Second Administrative Reforms Commission
Government of India

2nd Floor, Vigyan Bhawan Annexe, Maulana Azad Road, New Delhi 110 011
e-mail : arcommission@nic.in website : http://arc.gov.in

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STRENGTHENING FINANCIAL MANAGEMENT SYSTEMS

14

सत्यमेव जयते

FOURTEENTH REPORT

SECOND ADMINISTRATIVE REFORMS COMMISSION

STRENGTHENING FINANCIAL MANAGEMENT SYSTEMS

APRIL 2009

GOVERNMENT OF INDIA

SECOND ADMINISTRATIVE REFORMS COMMISSION

FOURTEENTH REPORT

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APRIL 2009

Government of India
Ministry of Personnel, Public Grievances & Pensions
Department of Administrative Reforms and Public Grievances

Resolution

New Delhi, the 31st August, 2005

No. K-11022/9/2004-RC. — The President is pleased to set up a Commission of Inquiry to be called the Second Administrative Reforms Commission (ARC) to prepare a detailed blueprint for revamping the public administration system.

2. The Commission will consist of the following :

(i) Shri Veerappa Moily - Chairperson
(ii) Shri V. Ramachandran - Member
(iii) Dr. A.P. Mukherjee - Member
(iv) Dr. A.H. Kalro - Member
(v) Dr. Jayaprakash Narayan - Member*
(vi) Smt. Vineeta Rai - Member-Secretary

3. The Commission will suggest measures to achieve a proactive, responsive, accountable, sustainable and efficient administration for the country at all levels of the government.

The Commission will, inter alia, consider the following :

(i) Organisational structure of the Government of India
(ii) Ethics in governance
(iii) Refurbishing of Personnel Administration
(iv) Strengthening of Financial Management Systems
(v) Steps to ensure effective administration at the State level
(vi) Steps to ensure effective District Administration
(vii) Local Self-Government/Panchayati Raj Institutions
(viii) Social Capital, Trust and Participative public service delivery
(ix) Citizen-centric administration
(x) Promoting e-governance
(xi) Issues of Federal Polity
(xii) Crisis Management
(xiii) Public Order

Some of the issues to be examined under each head are given in the Terms of Reference attached as a Schedule to this Resolution.

4. The Commission may exclude from its purview the detailed examination of administration of Defence, Railways, External Affairs, Security and Intelligence, as also subjects such as Centre-State relations, judicial reforms etc. which are already being examined by other bodies. The Commission will, however, be free to take the problems of these sectors into account in recommending re-organisation of the machinery of the Government or of any of its service agencies.

5. The Commission will give due consideration to the need for consultation with the State Governments.

6. The Commission will devise its own procedures (including for consultations with the State Government as may be considered appropriate by the Commission), and may appoint committees, consultants/advisers to assist it. The Commission may take into account the existing material and reports available on the subject and consider building upon the same rather than attempting to address all the issues ab initio.

7. The Ministries and Departments of the Government of India will furnish such information and documents and provide other assistance as may be required by the Commission. The Government of India trusts that the State Governments and all others concerned will extend their fullest cooperation and assistance to the Commission.

8. The Commission will furnish its report(s) to the Ministry of Personnel, Public Grievances & Pensions, Government of India, within one year of its constitution.

Sd/-
(P.I. Suvrathan)
Additional Secretary to Government of India

*Dr. Jayaprakash Narayan – Member, resigned with effect from 1st September, 2007
(Resolution No. K.11022/26/207-AR, dated 17th August, 2007).

ORGANISATION

Second Administrative Reforms Commission

1. Dr. M.Veerappa Moily, Chairman*
2. Shri V. Ramachandran, Member**
3. Dr. A.P. Mukherjee, Member
4. Dr. A.H. Kalro, Member
5. Dr. Jayaprakash Narayan, Member***
6. Smt. Vineeta Rai, Member-Secretary

Officers of the Commission

1. Shri A.B. Prasad, Additional Secretary
2. Shri P.S. Kharola, Joint Secretary#
3. Shri R.K. Singh, PS to Chairman#
4. Shri Sanjeev Kumar, Director
5. Shri Shahi Sanjay Kumar, Deputy Secretary

**Dr. M. Veeerappa Moily – Chairman, resigned with effect from 1st April, 2009*
(Resolution No.K-11022/26/2007-AR, dated 1st April, 2009)
***Shri V. Ramachandran was appointed Acting Chairman*
(Resolution No. K-11022/26/2007-AR, dated 27th April, 2009)
****Dr. Jayaprakash Narayan – Member, resigned with effect from 1st September, 2007*
(Resolution No.K-11022/26/2007-AR, dated 17th August, 2007)
 # Till 31.03.2009

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LIST OF ABBREVIATIONS

Abbreviation	Full Form
AME	Annually Managed Expenditure
ATNs	Action Taken Notes
BIA	Board of Internal Aduit
C&AG/CAG	Comptroller and Auditor General of India
CAPART	Council of Advancement of People's Action and Rural Technology
CAS	Core Accounting System
CAs	Controller of Accounts
CBS	Core Banking Systems
CCAs	Chief Controller of Accounts
CDA	Controller of Defence Accounts
CEO	Chief of Excellence for Internal Audit
CFSS	Consolidated Fund Standing Services
CGDA	Comptroller General of Defence Accounts
CIA	Chief Internal Auditor
COA	Chart of Accounts
COPU	Committee on Public Undertakings
CSR	Comprehensive Spending Review
CSS	Centrally Sponsored Schemes
DDO	Drawing and Disbursing Officer
DEL	Departmental Expenditure Limited
DFPR	Delegation of Financial Power Rules
DoH	Department of Health
DoIT	Department of Information Technology
DRDA	District Rural Development Agency
EU	European Union
EYF	End Year Flexibility
FA&CAO	Financial Adviser and Chief Accounts Officer?
FRA	Fiscal Responsibility Act
FRAB	Financial Reporting Advisory Board
FRBM	Fiscal Responsibility and Budget Management
GAR	Government Accounting Rules
GASAB	Government Accounting Standards Advisory Board
GDP	Gross Domestic Product

GFR	General Financial Rules
GOI	Government of India
GPRA	General Performance Results Act
IFAs	Integrated Financial Advisers
IFMIS	Integrated Financial Management Information System
IFRS	Integrated Financial Reporting Standards
IGs	Inspector Generals
IIA	Institute of Internal Auditors
MCI	Medical Council of India
MEP	Monthly Expenditure Plan
MoF	Ministry of Finance
MOU	Memorandum of Understanding
MTEF	Medium-term expenditure framework
MTFP	Medium Term Fiscal Plan
NDPBs	Non-departmental public bodies
NeGP	National e-Governance Plan
NGOs	Non Governmental Organizations
NIF	National Insurance Fund
NIPB	National Institute of Public Finance & Policy (Mimeo)
NIPFP	National Institute of Public Finance and Planning
NMAM	National Municipal Accounts Manual
NPA	National Performance Assets
OECD	Organisation for Economic Co-operation and Development
PAC	Public Accounts Committee
PAO	Principal Accounts Officer
PHED	Public Health Engineering Department
PPBS	Planning, Programming and Budgeting System
PRI	Panchayati Raj Institution
PSUs	Public Sector Undertakings
PWD	Public Works Department

QEA	Quarterly Expenditure Allocations
RBI	Reserve Bank of India
SIAFI	Integrated System of Federal Government Financial Administration (Brazil)
TME	Total Managed Expenditure
USA	United States of America
ZBB	Zero-based Budgeting

1

INTRODUCTION

1.1 One of the terms of reference of the Second Administrative Reforms Commission is 'Strengthening financial management systems'. It has been specifically asked to look into the following aspects of financial management systems:

> *"4. Strengthening Financial Management Systems*
>
> *4.1 Capacity building in financial management systems at all levels of Governance, to ensure smooth flow of funds for programmes / projects, proper maintenance of accounts and timely furnishing of necessary information / documents for this purpose.*
>
> *4.2 Strengthening of internal audit systems, to ensure proper utilisation of funds for the purposes/outcomes for which they have been provided, and checking that unit cost of delivery/ outcome is as per benchmark developed for this purpose.*
>
> *4.3 An institutionalised method of external audit and assessment of the delivery and impact of programmes."*

1.2 Collection of sufficient resources from the economy in an appropriate manner along with allocating and use of these resources efficiently and effectively constitute good financial management. Resource generation, resource allocation and expenditure management (resource utilization) are the essential components of a public financial management system. The TORs of the Commission basically focus on expenditure management. Efficient and effective expenditure management calls for expenditure planning, allocation of resources according to policy priorities and good financial operational management and control. Good financial operational management focuses on minimizing cost per unit of output, achieving outcome for which these outputs are intended and enhancing the value for money spent.

1.3 The Commission is of the view that reforms in the financial management system are an integral part of the reforms in governance in general. Therefore, these reforms are critical in achieving the national development objectives. The financial management system is quite wide and encompasses resource mobilization, prioritization of governmental efforts, resource allocation, formulation of detailed plans, setting up information systems that assist decision making, having meticulous accounting systems and creation of robust internal and external accountability mechanisms.

1.4 In the present Report, the Commission has focused primarily on expenditure management. The Commission studied various reports and literature on the subject. It also examined some of the best national and international practices and had consultations with experts on the subject. The Commission organized a national workshop, jointly with the National Institute of Public Finance and Planning (NIPFP), to discuss various aspects of the financial management system in the government. The workshop was attended by officers of the Ministry of Finance, Comptroller and Auditor General's office, State Governments, faculty from the NIPFP and experts on the subject. The NIPFP also prepared a document on the subject which was useful for the Commission in drafting this Report. Another study was commissioned on internal and external audit mechanisms. Besides, the Commission discussed the subject with the State Governments during its visits to the States.

1.5 Though this Report was finalized in April 2009 and printed in May 2009, the Commission would like to record its appreciation for the contribution made by Dr. M. Veerappa Moily in arriving at the conclusions. Before resigning from the position of Chairman, ARC on 31st March, 2009, Dr. Moily had played an important role in guiding the deliberations of the Commission on this subject.

1.6 The Commission is grateful to Shri Vinod Rai, Comptroller and Auditor General of India, for his valuable suggestions. The Commission would like to thank Dr Govind Rao, Director, NIPFP, for organizing the national workshop and also for preparing a useful document for the Commission. The Commission would like to place on record its thanks to Shri V K Shunglu, former Comptroller and Auditor General of India, who made very well reasoned suggestions for improving the system. The Commission also places on record its thanks to all the State Governments for their help. The Commission would like to take this opportunity to thank Shri I.P Singh, former Dy. CAG, who wrote a paper on the internal and external audit mechanisms. The Commission is grateful to Shri R. Sridharan, Joint Secretary (SP) & Adviser (FR), Planning Commission, for sharing his views on the subject and providing major insights. The Commission is grateful to Shri C.R. Sundaramurti, Controller General of Accounts and his team of officers for making a presentation before the Commission. The Commission is also grateful to Shri Naved Masood, AS&FA, Ministry of Health and Family Welfare, for his useful suggestions.

PUBLIC FINANCE MANAGEMENT-CONCEPTS AND CORE PRINCIPLES

2

2.1 Definition of Public Finance Management

2.1.1 Public Finance Management (PFM) basically deals with all aspects of resource mobilization and expenditure management in government. Just as managing finances is a critical function of management in any organization, similarly public finance management is an essential part of the governance process. Public finance management includes resource mobilization, prioritization of programmes, the budgetary process, efficient management of resources and exercising controls. Rising aspirations of people are placing more demands on financial resources. At the same time, the emphasis of the citizenry is on value for money, thus making public finance management increasingly vital.

2.1.2 For a long time, financial management in developing countries was viewed as a process that enabled central agencies like the 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 payment 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 a declining scale".*[1]

2.1.3 Reforms in financial management have concentrated on taxation reforms, the use of government budget as a vehicle for economic development, through improved budget classification system, accounting system reforms etc. Cost-benefit analysis techniques were 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 the system of financial management in developing countries has generally been slow in adapting itself to changing requirements. Basically, there has been a segmented approach to reforms.

2.1.4 A review of the literature on public finance management shows that initially the term 'public finance management' was defined quite narrowly and was confined to budgeting, accounting, monitoring and evaluation. But, it is now widely accepted that it includes taxation

[1] A. Premchand (2005), Controlling Government Spending, the Ethos, Ethics, and Economics of Expenditure Management, Oxford, p.5

and other resource mobilization, debt and cash management, budgetary process, accounting systems, information systems and internal and external audit. Thus, reforming the public finance system would entail several measures:[2]

i. *Improving the collection of revenue is critical. No country can be run properly without revenue. Moreover, tax can help to establish a government's authority. Tax policy itself is increasingly limited by external forces: in a globalised world, governments' choices are less about the tax rate than about the efficiency with which tax is collected and the reach of the tax net. Thus, the revenue services must be properly resourced and motivated to collect tax more efficiently.*

ii. *Debt and cash must be managed efficiently. In particular, sound principles for deficit funding should be established, efficiencies sought and proper risk management procedures introduced. Proper management of the government's borrowing program will reduce the cost of funding.*

iii. *Effective planning and allocation of resources is key and government should develop and institutionalise planning processes at all levels of government. The budgeting process must be transparent and inclusive. There should be focus on outputs rather than on mere expenditure and related inputs, with strong accounting and reporting procedures. The office of the accountant-general must be properly resourced and funded to fulfil this function.*

iv. *Effective oversight and monitoring are crucial to sound governance and PFM reform. A well functioning PFM system must have clear rules on transparency and reporting, as well as enforceable sanctions for failure. Oversight should be established by internal mechanisms in the national treasury as well as external oversight by bodies like independent parliamentary committees, a public ombudsman, a free media and civil society, and an independent auditor-general.*

2.2 Elements of Reforms in the Public Finance Management in Other Countries

2.2.1 The last few decades have witnessed large scale reforms in the public finance management systems in most countries of the world. These reforms include taxation, monetary and budgetary reforms. In line with its Terms of Reference, the Commission has focused on budgetary processes and expenditure management in this Report.

2.3 Evolution of Budgeting

[2]Guidelines for public financial management reform - http://www.mof.go.jp/jouhou/kokkin/tyousa/1803pfm_17.pdf

2.3.1 The Line item Budget

2.3.1.1 Budgeting is the process of estimating the availability of resources and then allocating them to various activities of an organization according to a pre-determined priority. In most cases, approval of a budget also means the approval to various spending units to utilize the allocated resources. In the early nineteenth century, government budgeting in most countries was characterized by weak accounting procedures, adhocism, little central control and poor monitoring and evaluation. In the late nineteenth century, line-item budgeting was introduced in some countries. Indeed line item budgeting which is the most common form of budgeting in a large number of countries and suffers from several drawbacks was a major reform initiative then. The line item budget is defined as *"the budget in which the individual financial statement items are grouped by cost centers or departments. It shows the comparison between the financial data for the past accounting or budgeting periods and estimated figures for the current or a future period"* [3]

2.3.1.2 In a line-item system, expenditures for the budgeted period are listed according to objects of expenditure, or "line-items." These line items include detailed ceilings on the amount a unit would spend on salaries, travelling allowances, office expenses, etc. The focus is on ensuring that the agencies or units do not exceed the ceilings prescribed. A central authority or the Ministry of Finance keeps a watch on the spending of various units to ensure that the ceilings are not violated.

2.3.1.3 The line item budget approach is easy to understand and implement. It also facilitates centralized control and fixing of authority and responsibility of the spending units. Its major disadvantage is that it does not provide enough information to the top levels about the activities and achievements of individual units.

2.3.1.4 The weaknesses of the line item budgeting were sought to be remedied by introducing certain reforms. Performance budgeting was the first such reform.

2.3.2 Performance Budgeting

2.3.2.1 Unlike the traditional line item budget, a performance budget reflects the goal/objectives of the organization and spells out performance targets. These targets are sought to be achieved through a strategy(s). Unit costs are associated with the strategy and allocations are accordingly made for achievement of the objectives. A Performance Budget gives an indication of how the funds spent are expected to give outputs and ultimately the outcomes. However, performance budgeting has a limitation - it is not easy to arrive at standard unit costs especially in social programmes which require a multi-pronged approach.

2.3.3 Zero-based Budgeting (ZBB)

[3]http://www.businessdictionary.com/definition/line-item-budget.html

2.3.3.1 The concept of zero-based budgeting was introduced in the 1970s. As the name suggests, every budgeting cycle starts from scratch. Unlike the earlier systems where only incremental changes were made in the allocation, under zero-based budgeting every activity is evaluated each time a budget is made and only if it is established that the activity is necessary, are funds allocated to it. The basic purpose of ZBB is phasing out of programmes/activities which do not have relevance anymore. However, because of the efforts involved in preparing a zero-based budget and institutional resistance related to personnel issues, no government ever implemented a full zero-based budget, but in modified forms the basic principles of ZBB are often used.

2.3.4 Programme Budgeting and Performance Budgeting

2.3.4.1 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 had much in common with earlier strands of performance budgeting.

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

2.3.4.3 PPBS went much beyond the core elements of programme budgeting and was much more than the budgeting system. It aimed at an 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 was adequate preparation time given nor was a stage-by-stage approach adopted. Therefore, this attempt to introduce PPBS in the federal government in USA did not succeed, although the concept of performance budgeting and programme budgeting endured.

2.3.4.4 Many governments today use the "programme budgeting" label for their performance budgeting system. As pointed out by Marc Robertson, the contemporary influence of the basic programme budgeting idea is much wider than the continuing use of the label. It is defined in terms of its core elements as mentioned above. Programme budgeting is an element of many contemporary budgeting systems which aim at linking funding and results. *"The extent of ongoing influence of programme budgeting is partly obscured by a wide variety of terminology used today to refer to programme such as "outcomes" or output groups (Australia) and 'Requests for Resource' (UK)"*.[4]

2.3.4.5 In 1993, the US Congress enacted the General Performance Results Act (GPRA)

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

to improve the effectiveness, efficiency and accountability of federal programmes, 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 a 7-year implementation time-frame, from the initial pilot projects to government-wide performance reports, incorporating feed-back mechanisms. GPRA's implementation approach also provided for a 2-year pilot project of alternative performance budget approaches in at least five agencies, with regard to their spending decision. GPRA aims for a closer linkage before resource and results. As a report of the General Accounting Report in Performance Budgeting states *"In the sense, GPRA can be seen as the most recent event in al almost 50-year cycle of federal government efforts to improve public sector performance and to link resource allocation to performance expectation."*[5]

2.3.4.6 The GAO Report states that the 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 defines a multi-year and iterative implementation process that 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 environments unknown to earlier reform processes, that is, persistent efforts have to be made to constrain spending.[6]

2.3.4.7 But the GAO Report on performance budgeting also makes two important points when it talks of outcome oriented budget: (i) past initiatives demonstrate that performance budgeting is an evolving concept that cannot be viewed in simple mechanical 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 outcome 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".[7]

2.3.4.8 The above points need to be kept in view by the reformers who are attempting to introduce `outcome' budgeting in government budgeting. Since this is a challenging task, the experience of some other countries in this regard would be useful, for example, in South

[5]Report to Congressional Committee, (1997) Performance Budgeting, US General Accounting Office, March
[6]Ibid
[7]Ibid

Africa, where attempts have been made to introduce outcome budgeting, in the later half of the 1990s, with the introduction of the medium-term expenditure framework (MTEF). The South African government began restructuring its 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 result-orientation into the budgeting process?. As an informed commentator puts it, the answer is less than sanguine for the following three reasons:[8]

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

- Secondly, in the South Africa case, 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 detail 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, and who should hold them accountable. "Very little thought appears to have been given to the process of institutionalizing political or accountability for the targets identified in their budget".[9]

2.3.4.9 So programme budgeting by itself may not bring the outcome orientation. 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.

2.3.4.10 These experiences make it clear that unless there are institutional reforms, like bringing in the 'agency' concept, where the heads of the agencies are 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 changes in the budgetary process. The Commission has examined the concept of executive agencies in its Thirteenth Report.

2.4 Weaknesses in the Budgetary Process

2.4.1 The World Bank after analyzing the budgetary processes of several countries came to the conclusion that government budgets generally have the following shortcomings:

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

"WEAKNESSES IN RESOURCE ALLOCATION AND USE[10]

Weaknesses that undermine public sector performance include:

i. *Poor planning;*
ii. *No links between policy making, planning and budgeting;*
iii. *Poor expenditure control;*
iv. *Inadequate funding of operations and maintenance;*
v. *Little relationship between budget as formulated and budget as executed;*
vi. *Inadequate accounting systems;*
vii. *Unreliability in the flow of budgeted funds to agencies and to lower levels of government;*
viii. *Poor management of external aid;*
ix. *Poor cash management;*
x. *Inadequate reporting of financial performance; and*
xi. *Poorly motivated staff."*

Many of the weaknesses in budgeting reflect the failure to address linkages between the various functions of budgeting. The following factors contribute to budget systems and processes that create a disabling environment for performance in the public sector, both by commission and by omission:[11]

- *Almost exclusive focus on inputs, with performance judged largely in terms of spending no more, or less, than appropriated in the budget;*

- *Input focus takes a short-term approach to budget decision making; failure to adequately take account of longer-term costs (potential and real), and biases in the choice of policy instruments (e.g., between capital and current spending and between spending, doing, and regulation) because of the short-term horizon;*

- *A bottom-up approach to budgeting that means that even if the ultimate stance of fiscal policy was appropriate (and increasingly after 1973 it was not) game playing by both line and central agencies led to high transaction costs to squeeze the bottom-up bids into the appropriate fiscal policy box;*

- *A tendency to budget in real terms, leading either to pressure on aggregate spending where inflation is significant (which was often validated through supplementary*

[10]Handbook of public expenditure, 1998
[11]Handbook of public expenditure, 1998

appropriations) or arbitrary cuts during budget execution with adverse consequences at the agency level;

- *Cabinet decision making focused on distributing the gains from fiscal drag across new spending proposals;*
- *Cabinet and/or central agencies extensively involved in micro-decision making on all aspects of funding for ongoing policy;*
- *Last minute, across-the-board cuts, including during budget execution;*
- *Weak decision making and last-minute cuts cause unpredictability of funding for existing government policy; this is highlighted to the centre by central budget agencies on the alert to identify and rake back "fortuitous savings;"*
- *Strong incentives to spend everything in the budget early in the year and as quickly as possible, since the current year's spending is the starting point for the annual budget haggle and the fear of across-the-board cuts during execution;*
- *Existing policy itself (as opposed to its funding) subject to very little scrutiny from one year to the next. (This and previous point epitomize the worst dimension of incremental budgeting);*
- *Poor linkages between policy and resources at the centre, between the center and line agencies, and within line agencies because of incremental budgeting;*
- *A lack of clarity as to purpose and task and therefore poor information on the performance of policies, programmes and services, and their cost because of poor linkages;*
- *The linking together (in association with the point above) within government departments of policy advising, regulation, service delivery and funding and an aversion to user charging; and*
- *Overall, few incentives to improve the performance of resources provided.*

2.4.2 Attempts are continuously being made to overcome as many of the shortcomings as possible. A good example is the trend in OECD countries. The common elements of the budgetary reforms in OECD member countries are:[12]

i. medium-term budget frameworks;

ii. prudent economic assumptions;

iii. top-down budgeting techniques;

iv. relaxing central input controls;

v. focus on results;

vi. budget transparency; and

vii. modern financial management practices.

2.4.3 Although they are identified as seven separate features, they do in fact build on each other and must be seen as a package. Each of these features is discussed below in detail:[13]

"Medium-term budget frameworks: Medium-term budget frameworks form the basis for achieving fiscal consolidation. They need to clearly state the government's medium-term fiscal objectives in terms of high-level targets such as the level of aggregate revenue, expenditure, deficit/surplus, and debt. They then need to operationalise these high-level targets by establishing hard budget constraints for individual ministries and programmes over a number of years. This lends stability and credibility to the government's fiscal objectives.

By their very nature, high-level fiscal targets are set in a medium-term context. They aim to achieve a certain fiscal outcome over a number of years. Budgets are however enacted for a time period of one year, and are notorious for their short-term focus. This short-term time horizon is often criticised for impeding effective expenditure management; decisions on resource allocation are said to be made on an ad hoc or piecemeal basis with the implications of past and present decisions beyond the next year being neglected. This is not a new criticism. Medium-term budget frameworks aim to bridge this gap. Their successful implementation has been nothing short of a "cultural revolution" in governments.

Although the level of detail of such frameworks varies from country to country, they generally mirror the format of the budget, i.e. the medium-term frameworks are at the same level of detail as the annual budget. This means that a formal framework (or hard budget constraint) exists for each and every appropriation, most often for three years beyond the current fiscal year. These are rolling frameworks that are presented with the budget each year; year-1 in the previous year's framework becomes the basis for the budget and a new year-3 is added. This has greatly increased the effectiveness of planning and eased the annual budget process. These frameworks are not, however, enacted into legislation; they are planning documents that reflect the political commitment to fiscal discipline.

…

[12] Budget Reform in OECD Member Countries: Common Trends. Meeting of Budget Directors from the G-7 Countries. Berlin, Germany, 5-6 September 2002.

[13] Budget Reform in OECD Member Countries: Common Trends. Meeting of Budget Directors from the G-7 Countries. Berlin, Germany, 5-6 September 2002.

Prudent economic assumptions

Deviations from the forecast of the key economic assumption underlying the budget are the government's key fiscal risk. There is no single factor more responsible for "de-railing" fiscal consolidation programmes than the use of incorrect economic assumptions. Great care must be taken in making them and all key economic assumptions should be disclosed explicitly. Sensitivity analysis should be made of what impact changes in the key economic assumptions would have on the budget. Furthermore, a comparison should be made between the economic assumptions used in the budget and what private sector forecasters are applying for the same time period where practicable. The establishment of an independent body to recommend the economic assumptions to be used in the budget may be considered as well. All this serves to place safeguards against the use of unrealistic, or "optimistic," economic assumptions.

Top-down budgeting techniques

Budgeting has traditionally operated on a bottom-up principle. This means that all agencies and all ministries send requests for funding to the finance ministry. These requests greatly exceed what they realistically believe they will get. Budgeting then consists of the Finance Ministry negotiating with these ministries and agencies until some common point is found. This bottom-up system has several disadvantages to it. First, it is very time consuming and it is essentially a game; all participants know that the initial requests are not realistic. Second, this process has an inherent bias for increasing expenditures; all new programmes, or expansion of existing programs, are financed by new requests; there was no system for reallocation within spending ministries and there were no pre-set spending limits. Third, it was difficult to reflect political priorities in this system as it was a bottom-up exercise with the budget "emerging" at the end of this process. This manner of budgeting is now being abandoned and replaced with a new top-down approach to budget formulation. This has been of great assistance in achieving fiscal consolidation.

The starting point for the new system is for the government to make a binding political decision as to the total level of expenditures and to divide them among individual spending ministries. This decision is made possible by the medium-term expenditure frameworks which contain baseline expenditure information, i.e. what the budget would look like if no new policy decisions were made. The political decision is whether to increase expenditures for a high-priority area, for example education, and to reduce expenditures, for example defence programs. Only the largest and most significant programmes reach this level of political reallocation. The key point is that each ministry has a pre-set limit on how much it can spend.

Once this decision is taken, the Finance Ministry largely withdraws from the details of

budgetary allocations for each ministry. The Finance Ministry concerns itself only with the level of aggregate expenditure for each ministry; not the internal allocations. "Each minister is his own Finance Minister," is the saying in some countries. Each ministry has a total amount and it can freely reallocate that money among its various agencies and programmes. This has several advantages to it. It serves to hamper creeping increases in expenditures as new policies are funded by reallocations from other areas within the ministry. It creates ownership in the respective ministries for the actions that are taken. Decisions are also better informed as spending ministries are in the best position to judge the relative merits of their programmes. The role of the Ministry of Finance is to verify that the offsetting cuts to finance new programmes are real.

...

Relaxing central input controls

Relaxing central input controls is another feature of successful fiscal consolidation strategies in Member-countries. This is based on the simple premise that the heads of individual agencies are in the best position to choose the most efficient mix of inputs to carry out the agency's activities. The end-result is that an agency can produce the same services at less cost, or more services at the same cost. This greatly facilitates fiscal consolidation strategies by mitigating their effects on services.

Relaxing central input controls operates at three levels. First, the consolidation of various budget lines into a single appropriation for all operating costs (salaries, travel, supplies, etc.). Second, the decentralisation of the personnel management function. Third, the decentralisation of other common service provisions, notably accommodations (buildings). The can be seen as the public sector's version of "deregulation."

The consolidation of budget appropriation lines is rather straightforward and simple. It is now common for agencies to receive one single appropriation for all of their operating expenditures. (It should be clear that this does not apply to transfers or capital appropriations, only to operating expenditures). This single appropriation is, however, not enough to generate managerial flexibility as various central management rules inhibit this flexibility.

It is in the area of human resource management where most of the central management rules exist. The cost of staff is generally the largest component of operating expenditures, and it makes little difference to consolidation budget lines if central rules in this area prevent any flexibility. All countries are increasing flexibility in this area, although to significantly varying degrees. The country that has gone the farthest in this area is Sweden.

Personnel management in Sweden has historically been decentralised with the outstanding exception of collective bargaining arrangements. Directors-general of agencies are, and have been, responsible for the recruitment, grading and dismissal of their staff. There are no restrictions on whom they may hire. There is no "civil service" encompassing the government as a whole. Vacancies are generally advertised in the press with all qualified applicants being treated equally. Staff are not tenured in Sweden. They can typically be dismissed at two- to twelve-month notice depending on how long they have been employed by the agency. In fact, there are essentially no difference between the labour legislation governing the public sector and the private sector in Sweden.

...

An increased focus on results

An increased focus on results is a direct quid pro quo for relaxing input controls as described above. Accountability in the public sector has traditionally been based on compliance with rules and procedures. It didn't matter what you did as long as you observed the rules. Now, when the public sector is deregulated, a new results-based system is needed to hold managers accountable. This is a fundamental change: holding managers accountable for what they do, not how they do it. Effectively implementing this is, however, very difficult in practice. The difficulties can be divided into several groups of issues.

At the most basic level, some government activities simply lend themselves to results measurement much more readily than others. For example, an agency that produces a single or a few homogenous products or services can be rather easily measured. An agency that issues passports is a good example. On the other hand, agencies that produce heterogeneous and individualised services can be very difficult to measure. The majority of government services fall into the latter category. Various social services are the outstanding example.

We are also faced with the choice of defining results either in terms of outputs or outcomes. Outputs are the goods and services that government agencies produce. Outcomes are the impact on, or the consequences for, the community of the outputs that are produced. An example highlights this. A government may wish to reduce the number of fatalities on highways caused by drunk drivers. This would be the outcome. In order to achieve this, it may launch a series of advertisements in the media highlighting the dangers of drunken driving. It's easy to measure the output, i.e. that the prescribed number of advertisements were in fact shown in the media. Let's, however, assume that at the same time the number of fatalities went up, not down. The link between the advertisements and this outcome is very unclear, since many other factors than the advertisements would impact on the outcome. But what

lessons do we draw from this. Do we abandon the advertisement campaign? Do we expand it? Do we try other outputs? Do we wait to see if this is a one-off or a sustained trend?

From an accountability point of view, the question arises whether you hold managers responsible for outputs or outcomes. Outputs are easier to work with in this context; but outcomes are what matters in the final analysis. Do we want an accountability regime based on outputs even though the outputs may not be contributing to the desired outcome? Or do we have an accountability regime based on outcomes, even though a number of factors outside the control of the director-general of the agency may have contributed to it? Of course, a combination of the two is the optimum choice, but experience in Member- countries shows that one will always dominate.

It is a well known phenomenon in management that "what gets measured, gets managed." As noted above, some activities lend themselves to measurement more readily than others. This also applies within agencies in that certain of their activities are more easily measured than others. If the agency's measurement systems is biased in favour of those activities that are more easily measured, there's every likelihood that management will focus its attention disproportionately on those activities since their accountability is based on that. This may lead to all sorts of unforeseen and undesired consequences. This creates a huge onus on those designing the agency's measurement system to ensure that it captures all aspects of their activities.

Budget transparency

Increased transparency in budgeting made significant advances in the late 1980s and early 1990s. This was a period associated with unfavourable budget conditions in most Member-countries; high annual deficits and increasing levels of outstanding debt. Governments needed to institute large fiscal consolidation programmes. These were often painful and getting the public's understanding of the problems was necessary. The most effective manner for achieving that was simply to throw open the books and say to the public: "Look, things are really as bad as we told you, we're not hiding anything." This may sound a bit sinister at first, but in actuality it is government at its best: Being honest with citizens, explaining the problem to them in order for an understanding to emerge as to the best course of action to take.

This time period also coincided with increased attention being paid to good governance in general. The budget is the principal policy document of government, where the government's policy objectives are reconciled and implemented in concrete terms. Budget transparency – openness about policy intentions, formulation and implementation – is therefore at the *core of good governance agenda.*

If we take a look at fiscal transparency in concrete terms, we can say that it has three essential elements:

- *The first is the release of budget data. The systematic and timely release of all relevant fiscal information is what we typically associate with budget transparency. It is an absolute pre-requisite, but it is not enough.*
- *The second element is an effective role for the legislature. It must be able to scrutinise the budget reports and independently review them. It must be able to debate and influence budget policy and be in a position to effectively hold the government to account. This is both in terms of the constitutional role of the legislature and the level of resources that the legislature has at its disposal.*
- *The third element is an effective role for civil society, through the media and non-governmental organisations. Citizens, directly or through these vehicles, must be in a position to influence budget policy and must be in a position to hold the government to account. In many ways, it is a similar role to that of the legislature albeit only indirectly.*

These three elements work together. The scrutiny of fiscal information by the legislature and by civil society can only take place if the information is released in the first place. Similarly, released budget information is only of value if it is effectively scrutinised by the legislature and by civil society. The legislature and civil society have a very similar function, one is responsible for shaping budget policy and for holding government directly to account while the other performs this role indirectly.

...

Modern financial management practices

The modernisation of financial management within governments made great advances during the past ten years. The sheer scale of government means that such improvements had a material effect on fiscal outcomes. These include the introduction of accruals, capital charges, carry-overs of unused appropriations, and interest-bearing accounts. Each of these is discussed below.

Accruals

Cash and accruals represent two end points on a spectrum of possible accounting and budgeting bases. The cash end of the spectrum has traditionally been applied by Member-countries for their public sector activities. In recent years, there has been a major trend towards accruals end of the spectrum in Member-countries. About half of Member-countries have now adopted accruals to one degree or another. This is a very rapid migration; it was only in the early 1990s that the world's first accrual basis financial statements and budget were produced by a government (New Zealand).

The objective of moving to accruals is to make the true cost of government more transparent. For example, accruals attributes the pension costs of government employees to the time period when they are employed and accumulating their pension rights rather than having this as an unrelated (and uncontrollable) expenditure once they have retired. Instead of spikes in expenditures when individual capital projects are undertaken, accruals incorporate them into the annual operating expenditures through an allowance for depreciation. Treating loans and guarantee programmes on an accrual basis fosters more attention to the risks of default by those who have been granted them, especially if there is a requirement for such default risks to be pre-funded. In a cash system, outstanding government debts can be designed in such a way that all interest expenditure is paid in a lump-sum at the end of the loan rather than being spread through the years when the loan was outstanding as would be the case under accruals. All of these examples show how a focus on cash only, can distort the true cost of government.

A further objective for adopting accruals is to improve decision-making in government by using this enhanced information. This needs to be seen in a wider context. The countries that have adopted accruals have generally been at the forefront of public management reforms in general. These reforms have been highlighted in this paper. A key aim is to hold managers responsible for outcomes and/or outputs while reducing controls on inputs. In this context, it is expected that managers should be responsible for all costs associated with the outcomes and/or outputs produced, not just the immediate cash outlays. Only accruals allow for the capture of these full costs, thereby supporting effective and efficient decision-making by managers. In short, when managers are given flexibility to manage their own resources (inputs), they need to have the necessary information to do this. The adoption of accruals is therefore an inherent part of these wider reforms...

Capital charges

Capital has tended to be viewed as a free good in the public sector. Once an asset was in place, there was no mechanism to track and charge for the cost of capital tied up in the *asset. A number of Member-countries have been making headway in this regard.*

Capital charging regimes generally operate as follows. The government decides to levy a charge on the cost of capital tied up in all assets in an agency. For example, if an agency has $10 million in assets, the government will levy a charge (often equivalent to the long-term government bond rate), of 10%. This means that the agency will have to pay the finance ministry 1 million dollars annually. When the system is first introduced, the appropriations to all agencies will be increased by the amount of their capital charge, so there's no net impact on agencies or for the government as a whole. However, agencies will in future be allowed to dispose of the assets and thus relieving themselves of the capital charge while retaining the original appropriation to cover it (or part thereof). This creates the incentive. Thus, they could decide to sell excess assets or move from high-priced areas to lower-priced areas and use the amount of the capital charge they save for other purposes. This has had a great impact on asset management in government, a field that was simply neglected previously.

...

Carry-overs

All countries operate on the principle of an annual budget. Previously, this meant that all appropriations lapsed at the end of the fiscal year thus creating a great and irrational rush to spend moneys before the end of the fiscal year. Not only because they would otherwise lose the money this year, but also because future years appropriations would take account of this underspending as well. You were losing what you did not spend in one year, permanently. This has now changed with operating expenditures generally being freely transferable (sometimes up to a certain limit) from one year to the next. Only in cases where an agency continuously, year-on-year, builds up carry-overs does the Ministry of Finance intervene. The advent of medium-term expenditure frameworks also gives a benchmark for agencies to see that their appropriations are in fact being carried-over.

Interest-bearing accounts

Some countries have also introduced interest-bearing accounts for agencies. This means, for example, that the appropriation of an agency is divided into twelfths (representing each month) and deposited into an agency's account (either within the finance ministry or with a commercial bank.) If an agency spends at less than this rate, they will receive interest on the difference. If they spend at a faster rate, they

will pay interest on the difference. The ability of individual agencies to vary their spending patters, does of course vary significantly but they are now much more aware of cash management practices.

All of these practices – accruals, capital charges, carry-overs of unused appropriations and interest-bearing accounts – serve to improve the information available for agency heads and giving them increased freedom to act on that information. Although a very technical area, the impact on the government's finances is great given the sheer size of government."

