INDIAN JOURNAL OF PUBLIC AUDIT AND ACCOUNTABILITY

INSTITUTE OF PUBLIC AUDITORS OF INDIA
NEW DELHI

Vol.-IV No.1 January – March 2010
Vol.-IV No.2 April - June 2010

INDIAN JOURNAL OF PUBLIC AUDIT & ACCOUNTABILITY

EDITORIAL BOARD

Editor-in-Chief
Vijay Kumar
Former Dy. Comptroller & Auditor General and Chairman, Audit Board
and President, IPAI

Editor
Dr. S.C. Pandey
Additional Financial Adviser and Joint Secretary,
Ministry of Defence

Asstt. Editor
Harish Chander
Director (Technical)
Institute of Public Auditors of India

CONTENTS

	Page No.
Editorial	(iv)
Financial Advisers and Auditors: Partners for Good Governance T. SETHUMADHAVAN	1-9
Genesis, Causes and Consequences of Global Financial Crisis: Dangers Ahead for India S.P KASHYAP AND BABULAL JAIN	10-19
Plan and Non-Plan distinction in Accounts and Budget DR. S. C. PANDEY	20-33
Audit Reports- A few Thoughts S. LAKSHMINARAYANAN	34-39
CCO Based Audit (CBA): A Commentary P.K. TIWARI	40-43
Auditor's Notebook	44-52
Delhi High Court on the DPC Act; Thirteenth Finance Commission on Government Accounts; Audit Reports and Annual Reports of the Ministries; & NREGA, Audit and PAC DHARAM VIR	
BOOK REVIEW: From Government to Governance: a Brief Survey of the Indian Experience (Prof. Kuldeep Mathur) DR. S. C. PANDEY	53-54
DOCUMENTS: Explanatory Memorandum as to the Action Taken on the recommendations made by the Thirteenth Finance Commission in its report submitted to the President on December 30, 2009	55-59

The Journal is also available on our Website: www.ipaiindia.org

EDITORIAL

Financial Advisers in various Ministries are uniquely placed in that they are both internal financial advisers to the Ministry/ Department to which they are attached and also they act on behalf of the Ministry of Finance in the areas that lie outside the delegated field. Amongst their multifarious and onerous duties the financial advisers also have an important role to play in the oversight functions since they are in overall charge of internal audit of the Ministry and vis-à-vis external audit or CAG's Audit, they are the interface between the Ministry to which they are attached and the Audit department. The article by T. Sethumadhavan analyses the role of financial advisers vis-à-vis internal and external auditors and how together they can enhance good governance. The article highlights the close and mutual beneficial relationship that ought to exist between the financial advisers and the auditors and outlines the approach for FAs to derive the best results from this partnership.

While there is growing optimism that the World may be gradually getting over the severe effects of global financial crisis but it is still too early to say that all is well. There are strong lessons to be learnt from this crisis. S.P.Kashyap and Babu Lal Jain have analysed the genesis, causes and consequences of global financial crisis and have drawn lessons for India in this context. While praising India for tackling the crisis quite well, the authors have listed areas that are of great concern.

Another interesting article in this issue by S.C. Pandey on 'Plan and Non-Plan distinction in Accounts and Budget' is a well-researched piece that gives a historical account of how public expenditure classification system in India evolved right from 1860; what are the vexed issues still unresolved and how do these relate to the ongoing debate on removing the plan/non-plan distinction. After a meticulous examination of pros and cons, implications and possible alternatives, the author concludes rather perceptively, that this is not a mere accounting issue. It is simply a proxy for debating the need for deeper institutional reforms in public expenditure management.

The article by Lakshminarayanan provides many useful practical suggestions to make the audit output and Audit Reports more effective. Discussing about common problems that Audit faces, the author single out the non-production of records and suggests an Audit Information Commission with requisite powers to ensure that records are produced in time to Audit.

P.K. Tiwari has written about a recent major audit policy decisions by CAG that has introduced the CCO based audit (CBA), instead of the DDO based audit, which was the case hitherto. The change is significant as Tiwari's commentary on this new audit system details the main features of CCO based audit and what it means for future in terms of prospects and challenges.

We commence a new section from this issue titled "Auditor's Notebook" which we intend to make a permanent feature. This section will highlight some of the interesting contemporary developments in the field of auditing and accounting. In this issue Dharam Vir has penned four such interesting developments. The first of these concerns a judgment of Hon' ble Delhi High Court of January 2010 relating to NDDB vs CAG. The Hon' ble High Court while upholding CAG's right to audit accounts of

a body or authority under the CAG's DPC Act held that the ordinary principle that a special law overrides a general law by virtue of the non-obstante provision in the NDDB Act would not be invoked to oust the application of DPC Act in this case. The Court made specific reference to the CAG's Regulations on Audit and Accounts, 2007 in its judgment and said audit, under DPC Act has much wider objectives and scope as enunciated in the Regulations. In the second development, Dharam Vir has discussed some issues raised by Thirteenth Finance Commission relating to Governent Accounts. All these issues are discussed meticulously with useful suggestions by the author which includes the practice of diverting public expenditure from budget to nominated funds, addition of separate annexure to Finance Accounts, issue of classification of expenditure, etc. The third development reported in Dharam Vir's article relates to a recent decision of printing of summary of important audit observations with response of the Ministries in the annual reports of the Ministries which is an outcome of the then Prime Minister's suggestion at the Annual Conference of Accountants General in 2001-02 and 2002-03. However, Dharam Vir has raised the pertinent point that these replies are inadequate because there is not much by way of action taken on the audit findings. Finally, Dharam Vir has discussed the Audit Report of CAG on the implementation of the National Rural Exployment Guarantee Act. Dharam Vir has discussed some interesting issues arising from PAC Report on this subject.

The Book Review section carries a review of Prof. Kuldeep Mathur's book titled "From Governance to Government".

In the Documents section, we are including the Explanatory Memorandum placed in Parliament on 25th February 2010 on the action taken by the Government on the recommendations made by the Thirteenth Finance Commission in its Report.

We do hope our readers will enjoy the volume and at the same time will also get motivated to contribute articles to the journal for its future editions.

Disclaimer:

The views and opinions expressed in the articles are entirely those of the contributors and do not reflect the official policy of the Institute.

INVITATION FOR ARTICLES

The Indian Journal of Public Audit and Accountability welcomes original articles of professional interest. The articles should broadly cover aspects relating to Public Accountability, Financial Management, Accounts, Audit, Public Administration with focus on Good Governance.

Ideally the article should be between 3000 and 3500 words and should not normally exceed 5000 words. Short articles on topical interest are also welcome which can be included in Commentary Section of the Journal. They should preferably be between 1000 and 2000 words.

Two printed copies of the articles should be submitted along with a soft copy in a word processing format. Articles can also be sent by e-mail followed by hard copy by post.

Articles in Hindi are also welcome, which will be published in original. They should preferably be in simple spoken Hindustani language format. An abstract of the article in about 100 words should also be sent.

FINANCIAL ADVISERS AND AUDITORS: PARTNERS FOR GOOD GOVERNANCE

T. Sethumadhavan[*]

Introduction

The present day institution of Integrated Financial Advisers advising the Secretaries incharge of various Ministries/Departments of the Government of India has evolved over time, starting in 1955, when a few selected Internal Financial Advisers were appointed in larger Ministries to represent the Ministry of Finance in the exercise of the limited delegated financial powers available at that time. Additionally, there were Associated Financial Advisers in the Finance Ministry to coordinate their functions as also to advise on important issues. The position underwent change in 1973 when an expert committee recommended that the responsibility for internal financial management should vest entirely with the administrative ministries themselves, and in 1975, the offices of Integrated Financial Advisers were created in all ministries/departments except Defence, Railways, Telecom, Atomic Energy and Space for which special arrangements in the form of empowered Boards or Commissions have been set up. In Ministry of Defence, the Ministry of Finance's IFA scheme was implemented in phases in 1976 and 1983 The Office Memorandum issued for the purpose clarified that the Integrated Financial Adviser henceforth referred as FA[1] would be responsible both to the administrative ministry and to the Ministry of Finance, and that in respect of the delegated powers, he will assist the administrative ministry to freely exercise the delegated powers, while outside the delegation, he will function under the guidance of the Ministry of Finance. It was further envisaged that he would be involved fully with the formulation of schemes and programmes from the beginning and were thus to be closely associated with the approval process of programmes, projects and schemes by Public Investment Board / Expenditure Finance Committees. On 1st June, 2006 the Ministry of Finance (Department of Expenditure) promulgated a 'Revised Scheme of Integrated Financial Advisers'.to redefine their role The revised scheme takes into account the "fast changing socio-economic scenario and attendant attitudes, processes and systems in the government functioning", and the consequent need to redefine the "authority as well as the accountability" of the FAs with a view to "enhance their capacity to meet the emerging challenges".

---

[*] The author is a former Budget Advisor, Government of Bahrain and presently Vice-President of the Institute of Public Auditor of India

[1] *In this Paper, we have used the term "Financial Adviser" to denote the Integrated Financial Adviser of a Ministry/Department under the 1975 scheme of the Ministry of Finance. These Advisors are appointed by the Appointments Committee of the Cabinet usually for a fixed tenure on deputation after joint consultation of the Ministry of Finance and the concerned Ministry/Department. They have dual reporting to both the Ministry of Finance and the administrative Ministry. They, as also the Secretaries incharge of the administrative Ministries/Departments serve the Ministry usually for a limited period only and are 'outsiders' to the permanent establishment of that Ministry/Department. However, many suggestions made here can also be applied mutatis mutandis to the financial advisers at lower levels – Attached or Subordinate Offices, Autonomous Bodies, Societies, Trusts, Companies, and Statutory Authorities.*

Financial Adviser and Internal Audit

Among others, the 2006 Charter for the Financial Advisers lays down the responsibility of FAs vis-à-vis internal audit in the following lines:

"Internal Audit Wings working under the control and supervision of CCAs / CAs[2] will assist the Financial Advisers in the appraisal, monitoring and evaluation of individual schemes. Moving beyond the narrow myopic confines[3] of compliance / regulatory audit, Internal Audit would focus on:

- 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 and course corrections".

According to a recent study[4], the envisaged role of FAs has been substantially diluted over time, since ministries and departments are generally averse to FAs asserting their independent views and questioning the wisdom of expenditures. As lamented by a former Secretary(Expenditure), 'FAs are often (*only*) expected to ensure budget availability for both Plan and Non-Plan expenditures and only state whether the project expenditures are as per budget and not raise *un-necessary questions of propriety and correctness of the expenditures'*[5]. In general, the role and contribution of Financial Advisers in financial administration appears to be getting diluted and he is often in an unenviable position of being at the receiving end from both the administrative Ministry and the Finance Ministry with a diminishing support system. .

Financial Advisers and Audit

Audit, both internal and external, is intended to provide to the stakeholders a reasonable degree of assurance that the organization follows established financial norms, rules, systems and procedures, and that the stated financial data, records, statements and results are true and fair and reliable. From that angle, auditors and FAs share a common objective. This must make them natural allies and partners for good governance; both FAs and auditors have to work in close cooperation with each other and in tandem. There should be no occasion for them to look at each other with suspicion or disregard. It is only natural that given the above perception, auditors

---

[22] *It shows that the focus of the Charter is mainly on 'Civil' Ministries whose accounts are handled directly by the Controller General of Accounts.*

[3] *It is becoming increasingly fashionable to trivialize the role of 'transaction audit' both by Internal and External Audit – partly influenced by perceived excesses or misuse of such audits – to the detriment of the overall quality and depth of auditing. It is not good for the system if the aversion to details spreads amongst executives and auditors alike. The devils lies in details.*

[4] *Strengthening Financial Management System; National Institute of Public Finance and Policy (2008)*

[5] *C.Ramachandran, Former Secretary, Expenditure, Ministry of Finance, Government of India., while addressing NIFM. Italysis supplied.*

often turn to the FAs for support, encouragement and cooperation in carrying out their tasks effectively, and vice-versa. This paper deals with the scope for cooperation between the two functionaries.

Financial Advisers and Internal Auditors

Every organization should have an effective and efficient internal control system or set up, which must ensure that rules and regulations are complied with, data and financial reports are accurate and reliable, and that there is economy, efficiency and effectiveness in the utilization of resources. Internal audit forms the most important aspect of any internal control system. Internal audit and other control systems, together, form the basic foundation of good governance. Since FAs are key players in the drive for good governance, they have to make sure that the internal audit system available in the department is sound, efficient and adequate.

Unfortunately, most government agencies in India do not appreciate the importance of internal audit and internal control, which impacts their financial management to the detriment of good governance. This also affects their efforts to inject accountability and transparency in administration. It must therefore be the endeavor of FAs to see that there is a reasonably reliable and sound system of internal audit in their departments, which will pave way for improved internal control as well. International public sector accounting standards contemplate that internal audit is a central component of internal financial control to ensure good financial administration.

Internal audit is of maximum significance to FAs since it is to act as a management tool, and forms an integral part of the management and internal control mechanism. Its role should not be confined to merely checking the aspects of regularity and compliance with rules and regulations, or conducting only 'regularity and compliance' audits. It should systematically and periodically review and test the soundness and reliability of the systems and procedures related to the financial management of the department and units under it, and suggest means and measures to improve them, as required. In other words, internal audit should act as the eyes and ears of the senior management in maintaining the integrity and uprightness of the various functionalities forming part of the administration[6].

Rule 64 of General Financial Rules, 2005 prescribes the **Duties and Responsibilities** of the Secretary of a Ministry / Department who is the Chief Accounting Authority of the Ministry / Department.) As the key officials responsible for assisting the Secretary incharge of the Ministry/Department in the prudent financial management of the department, it is the duty of FAs to:

- Establish and maintain a suitable and appropriate internal audit system in the organization. Ideally, the internal audit must function directly under the highest executive of the department, namely, the Secretary to the Department.

---

[6] *"The internal audit activity should evaluate and contribute to the improvement of risk management, control, governance process, using a systematic and disciplinary approach": Internal Standards for Professional Practice of Internal Auditing, Institute of Internal Auditors.*

- It must be ensured that the internal audit team is professional, trained, and competent. Besides, there must be sufficient and efficient supervision of the internal audit.
- It must be ensured that there are guidance materials and manuals to regulate the work of the internal auditors, and that annual comprehensive audit plans are drawn up to cover all vulnerable areas, and that the audits are supervised and detailed. The annual audit plans must be got approved by the top officials of the department.

- All financial and administrative functions must be subjected to internal audit, which shall not rely only on test audits. Audit plans must be drawn based upon a risk analysis.

- The Internal Audit must check the efficiency of the systems and procedures relating to various transactions and also, review the effectiveness of the internal controls and reporting systems.

- Machinery must also be in position to examine the findings and recommendations of internal auditors in time and to take appropriate follow-up actions. The internal audit reports must be brought to the notice of the highest officials in the department for review and approval.

Financial Advisers and External Audit

It is the duty and responsibility of the Comptroller & Auditor General of India (CAG) to audit all receipts and expenditures from the Consolidated Funds of the Union, the States and the Union Territories. The functions of the CAG are derived from the provisions of articles 149 to 151 of the Constitution and the CAG's (Duties and Powers and Conditions of Service) Act, 1971 . Sections 13, 16 and 17 of the Act define the duties of the CAG in relation to the audit of accounts and the transactions relating to the Consolidated Fund, Contingency Fund, and the Public Accounts of the Union, States and the Union Territories. Section 13 enjoins the CAG to audit all expenditures from the Consolidated Funds, which includes audit against provision of funds, regularity audit, propriety audit, and efficiency-cum-performance audit. It must be understood that "Audit also examines **the propriety of executive actions** and looks beyond the **formality of the expenditure to its wisdom, faithfulness and economy and** brings to the notice of the legislature, cases of **waste, losses, extravagant and nugatory expenditure**s, and thus challenges any improper exercise of discretion, and comments on propriety of expenditure".[7] Section 13 of the Act requires the CAG to audit all transactions relating to Contingency Funds and Public Accounts, as also all trading, manufacturing and profit and loss accounts and balance sheets and subsidiary accounts kept in departments etc. It is generally accepted that the term 'accounts' used in Art.151 of the Constitution includes receipts as well as expenditures. Accordingly, under the Act, the CAG's audit also covers all receipts of governments, grants and loans, and bodies receiving such assistance, subject to certain conditions. However, the audit of Government Companies is circumscribed by the provisions of the Companies Act.

---

[7] *Brochure on Duties and Powers of the CAG under the CAG's DPC Act,1971*

It will be seen from the above that the CAG has a very wide jurisdiction. Further, under the Act, he has *access and powers to requisition* the records of all ministries, departments, bodies and organizations forming part of and under the government. The question arises how and to what extent the FAs could make use of and benefit from the wide sweep of the public audit in pursuance of their own objectives, and in turn, help the external audit in its conduct of business. Further, the issue also relates to how the FAs could help the Executive, their own departments and organizations under them in avoiding unnecessary audit queries and observations, which may impinge on their time and resources, by 'efficiently managing the audit' and by acting as a link between the auditors and the audited units. In actual practice, auditors depend substantially on the cooperation and assistance extended by the FAs to carry out their tasks, and the close interaction between the two would be of mutual benefit. Some attributes for a fruitful relation between FAs and external auditors are discussed in the following paragraphs.

FAs Should be thorough with all aspects of the working of their own Departments.

The FAs are fortunate in that by virtue of their position they will be familiar with all policies and the entire gamut of programmes, schemes and activities of their departments, unlike most other senior officials who generally manage to have only a *partial or fractional* view of the activities taking place around them. Every administrative and project activity in the ministries and departments requires financial advice or financial clearance, and that makes the FAs privy to all such transactions. But instead of focusing only on the availability of funds and routine financial procedures, FAs must make sincere efforts to go deep into the various aspects of planning and execution of projects and schemes. This will not only enhance the knowledge-base of FAs, but will also help them to see the 'big picture' and have a holistic view of the entire programmes and activities of the ministry or department. This in turn, will help them to interact effectively with the external auditors especially when it comes to what is known as the "Performance Audit'.

The scheme of FAs, as designed, envisages that they must be fully involved in all aspects of planning, implementation, monitoring and evaluation of policies and programmes of the Departments concerned. Keeping away from these functions and restricting to only financial clearances would effectively limit the role of FAs. On the other hand, being pro-active in all the above processes would help them not only to become efficient in their areas of work, but also equip them with the required guidance and help to external auditors. In turn, it may enable the FAs to use the audit, both internal and external, as a tool to streamline the processes and procedures of various activities of the ministry/ department, and to facilitate mid-course corrections to the programme implementation thereby enhancing the economy, efficiency and effectiveness.

