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Valedictory Address at

National Seminar
on
Good Governance: Accounting Reforms

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National Academy of Audit & Accounts,
Shimla

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Introduction

1. It is a privilege to deliver the valedictory address for this National Seminar on "Good Governance: Accounting Reforms" to such an eminent audience.

2. Before I proceed, I would like to take this opportunity to thank Shri Vinod Rai, our distinguished C&AG and the Accountants General of all the States for the valuable support they have provided to the Finance Commission over the past year. The insightful presentations made by the AGs to the Commission on the finances of their respective States have been valuable for the analysis of state government finances we undertake prior to visiting each State. AGs (Audit) of all the 28 States have made the journey to the Commission and given us the benefit of their analysis. Their presentations to us have been uniformly outstanding. I am grateful to the C&AG for proactively supporting this important process.

The Economy

3. We are meeting at a time when the world economy is going through an unprecedented crisis which started in the financial sector in the US but now has spread globally. The crisis has impacted our economy. Recent growth forecasts estimate around 7 per cent growth in fiscal year 2008-09, down from 9 per cent in 2007-08. This estimate may well be further revised downwards. Growth prospects for 2009-2010 also seem to be rather uncertain as there are already indications of a significant deceleration in exports which is likely to impact industries like IT and also textiles. Credit is scarce and foreign institutional investment flows have reversed, essentially because of the global squeeze in the availability of finance. This has adversely impacted the stock market, as well as banking, business and consumer confidence.

4. Policy makers in the country have responded well in minimizing the impact of the global crisis in India. We should hope that this phase would soon be over with the interventions in the country and worldwide. India's financial sector has a strong foundation. Currently, inflation is under control and balance of payments position also continues to be sound. Recent monetary and fiscal policy interventions have shown the willingness of the Government to minimize the impact of the global economic crisis on the Indian economy. Some early trends, like recovery of the stock market, in this regard are somewhat encouraging.

5. This crisis has thrown up many issues and challenges for the Centre as well as for the States. These include the need for effective oversight, greater transparency, efficient use of resources and continued relevance of fiscal consolidation. Good governance has to be the bed rock for such initiatives. This seminar on how accounting reform can be one of the drivers of good governance is therefore timely. I note that three central issues, namely ownership of accounts, internal controls and audit and accrual accounting, have been discussed over the past two days. I would like to take this opportunity to broaden this agenda and discuss some issues relating to both accounts as well as audit in the government sector of concern to the Finance Commission.

Constitutional Bodies

6. The framers of Constitution with visionary foresight recognized the need to put in place strong independent and autonomous bodies with specific mandates to safeguard the various assurances provided therein. These institutional pillars have upheld the edifice of the Constitution in a very illustrious manner over the past 60 years. The independent and powerful Supreme Court provides us the continuing assurance that the rights and guarantees engrained in the Constitution will continue to subsist. More than ever, at this time we are being made aware of the vigorous efforts of the Election Commission to maintain the rubric of our often rambunctious democracy. The Union Public Service Commission continues to strongly and silently perform its duty of putting in place an efficient and qualified civil service. The Comptroller and Auditor General has demonstrated a fierce independence in discharging his constitutional obligations with respect to the accounts of the Centre and the States. May I venture to suggest that the Finance Commission is another such body which has set very high standards in equity and probity while examining contentious issues relating to fiscal federalism. Our constitutional bodies have performed extremely well over the past sixty years and it is this, in no small measure, which has contributed to the stability and growth of the country and the vigorousness of its polity. This has also raised the expectations of our citizens and created increasing challenges which have to be met continuously. Initiatives such as this seminar are a valuable contribution to such efforts.

Accrual Accounting

7. Finance Commissions have, in the past, have concerned themselves with improvements in accounting procedures as a means to ensure a better assessment of the fiscal position of the Central and State governments. One significant recommendation made earlier relates to the introduction of accrual based accounting systems in government. The Twelfth Finance Commission acknowledged that the current system of cash based accounting does not provide a full picture of the government's financial position at any given point. It felt that the cash based system "provides room for fiscal opportunism" where taxes can be collected in advance and

booked as receipts and current payments can be deferred and not booked as expenditure.

