performance measurement that strive toward but not initially demand outcomes.[78]

[78] United States General Accounting Office (1997), Performance Budgeting Past Initiatives offer Insights for GPRA Implementation, March

The performance budget in India, the current nomenclature of outcome budget and performance budget notwithstanding, should conform to its core objectives of enhancing allocative and productive efficiency in public expenditure. The formulation of performance budget should revolve round a multi-year framework and improved expenditure planning, as suggested, keeping department programmes at the core. The key features of performance budgeting to be followed are as follows.

- Each department would develop a medium term strategic plan covering a period of three to five years where the sector goals and objectives are identified and the sector policy to achieve these goals through its activities are elaborated. The primary focus of the sector plans is the sector programmes that are intended to achieve the goals or objectives. The objective of developing a medium term strategic plan is to align the sector programmes with government policies. The departmental strategic plan should not be confused with the broad based 'five year plan' developed by the Planning Commission, and are more specific regarding the sector goals and the plans to achieve such goals.
- The departments need to cost their projects and activities in a medium term that contributes to specific objectives. These objectives are the programme goals and through costing the expenditure implication of each programme over a number of years are estimated. The resource allocation in performance budgeting system requires output/outcome measures to be related to these costs. While costing the programmes practical difficulty may arise if the accounting system is not strengthened to pull all the cost data by programmes.
- On an annual basis the programme goals need to be defined and to monitor their achievements of the objectives a set of performance indicators framed. The significance of measuring performance indicators lies in securing accountability from the programme managers. In the traditional budget inputs are basic elements that are allocated on the basis of standards and rules and emphasis is on economy aspects. The purely output based budgets are based on services delivered and products produced and emphasis is on relating inputs to outputs, i.e., on efficiency aspects. The outcome based budgets are based on achievement of objectives, with emphasis is on outcomes and impacts, i.e., effectiveness of outputs produced. In the context of performance budgeting often the debate revolves round the indicators of performance – output versus outcome indicators. While outputs are generally under the control of

the executing agencies, outcomes are more complex and are influenced by elements outside the control of agency. For instance, health department can design an output indicator such as patients treated in public hospitals, it will be difficult to measure the performance on the basis of an outcome indicator such as improved health of patients. Further distinguishing between impacts of multiple programmes is also difficult. The point that needs to be clarified as to what managers should be accountable for.

Although the idea of linking funding to outcome measures seems to be difficult, establishing such a link is not totally impossible as shown by the PSA system devised in UK where the agencies come to an agreement to deliver improved services in measurable terms with increased level of funding. Without such institutional arrangement as developed in UK under its 'agency' concept, bringing in performance orientation to the budget management will be difficult. In chapter 2 we have discussed the usefulness of introducing 'Agency' concept as way forward in the context of institutional improvement for performance orientation. Various steps recommended here for bringing in performance orientation in budgeting system would be possible only when the institutional framework is changed in line with the 'Agency' concept.

The performance budget management should indicate outcome indicators that can be part of the performance information to be used for budget formulation and evaluation. The desired properties of the outcome indicators are that they should reflect government objectives adequately, indicate desired impact on the community, focus on target groups, and suitable for monitoring. The outcome indicators should be clearly defined devoid of ambiguities for reporting purposes and an achievable time frame should be fixed.

Caution needs to be exercised as the performance indicators only indicate the achievements; ex-post evaluation requires to be done to examine the level of outcomes. Retrospective analysis needs to be carried out to assess success of a project, programme, or policy, which will provide feedback future improvements. In other words, performance measurement should be accompanied with performance management to improve public service delivery or effectiveness of the public spending. The performance management system should have performance information system consisting of core set of data amenable for ready assessment. The appropriateness of such information/data should be assessed regularly and monitored on a continuing basis.

The performance budget prepared by the ministries/departments in India, now merged with the outcome budget has the objective of reviewing the past performance. In 2007-08 outcome budget, where the performance budget is merged, the review is limited to the physical achievements by indicating physical targets and achievements and reasons for variation[79]. The performance evaluation system should be comprehensive in nature by including the achievement of outputs and outcome measures. The performance information system is not only useful for the policy makers, but also to citizens and elected representatives. Different level of users may seek different types of information, such as; performance achieved vs. planned, performance achieved vs. the standards, or performance achieved vs. past achievements. This brings into notice the benchmarking of performance measures as provided in the guideline to outcome budget.

- Based on the above principles an annual performance plan should be developed that includes performance indicators to measure the relevant outputs and outcomes of each programme. In case of programmes where measurable goals are difficult to be expressed, non-quantifiable targets can be indicated. The annual performance plan will provide the much needed link between strategic plan and the means to achieve the goals indicated in the plans.
- The strategic plan for the sector including the sector goals, the programmes and activities proposed to achieve the goals and the relevant performance measurement plan in which performance indicators are specified should be formulated through proper consultation process involving the executive and the legislature.
- With the sector strategic plan for a medium term in place, the annual performance plan would be formulated *ex-ante* so that this information would be used or annual budget formulation. Given the early indication of spending limits, the departments would formulate their budget by prioritization consistent with the sector strategic plan and costing of their projects, activities and programmes.
- The formulation of outcome budget in the Indian context, although, stated to be the essential responsibility of the departments, the financial advisor serves as the nodal

[79] For the year 2006-07, the departments presented outcome budget 2006-07 and performances budget 2005-06 separately in the parliament. The performance budget 2005-06 contained provisions for review of scheme-wise performance and review of actual achievements vis-à-vis intended outcomes.

officer in charge of coordinating the whole exercise and prepares the outcome budget. The programme managers are supposed to provide draft write-ups to the finance advisor. This organizational arrangement seems to be inadequate, as emphasized in a latter chapter, to undertake the mandate of such a dimension. The outcome /performance budget to be effective needs the head of the department who is designated as chief accounting authority (CAA) should have the ultimate responsibility. A Financial Management Board (FMB) should be constituted in the department with the secretary as chairman, FA as a convener, and all the senior officers in charge of various programmes as members to establish a broad consultative process to undertake the formulation of outcome/performance budget in a multi-year mode.

The FMB will be in charge of formulating sector strategic plan, programme goals, costing of programmes through costing of projects and activities, and annual performance plan (with performance indicators). Such an institutional arrangement is different from the itemized budgeting where the programme managers have very little involvement in expenditure allocation. In the outcome/performance budgeting system by strengthening institutional arrangement accountability can be ensured from the programme managers. This will infuse a collective responsibility in budget formulation and implementation.

- In the performance budgeting system one other crucial factor which to a great extent influences the achievements of programme managers is according flexibility in the operation management. This entails reducing centrally determined budgetary control over the use of inputs to deliver the services. In the existing traditional inputs based budget appropriation is based on detailed input categories, the agencies are largely unable to shift funding from one line-item to another. The performance budget calls for more flexibility to the sectors by removing such constraints that will facilitate budget execution and achievements of budget goals.
- Performance budgeting system requires greater coordination between the executive wing that develops the programme performance measures and the legislature that approves the budget. The budgetary decision are to a great extent are political in nature for which political ownership to departments' initiatives are paramount for the success of performance budgeting system. The present outcome budget provides for

presentation of outcome budget in March and the documents are made available to the members of parliament and departmental standing committees for their examination during the recess period and put in the departmental web site. The procedure makes it possible for circulation of outcome budget among the stakeholders, but only in an *ex-post* sense. The legislature through appropriate institutional arrangements should be involved in the formulation of outcome/performance budget. The standing committees associated with the departments are most appropriate bodies to provide initial interface between the executive and the legislature by reviewing sector strategic plan, sectors programmes and performance measures to evaluate the achievements. The standing committees should also go through the process details for operationalising the performance budget and cost estimates. The minister in charge of the department should be appraised about the performance budget details from the beginning it self and his or her inputs should be made part of the budget formulation for wider acceptance. At a higher level the estimates committee that examines budgets should also look into the performance budget closely to provide guidance.

- The departments should work by closely aligning with the Ministry of Finance. The Ministry of Finance would provide the initial indication of availability of resources in terms of spending limits in a medium term framework that will be used by the departments to formulate the annual budget consistent with medium terms sector strategic plans. In the evaluation and periodic assessment of performance measures the Ministry of Finance should be involved closely.
- The performance measurement to be credible the performance information should be verified. Although periodic assessments and verification would be carried out internally, the involvement of external audit agency is important in this context. The external audit agency, CAG, should on an annual basis of on a rotational basis cover all the programmes in a specified duration of time. The performance audit that the CAG has been undertaking should be expanded to include the performance budgeting elements and audit the performance of programmes.

The above suggested budgetary system changes should be introduced as part of a Budget Law. The introduction of such a Budget Law will provide a legal backing to some of the initiatives already started and budgetary reform suggested here. The performance budgeting initiatives are acknowledged to be part of broader set of reforms that influence the management of public sector. The PES system that has been recommended for adoption (chapter 1) would provide such an initiative for wider management reforms by focusing on policy issues and costs of programmes.

# Chapter 4

## Role of Integrated Financial Advisor in Financial Management

### Introduction

Under the existing scheme of budgetary and financial control and delegation of powers, the Ministries have a Financial Adviser (FA), who plays a pivotal role in the Ministry's financial management. With his assistance, administrative ministries exercise the enhanced powers delegated to them. FA is responsible to the administrative ministries in the exercise of its delegated powers. Outside the scope of the delegations, the FA functions under the guidance of the Finance Ministry.

In accordance with the Government of India (Allocation of Business) Rules 1961, financial powers of the Government are vested in the Ministry of Finance (MoF). The Department of Expenditure (DoE) in the Ministry of Finance has the authority to delegate financial powers to various subordinate authorities of the Government of India. The financial powers of the government, which are not delegated to any subordinate authority, remain with the Ministry of Finance. The Department of Expenditure has the authority to prescribe financial rules and regulations necessary to run the affairs of the Government.

At present there are 29 Financial Advisers, many of them have additional charge of more than one ministry/department. It is necessary for proper functioning of the Integrated Financial Adviser system that there should be no multiple charges and every department should have its own full time Financial Adviser.

The FA's position is the outcome of a process of decentralization of financial powers within the Government of India. In 1955, Internal Financial Advisers were appointed in selected administrative ministries to represent the Ministry of Finance and in order to exercise the MoF delegated powers. Each ministry had an Internal Financial Adviser and associated Financial Adviser based in the Ministry of Finance, Department of Expenditure.

In 1973 the Yardi Committee report recommended that responsibility for internal financial management should be entirely that of administrative ministries. It reiterated the need for performance budgeting and management accounting, under which internal financial management would have a fruitful role.

**II**

## Genesis of Integrated Financial Management System

By the Office Memorandum of 6th October, 1975 the concept of Integrated Financial Adviser was introduced. The Office Memorandum merged the posts of Internal Financial Adviser in the separate administrative ministries and the associated Financial Adviser, based in DoE.

"In the new scheme, the Financial Adviser will be responsible both to the administrative Ministry and to the Ministry of Finance. With the assistance, the administrative Ministry will be able to freely exercise the enhanced powers delegated under the Department of Expenditure and outside the scope of delegations, he will function under the general guidance of the Finance Ministry."[80]

With the introduction of the scheme of Integrated Financial Adviser and enhanced delegation of financial powers to ministries, the role of the Ministry of Finance declined significantly in the micro management aspects of financial management of the Ministries.

It was also stated in the Office Memorandum of 6$^{th}$ October 1975 that, "It is cardinal to the working of the new scheme that the Financial Adviser should be associated with the formulation of schemes from the initial stages". This, in practice, never happened. Normally, the Financial Adviser comes into the scene much later when the scheme has taken a concrete shape when he can play only a limited role of concurring with the proposal or raise some points, which get answered in due course. The repeated asking of questions or raising issues is frowned upon as an unnecessary intrusion. Raising basic issues questioning the "necessity" of the scheme/proposal, became more and more difficult under the integrated financial advice system.

The other argument in favor of introducing the scheme that the financial expertise of Financial Adviser would assist "the Secretary of administrative Ministry and other senior officers in the planning, programming, budgeting, monitoring and evaluation,

[80] OM No. F10(13)-E.Coord/75 dated 10$^{th}$ April, 1975

functions of the Ministry", was empty in content, as the system of planning, programming, budgeting and evaluation as a decision-making process in resource allocation and financial management, was never introduced. What came into effect was a watered-down version of performance budgeting, which also never took off and was more in the nature of "window dressing". So the benefit of the integrated financial advisor system, as contemplated while introducing the scheme, never materialized.

Rather the net effect of the integrated financial advice system has been gradual erosion of the position of Financial Adviser in the role of giving objective financial advice for achieving 'value for money' in government expenditure. This would be very clear if one looks at the role envisaged for the Financial Adviser, before introduction of the integrated financial advice system. For example, we can see role envisaged for Financial Adviser (Defence Services) in the financial rules, which was not different from other FAs in content, under earlier scheme of things, which is mentioned even today (perhaps as a nostalgic memory) in an appendix of Defence Services Estimates, though the Integrated Financial Adviser scheme has been introduced. To quote, "The financial control exercised by the Secretary (Defence/Finance) and his officers is really a careful and intelligent scrutiny of all proposals involving expenditure from the public funds, the objective being the safeguarding of economy, efficiency and propriety in public finance. Before according financial concurrence to any proposal involving fresh expenditure, it is the duty of Finance Officer to seek justification for the proposal. *He may even challenge the necessity for spending so much money or on such a scale to secure a given object. He asks whether the proposal is really necessary; whether the same results could not be obtained otherwise with greater economy; whether the expenditure involved is justified in the circumstances*; *whether individual items are in furtherance of the general government policy, whether the cannons of financial propriety have been observed. In fact, he asks every question that might be expected from an intelligent taxpayer bent in getting best value for money*" (emphasis added)[81]. Under the integrated financial advisor system, it is indeed difficult to ask questions relating to 'necessity' of a proposal or ask any basic questions. Same problems are faced in raising questions on the basis of principles of financial propriety. Two most important canons of financial propriety are: (i) "Every officer is expected to exercise the same vigilance in respect of expenditure incurred from

[81] Pragraph 2 of Appendix B, of Defence Services Estimates 2006-07; for that matter the Defence Service Estimates of any year would show the same para

public moneys as a person of ordinary prudence would exercise in respect of expenditure of his own money"; ii) "The expenditure should not be prima facie more than the occasion demands".[82] **In 1989, to bring in the principle of accountability in expenditure management to the existing five standards of financial propriety, a sixth one was added by a specific amendment by Government of India, MoF in 1989, which read: "The responsibility and accountability of every authority delegated with financial powers to procure any item or service on Government account is total and indivisible. Government expects that the authority concerned will have the public interest uppermost in its mind while making a procurement decision".[83]**

**It is interesting to note that in the 2005 edition of GFR the 'accountability principle' inserted in 1989 has been omitted. Such is the apathy in the matters that relate to financial propriety, that omission of this important principle from the standards of propriety of GFR, is neither discussed nor debated.**

## III

### Problems faced by Financial Advisors in Playing an effective Role

While every officer concerned with spending government money was supposed to observe the standards of propriety, in effect, it became duty of the FA to ensure, while examining proposals for financial concurrence, that these principles were indeed observed by the spending authorities. This was in effect a role of a controller in the ministry/department for achieving economy, efficiency and propriety in public finance.

That the above role envisaged is incongruous with the present position of the Financial Adviser, as far as Defence Ministry is concerned, is brought out from the very first paragraph of the amended Appendix B, (where the Integrated Financial Advice system came later after some hesitation from 1 August 1983), which stated, "Thus there is now complete integration of the former Defence Division of the Ministry of Finance with Defence Ministry. The designation of the Financial Adviser emphasizes the Advisory as distinct from the restrictive function of the treasury control".[84] (p. 123, para 1, Appendix B, of Defence Services Estimates)

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[82] GFR Rule 6, 19th edition, 2002
[83] G.I., O.M.No.F.23(10-E.ii(A)/86,dt the 29th June,1989
[84] Appendix B, of Defence Services Estimates,2006-07, p. 123, para 1

Thus, in effect, neither the Ministry of Finance, who has delegated the powers to administrative ministries/departments, nor the Financial Adviser under the Integrated Finance Scheme can play a pro-active role with the aim of assuring an "intelligent tax payer bent on getting the best value for his money", that the public money is really well-spent.

The problem is compounded by the fact that while there is a concept of dual responsibility as far as FA is concerned, but the role of MoF in the scrutiny of proposals referred to it, is being questioned as pointed out above by former Secretary, Expenditure.

Indicating the problem being faced by financial advisors and expenditure department in the discharge of their functions, C. Ramachandran, the then Secretary Expenditure, in a key-note address in a workshop of financial advisors in National Institute of Financial Management (NIFM) in 1999 drawing upon his experience as Financial Advisor in Department of Industry, stated that "he should be concerned himself with whether there was budgetary provision or not without going into details of the schemes. The Financial Adviser is supposed to be a person who should only state whether the project expenditure is as per the budget but should not go into the questions of propriety or correctness of the use of the budget. In the Finance Ministry, especially in Expenditure Department, we have reached a stage where every ministry points its hand criticizing the Finance department. There are criticisms, starting from Courts of law to Committees of Parliament. Whenever questions are asked from agencies or Departments why they had not taken a particular action they say that 'Finance' had not given them adequate funds or 'Finance' had objected to the scheme. We are sometimes being called upon by the Committees of Parliament as to why we had raised a particular objection due to which proposal could not go through".[85]

The point regarding 'budgetary provision' would have been very valid for supporting a scheme if the budget was drawn on the basis of prioritization of programmes and schemes after thorough deliberation and evaluation applying zero-based approach. In that event, the budgetary provision alone would have been adequate for approval of a proposal. But, as we know, the budget formulation is input-oriented without much

[85] B. P. Mathur (1999), Budgetary Reforms and Expenditure Management in Government, National Institute of Financial Management, Mudrit, p. 6

reference to programme aspects and their prioritization. **Therefore, the budget ceases to be an aid in decision-making in clearance of proposal. This problem is faced by all financial advisors in their respective departments. It also means that unless the budget formulation is re-oriented by bringing in the programme concept focusing on costs of programmes in a multi-year framework, which are prioritized within the ceilings indicated by MoF, the financial advice rendered by FAs would be piece-meal and would not be helpful in achieving value for money. Therefore, reforming the budgetary process is central to reforming the financial management system. This would strengthen the role of financial advisors in the scrutiny of proposals as it was envisaged under the 1975 letter introducing the integrated financial advisor system.**

What to speak of financial advisors, even in the cases which are not within the ambit of delegated powers to the ministry, and are required to be referred to the MoF, questions are being asked about the nature of the examinations done there.

This is clearly brought out in the oral evidence by the Finance Secretary before the Standing Committee as of Parliament on Defence on the Demands for Grants 2006-07.[86] Answering a query relating to cutting down the delay in clearing the proposals by Ministry of Finance, the Finance Secretary during oral evidence stated as under:

“At the beginning to cut out the delays and remove the bottlenecks, I should present to the Committee the communications which have been exchanged at the level of the Finance Secretary with the Defence Secretary, the Finance Minister and the Defence Minister and vice versa. You will be glad to know that a core of consensus has now developed on what are the criteria or parameters on which Ministry of Finance shall examine the proposals of the Ministry of Defence and what are the things which prima facie, in the first instance, the Ministry of Defence shall contain in their proposals. No cross-referencing should be there. The obvious questions should not be asked and they should be answered prima facie. Secondly, we have delimited ourselves by saying that these are the only points on which we shall query and not beyond that”.[87]

The Ministry who has been entrusted with the function of financial control and management under Transaction of Business Rules of the Government of India has to

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[86] Report of the Standing Committee of the Parliament on demand for Grants, Defence, 2006-07, para 1.49, p 21

[87] Ibid para 21

delimit its role, who cannot ask the so-called “obvious questions” and has to arrive at a “consensus” on the “criteria or parameters” on the basis of which it shall examine an expenditure proposal.

If this is the position of MoF, one can imagine the role of Financial Adviser under the system of Integrated Financial Adviser scheme, as it has evolved during last three decades, as to what extent it can examine a proposal on its merits, keeping in view the criteria of economy, efficiency and financial propriety.

This also indicates the FA of the department has ceased to be a ‘bridge’ between the spending department and the Ministry of Finance. In fact under the scheme of Integrated Financial Advisor system this is a major role, which FAs were expected to play.

One obvious adverse effect has been on budget formulation and budgetary control which is the core of financial management. For example, as per the evidence before the Standing Committee on Defence, for the year 2006-07, Defence (Finance) in the Ministry of Defence who is in-charge of formulation defence budget, sought an allocation of Rs. 94,183.17 crore from the Ministry of Finance, against which the allocation made was Rs. 89,000 crore, a reduction of 6 percent from the projection made.[88] This reduction was questioned in the Standing Committee’s deliberations.

Earlier practice was, the budget that was finally allocated became the budget which was fully ’owned’ by the Ministry concerned and no further questions asked. There was the culture of ‘trust’ at the senior executive level, which is basic necessity in good financial management system. Describing the UK system of financial management in mid-seventies in the context of examining of PESC system, Helco and Wildavsky stated, “Mutual trust is considered paramount by officials who know they will have to do business with each other year after year on issue after issue. They believe that, of professionalism means anything, it means knowing how to treat members of one;s own group… From this central place of personal trust, much else flows… Treasury-spending department relations are superb expression of the network of reciprocal trust”[89]

[88] Ibid p 8
[89] Hugh Helco and Aron Wildavsky (1974), The Private Government of Public Money” Macmillan, p 15-16

Now it is seen from the Standing Committee, deliberations has become the forum, where Finance Secretary has to explain the cuts and rationalize the allocation made both at the Budget Estimate (BE) stage and Revised Estimate (RE) stage.

Explaining the cuts made in the budget the "representatives of the Ministry of Finance during deposition before the Committee stated that: "In no year during the past decade, the Ministry of Defence was able to spend hundred percent of the budget allocated to them. The shortfalls have been from 0.1 percent to 10 percent of the allocation".[90] (para 1.33, page 13, of the Standing Committee Report on Demands for Grants: 2006-07)

Significant cuts are now made in the Revised Estimate stage, in contrast to the earlier periods, where at the RE stage there was some increase in the budgetary allocation, on the basis of trends of expenditure. The cuts are now made by the Ministry of Finance on the basis of trend of expenditure, which are also contested by the Ministry of Defence.

In 2005-06 for Ministry of Defence at the Revised Estimates stage, on the basis of mid-term review of the trend of expenditure, the Ministry of Finance reduced the BE figure of Rs. 83,000 crore to Rs. 81,700 crore (a reduction of Rs. 1.30 crore), about which Ministry of Defence expressed its unhappiness before the standing Committee of Parliament, but ultimately the Ministry of Defence actually surrendered about Rs. 2,646 crore in the year 2005-06. This is not an isolated phenomenon. This has happened year after year, as shown by following figures in the Ministry of Defence.

**Table 6 Trend of Expenditures, Ministry of Defence**

(Rs. crore)

| Year | BE | RE | Actuals | Shortfalls |
|---|---|---|---|---|
| 2000-01 | 58587.00 | 54460.91 | 49622.04 | 4838.87 |
| 2001-02 | 62000.00 | 57000.00 | 54265.73 | 2734.27 |
| 2002-03 | 65000.00 | 56000.00 | 55661.83 | 338.17 |
| 2003-04 | 65300.00 | 60300.00 | 60065.80 | 234.20 |
| 2004-05 | 77000.00 | 77000.00 | 75855.92 | 1144.08 |

[90] Report of the Standing Committee of the Parliament on demand for Grants, Defence, 2006-07, para 1.49, para 1.33, page 13

| | | |
|---|---|---|
| 2005-06 | 83000.00 | 81700.00 |

As the Ministry of Finance stated, "It may merit attention that Defence expenditure is the single largest item of expenditure, after 'interest payments' and the Ministry of Defence gets major allocation from Government budget. In all these years, it was found that during the course of mid-year review that capital expenditure of the Ministry of Defence was much below the amount provided in the budget".[91]

This kind of mutual bickering in the open, which gets published, do not help in building up mutual trust. Clearly, FAs have to play a constructive role in building it up. The concept of dual responsibility of the FAs becomes relevant in this context, which should be encouraged. FA's be encouraged to act as a bridge between spending departments and the Ministry of Finance. The Ministry of Finance has to repose adequate trust on the judgment of FAs, who should in turn ask the same questions while examining a proposal, which Ministry of Finance ask. This was the orginal model and this is how IFA system worked, which should not be altered.

The inability to spend the allocated amounts (after significant reductions have been made in Revised Estimate stage compared to the allotted amounts nor Budget Estimates) is a phenomena which brings out decline in the effectiveness role of Financial Adviser in the budget formulation, monitoring and execution. That this is indicative of weak financial management, has been commented upon by the Comptroller and Auditor General and the Standing Committee of the Parliament, from time to time in their reports.

But, it is also indicative of the fact that FAs are not effectively playing the dual responsibility role and the trust of the Ministry of Finance in the judgment of the FAs is getting eroded. This, in turn, means that Finance Division may not be exercising the same amount critical scrutiny of the budget projections, as they are expected to do.

Again, for illustration, let us take the case of Department Heavy Industry (Ministry of Heavy Industry and Public Enterprises), in regard to budgetary management for which performance audit report of C&AG for 2005-06 is available. The Department administers 48 public sector enterprises a natural level laboratory and two non-operating

[91] Ibid, para 1.31 and 1.37, page 13 & 15

holding companies. The details of allocation of fund and expenditure incurred by the Department of Heavy Industry during the year 2003-04 to 2005-06 are given below:

**Table 7 Expenditure incurred vis-a-vis funds allocated, Department of Heavy Industry**

| Year | BE | | RE | | Expenditure | | percentage of expenditure to BE | |
|---|---|---|---|---|---|---|---|---|
| | Plan | Non-plan | Plan | Non-plan | Plan | Non-plan | Plan | Non-plan |
| 2003-04 | 100.00 | 500.65 | 85.00 | 790.81 | 84.91 | 753.57 | 84.91 | 150.52 |
| 2004-05 | 131.00 | 688.65 | 100.00 | 688.41 | 67.83 | 647.15 | 51.78 | 129.43 |
| 2005-06 | 406.00 | 463.10 | 500.00 | 710.76 | 382.53 | 1170.01 | 94.22 | 252.65 |

From the above it may be seen "that while there was a saving of 48.22 per cent of the plan budget in the year 2004-05, the extent of excess expenditure in Non Plan over the budget estimates during the years 2003-04 to 2005-06 ranged between 29 and 153 per cent, which indicated poor budgetary control".

This persistent savings, the audit report comments, indicated inadequate pre-budget scrutiny. To quote, "Scrutiny of Head/Scheme wise expenditure of 2003-04, 2004-05 and 2005-06 revealed that the total provision under various sub-head/scheme had not been utilized, with the savings ranging between 44 to 100 per cent in three years".[92] This was indicative of inadequate pre-budget scrutiny of schemes/funds. This again shows the decline of the role of FAs in control and monitoring of budgets.

The same lack of effectiveness in the role of FAs in controlling the expenditure is evident on the issues of rush of expenditure in the month of March, in which the Performance Audit report on Department of Heavy Industry comments. The Ministry of Finance has time and again in recent years emphasized that under an effective cash management system not more than 33 percent of budget should be utilized during the last quarter. The following table relating to Department of Heavy Industry shows that rush of expenditure during the last quarter could not be controlled.

[92] C&AG (2005-06), Performance Audit, Ministry of Heavy Industry and Public Enterprises, para 5.2.3.1

**Table 8 Rush of Expenditure in the Last Quarter of the Financial Year, Ministry of Heavy Industry**

| Year | Total expenditure | Expenditure from April to December | Expenditure in the last quarter i.e. January to March | Expenditure in March | Percentage of the expenditure in the last quarter/March |
|---|---|---|---|---|---|
| 2003-04 | 838.48 | 590.54 | 247.94 | 176.25 | 30/21 |
| 2004-05 | 714.98 | 417.91 | 297.07 | 138.06 | 42/19 |
| 2005-06 | 1552.54 | 647.61 | 904.93 | 752.30 | 58/48 |

"Rush of expenditure during the closing months of the financial years" the Performance Report comments, "reflects poorly on overall financial management implying lack of effective monitoring to ensure regular flow for expenditure".[93]

It is evident that effectiveness of financial advisors in monitoring and control of expenditure, in integrated financial advisor system has been adversely affected. This calls for an introspective look into the system.

At the same time it has to be realized that the solution to problem relating to budgetary control cannot be found by addressing the issues to Integrated Financial Adviser. Proper financial management and budgetary control is the responsibility of the entire Ministry/Department. All the Senior Executive Officers of the Ministry/Department, Joint Secretary upwards have to be equally concerned about the budget formulation and management in their areas of responsibilities. Secretary of the Ministry/Department has been designated as the Chief Accounting Authority who would be primarily responsible for the efficient financial management of his Ministry/Department. In this endeavour he/she has to have active support not only the Financial Adviser, but all the other senior officers of the Ministry/Department, who should be judged about their efficiency among other things, for their contribution for effective financial administration in their area of control.

**There is also an urgent need to set up a Financial Management Board in each Ministry/Department to be presided over by the Secretary of the Department/Ministry, to consider all budgetary and financial management matters. The convenor of the Board should be the Financial Adviser of the**

[93] Ibid, para 5.2.3.2

**Ministry/Department. Such a Board should meet at least once a quarter. Government should issue instructions for setting up such boards with clear charter of duties.**

**IV**

**A Review of Role of Financial Advisor and a Revised Charter**

An internal review has been made by Ministry of Finance and an office Memorandum of F(5)/L&C/2006 dated 1.6.2006 has been issued. Recognising that the institution of Financial Adviser (FA) occupies a unique position in the functioning of the Government of India" and considering changing scenario, it states, "It is necessary that the role, authority as well as accountability of the Financial Advisers be redefined and codified in unambiguous terms, and their capacity enhanced to meet the emerging challenges".[94]

The intention is clear. But the question is, does the OM of June 1, 2006 help in strengthening the role of the Financial Advisers and enable him to render more effective financial advice for achieving value for money?

To quote from the letter "The overarching concept in redefining the charter for Financial Advisers are meant to assist in achievement of objectives/goals of their respective Administrative Ministries, as approved by the competent authority; and they must commit themselves to facilitate implementation of the approved programmes, with due financial prudence, to ensure that monies allocated are spent on time, in prescribed manner, to achieve the intended outcomes defined in measurable and monitorable terms. Assisting Administrative Ministries in ensuring `value for money' would be the key objective for Financial Advisers…"

The tenor is clearly that FAs would be fully responsible to Administrative Ministries in the discharge of his/her functions, ending the concept of dual responsibility. It will be recalled that under Delegation of Financial Rules 1978 the Financial Adviser was to be responsible to both the Ministry of Finance (MoF) and relevant administrative ministry. It was not easy for FA to maintain balance between obligation to Administrative ministries in achieving their objectives and that to the Ministry of Finance to achieve fiscal and

[94] Ministry of Finance, Office Memorandum of F(5)/L&C/2006 dated 1.6.2006, Introduction, para 3

fiduciary objectives. By the paragraph quoted above in the OM dated 1-6-2006, attempt has clearly been made to end this problem by emphatically stating that the FA's responsibility is towards administrative ministries. Confusion however may be created by asking the FAs 'to commit themselves' to implementation of programmes, which can also be construed to mean that there was a lack of commitment on their part.

But in the very next sentence in the OM it is stated: "It may also be reiterated that FAs represent the Ministry of Finance in regard to all financial matters".[95] How does FA represent MoF? What would be the guiding principles which will make this 'representation' by FA effective? These are not answered in the OM of 1.6.2006. It further states: "The more complex responsibilities envisaged for FAs must be accompanied by corresponding authority and capacity. It would, therefore, be necessary to ensure that FAs are suitably empowered…" How would this empowerment come about? (original emphasis)

The same dilemma is seen when the role of Financial Adviser is defined in Section II of the OM as that of Chief Financial Officer. "The role of Financial Adviser is now conceived to be akin to the role of **Chief Finance Officer** in a corporate structure, with specific responsibilities for ensuring fiscal prudence and sound financial management."

The MoF OM dt. 1.6.2006 defining the role of Financial Adviser states, "The role of Financial Adviser will be crucial for successful planning, implementation and monitoring of various schemes and projects. Value for money will be the most important parameter in evaluating such schemes and projects. Therefore, it is imperative that outlay for a scheme is intrinsically linked with the Outcome Budget and Performance Budget".[96] In describing the role of Financial Adviser, the emphasis is on zero based budgeting, outcome budgeting and performance budgeting, apart from FRBM (the Fiscal Responsibility and Budget Management Act) related tasks.

But the point is, preparation of Performance Budget, Outcome Budget as also Zero Based Budgeting, are basically the responsibility of Administrative Ministries. As

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[95] Ibid, para 4 of Section I
[96] Ibid para 7

the OM itself recognizes “The Administrative Joint Secretaries have to take the lead role in project/ programme formulation, implementation and monitoring”.[97]

The OM of MoF, which attempts to redefine the charter of Financial Adviser, need not be acted upon by the Administrative Ministries. It does not become mandatory for them to implement these budgeting reforms. If this framework of programme-based budgeting and evaluation of results does not exist, then the role of FAs also gets circumscribed.

The OM does nothing to empower the FAs. Rather, as it indicates, empowering of FAs would depend on many factors, many of which require time to develop and would require lot of support from the administrative ministry and the extent to which they become oriented towards modern management techniques. It states, “Such strengthening may include the need for using information technology, setting up knowledge management structures, building requisite databases, networking with relevant institutions/expert bodies etc.”[98]

It also mention some other factors which are not exclusively in the domain of Financial Adviser, where it says, “It may also require changes in various decision-making process, conflict resolution, problem solving, programme/ project formulation/appraisal, monitoring, evaluation etc.” It does not elaborate how these are to be done. Therefore, the basic issue of empowering FAs remains unattended.

Increasing the role of Financial Advisers, unilaterally by addressing the issue to FAs would not help, as effectiveness of his role would be circumscribed by the management framework within which he functions, where he is only one of the players. If the Ministry/Department concerned does not lay down its performance goals or outcomes that it wants to achieve, if there is no link between performance indicators and budgeting, if the financial management system does not make it mandatory for drawing up of Annual Financial Statement with computation of assets and liabilities, it is simply not possible to redefine the charter of FAs.

The OM states, “In rendering their advice, the Financial Advisers would be expected to accord priority to macro management with a view to help in achieving

[97] Ibid, para 9
[98] Ibid, para 23

outcomes set by the Ministries as goals for themselves. These macro issues could include schematic appraisal and concept functions, revenue management, subsidy management, fiscal resource transfer issues, defining and evaluating outcomes besides maintaining and safeguarding the budgetary integrity etc."[99] The macro management is to be given priority by FAs. But who would thus do 'micro management' which would mean examination of schemes and proposals put up for financial concerns?

The above para also assumes that 'outcomes' (goals) that are to be achieved by the Ministries have been worked out with due deliberations and accepted by the Minister; that macro management issues referred to above, have been considered by the Ministry/Department in a systematic way and a plan to address the issues have been drawn up, so that evaluation of the progress made in achieving the goals, could be the basis for rendering financial advice.

But there is no basis for such an assumption. Therefore, the role envisaged for FAs for macro management may not materialize at all.

The FAs are advised to move away from "itemized" control of expenditure to "budgetary control", hinting probably towards adoption of programme based budgeting[100].

Criticising the present system of budgeting, it states, "The present system relies largely on previous years programme allocations and continuing commitments, without any real evaluation and expenditure analysis. FAs would now be increasingly required to assist the Administrative Ministries/Departments in moving towards zero based budgeting and assist in better inter se programme prioritization/allocation within indicated budgetary ceilings, basing on analysis of expenditure profiles of each programme/sub-programme and information on cost centre/drivers; assessment of output, outcome and performance; and status of projects/programmes".[101]

In other words reference is to programme based budgeting and implicit assumption is that, it exists. There is no ground for such an assumption as MoF never asked for its introduction or gave any guide lines for its introduction. Nor does the OM

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[99] Ibid, para 8
[100] Ibid, para 9 (1)
[101] Ibid para 9

dated 1.6.2006 call for its introduction. Therefore the role of FA in this regard remains ambiguous.

Under the Office Memorandum of 1.6.2006, FAs would be required to prepare an "Annual Finance Report", "Annual Outcomes and Systems Reports" indicating operational aspects of the financial management of the Department/Ministry. How objective can FA be in furnishing such a report under the present situation when he is placed as an Integrated Financial Adviser in the ministry on which he is reporting?

Very often it is seen that the FAs who are not prepared to "tow the line" comes in for adverse notice. Therefore, it is not practical to think that the FAs would be able to render an objective Annual Financial Report, which would be critical of the administrative ministry in the execution of budget and other aspects of financial management. More likely, it would contain routine observations, which would hardly be of much use in imporving the system.

It needs to be emphasized again that the role of the FAs is that of a supportive one. He can help in preparing an Outcome Budget, but the basic initiative must come from the managers in administrative ministries. If the Administrative Ministry is not included to put together a carefully worked out outcome budget with performance indicators, how can the FA compare the outcome achieved vis-a-vis intended results?

**V**

**The Role of Chief Accounting Authority**

The designation of the Secretary of a Ministry/Department as the Chief Accounting Authority (under Government Accounting Rules 1990) and laying down his specific role in this regard in General Financial Rules, Rule 64, should be regarded as major milestone in securing accountability of public money. Unfortunately, this very major event in the conception of financial management system in the Government of India, has gone without a major discussion on how this role would be given effect to, what would be its institutional implications, and how in particular, it would affect the role of Financial Adviser. Even the letter F.No. 5(6)/L&C/2006 dated 1.6.2006, re-defining the role of Financial Adviser, does not address this basic issue, nor does it mention about the effect of change in GFR provisions regarding designating the Secretary of the Ministry/Department as the Chief Accounting Authority.

This indicates that financial management reforms do not come about by just by amending GFR provisions, which the concerned persons may not even look at, or by issue of Government letters, which do not have the backing of an Act, as in the case of FRBM Act 2003.

To see the implications of this re-designation, one has to refer to provisions in other countries in this regard. In U.K. the designation is that of Accounting Officer. The key element of accountability for public money is the role of the Accounting Officer. The Treasury appoints the most senior official in the department as the Accounting Officer to be responsible for departmental expenditure. As the Report by Lord Sharman, indicating the responsibility of Accounting Officer states, “This responsibility is for the propriety and regularity of public finances; for keeping proper accounts; for prudent and economical administration; for the avoidance of waste and extravagance; and for the efficient and effective use of all available resources”.[102] Many of these duties, we implicitly assumed are to be performed by the Financial Advisers in the Ministries/Departments of the Government of India.

The role assigned to the Secretary of a Ministry/Department, who is the Chief Accounting Authority, under GFR 64 is very impressive as far as financial management is concerned. Some of the important points indicated in the GFR are as follows:

The Chief Accounting Authority would:

i. be responsible and accountable for financial management of his Ministry or department;

ii. be responsible for the effective, efficient, economical and transparent use of resources of the Ministry or Department in achieving stated project objectives of that Ministry or Department, while complying with performance standards;

iii. be responsible for preparation of expenditures and other statements relating to his Ministry or Department as required by regulations, guidelines or directives issued by Ministry of Finance;

[102] Report by Lord Sharman of Redlynch (2001), “Holding to Account: The review of Audit and accountability for Central Government”, February, para 3.12)

iv. shall ensure that his Ministry or Department maintains full and proper records of financial transactions and adopts systems and procedures that will *at all times afford internal controls*;

v. shall ensure that his Ministry or Department follows the Government procurement procedure for execution of works, as well as procurement of services and supplies, and implements it in a fair, equitable, transparent, competitive and cost effective manners;

vi. shall take effective and appropriate steps to ensure his Ministry of Department:

a. collects all moneys due to the Governments and

b. avoids unauthorized, irregular and wasteful expenditure.

While the role of the Chief Accounting Authority has been properly spelt out through the above provisions in GFR 64, in keeping with the practice in many other countries, what is lacking is the force of law to give effect to these provisions and laying down modus operandi to implement them in practice.

One point however is clear. With the coming into force of this Rule, the responsibility of FA as the Chief Financial Officer (CFO) of the Ministry or Department, should be only to the Secretary of the Ministry/Department, who is the Chief Accounting Authority as such is 'responsible as well as accountable' for proper financial management of his Ministry/Department. As he is responsible for economical, efficient and effective use of resources, effective internal controls and for avoidance of irregular and wasteful expenditure, the role of FAs would be to support the secretary of the Ministry in this endeavour. If the analogy of the corporate sector is to be drawn, the role of the Secretary of a Ministry/Department is that of a Chief Executive Officer. The FA as Chief Financial Officer should be fully responsible to the CEO. Would the concept of dual responsibility to the Administrative Ministry, as well as Ministry of Finance be valid any more?

This is a major amendment to GFR, which redefines the role of secretaries of Administrative ministries by assigning them the pivotal role in financial management of the ministries/departments, with the aim of bringing improvement in them. But, there is no visible impact of this. It is necessary to incorporate these provisions in an Act, which can be called **Public Financial Management Act.** In other countries also such important changes in financial management are given effect to by enactment. Changing of rules does not have much impact.

The Secretary of a Ministry/Department should be recognized under the Act, which could be called Public Finance Management Act, as the Chief Accounting Authority and his role spelt out therein as to how this role would be performed. The Act should specify the role of FA, as Chief Financial Officer would be to assist Chief Accounting Authority in discharging his responsibilities relating to financial management. It should also provide for the Chief Accounting Authority to delegate to the Chief Financial Officer in writing any of the powers entrusted or delegated to the Chief Accounting Authority under the Act.

At the same time it should be recognized that just by designating the Secretary of the Ministry/Department as Chief Accounting Authority and assigning roles under an Act, will not solve the basic problems of financial management, unless systemic changes are also brought about.

What is required is a modern financial management system, through performance based budgeting, evaluation of programmes for achievement of results, better internal control system, and effective internal audit. It should also include accrual accounting for effective financial reporting about all aspects of financial management of the department/ministry, which cash-based accounting cannot do.