FAs Must Look Upon External Audit as a Friend and Associate, as also a Mechanism to Assist in Ensuring Proper Utilization of Resources.

Often, there is a tendency is to look upon audit only as a fault-finding agency, a necessary evil, and *not as an aid to administration*. This is not difficult to understand; but is indeed an unwise approach. There is no gainsaying that FAs must accept the need and the role of the audit as envisaged in the Constitution and try to welcome

audit in a positive and supportive role. FAs must also place the entire facts and developments, including reports, records and noting relating to the programmes and activities of the department concerned before the auditors in the right perspective. Auditors are not adversaries, but a fact-finding agency and merit FAs' whole-hearted support. In every organization, private or public, the absence of proper controls and process mechanism would at some time or other lead to the perpetuation of inefficiencies and waste or the commission of irregularities and frauds; a good and efficient audit is a major safeguard against inefficiency, wastes and frauds.

It is necessary for the FAs to prepare themselves and other departmental officers in advance to receive the external auditors and be in a position to meet their demands for information and documents. The following steps may help FAs in assisting the auditors to perform their statutory obligations satisfactorily.

i) Review of Previous Audit Reports

FAs, especially new incumbents to the position, should review the previous audit reports / inspection reports relating to their departments in anticipation of the audit, and familiarize themselves with all major observations made in the past and previous audit reports. Special care must be taken to list out pending and unsettled objections and efforts be made to settle them since these are usually included in the subsequent reports. If there are serious observations which may have a persisting impact, these must be discussed with the concerned officials to see how they could be remedied.

ii) Review of Reports of Legislative Committees

Similarly, FAs must study the findings and recommendations of legislative committees such as the Public Accounts Committee (PAC), Estimates Committee, Budget Committee etc., and review the follow-up actions taken regarding them, prior to the audit.

iii) Review of Internal Audit Reports

The Internal Audit Reports also require similar attention, since the CAG's audit teams would review them closely, and satisfy themselves that appropriate actions have been taken on those objections. The past IA Reports and action taken notes must be kept ready for the perusal of the CAG's team.

iv) ***Appoint a Contact / Resource Person***

The practice is to appoint a middle level contact person to help the audit team, and to interact between the auditors and the departmental officers. The person to be appointed should be one with fairly long experience in the department and must be capable of interacting with senior staff on behalf of the auditors. He should be responsible to collect records, data and details requisitioned by the auditors to avoid delay in providing them.

v) Entry Conference

CAG's auditors usually send an advance list of documents to be kept ready for inspection. FAs must insist on an Entry Conference with the audit team on the first

day of the audit programme. This must be used to explore the special areas selected for the audit, and to obtain details of the requisitions of documents, data and records etc during the course of audit. More importantly, FAs must specify the important and special areas *they would like the auditors to look into*, if considered appropriate.

vi) Coordination with Audit Team

It may not be possible for the FAs to interact with the audit teams and its leader on a day-to-day basis; but a wise FA will keep a continuous oversight on the progress of the audit to keep himself abreast of developments. He must also ensure that responses and replies to audit queries and observations are provided without delay and that these are duly vetted for accuracy and facts. By doing so, the FAs may be able to avoid any presumptive or avoidable observations creeping into the draft audit reports, and to ensure the accuracy of the reports which will be presented after the audit. In case of major observations which may have impact on the departments' crucial, long-term activities and programmes, the FAs should consult the dealing senior officers concerned before replying to the audit, so as to bring out the correct views of the department on the subject.

vii) Procedural and Substantial Observations must be Distinguished

One aspect to be kept in view while responding to audit findings is the need to distinguish between the routine observations and significant findings. The latter will indeed merit more detailed consideration. It is the duty of auditors to point out variations from rules and procedures which need remedial action. In the interest of financial probity, none of them is to be neglected or ignored. While action should be taken to rectify them, it is also necessary to see their impact on the wider canvas. For instance, an observation regarding the surrender of funds in consecutive years for a program must lead to an examination of the process of planning, budgeting and (possibly tardy) implementation of the programme itself. An observation relating to the rush of expenditures in the last few weeks of the financial year must guide the FAs to re-examine the procedure for budget appropriation / implementation and the efficiency of the project monitoring system.

viii) Financial Advisers and Performance Audit

According to the international best practices, and the auditing standards of the International Organizations of Supreme Audit Institutions (INTOSAI), the CAG carries out what is known as "Performance Audit" of major programmes and schemes of the Government. These may be of completed programmes or schemes or those under implementation. According to the CAG, the salient features of performance audits will consist, among others, of **strategic planning in pursuit of realization of the strategic goals and objectives, risk-based planning, and selection of subjects and attainment of the ultimate objective of value-addition to the public sector programmes**[8]. Performance audit is concerned with the audit of economy, efficiency and effectiveness and embraces:

a) audit of the economy of administrative activities in accordance with sound administrative principles and practices and management policies;

---

[8] *V.N.Kaul, CAG ; Prologue to the performance audit Guidelines*

b) audit of the efficiency of utilization of human, financial and other resources, including examination of information systems, performance measures and monitoring arrangements and procedures followed by audited entities for remedying identified deficiencies;
c) audit of effectiveness of performance in relation to the achievement of the objectives of the audited entity and audit of the actual impact of activities compared with the intended impact[9].

It is to be noted that performance audit covers both conventional audit (such as regularity, propriety and compliance audit) as also an evaluation of the principles of economy, efficiency and effectiveness audit. While undertaking the performance audit, auditors seek to test the quality of information and advice available to the department concerned for policy formulation, and the efficiency of the administrative machinery to carry out the policy. It also tests the aspects of economy, efficiency and effectiveness of the programme implementation, apart from the ethics and equity of the means used to implement the programmes and schemes. Performance audit could be for a whole programme or activity or for a part of the programme only. Usually, the CAG selects subjects related to good governance for performance audit.

CAG expects high level of cooperation from the departments in the conduct of performance audits, and it must be the task of the FAs to provide the same. FAs must not only, for this purpose, ensure free and unhindered flow of data, documents and records related to the subject of the audit, but also secure the highest level of assurance on remedial actions to be taken on the recommendations included in the audits. As a matter of fact, CAG expects the departments themselves to suggest topics for performance audits since these audits would assist them enormously to strengthen the implementation of critical social and developmental programmes. In this regard, FAs of ministries and departments could take a leading role.

a) ***Presentation by Internal Financial Advisers***

When a subject is selected for performance audit by the CAG, it will be necessary for the FA to give a detailed and comprehensive presentation to the audit team on all aspects of the selected scheme or programme. Such presentations must not only be factual, but also must include details of the strategic planning which went into the programme, the performance indicators identified, the system of selection of beneficiaries, method of monitoring and evaluation, and feedbacks from the stakeholders, if available. It will be useful to invite the representatives of all concerned agencies such as the Planning Commission and other interested departments and agencies to attend such presentations so that they could also join the ensuing discussions and provide useful inputs.

Similarly, FAs must source information as to the audit objectives, process and other details from the audit team during the entry conference or at the presentation given by the team.

---

[9] *INTOSAI Auditing Standard*

b) ***Quality Check during Performance Audit***

Performance audits will not be confined to the documents and records of the programmes and schemes concerned. The audit team will usually verify the quality of implementation from the field usually by engaging an expert outside body or through sampling techniques. It will be necessary for the FAs to review the reliability and accuracy of such quality checks at the time of the audit, since raising doubts about the process after the event will be a wasteful exercise.

ix) Exit Conference

The audit team will take an exit conference on conclusion of the audit, and give a summary of its findings and conclusions and major points included in the draft report. FAs could use this opportunity to seek clarifications on the relevant issues and to provide explanations for any items of dispute, before inclusion in the draft audit report.

x) ***Reviewing the Draft Audit Report***

At the end of the audit exercise, the audit team will issue a draft report containing the observations and conclusions as also certain recommendations. It will fall upon the FA to study the report in depth, discuss with the planning and implementing officials and respond to the audit view in a most satisfactory and convincing manner. The opportunity must be used to point out mistakes and inaccuracies if any so that they do not find a place in the final report. Similarly, the feasibility of implementing the recommendations included in the report should be reviewed carefully in consultation with the dealing officials in the field and appropriate suggestions and comments must be furnished to the auditors in time.

xi) ***Following Up of the Audit Reports***

This is an important responsibility of the FAs. As mentioned, this task will have to be carried out with the cooperation of the executive, namely, the dealing officers at different levels. The success of the action will depend on the procedure adopted to follow up the audit reports. Ideally, the FAs must work to (establish and) make the Audit Committee function successfully under the Secretary / Addl. Secretary with the FA as the secretary of the committee. The Audit Committee must meet periodically and review the reports and ensure that action is taken in accordance with a specified time schedule. The Audit Committee must also review the internal audit plans and reports and monitor the progress of follow up actions.

Conclusions

The above discussion attempts to highlight the close and mutually beneficial relationship that should exist between the Financial Advisers and auditors and the approach that FAs must pursue to derive the best results from the exercise of audit. It must be realized that both internal and external audits are equally important for good governance and both form sides of the same coin. The FA's role, however, in relation to the internal audit is more direct and involved, while he acts as a facilitator and friend of the external audit. In both cases, however, the auditors concerned look up to the FA for help and close cooperation, which, it is his /her duty to provide in the interest of good governance and administrative accountability.

GENESIS, CAUSES AND CONSEQUENCES OF GLOBAL FINANCIAL CRISIS: DANGERS AHEAD FOR INDIA

*S.P Kashyap and Babulal Jain**

Introduction

The financial crisis that originated in the United States, and affected the global financial system, seems to have been handled quite effectively. Following the failure of the Lehman Brothers in Sept 2008, major (global) financial institutions have been saved through massive dozes of government bail-outs and so could be said about important components of real economy (auto-sector) that were heading towards disaster. The share markets, though still to gain the pinnacle once reached, have shown all round buoyancy and gained much of the lost ground. The growth rates though slow, hesitant and uncertain for most advanced capitalist societies, have been quite high for China, India and some other emerging economies.

Still all is not well. The bailout packages are facing question marks. The fraud charges (mid April 2010) faced by Goldman Sachs Group, a major investment bank, further fuel these doubts. It is feared that debt problem faced by some small and not so small economies e.g. Dubai and Greece may soon engulf Portugal, Spain, Ireland and Italy. The United States and major European countries are facing double digit unemployment rates. This does not take into account discouraged workers that withdraw from workforce (6 to 7% in the US). There are reasons to believe that many poor countries, including India, are having substantial addition to their poor and hungry masses. One is also not sure how global growth revival (if and when) would impact ecological sustainability.

In what follows, we shall be elaborating some of these vital considerations. As the title of the essay suggests, we hope to trace back genesis, causes and consequences of global economic and financial crisis and its likely impact on the India society. The approach is diagnostic rather than being prescriptive.

Genesis: A Discussion

Towards the end of 2007, the impending crisis was felt in the United States and assumed serious proportions with the bankruptcy of Lehman Brothers (a major investment bank). The immediate cause was attributed to the sub-prime housing loans, seemingly driven by political considerations of making housing loans available to all and sundry. The housing loans were available to even to persons with no-income-no job- no assets (NINJA loans). Such loans proliferated during the early years of the century, creating excess supply of credit to the housing sector and speculation fuelled the boom in asset prices[1]. The financing mechanism for such loans was quite opaque and complicated. Barest outline would suggest. [2]

- The banks would extend mortgage loans to the individuals; the mortgages would be bought primarily by the government sponsored housing finance giants like Fannie Mae and Freddie Mac.

---

* *S.P.Kashyap is former Director and visting professor, Sardar Patel Institute of Economic & social Research, Ahemdabad and Babu Lal Jain is CFO, world BPO Forum*

- The mortgage would be pooled together and converted into marketable securities (securitization) known as mortgage backed securities or MBS.
- The common pool of the mortgages will be divided into different slices, called tranches of varying risks and payment profiles to meet different investment preference: the resulting MBS would be rated by rating agencies and sold off as fixed income securities.
- This process of securitization was further complicated by another instrument of structured finance, the credit default swaps or the CDS, which were sold by the Insurance Companies (like AIG) to guarantee against the possibility of default of the borrowers (an estimated $ 62 trillion CDS are believed to have been written).

The fact however remained that NINJA loans were nearly worthless. However due to clever financial engineering and mathematical modeling the worthless assets landed in the books of investment banks and insurance companies.

The nature of the bubble (waiting to burst) was reflected in 300 % increase in housing price since 1999. When for the first time buyers got forced out of the market, there was slackening of demand and when the loans started defaulting, the asset prices declined, starting a series of panic actions. The housing bubble burst as the prices crashed. There was severe liquidity crisis and institutions had to be liquidated (Lehman Brothers – a major investment bank) or bailed by the government (AIG, Fannie Mac and Freddie Mac). The contagion led to crashing of the stock markets all over the world and to the attendant pain and misery. Thus the noble intention of broadening home ownership resulted in a major crisis.

It may be noted that business cycles are not uncommon in a capitalist society. The present crisis however is fundamentally different. As Panagariya notes that the earlier crisis in the United States during 1980 and early 1990 could be contained at the point of origin and depositors could be rescued at a moderate draft on public money. [3] In contrast, the current crisis engulfed the entire globe largely because the proliferation of financial derivates comprising the so called ‘shadow financial economy’ indirectly placed the risky mortgages on the balance sheets of financial institutions around the world. Defaults in the housing impacted all holding these derivatives. [4]

Panagariya further adds these events left all financial institutions unwilling to part with their liquid assets. “They also began pulling out investments elsewhere, including in the emerging market economies, to shore up cash. The financial markets froze entirely and even firms selling cars, furniture and other durables found themselves out of lenders. The Wall Street hurricane thus reached the main street.”[5]

The apparent cause of crisis, as seen from the above description, suggests that financial innovations, though well intended did not work. As Stiglitz puts it “…while the benefits of many of the financial engineering innovations are hard to prove, let alone quantity, the costs associated with them - both economic and social are apparent and enrormous.”[6]

Many perceptive observers feel that crisis is an outcome of lack of proper financial regulation. For instance Paul Krugman, who won the Noble prize in 2008, writes: “…the real sin; both of the Fed...and of the Bush administration was the failure to exercise audit supervision over markets running wild.” Also Dominique Strauss kahn,

the Managing Director of IMF writes: “To put it bluntly this crisis is the result of regulatory failure, especially in the United States.” [7]

Causes

Could the crisis be contained: It is believed that allowing Lehman Brothers to collapse was a major blunder. As Mohan puts the Lehman bankruptcy, “…..had implications for the market in three ways; one the impact on the credit default swaps (CDS); two the liquidation of money market funds due to losses suffered on Lehman debt, and three the consequences for the firms prime brokerage clients….there was lot of sentiment riding on paper issued by investment banks such as Lehman.” [8]

Ram Mohan also cites George Sores (2009), according to Sores, “…the decision to let Lehman fail acted as the “the game changer”- it possibily changed the complexion of the crisis from a modest one to a severe one.” The Lehman bankruptcy had the same stock effect as the bank failures of the 1930s. Mohan also argues that apart from the failure of proper and timely policy response, an adequate regulatory framework would have prevented a tidal wave turning into a Tsunami.

Fundamental imbalances as a cause: Absence of counter factual arguments makes it difficult to be sure about the position taken by Mohan. There are also strong contrary viewpoints which suggest that adequate regulation and short term policy interventions, at best, could have delayed the onset of the severe crisis. Given the fundamental imbalances of several years, the severe crisis had to happen, sooner or later. We may briefly dwell upon various facets of such a position.

It is asserted (Wade, 2009) that the crisis is an outcome of the failure of “neo liberal or the market ideology” that dominated the world, particularly since 1970s onwards.[9] The core of this ideology is summed up as “virtuous markets and stupid governments.” The ideology implies, “…….wherever the market works, the state should stay out and let ‘economic democracy’ prevail - let resources be allocated in accordance with the votes of consumers (however unequally distributed), with the state’s role limited to ensuring competition or pretending to ensure competition…..” [10.]

Such a model no doubt unduly favored advanced countries and the elites in these countries. As Wade points out, the global rules of the free trade, boosted the economic power of big industrial and financial groups of the top countries by giving them easier access to the new resources, markets and sources of profit. It enabled the US, riding on the world’s main international currency, to draw capital ‘uphill’, including from the developing countries, to the extent that in 2006 it imported more than it exported by an amount equal to India’s GDP, a country with four times its population.

“Second, the new liberal order has delivered a rapidly rising share of national income into the hands of the top few percentiles of the population of the US and other leading capitalist States….the share of top 1% of households in US’s disposal income … went from an high of about 23% in 1929, steadily down to about 9% in the early 1970’s and then after the late 1970’s it rose like a rocket to reach 23% in 2006. On the other hand, average income of the bottom 90% was almost stagnant after 1980 - although consumption kept rising thanks to the build-up of private debt.” [11]

The rising income inequalities, to a large extent are rooted in changes in the Capitalist Production System. Taylor- Ford model of a assembly line production gave way to alternate production systems. Japanese style of ‘Just-In-Time’ subcontracting to small

firms is viewed as an important device to introduce labour market flexibility aimed at reducing labour cost. Equally important has been the Italian 'Industrial District' model where small firms cooperate and compete with each other and with large vertically integrated firms. Further as Kozul Wright (2008) notes that since early 1970s there has been accelerated process of outsourcing of manufacturing and servicing activities to lower cost locations, leaving only core competencies at home. The process enabled tapping of vast sources of labour in the developing world particularly in China and India. The process was facilitated by falling transport and communication cost. [12] This contributed to raising the workers vulnerability in the industrialized countries as also led to dependence of developing countries on the developed world.

