UNIT 21 ACCOUNTING SYSTEM IN INDIA

Structure

21.0 OBJECTIVES

After studying this unit, you should be able to :

- explain the differences between Commercial and Government Accounting
- discuss the advantages and disadvantages of the separation of accounts from Audit and its present position in Government
- explain the main features of Departmentalisation of Accounts
- describe the essentials of the Revised Accounting Structure; and
- analyse the concept of Management Accounting and its limitations in Government.

21.1 INTRODUCTION

Accounting, whether in a commercial organisation or in Government, is a tool of management. In a manufacturing organisation, it provides information to management about the cost of manufacturing a product, the cost of performing a job, the cost of sales and the profit earned or loss incurred etc. Similarly, in a commercial organisation, it provides information about the profit or loss and also the increase or decrease in the assets and liabilities of the organisation. It also provides data for proper budgetary control. In the case of government, accounting helps the various levels of management, in the preparation of plans and exercise of proper financial control. By providing data about the expenditure incurred on various activities, it helps budget planners to determine in advance, the taxes to be levied and also the areas, where the cut in expenditure is possible. Again, it helps the management in proper monitoring and implementation of plans, schemes. Thus, accounting is an useful aid to management in performing its various managerial functions effectively.

In this unit, the difference between commercial accounting and government accounting has been explained. The recent reforms in government accounting viz., Departmentalisation of Accounts, Revised Accounting Structure, Management Accounting have also been explained.

21.2 ACCOUNTING: DEFINITION AND IMPORTANCE

The word **accounts** in the financial sense, has been defined as **statements of facts relating to money or things having money value.** The facts that are incorporated in accounting records are described as **transactions**.

In the early stages of civilisation, the number of transactions to be recorded was so small that each businessman was able to record and check for himself/herself all the transactions. But with the growth of trade, it became difficult for him/her to know from the records, how she/he stood in relation to his/her customers and whether her/his business was profitable or not. This gave rise to the maintenance of accounts on a double-entry basis, which was helpful in the preparation of profit and loss account and balance sheet of the business. The process through which these ends are effected is called "accounting."

Accounting is a discipline which records, classifies and summarises data and presents it in a convenient form to various levels of management in an organisation for decision-making purposes. It helps managers to prepare their budget plans realistically so that the expenditure could be watched against the budget allocation, and corrective action could be taken, wherever necessary. It also helps outsiders i.e. shareholders/government, to know the working of the business firm, by presenting data about its activities, profit or loss and its assets and liabilities.

In government, accounting provides information for the preparation of annual budgets. It helps budget planners to determine, in advance, the taxes to be levied for meeting the committed expenditure, or to reduce the expenditure, wherever possible. It provides information to managers about the expenditure involved annually, on pay, allowances, materials etc. and also the expenditure incurred on **Plan Schemes**. It also provides information regarding expenditure incurred on functions, programmes, activities, for the speedy development of performance budgeting in all departments of government. It further helps in exercising proper financial control and observance of rules and regulations by the various authorities. Its main purpose is to provide timely information to various levels of management, for taking proper decisions in respect of their areas of operations and for monitoring the performance of activities against their physical targets and also the expenditure against the budget, so as to enable the government to take corrective action, wherever considered necessary.

21.3 PRINCIPLES AND METHODS OF GOVERNMENT ACCOUNTING

The principles of commercial and government accounting differ in certain essential points. The main function of a commercial concern is to produce goods and sell them to earn a profit. On the other hand, the main function of government, is not to make profit but to govern the country and administer the various functions in the best way possible in the interests of the society at large.

A commercial concern deals primarily with the utilisation of capital for the purpose of making a profit. It is interested in seeing at intervals, how it stands in relation to its debtors and creditors, whether it is gaining or losing, what are the sources of its gain or loss. In order to obtain ready answers to these questions, the concern has to keep a system of detailed accounts. In respect of each person dealt with, and each department of its activities, it maintains a separate account, so that the result of the transactions in each case may be ascertained. By preparing the manufacturing, trading and profit and loss accounts and balance sheet, the concern is able to know the profit earned or loss incurred during the year.

It is a generally accepted practice in the commercial world to maintain account books on the double entry system. The double entry system is based on the fact that in every transaction, two parties or accounts are involved—one giving and the other receiving. Under that system, every transaction requires two entries in the books, one against the party or account giving and the other against the party or account which is receiving.

The activities of a government, on the other hand, are determined by the needs of the country. If the activities to be carried out, during the coming years, are known, it becomes easier to determine the funds required to carry out those activities. Government accounts are, therefore, designed to enable the government to determine, how much money it needs to collect from the tax-payers in order to maintain its activities.

The classification of transactions in government accounts is determined firstly by the administrative classification of the activities and secondly by the classification of the nature of the transactions. The government accounting is, therefore, quite elaborate and is kept on a single entry basis.

21.4 SEPARATION OF ACCOUNTS FROM AUDIT

i) Introduction

Accounting and auditing are interrelated but have independent functions. For reasons mainly of economy, these have been traditionally combined under one authority. From time to time, however, attempts have been made to separate accounting from auditing as in the case of railways, defence, food, rehabilitation and supply. In 1971, the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act was passed, which visualised the need for separating accounts from audit. Section 10 of the Act empowered the President, after consultation with the CAG, to relieve the Comptroller and Auditor General from the responsibility of compiling the accounts of any department of the Union Government. A scheme for the separation of accounts from audit was approved by the Government of India in June 1975. An ordinance was issued by the President, which was followed by passing an Act, which amended the Comptroller and Auditor General's (DPC) Act 1971, thereby relieving him from the responsibility of compiling accounts of Ministries/Departments of Government of India. He, however, still performs the accounts and audit functions in each state.

ii) Advantages of Combined Audit and Accounts

Continuance of combined audit and accounts under one functionary has been justified on the following considerations:

a) Accounting and audit functions are interrelated. The pre-audit of claims before admission for payment, the examination of contract documents, etc. with reference to the financial principles and rules is essentially an audit process. Therefore, the combination of the two functions is not wrong.

b) An accounts organisation, independent of the administration, is a must to ensure that the internal accounting organisation is not coerced by the administration to admit questionable claims, overlooking irregular practices.

c) Under the existing practice, certain accounting responsibilities have been imposed on the Comptroller and Auditor General. Consequently, arrangements will have to be made by him for the consolidation of departmental accounts and the compilation of Finance Accounts of the Central and State Governments as a whole. The co-ordinating role will imply that the uniformity in accounting principles and processes in the units has to be maintained.

d) The Constitution has provided for a single Comptroller and Auditor General, unlike other Federal Constitutions. Hence, it would be better to keep accounts and audit with the Comptroller and Auditor General.

iii) Disadvantages of Combined Audit and Accounts

The basic disadvantages of the combined system are as follows:

a) It violates the fundamental spirit behind the provisions of the Constitution and of the CAG Act of 1971, which expects that the duties of Comptroller and Auditor General should essentially be auditorial.

b) Combination of audit functions with payment and account functions brings the Comptroller and Auditor General under the indirect control of the Finance Minister. Questions tabled in the Houses of Parliament pertaining to his accounting duties are answerable by the Minister of Finance.

c) Federal structure has been prescribed by the Constitution with autonomy to the states. With the state accounts handled by a functionary directly under the President, entrusting accounting duties to the Comptroller and Auditor General would lead to the loss of the accounting autonomy of the states.

d) The combined accounts and audit offices function with less speed in the performance of their accounting duties, i.e. in the timely payments of dues, such as salary, pension, provident fund, gratuity etc.

The disadvantages listed out above are not so great as to justify opposition to the separation for all times to come. The mere fact that separate accounts organisations of Defence, Railways, Lok Sabha/Rajya Sabha Secretariat and the separated Ministeries of Works, Housing and Supply etc. are functioning with efficiency, it dispel the fears enumerated. In fact, the disadvantages arising out of combined accounts and audit organisations are more than the advantages accruing out of it.

iv) Advantages of Separation or Departmentalisation of Accounts

Departmentalisation of accounts has many advantages. It establishes a definite accountability on the decision-making departments for the expenditure incurred by them, out of the approved budget. He, who spends, should account for the expenditure. But an executive without administrative control over its accounting machinery, will hardly be able to discharge effectively its financial and accounting responsibility.

Departmentalisation of accounts enables the audit department to confine its attention to audit matters in greater depth. The activity of higher audit (i.e. Efficiency-cum-Peformance Audit) may get blurred, when audit is involved with routine accounting duties. Moreover, accounting duties bring the Audit Department partially under the control of the executive, whose accounts it compiles.

v) Separation of Accounts

Realising the increasing need for separation of accounts from audit, the Government of India decided to departmentalise the accounts of the Central/Ministries/Departments, which had been with the Comptroller and Auditor General of India. All Ministries of the Government of India including the Posts and Telegraphs Department were brought under the Scheme of departmentalisation of accounts between 1st April to 31st December, 1976.

21.5 DEPARTMENTALISATION OF ACCOUNTS

The scheme of Departmentalisation of accounts introduced from 1st April, 1976, is in character and method different from the earlier attempts made in this regard. The main objective behind this scheme was that in view of the manifold increase in Government expenditure and the need to implement effectively the developmental plans, management accounting should be properly developed as an integral part of each Ministry/Department It was realised that to achieve this objective, the externality of the accounting system should be eliminated and there should be a vertical functional integration, coupled with horizontal administrative integration at each level of management. Accordingly, the Departmentalisation of accounts involved not only relieving the Comptroller and Accountant General of the responsibility of compilation of accounts but also taking over most of the payment and reciept functions from the Treasuries.

The broad features of the Scheme of Departmentalisation are detailed below:

i) Each Ministry functions administratively under a Secretary, who is assisted by an Additional Secretary, a Joint Secretary, and Under Secretaries supported by subordinate officers. Apart from the Headquarters set up, every Ministry

ii) The Comptroller and Auditor General was relieved of the responsibility of compiling and keeping the accounts of transactions relating to the Departments of the Ministries. Payment functions discharged by the treasuries were also taken over by the Departments. According to the practice, prior to departmentalisation of Accounts, the main Ministry and the subordinate offices used to draw funds by means of presenting bills in treasuries. The treasuries used to render accounts to the respective Accountant Generals, who compiled the monthly accounts. Each Accountant General rendered a monthly account of Central Government transactions to the Accountant General, Central Revenues in Delhi, for consolidation and preparation of civil accounts.

iii) The Secretary of each Ministry is designated as the Chief Accounting Authority responsible for all transactions of the Ministry and its Departments. This responsibility is discharged through the Integrated Financial Advisor (IFA) of the Ministry. The Secretary has the over-all responsibility for the functioning of the accounting and payment set-up and is responsible for certification of monthly accounts.

iv) The Integrated Financial Advisor performs the following duties, on behalf of the Chief Accounting Authority. He/She will be responsible for:

   a) The preparation of the budget of the Ministry and its Departments in coordination with the Heads of Departments concerned and distribution of the budget allotment among the various wings/departments of the Ministry. Control of expenditure will also form a part of his/her responsibility.

   b) Arranging payments to autonomous bodies, corporations, authorities, and also grants-in-aid, loans etc.

   c) Arrangements for making payments through the Pay and Accounts offices of pay and allowances, office contingencies and miscellaneous payments.

   d) Consolidation of the accounts of the Ministry as a whole, in accordance with the instructions issued by the Central Government.

   e) Preparation of Appropriation Accounts for the grants controlled by the Ministry.

   f) Organising a sound system of internal check to ensure accuracy in accounting and efficiency of operation as part of management.

   g) Introduction of an efficient system of Management accounting best suited to the functional requirements of the Ministry and its Departments.

v) The payments relating to the Ministries/Departments which are now made by the Bank and non-Bank treasuries, Accountant General and State Pay and Accounts Officers, will be made by the Departmental Pay and Accounts Offices.

In brief, departmentalisation of accounts was done mainly with a view to enable the Ministries to exercise direct control over their expenditure and to introduce a management accounting system, so as to provide relevant information to various levels of management for taking proper decisions.