2.5 Core Principles of Reforms

2.5.1 The Commission broadly endorses the common elements of the budgetary reforms suggested by the OECD member-countries as mentioned in paragraph 2.4.2. The Commission feels that after incorporating suitable additions relevant to the Indian context, these could constitute the core principles for reforming the financial management system in the country. These core principles are described below:

i. *Reforms in Financial Management System are part of overall governance reforms:* Governance reforms to bring about improved transparency, greater accountability, streamlining the structure of the Government, elimination of corruption, and fiscal and environment sustainability have to be backed by reforms in the financial management system in order to deliver the desired results. At the same time, it needs to be understood that reforms in the management system are not an end in itself but a means to achieving good governance.

ii. *Sound financial management is the responsibility of all government departments/agencies:* Maintaining financial prudence, discipline and accountability, while at the same time, ensuring prompt and efficient utilization of resources towards achieving organizational goals is the responsibility of all government agencies/organizations and not only of the Finance wing/Finance Ministry.

iii. *Medium-term plan/budget frameworks and aligning plan budgets and accounts:* Medium-term plan/budget frameworks attempt to bridge the gap between the short-term time horizon of annual budgets with the medium-term objectives of the schemes and programmes of government. Even when there are medium- term frameworks like five-year development plans, there is need for aligning the annual budgets explicitly with the plans and with the accounting mechanisms so that there is a clear 'line of sight' between the medium term developmental plan and the annual budget exercise.

iv. *Prudent economic assumptions:* The economic assumptions that underline the budget have to be prudent and accurate in order to ensure that the budgetary estimates do not go haywire. The tendency to be overly optimistic has to be avoided.

v. *Top-down budgeting techniques:* There is need to shift from the traditional bottom up approach to budgeting to a top-down framework where the desired outcomes should point to the resources required which should be allocated thereafter at the macro level sector-wise. This in turn would lead to focus on outputs and outcomes rather than on inputs and processes.

vi. *Transparency and simplicity:* The budget documents should be simple and easy to comprehend and be available in the public domain. Also the procedures involved in operating the budget and release of funds should be simple. Suitable financial management information systems need to be developed in order to ensure that all transactions are captured and ultimately made available for public scrutiny.

vii. *Relaxing central input controls:* Government agencies need to be given greater operational autonomy and flexibility by consolidating budget items and decentralization of administrative and financial powers.

viii. *Focus on results:* Accountability in government needs to shift from compliance with rules and procedures to achievement of results. This is all the more necessary with relaxed central input controls. There should be emphasis on 'value for money'.

ix. *Adopting modern financial management practices:* Modern financial management tools like accrual accounting, information technology, financial information systems etc. need to be used to improve decision making and accountability. However, care needs to be exercised to ensure that a congenial environment is created and adequate capacity is developed before adopting new practices.

x. *Budgeting to be realistic:* Unless the projections made in the budget are reasonably accurate, the budgetary exercise loses credibility.

3 AN OVERVIEW OF THE EXISTING FINANCIAL MANAGEMENT SYSTEM IN INDIA

Introduction

The basic framework of the financial management system in India is provided in the Constitution. This has been elaborated further through Legislations and Rules. In this Chapter, the legal provisions regarding the financial management system in the country are described. It focuses on the Constitutional provisions on legislative 'procedure in financial matters', general Constitutional provisions regarding 'finance', framework for preparation of accounts, external and internal audit and flow of funds in case of Centrally Sponsored Schemes (CSS).

3.1 Financial Statements and Accounts

3.1.1. Constitutional Provisions on Legislative Procedure on Financial Matters

3.1.1.1 The Constitution of India provides that in respect of every financial year, a statement of the estimated receipts and expenditure of the Government of India or the Government of any State for that year, is to be laid down before both the Houses of Parliament/State Legislature. This is referred to as the "annual financial statement" of the concerned Government (Articles 112 & 202). As per Article 112, this statement should show, inter alia, the following:

> *"112. (2) The estimates of expenditure embodied in the annual financial statement shall show separately-*
>
> *(a) the sums required to meet expenditure described by this Constitution as expenditure charged upon the Consolidated Fund of India; and*
>
> *(b) the sums required to meet other expenditure proposed to be made from the Consolidated Fund of India, and shall distinguish expenditure on revenue account from other expenditure.*
>
> *..."*

Article 202 contains similar provisions with regard to annual financial statement of a State Government.

3.1.1.2 To meet such expenditure, appropriations have to be made out of the Consolidated Fund of India (or of the respective States). The appropriations are required to be made in the manner provided in the Constitution. The procedure in these matters in relation to the Parliament is provided in Articles 113 to 117 and 119. These pertain to the procedure in Parliament with respect to estimates, Appropriation Bills, supplementary, additional or excess grants, votes on account, votes to credit and exceptional grants, special provisions as to financial Bills and regulation by law of procedure in Parliament in relation to financial business. These provisions are mentioned below:

> *"113. Procedure in Parliament with respect to estimates.- (1) So much of the estimates as relates to expenditure charged upon the Consolidated Fund of India shall not be submitted to the vote of Parliament, but nothing in this clause shall be construed as preventing the discussion in either House of Parliament of any of those estimates.*
>
> *(2) So much of the said estimates as relates to other expenditure shall be submitted in the form of demands for grants to the House of the People, and the House of the People shall have power to assent, or to refuse to assent, to any demand, or to assent to any demand subject to a reduction of the amount specified therein.*
>
> *(3) No demand for a grant shall be made except on the recommendation of the President.*
>
> *114. Appropriation Bills.- (1) As soon as, may be after the grants under Article 113 have been made by the House of the People, there shall be introduced a Bill to provide for the appropriation out of the Consolidated Fund of India of all moneys required to meet-*
>
> *(a) the grants so made by the House of the People; and*
>
> *(b) the expenditure charged on the Consolidated Fund of India but not exceeding in any case the amount shown in the statement previously laid before Parliament.*
>
> *(2) No amendment shall be proposed to any such Bill in either House of Parliament which will have the effect of varying the amount or altering the destination of any grant so made or of varying the amount of any expenditure charged on the Consolidated Fund of India, and the decision of the person presiding as to whether an amendment is inadmissible under this clause shall be final.*
>
> *(3) Subject to the provisions of Articles 115 and 116, no money shall be withdrawn from the Consolidated Fund of India except under appropriation made by law passed in accordance with the provisions of this article.*

115. Supplementary, additional or excess grants.-(1) The President shall-

(a) if the amount authorised 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 the current financial year for supplementary or additional expenditure upon some new service not contemplated in the annual financial statement for that year, or

(b) if any money has been spent on any service during a financial year in excess of the amount granted for that service and for that year, cause to be laid before both the Houses of Parliament another statement showing the estimated amount of that expenditure or cause to be presented to the House of the People a demand for such excess, as the case any be.

(2) The provisions of Articles 112, 113 and 114 shall have effect in relation to any such statement and expenditure or demand and also to any law to be made authorising the appropriation of moneys out of the Consolidated Fund of India to meet such expenditure or the grant in respect of such demand as they have effect in relation to the annual financial statement and the expenditure mentioned therein or to a demand for a grant and the law to be made for the authorisation of appropriation of moneys out of the Consolidated Fund of India to meet such expenditure or grant.

116. Votes on account, votes of credit and exceptional grants.-

(1) Notwithstanding anything in the foregoing provisions of this Chapter, the House of the People shall have power-

(a) to make any grant in advance in respect of the estimated expenditure for a part of any financial year pending the completion of the procedure prescribed in Article 113 for the voting of such grant and the passing of the law in accordance with the provisions of Article 114 in relation to that expenditure;

(b) to make a grant for meeting an unexpected demand upon the resources of India when on account of the magnitude or the indefinite character of the service the demand cannot be stated with the details ordinarily given in an annual financial statement;

(c) to make an exceptional grant which forms no part of the current service of any financial year; and Parliament shall have power to authorise by law the withdrawal of moneys

from the Consolidated Fund of India for the purposes for which the said grants are made; and

(2) The provisions of Articles 113 and 114 shall have effect in relation to the making of any grant under clause (1) and to any law to be made under that clause as they have effect in relation to the making of a grant with regard to any expenditure mentioned in the annual financial statement and the law to be made for the authorisation of appropriation of moneys out of the Consolidated Fund of India to meet such expenditure.

Similar provisions are contained in Articles 203 to 207 and 209 with regard to the State Legislatures.

3.1.1.3 Provisions contained in Chapter I, Part XII of the Constitution of India necessitate the maintenance of government accounts in three parts with regard to receipts – (1) the Consolidated Fund of India / separate Consolidated Funds of the States, (2) the public account of India/public accounts of the States and (3) the Contingency Fund of India/Consolidated Funds of the States. This is based on the provisions of Articles 266 and 267. Thus, Article 266 provides for the Consolidated Funds and Public Accounts of India and of the States in the following manner:

"266. Consolidated Funds and public accounts of India and of the States.- (1) Subject to the provisions of Article 267 and to the provisions of this Chapter with respect to the assignment of the whole or part of the net proceeds of certain taxes and duties to States, all revenues received by the Government of India, all loans raised by that Government by the issue of treasury bills, loans or ways and means advances and all moneys received by that Government in repayment of loans shall form one consolidated fund to be entitled "the Consolidated Fund of India", and all revenues received by the Government of a State, all loans raised by that Government by the issue of treasury bills, loans or ways and means advances and all moneys received by that Government in repayment of loans shall form one consolidated fund to be entitled "the Consolidated Fund of the State".

(2) All other public moneys received by or on behalf of the Government of India or the Government of a State shall be credited to the public account of India or the public account of the State, as the case may be.

(3) No moneys out of the Consolidated Fund of India or the Consolidated Fund of a State shall be appropriated except in accordance with law and for the purposes and in the manner provided in this Constitution."

3.1.1.4 The provisions regarding the Contingency Funds of India and of the States are contained in Article 267 of the Constitution:

> *"267. Contingency Fund.- (1) Parliament may by law establish a Contingency Fund in the nature of an imprest to be entitled "the Contingency Fund of India" into which shall be paid from time to time such sums as may be determined by such law, and the said Fund shall be placed at the disposal of the President to enable advances to be made by him out of such Fund for the purposes of meeting unforeseen expenditure pending authorisation of such expenditure by Parliament by law under Article 115 or Article 116.*
>
> *(2) The Legislature of a State may by law establish a Contingency Fund in the nature of an imprest to be entitled "the Contingency Fund of the State" into which shall be paid from time to time such sums as may be determined by such law, and the said Fund shall be placed at the disposal of the Governor of the State to enable advances to be made by him out of such Fund for the purposes of meeting unforeseen expenditure pending authorisation of such expenditure by the Legislature of the State by law under Article 205 or Article 206."*

3.1.2 The Budgetary Process[14]

3.1.2.1 *Annual Financial Statement*

3.1.2.1.1 Based on the Constitutional provisions and provisions contained in the General Financial Rules (GFR), General Accounting Rules (GAR), Budget Manual (in the States) etc, a statement of its estimated annual receipts and expenditure is prepared by each Government and presented to its Legislature. This "Annual Financial Statement" is commonly known as the Budget. In this statement, the sums required to meet the expenditure charged[15] upon the Consolidated Fund of India or the Consolidated Fund of the State or the Consolidated Fund of the Union Territory and the sums required to meet other expenditure proposed to be met from the Fund are shown separately. Further, the expenditure on revenue accounts is distinguished from other expenditure (Articles 112 & 202 of the Constitution and Section 27 of the Government of Union Territories Act, 1963). As stated earlier the Annual Financial Statement shows the receipts and expenditure of Government in three separate parts under which Government accounts are maintained viz. (i) Consolidated Fund of India (ii) Contingency Fund of India and the (iii) Public Account.

3.1.2.1.2 The part of the estimates pertaining to expenditure charged upon the Consolidated Fund is not submitted to the vote of the Legislature (although it is open to discussion in the Legislature). The part of the estimate which is concerned with other expenditures is submitted

[14]Mainly based on 'Introduction to Indian Government Accounts and Audit'

[15]Expenditure charged upon the Consolidated Fund of India is not submitted to the vote of Parliament (Article 113) or State Legislature

to the Legislature concerned in the form of Demands for Grants on the recommendation of the President or the Governor of the State or the Administrator of the Union Territory with legislature, as the case may be.

3.1.2.1.3 Normally, a separate demand is presented for each Department or the major services under the control of a Ministry/Department. The number of Demands for Grants and their coverage is decided by the Ministry of Finance. Each demand generally includes the total provisions required for a service, that is, provisions on account of revenue expenditure, capital expenditure, Grants to States and Union Territories and also loans and advances relating to that service. The estimated expenditure included in the Demands for Grants are for gross amounts. The receipts and recoveries taken in reduction of expenditure are shown by way of footnotes.

3.1.2.1.4 The Finance Bill containing the annual taxation proposals is considered and passed by the Legislature only after the Demands for Grants have been voted and the total expenditure is known. Then it enters the statute as the Finance Act.

3.1.2.1.5 The House of the People (and the Legislative Assemblies) also has the power to authorize by law the withdrawal of moneys from the Consolidated Fund of India for the following purposes (Article 116/206):

- *Vote on Account* – for making any grant in advance in respect of the estimated expenditure for a part of any financial year pending the completion of the parliamentary procedure;
- *Vote of Credit* – for making a grant for meeting an unexpected demand upon the resources of India when on account of the magnitude or the indefinite character of the service the demand cannot be stated with the details ordinarily given in an annual financial statement; and
- *Exceptional Grant* – for making provision for an exceptional grant that does not form part of the current service of any financial year.

3.1.2.1.6 As per the requirements of the Fiscal Responsibility and Budget Management Act, 2003 three Statements are to be presented to the Parliament, which form a part of the budget documents: (a) the Macro-economic Framework Statement, (b) the Medium term Fiscal Policy Statement, and (c) the Fiscal Policy Strategy Statement. The Macro-economic Framework Statement contains an assessment of the growth prospects of the economy. The Medium term Fiscal Policy Statement indicates the three-year rolling targets for four specific fiscal indicators in relation to GDP at market prices, namely, (i)Revenue Deficit, (ii) Fiscal Deficit, (iii)Tax to

GDP Ratio, and (iv) Total Out-Standing Debt at the end of the year, while the Fiscal Policy Strategy Statement seeks to outline the strategic priorities of the Government in the fiscal area for the ensuing year.

3.1.2.2 *Appropriation Act*

3.1.2.2.1 After the Demands have been passed by the Legislature, an Appropriation Bill is introduced to provide for the appropriation out of the Consolidated Fund of India or of the State or of the Union Territory with Legislature for all moneys required to meet:

a. The Grants made by the Legislature and

b. The expenditure charged on the Consolidated Fund, but not exceeding in any case the amount shown in the statement previously laid before the Legislature. (This charged expenditure is referred to as Appropriation).

3.1.2.2.2 No money can be withdrawn from the Consolidated Fund until this Bill is passed by the Legislature. Once this Bill is passed, it becomes the Appropriation Act. The sums authorized in the Appropriation Act are intended to cover all the charges including the liability of past years to be paid during a financial year or to be adjusted in the accounts of that year. Any unspent balance lapses and is not available for utilization in the following year.

3.1.2.3 *Allotments and Re-appropriations*

3.1.2.3.1 Within the amount of each Grant or Appropriation as shown in the schedule to the Appropriation Act, all allotments and re-appropriations within sub-heads and sub-divisions of sub-heads may be sanctioned by Government or by such subordinate authorities as are duly authorized to do so. This is, however, subject to the limitation that any expenditure not falling within the scope or intention of a Grant may not be authorized from funds provided under that Grant. Any allotment or re-appropriation may be authorized at any time before, but not after the expiry of the financial year to which such Grant or Appropriation relates. Generally, re-appropriations from one Grant or Appropriation to another Grant or Appropriation are not permissible.

3.1.3 Form of Accounts

3.1.3.1 Article 150 of the Constitution states the following regarding the form of Accounts:

"150. Form of the accounts of the Union and of the States. – The accounts of the Union and of the States shall be kept in such form as the President may, on the advice of the Comptroller and Auditor General of India, prescribe."

3.1.3.2 As per Notification No. CD-896/80 dated 27th September, 1980, the function of prescribing the form in which the accounts of the Union and the States are to be maintained has been delegated to the Controller General of Accounts (CGA) by incorporating entry 7A (i) in the Government of India (Allocation of Business) Rules (for Department of Expenditure under the heading Ministry of Finance) –

"General principles of accounting relating to the Union or State Governments and form of accounts, and to frame or revise rules and manuals thereto."

3.1.3.3 The general principles of government accounting are presently prescribed by the Government Accounting Rules, 1990 (GAR). Rule 21 of GAR provides for cash system of accounting in the government in the following way:

"21. Cash basis of Accounts

With the exception of such book adjustments as may be authorized by these rules or by any general or special orders issued by the Central Government on the advice of the Comptroller and Auditor General of India, the transactions in Government accounts shall represent the actual cash receipts and disbursements during a financial year as distinguished from amounts due to or by the Government during the same period."

This is reiterated by the General Financial Rules, 2005 (GFR) in Rule 68.

3.1.3.4 As per GAR (Rule 23), in consequence to the constitutional provisions mentioned earlier, government accounts are kept in three parts:

Part-I Consolidated Fund	of India (including Union Territory Administration or of the State or Union Territory Government concerned.
Part-II Contingency Fund	
Part-III Public Account	of India (including Union Territory Administration/ Government) or of the State concerned.

3.1.3.5 In case of Part I of the accounts, there are two main divisions:[16]

(i) *Revenue* - consisting of sections for 'Receipt heads (Revenue Account)' and 'Expenditure heads (Revenue Account)'.

(ii) *Capital, Public Debt, Loans* - consisting of sections for 'Receipt heads (Capital Account)', 'Expenditure heads (Capital Account)', and 'Public Debt', 'Loans', and 'Advances'.

3.1.3.6 The first division comprises the section 'Receipt heads (Revenue Account)' dealing with the proceeds of taxation and other receipt classified as revenue, and the section 'Expenditure heads (Revenue Account)' dealing with expenditure met therefrom.

3.1.3.7 The second division comprises the following sections:–

(a) The section 'Receipt heads (Capital Account)' dealing with receipts of a Capital nature which cannot be applied as a set off to Capital Expenditure.

(b) The section 'Expenditure heads (Capital Account)' dealing with expenditure met usually from borrowed funds with the object of increasing concrete assets of a material and permanent character. It also includes receipts of a Capital nature intended to be applied as set off to Capital expenditure.

(c) The section 'Public Debt', 'Loans' and 'Advances', comprises loans raised and their repayments by Government such as, Internal Debt, External Debt of the Union Government and loans and advances made by Governments and their recoveries; transactions relating to 'Appropriation to Contingency Fund' and 'Inter-State Settlement'.

3.1.3.8 In Part II of the accounts, the transactions recorded are connected with the Contingency Fund set up by the Government of India or of a State or Union Territory Government under Article 267 of the Constitution/ Section 48 of the Union Territories Act, 1963.

3.1.3.9 In Part III (i.e. Public Account) of the accounts, the transactions relating to Debt (Other than those included in Part I), 'Deposits', 'Advances', 'Remittances' and 'Suspense' are recorded. The transactions under Debt, Deposits and Advances in this part are such in respect of which Government incurs a liability to repay the moneys received or has a claim to recover the amounts paid, together with the repayments of the former (Debt and Deposits) and the recoveries of the latter (Advances). The transactions relating to 'Remittances' and 'Suspense' in this Part embrace all 'merely adjusting heads' under which appear such transactions as remittances of cash between treasuries and currency chests and transfer between different accounting circles. The initial debits or credits to these heads are cleared eventually by corresponding receipts or payments either within the same circle of account or in another account circle.

[16]Based on GAR, 1990

3.1.3.10 Within each of the divisions and Sections of the Consolidated Fund as referred to above, the transactions are grouped into Sectors such as, "General Services", "Social Services", "Economic Services", under which specific functions or services are placed. These Sectors are further sub-divided into 'Major Heads of Account'. However, in some specific cases, the Sectors are sub-divided into sub-sectors before their division into Major Heads of Account.

3.1.3.11 In case of the Contingency Fund, there is a single Major Head and all the transactions met out of the Contingency Fund are recorded under it.

3.1.3.12 In the case of the Public Account, the transactions are again grouped into sectors and sub-sectors, which are further sub-divided into Major Heads of Account.

3.1.3.13 *Major, Minor and Detailed Heads:* The main unit of classification in accounts is the major head which is divided into minor heads, each of which has a number of subordinate heads, generally known as sub-heads. The sub-heads are further divided into detailed heads. Sometimes major heads may be divided into sub-major heads before their further division, into minor heads. Thus, the Sectors, Major heads, Sub-heads and Detailed heads together constitute a five-tier arrangement of the classification structure of Government Accounts.

Box 3.1: Allocation between Capital and Revenue Expenditure on a Capital Scheme

The allocation between capital and revenue expenditure on a capital scheme for which separate capital and revenue accounts are to be kept are determined in accordance with such general or special orders as may be prescribed by the Government on the advice of the Comptroller and Auditor General. The main principles governing the allocation of expenditure on a Capital Scheme between Capital and Revenue accounts are as follows:

a. Capital account should bear all charges for the first construction and equipment of a project as well as charges for intermediate maintenance of the work while not yet opened for service.

b. Subject to (c) below, revenue account should bear all subsequent charges for maintenance and all working expenses. These embrace all expenditure on the working and upkeep of the project and also on such renewals and replacements and such additions, improvements or extensions as prescribed by government.

c. In the case of works of renewal and replacement which partake both of a capital and revenue nature, the allocation of expenditure should be regulated by the broad principle that revenue should pay or provide a fund for the adequate replacement of all wastage or depreciation of property originally provided out of capital grants and that only the cost of genuine improvements, whether determined by prescribed rules or formulae or under special orders of Government should be debited to Capital account.

d. Expenditure on account of reparation of damage caused by extraordinary calamities such as flood, fire, earthquake, enemy action, should be charged to Capital account or to Revenue account or divided between them in such a way as may be determined by Government according to the circumstance of each case.

e. Capital receipts in so far as they relate to expenditure previously debited to Capital heads, accruing during the process of construction of a project, should be utilized in reduction of capital expenditure. Thereafter, their treatment in the accounts will depend on circumstances, but except under a special rule or order of Government, they should not be credited to the revenue account of the department or undertaking.

(Source: Based on Rule 31, GAR, 1990)

3.1.3.14 The Major Heads of Account

falling within the Consolidated Fund generally correspond to 'Functions' of Government, such as different services like 'Crop Husbandry', 'Defence' etc being provided by Government, while minor heads subordinate to them identify the 'Programmes' undertaken to achieve the objectives of the function represented by the major head. A programme may consist of a number of schemes or activities and these generally, correspond to sub-heads below the minor head represented by the programme. In certain cases, especially in regard to non-developmental expenditure or expenditure of an administrative nature, the sub-heads may denote the components of a programme, such as 'Organizations' or the different 'Wings of Administration'.

3.1.3.15 A 'detailed head', is termed as an object classification. On the expenditure side of the accounts particularly in respect of heads of accounts within the Consolidated Fund, detailed heads are primarily meant for itemized control over expenditure and indicate the object or nature of expenditure on a scheme or activity or organization in terms of inputs such as 'Salaries', 'Office Expenses', 'Grants-in-Aid', 'Loans', 'Investments'.

3.1.4 Preparation of Accounts

3.1.4.1 The annual accounts of the Government comprise the Appropriation Accounts and the Finance Accounts. The Finance Accounts show the details of receipts and expenditure for all the three Funds in the form of various statements including liabilities of the government such as guarantees etc. and loans given to States, Union Territories and public sector undertakings. Through the Appropriation Accounts, Parliament is informed about the expenditure incurred against the appropriations made by the Parliament in the previous financial year.

3.1.4.2 These documents are presented before the Parliament after their statutory audit by the Comptroller and Auditor General of India. Preparation and submission of Appropriation Accounts to the Parliament completes the cycle of budgetary process.

3.1.4.3 *Appropriation Accounts*[17]

3.1.4.3.1 Appropriation Accounts are accounts of the expenditure, voted and charged of the government for each financial year compared with the amounts of the voted grants and charged appropriation for different purposes as specified in the schedules appended to the Appropriation Acts passed by the Parliament or Legislature, to exhibit the excess or savings as the case may be, over the final grant or appropriation. These accounts are complementary to the accounts of the annual receipts and disbursements of Government otherwise known as Finance Accounts.[18]

3.1.4.3.2 From 1961-62, Appropriation Accounts are complied by group-heads to

[17]Source: Based on 'Introduction to Indian Government Accounts and Audit', Fifth Edition, 1987; issued under the Authority of the Comptroller and Auditor General of India

eliminate unimportant matters and to enhance their usefulness. The Appropriation Accounts include:

i. A consolidated statement tilted "Summary of Appropriation Accounts" showing the total amount of funds (original and supplementary) provided by the Parliament/Legislature under each voted grant and charged appropriation, actual expenditure incurred against each and the saving or excess and

ii. Appropriation accounts of each grant/appropriation indicating original grant/ appropriation, additional funds provided during the year by supplementary grant/ appropriation as a whole and the amount surrendered during the year.

3.1.4.3.3 This is followed by "Notes and Comments" which bring to the notice of the Parliament/Legislature (giving relevant particulars of the group heads) excesses over grants/ appropriations requiring regularization, expenditure booked against the grant/appropriation but not really debitable to it, expenditure incurred on a "New Service" without specific authority of the Parliament/Legislature unjustified or excessive provision of funds leading to large savings and lapses and also cases of defective control over expenditure e.g. excessive, irregular or unjustified re-appropriations or surrenders within the grant/appropriation.

3.1.4.3.4 In the summary of Appropriation Accounts, provision is made for:

i. Indicating the expenditure met by advances from the contingency Fund which were not reimbursed to the fund during the year by authorization of the Legislature;

ii. Reconciliation of the total expenditure according to Appropriation Accounts with the total expendire as shown in the Finance Accounts after taking into account recoveries of expenditure; and

iii. Drawing attention to cases of excesses over grants/ appropriations requiring regularization.

3.1.4.3.5 The general rule is that a grant is voted or an appropriation is authorized for the gross expenditure required for each service. The expenditure shown against each grant or appropriation in the Appropriation Accounts thus exclude recoveries of expenditure relating to respective grants or appropriations. The Finance Accounts, on the other hand, show the net expenditure after taking into account the recoveries. A reconciliation statement showing:

a. Total expenditure according to Appropriation Accounts

[18]http://cga.nic.in/html/app.htm

b. Total of recoveries and

c. Net total expenditure as shown in the Finance Accounts is therefore included below the summary of Appropriation Accounts. A detailed statement showing recoveries relating to each grant/appropriation is also included as an appendix to the Appropriation Accounts.

3.1.4.4 *Finance Accounts*

3.1.4.4.1 As soon as the accounts of a year are closed, the Finance Accounts of each Government of a State or Union Territory with Legislature for the year are prepared by the Accountant General concerned and submitted to the Comptroller and Auditor General for approval and the transmission to the Governor of the State/Administrator of the Union Territory to be laid before the respective Legislature. The Finance Accounts of the Union Government which comprise transactions of Civil as well as Railways, Defence, Posts and Telecommunication are prepared by Controller General of Accounts and submitted to the Comptroller and Auditor General for certification and transmission to the President for being laid on the table of the Parliament.

3.1.4.4.2 The Finance Accounts present the accounts of the receipts and outgoings of the Government for the year together with the financial results disclosed by the revenue and Capital accounts, the accounts of the Public Debt and the liability and assets of the Government concerned as worked out from the balances recorded in the accounts.

3.1.4.4.3 The statement in Part I is intended to give, in a summarized form, information in regard to:

i. Transactions of the year relating to the Consolidated Fund, Contingency Fund and the Public Accounts.

ii. (a) Capital outlay outside the Revenue Accounts and progressive Capital expenditure to end of the year.

(b) Revenue expenditure temporarily capitalized

iii. Financial results of irrigation and electricity schemes.

iv. Debt position of Government including expenditure incurred on the service of debt.

v. Loans and advances by Government.

vi. Guarantee given by Government

vii. Cash balance and investments of cash balances

viii. Summary of balances under Consolidated Fund, Contingency Fund and Public Account.

3.2 Audit[19]

3.2.1 The Comptroller & Auditor-General of India

3.2.1.1 Article 148 of the Constitution provides that there shall be a Comptroller and Auditor-General of India (CAG) who shall be appointed by 'the President by warrant under his hand and seal and shall only be removed from office in like manner and on the like grounds as a judge of the Supreme Court '.

3.2.1.2 Article 149 of the Constitution provides that the Comptroller and Auditor-General of India (CAG) shall perform such duties and exercise such powers in relation to the accounts of the Union, the States and of any other authority / body as may be prescribed under law by Parliament. It also provides that until such law is passed, the Auditor-General of India would continue to perform such functions as were exercised by him before the commencement of the Constitution. Accordingly, the Parliament passed The Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971. The functions and duties of the CAG are described in the following paragraphs.

3.2.1.3 *Accounting Functions*

3.2.1.3.1 Article 150 of the Constitution mandates that the Accounts of the Union and the States shall be kept in such reforms as prescribed by the President on the advice of the CAG. Before the commencement of The Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, the accounts of Defence, Railways, certain other department of the Union Government, Lok Sabha and Rajya Sabha Secretariats and the Union Territories of Goa, Daman and Diu and Puducherry were not being compiled by the C&AG. This arrangement was not revoked by this Act.

3.2.1.3.2 Under the Act, the CAG has been made responsible for preparing each year the accounts showing, under the respective heads, the annual receipts and disbursements for the purpose of the Union, the States and each Union Territory having a Legislative Assembly. However, the President and the Governor may, after consultation with the CAG, may relieve him from this responsibility in case of the Union / UTs and States respectively. With respect to the accounts for

[19] Based on 'Introduction to Indian Government Accounts and Audit', Fifth Edition, 1987; issued under the Authority of the Comptroller and Auditor General of India

which the CAG is responsible for compilation / keeping, necessary assistance is to be rendered by him in preparation of respective 'Annual Financial Statements'.

3.2.1.3.3 An exercise towards departmentalization of accounts in the Union with the main objective of integrating accounts with the administrative Ministries and Departments was conducted in a phased manner from 1976 onwards. Under this scheme, accounts and finance form an integral part of overall financial management. Administrative Ministries are entrusted with the responsibility of arranging payments and timely compilation and rendering of accounts. As mentioned earlier, the CAG was relieved of the accounting functions as a consequence of this scheme.

3.2.1.3.4 The salient features of the scheme are briefly indicated below:

a) The Secretary of the Department/Ministry acts as the chief accounting authority and discharges this responsibility through and with the assistance of the Integrated Financial Adviser of the Ministry / Department.

b) Payment and accounting functions of the Ministry / Department is discharged through departmental Pay and Accounts Offices functioning at the headquarters of the Department / Ministry and regional Pay and Accounts Offices functioning in various regions of the country. The formation of regional Pay and Accounts Offices is determined with reference to the number and spread of field organizations in various regions of the country.

c) The payments as well as receipt transactions relating to the Ministry / Department and its attached and subordinate offices are transacted at the branches of the Reserve Bank of India and State Bank of India or its subsidiaries or at specified branches of the public sector banks accredited to the department without intervention of the treasury.

d) The regional Pay and Accounts Offices compile the accounts of the region and render them to the central accounts office at the headquarters, which is responsible for compiling the accounts of transactions directly paid for by him or received by him, and consolidating the accounts of the Department as a whole on the basis of the compiled accounts received from the regional Pay and Accounts Offices and his own office.

3.2.1.3.5 However, as yet, there is no separation of accounts and audit functions at the State Government level.

3.2.1.3.6 The accounting function in the Ministries/Departments has now been delegated to

the CGA under the General Accounting Rules, 1990.

3.2.1.4 *Audit Functions*

3.2.1.4.1 Article 151 of the Constitution provides that the CAG shall submit his/her reports, in case of the Union, to the President who shall cause them to be laid before each House of Parliament. Similar provisions exist in case of the States. Under Sections 13, 16 and 17 of the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971, it is the responsibility of the CAG:[20]

a. To audit all receipts which are payable into the Consolidated Fund of India and of each State and each Union Territory having a Legislative Assembly and to satisfy himself that the rules and procedures in that behalf are designed to secure an effective check on the assessment, collection and proper allocation of revenue and are being duly observed and to make for this purpose such examination of the accounts as he thinks fit;

b. To audit all expenditure from the Consolidated Fund of India and of each State and of each Union Territory having a Legislative Assembly and to ascertain whether the money shown in the accounts as having been disbursed was legally available for and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority which governs it;

c. To audit all transactions of the Union and of the States relating to Contingency Funds and Public Accounts;

d. To audit all trading, manufacturing, profit and loss accounts and balance sheets and other subsidiary accounts kept in any department of the Union or of a State; and

e. To audit the accounts of stores and stock kept in any office or department of the Union or of a State and in each case to report on the expenditure, transactions or accounts so audited by him.

3.2.1.4.2 Apart from the above, the CAG is also authorized by the Act to audit the receipts and expenditure of bodies or authorities substantially financed by grants or loans from Union or State or Union Territory revenue. In fact, the President or the Governor of a State or an Administrator of a Union Territory having a Legislative Assembly may also request the CAG to undertake the audit of accounts of any authority / body which has not been entrusted to him under law.

[20]Based on 'Introduction to Indian Government Accounts and Audit', Fifth Edition, 1987; issued under the Authority of the Comptroller and Auditor General of India

3.2.1.4.3 The Reports submitted by the CAG and laid before each House of Parliament is examined by the Committee on Public Accounts (PAC) under Rule 308 of 'Rules of Procedure and Conduct of Business in Lok Sabha'. In case of the Public Undertakings, these Reports are examined by Parliamentary Committee on Public Undertakings (COPU). These are further discussed in Chapter 8 of this Report.

3.3 Internal Audit

3.3.1 Presently, 'internal audit' is recognized as an aid to the management for monitoring the financial performance and effectiveness of various programmes, schemes and activities. In Government of India, internal audit is conducted through the Internal Audit Wings in the Principal Accounts Offices of various Ministries/Departments.[21]

3.3.2 The scheme of departmentalization of Union Government Accounts provided for setting up an internal audit organization. Accordingly, these were set up in most Union Government Ministries under the Chief Controller of Accounts/Controller of Accounts. The Secretary of the Ministry/Department acts as the Chief Accounting Authority. However, it is the Financial Adviser who, for and on behalf of the Secretary, is responsible for internal audit of payments and accounts from the records maintained by the various secretariat and field formations and Pay and Accounts Offices of the Ministry/Department.[22]

3.3.3. The revised charter of the role and responsibilities of the Chief Controller of Accounts (CCA)/Controller of Accounts (CAs) envisages that the internal audit wing working under the control and supervision of the CCAs/CAs would move beyond the existing system of compliance/regulatory audit and would focus on:

- The appraisal, monitoring and evaluation of individual schemes;
- Assessment of adequacy and effectiveness of internal controls in general, and soundness of financial systems and reliability of financial and accounting reports in particular;
- Identification and monitoring of risk factors (including those contained in the Outcome Budget); critical assessment of economy, efficiency and effectiveness of service delivery mechanism to ensure value for money; and
- Providing an effective monitoring system to facilitate mid-course corrections.

The above revised functions are to be carried out as per the guidelines issued by the CGA from time to time.

3.4 New Charter for the Integrated Financial Adviser (IFA)

3.4.1 A scheme of Integrated Financial Advisers was put in place in 1975.[23] In general, the

[21] http://cga.nic.in/html/iaudit.htm
[22] Introduction to Indian Government Accounts and Audit

IFAs were made responsible for:[24]

1) Preparation of the budget of the Department/Ministry, distribution of budget allocations to the various wings, departments/formations;

2) Arranging payments directly to the bodies, corporations and authorities of grant-in-aid, loans, etc., as may be sanctioned by the Department;

3) Arranging payments through Pay and Accounts Offices under him in various regions of the country, all pay and allowances, office contingencies, miscellaneous payments, all admissible loans and advances to government servants including provident funds claims in accordance with prescribed financial and treasury procedures;

4) Compilation and consolidation of the accounts of the Department/ Ministry in accordance with the instructions issued by the Union Government and/ or the Comptroller and Auditor General and rendering the appropriation of accounts;

5) Introduction of a system of management accounting suited to the functions and requirements of the Department/Ministry;

6) Installation of a sound system of internal inspection within the department to ensure both accuracy in accounts and efficiency in operation as a part of the management.

3.4.1 This scheme was reviewed in 2006. The new charter of the Integrated Financial Advisers is analysed in Chapter 7. In brief, it redefines the role of the IFAs in financial management within Ministries/Departments ranging from formulation of the Budget Estimates to cash management and internal audit.

3.5 Flow of Funds Related to Union Government Programmes

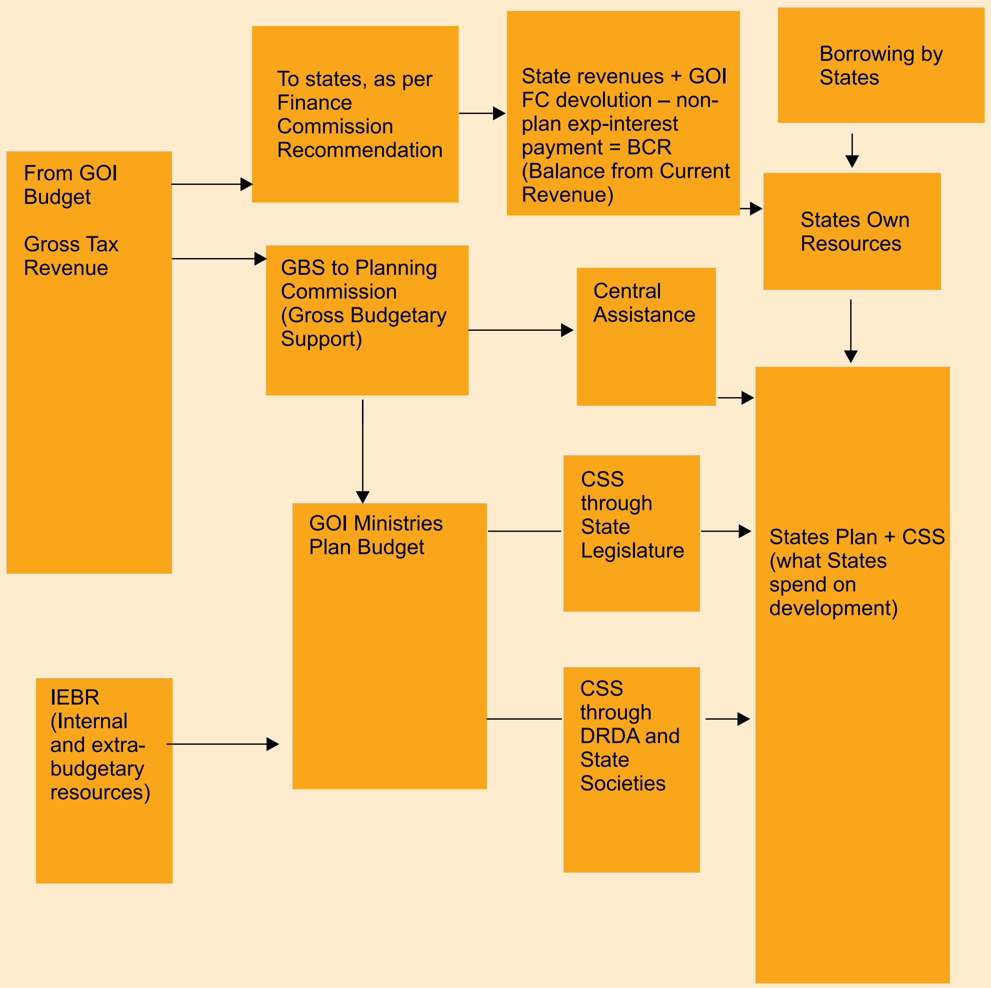
3.5.1 Transfer of funds from the Union to the States due to the inadequacy of sources of generation of revenue takes place through various means. The first and foremost is by way of devolution as per the recommendations made by the Finance Commission (in terms of Articles 280 and 281 of the Constitution). The second channel is through the Planning Commission. In this case, the States receive Plan funds from the Planning Commission in the form of 'Central Assistance' under the 'Scheme of Financing of States' Annual Plan. They also receive Plan Funds through various Union Government Ministries/Departments in respect of certain schemes implemented by State Governments. These schemes are known as 'Centrally

[23] OM F.No.10(29)-E.Coord/73, dated 6.10.75
[24] Introduction to Indian Government Accounts and Audit

Sponsored Schemes' (CSS). The mechanisms of transfer of funds in case of the CSS are as contemplated in the design of the respective schemes. A schematic diagram of flow of funds from the Union to the States is presented in Fig 3.1.[25]

3.5.2 In this Report, the Commission has focused on the transfer of funds from the Union to the States in case of the CSS only. The Centrally Sponsored Schemes do not fall within the subjects allocated to Union Government in List I of the Seventh Schedule of the Constitution. However, they are funded by the Union Government to achieve certain national objectives. The flow of funds from the Union Government to the ultimate implementing agencies for any scheme is through one of these two channels.