Onaran (2009) lends further support: 'The increase in globalization, in particular, the mobility of capital, and the stagnation in aggregate demand have been the central powers behind the pro capital redistribution of income. The stagnation in demand led to higher unemployment and eroded the bargaining power of labour via a vis capital …….a decrease in the share of labour in income set the conditions for the vicious cycle of deficient aggregate demand, low growth, low employment, and a crisis prone global economy'. [13]

As an outcome of such changes in the production system and due to absence of financial regulation, led to a process where profit making increasingly occurred through financial channels rather than commodity production. As Vasudevan (2009) notes that financialization , "….emerged as a powerful force shaping the structure of the US economy. Financial assets were less than 5 times US GDP in 1980, but over 10 times as large in 2007. US credit market debt rose from about 1.6times larger than GDP in 1973 to over 3.5 times GDP by 2007… Both the level of debt and the extra ordinary share of the richest 1% of the population of the US parallel those witnessed during those gilded age that was a prelude to the crash of 1929. At that time, the share of debt was 3 times GDP and the richest 1% enjoyed 23 % of the income." [14]

The crisis that the global economic system is facing is not merely a crisis of inadequately regulated markets. There have been other potent forces in operation, such as, rising financialization, often at the cost of real economy, changes in production process leading to gross inequalities, loss of employment both quantity and quality, stagnation of effective demand to some extent overcome (temporarily though) by debt finance. In addition it is felt that damage from climate change contributed to unfolding of the current crisis. "Soaring food and fuel prices and major natural disasters played an important role in under, mining financial markets, household purchasing power, and even political stability." [15]

Consequences

Financial System: The crisis, at least for the time being seems to have been halted in its tracks. The dooms day comparison with great depression were not uncommon at least till the early part of the last year. Paul Krugman in early 2009 opined: "This looks an awful lot like the beginning of the second great depression…recent economic numbers are too terrifying not just in the United States, but around the world. Manufacturing, in particular, is plunging everywhere. Banks aren't lending business and consumers aren't spending."[16] In a similar vein Wade writes: "…two indicators sum up the global magnitude of the shock. First, the stock market of the nine months

of 2008 lost a value equivalent to 3000 euros for every man; woman and child on the planet….Second, world trade in the four months from November 2008 to February 2009 fell at a faster rate than at any time during the great depression."[17]

The rot was arrested by heavy government spending by advanced capitalist countries. A step, particularly in terms of its content, is not viewed kindly. Stiglitz (2010) writes, "…under the threat of a collapse of the entire system the safety net intended to help unfortunate individuals meet the exigencies of life was generously extended to commercial banks, then to investment banks, insurance firms, auto companies, even car loan companies. Never has so much money been transferred from so many to so few." [18]

It is also feared that arrest of melt down and weak revival in some countries is illusory or transient. Nouriel Roubini [19], as cited by Samuelson (2009) [20] warns that Federal Reserve and other Central Banks are fuelling a massive new 'assets bubble' that - while not in imminent danger of bursting - will some day do so with calamitous consequences. Roubini argues that, "…as the fed is holding short-term interest rates near zero, the investors and speculators borrow dollars cheaply and use them to buy various assets- stocks, bonds, gold, oil, foreign currencies. Prices rise. Huge profits can be made……the Fed would eventually raise interest rates or outside shocks…will change market psychology. Then investors would rush to lock in profits and the sell-off will trigger a crash…Policymakers seem unaware of the monster bubble they are creating…. The longer they remain blind the harder the markets will fall.'' [21]

Roubini's is not a lone voice. Simon Johnson, previously chief economist of the IMF writes that "Another Lehman/AIG- tight situation lurks somewhere on the European continent." [22] Whatever it may be, the fact remains that the United States, England and several European countries are running double digit deficit as a percentage of GDP. The problem is that no Central Bank can "finance a large fiscal deficit in a sustained basis, without invoking wrath of the gods" [23]

Added to this is the sovereign debt crisis as Standard and Poor (S&P) recently cut Greece's rating to junk (BB+) and lowered Portugal by two notches (A-). [24] This is followed by cut in Spain's rating by one notch. [25] In addition Italy is also being watched nervously by the market. All these countries stare at a default.

Unemployment: We do not want to be unduly pessimistic. Facts however have to be faced. Gloom is not limited to financial system; its grip on real economy, particular in terms of unemployment, is as strong as ever. Spain has recently exceeded 20% unemployment rate. The United States in a period from 2007 to October 2009 lost nearly 8 million jobs. "The unemployment rate at the end of 2009 was above 10%, duration of joblessness was the longest since the great depression, millions had had their working hours cut and millions more were too discouraged by a lack of jobs to seek work." [26]

According to International Labour Organization[27] the continued labour market deterioration in 2009 may lead an estimated increase in global unemployment to the tune of 39-61 million. By the end of 2009 world wide unemployed may range from 219-241 million- the highest number on record. Spense argues that it is high time to "…focus on distributional issues, particularly the unemployed… unemployment benefits need to be substantial and prolonged.'' [28]

There also appears to be a rapid rise in the ranks of poor. The World Bank warns that 89 million more people may be trapped in the wake of crisis, adding to 1.4 billion

people estimated in 2005 to be living below the international poverty line of $ 1.25 a day. [29] Rising poverty and hunger exacerbated by rising oil and food prices, is a threat to world peace. "Chronic hunger poses a threat to the stability of the governments…desperation can lead to tension, conflict and even violence. Since 2007 there have been riots over food in more than 60 countries."[30]

The World has witnessed (particularly 2008 onwards) steep rise in food prices. "The rapid and simultaneous rise in world prices for all basic food crops…is having a devastating effect on poor people all over the world." [31] Various reasons are attributed to such a sorry pass. Prominent being ongoing liberalization process, domination of transnational corporations in food and seed markets, loss of farm land to other uses and changes in consumption pattern (a major part of food grains go for feeding animals and birds). In addition speculation and hoarding, as sub-prime mortgaged crisis deepened, led to investment in food and metal to take advantage of the "commodities super cycle" [32] Stiglitz laments that , "…millions of poor people in developing countries are hurt as the US helps some of the world's richest farmers."[33]

Global Crisis and India

"The …Government has had a history of inept governance and public finances with burgeoning expenses on their public sector workforce- without enough accountability on productivity- being financed by ever increasing government borrowings… has one of the lowest tax rates…with relatively high levels of tax evasion and most commentators believe that the official figures are not very reliable."

No, the above quote is not about the Indian economy. This is the description of Greek Tragedy. [34] But one may as well be talking about the Indian economy. The Central Government's Fiscal deficit for 2009-10 (RE) turned out to be 6.7% of GDP. In case one adds deficits incurred by the States, the figure would easily exceed 10%. The fiscal deficit figures given in the budget, which should ideally reflect the net increase in Government's liabilities actually do not do so. A number of real liabilities incurred by the Central Government by issue of bonds and securities – both negotiable and non-negotiable – to companies, banks and financial institutions are excluded from the reckoning of fiscal deficit so as to window dress the deficit figures. The actual growth in liabilities and thus the debt stock is much more alarming than what the deficit figures would suggest. Even more worrisome is the The current budget intends to cut the fiscal deficit to 5.5% which may be feasible to achieve through large-scale disinvestment and receipts from sale of 3G and 4G telecom spectrum but it would be interesting to see if the government can resist pressures for increasing expenditure commitments. As brought out by Pandey [35], the State governments are piling up cash balances while the Central government continues to borrow and pump money in the areas which are essentially in the domain of States (Right to Education, Food Security, Rural Health Mission, Social Security for unorganized labour and older persons, Rural Courts and so on, not to mention the burgeoning growth in Central Paramilitary Forces to cover up the failures of State Police). In the race for competitive populism to label programs as 'financed from Delhi, not from State capitals', a perverse incentive has been created in increasing the extended public sector debt and deficit. Disinvestment or spectrum sale are one off measures and cannot be a sustainable source for bringing back the government to the path of fiscal consolidation. The softening of interest rates due to liquidity expansion caused by foreign currency inflows has given the government an opportunity to swap high cost loans with softer loans but that has only transferred the risk from the government to

the banks, still largely in public sector. The quality and returns of the asset of banking sector as also the size of accumulated government debt stock are now more than ever before susceptible to huge interest rate shocks. That the greater dependence on foreign currency inflows numbs the impulse for real reforms and leaves us vulnerable to global fluctuations goes without saying.

Following the crisis, India no doubt faced a difficult situation- crashing of share market, deceleration of economic growth and dismal export performance. The period also witnessed hefty revisions in the pay scales of government financed economic, social and public services. Pay packages in financial services, like in advanced capital societies, are still to fall from the dizzy heights. The front page headline in the Economic Times (May 3, 2010, Ahmedabad) reads: "Fat Cats draw bigger pay packets despite profits dip. It's interesting to note that following the period of crisis the number of billionaires doubled in India.

Another interesting parallel with advanced countries could be noted. In India it is not the commodity production but the tertiary sector that has been forging ahead and acting as the engine of growth accounting for more than half of GDP. It gives the feeling that a massive structure is being raised on a weak foundation. Since nearly half of the country's population is under 25, the young demographic profile can be a curse or a boon depending upon what kind of health, education and skills we are able to impart to them. The shortage of appropriate skills poses a major risk to the economy – whether manufacturing sector or the services sector.

Above features undoubtedly are worrisome. More serious indictment is due to jobless growth in the organized sector and rising informalization, deterioration in the quality of employment and galloping food prices. These trends, in all probability, are adding to a rise in inequalities, hunger and poverty. The rescue packages that have been activated mainly aim at the high and mighty. As Nachane (2009) mentions: "…very little seems to have been done towards relieving the distress caused by the crisis to the vulnerable sections of society." [36]

What about progress on much talked about official strategy of 'inclusive growth'? Such a strategy, apart from 7 to 8% growth rate, aimed to provide employment so that each family is assured of safe and viable livelihood. Various components of the approach included employment guarantee, enhanced flow of rural credit, rise in public spending on education and health and so on.

Amongst the bright spots, India deserves a lot of credit for the way it has faced the crisis. Subsequent to initial setbacks, Indian economy and the banking system have shown considerable resilience. Strong skill base, high order of enterprising spirit and a very large untapped home market (greater equality would widen it further) can keep the economy on high growth trajectory. But this will have to be backed by a strong, efficient and committed governance.

A word about India's growth performance. Various government agencies- Ministry of Finance, Reserve Bank of India, Prime Minister's Advisory Council, frequently (every quarter) draw attention to high growth. But growth though important conveys only a partial picture. High growth may be accompanied by growing inequalities and also endangering sustainability. [37]

Concluding Remarks

It emerges that global crisis is not only due to improperly regulated markets. Unequal distribution across countries and across income classes within a country played a major role in the phenomenon of global crisis.

Global economy calls for an approach which eschews competitive individualism and bases itself on inter-country cooperation aiming at equality and sustainability of development process. A shift has to occur from financialisation to commodity production and from jobless to an employment generating production system.

It is rightly suggested that we need, "…to reinvent fiancé so that it works to enrich the real economy instead of enriching only the financiers. This means changing the incentives and rules that govern the financial sector." [38] In a similar vein Stiglitz suggests that banks that are too big to fail are too big to exist. This is because: "…too big to fail banks have perverse incentives; if they gamble and win, they walk off with proceeds; if they fail tax payers pick up the tab." [39]

India would do well to overcome its obsession with growth rates. There is now greater realization that if high growth is to be maintained we need to do more. "Trickle- down will not work. We will have to pay more attention to long neglected areas like infrastructure, physical and social, agriculture and governance and so on."[40] Issues of governance are of vital significance. Growth commission led by Nobel Laureate Michael Spence noticed that all successful economies have committed credible and capable governments. [41] For years to come India will have to be very watchful.

Endnotes

1. For a detailed discussion, see Tiwari, Praveen(2008),Financial Sector Oversight: Issues and Challenges, *Indian Journal of Audit and Accountability*, pp 57-74.
2. Ibid, p 59.
3. Panagariya, Arvind (2009), Anatomy of the financial crisis, The Economic Times, September 24, Ahmedabad.
4. Ibid.
5. Ibid.
6. Stiglitz, Joseph E (2010), Hard Knocks, Hard Battles, The Times of India, January 2, Ahmedabad.
7. As citied in Tiwari (2008), op.cit.
8. Mohan, Ram (2009), The Impact of the Crisis on the Indian Economy, Economic and Political Weekly, March 28.
9. Wade, Robert(2009), Steering out of the Crisis, Economic and Political Weekly, March 28.
10. Ibid, p 41.
11. Ibid.
12. Kozul - Wright, Richard (2008), Overcoming Economic Insecurity, Economic and Political Weekly, October 4.
13. Onaran, Ozlem (2009), A Crisis of Distribution, Economic and Political Weekly, March 28, p 172.
14. Vasudevan, Ramaa (2009), The Global Meltdown: Financialization, Dollar Hegemony and the Sub-prime Market Collapse, Economic and Political Weekly, March 28, p 193.
15. Sachs, Jefferey D. (2009), Transition to Sustainability, The Economic Times, April 21, Ahmedabad.
16. As citied by Wade, op.cit.
17. Ibid, p 40.
18. Stigliz, Joseph E. (2010), Hard Knocks, Hard Battles, The Times of India, January 2, Ahmedabad.
19. The New York economist gained global acclaim because his warnings about a financial crisis proved prophetic.
20. Samuelson, Robert J, (2009), The Next Big Bubble?, The Economic Times, November 12, Ahmedabad.
21. Ibid.
22. As cited in Chaudhri, Soumitra (2010), What Market Jitters Portend, The Economic Times, February 9, Ahmedabad.
23. Chaudhri, Soumitra (2010), The Challenges in The New Year, The Economic Times, January 12, Ahmedabad.

24. The Economic Times, front page, April 28, 2010, Ahmedabad.
25. The Economic Times, April 29, 2010, Ahmedabad.
26. Freeman Richard (2009), Time to Reinvent the Job Factory, The Times of India, December 31, Ahmedabad.
27. Lin, Justin (2009), Globalization after the Recession, The Times of India, December 28, Ahmedabad.
28. Spence, Michael (2010), Less Bang for US Stimulus Buck, The Economic Times, March 26, Ahmedabad.
29. Lin, op.cit.
30. Clinton, Hillary Rodham (2009), World without Hunger, The Times of India, October 16, Ahmedabad.
31. Sundaram, Jomo Kwame (2010), Lessons from the 2008 World Food Crisis, Economic and Political Weekly, March 20, p 35.
32. Ibid, for a detailed discussion.
33. No time for Trade War, The Economic Times, April 16, Ahmedabad.
34. Bhat, UR (2010), The unfolding Greek Tragedy, The Economic Times, April 16, Ahmedabad.
35. Pandey SC, Has the FRBM Act became irrelevant in the current crisis, Journal of Management and Training
36. Nachane, Dilip M (2009), The Fate of India Unincorporated, Economic and Political Weekly, March 28, pp 121.
37. Stiglitz, Joseph E. (2009), The GDP fetishism, The Economic Times, April 16, Ahmedabad.
38. Freeman, Richard (2009), op.cit.
39. Stiglitz, Joseph E. (2009), Mega Banks: Too Big to Live, The Economic Times, December 14, Ahmedabad.
40. Bhusnurmath, Mythili (2009), Annus not-so-horribilis?, The Economic Times, September 7, Ahmedabad.
41. Lin, Austin (2009), op.cit.

PLAN AND NON-PLAN DISTINCTION IN ACCOUNTS AND BUDGET

Dr. Subhash Chandra Pandey *i

Abstract

1. The Government has recently decided to review the extant distinction between Plan and non-Plan expenditure. The issue has been raised from time to time by the Finance Commissions and Planning Commissions. While presenting Regular Budget 1998-99, the Finance Minster had announced to set up a Task Force to "look into the existing distinction between Plan and non-Plan expenditure and to make recommendations for a functionally viable and more focussed presentation of Government expenditure in the Budget". However, consensus on the subject has been elusive so far for various reasons surmised below.

2. This Paper explores the genesis of the classification of government expenditure in the accounts and budget in India, their rationale and associated problems. It is deliberated whether we can simply dispense with the Plan/non-Plan distinction and follow only the Constitutionally mandated Revenue/Capital & Voted/charged classification of expenditure or whether we can replace it with another system of developmental and non-developmental expenditure or otherwise improve expenditure classification that is suited to macro-economic analysis. We also consider the role and relationship of the Planning Commission and the Ministry of Finance in the changed scenario. The Plan/non-Plan distinction has significant implications for sound expenditure management of both the Centre and the States. For several Ministries (HRD, HFW, Posts, I&B etc.), removal of such distinction is key to their integrated budgetary appraisal. Reckless expansion of coverage of existing schemes and services creates budget sustainability issues in terms of unfunded future commitments. The neglect of maintenance of old assets has been one of the direct results of emphasis on plan budget providing only for creation of new assets. The neglect of maintenance or other committed liability is not an accounting issue. So long as we have larger and larger plan outlays within given resource constraints, the inability to fully provide for maintenance and other committed expenditure is built into this system. This cannot be addressed by merely reviewing the Plan and non-Plan distinction or change in accounting.

3. Removal of such distinction is intended to ensure that the Government should closely monitor the use of all funds and differential norms don't apply. As the revenue component of the Plan is growing and the committed liabilities are not being adequately provided, the distinction is in any case losing relevance. The gap - filling approach of Finance Commissions and launching of new Plan schemes in the face of inadequate provision for committed liabilities of completed Plans have often added to the financial management problems of both the Centre and the States. Unless the Plans are made on realistic assessment of resources (after fully providing for committed liabilities and mindful of future liabilities), fiscal problems – including

---

[*] *Dr. Pandey,, IA&AS is presently, posted as Additional Financial Adviser and Joint Secretary, Ministry of Defence*

debt sustainability issues - will persist for which the blame does not lie on the classification system.

Classification of Government Expenditure in Accounts and Budget

1. Presently, there are 3 distinct top level classifications of expenditure in the accounts and budget of both the Central Government and State Government: Revenue expenditure and Capital expenditure; Voted expenditure and Charged expenditure; Plan expenditure and non-Plan expenditure. The first two classifications are Constitutional requirements while the third classification is a non-statutory classification

History of Classification of government expenditure in India

2. The Accountant General to the Government of India (also designated as Auditor General of India at that time) came into being in 1860 for 'bringing the accounts of the Empire together'. In 1865, a monthly consolidation of the accounts of receipts and charges of India was introduced for the first time. The Accountant General, who was by then designated as Comptroller General of Accounts, was entrusted with the responsibility of maintenance of accounts including issues such as classification of receipts and payments, the process of recording them, etc. In 1878, first edition of the 'Civil Account Code' was brought out. In 1881, the 'List of Major and Minor Heads of Account' was added for the first time, as an appendix to Volume -II of the Civil Account Code. At that time, there were 30 major heads for revenue receipts and 38 major heads for expenditure, and no distinction was made between Capital and Revenue expenditure. After passing of the Government of India Act, 1919, the Civil Account Code was replaced by several codes and manuals. Instructions in regard to the accounts to be kept in Audit and Accounts Offices were embodied in the Account Code. The 'List of Major and Minor Heads of Classification' formed an appendix to the Audit Code and was published as a separate volume. By that time the total number of receipt major heads had increased to 42 and the number of expenditure major heads including capital expenditure not charged to revenue, to 60. Further, the major heads of account were, for the first time, grouped under several sections. The system of distinguishing the sections by letters of alphabet, single letter (say A, B, C, etc) denoting the section in Revenue account and double letters of the same alphabet (say AA, BB, CC, etc) denoting the corresponding section in Capital account was also introduced. The major heads were serially numbered, Roman numerals being employed for receipt heads and Arabic numerals for expenditure heads. The debt, deposit and remittance heads were grouped into sections, but the major heads in these sections were not numbered. The Government of India Act 1935 resulted in important changes in the accounting procedures but no major changes were made in the classification pattern excepting that the number of receipt major heads gone up to 53 and the number of expenditure major heads, both on Revenue and Capital accounts, had increased to 63.