8. The Twelfth Finance Commission, while recommending a changeover to accrual accounting in government had recognized that this would need to be a gradual and calibrated process. In the interregnum, it had suggested that additional information be provided in the government accounts and listed eight statements which could be usefully added to the accounts. These were -

a. A statement of explicit and implicit subsidies.
b. A statement containing expenditure on salaries by various departments
c. Detailed information on pensioners and expenditure on government pensions.
d. Data on committed liabilities in the future.
e. Statement containing information on debt and other liabilities as well as repayment schedule.
f. Accretion or erosion in financial assets held by government including those arising out of changes in the manner of spending by government.
g. Implications of major policy decisions taken by government during the year or new schemes proposed in the budget for future cash flows; and
h. Statement on maintenance expenditure with segregation of salary and non salary portions

9. As is evident, these statements were designed not only to bring in more transparency into the accounts but also to provide a transition path to the accrual accounting framework. They represent milestones on the high road to accrual accounting and the fact that all the recommendations of the Twelfth Finance Commission were accepted by the Central Government indicated the latter's commitment to travel on this road. And yet, five years down the road, only five of these statements have been introduced in the Finance Accounts of the State governments. Regrettably, these statements have yet to be introduced in the Central Government accounts. It also appears that the road map and operational framework for migration to accrual accounting prepared by GASAB is yet to be finalized. Important steps yet to be taken include completion of the pilot phases and internalization of lessons learned, notification of accounting standards, preparation of accounting manuals, and training. It appears that some stakeholders are questioning the feasibility of this reform. Clearly more consensus needs to be built up for the move to accrual accounting, especially amongst the keepers of the accounts.

10. Perhaps we may also need to differentially approach the target audience and look for three separate road maps, one for the Central Government, one for the State Government and one for Local Governments for moving to accrual accounting. Scholars

have suggested a 'bubble up' approach to integrate all three road maps. Under such an approach, local bodies (and within local bodies – large municipal bodies) would adopt accrual accounting first, given that the National Municipal Accounting Manual which incorporates the principles of accrual accounting stage has already been prepared under the aegis of the C&AG. This initiative would then slowly 'bubble up' to the State and Central Governments. However, the level of complexity of such accounts must necessarily reflect the capacity at each level. Panchayat accounts would need to be the simplest and should not necessarily be designed to be a mirror image of the state government accounts.

11. Concomitant with such a sectorally differentiated approach, accrual accounting itself could be implemented incrementally. Stage-I could introduce accrual accounting only for current expenses and capital expenditure and all revenues continuing to be accounted for on a cash basis. This would be relatively easy to implement. The scope could then be gradually widened. States and central government could usefully adopt such an incremental approach. In this regard, the fact that 21 state governments have agreed in principle to introduce accrual accounting and 10 of them have constituted task forces is indeed encouraging.

12. The Prime Minister in his address to the All India Conference of Accountants General had on 16th October 2008 emphasized the need for accelerated movement towards accrual based accounting. Now with your help, we meet to identify the concrete steps to be taken to fulfill this important mandate. I should mention that the Finance Commission is prepared to support such transition through conditional grants. In this regard, I look forward to receiving suggestions from the State governments or from the C&AG. Now, let me turn to the other pressing issue relating to better governance with improved accounting systems.

Ownership of Accounts

13. State governments and their parastatals assuming responsibility and ownership of accounts is critical to any reform of the accounting process. During our visits to the States, we have come across some disturbing features. One of them is the huge backlog in the audit of accounts of State public sector undertakings as well as other autonomous bodies which get substantial support as grants-in-aid from Government. In one State, audit of PSUs are pending from as early as 1992-93. We have come across a Public Sector undertaking whose accounts have not been finalized for the past 37 years. This malaise is widespread across States with only a handful of them having PSUs with updated and certified accounts. Such a position is extremely detrimental to financial accountability as well as fiscal transparency. Keeping in mind the contingent liabilities of the State governments on account of these PSUs, the switchover to accrual accounting will succeed only if this problem is tackled upfront.

14. Given the dead weight of the past pending accounts, which keeps mounting every year, this problem is akin to Sisyphus perennially rolling the boulder up the hill, starting anew every time. Successfully addressing this difficulty would require new and innovative solutions. One possible way out could be to undertake a physical audit of the PSUs whose accounts are in arrears, determine by whatever best way possible its current assets and liabilities and prepare a fresh balance sheet. Those PSUs which are working will then at least have their future transactions embodied within a regular framework of accounts. The non working companies could be wound up. The knotty problem of how to address the "missing account years" will however remain. I request the C&AG to assume leadership and guide the States and the centre to resolve this long standing issue. A sustainable framework also needs to be put in place to ensure that these companies comply with their statutory obligations in the future. The Finance Commission on its part stands ready to incentivize the States in whatever manner possible to move in this direction.