Fig. 3.1: Devolution of Funds from Union to States



[25]Source: Based on 'Central Transfers to States & Centrally Sponsored Schemes', by Naresh C. Saxena; http://pmindia.nic.in/nac/concept%20papers/Central%20Transfers.pdf

i) Funds are transferred to the Consolidated Fund of the State Governments which spend the money through the implementing agencies.

ii) The Union Government transfers funds directly to implementing agencies in the States through normal banking channels.

3.5.3 The types of fund release mechanism in case of some Schemes is illustrated in Table 3.1.[26]

3.5.4 Actual expenditure under the CSS is incurred only when payment is made either to a beneficiary of the scheme or to the supplier of goods and services. However, due to lack of a proper information system, the tracking of fund flow and correlation between the amount released and expenditure made could not be determined without a degree of uncertainty. Further, when funds are transferred directly to the implementing agencies in the States, it

Table 3.1: Types of Fund Release Mechanism (Select Cases)

Sl. No.	Type-I	Type-II	Type-III	Type-IV
	To State Governments through credit to the state government account at the RBI by the Finance Ministry	To State Governments through credit to the state government account at the RBI by concerned Administrative Ministry/ Department or a subordinate office of that Department	To separate agencies at State or district level directly by the concerned Administrative Ministry / Department or a subordinate office of that Department	To State Government departments by means of a bank draft by the concerned Administrative Ministry / Department or a subordinate office of that Department
1.	Hill Area Development Programme	Integrated Dairy Development Project	Employment Assurance Scheme	North Eastern Council
2.	Slum Development Scheme	Special Central Assistance Tribal Sub Plan	Balika Samridhi Yojna	
3	Prime Minister's Gramodaya Yojna	National Pulses Development Programme	Indira Awas Yojna	
4	Prime Minister's Gram Sadak Yojna*	National Oilseed Production Programme	National Programme on Biogas Development	
		Operation Blackboard		
			National AIDS Control Programme	
			National TB Control Programme	
			Swarna Jayanti Shahari Rozgar Yojna**	

* *In 2000-2001, the release was made in this fashion and from 2001-2002 it moved to a type III mechanism.*

** *In practice, most states have not established a registered state level agency and the concerned state government office is receiving the funds but instead of depositing these in the state government account and securing budgetary allocation for further disbursing to implementing agencies, they have been routing these through bank accounts. In effect, they have been functioning in much the same fashion as a registered state level agency would be expected to.*

[26]http://planningcommission.nic.in/reports/sereport/ser/stdy_flwfnds.pdf

has to be done in advance which results in a substantial accumulation of funds in the pipe line.

3.6 Earlier Initiatives in Budgetary Reforms

3.6.1 Initiatives relating to Performance Budget (1969), Zero-based Budget (1986-87) and Outcome Budget (2005-06) have been briefly outlined in Chapter 2. They are further discussed in the following Chapter while considering issues related to budgetary reforms.

4 ANALYSIS OF THE BUDGETARY PROCESS

4.1 The Budgetary System

4.1.1 In an input-based budget system the linkages of budget outlays with productivity of public expenditure and delivery of public services generally remain nebulous. In the conventional line-item budgeting, the major focus is on ensuring that agencies do not exceed the specified allocation.[27] Financial compliance is sought to be achieved in this system through a detailed budgetary specification of inputs and to achieve this, detailed procedures are designed for expenditure control. The budgeting system in India, both at the Union and State levels, continues to be conventional and inputs based though the recently introduced outcome budgeting is a major reform towards achieving results.

4.2 Parliamentary Procedures

4.2.1 As per Rule 204(1) of the Rules of Procedure and Conduct of Business in the Lok Sabha, the Budget is presented to the Parliament on such date as is fixed by the President. The present convention is to present the Budget at 11.00 am on the last working day of February i.e. about a month before the commencement of the financial year except in the year when General Elections to the Lok Sabha are held. In an election year, the Budget may be presented twice, first to secure a Vote on Account for a few months and later in full.

4.2.2 The General Discussion on the Budget is held on a day appointed by the Speaker, subsequent to the day of presentation of the Budget and for such period of time as the Speaker may decide. During the general discussions, the House is at liberty to discuss the budget as a whole or any question of principle involved therein, but no motion can be moved nor can the budget be submitted to the vote of the House. The Finance Minister has a right to reply at the end of the discussions. The scope of discussions at this stage is confined to general examination of budget, policy of taxation as expressed in the Budget speech of the Finance Minister and general schemes and structures etc. Specific points or grievances can be discussed on the floor of the House when it takes up relevant Demands for Grants or the Finance Bill.

4.2.3 After the conclusion of the General Discussion, the Demands for Grants of individual Ministries/Departments are taken up in the Lok Sabha for discussion as per the time table decided by the Business Advisory Committee of the House and is subjected to vote. In order to facilitate proper examination of different Demands for Grants, different Departmentally related Standing Committees of the Parliament are constituted every year to consider the concerned Demands for Grants and make a report on them to the House. However, these Committees are not empowered to suggest anything in the nature of 'cut motions' and they have only persuasive value.

4.2.4 When a Demand is taken up for discussion, any Member may seek reduction in the

[27] For example, 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.

amount of the Demand by moving any of the following types of Cut Motions:

- Disapproval of Policy Cut (by moving "that the amount of the Demand be reduced to Re. 1", thereby representing a disapproval of the policy underlying the demand);
- Economy Cut (by moving "that the amount of the demand be reduced by a specified amount", thereby representing the economy that can be effected); and
- Token Cut (by moving "that the amount of the demand be reduced by Rs. 100", in order to ventilate a specific grievance).

4.2.5 At the end of the period allotted for discussion on the Demands for Grants, the Speaker puts all the outstanding Demands for Grants to the vote of the House. This process is known as 'Guillotine' which acts as a device for bringing the debate on financial proposals to an end within a specified time with the result that several Demands have to be voted by the House without discussions. At the same time, Cut Motions which have been moved are also put to vote and disposed of. The Appropriation Bill for withdrawal from the Consolidated Fund of India is introduced in the Lok Sabha with the prior approval of the President. For its introduction, consideration and passing on the same day, special permission has to be sought from the Speaker. The scope of debate on an Appropriation Bill relating to Demands for Grants for the financial year after the remaining demands have been guillotined is restricted to matters of public importance or administrative policy implied in the grants covered by the Bill which have not already been raised while relevant Demands for Grants were under consideration.

4.3 Preparation of the Budget

4.3.1 Preparation of the Annual Budget in the Government of India follows both the top-down and bottom-up approaches. While guidelines and instructions are issued by the Ministry of Finance and Planning Commission, the spending Ministries/Departments make requests for budgetary allocations based on their own estimates. The provisions which govern the preparatory process are contained in the General Financial Rules. The Ministry of Finance issues a Budget Circular annually which contains the guidelines applicable to the particular year along with instructions and guidelines issued by different authorities in the form of annexures.

4.3.2 The process of preparation of the Budget begins with the issue of the Budget Circular by the Budget Division of the Ministry of Finance in the month of September. This Circular is issued for the guidance of Ministries/Departments in framing the Revised Estimates for the current year and the Budget Estimates for the ensuing year. It gives detailed instructions about the preparation of estimates of receipts and expenditure, the required format and the various statements that are to be appended to the estimates. It also specifies the processes to be

followed and their scheduled dates. The procedure for preparing the estimates for expenditure is briefly outlined in the following paragraphs.

4.3.3 The first step to be taken by the Ministries/Departments is to review the existing Expenditure Budget so as to prioritise the activities and schemes, both on the Plan and Non-Plan side and identify those activities and schemes, which can be eliminated or reduced in size or merged with any other scheme. Thus, all ongoing schemes/programmes need to be evaluated to determine their continued relevance.[28] Schemes that are not to continue beyond the current year, need to be excluded from the BE of the ensuing year. From the Eleventh Five Year Plan onwards, Planning Commission's guidelines regarding inclusion of new Schemes in the Plan, enhancement of Five Year Plan/Annual Plan outlays and major changes in the scope and investment approval of the Plan Schemes is to be adhered before firming up the estimates.[29]

4.3.4 Instructions are issued regularly giving due consideration to past performance, the stages of formulation/implementation of the various schemes, the institutional capacity of the implementing agencies to implement the scheme as scheduled, the constraints on spending by the spending agencies, and most importantly the quantum of Government assistance lying with the recipients unutilised/ unaccounted for etc. while making estimates. These are all aimed at minimising the scope for available surrenders at a later stage.[30] The Ministry of Finance has issued instructions on the need for the individual Ministry/Department to put in place effective mechanism for realistically assessing their requirement of funds in a way that would ward off the occurrence of unwarranted surrender of savings at a later date. Under the standing instructions of the Ministry of Finance, no provision should normally be made in the Budget without completion of a pre-Budget scrutiny of a project/scheme. However, the Budget Circular also provides that where, such a provision has been made without the necessary scrutiny, such scrutiny should be completed and appropriate approvals obtained therefor before the commencement of the financial year or latest by the time the Budget is passed by the Parliament.[31]

4.3.5 The departmental estimates are examined and analysed by the Financial Adviser and then forwarded to the Budget Division in the Finance Ministry. This is followed by pre-budget meetings with the Secretary (Expenditure). Once this stage is over, the expenditure ceilings are communicated (which include ceilings on both revenue and capital expenditure). The Departments then prepare the Statement of Budget Estimates (Final). In case of the 2009-10 Budget, the due dates for rendition of estimates by Ministries/Departments to the Budget Division are given in in Table 4.1 : [32]

4.3.6 In the following paragraphs, different issues related to strengthening of the financial management system, so far as the budgetary processes are concerned, and the agenda for

[28]Secretary (Expenditure)'s O.M. F. No. 7(5)/E-Coord/2004 dated 24.09.2004
[29]Planning Commission U.O. No. N- 11016/4/2006-PC dated 29.8.2006
[30]O.M. F. No. 7(6)-B(R)/2001 dated 20th July, 2001; F.No.7(1)/B(D)/2006 dated 31st July, 2006
[31]Para 3.2.6; Budget Circular, 2009-10

reforms in the budgetary process are discussed.

4.4 Weaknesses in the Budgetary System and Implementation

4.4.1 The Commission has analysed the recent Annual Budgets and their implementation and has found that they have the following weaknesses:

i. *Unrealistic budget estimates:* The amounts budgeted are often not realistic.

Table 4.1: Due Dates for Rendition of Estimates by Union Ministries/Departments

Statement of Budget Estimates (proposed):	October 24, 2008 (followed by pre-budget discussions)
Statement of Budget Estimates (Final):	Immediately after ceilings are communicated
SBE with BE 2009-10 (Plan) and statement showing provision for externally aided projects in Central Plan	Within 3 days of receipt of Plan allocation from Planning Commission
Notes on Demands for Grants for Expenditure Budget Vol. 2	Within 3 days of rendition of SBE (Final) for Plan Expenditure 2009-10
Material for Statements to be appended to Demands for Grants/Expenditure Budget	-Do-

Weakness in preparing proper estimates leads to frequent revisions and supplementaries. On the other hand, there are major unspent provisions at the end of the year.

ii. *Delay in implementation of projects:* Resources are being spread thinly with only token provisions in some cases, often leading to inordinate delays in execution of projects.

iii. *Skewed expenditure pattern:* The expenditure pattern is skewed, with a major portion getting spent in the last quarter of the financial year, especially in the last month.

iv. *Inadequate adherence to the multi-year perspective and missing 'line of sight' between plan and budget:* Though the Five Year Plan provides the basis for multi-year perspective, often ad hoc deviations from it distort the long-term plan objectives. The Plan schemes get dispersed into line-items in the budget estimates and there is no consolidation afterwards – both in the estimates and the final accounts. There is need for alignment between the plan, budgets and accounts.

v. *No correlation between expenditure and actual implementation:* The expenditure figures do not reflect actual expenditure made towards receipt of goods and services.

vi. *Mis-stating of financial position:* Parking of funds by implementing agencies, outside the government accounts portrays an incorrect picture of the financial position of government. This also means that the Government's financial position is not known with reasonable accuracy at any given point of time.

vii. *Ad hoc project announcements:* Indiscriminate announcement of projects/ schemes not included in the plan/budget is regularly made, often without proper consideration and detailing.

viii. Emphasis on compliance with procedures rather than on outcomes.

ix. Irrational plan / non-plan distinction leads to inefficiency in resource utilization.

4.5 Unrealistic Budget Estimates

4.5.1 The Report of the CAG on Union Government Accounts 2007-08 mentions in paragraph 8.4 that "Unspent provisions in a grant or appropriation indicate either poor budgeting or shortfall in performance or both. Unspent provisions of more than Rs. 100 crore, which need a detailed explanatory note to the Public Accounts Committee (PAC), occurred in 60 cases of 47 grants (including Civil, Posts and Defence) during the year 2007-08. The unspent provisions were attributed by the Ministries/Departments to some of the schemes failing to take off." In fact, this Report also points out that there were 24 sections of 20 grants/appropriations including six capital sections which had persistent savings of Rs. 100 crore and above during the last three years (2005-08). These are presented in Table 4.2.

Table 4.2: Details of Persistent Unspent Provision of Rs.100 Crore or More under Grant / Appropriations

(Rupees in crore)

Grant No.	Year	Savings during the year

[32]Budget Circular 2009-10

Revenue (Voted)		
6 – Nuclear Power Schemes	2005-06	104.73
	2006-07	205.83
	2007-08	709.46
18 – Department of Food and Public Distribution	2005-06	3299.01
	2006-07	205.13
	2007-08	495.87
33 – Payments to Financial Institutions	2005-06	1523.18
	2006-07	1687.99
	2007-08	1224.47
35 – Transfers to State and Union Territory Governments	2005-06	1106.34
	2006-07	722.37
	2007-08	1481.30
46- Department of Health and Family Welfare	2005-06	1406.50
	2006-07	2274.91
	2007-08	1467.46
48 – Department of Heavy Industry	2005-06	1183.7
	2006-07	138.52
	2007-08	477.77
52 – Police	2005-06	117.82
	2006-07	600.93
	2007-08	285.07
56 – Department of School Education and Literacy	2005-06	505.92
	2006-07	373.19
	2007-08	2668.29
61 – Department of Law and Justice	2005-06	217.74
	2006-07	199.72
	2007-08	309.78
65 – Ministry of New and Renewable Energy	2005-06	276.18
	2006-07	207.85
	2007-08	139.67
81 – Department of Science and Technology	2005-06	205.09

Table 4.2: Details of Persistent Unspent Provision of Rs.100 Crore or More under Grant / Appropriations *Contd.*

(Rupees in crore)

Grant No.	Year	Savings during the year
Revenue (Voted)		
	2006-07	490.04
	2007-08	271.06
85 – Department of Road Transport and Highways	2005-06	448.17
	2006-07	515.54
	2007-08	335.62
88 – Department of Space	2005-06	435.95
	2006-07	505.09
	2007-08	374.81
89 – Ministry of Statistics and Programme Implementation	2005-06	154.41
	2006-07	145.50
	2007-08	138.76
91 – Ministry of Textiles	2005-06	118.28
	2006-07	763.18
	2007-08	147.35
99 – Department of Urban Development	2005-06	718.29
	2006-07	197.19
	2007-08	118.11
102 – Ministry of Water Resources	2005-06	112.53
	2006-07	195.08
	2007-08	102.75
Revenue (Charged)		
35- Transfer to State and Union Territory Governments	2005-06	740.51
	2006-07	1161.69
	2007-08	3748.34
Capital (Voted)		
5 – Department of Atomic Energy	2005-06	298.17
	2006-07	164.03

Contd.

Table 4.2: Details of Persistent Unspent Provision of Rs.100 Crore or More under Grant/ Appropriations

(Rupees in crore)

Grant No.	Year	Savings during the year
Revenue (Voted)		
	2007-08	458.65
6 – Nuclear Power Schemes	2005-06	1013.46
	2006-07	713.49
	2007-08	1240.53
52 - Police	2005-06	152.81
	2006-07	192.72
	2007-08	1788.67
72 – Ministry of Power	2005-06	1417.13
	2006-07	737.70
	2007-08	775.28
Capital (Charged)		
35 – Transfer to State and Union Territory Governments	2005-06	350.53
	2006-07	1000.00
	2007-08	1000.15
27 – Capital Outlay on Defence Services	2005-06	2033.97
	2006-07	3653.05
	2007-08	4417.70

4.5.2 Further, in paragraph 8.14, the Report states that in 25 cases relating to 25 grants/ appropriations, while supplementary provisions aggregating to Rs. 65887.93 crore were obtained during 2007-08 in anticipation of higher expenditure, the final expenditure was less than even the original grants/appropriations resulting in unspent provisions of Rs. 70108.62 crore. This is presented in Table 4.3.

Table 4.3: Unspent Provision Were More than the Supplementary Grant / Appropriation

(Rupees in crore)

Sl. No.	Grant/ appropriation	Original provision	Supplementary grant obtained	Actual disbursements	Unspent provision
Civil					
Revenue - Voted					
1.	14 – Department of Tecommunications	5445.00	377.01	4788.22	1033.79
2.	19 – Ministry of Culture	882.61	115.00	850.52	147.09
3.	20 – Ministry of Defence	6865.08	229.79	6842.77	252.10
4.	43 – Indirect Taxes	1689.80	59.70	1636.08	113.42
5.	46 – Department of Health & Family Welfare	16270.63	280.54	15083.71	1467.46
6.	50 – Ministry of Home Affairs	765.77	28.27	763.42	30.62
7.	56 – Department of School Education & Literacy	33535.22	49.15	30916.08	2668.29
8.	58 – Ministry of Information & Broadcasting	1391.76	4.94	1363.71	32.99
9.	69 – Ministry of Personnel, Public Grievances & Pensions	320.88	6.47	306.46	20.89
10.	72 – Ministry of Power	4883.91	2.27	4309.97	576.21
11.	83 – Department of Biotechnology	694.70	8.30	636.62	66.38
12.	85 – Department of Road Transport & Highways	12003.90	161.88	11830.16	335.62
13.	86 – Ministry of Micro, Small & Medium Enterprises	585.41	4.08	486.35	103.14
14.	90 – Ministry of Steel	85.50	4.27	81.04	8.73
Revenue - Charged					
15.	52 – Police	2.94	0.65	2.78	0.81
16.	62 – Appropriation – Supreme Court of India	53.26	3.48	52.93	3.81
17.	93 – Ministry of Tribal Affairs	1489.29	18.42	1357.18	150.53
Capital - Voted					
18.	28 – Ministry of Development of North Eastern Region	154.37	1.76	147.78	8.35
19.	46 – Department of Health & Family Welfare	725.59	51.25	261.66	515.18
20.	48 – Department of	628.58	165.79	615.81	178.56

Table 4.3: Unspent Provision Were More than the Supplementary Grant / Appropriation *Contd.*					
					(Rupees in crore)
Sl. No.	**Grant/ appropriation**	**Original provision**	**Supplementary grant obtained**	**Actual disbursements**	**Unspent provision**
	Heavy Industry				
21.	51 – Cabinet	33.36	0.26	17.02	16.60
22.	52 – Police	4529.81	81.10	2822.24	1788.67
23.	81 – Department of Science and Technology	73.90	1.95	72.59	3.26
24.	94 – Andaman & Nicobar Islands	816.90	1.00	813.93	3.98
25.	37 – Appropriations Repayment of Debt	1611645.92	64230.60	1604110.47	70108.62
	Total		65887.93		

4.5.3 The Commission has analysed the Reports of the CAG pertaining to the Civil Ministries in the Union Government from year 2000 onwards with regard to unspent provisions, injudicious re-appropriations, supplementary grants without requirement, rush of expenditure in the month of March etc. The findings are presented in Table 4.4.

4.5.4 Table 4.4 shows that despite having such an elaborate and time consuming system of making budgetary estimates, large amounts of unspent money have been surrendered every year at the lapse of the financial year. Large-scale unspent provisions are indicative of lack of efficiency in programme management at the departmental level in an annual budget cycle and undermine efficient use of public money which is one of the major objectives of any budgeting system. 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. It also shows that proper forecasting methods are not used to estimate expenditure on account of various items.

Table 4.4: Analysis of Observations by CAG in case of Civil Ministries/Departments

Year of CAG Report / FY	Unspent provision (Rs. crore)	Unspent provision of Rs. 100 crore or more	Excess Disbursements over Grants / Appropriations	Charged Expenditure as % of total expenditure	Injudicious reappropriations	Supplementary grants without requirement
2000 (1998-99)	35021.40 (5.44% of total authorization)	25 cases of 20 grants and one appropriation	Rs.11824.46 crore in 56 segments of 42 grants / appropriations	77	Rs.9481 crore in 32 cases of 16 grants / appropriations where even the original provision could not be utilised	In five cases, actual expenditure was less than the original provision (Rs. 17 crore)
2001 (1999-2000)	68017.08 (10.15% of total authorization)	32 cases	Rs.0.57 crore in 2 segments of two grants / appropriations	75	Rs.17.64 crore in 17 cases of 12 grants/ appropriations where even the original provision could not be utilised	In 16 cases relating to 15 grants, actual expenditure was less than the original provision (Rs. 317.33 crore)
2002 (2000-01)	138164.89 (19.61% of total authorization)	34 cases of 24 grants and two appropriations.	Rs.0.44 crore in one segment of one grant / appropriations	72	Rs.324.97 crore in 28 cases of 17 grants/ appropriations where even the original provision could not be utilised	In 14 cases relating to 13 grants, actual expenditure was less than the original provision (Rs. 295.89 crore)

Table 4.4: Analysis of Observations by CAG in case of Civil Ministries/Departments *Contd.*

Year of CAG Report / FY	Unspent provision (Rs. crore)	Unspent provision of Rs. 100 crore or more	Excess Disbursements over Grants / Appropriations	Charged Expenditure as % of total expenditure	Injudicious reappropriations	Supplementary grants without requirement
2003 (2001-02)	24290.85 (3.47% of total authorization)	37 cases of 29 grants and two appropriations	Rs. 878.67 crores in five segments of five grants / appropriations	70	Rs.499.62 crore in 21 cases of 17 grants/ appropriations where even the original provision could not be utilized	In 17 cases relating to 16 grants, actual expenditure was less than the original provision (Rs. 1202.01 crore)
2004 (2002-03)	59849.32 (7.69% of total authorization)	57 cases of 48 grants and one appropriation	Rs. 1864.47 crore in nine segments in eight grants / appropriations	70	Rs.52.27 crore in 29 cases of 18 grants/ appropriations where even the original provision could not be utilized	In 20 cases relating to 20 grants, actual expenditure was less than the original provision (Rs. 916.34 crore)
2005 (2003-04)	(Excess Expenditure of 12386)	46 cases of 38 grants and one appropriation	Rs. 42190.20 crores in seven segments of seven grants / appropriations	72	Rs.40.88 crore in 7 cases of 6 grants/ appropriations where even the original provision could not be utilized	In 17 cases relating to 12 grants, actual expenditure was less than the original provision (Rs.2044.46 crore)

Table 4.4: Analysis of Observations by CAG in case of Civil Ministries/Departments *Contd.*

Year of CAG Report / FY	Unspent provision (Rs. crore)	Unspent provision of Rs. 100 crore or more	Excess Disbursements over Grants / Appropriations	Charged Expenditure as % of total expenditure	Injudicious reappropriations	Supplementary grants without requirement
2006 (2004-05)	5194 (0.52% of total authorization)	48 cases of 38 grants and one appropriation	Rs. 33784.53 crores in three segments of three grants / appropriations	74	Rs.33.09 crore in 7 cases of 7 grants/ appropriations where even the original provision could not be utilized	In 29 cases relating to 22 grants, actual expenditure was less than the original provision (Rs.2259.81 crore)
2007 (2005-06)	(Excess Expenditure of Rs. 66896 crore)	53 cases of 44 grants	Rs. 97062.69 crores in 8 segments of 8 grants / appropriations	81	Rs.194.65 crore in 20 cases of 13 grants/ appropriations where even the original provision could not be utilized	In 24 cases relating to 20 grants, actual expenditure was less than the original provision (Rs.443.80 crore)
2008 (2006-07)	(Excess expenditure of Rs. 1034 crore)	60 cases of 47 grants (including Defence etc.)	Rs. 36637.20 crores in 4 segments of 4 grants / appropriations	80	Rs.426.23 crore in 17 cases of 11 grants/ appropriations where even the original provision could not be utilized	In 36 cases relating to 33 grants, actual expenditure was less than the original provision (Rs. 3432 crore)
2009 (2007-08)	10772 (4.40% of total authorisation)	60 cases of 47 grants and one appropriation (including posts and defence)	171.32 crores in 4 segments of 4 grants / appropriations	78	Rs.430.76 crore in 22 cases of 13 grants/ appropriations where even the original provision could not be utilized	25 cases relating to 25 grants, actual expenditure was less than the original provision (Rs.65887.93 crore)

4.5.5 In fact, the serious nature of this state of affairs has also been taken note of by the Public Accounts Committee in its reports. Thus, the observations of the PAC (13th Lok Sabha) in para 13.1 of their 16th Report were communicated by the Ministry of Finance (MoF) to all Ministries/Departments in the following manner: *"the Public Accounts Committee while taking adverse note of the whopping saving of Rs. 44231.22 crore in the grants pertaining to civil Ministries/Departments for the year 1996-97 has noted that out of the above savings, Rs. 29466.03 crore was on account of less withdrawal 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 and 3.5 per cent of the total provision of Rs. 420902.71 crore. The Committee has further observed that there was aggregate savings (both Revenue and Capital Sections) amounting to Rs. 11266.16 crore in the Voted portion and Rs. 32965.06 crore in the Charged portion."*[33] It was further mentioned that the PAC has observed that "*this indicates the lack of earnestness on the part of Ministries/Departments concerned reflecting on the injudicious formulation of budget estimates/utilisation of funds, where such savings could have been significantly reduced, if not avoided altogether, by making realistic budgetary projections by the concerned Ministries/Departments.*" To avoid this 'recurring malady', the Ministry of Finance advised the Ministries/Departments to gear up the 'existing mechanism of review, monitoring and control' as to make a careful formulation of plan/schemes having regard to 'ground realities and achievable targets' and also to make 'realistic assessment of funds'.[34]

4.5.6 However, apparently, the 'existing mechanism of review, monitoring and control' could not be geared up to take into account the ground realities and make realistic assessment of funds in the ensuing period as another OM was issued in 2006 which cited the 17th Report of the PAC (14th Lok Sabha) in observing that "*large sacle unspent provisions under Grants/Appropriations by the civil Ministries/Departments have become an almost recurring feature and the position is still to improve. The Committee is inclined to conclude that the concerned Ministries/Departments have not made any serious attempts to apply effective corrective measures in accordance with the Committee's recommendations.*"[35] This time, reliance was placed on the role of the Financial Adviser under the new Charter, wherein he was required to provide analytical inputs into the budget formulation process in such a way that large savings/unspent provisions were reduced if not altogether avoided. Thus, the Financial Advisers were enjoined to take the following steps in this regard:

- Budget Estimates and Revised Estimates should be prepared with reference to

[33]OM No.F.7(6)-B(R)/2001, dated 20th July, 2001
[34]ibid

the measurable/monitorable commitments made in the Outcome Budget. Fiscal discipline should be enforced in implementation of programmes/projects to ensure 'value for money'.

- Ministries/Departments may review the expenditure profile of each major scheme/programme at regular intervals and apply the result of such analysis at the time of initial budget formulation so that a more realistic estimation of expenditure is made.

- Ministries/Departments may, after carrying out such review, intimate the MoF at the time of finalisation of Revised Estimates of the current year about the possible savings so that they could be re-deployed.

4.5.7 However, there has been little improvement in the situation. This shows that in spite of repeated observations by the PAC, CAG and MoF, Ministries/Departments are actually not in a position to make a true assessment of fund requirement or gauge the ground realities regarding implementation of schemes/programmes. The Commission is of the view that the root cause of the problem lies in the prevalent method of formulation of the annual budget by getting details from different organizations/units/agencies and fitting them into a pre-determined aggregate amount leading to unrealistic budget estimates. This method should be given up along with the method of budgeting on the basis of 'analysis of trends'. As mentioned in Chapter 2, many countries have now adopted top-down budgeting techniques where a medium-term expenditure framework provides baseline expenditure information leading to fixing of the total level of expenditure (the medium-term perspective and expenditure limits are discussed in paragraph 4.8 of this Report). This is then allocated among different Ministries/Departments. These Ministries/Departments are thus free to reallocate moneys among its various agencies or programmes in accordance with their priorities. In case a new policy decision is made, it is funded by reallocations from other areas within the Ministry/Department. The Finance Ministry, however, generally examines the appropriateness of these reallocations. The Commission is of the view that such a 'top-down' method may be adopted in India also. Further, it also needs to be ensured that assumptions made while arriving at estimates are realistic.

4.5.8 Recommendations

[35]Para 14; cited in F.No.7(1)/B(D)/2006 dated 31st July, 2006

a. **The assumptions made while formulating estimates must be realistic. At the end of each year the reasons for the gap between the 'estimates' and 'actuals' must be ascertained and efforts made to minimize them. These assumptions should also be subject to audit.**

b. **The method of formulation of the annual budget by getting details from different organizations/units/agencies and fitting them into a pre-determined aggregate amount leads to unrealistic budget estimates. This method should be given up along with the method of budgeting on the basis of 'analysis of trends'. This should be replaced by a 'top-down' method by indicating aggregate limits to expenditure to each organization/agency.**

c. **Internal capacity for making realistic estimates needs to be developed.**

4.6 Delay in Implementation of Projects

4.6.1 Another aspect of financial management concerns the delays in implementation of projects. In fact, time and cost overruns have been a major problem affecting the central sector projects. The analysis made by the Ministry of Statistics and Programme Implementation shows that 308 projects have accounted for a cost over run of Rs. 57,193 crore (i.e. 49.48%) with respect to their original sanctioned cost during the April-June, 2008 quarter. This is shown in Table 4.5.

4.6.2 The details of time over-runs are given in Table 4.6.

4.6.3 As stated in an earlier paragraph, the Report of the CAG on Union Government Accounts 2007-08 mentions that in a large number of cases, many Ministries/Departments have reported that there were unspent provisions due to various schemes not taking off. In many cases, such delays and unspent provisions are due to token provisions made on account of ill-conceived or hastily conceived projects which fail to take off leading to wastages on the one hand and tying scarce resources on the other, thereby resulting in delayed implementation of other schemes/programmes which are starved of funds.

4.6.4 Thus, the Commission feels that there is need for stricter adherence to project formulation norms so that budgetary provisions are made only when administrative and technical sanctions have been obtained and a detailed feasibility report and cost-benefit analysis have been made. In the same vein, clear and unambiguous provisions should be made for jettisoning of

Table 4.5: Extent of Cost Overrun in Projects with Respect to Original Cost (Status as on 30.06.2008)

Sl. No.	Sector	Total Projects: No. of Projects	Total Projects: Original Cost (Rs. Cr)	Total Projects: Antici-pated Cost (Rs. Cr)	Total Projects: Cost Over run %	Total Projects: No. of Projects	Total Projects: Original Cost (Rs. Cr)	Total Projects: Anticipated Cost (Rs. Cr)	Total Projects: % increase
1.	Atomic Energy	5	24291.26	23360.26	-3.83	0	0.00	0.00	0.00
2.	Civil Aviation	32	2132.11	2231.82	4.68	8	342.46	442.17	29.12
3.	Coal	116	22357.34	23342.48	4.41	16	6065.60	7404.08	22.07
4.	I&B	1	35.00	35.00	0.00	0	0.00	0.00	0.00
5.	Mines	1	4091.51	4091.51	0.00	0	0.00	0.00	0.00
6.	Steel	45	15922.88	20234.77	27.08	11	10383.57	14698.20	41.55
7.	Petroleum	40	55719.67	60680.90	8.90	15	24509.47	32618.55	33.09
8.	Power	71	108303.40	111467.04	2.92	24	26567.42	30701.02	15.56
9.	Health & FW	1	71.18	443.15	522.58	1	71.18	443.15	522.58
10.	Railways	264	43615.77	79497.96	82.27	189	31660.29	67739.93	113.96
11.	Road Transport & Highways	220	60771.27	61443.39	1.11	19	5629.72	6512.34	15.68
12.	Shipping & Ports	30	6323.79	6544.85	3.50	12	557.83	807.97	44.84
13.	Telecommunication	52	11624.31	10658.38	-8.31	9	1092.65	1472.06	34.72
14.	Urban Development	20	15289.53	15852.97	3.69	2	8147.92	8714.14	6.95
15.	Water Resources	1	542.90	1187.00	118.64	1	542.90	1187.00	118.64
16.	Information Technology	2	64.90	86.86	33.84	1	20.00	41.96	109.80
	Total	901	371156.82	421158.34	13.47	308	115591.01	172782.57	49.48

projects where justifiable reasons are on record. Further, a more strict regime needs to be put

Table 4.6: Extent of Time Overrun in Projects With Respect to Original Schedule (Status as on 30.06.2008)

Sl. No.	Sector	Total Projects: No. of Projects	Total Projects: Original Cost (Rs. Cr)	Total Projects: Antici-pated Cost (Rs. Cr)	Total Projects: Cost Over run %	Projects with time overrun: No. of Projects	Projects with time overrun: Original Cost (Rs. Cr)	Projects with time overrun: Anticipated Cost (Rs. Cr)	Projects with time overrun: Range of delay (Months)
1.	Atomic Energy	5	24291.26	23360.26	-3.83	3	16586.26	16586.26	13-25
2.	Civil Aviation	32	2132.11	2231.82	4.68	17	861.94	916.95	2-41
3.	Coal	116	22357.34	23342.48	4.41	17	1079.87	1232.86	4 – 108
4.	I&B	1	35.00	35.00	0.00	0	0.00	0.00	--
5.	Mines	1	4091.51	4091.51	0.00	0	0.00	0.00	--
6.	Steel	45	15922.88	20234.77	27.08	14	11017.48	15151.96	4-20
7.	Petroleum	40	55719.67	60680.90	8.90	21	28869.58	36759.48	1-49
8.	Power	71	108303.40	111467.04	2.92	30	52726.59	55236.22	1-68
9.	Health & FW	1	71.18	443.15	522.58	0	0.00	0.00	--
10.	Railways	264	43615.77	79497.96	82.27	67	14473.32	28402.09	3-159
11.	Road Transport & Highways	220	60771.27	61443.39	1.11	144	34875.67	35567.43	1-80
12.	Shipping & Ports	30	6323.79	6544.85	3.50	17	1625.61	1766.63	4-96
13.	Telecommunication	52	11624.31	10658.38	-8.31	30	8851.74	8278.55	1-127
14.	Urban Development	20	15289.53	15852.97	3.69	11	8502.21	9067.93	3-56
15.	Water Resources	1	542.90	1187.00	118.64	1	542.90	1187.00	60
16.	Information Technology	2	64.90	86.86	33.84	0	0.00	0.00	---
	Total	901	371156.82	421158.34	13.47	372	180013.17	210153.36	

in place to prevent cost and time over-runs which would contain measures to deal with various factors causing delays in projects. However, there is also a need for taking holistic approach as there is a whole host of factors, apart from financial constraints, which leads to delays in implementation of projects.

4.6.5 Recommendation

a. **Projects and schemes should be included in the budget only after detailed consideration. The norms for formulating the budget should be strictly adhered to in order to avoid making token provisions and spreading resources thinly over a large number of projects/schemes.**

4.7 Skewed Expenditure Pattern - Rush of Expenditure towards the End of the Financial Year

4.7.1 There is a tendency to incur a significant part of the annual expenditure in the last quarter of the financial year, especially during the month of March. The details of month-wise Plan expenditure in case of Union Ministries/Departments for the period April 2004 to February 2009 are shown in Fig.4.1. This Figure clearly indicates that every year, there is a rush for expenditure in the month of March, which is represented by the peaks observed in the figure. The figures for monthly non-plan expenditure during the same period show similar trends. This is shown in Fig 4.2.

4.7.2 A modified exchequer control-based expenditure management system was put in place in December 2006 to curb this rush of expenditure in the last quarter of the financial year. The Modified Cash Management System[36] seeks to achieve, inter alia, the following objectives: –

i. Obtaining greater evenness in the budgeted expenditure within the financial year, especially in respect of items entailing large sums of advance releases and transfers to corpus funds.

ii. Reducing rush of expenditure during the last quarter, especially in the last month of the financial year.

Fig. 4.1 : Monthwise Plan Expenditure (Rs in crores)

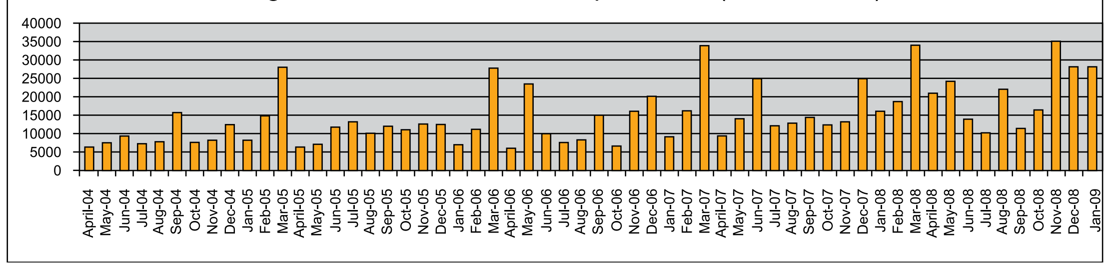
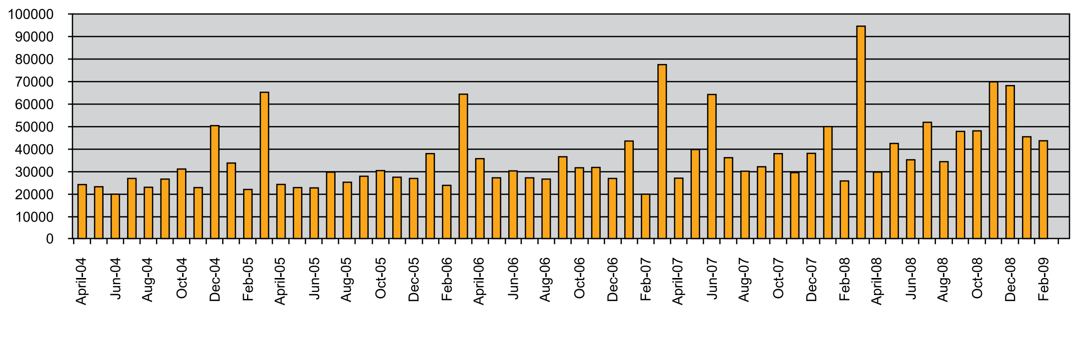


Fig. 4.2 : Monthwise Non Plan Expenditure in Crores



iii. Reducing tendency of parking of funds.

iv. Effectively monitoring the expenditure pattern.

v. Better planning of Indicative Market Borrowing Calendar of the Central Government.