Post-Independence developments

3. The accounting and classification structure drawn up at the time of introduction of Government of India Act, 1935 continued after the Constitution came into force, in the same form by and large except that the accounts from 1950-51 are

kept in three parts viz. The Consolidated Fund, Contingency Fund and Public Account, as envisaged in Art.267 of the Constitution of India. The classification structure bore close affinity to departments and organizations in which the transactions occur and within them in terms of inputs such as establishment charges, travel expenses, material and equipment, etc. Provision was made for the principles of accounting classification, the classification structure and the heads of account etc to be finalised in consultation with the Comptroller and Auditor General (C&AG) under Article 150 of the Constitution. The phrase 'in consultation with' has since been replaced by 'on the advice of'.

4. Accounting for 'developmental Activities During 1951-60, there was a need to accommodate transactions related to new social and developmental activities launched under the Five-Year Plans. Hence, some ad hoc changes were made in the heads of classification. During 1961-63, a proper review of the major heads and minor heads of account was conducted and the grouping of major heads into sections was modified to indicate the social and developmental services undertaken by Government separately. The nomenclature of some of the sections was changed. A few new major heads were introduced and a semi-functional classification structure was evolved. All changes were effected mostly at the major head level and minor heads remained more or less the same. The concept of accounting the receipts and expenditure with reference to the organisation incurring the expenditure, rather than the purpose of receipt and expenditure was also not changed.

5. Evolution of Plan classification As the Planning commission started making allocations of plan outlays, a sectoral classification emerged in the Plan documents. Every Sector was divided into a number of Heads of Development, which in turn was divided, into a number of Programmes. Thus, a three-tier classification system emerged in the Plan documents. Later on, the number of tiers increased from three to five. The funds so allocated by the Planning Commission were reclassified in the Budget documents following the standard accounting classification system. For a given function or Programme, apart from Plan allocations, additional funds were also directly allocated wherever required, to the concerned Ministry. Such provisions came to be known as 'Non-Plan' provisions. To distinguish the two categories separately, a separate statement indicating Plan items was introduced in the Budget documents. Slowly, the necessity for greater monitoring of plan expenditure brought in further refinements. A practice of exhibiting Plan and Non-Plan components of provisions for the various programmes, activities and schemes at the sub head/object level of classification into two separate horizontal columns was introduced. The practice began in the year 1959-60.

6. Efforts towards unifying classification in Accounts and Plan: A K Mukherjee Committee The Plan Heads of Development roughly corresponded to the major heads of account. The Programmes and Schemes in the Plan classification similarly corresponded to Sub-Major Heads or Minor Heads of Accounts. However, there were a number of divergences between plan Heads of development and the major heads of account. These divergences created problems in plan budgeting and monitoring of actual expenditure against plan outlays.

7. A lot of efforts were directed towards eliminating the divergences between

accounts and plan classification systems. The efforts started from the report of the 1st Administrative Reforms commission (1st ARC) on 'Finance, Accounts and Audit'. 1st ARC recommended that the structure of Major Heads of Accounts may be reviewed and recast in terms of broad functions and major programmes of Government. The ARC recommended that a supplement to budget documents should be prepared analysing the Plan Outlays under various heads of development into components corresponding to the accounting heads. Programmes, activities and projects of all the departments and organisations should be clearly identified and the minor heads connected with these programmes suitably recast so as to reflect those activities properly in accounts.

8. Based on the above recommendations of ARC, a committee was set up under Shri. A K Mukherjee, the then Deputy Comptroller and Auditor General of India (March 1969).The committee submitted its first report in September 1971 covering restructuring of detailed demand for grants, etc. It formally recommended depiction of Plan and Non-Plan components of various programmes, activities, schemes, etc. in two horizontal columns. The second report of the Committee (1972) examined the issues of classification in budget and accounts vis-à-vis the Plan. They considered the necessity for a functional classification in accounts as against the then existing semi-departmental/organisational and semi-functional classification structure. In recommending such a change, the committee took into account the recommendations contained in the UN Manual on Classification of Government Transactions. [The Department of Economic and Social Affairs of the United Nations attempted to evolve a functional classification of Government transactions and brought out in 1958 a Manual of Functional and Economic Classification of Government Transactions for the guidance of member countries.] The committee proposed a new five-tier sectoral classification system for both Plan and Accounts. It was introduced in accounts w.e.f. 1.4.74. While designing the structure, the committee had taken into account the requirements of Plan classification also. Based on A K Mukherjee Committee's recommendations, for the first time the principle — classification should have closer reference to the function, programme and activity of the Government and the object of the revenue or expenditure, rather than the department in which the revenue or expenditure occurs' was introduced.

9. R C Ghei Committee Recommendations: With the passage of time, the divergences between accounts and plan classification grew enormously. Finance Ministry was facing problems in releasing block grants to States as the Accountant Generals were not able to certify the expenditure incurred on earmarked schemes based on which the amount of block grants were to be finalised. Planning Commission could not monitor the progress of plan expenditure from the accounts data. They tried to centrally codify all the plan programmes and schemes and establish a link with accounts to generate reports. But they were unsuccessful, as the divergences were too many. In 1986, R C Ghei Committee reviewed so as to establish one to one correspondence between the Plan classification system and the accounts classification system. On its recommendation, a new 6-tier classification system was introduced w.e.f. 1987-88. [The 6 tiers are: Major and Sub-Major Heads for functions of the Government, Minor Heads for Programmes or major wings of administration, Sub-Heads or Detailed Heads for Schemes or activities and Object Heads for Object of expenditure such as Salaries meant for expenditure control purposes. Accounting authorities have been following a 6-tier classification system and a 15-digit coding

system. However, Budget makers have continued to make demands for more and more heads.

10. Standard object heads as primary units of appropriation: Shri Vijay Ramachandran sub committee of Shri Geethakrishnan Committee. The committee sought to check the proliferation of objects heads and recommended a set of 'Standard Object Heads' as primary units of appropriation which was introduced from 1995-96. The Alpha numeric- coding pattern followed in the budget was discontinued and in the detailed demand for grants, the 15 digit coding followed in accounts was introduced so as to help budget monitoring through accounts.

Inadequacies in the existing accounting system

11. From the days of Mukherjee Committee in early 70s, there has been dramatic increase in the range and depth of government schemes/projects/activities in both Plan and non-Plan and the information requirements of different stakeholders are simply overwhelming. Stakeholders would like to know break-up of expenditure according to Revenue/Capital, Voted/Charged, Plan/non-Plan; according to class of beneficiaries (SC/ST/OBC/Women and children/Minorities); according to the States/UTs or even regions within States which benefited from Central and State government expenditures; according to economic classification in terms of 'Transfer Payments'/Consumption/Investment/Capital Formation etc; according to the source of funding (tax financed or debt financed, domestically financed or financed through external aid); according to functional classification of government activities; according to payees; according to Programme/Scheme/Project-wise; according to Budget-holders or according to paying/accounting authorities and so on. Data is there is a scattered form but advanced data mining tools cannot be used as the classification system lacks uniformity. Moreover, a single vertical PINCODE type of classification cannot meet such diverse information needs.

12. Over the years, the accounting system has been tinkered in a piecemeal manner resulting in several drawbacks/ inconsistencies. These only manifest our struggling efforts to try meeting multi-dimensional information needs from a single dimension classification code. We need to invest in a multi-dimensional accounting classification that is possible only through use of advanced Information Technology based database management systems.

13. Those conversant with the 'List of Major and Minor Heads of Accounts' can quickly relate to these drawbacks. We find that the original intent of creating 6-tier classification stands diluted due to extraneous considerations coming into play. State Schemes do not generally come at Minor head levels and the purpose of a uniform set of accounting structure for both the Union and the States is also coming to a naught in many areas with accounts not yielding the kind of information expected by the users. All Major Heads are not standardized across Sections, some tiers are not adequately utilised while some tiers have proliferated, the six tiers get inter-mixed, ad hoc additions/ upgradation/ downgradations are made on materiality consideration rather than on the basis of accounting principle. A functional classification should consider the nature of functions as the basic norm for various divisions or sections. Instead of taking a function as a primary division, the 'Sections' are based on the nature of the inputs like 'Revenue', 'Capital', 'Loans', etc. Normally a scheme or a programme has

any or all of the following components: Direct Revenue Expenditure, Grants-in-aid to States/UTs or other agencies, Direct Capital Expenditure, Loans/Advances to States/UTs or other agencies, etc. The extant classification system has different Sections and different Major heads under each of those sections for all or any of the above said components. A single scheme has to be repeated under different accounting heads as may be required. This poses many practical problems in generating expenditure reports scheme wise. The correspondence table between accounting heads and schemes is not available in any structured, user friendly document though many States do prepare a document called Plan-Budget Link.

14. The Economic and Functional Classification of Union Budget is prepared by the Economic Division, of course with several months time lag, after the presentation of Budget. This helps in macroeconomic analysis of budget. However, it is true that classification of government expenditure between developmental/non-developmental and plan/non-plan obscures the economic nature and impact of fiscal actions. Earlier, merely a statement of "developmental expenditure" was appended in the Central General budget. Reserve Bank of India has for long been categorizing government expenditure as "developmental" and "non-developmental" expenditure in its Reports. These isolated, unsynchronized efforts are insufficient to bring desired user-friendliness in fiscal reporting.

Basis of existing classification of expenditure as 'Plan' or 'Non-Plan'

15. Separate classification for Plan and Non-Plan in a purely functional classification system can be justified only if they have different sets of objectives but as observed above, the information needs from accounts are more than mere functional classification. If we make a 'Plan' and allocate resources to achieve that Plan, the Plan execution needs to be monitored vis-à-vis Plan allocation. If the 'Plan' only caters for new investments and does not provide for maintenance of old assets, it is a financial management issue not an accounting issue. But is there some defined rational, theoretically consistent criterion for differentiating the 'Plan' expenditure with 'non-Plan'? Before formulating any 5 year Plan, the Planning Commission issues very detailed guidelines to the States and Central Ministries specifying what will or will not be included in the 'Plan Outlay' and 'Plan Budget'. While there are some dominant themes underlying such inclusion criteria, the exceptions are also there contradicting the theme. Some of these underlying considerations are discussed below.

16. May be 'Plan' includes only 'creation of new physical and social assets' and not maintenance of old assets. This is generally true but there have been notable exceptions [say in HRD and HFW Ministries] where Plan Outlay has included operation & maintenance expenditure of old schools / hospitals/clinics including payment of salaries/wages. Even where the provision is made for 'new', States often divert them to take care of 'old' taking advantage of the gaps in the accountability mechanism. Further, many schemes/projects span more than 5 years and such 'incomplete' / 'spillover' schemes/projects are also carries forward to next Plan. Spillover Projects/schemes with poor expenditure record are reviewed for possible closure. Also, schemes for 'additions or extensions to capacity, of existing institutions/establishments for further development thereof' or 'Investment outlays for improving performance levels of existing capital stock or to replace wornout capital

stock' are also included in Plan. All grants-in-aid at current levels at a 5 year Plan end may also be considered for continuation during next 5 year Plan.

17. May be Plan includes 'capital formation' while non-Plan includes 'transfer payments' and O&M expenses. All social sector schemes which are in the nature of transfer payments, such as old age pensions and subsidies to various items of consumption are to be treated as non-plan outlays unless specific approval by the Planning Commission has been obtained. However, exceptions apply. Many plan schemes carry large element of hidden subsidies and are economically akin to ('unrequited') transfer payments like subsidies and pensions. Both supply of food below market price or payment of wages at above market price technically would fall in the category of 'transfer payments' in economic classification of public expenditure. So transfer payments are taking place both under non-Plan and even Plan. On the other side, budgetary interventions like job guarantee schemes can also be viewed as 'market development activities'. They help to build consumer base amongst 'the bottom of the pyramid' and assist consumption led growth. In fact many analysts have attributed recent episodes of inflation to rising demand outstripping supply due to large budgetary subventions.

18. May be 'Plan' includes only 'CAPITAL' and not "REVENUE'. This is certainly not true. Plan budget used to have sizeable share of Capital expenditure but now predominantly comprises Revenue expenditure. Three important developments have led to substantial reduction in the capital expenditure component of the Plan budget. Firstly, the external aid/loans received by the Central government and then passed on to Public Sector undertakings as equity or loan has for past 20 years been disintermediated. They contract and receive the external loans direct in their balance sheet. Secondly, following the recommendation of the Finance Commission, 'loan' component of Central Assistance for State/UT Plans has been discontinued w.e.f. 2005-06. States are encouraged to borrow direct from domestic market and only external loans are routed through Central Budget. Third development is a conscious policy shift where the Government no more invests in direct physical infrastructure and instead facilitates direct market financing or through Public Private Partnership ventures where the capital is largely provided by the private party. Government may provide land in lieu of equity capital which of course is not monetized and not reflected in the budget. Bulk of Plan Revenue expenditure is in the form of grants-in-aid to States and autonomous bodies/societies. Although a part of such grants may be used to create assets, but the ownership of these assets vests in the grantee. A debate has been going on since long that these should be treated – in compromise to basic principles of accounting – as 'capital' expenditure but such arguments broadly emanate more from a perceived threat to the size of Plan budget in pursuit of objective of the abolition of revenue deficit under the Fiscal Responsibility and Budget Management Act. Ultimately when consolidated fiscal accounts of the Union and the States are made [not a regular, formalised practice] such inter-governmental transfers cancel out and capital formation aided by government spending is revealed.

19. May be 'Plan' includes only 'Developmental expenditure'. This is true but not entirely. How can we argue against Defence expenditure's contribution to industrial growth and technological capability build-up? The grants recommended by the Finance Commission for upgradation of standards of administration, for local bodies

and for some earmarked sectors are all developmental in nature and yet these are presently classified under 'non-Plan'

20. May be the allocation made by/through Planning Commission is 'Plan', and allocation made directly by the Ministry of Finance is 'non-Plan'. This is closest to reality. All other classification criteria of Plan and non-Plan stand diluted.

Problems in removal of Plan / Non-Plan distinction

21. The Finance Minister observed in his Budget Speech 98-99(vide para 48) that the distinction between plan and non-plan expenditure had 'led to an excessive focus on so called plan expenditures with a corresponding neglect of items such as maintenance'. He, therefore, announced that a Task Force would be constituted to look into the existing distinction between Plan and non-Plan expenditure and to make recommendations for a functionally viable and more focussed presentation of Government expenditure in the Budget. However, so far it has not been feasible to remove the distinction between Plan and non-Plan expenditure.

22. The general perception seems to be that the non-Plan expenditure is a necessary evil to be suffered and to be kept under tight control whereas the Plan expenditure is good expenditure to be encouraged. In 1983, the D/o Science and Technology secured Government approval to treat the expenditure of all Scientific Departments/Establishments as 'PLAN' [with the intention of freeing them from the harsh restrictions applied on non-Plan expenditure.] All the real or perceived problems associated with the existing system stem from this perception.

23. The original intent of the classification was to demarcate new investment or developmental schemes, which creates physical or social assets as against non- developmental and maintenance expenditure, which is necessary to carry on the basic functions of the government as well as maintenance of existing public infrastructure. Plan expenditure was supposed to indicate new developmental and capital formation activities which were expected to increase the productive capacity of the economy. The classification is valid only over a period of five years in the sense that plan investment is the investment on new schemes undertaken in the five year plan period. Future expenditure on these becomes non-plan after the Plan period.

24. Public perceptions are nurtured on the belief that plan expenditures are good while all non-plan expenditures are wasteful and hence bad. Understandably, desire to show successively larger and larger Plan outlays is strong. Under the present classification, only incremental development expenditure during a Plan period qualifies as Plan expenditure. The maintenance expenditure is termed as non-Plan after the end of the plan period during which the asset was created. Because of the erroneous association of Plan with development and non-plan with non-development, expenditure on items like maintenance gets lower priority. New schemes therefore take priority over existing ones resulting in sub-optimal use of resources. An attitudinal bias has resulted in the past is an unnecessary tilt in favour of enhancement of Plan size of States, sometimes only perhaps for the sake of such enhancement, without commensurate or adequate consideration for the resources or capacity of the States. The bias encourages avoidable tendency to use borrowings to finance revenue expenditure. Such a diversion has potential ser implications for a capital scarce

economy. It may be possible to increase the productive capacity of the economy at a lower cost through emphasis on maintenance rather than by costly addition of capacity through new schemes.

25. The Tenth Finance Commission had noted: "In an effort to project larger plan outlay, inadequate provision was made for crucial expenditures like the maintenance of existing assets which are, in current practice, regarded as non-plan expenditure and hence of lower priority. There have been pleas that in view of the importance of maintenance and upkeep of assets created during previous plan period, the Group has recommended that maintenance expenditure in regard to irrigation works, bridges, rural and urban primary schools and primary health centres and sub-centres could also be treated as plan expenditure. Some 30 years back, borrowed funds financed only capital expenditure. Now we are borrowing to finance current expenditures. Plan funds earmarked for creation of new assets had to be diverted for maintenance of old assets, for which there was inadequate non-Plan provision. Diversion of Plan funds by the States and other recipients to meet non-Plan requirements is often commented by CAG in the Audit Reports. Neglect of assets arises not because of a particular classification of expenditures but because of inadequacy of resources and/or lack of will to raise resources for maintenance and upkeep of assets. Fortunately, the tendency to seek very large State Plans has been somewhat subdued in the current decade due to the effect of the restraint brought in by the Fiscal Responsibility and Budget Management Act.