Check Your Progress 1

Note : i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) Explain the advantages of the separation of accounts from audit.

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2) Explain the disadvantages of the separation of accounts from audit.

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3) Explain the salient features of departmentalisation of accounts.

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21.6 REVISED ACCOUNTING STRUCTURE

The accounting system introduced by the British in the early years of this century remained more or less unchanged till April 1974.

The classification in the accounting system introduced by the British, was mainly to facilitate financial and legal accountability of the Executive to the Legislature and within the Executive, of the spending agencies to the sanctioning authorities. Again, the classification had close relationship to the department in which the expenditure occurred than to the purposes for which the money was spent. The basic concern was the item on which money was spent rather than the purposes served by it. This system served well so long as the functions of the Government were limited. But with a change in the role of Government, i.e. undertaking developmental programmes for the socio-economic development of the country under the successive Five Year Plans, need was felt for bringing in necessary reforms in the system of accounts, so as to meet the challenges of development administration.

The Administrative Reforms Commission set up by the Government in 1966, to bring about reforms in administration examined the existing system of accounts and recommended in their Report on "*Finance, Accounts and Audit*", some changes in the system. This was done mainly in the context of introduction of performance budgeting in India. The Commission recommended that the structure of major heads of accounts should be recast to reflect broad functions and major programmes of Government. Also, the programmes, activities and projects of the various departments and organisations should be clearly identified and the minor heads connected with these programmes suitably recast, so as to reflect these activities. The Commission also suggested that the heads of development adopted for Plan purposes should be reviewed with a view to establish a direct correlation between these heads and the general accounting heads. The Commission also recommended that the Government should constitute a team composed of representatives of the Comptroller and Auditor General, the Planning Commission, the Ministry of Finance, and the Administrative Ministry concerned which should be assigned the task of drawing up a programme for the implementation of the commission's recommendations.

The Government of India accepted the suggestions of the Commission. It appointed a team of officers composed of the Deputy Comptroller and Auditor General, the Joint Secretary (Budget) of the Ministry of Finance, and a representative of the Planning Commission, to undertake a review of the Heads of acounts and the Heads of development adopted for Plan purposes. The team submitted two reports on the reforms in the structure of demand for grants. In part I of the report, it suggested that a Ministry/Department in charge of a number of distinct services may present a separate demand for each of the major activities.

In part II of the Demands, details of expenditure upto the level of major and minor heads of account may be included.

In part III of the Demands, further details may be given about the provisions made in part II for minor heads and for activities/schemes/organisations under minor heads.

The team submitted the second report in November 1972. It proposed a five tier classification structure.

The team mentioned that the new classification would facilitate a link between budget outlays and functions, programmes and activities. It would also ensure itemised control of expenditure. Also, the classification would facilitate introduction of performance budgeting.

The Government of India accepted the recommendations of the team on reforms in the structure of Budget and Accounts.

A revised accounting structure was introduced by the Government of India from April, 1974. Under this scheme, a five-tier classification has been adopted, namely Sectoral Major Head, Minor Head, Sub-Head and Detailed Heads of account. Sectoral classification has grouped the functions of government into three sectors, namely, General Services, Social and Community Services and Economic Services. General Services Sector includes services indispensable to the existence of an organised state, such as Police, Defence, External Affairs, Fire protection etc. This sector includes Organs of State (Parliament), Head of State, Judiciary, Fiscal and Administrative Services and Defence Services.

Social and Community services sector covers programmes and activities relating to provision of basic social services to consumers, such as Education, Medical Relief, Housing, Social security and Welfare and Services required for community living such as Public Health, Urban Development, Broadcasting etc. Economic Services Sector includes programmes and activities in the fields of Production, Distribution, Trade, Regulation etc.

In the new scheme of accounts, a Major Head is assigned to each function, and a Minor Head is allotted to each Programme. Under each Minor Head, there would be sub-heads assigned to activities/schemes/organisations covered by the programme. Major and Minor Heads classification is common to Union, States and Union territories Governments. Under the new scheme, the object classification has been retained and placed as the last tier. It is meant to provide item-wise control over expenditure and to ensure financial control.

The revised accounting structure in terms of programmes, activities, and projects establishes adequate links between Budget and Account Heads (i.e. Major Head, Minor Head and Sub-Head) and the Plan Heads of development. It helps in obtaining information of the progressive expenditure incurred in plan programmes and projects. It also helps in the speedy implementation of performance budgeting. Further, it also helps in monitoring and analysis of expenditure on programmes/activities/projects to perform the management functions effectively.

21.7 MANAGEMENT ACCOUNTING IN GOVERNMENT

According to American Accounting Association "Management Accounting is the application of appropriate techniques and concepts in processing historical and projected economic data of an entity to assist management in establishing plans for reasonable economic objectives and in making of rational decisions with a view toward those objectives." Management accounting involves collection and presentation of all such information which can be of help to management in the preparation of budget plans for the organisation. It helps in proper monitoring and evaluation of performance of the activities, as compared to the budget plan in terms of financial expenditure and the corresponding physical accomplishments. Its purpose is to provide timely information to various levels of managements to facilitate decision-making, for efficient and economical achievement of their tasks.

Management accounting encompasses financial accounting, cost accounting and all aspects of financial management. It involves not only collection of information from financial records but also from cost records. In a system of management accounting, information has to be collected from various sources inside and outside the organisation and presented to management for taking decisions.

A good management accounting system should provide timely accounting information to various levels of management, for a continuous review of the progress of expenditure as related to the budgeted funds and the planned tasks. It should also facilitate the working of the scheme of performance budgeting.

Management accounting varies from organisation to organisation depending on its objectives, organisational structure, and the information requirements at various levels etc. In Government, it is difficult to prescribe a standard system of management accounting, applicable to all departments of Government, as the functions of each department vary from one another. It is necessary, therefore, to evolve a management accounting system suited to the department, keeping in view its objectives, organisational structure, information requirements etc. Again, management accounting system, once introduced, should be reviewed periodically to cope with the changing requirements of that particular department.

An Advisory Committee had been appointed, in 1976, by the Government of India under the Chairmanship of the Finance Minister, to consider and recommend management accountancy concepts to suit the requirements of different Ministries/ Departments. The Committee was also required to make recommendations regarding management information system necessary to be developed for the purpose. Very little progress has, however, been in this direction due to various constraints.

The constraints in developing a system of management accounting in government have to be recognised. Government accounting, is done on a cash basis (not double entry basis) which makes it difficult to know the entire cost assignable to an activity. Again, the present structure of financial accounting is not conducive to serve the purposes of management accounting. The existing classification of accounts does not allocate cost to a 'cost-centre' or responsibility centre so as to evaluate actual cost against standard cost. Although the new classification structure developed for performance budgeting in terms of functions, programmes, activities had helped in monitoring expenditure on a programme or activity, the classification still needs to be linked with **cost-centres** or **responsibility centres** for speedy development of management accounting in Government.

It may be concluded that the recent financial reforms introduced in the Government of India, namely, revised accounting structure, departmentalisation of accounts, performance budgeting, Integrated Financial Advisor Scheme etc. are all intended to facilitate the early introduction of management accounting in government. The reforms already started should be carried forward, so that the management accounting system developed in a Ministry/Department, could provide timely information to various levels at management for speedy decision-making.

Check Your Progress 2

Note : i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) Why was the accounting system introduced by the British revised?

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2) Explain the concept of Management Accounting.

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21.8 LET US SUM UP

Thus, in this unit, the developments in the area of Government accounting right from the beginning of this century to the present, have been explained. The importance of management accounting and its limitations in Government, has also been explained.

21.9 KEY WORDS

Cost Accounting: Analysis of accounting and other information to determine the cost of each activity/product/job.

Capital Expenditure: Payments in respect of which, services will be available for many years to come e.g. machines.

Financial Accounting: Art of recording, classifying and summarising transactions, which are of a financial nature.

Revenue Expenditure: Payment in respect of which services have already been obtained e.g. wages, salaries, rent etc.

21.10 REFERENCES

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Ramachandran K.S., 1911. *Watching over a Watch Dog*, Ashish Publishing House: New Delhi.

21.11 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Your answer should include the following points:

Advantages

- Accounting and audit functions are interrelated
- An Accounting organisation, independent of the administration, is necessary to prevent irregular practices in administration.
- There is a need to maintain uniformity in accounts.

2) Your answer should include the following points:

Disadvantages

- The Combined system of audit and Accounts violates the fundamental spirit behind the provisions of the Constitution and of the CAG (DPC's) Act 1971.
- It brings the Comptroller and Auditor General, under the indirect control of the Finance Ministry.
- It does not help in speedy performance of accounting duties.
- Departmentalisation of accounts was done in all Ministries of Government in 1976.

3) Your answer should include the following points:

- The Comptroller and Auditor General was relieved of the responsibility of compiling the accounts of the Ministries/Departments.
- Each Ministry functions administratively under a Secretary, who is designated as the Chief Accounting Authority. He/She is responsible for the accounting transactions of his/her Ministry/Department.
- The Integrated Financial Advisor assists the Secretary of the Ministry/Department in the performance of his/her accounting duties, by preparing the Budget of the Ministry and watching the expenditure from time to time.
- The scheme helps in speedy introduction of Management Accounting in Government.

Check Your Progress 2

1) Your answer should include the following points:
   - Change in the role of the government.
   - Extension of the government functions.

2) Your answer should include the following points :
   - Management accounting encompasses Financial Accounting, Cost Accounting and all aspects of Financial Management.
   - Government accounting is done on a cash-basis.
   - Classification in Government accounts is not in terms of Cost Centres or Responsibility Centres, which are essential for allocation of expenses and providing timely information to management.

UNIT 22 AUDITING SYSTEM IN INDIA

Structure

22.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning and importance of audit
- describe the differences between Internal and Statutory audit
- analyse the features of Regularity audit and Performance audit
- understand the utility of audit reports and their impact on administration.

22.1 INTRODUCTION

Audit deals with papers and figures. It is in the nature of a post-mortem examination of accounting and financial transactions of a firm or a company or a department of Government.

An auditor has a vital role to play in modern economy. With the growth of joint-stock companies with limited liability, there is **divorce** between owners (share-holders) and managers (Board of Directors). This has made it important that there should be an independent auditor to check the correctness of the financial transactions of a limited liability company on behalf of the shareholders, as a means of managerial accountability to the owners. Likewise, on the basis of audited accounts, certified by an auditor, the tax authorities can be reasonably certain that the profit or loss, disclosed by an assessee, is reasonably true and correct, instead of undertaking a check of accounts of the assessees.

In the case of governmental activities, audit acts as a 'watchdog' of the nation's financial interests. The administrative structure of the State is so vast and its operations so complex that it is impossible for an ordinary tax payer to know that the money contributed by him/her to the running of the state is being misused. Audit helps to highlight losses, waste and under-utilisation of capacity, due to improper decisions at the appropriate levels. Above all, Parliament/State Legislatures vote supplies but they have no means to know that the moneys' have been spent for the purposes for which they were voted and also not in excess thereof. It is for the proper exercise of these important aspects of control that Parliament has been armed with a constitutional audit authority in the office of the Comptroller

In this unit, you will study the meaning and importance of audit and the evolution of auditing in India. You will know the various types of audit conducted by the Comptroller and Auditor General for effecting economy and efficiency in administration. This unit will also explain the importance of audit reports and their examination by the Public Accounts Committee of the Lok Sabha.

22.2 AUDITING: DEFINITION AND IMPORTANCE

The world **Audit** is derived from the Latin word **Audire** to hear. Originally, the accounting parties were required to attend before the auditor, who heard the accounts. In the early stages of civilisation, the methods of accounts were so crude and the number of transactions to be recorded so few that each individual was able to check for himself/herself all his/her transactions. But soon with the establishment of empires, a system was established to record account transactions and audit them. The person whose duty, it was to check such accounts came to be known as the **Auditor**.