4.7.3 The implementation of this modified system has been entrusted to the Financial Advisors. In accordance with the modified system, a Monthly Expenditure Plan (MEP) has to be worked out for each Demand for Grant. There has to be a separate MEP for Plan and Non-plan expenditure which would be annexed to the Detailed Demand for Grant. The MEP would form the basis of a Quarterly Expenditure Allocations (QEA) and the Ministry/Department concerned would have to limit issuing of cheques accordingly are arrange prior consent of Ministry of Finance. The MEP now needs to be finalized taking into account the following:

a) MEP for the month of March may not exceed 15 per cent of the budgeted provision [Budget Estimate];

b) MEP for the months of January-March may be so fixed that the QEA for the last quarter may not exceed 33 per cent of the budgeted provision; and

c) The extant guidelines of the Ministry of Finance, Department of Expenditure, including D.O.No.7(3)/2006/E.Coord, dated December 21, 2006.

4.7.4 Under the new system, savings would not be available for automatic carry forward to the

[36]F.No.21(1)-PD/2005 Dated 27th November, 2006, Ministry of Finance, Department of Economic Affairs.

next quarter. The Ministry/Department concerned has to approach the Ministry of Finance for revalidation of such savings. Further, even in case of Demand for Grants not covered by the modified exchequer management system, the expenditure in the last quarter of the financial year may not exceed 33 per cent of the budget allocation. The 23 Demands for Grants covered under the modified system are given in Table 4.7 below:

Table 4.7: Demands for Grants Covered under the Modified Cash Management System

Sl.No.	Demand No	Name of the Ministry / Department
1.	1	Department of Agriculture and Cooperation
2.	2	Department of Agricultural Research and Education
3.	8	Department of Fertilizers
4.	11	Department of Commerce
5.	14	Department of Telecommunications
6.	18	Department of Food and Public Distribution
7.	31	Ministry of External Affairs
8.	32	Department of Economic Affairs
9.	41	Indian Audit and Accounts Department
10.	42	Department of Revenue
11.	43	Direct Taxes
12.	44	Indirect Taxes
13.	47	Department of Health & Family Welfare
14.	57	Department of School Education and Literacy
15.	58	Department of Higher Education
16.	68	Ministry of Panchayati Raj
17.	71	Ministry of Petroleum and Natural Gas
18.	73	Ministry of Power

Table 4.7: Demands for Grants covered under the Modified Cash Management System		
Sl.No.	Demand No	Name of the Ministry / Department
19.	79	Department of Rural Development
20.	86	Department of Road Transport and Highways
21.	92	Ministry of Textiles
22.	100	Department of Urban Development
23.	104	Ministry of Women & Child Development

4.7.5 The modified exchequer-based expenditure management is basically a Cash Management System which emphasises the time value of money. The Ministries/Departments covered under the Cash Management System are required to annex a Monthly Expenditure Plan (MEP) along with their Detailed Demand for Grants. By identifying specific Demands for Grants, it aims at ensuring greater evenness in the budgeted expenditure within the year especially in respect of items entailing large sums of advance releases. Thus, it enables the Ministry of Finance and the Reserve Bank of India to plan their market borrowing calendar-based on more predictable patterns of cash flows.

4.7.6 However, in spite of this cash management system, these targets have not been achieved in many cases. For example, the actual expenditure (Plan) up to December 2007 in case of Ministries/Departments having a BE of more than Rs. 1000 crore (Fig 4.3) shows that in the FY 2007-08, a number of Ministries/Departments were not able to spend 67% of the BE (Plan expenditure) in the first three quarters of the year.[37]

4.7.7 Thus, it is seen that the rush of expenditure in the last quarter of the financial year and especially in the month of March continues. While the Modified Cash Management System introduced in some Demands for Grants has shown improvement in this area, the Commission feels that there is scope for further improvement in this regards. It is also of the view that apart from stricter adherence to the system, there is need for its extension to all Demands for Grants as soon as possible.

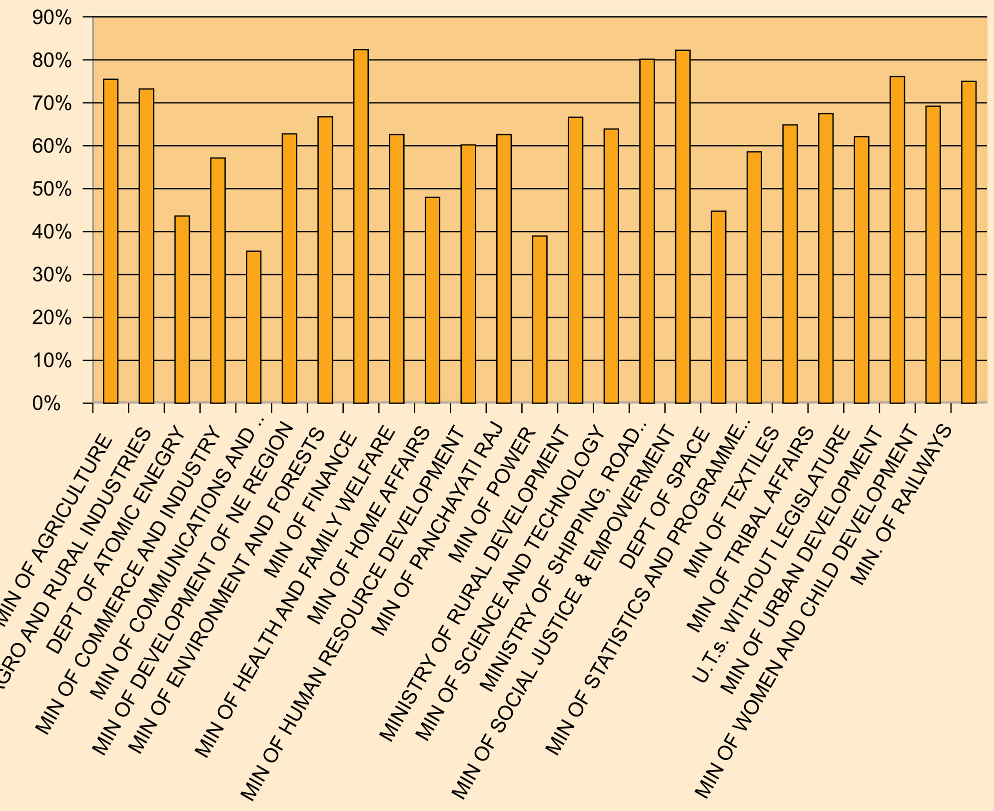
4.7.8 Recommendation

a. **The Modified Cash Management System should be strictly adhered. This System should be extended to all Demands for Grants as soon as possible.**

4.8 Inadequate Adherence to the Multi-year Perspective and Missing Line of Sight between

[37]Source: CGA website

Fig.4.3: Actual Expenditure (Plan) for 2007-08 (up to December 2007) in case of Ministries/Departments having a BE of more than Rs. 1000 crore



Plan and Budget

4.8.1 Multi-year budgeting addresses the basic problem faced in budgeting, - how to integrate planning and budgeting. 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. Today, 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.

4.8.2 A step towards such a medium-term framework was attempted in the 1980s also. Thus, the then Finance Minister, in the Budget Speech for 1985-86 mentioned that:

> *"71. The formulation of the Budget is an annual exercise but, to be meaningful, it has to be set in a longer time frame. Our fiscal system has served us well. However, over the years, objective conditions have changed calling for new responses. I am quite aware that it is not possible to usher in all the changes at one stroke, yet we have to initiate a process of reform which can be completed in a phased manner in a time-bound frame. We will be moving towards the formulation of a long-term fiscal policy co-terminous with the Plan. I hope to initiate a debate on this after the budget session is over."* [38]

4.8.3 A medium-term fiscal policy was indeed drawn up in 1985. This, however, was concerned only with taxation. Further, it was not followed up in later years.[39] The basic issue here is to arrive at a reasonably true picture of the resource situation in a medium-term of 3-5 years and formulate truer estimates of different developmental schemes/programmes/projects within the limits suggested by the availability of resources and follow it up with well formulated annual budgetary estimates for executing the schemes. In the end, the accounts for the actual expenditure, the budgetary estimates and the plan document (the medium-term framework in the Indian context) should be integrated in such a way that a holistic picture emerges and the outcomes could be evaluated. Such a system has been put to practice in the UK where the process of reforms is still continuing. As its governance structures, at least at the Central level, are very similar to that of India, these reforms and developments need consideration. These are described below.

4.8.4 An improvised framework for the planning and control of public expenditure has been in operation in the UK since the 1998 Comprehensive Spending Review (CSR).[40] This framework is based on the following key principles:

- consistency with a long-term, prudent and transparent regime for managing the public finances as a whole;
- the judgement of success by policy outcomes rather than resource inputs;
- strong incentives for departments and their partners in service delivery to plan over several years and plan together where appropriate so as to deliver better public services with greater cost effectiveness; and
- the proper costing and management of capital assets to provide the right incentives for public investment.

[38]Budget Speech of the Finance Minister (1985-86); http://www.indiainfoline.com/per-budg/bs/bs198586.pdf
[39]Source: http://www.hindu.com/2007/01/01/stories/2007010101961500.htm

The framework has two components:

i. Departmental Expenditure Limit (DEL) spending, which is planned and controlled on a three-year basis in Spending Reviews; and

ii. Annually Managed Expenditure (AME), which is expenditure which cannot reasonably be subject to firm, multi-year limits in the same way as DEL. AME includes social security benefits, local authority self-financed expenditure, debt interest, and payments to EU institutions.

4.8.5 In Spending Reviews, firm DEL plans are set for Departments for three years. To ensure consistency with the Government's fiscal rules, departments are set separate resource (current) and capital budgets. To encourage Departments to plan over the medium term, Departments are allowed to carry forward unspent DEL provision from one year into the next and, subject to the 'normal tests for tautness and realism of plans', these may be drawn down in future years also. This facility is called 'End Year Flexibility' (EYF). This EYF also removes any incentive for Departments to use up their provision as the year-end approaches with less regard to value for money. To reap the full benefits of this facility, it is expected that EYF and three-year budgets should be cascaded from Departments to executive agencies and other budget holders, ultimately resulting in improved public service delivery. This ensures that the benefits of this facility is also passed on to lower levels.

4.8.6 The basic principle at work behind three-year budgets and EYF is that the implementing agencies and administrative departments need the stability to plan their operations on a sensible time scale. Further, the implementation of this system also means that departments cannot seek to bid up funds each year (before 1997, three-year plans were set and reviewed in annual Public Expenditure Surveys).

4.8.7 Departments now have certainty about their budgetary allocation over the medium-term and these multi-year DEL plans are strictly enforced. Departments are expected to prioritise competing pressures and fund these within their overall annual limits, as set in Spending Reviews. So the DEL system provides a strong incentive to control costs and maximise value for money.

4.8.8 Apart from the above, there is also a small centrally held DEL Reserve. Support from the Reserve is available only for genuinely unforeseeable contingencies which Departments cannot be expected to manage within their DEL.

4.8.9 As mentioned above, the second component of the public expenditure framework is the AME. This typically consists of programmes which are large, volatile and demand-led, and

[40]Source: http://www.hm-treasury.gov.uk/spend_plancontrol.htm

which therefore cannot reasonably be subject to firm multi-year limits. In the UK, the biggest single element in this category is social security spending. Other items include tax credits, Local Authority Self Financed Expenditure, Scottish Executive spending financed by non-domestic rates, and spending financed from the proceeds of the National Lottery. AME is reviewed twice a year as part of the Budget and Pre-Budget Report process. Although AME is not subject to the same three-year expenditure limits as DEL, it is still part of the overall envelope for public expenditure. Given an overall envelope for public spending, forecasts of AME affect the level of resources available for DEL spending. Cautious estimates and the AME margin are built in to these AME forecasts and reduce the risk of overspending on AME.

4.8.10 The Departmental Expenditure Limit (DEL) and Annually Managed Expenditure together amount to 'Total Managed Expenditure' (TME). TME is a measure drawn from national accounts and represents the current and capital spending of the public sector. The public sector is made up of central government, local government and public corporations.

4.8.11 It needs to be mentioned here that the Budget and Spending Reviews in the UK are roughly equivalent to Five Year Plans in the Indian context and should not be mixed up with the Annual Budget as presented to the Parliament in India. In the UK, annual Parliamentary authority for the expenditure of individual departments is sought through 'Supply Estimates' following the plans announced in Spending Reviews.

4.8.12 Thus, these initiatives not only integrated the planning process to the budgetary process and provided a medium-term perspective to annual expenditure estimates but it also put a stop to the phenomenon of the 'March rush' by providing for the EYF facility.

4.8.13 It was also felt that the financial information presented before the House of Commons needed 'alignment' in order to:

i. make the Government's financial decisions transparent, including the relationship between its stated priorities and its funding decisions;

ii. have the opportunity to influence the Government's financial decisions;

iii. hold the Government, individual Departments and other public bodies to account for their financial decisions and financial management;

and thereby contribute to an improvement in the quality of Departments' financial

decisions and management and improved value for money in public services.[41] It was felt that under current arrangements, there were a number of different systems for presenting Government expenditure. The Government uses budgets to plan what it will spend; it then presents Estimates to Parliament for approval; and finally, after the year-end, it publishes resource accounts. However, there were two main issues with these arrangements:[42]

i. there is significant misalignment between the different bases on which financial information is presented to Parliament; and accordingly

ii. Government financial documents are published in different formats, and on a number of different occasions during the year, making it difficult to understand the links and inter-relationships between the bases on which financial information is presented.

4.8.14 Thus, the UK Government came out with a "Vision" for the Alignment Project in order to simplify its financial reporting to Parliament:

> *"to create a single, coherent financial regime, that is effective, efficient and transparent, enhances accountability to Parliament and the public, and underpins the Government's fiscal framework, incentivises good value for money and supports delivery of excellent public services by allowing managers to manage".*

4.8.15 The frameworks in case of the National Accounts, budgets, Supply Estimates and the 'Resource Accounts' had developed in different ways over the years as they served different purposes. However, it was found that this has resulted in significant misalignment between the different frameworks, with only about two-thirds of government expenditure fully aligned across budgets, estimates and resource accounts.[43] The following misalignments were noticed:[44]

i. Differences in the various boundaries – i.e. the entities and spending included in budgets, estimates and accounts – covering both:

- different types of income and expenditure within the budgets, estimates and accounts boundaries – for example, payments from the National Insurance Fund (NIF) and Consolidated Fund Standing Services (CFSS), which are covered by separate legislation and are included in budgets and resource accounts, but not in estimates; and
- different treatment of entities within the respective boundaries – for example,

[41] Alignment ("Clear Line Of Sight") Project; Memorandum submitted by HM Treasury
[42] ibid

non-departmental public bodies (NDPBs). NDPBs' spending scores in budgets, but it is the grant-in-aid paid to these bodies which scores in estimates and resource accounts.

ii. Differences in the policies – specific transactions are often treated differently between the three frameworks. Examples include capital grants, provisions and other non-cash items within budgets.

4.8.16 In order to effect the 'alignment', the following key principles have been pronounced:

i. Alignment should not be pursued if the results are likely to be manipulated, or if doing so risks causing serious damage, bearing in mind that the different purposes of various frameworks may lead to the conclusion that different treatments may, in certain cases, be legitimate.

ii. Alignment will not change the National Accounts, nor the way in which they measure economic or fiscal performance. There will be no increased residual risk to fiscal control – although the places where risk is managed, and the nature of the mitigations, may change.

iii. Flexibility may be needed in certain areas to achieve alignment:

- For budgets, while the overriding need is to maintain firm control over public spending while incentivising value for money, it may be possible to achieve this in different ways in order to achieve better alignment.
- For estimates, the aim should be to align with whatever is needed in budgets to control public spending, consistent with the requirements of Parliament.
- For resource accounts, if it is not desirable in the context of alignment to implement IFRS strictly in specific areas, it may be possible to achieve alignment in other ways through seeking adaptations to IFRS – in limited cases and subject to the agreement of the Financial Reporting Advisory Board (FRAB) – while still satisfying its overall intentions.

iv. It is unlikely to be possible to achieve full alignment in all areas, given the different purposes for which the different frameworks have been developed, for good reasons, over the years. In the absence of full alignment, the aim should be to ensure that any necessary reconciliation is kept as simple as possible.

4.8.17 In accordance with these general principles, the UK Government has proposed the

[43]'Alignment (Clear Line of Sight) Project'; March 2009; HM Treasury Cm 7567
[44]ibid

following in order to effect the desired alignment:[45]

i. All non-voted expenditure and income within budgets should be brought within the coverage of estimates.

ii. Parliamentary controls in estimates should be on a net (rather than both gross and net) basis, to line up with budgetary controls, with details of income shown in the estimates and appropriate safeguards in place so that firm control is maintained over the use of incomes by Departments.

iii. The estimates and accounting boundaries should be extended to accommodate NDPBs and other bodies classified to the central government sector.

iv. The budgeting concepts of near-cash and non-cash should be removed from budgets, so that there is a single Resource DEL budget.

v. Parliamentary controls over government spending should be aligned with the Treasury's budgeting controls, consistent with the Treasury Committee's recommendation.

vi. Resource accounts should, as far as practicable, be based on IFRS, as adapted in the public sector context. The Government's proposals in this Memorandum have, where appropriate, been agreed in principle by the independent Financial Reporting Advisory Board (FRAB).

vii. The number of departmental and HM Treasury expenditure documents should be reduced to just three "publication events" each year.

4.8.18 The UK Government expects that if implemented, the Government's proposals would mean that budgets and estimates would be fully aligned for the generality of departments. It is also of the view that the whole "package" of changes outlined above need to be implemented in full, otherwise it would lead to a situation where budgets and Estimates were not fully aligned for the generality of Departments and there were further continuing misalignments between estimates and accounts, all resulting in a very complex situation. In such circumstances, the benefits for Parliament and the public would be significantly reduced, since more reconciliations would be needed between budgets and estimates, and between estimates and resource accounts. Accordingly, it is proposing these changes as a single package.

4.8.19 One of the reasons why the UK Government is pushing for the whole package of reforms under the alignment project relates to 'Non Departmental Public Bodies' (NDPBs),

[45]ibid

which has great significance in the Indian context. The UK Government feels that "In fact, the implications for alignment would be particularly severe if misalignments remained which affected the majority of Departments. If, for example, NDPBs were not consolidated in Departments' estimates and resource accounts, this would result in a continuing misalignment, for all Departments with NDPBs, between budgets and estimates/accounts; or if it did not prove possible to secure agreement to moving to net control in estimates, this would result in a continuing misalignment, for all departments, between budgets/accounts and estimates.[46]

4.8.20 The changes regarding the NDPBs would be effected through a legislation which would contain an explicit provision that consolidation of NDPBs and other bodies into Departmental accounts and estimates will not change the status of the consolidated bodies or their relationship with the Department sponsoring them. The purpose of this is to ensure that the independence of NDPBs is not compromised, and that they are not subject to any additional control as a result of consolidation.

4.8.21 The significance of this and the need for having such alignment in case of NDPBs would become apparent in Chapter 5 of this Report while discussing flow of funds from the Union to implementing bodies in the States in relation to the Centrally Sponsored Schemes.

4.8.22 In India, the Five Year Plans provide the basis for a medium-term multi-year perspective for resource allocation. On the basis of this, each year the Planning Commission, in consultation with the Ministry of Finance, allocates annual limits for plan expenditures to each Ministry/ Department. It has been noticed, however, that often, major projects and schemes are launched by government which are not provided for in the plan. This results in change in allocation for other projects and schemes thereby diluting plan objectives.

4.8.23 Another weakness of the current budget exercise is the absence of a clear link between the plan and the budget. While preparing the budget estimates, the allocations indicated by the Planning Commission get dispersed over various heads and sub-heads of expenditure. Further, while the plans are formulated scheme-wise and sector-wise, the budgets are formulated under different heads and sub-heads which is also the case with accounts. Thus, in the Indian context also, this 'clear line of sight' is not present. Consequently, even the final accounts reflect the expenditure only under various heads. This makes it difficult to link the expenditure under various heads to the objectives sought to be achieved by the different developmental schemes/ projects. Thereby the accounting process loses its potential as a measuring tool for achievement of government objectives.

[46]ibid

4.8.24 Accounting is an integral part of the budgetary process. A good accounting system should be able to reflect the objectives of any amount being spent by government, where and how is the amount spent and finally what have been the results of any such expenditure. For the accounting exercise to be meaningful it should be able to measure the extent to which the results envisaged from expenditure have been achieved.

4.8.25 The Commission is of the view that the developments in the UK need examination in the Indian context, especially the need and ways for having similar medium-term expenditure limits for Ministries/Departments through the Five Year Plans and linking them to annual budgets with carry forward facility in relation to funds for plan schemes. Further, to bring about clarity, transparency and consolidation, a similar 'alignment' project with regard to the plan, budgets and accounts may be required to be implemented in India too. The Commission is of the view that a High Powered Committee should be constituted to examine and recommend on these issues.

4.8.26 Recommendations

a. A High Powered Committee may be constituted to examine and recommend on the need and ways for having medium-term expenditure limits for Ministries/ Departments through the Five Year Plans and linking them to annual budgets with carry forward facility.

b. In order to bring about clarity, transparency and consolidation, the ways and means for implementing an 'alignment' project, similar to that in the UK, may also be examined by the High Powered Committee so constituted.

4.9 No Correlation between Expenditure and Actual Implementation

4.9.1 At present, the release of funds from any head of account is deemed as an expenditure. In a large number of cases, especially in Centrally Sponsored Schemes, such releases cannot be construed as expenditure because funds lie in the pipeline with various project authorities and there is considerable lag before they are actually utilized. Thus the accounts do not reflect the correct position as regards the implementation of government schemes and programmes.

4.9.2 This issue is examined in the chapter on flow of funds from the Union to the States.

4.10 Mis-stating of Financial position

4.10.1 The present system of release of funds to project authorities outside the government often leads to parking of funds which is often resorted to in order to prevent lapsing of funds. This leads to idle funds being maintained outside government accounts and thus portrays an incorrect picture of government funds besides causing loss of interest to government.

4.10.2 This underlines the need for a modified fund flow system backed up by a comprehensive financial information system that captures the entire range of transaction in government accounts. This has been discussed in the Chapter on flow of funds from the Union to the States.

4.11 Adhoc Project Announcements

4.11.1 Even though detailed exercises are made over a length of time to prepare and get the Five Year Plans approved by the National Development Council and the Union and State Cabinets, projects and schemes are announced on an ad-hoc basis in almost every budget of the Union and the States. They are also announced on important National Days (e.g. Independence Day, Republic Day, Birthday of Mahatma Gandhi etc.) and during visits of dignitaries to States, in the form of 'packages'. Such announcements of large sums seriously distort the plan allocations and disturb the faithful implementation of schemes already approved and under implementation. This often leads to announcements not being followed by formal approvals thereby resulting in discontent and disaffection. The proper method would be to include projects that may be considered absolutely essential at the time of preparing the annual plans or during the mid-term appraisal.

Box 4.1: Accounting Deficiencies in case of Centrally Sponsored Schemes (CSS)

An increasing proportion of fund transfers to the States in the recent years take place under CSS. These funds are routed to States and district level bodies directly from the Central Government. This practice is motivated by the desire to avoid delays and to prevent diversion of CSS funds by the States to support their ways and means position. Of late, the emerging concern is ensuring accountability on the usage of these funds.

The existing system of accounting for plan schemes, both for States and the Centre, does not adequately support informed planning, budgeting, effective monitoring, and decision making. The current accounting system does not capture transaction-oriented information. It also does not distinguish between transfer to States, final expenditure, and advance payments against which accounts have to be rendered. The extantaccounting framework is not structured to generate State-wise and scheme-wise releases of funds by the Central Government to States, and other recipients, and also the actual utilization for the intended performance.

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4.11.2 Recommendation

a. **The practice of announcing projects and schemes on an ad-hoc basis in budgets and on important National Days, and during visits of dignitaries functionaries to States needs to be stopped. Projects/schemes which are considered absolutely essential may be considered in the annual plans or at the time of mid-term appraisal.**

4.12 Emphasis on Meeting Budgetary Financial Targets rather than on Outputs and Outcomes

4.12.1 At present, government departments often measure their performance in relation to the expenditure targets laid down in the budget without adequate regard to outputs and even less to outcomes. Furthermore, little emphasis is placed on efficient utilization of resources.

4.12.2 Various reforms measures have been attempted in the past to move away from the compliance aspects of the annual budget towards measurement of actual outcomes of the expenditure made. The first significant step in this regard was suggested by the First Administrative Reforms Commission (ARC) in the form of 'Performance Budget'. This is described below.

4.12.3 Performance Budget

4.12.3.1 The Report of the Study Team on Financial Administration (Volume I & Volume II, May 1967) presented the concept of Performance Budgeting, as essentially 'a technique of presenting Government operations in terms of functions, programmes, activities and projects'. Thus, governmental activities were sought to be identified in the budget in financial and physical terms so that a proper nexus between inputs and outputs could be established and performance assessed in relation to costs. Under performance budgeting, the emphasis would get shifted, as the ARC hoped, from the means of accomplishment to the accomplishments themselves. The important thing under this technique was the precise definition of the work to be done or services to be rendered and a correct estimate of what that work or service would cost. A performance budget is prepared in terms of functional categories and their sub-division into programmes, activities and projects and not merely in terms of organizational units and the objects of expenditure. A performance budget thus developed in terms of costs and results facilitates management control by bringing out the programmes and accomplishments in financial and physical terms closely interwoven into one comprehensive document.

4.12.3.2 In the view of the First ARC, three basic steps were required in the introduction of the system of performance budgeting. These were:

a) establishing a meaningful functional, programme and activity classification of governmental operations;

b) bringing the system of accounting and financial management into accord with this classification: and

c) evolving suitable norms, yardsticks, work units of performance and unit costs, wherever possible under each programme and activity for their reporting and evaluation.

4.12.3.3 The First ARC was of the view that in the context of planned economic development, accountability is not merely confined to ensuring that the amounts have been spent for the various purposes and within the limits laid down in the budget. It also extended to ensuring that the expected results are achieved. Thus, it was necessary to ensure that the budget reflects the pattern of the Plan both in content and classification. The performance budget was a step towards achieving this.

4.12.3.4 Performance budgets were initially presented for a few Departments on a supplementary basis in 1969[47] and later 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 as the scope of the document was limited to plan programmes. The Departments continued the practice of preparing performance budgets annually in addition to their regular budget. The preparation of performance budget has become a routine affair without any discernible influence on expenditure management.[48] It, however, needs to be pointed out that the Working Group constituted by the First ARC had clearly warned against this approach. In their own words, "The Working Group has given careful consideration to these aspects and is of the opinion that it would not be sufficient to have the performance budget document as a supplementary one to the existing set of documents, as in that case it will not have any impact whatsoever on the existing system. For one, the performance budget is being evolved to overcome the deficiencies in the existing budgetary process and framework and not to supplement it. The idea of a supplementary document in such a context would inevitably mean the continuation of the existing procedures, financial practices, accounting classification, etc., with their inadequacies. Indeed, if performance budgeting is not made an integral part of the budgetary process, but only an additional exercise, unconnected with the main process, the advantages that are expected of it would not materialize. Secondly, performance budget is not merely a matter of form; it represents a change in concepts that has significant effects on the approach to the budget and the decision-making process. The performance

budget as a supplementary document would be somewhat in the nature of a fifth wheel to the coach."

4.12.4 Zero-Base Budgeting

4.12.4.1 A system of Zero-Base Budgeting (ZBB) was first introduced in the United States Department of Agriculture in its 1964 fiscal year budget. It was based on the concept that all programmes of the Department were to be reviewed afresh from the base zero and not merely in terms of incremental changes proposed for the budget year.[49]

4.12.4.2 In India, the first application of Zero-Base Budgeting was in the Department of Science and Technology, which through its Memorandum[50] of December 1983 conveyed Government's acceptance in principle that the budgets of all S&T Departments / Agencies/ Institutions should be formulated each year on the principles of Zero-Base Budgeting. The Seventh Five Year Plan also emphasized the need for introducing Zero-Base Budgeting. The Plan document stated that :

> *" The principle of Zero-Based Budgeting which requires the expenditure on even on-going activities to be justified needs to be introduced. It is to be applied not only to items of non-development expenditure, but also to those of development expenditure."*[51]

4.12.4.3 Subsequently, the Economic Survey, 1985-86, also stated that :

> *"The Government has recognised, in principle, the need for Central Government Departments to adopt Zero-Base Budgeting. This would require identification and sharpening of objectives, examination of various alternatives of performing identified tasks, cost-benefit analysis, prioritisation of objectives and activities, identification and elimination of redundant activities and designing and ranking of decision-packages."*

4.12.4.4 The Ministry of Finance formally introduced Zero-Base Budgeting through their letter of 10th July, 1986, addressed to all Ministries and Departments of the Government, asking them to adopt Zero-Base Budgeting approach with effect from the budget for 1987-88. The letter also emphasized the need for applying Zero-Base budgeting approach in Public Sector Enterprises, Departmental Undertakings and Autonomous Bodies under the administrative control of Ministries / Departments, adopting such methodology in each case as would suit the culture and requirements of each organisation.

4.12.4.5 The methodology employed in applying Zero-Base Budgeting involves

[47] F.No.2(1)Pers/E-Coord/OB/2005, dated 30th December, 2005
[48] 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
[49] Based on 'Zero-Base Budgeting' by Prof K.L. Handa; http://cgda.nic.in/rt/rtcblr/website/Training%%20Material/R%20&%20D/R&D%20 Purchase%20Training%20Material/D-%20Availability%20of%20Funds/Advanced/Zero-based%20Budgeting.htm
[50] Government of India, Department of Science and Technology, Office Memorandum No. DST / JSF / 17(3) (1) / 83 dated 28th December, 1983.

(i) Identification of Decision Units,

(ii) Formulation and Development of Decision Packages,

(iii) Evaluating and ranking Decision Packages in order of priority, and

(iv) Preparation of budget by allocating resources to activities or decision packages by utilising hierarchical funding cut-off levels.

4.12.4.6 However, due to lack of capability building, this concept did not prove to be effective in the Indian context. Another important issue involved in the application of ZBB is the distinction being followed in India between Plan and Non-Plan expenditure. Ideally, prioritisation should be done among all items of expenditure whether on-going or new, Non-Plan or Plan. But the system in which Plan and Non-Plan expenditure are treated differently and assigned varying priorities, ZBB would have to be applied separately to Plan and Non-Plan expenditures.

4.12.5 Outcome Budget

4.12.5.1 Due to the realisation that 'certain weaknesses ... have crept in the performance budget documents such as lack of clear one-to-one relationship between the Financial Budget and the Performance Budget and inadequate target-setting in physical terms for ensuing years'...[52] it was felt that there was need for tracking 'outcomes' and not the readily measurable 'outputs'. This found mention in the Budget speech of the Finance Minister (Budget 2005-06) which was re-emphasised by the Prime Minister in his letter to all Union Ministers in March 2005. The first outcome budget was passed in the Parliament on August 25, 2005. The guidelines for the 2006-07 outcome budget provided that each Ministry/Department will separately prepare the outcome budget documents in respect of 'all Demands/Appropriations controlled by them'. These contained:

i. Details about the mandate, goals and objectives as well as the policy framework and vision statement of the Ministry/Department

ii. Details in indicated tabular format comprising financial outlays, projected physical outputs and projected/budgeted outcomes.

4.12.5.2 The key words used here are 'Outlays', 'Outputs' and 'Outcomes'. It has been recognised in the guidelines that converting 'outlays' into 'outcomes' is a complex process addressing "value for money" concerns; being more a management process than merely a

[51]Government of India, Planning Commission, Seventh Five Year Plan, Vol.1, new Delhi, 1985, P.70

financial process and admitting possibilities of different approaches and modalities, which may differ from Ministry to Ministry and programme to programme. It has also been stated that preparation of the Outcome Budget is an evolving and dynamic process, which will require detailed scrutiny and examination on yearly basis, with value addition based on the preceding year's experience. The guidelines have prescribed the following steps in this conversion process:

a Defining intermediate and final outcomes specifically in measurable and monitorable terms;

b Standardizing unit cost of delivery;

c Benchmarking the standards/quality of outcomes and services;

d Capacity building for requisite efficiency at all levels, in terms of equipment, technology, knowledge and skills;

e Ensuring adequate flow of funds at the appropriate time to the appropriate level, avoiding both delay and 'parking' of funds;

f) Setting up effective monitoring and evaluation systems, to indicate the directions for further calibration and honing the processes, to deliver the intended outcomes; and

g) Involving the community/target groups/recipients of the service, with easy access and feedback systems.

Box 4.2: Decision Units and Decision Packages in Zero-Base Budgeting

A Decision Unit is a distinct segment of an organization for which budget is prepared. It can also be a programme, scheme, project, or an operation. A decision package is a budget request which should contain the following :

- A description of the function or activity of the decision unit
- The goals and objectives of the various functions / activities of the unit
- Benefits to be derived from financing the activity / programme
- Relevance of the activity / programme to the overall objectives of the Organisation / Department in the present context.
- The consequences of its non-funding
- The projected / estimated cost of the package
- The yearly phasing of the proposed expenditure / project cost
- Alternative ways of performing the same activity or achieving the same objectives.

Source: 'Zero-Base Budgeting' by Prof K.L. Handa

4.12.5.3 The guidelines have defined the three terms used in the performance budget. Thus, 'outlays' imply total financial resources deployed for achieving certain outcomes. Part of this money may come directly from the Government budget and part may be contributed by other

[52]F.No.2(1)Pers/E-Coord/OB/2005, dated 30th December, 2005

stakeholders such as the State Governments, Public Sector Undertakings or even private parties in the growing area of Public Private Partnerships. It has been mentioned that the outlays should be segregated scheme-wise, covering both Plan / Non-Plan budget (as shown in the Expenditure Budget Vol II) for the financial year in monetary terms. In case of projects (whether Government or parastatal) spanning multi-year time frames, total sanctioned cost of the project and the planned annual expenditure both should be brought out as both are relevant 'outlays' for effecting linkage with outcomes.

4.12.5.4 'Outputs' have been defined as the 'measure of the physical quantity of the goods or services produced through an activity under a scheme or programme'. They are identified as an intermediate stage between 'outlays' and 'outcomes'. For example, in case of a social sector programme/scheme, the intermediate results before identifying, measuring and arriving at the 'final outcome' as per the objectives of the said programme/scheme, may be treated as 'output'. The purpose is to capture intermediate 'outputs' before identifying and measuring the 'final outcome'.

4.12.5.5 'Outcomes' are the end product/results of various Government initiatives and interventions, including those involving partnership with the State Governments, Public Sector Undertakings, Autonomous Bodies, private sector and the community. They involve much more than mere 'outputs', since they cover the quality and effectiveness of the goods or services produced as a consequence of an activity under a scheme or programme. The 'outcomes' are required to be measured keeping in mind the objectives of the programme/scheme by following appropriate methodology.

4.12.5.6 For the year 2007-08, the Outcome Budget and Performance Budget were merged and placed in one combined document, the latter providing information relating to the preceding year. This has been done in order to compare the performance of the past year vis-à-vis the performance indicators used for the budget year. The Ministries/Departments 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 the Annual Financial Statement and outcome budget would be for the ensuing financial year, the performance budget would present the picture of actual achievement/performance for

the financial year gone by.

4.12.5.7 However, the outcome budget for 2007-08 shows that in many cases the measurement of outputs and outcomes seems to have been mixed up. While the outputs could be measured in quantifiable terms, measuring outcomes is a difficult proposition given the fact that proposed outcomes of a specified programme could be influenced by many other extraneous factors. It is also seen that in some cases Departments have merely reproduced the outputs targets as outcomes and, in many other places, general intents of the programmes are described as outcomes. Some illustrative cases are presented in Table 4.8:

4.12.5.8 This is in spite of the fact that the guidelines clearly spell out that wherever 'physical outputs' are in a sense the 'final outcomes', assessment of 'quality of output' through 'appropriate indicators of quality' should be brought out. However, the moot question is whether there is need for preparing an 'outcome budget' for each and every item prescribed in the Expenditure Budget Vol.II (the guidelines clearly point out that the description of items should exactly match with the description shown for the different items in the Statement of Budget Estimate as included in Expenditure Budget Vol.II).

4.12.5.9 The Commission is of the view that the Outcome Budget cannot be prepared for all Ministries/Departments simply by way of declaration. It's a complex process and a number of steps are involved before it can be attempted with any degree of usefulness. In many cases, the 'outcomes' would influence and be influenced by developments in other sectors. For example, rural electrification would influence the outcome of schemes related to education, health, irrigation and agriculture, to name a few. The view of the Commission is that a beginning may be made with proper preparation and training in case of the Flagship Schemes and certain national priorities.

4.12.6 Recommendation

a. **Outcome budgeting is a complex process and a number of steps are involved before it can be attempted with any degree of usefulness. A beginning may be made with proper preparation and training in case of the Flagship Schemes and**

Table 4.8 : Outcome Budget – Illustrative Cases (2008-09)

Sl. No.	Ministry / Department	Name of the Scheme	Objectives / Outcomes	Quantifiable Deliverables/ Physical Outputs	Projected Outcomes
1.	Department of Agriculture and Co-operation	Construction of Rural Godown (Plan)	The main objectives of the scheme include creation of scientific storage capacity with allied facilities in rural areas to meet the requirements of farmers for storing farm produce, to prevent distress sale of produce, promote pledge financing and marketing credit and to introduce a national system of warehouse receipts for agricultural commodities stored in such godowns.	Construction / renovation of 15.00 lakh tonnes storage capacity.	Construction / renovation of 15.00 lakh tonnes storage capacity.
2.	Department of Agriculture and Co-operation	Development of Agricultural Marketing Infrastructure Grading & Standardisation (Plan)	To provide additional agricultural marketing infrastructure to cope up with the large expected marketable surpluses of agricultural and allied commodities including dairy, poultry, fishery, livestock and minor forest produce, to promote competitive alternative agricultural marketing infrastructure by inducement of private and cooperative sector investments; to promote direct marketing through reduction in intermediaries and handling channels thus enhancing farmers' income; and to provide infrastructure facilities for grading.	1. Development of 300 new Agricultural Marketing Infrastructure Projects. 2. Strengthening / Modernisation of infrastructure in 90 Wholesale Markets. 3. Strengthening / Modernisation of infrastructure in 200 Rural Primary Markets / Apni Mandies etc. 4.Remaining work on Modernisation and required supplies in CAL, Nagpur and 6 RALs.	1. Development of 300 new Agricultural Marketing Infrastructure Projects. 2. Strengthening / Modernisation of infrastructure in 90 Wholesale Markets. 3. Strengthening / Modernisation of infrastructure in 200 Rural Primary Markets / Apni Mandies etc.