26. The issue of Plan/non Plan classification has aspects of management and accounting woven into it. Thus while examining the efficacy of the pattern of expenditure this classification has produced, and in evaluating its continuing relevance, its effectiveness as a tool of management and as an efficient and transparent accounting procedure has to be thoroughly appraised. The Plan/non-Plan distinction is a handy tool for macro level assessment of public sector allocations for developmental schemes, progress in implementation & evaluation. However, on resources side, it creates incentive to squeeze out allocations for key regulatory functions and basic governance. On expenditure side, it creates incentive for creative accounting by including even administrative expenditure and transfer payments under Plan. There is obvious need for reorienting the accounting system to permit the public expenditure being presented in a more transparent manner to reflect the development and non-development items of expenditure for expenditure. Merely Revenue-Capital classification is insufficient. In fact, with increasing computerisation, it should be possible to have as many sub-classifications as possible. It is important to know the extent to which the borrowings have been used for developmental purposes and for non-developmental purposes. Also, there is a clear need to classify the committed expenditure separately from the new expenditure.

27. One of the proclaimed objectives of removing the Plan/non-Plan distinction is to ensure that the entire gamut of government expenditure is reviewed by the Planning Commission. Despite its own rigidities, a significant part of non-Plan expenditure is theoretically discretionary expenditure [rather than obligatory commitments] and is amenable to a 'PLANNING' exercise. For example, modernization of Defence Forces, para-military and Police Forces, judicial administration and 'Subsidies' of various types. The Defence budget has significant share of obligatory/committed payments on pay and allowances, ration, ammunitions, maintenance of troops and war

machinery plus a sizeable provision for acquisitions of new weapon systems. It is this later part that is susceptible to 'planning'. Actually, although Defence Budget is classified as non-Plan in budget papers it is not 'UN-PLANNED'! Just like 5-year plans made by the Planning Commission, Ministry of Defence also makes 5 year Defence Plans and bases its budgetary requirements on 15 year perspective plans called Long Term Integrated Perspective Plan. Internal security expenditure is not only on account of the increase in salary and allowances and the growth in numbers, but also on account of a recent trend in providing support to the States' internal security expenditure beyond the recommendations of the Finance Commission, say for the States affected by 'Left Wing Extremism'. The budget provision for food subsidy and fertiliser subsidy is a direct fall out of the government policies concerning target consumer prices and the size of consumer base. Once these policies are frozen, it is immaterial as to who calculates the total bill [MoF or Planning Commission] and under what nomenclature budget funds are provided [plan or non-plan] and how actual release of subsidy is regulated.

28. If the Government decides to dispense with the Plan/non-Plan distinction and follow only the Constitutionally mandated Revenue/Capital & Voted/charged classification of expenditure, the existing concept of Gross Budgetary Support(GBS) for the Annual and 5 year Plan would have to be re-defined because the whole expenditure would come up within the purview of integrated planning and allocation. Government may decide that budgetary allocations would be done by the Planning Commission alone or jointly with MoF and that MoF should focus only on assessing available budgetary resources [tax and non tax revenues, non-debt capital receipts like disinvestment and loan recoveries and debt receipts whether in Consolidated Fund or in Public Accounts. Both the exercises [resource availability and budget allocation] may be taken up jointly by MoF and Planning Commission or divided on some other basis. For example, instead of both M/o Finance and Planning Commission allocating budget to various Departments, the Planning Commission may concentrate on some Ministries and exclusively deal with their budgetary allocations. Rest can be exclusively dealt with by MoF. Consensus needs to be built for such alternatives.

29. Another alternative is for the Government to substitute Plan/non-Plan distinction with another system of developmental and non-developmental expenditure and to place the bulk allocation for developmental expenditure with Planning Commission, GBS for Plan (or rather developmental expenditure) will then depend upon the definition of developmental expenditure. If expenditures like Defence Capital expenditure and certain types of subsidies are classified as developmental expenditure, GBS can significantly go up. Consensus needs to be built for such alternatives.

30. There are also a few departments which obtain funds from both the Plan and non-Plan for, broadly, overlapping activities or for complementary activities. In these cases, there will be definite advantage in taking a holistic look at the allocation for the departments. In many cases plan programmes initiated have direct but unperceived implications on the non-plan budget by creating future non-plan commitments. Therefore, if the plan and non-plan allocations are finalised jointly between the Planning Commission and the Finance Ministry, there are obvious advantages. Consensus needs to be built for such alternatives.

Stakeholders in the change process for new system

31. Obviously, the role/responsibility of the Ministry of Finance and the Planning Commission would have to be redefined.

32. The consent and cooperation of States would be crucial to removal of the Plan and Non-Plan distinction.

33. Any material change in the structure and format of budget documents requires clearance of the Estimates Committee of the Parliament. The last time the Government approached the Committee was in 1986-87 (37th Report of the Estimates Committee, Lok Sabha 1986-87).

34. Any change in such presentation will also require corresponding changes in the accounting classifications. For example, grants and loans to State and Union Territory Governments, at present, are segregated into non-plan and plan on the sub-major head levels in the accounts and within plan by categories, namely, Central Plan, Centrally sponsored plan and State and Union territory plans. In the book on detailed "Demands for Grants", the provisions are indicated accordingly. According to the accounting classification presently followed, State governments also exhibit the above receipts in their accounts with corresponding sub-major heads and minor heads. Any change in the heads of accounts of the Central and State Governments would need to be examined by the Controller General of Accounts and the Comptroller & Auditor General of India under Article 150 of the Constitution.

Implications of removing Plan and Non-Plan distinction

35. The first requirement of a new system would be to provide for integrated allocation of resources, instead of the current system in which the plan allocations are made by the Planning Commission based on the GBS, and non-plan allocations are made by MoF. The responsibility for integrated allocations may now be entrusted either to MoF or the Planning Commission with corresponding changes in their organizational structure and profile. Alternatively, Planning Commission could be the agency to appraise the programmes/projects/schemes, and MoF could utilise this appraisal for deciding on budgetary allocations. A reinvented Planning Commission could also continue to responsibility for monitoring evaluation of the implementation and outputs/deliverables. If the responsibility for integrated resource allocation is entrusted to the Planning Commission, MoF could focus on planning and mobilisation of financial resource through taxation, borrowings etc.

36. The expenditure provisions, under whatever heads they are made, cannot be delinked from the totality of the budget exercise and cannot be looked at in isolation from either the need or resource availability angle. These are inter-related issues, which form a cohesive whole so far as budgeting is concerned and form the core function of the Finance Ministry. The Planning Commission has to do sectoral/schematic prioritisation within the resource constraints indicated by the MoF. In a system wherein there is no Plan/non-Plan distinction, a different principle of determination of the budgetary provision, either as "developmental" or "capital" will be necessary to arrive at the ceiling within which Planning Commission has to organise prioritisation.

37. Any change in the classification of accounts and methodology of funding at the Central level must also be followed by corresponding changes in the State governments. Consensus is needed to be built for this.

38. In case the distinction is removed, the List of Major and Minor Heads may be modified strictly on functional basis by eliminating separate major heads under Grants in aid, Capital Outlay, Loans and Advances. A truly functional list of major and minor heads could be prepared. Revenue and capital could be shown as two horizontal columns in the budget and accounts documents, in the same manner of showing Plan and Non-Plan against the existing semi-functional classification. Alternatively, class of object heads can be used to distinguish Revenue and Capital. Presently, the utilisation of object heads under Revenue and Capital heads is quite ad hoc.

What is the alternative to Plan / non-Plan distinction?

39. Purely from public finance theory angle, the allocative efficiency in budget allocation can be improved if a single agency is made responsible for holistic assessment of the funding requirements of an entity. Current system does not conform to this and is, therefore, perceived to be sub-optimal. For example M/o HRD, M/o HFW get some budget from MoF and some from Planning Commission so there is truncated assessment of their funding needs. There is no consideration about the right balance between opening of new schools and clinics and the need to properly equip and maintain the existing infrastructure. If a single agency, either MoF or Planning Commission, were to decide the entire budget of these Ministries, the chances of striking such a balance are brighter. It is in this context that the distinction between Plan and non-Plan draws flak. The current budgetary practice leads to thin spread of resources over a large investment portfolio, inadequate maintenance of existing public assets and large number of under-funded, on-going projects.

40. While the Planning Commission has its own compulsions to seek a high Plan size, the Ministry of Finance often finds it difficult to accept such Plans considering the system's capacity to spend and the availability of the resources for funding Plan, consistent with prudent management of debt and deficit. The Planning Commission often articulates that Ministry of Finance is not doing enough to cut down non-Plan expenditure and improve tax collection to achieve a qualitative shift in public expenditure pattern. Abolition of distinction between Plan and non-Plan expenditure is a major reform and requires setting aside the turf issues and bringing to table radically new ideas to restructure the whole budget allocation process. Following alternatives are suggested.

Alternative - I Back to basics – PC's role of official think-tank

41. Planning Commission may consider disassociating itself with executive functions of "scheme/project approvals" and "budget allocations" processes. It may instead focus on its primary role of formulation of Annual and 5-Year Plans and evaluation of the field impact of various developmental schemes, programmes and projects. There is a lot of overlap in various programmes. The Commission can take up review of all on-going programmes for appropriate restructuring. The Commission is intended to be a thinktank on formulation of national policy - macro and sectoral - and thus be a source of support to the concerned Ministries in evolving the right policies. For example, we don't have an integrated national policy on transport. The

sectoral Ministries - Railways, Surface Transport (National Highways, inlandwaterways,), Shipping, Civil Aviation - and State governments pursue their own objectives, often without any consideration of synergies to be exploited and of optimum use of scarce public resources in national interest. Same applies to other areas like energy, food, water, education, health, social welfare.

Alternative - II Planning Commission handles scheme/project approval and monitoring process and MoF handles budget allocation process.

42. The entire work of approval/monitoring of schemes and projects; evaluation of outcomes; and weeding out of schemes may be handled by the Planning Commission with MoF lending its expertise, wherever sought or through regular participation in appraisal committee system. Then the budget allocation and the funding pattern (grant; equity; loan; direct expenditure) for each scheme/project may be decided by MoF based on a prioritized portfolio of approved schemes and projects to be included in the budget. MoF may also join the Planning Commission in monitoring the progress of expenditure to achieve the stated objectives of the budget.

Alternative –III Ministry-wise distribution of budget allocation work between MoF and Planning Commission

43. The Planning Commission may handle the entire budget of Ministries having a larger Central Plan budget than non-Plan budget, e.g., Agriculture, Rural Development, Human Resource Development, Health and Family Welfare, Urban Development, Railways, Power, Roads etc). Remaining Ministries can be handled by MoF directly. Another rational division could be Ministries handling “core social sector and physical infrastructure” and other Ministries. Of course, MoF would continue to deal with determining the Revised Estimates and handling Parliamentary interface, monitoring of the progress of expenditure and handling re-appropriations, as required for achieving the stated objectives of the budget. The funding pattern (grant; equity; loan; direct expenditure) could be settled as a general policy applicable for all Ministries.

44. Centre’s budgetary support to States for Central, Centrally Sponsored and State/UT Plans is budgeted under Plan budget of MoF and different Ministries. Grants under Finance Commission awards, Police modernization etc. are budgeted under non-Plan budget of MoF and different Ministries. The budgeting and release of such funds often depends on verification attached ‘conditionalities’ by MoF and/or the concerned Ministries. Being very large outlays, the transfers to States are important to MoF for management of cash and Ways and Means advances from the Reserve Bank of India. Also, MoF has to remain focussed on macro-economic assessment of the States’ finances, their indebtedness and on fixing limits on States’ borrowings under Article 293 of the Constitution. It may, therefore, be desirable to let the status quo continue for the transfers to States. Likewise, the funding of Externally Aided Projects is another area where a complete separation of budget work between MoF and Planning Commission is difficult. These Projects can be put in a separate Demand for Grant directly controlled by MoF – with implicit compromise of Ministerial responsibility on functional basis - because MoF is the nodal Ministry for interfacing with external aid agencies and management of country’s external debt. Since a significant quantum of external aid is tied to specific purposes and specific recipients, there is in any case limited discretion in making budgetary allocations against such

receipts. In fact, the concept of 'net budgetary support for Plan', i.e., Gross Budgetary Support less the earmarked provision for external aided projects, is often used to denote that part of GBS which the Planning Commission is theoretically free to allocate at its discretion.

Concluding remarks

45. The issue of Plan/non-Plan distinction has been raised from time to time as an expression of dissatisfaction with the fairness and efficiency of the budget allocation process. Formally the budget allocation function is vested with Ministry of Finance. A large part of budgetary resources are pre-empted and not available for discretionary allocations, substantially in non-Plan but also in Plan. Allocation of a sizeable portion of budgetary resources is done mainly by/through the Planning Commission. The issue of removing Plan/non-Plan distinction is not merely a matter concerning the design and presentation of the budget or structure of accounts but one involving redefining the role of the Planning Commission and the Finance Ministry in budget allocation process. This is an important issue of institutional re-engineering involving all stakeholders in public finance management in the Centre and the States. There are obvious advantages if the budgetary requirements of any entity are appraised by a single agency in a holistic manner and new investments are made keeping in view maintenance of already created assets and commitments being undertaken on future maintenance liabilities. For Ministries like HRD, HFW, Posts, I&B such an integrated approach to budgeting would be most beneficial. Moot point is whether a revised system of classification should precede and synchronize the respective roles of Planning and Finance Commission/Finance Ministry or should the revised role of these institutions be defined prior to addressing the issue of classification.

Bibliography

1. Reports of the 1st Administrative Reforms Commission (1968) on "Accounts, Finance and Audit" etc.
2. Reports of the committee headed by Shri. A K Mukherjee, (1971 and 1972)
3. Report of the Committee on Fiscal Responsibility Legislation (2000)
4. Report of the Advisory Group on Fiscal Transparency (2001)
5. Fiscal Responsibility and Budget Management Act (2003)
6. Fiscal Responsibility and Budget Management Rules (2004)
7. Report of the Core Group on Voluntary Disclosure Norms for State Governments (2001)
8. Report of the Expert Group on Review of Classification System for Government Transactions (2004)
9. Reports of the Finance Commissions (1st to 13th)
10. 5 Year Plan Documents
11. Budget documents of the Union and the States
12. List of Major and Minor Heads of Accounts published by Controller General of Accounts, Ministry of Finance.

AUDIT REPORTS - A FEW THOUGHTS

S. Lakshminarayanan[*]

The Executive is accountable for the money sanctioned by the Parliament /Legislature through the mechanism of Public Accounts Committee (PAC). The Comptroller and Auditor General (C&AG) assists this Committee through his Audit Reports and participation in the proceedings of the Committee. The Committee's reports are recommendatory in nature and are laid on the table of the Parliament/Legislature. The Audit Reports or PAC Reports thereon are seldom discussed or otherwise "taken note of" by the Parliament/Legislature as in the United Kingdom. Thus the whole exercise of accountability through the Constitutional mechanism of CAG's audit is rendered almost infructuous due to inaction by Parliament/Legislature and finally the Executive is left to act in a manner it thinks fit!

Broadly the C&AG's findings reveal the paucity of planning, slippages in the achievement of financial and physical targets, the inadequacy of monitoring procedures and the lack of accountability on the part of the Executive. Despite PAC's recommendations on specific remedial action, same lapses often continue continue to recur from year to year in many of the major projects and schemes and other governmental activities.

The problems of volume:

With the expansion of Government spending in several areas and outlays becoming very large, apart from the implementing agencies being varied, Parliamentary control has also become nebulous. The Comptroller and Auditor General produces several reports for the Central Government and many more for the State Governments. His position is unique in the sense that his is the only organization capable of looking at the expenditure of both at the Centre and in the States in a holistic manner. This enables him to produce All-India reviews of schemes and projects being implemented from Central funds by the States. It is another matter that the traceability of Central funds to ultimate destinations is highly diffused due to disharmony in the prevalent accounting system of the Centre and the States and direct transfers of Central funds to district and State level societies having poor accounting standards and compliance. For various reasons, Audit reports have grown both in volume and content. To handle such volumes the PAC now selects a few reviews and paragraphs from the Audit Reports for taking evidence in person and asks the Executive to furnish a written reply for the other points, within a certain time frame. Even these selected paragraphs are unfortunately not fully discussed due to lack of time and infrequent meetings of the Committee. The present system, which was adapted from the British Parliament model, is therefore no longer able to enforce accountability - not due to lack of knowledge or expertise but due to the volume it has to handle.

We have to now look for a different model within the existing Parliamentary framework. Before this can be discussed, let us look at some of the other issues which can be considered by the Audit Department to strengthen its own hands:

The excuses we hear:

---

[*] *The author is a former Deputy Comptroller & Auditor General of India*

Many of us, who have worked as Accountants General, experience different emotions after attending the Public Accounts Committee (PAC) meetings. While the Committee's approach and its conclusions are satisfying, it is often the Executive's attitude which leaves much to be desired.

Many a time we have heard one of the following submissions by the Executive:

1. Require some more time as he had assumed charge only recently and will get back to PAC early.
2. He is quite surprised that such a thing has happened, will initiate action immediately to set right things.
3. Disputes the facts and figures in the audit paragraph and quotes different set of facts and figures.
4. Acts as arbitrator between the PAC, AsG and the Departmental Head during discussions.
5. Chides the Departmental Head in front of PAC thus distancing the Ministry from all lapses.
6. Tries to either generalize the discussion to a larger socio-economic and governance context or expound the various good things achieved or under planning so as to trivialize the point raised by Audit

The whole approach, generally, is not to see the merits in the Audit paragraph and to find ways to address it, but to side step or dispute it. Audit would instead have expected the Executive to be more concerned about the irregularities brought out, as they are the custodians of Public funds! Instead Audit finds them making efforts to justify, trivialise or explain away the irregularities pointed out. One suggestion to address this problem could be to follow the UK PAC practice of allowing the general public to attend the PAC and making available its proceedings to the public. This would drive public opinion to make the Executive more accountable. In United Kingdom, the PAC's meetings are open to the public. The Committee meets twice a week (Mondays at 4.30 pm and on Wednesdays at 3.30 pm). When the Committee is being televised, a website link on interne enables public to watch proceedings in real time. Recording of previous Sessions is also avialble on Parliament website. The Parliamentary Recording Unit also supplies tape recordings of televised committee meetings on request. All these measures help disseminate Audit reports and the discussions thereon to the real stakeholders in a democratic setup, the people.

Further, in the House of Lords, debates may take place on a motion "That this House takes note of..." This formula enables the House to debate a situation or a document without coming to any positive decision and is regularly used for select committee reports. Motions to take note are also used when a minister wishes to put down a neutral motion. Such motions are usually agreed to.

In our case PAC proceedings are held in camera and all attending are warned not to mention anything said in the meeting outside.

What can Audit do?