An audit is an examination of accounting records undertaken with a view to establishing, whether or not they correctly and completely reflect the transactions to which they purport to relate. Its purpose is to see that expenditure has been incurred with the sanctions of the competent authority and applied for the purpose for which it was sanctioned. It should be duly supported by vouchers, as a safeguard against fraud and misappropriation.

Audit is an instrument of financial control. In its relation to commercial transactions, it acts as a safeguard, on behalf of the proprietor, against extravagance, carelessness or fraud on the part of the proprietor's employees in the realisation and utilisation of his/her moeny or other assets. It ensures on proprietor's behalf, that the accounts maintained truly, represent **facts** and that expenditure has been incurred with due **regularity and propriety.**

The financial transactions of a government need to be similarly watched. The agency employed for the purpose should be independent from the employees of Government, who are entrusted with the realisation and utilisation of public money or other assets. This task is entrusted, in India, to the Indian Audit and Accounts Department. So far as its audit duties are concerned, the position of the Indian Audit and Accounts Department in relation to government transactions, is to a large extent, similar to that of an **auditor**. In this context, Parliament/Legislatures may be regarded as the shareholders of the **Government concern** and the **Executive Government** as its directors. The object of this **concern** is, however, not profit-making.

Audit is one of the four pillars of democracy viz., (i) Parliament (ii) Judiciary (iii) Press and (iv) Audit. Firstly, Parliament is the most important organ of democracy. It is composed of people's representatives, elected on the basis of adult franchise. The members belonging to the majority party in Parliament form the Government. All laws necessary for the running of the Government have to be passed by the Parliament. Again, it votes taxes which provide government the resources, necessary for running the administrative machinery and also votes funds for meeting the expenses. Secondly, judiciary and the press are the other two pillars which are necessary for administration of justice and functioning of a healthy democracy. Lastly, audit is a vital instrument of ensuring effective supremacy of Parliament over the executive. Parliamentary control consists not only in voting suppliers and approving the imposition of taxes but also in ensuring that actually the funds have been applied to the purpose for which these were voted.

Audit is a valuable aid to administration. In all countries, audit is not just tolerated as a necessary evil but is looked upon as a valued ally, which brings to notice procedural and technical irregularities and lapses on the part of individuals, whether they may be errors of judgment, negligence or acts and intents of dishonesty. The complementary roles of audit and administration are now accepted as a fact, being essential for toning up the machinery of government. In the ultimate analysis, audit and administration are the components of the machinery of Government. It is only

22.3 EVOLUTION OF AUDITING IN INDIA

The evolution of auditing in India, as well as in other countries, has been a gradual process. It has been closely related to the activities undertaken by the government, the internal control and management systems available in government departments.

In the pre-war era, the main functions of government were collection of revenue, maintenance of law and order, defence and execution of public works of certain kinds. Few governments undertook commercial activities. In such a situation, the function of audit was largely one of regularity and compliance audit. The principal components of audit in the pre-war era were (a) audit against budget provisions (b) audit against sanctions (c) audit of accounts and appropriations (d) expenditure audit and (e) propriety audit. Audit against budget provisions and against sanctions constituted what was known as **compliance or regularity audit** [See Section 22.5 (i)]. The highest form of audit within the traditional framework, was considered to be propriety audit. A transaction, which was otherwise in order and in conformity with rules and regulations, could still be objected to on the ground that it breached broad concepts of financial ethics.

In the post-war era, the welfare state had to undertake several socio-economic, commercial and industrial programmes to speed up development and improve the quality of life of the people. Correspondingly, audit had to shift its emphasis so that it was in a position to report to Parliament, whether or not these programmes/activities had achieved their objectives. New areas of audit had to be covered and new techniques had to be developed. With increasing activity, government departments and agencies had to build up their own systems of internal control.

The transition from the traditional type of audit to the audit of economy, efficiency and effectiveness of activities (the three E's audit) was achieved, through an intermediate stage of **value for money** audit, which covered the economy and efficiency aspects. Broadly, it can be said that economy audit is aimed at ensuring that the activities are undertaken and completed at the lowest possible cost. Efficiency audit is concerned with ascertaining that an activity is completed according to a pre-determined output to input ratio and according to a pre-determined time table. In the audit of effectiveness of programmes, it is necessary to determine whether the objectives for which the programmes were undertaken, have been achieved and whether the programmes had the intended effect on the social and economic life of the people. Thus, broadly, it can be stated, that in the earlier stage, traditional audit was concerned with **economy**, at the intermediate stage, it was concerned with **economy and efficiency** and that today it is concerned with **economy, efficiency and effectiveness.**

As already mentioned, the evolution of government auditing in India has been a gradual process, coinciding with the changes in the functions of government. Until 1950, government audit was mainly expenditure oriented. Appropriation audit, regularity audit, sanction audit, propriety audit etc. were conducted by the Indian Audit and Accounts Department, in so far as they related to individual transactions of government. The techniques and procedures prescribed for conducting audit, by and large, fulfilled the task of transaction audit of government expenditure.

The concept and practice of audit of expenditure has undergone radical changes in the post-independent era (after 1950). Following the development of parliamentary democracy and introduction of successive Five Year Plans for national development—social, economic and industrial—massive investments have been made by the government at the centre and in the states. When the pattern of government expenditure-dimension underwent a radical and rapid transformation in the wake of successive national plans, it was felt that the scrutiny of individual transactions was inadequate, as it tended to mistake the tree for the woods. It became, therefore, essential for audit to ascertain whether the various development programmes and welfare activities were being properly executed and their operations conducted economically, whether they were producing the results expected of them. Hence the concept of efficiency audit was introduced to meet the changing requirements in the pattern of government expenditure.

Introduction of performance budgeting and functional classification in government accounting gave a new dimension to efficiency-cum-performance audit. Since 1962, when the technique of efficiency-cum-performance audit was developed, it has been applied to the transactions connected with the development programmes. The introduction of comprehensive appraisal of the public sector undertakings and evolution of the mechanism of Audit Boards with built-in external expertise, saw yet another extension of the technique of efficiency-cum-performance audit. In addition, audit also covered new areas i.e. audit of tax receipts, audit of scientific departments etc.

With the shift in approaches in audit, changes have been introduced in the content and presentation of audit reports. Thus, the evolution of auditing in India has been a gradual process, matching with the changes in the functions of government.

22.4 STATUTORY AND INTERNAL AUDIT

Statutory Audit

Statutory audit refers to the audit conducted by the Comptroller and Auditor General, through the agency of the Indian Audit and Accounts Department. As per the Constitution as well as by the CAG (DPC) Act, 1971, it is the function of the Comptroller and Auditor General to (i) audit all expenditure from the Consolidated Fund of India of the Union, of each State and of each Union Territory, having a Legislative Assembly and to ascertain whether the money shown in the accounts as having been disbursed were legally available and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority who governs it and (ii) to audit all transactions of the Union and of the states relating to the contingency funds and public accounts. The Comptroller and Auditor General has been given, under the Constitution, access to the accounts of expenditure incurred against appropriations granted by Parliament. The CAG is empowered to inspect any office connected with the transactions to which his/her authority extends.

Statutory audit has a three-fold purpose. First, it is an **accountancy audit** to check the accuracy of arithmetical calculations and to see that all payments are supported by receipted vouchers. In its essence, it is no different from the limited audit of private auditors. Its objects are (i) detection of fraud (ii) the detection of technical errors and (iii) the detection of errors of principles. It is usually a continuous audit, but of a small percentage of transactions.

Secondly, it is an **appropriation audit** to check the classification of expenditure, in order to make sure that the items have been charged to the proper heads of accounts and further that the appropriation for these heads have not been exceeded.

Thirdly it is an **administrative audit** or **audit of sanctions** to check that expenditure has been incurred according to the rules and regulations or where not so covered, it has been sanctioned by the competent authority.

Statutory audit, can assure the Parliament, that appropriations have been utilised in accordance with the rules and regulations and within limits specified. It can vouch for the accuracy of accounts and detect misapplication of funds, frauds, and defalcations.

Internal Audit

Internal audit, on the other hand, is internal to the organisation. Internal audit is conducted by an agency or department created by the management of the organisation. It is an integral part of the organisation and functions directly under the Chief Executive. It is in the nature of an internal service to the Executive for smooth and efficient functioning and for reviewing and improving its performance.

The common objectives of an internal audit, inter-alia are to (i) check the adequacy, soundness and applicability of the systems of internal controls (Accounting, financial and other operating controls); (ii) prevent and detect frauds (iii) check on the adequacy and reliability of the accounting and reporting systems and (iv) conduct performance-cum-efficiency audit of an operation/ programme/ activity of an entity as a whole, or its parts designed to different levels for any of the objective, set by the management.

Internal audit, in any organisation, does not possess the same kind of independence as is available to the external audit, conducted by the Indian Audit and Accounts Department. There is, however, no conflict between internal and external or statutory audit. Where internal audit is adequate, the extent of statutory audit is limited to test checking of internal audit work.

Check Your Progress 1

Note: i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) Explain the meaning and importance of audit in a democracy.

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2) Explain the difference between Statutory audit and Internal audit.

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22.5 TYPES OF AUDIT

The broad aim of audit is to safeguard the financial interests of the tax payer and to assist the Parliament/ State/ Union territory legislatures in exercising financial control over the executive. It is the function of the Comptroller and Auditor General to ensure that the various authorities set up by or under the Constitution, act in regard to all financial matters, in accordance with the Constitution and the laws of Parliament and appropriate legislatures and rules and orders issued thereunder. In order to discharge the auditorial duties entrusted by the Constitution to him/ her, the Comptroller and Auditor General (CAG) conducts various types of audit viz., Financial audit, Regularity audit, Receipts audit, Commercial audit, Audit of stores and stock, Performance audit etc. In the performance of this stupendous task, the CAG is assisted by the accounting authorities in various ministries and by the Principal Accounts Officers functioning in various states. Some of the features of Financial audit, Regularity audit, Receipts audit, Performance audit are explained in the following paragrahps.

Financial Audit

Financial audit is the audit conducted by the Indian Audit and Accounts Department to see whether the administrative action of the executive is not only in conformity with prescribed law, financial rules and procedures, but it is also proper and does not result in any extravagance. Financial audit does not concern itself with the audit of administrative organisations and procedures and is different from administrative audit. It is the duty or the function of the executive government to frame rules, regulations and orders, which are to be observed by its subordinate in waste, extravagance or improper expenditure, it is certainly the duty of audit to call specific attention to matters of that kind and to bring the facts to the notice of Parliament. For instance, in a canal project construction, audit would not concern itself with the administrative set-up for the actual construction of the canal and whether it should pass through a particular part of the country or not. These are matters of administration and no scrutiny of these processes will be done by the audit. But if it is found that the alignments had been drawn up on insufficient data, necessitating a subsequent change involving additional expenditure or that the financial results were less than what had been anticipated, then it is the duty of audit to examine the circumstances which resulted in the wrong alignments resulting in loss or avoidable expenditure to the tax payer. Audit interferes only when administrative action has serious financial implications and is not in comformity with prescribed law, financial rules and procedures. Financial audit also includes audit against propriety or broad principles of orthodox finance. Thus, financial audit safeguards the interests of tax-payer by bringing to the notice of Parliament, wastage in government expenditure.

Regularity Audit

Regularity audit consists mainly in checking that the payments have been duly authorised and are supported by proper vouchers in the prescribed form. Its main purpose has been to ensure conformity with the relevant administrative, financial budgetary and accounting rules and regulations provided for in the Constitution or the laws made by Parliament.