Professional guidance is required for modernizing the government's financial management system in all aspects. The financial management system in Central Government, which is run by generalists have not undergone any basic change over last several decades, though various new challenges have come. Attempts to bring about reforms in budgeting system have not made any impact and have failed away, because of lack of professional guidance. The same fate may befall attempt to introduce accrual accounting system in the absence of professional expertise in the government. Cost information is also lacking from the financial reporting.

Developing a modern financial structure for the Central government and associated system is an extremely challenging task, which needs are overall direction, leadership and professional expertise.

Public money lost through waste, mismanagement and fraud can not be controlled through piecemeal efforts and calls for improved central co-ordination of internal controls and financial accounting, which is the essence of controllership function. Where public money is involved, the accountability concept is wider than in the private sector, the controllership function has its own importance.

**Validity of the Corporate Model**

As stated above, the responsibility of a Chief Financial Officer, in a corporate structure can only be to the Chief Executive Officer and to the Board of Management, for ensuring sound financial management, not to any other outside authority. But in the Government sector dealing with public money, there may be occasionally issues where fiduciary duties may make it necessary to go beyond the organizations and consult externally.

In Government sector, where principles of financial propriety will always apply, the corporate model may not often the right model to emulate. A strong internal control system with focus on risk management, a well-resourced and independent internal audit guided by a formally constituted audit committee in each Administrative Ministry/Department, would be pre-requisite before the corporate model can be applied to a ministry or department.

If the FAs are to act as Chief Financial Officer of a government department, as envisaged in the OM dt.1.6.2006, then his/her role needs to be clearly defined, keeping in view the objective of ensuring accountability and achieving value for money.

**There is another challenge brought about by more and more delegation of powers and decentralization of responsibilities in financial management. The challenge is, how to reconcile the need for decentralization of responsibilities for financial management, with the needs for central guidance and leadership for bringing about modern financial management practices.**

The general impression that one gathers from pursuing the letter dt.1.6.2006 redefining the charter for Financial Advisors, is that ministry of Finance wants to get away from its leadership role in improving financial management of the government and wants to confine itself to macro-management issues, leaving it to the Ministries/Departments to improve their financial management on their own. In this process, it wants the FAs to assume leadership role in several aspects. Two of which can be mentioned: (1) regarding projects and programmes, it states, "FAs should lead in ensuing high quality appraisal and evaluate with requisite rigour";[103] (ii) regarding 'Financial Management', it states, "FAs would periodically review, the financial management of the various programmes/projects of the Ministry from the systemic point of view, and take appropriate action for making the financial management systems more effective".[104]

Both the roles expect too much from an FA in an integrated structure. But both the above roles are very important to ensure accountability and value for money. As public money is involved, both would call for not only guidance but active involvement of Ministry of Finance. But review from 'systemic' point of view of financial management of programmes and 'high quality appraisal with requisite rigour' would call for professional expertise, which cannot be provided by generalists in Ministry of Finance. It has to acquire professional expertise to perform these roles, as also to give guidance regarding developing of 'outcome' budgeting. This would call for reorgansiing of Ministry of finance to develop necessary expertise.

**It needs to be reemphasized that Ministry of Finance has to play leadership role in strengthening the financial management system, in accordance with its basic mandate, and continue to actively guide the FAs in their functioning as also involve itself in systemic review of financial management of the programmes/projects of the Ministries/Departments.**

The letter dt. 1.6.2006 also indicates that FAs should function like CFOs. This concept is not new in financial management of the government. But to avoid confusion

[103] Ministry of Finance, Office Memorandum of F(5)/L&C/2006 dated 1.6.2006, Introduction, para 9 (vi)
[104] Ibid para 9 (xiv)

and clarify about the roles to be played by central agencies CFOs in financial management, a suitable enactment is called for.

As indicated in Chapter 1, Ministry of Finance also needs to be reorganized to bring in more professionalism and involvement in the programme of the spending department.

## VI

### The Role of FAs as Chief Financial Officers (CFO) and Need for Enabling Legislation

In this context attention gets drawn to the provisions of the Chief Financial Officers Act, enacted by the U.S. Government in November 1990. The Act, recognized the urgent need for providing overall direction and leadership to the executive branches on financial management matters, (a) by establishing financial management policies and requirements and (b) by monitoring the establishment and operation of Federal Government financial management systems, and various other financial matters.

The US Congress, therefore, felt that financial management functions of the office of Management and Budget need to be significantly enhanced so that necessary leadership and overall direction can be provided in developing a modern financial management system (Section 102(a) & Section 202 of the Act). A post of Deputy Director for Management was created and an office of Federal Financial Management was established under the direction and control of Deputy Director for Management. A Controller was to be appointed by the President with the advice and consent of the Senate to head the office of Federal Financial Management. The Controller was to be a person with demonstrated ability and practical experience in accounting, financial management and financial systems, as also extensive practical experience in large governmental or business entities.

The Act also established in each agency Chief Financial Officer, to be appointed by the President with the consent of Senate. The agency Chief Financial Officer is to report directly to the head of the agency regarding financial management matters. He is to is oversee all financial management activity relating to the programmes and operations of the agency; develop and maintain an integrated agency accounting and financial management system, including financial reporting and internal controls. Most importantly, the act requires that financial statements be prepared by agencies and get them audited.

To meet the requirements of the job of CFO requires professional expertise. Deputy Director for management in Office of Management and Budget (OMB) is to provide advice to agency heads regarding qualification and selection of Chief Financial Officer, as also qualifications and capabilities of financial management staff throughout the Government.

The Director of the OMB would inter alia also prepare the 5 year financial management plan, which is to be implemented by the CFO of each agency by preparation and annual revision of an agency plan.

This is how a very major effort was made to improve the financial management system in U.S. federal government. Comptroller General of the United States in the preface to their booklet on the Chief Financial Officers Act wrote, “The Chief Financial Officer (CFO) Act of 1990 (Public Law 101-576) marks the beginning of what promises to be a new era not only in federal management and accountability, but also in efforts to gain financial control of government operations………This is the most comprehensive and far-reaching financial management improvement legislation since the Budget and Accounting Procedure Act of 1950 was passed over 40 years ago. *The CFO Act will lay a foundation for comprehensive reform of federal financial management*”.[105]

Drawing attention to the need to draw up a five year financial management plan as provided for in CFO Act, the booklet states, “The CFO Act requires OMB to prepare and submit to the Congress a government wide 5 year financial management plan. The plan, which is to be updated annually, is to describe planned OMB and agency activities for the next 5 fiscal years to improve the financial management of federal government. It should be a vision of financial management reform will be carried out – a blueprint for change

[105] United States General Accounting Office (1991), “The Chief Finance Officers Act: A Mandate for Financial Management Reform”, GAO/AFMD-12.19.4 dated September

with a set of clear expectations. Further, the act requires agency CFOs to prepare and annually revise agency plans to implement OMB's 5-year financial management plan".[106]

The comprehensive government-wide and agency plans called for in the act were to enable top managers to monitors major financial management systems development efforts and operations.

The CFO Act particularly recognized that the lack of a cadre of highly qualified financial management professionals had long hampered effective financial management operations.

To put briefly, the CFO Act thus changed the US federal financial management system in three ways: It created a new organizational structure for financial management, it encouraged the development of new and compatible accounting systems, and it required new form of reporting. Let us once again note the three basic changes introduced in organizational structure. First, to brighten management priorities and centralize primary accountability the act provided for appointment of a deputy director for management in OMB. This individual, one of the two deputy directors at OMB, is the Chief Financial Officer of the United States Federal Government with the responsibility for general management and financial management policies. The second was the creation within OMB of the office of Federal Financial Management under the deputy director for management. A Controller who functions primarily in the area of financial management, heads this office and serves as principal adviser to the deputy director for management. The final component of the organizational reform was the designation of CFOs and deputy CFOs for fourteen cabinet departments and eight major agencies of the executive branch. Accounting, budgeting, and financial activities were consolidated under agency CFOs who report directly to agency heads.

The need to strengthen financial management as a result of challenges faced by public sector has led many countries to establish financial management legislation. We have already discussed the Chief Financial Officer Act, 1990 of the United States. Then there are other acts like Financial Management and Accountability Act (FMAA) 1997 of

[106] ibid, page 72

Australia, Financial Accountability Act of Canada, and Public Finance and Management Act (PFMA) 1999 of South Africa.

The legislative mandate has greatly enhanced the role of financial management in the public sector of these countries and has given them a new direction. This would not have been possible without the legislation. With the enactment of basic legislation for strengthening financial management, giving necessary mandate to Finance Officers and strengthening the role of Accounting Officer in the financial management of the department/agency, it became possible to bring in other management oriented reforms. For example, in 1993 US Congress enacted the Government Performance and Results Act (GPRA), requiring agencies to develop strategic plans, their and report their performance against their goals. CFOs were the key component in the implementation of GPRA. Without the foundation laid for better financial management by the CFO Act of 1990, it would not have been possible to implement the GPRA.

Following the enactment of the CFO Act in USA, the policies and standards that govern government's financial management system were revised and various systems were upgraded or modernized, though the progress was slow. When the CFO Act was passed in 1990 only three agencies were issuing audited financial statements. The number steadily increased and in the fiscal year 1994 audited statements were issued for 124 federal reporting agencies and many of them received unqualified opinions.

This improved greatly the timeliness and accuracy of financial information used by executive branch. It also helped uncover material system deficiencies, strengthening internal controls and disclosure of measures of programme performance. Encouraged by the results, the US Congress enacted the Federal Financial Management Act 1994 extended the requirement of audited financial statements to all 24 agencies en-compassed by the CFO Act.

On the basis of these experiences, the need for enactment of suitable legislation for strengthening the financial management system is a must. It should indicate the role of each functionary, stress the need for established proper financial and accounting standards, and indicate improvement in the financial reporting system including the cost information. The Act should emphasize the need for strengthening internal control and internal audit is a must.

Apart from suitable legislation to improve financial management, other points that come out of the CFO Act are:

*1.* When the aim is to improve financial management system in the government by introducing better accounting and financial standards, improved financial reporting system and better standards of internal auditing, *it is necessary to have a central authority to guide the CFOs in setting up standards in all the aspects.*

2. Important organizational changes are required to establish new functionaries to support the initiatives for improved financial management.

3. Roles of various functionaries in the financial management system should be specifically laid down in an Act to avoid ambiguities and to provide necessary authority to perform the roles designed for them.

4. The need for improving the professional qualification of CFOs and their staff, can not be over emphasized in any serious attempt, to improve the financial management system.

5. Any contemplated Act for improving financial management in government, among other things, must provide for preparation and implementation of a 5-year financial management plan to improve financial management indicating milestones to be achieved which should be updated every year. It should be the specific responsibility of the central authority to draw up such a plan in consultation with CFOs and monitor its implementation.

The same realization that without establishing such a central authority significant improvement in financial management cannot be brought about, led the Government of Canada in 2004 to establish an office of Comptroller General (OCG), within Treasury Board Secretariat, "as a key element in strengthening government-wide comptrollership and oversight, particularly the areas of financial management and audit"[107].

[107] Treasury Board of Canada, Secretariat, Office of the Comptroller General, website - http:/www.tbs-set.gc. ca/organization/ocg-beg_e.asp

The President of the Treasury Board mentioning about the initiatives taken by the Canadian Government in strengthening public sector management, in the context of Budget 2004, stated "Globalization, increased public scrutiny and demand for greater openness, transparency and accountability, and the rise of knowledge-based economy have all placed huge demands on pubic sector management".[108]

Therefore, strengthening public sector management would involve ensuring greater transparency, accountability, fiscal responsibility, and ethical conduct in government. To achieve these objectives and strengthen public sector management, the Government of Canada decided to:

i. strengthen comptrollership and improve oversight,
ii. enhance the role of Parliament and practice disclosure of information,
iii. modernize and transform management practices and the ongoing review of government spending to improve administration,
iv. build capacity and better tools within public service to support good management.

The most important step in Budget 2004 of the Government of Canada was to re-establish the office of Comptroller General of Canada (OGC) who was "to provide leadership across the public service financial management community, and to ensure standards are set and adhered to".

The other important initiative was to, "Re-organise and bolster the internal audit function on a government-wide basis to ensure comprehensive audit progress, based on sound risk analyses of all departmental activities, with the authority to delve into every corner of every portfolio."[109]

Presently, the OGC's priorities among other things are aimed at:

- promoting strengthened financial and internal audit controls to ensure rigorous stewardship of public funds and value for money,
- setting and reviewing financial, accounting, and internal audit standards and policies for Government of Canada,

[108] http://www.fin.gcca/budget04/pamph/pamgte.htm
[109] http://www.fin.gc.ca/budget04/pamph/pamgte.htm

- providing leadership to ensure and enforce appropriate financial controls across the federal pubic service,
- cultivating sound resource stewardship at all levels throughout government,
- providing ongoing financial management and internal audit advice and support to the President, the Secretary and other branches of government,
- developing and implementing a comprehensive HR strategy for financial management and internal audit committees.[110]

**Considering the challenges faced in financial management of public sector in India, the new initiatives in Canadian government provides a good model for consideration. The need for establishing the controllership gets emphasized as also an authority called Controller General in the Ministry of Finance to oversee reforms in financial management and strengthening internal audit as well as provide leadership, who can be designated as Controller General of Financial Management.**

## VII

## Need for a Financial Management Wing in Ministry of Finance

In view of general deterioration of financial standards in India, as evidenced from audit reports of the Comptroller and Auditor General, both in the Centre and the States, there is need for reviving the controllership function.

Financial management cannot just be equated with expenditure management. Financial management has many other aspects, which requires professional and technical expertise. Internal control and internal audit is another very vital area of our financial management system. Integrated financial advice system and the present institutional arrangement have not been able to take up internal audit beyond a rudimentary level. What is, therefore, required is to create a separate Wing in the Ministry of Finance, for overseeing government's financial management practices and strengthening internal audit.

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[110] RPP 2006-07, Treasury Board of Canada Secretariat, The Office of Comptroller General has six branches excluding a Financial Management Branch and an Internal Audit and Advisory Services Branch. http://www.tbs-sct.gc.ca/rpp/0607/TBS-SCT/tbs-sct03_e.asp

This wing could be called Financial Management Wing. It should be headed by a person who could be designated as Controller General (Financial Management and Internal Audit), who should be a secretary level officer. The person selected for the post should be a professional expert. If government does not have a person with requisite qualification for the post, then recruitment should be made from outside the government sector.

There should be a specific Act establishing this post and creation of the financial management wing in the MoF, indicating its functions relating to financial management and internal audit. The same Act should give statutory mandate for the functioning of the Financial Adviser, enhancing his role emphasizing the controllership function.

It cannot be overemphasized that in the management of public monies principles of financial propriety have to be applied. As envisaged in the financial regulations in the past, the FA of a ministry/department would continue to have a special role in upholding these principles, as he/she has to give concurrence to expenditure proposals, which take them to finality. Integrating the FA in the administrative ministry should not in any way take away this important function. Designating the secretary of a ministry/department as chief accounting authority should not also diminish the role of FA in this regard. The proposed Act should reiterate this point.

The law (Public Financial Management Act) should spell out the role of both Chief Accounting Authority and Financial Advisers.

As recommended earlier there should be a **Financial Management Board**, headed by the secretary and include other senior functionaries of the ministry/department concerned with resource allocation and management. This Board should take final view about prioritization of programmes/sub-programmes/projects and resources to be allocated to them. The evaluation reports on the on-going programmes/projects should also be put up to the Board. The quarterly progress reports on the budget execution should also be reviewed by the Board and give direction about action to be taken for the next quarter. FA should be Convener of this Board. The proposed Act should provide for setting up such a Board for better financial management of the ministry/department.

## VIII

### Capacity Building

Financial management in public sector can no longer be treated as function of generalist officers. In India, there is no separate cadre of Financial Advisers. There is also no institutional arrangement for capability building of FAs.

The lack of attention to the technical and professional skills of FAs compares unfavourably with the heavy and technical nature of responsibilities required of them. A “background in finance” is cited as an additional skill in FA selection, but this is not essential.

There are several ministries having a predominantly public sector presence. Government has vital stakes in their efficient operations. The government has to undertake systematic and in-depth review of their performance from time-to-time. In the present set up of integrated finance wing, which have no management and cost accountants as part of the team, such reviews can be done only superficially. In an workshop for FAs, the then Secretary, Ministry of Power E.A.S. Sarma (who had been a member of Eswaran Committee 1996, which went into the role of FAs) stated, “I feel that one of the shortcomings of the FA system is that there is no professionalisation. It is a highly specialized, highly technical subject where you deal with budgets, you deal with appraisal procedures. So you required people who are trained. Secretary (Banking) in his evidence to the Committee said that in the Ministry you require a person who knows the new financial instruments which are emerging in the capital market. He said that Integrated Finance Division rarely understood and appreciated the issues emerging from time to time. He said that he would like someone from the capital market who is good in this in the Ministry. Similar is the situation in the department of Heavy Industry. You require somebody who knows how to restructure a sick PSU. Reading a balance sheet is a fundamental thing that most people do not understand in the Government. These are the types of problems which FA has to face.” (Publication of National Institute of Financial Management, *Budgetary Reforms and Expenditure Management in Government*, Ed. B.P. Mathur, 1999 p.211.)

The generalist’s approach to finance function contrasts with the situation in other countries; particularly those who have adopted accrual accounting have rapidly professionalized their staff. In Australia and New Zealand, the Chief Finance Officer should be a full member of a relevant professional body or have significantly demonstrated expertise in financial management. UK has also adopted the policy of recruiting professionally qualified accountants with senior level experience for the post of Finance Directors, equivalent of FAs in our system. In the United States, the Chief Financial Officer (CFO) is modeled on private sector Chief Finance Officers. Recent developments in governance and accounting and reporting standards in USA, have made it increasingly likely that qualified accountants will fill both CFO and Dy. CFO posts.

There are limits up to which persons without professional background can be trained to carry out onerous duties of today's CFOs. There should be no doubt that specialized, not generalized skill are necessary to develop and maintain integrated accounting and financial management system, for preparing organization-wide financial statements for performing proper financial audits. Introducing accrual accounting provides fresh challenges which cannot be met by persons not having professional background in accounting. It is only by applying accrual method can the management get a complete picture of their programme's financial performance, and thus offers a better tool for deciding how best to manage available resources.

The financial information would continue to be unsatisfactory, so long as no use is made of accrual financial information, as a regular management tool.

In the MoF OM dated 1.6.2006, there is no mention of introducing accrual based accounting for financial information. Regarding the Reporting system its says, "FAs will be required to prepare an "Annual Financial Report" which would be a factual report indicating operational aspects of financial management of the Department/Ministry, including information on resource requirement pattern of expenditure with reference to outlay/budget, opening and closing unspent balance etc." (para 13)

Annual Financial Report would be cash-based. This report cannot be a substitute for a financial statement indicating both assets and liabilities position, duly audited. Such statements can be prepared and interpreted only by persons having adequate professional background.

**Therefore, for strengthening financial management system in central government, it would be necessary to recruit persons with professional background in accountancy and audit. A cadre would require to be built up based on an examination open only to those having required professional background. One can also think of lateral entries at higher levels at the rank of Directors and above, who have required experience in accountancy and financial management. In future, the posts of FAs should be open only to those have this kind of professional background and experience in financial management.**

## IX

### How to Make FA's Role in Budget Formulation More Effective

The Financial Advisors in the integrated financial advice system have to play a crucial role in the formulation and execution of Ministry's budget. FAs are supervising the Chief Controllers of Accounts. This enables them to have access to information essential for budget formulation. This should lead to accurate formulation of budget. But from the prevalence of supplementary budgets, and the phenomena of March-rush and surrender of funds, it is clear that budget is not prepared with as much scrutiny and attention as was the practice earlier.

There has been clearly erosion in the role of FA in giving critical attention to details in budget formulation and subjecting the proposals to detailed analysis so that a realistic budget is formulated.

Following advice to FAs contained in the OM dated 1.6.2006, should be seen in the above background: "FAs would continue to be responsible for budget formulation. They would bring in more analytical inputs into budget formulation process, for improved budgeting and facilitating moving from "itemized" to "budgetary" control of expenditure. The present system relies largely on previous year's program allocation and continuing commitments, without any real evaluation and expenditure analysis." Para 9(1).

The erosion in the role of FAs in formulation and monitoring of budget execution would be evident from the reports of the CAG relating to Appropriation Accounts. For example, analysis of Appropriation Accounts for the year 2005-06 shows that during 2005-06, there was an excess disbursement of Rs. 97,062.69 crore in eight segments of eight grants/appropriations in Civil ministries; Rs. 2,296.13 crore under fifteen segments of eleven grants/appropriations of Railways; Rs. 44.84 crore in two segments of two grants in Defence; and Rs. 97.65 crore in one segment in one grant in Postal Services.[111]

According to the provisions of G.F.R.-56, unspent provisions in a grant or appropriation are to be surrendered to government as soon as these are foreseen without waiting for the last day of the year. The following table, taken from the analysis of appropriation accounts of CAG gives the summary of unspent provision and amounts surrendered.

**Table 9 summary of unspent provision and amounts surrendered**

(Rupees in crore)

| | Net unspent provision | Amount surrendered | Amount surrendered on the last date | Amount not surrendered |
|---|---|---|---|---|
| Grand total | (+) 66,895.99 | 28,089.65 | 26,224.39 | 1,871.55 |

The above table also vividly brings out the absence of planning in budgetary management. It also brings out that the traditional method of budgetary control is not working satisfactorily and expenditures are being incurred by violating budgetary rules. It also underlines the necessity of mandatory provisions in Budget Law, under which excesses of budgetary provisions are not permitted; as also making it obligatory to surrender the funds unlikely to be used by a particular date in a financial year. The sanctity of the budget has to be brought back.

The above excesses and surrenders indicate that budget is being formulated without meticulous scrutiny. Since budget formulation is the responsibility of FA, the phenomena mentioned above indicates that budget formulation is also not being done by FA and his staff with due care and without taking into account the departmental plans and ability to spend.

The lack of analytical inputs in today's budget-making is also the off-shoot of integrated financial management system, where the line of least resistance is being

[111] CAG (2005-06), Appropriation Accounts An Analysis, Para 7.1

followed in formulation of budget. Administrative ministries are more comfortable with bigger budgets than what 'realistic' budget-making would lead to. So, telling FAs to provide more "analytical inputs" may not fetch much result in the present scenario where FAs responsibility is only to the administrative ministries.

Further, when the process of budget formulation is input-oriented, with line-item budgeting, the control of expenditure to be exercised by FA would have also to be item-by-item and there is no point in exhorting him to exercise a different kind of control of expenditure.

If the goal is output budgeting, then next step from input budgeting is programme budgeting and allocation on the basis of prioritization of programmes. Improved expenditure planning involves a consideration of the determination of the aggregate level of expenditures as well as the ceilings on allocations for different sectors and their programmes. Therefore, programme concept is important for expenditure planning purpose.

Programme based budgeting also involves the concept of multi-year budgeting, as the commitments relating to programmes would continue in future years. The concept of programmes and multi-year budgeting are in that sense, inter-linked. It is high time that we introduce rolling system of budgeting with adequate time to evaluate the programmes and subject them to critical analysis, while removing the meaningless distinction between plan and non-plan expenditure.

The rolling multi-year programme-wise budgeting can by itself transform the financial management system into an effective instrument for rational allocation of resources, and thereby revolutionize the entire financial planning process. Therefore, the FAs and the administrative ministries, of which they are an integral part, should concentrate on bringing about a well-structured programme concept into their respective departments for better expenditure management.

The multi-year perspective in budgeting is the most important concept, which is yet to be adopted in our financial management system. Stressing the need for it, the 11th Finance Commission stated: "It is now well recognized that if the budgets are to remain under control, there should be a multi-year perspective. In U.K., for instance, now the budges lay down limits on expenditure which the departments can control, for a three-year period, allowing flexibility and incentives for managing the budgets. A comprehensive review on expenditure is undertaken involving a thorough examination of departmental accounts and objectives and a zero-based analysis for each programme to find the best way of delivering the government's objectives. The comprehensive spending review led to significant changes in the framework for planning and controlling public spending. In India too, a similar review of all government programmes and longer-term expenditure targets for government departments/ agencies should be laid down and variation or departure should be allowed only very sparingly." [para 3.62, p.33, Report of the 11th Finance Commission for 2000-2005].

The above recommendation should now be implemented for better financial management system and for strengthening the role of FAs in financial management.

The OM dated 1.6.2006 states that "FAs would now be increasingly required to assist administrative ministries/departments in moving towards zero-based budgeting, and assist in better inter se programme prioritization/allocation in the indicated budgetary ceilings, based on analysis of expenditure profiles of each programme/sub-programme and information are cost centres/drivers; assessment of output, outcome and performance; and status of projects/programmes."

**The point regarding programme prioritization within 'indicated budgetary ceilings' is materially different from our present budgetary process, where 'ceilings' are imposed by MoF at the end of the budgetary process. Thus, the ceiling concept, though existing, does not promote prioritization because it comes at the end of the budgetary process. Nor has the programme concept been introduced in the budget formulation process. Therefore, prioritization of programmes, within ceilings, would not be a valid exercise.**

As stated above, programme concept requires longer-term horizon than single year's budget. Without multi-year budgeting framework and without indicated budget ceiling for each year, this kind of analysis is not possible. But the concept of multi-year budgeting and program budgeting is not discussed at all in the OM dated 1.6.2006 and this is the basic lacuna in the letter.

For bringing about zero-based budgeting, the basic responsibility is that of administrators of programmes in administrative ministries. FAs can only help them by providing information based on analysis of expenditure, information on cost and output. Zero-based budgeting is not a new concept. While presenting budget estimates for 1986-87, the then Finance Minister announced that the Zero Based Budgeting (ZBB) would be used for fiscal year 1987-88. A note was circulated in July 1986 to all ministries, departments, public sector undertakings, state governments for adoption of ZBB. As is well known, ZBB discards the principles of 'incrementalism'. It does not take previous year's allocation as a basis for budgeting.

Unfortunately, nothing came out of this exercise, as it was left to FAs to take lead role in implementing it. Administrative ministries took no interest in implementing it. Since FAs are to formulate the budget, by implication it was thought that it was for the FAs to implement ZBB. As expected, the attempt to implement ZBB completely failed. Unless the budget formulation becomes as much the responsibility of the secretaries of the ministries/departments as that of FAs, the output-oriented budgeting cannot come out.

ZBB analysis requires programme-wise and sub-programme-wise analyses, as the aim is to arrive at prioritization of programmes and sub-programmes. Even for performance budgeting, the basis has to be a well-structured programme budget.

Movement from input budgeting to outcome/performance budgeting involves series of inter-linked steps which requires a well-planned approach to be implemented within a given time frame. This would invariably require a thoroughly professional and coordinated approach, with a central authority to guide and motivate them. Evolving a suitable programme structure for each ministry/department is itself a challenging task, which requires in-depth analysis and vision. Fixing of performance norms and multi-year budgeting also require professional expertise in the government which are lacking today. The necessary expertise and guidance in this direction can come from the proposed Controller General of Financial Management.

For strengthening financial management there should be a Budget Law laying down the principles of budget formulation as also execution. Without a proper framework for budgeting, financial management will be an ad hoc affair. The present method of budgeting based on BE, RE concept with liberal provisions for supplementary budget leads to very short term view of budget management and does not serve the purpose of planning and rational allocation of resources.

**The practice of multiyear budgeting with hard budget constraints must be introduced to avoid the problem of March rush, help in planning for expenditure with output orientation, would lead to overall strengthening of financial management. There is also a need for making a strict provision under which exceeding a budgetary provision under a sub-head or detailed head cannot be made without a duly approved re-appropriation orders.**

**There is need for a comprehensive Budget Law covering above aspects, as also providing for performance orientation in budgeting, zero-based approach to budget formulation within a given time frame. Institutional mechanism for evaluation of budget execution and results thereof should also be provided in the Law. Executive orders in this regard, have not had any effect, and we are stuck with colonial system of budgeting, with liberal provisions for supplementary budget, with original Budget Estimates losing all sanctity. This situation does not help financial management in any sense. Therefore, need for a suitable Budget Law to aid financial management is necessary.**

## X

### Need for Further Delegation of Powers to Budget Managers

Performance orientation to budget management involves providing increased flexibility to spending agencies in their access to budget funds and the uses to which the funds can be put. Organizations and managers are to be given greater freedom in operational decisions. In return, organizations and managers are more directly accountable for results.

In this context reference can be made to attempts to give management orientation to defence budgeting in India in the 1990s, with its objective of achieving enhanced accountability and transparency. It was felt that safeguarding of economy, efficiency and propriety is as much a management function as a finance function. The concepts like authority-cum-responsibility centers (ARC), budget centers and budget holders were introduced for decentralized management of budget with performance orientation. Naval Headquarters (NHQ) named it New Management Strategy (NMS) in 1993, with its plan for phased introduction of the system in various formations, starting with Naval

Dockyards. Enhanced delegation of financial powers was conveyed by Ministry of Defence for implementing the NMS. The concept of Internal Financial Advisers (IFA) was accepted for exercise of enhanced delegation of powers. IFAs were posted in all Service Headquarters as also lower formations for exercise of enhanced delegated powers. The concluding paragraph of the Implementation Directive of NMS issued by Naval Headquarters (letter no. PL/3221 dated 21st October 1993) caught the spirit of the whole thing when it stated, "NMS is a new concept for the Armed Forces in India and provides an opportunity for Navy Managers to manage their own business/activities in financial terms, whilst empowered to do so."

The role of NHQ may be seen as being equivalent to that of a holding company whilst the dockyards would be to achieve their targets in the most cost-effective manner.

There could not be clearer enunciation of defence as a business activity which was, in fact, the hallmark of the concept of NMS in defence.

The Government of India, Ministry of Defence in a letter dated 23rd November 1994 addressed to the Chief of Naval Staff, conveyed the implementation of the NMS for logistics. It delegated more financial powers to the naval authorities. The Controller of Logistics (CoL) was to act as Authority-cum-Accountability Centres for logistics and was to be responsible for cost-effective management of logistics in Navy. "This center will control all items of budget under revenue expenditure for achieving the objectives pertaining to its sphere of responsibilities and will have full authority for management of all activities pertaining to them."[112]

Below the Authority-cum-Accountability center was the Responsibility Centres, responsible for allocation of jobs of refits, costing of refits, planning of resources, to allocate budgets to lower formations (Budget Centres).

Delegation of powers under the new management strategy was enhanced for Air Force authorities by Government of India letter dated 3rd April 1997. Two significant points were made in that letter which deserves attention. The first was, to quote, "The responsibility and accountability of every authority delegated with financial powers to procure an item or service on government account is total and indivisible and standards of

[112] Letter PL/3402/NHQ/6515/94/D(N-I) dated 23 November 1994

financial propriety laid down in Rule 6 of Financial Regulation part 1 are to be strictly adhered to."[113]

The second point was, "The liabilities to be created should not only take into account the cash out go of the current financial year but also requirement of funds arising in subsequent financial years as a result of liabilities so created".[114]

This point would have great relevance for budgetary control of liabilities as also planning of expenditure if indicative budget was available for next three to four years for each budget center, which could flow from budget center, which could flow from top-down budgeting process.

For the Army, the new management strategy and enhanced delegation of financial powers was introduced in the branch of Master General of Ordnance (MGO) in April 1997. It was called 'Financial Management Strategy' (FMS). The Government of India (in MoD) letter stated that the FMS was being sanctioned with a view to "introducing efficiency in performance, financial control and establishing linkage between utilization of resources allotted and targets/output achieved."

The important elements of the strategy were:

a) "Greater decentralization of responsibility for budget formulation and control together with the addition of the concept of accountability."

b) "Creation of Authority-cum-Responsibility and Budget Centres (ARB) at MGO Branch at the aegis of MGO."

c) Introduction of concept of intermediate budget holders in Budget Centres.

Institution of Internal Financial Advisers (IFAs) was firmly established by this letter. An IFA is to render financial advice on all financial matters to MGO's branch (which was later extended to other branches, with establishment of additional IFAs), "in all matters within delegated powers of MGO, DGOS, DGEME, IFA is to be consulted in respect of

[113] Letter no. AirHQ/PC/S/95307/542/DfinP/564/US/D(Air 1) dated 3rd April 1997, para 3
[114] Ibid para 2(a)

all cases of specific expenditure proposal and then powers will be exercised with his consultation."[115]

The role of IFA has become very important under the new strategy of decentralized management. Decision-making got quickened in the process. It also led to better management of resources.

But the strategy also contemplated preparation and adoption of Departmental Plan for 3 to 4 years at the MoD level and a Management Plan at the Service HQ level. These plans were basis for laying down objectives for budget holders. The Departmental Plan was to be approved by a top-level management board in USA. This did not happen, as a result, there was no clear focus on objectives. In formulating the strategy it was realized that, "There is no conflict between program budgeting and performance budgeting. For introduction of performance budgeting, it is necessary to establish a meaningful functional programme and activity classification of government operations as also evolve suitable norms, unit costs and yardsticks of performance wherever possible under each programme to facilitate better estimates of financial requirements, and later, appraisal and evaluation."[116]

In the zeal for delegation of powers, these considerations were lost sight of. Therefore, accountability for output and results was not adequately stressed, nor was an evaluation mechanism evolved. Thus, an opportunity was missed of introduction of performance orientation in budgeting and stressing accountability for results.

## XI

## Creation of Authority and Responsibility Centers for Better Performance Orientation

But the basic point remains that for introduction of performance orientation in budget management, a decentralized approach by creation of Authority and Responsibility Centres, with enhanced delegation of powers is necessary. It is also prudent to establish Internal Financial Adviser System, with the object of achieving "value for money" in expenditure management in lower formations. But there is an urgent

[115] Ibid para 11
[116] Amiya Kumar Ghosh (2006), Defence Budgeting and Planning, The Way Forward, USI and Knowledge World, p.178

need for a strategic departmental plan, to be developed by the top management team with clear focus on objectives to be achieved, a rolling plan to achieve the objectives, and three to four years with budget ceilings and a top-down budgeting approach, where each Budget Centre and a Budget Holder can have a longer term view of achieving the objectives laid down at the top along with the resource constraint. These are important pre-conditions for bring about performance orientation in resource management in government.

Adoption of output-focused approach should not end with giving new charter of duties to Integrated Financial Advisers. Ministries/Departments have agencies under them with attain the objectives in their sphere of duties. Such agencies and important operating units can be designated as Authority-Responsibility centres, for budget management purposes. To give an output focus to their activities, it is necessary to agree on performance targest for each such Authority-cum-Responsibility Centre. They should be chosen carefully with clarity of information so that they provide clear indication of the degree of output and even outcome achieved in any time period. It will be useful to set out information on how each target will be estimated along with implications for cost of output so that it helps in variance analysis. Meaningful targets should be put alongside budget allocated for each Authority and Responsibility Centre and Budget Centre created under a Ministry/Department. One should aim at Public Service Agreements (PSAs), which should include targets on inputs, outputs and outcomes, as in the United Kingdom.

In this endeavor, to provide for output/outcome focus to budgeting, it is necessary for devolution of powers to operating units (Budget Centres) and institute the system of Internal Financial Advisers to enable the managers to use the enhanced powers on the basis of professional financial advice, and act proactively with managers to achieve the performance targets, by providing the required information and cost data for resource allocation decision, control and monitoring of use of resources, helping in the evaluation results. The budget centers conceptually are not different from the decision units under Zero Based Budgeting, which would consider Decision Packages for prioritization purposes, which are akin to sub-programmes. Introduction of Budget Centers would help in ushering in zero based budgeting techniques in budget management, which has eluded us so far.

## XII

### Financial Management in State Governments

Financial powers in the States are still basically with the Finance Department. States have also to move towards performance budgeting, which cannot be helped by centralization of financial powers. As far back as 1994, the Lok Sabha recommended performance budgeting in order to relate expenditure to outcomes. In 1969 the Government of India adopted the recommendation of First Administrative Reforms Commission regarding performance budgeting and issued guidelines to all ministries. In 1973, the Yardi Committee, while reiterating the need for performance budgeting, recommended that responsibility for internal financial management and operational performance should be entirely that of the administrative ministries. By OM dated 6th October 1975, the MoF introduced the scheme of Integrated Financial Adviser. In the forwarding letter, it stated: "It has been felt that Ministry in a larger measure than at present to enable him to play a more effective and constructive role in its developmental activities and should bring his financial expertise to bear in assisting the Secretary of the administrative Ministry and other senior officer in the planning, programming, budgeting, monitoring and evaluation, functions of the Ministry. A scheme of 'Integrated' Financial Adviser has accordingly been drawn up…"[117]

Subsequently, the MoF issued the Delegation of Financial Powers Rules (DFPR) specifying in great detail what ministries were allowed to do with concurrence of Integrated Financial Advisers, and what they could do with the approval of MoF. The DFPR made FAs representative of MoF.

The same compulsion that made the Central Government implement the scheme of Integrated Financial Adviser for assisting administrative ministries in planning, programming and budgeting should now be the reason for State Governments to introduce the system of FA scheme in various departments where FAs would be the representatives of the Finance Department. But this is not enough. Studies in selected States have brought out weaknesses in basic accounting system, delayed and unreliable expenditure data, unrealistic revenue estimation, weaknesses in cash, asset and debt management and inadequacies in internal control. Weaknesses from a fiduciary

[117] F.No. 10(29)-E.Coord/73 dated 6th October 1975

perspective have also been identified. [See extracts of the Report of CAG] These have to be addressed. States like Karnataka have implemented Medium Term Fiscal Plan (MTFP) since 2001-02, a rolling document prepared annually. The MTFP is a medium-term statement of the governments, medium-term fiscal objectives and also provide projection of key fiscal variables for the current year and three subsequent years. Each MTFP also reports performance against targets. The MTFP serves two purposes. First, it helps to put annual budget formulation within the medium-term context. Second, it serves as a communication channel to the people of government's fiscal intentions and strategy. Many other states have followed this practice. This needs to be followed by all the states. Karnataka was the first state in India to enact a Fiscal Responsibility Act 2003 (FRA), which became the most influential factor in budget making. FRA indicates the fiscal management principles that will guide the state government. While these steps are in right direction to improve the financial management, these are not enough to improve the budgeting system.

**Multi-year Budgeting**

In the present system of budgeting in the States for a year at a time suffers from a number of weaknesses. The most important is that full financial implications of projects, which are to be implemented over a number of years, are not brought out fully. A government decision may entail only a nominal expenditure in year one, but may call for sizable expenditure in the following years. With one year budgeting system, the full implications of incomplete work are not realized. It is, therefore, necessary that state governments shifts to multi-year budgeting and give the estimates of revenue and expenditure for a period of four years in addition to the year which the budget pertains. This should be done on a roll-on basis.[118] This will enable better estimation of the fund requirements of on-going schemes, programmes and projects. This will also bring in better sense of realism in budgeting. Along with the introduction of the FA system, multi-year budgeting would help in bringing about better fiscal discipline and financial management.

**Increasing Transparency in the State Governments**

(i) Budget Framework

[118] Madhav Godbole (2003), Public Accountability and Transparency, Orient Longman, p.231

Reduction in number of grants; formulation of demands as per functions and as per controlling officers, would lead to better sense of accountability in the execution of budget. Very often the budgets are prepared on a very unrealistic basis. It is necessary to bring out the assumptions underlying the estimation of revenues and expenditure in the budget document.

(ii) Classification of Outstanding Debts

The debt of the state government concerned should be classified on the basis of maturity profile. The maturity profile of the debts raised in the last one year may also be indicated separately. The interest rates payable on various bond issues should be shown separately. At present, budget documents normally give stock of debt of the preceding year only. It does not give the repayment profile of the debt spread over next ten years. As a result, it is not possible to assess the bunching of repayments, if any. If the debt repayment profile for a ten-year period on a roll-on basis indicated along with the budget document then it may lead to better financial management by making everybody aware of future liabilities.

(iii) Contingent Liabilities

An annual statement of total contingent repayment liabilities on account of guarantees, disputed liabilities, litigations and other claims on the state government may be placed along with the budget documents. Since all guarantee obligations are not due in any one year, it is necessary to give break up of guarantee liabilities in terms of the years in which these contingent liabilities might become cash out flow. It may be worthwhile to hire professional actuaries to assess the existing contingent liabilities with a view to assessing the risk attached to them and probable payments that might occur in future years, as professional competence in risk assessment may not be available in the government.

(iv) Work-in-progress

There is a problem of large number of incomplete works in state government. It is, therefore, necessary that consolidated figures of work-in-progress, indicating the original cost and revised cost thereof and the balance investment remaining to be made for the completion of the work, may be provided for each year by the department and the category of work.

**Internal Control and Internal Audit**

Internal control and internal audit are weak areas in the financial management in the departments of the states. The proposed IFA should be made responsible for both internal audit as well as accounting in their respective departments, as is the practice in the central government. The Accounting Standards should conform to International Accounting Standards and they should move gradually to accrual accounting.

If the internal audit system is not improved with required institutional reforms, financial management system in the states would not improve. There should be necessary enactment to bring in better internal auditing system. Internal audit manuals are to be prepared on modern lines so that internal audit system can help in improving the internal control system. The evaluation by C&AG of the internal audit and internal control system in the states is very limited in scope and too infrequent to make an impact on improvement of financial management system.

These aspects are discussed in detail in the next chapter. But introduction of FA system in different departments of the states with decentralized management of budget, with mandate for improving internal audit can have immediate impact on financial management of states, if it is accompanied by multi-year budgeting with performance orientation.

# Chapter 5

## Internal Audit and Internal Control

### Introduction

Internal control systems are basically management control systems with a view to ensuring compliance with rules and regulations, reliability of financial data and reports, and to facilitate efficiency of government operations. A sound internal control framework, of which internal audit is an important element, is required to assure that government operations attain some basic fiduciary standards in guarding against misuse and inefficient use of resources; for safeguarding government assets; countering fraud and error; checking maintenance of satisfactory accounting records; and whether budgetary objectives set out in the government policies are being achieved. Thus, "Internal controls can be regarded as one of the foundations of good governance and the first line of defense against improprieties. They also provide the public with 'reasonable assurances' that if improprieties do occur, they will be made transparent and made appropriately addressed."[119]

Though internal audit is also a part of internal control system, it has a distinct role in that it is one of the tools for evaluating and improving the internal control system. Internal audit in government also involves audit on the basis of standards of financial propriety (as does the external audit) and, therefore, are required to observe upon cases of improprieties in financial operations.