Audit briefs the Chairman and the members of the Public Accounts Committee on the issues raised in the audit paragraph/review. Audit also assists them in questioning the Executive. Audit vets the written replies given by the Department to the PAC. However there are some areas of presentation of Audit report, which can be attempted

to provide more information to the PAC and the Executive. Some of them are as follows:

After the 'Prefatory Remarks at the beginning of the Audit Report and before the 'Overview', Audit can add one page, listing out the stages of progress of an inspection report in general to the final Audit paragraph stage. We should clearly state in the opening remarks that all material collected and commented are from the Governments records and based on the targets and milestones laid by the Government. Best practices wherever quoted should be from well recognized and published documents.

1. Date of issue of Inspection report/ time given for reply
2. Dates of Special letters, if any, written to the Head of the department/Secretary
3. Date of issue of draft paragraph/time given for reply.
4. Date of receipt of reply or discussion, if any.

This is just to give a general idea to all concerned about the various steps in audit process before a material becomes an audit paragraph and printed in the report.

The same format of information from the special letter / draft paragraph stage specific for each paragraph or review can be incorporated at the end of each paragraph or review through out the report. This will give a clear picture to all concerned about the time taken for replying to Audit and any further dispute on facts or figures would only indicate a casual approach to replying to Audit.

In addition, under each paragraph or review, we should indicate the total number of key documents sent to the executive on that particular paragraph or review. In the paragraph or review itself, we can put a star* to indicate the particular fact or figure, for which key documents have been sent to the Executive. Very often, the Executive would say that they are not aware from where the Audit had got the facts or figures. This procedure would put an end to this type of argument. In case the Executive had asked for additional information, this aspect can also be brought out suitably.
Audit as well as PAC would have often covered the same issues earlier and the PAC would have given some recommendations to avoid such situations in future. Executive on receipt of such directives from PAC, issues a circular to all concerned and it ends there. There is no follow up. We should advise the PAC that all circulars issued by the Government should be incorporated in the respective manuals of the Department and this fact should be incorporated in their action taken note to PAC, which can also be verified by Audit. In future, Audit will have a base to point out the violation of rules as per the Manuals to PAC. Thus the PAC recommendation will not go in vain.

We can add one or two pages at the end of a paragraph or review to incorporate similar lapses in the past, PAC recommendation on these lapses etc. The Compendium of PAC recommendations, compiled for Civil, Defence and Railways by Audit will help immensely in collecting this information. (Audit has been quoting such cases even now, but it should be a regular feature)

The common problems:

1. Non-production of records

There are frequent problems of non-production of records. This results in frustrating the effort of Audit to faithfully report to the Parliament /Legislature. The delay in production of records also affects the time span in reporting on any transaction. Over a period of time some important transaction or activity of the Executive can completely escape Audit scrutiny. It is essential not only to report on non-production of records but also its impact and implication to the financial health of the Government. Audit should start highlighting some cases, if not all, falling within the period of Audit coverage, in its report to Parliament/legislature, listing out records sought by Audit but not made available to it.

An institution like **Audit Information Commissioner with All-India jurisdiction, covering both the Centre and the States** only to deal with the delays and non-production of records could be considered. (As mentioned earlier C&AG's audit covers both Centre and the States) As he will have the powers to levy fines on individual officers, this could be an effective institution to ensure production of records on time**. He should not go into the merits of requisitioning of the records by Audit but only deal with the issues relating to non-production of the records. Under the C&AG's DPC Act, the C&AG is the sole authority to decide what records he needs to discharge his functions.**

2. Motivation!

Audit reports are product of long and exhausting toil both in the field and in the office. The persons who contribute to this mammoth effort do not get any recognition except a certificate or cash awards once in a while. It may also be mentioned in the annual assessment but open recognition is something all crave. Mentioning of the Audit team that prepared the reports is common in other countries. As a policy, the Audit Department does not reveal the names of team members who were involved in preparing a particular paragraph or review. The Department can also make a start in this direction. This will go a long way in giving satisfaction to the officers and staff that had put in their best. Indeed, this will also ensure greater attention from the members of the Audit team in improving the quality of the reports.

Some of these suggestions may result in increasing the size of already voluminous Audit Reports, but will go a long way in avoiding the usual contentious areas at the time of discussion in the PAC.

3. More reports, less meetings

Coming to the PAC, we have already seen how the volume of material produced by Audit has the reverse effect of non-accountability of the Executive. In UK, the PAC meets regularly twice a week on Mondays and Wednesdays during the Parliament sessions. Its meetings are open to public (subject to some restrictions) and the records of discussions are made available to all. Twice a year debate is held to "take note" of all the PAC reports that have been published and to which the Government has replied since the last debate. In the year 2006-07 the UK PAC held 60 meetings to discuss the Audit Reports and published 62 reports.

In India, the Members of Parliament and the Legislatures have to nurture large constituencies and travel long distances. In addition, the PAC also undertakes tours to various projects and schemes to have firsthand knowledge of the local conditions. All this cuts into the actual number of days the PAC can meet and discuss selected audit

paragraphs. During the years 2006-07 the C&AG submitted 12 Reports with 1606 paragraphs to the Parliament. The PAC discussed 25 paragraphs in its 30 meetings during the same period.

Is there an alternative?

We also have a mechanism of 'Standing Committees' for each Ministry/Department. They discuss the annual budget in detail and various other issues pertaining to that Ministry/Department. If the PAC can share their work with these Standing Committees, there can be more meaningful and fruitful discussions and recommendations. The Standing Committees can take up Ministry/Department specific paras and the PAC can take up paragraphs that cover general government-wide issues or those concerning more than one Department or Ministry. In the case of Defence and Railways, the PAC can pick up areas it would like to discuss and the Standing Committees could take up the balance. The C&AG is now in a position to provide necessary support to these Committees. At one time C&AG was asked for support to the Standing Committees but it was not agreed to due to lack of manpower for this purpose at that time.

If this is considered intrusion into the PAC working, the PAC can be extended by including the members from the Standing Committees, as sub-committee members. This will increase the number of sub-committees of the PAC and will provide a wider and in-depth coverage of Audit Reports. This may also be a value –addition to the Standing Committees when they discuss the individual department's budgets, policies etc. PAC can also consider calling the transferred or retired officials who had been in-charge of the Ministry/Department when the irregularity pointed out by the Audit occurred. They can also, in the case of Social sector programmes call, if necessary, the NGO's or other organistions to give out their views on the implementation of the programmes. In the case of aided bodies, the executives from these bodies can be called to give evidence on the implementation of the Government policy/programme. This would enhance the public involvement in the implementation of the Government's policy.

In the Centre and the States, creation of a separate PAC for "Revenues" would go a long way in minimizing the delays in discussing the reports. In addition smaller Committees to deal with some big departments from amongst the PAC members would also hasten the discussion in many cases.

One major area which gets neglected is the accounts of the Union and the States. The excesses and savings with reference to the budget allocation is to be regularized after scrutiny by the PAC. This has now become a routine exercise and rarely do we discuss the detailed reasons. The accounts indicate a wealth of information about the allocations, expenditure sector-wise, scheme- wise and how the Executive is able to implement on ground the policies and programmes of the Government. While approving the future budgets, the past expenditure trends would come in very handy. Similar would be the experience in revenue collection area. This is one area where more emphasis is required by the PAC.

Publicity

The media covers some aspect of the Audit reports. However the need to highlight not only the work of the Audit department but also to ensure executive accountability through wider publicity of the contents of Audit Reports is a need of the hour. One area which can be explored by the Audit Department is the use of the Lok Sabha TV channel to conduct periodical panel discussions involving the Government, members of PAC, well known personalities , NGO's and the public on selected Audit paragraphs/ reviews. The selection can be on the basis of discussions amongst Chairman PAC, C&AG and the Speaker. This would involve wider audience and could result in better response from the Executive.

The need of the hour:

The time has come to think of some out of the box solutions to ensure effective Parliamentary control over public finances. Any move to strengthen the hands of the Parliamentary Committee and the C&AG would be a step in the right direction, to ensure accountability of the Executive. As of now the only consolation for the Audit Department is that all political parties criticize audit when in power and quote audit reports when in opposition, to bolster their arguments! This only indicates that the oath undertaken by the Comptroller and Auditor General while taking over the office is fully met - to "duly and faithfully and to the best of my ability, knowledge and judgment perform the duties of my office without fear or favour, affection or ill-will and that I will uphold the Constitution and the laws".

CCO BASED AUDIT (CBA): A COMMENTARY

P.K. Tiwari[*]

Introduction

In a major policy development the Comptroller and Auditor General of India recently issued instructions for CCO based audit of the state governments. The audit essentially revolves around the Chief Controlling Officer (CCO) of a Department, usually a secretary or principal secretary, and the mandate the department or its CCO is expected to carry out. In doing so, the focus of the audit reporting has shifted from the Drawing and Disbursing Officer (DDO), which represents a microcosm of the government spending system to the CCO which represents the apex level of expenditure, usually represented by one or more grants of expenditure approved by the legislature. In the following paragraphs an attempt has been made to explain the main features of the CCO based audit and what it holds for the future in terms of the prospects and challenges.

Salient features of the CCO based audit

1. The focus of the audit should be on the Chief Controlling Officer. Thus the planning, organizing and reporting of the audit should be CCO centric and not DDO centric as at present.

2. The DDO will continue to remain the basic unit of audit, inasmuch as it corresponds with the basic unit of expenditure. The DDOs falling under a CCO will be selected in such a manner that they constitute a representative sample of the CCO and the audit findings will be generalized to present the overall picture of the CCO's functioning.

3. A wide gamut of areas of the department's functioning would be selected for review, from financial management to planning, coordination, project management, materials management, human resources management, internal controls and systems and vulnerability to fraud and corruption. The CAG's instructions lay down the broad parameters of evaluation on each of these areas.

4. The focus of reporting would shift to systems and processes as evidenced by the audit findings from the sample DDOs. The individual cases of material irregularities should continue to be reported as standalone paragraphs as is being done now.

5. The key difference in both the approaches will be in selecting the DDOs under a CCO according to a scientific sample design and reporting the findings accordingly.

---

[*] *P.K.Tiwari,, IA&AS is Executive Director, Pension Fund Regulatory and Development Authority*

6. For the departments that have multi layer structures, at state, district and block levels, the auditable units at each level would be enumerated in a stratified manner and sampling techniques applied to select the representative sample from each level.

7. In the conventional DDO based audit the focus is essentially on regularity and compliance issues, while the CCO based audit by its very nature will have a much wider focus and will include macro level issues of efficiency, economy and effectiveness.

8. A very modular form of reporting has been recommended. Each report will start with an overview of the department, its mandate, the number of DDOs/ auditable units, the number of units audited, the sampling procedure followed and the broad findings. This will be followed by specific findings under different heads (financial management, expenditure control, project management, human resource management, internal controls in the department etc.) illustrated by specific cases (akin to shortened version of draft paragraphs). If there are any autonomous bodies or PSUs under a department, a broad reference may be made relating to the expenditure audit (e.g., the equity contribution made to the PSU or the broad financial results of the PSUs with their impact on the functioning of the department during the year, etc) and the reader may be referred to the relevant chapter of the Audit Report where detailed audit findings relating to autonomous bodies and commercial undertakings are discussed. If any projects or schemes under the Department/CCO have been taken up for performance audit, a reference should be made to the appropriate section of the Audit Report where such performance audit has been discussed.

9. The reporting of the CCO based audit would be done under Chapter V, which was so far assigned to review on internal controls.

Why CCO based audit?

As per the CAG’s instructions note, there is considerable merit in the CCO based audit as a concept, inasmuch as it enables the Audit to form an opinion about the functioning of a Department/ CCO in all its aspects such as financial management, planning and programme management, internal controls, materials management etc. by designing a scientific sample size and basing the audit conclusion on the audit evidence gathered during such audit. One of the oft-repeated criticisms of the Audit in the past has been that the audit paragraphs give a very limited view of the functioning of a department, being in the nature of exception reporting, and therefore are of limited value for the higher management. The CCO based audit plugs this gap. Being based on a scientific selection of sample of DDOs, and a full scope audit on predetermined parameters, the CCO based audit has the potential of throwing up very important systemic findings with statistically valid conclusions about the different facets of a department’s functioning. Such an output will address the systemic issues that are important from the department’s perspective and silence the critics that audit findings are only exceptional in nature and therefore unimportant from a systemic point of view.

CBA: outcome of an evolutionary process

The earlier audit reports followed a predominantly paragraph based reporting, where each audit paragraph represented an individual case, pointing out regularity, propriety or compliance issues. A major development was the onset of performance auditing (PA). Performance auditing focused on the performance of schemes, programmes or projects undertaken by the governments or government owned entities. PA revolved around developing audit objectives and audit criteria to evaluate performance based on the objectives of the scheme, project or programme. The auditor works on the basis of a set of predetermined questionnaire that seeks to evaluate the performance on predetermined criteria.

The introduction of PA marked a major shift in the approach of the Indian Audit and Accounts Department (IAAD) in terms of audit methodology, scope and reporting. PA introduced extensive use of statistical sampling in designing and planning the audit which provided a scientific basis for drawing valid audit conclusions. Gradually, a significant part of the resources of the Audit department has come to be allocated to the performance audit. CBA is a step forward in the same direction. It has widened the scope of audit tremendously bringing in its fold all the major areas of a department's functioning (as distinct from the performance auditing where the focus is usually on one area e.g., programme management) as a part of one exercise. This enables the auditor to have a comprehensive view of the department's functioning and helps find answer to the questions such as how well the department is geared to carry out its mandate or how the department is carrying its mandate. CBA adds a very significant macro perspective to the audit process that has been lacking so far. It is a logical step forward in the direction charted by the performance audit.

Challenges

CBA presents several challenges. The author's experience as an accountant general shows that a majority in the field offices, deeply rooted in the regularity audit (the so called DP based output), is still not comfortable with the concepts of the performance audit. It is a common sight that many performance audit attempts end up being a motley group of paragraphs without a connecting theme or orientation. This is due to our penchant for DP type reporting, honed over decades to great effectiveness. There is also some amount of cynicism and the associated resistance to the performance auditing emanating from the fact that DPs are more effectively handled at the PAC stage, with greater degree of accountability and hence are perceived as furthering audit effectiveness. Notwithstanding, however, performance auditing has taken firm roots in the Audit department and its usefulness has started getting appreciated by all stakeholders, including a majority of the auditors.

In this backdrop, the CBA presents even bigger challenges. For one, what is being evaluated is not one programme, project or scheme, but the department as a whole. This implies that several complex issues have to be examined together, with significantly different auditing skills, and then put together into an organic whole for the purpose of reporting. Clearly, it requires a significantly higher level of reporting skills since the entire gamut of audit findings ranging from financial management to human resources management, materials management, programme management etc.,

coming out of a cross section of auditable units, have to be compiled into a readable, comprehensible and focused report. This will require training and practice.

Another issue will be the allocation of resources. With a vastly enlarged scope, CBA would require much greater resources than the conventional audit, and a greater degree of coordination. At this early stage, it is difficult to make a quantitative guess but it would be helpful if beginning is made with one or two departments a year and make an assessment of the resource requirement as we go along. What is important is that the audit teams are imparted a thorough grounding in the conceptual framework of the CBA so that their reporting does not get clouded by the DP type reporting, where the context requires too many details that may look out of place in the CBA framework.

Another challenge would be to develop in each office expertise in audit of specialized areas like financial management, human resources management, materials management, programme management etc. This will require a medium to long term plan.

Perhaps one of the major concerns in the way of CBA would be to dispel the notion that CBA would be at the expense of DP type audit. The CAG's instructions have done well to clarify that the switch over to the Department (CCO) based audit should in no way affect the DP type audit outputs. The instructions add that while the findings from the sampled DDOs under a CCO will be used to make general conclusions about the processes and systems, instances of significant and material irregularities under a DDO will continue to be processed as standalone paragraphs for Chapter 3 of the Audit Report, with suitable cross references in the chapter 5 featuring the CCO based audit. CBA will be featured in Chapter 5 of the Audit Report which has so far been devoted to reviews of internal controls in a selected department. In CBA, assessment of internal controls would be one of the several topics. Hence this chapter is expected to provide audit output that is much wider in scope than the conventional internal control review.

How to keep it simple and focused?

With the introduction of CBA, the audit reports are now in a position to present three distinct type of outputs: a DP type output that has a micro focus and orientation, a performance audit that relates to schemes, projects or programmes and has a relatively wider focus and scope, and now the CCO Based Audit that focuses on the whole gamut of activities undertaken by a department. Because of its wide scope, it is important to relate this audit to the mandate or mission of the department being audited. Asking simple questions like whether the department has been successful in delivering its mandate, whether the systems and procedures in place to deliver the department's mandate, and whether the department has the required level of preparedness to deliver its mandate would help the auditor to design the set of parameters required for a purposive and focused audit. It is extremely important to keep this fact in mind; else much of the benefits of this new initiative would be lost.

AUDITOR'S NOTEBOOK

DELHI HIGH COURT ON THE DPC ACT; THIRTEENTH FINANCE COMMISSION ON GOVERNMENT ACCOUNTS; AUDIT REPORTS AND ANNUAL REPORTS OF THE MINISTRIES; & NREGA, AUDIT AND PAC

Dharam Vir[*]

1. High Court of Delhi on the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971

The January 2010 judgment of The Hon'ble High Court of Delhi[♣] in National Dairy Development Board vs. the Comptroller and Auditor General of India is probably the first ever judicial pronouncement on the provisions of the Comptroller and Auditor General of India (Duties, Powers and Conditions of Service) Act, 1971 particularly those relating to the audit of autonomous bodies, Government companies and corporations and Government assisted bodies and authorities. Although the case was instituted by the NDDB in 1998 and the Court's decision has come after more than 11 years, during which the very subject matter of the case had lost much of its topicality, its importance as a landmark judgment is not diminished thereby.

The Sections of the DPC Act extensively discussed in the judgment are Sections 14(1), 14(2), 15(1) 15(2), 19(1), 19(2) and 20 and the interplay between these Sections. While discussing these Sections, the judgment makes copious references to the Regulations on Audit and Accounts, 2007, framed and notified by the CAG in the Gazette of India under Section 23 of the DPC Act.

Briefly, the matter before the Court related to the power of the CAG to audit all receipts and expenditure of the NDDB under Section 14(2) of the DPC Act as the aggregate amount of annual Government loans and/or grants received by the NDDB had touched the stipulated threshold of Rs. one crore and the requisite Presidential approval for CAG's audit had been granted. The NDDB had contested the CAG's audit jurisdiction on the ground that the NDDB Act, 1987 specifically prescribes audit of its accounts by auditors duly qualified to act as auditors of companies under the Companies Act and that the NDDB Act also stipulates that it had overriding effect on any other law which estopped the application of the DPC Act enacted much earlier in 1971.