The objectives of audit against regularity as specified in the Audit code, inter-alia, are to ensure:

i) that there is provision of funds for the expenditure, duly authorised by competent authority;

ii) that the expenditure is in accordance with a sanction properly accorded and is incurred by an officer competent to incur it;

iii) that the claims are made in accordance with the rules and in proper form;

iv) that all prescribed preliminaries to expenditure are observed, such as proper estimates framed and approved by competent authority for works expenditure, a health certificate obtained, where necessary, before disbursement of pay to a government servant;

v) that the expenditure sanctioned for a limited period is not admitted in audit beyond that period without further sanction;

vi) that the rules regulating the method of payment have been duly observed by the disbursing officer;

vii) that payment has been made to the person and that it has been acknowledged and recorded 50 that a second claim against government on the same account, is not possible; and

viii) that the payments have been correctly brought into account in the original documents.

Audit against provision of funds, aims at determining that the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made. Audit, in relation to audit of expenditure, is to ensure that each item of expenditure is covered by a sanction of the competent authority. Audit against rules and orders is an important aspect of regularity audit. It ensures that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made thereunder. Audit of expenditure against regularity is a quasi-judicial type of work, performed by the audit authorities. It involves interpretation of the Constitution, rules and orders.

Receipts Audit

Receipts audit involves the audit of income-tax and custom and excise receipts at the Union level. It involves the audit of sales tax and state excise receipts at the state level. From the late fifties, receipts audit has been conducted by the Indian Audit and Accounts Department.

In receipts audit, the function of audit department is to ensure that adequate regulations and procedures have been framed and are being observed by the revenue department, to secure an effective check on assessment, collection and proper allocation of revenue. Since the assessments in a revenue department are of a quasi-judicial nature, audit should ensure that the discretion used has been exercised in a judicious manner.

Performance Audit

Financial audit and Regularity audit generally involve scrutiny of individual transactions. They do not focus on the evaluation of a scheme or a programme to which these transactions relate. Therefore, both types of audits have been found inadequate for an evaluation of the performance of an organisation in terms of its goals or objectives.

Ever since the Government launched Five-Year Plans, investment on a large scale has been made on developmental activities for acceleration of socio-economic development of the country. In many cases, the investments did not give the expected returns. Therefore, public has a right to know whether the results achieved had been commensurate with the resources invested. The public concern has found expression in the introduction of performance budgeting in government.
The change in the thinking of government, in recent times, about the need to relate expenditure to corresponding physical accomplishments made it also to think about the functions of audit. It has been accepted that Regularity audit/Propriety audit is essential for parliamentary control of expenditure. However, in view of the increasing developmental expenditure, under the successive Five Year Plans, audit should examine the achievements of specific programmes, activities and projects in terms of their goals or objectives. It has been felt that audit should bring out those cases where utilisation of resources has been sub-optimal. This has resulted in a serious thought being given to the need for performance audit which is also called efficiency unit.

Performance audit seeks to find out whether the resources have been utilised efficiently by deploying them in an optimum manner. It highlights the extent to which resources are put to productive uses. It also highlights as to what extent quantified benefits could be expected from such deployment of resources.

Although the technique of performance audit is sound and useful, there are many problems in conducting such an audit. Firstly, performance evaluation of an activity can be made only in the light of the objectives, which is expected to achieve. Objectives spell out the results desired from an activity. Whereas inputs are easy to measure for an activity, tremendous effort is required to quantify and measure the resulting output, particularly when this output has a social context.

Secondly, according to the concept of **Net Welfare,** the utilisation of resources has to be optimised not only at the point where they are deployed but also at other points, where the effects of such investments are carried. In other words, investment decisions need to be justified by the application of the technique of social cost-benefit analysis.

Thirdly, the objectives of investment are often a combination of financial and non-financial factors. There may be situations, when these objectives of public investment which are otherwise considered socially desirable, are found incompatible with immediate financial objectives. For instance, a public undertaking engaged in the production of fertilisers, may have to sell its output at a low price fixed by the government to support agricultural programmes. If the undertaking does not get adequate subsidy from government, its financial results may present a discouraging picture. The undertaking may have served a long-range national objective of achieving self-sufficiency in food production. But in the process, its profits get reduced considerably or it may incur losses. In situations, where the objectives act against financial performance of a public undertaking, it would not be proper to

Fourthly, performance audit presupposes a good information system. A good information system is necessary, to furnish information about what has been actually achieved and at what cost, as against what was planned to be accomplished at a particular cost.

Lastly, effectiveness of performance audit would depend on how best the yardsticks of performance have been evolved. The technique of performance audit can be applied successfully in cases, where norms/standards are available for application. It is easier to apply in manufacturing organisations, than in the case of governmental organisations.

In India, the concept of performance audit is of recent origin. Its scope is unlimited. To conduct performance audit of public undertakings, Audit Boards have been set up. These Boards have been functioning, under the Comptroller and Auditor General, since April, 1969.

The utility of Performance audit can hardly be over-emphasised. It, however, requires expertise in identifying quantifiable objectives in government. It also necessitates framing of precise yardsticks against which the use of resources can be evaluated. In view of these problems, the scope of performance audit in government appears to be at present limited.

22.6 INDEPENDENCE OF AUDIT

In India, independence of the audit has been ensured by the Constitution in many ways. Firstly, the Constitution had made audit of the accounts of the Union and of the States a **Union subject**, by virtue of Entry 76 in the Union List under Article 246 of the Constitution. There is, thus, a common auditor of both the Union Government as well as the States and this is a unique feature of the Indian Constitution.

Secondly, the Constitution provides that the Parliament shall have exclusive power to make laws on the subject of audit of the accounts of the Union and of the States. At the same time, the Constitution has not made the Comptroller and Auditor General of India an officer of Parliament or of the House of the People. In practice also, the States do not regard him as an officer of the Union but a functionary created by the Constitution for purposes of both the States and the Union Government.

Thus, the Comptroller and Auditor General of India occupies a unique place. He certifies the share of the States of the taxes collected by the Union and the amounts so certified are accepted by the State Governments without demur. He certifies the expenditure incurred by the States on public expenditure programmes initiated and financed by the Union and the Union Government accepts the figures without question. The Comptroller and Auditor General of India, thus plays a fiduciary role in the sensitive Union-State relations.

Thirdly, the Constitution guarantees the independence of the Comptroller and Auditor General of India by prescribing that he shall be appointed by the President of India by warrant, under his hand and seal, and cannot be removed from office except on the ground of **proved misbehaviour** or **incapacity.**

Fourthly, while Parliament will be competent to make laws to determine his salary and other conditions of service, they cannot be varied to his disadvantage, after his appointment.

Fifthly, on retirement, resignation or removal, the Comptroller and Auditor General is prohibited from holding any further office either under the Government of India or under the Government of any State.

Sixthly, the salary and allowances of the Comptroller and Auditor General, the pension etc., payable to retired Auditors General and the administrative expenses of Comptroller and Auditor General's personal office, shall be charged on the Consolidated Fund of India. That is, they will not be subjected to the vote of

Lastly, the Constitution further provides that the conditions of service of persons serving in the Indian Audit and Accounts General shall be determined by the President after consultation with him. The Constitution, thus, provides adequate safeguards to the Comptroller and Auditor General to enable him/her perform his/her constitutional functions, without any fear from the Executive. (These issues are dealt with in detail in assessing the role of Comptroller and Auditor General in Unit 23.)

An independent judiciary and an independent audit are two of the more important elements of democracy. On them, devolves in varying degrees, the responsibility of protecting democracy from authoritarian trends and executive excesses. Our Constitution has taken, therefore, reasonable care to safeguard their independence.

22.7 RESULTS OF AUDIT—AUDIT REPORTS AND THEIR FOLLOW UP WITH ADMINISTRATION

Audit conducted by the Indian Audit and Accounts Department is in the nature of **ex-post facto** examination. In some cases, certain classes of payments are made after the claims have been audited and passed by audit. But these payments comprise a negligible percentage of the total expenditure of government. Since audit is conducted after the events have occurred, it cannot prevent an overpayment or non-observance of the financial rules and regulations. Also, it cannot stop the executive authorities from the commission of any irregularity or impropriety during the course of transactions. But the effectiveness of audit depends upon its right to report the results of audit to the proper authorities, which may be a departmental authority, the Government itself, or Parliament through the Public Accounts Committee. These bodies can then take appropriate action to rectify the irregularity or impropriety.

The results of audit are required to be reported by the Audit Officer to the administrative authorities concerned at the earliest opportunity. These authorities then become responsible for the settlement of objections raised by audit authorities. It is also the responsibility of the administrative authorities to effect recovery of any amount disbursed wrongly. The Audit officers keep pursuing the objections raised by them till these are settled to their satisfaction by the administration. Finally, after completion of a year's accounts, the results of audit are reported to the concerned Government and their legislatures through the instrument of Audit Reports.

Though Audit Reports appear post mortem, they serve many purposes:

- They are an aid to administration/management to ensure that irregularities are not repeated in future.
- They help the planning process in not conceiving faulty schemes.
- They give the right signals for mid-course corrections in on-going schemes.
- They also serve the basis for taking appropriate disciplinary action by the administrative authorities concerned against the persons who have caused loss to the exchequer by their acts of omission and commission to act as a deterrent.

Audit Reports should, however, be largely current and should be able to bring out the failures, drawbacks or the deficiencies as quickly as possible, so that prompt remedial measures can be taken by the administration.

The Constitution has prescribed the procedure to be followed by the Comptroller and Auditor General for presentation of the audit reports. The reports of the CAG in regard to the Union Government accounts shall be submitted to the president and the State Government accounts, shall be submitted to Governor of the State. At present, the Comptroller and Auditor General submits three reports viz., i) Audit Report on the Appropriation Accounts, ii) Audit Report on the Finance Accounts and iii) Audit Report on the commercial and public sector enterprises and revenue receipts on Union and state governments.

The responsibility of the Comptroller and Auditor General ceases with the submission of the audit reports to the President/Governor who causes them to be laid before the Parliament/State legislatures respectively. In actual practice, the audit reports of various governments are received by the Ministry of Finance on behalf of the President. The Finance Minister lays them on the table of each House of Parliament. Regarding Audit Reports of states, similar procedure is followed generally.

The authority of Parliament and state legislature to grant supplies to be effective, will require that Parliament and legislature should assure itself that the money is spent by the executive on purposes for which it was granted. And that the expenditure incurred does not exceed the amount sanctioned by them.

The details of these are contained in the accounts and audit reports presented by the Comptroller and Auditor General for both Union and State governments. It is impossible for parliament and legislatures to examine in detail, the accounts and audit reports thereon which are technical and voluminous documents. The Houses are unable to spare the time that a proper examination requires. Parliament (Lok Sabha) and state legislatures have, therefore, set up a Committee known as the Committee on Public Accounts and have entrusted to it the detailed examination of accounts (appropriation and Finance) and audit reports thereon.

An important function of the Public Accounts Committee is to ascertain that the money granted by Parliament has been spent by the government within the scope of the demand. This implies that the money recorded as spent against the grant, must not be more than the amount granted and the grant should be spent on purposes, which are set out in detailed demand. The functions of the committee extend, however, beyond the formality of expenditure to its **wisdom, faithfulness and economy.** When any case of proven negligence, resulting in loss or extravagance, is brought to the notice of the committee, it calls upon the Ministry/Department concerned to explain what action, it has taken to prevent a recurrence. In such cases, it might record its opinion in the form of disapproval or pass strictures against the extravagance or lack of proper control by the Ministry/Department concerned. The Committee is, however, not concerned with questions of policy in the broad sense.

The efficient functioning of the Public Accounts Committtee depends largely on the assistance given to it by the Comptroller and Auditor General and other officers. Apart from providing the basic material, **audit assists the Committee** in many ways. It provides notes to the members of the Committee which explain the significance of an irregularity or impropriety commented upon in the Audit report. Also, the auditors brief the members orally so that they can seek clarification and additional information in the course of oral examination of departmental witnesses. They also assist the committees in drafting reports, after considering the oral and documentary evidence. They also help the Committee in keeping a watch over implementation of those recommendations, which have been accepted by Government.