A robust internal control system and an effective internal audit system are foundations for sound financial management. However, these systems unless updated continuously have a tendency to become obsolete over time, because of inability to cope with new challenges.

**One of the main weaknesses of the financial management in Government of India, emanates from the fact that the system of internal audit and internal control in financial management of the government, have not been updated over several**

[119] Jack Diamond (2006), "Budget System Reform in Emerging Economies", , IMF, p.44

**decades, nor has the government given due importance to it in securing ‘value for money’ and accountability.**

## II

### Internal Audit as a Management Tool

In the face of demand for improved accountability and greater transparency within government, mandate given to internal audit has increased significantly all over the world.

This has led to improved internal audit procedures so that public sector managers get `reasonable assurance’ about the functioning of various control systems to achieve desired objectives. These procedures have got incorporated in international standards for government auditing.

The modern concept of internal auditing goes far beyond its traditional limits. Internal audit is no longer considered as a mere routine review of financial and other records by specially assigned staff. The Institute of Internal Auditors, Florida, USA defines the scope of internal auditing as “the examination and evaluation of the adequacy and effectiveness of the organization’s system of internal control and the quality of performance in carrying out assigned responsibilities.”[120] Thus, internal auditing in corporate world is concerned with an evaluation of both internal controls as well as the quality of actual performance.

International standards for government accounting and auditing emphasizes that internal audit is a central component of internal financial control aimed at protecting governments’ financial interests.

Both the International Organization of Supreme Audit Institutions (INTOSAI) as well as Institute of Internal Auditors (IIA) issued auditing standards to guide the auditing and accounting professions. These standards are regarded as reflecting “best practices” which the countries are expected to keep in view, which setting up internal auditing standards.

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[120] The Institute of Internal Auditors (1978), Standards for Professional Practice of Internal Auditing, Florida, USA, p.1

The standards adopt a broad view of role of internal audit placing it as a more central element of Public Expenditure Management (PEM). It goes beyond the narrow function of compliance or financial regularity. "The emphasis is on internal audit as a management tool. It is treated as an integral part of both management controls and communication processes." [121]

In this changed perspective, the purpose of internal audit is to review and appraise on the soundness and adequacy of internal controls. We are yet to assign the internal audit this role. This has adversely affected the financial management system as the traditional control systems are unable to cope with prevalence of mismanagement and fraud in the government sector.

**III**

## Standards of Internal Audit

It is now accepted that internal control is an essential prerequisite for efficient and effective management of any organization. Before undertaking a detailed verification of transactions, a modern day auditor, whether in government or private sector, is supposed to carry out a review of relevant internal control system in the organization, in order to determine the degree of reliance he can place on various systems and procedures.

In the statement on Standard Auditing Practices (SAP), Institute of Chartered Accountants of India defines the system of internal control as, "all the methods and procedures adopted by the management of an entity in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of business, while following the policies of management, the safeguarding of assets, prevention and detection of fraud and error, the accuracy and completeness of records and timely preparation of reliable financial information. The system of internal control extends beyond those matters which relate directly to the functions of the accounting system".[122]

The scope of internal control according to this definition extends much beyond accounting controls. One of the basic reasons for neglect of internal audit in India is due

[121] Jack Diamond (2006), "Budget System Reform in Emerging Economies, IMF, p.45
[122] Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit, Statement on Standard Auditing Practices (SAP) 6, Institute of Chartered Accountants of India, 1988 para 5

to not giving much importance to evaluation of internal control systems in an organization under audit. While external audit can do the evaluation of internal control system, it is the internal audit, given the mandate, is best placed to conduct these assessments. This is because, being part of the organization, gives the internal auditor opportunity to know the areas of weaknesses in the financial operations of the organizations. Further, assessment of internal control should be a continuous process. This cannot be performed well by occasional visits by external audit because of constraint on resources. In India, external audit has tried to evaluate internal control system in states, as internal audit has failed to do it; but the impact of such audit is not much.

Internal control has been a matter of constant interest to INTOSAI. In 1992 they offered general standards for an internal control structure. Control processes of an organization ensure proper planning, resource allocation and coordination of an organization's activity. It also includes feedback of these activities for prioritization and planning. This emphasizes need for relevant and timely information. It is now regarded that internal audit can make substantial contribution in this direction.

Because of these challenges, internal auditing standards for government have been laid down in many countries. In India, on the other hand, the internal auditing standards in government, after it was inherited from the colonial era, have not evolved at all.

## IV

### Function of Internal Audit in Government of India

Internal audit in Government of India is conducted on the basis of departmental codes and manuals, which are legacy of the past. Internal audit, for example in Defence Accounts Department—where it is fairly well organized—is done with reference to rules laid down in Defence Audit Code, Financial and other Regulations for Defence Services and other orders issued by Government and other competent financial authorities.[123] Similarly, in the civil departments internal audit is conducted with reference to relevant departmental codes and manuals.

[123] Rule 17 of Defence Audit Code

These codes mainly emphasize regularity audit and does not encompass management audit and operational audit. These codes and manuals also do not contemplate evaluation of internal control system of the units under audit.

Internal audit units have been set up in the Accounts organizations in the Ministries. The respective (Chief) Controllers of Accounts oversee functioning of each unit. As mentioned above, the main objectives of internal audit are to check the accuracy of accounts and to point out the irregularities in accounting. The work relating to internal audit is conducted by local audit staff by on-the-spot verification of accounting records. There is an Inspection Wing in the Controller General of Accounts and Controller General of Defence Accounts for inspection of audit work. The reports of internal audit are issued to audited units. Important audit observations are brought to the attention of the Secretary of the Department concerned.

The revenue departments have their own internal audit departments. The focus of audit is on post assessment reviews. The reports of such audit are not sent to the Secretary of the Departments.

**Standards of Financial Propriety**

The Audit Codes relating to internal audit also refer to "Standards of the Financial Propriety". Internal audit involving principles of financial propriety involves going beyond the observance of rules or orders of competent authorities to see whether principles of orthodox finance are observed or not. "It is an essential function of audit to bring to light not only cases of clear irregularity but also every matter which, in its judgement, appears to involve improper expenditure or waste of public money or stores, even though the accounts themselves may be in order and no obvious irregularity has occurred. It is thus not sufficient to see that sundry rules or orders of competent authority have been observed. It is of equal importance to see that the broad principles of orthodox finance are borne in mind not only by disbursing officers but also by sanctioning authorities."[124]

[124] Rule 38, Defence Audit Code, Volume 1, 1992 edition, Audit Against Propriety, Rule 38

The internal audit code also states that no precise rules can be laid down for regulating the course of audit against propriety. Audit officers in the performance of their duties are supposed to ensure application of the principles of financial propriety.[125]

Three of the principles given below are very well known:

- The expenditure does not seem prima facie more than the occasion demands and that every government servant exercises the same vigilance in respect of expenditure of government money as his own money
- The expenditure should not be prima facie more than the occasion demands.
- the public moneys are not utilized for the benefit of a particular person or section of the community, unless the expenditure is in pursuance of a recognized policy or custom[126]

Two very important points come out from the above. First, it will be recalled the same principles of financial propriety mentioned above are supposed to govern the financial advisers and his officers in the performance of their duties in the scrutiny of proposals involving expenditure of public monies. **This brings out the point that the objective of financial advice system and audit is the same, i.e., securing economy, efficiency and effectiveness. Therefore, internal audit and external audit should also be regarded as part of the financial management system.**

Second, in application of principles of financial propriety, the auditors cannot be left to apply only their judgements in highlighting cases of financial improprieties. In this endeavour, internal auditors should be able to refer to universally acceptable norms relating to financial propriety and not just to general principles. Our codes and manuals have not gone into these aspects and, therefore, these general principles of financial propriety cannot be operationalised.

## V

## Internal Audit is today is just Compliance Audit

[125] Ibid, Rule 39

[126] *An Introduction to Indian Government Accounts and Audit*", issued under the authority of Comptroller and of Auditor General of India, 5th edition, 1987 and *"Defence Audit Code"*, Rule 39, 1992 Edition

The problem is that no hard and fast rules can be laid down for enforcement of the principles contained in Standards of Financial Propriety. No auditing standard can evolve out of these principles. And application of the second principle that the expenditure is not more than the occasion demands, involves going into host of questions and in-depth examination of issues, which internal audit with its present mandate, can hardly attempt. It involves full-fledged performance auditing. So they remain as ethical principles, leaving little impact on the internal auditing techniques. Internal audit is thus basically confined to compliance audit or regularity audit, notwithstanding the fact that standard of financial propriety are enshrined in internal audit codes and manual to guide internal audit.

As the internal audit is conducted on the basis of departmental codes and manuals, which are issued by accounting departments (therefore limited in scope), it does not necessarily bind the audited entity to take action on the basis of observations and recommendations of internal audit.

Further, the audit is undertaken at clerical level, which enables them to bring out only routine observations and minor objections pertaining not following a particular rule or instruction. Internal audit today in India has neither the mandate nor the capacity to look into the internal control systems. Sanctions issued by government are not subjected to internal audit.

Internal audit in central government thus is basically a regularity audit, conducted in a routine manner, and the result of this audit on improving the financial management is insignificant. Thus the large number of mandays devoted to internal audit in India are not cost effective and involves wasteful use of resources.

**The present position of internal audit in central government is so much in disharmony with international standards and practice (as brought out in opening paragraphs) that unless urgent steps are taken to rectify the situation, the financial management of the government will remain much below the desired international standards.**

In the conduct of internal audit, there is quite a bit of procedures involved, which are carried on in a fairly routine way. For example, in Defence where internal audit is comparatively well organized, the (Chief) Controller of Defence Accounts are required to prepare—on the basis of audit conducted at the field level—quarterly reports on major financial and accounting irregularities, dealing with matters relating to units and formations within his audit jurisdiction. In the report following types of irregularities are required to be highlighted:

- Cases involving irregular or non-maintenance of accounts;
- Cases in which value of financial irregularities or loss involved cross a particular financial limit and cases that disclose loopholes or fraud.

**As regards (b) above, since the audit is basically compliance audit and conducted at low levels (with no mandate for investigative audit), the chances of finding `loopholes' or `fraud' is rare. So it remains confined to mentioning of cases of loss due to various reasons. Since no in-depth investigations in the alleged cases of loopholes/fraud, get carried out, the lacunae in the system does not get refined. General audit observations do not help in rectification of any internal control system.**

Then there is system of rendition of Annual Appropriation Accounts. The object of the Appropriation Accounts for all the departments is to present the audited accounts of expenditure from the appropriation for the year with explanation of variations between final appropriation and actual expenditure. It includes statement of losses of cash, arrear payments etc., dealt with during the year; statement of various kinds of store losses dealt with finally; statement of infrastructure expenditure exceeding a particular amount etc. Very important audit points concerning serious irregularities can also be brought out while rendering the appropriation accounts and these needs to be brought to the attention of the Public Accounts Committee. But such occasions rarely occur, as internal audit is not structured to detect serious cases of irregularity.

Since the internal audit conducted in the field level is very limited in scope rendition of Annual Appropriation Accounts take the form of routinised activity, with elaborate form but not much in content.

## VI

### Financial Advice and Audit

One of the features of expenditure management in government is the assumption that financial advice and audit are closely linked, and the one emanates from the other. This is underlined by the fact that both the activities are performed by the same authority. For example, in Defence the regional controllers of defence are ex-officio financial advisers to various military authorities in the field exercising financial powers in the discharge of their duties. The regional controllers are also accounting and auditing authorities, and two activities get linked. To substantiate the point, we shall quote a para from Defence Audit Code: "Financial advice tendered to the above authorities can be divided into two portions namely:

Responding financial advice which consists of : (a) advice on definite points referred to controllers by unit authorities; and (b) advice on the results of investigation into fact and original financial advice, which consists of any method by which equal efficiency can be obtained with less expenditure. *Audit will not only see that authority for expenditure is quoted but on legitimate occasions investigate the necessity for it. It will examine whether the individual items were in furtherance of schemes for which the budget provided; whether the same results could have been obtained otherwise with greater economy; whether the rate and scale were justified in the circumstances; in fact they ask every question that might be expected from an intelligent taxpayer bent upon getting best value for money*[127] (emphasis added).

As would be seen from the italicized portion, the critical scrutiny while rendering financial advice is designated as auditing activity and no distinction is made auditing and offering financial advice.

The similarity of the roles envisaged of the Financial Adviser, at the Ministry level and that of (Chief) Controller of Defence Accounts in the field, is quite evident. If, as pointed out in the earlier chapter, it is becoming difficult for the Financial Adviser to raise these points relating to economy and efficiency, after assuming the role of Integrated Financial Advisers, it would also be difficult for field level officers to raise these points while carrying out internal audit, if not more so, in the discharge of their duties ex-officio Financial Advisers to military authorities.

[127] Defence Audit Code, para 74

These kinds of points are difficult to raise on the basis of compliance audit that is conducted, however legitimate they may be. To quote from Defence Audit Code about the restricted scope of internal audit, "The primary function of audit is to verify the accuracy and completeness of accounts to secure that receipts are brought to account under the proper head and that expenditure and disbursements are authorized, vouched and correctly classified and that the final accounts represent a complete and true state of financial transactions".[128]

It is relevant to quote from practice in defence, not only because defence represents largest single item of expenditure, after interest payments, and therefore expenditure management in defence has lot of significance for overall expenditure management of central government, but also because internal audit in defence has a long tradition and fairly well organized and therefore the codes and manuals can be cited to indicate the way the internal audit is carried out in government sector in general.

To underline the point that there is indeed a very limited mandate for internal audit we shall quote from another paragraph of Defence Audit Code, which says that clear distinction between Auditorial and Administrative Functions should always be borne in mind. "It is the function of Government to make Financial Rules and Orders for the Defence Services and for the Defence Accounts Department responsible for making payments to apply these rules and orders. It is the function of audit to verify that these rules and orders are properly applied. It is not the function of audit to prescribe what such rules and orders shall be or interfere with their administrative application".[129]

The principles can be treated as general philosophy underlying the conduct of internal audit in Government sector.

**Important points in audit, when question of application of standards of financial propriety arises, as stated above, can only be raised, when a particular case or transaction is seen from administrator's point of view. If audit is to get involved into assessment of internal control system, this kind of distinction between auditorial and administrative function, would not be helpful at all. Nothing should be done in internal audit, which can be treated as interference with administrative function. Thus, lot of mental reservations about role of internal audit, have to be overcome, if**

[128] Ibid, para 15
[129] Ibid, para 16

**it is to play an effective role in the improvement of financial management system in India.**

## VII

### Internal Audit in Private Sector

Models for functioning of internal audit in government sector in countries who have tried to reform internal audit system, have to a great extent been derived from the evolution of internal audit in private sector. We have already indicated the role of audit in evaluation of internal control system in achievement of management objectives as laid down by SAP6 of the Institute of Chartered Accountants of India, in 1988. The standard clearly states that this kind of evaluation of internal control system would take audit much beyond the function of accounting system.

The scope of internal audit has expanded because of challenges faced in corporate governance in ‘80s and ‘90s. In 1985 following a series of high profile business failures in USA, the Treadway Commission was formed by private sector initiative. The Treadway Report published in 1987, highlighted the need for proper control environment, independent audit committees and an objective Internal Audit function. It called for published reports on the effectiveness of internal control. It also requested the sponsoring organizations to develop an integrated set of internal control criteria to enable companies to improve their controls.

As a result of this initial report, the Committee of Sponsoring Organisations (COSO) was formed involving a major CPA firm to study issues and author a report regarding an integrated framework of internal control. COSO is sponsored and funded by 5 main professional accounting associations and institutes.

COSO has established a common definition of internal control standards and criteria against which companies and organizations can assess their control system,

In Treadway Commission among other items, recommended that the organizations sponsoring the Commission work together to develop integrated guidance on internal control.

A report entitled "Internal Control – Integrated Framework" came out in 1992. This report is the standard that U.S. companies use to evaluate their compliance with relevant laws.

**COSO Framework**

The COSO framework defines internal control as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of **operations.**
- Reliability of financial **reporting**.
- Compliance with applicable laws and regulations.

According to COSO framework[130], internal control consists of interrelated components. These components provide an effective framework for describing and analyzing the internal control system implemented in an organization. These five components are, control environment, risk assessment, control activities, information and communication.

Control environment is by far the most important component, as it sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment encompasses integrity and ethical values, managements operating style, as well as processes.

Risk assessment: Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives. Therefore, risk assessment is the identification and analysis of relevant risks to achievement of assigned objectives. Risk assessment is a prerequisite for determining how the risks should be managed.

Control activities: Control activities are the policies and procedures that help to ensure management directives are carried out. They help to ensure that necessary actions are taken to address risks to achievement of the entity's objectives. They include a range of

[130] http://en.wikipedia.org/wiki/coso.

activities like approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

Information and communications: Information system plays a key role in internal control systems, as they produce reports, including operational, financial and compliance related information. Communication involves communicating the audit report in an effective manner.

As stated above, though these components are interrelated, the most important component is the control environment. It should, therefore, be the first endeavour of any management be it in private or public sectors to foster the adequate **control environment, through pronouncements about importance of these controls. In public sector, control environment can be created by enactment of laws making it mandatory to institute a proper internal control system and get it continuously assessed for efficacy. The role of internal audit should be defined in this background.**

Following points are to be kept in view in this regard. First, internal auditors have to play a valuable role in evaluating the effectiveness of control system. It should be therefore an independent function, which should be able to report to the top management. Only then internal audit can assess the internal control system objectively, and contribute to the organisation's effectiveness. It can also play a significant monitoring role. The support of the top management of the Ministry/Department in the independent functioning of internal audit is absolutely essential.

On the basis of above background two points need to be stressed at the outset. As mentioned above, scope of internal audit described in the International Standards is based on the broader view of the internal audit (IA) as a tool of management. Internal audit function is supposed to close the loop in pubic expenditure management cycle to ensure efficient and effective use of resources. Therefore, internal audit should get involved in broader management issues, pertaining to management of resources.

The second point that needs to be stressed is that in order to preserve its independence of judgement, Internal Audit should not take any direct responsibility in designing, establishing or maintaining the controls it is supposed to evaluate. From this principle another important point follows. **Accounting and payment system is also one of the important control systems. Internal audit should be able to evaluate it also.**

**Therefore, on the basis of above principles, internal audit if it is get involved in assessment of accounting and control system, should not be part of the accounting system. If we have to maintain independence of internal audit, then it should not be part of accounting activity and organizationally it should function independently from accounting actiity.**

In UK the report of the Cadbury Committee (Sir Adrian Cadbury) in 1992 provided the framework for corporate governance which has become the basis for the arrangements whereby UK companies govern themselves. It contained a recommendation that the board of listed companies should report on the effectiveness of their systems of internal control. It also recommended that auditors should report on the statement, which became controversial as responsibility for expressing an opinion on the internal control system was not easy. It was resolved in 1999 by the Turnbull Report which required the companies to report whether the board has reviewed the system of "internal control and risk management". The close coupling of internal control and risk management in the Turnbull Report echoed similar developments in USA and Canada where other important reports had emphasized the importance of risk management as well as internal control. Both the Cadbury Committee and Turnbull Report expanded the role of internal audit in business community in UK.[131]

The corporate world in India could not remain indifferent to developments that were taking place in the UK. This led to laying down our ground rules on corporate governance.

The stress in the Cadbury Report is on crucial role of the Board and the need for it to observe a Code of Best Practices. Its important recommendations include the setting up of an Audit Committee with independent members.

In India the emphasis in the past few years as far as private sector is concerned, have been mainly limited to only some of the recommendations of the Cadbury Committee – such as the role and composition of Audit Committees and the importance

[131] Michael Page and Laura F. Spira, "The Turnbull Report, Internal Control and Risk Management: Developing Role of Internal Audit". Executive Summary – http://www.icas.org.uk/site/cms/ counteriesarticle.asp

of making all the necessary disclosures with annual statements of accounts, which are considered important for investors' protection.[132]

From these developments in the corporate world, it would be seen that risk assessment and risk management did not become a major theme of corporate governance till late nineties. In Indian corporate world importance of evaluating internal control system is being felt and need for independent Audit Committees. Risk assessment and risk management does not seem to have made a major impact in the corporate sector.

In many respects, entity risk management may be regarded as a natural evolution of internal control model. Most organizations will seek to fully apply the internal control model before implementing the concepts inherent within entity risk management. Therefore, one need not, before a securing a proper internal control model, seek to focus on risk management as a primary objective of internal control and internal audit.

These points need to be kept in view while determining the scope of internal audit in public sector in India.

## VIII

### Steps towards Effective Internal Audit in Government Sector

But this is yet to happen in many parts of the world including India. As Jack Diamond observes, "For many parts of the world, the IA has often been, and continuous to be, defined rather narrowly – focusing on financial compliance and regularity, rather than broader management issues. Moreover, governance problems and lack of professional competence also constrains the IA to this role and hinders its ability to generate timely and relevant reports".[133]

To approach international standard, the first point to be noted is that internal audit should be treated as a tool of management. Lack of professional competence often restrains the internal audit from playing its rightful role in implementing the international standards. This poses a basic problem in implementing international standards.

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[132] Address by Vepa Kamesam, Dy. Governor, RBI at Administrative Staff College of India, Hyderabad on 22.11.2001. http://www.geocities.com/kstability/inbank/corpgovrn/index.html

[133] Jack Diamond (2002), "The Role of Internal Audit in Government Financial Management: An International Perspective". 2002 IMF Working Paper

In many countries audit skills are in short supply, and professional proficiency can be very low, or the governments' pay scale cannot attract or maintain suitable staff. These factors often represent important constraint on attempts to strengthen IA".[134]

The problem of professional proficiency is not just confined to technical competence. Professional proficiency assumes an appropriate audit methodology, technical competence, and sufficient level of resources for the internal audit function. **If government wants to have proper internal audit system then adequate resources should be allocated for its development, as a part of deliberate policy to promote better internal control and for promoting better financial management.**

To strengthen internal audit as a tool of management, apart from increasing its scope, and securing it an independent functioning the problems of professional proficiency has to be tackled. But at the same time it must be remembered that internal audit is not a substitute for good financial management. It cannot also substitute for weak external audit. The two systems, internal and external audit, must go hand in hand and complement each other.

The internal audit rightly designed, can play a very important role in improving the public expenditure management. Though practices vary, in recent years a number of countries have reoriented internal audit away from compliance audit towards performance issues.[135]

**The Task Force on Internal Audit**

That the present role and function of internal audit has been the cause of concern to the Government of India is brought out by the fact that at the request of the Ministry of Finance, Department of Expenditure, the Comptroller and Auditor General of India, constituted a Task Force on 17 July, 2006 for benchmarking the status of internal audit in the Central Government and determination of roadmap for its improvement.

The Task Force, it is understood, after detailed deliberation came to the conclusion that due to **severely restricted mandate and lack of interest of the management, the internal audit has not been able to systematically evaluate the risks**

[134] Ibid
[135] Ibid

**associated with various activities of the ministry/department for determining their audit strategies and thrust areas**. PSUs and autonomous bodies have been kept outside the purview of internal audit thus diluting its usefulness and effectiveness. Internal audit is also not conducting evaluation of the adequacy of the internal control mechanisms in various ministries/departments. Inadequate inspection of each section/desk in the department by internal audit has resulted in continued non-observance of prescribed procedures and systems, as the Task Force has observed.

The Task Force is stated to have noted that countries like USA, Canada and UK etc. have formally prescribed internal audit standards for their government departments. Canada has outlined its policy on internal audit of the government departments in a detailed document. It observes that there are international audit standards, which have been laid down by the Institute of Internal Auditors (IIA), which are basically applicable to private sector and International Organization of Supreme Audit Institution (INTOSAI) for the government. UK has issued the Government Internal Audit Standards in October 2001.

We are yet to evolve such standards for internal audit, confining to fairly insignificant role. Government does not give much attention to the findings of internal audit, which as indicated above contain basically routine observations.

Independence is a major issue in internal audit. The Task Force felt that independence was the "cornerstone" of effective functioning of internal audit which is accepted internationally.[136]

The Task Force noted that the Government of India had redefined the charter of Financial Advisers by Ministry of Finance, Department of Expenditure OM No. F.No.5(6)/L&C/2006 dated June 1, 2006. The redefined charter inter alia has made FA responsible for regularly reviewing the progress of internal audit and action taken thereon, so as to make an important tool for financial management.[137]

As the Task Force observes, there was no segregation of duties especially at supervisory levels between those who are responsible for internal audit and those

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[136] Government of India (2007), Report of the task Force for Benchmarking the Status of Internal Audit in the Central Government

[137] Ministry of Finance, Office memorandum, F. No. 5(6)L&C/2006, dt. June 1 2006, para 9(XII)

responsible for pre-audit, disbursement and accounting functions. The internal audit set-up also did not report directly to the chief executive in any of the organizations. In Department of Telecommunications, internal audit functions and accounting functions were not segregated at supervisory levels.

In Defence, sanctions issued by Ministry of Defence, were not subject to internal audit. While there was segregation of duties in respect of personnel engaged in internal audit in Defence up to supervisory level, they reported to Controllers of Defence Accounts, who were responsible for other functions also. The inspection wing of the Railways, both on the revenue as well as expenditure side, functioned under the concerned FA&CAO, who was also responsible for accounting and pre-audit functions.

The Task Force, is stated to have observed that both the Secretary (Defence Finance) and FC (Railways) were of the view that realigning the existing structure ensuring greater independence for internal audit, would increase its effectiveness.

The Task Force particularly noted that in the Civil Ministries, the oversight of internal audit vested with the Chief Controllers of Accounts, who were also responsible for accounting and payment functions. In Defence, it is the Chief Controller/Controller of Defence Accounts, who were responsible for both payment functions and internal audit. **This means that internal audit did not have the required independence for its effective functioning. An independent internal audit should be able to look into payments made after approval of Controller of Accounts, at least from the propriety angle.**

Task Force apparently does not support the present approach of internal audit that it should be confined only to ensuring that accounting and allied records have been properly maintained, asset management is in place and policy and procedures are being adhered to. It subscribes to modern view that internal auditing should not be restricted to financial issues alone, but should also extend to issues like cost benefit analysis, utilization and deployment of resources, matters of propriety, effectiveness of management etc. and the focus should be on risk, control and governance issues.

In view of the required change in mandate for internal audit, the Task Force considered it necessary that in the interest of independence and more effective functioning of internal audit, there is need for segregation of duties relating to internal audit from those relating to financial advice and accounting functions. All the reports of internal audit, the Task Force felt must be submitted directly to the Secretary of the department.

The Task Force is reported to have noted that although instructions had been issued earlier by the Department of Expenditure that the internal audit should report directly to the Secretary, yet in actual practice this does not happen. This is because (Chief) Controllers of Accounts have other responsibilities for which they report to the Financial Adviser.

At the same time, Ministry of Finance OM F.No.5(6)/L&C/2006 dated June 1, 2006 enjoins upon the Financial Advisers to `review the progress of internal audit'. This has resulted in the (Chief) Controller of Accounts who is in-charge of internal audit being put under the administrative control of the FA (para 8.1.4). Task Force came to the conclusions that this has resulted in compromising the intended independence of internal auditing functions. Therefore, they felt the need for an effective alternative model.

## IX

### An Alternative Model

After considering various models that are available internationally, the Task Force have felt that the Inspector General model of the U.S.A., with appropriate modifications—as the one most suited for effective internal audit. But it felt that it might not be possible for us to implement that model immediately. It did not, however, specify any reasons. Noting that work of internal audit is now totally decentralized, both at policy and operational level, there was no single authority for either prescribing standards or supervising internal audit, whether administratively or through technical guidance, the Task Force felt that there was a strong case for the setting up of an Apex Board to prescribe internal audit standards and processes across jurisdictions. There was need for legislated internal audit standards and policies.

In the interim period, it recommended that to facilitate moving towards legislated internal audit, a **Board of Internal Audit** (**BIA**) comprising of Controller General of Accounts, Controller General of Defence Accounts, Financial Commissioner, Railways and Member (Finance) Telecommunications, might be constituted for the oversight of internal audit in Government of India. Eventually under a proper mandate through a specific statute or cabinet resolution, internal audit in each ministry/department should be established as an entity directly reporting to the Secretary of the department/ministry, and becoming exclusively responsible for internal audit activities. The internal auditor will act strictly in accordance with the prescribed standards and processes.

The Task Force recommended that in the interest of independence of internal audit and its more effective functioning, the ultimate objective of the Government should be to appoint Chief Internal Auditor (CIA), professionally trained in auditing. The CIA should function in accordance with standards and procedures prescribed by BIA. This kind of interim solution recommended is no solution at all, given the present weakness of internal audit.

The Task Force is right in its conclusions that if internal audit has to function independently, then it should not be combined with financial advice. Accordingly, the Financial Adviser, while drawing upon the findings of internal audit to the extent it helps in financial advice, should not be controlling the internal audit work.

Similarly, Accounts Departments should confine itself to maintenance of accounts, disbursement of payments, local financial advice to field level officers. It need not control the internal audit work, which has a distinct function to perform. In its envisaged expanded role in the management of expenditure, IA has to go much beyond scrutiny of accounts of transactions (the role envisaged in the departmental codes and manuals issued by the Accounts Departments), and get into issues which would have earlier been regarded as ‘encroachment’ in the functions of administrative authorities.

The concept of Chief Internal Auditors (CIA) for each department/ministry as envisaged by the Task Force, who are professionally trained in auditing, reporting to the Secretary, is the right concept. But to be effective, it must have a proper mandate for which there has to be legislation to grant him sufficient independence as also adequate charter of duties.

But the Task Force recommends that this should happen `eventually’ and appointment of CIA should be ‘the ultimate objective of the government’. In view of the lacunae pointed out in the existing system, the time for bringing out the basic reform is now, and not sometimes later. Since reform in internal audit is urgently required for better financial management in the Government, let us look at a suitable model.

Since internal audit has to function independently of both Finance and Accounts, the concept of Board of Internal Audit (BIA) consisting of 'Controller General of Accounts, Controller General of Defence Accounts, Financial Commissioner (Railways), Member Finance Telecommunication for "oversight of internal audit in Government of India" even for interim period is not the right solution.

What is urgently required is to enact provisions of internal audit with required institutional support and with clear policies regarding its role and method of functioning.

**X**

**The Inspector General Model**

The Task Force referred to Inspector General model of the United States with appropriate modifications might be the one most suited to effective functioning of the internal audit" though was hesitant to recommend its adoption immediately.

Let us look into basic features of Inspector General (IG) model to appreciate why this was felt by the Task Force as an appropriate model.

The Inspector Generals are appointed by the President of USA with the advice and consent of the Senate. **The most important feature of Inspector General Act of 1978 in USA was to combine internal audit and investigations into programmes and activities under one authority that of IG**.

The basic purpose of the Act was "to create independent and objective units to conduct and supervise audits and investigations relating to programs and operations of the establishments listed."[138] The IGs were also to provide leadership and co-ordination and recommend policies for activities designed, to promote economy, efficiency and effectiveness in the administration of, and to prevent and detect fraud and abuse in such programmes and operations.

[138] Inspector General Act of 1978, USA, section 2

The IGs were also to keep the head of the establishment and the Congress fully and currently informed about the problems and deficiencies relating to administration of such programs and operations.[139]

The point to note from above provisions is that, unless some authority provides leadership and coordination as well as takes a proactive role in audit and allied activities, it is not possible to achieve economy, efficiency and effectiveness in the administration of programmes.

**The other important point is that in internal audit, prevention and detection of fraud is as important as promoting economy and efficiency**. Unless frauds get detected in time, the steps taken towards economy and efficiency would be nullified. Therefore, prevention and detection of fraud is as important part of financial management for getting best value for money, as other steps like adopting proper criteria for selection of projects, evaluation and monitoring of programmes and setting up internal audit standards.

The IGs in USA have four major responsibilities:

- Providing an independent set of "eyes and ears" on the efficiency and effectiveness of Departmental operations;
- Serving as objective fact finders in controversial, high profile matters of agency concern; and
- Bringing to justice those attempting to defraud the U.S. government
- Finally, most importantly, the Inspector General community works to ensure that the interests of citizens are represented when governmental decisions are made.

As per the Act, each Inspector General is to appoint an Asst. Inspector General for Audit, who shall have the responsibility for supervising the performance of auditing activities relating to programmes and operations of the establishment; and an Asst. Inspector General for Investigations with the responsibility for supervising the investigation activities relating to programmes and activities.[140] **Thus auditing and investigation is given equal importance to enforce accountability.**

[139] Ibid, Section 2 of the Act provisions (1), (2) & (3)]
[140] Ibid, Sec. 3 of the Act

XI

## Applicability of IG Model in the Indian Context

To substantiate the same point in the Indian context, one can quote from a Sub-Committee of Central Public Accounts Committee (PAC) headed by E. Ayyapu Reddy, who observed that delayed response on the part of Departments to audit findings were responsible for constant and repeated failures to enforce accountability, and observed: "It is very depressing to find that in spite of audit reports revealing loss of public funds or misuse and misapplication of public funds, there is no investigating agency charged with the duty to probe into these aspects and identify the culprits responsible for these. Recommendations of Public Accounts Committee (PAC) for investigation to enforce accountability for undisputed misuse of public funds are not yielding any tangible results for the simple reason that long lapse of time between transaction and recommendations normally result in disappearance of incriminating evidence."[141]

In this context, it is also worthwhile to note the summary of recommendations relating to Audit, made by the Second Administrative Reforms Commission (ARC), Fourth Report, "*Ethics in Governance*".

"Audit":

a. "It should be prescribed that as soon as any major regularity is detected or suspected by the audit team, it should be immediately taken note of by the government. A suitable mechanism for this may be put in place. It shall be the responsibility of the head of the office to enquire to any such irregularity and initiate action." and

b. "Audit teams should be imparted training in forensic audit"[142]

Elaborating the point at (a) above, the ARC stated: "The audit authorities often do not convey information which has come to their knowledge in respect of serious irregularities in which criminal misconduct is involved, to the anti-corruption bodies. The information becomes available to the anti-corruption bodies only when the audit report of the CAG is laid before the Parliament or the State Legislature as the case may be. By the

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[141] *India: Accountability of Administration, Lok Sabha Secretariat,* February 1987, quoted by B.P. Mathur in "*Government Accountability and Public Audit"*, Uppal Publishing House, 2007, p.206

[142] Second Administrative Reforms Commission, (2007), Ethics in Governance, para 6.13.2, p 153

time a serious irregularity (which is detected in audit and reported to the department for response as an audit query and incorporated as a part of the annual audit report laid before the house), comes to the knowledge of the anti-corruption bodies, a lot of time is lost. Such delays not only alert the culprits in the organization but also give them enough time to cover their tracks and destroy the evidence and material records thus making it extremely difficult for the investigating agencies to successfully complete their investigations."[143]

The ARC felt that it would be desirable to make a standing arrangement with CAG and AG to report such instances as soon as they are unearthed in audit.

As external audit takes place on test check basis and at long intervals, it may be much better to follow the IG model of USA to revamp the internal audit system and entrust to single authority with both internal audit and investigation, so that audit can be focused on high risk areas, and as soon audit indicates likely fraud or serious irregularity, investigation may follow immediately. For otherwise, incriminating evidence may disappear as pointed out by sub-committee of PAC in 1987.

The advantage of internal audit is that it can be done on a continuous basis and very soon after the transactions take place. It is in a much better position to do the risk analysis, because of its familiarity with the systems and procedures in a particular department.

Therefore internal audit should be empowered to investigate the cases of irregularity unearthed during audit. This would reduce chances of disappearance of incriminating evidence. Empowerment of internal audit in this regard itself will have a salutary effect in creating suitable 'control environment', which is essential for effective functioning of internal audit. Being located in the departments concerned, internal auditors have much better opportunity to identify weak areas of control and concentrate their attention to those areas to unearth cases of irregularity and misuse. They can also monitor the corrective action taken and make it part of the periodic audit report furnished to the top management.

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[143] Ibid, para 6.13.1, p 152-153

Falling ethical standards make it necessary that audit authorities, both internal and external, are empowered with power of investigation in cases of financial irregularities detected by them.

**Recommendations:**

1. Suitable provisions could be incorporated in the proposed Public Financial Management Act (Chapter 3) for appointment of a Chief Internal Auditor (CIA) in each ministry/department in the rank of Addl. Secretary. He should be entrusted with responsibilities of both audit and investigation.

2. The proposed Controller General (Financial Management and Internal Audit) to be located at Ministry of Finance could provide the necessary leadership and coordinate the functioning of CIAs. In consultation with CAG, he should also be responsible for laying down the norms of conducting internal audit.

3. There should be Audit Committees in each ministry/department. It should be headed by the secretary of the ministry/department. This committee should also consist of Chief Internal Auditor, Financial Adviser, CGA/CGDA/Financial Controller (Railways), as the case may be and the head of the concerned unit or division of the ministry. Subject experts may be associated wherever necessary.

4. The Audit Committee should give concurrence to audit plan covering various activities of the ministry/department on a quarterly basis, as also for reviewing the actions taken on the earlier recommendations of the internal audit report. The audit committee should be sub-committee of the Financial Management Board. The Board should also decide on the action to be taken on the internal audit reports, as also that of the external audit.

5. The Audit Committee of the department should also be empowered to appoint professional audit firms for carrying out audit in specialized field on a temporary basis, in conjunction with internal auditors of the department to fill up the capacity gaps and impart required professionalism.

6. A strategic decision to be taken by the Audit Committee is where best to deploy the scarce audit skills. There are ways to economize on the use of audit resources. One of

them would be to move away from routine audit to focus on priority areas and key weaknesses. One important function, as mentioned above, in internal audit is to examine and evaluate the adequacy and effectiveness of internal controls in existing systems. Another would be to empower them to conduct special audit in specific areas, which are vulnerable from risk assessment point of view. Audit Committees should mandate the internal audit teams to go into them.

## XII

### Need for Forensic Audit

To detect fraud and misuse of public money, there would be need for forensic audit. This will be in keeping with the recommendations of ARC relating to this kind of audit, which they term as ‘innovation’. To quote: “A second innovation in this regard would be to equip the agency concerned in the mechanics of forensic audit so that aspects crucial for criminal investigation could be taken due care of. It would be in the fitness of things if the anti-corruption bodies are equipped to undertake such forensic audit of such government departments where such irregularities come to their notice. The idea is to have an in-house forensic team in these offices. Similar capability could be built in the local fund audit departments.”[144] In keeping with the spirit of this recommendation, instead of placing anti-corruption bodies in the departments, it would be better to place internal audit team within departments who should be suitably empowered to investigate and reach appropriate conclusions before deciding to hand over cases to prosecution agencies.

Shri M Veerappa Moily, Chairman, Second Administrative Reforms Commission in a speech commenting on internal control systems in India stated: “The internal control system has not worked in India. This is for several reasons. First, there is collusion at work at all levels of government and a sharing of the gains from corruption. As a result, there have been very few cases in which corruption is reported, and even in those few cases, there are the usual delays and soft actions, which characterize the process of investigation in India.” [145]

[144] Ibid, para 6.13.1

[145] Speech on the Occasion of the National Colloquium on Ethics in Governance on September 1 2006, incorporated as Annexure 1(2) in the Fourth Report of ARC, p. 219

It is considered that adopting a model like that of IG of USA of 1978 provides most suitable option where unearthing of irregularities and timely investigations into them would strengthen financial management system in a big way by prevention and detection of fraud.

The staff functioning as internal auditors in various departments should be brought under the Chief Internal Auditor of the ministry/department forming a separate cadre. To impart professionalism, these auditors should be trained in the modern concepts of auditing. Some of the internal auditors in the ministries/department should be trained in forensic audit, i.e., auditing practices carried out to detect possible criminal activity concealed in financial accounts.

## XIII

## Relationship between Internal and External Audit

The relationship between internal and external audit functions should be recognized as symbiotic. It is important for internal audit that there is strong external audit, and vice versa. External audit should use the work of internal audit.[146] ["*The Role of Internal Audit in Government Financial Management: an International Perspective"*, Jack Diamond, IMF Working Paper, May 2002]

The external auditor should review the performance of internal auditors in that whether they are performing according their objectives and plans. An assessment of the quality of internal audit work should be part of audit reports relating to the departments concerned. This should be made part of the CAG Act by suitable amendments.

There should be access to each other's audit plans and programmes. Periodic meetings should be organized to ensure common understanding and sharing of audit techniques and methods. With these interactions, internal audit would get further strengthened.

## XIV

## Internal Control and Internal Audit in States

[146] Jack Diamond (2002), "The Role of Internal Audit in Government Financial Management: an International Perspective", IMF, Working Paper, May

Internal control system safeguards against errors and irregularities in operational and financial matters. It examines and evaluates the level of compliance of the departmental rules and procedures. It also assures senior management on the adequacy of risk management and internal control framework in the department.

Reports of CAG on the results of audit, conducted by Auditor General in their respective states on “Internal Control and Internal Audit” makes a dismal reading. Because of limitation of audit resources, only one department of a state government is selected for review for a particular year.

Basic limitation of internal control and internal audit system also comes out results of ‘Transaction Audit’, which does not specifically go into the systems, but the nature of audit objection brings out the inefficacy of internal control in the department under audit.

One point that comes out prominently from audit observations on the internal control system of the department selected for audit, is the utter disregard of the existing rules, regulations and codal provisions, which lead to the audit objection. It shows that codes and manuals do not have any more the sanctity that they earlier had.

There is also non-observance of laid down budgetary procedure in Budget Manuals, which leads to lack of budgetary control. The other point is, inadequacy of the internal audit staff in the departments audited that makes it impossible for them to cope with the workload. Even when they are not inadequate, they are underutilized by the departments concerned.

Some of the audit objections clearly indicate that frauds have been committed, but because of the lack of mandate, the audit authorities could not clearly fix the responsibility on the persons involved. The actions to be taken against the objections are left to the concerned administrative unit or the internal audit establishment of the state.

We shall cite references to a few observations of the CAG on internal control systems of government departments in the states to illustrate the point that internal control system is not working properly in the departments under audit. These observations have been picked up at random. Since budget provides the basic control structure for expenditure management, lacunae in budgeting system indicates the problems associated with internal control system. Therefore, deficiencies in budgeting are also highlighted in assessing the efficiency of control system.