The Court held that both the DPC Act and the NDDB Act are special laws and that the ordinary principle that a special law overrides a general law by virtue of the non obstante provision in the NDDB Act could not be invoked to oust the application of the DPC Act in the present case. Audit under the DPC Act has much wider objectives and scope as enunciated in the Regulations and comprises financial, compliance and performance audit. This goes far beyond the audit of accuracy of financial statements that is ordinarily conducted by the Chartered Accountants. In view of this audit by the Chartered Accountants under the NDDB Act does not preclude audit by the CAG if the prescribed conditions are otherwise satisfied.

---

[*] *Shri Dharam Vir is a former Deputy Comptroller & Auditor General of India*

[♣] *The text of judgment is available on the CAG's website http://www.cag.gov.in*

The Court also took cognizance of a significant difference in the nature of conditionalities attaching to CAG's audit jurisdiction under sub Section (1) and sub Section (2) of Section 14 of the DPC Act. While audit under sub Section (1) is "subject to the provisions of any law for the time being in force applicable to the body or authority", no similar qualification attaches to sub Section (2) which is "notwithstanding anything contained in sub-Section (1)". In view of this once the conditions prescribed in sub section (2) are satisfied the fact that a body or authority cannot be audited under sub Section (1) because of the "provisions of any law for the time being applicable to the body or the authority" is irrelevant. These are two independent provisions and the qualification prescribed in sub Section (1) cannot be imported into sub Section (2).

Likewise the provisions of Section 14(2) of the DPC Act are not affected by the provisions of Section 19(2) ibid. which regulates the audit jurisdiction of the CAG in relation to statutory corporations. CAG's power to audit the receipts and expenditure of a corporation under Section 14(2) is independent and irrespective of the audit provisions in the law by or under which the corporation might have been established. In other words, even if the law by or under which a corporation has been established prescribes audit of its accounts by any other authority, it will still be amenable to CAG's audit in the matters of its receipts and expenditure if the amount of grant and/or loan received by it in a year is not less than Rs. one crore and approval of the President/Governor has been obtained.

In making references to the Regulations on Audit and Accounts 2007 in its judgment the Court has in a way given judicial blessings and recognition to this important subordinate legislation. The judgment takes note of the distinctive features of CAG's audit as enunciated in the Regulations that goes beyond the mere scrutiny of financial accuracy of the financial statements and thereby places performance audit on a firm judicial footing as a part of CAG's remit under the DPC Act. These are welcome offshoots of the judgment.

The Court has also held that CAG's power to audit the receipts and expenditure of a substantially funded body or authority under Section 14(1) of the DPC Act is vulnerable or amenable to the law applicable to such a body or authority in view of the clause "subject to the provisions of any law for the time being in force applicable to the body or authority", and thereby the same can be curtailed or conditional or even prohibited. This needs to be properly understood. Obviously a law made by a State legislature cannot override the provisions of the DPC Act which is a Central law and must prevail over the State law by virtue of Article 251 of the Constitution. Thus the CAG's audit jurisdiction remains unaffected by any State law applicable to a body or authority. Even in the case of a Central law, the CAG's audit jurisdiction under 14(1) is not affected (i.e. curtailed, conditional or prohibited) unless so specifically stipulated in the Central law applicable to the authority or body. The mere provision in the Central law applicable to the body or authority for audit of its accounts by any other agency is no bar on the application of the DPC Act. The principle of 'co-existence' of two audits, one by the CAG and the other by another agency that may have been prescribed in the law applicable to the body or authority, has been accepted and stood the test of time ever since the DPC Act was enacted. This is also in line with the logic of the distinctive and more comprehensive nature of CAG's audit vis a

vis audit by any other agency that has *inter alia* been relied upon in the Court's judgment in upholding the application of the DPC Act to the NDDB

And there is also the over arching requirement of Section 13 of the DPC Act which is captioned as "general provisions relating to audit". Under the said Section it is the duty of the CAG to audit all expenditure and to ascertain whether 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. The CAG is also mandated to render a report to the legislature on the expenditure so audited. The services or purposes for which funds are voted by the legislature are prescribed in the budget documents and more specifically in the outcome budget that is designed to correlate financial outlays with outputs and outcomes. The mandate of ascertaining the application of Government moneys to the intended services or purposes and rendering a report to the legislature necessarily carries with it the power to audit the expenditure till its ultimate disbursement and application irrespective of the agency through which the disbursement has been made and the law applicable to it.

Hopefully, the issue will get placed beyond doubt with the enactment of revised audit law that is stated to be on the anvil. In order to remove any ambiguity the revised law may also explicitly prescribe CAG's powers to audit the assets and liabilities of Government although such powers are embedded in and automatically conferred by Article 151 of the Constitution which deals with the CAG's Audit Reports on the *accounts* of the Union and the States. The *accounts* of the Union and States necessarily include their respective assets and liabilities thereby carrying the authority of the CAG for their audit.

2. Thirteenth Finance Commission on Government Accounts

The Thirteenth Finance Commission (TFC) has deprecated the practice prevailing in some of the States of diverting public expenditure from the budget to nominated funds which are operated outside the authority of the legislature. In one State four such funds are reported to have been created outside the budget to which significant amounts of budgetary provisions have been transferred. The expenditure incurred through such arrangement not only bypasses the oversight of the legislature but also the audit of the CAG. Reminds one of the famous picturesque phrase "fraud on the Constitution" used by the first post-independence CAG Shri Narhari Rao in his statement before a PAC sub-Committee on Exchequer Control over Public Expenditure in December 1952 in the context of creation of Government companies through executive orders and with no statutory provision for their audit by the CAG.

The TFC has recommended addition of a separate annexure to the Finance Accounts containing the details of amounts transferred from the Consolidated Fund to the Public Account and vice versa. This will no doubt enhance the transparency of accounts. Transfer of budgetary provisions to the Public Account is nothing but virtual expenditure. The effect of such transfers should also be reflected in the Appropriation Accounts. Additionally, the amounts parked outside the Government, say for example with the public sector enterprises or lying undisbursed with the implementing agencies should also be similarly disclosed.

The TFC has flagged the issue of classification of expenditure by way of grants-in-aid intended for meeting expenditure of a capital nature by the grantee by referring to the exhibition of expenditure on the National Rural Employment Guarantee Scheme as capital expenditure in one State. The TFC Report also mentions that in several States local body grants are being classified as capital expenditure. The issue of classification of grants intended for creation of asset by the transferee is indeed a tricky one, since the ownership of the assets so created which is critically relevant to the classification of such expenditure as capital expenditure does not vest in the transferor. A Government of India Expert Group under the Chairmanship of Dr. Ashok Lahiri to Review the Classification System for Government Transactions (2004) had recommended the classification of such grants as Capital Grants in the Revenue Section of the books of the transferor[1]. Also, although an enabling provision in the General Financial Rules permits classification of expenditure on account of grants-in-aid as capital expenditure on the advice of the CAG, this does not seem to have been significantly invoked. According to the TFC there are several examples, globally, in this connection. In some cases, grants to finance capital expenditure are classified as 'capital spending' by both the disbursing and recipient entities. In some cases such transfers are classified as capital receipts by the recipient entity only. In view of the increasing role being assigned to non-departmental agencies for implementation of flagship schemes of Government to which amounts are directly transferred there is urgent need to address the issue.[*] A recent amendment to the Delegation of Financial rules requires the exhibition of grants-in-aid intended for capital expenditure under a separate head. Nevertheless there is need to address the matter in a more comprehensive manner to cover cases of Union transfers to states intended for capital expenditure.

In addition to the Statements currently appended to the State Finance Accounts, the TFC has recommended the inclusion of a separate statement of Maintenance Expenditure. The TFC has also recommended that the existing Statement of Subsidies should include the expenditure in the nature of subsidies but classified as 'other expenditure' or as 'grant-in-aid' in accounts to reflect the true amount of subsidies. In regard to the Statement of Salaries, the TFC has recommended that the amounts paid as assistance to autonomous organizations and local bodies for meeting their expenditure on salaries should be separately disclosed by way of an additional statement to be appended to the Finance Accounts. These are welcome recommendations and will enhance the transparency of Government accounts as well as their usefulness for analysis and policy making.

---

[1] *Government of India has recently constituted a 18 member high level committee on Management of Public Expenditure headed by Dr. C. Rangarajan to suggest measures for efficient management of public expenditure. One of the terms of reference of the Committee relates to examination of classification of expenditure into Revenue and Capital in the context of constitutional provisions and requirements under the Fiscal Responsibility Acts, the committee is to suggest measures to address the inconsistencies in our current system of classification so as to ensure rational and efficient public expenditure management. In this context, the Committee should consider the merit of classifying expenditure as revenue or capital depending on the end use.*

[*] *Union Budget 2010-11 envisages direct transfer of Central Plan Assistance amounting to Rs. 107552 crore to State/district level autonomous bodies/implementing agencies, but only a small amount of Rs. 663 crore to be transferred by the Ministry of Commerce and Industry has been exhibited under 'capital'.*

The TFC has recommended inclusion of a supplement in the State budget documents showing the details of plan and non-plan transfers to each category of urban local bodies and each tier of Panchayati Raj Institutions from major head to object head. This supplement should also incorporate details of funds transferred directly to the local bodies outside the State budget. The supplement should aim to capture details of spatial distribution of transfers – at least up to the district level. Parallel to this, the Finance Accounts should include a separate statement showing the details of plan and non- plan transfers separately for each category of urban local bodies and each tier of Panchayati Raj Institutions classified up to the object level. Although the TFC has recommended that this should be implemented from 31 March 2012, this is bound to be an uphill task. Also, to be really meaningful and useful the statement to be included in the Finance Accounts should also disclose details of amounts actually spent against the amounts released to the urban local bodies and Panchayati Raj Institutions.

Further, large amounts of central assistance are also directly transferred to other State-level agencies like the District Primary Education Societies[10]. These amounts should also be reflected in the State budgets and accounts in order to fully capture the spatial distribution of Government interventions.

The TFC has referred to the accumulation of large cash balances with some of the States. Cash management in the State Governments may be a fruitful subject for in-depth audit to examine whether systems and procedures are in place and implemented for dynamic forecasting of cash requirement, raising of additional cash at the right time, right rate and in right quantities and investment of any surplus cash balance to the most beneficial advantage to the State.

3. Audit Reports and Annual Reports of the Ministries

The Annual Report of the Ministry of Finance for the year 2008-09 carries a summary of important audit observations on the working of the Ministry in the Audit Reports for 2007-08. While in respect of expenditure audit paragraphs, only a gist of the audit observations has been provided without mentioning the Ministry's response, the Report includes the Ministry's response to paragraphs relating to direct and indirect taxes. A study of the response shows as follows.

- In several cases action is stated to be 'underway';
- In a number of cases the Annual Report merely states that the audit observation has been accepted by the Ministry but there is no indication of the remedial and corrective action taken including recovery of amounts from the assessees; these cases involve large amounts of underassessment and consequent loss of revenue to Government;
- In some cases it has been averred that the replies will be given by the lower formations like the Commissioners of Income Tax; thereby the Ministry would

[10] *According to the Union Budget 2010-2011 out of the total provision of Rs. 136555 crore on account of Central assistance for Central and Centrally Sponsored Schemes an amount of Rs. 29003 will be remitted to the State Governments and the remaining amount of Rs.197552 crore (nearly 79 per cent) will be released directly to the State and district level implementing agencies*

appear to have absolved itself of any responsibility for ensuring compliance with the tax laws. These cases also involve large amounts of underassessment and consequent loss of revenue to Government; according to the Audit Report in one of these cases, mistakes relating to Rs. 2037.22 crore and revenue impact of Rs.932.29 crore had been detected;

- In some cases it has been stated that the Ministry's response to audit observations had already been furnished to CAG, without specifying the response and whether the same had been accepted by audit. According to the Audit Report the Ministry had merely promised to 'look into the matter'; thus the final position of the Ministry remains unknown;

- In some cases the replies are merely interim in nature; the Ministry's response is under preparation and 'is being forwarded to audit shortly' or 'the present position of the cases is being ascertained from the field formations';

- There is no mention in any case whether similar other cases have been reviewed and remedial and corrective action has been taken; this is important since many times the under-assessments are on account of the erroneous application/interpretation of tax laws;

- In a majority of cases no indication is available whether the underlying systemic deficiencies have been identified and addressed;

- There is no mention in respect of any case regarding the action taken to fix responsibility on the individual(s) responsible for the loss, failure, infructuous expenditure etc. and the likely time frame within which such action is expected to be completed;

- According to the Audit Report the Ministry had accepted the audit position in cases involving Rs. 665 crore, against which only Rs. 44 crore had been recovered. No information is available in the Ministry's Annual Report regarding recovery of the remaining amount.

- The Ministry's response is confined to audit paragraphs that had featured in the Audit Reports presented during 2007-08. There is no mention regarding action taken on the previous years' cases which numbered as many as 1979.

- Some parts of the Annual Report read like office notes extracted from the file(s) of the Ministry.

The practice of including the executive response and action on Audit Reports in the Annual Reports of the Ministry is in consequence of one of the suggestions made by the then Prime Minister Shri Atal Bihari Vajpayee in his inaugural addresses on the occasions of the XXI and XXII Conferences of Accountants Generals in 2001 and 2003. Recognizing the constraints and limitations of the PAC/COPU system to pursue all paragraphs of Audit Reports because of the sheer volume of audit output and consequential system overload, the Prime Minister had observed as follows in his inaugural address in 2003:

"I am aware that a lot of good work done by the CAG is still awaiting examination by the Legislative Committees. Inadequate follow-up action on audit reports presented to Parliament and State legislatures is a matter of concern. I have been the Chairman of the Public Accounts Committee and I know that the task before the Public Accounts Committee and the Committee on Public Undertakings is a difficult one….

"It is heartening that the Audit Reports are now engaging wider public attention…..Administrative Departments of the Government should now come a step forward and append major audit findings and **action taken** thereon to their Administrative Reports….This would further deepen the accountability process by informing the silent, yet the most powerful stakeholders of Government and enhance transparency."

The action taken reported by the Ministry of Finance falls far short of the requirements of Action Taken Note as prescribed by Government in accordance with the directions of the PAC. It is incapable of providing sufficient assurance that the concerns expressed in the Audit Reports have been adequately addressed.

A study of the available Annual Reports of some of the important other Ministries also shows that the Ministries merely mention the gist of audit paragraphs relating to the Audit Reports tabled during the year and generally no indication is available on the action taken in the cases mentioned therein as was intended in the Prime Minister's address ibid. The Ministries' Annual Reports do not provide any information on the pending audit paragraphs of the previous years.

It is indeed indicative of the limitations of placing reliance on the Ministries' Annual Reports for completing the accountability cycle that begins with the authorization by the legislature and must find final closure in the executive being held accountable.

There is apparently no mechanism by which the further action can be monitored and put in the public domain where only interim action/status has been stated in the Ministry's Annual Report.

Incidentally, such reports of mere interim action/status relating to the Audit Reports presented in the preceding year are inexplicable. First, the audit reports are written in a highly transparent and participatory manner that provides ample opportunity to the executive to take remedial and corrective action on the concerns expressed in the audit paragraph. Second, a copy of the finalized audit paragraph is invariably sent to the Departmental Secretary well before the Audit Report is printed and presented to the legislature; this provides additional time for initiating remedial and corrective action. Third, the Ministries' Annual Reports are required to disclose the action taken on the Audit Reports prepared in the preceding year. For example, one of the cases in which action is reported to be under way as per the Annual Report of the Ministry of Finance had been referred to the Ministry in 2007.

The primary purpose of the advice of the Prime Minister ibid. was to ensure that the Ministries do take adequate action on the Audit Reports and address the concerns expressed by audit and disclose the action taken to the stakeholders thereby promoting accountability as well as transparency in administration. This does not seem to have been served.

It is also doubtful if the Ministries' Annual Reports can serve as an effective and purposeful vehicle of reporting action taken on the Audit Reports since the same is

likely to be overshadowed and overwhelmed by other matters included in the Annual Reports. At the best of times these can be regarded as something being better than nothing.

There is also a nagging sense of unease at linking the disclosure of the action taken on the audit paragraphs with the Ministries' Annual Reports which may be delayed.

Incidentally, there no mention of the Action taken on Audit Reports on Receipt Audit in the Finance Ministry's Annual Report for 2009-10.

4. NREGA, Audit Report and the PAC

There is a remarkable similarity in the recommendations made by audit in the Performance Audit Report on the Implementation of the National Rural Employment Guarantee Act (since rechristened after Mahatma Gandhi as MNREGA) and those made by the Committee on Public Accounts (PAC) in its Eighth Report (Fifteenth Lok Sabha) which followed up the Audit Report. Such similarity is noticed not merely in regard to the thrust of the recommendations but also in precise wording in several cases.

The request for performance audit had come from the Ministry of Rural Development and the Audit Report which covered the period from February 2006 to March 2007 and ranged over 68 districts all over the country had been prepared in a highly participatory manner. The Ministry not merely sent its response to the draft report along with the comments of the State Governments but also made a presentation to audit highlighting its concerns relating to issues raised in the draft report. Audit revisited some of the sampled units for verification of improvements to cure the deficiencies in the maintenance of records noticed during original audit. The Audit Report is dated October 2008; the PAC took the evidence of the Ministry in November 2009 and presented its report in March 2010.

The similarity between the recommendations contained in the Audit Report and those made by PAC is at once a tribute to the high quality of audit with its positive approach of in-built recommendations for systemic and other improvements for programme delivery and also indicative of the unity of approach and direction of audit and the PAC. However, the PAC Report also raises some interesting issues.

Under the scheme each State Government was required to designate a Commissioner (or higher) level officer for ensuring that all the activities related to the objectives of the Act were carried out as intended. Although the Rules of Procedure and Conduct of Business of the Lok Sabha authorize the Central PAC to summon the State Government functionaries for evidence with the approval of the Speaker, the PAC did not exercise this option and finalized its Report with reference to the evidence of the Union Government functionaries and the information supplied by them. The PAC Report (and the Audit Report) contains exhortations to the State Governments for ensuring effective implementation of the prescribed instructions for better delivery. The PAC report also recommends punitive action against officials responsible for non-payment or delayed payment of wages but the question is how the action on Central PAC's recommendations which lies with the State Governments will be followed up and monitored.