Table 4.8 : Outcome Budget – Illustrative Cases (2008-09) *Contd.*

Sl. No.	Ministry / Department	Name of the Scheme	Objectives / Outcomes	Quantifiable Deliverables/ Physical Outputs	Projected Outcomes
					4. Remaining work on Modernisation and required supplies in CAL, Nagpur and 6 RALs.
3.	Department of Agriculture and Co-operation	National Food Security Mission	To enhance the production of rice, wheat and pulses by 10, 8 and 2 million tons respectively by 2011.	**Rice** Demonstrations (No) - 10,000 SRR – (qtl) - 3,00,000 Micro nutrients (ha) - 20,000 Liming of acidic soils (ha) – 20,000 Conoweeders & other implements (no) 33300 IPM (ha) 1,00,000 Training FFS (no) 1000 **Wheat** Demonstration (no) – 1,20,000 SRR (Qtl) 3,00,000 Seed minikits (no) – 28,000 Micronutrients (ha) 10,00,000 Gypsum (ha) – 6,00,000 Zero till seed Drill machines (no) – 6,000 Rotavators (no) – 3000	Production: Wheat – 1m.tonnes Rice – 2m.tonnes Pulses – 0.5 m.tonnes

Table 4.8 : Outcome Budget – Illustrative Cases (2008-09) *Contd.*

Sl. No.	Ministry / Department	Name of the Scheme	Objectives / Outcomes	Quantifiable Deliverables/ Physical Outputs	Projected Outcomes
				Purchase of Pump sets (no) – 15000 Training of farmers FFS (no) - 3000 **Pulses** Production of breeder Seed by ICATR (qtl) 14,330 Production and distribution of seed (qtl) 1,21,000 Strengthening of State Seed certification agencies (no) 20 INM (ha) 9,62,000 IPM (ha) 9,62,000 Irrigation by Sprinkler sets (ha) 44338	
4.	Ministry of Textiles	Secretariat – Economic Services	The Ministry is responsible for policy formulation, planning and trade regulations of the Textile Industry	Not mentioned	Not mentioned

Table 4.8 : Outcome Budget – Illustrative Cases (2008-09) *Contd.*

Sl. No.	Ministry / Department	Name of the Scheme	Objectives / Outcomes	Quantifiable Deliverables/ Physical Outputs	Projected Outcomes
5.	Ministry of Textiles	Integrated Handloom Development Scheme Components	i. Focus on formation of weavers group as a visible entity. ii. To develop the Handloom Weavers Groups to become self-sustainable. iii. Inclusive approach to cover weavers both within and outside the co-operating fold. iv. Skill upgradation of Handloom weavers / workers to produce diversified products with improved quality to meet the marker requirements	3,10,000 weavers	Not mentioned
6.	Ministry of Information and Broadcasting (Films Division)	Webcasting and Digitalisation of Films Division films	The objective being the exposure of Documentary, Short & Animation Films of Films Division to the world through the medium of Internet. For this purpose, films are digitally transferred to DVD's through the medium of High Definition Technology. The outcome being the availability of FD Films in its official website **www.filmsdivision.org**	To webcast the films of Films Division for global access to audio-visual encyclopaedia of post-independence India and to transfer the films of Films Division in digital format for preservation thereof. **Quantifiable Deliverables** Continuous replacement of filmic contents of the website and transfer of films on DVDs. Spill over financial liability of the last financial year has	Continuous replacement of filmic contents of the website and transfer of films on DVDs.

Table 4.8 : Outcome Budget – Illustrative Cases (2008-09) *Contd.*

Sl. No.	Ministry / Department	Name of the Scheme	Objectives / Outcomes	Quantifiable Deliverables/ Physical Outputs	Projected Outcomes
				been cleared by passing the outstanding bills. During the current financial year, 1058 titles of Films Division's Archieve have been verified and 507 films digitized.	
7.	Ministry of Water Resources	Ground Water Management and Regulation	i) Integrated Groundwater Management Studies to prepare ground water management plan ii) Groundwater exploration utilizing scientific tools viz. Remote sensing and GIS, Geophysical surveys aided by drilling to locate ground water worthy areas. iii) Monitoring of groundwater levels from groundwater monitoring stations iv) Short term water supply investigations for source finding to Central/State Government departments	Groundwater Management studies – 1.50 lakh square metre Analysis of Water Samples – 20000 Groundwater Exploration -800 Wells Geophysical survey: VES-2200 Line KM-10 Well logging – need-based Groundwater Monitoring – 15,600 Short-term water supply investigations – need-based (-300) Preparation of district report-40 Groundwater Year Book – 23 Mass Awareness – 57	Not mentioned.

Table 4.8 : Outcome Budget – Illustrative Cases (2008-09) *Contd.*

Sl. No.	Ministry / Department	Name of the Scheme	Objectives / Outcomes	Quantifiable Deliverables/ Physical Outputs	Projected Outcomes
			v) Preparation of Report, Maps for use by planners and administrators. vi) Demonstrative projects for Artificial regarge to GW for replicating the same by State Government and other agencies.	Water Management Training Programme – 57 Regulation of Ground Water development in motified area Demonstrative studies of Artificial Recharge-15	

certain national priorities.

4.13 Irrational 'Plan – Non-Plan' Distinction Leads to Inefficiency in Resource Utilization

4.13.1 Since the country follows a Plan-based model of economy, the expenditure of Government is divided into Plan and Non-Plan. As the name suggests, Plan expenditure is directly related to expenditure on schemes and programmes envisaged in the Five Year Plans. Non-Plan expenditure is the expenditure incurred on establishment and maintenance activities.[53] Thus, 'Plan' in this context includes what is provided by the Planning Commission and is included in the Five-Year Plan. Non-Plan expenditure covers expenditure on security, interest payments and subsidies etc. 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 an unnecessary development that has adverse effects on the quality of public services.[54] Moreover, in order to find funds for the plans, over the years, a tendency has developed to view non-plan expenditure as far less important and subject it to cuts and economy measures, although many of them are vital in nature.

Box 4.3: Shift in Focus from Inputs to Outcomes

"10.35. Traditionally, government schemes are evaluated in terms of expenditure incurred and adherence to process requirement. It is necessary to shift the focus from vertical input controls to horizontal coordination and monitoring of outcomes. The need for horizontal coordination is evident from the fact that interventions in one are, say, rural drinking water nad sanitation, affect outcomes in health, which affect outcomes in education. These examples can be multiplied. Given the manner in which government structures are organized at the Centre and States, horizontal coordination is very necessary to achieve the desired outcomes. Mechanisms for this coordination, convergence and synergy at all levels have atrophied or are non-existent. Reinstating dynamic coordination, to break through excessive hierarchy and securing teamwork and mechanisms for vertical coherence and horizontal coordination to achieve outcomes is a major challenge at all levels of government. Emphasis will be laid on effective monitoring on outcome at all levels. The district level and other functionaries will need to be strengthened with authority and powers so that they are made fully accountable for the outcomes."

Source: Eleventh Five Year Plan

4.13.2 This distinction, however, undermines the budget formulation process of the departments by bringing in complexity. The Five Year Plans prepared by the Planning Commission are indicative in nature and are operationalised through Annual 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 individual Department 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.

Box 4.4: Distinction between Plan and Non-Plan

It is argued that the distinction between plan and non-plan expenditure is illogical and even dysfunctional. The distinction has led to ever increasing tendency to start new schemes/projects to the utter neglect of maintenance of existing capacity and service levels. The distinction also often leads to the misperception that non-plan expenditure is inherently wasteful and should be avoided. This dichotomy has resulted in fragmented view of resource allocation to various sectors. The problem is assuming greater significance with higher 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 coordinated activity.

Source: Economic Survey -2007-08

4.13.3 The plan versus 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 the flexibility in formulating their budgets with prior indication of resource availability. Though this has been considered by many Committees over the last forty years and repeated recommendations have been made to do away this division, this has not been done so far. Just as Public Undertakings, Autonomous Bodies, Societies etc. are required to consider their resources as a whole and plan accordingly, the Departments should also be allowed to work out the committed resources and plan within overall allocations.

Box 4.5: Planning Commission on Plan and Non-Plan Expenditure

"3.58. Other perceptions that have developed around this distinction, namely, that Non-Plan expenditure is inherently wasteful and has to be minimized, that Non-Plan expenditure is different in kind from Plan expenditure, etc., are patently incorrect assessments that have nevertheless taken deep root in the process of government expenditure planning. This dichotomy also results in a fragmented view of resource allocations to various sectors. The problem has become particularly acute as government's emphasis has shifted to the social sectors where salary costs are high. Routine bans on recruitment for Non-Plan posts, ostensibly imposed to conserve expenditure, cause serious problem for service delivery in health, education, extension systems, etc. The case against the use of these categories, both on grounds of illogicality and dysfunctionality, is therefore indisputable.

3.59. At the same time, it is necessary to understand that this classification of expenditures has been used essentially as a convenient shortcut for the performance of functions that are inherent in public expenditure management. It is perhaps in the manner in which the Plan and Non-Plan distinction has been denuded of its substance over the years, rather than in any inherent conceptual inadequacy, that the causes of the present state of affairs need to be found."

Source: Eleventh Five Year Plan

4.13.4 Recommendation:

a. **The Plan versus non-Plan distinction needs to be done away with.**

[53]http://cga.nic.in/%5Chtml%5Coverv.htm
[54]Government of India (2000), Report of the Eleventh Finance Commission, p.33

FLOW OF FUNDS FROM THE UNION TO THE STATES - CENTRALLY SPONSORED SCHEMES

5

5.1 Flow of Funds related to Centrally Sponsored Schemes

5.1.1 The Centrally Sponsored Schemes (CSS) do not fall within the subjects allocated to the Union Government in List I of the Seventh Schedule of the Constitution. However, they are funded by the Union Government to achieve certain national objectives. The CSS have formed an important part of successive Five Year Plans. As mentioned in Chapter 3, the flow of funds from the Union Government to the ultimate implementing agencies for any scheme is through one of these two channels:[55]

i. Funds are transferred to the Consolidated Fund of the State Governments which spend the money through the implementing agencies. In such cases, the agency banks at the field level, honour the payment claims made by authorized officers of the State Government and, in return, place the claim on the State Government through the RBI office at the State Headquarters.

ii. The Union Government transfers funds directly to implementing agencies in the States through normal banking channels. These agencies distribute funds progressively to lower level field formations through banking channels. The banks honour cheques up to the amount lying as credit in their respective bank accounts.

5.1.2 Actual expenditure under the CSS is incurred only when payment is made either to a beneficiary of the scheme or to the supplier of goods and services. However, due to the lack of a proper information system, the tracking of fund flow and correlation between the amount released and expenditure made could not be determined without a degree of uncertainty. Further, when funds are transferred directly to the implementing agencies in the States, it has to be done in advance which results in a substantial accumulation of funds in the pipeline. The Report of the CAG on 'Union Government Accounts 2007-08' has the following to say in the matter:

"2.2 Unascertainable unspent balances in the accounts of Implementing Agencies

In recent years, there has been a paradigm shift in the Central Government strategy for implementation of flagship programmes and other centrally sponsored schemes (CSS) for

[55]Source: Note received from the Office of CGA

poverty alleviation, health care, education, employment, sanitation etc,. Most of these schemes were earlier implemented on cost sharing basis with transfer of central share to State Government. The Union Government has now started transferring central plan assistance directly to state/district level autonomous bodies, societies and non-Governmental organisations for implementation of CSS without devolving funds through the State Government accounts. The State and District level implementing bodies keep these scheme funds in their accounts in banks outside Government Accounts.

For the year 2007-08, Union Government made a provision for transfer of central plan assistance of Rs. 51259.85 crore (as per revised estimates) directly to State/District level autonomous bodies and authorities, societies, non-governmental organisations, etc., for implementation of centrally sponsored schemes. Since the funds are not being spent fully by the implementing agencies in the same financial year, there remain substantial amounts of unspent funds in their accounts. The aggregate amount of the unspent balances in the accounts of the implementing agencies kept outside Government accounts is not readily ascertainable. The Government expenditure as reflected in the Accounts to that extent is, therefore, overstated."

5.1.3 The basic issues here are:

i. whether the simple release of funds by Union Government Ministries/ Departments to State Governments/other implementing agencies, NGOs, societies etc in the States for implementing various centrally sponsored schemes could be termed as expenditure in their accounts,

ii. whether real time information about the use of funds so transferred is available,

iii. whether such use of funds gets adequately reflected in government accounts, and

iv. how to minimize the costs of raising the financial resources which are lying unutilized.

5.1.4 The Planning Commission, realizing the import of such issues, had formed an Expert Group to Develop Concrete Proposals for Restructuring the Centrally Sponsored Schemes. This Expert Group submitted its Report in September 2006 which contained, inter alia, a note from the Deputy Comptroller and Auditor General of India on the financial aspects of these Schemes. This note pointed out the following:

"In the existing system, the amounts under Centrally Sponsored Schemes are released by the Central Government through a variety of channels. The amounts released to all or most of them are booked as final expenditure in the books of the Union Government, even when the whole or part of it may not have been utilized for the purpose for which the funds were appropriated during the year."

5.1.5 While mentioning that some of the channels of release of the funds as:

- To State Governments, when the amounts are further released / spent;
- Directly to the state autonomous bodies (viz., DRDA etc);
- To Central autonomous bodies for specific tasks / jobs (viz., research etc.);

it observed that:

"The existing procedure does no facilities capture, at any given point of time, of (i) amounts actually utilized for the end-use, (ii) amounts in transit viz., advances to local bodies / PRI or to the executive departments (viz. PWD, PHED, etc.) and (iii) unspent amounts with the state governments / agencies."

5.1.6 Thus, it was pointed out that in case of expenditure incurred on Centrally Sponsored Schemes through the State Budget, the Accountants General (Accounts & Entitlements) in the States would not be able to link such expenditure unless the expenditure incurred on a scheme can be ascertained across all functional Major Heads of Accounts involved. Further, even the accounts compiled by Accountants General (A&E) would not capture the data distinctly under each Centrally Sponsored Schemes in the absence of uniform plan-budget link and a distinct sub-head for the each of the Centrally Sponsored Schemes. Moreover, the expenditure booked in the State Accounts consists of expenditure for the end-use as well as advances to implementing agencies without any distinction between them. There is no coding or accounting rules prescribing coding of the expenditure by their type (end- use, advance etc.)

5.1.7 Further, in many cases, transfers are recorded in registers and not made through account books. This further aggravates the position and the link to end use gets lost in transition. In case of transfers to societies, NGOs etc., their accounts do not get reflected in the governmental accounts. The problem of absence of coding by the type of expenditure exists here also, in the same manner as with the State Government.

5.1.8 It was, therefore, suggested that the following aspects, inter alia, would need to be taken care of:

i. As in the case of funds from the State Budget, a provision / system should be mandatory for autonomous bodies and NGOs to capture their expenditure that can be identified to the particular Centrally Sponsored Schemes and the type of expenditure.

ii. A system may be put in place to track the amount in transit to the end-use through accounts / subsidiary accounts rather than through registers.

5.1.9 As mentioned in Chapter 4 earlier, a similar problem has been encountered in case of Non Departmental Public Bodies (NDPBs) in the UK as far as their accounts are concerned. It is not that the problem has not been identified in India. In fact, in his budget speech (2008-09), the Finance Minister had already announced the following:[56]

> *"Robust economic growth has necessitated a need to put in place effective monitoring, evaluation and Accounting systems for the large sums of money that are disbursed by the Central Government to State Governments, district level agencies and other implementing agencies.*
>
> *I think we do not pay enough attention to outcomes as we do to outlays; or to physical targets as we do to financial targets; or to quality as we do to quantity.*
>
> *Government therefore proposes to put in place a Central Plan Schemes Monitoring System (CPSMS) that will be implemented as a Plan scheme of the Planning Commission and also a comprehensive Decision Support System and Management Information System. The intended outcome is to generate and monitor scheme-wise and State-wise releases for about 1,000 Central Plan and centrally sponsored schemes in 2008-09".*

5.1.10 As stated earlier, the CAG in its Report has mentioned that more than Rs. 50,000 crore is being released by the Union Government to State and District level bodies directly and a significant portion of this amount remains unutilized at different levels. The practice to transfer funds directly to state and district level bodies, non-governmental organizations, societies etc. is motivated by the desire to avoid delays on the one hand and prevention of diversion of these funds by the State Governments in order to support their 'ways and means' position. There is no doubt that when funds are transferred to the Consolidated Fund of the States, it leads to legislative approval and appropriations at two stages. Thus, in case of the Centrally Sponsored Schemes, first the appropriations are approved by the Parliament in case of the Union Government Ministries / Departments and second when they are transferred to the consolidated fund of the States, the appropriations are again required to be approved by the State Legislature before these funds could be transmitted to implementing agencies. However, this has led to a position where transparency and accountability are not being ensured leading to a failure in getting a complete picture of expenditure related to these schemes.

[56]Source : http://www.cgaindia.org/pdf/International_Conferecnce33.pdf

5.1.11 In fact, the existing system of accounting for plan schemes in case of both the Union and State Governments does not adequately support informed planning, budgeting, effective monitoring and decision making. The present accounting system does not capture transaction-oriented information. The main contours of this problem are presented in the following paragraphs.

5.2 Absence of a System for Managing the Flow of Financial Information

5.2.1 There exists a hierarchical chain of implementing agencies through which GOI funds flow to the grass roots level. A bulk of the actual expenditure is carried out at the block/panchayat level in most schemes. The current system does not facilitate tracking of fund flow from the point of release in GOI to final expenditure at the spending unit level. The current system lacks a reliable reporting system for utilization of plan scheme funds. Moreover, it does not generate (i) agency-wise (ii) geographical location-wise and (iii) scheme-wise information on flow of funds. Huge funds are lying unutilized in the banking system parked in different accounts of different implementing agencies across several schemes.[57]

5.2.2 The present Chart of Accounts allows 'releases' to be treated as 'expenditure'. Further, the Chart of Accounts followed by the Civil Ministries, State Governments, NGOs and other agencies is not uniform and each agency adopts its own Chart of Accounts for maintaining accounts pertaining to plan schemes. There is thus a need for a common Chart of Accounts (COA) so as to ensure a seamless flow on information from all stakeholders.

5.2.3 The existing system of expenditure classification is one-dimensional as it flows only in the direction namely from the fund to the sector/sub-sector. It does not permit an integration and consolidation with regard to functions, programmes and economic categories in a single hierarchy. Presently, budget classification focuses on compliance rather than on government policies and priorities and the two main dimensions (functions/programmes and objects) are clubbed together with a 15-digit accounting code, which has limited flexibility and scope for segregating and correlating various budget dimensions. Thus, it does not allow capture of information regarding:

- Schemes as defined by Planning Commission (Schemes defined in Chart of Accounts are often not the same as defined by Planning Commission)
- Recipient agency identification
- Geographical location identification

5.2.4 Moreover, the classification system between the Union and State Governments is uniform only till the programme level - at the scheme level there is no uniformity of classification.

[57]Source : Adapted from 'Development of a Management Information & Decision Support System for Plan Schemes' by Archana Nigam and Dipankar Sengupta

5.2.5 In consultation with the Controller General of Accounts (CGA), it has now been planned that the Government should shift over to a system of transfer of debits in respect of the CSS. The Core Banking Systems (CBS) which most banks have now rolled out is sought to be linked with a Core Accounting System (CAS), which is to be set by the CGA. Under the proposed CAS, only the sanctions will move down the line to the final implementing authority. These sanctions, through the proposed linkage between the CAS and the CBS, would also move in parallel down the CBS to the bank branch that will make the payment upon the authorisation of the field level implementing agency.

5.2.6 In order to implement this, the CGA have proposed the use of an IT-based platform which would address the following concerns:

- Identifying the entities involved in fund devolution,
- Identifying schemes under which funds are devolved to the agencies/spending units,
- Identifying geographical location of the entities receiving funds, and
- Using the extensive banking network for reducing float in the system.

5.2.7 The objective here is to build a comprehensive centralized database from the source for enhanced financial reporting for monitoring plan schemes implementation by including sanction ID with the current system of classification of accounts. This will facilitate complete information base for Plan Schemes about:

- Funds released under a scheme of Planning Commission
- Funds received by an agency
- Funds received geographical location-wise

5.2.8 Thus, sanctions pending release of funds under Plan schemes can be monitored more effectively and recipient agencies/States can also use the sanction ID for referencing purposes. A sanction in such cases would include both actual expenditure and transfer. This will create a system in which only "authorization to spend" and not "funds to spend" flows through the system. This will use the existing banking networks to transfer these "authorizations" instead of real funds. A system of authorizations also implies that all these entities become a part of the preparation process of national accounts.

5.2.9 It is expected that the proposed CAS will solve two major problems being faced at present. First, it will provide a platform for consolidating accounting data relating to all plan schemes on a uniform basis, irrespective of the agency that is actually charged with the receipt of funds and with programme implementation. Secondly, the CAS will have the advantage of ensuring that expenditure is booked in the accounts of the Union Government only at the time when the actual payment at the field level takes place.

5.2.10 The Commission has already recommended in Chapter 4, the examination of the 'line of sight' project ('alignment' project) of the UK Government in the Indian context by a High Powered Committee. It is of the view that first, a reform in the structure of the Chart of Accounts and its codification has to be carried out in order to arrive at an alignment between the Plan, budget and the accounts. Further, it needs to be ensured that the IT-based systems being thought of for implementing the CAS are in tune with the National e-Governance Plan (NeGP), and take advantage of the connectivity offered by SWAN and the CSCs.

5.2.11 As already observed in Chapter 3, Article 150 of the Constitution provides that the accounts of the Union and of the States are to kept in such form as the President may, on the advice of the C&AG, prescribed. By incorporating Entry 7A (i) in the Government of India (Allocation of Business) Rules in case of the Department of Expenditure, the Controller General of Accounts has been delegated to carry out the business of prescribing 'General principles of accounting' relating to the Union or State Governments and 'form of accounts'. The Commission is of the view that the Controller General of Accounts, in consultation with the C&AG, should lay down the principles for implementing the new system of transfer of funds mentioned in the fore-going paragraphs taking into account the available technology, the modifications required in the Chart of Accounts and should implement the system within a prescribed time frame.

5.2.12 Recommendation

a. **The Controller General of Accounts, in consultation with the C&AG, should lay down the principles for implementing the system of flow of sanctions/approvals from the Union Ministries/Departments to implementing agencies in the States to facilitate release of fund at the time of payment. After taking into account the available technology and infrastructure for electronic flow of information and funds, especially under the NeGP, and putting in place a new Chart of Accounts, the scheme should be implemented in a time bound manner.**

5.3 Development of Financial Information System

5.3.1 A robust financial information system is necessary as it helps in:

- Providing timely and reliable information to the decision makers
- Providing inputs to control systems
- Monitoring financial and physical progress
- Ensuring proper utilization of resources

5.3.2 Brazil is one of the countries which has made substantial progress in implementing a modern IT-based financial information system. Until 1986, each Federal Government Unit in Brazil had its own accounting system and there was lack of integration among the units. From 1987 onwards, the Federal Government implemented an integrated System for Financial Management (SIAFI) which has been continuously improved. The main objectives of this system were to :

- Provide Public Administration Agencies with proper mechanisms for budget daily control as well as financial execution;
- Provide means to speed up financial programming, optimizing the usage of the National Treasury's resources, via unification of Federal Government's funds;
- Ensure safety and timely information recording by Public Accounting;
- Standardize budgetary and financial management and execution procedures throughout the Federal Government; and
- Allow the follow up and evaluation of public expenses.

5.3.3 Presently, all Federal Government Units (Executive, Legislation and Judiciary) including all State/owned company units are required to use SIAFI.[58] The outcome has been that accounting system has become integrated with standardized procedures, on-line automatic book keeping, data compatibility, availability of reliable and timely management information and transparency.

5.3.4 In fact, as far as transparency in financial matters is concerned, in Brazil, the creation of such a robust financial information system has also resulted in the public having direct access to data on government spending at the federal, state and municipal levels[59] through the transparency portal (www.portaldatransparencia.gov.br). Information about even the smallest payment is now accessible to the public, thus providing suo motu information at a very advanced level.

5.3.5 The Commission is of the view that a robust financial information system needs to be

[58]http://www.cga.gov.in/pdf/FederalGovernmentIntegratedSystemFinance%20Management.pdf

created in the government. This system should also make accessible to the public real time data on government expenditure at all levels and should be available in the public domain. This would also be honouring the spirit of the Right to Information which mandates that government organizations should attempt to provide maximum information through voluntary disclosures.

5.3.6 Recommendation

a. **A robust financial information system, on the lines of SIAFI of Brazil, needs to be created in the government in a time bound manner. This system should also make accessible to the public, real time data on government expenditure at all levels.**

5.4 Capacity Building

5.4.1 The changes in the accounting and financial management system discussed above would necessitate capability building in not only the accounts and finance personnel but also non-finance personnel. Better skills would allow better preparation of estimates and better management of expenditure. A lot would require to be done for improving the estimating and forecasting capabilities within Ministries/Departments and implementing agencies. Specially designed and periodic training modules for personnel at different levels need to be designed to meet these needs.

5.4.2 The Commission is of the view that major reforms in financial management can only be undertaken if capacity of both - individuals and institutions – is improved. For this to happen, a proper programme of training needs to be devised and implemented in a time bound manner.

5.4.3 Recommendation

a. **The capacity of individuals and institutions in government needs to be improved in order to implement reforms in financial management. To facilitate this, a proper programme of training needs to be devised and implemented in a time bound manner.**

[59]http://www.brazzilmag.com/content/view/3039/54/

6 ACCRUAL SYSTEM OF ACCOUNTING

6.1 As mentioned in Chapter 3, both the General Accounting Rules, 1990 and General Financial Rules, 2005 prescribe cash based accounting in the Government. The basic reasons for maintaining accounts of the Government on cash basis and its 'fundamental' difference with commercial accounting has been succinctly analysed in the 'Introduction to Indian Government Accounts and Audit' issued by the Comptroller and Auditor General of India.[60] This is reproduced below:

> *"The principles of Commercial and Government Accounting differ in certain essential points. The difference is due to the fact that, while the main function of a commercial concern is to take part in the production, manufacture or inter-change of goods or commodities between different groups or individuals and thereby to make profit, Government is to govern a country and, in connection therewith, to administer the several departments of its activities in the best way possible.*
>
> *<u>Principles and Methods of Commercial Accounting</u>*
>
> *6.1 A non-Government commercial concern deals primarily with the utilization of Capital for the purpose of making a profit; and it is interested to see at intervals how it stands in relation to its debtors and creditors, whether it is gaining or losing, what are the sources of its gain or loss, and whether it is solvent or insolvent.*
>
> *6.2 In order to obtain ready answers to these questions the concern has to keep a system of detailed accounts. In respect of each person dealt with each cases of assets held, each article dealt in and each department of its activities, it maintains a separate account so that the result of the transactions in each case may be ascertained. It then becomes necessary for it to collect the result of all these accounts in one place in order to record the assets and liabilities under different heads and finally to prepare the Manufacturing, Trading and Profit and Loss Accounts and a Balance Sheet, which shall show what is the gain or loss of the concern as a whole and whether it is solvent or insolvent.*

[60]Fifth Edition, 1987

6.3 It is the generally accepted practice in the commercial world to maintain account books on the Double Entry System, which is based on the fact that in every transaction or financial change two parties or accounts are involved, one giving and other receiving. Under that system, every transaction, therefore, requires two entries in the books, one against the party or account giving and the other against the party or account receiving. Further, if the concern is a manufacturing one, it has also to maintain set of books for (a) costing and (b) stores accounting in order to ascertain as regards (a) the cost of production of each article so as to control costs or increase price suitably provided of course the market permits, and as regards (b) that there is an efficient system of stores control.

6.4 The main concepts applicable to commercial accounts are:-

(1) Financial conditions – This is represented by the assets, liabilities and shareholder equity and refers to the impressions or conclusions one might draw from a balanced array of the Company's assets and claim against those assets i.e. a balance sheet and other associated accounts indicating long range and current positions and solvency and liquidity.

(2) Results of operations – The economic results of operations aimed to show what the enterprise has accomplished and at what cost, are generally reflected by the Profit and Loss Accounts. In arriving at the net income, financial conservation dictates that all foreseeable losses should be provided for, no credit should be taken for unearned profits.

(2) True and fair view – As accounting statements contain subjective evaluation, the results presented to the shareholders should be a fair view of the affairs of the company. Such fairness is assured by:

- *Generally accepted accounting principles which include a number of conventions and practices which have over a period of time been found to be most useful.*
- *Consistency in treatment accorded to various items which are material to the statements to make comparisons with the earlier years possible and meaningful.*
- *Full disclosure to enable informed readers to come to appropriate conclusions.*

Principles of Government Accounting

6.5 The activities of good Government in any country are determined by the needs of the country. The main branches of its activities being known, it is a matter for decision what expenditure will be necessary during any year in carrying out these activities. After a decision has been reached on this point, it becomes necessary to determine how to raise sufficient money to meet that expenditure.

6.6 With a Five-tier classification of Government Expenditure under Sectors, major heads, minor heads, sub-heads and detailed heads of account, the accounting is more elaborate than that followed in commercial accounts. But the immediate objective of Government accounting is not to ascertain the gain or loss on the transactions of the Government as a whole in carrying out its activities. The method of budgeting and accounting under the service heads is not designed to bring out the relation in which Government stands to its material assets in use, or its liabilities due to be discharged at more or less distant dates. The accounting methods adopted for commercial concerns, and the preparation of Manufacturing, Trading and Profit and Loss Accounts and a Balance Sheet, in the commercial sense, are, therefore, unsuitable and unnecessary. In its Budget for a year, Government is interested to forecast with the greatest possible accuracy what is expected to be received or paid during the year, and whether the former together with the balance of the past year is sufficient to cover the latter. Similarly, in the compiled accounts for that year, it is concerned to see to what extent the forecast has been justified by the facts and whether it has a surplus or deficit balance as a result of the year's transactions. On the basis of the budget and the accounts, Government determines (a) whether it will be justified in curtailing or expanding its activities (b) whether it can and should increase or decrease taxation accordingly.

6.7 In the field of government accounting, the end products are the monthly accounts and the annual accounts. The monthly accounts serve the needs of the day-to-day administration, while the annual accounts present a fair and correct view of the financial stewardship of the government during the year.

Purpose of Government and of Commercial Accounts

6.8 Government Accounts are designed to enable Government to determine how little money it need take out of the pockets of the tax-payers in order to maintain its necessary activities at the proper standard of efficiency. Non Government Commercial accounts on the other hand are meant to show how much money the concern can put into the pockets of the proprietors consistently with the maintenance of a profit-earning standard in the concern.

Commercial Undertakings of Governments

6.9 The operations of some departments of Government, however, sometimes include undertakings of a commercial or a quasi-commercial character, e.g. an industrial factory or a store. Even though these may be maintained almost entirely for the benefit of the department, it is still necessary that the financial results of the undertakings should be expressed in the normal commercial form so that the cost of the service or undertaking may be accurately known. This implies the maintenance of suitable capital, Manufacturing, Trading and Profit and Loss Accounts, and as the Government system of accounts, being on a purely cash basis, is unsuitable for such commercial accounts, these are usually kept on a proforma basis outside the general accounts of Government. The actual transactions entering these proforma accounts except those adjusted on a liability basis find a place primarily in the regular accounts and the commercial accounts are additional as well as separate.

Methods of Government Accounting

6.10 The mass of the Government accounts being on cash basis is kept on Single Entry. There is, however, a portion of the accounts which is kept on the Double Entry System, the main purpose of which is to bring out by a more scientific method the balance of accounts in regard to which Government acts as banker or remitter, or borrower or lender. Such balances are, of course, worked out in the subsidiary accounts of single entry compilations as well but their accuracy can be guaranteed only by a periodical verification with the balance brought out in the double entry accounts".

6.2 Accounting in Commercial Undertakings of the Government

6.2.1 As stated above, only in case of certain commercial undertakings of the Government, are the accounts maintained in a manner so as to reflect the true outcome of the commercial enterprise. However, these accounts are kept separate from the normal Government accounts. A classic example of such accounts is presented by the Railway Accounts. As the Indian Railways function as a 'Departmental Commercial Enterprise', there is need for securing the essential requirements of commercial accounting apart from conforming to the norms of Government accounting. This is achieved in the Railway Accounts by keeping the accounts of the railways on a commercial basis outside the regular Government account and by maintaining a link between the two for necessary correlations. Thus, the accounts which facilitate a review of the finances of the railways as a commercial undertaking are known as 'Capital and Revenue Accounts' which are compiled annually and included in the Annual Report of the Railways. On the other hand, the accounts maintained in accordance with the requirements of the government accounts are collectively termed as the 'Finance Accounts'.[61]

6.2.3 Unlike Government accounts which record expenditure only when actually disbursed or receipts only when actually realized, the commercial accounts of the railways record the expenditure incurred or earnings accrued in a month irrespective of whether they have actually been paid or realized. On the expenditure side, the revenue liabilities of the Railways for a particular month, which are not payable within the same month, are brought to account as working expenses for the month by taking contra credit to a suspense head called 'Demands Payable'. When the liabilities are actually discharged by payments, the suspense head is debited with that amount. Thus, the balance at the end of a particular month in the suspense head represents liability incurred but not actually discharged during that month. In case of earnings, similar suspense account is maintained under the head 'Traffic Accounts'. In case of wages and allowances for a month for labour, another suspense account is maintained under the head 'Labour'. These three accounts thus linked the commercial accounts with the Government accounts.

6.2.4 Thus, basically the Railway Accounts follow a modified accrual system in their accounts so that the performance of their commercial activities could be captured in a proper way. However, this is maintained separately from the normal government accounts.

6.2.5 In the 1990s, international financial institutions began stressing on adoption of the accrual system of accounts while disbursing financial aid. Thus, in a loan given to Kumbakonam Municipality (Tamil Nadu), the World Bank included the introduction of accrual accounting as a part of its conditions. Similarly, while extending financial assistance to the Ahmedabad Municipal Corporation, the USAID insisted on introduction of accrual accounting so that the Corporation could borrow from the public market.[62]

6.2.6 The Twelfth Finance Commission (2005-10) in its Report has summed up the benefits arising out of adoption of the accrual system of accounting as follows:

> *"14.14 The cash-based system of accounting lays emphasis on transactions vis-à-vis the budget. It does not record and report complete financial information required for management of resources. It does not provide a full picture of the government's financial position at any given point and the changes that take place over time as a result of government policy. The system fails to reflect government's liabilities such as accrued liabilities arising due to unfunded pensions and superannuation benefits and current liabilities arising from a disconnect between commitments and payments. Similarly, the present system is unable to track current assets as well as non-financial assets. It does not provide information on the assets held by the government, much less the cost of holding and operating these assets and the impact of current consumption on the stock of assets. Another major limitation is its inability to record the full cost of providing services by the government's departments or the commitments made by the government regarding payment in future years. The cash-based accounting provides room for fiscal opportunism, as tax revenues can be collected in excess during a period followed by high incidence of refunds, payments can easily be deferred and passed on to future periods, revenues due in the future could be compromised by providing for one-time payments, etc. To quote some other examples, it takes no note of transformation of indebted government agencies into autonomous legal entities outside government through suitable state guarantees, and on the expenditure side, omit existing net liabilities of public enterprises and agencies outside the government, though the latter cannot escape such liabilities.*
>
> *14.15 Compared to the cash-based system, the system of accrual accounting recognizes financial flows at the time economic value is created, transformed, exchanged, transferred or extinguished, whether or not cash is exchanged at that time. It is different from cash-based system in that it records flow of resources. Expenses are recorded when the resources (labour, goods and services and capital) are consumed, and income when it is earned, i.e. when the goods are sold or the services rendered. The associated cash flows generally follow the event after some time and may or may not take place during the same accounting period. Thus, in addition to cash flow, unpaid consumptions (payables) and unrealized income (receivables) are also recorded. Resources acquired but not fully consumed during an accounting period are treated as assets (inventory and fixed assets). Payments made for acquisition of inventory are included in the operating cost for the period in which it is consumed. Payments made for acquisition of physical assets, that have future service potential, are amortized over the entire useful life of the asset by charging depreciation.*
>
> *14.16 The system of accrual accounting, thus, inter alia, allows better cost – price calculations, records capital use properly, distinguishes between current and capital expenditures, presents a complete picture of debt and other liabilities and focuses policy attention on financial position, as shown in the whole balance sheet not just cash flows or debts. It gives a complete measure of cost of various services, takes care of disinvestment receipts and provides adequate information of both fiscal balance and net worth and their changes over time. Information, as would be available under accrual accounts, constitutes an essential input for bodies like finance commissions, not only in assessing the revenue requirements of the centre and states vis-à-vis the available resources, but also in appraising their fiscal performance with a view to assigning due credit to the governments, which have performed well and providing disincentives to those, which fail to measure up-to expectations. ..."*

6.2.7 It needs to be mentioned here that in order to implement the recommendations of the Twelfth Finance Commission, the Government Accounting Standards Advisory Board (GASAB) in the Office of the C&AG has been entrusted with the task of recommending a detailed road map and an operational framework. The Roadmap prepared by GASAB for

[61]Source : Indian Railways Code for the Accounts Department, Part-I: http://www.indianrailways.gov.in/Finance Code/AccCode1/Chapters/Chapter2.pdf
[62]Source: Trapped in the Comfort Zone of Denial: 50 years of Expenditure Management in India; A. Premchand; NIPFP; pp 30-31

transition to accrual accounting envisages a 10-12 year transition period. The main activities proposed under this Roadmap are:[63]

i. Setting up a Task Force or Cell or designating a nodal agency preferably at Ministry for Finance for coordination and overseeing the implementation. Besides representative from the Ministry of Finance, the said Task Force may comprise :

representative of the office of the CAG,

representative from the office of the CGA,

representative from Railways,

representative from the office of the CGDA,

representative from Posts, and

representative from State Governments (select State Governments).

This Task Force would work as a nodal agency for implementation and coordination of transition to accrual accounting. It would further consider and suggest ways and means of setting up separate task forces in the concerned Ministry / Department and State Governments for supervision and monitoring of such transition. It would focus on facilitating an integrated approach across Governments aimed at maintaining broad uniformity in the form of accounts. Further, it would also provide a forum for evolving accounting policies and accounting standards and facilitate resolution of issues faced by different stakeholders. Finally, it would bring about a detailed plan of action for scheduling of different activities involved in the transition.

ii. Identification and collection of data required for preparation of accrual-based Financial Statements.

iii. Pilot Studies covering a few Ministries/Departments/State Governments with a view to assess the gaps and problems in the existing system. This would also be crucial for process mapping.

iv. Detailed process study of various activities and accounting practices to assess the extent of departure from the existing system in terms of accounting principles, recognition and measurement of elements, classification and disclosure of information.