The Public Accounts Committee of Parliament/State submits its report embodying the findings on the audit reports of the Comptroller and Auditor General to Ministry/Department for implementation. The ministries are required to inform the Committee of the action taken by them on these recommendations within a period of six months from the date of the presentation of the Report. The Committee's recommendations are generally accepted by the Government. In cases, where the recommendations of the Committee are not acceptable to the Government, the reasons for Government's disagreement are placed before the Committee.

Check Your Progress 2

Note : i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) Distinguish between Regularity Audit and Receipts Audit.

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2) Explain the meaning and scope of Performance Audit in India.

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3) Discuss the importance of Audit Reports and their utility to administration.

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22.8 LET US SUM UP

Audit is an examination of accounting records, undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate. Its purpose is to see that expenditure has been incurred with the sanction of the competent authority, applied for the purpose for which it was sanctioned, and is duly supported by vouchers, as a safeguard against fraud and misappropriation. Audit is one of the four pillars of democracy. It is a vital instrument of ensuring effective supremacy of Parliament over the Executive. It is also a valuable ally to administration.

The evolution of auditing in India has been a gradual process, coinciding with the growth in the functions of Government. Initially, auditing was primarily expenditure oriented. Gradually, audit of receipts was taken up. With the growth of public enterprises, commercial audit came into being. Recently, audit has gone into the evaluation of the performance of organisations, activities, projects etc.

The Comptroller and Auditor General of India is responsible for conducting audit of the accounts of the Union, states and union territories with legislature. He/She conducts regularity audit, receipts audit, commercial audit, performance audit etc. The Constitution has provided adequate safeguards to protect the independence of the Comptroller and Auditor General from the Executive. He/She will be appointed by the President but can be removed only by the Parliament. His/Her tenure, conditions of service cannot be varied to his/her disadvantage, after his/her appointment. He/She cannot accept employment after retirement or dismissal, either under the Union Government or under the state government. His/Her salary, allowances and pension as well as his/her establishment will be charged upon the Consolidated Fund of India and not voted.

Audit Report is the final destination of audit. The Comptroller and Auditor General submits three reports i.e. Audit report on appropriation accounts, audit report on finance accounts, and audit report on the commercial and public sector enterprises and revenue receipts on Union and State Governments, to the President/Governor of the State/Administrator of Union territory with legislature, who causes them to be laid on the table of the Parliament/State legislatures respectively. The Audit reports are examined by the Public Accounts Committee. Besides providing the material, the Comptroller and Auditor General assists the committee, by preparing memos on Audit paras for the members of the Committee to conduct oral examination and also in drafting the reports of the Committee. In fact, the Comptroller and Auditor General is the **friend, philosopher and guide** of the committee. The Public Accounts Committee submits its Report to the Ministry on the basis of the findings made in the Audit Report for acceptance. Most of the recommendations of the Committee are accepted by the Government. In case some recommendations are not acceptable to Government, the Committee examines the same and submits **Action-taken Report** to the Parliament.

To sum up, audit is not an inquisition and its mission is not one of fault-finding. Its purpose is to bring to the notice of the administration lacunae in the rules and regulations, irregularities and lapses and to suggest wherever possible, ways and means for the execution of plans and projects with greater expedition, efficiency and economy.

22.9 KEY WORDS

Audit Reports: Comments on the regularity and propriety of expenditure as deemed necessary and proper on the results of audit investigation.

Corporation Audit: Audit of the accounts of corporation either by or under law made by Parliament.

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22.11 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Your answer should include the following points :

- Audit is an examination of accounting records with a view to establishing whether they correctly and completely reflect the transaction to which they purport to relate.
- Audit is an instrument of financial control.
- Audit is an aid to administration.
- Audit is one of the four pillars of democracy. It watches the interests of tax-payer and also helps Parliament to exercise control over the Executive.

2) Your answer should include the following points :

- Statutory audit is an audit conducted by the CAG of the transactions of the Government of the Union and of each state and Union territory with legislature.
- Statutory audit serves a three-fold purpose. It is an accountancy audit, appropriation audit as well as administrative audit.
- Internal audit is conducted by an agency within the organisation and is integral to management.
- Internal audit concerns itself with the examination of accounting, financial and other operations within the organisation.
- There is no conflict between internal and external audit.

Check Your Progress 2

1) Your answer should include the following points :

- Regularity audit consists in checking that payments have been duly authorised and supported by proper vouchers. It ensures conformity with the relevant rules and regulations provided in the Constitution or the laws made by Parliament.
- Receipts audit involves the audit of income-tax and customs receipts.
- Purpose of receipts audit is to ensure that adequate regulations and procedures have been framed and are being observed by the revenue departments to secure an effective check on assessment and collection of revenue.

2) Your answer should include the following points:

- Regularity audit involves the audit of individual transaction. It is not an evaluation of performance of an organisation, in terms of its goals or objectives.
- The change in thinking of Government to link expenditure to accomplishments led audit also to examine the performance of an organisation in terms of its goals or objectives. This is done by the performance audit.
- There are difficulties in the application of Performance audit viz., difficulties in determination of objectives at micro-level, difficulties in assessing performance in the case of public undertakings, where there are financial as well as non-financial objectives, difficulties in evolving norms/standards for Governmental activities etc.

3) Your answer should include the following points :

- Results of audit find expression in Audit Reports.
- Audit Reports are examined by the Public Accounts Committee and the CAG assists the Committee. The CAG is the **friend, philosopher and guide** of the Committee.
- The Public Accounts Committee forwards Report to Government for implementation of its recommendations. Where there is disagreement with the recommendations of the Committee, the Government should forward its views to the Committee within a period of six months which will, after examination, submit an **Action-taken Report** to the House.

UNIT 23 ROLE OF THE COMPTROLLER AND AUDITOR GENERAL (CAG)

Structure

23.0 OBJECTIVES

After studying this unit, you should be able to:

- understand the origin and constitutional position of CAG;
- describe the duties of CAG in respect of Accounts and Audit; and
- analyse the role of CAG in Indian Democracy.

23.1 INTRODUCTION

Exercise of financial control is one of the principal responsibilities of the legislature. Parliamentary financial control on government spending is implemented in two stages: primarily at the time of policy making and subsequently by controlling the implementation of the policy. Budget or the Annual Financial Statement showing the estimated receipts and expenditure of the Government for the ensuing financial year is presented and discussed in the Parliament or Legislature. The initial parliamentary financial control is exercised through the Annual Budget Estimates of the Government for the ensuing financial year, which is presented to the House for approval.

The second stage of control over the implementation of policies is exercised by examining that the funds voted by the Parliament/Legislature have been utilised for the purpose and in the manner in which the Parliament/Legislature had desired. The control is exercised through the Financial Committees in Parliament and States Legislatures. During the second stage, the Comptroller and Auditor General of India (CAG) comes to the aid of Parliament and State Legislatures. Audit is the principal instrument to ensure the financial accountability of the Executive to the Legislature of the Union and State. The Comptroller and Auditor General in India, has been, made responsible by the Constitution, to conduct the audit of the transactions of the Union and the States and Union Territories with Legislature.

In this unit, you will study the origin of the office of Comptroller and Auditor General (CAG), the constitutional position and also the powers and duties of the CAG in relation to accounts and audit. This unit will also make an appraisal of the role of CAG in Indian democracy.

23.2 ORIGIN AND CONSTITUTIONAL POSITION OF CAG

i) Origin

Finance, Accounts and Audit are as old as history itself. History bears out that a good accounts and audit organisation existed in ancient India. **Kautilya** in his famous **Arthasastra** gives an elaborate account of the accounting system that existed in the **Mauryan period.** According to the Arthasastra, "In the Mauryan policy, the final authority, in the matter of Finance, was the King; one of whose daily duties was to attend to the accounts of receipts and expenditure. Each Minister was responsible for the finance of his department and each department had its own accountant, treasurer and others. The Collector General was the head of the Finance Department. Below him was the special commissioner (Pradeshtara), who was a kind of Government Auditor checking District and Village group account, in addition to being in charge of collecting certain kinds of revenue. The accounting and financial year closed on the last day of Ashadha".

Similarly, **Gupta rulers** introduced more elaborate and orderly system of accounts and audit during their rule. According to Ramachandra Dikshitar "The accounts were maintained, as during the days of their predecessors, the Mauryas, and were submitted periodically for audit and approval. This is made clear to us by the term PATYUPARIKA. This may be translated broadly as corresponding to the modern Accountant General. The Accountant General who presided over the accounts department was responsible to the Council of Minister for his acts. It is evident that there was an elaborate Department of Accounts in the Gupta time." Likewise, the medieval rulers, viz. Sultans and Moghuls, laid proper stress on collection of revenue and conduct of audit. The Moghuls vested greater authority in their financial chief, by naming him as the **Vazir** or **Dewan.**

Although the ancient and medieval administrations established a coherent account and audit organisations, it went into decay, during the period of later Moghuls. Subsequently, it was the British, who introduced a proper system of accounting and auditing. This system is being followed, by and large, in our country today.

In 1858, when the East India Company's administration was taken over by the Crown, a complementary post of Accountant-General at the India office was created to prepare the accounts of the expenditure incurred in England. Simultaneously, an independent Auditor was appointed by the Crown for the audit of these accounts. This arrangement was, however, shortlived. In 1860, both accounting and auditing functions were amalgamated and placed in charge of the Accountant-General to the Government of India, who was designated as 'Auditor General'.

The statutory recognition of the Auditor General came, however, **only in 1919,** with the introduction of Constitutional Reforms. He was made independent of the Government of India and was appointed by the Secretary of State and held office as the administrative head of the Indian Audit Department, during his Majesty's pleasure. The Government of India Act 1935 gave further recognition to the importance and status of this office. Thereafter, his appointment was made by His Britannic Majesty and the conditions of his service were also determined by His Majesty-in-Council. His duties and powers were prescribed by rules made under the order of His Majesty-in-Council. His salary, allowances, and pension were made chargeable on the revenues of the Federation. **He could be removed from office only** in the same manner and on the same grounds, as a Judge of the Federal Court.

With the incorporation of the Government of India Act 1935 in the Independence Act 1947, the authority of the Auditor-General was further enhanced and the auditor of the Indian accounts in United Kingdom was placed under his administrative control. With the subsequent integration of the princely states in the federal structure of the Indian Union, his audit responsibility was extended to the whole of India.

The Constitution Act, 1950, redesignated the **Auditor General as Comptroller and Auditor General** and made him, alongwith the Judges of the Supreme Court, an officer of the Constitution. The Constitution Act recognised that the field of financial administration of India, whether in the States or the Union, should come under the coordinating authority of a single officer of Constitution, the Comptroller and Auditor General.

ii) **Constitutional Position of CAG**

The Constitution has installed the Comptroller and Auditor General (CAG) as a high independent statutory authority. The CAG is the one dignitary, who sees on behalf of the Legislatures that the expenses voted by them are not exceeded or varied and that the money expended was legally available for and applicable to the purposes to which it has been applied. Nothing can fetter the CAG's discretion or judgement in any manner on matters which he/she may bring to the notice of the Legislatures in the discharge of his/her duties. The oath of office under the Constitution requires him/her to uphold the Constitution and the laws and to discharge the duties without fear or favour, affection or ill-will.

For the purpose of securing the highest standards of financial integrity of the administration and watching the interest of the tax-payer and also for purposes of Legislative control, the Constitution safeguards the independence and freedom of the Comptroller and Auditor General in the following ways.

1) Article 148 of the Constitution lays down that the Comptroller and Auditor General of India would be appointed by the President by warrant under his hand and seal. The CAG will hold office for a period of six years or till he attains the age of 65, whichever is earlier. And he can be removed from office only in the same manner and on the same grounds as a Judge of the Supreme Court i.e. by impeachment in Parliament.

2) To further ensure that the Comptroller and Auditor General cannot be influenced by the Executive, the Constitution provides, as per Article 148(3) that the salary and other conditions of service of the Comptroller and Auditor General are such as determined by law and cannot be varied to his disadvantages, after his appointment.