15. Another feature of the lack of adequate ownership of accounts is reflected in the functioning of the Public Accounts Committee at the state level. The Constitution has provided a very strong tool to the legislature for demanding financial accountability by way of the Public Accounts Committee. This arrangement also reflects the philosophy that while the bureaucracy can be held responsible for outputs, the political executive must accept responsibility for outcomes and they can be held accountable only by their peers in the PAC. The State Accountant General plays a very pivotal role in the effective functioning of the PAC. Unfortunately, much more needs to be done to sharpen such tools and make them more effective. We were told that in some cases, AG's reports submitted decades ago, have still to be discussed by the respective State PACs. In some States, departments give Action Taken Notes only on paragraphs selected for discussion by the PAC and not all the paragraphs in the report. Audit compliance will take as much importance as State governments at the highest level of decision making give it. This depends vitally on developing strong ownership of accounts. It will only be then that audit findings will be taken seriously.

Obtaining Better Outputs and Outcomes

16. The Thirteenth Finance Commission has in some ways a unique Terms of Reference when compared to its predecessor Commissions. For the first time, we have been charged with considering amongst other things "the need to improve the quality of public expenditure to improve outputs and outcomes". This is an onerous mandate to discharge for which we are seeking the assistance of the Administrative College of India in Hyderabad and the Lal Bahadur Shastri National Academy of Administration in Mussoorie. The Administrative Staff College of India is undertaking a study on "Outputs versus Outcomes in the management of Public expenditure". Lal Bahadur Shastri National Academy of Administration is undertaking a study on "Developing an index of Governance". Both these studies are treading new ground – how to incentivize State governments to ensure better outcomes in the provision of services and how to put in

place more effective governance structures. It is in this context that we see accounting reforms, as an integral and essential part of larger governance reforms. Let me explain further.

17. The Government of Maharashtra have referred to our mandate to consider improvement of outcomes and suggested that the Commission provide financial incentives to States linked to performance against specific parameters within the period 2010-2015. They have suggested a number of parameters that could be adopted including the scale of devolution to the local bodies, increase of non tax revenue, reforms in the power sector and removal of intra state disparities. The Government of West Bengal have suggested that governance per se be included as a devolution criterion with parameters like power sector reforms , restructuring of PSUs , implementation of information technology for providing better services to citizens being used to compute eligibility. Other State governments have suggested the degree of financial devolution to local bodies should be a criteria to measure good governance.

18. Essentially, these suggestions propose the use of forward looking indicators to incentivize change in state governments and enhance the quality of their governance. Such an approach which leverages change in the future rather than reward past behavior is extremely attractive. However, for such suggestions to be considered, the selected indicators must be measurable uniformly across States. This requires that the finance accounts must be consistently maintained across States as well as be produced in a timely fashion. It appears that this is not yet completely the case. I shall revert to this point when I later discuss maintenance of Calamity Relief Fund accounts and accounts of Centrally Sponsored Schemes.

19. Additionally, if States have to be incentivized to produce better outcomes, then performance indicators which mirror such outcomes will have to be identified and more importantly, measured accurately and periodically. The only institution, with the capacity to undertake this measurement, and which simultaneously carries credibility with both the Centre and the States is the C&AG. The C&AG's measuring instruments include the Finance Accounts performance and special audits. The office of the C&AG has been producing performance audit reports of exceptional quality. The reports on NREGA as well as the more recent one on 'Modernisation of the Police Force' come immediately to mind. Moving from here to assessing progress in outcome indicators would in theory not be difficult, but may require considerable logistical organization since all States will have to be covered simultaneously.

20. Another proposal to improve outcomes is the introduction of a medium term expenditure framework (MTEF) on a three year rolling basis. Activities are usually planned on an annual basis. Outputs can be realized in the near or medium term. However, outcomes can be measured only in the medium to long term. Thus, there will be a temporal mismatch between the financial and outcome budgets since the budget is an annual process. To bridge this, the budget would have to include indicative

budgetary outlays for the second and third years. I would welcome the views of the C&AG on these considerations and seek his advice on how best they can be accommodated within the mandate of our constitution.

Governance related issues in the present Accounts and Audit Framework
Accounting Issues

21. I wish to share with you three issues in today's accounting framework which impact the quality of governance. These issues which were highlighted during presentations by Accountants General and during our state visits also affect the assessment of state finances by the Commission. These are (a) contra entries in accounts, (b) administration of the calamity relief scheme and (c) consistent budgetary classifications for Centrally Sponsored Schemes across States.