The observations have been grouped under following heads for convenience and to broadly indicate the nature of failure in different states. The annexure to the chapter indicate the nature of objections in somewhat more detail. The groupings made are:

i. Failure in budgeting and budgetary control
ii. Inadequacy of internal audit and internal control
iii. Other irregularities
iv. Flouting of treasury rules

**Failures in Budgeting and Budgetary Control**

i. Budget Estimates (BEs) are finalised without any inputs from the estimating officers. The estimates were, therefore, unrealistic resulting in huge surrenders and re-appropriation of funds.

ii. As per the Budget Manual, spending departments are required to surrender the Grants/Appropriations or portion thereof to the Finance Department as and when the savings are anticipated. But it is seen that substantial amounts are surrendered by the department under audit on the last day of the financial year in violation of the Budget Manual.

iii. Budgetary controls were ineffective as there were instances of defective preparation of estimates, non-utilisation of substantial amounts of grants, savings not being surrendered or surrendered only at the fag end of the year.

iv. In order that the departmental accounts are accurate to ensure efficient financial control, the Budget Manual requires that the consolidated accounts of the Chief Controlling officer (Head of the Department) have to be reconciled with those recorded in the books of the Accountant General. However, wide variations were noticed between the two sets of expenditure figures. Non-completion of reconciliation of expenditure figures adversely affected the process of financial control besides carrying the risk of non-detection of a possible fraud.

v. The Drawing and Disbursing of officers were required to prepare Budget Estimates (BE) and transmit the same to the Heads of Department before September. In 2003-04, it was observed that not a single DEO submitted the BEs in due date. Therefore, the BEs for the year 2003-04 was submitted to Finance Department on the basis of assumed figures.

vi. Article 205 of the Constitution of India envisages excess expenditure to be regularized by Legislative Assembly. The scrutiny of records revealed that a substantial amount of expenditure during 1999-2000 required regularization from the Legislative Assembly, which was not done so far (2005). It was intimated by the authorities (January 2005) that excess occurred due to non-receipt of monthly expenditure statement from many DDOs.

vii. Since budgets were prepared on inappropriate assumptions in a particular department there were persistent savings during four years ending March 2004 under several grants.

viii. Large savings under Plan schemes as also persistent excess expenditure under Non-Plan schemes indicated that budgetary control was deficient [

ix. Unnecessary supplementary provision was obtained by a department when there were overall savings at the end of March 2003, indicating deficient budgetary control by this department.

x. As of March 2004, it was seen that some offices of a department had accumulated credits of Rs. 82.54 crore under civil deposits head by drawing from the budget provisions of the service major heads in earlier years (1991-2004) to avoid lapse of funds. All such irregular withdrawals had the approval of the controlling officers of the grants i.e. the Commissioner-cum-Secretary to the Government and in some cases, had the approval of even the Finance Department. This irregular practice resulted in erosion of legislative control over expenditure, as the withdrawals from civil deposits in the subsequent years neither required further legislative approval nor were the expenditures incurred subject to legislative authority through the appropriation mechanism. Thus, using the facility of transfer credit from the Consolidated Fund to the civil deposit head violated the basic budgeting discipline.

xi. The expenditure incurred during March 2002 was 56 to 85 percent in respect of three Heads of Account. The expenditure incurred during March 2003 in respect of two Heads of Accounts was 63 percent and 71 percent respectively. The Government did not adduce any reason for the rush of expenditure.

xii. Faulty preparation of budget by the Department resulted in persistent savings ranging between 36 and 41 percent under revenue heads during 2003-06 mainly on account of provision made for the vacant posts in the budget estimates in violation of the financial rules.

xiii. Failure of the Divisional Officers in observing the conditions for incurring the expenditure and Controlling Officers in watching the progress of expenditure led to an excess of Rs. 478.54 crore over the allotment of funds during 2001-04

xiv. In the absence of effective controls for monitoring expenditure, savings aggregating Rs. 309.14 crore were not surrendered to the Finance Department in time for utilization in other sectors in the respective financial years.

xv. Out of 389 DDOs of the two directorates, only 123 to 57 DDOs submitted the expenditure statements during 2000-2005. As a result, the budget estimates were prepared on ad-hoc basis by adding 10 percent to previous year's allocations under different heads of accounts. The Department also failed to prepare departmental accounts and to reconcile the same with those booked by the Accountant General (Accounts & Entitlement) as required under Rule.

xvi. It was seen that 66 to 100 percent of budget provisions during 2002-2005 for 35 schemes were sanctioned and released to field offices in the month of March of respective years thereby enhancing the possibility of imprudent spending.

xvii. Non-observance of budgeting procedure such as compilation of inputs from field offices, consideration of previous year's expenditure and actual men on roll, etc. made the budget provisions unrealistic and resulted in savings during each of the years 2001-2006.

xviii. In a particular department against the outlay of Rs. 3025.41 crore during 2001-06, expenditure was Rs. 1788.08 crore only and unspent balances under Central schemes were credited to State accounts in violation of the codal provisions.

**Inadequacy of Internal Audit and Internal control**

i. Test-check of records revealed the lack of audit plan, absence of in-service training to Audit staff, pendency of audit, delay in issue of inspection reports and large number of outstanding audit objections.

ii. Large number of units within the department concerned has not been subjected to internal audit year after year. It was admitted by the departmental authorities that the pendency in audit is due to inadequacy of internal audit staff.

iii. Non-exercise of prescribed controls effectively, arrears in audit and incomplete inspections all resulted in misappropriation of substantial amounts, involving departmental employees, office bearers and employees of the cooperative societies.

iv. The Finance Department issued (December 1992) guidelines to improve the quality of functioning of Internal Audit Wing (IAW) of Government Departments to enhance fiscal discipline. However, no IAW had been constituted (March 2006) in the Cooperation Department though it has been in existence for 100 years.

v. The draft Internal Audit Manual was prepared and sent to Government during August 1999. However, approval of Government was awaited (August 2004).

vi. No training was imparted to the personnel posted to Internal Audit Wing and no criteria were fixed by the Directorate for posting of personnel to Internal Audit Wing.

vii. In respect of 21 institutions audit was in arrears ranging from two to 13 years. The above position would indicate that there was no audit planning at all and the audit was taken up as and when found necessary and on ad hoc basis.

viii. The effectiveness of the internal audit in the DPH and PM was diluted due to various factors like non-availability of internal audit manual, vacancies in audit posts, utilization of audit staff for work other than audit and adhoc planning for audit of various institutions.

ix. Internal Audit arrangement in the departments was at the nascent stage and yet to be equipped with adequate manpower, professional skills and methodologies to achieve its objectives.

x. The Department neither formulated any auditing standard nor prepared any audit plan and internal audit manual. No register to monitor number of auditable units and periodicity of audit was maintained either. No action was also taken to impart training to audit personnel.

xi. Internal audit was rendered ineffective as only 29 percent of units due was internally audited during 2005-06 and 1,675 internal audit reports containing 9,821 paras were pending for settlement as of 31 March 2006. In the absence of a vigilance cell in the Department, no discipline or accountability could be enforced.

xii. Internal controls viz., Cash controls, Administrative controls, Operational control, Store and Inventory controls were inadequate and ineffective in the department. Cash books were not maintained as per rules and these were not verified and signed by the Head of office at the end of each month. The lack of Administrative control led to improper maintenance of General Provident Fund and Group Insurance Scheme accounts, as consolidated statements were not sent to Finance Department/Accountant General (A&E).

xiii. Embezzlement of Rs. 53.42 lakh by fraudulently drawing pay and allowances of six fictitious medical officers who were not attached with the office of the Chief Medical Officer, was revealed through test check of records by external auditors. These irregularities were not detected in internal audit.

xiv. Failure of internal control resulted in doubtful procurement and suspected leakage of chemicals worth Rs. 4.66 crore by way of fake entries and intentional omission of closing balance during 1996-2003.

xv. The Local Fund Audit Organisation functions under the authority of the Local Fund Audit Act, 1948. It conducts Statutory Audit of Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs) and Non-statutory Audit of Aided Educational Institutions, Universities, Board of Secondary Education, Council of Higher Secondary Education, Religious Endowments and some miscellaneous institutions receiving Government Grants, on 100 percent basis. The following deficiencies were noticed in the functioning of Local Fund Audit

- The LFA did not have an audit manual for its auditors.
- No watch register was maintained to watch the receipt of compliance from the auditee units.
- No review meetings were held with the local bodies/authorities by the higher management of ensuring early compliance to audit reports.
- No consolidated reports on outstanding audit reports and paragraphs were prepared at the departmental level.

**Other Irregularities**

i. Recovery of loans from poultry c-operative societies was not monitored properly. During 2001-2006, only Rs. 37 lakh had been recovered out of Rs. 61.44 crore due for recovery

ii. The DST had not received consolidated statements from the depots etc., for the last five years ending 2005-06 showing details of total amount of subscription received in the Saving Fund and Insurance Fund and payments made out of these funds to employees who resigned/retired or otherwise ceased to be in Punjab Government service or died in harness.

iii. According to the orders issued by Government (March 2002), the advances drawn on Abstract Contingent (AC) Bills should be settled by submitting Detailed Contingent (DC) Bills to the Accountant General (A&E)/Pay and Accounts Officer for the expenditure incurred with supporting vouchers, within three months. The Director Treasuries and Accounts reiterated these order in a circular memo issued to all District Treasury officers and instructed them to watch the receipt of DC Bills. However, Rs. 804.23 crore drawn in 1.25 lakh AC Bills during he period 1978-79 to 2005-06 have not been adjusted as of June 2006. This indicated that the orders issued by the Government were disregarded by large number of Drawing and Disbursing Officers and also Treasury Officials.

iv. The accounts of the State compiled by the Accountant General (Accounts and Entitlements) should reflect the correct and true state of affairs and this could be ensured only when the departments incurring expenditure periodically reconcile the departmental figures of expenditure with those booked by the Accountant General. Timely reconciliation will also help to detect fraudulent drawl of money or any misappropriations. However, for 2005-06, expenditure of Rs. 44,210.39 crore remained unreconciled as of June 2006 in respect of 27 departments.

v. Failure of the Executive Engineer to follow the procedure laid and observe codal provisions and instructions issued for handling government money, facilitated embezzlement of Rs. 70.30 lakh. The provision in the Punjab Financial Rules were flouted.

vi. Failure of the Treasury Officers to exercise prescribed checks led to excess/irregular payment of pension/family pension aggregating Rs. 1.79 crore.

vii. Posting of 42 personnel on fake transfer orders led to fraudulent payment of Rs. 35.24 lakh.

**Flouting of Treasury Rules:**

i. According to the Treasury rules, the DTI or a gazetted officer nominated by him was to conduct inspection of treasuries/sub-treasuries at least once in a year. However, out of the 161 Treasuries/Sub Treasuries functioning under his control, there were shortfall in inspections conducted by the DTI ranging from 114 to 154 treasuries/sub-treasuries during 2000-05. The fact however was that the treasury administration being one of the important financial functions of the Government, the shortfall in inspection by the DTI affected the quality and timeliness of initial accounts rendered by the treasuries to the Accountant General (A&E) and adequacy of checking of entitlement claims etc. The lack of inspection also affected the sense of accountability at the Treasury level.

ii. Scrutiny of cash books maintained by the Directorate disclosed drawal of funds from the Treasury far in excess of immediate requirement, as evidenced by the huge balance in cash and in bank.

## XV

### Steps for Improvement

Above audit observations indicate deficiencies in internal control and internal audit, which need to be rectified by installing appropriate systems and institutional mechanism.

We have recommended introduction of large-scale computerization in the states for streamlining flow of funds and for ensuring payments made are as per budgetary provisions by networking of treasuries and other departments.

In the computerization programmes, self-auditing checks can be built in to provide concurrent internal audit. If properly designed, the computerization programme to a great extent will fill up existing deficiency in the states in the internal control system and internal audit.

But internal audit checks cannot be confined only to pre-audit checks of payments to be made. The internal audit has to include not only transaction audit but also audit of systems and procedures and evaluation of internal control systems. It has also to move towards performance evaluation. So computerization alone cannot provide solutions to the challenges faced by modern internal auditing system.

The basic problem that affects both the central and state governments is the lack of interest of the management in internal audit. The PSUs and autonomous bodies have also been kept out of its purview and, thereby, diluting its effectiveness.

The report on the Task Force on internal audit in central government has referred to the model of internal audit in West Bengal Government, who have created a full-fledged Internal Audit Wing in Finance Department through a cabinet resolution in November 1998 for conducting internal audit in all state government departments, their field offices, Directorates, state undertakings and autonomous bodies and local bodies.

Internal audit wing was converted into separate department named Finance (Internal Audit) Department in October 2001. This department is headed by Commissioner, Audit and ex-officio Principal Secretary to the Government of West Bengal, who reports functionally to the Minister of Finance and administratively to the

Chief Secretary. Under the cabinet resolution, the Commissioner has to be a member of the Indian Audit and Accounts Service. This ensures independence and professionalism in internal audit activity. The commissioner is assisted by Deputy Commissioners/Joint Commissioners, who supervise the internal audit teams, working in various departments.

The steps taken by the West Bengal government in regard to internal audit are laudable ones in that it gives due importance to internal audit in the financial management of the states, as also required status and independence to it. These are essential to make internal audit effective as emphasized above.

It is a centralized model of internal auditing, in which the basic authority is with the Finance Department in conducting the internal audit. But if the goal is adoption of performance oriented budgeting in the states, it is important to consider whether a decentralized model of internal audit would be more appropriate. In this endeavour, the internal audit has to aid in the process of evaluation of performance and also get involved in operational aspects of the departments concerned. We have also indicated that unless the departmental heads take active interest in financial management of the department, which includes budgetary control, efficient use of resources and using internal audit as an aid to management, the internal audit will not get the required mandate. It may, therefore, be essential that, as in the central government, the secretary of a department in the state government should be designated as Chief Accounting Authority and his responsibilities defined as in General Financial Rule 64 of the Constitution. That would include inter-alia responsibility and accountability for financial management of his department, ensuring that public funds appropriated for his department are used for the purpose for which they were meant, as also be responsible for effective, efficient and economical use of resources while complying with performance standards. As recommended in the case of Central Government, it is not enough to amend the Financial Rules, as nobody gives any attention to them, to pass suitable act in the state legislature, incorporating establishment of Chief Accounting Authority and his responsibility. The act should also provide that it should be his responsibility to avoid unauthorized, irregular and wasteful expenditure.

If this model is to be followed, then chief of internal audit should report to the secretary of the department concerned, who would be acting as the chief accounting authority for the department. In consonance with the principles of decentralized model of resource management, we have recommended adoption of model of Integrated Financial

Adviser system in the state governments for moving towards outcome-oriented and performance budgeting. As in the central government model the integrated financial advisor should be monitoring the functioning of the internal audit wing of the department to which he is attached, while being responsible to the department of finance of the state government. This point requires careful pondering over. In this model, the financial adviser will also function as the chief internal auditor and report to the secretary of the department.

The central wing in MoF can make supervision of internal audit function of various department, as also set up standards and norms for internal audit.

**Status of State Accountant General (Audit)**

For effectiveness of internal audit, we have talked about symbiotic relationship between external audit and internal audit. Effectiveness of internal audit would to a great extend depend on how much importance State government and Public Accounts Committee (PAC) of State legislature gives to findings of external audit. The seriousness, with which external audit findings are taken, apart from the content of the findings, would depend on the status of that the AG of the state enjoys.

The Constitution of India under articles 149 and 150 states that Comptroller and Auditor General of India (C&AG) will perform duties prescribed under law "in relation to accounts of the states" and the "reports of the Comptroller General of India relating to accounts of a state shall be submitted to the governor who shall cause them to be laid before the Legislature of the State".

This is somewhat anomalous in that, if C&AG is to perform duties in relation to accounts of the State, he should be available to the State legislature and attend meetings of the State PAC. But this is not possible for a single individual to perform.[147]

An Accountant General of the State discharges all the duties prescribed on behalf of C&AG, but he has no legal status. Most developed countries have realized the importance of decentralized system of audit to make it efficient. We are yet to move in this direction by conferring proper status to State AGs. Because of his legal standings, or lack of it, State government officials can ignore his audit findings. He is unable to

[147] *A Consultation Paper on Efficacy of Public Audit System in India: C&AG—Reforming the Institution,* National Commission to Review the Working of the Constitution, By Advisory Panel on Legal Control of Fiscal and Monetary Policies; Public Audit Mechanism; Standards in Public Life, January 2001, Para 4.4]

persuade the PAC to hold its sittings and discuss the audit reports so that a remedial action can be taken. "There are States where Audit Reports have not taken up for discussion for several years."[148] [*Government Accountability and Public Audit*, B.P. Mathur, Uppal Publishing House, 2007, p. 98].

The State AG need to be given greater authority relating to audit matters of the State by appropriate legal recognition. The Consultation Paper on Efficacy of Public Audit System in India (referred above) recommends: "*that in order to make State audit effective independent Auditor Generals for the States who have the same status as a High Court Judges are created by amending the Constitution. The appointment of State Auditor General be made with the approval of President of India on the basis of recommendations of an independent Committee headed by C&AG and qualification for holding the post be laid down. However the Auditor General of India should have power of superintendence over State Auditor Generals, in policy matters relating to accounts and audit, in the same manner that Supreme Court has over the High Courts*."[149]

In the absence of well-defined legal position, an AG is seriously handicapped in the discharge of his functions. This gets reflected in his dealings with the PAC of the legislature. There should also be provision in the law providing a time limit for discussing the reports of the AG in PAC. The reports of AG should contain his findings on the evaluation of internal audit function carried on by the State government in various departments. Only when the weaknesses of internal control and internal audit in the State governments are discussed in the PAC in a time-bound manner and recommendation for adopting remedial measures, it can lead to more effective internal audit in the States.

One can state without exaggeration that strengthening the role of State AG would be an important pre-requisite for improved financial management of the States.

## XVI

### Audit Commission for Third Tier

Bulk of the finances of the Panchayats / Municipalities come from the government, but there is no satisfactory arrangement of their audit. The Consultation Paper on Efficacy of Public Audit System in India (mentioned above), referred to setting

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[148] B.P. Mathur (2007), *Government Accountability and Public Audit,* , Uppal Publishing House, 2007, p. 98

[149] Ibid, A Conultation Paper, para 35

up of Audit Commission in UK for auditing Local Authorities and National Health Service. Similarly in France, Regional Courts of Accounts have been created in 1982 as part of wider policy of decentralization which is empowered to audit all local authorities.[150]

Following the recommendation of the 11th Finance Commission, C&AG has prescribed the budgets and accounts formats of Panchayati Raj Institutions (PRI) and Urban Local Body (ULB). Most of the states have accepted the proposal relating to C&AG's technical guidance and supervision over audit and accounts of PRI and ULB. What is to be kept in view is the large number of PRIs that have to be audited. For example, UP has 58,600 panchayats, MP has 31,100 and Maharashtra has 27,600. There is basic necessity of keeping their accounts in order, for which there is no trained staff. This problem has to be tackled on an emergent basis. A trained accountant has to be placed at least at the block level, who should be made responsible for keeping accounts for about 20-25 panchayats.[151]

**It may be necessary to create a separate cadre of accountants to cater for the needs for PRIs/ULBs in a State government. The basis for sound financial management is proper account keeping for providing the necessary management information, as also for budgetary control. These accounts would also facilitate furnishing of Utilization Certificates for the money provided to enable further flow of funds for the Panchayats.**

For audit of accounts of such bodies, the existing institutions for auditing would not be adequate not only because of the load involve, but also because of the nature of challenges it poses in terms of physical verification of work, interaction with the beneficiaries, investigations into likely fraud and misuse of funds.

In this connection, it would be worthwhile to study some of the provisions of Audit Commission Act of UK (1998). The act established the *Audit Commission for Local Authorities and the National Health Service in England and Wales*. The Secretary of the State appoints the Commission members. The Commission appoints the auditors to audit the accounts of the local bodies and units of National Health Service. The appointed auditors can either be an officer of the Commission or an external professional

[150] Ibid, Section 3.3, para 25 and 26
[151] B.P. Mathur (2007), *Government Accountability and Public Audit,* , Uppal Publishing House, 2007, p. 70

firm/person. The appointed auditor should be a member of a professional accounting institute in UK.

The Act gives a lot of importance in formulation of norms and standards of audit which are incorporated in the Audit Codes. To quote: “The Commission shall prepare, and keep under review, a code of audit practice prescribing the way in which auditors are to carry out their functions under the Act.” [Sec 4 (1) of the Act]

The Code to be adopted shall embody “what appears to the Commission to be the best professional practice with respect to the standards, procedures and techniques to be adopted by auditors.” [Sec 4 (3)]

“A code does not come into force until approved by a resolution of each House of Parliament, and its continuation in force is subject to its being so approved at intervals of not more than five years.” [Sec 4 (4) of the Act] This indicates that codes for audit cannot be just based on department instructions and has to have legal authorization so that quoting of the relevant provisions of the code in making an audit observation gets the required force and makes the auditing units take remedial actions without further dithering. But the practice in India is that drawing reference to any departmental codes pertaining to audit in support of an audit objection can be totally ignored by the executive authorities, as these have not the legislative backing.

Some other provisions of the Act are also relevant. These pertain to auditors right to obtain relevant documents and information for arriving at right conclusions, as this is one of the lacunae in our system.

“An auditor has a right of access at all reasonable times to every document relating to a body subject to audit which appears to him necessary for the purposes of his funct8ions under this Act.” [Sec 6 (1) of the Act]

“An auditor may—

a) Require a person holding or accountable for any such document to give him such information and explanation as he thinks necessary for the purposes of his functions under this Act; and

b) If he thinks it necessary, require the officer or member to attend before him in person to give the information or explanation.” [Sec 6 (2) of the Act]

The Act further empowers the auditor to require any officer of the body under audit to provide any information or explanation that the auditor thinks are necessary for the conduction of his work, as well as require those officers to present themselves in person before the auditor to provide those information and explanation. The officers would be guilty of an offence and liable to a fine if they fail to provide the required information and explanation to the auditors [Sec 6 (4) & (6) of the Act]

On discovering that an item of account is contrary to law, the auditor has the right to go to the Court to get it declared unlawful. On finding that an item of account is contrary to law, the Court may order those persons responsible for authorizing the expenditure to repay the amount to the body under audit. [Sec 17 (1) and (2)]

The above provisions are quoted to indicate that there should be a proper framework of laws to enable audit to function effectively if it is to contribute effectively to financial management in the government. These provisions are not only relevant for the audit of third-tier government, but also relevant for audit of Central and State governments. It also brings out, as mentioned above, that audit and investigation into irregularities cannot be segregated.

From this it can be derived that even for the functioning of internal audit, there has to be proper enactment in State Legislature so that audit findings are given due importance in rectification of deficiencies.

**In view of the importance of PRIs in development of rural India and Urban Local Bodies in city life, it is recommended that a separate statutory body to audit them should be created in each state on the UK pattern.**

# Chapter 6

# Accrual Accounting for Better Accountability

## Importance of Accrual Accounting for Performance Measurement

Most government accounts in India today are on-cash basis. In this system of accounting transactions are recorded when there is actual flow of cash. Revenue is recognized in a given period, only when cash is actually received. Expenditure is recognized only on the basis of outflow of cash in a given period. The whole focus is on-cash management. No consideration is given to the `due' factors of the transaction. This does not give a fair view of the financial position of the government entity concerned.

As against the cash system of accounting, in the accrual system transactions are entered into the books of accounts, when they become due. The transactions are recognized as soon as a right to receive revenue and/or an obligation to pay a liability is created. Following this principle, revenues are recognized as when income is earned, and expenses are recognized when liabilities are incurred or resources consumed. Accrual accounting in the context of public sector would imply recording of transactions on accrual basis, and preparation of accrual based financial statements for the government as a whole. The point, however, is that very few countries do it.

It has often been argued by financial management experts that for large number of developing countries, moving to accrual accounting is of dubious advantage. In many countries administrative capacity and skills required may be inadequate to bring about such a major reform in accounting system. "While the benefits of accrual based accounts and reports are yet to be clearly demonstrated in practice, the costs of such reforms are clear and significant, many are recurrent rather than being one time".[152] And it is easy to overstate the case for introduction of accrual accounting by understating the cost involved in its introduction and maintenance. In India, as we shall see, earlier both C&AG and Controller

[152] Jack Diamond (2006), "Budget System Reforms in emerging Economies", IMF, p 64-65

general of Accounts (CGA) had expressed their reservations about introduction of accrual accounting considering the costs and benefits.

In this context, three things should be kept in view. First, undertaking any major reform is really a journey not an end state. Systematic efforts would have to be made over a number of years to implement it. In this process many of the hurdles mentioned, may be successfully overcome by imparting necessary training, recruiting suitable professionals, preparation of accrual accounting manuals, getting together comprehensive data regarding assets and liabilities, establishing suitable accounting standards and norms, by acquiring suitable software, and above all by expert advice.

Second, the effect of any such major reform process on the mindset of the management should not be ignored. As the basic approach of accrual accounting percolates to the management level, they would tend to become oriented towards balance sheet approach of financial management rather than compliance with budget. Many other reforms are likely to take place when accrual concepts are kept in view; for example, it may lead to better management of liabilities and assets, which are negelected to day in public sector, but are essential for sound financial management.

Third, in India, some of the municipalities have successfully switched over to accrual based accounting system by following proper strategy, which has improved their financial management. So it is very much within our administrative and accounting capability to bring about such reforms, provided determined effort is made.

We must recognize the importance of accrual accounting principles from the macroeconomic policy point of view. The importance of accrual accounting for macroeconomic policy arises from the fact that it measures assets and liabilities that are relevant to the overall stance of fiscal policy and fiscal sustainability, which can not be done in a cash accounting system. Further whereas cash accounting measures only conventional debt, accrual accounting measures quasi-debt liabilities such as amounts payable for the receipt of goods and services, and employee liabilities like civil service pensions. This information is important for both developing and developed countries.

We are stressing now on performance budgeting. From the performance measurement point of view also, an accrual framework is essential to determine full-cost of a governments' activities. Depreciation costs, accrued civil service pension are essential to get full cost information of rendering a service by government, which are ignored in cash accounting system. Information about full costs of government service can be extremely important when considering alternative service delivery options. In many cases, in India, this option has to be considered to cut down the cost of delivery of service.

## II

### Limitations of Cash System of Accounting

Limitations of cash system of accounting have been highlighted by Government Accounting Standards Advisory Board (GASAB), which has been set up by the Comptroller and Auditor General (CAG), of which, following are important[153]:

- It does not provide the complete picture of the financial position as information on fixed assets like land, building, and machineries are not available.
- It does not give the full information on current assets e.g. accrued income like outstanding royalty, fees, service charges, tax arrears etc.
- Comprehensive information is not available about government liabilities (pensionary commitments, interest due, bills payable, depreciation for replacement of assets etc.).
- Unit cost and total cost of services provided by the Government departments like health, education, water supply, transportation etc. is not ascertainable (as depreciation, interest etc. are not apportionable).

[153] See "Primer on Accrual Accounting", Government Accounting Standards Advisory Board (GASAB)

- No disclosure is made about contingent assets and contingent liabilities which may turn into committed ones on account of guarantees given or letter of comforts issued by the government.
- No information is provided about existing net liabilities of public enterprises and agencies outside the government, although the latter cannot escape such liabilities.

Due to above disadvantage it is not possible to get real picture of government financial performance and position through cash accounting system followed by the Government.

## III

### Accrual Accounting for Indicating Financial Position of Government

Among the advantages of accrual system of accounting, the following four are very important to indicate the financial position of the government[154]:

1. It helps in the assessment of financial performance by correctly reflecting surplus/deficit, as all expenses whether paid or not but payable and all incomes which are due whether received or not, are duly accounted for.
2. It provides comprehensive information on expenses which helps in knowing the cost consequences of policies and enables comparison with alternative policies. Also, information about calculation of subsidy can be extracted from the accounts, which helps in its rationalization. This ensures the adoption of best policy, which in turn assures optimal use of scarce resources. It also helps in ascertaining the future sustainability of programmes.
3. It gives comprehensive information on the financial position i.e. assets and liabilities of government. In this system of accounting the financial decisions are not seen merely from the point of view of cash outgo or inflow but also from their impact on asset-liability position of the government, future funding requirements of assets enabling planning of their timely maintenance and replacement.

[154] Ibid

4. It gives disclosures on account of contingent assets and contingent liabilities so that risk associated with the guarantees issued and letters of comfort given can be better assessed by the user of the financial statements.

There is also the concept of modified accrual basis of accounting. In modified accrual basis of accounting (sometimes also called as expenditure basis) there is no deferral of costs that will be consumed in future periods. Physical assets that will provide services in the future are written off (or expensed) in the period acquired. Under modified accrual accounting, supplies are considered consumed and assets are written off as soon as they are acquired.

In Spain, for example, the public sector financial statements are prepared using a modified accrual basis. Two most significant exceptions made to full accrual basis are the following;

a. Government capital assets, when for direct public use by citizen are recognized as capital investments during construction and are written-off (or expensed) when completed. This is the case for infrastructure, defence and cultural assets. Consequently, no depreciation expense is recognized for these capital assets.
b. Capital subsidies are recognized using a modified cash basis and transformed to income when collected or when receivable within three months or less. As a consequence of this, there are no deferred revenues to be recognized in future periods.

It would be fair to describe the Spanish system as modified accrual basis of accounting. We should also aim at adopting modified accrual system of accounting, as it is comparatively simpler that that of the full accrual accounting and serves the basic purpose of indicating the financial position.

## IV

## Transition to Accrual Based Accounting

GASAB indicates following strategy for transition to accrual system for accounting. The transition to an accrual based system should be on the following lines. To start with Ministries/Departments with a commercial focus should implement the new accounting system. These departments (and the organizations under these departments) essentially provide commercial products/ services, and compete with private sector entities. In these departments, there are tangible commercial benefits flowing from accounting which are essential for their competitiveness and economic viability.

The next phase should cover departments with a social orientation. These departments fulfill the social responsibilities of the government. As opposed to the departments that have a certain amount of commercial and revenue focus, these are typically “spending” departments. The thrust here is on the delivery or services and ensuring that the output and outcome are commensurate with the inputs and targets. Transition to an improved system will provide these departments with better tools to monitor and evaluate service delivery and the costs.

Finally, administrative/regulatory departments concerned with general administration and/or provision of regulatory functions should transit to accrual accounting. The accent of these departments is not as much on costs or revenues but on providing the necessary support and administrative services for overall running of the government and the economy. Select departments in each of the categories may be identified for pilot implementation. In the case of state governments, either an entire state government or a geographical unit such as a district or a set of districts should be chosen for pilot implementation.

As indicated by GASAB some important issues are to be addressed at the time of transition to accrual accounting.

i. The decision on the format of financial statements on migration to accrual accounting and generation of first set of financial statements is of key importance in transition. The format has to facilitate transparent, accurate and complete depiction of financial position. Checks and balances have to be in place to ensure appropriate measurement and recording of accounting data. Issues like preparation of assets register and valuation of assets have to be addressed.

Internationally the role of auditor has been significant in ensuring a smooth transition to accrual basis of accounting. Auditors may be helpful in framing the accounting policies on assets and liabilities, recognition of revenues and expenses, citizen's net worth, reporting period, measurement basis etc.

ii. Accurate information of revenues is essential for assessing the impact of taxation and other revenues on the Government's fiscal position, in assessing the need for borrowing in the long term and also to assess whether current revenues are sufficient to cover the costs of current programs and services. It is necessary to take a decision on the types of revenues that are capable of accruing with reasonable degree of certainty. In case there are few line items that are not suitable for accruing, they may be continued under cash basis accounting. The decision in this regard has to be taken by government.

**V**

## Accrual Budgeting

Accrual base budgeting has to be output-based. It also requires that all the budgeting and reporting at the department level use accrual methods. For example, until 1989, New Zealand's budgeting process was based upon a cash accounting system. With the passage of Public Finance Act of 1989, New Zealand redefined the government's budget process, making it output-based. It required that all budgeting and reporting at the department level use accrual methods. This is because an output-based budgeting process emphasizes "the use of output (product) cost information as a managerial tool and more specifically as the basis for a purchaser/provider (quasi-market) model of budgeting"[155]. In other words, government agencies and departments are viewed as producing outputs (for instance, maintenance of armed forces, prison management, etc.), which Parliament then purchases, so to speak. As

[155] Marc Robinson (2002) *Accrual Accounting and Australian Fiscal Policy*, 23 Fiscal Study, p. 287, 288.

such, the departments must use accrual-based projections and reports so that Parliament can know the full costs of the outputs and compare costs with private suppliers if possible.

The accrual based reforms in New Zealand are most comprehensive that any country has undertaken today. Most observers agree that the accrual measures have provided better information for purposes of asset management and cost calculations. Many believe that the accrual measures have produced much greater fiscal discipline, especially in as much as legislators and other government officials can more easily ascertain the fiscal sustainability of government programs.

Since implementing the reforms, New Zealand has demonstrated strong fiscal restraint. In terms of budgeting New Zealand has more or less tolerated increases to core budgets of each department at only a constant nominal level. Remarkably, New Zealand's gross financial liabilities have decreased from 65 percent of GDP in 1993 to 23 percent in 2005. The country has also reported budget surpluses in nearly every year since the early 1990s. As a result, New Zealand's net debt has decreased significantly, from approximately 52 percent of GDP in 1992 to near 10 percent in 2005. During the same time, New Zealand has enjoyed, for the most part, moderate to strong economic growth, averaging around 3.3 percent annual growth in real GDP over the last decade. But as brought out by Mark Champoux "To what extent any economic success can be attributed to New Zealand's major reforms, and more specifically, to its use of accrual accounting, is highly unclear"[156].

Cash accounting has also some advantages from the management point of view. When the primary requirement is to enforce compliance with budgetary provisions, then cash based system serves the purpose quite well.

But if the attention gets focused on efficiency and effectiveness, then accrual accounting offers many advantages over cash accounting. Under accrual system, fixed assets

[156] Mark Champoux, 2006 "Accrual Accounting in New Zealand and Australia: Issues and Solutions", *Briefing Paper No. 27*, Harvard Law School.

are valued on current cost, the depreciation amount can also provide an indication of the future expenditure required to replace existing assets at the end of the useful life.

The most important point is that managers get more accountable when they become responsible not only for cash inflows and outflows but also for proper management of assets and liabilities.

Governments generally have significant assets and liabilities, and disclosure of this information is an essential element of fiscal transparency and accountability. This is facilitated by accrual accounting framework, which is not only supposed to give full statement of assets and liabilities, revenues, and expenditures, but mostly importantly has to integrally link these with one another.

In public sector often, valuation of assets is less important than proper maintenance of existing assets. Recognizing this point, the UK treasury adopted a pragmatic approach in determining which assets are to be valued in resource accounts. But the point is that attention in expenditure management should first get focused on efficiency and effectiveness.

## VI

### A Stage by Stage Approach

A stage-by- stage approach to introduce accrual accounting is often advocated. What is important in this context is to make the cash accounting work well[157]. It will involve removing its common abuses and to supplement the cash accounts with adjustments to improve fiscal reporting. Most cash systems are deficient in providing information on liabilities. The logical step, therefore, should be to generate information on commitments undertaken, bills payable, and bills due for payment.

For introducing accrual accounting it is often felt that adopting an accrual classification structure that facilitates the recording of revenues, expenditure, assets,

[157] See Jack Diamond, "Budget System Reforms in Emerging Economies" IMF, 2006, pp, 67

liabilities, and cash flows should be considered as the first major step. The next step logically should be, introduction of general ledger based double entry system. Considering the expertise available in government sector in accounting, this step could be quite difficult to implement. This hurdle can only be removed in medium term by initiating intensive training of accounts staff and accountants. This then brings into the focus the question as to what should be the first step. Considering the limitation in accounting expertise, and from the cost benefit point of view, it may be worthwhile to consider an alternative strategy of exploring the best option available for recording and reporting on selected assets and liabilities. In fact, considering that very little information is available on asset side, recording and reporting on assets, should take priority over all other steps in moving towards accrual accounting.

Risk of implementing accrual accounting, as Noel Hepworth points out, is that it may seen as a technocratic exercise and not a management driver[158]. Accruals create illusion of a quality system, but the reality is that quality depends, among other things, on independence of the standard setting process, the skills of government accountants, and management capacity to use the information. According to Noel Hepworth following pre-conditions need to be satisfied for success of accrual accounting;

- Politicians/management understands the change and how the information can be used to improve efficiency.
- Accounting standards are set independently of government or jointly with third parties.
- The accountancy profession is willing/able to cooperate with civil service, to train accountants in government and to educate staff in an understanding of standards.

If a determined effort is made to introduce accrual accounting in India, and it is properly conceived, all those conditions can be met as the experience of accounting reforms in selected municipalities of some of the states (to be discussed latter) indicate.

[158] See Noel Hepworth, "Accrual Accounting in the Public sector MIDA Programme Ancara", Public Finances and Accounting UK, CIPFA, UK, 22-25 November, 2004

## VII

### Acceptance 'in principle' by GOI of Introduction of Accrual Accounting

Government of India had accepted in principle the recommendation of the Twelfth Finance Commission (TFC) that a "gradual" switchover be made to the accrual system of accounting. Finance Minister, Mr. P. Chidambaram indicated that Government believe that the recommendations of the TFC could be implemented over a period of time. He also wanted to examine the implication of this principle in terms of time, cost and beneficial aspects".[159] Because accrual accounting is not used many large liabilities are hidden like the pay as you go pension system. As there was no funding of the pension system, liabilities were not calculated correctly. These are neither provided for nor accounted for.

The Finance Minister expressed hope that the State Governments would also follow suit and take initiatives towards adopting an accrual-based accounting system. He said the Centre's latest initiative to look at adoption of accrual accounting is as important as the initiative taken in 1976 to departmentalize the accounts in the Central Government. He felt that the Centre cannot move forward or fast enough on this front (accrual accounting) unless at all levels there is full computerization.

Subsequent to this it was indicated that the Finance Ministry will soon commission feasibility studies for the introduction of accrual accounting in certain Central Government departments. This initiative would be undertaken through selected pilot projects in two Union Ministries and formed as part of a World Bank assisted project for modernizing the Controller General of Accounts (CGA) organization. A senior Finance Ministry official said that the pilot projects to test the feasibility of accrual accounting are likely to be undertaken in certain specified areas coming under the Health Ministry and the Urban Development Ministry.

[159] Address at the workshop on Accrual Accounting and Classification Systems *The Hindu Business Line*, 15 September 2005.

## VIII

## Views for and against Accrual Accounting

On the subject of "Accounting Reforms" the Committee on Fiscal Responsibility Legislation, expressed its views in favour of introduction of accrual accounting system and was inclined to make it part of Fiscal Responsibility and Budget Management Act, as it felt it would be an instrument of fiscal control.

"The Union Budget should progressively move towards greater disclosure on accrual basis of all contractual liabilities, explicit contingent liabilities, revenue demands raised but not realized, committed responsibility in respect of major works and supply contracts in progress, hidden subsides by way of below cost supply of goods and services etc"[160]. The information, to begin with, could be extracted from departmental management information system (MIS) and gradually integrated into main accounts compiled by Controller General of Accounts (CGA) and audited by the Comptroller and Auditor General. They expressed the view that the cash accounting system should be progressively supplemented by accrual accounting and wherever necessary, general accounting norms should be aligned with internationally accepted best practices.

They also pointed out the weaknesses of the cash based accounting system as it does not bring out accrual aspect of accounting such as liabilities arising from unpaid bills, unrealized tax revenues and other receipts as well as the cost of using existing revenues (i.e. depreciation). Furthermore, all transactions are recorded in the accounts at their historical values. As most external loans have long have long repayment period, considerable distortions arise if we overlook the current valuation of these liabilities are overlooked. A view was, therefore expressed that switching over to an accrual system of accounting would be desirable for effective fiscal control[161]

[160] From the Report on the "Committee on Fiscal Responsibility Legislation July 2000", para 46, Fiscal Responsibility and Budget Management Act 2003 and its implementation, Seminar Volume, October 2004, National Institute of Financial Management.
[161] Ibid, para 47

But both Comptroller General of Accounts and representation of Comptroller General expressed their reservation about it, who felt that “it was neither desirable nor feasible” to incorporate features accrual accounting part of the Fiscal Responsibility Act. They wanted the issue to be examined separately. They however were in favour of disclosure of accrual based information. In fact, Controller General of Accounts stated that most of the information needed for managerial purposes is already available in the existing financial information system.

The Committee had extensive discussion on the need to introduce accrual accounting and stated “After careful deliberation on various issued raised by the CGA and the representative of the C&AG, the committee felt that introduction of accrual accounting as a part of proposed fiscal responsibility legislation would not be desirable. However, the need to gradually introduce an accrual system of accounting may be separately examined. Meanwhile, greater disclosure of accrual-system of accounting may be separately examined. Meanwhile, greater disclosure of accrual-based information in the budget document should be set as target in the proposed FRA”.

Views of CGA and the C & AG regarding introduction of accrual accounting was made part of the report (Annexure VII of the report). Responding to the suggestions to introduce accrual accounting, the CGA pointed out that most of the information needed for managerial purposes is already available with Administration Department/Ministries. Under General Financial Rules, they pointed out, a register of liability is required to be maintained in each Department and Ministry, particularly in works departments concerning pending contractual liabilities. Therefore, it should be possible for the department MIS to generate reports on carry over liabilities by way of unpaid bills etc. Likewise the MIS can generate reports regarding outstanding tax or non-tax revenue arrears, committed liability in respect of ongoing works/supply contracts and the commitments charged on future budgets in respect of incomplete projects. “These can be suitably incorporated in the budget document, and for this reason alone there is no need to <u>tamper</u> with the accounting system. Information, regarding unrealized tax measures is also available in CBDT/CBEC in respect of demand raised."[162]

In fact C&AG had serious reservation about benefits of accrual accounting in governmental system as opposed to commercial sector. "If government accounting system is to be maintained on an accrual basis, a lot of spade work would have to be done including setting up independent Accounting Standards Boards, for laying down norms for recognition of accrual liabilities revenues."[163] The representative of C&AG also pointed out in Netherlands, a system of accrual accounting was introduced but did not prove successful. Even in New Zealand accrual accounting has been introduced for limited purposes.