3) The Comptroller and Auditor General is debarred by Article 148(4) from holding any office either under the Government of India or the State Governments, after he retires from the office of the Comptroller and Auditor General.

4) Furthermore, as per Article 148(6) all salaries, allowances and pensions payable to or in respect of persons serving in that office, shall be charged upon the Consolidated Fund of India.

5) The Comptroller and Auditor General is the Administrative Head of the Indian Audit and Accounts Department. His administrative power will be governed by rules made by the President, in consultation with the former.

Thus, the Constitution assures to the Comptroller and Auditor General, constitutional independence and has also placed him beyond fear or favour of the Executive, whose transactions he is expected to audit.

23.3 DUTIES AND POWERS OF THE CAG IN REGARD TO ACCOUNTS AND AUDIT

i) **Accounting Duties**

The duties and powers of the Comptroller and Auditor General have been prescribed by the Comptroller and Auditor General's (Duties, Powers and Conditions Service) Act 1971 as required by Article 149 of the Constitution of India. Under the Act, it is the responsibility of the Comptroller and Auditor General to audit all expenditure and receipts of the Government of India, the State Governments and of the Union Territories. He is also empowered to audit the expenditure and receipts of bodies or authorities substantially financed from Union or State revenues in the form of grants or loans.

As per Section 10 of the CAG (DPC) Act 1971, it is the responsibility of the Comptroller and Auditor General to compile the accounts of the Union and of each State, and prepare the **Finance Accounts.** Again, it is the duty of the Comptroller and Auditor General to prepare, from the accounts, **Appropriate Accounts,** showing under the respective heads, the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly. These accounts (i.e. Finance Accounts and Appropriation Accounts) are to be submitted to the President or Governor of a State or Administrator of the Union Territory, as the case may be.

He also provides the necessary information to the Union and States in the preparation of their Budgets (i.e. Annual Financial Statement).

The functions of the Comptroller and Auditor General, in brief, in so far as accounts are concerned, are mainly:

1) the prescription of forms in which accounts are to be kept in the Union and of the States;

2) preparation and submission of Finance Accounts and Appropriation Accounts to the President/Governor/Administrator of Union Territory as the case may be, and

3) providing information to Union/State Governments for preparation of their annual budgets.

ii) Auditing Duties

The real duty of the Comptroller and Auditor General is that of an auditor. The primary audit function is to verify the accuracy and completeness of accounts; to secure that all financial transactions viz., receipts and payments are properly recorded in the accounts, correctly classified and that all expenditure and disbursements are authorised and vouched and that all sums due, are recorded regularly in accordance with the demands and brought into account. He/She acts as a **watchdog** to see that the various authorities under the Constitution function in regard to financial matters, in accordance with the Constitution and the laws of Parliament and appropriate Legislatures and Rules and Orders issued thereunder.

As per the CAG (DPC's) Act, 1971 the auditorial functions of the Comptroller and Auditor General are as follows:

a) to audit all receipts into and expenditure from the Consolidated Fund of India and of each State and of each Union territory, having a Legislative Assembly and to ascertain whether the money shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose for which they have been applied.

b) to audit all transactions of the Union and of the States relating to Contingency Funds, and Public Accounts.

c) to audit all trading, manufacturing, profit and loss accounts and balance sheets and other subsidiary accounts kept in any department of the Union or of a State; and in each case to report on the expenditure, transactions or accounts so audited by him.

d) to audit receipts and expenditure of bodies or authorities substantially financed from Union or State revenues.

e) to audit the accounts of Government, Companies and Corporations established by or under the Law of Parliament, or in accordance with the provisions of respective Legislations.

f) to audit account of bodies or authorities by request.

In connection with the discharge of the auditorial duties, the Comptroller and Auditor General can inspect any office of accounts under the control of the Union or a State, including treasuries and offices responsible for keeping initial or subsidiary accounts. In short, the Comptroller and Auditor General is responsible for the audit of the accounts of the Union and of the States and of bodies substantially financed from Union or State revenues. Further, he/she audits the accounts of companies and corporations and of autonomous authorities, whose audit has been entrusted by law to him/her public interest. In the performance of the duties, he/she is assisted by the Indian Audit and Accounts Department.

23.4 OTHER DUTIES OF CAG

Besides the duties and functions relating to the auditing and reporting upon the accounts of the Union, of the States and of the Union territories with Legislature, the Comptroller and Auditor General may be entrusted with duties and functions in relation to the accounts of any other authority or body, as may be prescribed by or under any law made by Parliament. The Comptroller and Auditor General's additional duty at present, is to undertake audit of companies, the Comptroller and Government companies. In the case of Government companies, the Comptroller and Auditor General may comment upon or supplement the report of the professional auditors. Also, his/her duty involves rendering assistance to the Public Accounts Committee in its functions.

Check Your Progress 1

Note : i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) Explain the historical development of Audit in India and the constitutional position of the Comptroller and Auditor General.

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2) Describe the Accounting and Auditing duties of the Comptroller and Auditor General.

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23.5 ROLE OF CAG: AN APPRAISAL

The Constitution of India assigns an independent and important position to the Comptroller and Auditor General to perform the duties without fear or favour. It has provided adequate safeguards for his/her independence from the Executive. The office of the Comptroller and Auditor General of India is created by the Constitution itself. It has perpetual existence like other Constitutional organs of the State viz., the Supreme Court, the High Courts and the Election Commission. The Comptroller and Auditor General is an officer of the Constitution and not an officer of Parliament, even though he/she exclusively serves Parliament and State Legislatures. Thus, the Comptroller and Auditor General occupies a unique place in Indian democracy.

i) Appointment, Tenure and Removal of CAG

The Constitution guarantees the independence of the Comptroller and Auditor General by prescribing that he/she shall be appointed by the President of India by warrant, under his hand and seal and shall not be removed from office except on the ground of **proved misbehaviour** or **incapacity**. In a democratic set-up, independence in adequate measure is an indispensable necessity for this constitutional functionary to perform his/her duties undeterred. A.K. Chanda, a former Comptroller and Auditor General, has argued in favour of autonomy to "maintain the dignity, independence, detachment of outlook and fearlessness necessary for a fair, impartial and dispassionate assessment of the actions of the Executive in the financial field". As in the case of a Judge of the Supreme Court, the Comptroller and Auditor General can be removed from office only on two grounds—**proved misbehaviour** or **incapacity.** The address must be presented by both houses in the same session, and special majority is obligatory in each house for the passing of the resolution. The procedure for presentation of the address, investigation, and proof of the misbehaviour and incapacity is to be decided by Parliamentary legislation. Thus, the removal procedure appears to be a very difficult procedure and service as an effective safeguard against executive interference.

ii) **Terms of Appointment**

The Constitution guarantees his/her salary and other conditions of service, which cannot be varied to his/her disadvantage after his/her appointment. Also, the salary, and allowances of the Comptroller and Auditor General, shall be charged on the Consolidated Fund of India. Interference with the Comptroller and Auditor General's function is likely, if the salary and terms of conditions of service are left to the discretion of the Executive. Again, even in the event of Parliamentary displeasure with a Comptroller and Auditor General, his/her salary, pension or age of retirement will not remain within the competence of Parliament to change, if it so wishes to penalise him/her. On his/her retirement, resignation or removal, the Comptroller and Auditor General is prohibited from holding any office under the Government of India or under the Government of the State. The purpose is to keep the incumbents immune from allurement of receiving favours from executive, which in turn might influence his/her actions or decisions in office, prior to retirement. Indirectly, this provision strengthens the hands of the incumbents in making fearless assessment of executive actions. In actual practice, the spirit of this provision does not appear to have been strictly followed. The Constitution has provided that salaries, allowances and administrative expenses of the Comptroller and Auditor General be charged upon the Consolidated Fund of India. Unlike the other expenses of the Government, his/her expenses will not be votable in the budget. Hence, his/her action and official conduct is intended to be excluded from the scope of Parliamentary discussion and vote. The Constitution has thus accorded a very strong protection against Parliamentary interference with the working of the Comptroller and Auditor General's organisation.

iii) **Duties and Powers**

Parliament has prescribed the duties and powers of the Comptroller and Auditor General by enacting the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act 1971. With the separation of accounts from audit in certain departments of Union Government, the Comptroller and Auditor General had ceased to be responsible for maintaining the accounts of Food, Rehabilitation, Supply Departments, Lok Sabha and Rajya Sabha Secretariats, since separate accounts offices were in existence for them. In 1976, the Government of India took on accounting functions under its own administrative Ministry/Department with the result that separation of accounts from audit in Central Government became complete. But the responsibility for preparing annual accounts separately for each of the State Governments and Union territories having Legislative Assemblies and to submit them to the Governor or Administrator respectively remains with the Comptroller and Auditor General. The combination of auditing functions in one authority, though justified on grounds of economy, is contrary to the principles of independence of Audit. It amounts to making the Comptroller and Auditor General partly responsible to the Executive and Legislature. He/She becomes answerable to Parliament and Legislature for his/her accounting duties, which is an executive responsibility. Moreover, the accounting authority will hesitate in publishing in its Audit Reports, major instances of accounting irregularity arising out of the accounts compiled by itself. To that extent, auditing functions would suffer.

The Constitution prescribes that the Comptroller and Auditor General is the authority to prescribe the forms in which the accounts of the Union and of the States shall be kept. The purpose of having a centralised system of accounts is primarily to ensure uniformity and economy. Moreover, the technical expertise of

Comptroller and Auditor General in accounting matters of the Union and States is to be taken advantage of by the Government in the preparation and presentation of Annual Budget. So, the provision has its own advantages. It entrusts the Comptroller and Auditor General with a very important responsibility.

iv) Audit Reports

The Constitution has prescribed the procedure to be followed by the Comptroller and Auditor General for presentation of his/her reports. His/her reports, in regard to the Union Government accounts, shall be submitted to the President. And the accounts of the State Government shall be submitted to the Governor of the State. His/Her responsibility thereafter ceases. But it becomes obligatory for the President/Governor to cause them to be laid before the House of Parliament/State Legislature respectively. He/She submits three Reports viz., Audit Report on Finance Accounts, Audit Report on the Appropriation Accounts, and Audit Report on the Commercial and Public Sector Enterprises and Revenue Receipts on Union and State Governments respectively. The Constitution does not prescribe any form or guidelines for the contents of the Audit Report of the Comptroller and Audit General. It has thus been left with the Comptroller and Auditor General, the complete freedom and discretion to decide the form, the materials and the contents of the reports.

v) Limitations

Inspite of the various safeguards provided by the Constitution to maintain the independence of Comptroller and Auditor General from the Executive and Parliament, his/her independence appears to be limited by four factors viz., (a) restraint of the Executive on his/her budgetary autonomy (b) block of control over staff (c) indirect accountability to the Finance Ministry of the Union and the Finance Department of the State Government for handling accounting duties (d) absence of direct access to Parliament (unlike the Attorney General) in defence of his/her official conduct, if and when questioned on the floors of Parliament.

To conclude, notwithstanding these limitations, the Comptroller and Auditor General plays a unique role in Indian democracy, by upholding the Constitution and the laws in the field of financial administration. He/She is neither an officer of Parliament nor a functionary of Government. He/She is one of the most important officers of the Constitution and his/her functions are as important as that of Judiciary.

Check Your Progress 2

Note : i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) Evaluate the role of the Comptroller and Auditor General in Indian Democracy.

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23.6 LET US SUM UP

As already mentioned, the Comptroller and Auditor General of India ensures the supremacy of the Parliament over the Executive in financial matters. He/She is an officer of the Constitution and not an officer of the Parliament. The independence of the CAG is guaranteed by the Constitution in many ways to enable him/her to perform his/her functions without any inteference from the Executive. His/Her primary duty is to uphold the Constitution and the laws in the field of financial administration.

23.7 KEY WORDS

Compilation of Accounts: To compile is to compose and arrange materials collected from other records. The initial accounts of Government transactions in India are prepared by the authorities through whom the transactions occur; these authorities being unconnected with the Indian Audit and Accounts Department.