22. Contra entries in the accounts make it difficult to estimate the true revenue and expenditure of a State government. For an objective and normative comparison of the performance of State governments across the country, it is necessary that such entries to be identified in every State's accounts and filtered out. Unfortunately, there is no easy way to detect contra entries in the finance accounts. The Finance Commission has to necessarily depend upon the State governments themselves to furnish this information. This is not a desirable situation. Perhaps a separate Annexe in the Finance Accounts detailing the contra entries is called for.

23. The scheme for constitution and administration of the Calamity Relief Fund has been notified by the Government of India. The Fund is required to be constituted in the Public Account. Both the Central Government share and the State Government share are to be transferred to the CRF and the proceeds invested in specified securities. Interest on these securities should be credited to the CRF. Whenever expenditure on relief is incurred by State Governments, reimbursement should be sought from the CRF. We have come across instances where state governments are not adhering to the notified scheme. Sometimes, this is to their detriment. Relief expenditure of the State Government is booked under the major head 2245 without reimbursement being drawn from the CRF. This results in overstatement of the state government's fiscal deficit. In other cases, State governments have not contributed their share to the CRF. Some State governments are using CRF support from the Centre as a ways and means float. The notified scheme needs to be implemented uniformly across States. This will ensure that some States are not unfairly disadvantaged merely because they adhere to the rules.

24. Another issue is the uniform treatment of expenditure on similar schemes by State governments. This is specially applicable to centrally sponsored schemes like National Rural Employment Guarantee Scheme (NREGS), the Rashtriya Sam Vikas Yojana (RSVY) and the Swarnajayanti Gram Swarojagar Yojana (SGSY). While most States book NREGS expenditure in the revenue account, at least one state

however books it in the capital account citing the practice adopted during the earlier Food for Work Program. The budgetary treatment of expenditure in the other two schemes also differs across States. Such divergences in the finance accounts across states makes it difficult to analyze whether the program has been implemented as mandated including payment of state's share.

Audit Issues

25. I now turn to two governance related audit issues we have come across during our state visits.

26. An undesirable trend noticed is the tendency to divert public expenditure from the budget to nominated funds which are operated outside the authority of the legislature. In one State, four such funds have been created outside the budget. These funds have been ostensibly set up to promote rural development, infrastructure development, utilization of vacant government land and development of municipalities – all activities which can legitimately be taken up within the budget. One of these funds receives 10% of the VAT collection of the State, while the other funds are supported by disbursals from the Consolidated Fund of the State. The total amount transferred to these funds was about Rs 2100 crore during 2008-09 alone. The disposition of these funds is decided by different Committees chaired by the Chief Minister of the State. The expenditure incurred through these irregular arrangements not only bypasses the control of the State legislature but also the audit of the C&AG.

27. Another unorthodox practice is the transfer of budgetary allocations from the consolidated fund to civil deposits in the public account at the end of a financial year to avoid lapse. When these funds are transferred to public account, they are depicted as expenditure in the consolidated fund though not actually spent, thus inflating both expenditure as well as fiscal deficit of the State. These deposits inflate the State's total liabilities. It also appears that audit scrutiny of expenditures incurred from civil deposits is not consistent across States. Such practices vitiate prudent financial management while sidestepping the legislature's privilege of approving expenditures through the budgetary process.

28. Similar situations may arise when both the Centre and States route funds outside the budget, directly to implementing agencies ostensibly for administrative and financial ease.

Looking Forward

29. I now come to the last section of my address – how do we move forward on accounting and audit reform? While no doubt the seminar would have identified a number of important areas where the envelope can be expanded, I wish point to three areas. These are (a) CAG monitoring the compliance of Center and States with their

respective FRBM legislation (b) introduction of an Advance Audit Authority for new schemes/projects and (c) accounting support for the National Informational Utilities proposed by Nandan Nilekani.

Monitoring compliance of Center and States with their FRBM legislation

30. All States (barring three) have brought into effect Fiscal Responsibility and Budget Management Acts that bind them to a minimum level of fiscal discipline. This has been one of most commendable developments in recent years that is expected to have a lasting impact on the fiscal health of the States. These Acts focus on number of fiscal reform measures ranging from control over deficits to being more transparent in fiscal reporting.

31. Though the Centre has recently given its consent to the States relaxing their fiscal deficit targets, there is a need to monitor States' compliance to all the stipulations in their respective legislation. Only some of the Acts provide for monitoring by an outside agency. In cases where the Acts provide for independent monitoring, and some States do not nominate the C&AG for this purpose, this will not bar the C&AG from monitoring compliance in his audit report. The advantage of the C&AG doing this for all States will be the achievement of uniformity and objectivity across States- eminently relevant parameters for bodies like the Finance Commission. This Commission is required to prepare a revised road map for fiscal adjustment and it would be extremely useful to future Commissions if compliance can be monitored by the C&AG both for the Centre as well as the States and commented upon in his reports.