It was brought out that a committee headed by Shri A.C. Tiwari, formerly Dy. C&AG had examined the issue of introducing accrual accounting earlier, did not recommended its introduction. "The requirement of accrual accounting, in government, has not yet been established, as the needs of government accounting are quite different from those of commercial enterprises. Accrual accounting is untested, difficult to implement and not really useful. There are practical problems, huge costs and timeframes involved and it would not be cost effective".[164]

It was pointed out that "unified accounting system is key factor of federal structure since accounting system is common for Centre and the States, we cannot start it for the Centre without examining its implications for the State Accounts." These earlier reservations of C&AG and CGA regarding introduction of accrual accounting have to be kept in view while developing the implementation strategy of accrual accounting.

## IX

## Considering an Implementation Plan of Accrual Accounting

[162] Ibid
[163] Ibid
[164] Seminar in Fiscal Responsibility and Budget Management Act 2003 and its Implementation, NIFM, October 12, 2004, para 72.

Having accepted the need for introduction of accrual accounting and having taken initial measures towards it implementation like setting up GASAB, and sensitizing the departments about the need for introducing it through workshops and seminars, it is necessary to develop a sound implementation plan.

**Introduction of accrual accounting should be treated as a project and specific amounts should be allocated for it annually in the Finance Ministry's budget. The three most important initial steps would be:**

- **establishment of Project Implementation Steering Committee;**
- **drafting and passage of requisite financial legislation;**
- **Adoption of accounting policies consistent with international accounting standards.**

**Establishment of a Steering Committee at an appropriate level for implementation of the project accrual accounting should be regarded as the most important step. Considering the challenges involved and hesitations mentioned earlier, it should be headed by no less than the Finance Minister.**

The Steering Committee should apart from sanctioning annual expenditure and its allocation from the allocated budget, take decisions regarding project governance structures, and determination of the sequencing of accrual business areas for implementation purposes as also for review of the progress. There should be specific budget head in the demands for grants of Finance Ministry, for allocation of resources for the implementation phase.

**There should also be an Executive Committee headed by Finance Secretary, among other things, for appointment of technical advisors, setting up consultation groups, project managers, team leaders, project quality assurance and audit. It would take decision regarding selection of a system solution to meet accrual accounting requirements, including conceptual design, functional and technical requirements.** These decisions are to be taken on the basis of recommendations of expert groups appointed to advice on these issues. The committee has also to decide on the development of request for proposals (RFP), evaluation of proposals, selection and contracting of vendors(s) and implementation consultants. Decision has to be taken regarding development of an opening balance sheet for each department and establishment of communication and training programme.

For adoption of accounting policies GASAB has already been appointed. C&AG have to take pro-active steps on its recommendations.[165] A stage by stage approach has to be adopted for implementation of accrual accounting in the government. In the stage one of the Illustration of a possible implementation process of accrual accounting to the implemented between year 1-3, *inter alia,* following are indicated*:*

- **General ledger – management of the government's control financial data reprinting, ledger structure and journal structure.**
- **Purchasing-management of the full procurement cycle, including commitment management.**
- **Payments and accounts payable management of all supplier and grantee payments, including management of accounts payable (arrears).**
- **Revenue management of all invoicing and related process (excluding taxation revenue – this will be managed by the central tax agency).**
- **Receipts and accounts receivable – management of receipts and receivable functions (excluding tax revenues – this will be managed by the central tax agency).**

Above are one indicated for illustration purposes. But if time bound, stage by stage approach are not taken towards introduction of accrual accounting for each kind of relevant transactions, even after 8 to 10 years, accrual accounting even in modified form will remain an unachieved objective.

[165] See PFM Technical Guidance Note No. 1 "Transition to Accrual Accounting"; prepared by Abdul Khan and Stephen Mayes. October 2007.

In the Indian context, the concepts of a Lead Agency has been suggested[166] for implementation of accounting reforms, which would develop among other things policy parameters within which the accounting policies of the Ministries and departments are to be grounded, determining the accounting procedures and controls, evolving standards setting process working out the value, and contents of evolving legislature procedure etc. It has also been suggested the ministry of finance, and in particular the Controller General of Accounts, could be designated as the lead agency and in particular the Comptroller General of Accounts could be designated as lead agency.

The concept of lead agency is right, but its functioning should be guided by the steering committee as suggested above. The Executive Committee should be the coordinating agency as also takes those steps, to implement the transition to accrual accounting, as suggested above.

For setting up accounting standards, as stated above the Comptroller and Auditor General of India has set up a standards setting body the GASAB. The point made by S.K. Das is, "with its present government-dominated composition, GASAB does not come across as a truly independent body. The accounting standards board of the ICAI[167] which is responsible from establishing accounting standards for the private sector companies – could be ideal candidate for the purpose" (ibid p189). This is a valid observation and government should consider the suggestion with the seriousness it deserves.

**X**

**Lessons from Accrual Accounting in Municipalities**

Some of the municipal bodies in India are changing over to accrual accounting. One of the important reasons for it is the pressure from the financial institutions. Certain

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[166] See, S.K. Das, `Rethinking Public Accounting' various steps have been suggested in the chapter page 182-83 "Implementation of Road Map, which require

[167] Institute of Chartered Accountants of India (ICAI). It is printed by S.K. Das, that ICAI's accounting standards published a booklet in October 2000 guiding the urban local bodies seeking to introduce accrual accounting p.160 (ibid)

important ideas about implementation strategy for transition to accrual accounting on government wide basis can be drawn from the reforms undertaken in this regard in municipalities across the country. The basic aim should be to introduce modified accrual accounting system. Total support from the top level of government including technical leadership is essential for transition to accrual accounting system. Most successful municipal accounting reform is in Tamil Nadu, which came at the behest of Asian Development Bank. The accounting reforms took three and half years to implement, with one more year for computerization. All the municipalities in Tamil Nadu have now converted to a computerized accrual accounting system. "Tamil Nadu experiment is a model not only for the success of accounting reforms but also for the success of progressive municipal governance with municipal accounting reforms"[168]

It is worthwhile to go briefly into the background of its success in Tamil Nadu, in order to draw appropriate conclusion for implementation of accrual accounting in other municipal bodies. An accrual accounting system is most suited in municipalities as they are directly engaged in delivery of services to the citizens. In 1997, the Tamil Nadu Urban Development Fund (TNUDF) was conceived, which made a proposal to the state government for introducing modern accounting system. TNUDF is not a fully owned government organization. It has equity participation from the private and public sector as well as leading of financial institutions of India. One of the activities of TNUDF is to provide loan assistance to municipal bodies for urban infrastructure development.

A three member committee was appointed in 1998 to prepare Accounting Manual to guide the introduction of double entry accounting system. The accounting manual and the project to introduce accounting reforms in municipal bodies received government clearance in January, 1999. Immediately the TNUDF commenced training the officers and employees of municipal bodies. To ensure smooth and effective implementation, a system of review at different levels of implementation was introduced. The result of review was regularly communicated to the Chief Secretary of the State Government (who headed the TNUDF), the

[168] Accounting to Accountability, Building the case for Municipal Accounting Reform" Dr. Ravikant Joshi, Yura Books 2004 p. 332

Secretary for Municipal Administration – Urban Development. The TNUDF also appointed local consultants to help municipal bodies in the implementation process. A state wide, unified accounting system approach was adopted from the start. While the top level support and guidance is essential, for effective implementation for accounting reforms, the Tamil Nadu experience shows that the process has to start from the bottom-most layers of an organization. It is the accounts clerk and accountants who have to implement the transition. Implementation strategy has to take this basic fact into account make the process work from the bottom of the hierarchy.

Adoption of this strategy requires an accounting and system manual, which is to be prepared prior to the implementation process. As stated above, in Tamil Nadu Municipal Accounting reform process, a committee was appointed to prepare an accounts manual to guide introduction of double entry accrual accounting system. This was the initial step. The draft manual was discussed in detail by various important municipal functionaries, including Director Local Fund Audit and finally was reviewed by the Finance Department of the State.

In Tumkur City Municipality accounting reform, the Karnataka Urban Infrastructure Development Finance Corporation (KUIFDC) identified Public Affairs Centre (PAC) a leading NGO to coordinate implementation of Fund Based Accounting System (FABS) in City Municipal Council. PAC studied closely the Tamil Nadu municipal accounting system reform initiatives. In February 2000, the PAC submitted a manual of prepared accounting system to KUIFDC for approval, which was subsequently submitted[169]. (ibid, p. 334).

In comparison to above success stories, the experiment in Gujarat of introducing municipal accounting reforms in a few municipalities have not been successful. The lack of support from the state government is one important reason for it. But another point to note is that the Municipal Accounting Code had not been amended or rewritten even after implementation of accrual based double entry accounting system in six municipal corporations (ibid p. 328). As a result parallel accounting systems exists and preparation of balance sheet poses a problem (Anand municipality experiment).

[169] Ibid, pp, 334

“The preparation of accounting manual is very important stage of the reform implementation process. It served as the foundation on which the entire edifice of the improved accounting system will stand. Therefore, utmost care must be taken for its preparation[170]. The manual should *inter alia* be cognizant of the various internal processes, the statutory and regulatory environment, compliance with organizational processes, and budgetary structure and system. Simultaneously, the policy issues relating to valuation of assets and determination of liabilities should be resolved during preparation of manual.

Another important point that emerges from the implementation process in municipality accounting reform is that the accounting and financial system reforms should aim not only for conversion from single entry to double entry but must also aim at improving existing accounting, financial and administrative procedures, information flows and work flow etc. The aim should be to bring about total financial management reform, not just accounting reform. The implementing agencies for accrual accounting should therefore review the entire accounting and financial reporting system with a view to make it more efficient. Then only the true benefit of introducing accrual accounting system would then be achieved[171]. Actual benefits of a accrual accounting are more indirect than direct. Indirect benefits are considerable, particularly by providing required information relating to hidden costs and liabilities, and by bringing in better sense of accountability to management through cost accounting.

**XI**

**Training Needs**

Next important point regarding implementation process is the capability building process. Training constitutes the backbone of any reform process. Given the present background of accounts personnel, training in accrual accounting used be the crucial

[170] Ibid, pp 356
[171] Ibid, 238

precondition for its success. Training programme should be structured as per the training need of the trainees.

To quote from the Twelfth Finance Commission Report, "The change over to the accrual based system of accounting will place considerable demands on accounting personnel in various government organization, particularly at the lower and middle levels of accounting hierarchy, consisting of accounts clerks, accountants, assistants treasury officials and others… In most countries accountants are required to acquire recognized vocational qualifications in public sector accounting and audit. The absence of professionalized accounting personnel in the public sector in India has been commented upon by several analysts. Considering the need for qualified and professional accounts staff and training for capacity building particularly in the context of our recommendation for changeover to the accrual based system of accounting, we recommend that a National Institute of Public Financial Accounts be set up by the government of India and its charter be decided in consultation with C&AG"[172].

**There is an urgent necessity to set up such an institution to train up not only accountants, but also internal auditors, if government is serious about introducing accrual accounting system and strengthening internal audit.**

## XII

### Computerization of the Accounting System

Introduction of accrual base double entry accounting system is greatly aided by the application of computer technology. To quote Dr. Joshi in this regard in the context of municipal accounting reform, which has wider message; "Cost effective and user-friendly accounting software is readily available today. There is no need for individual municipal bodies to develop customized system for this purpose. A municipal body should design its accounting system manual in accordance with software selected. The advice of external

[172] Para 14.18 of Twelfth Finance Commission Report p. 285-256

professional support will be useful to finalize accounting software. Vadodara (Gujarat) and Mizapur (Uttar Pradesh) have convincingly demonstrated that accounting system of a municipal body can be connected into a readymade computerized accrual base double entry accounting system in a most economical manner."[173](ibid p. 357).

In the more general context of financial management, A. Premchand, points out, most of the information that is sought to be provided by accrual system is in fact built into the off the shelf computer accounting software. It enable maintenance of information in terms of budgetary appropriation, initial and firm commitments, vender lists, lags in supply of equipment or services submission of payment vouchers, and eventual payment or liquidation of claim. It, thus, provides data in terms of multiple bases, without additional cost[174].

But we must work beyond the computerized system for the aim is not just introduction of double entry system of accounting, or better information about liabilities, but to bring about a much better financial reporting system with a view to bring about better financial management.

Better asset and liability management are much important off-shoot of implementation of accrual accounting system. In a more general context as a part of financial management information system, computerization of existing procedure does two kinds of reform; efficiency reform that accelerates the operation of existing procedure and effectiveness reform, that change existing procedure. Redesigning information flows the way these flows are processed and managed and used for dicisions, usually require changing operating procedure.

## XIII

## Accrual Accounting and Resource Management

[173] Joshi, Ravikant (2004), Accounting to Accounatbility, Yuva Book
[174] A. Premchand, (2005), Controlling Government Spending, Ethos, Ethics, and Economics of Expenditure management, Oxford University Press, pp 73

Accrual based reporting means recognizing assets and liabilities in existence as at a reporting date. One of the key advantages of accrual based accounting is that it gives the opportunity to the government to improve their management of assets and liabilities. Good asset management, through critical in public sector, is often neglected. Assets management is particularly important in public sector due to the very long life of many physical assets. Because of the way capital expenditure are reported under traditional cash basis, there is a natural tendency in the public sector to acquire or build new assets rather than adopting a systematic approach to assets management.

Accrual accounting assists in re-focusing public attention on state of long term community and infrastructure assets (such as hospitals, school, roads, bridges) and the linkage between assets and service delivery objectives. From a resource allocation perspective it may be more effective to undertake a major renovation of a hospital than to build a new hospital a few kilometer away.

That is accrual based reporting gives decision maker broader range of options in managing assets. It leads to proper inventory management. Building up unnecessary inventory is a one of the critical weakness of government resource management as the high cost of inventory goes unreported in cash system of accounting. Lot of capital outlay gets blocked in building up inventories which may became obsolete in course of time.

Assets information disclosed in the balance sheet together with depreciation charges and maintenance costs in the operating statement would be extremely useful in financial planning and decision making over time.

Merely setting up asset and inventory register by itself would not improve asset management. Principle of good asset management has to be developed and implemented by an empowered group.

This is also the need to focus on financial assets and ensuring they are measured reliably. A government cannot make appropriate financing decision without accrual based information on financial assets, measured using an objective method of their recoverability.

Assessing the value of all assets and posting their in the accounts would major difficulty but has to be faced by setting up task forces with time bound action plan. They should be able to take assistance of outside experts in developing the formats and principles to be followed in valuation. Such assets register should be maintained and subjected to periodic physical inspections, particularly for sectors for which assets management is crucial to promote transparency in operations relating to sale of assets must be disclosed.

Valuation of certain types of assets call for details. For example, "issues relating to the valuation of military equipment, national park, museums and other heritage assets are debated. Critiques argue that there is no market for these assets and that, by definition they are not to be sold in any case. On such issues, standards vary, depending on the nature of the assets and on the country."[175]

**Use of Assets**

But the accrual system of asset accounting does not indicate the use of existing assets. Unless one known how are existing assets being utilized, one cannot take relevant decisions for management of existing assets, or take a relevant decisions about acquisition of new assets. This is the basic limitation of accrual accounting. "A more fundamental limitation of the accrual system is that if does not reveal the use of existing assets. Their valuations show their place in the market. Even this feature is only selectively fulfilled in that is some countries, as in the United States, information on the land holdings of the government is given in hectares, which illuminates no part of the use of assets."[176] This kind of information serves no purpose in better management of assets on account of land holdings, which would be substantial in value. Value of any accounting system would to a large extent

[175] Salvator Schiavo-Compo and Daniel Tommasi, "Managing Government Expenditure" 1999,. Asian Development Bank, p. 235

[176] A. Premchand, "Controlling Government Spending, the Ethos, Ethics and Economics of Expenditure Management" Oxford, 205, p. 72.

be judged by the aid it provides management with relevant information leading to better management of resources. "From an economists' point of view, a system of accounting should enable an understanding of the way an assets is used, so that to the extent that an assets is underutilized or utilized in an improper direction, more profitable or remunerative uses can be explored."[177]

In fact, to know what the assets in an entity's possession are their valuation, uses to which they are put and whether better alternatives are available from resource management point of view, can be the most important offshoot of steps taken towards accrual accounting if it is properly conceptualized for implementation. Therefore, focused attention needs to be given, by setting up committees in each of the agencies, to undertake the task relating to complete listing of assets particularly land, their valuation on the basis of market and the use to which they are being put currently. This job should be done in a time bound manner, say within next 3 years, for which government should issue special instruction. An empowered group at a higher level with representation of Finance, and an outside consultation should be set up, to make recommendation regarding alternative and more productive use of these assets, if the present use to which they are being put are considered unremunerative by the empowered group. The recommendation can include suggestion regarding relocation of units, if they are occupying lands, which are exclusively valuable on the basis of current market prices.

Need for this kind of direction from the government for setting up task force cannot be over emphasized from the point of view of better financial management.

In Bangalore City Corporation, Bangalore Agenda Task Force (BATF) which implementing introduction of accrual accounting system, focused on the collection of information about assets of the Corporation from October 99 and May 2000. After verification and updating the list was revised in 2003. Then BATF physically verified the list by checking records and from other governmental agencies such as Income Tax Department.

[177] Ibid

The lack of information on number of works or expenditure in the pipeline and receipts necessitated creation of a basic information flow system. An information system for the Revenue Department was set up in May 2000, subsequently for engineering department.

The parallel run of the modern accounting system was initiated in April 7, 2001. It was a fund Based Accounting System as in case of Tumkur. Though all day-today entries were recorded on double entry accountings system, the opening balance sheet was not constructed.

The connectional framework and guidelines for implementing modern government a financial accounting system was prepared by TATA consultancy (TCS-India) service.

The computerized software for the new accounting system was completed only by the time the accounting system got implemented across the corporation.

## XIV

### Liabilities – Hidden Debt

The most serious shortcoming of the cash basis of accounting is the fact it fails to provide the government complete information on all that they owe. One of the main disadvantages of cash based accounting is the production and reporting of incomplete financial information, particularly regarding liabilities. Spending controls can be effectively by circumvented by simply deferring payment. Under cash basis of accounting, huge amounts owing by the government go unreported. They are not, taken into account when assessing a governments financial position or determining its future revenue requirement.

Pensionary liabilities and post retirement benefits lead to long term liabilities, which with inflation, can pose lot of problem. Some government have taken the opportunity to introduce funding policies to manage their liabilities over the medium term rather then adhering to the traditional policy of “pay as you go” management.

Debt management has occupied an important place in government financial management. The focus is to a large extent due to the fact that government debts are regularly reported and commented upon among others by credit rating agencies.

Accrual reporting encourages a large term perspective by focusing a assets and liabilities, and the nature of each major item in order to determine their impact on future cash flows.

Accruals accounting should not be used only for reporting purposes, rather should provide a framework needed to enhance public sector financial management in achievement of the governments social objectives and priorities.

**Control of Liabilities also Involve Control of Commitments**

The commitment stage in expenditure cycle is the stage where future obligation to pay is incurred. A commitment consists of placing an order, awarding a contract etc, for the service to be received. It entails an obligation to pay only if the third party has complied with the provisions of the contract.

Normally, commitment controls are purely internal. Agencies have to keep a commitment register. In practice, such register are not systematically kept. Even if commitment information exists they are not computerized. Therefore, Ministry of Finance cannot monitor budget execution.

Monitoring and recording of multi-year commitments may be necessary especially when the investment budget is large. A multi-year expenditure programme that is defined more restrictively could provide this framework if its identifies the activities, that will be carried out through multi-year contracts.

To monitor and control these multi-year commitments, a ceiling of forwards commitments should be established. It could take the form of commitment authorization included in the budget authorization derived from a multi-year programming document.

This is particularly true for defence expenditure, which has a huge capital budget, (upward of 40% of the budget) and one can enter into huge commitments by down payments of even 10 percent of total liability in case of contract.

The primary advantage of an accrual system is that it permits an explicit recognition of the full extent of the liability and the relationship of the annual budget provision to the full liability. Once a complete liability is recognized full annual funding became both necessary and automatic.

The accrual system is expected to have a restrictive influence in spending proclivities of the communities and government, because when spending is not matched by corresponding assets, the balance sheet would reveal it and the credit-worthiness of the government may suffer.

**The value of any accounting system would be judged by the use to which it is put. As accrual accounting is expected to bring about better control of expenditure and better resource management than the cash accounting system, a proper implementation strategy should be put in place with focus on better management of assets and liabilities. Since attempt is being made to bring in performance orientation in budgeting and to define performance in terms of outputs and outcomes, the accrual accounting gives the manager the means to focus on the resources used and prices paid for these resources. Therefore, the implementation of accrual accounting should be viewed as an integral part of new financial management strategy in the government sector, to get better value for money.**

# Chapter 7

# Computerization of Treasuries and Flow of Funds in States

## Introduction

Prior to late nineties most of government financial transactions in states were maintained manually resulting in large increase in volume of transactions. In the manual system there are systemic deficiencies, which results in overdraws, temporary diversion of funds, misclassification of accounts, and delay in settlement of claims. The consequences are lack of budget control, poor monitoring and supervision. Efforts are now being made to establish financial information system for better management of state finances. Major emphasis is being given to computerization of treasury as bulk of the financial transactions pass through them. Treasury system being the core of the state finance management system, emphasis accorded to its computerization is a significant development in budget management of the states.

The government of India (GOI) has also recognized the importance of Treasury computerization, and to provide digital connectivity across the country. GOI in its national e-governance policy has emphasized the treasury computerization as one of the important projects to be carried out in a mission mode. It has also taken up state wide area network (SWAN) and setting up of state data centers on a priority basis. These steps will facilitate strengthening financial management system in the states.

**II**

## Computerization of Treasuries

As state treasuries are the first source of capturing receipt and expenditure data, the IFMIS system can be built around it. A computerized treasury system facilitates, (i) better cash flow management, (ii) effective monitoring of budget execution, (iii) better accounting of receipts and expenditures and reporting thereon, and (iv) pre audit of government bills. It can provide timely and accurate receipt and expenditure reports. For getting full benefit, the treasury database has to be integrated with databases of other departments to establish a robust Financial Management System for the States. An effective treasury computerization scheme, leading to better financial management should have the following features;

1. Networking of all the treasuries in the State.
2. Online bill passing system.
3. All bill clearance to be monitored by a central server.
4. Effective budget control through the system.
5. Direct payment of salaries and pensions to the employees' bank account using HRMS Database.
6. Generation of monthly classified accounts through the system.
7. Generation of various reports through the system for better monitoring of cash flow.
8. Generation of comprehensive reports on receipts and expenditure, for the use of finance department.
9. Generation of district wise and scheme wise expenditure reports for planning and other departmental officers, for better review and monitoring of implementation of various developmental schemes.
10. Any other specific reports specially required by different departments

An effective computerization of treasury system should be help to both Department of Finance and other administrative departments. As mentioned above, a good computerization system should also allow for direct payment of salaries and pensions to the employees' bank account, thereby, improving the moral of employee sand employers.

The treasury computerization began in a small scale with offline preparation of monthly accounts through computers and generation of various reports using offline accounts. However, considerable progress has been made by some states in computerizing their treasuries and generating online financial management information for the use of finance department and other administrative departments. Although state treasuries are major entities in the financial management system, strategic action needs to be taken to integrate their information system with other systems and databases maintained by various departments and agencies. The deficiencies and gaps in the present system (indicated later) needs to removed to have a robust IFMIS for the states.

The level of computerization across states is not uniform and in many cases comprehensive computerization of financial activities of various departments has not been carried out. Wherever computerization of departments has been done, different application software is being used. There is no standardization of either the database or the application software. The activities of finance and planning departments to a large extent have been computerized. The treasury department which conducts 60-70 percent of state financial transactions is at different level of computerization. The connectivity issue still remains as a major bottleneck and in many cases the information is exchanged through external media like floppies, CDs and some times through dial up connections. The connectivity among the treasuries through dedicated network exists only in few states.

States like Karnataka, Madhya Pradesh, Orissa , Tamilnadu have networked all their treasuries and in these states entire treasury operations are fully computerized (Annexure 6.1). Karnataka was the first state which went for comprehensive computerization of treasury activities in November 2002 under its ‘Khajane’ project. The experience of computerization of the treasuries in these states, especially the ‘Khajane’ system in Karnataka can serve as models for other states to improve upon their financial management information system. In this system, the transactions are online, and are controlled through a central server. States like Maharashtra, UttarPradesh, Gujarat, Uttaranchal West Bengal, Andhra Pradesh, Assam, Chattisgarh, Haryana, and Bihar have computerized their treasury transactions; but all are in stand alone mode and are not networked. The information on receipts and payments are being sent offline through floppies or through a dial up connection to a central data base. Other states are in different stages of computerization.

There are problems with regard to developing appropriate software for this purpose and availability of networking facility to connect all the treasuries in the state. **The states which have not yet started computerization of their treasuries need not go for development of new application software. They can replicate the software already used by other states where the computerized system has shown good results.** Networking of treasuries, should therefore, be the first priority in the computerization process. Given the improvements in ICT in the country, it should not pose much problem. **After establishing**

**online computerized treasury system, other important modules such as pension, Human Resource Management System (HRMS), debt management etc could be integrated with the computerized treasury sequentially depending upon the computerization of individual databases. Auditing of state expenditure being an essential element, meaningful and robust pre audit system should be made part of the computerized treasury system that can improve financial discipline.**

**Thus immediate attention should be paid to comprehensively computerize all departmental financial activities, establishing a central database, improve connectivity with finance department and treasury system, and training of officials to handle the computerized activities. For all these activities Government of India should extend both technical and financial assistance to state governments so that a good IFMIS system can be established to strengthen financial management in the states.**

**Deficiencies in Existing Treasury management System and Remedies**

The present treasury system in the states, level of computerization not withstanding, does not capture many transaction that are in the nature of transactions between central and state governments and transactions of some departments that lie out of the treasury system like Letter of Credit (LOC) transactions, inter state adjustment done at Accountant General's level, adjustment of Government of India Receipts to the states and repayment of loans by the state to the Government of India which are adjusted at central accounting system at Nagpur. The government of India also releases fund under various different centrally sponsored schemes to directly the implementing agencies bypassing the state budgets (treasury). Many a times the mere release of funds to the implementing agencies is getting depicted as expenditure. Though technically the funds have gone out of the consolidated fund, they might not have reached the intended beneficiary but parked in the personal deposit accounts or bank accounts. This would result in a distorted picture of progress and implementation of schemes. Further there are certain other drawal fund called payees receipts which allows a drawing officer to draw the funds from the treasury without supporting vouchers for a claim. These information need to be captured in the treasury system to get a comprehensive financial picture of the state government. Some possible remedies for all these transactions that remain outside the treasury network are elaborated in the following paragraphs.

**Information on Fund Flows from Government India to the States**

The Treasuries do not get the details of funds released by Government of India. State finance department get the communication of these funds adjusted to the state consolidated fund through central accounting system (CAS) set up at Nagpur by the Reserve Bank of India (RBI) and this information is not transmitted to the treasuries. When the funds released by various ministries of Government of India for the states, the details of these are also sent to CAS, Nagpur. After the adjustment of these amounts to the state consolidated funds, it is communicated to the finance department through RBI Website. The release order at this stage also does not have complete information relating to schemes for which the money is released, the amount released, and corresponding head of account. The finance department has to wait for the receipts of release orders from GOI Ministries. **To avoid this delay and confusion CAS Nagpur as a nodal agency should publish in their website the complete information on fund released from government of India. The treasury department of the states may be given permission to access this website Receipt should be recorded on the date on which CAS Nagpur has credited the amount to the state account.**

The direct routing of central funds through the implementing agencies under many CSS, bypassing the state budget poses problem for the treasuries to generate comprehensive financial report, as the treasury operation is limited to state budget transactions. If any fund is routed outside the budget the expenditure of these funds cannot be monitored and controlled by the treasuries. **Government of India should release all CSS funds through the State budget only so that expenditure tracking and monitoring of financial progress relating to CSS and generation of detailed expenditure reports can be done by the state treasuries.**

**Information from Accountant General to the Treasury**

All repayments of Government of India loans, inter state adjustments are done at CAS, Nagpur by debiting or crediting to the State account. While these information's are regularly sent by CAS, Nagpur to Accountant General (AG) of the State, these are not communicated to the treasury. Similarly the accountant general makes adjustments in the state accounts relating to interstate payments. This is poses a major problem for the state treasuries in generating the receipt and expenditure Report. **This problem could be overcome if the Accountant General of the State informs the treasury department of receipt and adjustment of various grant-in-aids, loans, and pensions etc. on day to day base in a detailed manner including head of accounts and the amount involved. The will facilitate the treasury to generate real time receipt and expenditure reports and help the finance department for better cash management.**

**Linking Agency Banks to the Treasury**

The other major issue that needs to be addressed is to get the classified receipt details from the agency banks and also to streamline the receipts in district headquarters. Receipt transaction of the state Government is carried out through Reserve Bank of India or any authorized public sectors banks, which are called agency banks. Each treasury is linked to an agency bank. The agency banks send a detail scroll along with challans through which tax and non-taxes are deposited to the treasury and also to the focal branch which in turn sends the details to CAS Nagpur to credit to the State Government account. The treasury which receives the receipt scrolls along with challans, sorts them by scheme wise head of account (12 digits) and enters them into treasury database manually every day. These details are used in generating the reports on revenue receipts and schedule of receipts for accounting purpose. Such a manual system causes delay waste of man power.

**As most of the banks are computerized, they can enter the details of receipts (including the 12 digit head of account of particular receipt) in their databases and send this information electronically to treasury after validation. This will save time as well as manpower at the treasury end.**

Another impediment in receipt of taxes and non taxes especially in urban areas is the concept of one treasury one agency bank. In big metropolitan cities it is impossible for one agency bank to cater to the needs of the entire city. In some states several banks are authorized to receive taxes and non taxes; but at the end of the day all these banks have to be route the receipts through the agency bank. With development in technology such as core banking system and Real Time Gross Settlement system, any bank can receive governments receipt and transfer it to the designated agency bank. Another option could be to open a WEB based E- receipt portal where citizens can pay taxes at their convenience from anywhere in the city.

**The problem of Drawal of Funds Using Payees Receipt**

The drawing and disbursing officers (DDO) in the state draw funds from the treasury for implementation of various schemes utilizing mainly three types of bills, detailed contingency bills (DC), abstract contingency bills (AC) and payees receipt bills. The DC bills are submitted along with complete paid voucher along with the bill. This ensures that the money has really been spent on the scheme and this could be taken as actual expenditure. In the case of AC bills, which are drawn in emergency cases and are advance drawal in nature, no voucher is attached to the bill and only a sanction order is attached. This has to be followed by submission of a non detailed contingency bill (NDC) with complete vouchers within a period of 30 days and in some specific cases permission up to 3 months is given for this purpose. When the NDC bill is presented to the treasury, this can be treated as actual expenditure. When the DDO draws the fund on payees receipt only sanction order is attached and no voucher is insisted on. So for all practical purposes any fund drawn on payees receipt can be treated as an advance and treasury will never come to know about the real expenditure. Such aberration needs to be removed to establish an effective expenditure control system. **To overcome this problem and to get the real expenditure the drawal through payees receipts should be abolished by amending the financial code. The DDOs may be allowed to draw the money an at best through abstract contingency bill.**

**Transactions of Public Works, Irrigation and Forest Departments**

In most of the states the departments like public works, irrigation and forest except for their salary component utilize the system of Letter of Credit (LOC) for their expenditure purposes. Under the LOC system the funds for Implementation of works/programmes are directly released by the finance department in the form of Letter of Credit. The departments incur the expenditure on various works/programmes by issuing a bank cheque and render the accounts directly to the accountant general. Such a system is devised to provide flexibility in completing various works and projects. **Essentially the transaction under LOC system remains outside the treasury system. However, this system has resulted in inadequate expenditure control and lack of accountability. The pending bills and incomplete works have increased over the years and sometimes the ongoing works even exceed the budget provision. The LOC system needs to be abolished and the financial transaction of these departments should be carried out through the treasury.**

The works and projects undertaken by these departments are difficult to be completed within the annual budget cycle. Therefore commitments on of works and projects undertaken should be worked out before according administrative approval and quantum of funds available to these departments should be communicated in advance for a longer period of time, 3 to 4 years in multi year budgeting mode. **The financial clearance for any work should be committed through the system, keeping in view of the funds available and projected for next 3 to 4 years. The commitment module should be integrated with finance, planning and treasury modules. This computerized system will ensure that commitment is given to only those works, which has been approved through the software. The system will not allow any work to be approved if funds are not available. This may bring in some financial discipline and also the completion of the project on time.**

## III

### Human Resource Management System (HRMS) and Payment of Salary and Pensions through Treasury System

Most of the States have started making efforts in developing human resource management system database (HRMS) of their employees. Normally this database is being maintained by department of personnel. This database should be integrated with treasury database to streamline salary payments, pension payments, general provident fund payments, maintenance of individual advance, and maintenance of insurance and contributory pension accounts.

The payment of salaries and pension to government employees is one of the major expenditure items of the state governments. Lots of manpower is required in generating the salary and pension bills every month. The HRMS database has the potential to capture the profile of each government employee that include name of the employee, date of birth, education qualifications, personal details, date of joining service, pay scale, increment date, LIC, GIS, GPF account number and details, loans availed from the government, and family details. **If HRMS database is created with all relevant details of individual employees and linked to the treasury database, the treasuries will be in a position to generate salary bills automatically and disburse the salaries through employee's bank account.** The HRMS database can also generate a complete list of employees who would be retiring in a particular month and their pension records, which is done by separate pension department in some states or by the Accountant General in other states. Since all the details of service particular and pay drawn would be available in the HRMS database, the pension payment order could be automatically generated and this should be transferred to the treasury database. With this information, Treasuries can generate pension bills and directly make pension payment to the pensioner's bank account. **As all the payments would be controlled by the computerized system it will help to eliminate corruption in the payment of salary and pension which will be the most important benefit of the computerized system.** The newly introduced contributory pension system in some states can also be taken care of along with all other standard deductions through salary bills. Since the clearance of salary bill is automatic through the software, there will be no cases of missing credits under these deductions. The system will take care of automatic transfer of these deductions to respective departments. To streamline the payment of salary and pensions through the treasury system, the HRMS database needs to be updated regularly.

The commitment on salaries and pensions forms a major component of expenditure of the government, which is around 30 percent of the total committed expenditure of the government. The HRMS database in addition to enabling automatic generation of pay bills also will facilitate generation of reports on sanctioned strength in each office and scale wise salary details, which form an important component of budget documents.

It has been pointed out in the audit reports of the AG that often excess payments are made with regard to the family pension in cases of death of the government servant in service. The banks those which have the responsibility of paying pensions do not follow the provision of reducing the pension by 50 percent after 7 years. In some cases the pension payable is not reduced even after lapse of considerable time resulting in excess payments. The HRMS system can generate the regular pension or family pension payment orders automatically when a person retires or dies while in service. As it is integrated with the treasury database, the treasury can directly make payment of pension either through ECS or by cheque or by standing advice to the banks. Since payment is monitored by the computerized system, the system will automatically take care off any instruction on revision of pension with a specific date. The scope of excess payment of pension / family pension would be eliminated. **A full fledged HRMS can be of great help in eliminating fraudulent claims, preventing ghost employees and pensioners and excess payment of salary and pension and family pension which are common in any manual system.**

Further the HRMS can generate annual statements of accounts of various statutory deductions as all these details are captured while processing the pay bills. Annual statements of GPF/Loans/Insurance / Income tax could be provided to individual employees. This will reduce the manpower needs in the offices. This HRMS database will also enable the Government, in projecting the retirement profile of Government and Grant-In-Aid employees.

The payments of salary and pensions can be centralized at district level and such activities at lower level treasuries can be dispensed with thus saving resources and manpower. The district treasury can make direct payment of salaries and pensions to the employees and pensioners through the computerized banking network. However, it requires strengthening of IT infrastructure at the district treasuries.

**Cash Management**

Management of finance of the states involves getting reliable and timely information on its cash position - inflows and outflows. The Government can manage its cash out flow more efficiently with comprehensive picture of fund flows and of the liabilities, daily receipts, payments, and bills pending in the treasuries, and accurate, and timely forecasts of its major expenditure items. Since the Treasuries are generating reports on receipts of tax and non tax revenue from the payments made through the agency banks, the finance department will have more accurate information cash inflows in a timely manner. The computerized treasury system can provide on-line information on expenditure on real time basis. Any request received for additional requirement from any department, the finance department can access the treasury database and check up whether money is available for the particular scheme and take decision on providing additional amount.

**Transparency in treasury administration**

The computerized treasury will bring in more transparency. The first in first out (FIFO) for bill clearance through the system will eliminate any discretion hitherto exercised by treasury officers. The system will follow the bill in the order of its receipt in the treasury and accordingly will allow the bills to be cleared as per the FIFO. The system with appropriate technology will provide an opportunity to citizens and departmental officers to know the status of the bills pending in treasuries.

**Pre audit of bills in computerized system**

The drawing and disbursing officers (DDO) and implementing officers draw funds from the treasuries to make payment of salaries office expenses, payment to material suppliers, service providers, and beneficiaries regarding implementation of various schemes. They draw money on prescribed bills following the relevant rules prescribed in financial codes and treasury codes. The genuineness of claims solely depends upon the drawing officers. In the manual system these bills are checked in the treasury for compliance of various rules. The responsibility of treasury is only to the extent of checking the authenticity of drawing officer and the arithmetical accuracy of the claim. The pre auditing responsibility is on controlling officer who counter signed the bills with regard to authenticity of the claim and budget availability.

In the computerized treasury system with the provisions for budget monitoring, the system will automatically check for the genuineness of the drawing authority and the claim, budget availability, arithmetical accuracy etc. In the manual system (or standalone computerized system) the genuineness of claim is verified by the treasury officer by scrutinizing the sanction order attached to the claim. But when the databases of different departments are integrated with the treasury database, the system itself takes care of checking the genuineness of the claims and sanction orders. In the computerized environment it is possible to ensure the pre audit of the bills. As far as the pre audit of the work bills is concerned the system can also cross check the department data base regarding the work code, total cost of the work, payments already made, and ensure that the expenditure is limited to the sanctioned amount. As already pointed out this requires the computerization of different schemes and work details at the departmental level and the connectivity between the departmental databases and treasury database.

### Formal Audit

**With the Treasury Computerization, real time information on expenditure will be available department wise / major head wise/ scheme wise, district wise, taluk wise, DDO wise. All these information will be available at a central place. The audit party can access this database and scan for any anomaly and pick up those cases for detail audit and analysis. This will not only help them in saving time, but also can improve the quality of audit as they will be concentrating more on abnormal cases.**

## IV

### Flow of Centrally Sponsored Schemes (CSS) Funds through State Budget

In addition to the CSS flowing through the state budget large amount of central funds under another set of CSS flow directly to the implementing agencies bypassing the state governments. The CSS by-passing the state budgets are directed to rural local bodies, ZPs, DRDA or implementing agencies as formulated under the provisions of different schemes. The state budgets, therefore, do not give a comprehensive view of expenditures incurred in any particular sector and in aggregate as a substantial portion of CSS remains out of the budgeting process. In the off budget CSS, the funds are released by the central government to the implementing agencies on the basis of submission of utilization certificates. The utilization certificates by the implementing agencies indicate the disbursement of funds and are not based on proper audit of the accounts. However the utilization certificates are not based on audit of accounts of the implementing agencies. The expenditure tracking and the supervising mechanism to monitor the utilization of funds received by the implementing agencies is weak. Audit reports of the comptroller and auditor-general (CAG) have on several occasions brought out the issue of CSS funds lying unutilised for long periods and delayed reconciling figures by departments with the records maintained by banks. Undeniably, there are scopes for leakages and misappropriation.