Stores and Stock: The term "stores" applies generally to all articles and materials purchased or otherwise acquired for the use of Government. The term "stock" refers to plant, machinery, furniture, equipment etc.

23.8 REFERENCES

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23.9 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Your answer should include the following points:
   - Accounting system in the ancient and medieval period.
   - Amalgamation of Independent Accounting system in 1857 by Lord Canning.
   - In 1860, auditing and accounting functions were amalgamated and placed in charge of an Accountant-General.
   - Statutory recognition to the Auditor General in 1919.
   - Government of India Act of 1935 gave further recognition to the importance and status of the office of CAG.
   - Constitution Act, 1950 redesignated the Auditor-General as Controller and Auditor General and made him an officer of the Constitution.
   - Comptroller and Auditor General is an independent statutory authority.
   - The CAG is appointed by the President and can be removed only by the Parliament.
   - The CAG's tenure is fixed for six years or age of sixty five, whichever is earlier.
   - The CAG's salary, allowances and pension are charged and not voted.
   - The CAG' is debarred from accepting employment either under the Union Government or State Government, after demitting the office of CAG.
2) Your answer should include the following points:
   - The CAG prescribes the forms in which the accounts of the Union and of the

- The CAG prepares the Appropriation and Finance Accounts and submits them to the President and Governor in respect of the Union and of the States respectively.
- The CAG renders assistance to the Union/States in the preparation of their budgets.
- The CAG audits the accounts, expenditure and receipt of the Union/States.
- The CAG audits the bodies substantially financed from Union/States resources.

Check Your Progress 2

1) Your answer shoud include the following points:
   - Independence of the Comptroller and Auditor General is assured by the Constitution in many ways viz., Appointment, Removal, Fixed tenure, salary and terms and conditions of service.
   - Limitations in regard to control over staff, budget and direct access to Parliament.
   - The CAG upholds the Constitution and the laws in the field of Financial Administration.

UNIT 24 FINANCIAL ADMINISTRATION OF PUBLIC ENTERPRISES

Structure

24.0 OBJECTIVES

After going through this unit, you should be able to:

- explain the meaning and importance of financial administration in public enterprises (PEs)
- discuss the functions of financial administration in PEs
- describe the financial objectives and organisation of PEs
- explain the investment management and financing of PEs; and
- evaluate the financial performance of PEs.

24.1 INTRODUCTION

Financial administration is the key functional area in the management of PEs. The financial administrators of PEs have to interact continuously with the other operating administrators in the enterprise to achieve the financial objectives. Finance is a service function and, therefore, the counterparts of financial administrators in other operating departments approach them to receive the requisite decisional inputs to execute their responsibilities. In all the stages of operations, finance function occupies the place of primacy. Under gestation, finance is required for the implementation of projects. In the normal run of the business, finance provides capital for meeting the day-to-day needs i.e., working capital. In expansion, finance provides resources both for current operations and execution of new projects.

In this unit we shall discuss the meaning, importance, functions of financial administration in PEs. The financial objectives and organisation of PEs shall be dealt with. Various aspects of investment management and financing of PEs shall be described. The financial performance of PEs in India shall be evaluated.

24.2 MEANING AND IMPORTANCE OF FINANCIAL ADMINISTRATION IN PUBLIC ENTERPRISES

Financial administration in PEs has been defined variously. According to one school of thought, financial administration in PEs means raising the funds to fulfil the financing needs. This definition limits the scope of financial administration to the methods and instruments of raising finance. It presents the conventional view of financial administration in PEs. Today, financial administration goes far beyond the task of raising finance and deciding about the mix of financial instruments. According to another view, financial administration in PEs deals with the management of cash. This definition implies that all such activities which affect the cash flow in PEs can be considered as financial administration. This is a very broad definition of financial administration as there cannot be many activities which do not influence the cash flow in PEs and as such it lacks operational validity. Some experts conceptualise financial administration in PEs as that group of activities which deal with raising of finance, its allocation among different purposes and monitoring their financial performance. This definition possesses conceptual clarity and also combines operational validity.

As noted earlier, financial administration is one of the major functions in PEs. It has to frequently interface with other business functions. A healthy interaction between finance and nonfinance administrators is a pre-requisite for a successful functioning of PEs. In reality, however this interaction hardly exists. Despite the usefulness of financial input in operating decisions, the operating administrators refrain from interacting with the financial administrators. There is a popular belief that finance function is disliked by the various functionaries in PEs. However, a study on the audit practices carried out by the Institute of Public Enterprise reveals that about 85 per cent of functionaries at all levels and in the different age groups preferred the continuation of audit. The financial administrators have brought this important function to disrepute because they try to control the performance of their counterparts in the operating departments more in terms of means and procedures than ends. In terms of the help provided to the non-finance executives, the financial administrators are found mostly indifferent. The ideal situation is one of providing active help. The exercise of the preparation and execution of budgets can be cited as a case in point. The budget should not be reduced to a game of numbers by financial administrators. It should be transformed into an exercise that may enlist the support and cooperation of all functionaries in PEs. On the part of the non-finance functionaries, they will do well to inculcate a positive approach to finance function and overcome the inertia of consulting the financial administrators as and when required from time to time.

24.3 FUNCTIONS OF FINANCIAL ADMINISTRATION IN PUBLIC ENTERPRISES

The financial policy of PEs is designed to achieve an optimal output at the lowest cost. It further aims to arrange to provide the financial inputs in a manner that may contribute to smooth functioning of PEs. In the effort to achieve this end, financial administrators have to execute the following functions:

Acquisition of Long-Term Sources of Funds

The financial administrator has a dual responsibility with regard to the acquisition of funds. He/She advises on the choice of appropriate sources of funds and then takes steps to procure the funds from the chosen sources. The funds employed in the enterprise may be classified into two groups long-term funds and short-term funds. The long-term sources of funds are further classified as debt and equity. Successful enterprises seek debt in preference to equity for reasons of cost, convenience and control. Debt is a less expensive source, **since tax savings are possible on interest paid.** Servicing equity, on the other hand, entails payment of tax. The overall cost of capital, therefore, varies in an inverse proportion to the debt component in the capital structure of the enterprise. Secondly, debt is relatively more convenient to obtain when needed and to redeem when not required. Debt does not also result in any dilution of control over the affairs of the enterprises since lenders do not acquire any voting rights. Lastly, low-cost debt provides a leverage which helps in achieving a higher rate of return on equity.

There are, however, definite limits to debt financing. Debt involves financial risks which need to be commensurate with the business risks. The business risks arise

from likely changes in demand for the product, emergence of competition or imposition of controls over prices, imports, exports etc. The financial risk grows in proportion to the debt component in the capital structure. It is essential to set definite limits to debt financing.

Limits to debts are fixed keeping in mind three interrelated standards, namely, industrial norms, debt servicing capacity and the cash adequacy during recession.

1) Each industry adheres to certain norms of capitalisation on the basis of its asset structure and magnitude as well as volatility of its earnings in the long run. Industries whose earnings are subject to high risks of obsolescence prefer self-financing and go in for a large equity base which can withstand the shocks.
2) The second factor, namely, the debt servicing capacity is taken as a fraction of the annual cash accruals. Conservative bankers insist on debt service coverage ranging from 200 to 300 per cent.
3) The cash adequacy standard is a variant of debt service capacity standard and is based on cash flows expected during the recession period. The objective is to ensure the required capacity to service the debt even under the worst circumstances. The three norms together guide the management in deciding the limits upto which it can seek funds in the form of debt.

It may be relevant to have a closer look at the equity-debt proportion in the capital structure of the central PEs. There are very few instances where the debt is more than the equity and even in these cases, the excess is due to the erosion of net worth because of accumulated deficits. The overall position is more or less in confirmity with the age-old policy of the government to maintain a 1:1 ratio for debt and equity.

Acquisition of Short-Term Sources

The current assets held by one enterprise are financed mainly from short-term sources. However, the long-term sources are supposed to provide the margin money and also take care of investments in the core current assets. Bank borrowings in the form of overdrafts or cash credit, suppliers' credit and other current liabilities constitute the major sources of short-term finance available to an enterprise. Bank borrowings have become so expensive now-a-days that they are exerting a restraining influence on the enterprises. They are trying to manage their current assets more efficiently and are at the same time, looking for alternative and less expensive sources of short-term finance.

The government follows the policy of asking PEs to obtain their credit requirements from the nationalised banks. In those cases where the enterprises are short of margin money, the government extends a guarantee to cover the deficit. When they find it impossible to obtain their total requirements of working capital from the banks, the government provides, short-term loans for a specific period.

Investments in Long-Term Assets

The enterprises employ their capital partly in fixed assets and partly in current assets. The financial administrators have to ensure that funds at the disposal of the enterprise are judiciously employed and that the proposals for further investments are economically viable. The investments in fixed assets involve substantial long-term commitments in terms of finance as well as technology. The proposal for each investment is to be, therefore, subjected to a cost benefit analysis.

A professional analyst makes use of a number of techniques like average rate of return, internal rate of return, pay back period, net present value (NPV) etc., for carrying out the cost benefit analysis. All these techniques help financial administrators in choosing the best project. (Refer to Section 24.10 on Key Words for explanation of these terms.)

Short-Term Investments

Major investment decisions may be subject to external pressures on the enterprise. But the decisions on current asset-holdings fall well within the scope of internal management. Investments in inventory can be regulated to ensure that excess stocks and stock-outs are avoided. Similarly, efficient management of trade credit helps in keeping the investments in sundry debtors to the absolute minimum. Better management of cash offers scope for reducing the interest burden on the enterprise. The techniques of ABC analysis, economic order quantity, re-ordering level, value analysis, etc., help managing the current assets more efficiently.

Planning Systems

The planning process in the enterprise includes strategic planning, long-term corporate planning and annual performance budgeting. It also covers economic and financial analysis needed for short-term decisions.

Strategic planning refers to planning of major strategies concerning expansion, diversification, taking up manufacture of new products, entering new markets, etc. The financial administrator plays a crucial role in marshalling the relevant costs and benefits and in advising the management on the long-term financial implications in terms of outlays and cashflows expected. He/She works closely with the team engaged in the strategic planning process. The criteria for investment decisions mentioned earlier are integral to the process of strategic planning.

Long Range Corporate Planning is the process of developing a time bound plan for achieving the objectives of an enterprise over a period of five or more years. It takes into account all the on-going activities as well as the new projects being taken up and prepares an integrated total plan for the enterprise as a whole.

Here again the financial administrator plays a major role in assimilating the data, appraising the alternatives and developing master budgets and financial forecasts for covering the plan period.

The performance budget is an extension of the corporate plan. It is prepared in greater detail and sets physical and financial targets for each responsibility centre and builds the efficiency norms into them. The budget thus serves as an instrument of planning and control. Since profitability is not the guiding index of efficient performance, what is needed is a system for review and target setting for each segment of the enterprise. The Management by Objectives (MBO) may also provide a framework for formulating and implementing the performance budget. These budgets enable decentralisation of authority and centralisation of control. Budgets also help management-by-exception.

Operating Decisions

There are very few decisions at the enterprise level which do not affect its funds. It is, therefore, logical for the financial administrators to have a say in those decisions. Leaving aside the investment decisions mentioned earlier the operating decisions cover a wide range of problems such as capacity utilisation, pricing, overtime working, shift-working, product-mix, credit policy and incentives.

Control Systems

Budgetary control and standard costing systems provide the basis for monitoring enterprise performance at all levels. They introduce a participative element in the target-setting exercise.

The financial administrator is expected to develop an integrated system which incorporates financial accounting as well as management accounting systems. The system has to be so designed as to generate data for compiling periodical reports to be sent to the administrative ministry, Finance Ministry and Planning Commission etc. It should also provide information to enterprise managers at all levels about their achievements vis-a-vis plans and targets. These managers need assistance in identifying and analysing cost variance as well as profit variance.