Advance Audit Authority for New Initiatives

32. The former President Abdul Kalam in his address to Accountants General in September 2005 had proposed that auditors augment their role as partners in development of the country and enter the system at the design and planning stage itself to provide credibility and assurance to all the stake holders while a new scheme is being formulated. There are a number of instances where the lapses identified subsequently by audit and attributable to systemic deficiencies could have been avoided if proper systems had been put in place. Involvement of the audit system at early stages can help Governments avoid such embarrassment.

33. I am aware that auditors in the classical mould would see this as a conflict of interest – with the argument that no auditor should provide advice to institutions whose transactions he is subsequently going to audit. And yet President Kalam's plea made more than three years ago remains relevant even today. If new schemes and innovative approaches have to be encouraged in government, then a framework must be created which can provide such advice without compromising the integrity of the subsequent audit. Such a framework could be embodied in any structure – either an interdepartmental committee or a specially nominated task force, or an Advance Audit

Authority. For the sake of convenience, I shall call it an Advance Audit Authority. This could be akin to the Authority for Advance Ruling set up in tax departments at the Center and state governments. The Advance Audit authority could provide advice and consultancy to Departments and Ministries in Centre and States about how to put in place appropriate fiduciary and audit safeguards while designing new programs. This would provide significant credibility to stakeholders in new projects. At the same time, the advice provided need not estop all officers of the audit department from future action contrary to the advice. In some States under VAT, the advice of the Advance Ruling Authority is binding on all officers of the tax department except the Commissioner. A similar provision may provide comfort to audit authorities.

34. Let me give you an example of how such an intervention will significantly accelerate implementation of critical projects. I refer to the planned introduction of the Goods and Service Tax in 2010. This single biggest reform measure after the elimination of licensing in 1991 is estimated to have an economic impact of half a trillion dollars or 50% of the country's GDP. The rate of growth is estimated to rise by at least 1.4%. To leverage the maximum economic benefit to the nation at the earliest, it is vital that the design and operational protocols of GST are locked in place as early as possible. Some of the procedures which require to be adopted are totally new. For eg., let us take the case of inter state sales. There will be two contracting parties, an exporting dealer in one State who sells his product to an importing dealer located in another State. The exporting dealer will be required to collect GST from the importing dealer and then credit it to the account of state government under whose jurisdiction the importing dealer falls. This credit will then be used by the importing dealer's State government to approve the corresponding input tax credit to the GST payable by the importing dealer. Given the volume of such business, it will not be possible to set up a paper trail to enable audit of all these interstate transactions. Audit in an IT environment will be called for and the appropriate persons to advice on how to set up an audit friendly regime for such transactions will have to be the auditors themselves. This can best be done through the proposed Advance Audit Authority, which can be set up at arm's length from the regular audit structure.

National Information Utility

35. Nandan Nilekani in his book 'Imagining India' proposes setting up National Information Utilities which, amongst other things will 'handle all fund transfers of government money from the center to the States and local bodies to ensure predictable, efficient and leak proof cash flows.' This information will be available in the public domain. This is an exciting idea which if implemented can significantly empower local bodies while simultaneously making them more accountable to the people. Funds released by the Central government directly to a panchayat will be tagged and tracked right till it is spent. This proposal will also make state governments more accountable. Indeed it will make all governments accountable and answerable for all fund related

issues-be it delayed releases, lowered expenditure or merely amounts sanctioned for each project.

36. How best can such a proposal be implemented within the present framework of accounts is the last question I leave to this illustrious audience and our distinguished C&AG.

Conclusion

37. I would like to conclude by thanking Shri Vinod Rai our distinguished C&AG for his warmth and gracious hospitality as well as the opportunity to address this very important seminar.

This paper considers goals for better governance, key challenges confronting efforts at reform, examples of successful good-governance efforts, and action steps for improving both participation and institutions. Goals identified are: â€¢ Legitimate, effective, responsive institutions and policies (â€œembedded autonomyâ€) â€¢ Understandable processes and outcomes: â€¢ Transparency: â€¢ Incentives to sustain good governance: â€¢ Vertical accountability: â€¢ Horizontal accountability and leaders, and among segments of governmentÂ Similarly, checks and balances, public accounting procedures, open but orderly markets, competitive politics, and administrative transparency are institutions and values essential to good governance, but. 4.