The evidence of the State Government functionaries on the Central Schemes can also provide an opportunity for an assessment of the response of the State Governments to the concerns expressed in the Audit Report and the effect of the remedial and corrective action taken by them. In the instant case an assessment of the impact of action taken by the State Governments between December 2007 (when the draft Audit Report was issued) and November 2009 (when the PAC took evidence) could have been reassuring.

This assumes added importance since the State PACs are heavily in arrears and it may be quite some time before the subject is taken up by the State PACs. In the circumstances both accountability and follow up action might get delayed and diluted.

As a matter of fact the very configuration of the scheme is tilted in favour of diffusion and dilution of accountability. The State level Commissioner has been made responsible for ensuring that all activities are carried out as intended, but the Central funds, which constitute the overwhelming component of resources, are not routed through him and in stead sent direct to the districts and held by the District Project Coordinator. The District Project Coordinator releases funds to the Project Officer who in turns releases the same to the Gram Panchayats where the actual disbursement and spending take place. Releases to the Gram Panchayats are made on the basis of a statement of work-wise expenditure and the report of the Vigilance and Monitoring Committee approved by the Gram Sabha. Although a multiplicity of agencies are envisaged for monitoring the scheme, there is no system of effective enforcement of accountability. Nor has the Union Government Secretary who is the Chief Accounting Authority of the Ministry and responsible for the efficient economic and effective use of its budget any command or control over the State level Commissioner.

The PAC has expressed concern at the quality of assets created under the scheme which are by and large very sub-standard, non-durable and non-productive. This is indeed a significant value addition by the PAC. Additionally, concern has also been expressed at the large number of works remaining incomplete at the end of the year with only 39 per cent of the works taken up between February 2006 and September 2009 having been completed. A massive amount of nearly Rs. 70,000 crore is reported to have been spent so far. Unless this results in creation of durable and productive assets, the scheme will remain what the other schemes of direct attack on poverty like the Integrated Rural Development Programme and the National Rural Employment Programme had eventually become despite huge outlays, namely merely an income transfer programme with no sustained reduction of rural poverty. The Keynesian prescription of the State paying people for digging holes and filling them is the last thing the Indian economy can afford on a long term basis.

BOOK REVIEW:

From Government to Governance: A Brief Survey of the Indian Experience

Prof. Kuldeep Mathur, National Book Trust, New Delhi, 2008, ppviii+143, Rs.200.00 (hard bound), Rs.45.00 (paper back)

"From Government to Governance" by Prof. Kuldeep Mathur is a highly synoptic overview of the changes in the system of 'governance' in post-independent India. The term 'governance' is now well entrenched in the lexicon of public policy discourse. It is used not only in the context of Public Administration (role of 3 tier governments and all public institutions in economic and social spheres) but also in discussing 'Corporate Governance'. Governments and corporate are to be judged for 'Good Governance' for which the standards are being constantly improvised. The author traces the origin of this term crediting it to the World Bank Report on Sub-Saharan Africa in 1989 and details its implications at length.

2. With remarkable insight, the author dwells upon the elements of governance systems: Cabinet, Parliament, Judiciary, CAG, CVC, community participation and oversight, RTI Act, Media and Civil Society at large. He begins with surveying the evolution of Cabinet system of Government of India, commenting in the process on aspects like collective responsibility, role and authority of the Prime Minister's office issue-based bipartisan consensus, ascendancy of regional political parties and its impact on Cabinet system. With equal sweep and comfort, the author outlines the changes taking place in the parliamentary practices, the role of MPs in the House proceedings, the Parliamentary Committees and the research support to the Members of Parliament. He then sets out to review developments in the judiciary and discusses the emergence of judicial activism as an important input in governance. The developments in bureaucracy are broadly traced using the idioms of steel frame, adherence to the Weberian doctrine, 'committed civil service' with observations on the trend from professionalism to loyalty. He dwells upon some of the recommendations of the first Administrative Reforms Commission, which had the potential to radically alter the character of civil services but were not accepted.

3. The author then dwells upon the functioning of CAG, CVC & CBI curiously under the chapter titled "Corruption – Institutions of accountability". It is a reflection of popular view clouding academic correctness, that the author has bracketed CAG, CVC & CBI together and introduced the three Institutions as those established to hold public agencies accountable for their acts. This is a grave injustice to the Institution of CAG whose mandate is wider than corruption. Actually, the primary objective of CAG is to target maladministration by looking into the three Es: Economy, Efficiency, and Effectiveness of public expenditure. In the Audit parlance, it is usual to say that detection of fraud is an incident rather than object of audit. When it comes to actual detection of corruption, the audit reports merely provide pointers, not judicially admissible evidence. Nothing else can be expected from a record-based audit, as significant corrupt practices are usually off-the-record. It is only the relatively small fry that gets caught based on inconsistencies in the records.

4. After giving a bird's eyeview of the various organs of State, the author turns the spotlight on the civil society outside formal structure of State and provides us an interesting synthesis of isolated incidents that are happening here and there, which are increasingly making the public Institute more sensitive to the voice of civil society. He gives a somewhat detailed account of how the Right to Information Act is changing the governance paradigm, how NGOs are helping carry out the government functions particularly in education, health and social welfare. A notable omission here is a discussion on the formal Public-Private Partnership in the physical infrastructure sector and the role of regulatory bodies, where much more formalised and institutionalised changes in the Government – Citizen interface have taken place and, which are ushering a new paradigm of provision of public services.

5. Overall, this book is a valuable contribution to the field of public administration. It is and eminently one-stretch reading book written in a simple but remarkably candid narrative style, where deep academic insights are peppered with anecdotal evidence. All those interested in how we can take India forward would be benefited from the lucid presentation of the governance system in India. Everywhere the reader is left with enough curiosity to explore more.

DOCUMENTS:

Explanatory Memorandum as to the Action Taken on the recommendations made by the Thirteenth Finance Commission in its report submitted to the President on December 30, 2009 (Placed in Parliament on 25th February 2010)

1. The Thirteenth Finance Commission (hereafter referred to as the Commission) was constituted by the President on November 13, 2007 to give recommendations on specified aspects of Centre State fiscal relations during 2010-15. The Commission submitted its report to the President on December 30, 2009 covering all aspects of its mandate.

2. The report of the Commission (hereafter referred to as the Report) covering the five year period commencing from April 1, 2010, together with this Explanatory Memorandum on the action taken on the recommendations of the Commission is being laid on the Table of the House, in pursuance of Article 281 of the Constitution. Summary of the main recommendations of the Commission relating to the sharing of net proceeds of Union taxes between Centre and States, grants-in-aid of revenue of States under Article 275, Goods and Services Tax (GST), financing of relief expenditure and roadmap for fiscal consolidation are contained in Chapter 1 of the Report of the Commission.

3. The Government has carefully examined the main recommendations of the Commission. The action to be taken on these recommendations is detailed below:

Sharing of Union Taxes

4. The Commission has recommended that for its award period, the share of States in the net proceeds of Union taxes may be fixed at 32%. The Commission has also recommended on the inter-se distribution of the States' share amongst the States. The details of the formula for inter -se distribution and the corresponding share of each State recommended by the Commission are indicated in Chapter 8 of the Report. It has also recommended that the total transfers to the States on the revenue account be subjected to an indicative ceiling of 39.5% of the gross tax revenues of the Centre.

The Government has accepted the above recommendations of the Commission.

Grants -in-Aid of Revenues of States under Article 275 of the Constitution

5. The Commission has recommended grants-in-aid of revenues of States for non plan revenue deficit, elementary education, environment related issues, improving outcomes, maintenance of roads and bridges, local bodies, disaster relief, GST implementation and state specific grants under Article 275 of the Constitution.

Non Plan Revenue Deficit Grant

6. The Commission has assessed the revenues and expenditure of the States for the period 2010-15 and has projected the deficit for each State after taking into account the amount of share in Central taxes for that State. The Commission has

recommended a grant of Rs. 51800 crore to meet this deficit for eight States. The amount of grant recommended for each state year-wise is indicated in Chapter 12 of the Report. The Commission has also recommended a performance incentive grant of Rs. 1500 crore for three special category States of Assam, Sikkim and Uttarakhand that have graduated out of Non Plan Revenue Deficit. The details of this grant are indicated in Chapter 12 of the Report.

The Government has accepted this recommendation .

Grant for Elementary Education

7. The Commission has assessed the requirement of providing elementary education for each State based on the Sarva Shiksha Abhiyan norms and recommended to provide a grant of Rs. 24068 crore equivalent to 15% of the assessed requirement. The year -wise allocation for each State and the conditionality for release of this grant are given in Chapter 12 of the Report.

The Government has accepted this recommendation.

Environment Related Grants

8. The Commission has recommended three grants under this category of Rs. 5000 crore each aggregating to Rs. 15000 crore. The first grant of each of these Rs. 5000 crore grants is forest grant, the second is for promotion for renewable energy and the third is for water sector. The year-wise allocation for each State and the conditionalities for forest and water sector grants are indicated in Chapter 12 of the Report. The eligibility of each State for the grant for renewable energy is to be decided, as indicated in Chapter 12 of the Report, based on the achievement of each state on this front in the first four years of the award period.

The Government has accepted these recommendations.

Grants for Improving Outcomes

9. The Commission has recommended six grants under this category aggregating to Rs.14446 crore over the award period. An incentive grant for reduction in infant mortality of Rs. 5000 crore is to be released to States starting 2012-13 depending on the reduction in Infant Mortality Rate (IMR) achieved by the States with reference to the baseline level of 2009-10 figures. Grant of Rs. 5000 crore for improved delivery of justice has been recommended for Lok Adalats and Legal Aid, Alternate Dispute Resolution Centres, Heritage Court Buildings, State Judicial Academy and training of judicial officers and public prosecutors. The grant for Unique Identification (UID) programme amounting to Rs. 2989.10 crore is to be released based on the number of people covered under the UID database. Two grants of Rs. 616 crore each have been recommended for District Innovation Funds and improving statistical systems at district and State levels. Finally, a grant of Rs. 225 crore has been recommended for setting up database of employees and pensioners.

The Government has accepted these recommendations.

Grants for maintenance of Roads and Bridges

10. The Commission has assessed the requirement of ordinary repairs of roads in a State and has recommended grant of Rs.19930 crore equivalent to 90% of the assessed requirement for PMGSY roads and 50% of the assessed requirement for other roads, for four years of the award period starting 2011-12. The allocation for

each year for each State and the conditionality for this grant are indicated in Chapter 12 of the Report.

The Government has accepted these recommendations.

State Specific grants

11. The Commission has recommended grants aggregating to Rs. 27945 crore for various state specific needs of the States. The details of these grants for each item of grant for each State are indicated in Chapter 12 of the report.

The Government has accepted these recommendations.

12. For monitoring and implementation of all the above grants at the State level, the Commission has recommended setting up a monitoring committee under the chairmanship of the Chief Secretary of the State. In addition to the grants mentioned above, the Commission has recommended grants for GST implementation, local bodies and disaster relief which, alongwith the other recommendations relating to these areas, are explained below:

Goods and Services Tax

13. The Commission has recommended a model GST structure that includes features such as single rate, zero rating of exports, inclusion of various indirect taxes at the Central and State level in GST ambit, major rationalisation of the exemption structure, etc. The Commission has recommended a grant of Rs. 50000 crore for implementation of GST as per the recommended model. This grant is to be disbursed initially in the form of compensation for loss due to implementation of GST and residual amount to be distributed amongst States in the terminal year of the award period as per the devolution formula. It has also recommended administrative structure for implementation and monitoring of this grant.

The Government has accepted these recommendations in principle. However, in view of the ongoing discussions between Centre and States on this aspect, implementation of these recommendations alogwith modalities may await the outcome of the discussions.

Local Bodies

14. The Commission has recommended a basic grant and a performance grant for local bodies. Both these grants in any year have been quantified based on a percentage of the divisible pool of the preceding year. For every year of the award period, the Commission has recommended a basic grant amounting to 1.5% of the size of divisible pool in the preceding year. Similarly, for 2011-12 the Commission has recommended a performance grant of 0.5% of the divisible pool of the preceding year and for subsequent years in the award period, 1% of the divisible pool of the preceding year.

15. It has also recommended a separate special area basic grant of Rs. 20 per capita, carved out of the total basic grant, for every year in the award period for Schedule V and Schedule VI areas and areas excluded from Part IX and IXA of the Constitution. For these areas, it has recommended a special area performance grant of Rs. 10 per capita for 2011-12 and Rs. 20 per capita for subsequent years of the award period.

16. The performance grants are to be released if the States meet conditions specified by the Commission in Chapter 10 of the Report.

17. As per the revenue projections of the Commission, total grant recommended for the local bodies aggregates to Rs.87519 crore over the award period. The Commission has also recommended distribution of the grants between urban and rural areas and the inter-se distribution between States. The formula and the inter-se shares are indicated in Chapter 10 of the Report.

The Government has accepted these recommendations.

Disaster Relief

18. The Commission has reviewed the existing arrangement of financing relief expenditure in light of the Disaster Management Act, 2005 and has recommended merger of the National Calamity Contingency Fund (NCCF) into National Disaster Response Fund (NDRF) and merger of Calamity Relief Funds (CRF) into State Disaster Response Fund (SDRF) with effect from 01.04.2010 and transfer of the balances in the existing funds into the new funds.

19. The Commission has assessed the relief expenditure requirements of all States and recommended that 75% of the SDRF requirement for general category states and 90% for special category states be met by the Centre through a grant to the States. It has also recommended a grant of Rs. 525 crore for capacity building. Overall, to meet the Central share of SDRF and for capacity building, the Commission has recommended a grant of Rs.26373 crore. It has mandated all states to follow the required accounting practices to properly account for relief expenditure.

The Government has accepted these recommendations.

Fiscal Roadmap

20. The Commission has assessed the finances of the Union and States and specified a combined debt target of 68% of Gross Domestic Product (GDP) to be met by 2014-15. It has worked out a roadmap for Fiscal Deficit (FD) and Revenue Deficit (RD) for the award period. For Centre, it has recommended RD to be eliminated and FD to be brought down to 3% of GDP by 2013-14. For States, the Commission has worked out fiscal roadmap for each State depending on its current deficit and debt levels. The States are required to eliminate RD and achieve FD of 3% of their respective Gross State Domestic Product (GSDP) during the Commission's award period in stages, in a manner that all the States would eliminate RD and achieve FD of 3% of GSDP latest by 2014-15. The Commission has also recommended that the borrowing limits of the States should be fixed by the Centre in line with these targets.

The Government has accepted these recommendations in principle. Detailed proposals for amendment of the FRBM Act, as may be necessary, will be taken up separately.

Debt Relief to States

21. The Commission has recommended two debt relief measures to be extended to all States. Firstly, it has recommended that the interest rates on loans from National Small Savings Fund (NSSF) to States contracted till the end of 2006-07 and outstanding as at the end of 2009-10 be reset at interest rate of 9%. The implication of this relief during the award period is estimated by the Commission to be Rs.13517 crore. The financial implication over the entire period till the maturity of the last loan covered in this relief measure is estimated to be Rs. 28360 crore. The Commission has

also recommended that structural reforms should be brought in the NSSF to make it more market linked.

22. The second debt relief recommended by the Commission is write-off of Central loans to States that are administered by central ministries other than Ministry of Finance outstanding as at the end of 2009-10. The amount of loans outstanding as at the end of 2007-08 was Rs. 4506 crore as noted by the Commission. The Commission has also recommended that any further loans under Centrally Sponsored Schemes should be completely avoided.

23. The Commission has also recommended extension of the debt consolidation facility recommended by the Twelfth Finance Commission to States that have not yet availed this benefit.

24. All the above mentioned debt relief is available to States only if they amend/legislate FRBM Acts in accordance with the recommendations of the Commission. The Commission has also recommended that the States will be eligible for the state specific grants only if they comply with this condition.

With regard to the recommendation relating to interest rate reset on NSSF loans to the States, **the Government has accepted it in principle.** However, since the recommendations are comprehensive and cover other structural aspects like interest rate mismatch, tenor mismatch and other administrative matters, Ministry of Finance will constitute a Committee to work out detailed modalities for implementation of this recommendation.

With regard to write-off of the Central loans to States, extension of the debt consolidation scheme recommended by the Twelfth Finance Commission to States that did not avail the benefit till now, and the conditions laid down by the Commission for availing these benefits, **the Government has accepted the recommendations of the Commission.**

With regard to completely avoiding central loans to states in the future, **action will be taken in consultation with the respective ministries**.

Other Recommendations

25. In addition to the above, the Commission has made other recommendations that deal with issues including revenue and expenditure reforms at Central and State levels, accounting and budgeting reforms, additional disclosures by the Centre, State and local bodies, etc.

These recommendations will be examined in due course.

Implementation

26. Orders on the recommendations under Articles 270 and 275(1) of the Constitution relating to share in Union taxes and duties and grants-in-aid, respectively, will be issued after obtaining the approval of the President. The recommendations relating to reorganisation of Funds for disaster relief, debt relief to States and borrowing ceilings will be implemented by executive orders. Other recommendations of the Commission will be acted upon in due course.

INSTITUTE OF PUBLIC AUDITORS OF INDIA

223, 2nd Floor, 'C' Wing, AGCR Building, I.P. Estate, New Delhi-11002
Ph.: 91-011-23702330, 23702290, 23454326, 23454126; Fax: 91-011-23702295
E-mail: ipai@bol.net.in
Website: www.ipaiindia.org

PATRON
SHRI VINOD RAI
Comptroller & Auditor General of India

CENTRAL COUNCIL
(2009-2012)

President

Vijay Kumar	Former Deputy Comptroller and Auditor General-cum-Chairman, Audit Board

Vice-President

T. Sethumadhavan	Former Budget Advisor, Govt. of Bahrain

Treasurer

P.K. Verma	Director, 13th Finance Commission, Ministry of Finance

Members

J.N. Gupta	Additional Deputy Comptroller & Auditor General, office of the CAG of India
S.K.F. Kujur	Former Chairman, Jharkhand State Electricity Regulatory Commission
R.S. Rangarajan	Director General (AEC), office of the CAG of India
S.K. Bahri	Director General, International Centre for Information Systems & Audit
S.B. Pillay	Director General, National Academy of Audit and Accounts, Shimla
Anita Pattanayk	Pr. Accountant General (Audit), Maharashtra
D.J. Bhadra	Pr. Accountant General (Audit), Jammu & Kashmir
V. Prakasa Rao	Former Accountant General
James K. Joseph	Former Accountant General
Madanjit Singh	Sr. Audit Officer