There have been demands for routing all the CSS through state budget. However, the central government has been directly funding the implementing agencies and ZPs through various CSS to strengthen the local governments and due to the past experience of diversion of funds by the state governments from these schemes for other purposes resulting in delayed release of funds. Funds under these categories of CSS are directly released by the central government to bank accounts of implementing agencies at the district level. Funds are further passed on to bank accounts of lower level implementing agencies such as panchayati raj institutions (PRI). Such a flow of fund system has resulted in CSS funds being maintained by large number of small bank accounts at various levels of implementing agencies. Consequently there have been problems associated with reconciling expenditures and releases under these CSS and tracking of actual expenditure under various schemes. The implementing agencies can misreport releases of the CSS as expenditures. **The computerized treasury system with integrated databases provides opportunities for automatised expenditure tracking that would help smooth flow of funds. The funds**

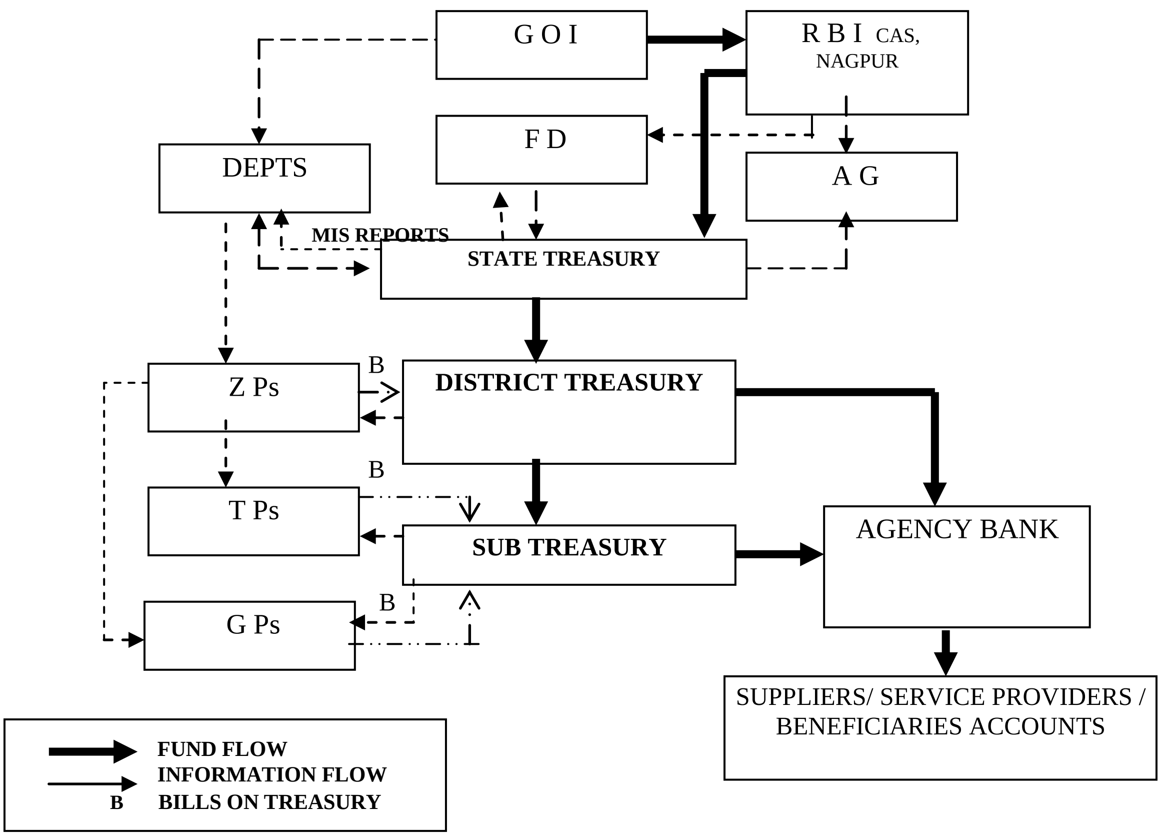
**under the CSS can be routed through the state budget and the actual transaction can be managed through the computerized treasury system. Through this system detail reports on actual expenditures on various schemes can be generated that will useful for deciding the actual fund requirements.**

The routing of CSS through the state budget and their financial management through the state treasury system requires first to develop the levels within the state which should allocate and release funds[178]. The criteria refer to fixing the authority at various levels in the implementing agencies to authorize spending of money under the CSS. While in some CSS such criteria are developed, in most of them the discretion is left to the state governments. Second, the processes of allocation and release of funds should be separated from the actual disbursement of the funds. Such a separation will result in minimization of fund movements and the scope for confusing release with expenditures, misreporting, and delayed reconciliation of accounts will be less. The fund flows will follow the basic principle elaborated in chart 1 where the physical movement of funds need not follow the release orders. **The transaction relating to CSS fund should be managed by the treasury system instead of being parked in the bank accounts of the implementing agencies. The treasury can release the funds directly to the accounts of beneficiaries upon submission of bills by the competent authority of the implementing agency.**

**Chart 1 Proposed System of Flow of Funds under CSS**

[178] Dikshit Ashutosh, Renuka Viswanathan, T R Raghunandan (2007), "Efficient Transfer of Funds for Centrally-Sponsored Schemes", Economic and Political Weekly, June 9

**FUND FLOW FROM GOI TO RLBs (PROPOSED)**




The chart 1 gives proposed flow of funds under the CSS considering PRIs (ZP, TP and GPs) as implementing agencies. The funds released by the central government are routed through the state budget. The state treasury gets the complete information on release of funds by central government and adjusted to state accounts by the CAS Nagpur as was discussed in an earlier section. The funds are retained in the treasury system and need not be accompanied by a corresponding physical transfer of funds to bank accounts of the implementing agencies. Release orders are issued by different administrative levels are entered into the computerized treasury database. **The computerized treasury system will release the funds to the bank accounts of the beneficiaries only when the final claim is presented. The DDOs of implementing the schemes would present the bill to the treasury along with the details of the beneficiary name, bank name, account number and amount. The treasury will clear the bill and issue a cheque to the agency bank**

**along with the beneficiary details. The Agency bank/bank will take action to transfer the funds to the beneficiaries.**

The apprehension of delayed release of funds by the state governments due to diversion of funds could be tackled in the computerized treasury system. The finance department can restrict the aggregate expenditures due to the liquidity problem through a 'ways and means' system incorporated in the treasury system. **However the clearance of CSS schemes can be exempted from the 'ways and means' control in the treasury, thus making the transaction automatic with, of course, the regular validation procedures carried out in the treasury.** This will allow the smooth clearance of CSS bills. The real time expenditure reports on CSS schemes can be generated through this system and GOI can have access to the state database for reviewing financial progress of various schemes. The subsequent release of funds would not depend upon the utilization certificate strictly as the funds can be released on the basis of review of the expenditure progress. The utilization certificate can be used for monitoring the physical and financial progress in post audit. The utilization certificate may be redesigned to incorporate the physical progress details.

Another requirement for generating real time expenditure reports on the CSS by the computerized treasury system is the mapping of the head of accounts of central government relating to these CSS to the head of accounts used in the state budget. The Charter of Account for the Country as a whole is notified by the Controller General of Accounts (CGA). The normal practice of expenditure accounting structure is six tired that includes major head, sub major head, minor head, group head, sub head and object head (detailed head). The coding system basically follows the pattern of department-function-programmes-scheme-item of expenditure. Up to Minor Head level the account coding is common across the Country. But below minor head level there are variations across the states. The Computerized Treasury System basically functions on the details of heads of account provided in the state budget document. It captures the expenditure details of schemes with 12 digit head of accounts. If the scheme description and the corresponding 12 digit scheme head in the state budget is known, then the computerized treasury system can generate real time expenditure report. However, the 12 digit scheme head in government of India and corresponding 12 digit scheme head in state government documents sometimes may not tally for the reasons of variation below minor head level at state level. Given the long chain of fund releases starting from the funding ministries till the implementing agencies, expenditure tracking could be a formidable challenge. **In a computerized treasury system the expenditure on any scheme could be tracked on real time basis provided the mapping of the heads of account is clearly done. Further, if unique detailed heads are used for individual schemes it will be better to generate expenditure details across the states. Through the charter of accounts the accounts coding can be standardized to facilitate integration of computerized systems used across the states for better monitoring of the CSS.**

**Expenditure Tracking at Panchayat Level through Computerized Treasury System**

Special mention need to be made regarding the financial transactions of the PRIs as these have remained outside the state treasury system. With the 73rd Constitution amendment most of the developmental schemes for the upliftment of rural areas have been entrusted to PRIs. The funds directly routed to PRIs under CSS remain outside the treasury ambit and deposited in their bank accounts as described in the earlier section. In the case of CSS flowing through state budgets and implemented by the PRIs, state treasuries do not handle the entire chain of financial transactions. Like other GOI releases these funds are adjusted at CAS, RBI Nagpur to the state account when release orders are sent by the concerned central ministries. The CAS Nagpur, in turn sends an intimation to the accountant general (AG) of the state and its finance department. On receipts of the confirmation of release, the finance department issues a credit authorization slip to the implementing departments and intimates the same to the treasury. The departments release funds individual scheme wise to the zilla panchayats (ZPs) and taluka panchayats (TPs). Based on these releases ZP/TPs draw funds from the State Governments account and deposit them in their bank accounts. As the funds transferred to the local bodies remain outside the treasury system pre-audit of bills raised and the expenditure control and monitoring of financial progress is not feasible.

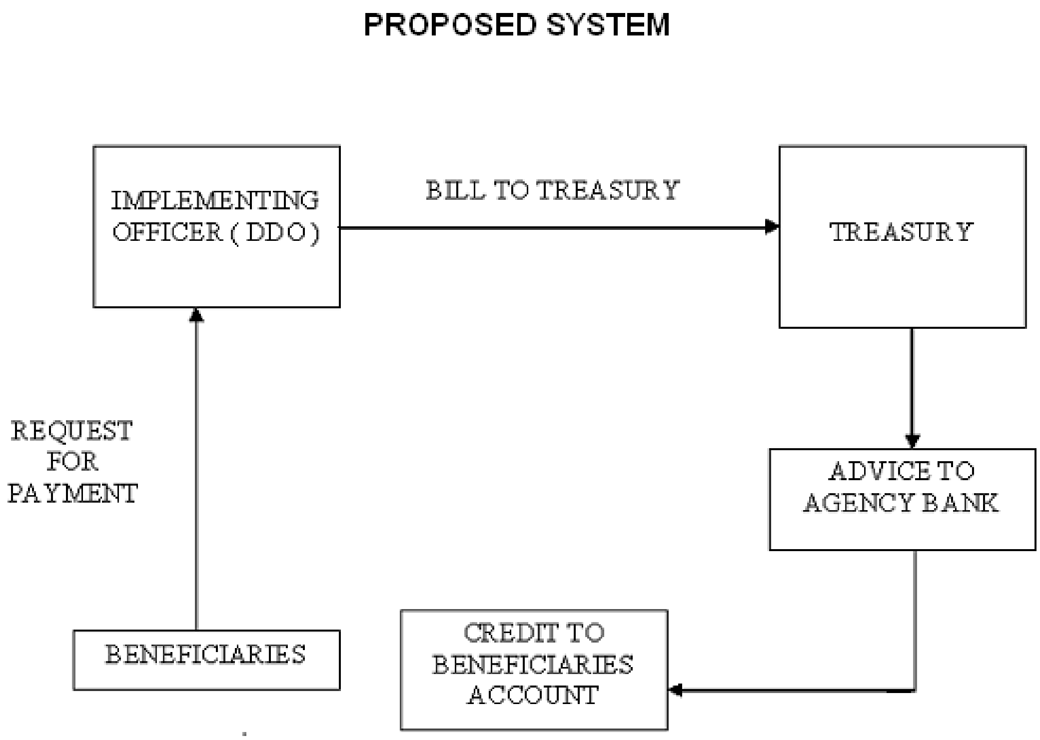
The funds as provided in the state budget are transferred to the three tier panchayati raj institutions (PRI) as grant in aid. The rural local bodies draw the funds from the treasury and keep it in their bank account. Further transactions of these funds are outside the treasury jurisdiction. Although the treasury system accounts for the funds released under state schemes, further expenditure tracking is not possible as the transactions of PRIs are not covered by the state treasury.

It is essential to bring in the transactions of PRIs into treasury fold for better financial management. The design of flow of funds in the case of off budget CSS implemented by the PRIs is already discussed in the earlier section. All other fund flows through the state budget should also be managed by the computerized treasury system. As proposed, in all types of flows to the PRIs, the fund should be retained in the treasuries. On submission of the bills by the designated officials of the PRIs, the treasury can release funds directly to the bank accounts of the beneficiaries and suppliers.

**Payments to Beneficiaries Directly Through Banks/Post office accounts**

The normal practice that is exists in the PRIs is to draw money from the treasury or the bank whatever the case may be and to disburse the cash to beneficiaries. Sometimes this leads to corruption. After drawing money from the bank/treasuries they were temporary misappropriated and paid to the beneficiaries after some time gap. These problems can be addressed, as described in the earlier section, by direct payments to the beneficiaries from the treasuries through their bank accounts. Wherever the PRIs are doing their transactions through the treasury system, they present the bill giving the details of 12 digit scheme, available budget and gross amount of the bill. In addition, in the proposed scheme, the PRIs would have to provide the details of individual beneficiaries, his bank and branch name and account number and amount to be paid. After the bill is approved for payment instead of printing the cheque, an advice could be generated to the agency banks as per the details furnished by the PRI officer. The agency bank will transfer the money to the respective bank accounts of individual beneficiaries. The money will be transferred to individual bank account either through core banking system or through fund transfer wherever they are connected electronically.  If such facility is not available a banker's cheque could be sent to the beneficiary.

**Chart 2 Proposed Payment System through Individual Bank account**




Banking facility has not been extended to all the villages. The Reserve Bank of India has issued guidelines to extend banking facility to the poorest of the poor, through financial inclusion.  Now the bank account could be opened by the poor people with zero balance. Reserve bank of India in its circular dated 5th January 2006 on financial inclusion by extension of banking service with the objective of ensuring greater financial inclusion and increasing the outreach of the banking sector enabled the banks to use the services of NGOs/SHGs, Micro Financial Institutions and other Civic Society Organizations as intermediaries in providing Financial and Banking service through the use of Business Facilitators and Correspondents.

Recently, mobile banking service through business facilitators and correspondents has been introduced. The beneficiary can open an account in the bank branch office in a

Taluk/District head quarters and banks issue a smart card, which has the relevant particulars for operating it. The business correspondents through online use of the smart card can make the banking facility available to people where there are no bank branches in the neighbourhood. Mobile banking will be helpful for the direct payments to the beneficiaries from the treasury.

# Chapter 8

## Strengthening Financial Management through Computerized System

### Introduction

Reliable and timely financial information and data for budget planning, monitoring, and expenditure control and reporting are essential elements that positively impact budgetary system and public expenditure management. Lack of such information in an appropriate manner affects management of government resources adversely often causing large buildup of arrears, misallocation of resources, poor cash management, unnecessary borrowings, and undermining the effectiveness and efficiency of public service delivery. It also becomes difficult to find accurate and complete account of financial position of the government in a transparent manner, which ensures accountability. Adopting a robust financial management information system (FMIS) is widely acknowledged as an important step that contributes to improved governance, by providing real time financial information for effective administration of programmes, development of budget and management of government resources. Computerization of various public expenditure management processes is the core element of FMIS. Its integration with other relevant information systems characterizes it as an integrated financial management system (IFMIS).

The FMIS implemented in an integrated manner can also act as a deterrent to corruption by enhancing government transparency and accountability. The transparency and accountability in the government system is facilitated by improved recording and processing of financial transactions that allows easy access to reliable financial data. FMIS also leads to better financial control by providing, (a) information relating to various aspects of financial transaction starting from budget releases, commitment, purchase, payment process, reconciliation between various accounts including that of the banks, and accounts could be maintained in an integrated manner, and (b) a complete and up to date picture of expenditures and commitments for expenditure on continuous basis.

## II

### Integrated Financial Management Information System (IFMIS) for States

An integrated financial management information system (IFMIS) supports Public expenditure management process that includes budget formulation, budget execution, accounting and reporting and internal control and audit processes. An IFMIS in a Government environment basically means integration of information systems of core financial management activities carried out by several agencies such as planning, budget formulation and execution, cash management, debt management, treasury systems, accounting and reporting, and sub-systems such as revenue realization, human resource management, payroll systems and pension. Having a common database for all the sub systems or at least inter connected multiple databases with easy inter operability is the basic need for an IFMIS to be efficient and effective. Capturing the data only once at the most proximal location to the event, using the same data for all future generation of reports, accounting, reviewing and analysis is the basic tenet of an IFMS System.

Government financial transactions are complex in nature. The annual budget document of the government gives the picture of the mobilization of the revenues and expenditure on various infrastructure and development scheme proposed by the Government, payment of salaries and pension to employees, and administrative expenses. Large number of entities is involved in these complex activities. Tax and non tax revenues from citizens are collected through agency banks and are accounted through treasuries. Similarly on the expenditure side payments are made through various departmental offices across the states drawing money from the state treasuries to meet various items of the expenditures. Some departments like public works, irrigation and forest departments incur expenditure by drawing cheques on the basis of letter of credit (LOC) issued by their controlling or chief controlling officers. In addition to this certain receipts and expenditure are also carried out through book adjustments at the Accountant General Office and the RBI. The cash transactions of the Government are handled by the RBI through its subsidiary nationalized banks and their branches. The Government has to monitor the expenditure incurred through large number of departments and drawing officers for implementation of various schemes envisaged in the budget. Some times it is very essential to monitor the physical progress and financial progress of schemes at a decentralized level to ensure proper implementation of the scheme.

The State Government has to keep a close watch on the receipts and expenditures to ensure that they are consistent with the provisions made in the budget. The finance department which is the nodal agency for management of state finances requires information on cash inflow and out flow on day to day basis, the collection of tax and non-tax revenues, financial progress in implementation of schemes formulated in the state budget. Day to day information on cash flow is required by the finance department to manage the finance of the state so that it does not resort to over draft or hold on to too much of cash balance. A number of reports are also required by the Government to monitor the expenditure on various schemes implemented.

In the manual system the collection of information from different sources and from different places and compiling them in the suitable format consumes lot of man power as well as time. Getting timely report on cash flow position and also the expenditure details to support policy decisions is difficult. Quite often by the time the information are collected and compiled, they become outdated and redundant. This results in sub optimal utilization of resources, data redundancy, need for special efforts to reconcile various accounts, and wasteful efforts for compilation of information at the level of each sub system.

Even when the activities of various agencies are computerized, they work as islands and create their own pools of data; therefore, utilization of available information in a holistic way is not possible. The finance department requires necessary inputs and reports on estimates of receipts and expenditure, commitments of different departments, debt servicing details, and inter-governmental adjustments for smooth operation state finances. It is almost impossible in an unintegrated system, to get the essential information at proper intervals and consolidated at one place for the effective and efficient use by the Government. Absence of automated consolidation and aggregation of data results duplication of efforts as well as inaccuracies, delays and fragmented pictures of state finances.

A good Financial Management System should be able to capture the details of receipts, expenditure and adjustments across the state, ideally on real time basis, otherwise at least on daily basis so that, necessary inputs to government are available for better monitoring of State finances. To achieve these details of receipts, expenditures, adjustment transactions should be captured at the point, where the transactions happen and all the information should be electronically transferred to a central server, where the data will be available for further analysis and generation of MIS reports for the use of finance department and other administrative departments. The real time or day to day information enables the administrative departments to take timely corrective actions.

As indicated in the previous chapter, to keep up with the ever-increasing government transactions, computerization of treasuries would have various facilities like, validation of the bills by the system itself, system control over expenditure. Strict budgetary control through the system will not only remove discretion of the local officers, but also eliminate lot of systemic deficiencies and prevents over drawls, diversion of funds etc. The classified accounts and generation of standard MIS reports can be prepared automatically in a computerized environment. At any point of time the Government/Administrative departments will have access to the receipts and expenditure information scheme wise in a fairly decentralized level.

**The computerized treasury system should be integrated with various financial modules used by different departments like planning, budgeting, accounting, works, auditing etc.** A large amount of data invariably flows from one department to other and output of one is the input for the other. In such circumstances integrated systems play a vital role in ensuring accuracy and time and effort saving. The treasuries reports on tax non tax receipt reports will be input to tax/non tax earning administrative departments to take immediate administrative actions wherever shortfalls against the budget projections are noticed. Similarly the treasuries generate monthly department wise and scheme wise expenditure reports, which will be input to departmental heads and controlling officers to review the progress and take corrective actions wherever the performance is poor. The treasuries also generate reports on funds released to individual drawing/implementing officers, how much has been spent and how much is available scheme wise. The controlling and chief controlling officers can review this report and divert the unspent fund to other places where there is need. These reports will facilitate the finance department to scrutinize the request for additional funds from the departments. Most of the times funds might have been exhausted in one district, but still in some other districts unspent balances are available.

Fundamental to an integrated system envisaged here is the use of the data captured at the time of incurring expenditure or remittance in generating various reports required by each department for processing the transaction, accounting, reporting, auditing and reviewing the expenditure.

The computerization of treasury and its integration with other systems will remove the duplication of data entry at various points. For instance the agency banks capture the details of tax/non tax collected from the citizens. If the same data is electronically transferred to the treasuries for preparation of monthly accounts, it will reduce the effort of treasuries entering the same data again. Similarly the accountant general should use the data rendered by the treasuries for monthly classified accounts and avoid entering the data once again in its system. However, such a transfer of data requires use of appropriate software.

**In this context the government of India should lead the way by prescribing standard IFMIS software for the states. Most of the financial and treasury codes are common across the states and the accounting standards are also uniform across the country as prescribed by the CAG of India. It is only at the level below the minor heads the classification differs across the states, which can be sorted out through uniform charter of accounts. This feature of the accounting structure will facilitate the adoption of uniform software by the states with some customization to cater to any specific requirements.**

The good connectivity between all the major stakeholders is the critical element in the integrated financial management information system. The Finance and Planning departments, Personnel department, CAS Nagpur, AG, agency banks as also GOI should have access to

IFMIS. All the secretaries, heads of the department and controlling officers should have access to IFMS database with proper security protocol. They can also generate reports as per their requirements for more meaningful review of their activities.

## III

### IFMIS in Budgeting, Payment of Salaries, and Pensions

IFMIS could play an important role right from the stage of budget formulation. As information regarding major component of the government committed expenditures relating to salaries, pensions, and debt commitments will be available to the Government for previous years, the same could be used to project for next years budget formulation.. Similarly expenditure under various ongoing schemes by the departments in the previous period could form the basis for next year estimates. Revenue realization details, trends and their analysis could be an important decision support tool in forming taxation policies. The departmental heads can also review various schemes that they are implementing, in the light of resources that will be made available to the department in multi-year mode. Before finalizing the proposal for next financial year they can prioritize the schemes with the available resources. They can dovetail the proposals as per the funds made available to them, taking into consideration the requirement of the on going works / programmes. With this advance information of probable funds made available to them for next 3-4 years, they can prepare the programme costs realistically for future years.

The computerized system has the unique feature of budget control inbuilt into the system. Through the budget control and monitoring system the problems such as expenditure beyond the budgeted amount for any particular scheme, diversion of funds meant for one scheme to another scheme and fraudulent drawls can be prevented. In the manual system it is not possible to prevent over drawls and diversions in a fool proof way. The system of budget monitoring, will have the complete information on how much fund has been released to an implementing officer, scheme wise and object code wise. The system will ensure that no excess will be allowed; diversion from one scheme to other scheme and even from one object code to other is prevented. In this computerized system treasury officer will have no discretion. By providing scheme wise information on budget provision to the departments and progressive expenditure to the controlling officers at various levels will enable them to closely monitor the financial progress in implementation of various schemes under their control.

In the computerized system there will be improvements in payroll system of the government, which will have impact on a wide range of the Governmental activities. It will eliminate the drudgery of preparation salary bills month after months, management of loans and advances, provident fund, insurance, and authorization of pensioners' benefits and disbursement of pension. Service particulars of the employees would be easily available. Many of these activities are labour intensive. With computerization, these activities can be handled with increased efficiency and reduced manpower.

**Projection of Fiscal Variables and Evaluation**

**Maintenance of the historical data on receipts and expenditure and time series analysis of various fiscal variables is an important aspect of fiscal management. The computerized treasury system and its integration with other databases will enable more accurate estimation of the revenues and the expenditure for any given period. Through this information, the performance of various departments in the past years can also be evaluated. The historical data of tax collections over a longer time period will provide an opportunity to tax administrators to analyze the tax realization against the budget estimates.** The information on taxpayer details and past performance will facilitate policy decisions on additional resource mobilization through changes in tax rate or base and changes in tax administration for better tax compliance. Similarly the historical data on payment of salaries and pensions coupled with the databases relating to HRMS, SOCIAL SECURITY PENSION will enable the government to make more accurate estimates on this expenditure. The historical database on debt management will help the government in debt swapping whenever interest rate falls and government can plan for future barrowings more cautiously.

With the Treasury Computerization and its integration with database of Works, Planning, Budgeting departments, sufficient information on receipts and expenditures over longer period relating to various schemes will be available. This database will help the finance department in projecting the future revenues and expenditure more realistically. Most of the states have already in place the medium term fiscal plan, as stipulated under the FRBM act, wherein the projection of receipts and expenditure is carried out next 3 years. With the integrated IFMIS the finance department can project the receipts and funds available for implementation of different schemes for next 3 years with more accuracy.

**Generation of Comprehensive Financial Management Reports**

The Comprehensive Online Computerized Treasury System is capable of generating various financial management information reports that are very useful for the finance, planning and other departments implementing various schemes.

1. **Cash Management Reports:** In the computerized treasury system daily statements of tax, non-tax collected in cash across the state and also funds adjusted to state consolidated funds at CAS Nagpur can be generated the following day. Similarly cash outflow through the entire agency bank in the state and also the expenditure booked on the state consolidated fund at CAS, Nagpur can also be generated in this system. This means the complete picture of cash receipts and payments of the state government becomes available in a day. The statement on revenue receipts will help respective administrative departments to monitor and take immediate corrective step wherever the progress is not satisfactory. As these reports are made available day to day basis they need not wait till the end of the month to initiate corrective action. In addition to the daily reports, the computerized treasury system also can generate monthly reports on revenues and expenditure flows in fairly detailed manner describing heads of accounts, and schemes in operation, budgetary provisions under various schemes, and financial progress.
2. **Cheques Issued During the Day:** The new system can generate the statement of number of bills, number of cheques and the gross amount cleared in the treasuries during the day. The system also generates the statement of number of bills pending in

the treasuries and gross amount of bills. This information is very useful for cash management by the finance department.

3. **Weekly Reports on Personal deposit accounts:** The deputy commissioners of the revenue department have been provided with the facility of personal deposit accounts. Each deputy commissioner has been permitted to operate two personal deposit accounts, one for calamity relief fund and another for miscellaneous purposes like Member of Parliament and Member of Legislative Assembly Local Area Development Fund. The treasury can generate weekly balance reports on the financial position of these accounts.
4. **Real Time Information on Expenditure on any Specific Scheme:** In the computerized system the information relating to budget allocation, amounts released, amount spent, available balance, and budget yet to be released under any particular scheme can be generated. Such information will facilitate relocation of money from the districts where unspent balance is available to the needy districts by the finance department. The generation of real time expenditure status information across the districts is a great advantage in financial management. The expenditures and balance of unspent money on schemes implemented by rural local bodies can also be tracked on real time basis.
5. **Human Resource MIS Reports:** The integration of human resource database, called Human Resource management System (HRMS), will result in obtaining detailed data on staff strength, salary expenditures, number of retirees, and pension dues. The information will be immensely helpful for budget preparation in respect of these components.

**Planning Department**

Planning department plays a crucial role in preparing the plan program of the state. This is an elaborate exercise, which is carried out in coordination with respective administrative departments, finance department and central planning commission. On any financial year there will be large number of on going schemes and new schemes are usually taken up during current financial year. The planning department has computerized its activity and they have fairly a good database on various plan programs implemented in the state. The computerized treasury system generates scheme wise plan expenditure report every month. The planning departments in the states can also make use of the information generated by the computerized treasury system on plan scheme for planning purpose. The facility to get financial data on various schemes for a longer period in decentralized manner will be very helpful for the planning department to formulate plans more realistically.

**Debt Management**

The debt management in the states is principally the responsibility of the finance department. Most of the activities under debt management like raising of new loan, repayment of old loans and interest payments have been computerized to a large extent. However, treasuries do not get the complete picture of these inflows and outflows. Majority of these transactions are accounted for at CAS, Nagpur and the AG records these transactions in the state accounts. The data base on debt management once integrated with the treasury system, the system can capture the details of loans and interest payments. The integrated system can generate the debt profile and repayment profile for a longer period of time. This will help Finance Department to make adequate provisions for repayment of loan and interest in the budget. This Module also has the data of Government guarantees given to various Public Sectors Units, Boards and Corporations, Co-operative Bodies etc. Through this system a close watch can be kept over these bodies so far as their repayments are concerned within the prescribed time limit. The system can generate the list of defaulting organization, so that the finance department can initiate suitable action for fulfillment of their obligations.

**Works Monitoring**

With integration of the database of the Public Works Department with IFMIS, financial progress of each work can be monitored and commitments on new schemes can be ascertained. The system can generate list of works, their estimate, amounts allocated and amounts spent on various works project during the current financial year.

**IV**

**Technical Requirements of IFMIS**

The basic requirement for a good IFMIS is that all the financial activity of the departments should be fully computerized and integrated with the treasury system. The departments can have their separate databases and these data bases need to host at the state data centers. All chief controlling officers (administrative secretaries, heads of the departments), Controlling officers (Normally the district level officers), all drawing and disbursing officers of the departments (normally the implementing officers), should be networked and connected with the treasury department. This will ensure smooth flow of funds and drawl of funds from the treasuries with regard to various items of expenditure like salaries, payments to suppliers and service providers and payments to individual beneficiaries under various schemes. The treasury system keeps track of accounts of all these transaction and these can be accessed by the concerned administrative departments and also by the accounting and audit agencies.

An ideal computerized financial management system for the state should have a common database and application Software which should cater to the needs of the finance department, planning department, treasury department, budget preparation, H.R.M.S., payroll and pension payments, debt management, commitment for Work approval, procurement, accounting, and auditing. While the application software would handle all government activities, it should have an interface with other external agencies like the Government of India, CAS, Nagpur, the Accountant General, the Agency Banks etc. In addition to common database software the departments / organizations should be connected to the central database. With the software and connectivity in place the IFMIS can provide necessary inputs to the finance department for better management of finances of the state. The best results can be expected out of the IFMIS when the data is captured at the source or at the possible earliest point and is accurate and transferred to the central database online in real time. The software used should have the feature of meeting any future requirements and can be suitably upgraded.

In the present scenario building such an ideal system is difficult mainly due to absence of a common platform catering to the needs of all the Government departments and organizations. Currently all the Government offices in the state are not networked for seamless flow of information. The Application Software, which can support entire Governmental Financial transactions, is not readily available in the market. The readymade Financial Application Software like Oracle Financials, SAPs Financial caters mostly to the needs of the business organizations. This software does not cover the entire Governmental activity. Even if it is used, it should be customized to departmental requirement.

**Given this the next best alternative is to exploit the present computerized systems available with different departments by integrating them using suitable software. The major activities of finance, treasury and DPAR (HRMS) could be integrated in the first stage. In the second stage planning, public works and other major departments could be integrated.** The major financial activity of the states like receipts of taxes and non taxes and expenditure on implementation of various schemes, salary payments, pensions payments are handled by the treasuries. Treasuries also render the accounts to the Accountant General. In the finance departments of state governments the preparation of the budget and debt management has been computerized. The departments of personnel and administration have also created a database on government employees. Planning department has also computerized most of their activities. External agencies like Agency Banks, Accountant General, and Government of India Ministries have also computerized their activities. These available standalone databases can be linked using suitable software to establish a integrated system. Such kind of technology and software's are available to integrate different databases and to extract the information that is required by the user departments.

**Apex Body to Develop Software and Provide Guidance for IFMIS**

Considering the importance of financial management of states government of India should extend full technical and financial assistance to the states. Already through its E-Governance programmes, central government has taken initiatives for treasury computerization, establishment of state wide area net work (SWAN ), and establishment of state data centers (SDC). However, the development of application software, which is crucial for the computerized financial management system remains a problem area. No such software is available in the market. The standard financial management softwares available in the market cater to needs of the commercial activities and are not suitable for complex government financial transactions. It is, therefore, advisable to set up an apex body at the national level to develop suitable financial management software for establishing IFMIS in the states. The apex body in addition to meeting software requirements should also provide guidance in establishing IFMIS. The apex body should ensure expenditure requirements in this regard are fully met and the IFMIS is established across the states in a time bound manner.

# Chapter 9

# Parliamentary Financial Control

## Financial Control as Seen in Appropriation Accounts

The system of Parliamentary financial control operates through the budgetary process. It works on the basis of inter-dependent functions discharged by different institutions like Ministry of Finance, Comptroller and Auditor General of India (CAG), its three Financial Committees – Committees on Estimates, Public Accounts and Public Undertakings.

Article 112 of the Constitution of India lays down that every year estimated receipts and expenditures of the Government of India for that year, which is referred to as "annual financial statement", shall be laid before both the Houses of Parliament. The sums required to meet the expenditure shall be divided into those "charged upon the Consolidated Fund of India" (CFI) and the sums to meet other expenditure proposed to be made from CFI.

The sums to be spent shall also be distinguished between those on revenue account and other expenditure.

Estimates as relate to expenditure charged upon CFI shall not be submitted to vote of Parliament. The relevant article also states that nothing in the clause shall be construed as preventing discussion in either House of Parliament of any of those estimates.[179]

Among the `charged' expenditure are *inter alia* the debt charges for which Government of India is liable including interest and other expenditure relating to raising of loans and the services and redemption of debts, a also sums required to satisfy any judgement, decree of award of any court or arbitral tribunal.

From the Appropriation Accounts of 2005-06, it is seen that out of total disbursements of Rs. 1590085 crore under civil ministries the charged disbursements were Rs. 1288816 crore. "The charged disbursements increased by 494 percent from Rs. 216958

[179] The Constitution of India, Article 113(1)

crore to Rs. 1288816 crore in 2005-06 and voted disbursements increased by 246 percent from Rs. 87054 crore to Rs. 301269 crore over the same period."[180]

The changed disbursements of ministries during 2005-06 were mainly on account of interest payment (Rs. 141375 crore) repayment of debt (Rs 1115210 crore), transfers to State and Union Territory governments mainly on account of grants under the proviso to Article 275(1) of the Constitution, block grants, loans for State plan schemes etc. and constituted 81 percent of total disbursements.

To quote from the Appropriation Accounts, "since charged disbursements are not subject to vote by Parliament, effectively the scope of financial control of Parliament is limited to about 19 percent of the total disbursement in the civil ministries. However, viewed in the background of total disbursement from CFI (gross Rs. 1777534 crore) the percentage of charged disbursements was 73 percent (Rs 1288929 crore including Post, Defence, Railways)".[181]

Above figures vividly indicates the gradual erosion in the financial control of the Parliament over government expenditure as voting is limited to a small percentage of total expenditure. Though, even for voted grants, hardly any debase on policy issues take place and thousands of crores of expenditure are voted for spending without much debate. The other problem showing lack of budgetary control emanates from the provision relating to Supplementary Grants.

Perusal of Article 115 of the Constitution would indicate that drawal of additional funds under supplementary grants is rather easy. It provides for supplementary grants, if the amount authorized by any law made in accordance with the provisions of article 114 to be expended for a particular service for the current financial year is found to be insufficient for the purposes of that year or when a need has arisen during current financial year for supplementary or additional expenditure upon some new service not contemplated in the annual financial statement of the year, or if any money has been spent on any service during a financial year in excess of the amount grants for that service for that year, then the

[180] C&AG (2005-06), Analysis of Appropriation Accounts, para 6.8
[181] Ibid, para 6.9

Government shall lay before both House of Parliament another statement showing the estimated amount of that expenditure or cause to be presented to the House of Parliament or a demand for such excess as the case may be.

These provisions indicate that getting additional money through supplementary grants is not at all difficult. Easy availability of supplementary grants, where hardly any debate takes place, as also surrendering of unspent funds without any questions being asked leads to poor budgetary control. It can lead to original budget estimates being made, without adequate scrutiny of expenditure proposals, making the budget estimates unrealistic.

To quote from Analysis of Appropriation Accounts 2005-06 by C&AG, "A scrutiny of the Appropriation Accounts for the year 2005-06 revealed that a large number of ministries/departments of the Central Government obtained supplementary grants/appropriations much in excess of original provisions. The supplementary provisions ranged between 65 to 535 percent of original provisions in some cases. This indicates that the ministries and departments did not prepare estimates for expenditure on a realistic basis and that the mechanism of holding pre-budget meetings and scrutiny by Ministry of Finance for ensuring realistic budgetary projections did not have the desired effect."[182]

Easy provisions for obtaining supplementary grants also lead to requests for supplementary grants, where they are not really necessary. To quote from the Appropriation Accounts, An Analysis for 2005-06, by C&AG, "In 24 cases relating to 20 grants ……while supplementary provisions aggregating to Rs. 443.80 crore were obtained during 2005-06, in anticipation of higher expenditure, the final expenditure was less than even the original grants/appropriations." This clearly indicates that original budget estimates, which normally should be derived from a medium-term expenditure plan, has lost all sanctity. In other words, it is a '"soft budget regime', where the Budget Estimates are, in fact, first approximate estimates, to be revised from time to time. Only hard budget can lead to to better planning of expenditure.

[182] C&AG (2005-06), Analysis of Appropriation Accounts, para 7.17

‘Soft Budget’ regime is on the other hand, inimical to planning of expenditure, as it does not promote hard choices, or consideration of alternatives which is the basis of planning. Additional funds can always be asked for and most probably be provided. This is one of the major weaknesses of financial management of government in India as it does not foster an environment of control.

To emphasize the point one can again cite Analysis of Appropriation Accounts, 2005-06. While obtaining supplementary grants, the Ministries/Departments resorted to Supplementary demands of large amounts of additional for different purposes under schemes/activities indicated in the report, “but they were unable to spend not only the entire supplementary grants or parts thereof but also the original budget provisions in certain cases”.[183]

This only means that in these cases no serious analysis of budgetary position was made before asking for additional funds. As indicated above, supplementary demands of budget can be made when an amount to be spent on a particular service “is found to be insufficient for the purposes of the year”, or if money spent is in excess of the amount grants for the service in that year. One cannot imagine easier provisions for supplementary grants by Parliament.

This provision for supplementary grants along with no accountability being fixed for surrender of unspent funds, leads to unrealistic budget estimates. The budget circulars issued by the Ministry of Finance every year stipulate that due note, while framing the estimates, be taken of the past performance, the stages of formulation/ implementation of the various schemes, the institutions capacity of the implementing agencies to implement the scheme, the constraints on spending by the spending agencies etc. The objective is to minimize the scope of avoidable surrenders at later stage. Further, no provisions should normally be made in the budget, without completion of pre-budget scrutiny of the projects/schemes. Scrutiny of head-wise appropriation accounts, however, accounts revealed that Ministries/ departments made excessive provisions under various sub-heads, which ultimately result in large savings and surrenders at the end of the year.

[183] Ibid, para 7.14

The justification given by the Ministries/Departments for the unspent provisions were found to be unsatisfactory by C&AG, "as the contributory reasons indicated in each case could have been avoided had proper pre-budget scrutiny of the projects, schemes, activities been undertaken, instructions for which have been issued by the Ministry of Finance from time to time. It is evident that the instructions issued by the Finance Ministry every year were not adhered to by the ministries and budget provisions were made without completion of pre-budget scrutiny".[184]

Following table gives the unspent amounts of civil ministries from 2000-01 to 2005-06.

**Table 10 Central Government: Unspent Amounts of Civil Ministries**

(Rs. Crore)

| | **Unspent amount (after adjustments)** |
|---|---|
| 2005-06 | 29756 |
| 2004-05 | 38642 |
| 2003-04 | 29619 |
| 2002-03 | 59473 |
| 2001-02 | 20237 |
| 2000-01 | 64883 |

Source: Audit reports of appropriation accounts of civil ministries, CAG.

Scrutiny of Appropriation Accounts of Defence Services disclosed a persistent trend of unspent provision during the years 2005-06, under voted segment of four grants. "The persisting trends of large unspent provisions in the aforesaid heads of grants are indicative of over-estimation of the request of funds by Ministry of Defence".[185]

## II

**Public Accounts Committee (PAC) deliberation on Appropriation Accounts**

Above analyses brings out two basic points;

[184] Ibid para 7.16
[185] Ibid, para 7.20

1. That easy availability of additional funds through supplementary grants lead not only to unrealistic budget estimates but also to subsequent surrender of unspent funds.

2. This kind of budgeting cannot be the basis for sound financial planning, nor can it lead to a properly conceived medium-term budget and expenditure plan, which necessarily imply `hard' yearly budget constraints, in the shape of ceiling.

The phenomena of asking for unnecessary supplementary grants and surrender of funds at the end of the year bring out the necessity of amending the Art 115 of the Constitution, pertaining to Supplementary Grants, making it more stringent. Supplementary demands should be considered only when there are exceptional grounds for it, nature of which should be spelt out by suitable amendment of the Art 115 of the Constitution.

One should also bother about is why in spite of repeated instructions of Ministry of Finance for pre-budget scrutiny of schemes, projects and get activities is not leading to better budget estimates, which avoids both supplementaries and surrender of funds. The point that can be briefly made here is that unless links are established between projects, schemes and activities and the input costs, (which involves enormous data links established through rigorous computation and analysis, which is called "cross-walk" in budgeting jargon), mere review of projects and schemes, will not lead to better input budgeting.

For example, if a scheme is not showing adequate progress, or has not reached pre-determined milestone, what would be its effect in terms of various inputs costs which go into the budget formulation, is not easy to determine, if the programme concept of budgeting where inputs are inked with various sub-programmes/activities, in various sub-heads of budgets, have not been adopted. This basic lacunae over budgeting can be addressed by making it programme based at the same time keeping clear links with inputs costs which go into budgets, in the shape of sub-heads and detailed heads of expenditure. **This would, as mentioned in an earlier chapter, require a separate Budget Law. Otherwise the goal of realistic budget estimate, through pre-budget scrutiny of projects, schemes and activities cannot be achieved, and the problem of recurring surrender of funds as also supplementaries would continue.**

Public Accounts Committee of parliament have also taken serious view of these "unspent balances".[186]

PAC deliberates on the Appropriation Accounts submitted by the C&AG and makes its recommendations. In this regard we can do no better than quote from Ministry of Finance circular of 20th July 2001, which refers to observation of Sixteenth Report of Public Accounts Committee (13th Lok Sabha) relating to Union Government Appropriation Accounts (Civil) – 1996-97, regarding 'unspent balances'. The PAC while taking adverse note of the whopping saving of Rs. 44231.22 crore for the year 1996-97 is the grants pertaining to civil Ministries/Departments for the year 1996-97 noted that out of the above saving, Rs. 29466.03 crore were on account of less drawal of 31 days Treasury Bills. "Excluding these Treasury Bills savings, the effective saving of Rs. 14765.13 crore constituted more than two times the supplementary grants of Rs. 7326.86 crore……."[187]

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[186] Public Accounts Committee, both at the Centre and provinces were constituted for the first time under Montague-Chelmsford Reforms of 1921. Rules framed under Government of India Act 1919 empowered the central and provincial legislatures to appoint Public Accounts Committee to examine the accounts of the respective governments. Till the appointment of Interim Government at the Centre later half of 1946, Finance Member of Executive Council was the Chairman of PAC and Committee was run by Finance Department. This restricted the free expression of views and criticism of the Executive. [G.C. Malhotra, former Secretary General of Lok Sabha, "Public Accounts Committee: Its Role in ensuring Executive Accountability", in *Public Audit, Good Governance and Accountability*, Institute of Public Auditors of India, Edited by B.P. Mathur, August 2000]

The PAC underwent a radical change with the Constitution coming into force in 1950. It became a parliamentary committee with a non-official Chairman appointed by a Speaker and its secretariat function was transferred from Ministry of Finance to Parliament Secretariat, now known as Lok Sabha Secretariat. Presently, the Committee consists of 22 members, of which Lok Sabha selects 15 members and Rajya Sabha selects 7 members. The terms of office of the members of the committee does not exceed one year at a time. The Chairman of the Committee is appointed by the Speaker from amongst the members of the Committee from Lok Sabha. In 1967-68, for the first time a member of opposition was appointed as Chairman of PAC and this practice continues. [*Ibid*]

The main function of the Committee include examination of accounts, showing the appropriation of the sums granted by Parliament for expenditure of the Government of India and such other accounts laid before the House as the Committee may think fit. The reports of CAG mainly form the subject matter of the deliberations of the Committee.