[63]Operational Framework of Accrual Basis of Accounting in Governments in India; GASAB; February, 2007

v. Preparation of a detailed accounting framework in line with the broad contours of the operational framework prescribed by GASAB.

vi. Laying down accounting policies

vii. Preparation of a Chart of Accounts

viii. Devising subsidiary ledgers/records to be maintained in accounting offices

ix. Streamlining accounting dataflow and defining role and responsibilities amongst officials dealing with accounting data

x. Putting in place a new IT system

xi. Pilot implementation of the new system in few Ministries/Departments

xii. Full implementation

6.2.8 The operational framework for this transition would have to encompass accounting and treatment of assets, liabilities, revenue and expenses and the final accounts of the Governments consistent with the provisions of the Constitution. Accordingly, the operational framework suggested by GASAB takes into consideration various issues related to this transition. It recognizes that different departments / organizations should have the flexibility to decide the appropriate degree and extent of accrual base that is useful and sustainable for them. Thus, accounting policies would need to be framed independently by them which would be consistent with generally accepted accounting principles. Due to these considerations, the operational framework designed by GASAB indicates broad deviations from the conventional approval basis of accounting as followed by commercial / industrial and business enterprises. This is necessitated on account of the specific requirements of accounting and reporting owing to the nature of governmental transactions, types of assets held, liabilities carried and revenue collected.

6.2.9 The proposed broad framework for transition to accrual accounting is presented in Table 6.1.[64]

6.2.10 GASAB has suggested that Stage 1 depicted in the above Table should be the starting point for introduction of the accrual basis of accounting and accounting reforms should incrementally graduate to Stage V which represents full accrual accounting. It also noted that certain entities within the government like the Railways may straightaway adopt full approval on account of their preparedness and nature of activities. A description of these stages is given

[64]Source: Operational Framework of Accrual Basis of Accounting in Governments in India; GASAB; February, 2007

Table 6.1: Operational Framework of Accrual Basis of Accounting in Government

Stages	Expenses	Revenues	Assets	Liabilities	Contingent Liabilities
Current Stage	Exp – Current & Capital	Receipts	Financial assets	Stock of Public debt and Borrowings on Public Account	Guarantees
Stage I	**Current Expense on accrual basis** and Capital Expenditure on cash basis	Receipts	Financial assets	Stock of Public debt and Borrowing on Public Account + **Payables**	Guarantees
Stage II	Current Expense on accrual basis and **Capital Expenditure on cash basis [excluding Expenditure on Military Assets]**	**Non Tax Revenues on accrual basis +** Tax Revenues on cash basis	Financial assets **+ Receivables + Military assets**	Stock of Public debt and Borrowing on Public Account + Payables + **All other Liabilities** [except superannuation benefits, compensated leaves, provisions and social security]	Guarantees
Stage III	**All Expenses on accrual basis + Depreciation**	Do	**All Assets** (excluding infrastructure, land, heritage, intangible assets)	All liabilities (except superannuation benefits, compensated leaves, provisions and security)	**All explicit contingent liabilities**

Table 6.1: Operational Framework of Accrual Basis of Accounting in Government *Contd.*

Stages	Expenses	Revenues	Assets	Liabilities	Contingent Liabilities
Stage IV	All expenses on accrual basis + Depreciation + **Provisions**	Do	All assets including **infrastructure and land** [excluding heritage and intangible]	Do	Do
Stage V	**All Expenses**	**All Revenues on accrual basis**	**All Assets**	**All liabilities**	**All explicit contingent liabilities**

below:

Stage I: Accrual-based recognition is introduced in case of current expenses leading to recognition of payables which would be shown as a liability.

Stage II: Accrual-based recognition is introduced in case of non-tax revenues which would lead to recognition of receivables, to be included in assets. This will also include military assets.

Stage III: At this stage, all expenses are recognized on accrual basis and recognition of depreciation is introduced. Further, all financial and physical assets (except for infrastructure, land, heritage and intangibles) and inventories are recognized on accrual basis. Further, disclosure of all explicit contingent liability begins to be made.

Stage IV: At this stage, inclusion of provisions as expense and extension of physical assets to cover infrastructure and land would be on accrual basis.

Stage V: At this stage, all the aspects of Government accounts are based on accrual system of accounting.

6.2.11 GASAB has proposed that successful completion of every stage should be considered for consolidated reporting for the entire government at different levels. The time frame for Stage I should be 3-5 years. This framework would require preparation of a Chart of Accounts for capturing accrual based information in account books. This Chart of Accounts should have two tiers, the first tier would capture information for use at the macro-level (uniform for all Departments as in the case of existing Major and Minor Heads) and the second tier would capture information for budget management in the Ministries/ Departments. Ministries / Departments / organizations should have the flexibility to design their own Chart of Accounts in case of the second tier.

6.2.12 GASAB has indicated that adoption of the accrual principle would necessitate certain changes in the financial statements. The new structure of financial reporting would comprise three inter-related statements.

Statement of operating performance (Income & Expenditure Account),

Statement of financial position (Balance Sheet), and

Statement of sources and uses of cash.

6.2.13 The accrual based financial statements will provide two important measures of

financial performance – Fiscal Balance and Net Assets / Equity (Net Worth). Fiscal balance will measure the operating performance and provide an indicator of the saving-investment gap of the government; Net Assets/Equity will provide a measure of government's financial position in terms of its ability to relinquish its liabilities. Changes in the net worth over time provide a measure of the sustainability of government's fiscal policies. However, all information previously recorded according to the cash basis of accounting will be retained and presented in a reorganized format in the statement of sources and uses of cash. Other statements will serve to provide an integrated presentation of the economic operations and positions of government.

6.2.14 The Appropriations from Parliament would continue to be obtained on cash basis and this will necessitate preparation of Appropriation Accounts showing compliance with parliamentary supply. Similarly, Finance Accounts would also continue to be prepared on cash basis till the new framework stabilizes. The statement of receipts and disbursements (Statement No.1 of Finance Accounts) would serve as the link between the accrualsbased Statement of Operating Performance and cash-based budgets.

6.2.15 As far as the Urban Local Bodies (ULBs) are concerned, the Commission in its Sixth Report entitled "Local Governance" had recommended that the accounting system for them as provided in the National Municipal Accounts Manual (NMAM) should be adopted by the State Governments (Paragraph 3.9.22.a). The NMAM prescribes that these accounts should be prepared on accrual basis. In case of the PRIs, the formats for accounts developed by the C&AG are basically in the form of a simple receipt and payment account on cash basis accompanied by key statements that take care of the items of accrued income and expenditure. The Commission has recommended in its Sixth Report that it should be ensured that the accounting standards and formats for Panchayats are prepared in a way which is simple and comprehensible to the elected representatives of the PRIs (paragraph 3.9.22.d).

6.2.16 However, in case of adoption of the accrual-based system, first in government accounts, and then in budgeting, some pertinent aspects would need to be addressed:

i) There is a high cost of transition from cash-based to accrual-based accounting system as it requires higher level of trained and skilled personnel, and higher costs are involved in identification and evaluation of assets and setting up the technological infrastructure.

ii) The transition period takes a fairly long time to settle, sometimes even more than a decade.

A number of activities associated with the accrual-based accounting system involve high level of subjectivity for example valuations and risk assessment. The nature disclosures and reporting could change substantially based on such valuations and assessments. Robust accounting framework for implementing such a system is also required.

6.2.17 In fact, discussions on adoption of the accrual system of accounting in the government has been on-going for quite some time. Even the Committee on Fiscal Responsibility Legislation, July 2000 was in favour of introduction of accrual accounting system and was inclined to make it a part of the Fiscal Responsibility and Budget Management Act, as it felt it would be an instrument of fiscal control. Its Report stated that:

> *"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"*.[65]

6.2.18 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. However, the offices of both the C&AG and the CGA expressed their reservations on incorporating the accrual-based system as part of the FRBM Act, which was accepted by the Committee: *"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-based information in the budget document should be set as a target in the proposed FRA".* In fact, it was pointed out that a committee headed by Shri A.C. Tiwari, former Dy. C&AG, had examined the issue of introducing accrual accounting earlier, and was of the view that *"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".*[66]

6.2.19 A word of caution has also been put in the OECD document 'Managing Public Expenditure – A Reference Book for Transition Countries'[67] in case of countries considering the implementation of a government-wide full accrual accounting system. In their view, *"Full accrual accounting requires a comprehensive registration of assets and a sound cost measurement*

[65]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. (cited in the Report furnished to ARC by NIPFP)

system. Implementing such systems government-wide needs time and its cost-effectiveness needs to be carefully examined. Full accrual accounting would not contribute to the development of a performance-oriented approach to budgeting at the agency level if depreciation is roughly estimated. If accounting standards are not clearly specified and reported, accrual accounting leaves room for "creative accounting", through manipulating estimates of depreciation, provisions, recognition of losses, etc."

6.2.20 A gradual approach was thus advocated in the OECD document: *"It might start with those areas of of government activity that require information on the value of physical assets, their uses and full costs (e.g. agencies that charge users for services provided). Taking into account the need to strengthen fiscal management, transition countries should focus first on implementing methods to better recognize financial liabilities in their accounts..... Making accrual accounting effective requires a true and fair recognition of expenses. Applying only formal accounting rules does not increase transparency. Accrual accounting therefore requires the availability of many highly skilled accountants both inside and outside the government. Accrual accounting can improve transparency but only if decision-makers and the public are well informed about the nature of the information provided and its financial implications. This is not always the case, even in many OECD countries..."*

6.2.21 They further point out that although including accrual accounting information in budgetary documents is desirable in principle, relatively few OECD countries (e.g. Australia, Iceland, the Netherlands, New Zealand, Sweden and the UK) have moved in this direction. The US has decided to retain its obligations-based system of budgeting in which information on cash transactions is supplemented by accruals information for certain categories of transactions.[68]

The implementation in OECD countries is presented in Table 6.2.

6.2.22 However, it needs to be pointed out that International experience also indicates various complexities and risks involved. For example:[69]

1. Many countries have attempted to move towards accrual accounting but success has not been widespread. For example, even among the OECD countries, Germany and Italy are yet to decide on the transition. The Netherlands has retracted its steps because of the costs involved. Japan has decided not to go for it, at least for the present. South Africa has reverted back after actively pursuing it.

[66]Seminar in Fiscal Responsibility and Budget Management Act 2003 and its Implementation, NIFM, October 12, 2004, para 72. (cited in the Report furnished to ARC by NIPFP)
[67]Ed. Richard Allen, Daniel Tommasi; OECD, 2001; page 306
[68]Ibid; page307

Table 6.2: OECD Member Countries : Government Accounting			
OECD Member	**Accrual Accounting for Individual Agencies / Departments**	**Consolidated Accrual Reporting**	**Accrual Budgeting**
G7 Economies			
Canada	Since FY 2002	Since FY 2002	Yes
France	Being introduced	Some, full accrual being introduced	ESA 95. Intends to move to modified accrual basis
France	Being introduced	Some, full accrual being introduced	ESA 95. Intends to move to modified accrual basis
Germany	Cash statements supplemented with accrual information	No	ESA 95. In preparation
Italy	Yes	Yes	ESA 95. Yes
Japan	Yes	Introducing	No
United Kingdom	Since FY 2000	From FY 2006	ESA 95. Since FY 2002
Other Members			
Australia	Since 1995	Since 1997	Since FY 2000
Austria	No*	No	No, but will be introducing modified accrual budgeting in accordance with ESA 95
Denmark	Some	Some	ESA 95. Is introducing full accrual budgeting
Finland	Since 1998	Since 1998	ESA 95. Yes
Greece	Some	Yes	ESA 95. Modified accrual
Hungary	Cash statements supplemented with accrual information	No	No, but will be introducing modified accrual budgeting in accordance with ESA 95
Iceland	Since 1992	Since 1992	ESA 95. Since 1998
Ireland	Cash statements supplemented with accrual information	No	ESA 95. Modified accrual.
Korea, Republic of	Is introducing full accrual accounting	No	Is introducing full accrual budgeting

Table 6.2: OECD Member Countries : Government Accounting			
OECD Member	**Accrual Accounting for Individual Agencies / Departments**	**Consolidated Accrual Reporting**	**Accrual Budgeting**
Luxemburg	No*	No	ESA 95
Mexico	No*	No	No
The Netherlands	Since 1994	Introducing	ESA 95. For agencies since 1997. Is introducing full accrual budgeting
New Zealand	Since FY 1992	Since FY 1992	Since FY 1995
Norway	No*	No	No
Poland	Some	Some	No, but will be introducing modified accrual budgeting in accordance with ESA 95
Portugal	Yes	No	ESA 95. Is introducing additional accrual information
Slovak Republic	No*	No	No, but will be introducing modified accrual budgeting in accordance with ESA 95
Spain	Modified accrual	Modified accrual	ESA 95. Modified cash
Sweden	Since 1994	Since 1994	ESA 95. Is introducing full accrual budgeting
Switzerland	Yes	No	Is introducing full accrual budgeting
Turkey	No*	No	No

* Most countries actually use modified cash accounting.
ESA 95: European System of Accounts 1995

Source : Accrual Budgeting and Accounting in Government and its Relevance for Developing Member Countries; by A.C. Athukorala & Barry Reid; http://www.adb.org/Documents/Reports/Accrual_Budgeting_Accounting/default.asp

2. Even in countries where the system has been implemented, the cost of implementation has been high and the system has stabilized in about a decade. However, it has not conclusively been shown that the information provided by accrual accounting system is being used in decision making.

3. Different countries have followed different approaches to adopting accrual accounting. In Australia, accrual accounting was first implemented at the provincial level and later at the national level. In the U.K, although departments prepare accrual based accounts, there is no consolidation of these accounts at the national level.

6.2.23 The enormity of the last mentioned task was also realized by the Twelfth Finance Commission. Thus, it stated that *"The change over to the accrual based system of accounting will place considerable demands on the accounting personnel in various government organizations, particularly at the lower and middle levels of accounting hierarchy, consisting of accounts clerks, accountants, assistants, treasury officials and others." As mentioned earlier, to be able to derive meaningful inferences from the new system of accounts and to see through window dressing exercises, all the stake holders involved in the decision making process in the government including Parliament and public at large would have to be aware of the intricacies involved. Realising this, the Twelfth Finance Commission also observed that "however, the transition would occur in stages, as this is a time consuming process. While we are in favour of a change over to the accrual based system of accounting in the medium term, we suggest that in the interim, some additional information as mentioned below in the form of statements should be appended to the present system of cash accounting to enable more informed decision making. An illustrative list of statements, which could be included are:*

a statement of subsidies given, both explicit and implicit;

a statement containing expenditure on salaries by various departments / units;

detailed information on pensioners and expenditure on government pensions;

data on committed liabilities in the future;

statement containing information on debt and other liabilities as well as repayment schedule;

accretion to or erosion in financial assets held by the government including those arising out of changes in the manner of spending by the government;

implications of major policy decisions taken by the government during the year or new schemes proposed in the budget for future cash flows; and

[69]Source: Information provided by the Office of the CGA, Ministry of Finance

statement on maintenance expenditure with segregation of salary and non-salary portions."

6.2.24 While discussing reforms in the budgetary system, the initiatives taken in the UK, especially its 'Alignment Project' has been described in detail. The Commission is of the view that a similar alignment in India would bring about the transparency as desired by the Twelfth Finance Commission.

6.2.25 So far as accrual system is concerned, it is observed that while its implementation has been costly and time consuming in countries where it has been adopted, empirical evidence of its benefits has not been conclusively demonstrated. Its implementation also places a high premium on capacity building, both in case of institutions and personnel. Views have also been expressed about limitations in its usefulness if the system of accounting does not cover the budgeting system also. The Commission has considered the views from both sides of the debate. It is of the view that while adopting the accrual system of accounting may be the ultimate objective in case of government accounts, in the present scenario the following steps would first need to be taken:

i. Setting up of a Task Force to examine the costs and benefits of this system. This Task Force should also examine its applicability in case of the Appropriation Accounts and Finance Accounts.

ii. A few departments/organizations may be identified where tangible benefits could be shown to be derived by implementing the new system within 2-3 years, especially departmental 'commercial undertakings'.

iii. The result may be studied by a committee of experts which would recommend or otherwise its further implementation in all departments/organisations at the Union/State level along with exclusions, if any. This may proceed in a phased manner.

iv. Training and capacity building needs of the accounting personnel and all stake holders in the decision making process would have to be addressed and a schedule worked out in line with the road map.

v. Before the new system is adopted, alignment of the plan, budget and accounts needs to be achieved and a viable financial information system needs to be put in place.

6.3 Recommendations

a. **A Task Force should be set up to examine the costs and benefits of introducing the accrual system of accounting. This Task Force should also examine its applicability in case of the Appropriation Accounts and Finance Accounts.**

b. **Initially, a few departments/organizations may be identified where tangible benefits could be shown to be derived within 2-3 years by implementing the accrual system of accounting, especially departmental 'commercial undertakings'.**

c. **The result of this initial implementation may be studied by a committee of experts which would recommend on its further implementation in all departments/organisations at the Union/State level along with exclusions, if any. This may proceed in a phased manner.**

d. **Prior to its implementation, training and capacity building needs of the accounting personnel and all stake holders in the decision making process would have to be addressed and a meticulous schedule worked out in line with the road map of implementation.**

e. **Before the new system is adopted, alignment of the plan, budget and accounts, as recommended in this Report elsewhere, needs to be achieved and a viable financial information system needs to be put in place.**

7

INTERNAL CONTROL AND AUDIT

7.1 Introduction

7.1.1 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."*[70]

7.1.2 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, is required to observe upon cases of improprieties in financial operations.

7.1.3 The function of audit has been entrusted to the Comptroller and Auditor-General of India by the Constitution. Internal audit, as the name suggests, has to be a part of the government organization. Presently, in Government of India, this function is discharged by the Office of the Controller General of Accounts in the Ministry of Finance through Chief Controllers/Controllers of Accounts in different Ministries/departments. The present scope of internal audit is as follows:

> *12.2.1 The Internal Audit Unit will work directly under the Pr.CCAs/CCAs/CAs, with overall responsibility remaining with the concerned Financial Adviser and the Secretary of the Ministry/Department. The Principal Accounts Office, the Pay and Accounts Offices as well as the offices of the D.D.Os in Ministries/Departments, Indian Missions and other Govt. of India offices abroad, shall be within the jurisdiction of internal audit. In addition*

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

to these offices, internal audit shall be required to audit the implementing agencies for various schemes and programmes of the Ministry/Department.

Internal Audit shall also check the initial accounts maintained in the executive offices to ascertain the extent of following of the rules and regulations, system and procedures in accounting and financial matters. The scrutiny would cover checking of all accounting records including those relating to fund accounts, loans and advances, disposal of confiscated stores (in CBEC), review of the installation and operating efficiency of expensive equipments and machinery and examination of records relating to physical verification of stores, equipments, tools and plant. The accounts of all grantee Institutions or Organizations shall be open to inspection by the sanctioning authority and audit, both by the Comptroller and Auditor General of India under the provision of CAG (DPC) Act 1971 and internal audit by the Principal Accounts Office of the Ministry or Department, whenever the Institution or Organization is called upon to do so and a provision to this effect should invariably be incorporated in all orders sanctioning grant in aid." [71]

7.1.4 Thus, the overall responsibility of internal audit lies with the concerned Financial Adviser and ultimately with the Secretary of the Ministry/department. The general duties of the internal audit organization in the Ministries/departments include the following:

(i) Study of accounting procedures prescribed for the department with a view to ensuring that they are correct, adequate and free from any defects or lacunae;

(ii) Watch over the implementation of the prescribed procedures and the orders issued from time to time;

(iii) Scrutiny and check of payments and accounting work of the accounting units;

(iv) Investigation of important arrears in accounting and other connected records;

(v) Coordination with other Ministries and C.G.A. regarding internal audit procedures;

(vi) Periodical review of all accounts records;

(vii) Pursuance/settlement of objections taken in test audit notes issued by statutory audit offices and other matters relating to statutory audit;

[71] Civil Accounts Manual; Second Revised Edition -2007

(viii) To examine and report on points or irregularities brought to its notice by the Principal Accounts Office/P.A.Os; and

(ix) Preparation and submission of 'Annual Review' on performance of internal audit wing to the Controller General of Accounts." [72]

7.1.5 However, the revised charter for the Chief Controllers of Accounts includes some additional responsibilities:

As per the new charter of duties and responsibilities of Chief Controllers of Accounts issued by the Secretary, Department of Expenditure, Ministry of Finance, the following functions will be carried out as per the guidelines issued by the Controller General of Accounts from time to time.

(i) The appraisal, monitoring and evaluation of individual schemes;

(ii) Assessment of adequacy and effectiveness of internal controls in general, and soundness of financial systems and reliability of financial and accounting reports in particular;

(iii) Identification and monitoring of risk factors including those contained in the Outcome Budget;

(iv) Critical assessment of economy, efficiency and effectiveness of service delivery mechanism to ensure value for money; and

(v) Providing an effective monitoring system to facilitate mid course corrections." [73]

7.1.6 Thus, whereas the original mandate of internal audit was to ascertain whether the rules and regulations have been followed and procedures in accounting and financial matters have been complied with, the revised charter includes appraisal and evaluation of individual schemes, assessment of adequacy of internal controls, monitoring of risk factors, efficiency etc.

7.1.7 In order to move towards risk assurance based internal audit, the CGA has decided to establish a Centre of Excellence for Internal Audit (COE) in the Office of Controller General of Accounts. Its objectives would be:

- to ultimately develop into a repository of technical resource and guidance centre for advising internal audit wings of line Ministries on effective, independent and objective internal audit functions, procedures, and "best practices". The approach of COE will be to cover important aspects of risk management strategy and the

[72] Civil Accounts Manual; para 12.3.1
[73] Ibid; para 12.3.2

management control framework and practices;

- to enhance the quality of internal audit so that the results of internal audit become an input into the processes of planning, project formulation and implementation; and

- to provide an assurance to the management that the "controls" in place provide adequate protection against likely "risks".

7.1.8 However, this initiative also realizes that 'risk based internal audit' would develop 'gradually, evolving over time, as the capacity to meet the objectives gets enhanced and standards and practices to carry out modern risk based internal audit are firmed-up'.[74] In order to formulate the future course of the Centre of Excellence, a Working Group has also been constituted to:[75]

1. Evolve guidelines and scope for the functioning of the Centre of Excellence.

2. Examine the current and future needs and charter the future course of the Centre of Excellence.

3. Suggest improvements which could be brought about in the scheme of Internal Audit being conducted by the Ministries / Departments.

4. Periodically evaluate the performance of audit and suggest changes for constant improvement in relation to the changing scenario.

5. Harness technological developments to aid the objectives of audit.

7.1.9 It is thus evident that internal audit as per the revised mandate, is in its infancy in India. It would be instructive here to look at some of the international best practices in this regard.

7.1.10 In the private sector of the developed economies, the scope of internal audit in the revolves around three functions: (i) risk management, (ii) control and (iii) governance of the organization concerned. The Institute of Internal Auditors (IIA), the leading institution in the field of professional internal auditing, has defined the nature of work with regard to internal audit as follows: *"the internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach"* (Internal Standards for the Professional Practice of Internal Auditing, Para 2100). **'Risk'** has been defined by IIA to mean *"The possibility of an event occurring that will have an impact on the achievement of objectives. Risk is measured in terms of impact and likelihood"*. **'Risk Management'** is defined as *"A process to identify, assess, manage and control*

[74]OM No.G.25014/48/07/MF.CGA/Insp./390 dated August 22, 2007; http://cga.nic.in/pdf/CentreOfExcellence.pdf
[75]OM No.G.25014/80/07-08/MF.CGA/COE/Insp./1275 to 1284 dated March 19, 2008; http://cga.nic.in/pdf/CentreOfExcellence.pdf

potential events or situations, to provide reasonable assurance regarding the achievement of the organizations objectives". **'Governance'** has been defined as *"the combination of processes and structures implemented by the Board in order to inform, direct, manage and monitor the activities of the organization toward the achievement of its objectives"*. Many countries of the developed world have tried to introduce these modern concepts into government institutions. Thus, the 'Government Internal Audit Standards' published by HM Treasury Audit policy and Advice, UK (October, 2001) defines Internal Audit in the following manner:

> *Internal audit is an **independent** and objective appraisal service **within** an organization:*
>
> - *Internal audit primarily provides an independent and objective opinion to the Accounting Officer on risk management, control and governance, by measuring and evaluating their effectiveness in achieving the organisation's agreed objectives. In addition, internal audit's findings and recommendations are beneficial to line management in the audited areas. Risk management, control and governance comprise the policies, procedures and operations established to ensure the achievement of objectives, the appropriate assessment of risk, the reliability of internal and external reporting and accountability processes, compliance with applicable laws and regulations, and compliance with the behavioural and ethical standards set for the organization.*
>
> - *Internal audit also provides an independent and objective consultancy service specifically to help line management improve the organisation's risk management, control and governance. The service applies the professional skills of internal audit through a systematic and disciplined evaluation of the policies, procedures and operations that management put in place to ensure the achievement of the organisation's objectives, and through recommendations for improvement. Such consultancy work contributes to the opinion which internal audit provides on risk management, control and governance".*

7.1.11 Internal audit in the UK provides objective opinion directly to the Accounting Officer. To facilitate this, specific internal audit standards have been prescribed which define the way in which the internal audit should be established and undertake its functions. They apply equally to internal audit services which are provided by in-house audit units, in-house audit units and service level agreements and by external contractors who provide either partial services in support of an in-house team or the whole internal audit service. The standards are organized in two groupings. The organizational standards deal with:

i. scope of internal audit,

ii. independence,

iii. audit committees,

iv. relationship with management etc. and

v. staffing, training and development.

The operational standards deal with:

i. audit strategy,

ii. management of audit assignments,

iii. due professional care,

iv. reporting and

v. quality assurance.

7.1.12 These definitions and standards are in general agreement with those provided by the IIA. Thus, internal audit in the government in the UK is designed to provide independent and objective advice to the Accounting Officer (generally the Permanent Secretary in Central Government Departments is designated as the Accounts Officer)[76] and is guided by the standards prescribed, covering the whole gamut of activities covered by such audit.

7.1.13 In the United States, responsibilities of internal audit carry a strong element of investigation following the enactment of the Inspector General Act of 1978. This Act established an office of Inspector General within each of the selected government establishments in order to create independent and objective units to:[77]

1. conduct and supervise audits and investigations relating to the programs and operations of the selected establishments;

2. provide leadership and coordination and recommend policies for activities designed

   a. to promote economy, efficiency, and effectiveness in the administration of, and

   b. to prevent and detect fraud and abuse in, such programs and operations; and

[76]http://www.hm-treasury.gov.uk/d/accounting_officers110608.pdf
[77]Section 1, Inspector General Act, 1978

3. provide a means for keeping the head of the establishment and the Congress fully and currently informed about problems and deficiencies relating to the administration of such programs and operations and the necessity for and progress of corrective action.

7.1.14 Thus, investigation into government programmes and prevention and detection of frauds therein are important objectives of these offices. In fact, this Act effectively combines internal audit and investigations into programmes and activities under the authority of the Inspector General of an establishment. The main functions and duties of the Inspector General include:[78]

1. providing policy direction for and to conduct, supervise, and coordinate audits and investigations relating to the programs and operations of the estsablishment within which he/she is functioning;

2. reviewing existing and proposed legislation and regulations relating to programs and operations of his/her establishment and to make recommendations regarding their impact on the economy and efficiency in the administration of programs and operations administered or financed by his/her establishment or the prevention and detection of fraud and abuse in such programs and operations;

3. recommending policies for, and to conduct, supervise, or coordinate other activities carried out or financed by his/her establishment for the purpose of promoting economy and efficiency in the administration of, or preventing and detecting fraud and abuse in, its programs and operations;

4. keeping the head of his/her establishment and the Congress fully and currently informed, by means of the reports, concerning fraud and other serious problems, abuses, and deficiencies relating to the administration of programs and operations administered or financed by the parent establishment, to recommend corrective action concerning such problems, abuses, and deficiencies, and to report on the progress made in implementing such corrective action.

7.1.15 However, so far as conduct of audit and investigation is concerned, the Inspectors General have to comply with the standards established by the Comptroller General of the United States for audits of Federal establishments, organizations, programs, activities, and functions. Further, the Inspectors General also have to pay regard to the activities of the Comptroller General of the United States so that there is no duplication and effective coordination and cooperation is achieved. With the objective of increasing the number of agencies with statutory IGs, the

[78]Ibid; Section 4

IG Act has been amended and there are now 67 statutory IGs.[79]

7.1.16 Thus, international best practices suggest that internal audit units, although being part of their respective organizations, are designed to provide independent assessment of government financial operations and programmes and prevent and identify frauds. The overall objective is to assist the management in improving performance and increasing efficiency and reducing risk. It is evident that the present situation in India is not in harmony with international best practices.

7.1.17 In order to benchmark the status of internal audit in the Union Government and determination of roadmap for its improvement, the Comptroller and Auditor General of India constituted a Task Force on 17 July, 2006 at the request of the Ministry of Finance, Department of Expenditure.[80] Its recommendations are discussed in paragraph 7.3.

7.2 Weaknesses of the Present System of Internal Audit

7.2.1 The existing internal audit set-up in Government of India has been described briefly in Chapter 3. The CAG, in their Reports, also discuss the status and functioning of internal controls (including internal audit). Thus, in their Report (No. 12 of 2006) on Union Government, they have commented on internal audit in some of the Union Ministries in the following manner.

i. **Deptt. of Health (Ministry of Health and Family Welfare):** The internal audit of the Department of Health (DoH) was conducted by the internal audit wing of the Ministry of Health and Family Welfare under the administrative control of the Chief Controller of Accounts. A test check of the internal audit wing of DoH revealed the following deficiencies:

   a. *Training of Internal Audit Staff:* Specific training programme for upgrading the skills of the staff was not conducted to enable efficient checking of various aspects of functioning of the Department.

   b. *Internal Audit of Schemes and PSUs:* A large number of central and centrally sponsored health programme financed mainly by the Ministry and involving outlays which constituted 70% of plan allocation of DoH were kept out of the purview of internal audit. Audit of PSUs and grantee institutions/ autonomous bodies receiving grants loan and advances were kept out of jurisdiction of internal audit, which defeated the purpose of internal audit wing in the Ministry.

[79]http://www.ignet.gov/
[80]Discussion on this Task Force is based on a paper furnished to the ARC by NIPFP

   c. *Non-preparation of Audit Plan:* No information regarding units planned to be audited and actually audited during previous years was documented nor any monthly, quarterly or annual audit plans were prepared.

   d. *Lack of response by Auditee Units:* The Ministry did not take timely and effective measures to rectify the deficiencies or to comply with the observations of the internal audit and statutory audit which lead to raising of repeated persistent paras in Inspection Reports (IRs) ultimately rendering a large number of outstanding audit observations. Thus lack of action by the Ministry in attending to internal audit objections made the efforts of internal audit wing ineffective.

ii. **Department of Information Technology (DoIT), Ministry of Communication and IT:** The Civil Accounts Manual provided for setting up of an efficient internal audit wing to ensure accuracy in accounts and efficiency in operation of accounts establishment. Each Ministry/ Department was, therefore, required to draw up a manual of internal audit specifying duties and functions of the wing. Audit examination revealed that DoIT neither prepared an internal audit manual nor established an internal audit wing. The internal audit plans were being prepared in an adhoc manner on case-to-case basis. Out of 37 units, internal audit of six, seven and 29 units was conducted during 2002-03, 2003-04 and 2004-05 respectively. Internal audit of 3 units had not been taken up even once during this period. The internal audit wing could not be established due to shortage of staff and ban on recruitment and the functions of internal audit were being managed by the existing staff.

iii. **Ministry of Urban Development and Ministry of Urban Employment and Poverty Alleviation :** The following observations were made:

   a. *Training of Internal Audit Staff:* For an efficient check of various aspects of functioning of the Department including its budget and accounts with reference to rules and orders, it was essential for the internal audit staff to undergo periodical in-service trainings. No specific training programme for upgrading the skills of the staff was conducted.

   b. *Audit Planning:* Internal audit had identified 447 units under its audit jurisdiction, which were to be audited annually as provided in the Civil Accounts Manual. However, due to inadequate sanctioned staff strength only 104, 132 and 126 units were audited during 2002-03, 203-04 and

2004-05 respectively. It was also observed that the audit plan was not documented, based on risk perception and the only criteria of selection was the date on which the unit was last audited.

c. *Internal Audit of Schemes and PSUs:* A large number of central sector and centrally sponsored schemes implemented were financed by the two Ministries and the outlays thereof constituted about 70% of plan allocation. However, these programmes were kept out of the purview of internal audit. The audit of PSUs and grantee institutions/ autonomous bodies was also kept out of the jurisdiction of internal audit. Out of 10 PSUs/ autonomous bodies, only 2 were audited by internal audit during 2004-05.

7.2.2 It was also pointed out that the Ministries/Departments neither took any effective action for rectifying the deficiencies nor complied with the observations of internal audit. Therefore, irregularities pointed out by the Internal Audit Wing persisted.

7.2.3 The above observation of the C&AG on the functioning of Internal Audit indicates that there are serious deficiencies in the existing internal audit system making it inadequate and ineffective. The internal audit guidelines are outdated and there are no manuals in many cases. There are also no prescribed internal auditing standards. Because of the acknowledged problem of under-resourcing of the internal audit service and shortage of manpower, including that of qualified professional staff, internal audit is not being conducted in many departments. The limited staff of the internal audit is also sometimes diverted for accounting and budgeting purposes. In cases where internal audits have been conducted, there is often lack of response to their reports by auditee units. As a result action is not taken to rectify the deficiencies and irregularities and the deficiencies pointed out persist. A large number of Central and State scheme and programmes as well as Public Sector Undertakings and Autonomous Bodies have also been kept out of the purview of internal audit. At the supervisory level, there is no segregation of duties relating to internal audit and other accounting functions. The reports of internal audit are of a routine nature. It is largely a faultfinding exercise with no positive recommendations. Extremely low priority is accorded to internal audit and to resource allocation for internal audit both in terms of manpower and finances.

7.3 The Task Force on Internal Audit

7.3.1 The Comptroller and Auditor General of India had constituted a task force at the request of the Ministry of Finance in July 2006 for benchmarking the status of internal audit in the Union Government. The task force had issued a questionnaire to 15 Ministries covering

various aspects of internal audit.[81] Some Ministries considered that the purpose, authority and responsibility of internal audit had not been formally defined in a charter and that it needed to be done to enable internal audit to play a constructive role as an aid to management and function as a tool for decision-making. The other issues that emerged from the responses were as follows:

i. Direct supervision is not being done regularly as a part of quality assurance techniques. Practices such as independent working paper review, audit client feedback and peer review are not prevalent. Assurance memos' are not adopted as an institutional mechanism and standards are lax.

ii. The practice of communicating all the reports of internal audit to the top management i.e. the Secretary is generally not followed.

iii. In some cases, the internal auditors are expected to function as internal advisers on financial matters and even on operational matters. Internal audit is also involved in pre-payment checking and other non-audit executive functions such as budget preparation, pre-audit and revenue collection. This dilutes the independence of internal audit.

iv. Risk areas such as unauthorized access to information systems, threats of lawsuit, adverse environmental impact, third party risks, fiduciary risks, etc. are not factored in by internal audit.

v. The practice of developing a risk assessment model and taking management inputs into account during planning are not prevalent.

vi. Field audit techniques such as statistical sampling, process reviews, analytical comparisons and physical inspections are not used regularly. Even transaction testing is not as widely prevalent as it should be.

vii. The scope of financial audit appears to be limited. Even in areas like adequacy of controls, accuracy, reliability and completeness of reports, usefulness of reports, and impact of changes in policies, etc. most of the respondents have not indicated whether these are covered by internal audit. Similarly, in the case of operational activities, most respondents have not given any indication whether important areas such as management system of controls, purchase agreements, safeguarding of assets, procurements, etc. are covered by internal audit.

viii. Despite large-scale computerization, very few respondents have indicated whether

[81]Source: Paper furnished to the Commission by Shri I.P.Singh

IT applications are audited by internal audit.

ix. Collaboration with external auditors in terms of sharing of audit plans and reports is completely absent. Joint annual planning/ risk assessment sessions are not held.

x. Though there is a mechanism for the disposal of internal reports, there is no enforcement mechanism in case of non-compliance. There is no time-bound mechanism for enforcing accountability. There is no practice of conducting follow-up tests for examining and implementing corrective action.

xi. In most cases, the final internal audit report does not incorporate a certificate indicating the status as determined by the results of internal audit.

xii. Data extraction and analysis is mostly manual. The use of desktop software such as spread sheets/ database or packages such as ACL, IDEA, etc. is rare.

xiii. The respondents expressed a need for capacity building in terms of trained personnel and constitution of multi-disciplinary teams.

xiv. A need for broadening of scope and greater commitment from top management was felt necessary.

xv. There was a need to develop Internal Auditing Standards consistent with international standards.

7.3.2 After making a detailed study of the present internal audit system, the Task Force observed the following:

i. Restricted mandate has resulted in non-evaluation of risk associated with various activities of the Ministries/Departments. PSUs and autonomous bodies have been kept outside the purview of internal audit thus further diluting its usefulness and effectiveness.

ii. No standards have been evolved for internal audit.

iii. There was no segregation of duties especially at supervisory levels between those who are responsible for internal audit and those 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. For example, in the Department of Telecommunications, internal audit functions and accounting functions were not segregated at supervisory levels. In the Ministry of Defence, while there was segregation of duties in respect of personnel engaged in internal audit up to the supervisory level, they reported to Controllers of Defence Accounts, who are 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.

iv. Independence is hampered in two ways. First, 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 are 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 the Controller of Accounts, at least from the propriety angle. Second, as per the revised mandate, the Financial Advisers are enjoined 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. This has resulted in compromising the intended independence of internal auditing functions.

7.3.3 Based on these observations and after examination of international best practices, the Task Force felt that the Inspector General model of the U.S.A. (already described above), with appropriate modifications is the most suitable for effective internal audit. The main advantage of the IG model is that it can be used to revamp the structure of internal audit into a single authority responsible for both internal audit and investigation, so that audit can be focused on high risk areas. As opposed to external audit, internal audit can be done on a continuous basis as soon as the transactions take place. It is also in a much better position to do the risk analysis because of its familiarity with the systems and procedures in a particular department and as soon audit indicates likely fraud or serious irregularity, investigation could follow immediately.

7.3.4 In other words, the Accounts Departments should confine themselves to maintenance of accounts, disbursement of payments and providing local financial advice to field level officers. Further, internal audit functions should not be combined with financial advice. Accordingly, the Integrated Financial Adviser should not be involved in management and control of internal audit.

7.3.5 However, the Task Force felt that it would be difficult to implement the IG model immediately. Consequently, in the interim period, it recommended setting up of an Apex Board to prescribe internal audit standards and processes across jurisdictions. This 'Board of Internal Audit' (BIA) should comprise of Controller General of Accounts, Controller General of Defence Accounts, Financial Commissioner, Railways and Member (Finance) Telecommunications. 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.

7.3.6 The Commission has examined this issue. It is of the view that if internal audit has to function independently of both Finance and Accounts, the concept of a 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" and for prescribing standards, even for an interim period, is not the right solution. In fact, the standards for internal audit should be prescribed by the C & AG of India, as is the case in the US (the Inspector General Act of 1978). As has been mentioned earlier, even the IG Act did not establish the Office of Inspector General in each and every government organization at one go. The Commission is of the view that an Office of Chief Internal Auditor should be established in select government Minstries/ Departments dealing with major governmental programmes such as those under the 'Bharat Nirman' initiative. Its duties and functions and independence should be provided under a statute. These Chief Internal Auditors should be directly responsible to the Secretary of the concerned Ministry/department. As provided in the IG Act in the US, the statute should also contain provisions regarding ensuring that there is no duplication of work and maintenance of proper coordination with the C&AG. The functioning and effectiveness of this new system may be examined and a cost benefit analysis done after allowing a suitable period of operation. Based on the outcomes of this examination, such offices may be instituted in other Ministries/ departments/organisations. The personnel for these offices may be inducted from existing accounts officers and given proper training. However, given the magnitude of the task of internal audit, the norms for using outside auditors may also be provided. The Commission is also of the view that internal audit should not concern itself with investigation of cases where irregularities are unearthed during audit. These may be dealt with by appropriate agencies created for this purpose. In fact, the Commission has already recommended the formation of a specialised agency to deal with serious frauds in its Fourth Report entitled 'Ethics in Governance'.

7.4 Audit Committees in Departments

7.4.1 Presently, Audit Committees have been set up in various Ministries/Departments to review the action taken on inspection reports and their speedy settlement. They are normally chaired by the Secretary or the Head of Department and include senior officers of the concerned Department and Finance. However, the performance of these Committees has not been satisfactory and they have been generally ineffective.

7.4.2 The Commission is of the view that to effectively coordinate Audit plans in the department with the internal audit structure on the one hand and external audit on the other, there should be an Audit Committee in each Ministry/Department. However, in order to make it independent and effective, its structure needs to be reorganised. Thus, its Chairperson should be a person of eminence in public life and should be appointed by the Minister in charge of the Ministry/department. It should have two more members with expertise in matters of audit and should not be from the government. The Audit Committee should have an independent status and deal with matters related to both internal and external audit. All Departments should be duty bound to furnish information as and when required by this Committee.

7.5 Recommendations

a. **An Office of the Chief Internal Auditor (CIA) should be established in select Ministries/departments to carry out the functions related to internal audit. Its independence, duties, functions, mechanism of coordination with the CAG etc. should be provided by a statute.**

b. **CIAs should be directly responsible to the Secretary of the Department.**

c. **In the initial stages, personnel may be inducted from existing accounts cadres. Norms for recruitment and utilizing private sector expertise in select tasks may also be devised. Capacity building needs for proper functioning of this Office should be identified in advance.**

d. **The modalities for ensuring non-duplication of work vis-à-vis the C&AG should be formalized. This should be aimed at assisting the C&AG in concentrating on carrying out specialized audit/tasks.**

e. **Standards for internal audit should be prescribed by the Office of the C&AG.**

f. **The Accounting functions should be completely separated from Internal**

Audit.

g. **The functioning and effectiveness of this new system may be examined after allowing a suitable period of operation. Based on the results of this examination, such offices may also be instituted in other Ministries/departments/organisations.**

h. **An Audit Committee should be constituted in each Ministry/Department. It should consist of a Chairperson and two members to be appointed by the Minister in charge of that Ministry/Department. The Chairperson should be a person of eminence in public life. The two members should be from outside the government. The Audit Committee should look after matters related to both internal and external audit including implementation of their recommendations and report annually to the respective Departmentally related Standing Committee of Parliament.**

7.6 Integrated Financial Adviser

7.6.1 The Ministries in the Government of India had an internal financial adviser prior to 1975, who was incharge of their Budget and Accounts. The Internal Financial Adviser was required to be consulted in all cases of exercise of delegated financial powers. There was also an 'Associate' Financial Adviser based in the Department of Expenditure who was required to be consulted in matters following outside the delegated field. In 1975, the question whether the functions of the 'Associate' financial adviser and the Internal Financial Adviser could, with advantage be integrated in a single official forming part of the administrative Ministry was considered. It was felt that combining the two functions in a single official would enable him/her to play a more effective and constructive role in the developmental activities in the Ministry and provide better financial expertise in assisting the Secretary of the administrative Ministry and other senior officers in the planning, programming, budgeting, monitoring and evaluation functions of the Ministry. Therefore, a scheme of Integrated Financial Adviser was drawn up and implemented in 1975 (vide O.M. F.No.10(29)-E.Coord/73 dated 6.10.1075). The Integrated Financial Adviser was responsible both to the administrative Ministry and to the Ministry of Finance.

7.6.2 The entire scheme of the Integrated Financial Adviser was reviewed in 2006 in the background of India emerging as one of the fastest growing economies of the world and the last two decades witnessing major reforms in the monetary and fiscal management of the country. The overarching concept in re-defining the charter for Financial Advisers was that they are meant to assist in the achievement of objectives/goals of the respective administrative

Ministry with due financial prudence and to ensure that monies allocated are spent on time to achieve the intended outcomes. It was thought that the more complex responsibilities envisaged for FAs must be accompanied by corresponding authority and capacity. Section 2 of the OM of Ministry of Finance dated 1.6.2006 states – "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 duties and responsibilities of the FAs have been enumerated in the DFPR. Rule 64 of the General Financial Rules designate the Secretary of the Ministry/Department as the Chief Accounting Authority. The role of the Chief Accounting Authority as indicated in the GFR is as follows:

- be responsible and accountable for financial management of his Ministry or department;
- 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;
- be responsible for preparation of expenditures and other statements relating to his Ministry of Department as required by regulations, guidelines or directives issued by Ministry of Finance;
- shall ensure that his Ministry of Department maintains full and proper records of financial transactions and adopts systems and procedures that will at all times afford internal controls;
- shall ensure 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;
- shall take effective and appropriate steps to ensure his Ministry or Department:

  a. collects all moneys due to the Governments and

  b. avoids unauthorized, irregular and wasteful expenditure.

7.6.3 The duties and responsibilities of the IFAs have been enumerated in the DFPR. Some of the tasks for which IFAs would be responsible for are as follows:

i. Budget formulation:

ii. Outcome Budget

iii. Performance Budget

iv. FRBM related tasks

v. Expenditure and cash management

vi. Project/programme formulation, appraisal, monitoring and evaluation

vii. Screening of proposals

viii. Leveraging of non-budgetary resources for sectoral development

ix. Non-tax receipts

x. Tax Expenditure

xi. Monitoring of assets and liabilities

xii. Accounts and Audit

xiii. Procurement and contracts

xiv. Financial Management Systems

xv. Nominee Director on Boards of Public Sector Undertaking

xvi. Use of technology

7.6.4 As a consequence of the OM dated 1.6.2006 and GFR 64, the Commission is of the view that there can be no room for doubt that the responsibility of FA as the Chief Financial Officer of the Ministry or Department should be to the Secretary of the Ministry/Department and the role of the FA would be to support the Secretary of the Ministry in discharging the responsibility for economical, efficient and effective use of resources, effective internal controls and avoidance of irregular and wasteful expenditure. The Commission believes that it is important for the Secretaries of the concerned departments as well as the Finance Ministry to recognize this and to discharge their responsibilities accordingly so that the concept of dual accountability of the FA to the administrative Ministry as well as to the Ministry of Finance is dispensed. At the same time it is essential that only officers with sufficient experience,

knowledge and exposure to modern financial management systems are posted as Financial Advisers so that they are able to effectively discharge the responsibilities of a Chief Financial Officer.

7.6.5 Recommendation:

a. The role of the Financial Adviser as the Chief Finance Officer of the Ministry who is responsible and accountable to the Secretary of the Ministry/ Department should be recognized and the trend of dual accountability should be done away with.

b. Officers with sufficient training and experience in modern financial management systems should be posted as Financial Advisers in the Ministries/ Departments.

8 EXTERNAL AUDIT AND PARLIAMENTARY CONTROL[82]

8.1 Importance of External Audit

8.1.1 External audit has a very important role to play in financial management, because it :

(a) provides assurance to Parliament/Legislature that public money has been spent for the purpose for which it was sanctioned by the Parliament/Legislature and that it has not only been properly spent but has achieved the purpose/ outcome for which it was sanctioned.

(b) is a crucial element of public accountability as it is an independent external scrutiny. External audit is, therefore, deemed to be a key element in ensuring proper accountability of the executive both to the Parliament/Legislature who provide/ sanction resources and to the community including tax payers, consumers and beneficiaries.

(c) is a deterrent against careless decision-making and irresponsible attitude towards public expenditure and project management.

(d) is expected to establish public confidence that public money is being properly spent.

(e) is expected to help in achieving full value for money. External audit includes examination of the economy, efficiency and effectiveness in the use of public resources including the evaluation of service quality and measurement of performance.

(f) adds value not merely by analysing and reporting what has happened after the event but also by looking ahead and identifying lessons to be learnt and by disseminating good practices.

8.2 The Comptroller and Auditor General of India

[82]Parts of this chapter are extracted from a paper prepared by Mr. I.P. Singh

8.2.1 As stated in the earlier chapters, the Comptroller and Auditor General of India (CAG) derives his position and authority in relation to the external audit of expenditure and receipts of both the Union Government and the State Governments from the Constitution of India. The duties and powers of the CAG are enshrined in Articles 148 to 151 of the Constitution and elaborated under CAG's (Duties, Powers and Conditions of Service) Act, 1971. The duties entrusted to the CAG fall broadly under two categories viz. (i) compilation and keeping of accounts and entitlement work in selected States under the Articles 149 and 150 of the Constitution and CAG's DPC Act, 1971, (ii) audit of public entities under Article 151 of the Constitution of India and CAG's DPC Act, 1971. The CAG also audits Government Companies and Corporations in accordance with the provisions of the Company's Act read with Section 19 of the CAG's (DPC) Act, 1971. The Constitution prescribes exhaustive safeguards for the independent functioning of CAG like fixed non-renewable term, full access to information, right to table the reports in the Parliament/ Legislature; power to determine the nature and extent of audit checks and to decide what should be included in the Audit Reports.

8.2.2 As per the Auditing Standards of the CAG, the purpose of Public Audit is to safeguard the financial interests of the Union/ States and to promote accountability and sound financial management practices. As per performance report of IA&AD (2005-06) the vision is:

> *"To promote excellence in public sector audit and accounting services towards improving the quality of governance".*

The mission is:

> *"To enhance accountability of the executive to the Parliament and State Legislatures by carrying out audits in the public sector and providing accounting services in the States in accordance with the Constitution of India and laws as well as best international practices. Where entrusted, to provide technical guidance and support to local bodies including Panchayati Raj Institutions to enhance their accountability."*

8.3 Types of Audit

8.3.1 The role of audit in India has been constantly evolving. Initially, in the pre-Independence period, audit was an integral organ of the Government keeping track of its expenditure and receipts, checking and exercising control over expenditure incurred by various Departments in accordance with rules, norms and instructions. In Independent India, planning and development changed the audit perspective. It was realized that Regularity (Compliance)

Audit and Financial Audit were not enough to evaluate the results of expenditure out of public funds. Performance Audit, slowly developed as an attempt to measure the economy, efficiency and effectiveness of the Government expenditure. The following types of audit are undertaken by the CAG:

- Performance Audit
- Regularity (Financial) Audit
- Regularity (Compliance) Audit
- IT Audit

8.4 Strengths of External Audit in India

8.4.1 The external audit by the CAG of India has many inherent strengths.

(i) The CAG has a high status enshrined in the Constitution, upheld by long traditions of public audit in India. The institution of audit under the CAG is often regarded as the fourth pillar in the democratic setup and an essential instrument of financial control and accountability.

(ii) The Constitution of India ensures independence and autonomy of the public audit.

(iii) The expression 'Audit' or scope of the audit has not been defined either in the Constitution or the CAG's DPC Act, 1971. The scope of external audit is, therefore, wide. Audit can respond to changes, reforms, new initiatives, changing patterns of Government activities, international developments in the profession and rising expectations of the stakeholders regarding public accountability.

(iv) The CAG has the power to determine the nature and extent of audit and related access to records and to relevant information.

(v) The CAG has the inherent right to determine what should be included in the Audit Reports.

(vi) There is a requirement that Audit Reports should be tabled in the Parliament/ Legislature and thereafter these become public documents.

(vii) There are well documented Audit Manuals and audit guidelines for the Auditors to follow.

(viii) Auditing Standards framed on lines of INTOSAI (International Organization of Supreme Audit Institutions) guidelines are available.

(xii) There are discussions in the Public Accounts Committee of the Parliament/ Legislature on the important observations contained in the Audit Reports.

8.5 Challenges before the External Audit

8.5.1 There is no doubt that external audit by the CAG has contributed a great deal in improving the financial management in the country keeping in view the large number of Inspection Reports issued, Audit Reports presented to the Parliament/Legislature and the recoveries made at the instance of audit. In its Reports, Audit raises many important issues relating inter-alia to weak budgetary controls, deficiencies in revenue collection, wastage of public resources, inappropriate accounting, poor returns on investments, diversion of funds, system deficiencies and numerous instances of poor management of public resources, etc.

8.5.2 There is, however, a feeling that the impact/effectiveness of external audit could be further enhanced. Some of the factors and perceptions, which are impeding the effectiveness of external audit are given below.

(i) Detailed examination of paras included in the Audit Reports by Public Accounts Committee is barely about 15-20 against the total number of 1000 to 1500 paras included in the CAG's reports submitted to the Parliament every year. The Ministries/Departments take only those audit paras seriously which come up for discussions in the PAC.

(ii) The Ministeries/Departments are supposed to submit Action Taken Notes on the paras not discussed. Such Action taken Notes are largely formal rather than substantive.

(iii) In the State Legislatures, there is a huge pendency of Audit Paras to be examined by State PACs. Some of the pending paras are 10 to 20 years old. Delay in examination of matters brought out in the Reports reduces their relevance.

(iv) Thousands of inspection reports containing a huge number of observations are lying unattended in the State and Union Government Departments. Many of these paras have revenue implications. There is hardly any accountability for not taking timely action on audit observations.

(v) There is a feeling that the CAG's reports are sometimes not timely because there is substantial time gap between occurrence of an irregularity and its reporting by Audit. It reviews programmes after these have run for a few years. CAG's audit itself is post facto and by the time, the process of auditing and reporting is completed, its findings and recommendations may be too late for corrective action. Many transaction audit comments relate to earlier years and not to the year of the Audit Report.

(vi) Audit findings are based exclusively on documents and files. Many a times, the situation on the ground is quite different from what is reflected in the papers. There is practically no physical verification to supplement or validate the audit findings.

(vii) There is a feeling that external audit reports tend to be unduly negative and their focus is on irregularities and faultfinding. Audit does not always recognize the practical constraints under which the Government/Government Agencies function.

- Audit often does not discriminate between errors arising out of bonafide intentions/malafide intentions.
- Government Agencies are handicapped by unknown/ unforeseen problems, delays beyond their control and unexpected hurdles. The auditors on the other hand have the benefit of hindsight. Audit as such could act as a dampner against new initiatives and risk taking.

(viii) Audit Reports are not always presented in a sufficiently constructive manner, as they often do not delve into the causes of the problems and how to address them.

- Reporting each year a large number of problems which are already known and which are not being addressed does not add value. Audit must therefore identify systemic problems.
- Findings are at times not focused and are in the nature of scattered observations. A macro level view of the functioning of a department is seldom available.
- Audit does not give due credit for good performance.

(ix) The relationship between the auditor and auditee is not always harmonious. Generally interaction is confined mainly to the lower levels.

- Audit is viewed as a system for policing Government Organisations. The view that audit is a valuable aid to management is normally missing.
- There is poor/inadequate response to external audit bordering sometimes on indifference on the part of Government officials, which seriously reduces the effectiveness of audit.

(x) Though Audit Committees comprising representatives of audit and government agencies have been set up to review the departmental action taken on inspection reports/recommendation, their functioning is not satisfactory.

(xi) There is lack of informed media coverage of CAG's reports on Union/ State Governments.

- The extent of public interface between the auditors and civil society is poor. Inspection reports are not in the public domain.

(xii) There is inadequate synergy/coordination between external audit and internal audit.

(xiii) External audit does not provide audit assurance on the fair presentation of financial statements of the Government in accordance with stated accounting principles and policies.

(xiv) There is rarely any audit of grants and loans to NGOs.

The Commission has examined some of these issues in the succeeding paragraphs.

8.6 Accountability to Parliament

8.6.1 Accountability of the Executive to the Parliament is ensured through various institutional mechanisms and procedures. The system of Parliamentary financial control works on the basis of inter-dependent functions discharged by different institutions like Ministry of Finance, Comptroller and Auditor General of India (CAG), and the Parliamentary Financial

Committees – Committees on Estimates, Public Accounts and Public Undertakings.

8.6.2 Committee on Public Accounts (PAC)

8.6.2.1 The provisions regarding the constitution and functions of these three Parliamentary Committees are contained in the 'Rules of Procedure and Conduct of Business in Lok Sabha'. Thus, Rule 308 provides that the Committee on Public Accounts shall examine the 'accounts showing the appropriation of sums granted by the House for the expenditure of the Government of India, the annual finance accounts of the Government of India and such other accounts laid before the House as the Committee may think fit'. In scrutinizing the Appropriation Accounts of the Government of India and the Report of the C&AG thereon, the Committee is enjoined to satisfy itself on the following:

a. that the moneys shown in the accounts as having been disbursed were legally available for, and applicable to, the service or purpose to which they have been applied or charged;

b. that the expenditure conforms to the authority which governs it; and

c. that every re-appropriation has been made in accordance with the provisions made in this behalf under rules framed by competent authority.

8.6.2.2 Apart from the above, the Committee is also empowered

a. to examine the statement of accounts showing the income and expenditure of State corporations, trading and manufacturing schemes, concerns and projects together with the balance sheets and statements of profit and loss accounts which the President may have required to be prepared or are prepared under provisions of the statutory rules regulating the financing of a particular corporation, trading or manufacturing scheme or concern or project and the report of the Comptroller and Auditor-General thereon;

b. to examine the statement of accounts showing the income and expenditure of autonomous and semi-autonomous bodies, the audit of which may be conducted by the Comptroller and Auditor-General of India either under the directions of the President or by a statute of Parliament; and

c. to consider the report of the Comptroller and Auditor-General in cases where the President may have required him to conduct an audit of any receipts or to examine the accounts of stores and stocks.

8.6.2.3 Apart from the above, the PAC is also authorized to examine the circumstances leading to expenditure in excess of moneys granted by the House for any service. However, the PAC is excluded from examining any subject which has been allotted to the Committee on Public Undertakings (COPU). The membership of the PAC is limited to 22, with 15 members from the Lok Sabha and 7 from the Rajya Sabha. The PAC has an annual term.

8.6.3 Committee on Estimates

8.6.3.1 Rule 310 provides that a Committee on Estimates is to be constituted for the 'examination of such of the estimates as may seem fit to the Committee or are specifically referred to it by the House or the Speaker'. The Committee has the following functions:

a. to report what economies, improvements in organisation, efficiency or administrative reform, consistent with the policy underlying the estimates, may be effected;

b. to suggest alternative policies in order to bring about efficiency and economy in administration;

c. to examine whether the money is well laid out within the limits of the policy implied in the estimates; and

d. to suggest the form in which the estimates shall be presented to Parliament.

Thus, the mandate of this Committee is very wide; it is empowered to examine not only the form and contents of the estimates, but also their relation to overall efficiency. Further, it is also mandated to suggest alternative policies. However, although the Committee may continue the examination of the Estimates from time to time throughout the financial year and report to the House as its examination proceeds, it has not been made incumbent on the Committee to examine the entire estimates of any one year. Notwithstanding these substantial powers, it has been provided that the Demands for Grants may be finally voted, even when the Committee has made no Report (Rule 312).

8.6.3.2 As in the case of the PAC, this Committee has also been excluded from examining the subjects allotted to the Committee on Public Undertakings. The membership of the Committee is limited to 30, all from the Lok Sabha and it has an annual term.

8.6.4 Committee on Public Undertakings (COPU)

8.6.4.1 Rule 312A provides for the constitution of a Committee on Public Undertakings for the 'examination of the working of the public undertakings' specified in the Fourth Schedule to these Rules. This Fourth Schedule contains a list of all Public Undertakings established by Central Acts. The Committee is empowered to examine the reports and accounts of the public undertakings specified in the Fourth Schedule; examine the reports, if any, of the Comptroller and Auditor-General on the public undertakings; examine, in the context of the autonomy and efficiency of the public undertakings, whether the affairs of the public undertakings are being managed in accordance with sound business principles and prudent commercial practices; and exercise such other functions as allotted to it by the Speaker. However, the Committee is excluded from examining the following:

i. matters of major Government policy as distinct from business or commercial functions of the public undertakings;

ii. matters of day-to-day administration; and

iii. matters for the consideration of which machinery is established by any special statute under which a particular public undertaking is established.

The membership of the Committee is limited to 22, with 15 members from the Lok Sabha and 7 from the Rajya Sabha. The Committee has an annual term.

8.6.5 Departmentally related Standing Committees[83]

8.6.5.1 To facilitate proper examination of different Demands for Grants leading to more meaningful discussions in Parliament, the Rules were amended in 1993 to provide for the constitution and functions of Departmentally related Standing Committees (Rules 331C to 331N). Each of such Committees consist of not more than 31 members, 21 from Lok Sabha and 10 from Rajya Sabha. The term of office of these Committees is one year. These Standing Committees have the following functions:

a. to consider the Demands for Grants of the concerned Ministries/Departments and make a report on the same to the Houses. (However, it has specifically been mentioned that the "report shall not suggest anything of the nature of cut motions");

b. to examine such Bills pertaining to the concerned Ministries/Departments as are referred to the Committee by the Chairman, Rajya Sabha or the Speaker, as the case may be, and make report thereon;

[83]Sub by L.S. Bn. (II) dated 29-3-1993, para 1921.

c. to consider annual reports of Ministries/Departments and make reports thereon;

d. to consider national basic long term policy documents presented to the Houses, if referred to the Committee by the Chairman, Rajya Sabha or the Speaker, as the case may be, and make reports thereon.

8.6.5.2 However, the Rules also lay down that these Standing Committees shall not consider the matters of day to day administration of the concerned Ministries/Departments. The general procedure relating to Demands for Grants to be followed by these Standing Committees is as follows:

a. after the general discussion on the Budget in the two Houses is over, the Houses shall be adjourned for a fixed period;

b. the Committees shall consider the Demands for Grants of the concerned Ministries during the aforesaid period;

c. the Committees shall make their report within the period and shall not ask for more time;

d. the Demands for Grants shall be considered by the House in the light of the reports of the Committees; and

e. there shall be a separate report on the Demands for Grants of each Ministry.

8.6.5.3 The Reports of the Committees are generally to be based on broad consensus. However, a Member of a Standing Committee is allowed to give a note of dissent on the report of the Committee which has to be presented to the House along with the report. The Committees are empowered to avail of the expert opinion or the public opinion to make the report. In the end, the report of a Standing Committee on any matter has only persuasive value and is to be treated as 'considered advice' given by the Committee (Rule 331N).

8.7 Parliamentary Control over Budgetary Policies-lessons from different countries

8.7.1 The issues involved in enhancing Parliamentary control over budgetary policies and finances need careful consideration. Legislatures in different countries differ substantially with regard to their control over budgetary processes. These may be categorized in the following manner:[84]

i. 'Budget making legislatures' have the capacity to amend or reject the budget proposal of the executive, and the capacity to formulate and substitute a budget of their own.

ii. 'Budget influencing legislatures' have the capacity to amend or reject the budget proposal of the executive, but lack the capacity to formulate and substitute a budget of their own.

iii. 'Legislatures with little or no budgetary effect' lack the capacity to amend or reject the budget proposal of the executive, and to formulate and substitute a budget of their own. They confine themselves to assenting to the budget as it is placed before them.

Table 8.1: Does the Legislature Generally Approve the Budget as Presented by the Government? (OECD)

	With no changes	With minor changes only	With significant changes
Australia	x		
Austria		x	
Canada	x		
Czech Republic			x
Denmark			x
Finland		x	
France		x	
Germany		x	
Greece	x		
Hungary			x
Iceland		x	
Ireland		x	
Italy		x	
Japan	x		
Korea		x	
Mexico		x	
The Netherlands		x	
New Zealand	x		
Norway		x	
Poland		x	
Portugal		x	
Spain		x	
Sweden		x	
Switzerland		x	
Turkey		x	
United Kingdom	x		
United States			x
Total	6	17	4
Percent of Total	22%	63%	15%

Source : OECD (2002b); Source : Back from the Sidelines? Redefining the Contribution of Legislatures to the Budget Cycle by Joachim Wehner; http://siteresources.worldbank.org/WBI/Resources/WBI/37230 Wenherweb.pdf

8.7.2 For example, the United States Congress sometimes functions as a budget making legislature. In certain years the presidential budget suggestion is pronounced as 'dead on arrival' and Congress proceeds to independently define its own budget policy. However, only a few other legislatures make such significant changes to budget proposals prepared by the executive. The position in different legislatures is presented in Table. 8.1.

8.7.3 From the Table, it is evident that most of the legislatures fall in the middle category of budget influencing legislatures (approving the budget proposed by the Government with only minor changes). Legislatures which do not exercise any significant influence on budget policy are basically the Westminster type Parliaments where any successful amendment to the budget is

[84]Source: 'Back from the Sidelines? Redefining the Contribution of Legislatures to the Budget Cycle' by Joachim Wehner; (adapted from Norton (1993: Table 4.1); http://siteresources.worldbank.org/WBI/Resources/WBI/37230 Wenherweb.pdf

considered a vote of no confidence that would prompt the resignation of the Government.[85]

8.7.4 However, even in the Westminster model changes have been incorporated leading to substantial presentation of information on the physical framework ahead of the tabling of the budget thereby generating more parliamentary debate. In fact, it has also been argued that in spite of limitations on amendment activity, parliamentary control over the budget can be enhanced substantially. This can be done through establishing systems which lead to parliamentary consultation on medium term budget policy, thereby diminishing the need for making amendments to the budget. Secondly, as expenditure related to plans/programmes take place on a continuous basis, parliament has sufficient opportunities to indulge in analysis of implementation of these plans/programmes and influencing subsequent budgetary allocations.

8.7.5 Thus, there are two ways of increasing parliamentary control over the budgetary process; if the legislature has to involve itself in decisions involving allocations, it will have to indulge in ex ante scrutiny during the accrual stage of the budgetary process; on the other hand, if it has to influence the operational efficiency it will have to vigorously conduct ex post scrutiny on the basis of audit findings after budget implementation. As mentioned earlier, the US Congress follows an ex ante process while the Westminster Parliaments follow the ex post process. However, there are countries where both the functions are blended in a single committee. Thus, in the German Bundestag, the Budget Committee both approves the annual budget and later considers audit results.[86] Different parliamentary powers to amend the budget are mentioned in Table 8.2.

Table 8.2:[87] Parliamentary Powers to Amend the Budget

Rights	Number of countries
Unlimited powers to amend the budget	32
Reductions of existing items only	17
May reduce expenditure, but increase only with	4
permission of government	4
Increases must be balanced with commensurate cuts elsewhere	13
Rights not specified	15
Total	81

Source: Adapted from PIU (1986 : Table 38A)

8.7.6 Even where committees deliberate over the budget, there are wide variations. Different committee systems prevalent in the OECD countries are described in Table 8.3: [88]

[85]ibid
[86]ibid
[87]ibid

Table 8.2: Parliamentary Powers to Amend the Budget *Contd.*

Rights	Number of countries

Table 8.3: What Best Describes the Committee Structure for Dealing with the Budget?

Committee structure	Number of countries	Percentage of total
Budget committee decides	19	47.5%
Budget committee decides; non-binding input from sectoral committees	6	15%
Budget committee decides totals; sectoral committees decides departmental budgets	7	17.5%
No budget committees; sectoral committees deal with departmental spending	2	5%
Other	6	15%
Total	**40**	**100%**

Source: OECD (2003), httpL//ocde.dyndns.org/

8.7.7 As mentioned earlier, in case of the Indian Parliament, the Departmentally related Standing Committees are prevented from making any suggestions which could be construed as a 'cut motion'. Even in the Australian Senate, while the committees deliberate on the budget, the Report to the House only mentions issues of concern. Further, in the House of Representatives, there is no committee stage for the budget.[89]

8.7.8 The Commission has considered these diverse scenarios and is of the view that the present system need not be tinkered with. The reforms suggested with regard to budgetary processes and programme based outcome budget would provide succour to ex-ante strengthening of the budgetary process. As far as the ex-post processes are concerned, these are discussed below.

8.8 Public Accounts Committee and CAG

8.8.1 The Audit Reports of the CAG upon their presentation to the Parliament/ Legislature stand referred suo-moto to the Public Accounts Committee (PAC) for all matters except the Reports on the commercial undertakings, which stand referred to the Committee on Public Undertakings (COPU) of the Parliament/ Legislature.

[88]Source: Good Governance, Parliamentary Oversight & Financial Accountability; Rick Stapenhurst, World Bank Institute;
[89]Source: The Role of Parliament in the Budget Process; Warren Krafchik and Joachim Wehner

8.8.2 The Reports of the CAG on the Union Government referred to the PAC contain about 1000-1500 paragraphs and performance audit reports every year. Out of these, the PAC has been selecting for detailed examination about 25-30 paragraphs, but has been able to discuss, with the concened Ministries/Departments, only between 10 and 15 paragraphs out of those selected for detailed examination. This is despite the fact that successive PACs have tried their best to discuss as many paragraphs as possible.

8.8.3 Hon'ble Speaker, Lok Sabha at a seminar organized by CAG's office on 22nd July 2005, made some suggestions in this regard.

> *"Many PACs including the PAC of the Parliament have setup working groups and sub-committees to deal with audit paras that cannot be considered in detail by the full committee. Ways must be found to strengthen the working of these sub-committees or working groups. The sub-committees should be empowered to deal with subjects referred to them by the main committee in a conclusive manner after approval of the Chairman of PAC and allowed to record evidence of the executive. Their recommendations should be approved by Chairman and endorsed by other members by circulation."*

8.8.4 He also suggested for consideration whether sub-committees particularly those of the PAC could be constituted department-wise for major departments like Defence, Railways at the Centre or the PWD in the States. He further suggested for consideration the need for a separate committee for Direct Taxes, Indirect Taxes and Non-tax Revenues as the Receipt Audit Reports of the CAG have direct revenue implications for the Government. It may also be debated whether formation of working groups or sub-committees on these lines to examine the paragraphs finally is possible within the existing strength of PAC and COPU.

8.8.5 In order to strengthen parliamentary control over the executive it is necessary to devise a system which envisages that PAC examines all the reports submitted by the CAG and submits its recommendations to the Legislature within a stipulated time limit. It has already been observed that this is possible only if the volume of CAG's Audit reports is reduced and their quality and content improved.

8.8.6 The Commission is of the view that in order to further strengthen the Parliamentary oversight mechanism, as many audit paras as possible may be examined by Parliamentary Committees. The PAC and COPU may like to decide in the beginning of the year itself, which paras would be examined by them and which by their sub-committees (to be constituted for the purpose). They may consider assigning other paras for examination to the respective Departmentally related Standing Committees. The objective would be to complete the examination of all paras within one year. In exceptional cases, Chairman, PAC or COPU may authorize keeping a para alive for more than one year. Thus, the PAC and COPU and their sub-committees and the Departmentally related Standing Committees (and their sub-committees) would be able to complete the examination of all paras within a year. If still there are pendencies, it is for the consideration of the PAC and COPU to refer such paras to the Departmental Audit Committees (recommended vide paragraph 7.5 of this Report).

8.8.7 Recommendation

a. **In order to further strengthen the Parliamentary oversight mechanism, as many audit paras as possible need to be examined by Parliamentary Committees. To facilitate this, the PAC and COPU may decide in the beginning of the year itself, which paras would be examined by them and which by their sub-committees (to be constituted for the purpose). They may consider assigning other paras to the respective Departmentally related Standing Committees. The objective would be to complete the examination of all paras within one year. In exceptional cases, Chairman, PAC/COPU may authorize keeping a para alive for more than one year. If still some paras are pending, it is for the consideration of the PAC and COPU to refer these to the Departmental Audit Committees (recommended vide paragraph 7.5 of this Report).**

8.9 Relationship between Audit and the Government/Government Agencies

8.9.1 Due to the very nature of its role as watchdog, independent audit is sometimes perceived by government agencies and auditees as a mere fault finding exercise. This perception has, on occasions, led to lack of adequate cooperation by the auditees which results in tardy repsonse to audit observations. In such cases, external audit does not have the desired impact.

8.9.2 There is need for better understanding and synergy between government agencies and

audit so that there is proper accountability and timely oversight and consequently better audit impact. The information provided by the external audit is useful only if the executive acts upon it. How to encourage a more collaborative approach to public audit is the real challenge. This calls for a more positive approach by both auditors and auditees.

8.9.3 Another area of concern is that audit is often perceived by the auditees as discouragement to innovate, change and reform. This is because departments associate risk taking or innovations with the increased possibility of something going wrong leading to financial loss and consequently their censure by the audit. Because of this apprehension officers prefer to play it safe and continue with the traditional time tested methods of functioning even when need for innovations or reforms is obvious because unlike audit, they do not have the benefit of hindsight. Therefore, before indicting an officer for an innovation or reform which may have caused a financial loss, the audit should carefully examine whether the department had taken adequate steps to identify the risks and planned suitably before carrying out the reforms/innovations. If this had been done and no malafide is indicated then audit should not be hasty to draw adverse conclusions.

8.9.4 There is a need for deepening and enhancing the level of interaction between audit and the executive at senior levels. They should discuss important issues, recommendations and what needs to be done arising out of audit. Audit should not remain isolated; While independence of audit is crucial to objectivity, it should not mean isolation. There should be increasing coordination with the executive. There should be a quarterly communication from the Accountant General to each Administrative Secretary informing the latter of significant points and systems deficiencies noticed during audit inspections. Additionally there should be quarterly meetings relating to pending inspection reports, audit observations and clearance during the quarter and various issues of common interest including audit recommendations for improvements. Audit should consider their views with an open mind and appreciate their constraints. A concern has been that the public audit reporting is unduly negative. While it is true that audit has a major role in ensuring accountability, this does not mean a negative or only faultfinding approach.

8.9.5 The Commission is of the view that there is paramount need to sensitize the executive towards the role and findings of audit so that the two sides realize that they are not working at cross purposes but for the same objective of delivery of the programmes in a manner which leads to achievement of objectives, outcomes and also promotes accountability. Further, the Auditing Standards require Auditors to be careful to avoid offering implied criticism in cases where although the original anticipations have not been realized, there are no strong indications, significant or substantive of inefficiency or waste on the part of the administrative authorities.

8.9.6 Audit organizations in all the developed countries have been moving towards positivism while still maintaining their key role. Everybody is sensitive to criticism but amenable to reason and logic and ready to take corrective action. Rather than focus exclusively on irregularities, external audit should conduct studies and evaluation of systems e.g. accounting, financial management, internal control, risk management, contracting, procurement, etc. and offer constructive suggestions for strengthening Government operations and reforms oriented towards best practices. Audit should look at itself as an agency for change and improvement rather than primarily detection of irregularities.

8.9.7 Recommendations

a. **There is need for better understanding and synergy between the audit and auditees for enhanced public accountability and consequently better audit impact.**

b. **There should be balanced reporting by the audit. Audit reports should not focus on criticism alone but contain a fair assessment or evaluation, which would mean that good performance is also acknowledged.**

c. **There is need for increasing interaction as well as coordination between the executive and the audit, including at senior levels. These should include regular and meaningful meetings where important issues could be discussed and conclusions reached on what needs to be done arising out of the recommendations made by the audit. There should also be quarterly communication from the Accountant General to Administrative Secretaries informing them about significant points and areas of improvement noted by Audit during their inspections.**

8.10 Timeliness of Audit

8.10.1 External Audit often reviews programmes after these have run for a few years. CAG's audit itself is post facto and by the time, the process of auditing and reporting is completed, its findings and recommendations may be late for corrective action.

8.10.2 Concurrent Audit

8.10.2.1 While performance audit is mainly a posteriori exercise, there is no bar to conduct performance audit of programmes concurrently, or at the initial stages of the implementation of the programmes, in cases where the risk and materiality are perceived as being significant. Concurrent performance audit of long-term on-going schemes should be undertaken at appropriate intervals. Accountants General are expected to be aware of issues where concurrent performance audit or audit at the initial stages of the programme may be desirable. The strategic plan should contain a list of recently introduced programmes and selection of subjects for audit in their initial stage should be made in the light of expected value addition.

8.10.3 Major Policy Shift Issues

8.10.3.1 Accountants General and the Supreme Audit Institution (SAI) should be alive to major shifts in the policies and programmes of the entity and the consequential new public sector programmes and select critical cutting-edge subjects for performance audit in the context of policy changes. Performance audit of such sunrise issues are likely to contribute value to the implementation of the policy shifts. The performance audit of such subjects could be undertaken singly or in generic form when they are at the early stage of their implementation. Some examples of such subjects are sale of assets, private finance initiative, public-private sector partnership, introduction of structural changes, major changes in industrial or export-import policy, etc.

8.10.3.2 With e-governance and Internet, apart from adjusting to the momentous speed of communications, Government is gearing up to generate responses to various issues and communications at a pace much faster than before. This will require audit to also review its procedures to reduce/ compress the time lag between the occurrence of an event and its reporting.

8.10.3.3 External audit has to spend considerable time on the audit of transactions because internal audit arrangements in the State Government and in many Union Government Departments are either weak or non-existent. Transaction audit is basically the job of internal auditors. External audit is supposed to do only sample checking. If internal audit is strengthened, CAG's audit will save considerable time spent on extensive audit of transactions (The Commission has suggested strengthening of internal audit in Chapter 7.

8.10.4 Recommendations:

a. **External audit needs to be more timely in inspecting and reporting so that their reports can be used for timely corrective action. All audits for the year under review should be completed by 30th of September of the following year. To start with, all Audit Reports may be finalized by 31st December and this date may be gradually advanced.**

b. **IT should be used increasingly and effectively for data collection and analysis.**

c. **Government agencies also need to be more prompt in responding to audit observations and ensure that the remedial and corrective action not only settles the irregularities reported but also addresses the systemic deficiencies.**

8.11 Inadequate Response to Audit

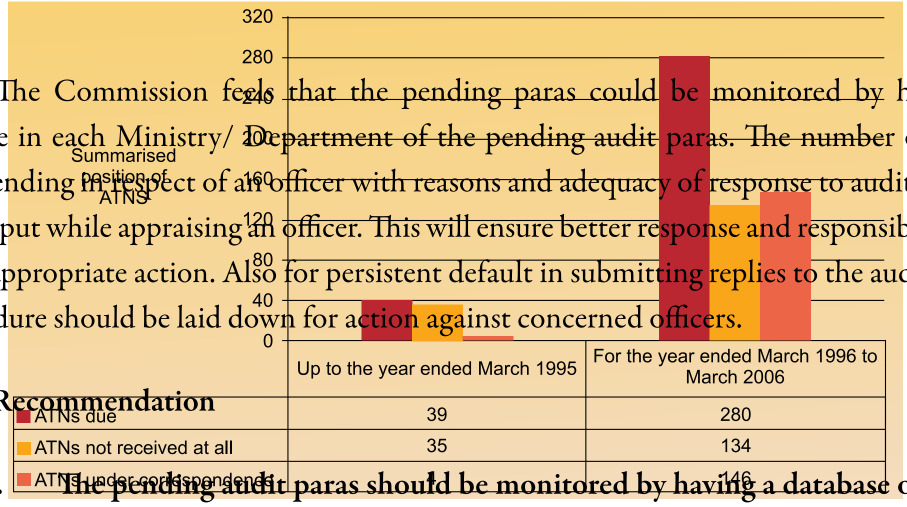
8.11.1 One of the reasons for Audit not having the desired impact is the inadequate response of government agencies. It has been observed that often they do not send replies to draft paras intended for inclusion in Audit Reports or furnish Explanatory Notes on paragraphs finally

included in CAG's Reports. A primary reason for this inadequate response to audit is that there are no significant consequences for non-compliance with financial rules, regulations and procedures laid down by the Government.