The parliamentary scrutiny of public finances operates mainly through functioning of the PAC. Giving the experience of UK government, Lord Sharman in his report stated: "It is widely considered that the rigorous parliamentary scrutiny of public finances (along with, for example, the existence of a non-political civil service) has played a significant part in ensuring low levels of fraud and corruption in central government in the United Kingdom. It has also ensured that, in general, public officials pay appropriate attention to ensuring public money is safeguarded and used with regard to value for money. Whilst such arrangements will never prevent problems arising with projects and programmes, which can result in poor value for money, they have helped to deter willful misuse of funds." [Report by Lord Sharman of Redlynch, *Holding to Account, The Review of Audit and Accountability for Central Government*, Feb 2001, Para 1.7]

[187] Ministry of Finance (2001), Office Memorandum, No.F7(6)-B®2001, dated 20 July 2001

PAC took a serious view of this state of affairs and observed as per the OM "this indicates the lack of earnestness on the part of Ministries/Departments concerned reflecting on the injudicious formulation of budget estimates/ utilization of funds, when such savings could be significantly reduced, if not avoided altogether, by making realistic budgetary projections by concerned Ministries/Departments".[188]

In order therefore to avoid this recurring malady and to make realistic assessment of funds all Ministries/Departments were advised that existing mechanism of review, monitoring and control should be so geared as to make more careful formulation of plan/schemes having regard to ground realities and achievable targets. The monitoring mechanism was to be tightened to oversee flow of expenditure scheme wise to keep monthly over flow of expenditure. In case there was the likelihood of any savings, corrective actions were to be taken immediately to surrender the saving well in advance as provided under Rule 69 of the General Financial Rules.

It did not occur to anybody that this so called "recurring malady" afflicting the budgetary process, is due to any systemic fault in budgeting, and unless the budgeting system is changed, these problems would continue to occur, and any amount of monitoring and control would not help.

As was expected, this circular also did not have much effect as subsequent appropriation accounts showed. Another OM was issued on 31st July 2006, citing reference to earlier OM dated 20 July 2001 in the context of earlier adverse comments of PAC again pointedly mentioned about the same malady which had continued to persist and asking for taking suitable corrective actions.[189]

The OM draws attention to Department of Expenditure's OM No. F.No. 5(6)/L&C/2006 dated 1st June 2006 regarding updated scheme of "Integrated Financial Adviser". It may be mentioned that Para 9(1) of the above mentioned OM reminds Financial Advisors about their responsibility of bringing in more analytical inputs into budget formulation process to ensure better ***inter se*** programe/prioritization and allocation within the

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188 Ibid

189 Ministry of Finance, Office memorandum, F.No.7(1)B(D)/2006

budget ceilings based on expenditure profiles of each programme, assessment of outcomes and current status of projects. **It states "such an analysis at the time of initial budget formulation should, over a period of time, help in enforcing hard budget constraints and reducing reliance on supplementaries".**

**Need for a Budget Law**

The point that needs to be reiterated that because continued existence of this malady inspite of repeated adverse 'comments of the PAC on this phenomena and ineffectiveness of the instructions issued by Ministry of Finance to the departments to tighten the budget formulation procedure, there appears to be no alternative to tighten the constitutional provision relating to supplementary grants to be promulgated through a Budget Law.

The Budget Law, which would include revised provision of Article 115 regarding supplementary grants, which can be provided only in exceptional cases. It should be the responsibility of Chief Accounting Authority to surrender likely savings if any, by end of December every financial year. This should also provide for specific responsibilities of both the Chief Accounting Authority and the Financial Adviser of the Ministry/Department in ensuring that need for supplementary grants or surrender of funds do not occur.

Only by promulgating such a Budget law can the repeated concern of PAC regarding formulation of budget without adequate scrutiny and examination of requirements, the evil of "March rush", supplementaries and surrender of funds towards the end of the financial year could be met. It would also help towards establishing output oriented budgeting.

Promulgation of such a Budget law would strengthen the hands of FAs in realistic formulation of budgets, minimizing and controlling the expenditure in such a way as no other measures can.

To provide evenness of expenditure throughout the year and avoid the problem of March Rush, Ministry of Finance has introduced Exchequer Control based expenditure management system. Exchequer based expenditure management system has been extended to

23 Demands for Grants with effect from April 1, 2007.[190] MEP would form the basis of Quarterly Expenditure Allocation (QEA). The Departments/Ministries concerned may not issue cheques beyond the Quality Expenditure Allocation (which would be equal to the sum of provisions under Monthly Expenditure Plan). It states MEP for the month of March may not exceed 15 percent of the Budget Estimate. MEP for months January to March should be so fixed that QEA for last quarter may not exceed 33 percent of budget provision.

Most importantly, savings if any incurred under the Quarterly Expenditure Allocation would not be available for automatic carry forward to the next quarter. The Ministry/Department may approach Ministry of Finance for revalidation of such savings through modification of Monthly Expenditure Plan and thereby QEA.

This is exchequer control of strictest kind. This takes away all flexibility in the system of financial management, and gives a veto power to Finance, if the expenditure is likely to go beyond monthly cost ceiling.

So even with adequate budget provision for the year and extensive delegation of financial powers under Delegation of Financial Powers Rules, the Ministry/ Department may not be able to spend the amounts provided if it is not in conformity with Monthly Expenditure Plan (separately for Plan and non-Plan expenditure). The stipulation that savings of one quarter cannot be automatically carried to the next quarter, may lead to non-utilisation of the yearly budgetary provisions. One wonders, whether this is what is intention of the Parliament when the annual appropriation Act is passed.

One could understand the provision of this kind of stipulation if the budget was formulated on the basis of evaluation of on going programmes and schemes so that one could draw up a monthly expenditure plan on the basis of detailed evaluation of the programme/scheme. But our budget is input based. At the same time our programmes and schemes are not subjected to detailed costing exercise, which would bring out its implication in terms of input-costs and their behaviour during the year. Therefore, programs/schemes wise analysis may not throw much light of the likely monthly expenditure pattern composed of various input-costs of which the budget is composed. This would pose bigger problem in

[190] Ministry of Finance (2007), Budget Circular 2008-09, dt.20 September

regard to capital expenditure when expenditure pattern may be quite unpredictable and some budgets have a significant expenditure under capital outlay (in defence it is more than 40 percent).

**There could be four year budget plan apart from the BE for the next year which can be published in a White Paper so that it can be a basis for planning. There is apparently no constitutional bar to have multi-year budget plan for each Ministry/Department, while appropriation would be for one year. If there is any such restriction in the Constitution, the same should be amended, which would greatly help in strengthening financial management. Provisions like MEP would instead of helping financial management may, in fact, hinder it, by bringing in unnecessary rigidity in the system.**

Rather, giving proper heed to observations of PAC regarding unnecessary supplementary demands and huge surrender of funds, should lead to enactment of Budget Law, providing for:

a. Stricter provision for supplementary demands, making it an exception rather than the rule

b. Introduction of the concept of programmes and sub-programmes in budgeting

c. detailed costing of programs, on a multi-year basis so that it could provide basis for budgeting keeping in view cost of inputs

d. multi-year budgeting on the basis of costing of ongoing programmes with carry over of funds which could not be spent from one year to the next

e. detailed review of the programme to examine the results and costing pattern, as part of the budgetary exercise (in fact programme review should preceed the budget exercise)

f. making Chief Accounting Authority and Financial Adviser responsible for realistic budget formulation and making them accountable, if significant surrenders of budget allocation takes place.

Enactment of such a Budget law would enhance the parliament's control over financial management.

### III

**Public Accounts Committee and CAG**

The reports of CAG mainly form the subject matter of the deliberations of the Public Accounts Committee. At the beginning of its term very year, the Committee make a selection of audit paras included in various reports of CAG laid on the table of the House for examination. The Committee generally selects for in-depth examination about 30-31 paras according to their relative importance out of an average of 400 paras included in various annual reports of CAG.[191]

Effectiveness of external audit to a large extent depends on the interest it evokes and support it obtains from the PAC. In turn, the effectiveness of PAC depends on the Government accepting its recommendation and implementing them. About 60 percent of the recommendations of the PAC have been accepted by the government between 1980 and 1999.[192]

Some of the Committee's recommendations have led to major changes in government's policy, amendment in tax laws and setting up of enquiry committees to probe into irregularities. But government has also been ignoring some of the key and critical recommendations.

The percentage of audit paras being discussed in PAC is also reducing. During last few years, the PAC is able to examine only a fraction of paras which appear in Audit Reports. During 2003-04, for example, out of 759 paras that featured in Audit Reports, PAC selected 93, but discussed only 9 paras in eleven sittings held[193]. In the States, there were 12,000 paras pending at the end of 2004, out of which State PACs could examine only

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[191] G.C. Malhotra (2000), "Public Accounts Committee: Its Role in Ensuing Executive Accountability" in B.P. Mathur (ed), Public Audit Good Governance and Accountability, Institution of Public Administration of India, p 53

[192] Ibid, p 57

[193] C&AG: Activity Report 2004-05, Quoted by B.P. Mathur (2006), Government Accountability and Public Audit, p166

around 500 paras. In some States the CAG's reports are pending discussion from 1983-84. In these circumstances, one can conclude that in most States legislature's control over public expenditure is practically non-existent.[194]

One of the main planks of sound financial management is to ensure that expenditure conforms to budget grants. Therefore, a major issue that Parliament/State Legislature should be concerned about is that budgetary allocations up to sub-head level, as approved by it, are not exceeded, or there are re-appropriations done at appropriate levels to cover excess expenditure by drawing savings from elsewhere. This issue has been discussed in the earlier section.

In India, the problem of exchequer control has not been properly addressed. The CAG (DPC) Act bypassed this basic issue. There is an element of exchequer control at treasuries. These are not effective as public sector banks, which are attached to the treasuries are at no point of time are in a position to know the balance of government account. They, therefore, cannot stop payment because of lack of funds. And as a former CAG puts it, "Besides, the treasury control is vulnerable to gross subversion as seen in Bihar, Assam, UP, etc. Even the inspection by CAG does not cover exchequer control operations as they mostly involve procedural aspects."[195]

This is compounded by the fact that treasury accounts are not prepared in time. The State Accountants General have to rely on the district treasuries, PWD and other departments compile the monthly and annual accounts of the State governments. In many of the State governments the treasury accounts are not prepared in time. Delays of several months are common. The compilation of the accounts of State governments is often delayed. "The accounts prepared by the Accountant General have to be reconciled with those of the departments. In more than half the cases, the reconciliation is not made. In a recent year reconciliation of about Rs. 6,000 crores was not made in Uttar Pradesh. This can very easily lead to fraud."[196]

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[194] B.P. Mathur (2006), *Government Accountability and Public Audit*, p. 166
[195] V.K. Shunglu (2000), "Reflection on Government Audit", in B.P. Mathur (ed), Public Audit Good Governance and Accountability, Institution of Public Administration , p. 19]
[196] K.P. Joseph,"Fifty Years of Government Audit: A Balance Sheet", in B.P. Mathur (ed), Public Audit Good Governance and Accountability, Institution of Public Administration, p. 128]

The treasury system of exchequer control is, therefore, vulnerable. This is a major weakness, which needs to be rectified by introducing stringent institutional mechanism for more effective supervision and periodic checks of treasuries, as also making it obligatory for rendition of monthly accounts to AG. These provisions should be incorporated in a suitable legislation. Computerization and networking of treasuries in states would also help.

Excess expenditure over budgetary provision is an abuse, which has to be prevented. To quote Shunglu, “excess expenditure is now a matter of routine and has camouflaged large fraudulent drawals in connivance with treasury officials.”[197]

Mechanism for ensuring accountability for excess expenditure operates through PAC. But as Shunglu points out, “Unfortunately, the PAC suffers from two main limitations, i.e. PACs have not been able to cope with the huge load of examining the excess expenditure on a timely basis in absence of explanations from the executive. Secondly, the power of PAC’s is to recommend, and the success of their recommendations depend on the goodwill of that very government, incurring excess expenditure in the first place. As of now nearly Rs. 94,000 crore of excess expenditure, dating back to the 1970s, remains to be regularized in 26 States.” He concludes, “Evidently, therefore comptrollership, as exercised by the executive has failed and made the system of control over finance vulnerable to gross abuse.”[198]

In order to strengthen parliamentary control over executive it is necessary to devise a system which envisages that PAC examines all the reports submitted by CAG and submits its recommendations to Legislature within a stipulated time limit. This is possible only if the volume of CAG’s Audit reports is reduced and their quality and content improved.

It has been pointed out that one of the reasons for non-inclusion of matters of lesser importance in CAG’s audit reports is that departments do not give adequate weight to audit observations and do not take remedial actions on its reports. Therefore, CAG has to bring these to the notice of legislature. There is also need for greater understanding between PAC and CAG regarding material to be presented in the audit reports, so that full use can be made of these reports. Close relationship between PAC and audit departments not only enhance

[197] V.K. Shunglu (2000), Ibid
[198] Ibid, pp 19-20

prestige of audit, but also bring financial discipline. This would make executive authorities conscious that an effective parliamentary body would oversee what is happening in a department relating to financial management, and motivate them to become more efficient.

If parliamentary control over expenditure is to be real, the functioning of PAC has to be more effective. It has been suggested in a Consultation paper on "Efficacy of Public Audit System in India", submitted to 'National Commission to Review the Working of the Constitution', that PAC be made a constitutional body by amending the Constitution. The life of the Committee be made five years to co-extensive with the life the life of the Parliament/State Legislature. To quote from the Consultation paper, "For PAC to function effectively and its members to develop specialization, the life of PAC be made five years co-extensive with the Parliament/State legislature with one-third of members retiring every year. It is for consideration whether PAC be given a Constitutional status with clearly defined mandate, duties and functions."[199]

Steps suggested above in making it a constitutional body and making its term coterminous with the life of the Parliament/State legislature would help in making this institution play a more effective role in improving the expenditure management of the government. A close link with CAG in processing of audit paras would help in the process.

It is also necessary to make statutory provisions prescribing dates for presentation of Appropriation Accounts to Parliament/State legislature showing excess expenditure over voted grants. It should also provide for regularizing excess expenditure over grants before the end of next year to which the accounts relate.

We are yet to realize the full potentiality of PAC in improving the financial management of the Central and State governments. To quote from the Report by Lord Sharman in relation to UK government: "The PAC could provide further powerful support to improvements in financial managements by continuing to examine themes across central government as a whole (such as risk management, corporate governance, developments in performance measurement and fraud). In particular, this could be undertaken by holding an

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[199] Consultation paper on "Efficacy of Public audit system in India: C&AG - Reforming the Institution< National Commission to Review the Woking of the Constitution, January 2001,para 51:

annual hearing, examining the main issues set out in a memorandum or report from the C&AG. This could be based on the C&AG's own work, his review of the findings of internal audit, and other sources."[200]

Apart from Public Accounts Committee there are two other Financial Committees of Parliament, namely Committee on Estimates and Committee on Public Undertakings.

The Estimates Committee is charged with detailed examination of budget estimates. It has four other specialized function of the Estimates Committee:

a. to report what economies, improvements in organizational efficiency or administrative reform consistent with policy underlying the estimates may be effected;
b. to suggest alternative policies in order to bring in efficiency and economy in administration;
c. to examine whether is well laid out within the limits of policy implied in estimates; and
d. to suggest the form in which estimates shall be presented in Parliament.

It is clear from these functions that the Committee is empowered not only to examine such of the annual estimates as it considers fit and suggest economies – consistent with policy underlying these estimates, but also to suggest alternative policies in order to bring economy and efficiency in administration.

The Committee has 30 numbers who are elected in accordance with system of proportional representation from among the numbers of Lok Sabha for a period of 1 year. For its more efficient working the Committee divides itself into groups or sub-committees and to each of this group is allotted a certain department for examination and report.

[200] Report by Lord Sharman of Redlynch, *Holding to Account, The Review of Audit and Accountability for Central Government*, Feb 2001, Para 9

But one serious handicap resulting from the present set up of Estimates Committee deserves mention here. From the nature of its functions, it has to perform the duties of an expert body. The Committee unlike the PAC, does not have the assistance of an expert body like that of Comptroller and Auditor General. Further, each year the membership is decided by election and there is no guarantee that one who has been a member the previous year would be re-elected.

These limitations need to be removed to make the committee a really effective instrument of Parliamentary control and financial management.

It is well recognized that the present mechanisms for the financial control of legislation over the executive are far from satisfactory. Rules Committee of the Lok Sabha recommended setting up of 17 Departmental Standing Committees (DRSCs). Accordingly, 17 Departmental Standing committees were set up in April 1993. Later, seven more Committees were set up. The functions of these Committees are:

a. to consider the demands for grants of various Ministries/Departments of Government of India;
b. to consider Annual Reports of Ministries/Departments;
c. to consider policy documents if referred to the Committee by the Chairman, Rajya Sabha, or Speaker, Lok Sabha and make reports on these.

With the setting up of Standing Committees, it is for the Parliament to consider what should be the proper role of the Estimates Committee. This committee could be given much wider terms of reference which would enable it to look at all government expenditure much more holistically. It could be mandated to look at policy issues affecting the public expenditures and to advise government suitably.

To make Estimates Committee an effective body, it can be assisted by the CAG, in examination of policy related issues in financial management, including budgetary and accounting reforms. The audit reports of the central government as well as states, now contain large number of reviews on various development schemes and programmes. Some of them contain very important observations which have bearing on policy issues. But the departments concerned hardly show any interest in them. “The Public Accounts Committee both at the Centre as well as States has hardly any time or inclination to examine these voluminous reviews. As a result, much of the work done by the Audit Department goes waste.”[201] It is for consideration whether the Estimates Committee could be mandated to go into performance audit reports particularly to look at the policy issues involved.

What can straightaway be done is to entrust the Standing Committees of various departments to examine the CAG’s reports both relating to department’s regulatory audit, as also performance audit. The Standing Committees after examining the reports can make their own recommendation to rectify the deficiencies and ask for action taken notes on the recommendations made within a stipulated period.

The role of Standing Committee attached to various departments can be reviewed by the Parliament. In this context the debates is the House of Commons, U.K., regarding powers and roles of Select Committees in the late seventies can be gone through. Select Committee like our Standing Committee are based on the structure of government departments. The terms of reference of the Select Committees are to monitor the expenditure, policy and administration of departments and associated public bodies. They also examine individual policy issues. There was however a consensus among analysts that Select Committee have often failed to conduct a vigorous analysis of spending priorities and instead tend to argue more for each service they look into. One important analyst argued before the Procedure Committee of the House of Commons, “Their weakness lies in their style of operating. They seem to concentrate too much on the events of the day, or policies which are in the public eye, and too little on systematic examination of the performance of departments. They do not generally adopt what might be called a ‘system approach’. That is they do not require departments to specify what their aims are and what are the objectives of, and justification for policies and programmes nor require them to establish indicators of performances which would permit the systematic comparison of results and objectives. This would call for

[201] B.P. Mathur (2007), Government Accountability and Public Audit”, p 80

management of departments regularly to account for the consequence, effectiveness and impact of their decisions."[202]

It was felt that to perform their role effectively the Select Committees should be supported by appropriate management information system. And they should have sufficient analytical staff to help them in this kind of analysis.

The role of our Standing Committees needs to be strengthened by expanding their mandate to go into the audit reports of CAG, both regulatory and performance audit. They should be suitably strengthened by induction of analytical staff and experts to help them to go into the issues in-depth. They should make suitable recommendations for improvement of financial management of departments concerned.

## IV

### Need for Amending CAG DPC Act

Efficacy of parliamentary control over financial management of the government depends on the effectiveness of the role of CAG, which is the supreme audit institution. The Constitution of India defines the roles and responsibilities of CAG in general terms and stated that his duties and responsibilities would be prescribed by law. [Article 149]. Under this article, the Parliament has passed CAG (DPC) Act 1971. This Act places several conditions limiting the mandate of CAG relating to bodies and authorities, e.g., it relieves CAG from making any scrutiny in respect of any body or authority receiving grant or loan, from scrutinizing the procedure by which sanctioning authority satisfies itself as to the fulfillment of conditions subject to which grants or loans were given under Section 15 (1). Government can also deny audit by CAG of bodies receiving substantial amounts of grants, if it is less than 75% of total expenditure of these bodies. Further, a large number of autonomous bodies which may be audited by CAG disburses substantial amounts of grants as sub-disbursing agencies. There is no provision of audit of such grantees receiving grants

[202] John Garrett (1992), Westminster, Does Parliament Work? Victor Gollancz, in his evidence before the Procedure Committee of the House of Commons.

from a sub-disbursing agency. The CAG Act also stipulates that audit should be subject to the "provision of any law", applicable to that body or authority. Thus, an authority, fully funded by the government, can be set up under a statute, which may not provide for CAG's audit.

Similarly, bodies registered under Society's Registration Act 1860, are not also subject to CAG's audit, as they are subject to jurisdiction of Registrar of Societies.

An important example of this is District Rural Development Authority (DRDA). The DRDAs are set up in every district of the country as autonomous societies under the Societies Registration Act to administer government's various schemes relating to rural employment and poverty alleviation. Large amount of grants are given annually to DRDA both by Central and State Governments. "The Accounting and audit arrangements of DRDA leave much to be desired. While the Ministry of Rural Development has drawn up a detailed Accounts Manual, there is hardly any trained staff to keep accounts and exercise financial control".[203] Under the rules framed, the Chartered Accountants (CA) have been entrusted with the responsibility to audit the accounts. But it is doubtful as to extent to which they have access to the original records of the organizations which have spent the money. CAG is entitled to conduct supplementary audit on the basis of rules framed by the Ministry. This may not be adequate.

The basic point to consider is, can CAG's audit, which is its constitutional responsibility, be governed by administrative orders?

To quote another authority on the subject, "The present arrangements for auditing the expenditures of local bodies are two weak to inspire confidence….Audit paras, even those pertaining to misappropriation and defalcation of funds, remain unattended for years. The respect of the local fund audit in Maharashtra for the year 1998-99 shows that there was a delay in reporting compliance by panchayati raj bodies in 71,263 cases and the total amount

[203] B.P. Mathur (2007), Government Accountability and Public Audit, Uppal Publishers House, p.69

of expenditure which was in question was Rs. 1,259.26 crores for 90,692 cases of audit objections involving expenditure of Rs. 1,087.46 crore, the final compliance was still pending"[204]

But the amount of audit work involved is daunting. A state like UP has 58,600 panchayats, MP has 31,000 and Maharashtra 27,600. There are 500 district level Zila Parishads in the country.

The challenge is how to keep proper accounts of these bodies. So there is need for separate accounts cadre for PRIs. We have also suggested setting up separate Audit Commission for audit of such bodies elsewhere in the report.

The Regulatory Authorities of the Government should also be brought under the purview of CAG's audit.

The principle of accountability requires that where government has substantial investment by way of shareholding should be subject to CAG's audit. In several countries, where government has substantial holding in private sector, it is subject to state audit.

For establishing parliamentary control over expenditure, Parliament may consider revising CAG (DPC) Act to remove the limitations of CAG's power.

During last 25 years, one the major initiatives of the audit department has been moving towards performance audit. The Audit Reports of Central government as well as States, now contains large number of review on various development schemes and programmes. These performance reviews have important policy implications. It has been suggested above that the Estimates Committee could be mandated to look into these performance audit reports from economy, efficiency and effectiveness point of view and make suitable recommendations.

Though under CAG (DPC) Act 1971 (Section 18), CAG has authority to inspect office, put questions and call for documents and information, these provisions are not backed

[204] M. Godbole (2003), Public Accountability and Transparency, Orient Longman, p. 132

by any compliance procedure. There is also a need to establish binding compliance procedures, including penal procedures to assist CAG's organization perform its legislative functions.

The quality of audit depends on the quality of audit officer/section officers who do not have the necessary training or background to do meaningful analysis and evaluation of development programmes. Senior officers in the level of deputy AG only perform supervisory role. Therefore, effective evaluation of programmes and projects is seriously handicapped. It may be necessary for CAG to recruit experts or engage consultants or private professional firms for conducting audit in specialized areas. We have also suggested in Chapter 3 decentralization of audit activities and setting up of Audit Commissions for carrying out audit for the third-tier of government. It has also been suggested that Audit Commission may appoint consultant/private firms for auditing, as is the practice in UK for audit of local bodies.

A basic problem faced by auditors in doing an effective audit in suspected cases of fraud, is difficulty in getting records. In such cases to arrive at a conclusion, the office of CAG should be given the power to summon officials to give give evidence on oath and the power to make departments to produce records (except which are classified) within a specified time schedule. Where default is established, after giving due opportunity, the concerned officer should be required to make good the loss from his own resources. Officials handling public money are personally accountable for its proper upkeep. This takes us to the next point. CAG (DPC) Act should be suitably amended to provide for it.

## V

### What is public money?

The question of what constitutes public money has come to forefront. As per traditional thinking, one way of looking at it is to concentrate on revenue raised. The other is to look on Parliamentary authorization of expenditure. On the first basis public money will consist of tax revenues and government borrowings, as also include income generated by public bodies from fees and charges. On the second basis, public money would consist largely of money voted in estimates, but would also cover cases where money was raised under statutory powers. However, these definitions are not exhaustive.

The presence of both public and private bodies spending public money, and the existence, in some sectors of government activity, of public money being passed down chains to final recipients, raises the question of when 'public money' becomes 'private money' for the purpose of ensuring proper public accountability.

It is not very clear where public accountability ceases when public money is paid out to independent and private sector bodies as grant, or for operating a contracted out service.

There is every indication in the 21st century that change will continue in public service delivery. A number of significant trends in service delivery system, which would affect ambit of government audit, needs to be noted;

- Government departments and other public bodies would probably provide fewer services themselves directly and would depend other mechanisms of service delivery;

- Private sector organizations would probably increasingly play a role in public service delivery. The management of contracts and contractors will thus be of great importance for government bodies. Therefore, scrutiny of accounts of contractors in their role of public service delivery may become important from the audit point of view

- Partnerships between public bodies and private voluntary sector organizations will continue to develop, where money spent might be regarded as public money, and external audit by C&AG should have a proper role to play

All the above trends have implications for audit and accountability, which and have been recognized in other countries. Developments are also likely to add to the complexity of the ways in which public services are provided and funded. In these circumstances, an answer has to be found as to how Parliament and the public be assured that public funds are being well utilized. This issue needs to be debated.

It is clear, however, that the concept of public money is much wider today than it was a few decades back. The interest of Parliament should cover all those cases where public money is spent.

In this context, one can mention that in developing Auditing Standards by CAG is "with increasing public consciousness the demand for public accountability of persons or entities managing public resources has become increasing evident so that there is need for accountability process to be in place and operating effectively".[205]

Therefore, while determining the ambit of audit by CAG, by the Parliament above trends in service delivery system, new connotation of public money and increased public consciousness about the need for accountability in the management of public resources, should be prominently be kept in view and those institutions that are presently outside the present ambit of audit, as indicated above, should be brought within the audit purview of CAG by suitable amendments of the Act of 1971. This is necessary because, as already mentioned, financial propriety (defined as the expectations as to how public money should be used), places a greater degree of accountability than would be the case for private money. It has to be demonstrated that the public bodies have conducted business in accordance with the standards of financial propriety expected of those dealing with public money.

## VI

### Auditing Fraud

The most important of 'Basic Postulates' mentioned in developing the 'Auditing Standards' by CAG as Supreme Audit Institution (SAI) of the country is SAI should comply with INTOSAI[206] auditing standards, in all matters that are deemed material.

Fraud and corruption have increasingly become important concerns for countries around the world and the role of audit in addressing this concern has come under critical scrutiny.

[205] C&AG, Auding Standards, Second Edition 2002, Chapter 1, para 3.2 (c)
[206] INTOSAI: International Organization of Supreme Audit Institutions

This concern is embedded in INTOSAI Auditing Standard in following words, “Auditors need to be alert for situations, control weaknesses, inadequacies in record keeping, errors and unusual transactions or results, which could be indicative of fraud, improper or unlawful expenditure, unauthorized operations, waste, inefficiency or lack of probity”.[207]

The XVI INCOSAI held in Uruguay in 1998 discussed the role of SAIs in Preventing and Detecting Fraud and Corruption, signifying growing weakness of INTOSAI of the problem in this regard. In Uruguay INCOSAI, it was agreed SAIs can and should endeavour to create an environment that is unfavorable to fraud and corruption. SAIs also agreed that they should be independent and have adequate mandate that enable them to effectively contribute to fight against fraud and corruption.[208]

The auditing standards developed by CAG recognizing the problems faced by the country due to fraud and illegal acts, has incorporated the following in their Reporting Standards; “When auditors conclude based on evidence obtained, that fraud or an illegal act has either occurred or likely to have occurred, they should report relevant information”. [209]

It also states, “In reporting the material fraud, illegal acts or other non-compliance, the auditors should place their findings in proper perspective. To give the reader a basis for judging the prevalence and consequences of these conditions, the instances identified should be related to the universe or number of cases examined and be quantified in terms of money value, if appropriate”.[210] Above provisions would probably have a constraining influence in reporting a fraud or corruption case. For example, ‘evidence obtained’ may not be adequate to come to a conclusion, but would be sufficient for further investigation of auditors themselves to reach a conclusion. The rules should provide for such investigations by the auditors. The second provision of asking the auditors to place their findings in ‘proper perspective or relating to the universe for the number of cases examined’ may make it very difficult for an auditor in reporting a suspected fraud case. Accessing relevant data is another problem.

[207] General Standards in Government Auditing, para xvi
[208] http://www.asosai.org/guidelines/guide_introduction.htm
[209] CAG Auditing Standards, Chapter 4, 2002 Para 9.1
[210] Ibid, para 9.4

**It is felt that if there is suitable mandate by a legislative provision to enable audit to investigate cases where there is suspicion of fraud, by in depth examination of relevant documents, putting questions to persons likely to have knowledge about the matter, to enable it to come to a conclusion. It would help in creating a right environment for ensuring probity and accountability.**

In this regard we can quote one of the points made in basic postulates in formulating Auditing Standards; "Legislative enactment's would facilitate the co-operation of audited entities in maintaining and providing access to all relevant data necessary for a comprehensive assessment of the activities under audit".[211]

Co-operation of auditing entities in auditing of suspected fraud cases would be very essential. It is therefore necessary to consider making provisions in CAG's Act to facilitate investigation of cases fraud and corruption. It should also make it necessary to design audit in such a way as to provide reasonable assurance of detecting fraud and illegal acts and expanding audit steps when evidence of irregularities or illegal acts exists. Audit also has to exercise due professional care so as not to interfere with further investigations or legal proceedings. These would call for proper training in forensic audit.

[211] Ibid para 3.2(h)

# Annexures

## Annexure 2.1 Revenue Receipts: Percentage Change Actuals over BE

| | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 |
|---|---|---|---|---|---|
| **Non-special Category States** | | | | | |
| Andhra Pradesh | -2.50 | -10.41 | -8.28 | -10.66 | -3.13 |
| Bihar | -11.67 | -3.72 | 2.65 | -3.81 | -4.71 |
| Chhattisgarh | -7.44 | 0.61 | -18.68 | -2.39 | 10.82 |
| Goa | -2.93 | -20.15 | -34.39 | -30.72 | -24.50 |
| Gujarat | -21.96 | -2.58 | -2.94 | -2.16 | 6.91 |
| Haryana | -6.33 | -3.00 | 0.33 | 3.31 | 15.09 |
| Jharkhand | 7.09 | 0.02 | -1.47 | 1.32 | 0.00 |
| Karnataka | -11.58 | -13.99 | 4.61 | 2.33 | 3.88 |
| Kerala | -14.77 | -11.21 | -6.97 | -8.53 | -7.99 |
| Madhya Pradesh | -10.10 | -6.57 | -10.60 | 13.30 | 3.77 |
| Maharashtra | -11.89 | -13.00 | -11.29 | 2.13 | -4.33 |
| Orissa | -17.41 | -12.12 | -6.12 | 3.38 | 10.97 |
| Punjab | -20.98 | -14.48 | -11.74 | -11.94 | -1.58 |
| Rajasthan | -8.35 | -8.92 | -0.01 | 1.60 | 1.47 |
| Tamil Nadu | -10.00 | -2.26 | 2.64 | 14.76 | 12.26 |
| Uttar Pradesh | -15.95 | -11.32 | -5.20 | 0.96 | 6.28 |
| West Bengal | -14.04 | -18.87 | -7.76 | -2.83 | 10.66 |
| **Special Category States** | | | | | |
| Arunachal Pradesh | -7.46 | -11.38 | 19.18 | 3.39 | 25.36 |
| Assam | -10.29 | -13.56 | -18.11 | -24.50 | -9.54 |
| Himachal | 15.54 | -1.46 | -1.26 | 8.90 | 12.23 |
| Jammu | 8.24 | 8.74 | 11.39 | 7.42 | 5.00 |
| Manipur | -3.56 | 0.30 | -6.25 | 15.84 | 1.22 |
| Meghalaya | -15.60 | -14.66 | -17.43 | -9.20 | -11.54 |
| Mizoram | -7.08 | -1.44 | 41.38 | 44.55 | 11.16 |
| Nagaland | -0.75 | -12.84 | 25.89 | -5.87 | 3.28 |
| Sikkim | 84.73 | 7.25 | -36.17 | -3.70 | -4.80 |
| Tripura | -4.88 | -7.70 | -4.74 | 2.46 | 0.97 |
| Uttaranchal | 7.90 | 10.93 | -21.67 | -11.73 | -7.79 |
| States | -10.50 | -8.80 | -5.42 | -0.69 | 2.35 |

Source: Finance Accounts of State Governments

## Annexure 2.2 Own Tax Revenue: Percentage Change Actuals over BE

| | 2001-02 | 2002-03 | 2003-04 | 2004-05 | 2005-06 |
|---|---|---|---|---|---|
| **Non-special Category States** | | | | | |
| Andhra | 6.99 | 65.15 | -14.05 | -5.85 | -3.87 |
| Bihar | -4.07 | 34.09 | -5.56 | -16.37 | -10.60 |
| Chhattisgarh | 1.64 | 31.11 | -2.44 | 3.98 | 18.65 |
| Goa | -8.04 | -57.78 | -7.27 | 2.49 | 19.13 |
| Gujarat | -13.20 | 42.58 | 10.02 | 9.69 | 10.76 |
| Haryana | -5.48 | 97.03 | 0.57 | 7.58 | 10.49 |
| Jharkhand | 1.96 | -18.75 | -5.21 | -7.08 | 0.00 |
| Karnataka | -9.20 | 161.88 | -0.15 | 4.28 | -0.26 |
| Kerala | -19.83 | 256.64 | -6.85 | -10.63 | -11.96 |
| Madhya | -10.77 | 39.50 | -5.01 | -2.53 | 2.14 |
| Maharashtra | -13.24 | 218.72 | -5.07 | 7.53 | -5.52 |
| Orissa | -13.17 | -11.62 | 4.23 | 20.15 | 24.74 |
| Punjab | -17.94 | -5.55 | -4.96 | -2.33 | 14.13 |
| Rajasthan | -9.05 | 58.61 | -0.17 | 0.35 | 2.93 |
| Tamil | -9.69 | 351.66 | -1.95 | 11.00 | 12.95 |
| Uttar | -20.89 | 108.05 | -6.45 | -2.11 | 3.10 |
| West | -19.63 | 63.53 | -8.02 | -5.02 | -3.77 |
| **Special Category States** | | | | | |
| Arunachal | 25.27 | -96.63 | 4.12 | -62.45 | -51.56 |
| Assam | -2.48 | -50.14 | 1.48 | -5.99 | 1.06 |
| Himachal | 17.91 | -62.34 | -2.21 | 12.40 | 18.25 |
| Jammu | 5.23 | -79.44 | 2.22 | 11.49 | 6.09 |
| Manipur | 2.97 | -93.44 | 0.00 | 11.72 | -5.00 |
| Meghalaya | -9.63 | -86.78 | -3.78 | -3.26 | 10.48 |
| Mizoram | 29.93 | -96.76 | 19.30 | 33.78 | 34.15 |
| Nagaland | -19.26 | -95.61 | -19.01 | -7.69 | -3.64 |
| Sikkim | 87.85 | -93.97 | 28.88 | 25.13 | 42.72 |
| Tripura | 11.15 | -88.67 | 20.11 | -18.64 | -3.90 |
| Uttaranchal | 11.87 | -28.26 | 2.12 | 11.34 | 7.66 |
| States | -10.64 | 50.53 | -3.79 | 1.83 | 2.20 |

Source: Finance Accounts of State Governments

# Annexure 4.1

## Extracts from the Audit Reports of CAG on Internal Control and Internal Audit of States

Following are extracts from the audit reports of the Comptroller General of India pertaining to internal control and internal audit during the financial years 2003-04 to 2006-07. The aim is to give a general impression of the lacunae in the internal control system in various state governments. The report for a particular year relates to a department selected for audit. Therefore, this may not reflect the general state of affairs as far as financial management in the state governments is concerned; though it may give an idea the nature of weaknesses that are present in the system

**ANDHRA PRADESH: 2006-07**

Budget Estimates (BEs) are finalised without any inputs from the estimating officers. The estimates were, therefore, unrealistic resulting in huge surrenders and re-appropriation of funds. (*para 5.1*) Andhra Pradesh

Tuition fee from Non-Resident Indian (NRI) students aggregating Rs. 14.40 crore was unauthorisedly diverted by the AP Health and Medical Housing and Infrastructure Development Cooperation and Kurnool Medical College, Kurnool for other purposes. Demand Drafts worth Rs. 67.21 lakh were lying for periods ranging between one to three years unremitted to Government account with the DME. (*para 5.1*)

**Delay in surrender of savings**

As per the Budget Manual, spending departments are required to surrender the Grants/Appropriations or portion thereof to the Finance Department as and when the savings are anticipated. During the year 2004-05, 2005-06, 2006-07, an amount of Rs. 78.59 crore was surrendered on 31 March of each year. Consequently, the funds could not be allotted to other needy departments. (*para 5.1.5.2*)

Tuition fees of Rs. 13.54 crore received (2001-07) by the Corporation in respect of NRI students from the Government medical colleges at Guntur, Kakinada, Vijayawada and Warangal was not utilized for repayment of loan and the Corporation diverted (2001-07) it for other purposes such as payment of inspection charges to MCI, civil works, etc. (*para 5.1.6.2*)

**HARYANA 2003-04: DEVELOPMENT AND PANCHAYAT DEPARTMENTS**

An Internal Audit Wing comprised of one Chief Accounts Officer, one Accounts Officer and five Section Officers functioning under the administrative control of the Financial Commissioner and Principal Secretary to Government Haryana Development and Panchayat Department, is responsible for conducting internal audit of Panchayat Samities. (*para 5.1.17*)

Test-check of records revealed the lack of audit plan, absence of in-service training to Audit staff, pendency of audit, delay in issue of inspection reports and large number of outstanding audit objections as discussed below. (*para 5.1.17*)

The department had not fixed any norms to work out the number of mandays required for audit of each unit for drawing audit plan. Selection of priority units was being made by the Internal Audit Wing on the basis of longer pendency of the units. (*para 5.1.18*)

The detail of total number of units, units audited and those pending during 1999-2004 was as under:

| S. No. | Year | Number of units | Number of units audited | Pending for internal audit | Percentage of auditee units |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| 1 | 1990-2000 | 111 | 37 | 74 | 33 |
| 2 | 2000-01 | 113 | 110 | 03 | 97 |
| 3 | 2001-02 | 114 | 89 | 25 | 78 |
| 4 | 2002-03 | 114 | 68 | 46 | 60 |
| 5 | 2003-04 | 115 | 81 | 34 | 70 |

Special Secretary to Government Haryana, Development and Panchayat Department, while admitting the pendency, stated (April 2004) that the pendency was due to shortage of staff. (*para 5.1.19*)

**KARNATAKA 2004-05**

Inadequate internal controls led to embezzlements aggregating Rs. 15.86 lakh in three institutions. (*para 5.1*)

The Government has been releasing substantial grants-in-aid to autonomous and other bodies functioning in the field of imparting medical education. During the period 2001-05, grants-in-aid of Rs. 289.14 crore was released to these bodies. The Department did not maintain the Register of Grants in the format prescribed in the Karnataka Financial Code[212] for exercising control over proper utilization, receipt of utilization certificates and audited statement of accounts, etc. The Department also did not maintain block accounts of permanent and semi-permanent assets acquired wholly or mainly out of Government grants, as required in the Karnataka Financial Code.[213] Non maintenance of the Register of Grants and block accounts of assets indicated inadequate internal controls at the Government level over release of grants-in-aid to autonomous bodies. The Government agreed (December 2005) to maintain the grant register. (*para 5.1.14*)

**KARNATAKA 2005-06: CO-OPERATION DEPARTMENT**

Budgetary controls were ineffective as there were instances of defective preparation of estimates, non-utilisation of substantial amounts of grants, savings not being surrendered or surrendered only at the fag end of the year. (*para 5.1*)

Non-exercise of prescribed controls effectively, resulted in accumulation of arrears in audit, inquiries and inspections remaining incomplete and misappropriation of Rs. 81.67 crore involving departmental employees, office bearers and employees of the societies. (*para 5.1*)

**Reconciliation of departmental figures**

In order that the departmental accounts are accurate to ensure efficient financial control, the Budget Manual requires that the consolidated accounts of the Chief Controlling officer (Head of the Department) have to be reconciled with those recorded in the books of the Accountant General. However, wide variations were noticed between the two sets of expenditure figures as under:

(All figures in Rs. Crore)

| Year | Expenditure according to | | Variation |
|---|---|---|---|
| | Accounts | Department | |
| 2001-02 | 61.50 | 30.83 | 30.67 |
| 2002-03 | 68.04 | 26.56 | 41.48 |
| 2003-04 | 127.31 | 28.70 | 98.61 |
| 2004-05 | 255.70 | 181.71 | 73.99 |
| 2005-06 | 1046.33 | 98.25 | 948.08 |

Non-completion of reconciliation of expenditure figures adversely affected the process of financial control besides carrying the risk of non-detection of a possible fraud. (*para 5.1.5.3*)

212 Article 161.
213 Article 161(c).

**Misappropriation cases**

The Act provides for recovery of loss or deficiency caused to a society by way of initiation of surcharge proceedings against the committee of management or any other person in cases of payment contrary to the Act, Rules or bye-laws of the society, deficiency caused in the assets of the society by breach of trust or negligence, misappropriation/fraudulent retention of money/property of the society found during an audit, inquiry, inspection or winding up of a society. According to the data furnished by the Department, the number of misappropriation cases increased from 9,821 (2003-04) to 10,079 (2005-06) involving an amount of Rs. 81.67 crore in 5,923 societies by 10,569 persons. These persons included 9,318 employees of the societies, 160 departmental employees, 860 office bearers of the societies and 231 others. This was indicative of lax monitoring of the affairs of the cooperative societies by the Department. (*para 5.1.7.4*)

**Internal audit**

Internal audit is an independent appraisal of operations to assess the internal financial, administrative and other controls and help implementation of policies and programmes. The Finance Department issued (December 1992) guidelines to improve the quality of functioning of Internal Audit Wing (IAW) of Government Departments to enhance fiscal discipline. However, no IAW had been constituted (March 2006) in the Cooperation Department though it has been in existence for 100 years. (*para 5.1.15*)

Budgetary control mechanism in place was not effective as there were instances of defective preparation of estimates and huge savings which were either not surrendered or surrendered only at the fag end of the year. Operational control of cooperative societies was ineffective as there was accumulation of arrears in audit, inquiries and inspections remained incomplete and misappropriation involving departmental employees as also office bearers and employees of the societies. The recovery of outstanding balances of principal and interest was tardy because of ineffective monitoring. The internal audit system had not been introduced in the Department. (*para 5.1.16*)

**MADHYA PRADESH 2003-04: INTERNAL CONTROL SYSTEM IN EDUCATION DEPARTMENT (DIRECTOR OF SCHOOL EDUCATION)**

Internal control system safeguards against errors and irregularities in operational and financial matters. It examines and evaluates the level of compliance of the departmental rules and procedures. It also assures senior management on the adequacy of risk management and internal control framework in the department. Review of the internal control mechanism (ICM) in school education department revealed that ICM in the department was not functioning properly. Cases of over payment of pay and allowances to teachers appointed under `Operation Blackboard Scheme' and irregular payment of grants-in-aid to Government aided educational institutions were noticed. Bank accounts were opened by Drawing and Disbursing Officers (DDOs) in 8 test checked districts without obtaining sanction from competent authority. There was gross deficiency in conducting departmental inspections of offices of District Education Officer (DEO) and Block Education Officer (BEO) and schools. (*para 5.1*)

Following points relate to budgetary control or absence it in the school education department during 2003-04.

Annual Budget Estimates (BEs) were to be prepared in September/October of the preceding year. The Drawing and Disbursing of officers were required to prepare Budget Estimates (BE) and transmit the same to the Heads of Department before September. In 2003-04, it was observed that not a single DEO submitted the BEs in due date. Similar information for the years 1999-2003 were not made available by the CPI. It was further observed that in order to have proper control over expenditure, the monthly expenditure returns (MERs) were required to be obtained from each district but these were never received in time. The CPI prepared the BEs for the year 2003-04 on the basis of assumed figures and submitted these to the Finance Department. (*para 5.1.5*)

Article 205 of the Constitution of India envisages excess expenditure to be regularized by Legislative Assembly. The scrutiny of records revealed that expenditure of 453.49 under grant no. 27 during the year 1999-

200 required regularization from the Legislative Assembly which was not done so far. CPI intimated (January 2005) that excess occurred due to non-receipt of monthly expenditure statement of 2247 DDOs…" (*para 5.1.5*)

Since budgets were prepared on inappropriate assumptions in school education department there were persistent savings during four years ending March 2004 under several grants. "Further in respect of the following schemes the percentage of savings were ranging between 87.5 and 100 as detailed below.

**Table**

| | **Grant no.** | **Scheme detailed head** | **Amount of savings** | **Percentage of savings** |
|---|---|---|---|---|
| 1999-2000 | 27 | 447 Operation blackboard | 8.90 | 100 |
| | | 8768 State share for Rajeev Gandhi Primary Education Mission (RGPEM) | 34.49 | 100 |
| | | 8783 Establishment of 1960 New Middle Schools | 6.89 | 100 |
| | 80 | 8823 Grant to local bodies for Primary Education | 91.50 | 100 |
| 2000-01 | 27 | 447 Operation blackboard | 14.99 | 100 |
| | | 1131 Informal Education | 5.25 | 87.5 |
| | | 8403 Grant for Shiksha Karmi | 11.39 | 90.4 |
| 2001-02 | 80 | 8403 Grant for Shiksha Karmi | 8.50 | 93.9 |
| | | 5056 $11^{th}$ Finance Commission | 8.26 | 100 |

**Transfer of funds to Civil Deposits**

Rule 284 of the M.P. Treasury Code Volume 1 provides that no money shall be drawn from the treasury unless required for immediate disbursement. Nevertheless, Rs. 21.81 crore were drawn and parked under Civil Deposits during these years 2001 to 2003. "The funds were kept under Civil Deposits to shore up the ways and means position of the State Government. Since the Central assistance of Rs. 21.81 crore was not utilized, it was required to be refunded to Government of India. (*para 5.1.6*)

**Unreconciled expenditure**

Financial rules require Departmental Controlling Officers to reconcile periodically the departmental figures of expenditure with those booked by the Accountant General (A&E) to ensure accuracy of accounts, identification of errors, misclassification, misclassification, detection of frauds etc. The reconciliation of the entire expenditure aggregating Rs. 9763.28 crore during 1999-2004 was not done. (*para 5.1.6*)

### MAHARASHTRA 2005-06: ANIMAL HUSBANDRY DEPARTMENT

Large savings under Plan schemes and persistent excess expenditure under Non-Plan schemes indicated that budgetary control was deficient. (*para 5*)

It was seen that grants paid to 16 ZPs in 2002-03, 29 ZPs in 2003-04 and 33 ZPs in 2004-05 were not assessed as of March 2006. Consequently, it could not be ascertained whether any amount remained unspent with the ZPs and grants diverted for other purposes. (*para 5.1.5.2*)

It was however, observed that 10 DDOs in six districts, out of the 54 DDOs in eight districts test checked, did not conduct surprise verification of cash balances, between April 2001 and March 2006 for periods ranging from 10 to 60 months. (*para 5.1.5.5*)

Recovery of loans from poultry c-operative societies was not monitored properly. During 2001-2006, only Rs. 37 lakh had been recovered out of Rs. 61.44 crore due for recovery. (*para 5.1*)

**ORISSA 2003-04: SCHOOL AND MASS EDUCATION DEPARTMENT**

Unnecessary supplementary provision of Rs. 55.88 crore was obtained by the School and Mass Education Department in December 2002 when there were overall savings of Rs. 140.64 crore at the end of March 2003 indicating deficient budgetary control by these departments. (*para 5.1*)

The financial discipline in cash management were not observed by the Drawing and Disbursing Officers. The heads of the administrative departments and controlling officers had also failed to stem the rot. (*para 5.1*)

As of March 2004, five[214] offices of the School of Mass Education Department (SMED) and two[215] offices of the PRD had accumulated credits of Rs. 82.54 crore and Rs. 17.02 crore respectively under civil deposits head by drawing from the budget provisions of the respective service major heads in earlier years (1991-2004) to avoid lapse of funds. All such irregular withdrawals had the approval of the controlling officers of the grants i.e. the Commissioner-cum-Secretary to the Government and in seven cases, had the approval of even the Finance Department. This irregular practice resulted in erosion of legislative control over expenditure, as the drawals from civil deposits in the subsequent years neither required further legislative approval nor were the expenditures incurred subject to legislative authority through the appropriation mechanism. Thus, using the facility of transfer credit from the Consolidated Fund to the civil deposit head violated the basic budgeting discipline. (*para 5.1.7*)

**ORISSA 2004-05: INTERNAL CONTROL MECHANISM IN FINANCE DEPARTMENT**

Internal Control Mechanism (ICM) in an organization is meant to ensure that its operations are carried out according to the applicable laws, rules and regulations in an economical, efficient and effective manner. The Government has an internal control system where the overall financial control (budgetary controls, expenditure controls, internal audit etc.) is exercised by the Finance Department whereas, administrative and operational controls over specific functional activities are exercised by the respective departments themselves. Audit review of the functioning of the ICM during 2001-05 in Finance Department (FD) revealed deficit budgetary and expenditure control, lapses in cash management, inadequate controls in stores management, purchases made without observing the prescribed purchase procedure, and poor operational and supervisory controls in the department. (*para 5.1*)

**Preparation of Budget of the State**

While the FD failed to control its own budget as per the provisions of OBM, it also failed to effectively enforce those provisions while scrutinizing and approving the budget proposals of other Departments. During 2000-05, there were excesses or savings under several Demands for Grants at the end of the year as reflected below.

(Rs. in crore)

| Year | Number of Grants in which there was | | | |
|---|---|---|---|---|
| | Excess | | Savings | |
| | Number of grants/ appropriations | Amount | Number of grants/ appropriations | Amount |
| 2000-01 | 8 | 2474.48 | 38 | 3770.57 |
| 2001-02 | 4 | 393.58 | 37 | 4597.38 |
| 2002-03 | 5 | 2068.93 | 38 | 3704.54 |
| 2003-04 | 2 | Negligible | 40 | 5452.26 |
| 2004-05 | 3 | 9.93 | 40 | 4488.29 |

[214] DEE, Bhubaneswar (Rs. 38.13 crore), DME (Rs. 3.52 crore), DTE (Rs. 3.07 crore), SMED (Rs. 236 crore) and DSE (Rs. 35.46 crore).
[215] PRD (Rs. 197 crore) and PRD(GP) (Rs. 15.05 crore).

| (Total number of grants during this period was 42) |
|---|

**Source:** Appropriation Accounts of the respective years.

This reflected the lack of effective monitoring by the FD to control such excess or savings through monthly reports and/or review meetings. There was lack of control over making a realistic budget and this also affected the expenditure control mechanism adversely. (*para 5..181*)

**Expenditure control through Letter of Credit (LoC) system**

To regulate flow of expenditure for works and to guard against excess expenditure over budget allotment as well as avoid creation of unnecessary liabilities, Government introduced the system of expenditure control through LoC system in April 1968 in Engineering and a few other high spending Departments. The LoC system was to be administered by the Finance Department. After passage of the Budget, the Finance Department would release funds in favour of each Chief Engineer (CE) on the basis of month-wise requisitions placed by him through a LoC. (*para 5.1.19*)

A review of expenditure of Works Department, Water Resources Department, Rural Development Department and Housing and Urban Development Department during the period 2001-02 to 2004-05 revealed that the expenditure continued to exceed the provisions under several detailed heads of accounts despite the LoC system being in operation. (*para 5.1.19*)

This indicated that despite existence of the LoC system, there was no effective control over expenditure by the Finance Department. (*para 5.1.19*)

Special Secretary was not verifiable in Audit. However, the reply of the Finance Department indicated total abdication of the responsibility in enforcing expenditure control through proper monitoring of the LoC system at their level. (*para 5.1.19*)

**Failure to carry out periodic inspections of Treasuries**

According to the Treasury rules, the DTI or a gazetted officer nominated by him was to conduct inspection of treasuries/sub-treasuries at least once in a year. However, out of the 161 Treasuries/Sub Treasuries functioning under his control, there were shortfall in inspections conducted by the DTI ranging from 114 to 154 treasuries/sub-treasuries during 2000-05. The fact however was that, the treasury administration being one of the important financial functions of the Government, the shortfall in inspection by the DTI affected the quality and timeliness of initial accounts rendered by the treasuries to the Accountant General (A&E) and adequacy of checking of entitlement claims etc. The lack of inspection also affected the sense of accountability at the Treasury level. (*para 5.1.21*)

**Local Fund (LF) Audit Organization**

The LF Audit Organisation functions under the authority of the Orissa Local Fund Audit Act, 1948. It conducts Statutory Audit of Panchayati Raj Institutions (PRIs) and Urban Local Bodies (ULBs) and Non-statutory Audit of Aided Educational Institutions, Universities, Board of Secondary Education, Council of Higher Secondary Education, Religious Endowments and some miscellaneous institutions receiving Government Grants, on 100 percent basis. (*para 5.1.25*)

The following deficiencies were noticed in the functioning of LFA.

- The LFA did not have an audit manual for its auditors.
- No watch register was maintained to watch the receipt of compliance from the auditee units.
- No review meetings were held with the local bodies/authorities by the higher management of ensuring early compliance to audit reports.
- No consolidated reports on outstanding audit reports and paragraphs was prepared at the departmental level.

**TAMIL NADU 2003-04: HEALTH AND FAMILY WELFARE DEPARTMENT**

Scrutiny of cash books maintained by the Directorate disclosed drawl of funds from the Treasury far in excess of immediate requirement, as evidenced by the huge balance in cash and in bank. (*para 5.1.6 of the Report*)

"Funds were drawn far in excess of requirement, contrary to the codal provisions, to avoid lapse of budget grant". (*para 5.1.7*)

The expenditure incurred during March 2002 was 56 to 85 percent in respect of three Heads of Account. The expenditure incurred during March 2003 in respect of two Heads of Accounts was 63 percent and 71 percent respectively. The Government did not adduce any reason for the rush of expenditure. (*para 5.1.20*)

**Internal Audit System**

The internal audit of all the Government Departments is headed by the Chief Internal Auditor & Chief Auditor of Statutory Boards (CIA & CASB). However, his oversight of internal audit is through Heads of Department to whom the internal audit wings report. (*para 5.1.21*)

The audit staff of the Director of Public Health and Preventive Medicine comprises one Internal Auditor (Assistant Director/IA), one Superintendent, three Assistants and three Junior Assistants for one static audit party and five Superintendents and eight Assistants for touring audit parties. (*para 5.1.22*)

The draft Internal Audit Manual in respect of DPH & PM was prepared and sent to Government for approval by CIA & CASB during August 1999. However, approval of Government was awaited (August 2004). (*para 5.1.24*)

No training was imparted to the personnel posted to Internal Audit Wing and no criteria was fixed by the Directorate for posting of personnel to Internal Audit Wing. It could not, therefore, be verified by Audit whether the personnel in the Internal Audit Wing has possessed requisite specialized knowledge for conducting audit in an effective manner. [*para 5.1.28*]

Under the audit purview of Internal Audit Wing there are 77 institutions and 384 Block PHCs. No data were available regarding arrears in audit of PHCs, at the time of transfer of control of PHCs from DM & HS to DPH & PM with effect from March 1996. [*para 5.1.29*]

Audit also observed that there was no planning for audit of institutions other than the PHCs. This is also evidenced by the fact that in respect of 21 institutions audit was in arrears ranging from two to 13 years. (*para 5.1.31*)

The above position would indicate that there was no audit planning at all and the audit was taken up as and when found necessary and on adhoc basis. (*para 5.1.33*)

The audit parties were diverted for other works in Directorate such as verification of service registers, pay fixation, pay anomaly, regularization of service etc. (*para 5.1.38*)

The effectiveness of the internal audit in the DPH and PM was diluted due to various factors like non-availability of internal audit manual, vacancies in audit posts, utilization of audit staff for work other than audit and *adhoc* planning for audit of various institutions. (*para 5.1.39*)

**TAMIL NADU 2003-04: SMALL INDUSTRIES DEPARTMENT**

Faulty preparation of budget by the Department resulted in persistent savings ranging between 36 and 41 percent under revenue heads during 2003-06 mainly on account of provision made for the vacant posts in the budget estimates in violation of the financial rules. Wrong provision of funds resulted in surrender of Rs. 7.35 crore during 2002-06. (*para 5.1*)

Cash management was defective as there was no physical verification of cash by the head of offices and cash books were not written regularly. (*para 5.1*)

Quarterly inspection of 77 industrial cooperative societies was in arrears in five sample districts as of January 2006. (*para 5.1*)

Internal audit wing was understaffed and there were arrears in internal audit of units even upto six years. (*para 5.1*)

**UTTAR PRADESH 2003-04: PUBLIC WORKS DEPARTMENT**

Lump sum provisions in the budget delayed communication of financial and administrative approvals to the divisions which led to underutilization and diversion of funds. (*para 5*)

Failure of the Divisional Officers in observing the conditions for incurring the expenditure and Controlling Officers in watching the progress of expenditure led to an excess of Rs. 478.54 crore over the allotment of funds during 2001-04. (*para 5*)

Non-adjustment of temporary advances and non-clearance of balances under Miscellaneous Work Advances aggregating Rs. 17.01 crore in the test-checked divisions indicated lack of necessary control. (*para 5*)

Utilisation of grants through irregular stock adjustments by the divisional officers was a serious breach of financial discipline. (*para 5*)

The Department failed to provide adequate quality assurance in respect of works executed by it, in the absence of adequate number of quality control tests in the departmental laboratories. (*para 5*)

Internal Audit arrangement in PWD was at the nascent stage and yet to be equipped with adequate manpower, professional skills and methodologies to achieve its objectives. (*para 5*)

**UTTAR PRADESH 2004-05: SECONDARY EDUCATION DEPARTMENT**

In the absence of effective controls for monitoring expenditure, savings aggregating Rs. 309.14 crore were not surrendered to the Finance Department in time for utilization in other sectors in the respective financial years. (*para 5*)

The Government redesignated (January 2003) the Director Departmental Accounts as Director Internal Audit (DIA), and assigned duties and responsibilities for implementation of the policies of internal audit, auditing standards, training of staff, monitoring of audit reports and over all effectiveness of internal audit to him. (*para 5.9*)

FC was responsible for framing Internal Audit Manual containing guidelines for planning and conduct of audit and was also required to frame an annual calendar of work. Records revealed that no work on these areas was done by the FC nor did he issue any instructions in this regard to RIAU. DIA had asked (March 2004) the Department to send its annual calendar and work plan of the Internal Audit Wing but it was not furnished to him due to non-maintenance of required information. (*para 5.9.1*)

Headquarters unit of Internal Audit was dealing with only complaint cases. During 2002-05, although special audit of 319 complaint cases received was done by it, no follow up action was taken on the reports in any of the cases. (*para 5.9.1*)

**WEST BENGAL 2004-05: ANIMAL RESOURCES DEVELOPMENT DEPARTMENT**

**Budgeting procedure ignored**

West Bengal Financial Rules (WBFR) envisaged that each budgeting authority was required to prepare budget estimates (BE) on the basis of actuals of the previous year, revised estimate of the current year and to submit the same to the Finance Department (FD) within 15 October each year. Scrutiny revealed that the department sent its estimates to FD after a delay of one to two months. In absence of proper monitoring and pursuance the DDOs were not submitting monthly expenditure statements showing allotment, expenditure and balances to the directorates. Further, out of 389 DDOs of the two directorates, only 123 to 57 DDOs submitted the expenditure statements during 2000-2005. As a result, the budget estimates were prepared on *ad-hoc* basis by adding 10 percent to previous year's allocations under different heads of accounts. The Department also failed to prepare departmental accounts and to reconcile the same with those booked by the Accountant General (Accounts & Entitlement) as required under Rule 385 of WBER. The *proforma* accounts of the commercial activities of the Directorate of Dairy Development were also not prepared before preparation of the budget. As a result, actual expenditure incurred and revenue collected during previous year were not considered for preparing the budget estimates. (*para 5.1.6*)

| | **Budget provision** | | **Expenditure (Rs. in crore)** | | **Savings** | |
|---|---|---|---|---|---|---|
| **Year** | **Revenue** | **Capital** | **Revenue** | **Capital** | **Revenue** | **Capital** |
| Total | 1482.54 | 36.51 | 1210.31 | 8.88 | 272.23 | 27.63 |

Rule 389A of WBER provides that rush of expenditure particularly in the closing month of the financial year will be regarded as a breach of financial regularity. Test-check revealed that-

- 66 to 100 percent of budget provisions during 2002-2005 for 35 schemes were sanctioned and released to held offices in the month of March of respective years thereby enhancing the possibility of imprudent spending.

A review of VLC data for the years from 2002-2003 to 2004-05 revealed that 42 to 50 percent of revenue expenditure excluding salary and 90 to 100 percent of capital expenditure were incurred by the Department in the month of March of the respective years, flouting the financial rules. (*para 5.1.8*)

Due to failure in utilization of fund in the respective financial years (2000-2005), scheme funds aggregating Rs. 13.41 crore were parked in the deposit account of DAIRPOUL.[216] Similarly, out of GOI grants of Rs. 8.60 crore received during 2003-05 for 17$^{th}$ Quinquennial livestock. Census, Rs. 3.18 crore were transferred to the Deposit Account of DAIRPOUL to avoid surrender of GOI grants. (*para 5.1.9*)

The Department neither formulated any auditing standard nor prepared any audit plan and internal audit manual. No register to monitor number of auditable units and periodicity of audit was maintained either. No action was also taken to impart training to audit personnel. (*para 5.1.33*)

The audit findings are communicated through Inspection Reports (IRs) to the heads of the offices/departments to comply with the audit observations and rectify the defects under intimation to the Principal Accountant General. As of 31 March 2005, 472 paragraphs relating to 125 Inspection Reports (IRs) issued upto 31 December 2004 were awaiting settlement. Of these 125 paragraphs relating to 49 Inspection Reports were more than 10 years old. (*para 5.1.34*)

Internal controls in the department were inadequate and ineffective. Due to deficient budgetary and expenditure controls, budget estimates were not realistic and there were huge savings of allotted funds coupled with rush of expenditure in the month of March. (*para 5.1.35*)

**WEST BENGAL 2005-06: COTTAGE AND SMALL SCALE INDUSTRIES DEPARTMENT**

[216] West Bengal Dairy and Poultry Development Corporation Limited, a State Government Undertaking.

Non-observance of budgeting procedure such as compilation of inputs from field offices, consideration of previous year's expenditure and actual men on roll, etc. made the budget provisions unrealistic and resulted in savings during each of the years 2001-2006. (*para 5.1.1*)

During 2002-2006, 43 to 88 percent of revenue expenditure excluding salary and 30 to 96 percent of capital expenditure were incurred by the department in the month of March of the respective years. (*para 5.1.1*)

The department neither maintained any loan register nor introduced any computerized database for loan management. The terms and conditions of 506 loans amounting to Rs. 184.13 crore sanctioned to ten units (three under closure) had not been settled and as a result recovery of these loans could not be ensured. (*para 5.1.1*)

Owing to lack of effective pursuance, the department failed to recover overdue instalments of principal and interest aggregating Rs. 23.80 crore from co-operative societies/SSI units/entrepreneurs. Of this, there was no scope for recovery of Rs. 5.70 crore from 799 defunct Co-operative societies in three test-checked districts. (*para 5.1.1*)

**GUJARAT 2005-06: INDUSTRIES AND MINES DEPARTMENT**

Against the outlay of Rs. 3025.41 crore during 2001-06, expenditure was Rs. 1788.08 crore only and unspent balances under Central schemes were credited to State accounts in violation of the codal provisions. (*para 5.1*)

Gujarat Treasury Rules (GTR) provides that all monetary transactions should be entered in the cash book as soon as they occur and attested by the head of office in token of checks. However, scrutiny of records of DIC, Ahmedabad revealed that grants amounting to Rs. 8.96 crore received during 2002-06 towards payment of subsidy to cottage industries, bankable loan and contingency and subsidy under Prime Minister's Rojgar Yojna; were spent without routing through cash book and instead the transactions were only entered in a Register and transactions were also not authenticated. (*para 5.1.6.1*)

As per terms and condition of payment of subsidy, the subsidy paid would be recoverable from the units not functioned for the minimum period of five years. A test check of records revealed that in all 569 industrial units, to whom IC paid subsidies aggregating to Rs. 12.33 crore, were closed as at the end of 2005-06. Only Rs. 13.54 lakh were recovered from the total amount of Rs. 12.65 crore that was recoverable, leaving a balance of Rs. 12.33 crore unrecovered. DIC, Rajkot had not maintained any records regarding the number of closed units and consequentially, recoveries were pending since 1994; and during 2001-06. DICs Gandhinagar and Junagadh have not effected any recovery of subsidy from the 45 closed industrial units. (*para 5.1.8.4*)

**RAJASTHAN 2005-06: SOCIAL WELFARE DEPARTMENT**

There were savings of Rs. 207.69 crore under non-plan during 2001-05 mainly due to formulation of budget based on sanctioned strength instead of working strength and Rs. 23.57 lakh were unnecessarily drawn during 2004-06 to avoid lapse of budget. During the years 2001-06, expenditure in the month of March constituted 25 to 36 percent of the total expenditure of the relevant year. (*para 5.1*)

Rule 59 of GF&AR requires all Drawing and Disbursing Officers (DDOs) to arrange reconciliation of remittances made in a month into treasury within a month. Audit observed that except DPSWO, Rajsamand and the Directorate at Jaipur, none of the other 11 DDOs test checked carried out reconciliation with treasury. This increases the risk of discrepancies and fraud, if any, going unnoticed. (*para 5 .1.7.2*)

Internal audit was rendered ineffective as only 29 percent of units due was conducted during 2005-06 and 1,675 internal audit reports containing 9,821 paras were pending for settlement as of 31 March 2006. In the absence of a vigilance cell in the Department, no discipline or accountability could be enforced. (*para 5.1.10*)

**PUNJAB 2005-06: INTERNAL CONTROL SYSTEM**

Cash management was deficit as neither the cash balances were verified by the head of the office nor the bill-wise details of the undisbursed amount was worked out against monthly closing balances of the cash book. (*para 5.1*)

As per instructions (May 1989) issued by Government of Punjab, DST was responsible to maintain General Provident Fund accounts. As per instructions, total figures of receipts and interest should be intimated to the Finance Department by the end of June for onward transmission to Accountant General (A&E) Punjab for compilation purposes. The consolidated statement of receipts and interest for the period 2002-05 had not been sent. This lack of internal control could give rise to inflated credits and deflated debits which could cause overdrawal from the fund, the reverse would affect the interests of the employees. (*para 5.1.6*)

The following irregularities in maintenance of the Punjab Government Employees GIS 1982 were noticed in Audit:

i. The DST had not received consolidated statements from the depots etc., for the last five years ending 2005-06 showing details of total amount of subscription received in the Saving Fund and Insurance Fund and payments made out of these funds to employees who resigned/retired or otherwise ceased to be in Punjab Government service or died in harness.

ii. Total amount credit and debited in the Saving and Insurance Fund accounts were not reconciled with the figures booked in the office of the Accountant General (A&E) Punjab on quarterly basis and certificate to this effect was not recorded on the broadsheet maintained by the DST, for the period 2002-06. (*para 5.1.7*)

Internal controls viz., Cash controls, Administrative controls, Operational control, Store and Inventory controls were inadequate and ineffective in the department. Cash books were not maintained as per rules and these were not verified and signed by the Head of office at the end of each month. The lack of Administrative control led to improper maintenance of General Provident Fund and Group Insurance Scheme accounts, as consolidated statements were not sent to Finance Department/Accountant General (A&E) Punjab. (*para 5.1.21*)

**CONCLUDING OBSERVATION**

The audit observations have been quoted to indicate the failure of internal control system in its several aspects. It is clear that internal audit of the Departments under audit, have been given scant attention by the departmental heads, resulting in multiple failures. Only test checks have been conducted by external audit. A full scale audit would have indicated large number of lapses. Since internal audit is under large arrears in most of the states, the real picture regarding financial management in the states, at the departmental level is yet to emerge. These results have come are on account of audit check on internal control mechanism only.

There are major objections under `Transaction Audit Results’ in the next appendix.

These are extracts from audit reports of the Comptroller Auditor General for the years 2003-04 to 2006-07 on the results of transaction audit of various state governments to give a general idea of the failures in financial management. Only one department in a state is picked up for particular year by the state AG for transaction audit purposes. Therefore, this may not be reflective of general state of affairs of financial management in the state government; though it may give an idea of the nature of weaknesses that are present in the system.

## TRANSACTION AUDIT RESULTS

### ANDHRA PRADESH 2005-06: NON-ADJUSTMENT OF ABSTRACT CONTINGENT BILLS

According to the orders issued by Government (March 2002), the advances drawn on Abstract Contingent (AC) Bills should be settled by submitting Detailed Contingent (DC) Bills to the Accountant General (A&E)/Pay and Accounts Officer for the expenditure incurred with supporting vouchers, within three months. The Director Treasuries and Accounts reiterated these order in a circular memo issued to all District Treasury officers and instructed them to watch the receipt of DC Bills. However, Rs. 804.23 crore drawn in 1.25 lakh AC Bills during he period 1978-79 to 2005-06 have not been adjusted as of June 2006. This indicated that the orders issued by the Government were disregarded by large number of Drawing and Disbursing Officers and also Treasury Officials.

Test check of the records of District Educational Officers, Adilabad, Chittoor and Warangal disclosed that Rs. 14.36 crore drawn in 43 AC Bills between December 1983 and March 2004, AC Bills worth (a) Rs. 0.48 crore were not adjusted as the relevant vouchers and files were missing (b) Rs. 7.86 crore were not adjusted as the unit officers did not submit expenditure particulars along with vouchers (c) Rs. 3.58 crore were adjusted based on the utilization certificates instead of expenditure particulars and paid vouchers and (d) unspent balances of Rs. 1.87 crore were kept in Bank accounts instead of remitting to Government account while Rs. 0.57 crore were remitted to Government account with a delay ranging between one and five years (*para 2.3.1*)

Financial rules prohibit drawal of money from treasury unless required for immediate disbursement.

Test check of 14 offices under departments revealed that out of Rs. 19.59 crore drawn during the period 2003-06, Rs. 2.46 crore were retained in Personal Deposit account and Rs. 12.91 crore in Savings Bank/Fixed Deposit/Current account. Reasons for non-remittance of unspent balances to Government account were not furnished. (*para 2.3.10*)

The Contingency Fund of Andhra Pradesh created with a corpus of Rs. 50 crore is meant for the purpose of meeting unforeseen expenditure including expenditure on a new service not contemplated in the budget pending authorization of such expenditure by the State Legislature.

During 2005-06, Rs. 4.99 crore was drawn from Contingency Fund of which Rs. 0.79 crore remained unrecouped at the end of the year.

The Municipal Administration and Urban Development Department drew ()March 2006) Rs One crore to meet the subsidy on interest component charged by Financial Institution on the loans raised by Self Help Groups after 1 July 2005. The liability of subsidy on interest component arises only from the year 2006-07 onwards and the Commissioner and Director of Municipal Administration (CDMA) advised Government to meet this expenditure through Budgetary support during 2006-07. However, Government ordered for drawl of amount from Contingency Fund and to deposit the same in Personal Deposit (PD) account of CDMA. When the nature of expenditure could be foreseen, and the amount was also not required for immediate disbursement the drawl of advance from Contingency Fund was unnecessary. (*para 2.3.11*)

The accounts of the State compiled by the Accountant General (Accounts and Entitlements) should reflect the correct and true state of affairs and this could be ensured only when the departments incurring expenditure periodically reconcile the departmental figures of expenditure with those booked by the Accountant General. Timely reconciliation will also help to detect fraudulent drawl of money or any misappropriations. However, for 2005-06, expenditure of Rs. 44210.39 crore remained unreconciled as of June 2006 in respect of 27 departments. The expenditure not reconciled was Rs. 1000 crore and above in each of the following departments (*para 2.3.13*)

**KARNATAKA 2005-06:**

Failure of the Department to regulate payments to the contractor in accordance with the terms of agreement resulted in excess payment of Rs. 3.58 crore. (*para 4.2.3*)

The Department paid Rs. 53.52 lakh to a contractor which was inadmissible as per terms of agreement. (*para 4.2.4*)

**MAHARASTRA 2005-06: WATER RESOURCES DEPARTMENT**

Land valued at Rs. 2.12 crore was distributed to 258 ineligible beneficiaries under Karmaveer Dadasahed Gaikwad Sabalikaran and Swabhiman Yojana. (*para 4.1.6*)

Failure in enforcing the provisions of an agreement resulted in short recovery of shipping fees of Rs. 1.59 crore and undue benefit of Rs. 67.42 lakh to a licensee. (*para 4.2.1*)

**ORISSA 2005-06: WATER RESOURCES DEPARTMENT**

Subsidised rice weighing 1345 MT valuing Rs. 1.68 crore received under Food for Works (FFW) Programme was allegedly misappropriate by an Assistant Engineer. (*para 4.1.1*)

**Rural Development Department**

Item rate of Water Bound Macadam (WBM) was computed incorrectly resulting in an undue benefit of Rs. 16.07 crore to contractors. (*para 4.3.1*)

**Works Department**

Undue financial benefit of Rs. 4.39 crore was extended to M/s Orissa Bridge & Construction Corporation by over loading the current concrete rates with inadmissible items. (*para 4.3.4*)

Government dues of Rs. 2.02 crore was not recovered from a contractor who had defaulted in completion of a High Level Bridge. (*para 4.3.5*)

**Water Resourced Department**

Failure to penalize a defaulting contractor and non-initiation of suitable action to recover the outstanding dues led to loss and non-recovery of Rs. 34.44 crore. (*para 4.3.6*)

**PUNJAB 2005-06: IRRIGATION AND POWER DEPARTMENT**

Failure of the Executive Engineer to follow the procedure laid and observe codal provisions and instructions issued for handling government money, facilitated embezzlement of Rs. 70.30 lakh. The provision in the Punjab Financial Rules were flouted. (*para 4.1.1*)

Non-adherence to prescribed rules in handling cash facilitated embezzlement of Rs. 15.30 lakh. (*para 4.1.2*)

**Industries and Commerce Department**

Grant of exemption certificate in violation of provisions of Industrial Policy 1996 resulted in loss of Rs. 1.01 crore to State exchequer. (*para 4.1.3*)

**Food and Civil Supplies Department**

Failure to make payments to the rice millers in time by the department despite its receipts from FCI resulted in avoidable payment of interest amounting to Rs. 2.12 crore, under court orders. (*para 4.2.1*)

**RAJASTHAN 2005-06: FINANCE DEPARTMENT**

Failure of the Treasury Officers to exercise prescribed checks led to excess/irregular payment of pension/family pension aggregating Rs. 1.79 crore. (*para 4.1.3*)

**TAMIL NADU: 2005-06**

Payment of Rs. 96.61 lakh was made by recording fictitious measurements towards receipt of materials and execution of works. (*para 4.1.1*)

Government of Tamil Nadu sanctions block grants every year to universities to meet committed expenditure on a net deficit basis with reference to their normal annual income and expenditure as certified by the Director of Local Fund Audit (Director). (*para 4.2.3*)

Government, while releasing (March 2001) grant for the year 2000-01, directed the Registrar, Periyar University to obtain and send audit certificate from the Director for further release of grants. The State Government continued to release the block grant without verifying the net deficit with reference to normal income and expenditure and thus also disregarded its instructions. The audit of the accounts of the university conducted revealed that the university had net surplus funds during 2001-05 and therefore was ineligible to received block grants. (*para 4.2.3*)

The University, while receiving ineligible grants from the Government during 2001-04 as brought out above, did not employ its surplus funds in a gainful manner. (*para 4.2.3*)

**UTTAR PRADESH: 2005-06**

Embezzlement of Rs. 53.42 lakh by fraudulently drawing pay and allowances of six fictitious medical officers who were not attached with the office of the Chief Medical Officer Rae Bareli, revealed through test check of records (October-November 2005). During discussion (October 2006) the Government accepted the embezzlement of Rs. 53.42 lakh and stated that FIR had been lodged against four officials with the police and charge sheets were served against other six officers including the Administrative Officer. The point is these irregularities were not detected in internal audit, but was revealed through test checks by external audit. (*para 4.1.1*)

Posting of 42 personnel on fake transfer orders led to fraudulent payment of Rs. 35.24 lakh. (*para 4.1.2*)

Despite Government orders, material approved for use in strengthening of a road was submitted by a costlier material which led to avoidable extra expenditure of Rs. 2.42 core. (*para 4.3.1*)

**WEST BENGAL 2005-06: HEALTH AND FAMILY WELFARE DEPARTMENT**

Failure of internal control resulted in doubtful procurement and suspected leakage of chemicals worth Rs. 4.66 crore by way of fake entries and intentional omission of closing balance during 1996-2003.

The West Bengal Financial Rules provide that the expenditure should be kept within the limits of the authorized appropriation and that all purchases must be made in accordance with the definite requirements of the public service. In contravention of the aforesaid rules the Director, Institute of Post Graduate Medical Education and Research (IPGMER), Kolkata purchased chemicals and equipment during the period 1999-2004 in excess of budget provision incurring a liability of Rs. 6.72 crore as of May 2006.

Test-check of vouchers against supply of chemicals along with the store ledger and store issue vouchers (SIV) during December 2005 and June 2006 showed the gross irregularities.

Cross-verification of SIVs in the store and its carbon copies in the respective departments disclosed that those items were neither requisitioned nor received by the departments concerned. The items of chemicals shown as supplied in store ledger were inserted in SIVs either in between the lines or in the black space. However, the same entries could not be traced in the carbon copy. The physical verification of stock of stores carried out in December 2002 and April 2004 also testified the non-existence of those items in ground stock. Payments particulars of suppliers were not furnished to audit for payment of Rs. 35.63 lakhs.

Similarly, fake issue of chemicals amounting to Rs. 3.36 crore between January 2002 and October 2002 to eight departments was noticed. These chemicals had neither been requisitioned nor received by the concerned departments. (*para 4.1.1*)

## Annexure 6.1
## Treasury Computerization in States

### KARNATAKA

Under the 'Khajane' project of computerization of treasuries in Karnataka operational from 2002 all the 216 treasuries are networked to a central server through VSAT technology. An access to classified accounts has been given to the accountant general of the state. The bill validation and clearance process across the state is monitored online by the central Server. Transparency has improved with the introduction of FIFO for Bill Clearance and IVRS system to inform the status of the bill in the Treasury over telephone to the general public and departmental officers. The data captured at the time of bill entry itself is used for generation of classified accounts and various FMIS reports. Strict Budget control and ways and means control are exercised through the system. Comprehensive expenditure reports for various schemes and programmes are generated on real time basis. The discretionary power of the treasury officers have been brought down to minimum, only to the extent of ticking bill enclosures and certificate on the bills. Online Fund Transfer facility has been provided to urban local bodies and deposit accounts holders. The system generates classified monthly accounts and a comprehensive management information system (MIS) reports for the use of Finance, Planning and other departments.

### MADHYA PRADESH.

In Madhya Pradesh all the treasury activities have been computerized and all the treasuries are networked to the central treasury server. The bill clearance system operates online and budget control is inbuilt in the system. Number of reports is being generated for the use of finance and other departments. The computerized treasury system in Madhya Pradesh is used to collect of taxes and non taxes in Bhopal city and through this system net banking facility is extended in cooperation with the agency banks. Madhya Pradesh has also introduced an innovative system of payments in departments like public works, irrigation, and forest by monitoring the LOC issued to these departments.

**ORISSA**

In Orissa all the treasury activities has been computerized and all the treasuries are networked to the central treasury server. This has interfaces with budget module, payroll and pension database. Budget allocation, disbursement and control are integrated with treasury system. The bill clearance system operates on line. Numbers of reports are generated for the use of finance and other departments

**TAMILNADU**

All the treasuries activities in the state have been computerized. The treasury bill passing system is automated and pay bills are generated through a central server In major district treasuries. All salary and non salary payments are either through ECS system or by crediting to employees account through cheques. The pension payment in state is centralized, which operates through the ECS system. The computerized treasury system renders compiled accounts to AG online. Tamil Nadu is also planning a treasury portal to facilitates e-remittances and e- refunds

**UTTAR PRADESH**

Although all the treasury activities are computerized in the state there is no online facility for bill clearance. The connectivity is proposed to be established in a phased manner. The bills are pre checked in the stand alone systems in the treasury. One major changes made in Uttar Pradesh is that the number of DDOs is reduced. Most of the payments are made in the district treasuries either by sending cheques or through ECS or Core Banking system wherever the facilities are available. The financial management information system in Uttar Pradesh is **KOSHAVANI**. The daily details of receipt and expenditure are sent to a server located in state finance department in electronic format. Some times they are sent through NIC net. The region wise/district wise details of receipt and expenditure details are made available through web access. The pensions are also directly sent from the treasuries.

**MAHARASHTRA**

Maharashtra has computerized its treasury activities. However, there is no online facility for bill clearance. Efforts are being made to establish the connectivity. The bills are pre checked in the stand alone systems in the treasury for budget availability and other system validations. The daily details of receipts and payments are sent to central server called **KOSH VAHINI** in finance department either through NIC net or through floppies. KOSH VAHINI could be accessed through WEB. The departmental officers can see the receipt and expenditure reports department wise, scheme wise, district wise .they can also get the details up to cahllan and voucher level. The salary and pension payment has been centralized at district treasury level. When the state wide area network is operational, all the treasuries will be networked and they will switchover to online bill passing through the central server.

**GOA**

All the treasury activities in the state are computerized. Goa has a unique system. The Director of accounts acts as Director of treasuries, Director of pensions, and Accountant general for the state. Since the same office is dealing with all these function, most of the integration is already in place. May be because of small size of the state, this system was possible. Another feature is that the payments are made only in two district treasuries, after pre audit. This has enabled them to have a strict budget monitoring.

**UTTARANCHAL**

In Uttaranchal the treasury activities have been computerized. The state has a good human resource database which has been very well integrated with the treasury database. The treasury officers have been authorized to act as pay drawing officers for all the departments. The responsibility of departmental officers is only to update the HRMS database regularly. The treasuries automatically generate E- pay bill from the system and credit the salaries to individual employee’s bank accounts. Similarly even the Pension payment has been centralized and pension also directly goes to pensioner’s bank account from the treasuries. The system generates various expenditure reports and accounts for the use of Finance, Administrative departments and Accounts to Accountant general.