8.11.2 In respect of the audit reports of CAG, on the recommendation of the PAC the Government of India has prescribed that Ministries/Departments must furnish replies to the draft paragraphs which are forwarded to the Secretaries of the Ministries/Departments demi-officially within 6 weeks. Yet it has been observed that Ministries/Departments often do not furnish their responses to the draft paragraphs within the prescribed time frame. Similar delays have been observed in case of Action Taken Notes on paragraphs included in the reports of CAG. A review of outstanding ATNs on paragraphs included in the Reports of the Comptroller and Auditor General of India, Union Government (Civil, Other Autonomous Bodies and Scientific Departments) as of October 2007 has disclosed that the Ministries/Departments had not submitted remedial ATNs on 169 paragraphs. This is shown in Fig. 8.1[90]

Fig. 8.1 : Summarised Position of Outstanding Action Taken Notes (ATNs; Source: Report No. CA1 of 2008; CAG)

[90] Report No. CA 1 of 2008



8.11.4 The Commission feels that the pending paras could be monitored by having a database in each Ministry/ Department of the pending audit paras. The number of audit paras pending in respect of an officer with reasons and adequacy of response to audit should be an input while appraising an officer. This will ensure better response and responsibility for taking appropriate action. Also for persistent default in submitting replies to the audit paras a procedure should be laid down for action against concerned officers.

8.11.5 Recommendation

a. **The pending audit paras should be monitored by having a database on them in each Ministry/Department. In case of persistent default in submitting replies to the audit paras a procedure should be laid down for action against the concerned officer.**

FINANCIAL MANAGEMENT IN STATE GOVERNMENTS 9

The Commission has not examined the States' budgets in detail, but it feels that the weaknesses highlighted earlier and the core principles stated would apply to the financial management systems in the States. Some of the issues which need to be addressed by the State Governments are briefly analysed below.

9.1 Integrated Financial Advisers

9.1.1 The extent of delegation of financial powers to Departments varies from State to State. It has generally been observed that since this delegation is quite limited, most of the financial proposals get referred to the Finance Department. Some States have created the mechanism of Financial Advisers in some major Departments, but their powers are also rather inadequate. The same compulsion that made the Union 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 in various departments where FAs would be the representatives of the Finance Department.[91] This should be coupled with greater delegation of financial powers to the Departments. But all these need to be preceded by capacity building of the Departments in financial administration.

9.2 Multi-year Budgeting

9.2.1 Along with the introduction of the FA system, multi-year budgeting would help in bringing about better fiscal discipline and financial management. 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 shift 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. This will enable better estimation of the fund requirements of on-going schemes, programmes and projects. It will also ensure realistic budgeting.

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

9.2.2 States like Karnataka have implemented the 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 provides 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 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. These are steps in the right direction.

9.3 Realistic Estimates and Proper Assumptions while Preparing Budget

9.3.1 There is need to have economic assumptions which are prudent and realistic in order to formulate budget estimates which are accurate and not overly optimistic. At the end of every financial year, the gap between the estimates and the actuals should be analysed so that the underlying economic assumptions could be suitably calibrated for the future.

9.4 Avoiding Ad hoc Announcements Token Provisions

9.4.1 As stated earlier in the case of Government of India, in States also, in spite of detailed instructions and guidelines in budget manuals, projects and schemes are announced on an ad-hoc basis during visits of high-level functionaries. Such announcements of large sums seriously distort plan allocations and disturb the faithful implementation of schemes already approved under the budget. This could also lead to announcements not being followed by formal approvals thereby resulting in discontent among people and financial indiscipline. The proper method would be to include projects that may be considered absolutely essential at the time of preparing the annual plans and budgets. The practice of announcing projects and schemes on an ad-hoc basis needs to be abandoned.

9.4.2 A related practice is to make token provisions in the budget. This is resorted to facilitate announcement of a large number of projects. This can result in spreading limited resources thinly over a large number of projects and starvation of projects already under execution. Cost and time over-runs are consequences of this practice. It is therefore necessary that norms for sanction of projects should be rigidly adhered to.

9.5 Skewed Expenditure Pattern

9.5.1 As in the case of Union government, the expenditure pattern of the State Governments is also highly skewed with the bulk of expenditure taking place in the last quarter and particularly in the month of March. Government of India has tried to overcome this problem by introducing the Monthly Expenditure Plan (MEP). A similar system should be adopted by the States.

9.6 Internal Control

9.6.1 The weaknesses of the internal audit system have been brought out by the CAG through various Reports:

Andhra Pradesh – Health, Medical and Family Welfare Department – [CAG's Report (Civil) for the year ending 31st March 2005 on Government of Andhra Pradesh]

1. The internal audit in the department was inadequate. The Department did not have any manual on internal audit nor did they prescribe the duties and responsibilities of the internal auditors
2. No training was imparted to the staff in internal audit methodology and techniques as of August 2005.
3. Only two AAOs were in position against the sanctioned strength of three (without any supporting staff) to cover the entire State with more than 100 subordinate offices and 1703 DDOs and other grant receiving institutions. No supervision was made by the Accounts Officer. This indicated that little importance was given to internal audit.

Goa – Police Department – (CAG's Audit Report on Government of Goa for the year ended 31st March 2005)

Internal Audit Arrangements

The Finance Department specified (August 1996) that in Departments where the post of Accounts Officer/ Senior Accounts Officer exists, the duty of carrying out the internal inspection of the establishment/ Drawing and Disbursement Officers would devolve on the Accounts Officer. It was, however, observed that neither was the internal audit of any unit conducted (2000-2005) nor was a separate internal audit wing within the Department set up.

Jharkhand – Rural Development Department – [CAG's Audit Report (Civil and Commercial) on the Government of Jharkhand for the year ended 31st

March 2005]

The Department did not have an internal audit wing. The internal audit wing of the Finance Department was responsible for internal audit of Rural Development Department. It was noticed that Finance Department also had not conducted internal audit of any of the test-checked units.

9.6.2 The above observations of the C&AG on the functioning of internal audit in some of the Departments of the Union and State Governments, PSUs and PRIs indicate that there are serious deficiencies in the existing internal audit system. The current internal audit arrangements are inadequate and ineffective. It is not even being conducted in some departments. Internal audit guidelines are outdated and there are no internal audit manuals in many cases, particularly in States. There is an acknowledged problem of under-resourcing of the internal audit service. There is shortage of manpower and often lack of qualified and professional staff, the capacity of staff is inadequate, and supervision is weak. There is lack of response to internal audit reports by auditee units. A large number of internal audit reports and observations remain pending. No effective action is taken to rectify the deficiencies. Because of lack of action on internal audit observations, the irregularities and deficiencies pointed out persist.

9.6.3 It is therefore necessary to develop a strategic view of internal audit to move beyond the financial regularity and compliance audit to exert a wider role. In the light of this strategic view, the scope and role of internal audit needs to be redefined. The organization structure of the internal audit should be recast with the internal audit directly reporting to the head of the organization followed up by proper staffing and capacity building of internal audit units. The Commission has suggested constitution of audit committees in respect of Government of India. The same could be considered by the State Governments.

9.7 External Audit

9.7.1 The Public Accounts Committees in some States have a practice of examining all paragraphs and performance audit reports included in the CAG's Audit Reports, while others have adopted a more selective approach. In the former case, due to the volume of work involved, the Reports of the CAG are sometimes not discussed for years together, often upto 10-15 years and the arrears keep mounting. The approach of discussing all the paragraphs in the order of the year of their presentation often results in examination of matters as old as 10-20 years many of which may have lost their relevance due to the lapse of time. In other State Legislatures, where selective approach is adopted, the status on effectiveness is similar to the one in the case of the Central PAC/ COPU discussed above.

9.7.2 The CAG had constituted a High Powered Committee under the Chairmanship of Shri S.L. Shakdher, former Chief Election Commissioner in August 1992 to review the status of Audit Reports pending examination by the State Legislatures. The Committee submitted its report in March 1993. Some of the recommendations were:

- A selective approach may be adopted by the PACs/ COPUs in all States in regard to taking oral evidence and having detailed discussions with witnesses as at Centre.
- The PACs and COPUs in all States may accord priority to the consideration of the latest Audit Report, selecting matters for detailed discussions in such a manner that they can complete scrutiny of that Report within one year.
- As regards the clearance of arrears, the PACs/ COPUs may simultaneously take up the outstanding past Audit Reports for selective scrutiny in a phased programme, so that the arrears would be cleared within a period of say two to three years.

9.7.3 The implementation of the aforesaid recommendations did result in some improvements but a large number of paras are still pending. As per the status paper of the CAG on the detailed examination of Audit Reports by the State PACs/COPUs, 14,715 paras/reviews were pending for discussion as on 31st March 2006 and some of the paras date back to 1983-84. This would indicate that the examination of CAG paras included in the Reports is still in heavy arrears in almost all States.

9.7.4 To overcome the situation, the Legislative Committees may like to adopt a time frame within which they would complete examination of audit reports also and submit their reports to the Legislature. The State Governments may also specify a time frame for the Departments for necessary follow up action on the recommendations of Audit and forwarding of the ATNs for vetting to the Accountant General before their final submission to the State PAC/ COPU. It is also necessary to ensure that all Departments adhere to the prescribed time limits.

CONCLUSION

In this Report on Financial Management, the Commission has examined the issue of reforms in the public financial management system as a part of the overall governance reform. Efforts aimed at improving the efficiency, responsiveness and accountability of Government organizations have to be complemented by reforms in financial management system in order to deliver the desired outcome. In accordance with its terms of reference, the Commission has largely emphasized the expenditure size of public finance in India with particular attention to proper maintenance of accounts, smooth flow of funds and strengthening of internal and external audit mechanisms.

Maintaining financial discipline and prudence while simultaneously ensuring prompt and efficient utilization of resources to achieve the goals of different government agencies has to be the underlying theme for all government agencies. Towards this end, accountability needs to shift from compliance with procedures to a much greater focus on results and outcomes. Tools of modern of financial management like information technology and financial information system need to be used to improve accountability combined with accurate budgeting and realistic economic assumptions.

In order to reform the financial management system in India, the Commission has suggested adoption of medium term plan/budget framework and alignment of plan, budget and accounts, in order to bring greater synergies between the annual budgets and the five year development plan. A paradigm shift from the traditional bottom up approach to budgeting to a top down technique focusing on broader resource allocations as well as on outcomes rather than processes has also been recommended. This has to be combined with greater operational autonomy to government agencies and decentralization of administrative and financial powers to them in order to improve their efficiency.

Any financial management system, howsoever sound, will not be able to deliver the desired outcomes unless there are strong internal and external oversight mechanisms. The Commission has therefore recommended measures for strengthening of both internal and external audit mechanisms.

SUMMARY OF RECOMMENDATIONS

1. (Para 4.5.8) Unrealistic Budget Estimates

a. The assumptions made while formulating estimates must be realistic. At the end of each year the reasons for the gap between the 'estimates' and 'actuals' must be ascertained and efforts made to minimize them. These assumptions should also be subject to audit.

b. The method of formulation of the annual budget by getting details from different organizations/units/agencies and fitting them into a pre-determined aggregate amount leads to unrealistic budget estimates. This method should be given up along with the method of budgeting on the basis of 'analysis of trends'. This should be replaced by a 'top-down' method by indicating aggregate limits to expenditure to each organization/agency.

c. Internal capacity for making realistic estimates needs to be developed.

2. (Para 4.6.5) Delay in Implementation of Projects

a. Projects and schemes should be included in the budget only after detailed consideration. The norms for formulating the budget should be strictly adhered to in order to avoid making token provisions and spreading resources thinly over a large number of projects/schemes.

3. (Para 4.7.8) Skewed Expenditure Pattern – Rush of Expenditure towards the end of the Financial Year

a. The Modified Cash Management System should be strictly adhered. This System should be extended to all Demands for Grants as soon as possible.

4. (Para 4.8.26) Inadequate Adherance to the Multi-year Perspective and Missing Line of Sight between Plan and Budget

a. A High Powered Committee may be constituted to examine and recommend on the need and ways for having medium-term expenditure limits for Ministries/ Departments through the Five Year Plans and linking them to annual budgets with carry forward facility.

b. In order to bring about clarity, transparency and consolidation, the ways and means for implementing an 'alignment' project, similar to that in the UK, may also be examined by the High Powered Committee so constituted.

5. (Para 4.11.2) Adhoc Project Announcements

a. The practice of announcing projects and schemes on an ad-hoc basis in budgets and on important National Days, and during visits of dignitaries functionaries to States needs to be stopped. Projects/schemes which are considered absolutely essential may be considered in the annual plans or at the time of mid-term appraisal.

6. (Para 4.12.6) Emphasis on Meeting Budgetary Financial Targets rather than on Outputs and Outcomes

a. Outcome budgeting is a complex process and a number of steps are involved before it can be attempted with any degree of usefulness. A beginning may be made with proper preparation and training in case of the Flagship Schemes and certain national priorities.

7. (Para 4.13.4) Irrational 'Plan – Non Plan' Distinction leads to Inefficiency in resource Utilization

a. The Plan versus non-Plan distinction needs to be done away with.

8. (Para 5.2.12) Flow of Funds relating to Centrally Sponsored Schemes

a. The Controller General of Accounts, in consultation with the C&AG, should lay down the principles for implementing the system of flow of sanctions/ approvals from the Union Ministries/Departments to implementing agencies in the States to facilitate release of fund at the time of payment. After taking into account the available technology and infrastructure for electronic flow of information and funds, especially under the NeGP, and putting in place a new Chart of Accounts, the scheme should be implemented in a time bound manner.

9. (Para 5.3.6) Development of Financial Information System,

a. A robust financial information system, on the lines of SIAFI of Brazil, needs to be created in the government in a time bound manner. This system should also make accessible to the public, real time data on government expenditure at all levels.

10. (Para 5.4.3) Capacity Building

a. The capacity of individuals and institutions in government needs to be improved in order to implement reforms in financial management. To facilitate this, a proper programme of training needs to be devised and implemented in a time bound manner.

11. (Para 6.3) Accrual System of Accounting

a. A Task Force should be set up to examine the costs and benefits of introducing the accrual system of accounting. This Task Force should also examine its applicability in case of the Appropriation Accounts and Finance Accounts.

b. Initially, a few departments/organizations may be identified where tangible benefits could be shown to be derived within 2-3 years by implementing the accrual system of accounting, especially departmental 'commercial undertakings'.

c. The result of this initial implementation may be studied by a committee of experts which would recommend on its further implementation in all departments/organisations at the Union/State level along with exclusions, if any. This may proceed in a phased manner.

d. Prior to its implementation, training and capacity building needs of the accounting personnel and all stake holders in the decision making process would have to be addressed and a meticulous schedule worked out in line with the road map of implementation.

e. Before the new system is adopted, alignment of the plan, budget and accounts, as recommended in this Report elsewhere, needs to be achieved and a viable financial information system needs to be put in place.

12. (Para 7.5) Internal Audit

a. An Office of the Chief Internal Auditor (CIA) should be established in select Ministries/departments to carry out the functions related to internal audit. Its independence, duties, functions, mechanism of coordination with the CAG etc. should be provided by a statute.

b. CIAs should be directly responsible to the Secretary of the Department.

c. In the initial stages, personnel may be inducted from existing accounts cadres. Norms for recruitment and utilizing private sector expertise in select tasks may

also be devised. Capacity building needs for proper functioning of this Office should be identified in advance.

d. The modalities for ensuring non-duplication of work vis-à-vis the C&AG should be formalized. This should be aimed at assisting the C&AG in concentrating on carrying out specialized audit/tasks.

e. Standards for internal audit should be prescribed by the Office of the C&AG.

f. The Accounting functions should be completely separated from Internal Audit.

g. The functioning and effectiveness of this new system may be examined after allowing a suitable period of operation. Based on the results of this examination, such offices may also be instituted in other Ministries/departments/organisations.

h. An Audit Committee should be constituted in each Ministry/Department. It should consist of a Chairperson and two members to be appointed by the Minister in charge of that Ministry/Department. The Chairperson should be a person of eminence in public life. The two members should be from outside the government. The Audit Committee should look after matters related to both internal and external audit including implementation of their recommendations and report annually to the respective Departmentally related Standing Committee of Parliament.

13. (Para 7.6.5) Integrated Financial Adviser

a. The role of the Financial Adviser as the Chief Finance Officer of the Ministry who is responsible and accountable to the Secretary of the Ministry/

Department should be recognized and the trend of dual accountability should be done away with.

b. Officers with sufficient training and experience in modern financial management systems should be posted as Financial Advisers in the Ministries/ Departments.

14. (Para 8.8.7) Accountability to Parliament

a. In order to further strengthen the Parliamentary oversight mechanism, as many audit paras as possible need to be examined by Parliamentary Committees. To facilitate this, the PAC and COPU may decide in the beginning of the year itself, which paras would be examined by them and which by their sub-committees (to be constituted for the purpose). They may consider assigning other paras to the respective Departmentally related Standing Committees. The objective would be to complete the examination of all paras within one year. In exceptional cases, Chairman, PAC/COPU may authorize keeping a para alive for more than one year. If still some paras are pending, it is for the consideration of the PAC and COPU to refer these to the Departmental Audit Committees (recommended vide paragraph 7.5 of this Report).

15. (Para 8.9.7) Relationship between Audit and the Government/Government Agencies

a. There is need for better understanding and synergy between the audit and auditees for enhanced public accountability and consequently better audit impact.

b. There should be balanced reporting by the audit. Audit reports should not focus on criticism alone but contain a fair assessment or evaluation, which would mean that good performance is also acknowledged.

c. There is need for increasing interaction as well as coordination between

the executive and the audit, including at senior levels. These should include regular and meaningful meetings where important issues could be discussed and conclusions reached on what needs to be done arising out of the recommendations made by the audit. There should also be quarterly communication from the Accountant General to Administrative Secretaries informing them about significant points and areas of improvement noted by Audit during their inspections.

16. (Para 8.10.4) Timeliness of Audit

a. External audit needs to be more timely in inspecting and reporting so that their reports can be used for timely corrective action. All audits for the year under review should be completed by 30th of September of the following year. To start with, all Audit Reports may be finalized by 31st December and this date may be gradually advanced.

b. IT should be used increasingly and effectively for data collection and analysis.

c. Government agencies also need to be more prompt in responding to audit observations and ensure that the remedial and corrective action not only settles the irregularities reported but also addresses the systemic deficiencies.

17. (Para 8.11.5) Inadequate Response to Audit

a. The pending audit paras should be monitored by having a database on them in each Ministry/Department. In case of persistent default in submitting replies to the audit paras a procedure should be laid down for action against the concerned officer.

Annexure-I(1)

Speech of the Chairman, ARC

National Workshop on
Strengthening Financial Management Systems
at National Institute of Public Finance and Policy, New Delhi

23rd July, 2008

The mandate of the Commission is vast. So far the Commission has submitted 8 reports on a range of vital issues. But now the Commission has to address itself to the key issue of how to administer and run the government structure. It has to suggest measures to achieve an efficient and accountable administration for the country. The difficulties inherent in the political economy of reforms cannot, of course, be underestimated. The country has tackled this path well. But a harder climb lies ahead. Given the same political will which has brought about the beginning of the effort and the widening support, the task shall be achievable.

Let me start by introducing you to the larger picture that the Administrative Reforms Commission is seeking to bring about through its various reports. In fact the most important trilogy of three reports that Commission shall now be bringing out shall be on:

1. Civil services reforms: personnel refurbishment
2. Structure of the Government
3. Financial management systems

The Commission would like to introduce a system of greater autonomy coupled with more accountability. For the purpose, it is proposing to recommend a system of executive agencies to be the implementation arm of the Government in its Report on Civil Service Reforms and separation of policy making and implementation of the policies. To bring this about we are suggesting the following steps.

Firstly-There should be broad separation of policy making from implementation responsibilities. The ministries should do only policy making. Implementation bodies need to be restructured as Executive Agencies (as done in the UK, Australia, New Zealand, Japan, Sweden, Singapore) by giving them greater operational autonomy and flexibility while making them accountable for what they do. For accountability purposes, the Executive Agencies have to sign annual

Annexure-I(1) (Contd.)

performance agreements with the departmental ministers, describing the performance targets to be achieved. The Executive Agencies would become directly accountable to the departmental Minister through performance targets that are defined in advance and used as a benchmark for measuring end-of–the–period performance. In return for such ex ante specification of accountability, the Executive Agencies should be given necessary financial autonomy. The heads of the Executive Agencies should be from the Senior Executive Service.

We are also proposing to recommend that government servants would be assigned to a domain early in their career, and with the years of experience in the domain shall acquire domain specialization. As suggested by the Surinder Nath Committee there shall be a specific domain dealing with "Public Finance and Financial Management". Officers shall therefore, once assigned to this domain have specialized knowledge in dealing with financial issues. There shall therefore be no dearth of officers having specialization in the fields of finance to assist the heads of the executive agencies in performing their functions. Once this responsibility has been given to the Heads of the executive agencies it shall be imperative that the requisite amount of financial freedom should be given to him to allow him to achieve the goals that have been set. To enable him to achieve this, a new scheme of financial management and accountability shall have to be spelt out to provide him an enabling environment which is not centralized and is more responsive to his immediate requirements. The present system of line based budgeting, cumbersome processes of reappropriation & demand for supplementaries, all done in a centralized system have to be, to my mind, done away with. In the modern system being envisaged for the future, the authority must have the financial autonomy; and this authority is to be exercised with consistency and efficiency to achieve a system where the goals are achieved and results are visible to all. The authority shall itself be vigilant about the processes and outcomes. An effective system of internal audit shall ensure that the financial propriety is being followed. I have some reservations about the role external audit plays in assisting in the financial management of the organization. External audits are not conducted in the contemporaneous time frame and at times there is a lag of many a years in finalizing the audit objections. This does not aid the organizational head in keeping the financial processes under control. The role of internal audit has to be well developed in maintaining the financial discipline in organisations that shall be given more autonomy. The system that we hope to put in place has worked well in the case of Deptt of Space and Department of Atomic Energy where financial delegation has been done and an effective internal system of checks and balances has been introduced.

The next serious concern that the Commission seeks to address itself is the need to introduce

Annexure-I(1) (Contd.)

accrual accounting. When we are managing our personal accounts we are adopting the system of dual accounting, maintaining a balance sheet of asset & liabilities; then why do we differ in approach when dealing with public money and public property. It has come to my notice that when there are time and cost over-runs there are at times difficulties in gathering from the records the total amount of funds that have been paid to the government agencies who are implementing the projects. Reconciliation of accounts and payments is not done for many a years when dealing with repairs and refurbishment of capital assets by government agencies. As the assets created do not find a mention in the books of the govt, many are languishing on account of poor maintenance. All these problems are compounded and the net result is that we do not have a fair idea of the cost of service that we are providing, we are not in a position to intelligently determine when and at what cost future capital investments are to be made. The opportunity cost of the funds deployed in a project are not known, so the returns on the investments can also not be determined. These are just some of the examples that come to my mind. I am sure this gathering has a better idea of the problems and drawbacks we face when restricted by cash accounting. Cash accounting has worked well in controlling expenditure. However now the Commission seeks to move the administration to a level where it shall be accountable for its performance. When we are to introduce greater autonomy with greater accountability then we need to have intelligent financial decisions and multiyear budgeting. Lapsing budgets at the year end have created problems in delivering the goals that have been set out. The quarter-wise and at times month-wise restriction on spending have brought about spending discipline but has affected the achievement of the targets. We must grow out of the system of the Finance Ministry monitoring our spending pattern and move to a system where the spending decisions are based on conscious decisions. Such decisions have a bearing on the transgenerational equity. The accrual accounting system is complex and this gathering shall have to help the Commission determine the road map for implementation of the accrual accounting system.

The Indian reform process should be seen to be part of a larger global process. Our policies and practices have to be adapted to the realities of the international economy. On the philosophical plane, our reforms should be in keeping with the paradigm shift which we are witnessing round the world. On studying the international experiences we realized that if Government were to survive in this competitive environment, they need to make a transition to a more disciplined and rigorous system of financial management. Other countries felt the pressure of globalization earlier than India did and they responded by adopting financial reforms. India has to now sooner rather than later embark upon strengthening its financial management system.

Annexure-I(1) (Contd.)

In this millennium the international economy has become more integrated and more complex and difficult. No country can afford to be island unto itself. There is, no need to fear the impact of globalization if we structure our policies right, for globalization does indeed accentuate the benefits of good policies even as it raises the cost of bad ones. We have to have confidence in ourselves – confidence born out of an appreciation of our potential, and a will to fashion our policies to realize that potential, we shall do so without loss of time.

It must be appreciated that the funds available with the govt. have an opportunity cost of not being available to the corporate and global economy. When dealing with the policies of expending such funds one now must be clearer about the outcomes sought and work towards delivering them efficiently within the government framework.

To bring about the changes, and also to provide a financial accountability and accounting framework, we need a legislation. In Australia, for example, the Financial and Accountability Act of 1997 provides such a framework. Under the Australian Act, the chief executives of the Agencies are given greater flexibility and autonomy in their financial management; they are also required to promote efficient, effective and ethical use of public resources. We do need such a legislation. In addition, this legislation could include some of the requirements for the budget process as recommended in the Report under discussion today.

Some of the other issues that have been raised at many an economic fora in the past are the need to do away with the artificial distinction between the Plan and Non-Plan expenditure, a more realistic differentiation of the Revenue and Capital expenditure, and the need for doing away differentiation of charged and voted expenditure in the Budget. I would like to call upon this gathering to debate whether resolving such issues will result in better budgeting.

Some of the other issues that come to mind are the need to ensure effective utilisation of funds that are transferred from the Centre to the States; the problems that are encountered in the implementation and in the release of funds of the Centrally sponsored schemes, and the Non plan Schemes and the steps that can be taken to remove such impediments.

Also it is high time we flag the issues that result in the failure or the poor quality of implementation of our policies; these can be in the nature of subsidies not reaching the poor, projects having a time and cost over-run. etc. All these result in outcome targets not being met. I feel that at the time of conceptualising and planning the programmes and projects, a strong financial management system should give a correct assessment of the risks that are associated. This entails recognising factors that may result in the programme failing or not meeting the

Annexure-I(1) (Contd.)

objective for which it is being set out.

I have noticed that at times there is mindless splintering of Plan Schemes. We lament the low impact of such schemes on the outcome desired. Do such steps detract from the achievement of the main objective. Should not the Financial Management system have a role to play in consolidating the programmes and working to make them more viable to achieve the goal for which they were set out.

Our financial system has served us reasonably well so far. It is capable of doing better. The Concise Oxford Dictionary defines 'reforms' as making or becoming "better by removal or abandonment of imperfections, faults or errors". This is what the Report of NIPFP has proposed – correcting the imperfections, faults and efforts of the past in the hope that our financial management system will enhance the progress of the economy and that credit would be, in Schumpeter's memorable phrase, "phenomenon of development".

The way the economy is now linked to international economic pressures, it is also necessary that the country takes steps to insulate itself and contain inflationary pressures. The old fashioned virtues of fiscal prudence and monetary restraint have thus not lost their contemporary relevance. It must be appreciated that there is indeed no substitute for sound and internally consistent macro management, covering aspects such as fiscal, monetary and exchange rate policies and an adequate institutional and legal framework which help in the efficient intermediation and control.

The system is always capable of improvement in productivity, efficiency and in the ultimate analysis of profitability, which again helps to increase the inherent strength of institutions and delivery systems. The process of reform in the social sector that we are now engaged in cannot succeed unless the financial system itself is strong and efficient so that it can help to support higher investment levels and accentuate growth and help to create a productive and competitive economy. Structural and financial reforms are thus mutually reinforcing and sustain each other.

No reform can indeed be painless. We have to appreciate that the quest for competitive efficiency will take its toll of the weak and the inefficient. These pains, however, are a necessary foundation for the emergence of a strong and viable financial system which will conform to best international practices and make its distinctive contribution to the furtherance of our national objectives of growth, equity and justice.

Annexure-I(1) (Contd.)

I am sure that a sound financial management system with the correct practices of planning, budgeting and accounting shall provide the desired framework for a result oriented delivery system in the government. In a democratic and federal polity like ours, it is necessary for reforms to have broad consensus. Such a consensus shall emerge. The states which were initially somewhat hesitant about the reform programme are now embracing it with enthusiasm. There has also been a broadening across the political spectrum for support of the reform effort. This augurs well for the future.

Our motto shall be the same as the oath taken by the Council Members in the ancient city of Athens:

> *"We will strive increasingly to quicken the public sense of public duty; that thus....we will transmit this city not only not less, but greater, better, and more beautiful than it was transmitted to us."*

Annexure-I(2)

Workshop on
Strengthening Financial Management System in India

23 July, 2008

National Institute of Public Finance and Policy, New Delhi

LIST OF PARTICIPANTS

Sl.No.	Name	Designation
1.	Shri Vinod Rai	Comptroller and Auditor-General of India
2.	Dr. Renuka Viswanathan	Secretary (C&PG), Cabinet Secretariat
3.	Shri V.N. Kaila	Controller General of Accounts
4.	Shri Rakesh Jain	DG (AEC), Office of CAG of India
5.	Shri R.S. Negi	AAO, Finance (Budget), Deptt., Delhi Government
6.	Shri I.P. Singh	Former Dy.CAG of India
7.	Shri Ashok Das	Principal Secretary (Finance), Govt. of M.P.
8.	Shri Subhash Garg	Principal Secretary (Finance), Govt. of Rajasthan
9.	Ms. Ananya Ray	Joint Secretary & FA, Ministry of Water Resources, New Delhi
10.	Shri B.B. Pandit	D.G.(Audit), Office of CAG
11.	Shri Sandeep Saxena	Dy.CGA, Office of CGA
12.	Shri V. Bhaskar	Joint Secretary, 13th Finance Commission
13.	Shri R. Sridharan	Joint Secretary (SP) & Adviser (FR), Planning Commission
14.	Shri Ajay Seth	Secretary (B&R), Govt. of Karnataka
15.	Shri K.P. Krishnan	Joint Secretary, Department of Economic Affairs, Govt. of India

Annexure-I(2) (Contd.)

16.	Shri S.C. Jain	ED(CF) IOC
17.	Shri Ajay Garg	Joint Secretary (Fin/Plg)
18.	Ms. Benita Sharma	Gender Specialist
19.	Dr. P. Umanath	Deputy Secretary (Budget), Finance Deptt. Govt. of Tamil Nadu
20.	Shri B.C. Mohapatra	Joint Secretary, Finance Deptt., Govt. of Orissa
21.	Shri Sunil Soni	Principal Secretary, Govt. of Maharashtra
22.	Shri Deepak Sengupta	Jt. Director-Plg., Govt. of Delhi
23.	Shri L.N. Meena	Jt. Director – Planning, Govt. of NCT, Delhi
24.	Shri Santosh Kumar	Director (Fin.), Min. of Health & Family Welfare
25.	Shri Ravindra Dhongde	Director of Accounts & Treasuries, Mumbai
26.	Shri B.L. Pathak	Joint Director (Plg. Deptt), Govt. of NCT of Delhi
27.	Shri D.K. Malhotra	Under Secy., Finance, Govt. of NCT of Delhi
28.	Shri B.S. Rawat	Dy. Director, Planning Deptt., Govt. of NCT of Delhi
29.	Ms. Parneet Suri	Spl. Secy., Finance, Govt. of Punjab
30.	Shri S.N. Shukla	COA, Govt. of NCT of Delhi
31.	Shri S.P. Singh	Dy. Director Finance
32.	Dr. B.K. Sharma	Director (Planning) Govt. of Delhi, Delhi Secretariat
33.	Dr. Ram Mohan	Advisor (Finance), Railway Board
34.	Dr. I.Y.R. Krishna Rao	Pr. Secretary (Finance), Govt. of Andhra Pradesh

Annexure-I(3)

Recommendations made by Groups

Group 1: Reforms in Budgetary System – Central

- Budget process: It is essential that accounts and other information required should be made available in time and should be reliable.
- Plan and Non-plan divide: The plan and non-plan distinction should be removed
- Capital and Revenue Expenditure: To begin with disclosure relating to revenue grants that are aimed at creating capital assets be made without changing the existing revenue and capital accounting system
- Multi-year Budgeting – Advance Expenditure Ceilings:
    - Three year perspective budgeting with first year approval, next two year are indicative – rolling framework
    - carry over provision
    - Annual ceilings of the ministries fixed within the three year perspective budget with scheme wise flexibility
- Performance Orientation in budgeting:
    - Programme based budgeting with performance indicators
- Institutional support: Departmental financial Management Committee to be convened by the FA and chaired by the Secretary

Group-II: Institutional Reforms for Strengthening Financial Reforms

I. Role of Integrated Financial Advisor in Financial Management

- Role of IFA laid out in the Charter issued by Ministry of Finance should be reconciled with the provisions of GFR 64 and reflected in a legislation defining the role of CAO and CFO and the relationship between the two.
- The detailed framework within which FAs should function should be laid down in terms of his professional competence, skills and support systems.

Annexure-I(3) (Contd.)

- The role of the FA as bridge between the spending department and the Ministry of Finance should be defined in the proposed statute.
- Accountability for programme implementation should be incorporated in the canons of financial propriety as well as in the proposed statute.
- In the Ministry of Finance there should be a separate wing called Financial Management Wing which should be headed by a Controller General of Financial Management drawn from a pool of specialists in the field of financial management and accounting.
- Supporting staff and all officers in the Financial Management wing should be recruited from among professionals having the requisite qualifications.

II. Internal Audit and Internal Control

- To strengthen the oversight function within the Ministries/Departments, there should be an independent and professionally competent internal audit and investigation set-up. It should be directly responsible to the Chief Accounting Authority of the department.
- For this purpose, the Inspector General Model of US should be adopted. This model should be given a statutory backing.
- In each department there should be an Audit Committee headed by the Chief Accounting Authority including some independent members to lay down the scope of internal audit, to consider its Reports and to monitor its effectiveness and competence.
- Internal Audit should be equipped with the requisite power and competence to investigate cases of frauds etc. (forensic audit). Such powers should be provided in the proposed statute.
- Chief Accounting Authority should lay down along with the budget, a positive statement containing assurance on existence and functioning of internal controls in his department.

Annexure-I(3) (Contd.)

III. Accrual Accounting for Better Accountability

- GASAB should be the nodal agency for preparing the standards and formats for accrual accounting.
- Accrual accounting should be taken up in project mode and implemented in a specific timeframe. Further, incentives for introduction of accrual accounting should be given by the Ministry of Finance to the State Governments in the form of grants.
- A steering committee should be set up under the chairmanship of the Finance Minister for implementation of the accrual accounting project.

IV. Parliamentary Financial Control

- PAC should be coterminous with the term of the Parliament. On-fifth of the PAC members may retire every year to involve more members.
- Financial limits for savings and excess expenditure should be periodically reviewed.
- The Standing Committee attached to each department while discussing the demands for grant may also discuss the internal control framework of each Ministry as well as outstanding audit paras.
- CAG DPC Act needs an amendment, particularly in relation to powers of CAG to secure documents, information and clarifications as well as access of audit in regard to audit of grants.
- FRBM may be amended suitably to incorporate provisions relating to control over savings/ excess expenditure and avoidable supplementary grants and costing and concept of programme budgeting.

Group 3: Strengthening financial management at State level

Flow of centrally sponsored schemes

- One size fits all approach will not work
- State should be involved in the Scheme formulation

Annexure-I(3) (Contd.)

- There should be enough flexibility for State specific variation
- There can be a MOU to regulate flow of funds.
- If there is delay on part of state Government to release the funds, additional contribution by way of interest may have to be made.
- An alternative can be to release the funds directly to executing agencies, but make a non cash credit in favour of State Government.
- State Government in turn releases it share in cash and also makes a non cash release corresponding to the central share.
- All releases from GOI should be posted on a common website.

IFMIS

- The standard software for all states will not work.
- Instead GOI should help in putting together a common framework incorporating best practices from different states.
- The protocol for inter-state communication and standards for financial transactions having all India implications should be prescribed by GOI.
- States should be encouraged to develop to their own IFMIS based on the common framework.
- This can be an area for funding by GOI/Finance Commission.

Expenditure tracking at local bodies

- Expenditure tracking should include all funds of the local bodies including their own resources.
- The major lacuna found in proper expenditure tracking/auditing is non-maintenance of Accounts and non closing of Accounts on time by local bodies.
- This can be out sourced to Chartered Accountants and Accounts maintained and closed on time to facilitate proper auditing.

Annexure-I(3) (Contd.)

- Outcome/performance auditing should also be taken to see how well the funds are spent.

Programme based expenditure classification

- Distinction between revenue and capital should remain
- Grants to another level of Government for asset creation should be accounted as Capital expenditure at the level where the assets are created.
- Distinction between Plan and Non-Plan should be removed. It should be development expenditure and expenditure on statutory and sovereign functions.
- Further classification may be for
  - Programme activities
  - Administrative Cost
  - Overheads
  - Financing cost
- Performance parameters should be a part of the Budget

Multi Year Budgeting

- There can be multi year planning of resources and expenditure
- This exercise should feed into the Annual Budget
- Multi year budgeting and carry over of funds from one year to another may not be practical.

List of Reports Submitted by the Second Administrative Reforms Commission up to April 2009

1.	First Report:	*Right to Information: Master Key to Good Governance*
2.	Second Report:	*Unlocking Human Capital: Entitlements and Governance – A Case Study*
3.	Third Report:	*Crisis Management: From Despair to Hope*
4.	Fourth Report:	*Ethics in Governance*
5.	Fifth Report:	*Public Order – Justice for All . . . Peace for All*
6.	Sixth Report:	*Local Governance – An Inspiring Journey into the Future*
7.	Seventh Report:	*Capacity Building for Conflict Resolution – Friction to Fusion*
8.	Eighth Report:	*Combatting Terrorism – Protecting by Righteousness*
9.	Ninth Report:	*Social Capital – A Shared Destiny*
10.	Tenth Report:	*Refurbishing of Personnel Administration – Scaling New Heights*
11.	Eleventh Report:	*Promoting e-Governance – The SMART Way Forward*
12.	Twelfth Report:	*Citizen Centric Administration – The Heart of Governance*
13.	Thirteenth Report:	*Organisational Structure of Government of India*