Internal Audit is considered to be an integral part of finance function in most of the PEs. It is internal appraisal and is mainly concerned with the evaluation of the effectiveness of managerial controls including systems and procedures. The external auditors rely very much on the internal audit for ensuring the credibility of basic records.

The financial executive coordinates with statutory auditors in carrying out the external audit. PEs are audited directly by the Comptroller and Auditor General of India (CAG) or by chartered accountants appointed by him as auditors. In the latter case, he has powers to carry out a supplementary test audit. There is an audit board which coordinates the external audit work in respect of central PEs in India.

24.4 FINANCIAL OBJECTIVES FOR PUBLIC ENTERPRISES

PEs are different from private sector enterprises in terms of their nature as well as their obligations to the nation. The private sector enterprises possess a great deal of clarity in terms of their objectives which is essentially the maximisation of their profitability. PEs are composed of two terms, viz. 'public' and 'enterprise'. By being 'public' these enterprises stand accountable to the government. Their management and ownership also rests with the government on account of this characteristic. The term 'enterprise' means that PEs have to produce certain goods or render certain services at a price resulting in excess of income over expenses which should be duly reflected in the profit and loss account and balance sheet. Further, these enterprises operate in diverse sectors including manufacturing, financial, promotional and welfare activities. There are about 1100 State Level Public Enterprises (SLPEs) run by state governments of the Indian Union and 240 central PEs. However, these enterprises can still have uniform financial objectives which may range from the retention of the net worth to its maximisation implying the fact that enterprises at the bottom of the scale will have to keep their net worth intact whereas enterprises at the other point of the scale can multiply their net worth in a business like manner. The welfare enterprises engaged in serving the needs of the weaker sections of the society are not suited for profit maximisation. However, in order to maintain their present level of operations and their likely expansion, they must keep their net worth intact. On the other hand, the manufacturing enterprises operating in competitive sectors can maximise their net worth based on the market leads.

Check Your Progress 1

Note: i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) Why is financial administration the key functional area in the management of PEs?

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2) Summarise the functions of financial administration in PEs.

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24.5 FINANCIAL ORGANISATION OF PUBLIC ENTERPRISES

Organisation for finance has undergone a radical transformation in PEs with the changes in the environment governing PEs and their structures. The financial organisation has acquired sophistication and complexity with the marketisation and partial privatisation of PEs.

Diagram 1 shows a typical organisation chart of the Financial Management Division in PEs.

Board of Directors

Chairman-cum-Managing Director

Director (Production) | Director (Marketing) | Director (Personnel)

Director (Finance)

Executive Director (Finance)

General Manager (Finance)

Deputy General Manager (Corporate Finance)
- Finance Manager
- Deputy Finance Manager

Deputy General Manager (Accounts)
- Senior Finance Manager
- Deputy Finance Manager
- Senior Accounts Officer
- Accounts Officer

Chief (Finance) (One at each Unit/Region)

Diagram 1

As the diagram shows, the Finance Division is headed normally by the Director (Finance) who holds a board level position. He advises the Chairman-cum-Managing Director (CMD) on all matters pertaining to finance and accounts. He is responsible for formulating and coordinating the financial plans. He executes a staff function and at the same time happens to be a line authority for the executive in the finance department. He is assisted in his task by Executive Director (Finance) and General Manager (Finance). The Executive Director is assigned some specific tasks besides helping the Director (Finance) in the formulation of financial policy. These may include responsibility for audit and preparation of budget. The General Manager (Finance) is saddled with routine affairs such as the preparation and finalisation of accounts, compilation of budgets, handling of cash credit and arranging corporate finance. In most of the PEs, the Director (Finance) is recruited by the Public Enterprise Selection Board. The earlier convention of deputing the officer from the Finance Ministry or the Indian Audit and Accounts Department has been abolished by the government. Diagram 1 shows that in case an enterprise is a multi-unit/multi-product concern, the financial organisations provide for a functionary (normally of the level of General Manager) to head this function at the various locations or product groups.

24.6 INVESTMENT MANAGEMENT IN PUBLIC ENTERPRISES

Investment proposals for establishment of new units or expansion of existing units emanate either from ministries/departments of the government or from the enterprises desiring expansion and growth. The broad nature of investment is determined by the priorities indicated in the National Plan. Individual investment proposals are required to be within the overall programmes outlined in the plan document. The government exercises a measure of control over the size and pattern of investments in the PEs by reserving to itself the power to approve capital outlay exceeding certain financial limits. The government also exercises control over such investments through the mechanism of scrutiny and approval of the annual capital budgets of the concerned enterprises.

The investment proposals are examined by various agencies of the government including the Projects Appraisal Division of the Planning Commission and the Plan Finance Division from financial, technical, economic and management viability angles. Their relevance to the overall plan objectives, availability of resources, social cost-benefit, etc., are also assessed. All investment proposals costing Rs. 20 crore and above require approval of the government at the highest level after these are cleared by the Public Investment Board. The Public Investment Board is constituted with the Secretary (Expenditure) in the Ministry of Finance as Chairman. Its other members include Secretary, Planning Commission, Secretary, Department of Economic Affairs, Secretary, Industrial Development, Secretary, Department of Public Enterprises, Secretary to the Prime Minister and Secretary of the Administrative Ministry which has made the investment proposal to the Board. As per the delegation of financial powers effective from 8th June 1988, the powers of the ministry/departments with integrated finance system, for sanctioning projects/schemes, was enhanced upto Rs. 20 crore but this power can be exercised after following usual Expenditure Finance Committee (EFC) procedure and after obtaining the comments of the Planning Commission and other appraising agencies. Projects costing Rs. 20 crore and above continue to be considered by the Public Investment Board, and Cabinet Approval is also obtained where expenditure is Rs. 20 crore or more. The powers of the Board of Directors of PEs to sanction capital expenditure were also enhanced in August 1986. As per the revised delegations, the powers of the Board of Directors are as indicated below:

Public Enterprises with Gross Blocks of:	Power to sanction capital expenditure without prior approval of Government
Less than Rs. 100 crore	Rs. 5 crore
Between Rs. 100 crore and Rs. 200 crore	Rs. 10 crore
Above Rs. 200 crore	Rs. 20 crore

In addition to the above delegation, Government (vide O.M. dated 7.11.88 and 29.8.1990) has further delegated enhanced powers to Board of Directors of Memorandum of Understanding (MOU) signing companies to incur capital expenditure. As per the revised delegation, it has been decided that in respect of companies signing MOUs and having gross block of over Rs. 200 crore, the power to incur expenditure on additions, modifications and new investments will be raised from the existing limit of Rs. 20 crore to Rs. 50 crore without prior approval of the government. Further, the power to incur expenditure on replacement renewal of assets from the present limit of Rs. 50 crore to Rs. 100 crore is provided subject to certain conditions.

24.7 PUBLIC ENTERPRISES—SOURCES OF FINANCE

There are various sources of financing PEs. These mainly constitute equity and grants received from the government, public participation in equity, borrowings from the open market in the form of public deposits and issue of bonds, foreign investment and cash credit advances.

The government is the main provider of funds to PEs. It finances PEs through equity grants and borrowings. The borrowings are provided at a rate of interest of 14-16 per cent per annum for long-term funding. The equity is provided for long-term funding at no cost. Thus, the equity represents the perpetual interest-free capital. To check the misuse of cost-free funds, the government has initiated a scheme of disinvestment of equity in PEs from 1991-92 in which year Rs. 3,000 crore was received from the sale of PE shares through mutual funds. The government's total equity in the Central PEs was of the order of Rs. 38,634 crore as on March 1, 1990. The long-term loans provided by the Government to PEs amounted to Rs. 24,585 crore as on the same date. The central government provided about 68 per cent of the total financing needs to these enterprises in 1989-90. The foreign participation in terms of equity and debt amounted to Rs. 14,221 crore as on the same date which amounted to about 14 per cent of the total financing needs in 1989-90. The equity and loans provided by the financial institutions amounted to Rs. 5,213 crore and constituted about 5 per cent of the total financing needs as on March 31, 1990. The private participation by way of bonds, equity and public deposits amounted to Rs. 60,496 crore which represented roughly 16 per cent of the total financing needs as on March 31, 1990.

The working capital requirement of PEs are generally met through cash credits and advances arranged with the State Bank of India and nationalised banks. The total amount of outstanding cash credit drawn by the central PEs stood at Rs. 13,973 crore as on March 31, 1990. In special cases nonplan loans also are arranged by the central government to some enterprises to meet their working capital requirements. As on 31 March 1990 an amount of Rs. 14.40 crore was due from these enterprises under this head.

Despite the recommendations made by several expert committees/commissions such as the Krishna Menon Committee (1959), Administrative Reforms Commission (1967) and Committee on Public Undertakings (1971), these enterprises did allow public participation in their equity. The internal financing through generation of internal funds by way of depreciation, write-offs and retained profits constitute another important source of financing PEs. Internal financing is a cost free source of finance. Between 1985-86 and 1989-90 internal resources generated by these enterprises stood at Rs. 37,677 crore. Not only the volume of internal generation of resources increased between 1985-86 and 1989-90 from Rs. 5,067 crore to Rs. 10,779 crore, respectively, but the number of PEs generating internal resources also increased from 126 to 150 during the same period. The generation of internal resources reduces the dependence of PEs on the government and thereby acts as an important measure of autonomy.

24.8 FINANCIAL PERFORMANCE OF PUBLIC ENTERPRISES

Financial performance of the Public Sector has assumed critical importance in the present context of severe resource crunch faced by the Indian economy. The public sector in India contributes 25 per cent to the country's Gross National Product. It holds a position of great strength in several economic activities despite the present move about privatisation. It is expected that PEs in India will double their size in terms of the investment from Rs. 3 lakh crore at the end of Seventh Plan to Rs. 6 lakh crore at the end of the Eighth Plan. These enterprises contribute substantially to our foreign trade. About 20 per cent of the foreign trade is transacted through these enterprises.

Table 1 shows that the central PEs with an investment of over Rs. 1,10,000 crore as on March 31, 1991 had earned profits of less than Rs. 3,000 crore. The table also shows that the profitability of the central PEs declined by 40 per cent during 1990-91 over the previous financial year.

Table 1: Profit Status of Central PEs

	Units	1980-81	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
1	2	3	4	5	6	7	8	9	10	11
1. Number of running Public Enterprises	Number	163	201	207	211	214	221	226	233	236
2. Capital Employed	Rs. Crore	18207	29851	36382	42965	51835	55554	67629	84869	101797
3. Turnover	Rs. Crore	28635	47272	54784	62360	69088	81271	93137	106069	118355
4. Gross Margin (Profit before depreciation, interest and tax)	Rs. Crore	2401	5771	7386	8230	9897	11134	13438	16412	18510
5. Depreciation*	Rs. Crore	983	2205	2758	2983	3376	4150	4866	5790	7151
6. Gross profit before interest and tax	Rs. Crore	1418	3565	4628	5287	6521	6984	8572	10622	11359
7. Interest	Rs. Crore	1399	2086	2529	3115	3420	3595	4167	5329	7539
8. Net profit before tax	Rs. Crore	19	1480	2099	2172	3101	3389	4405	5293	3820
9. Tax	Rs. Crore	222	1239	1190	1000	1330	1329	1411	1504	1452
10. Net Profit after tax	Rs. Crore	−203	240	909	1172	1771	2060	2994	3789	2368
11. Internal Resources generated (Gross)	Rs. Crore	1225	3278	4251	5068	6014	6947	8915	10774	11372
12. Net Profit (after tax) to capital employed	Per cent	−1.1	0.8	2.5	2.7	3.4	3.7	4.4	4.5	2.3

* Includes deferred revenue expenditure.

(Source: Financial Express, Economic Survery: 1991-92, Bombay, March 1 1992, p. vii).

Table 2 shows that the position of the state level PEs was none too good. These enterprises incurred losses continuously.

Table 2: Financial Results of Departmental Commercial Undertakings of States & UTs
[Profit(+)/Loss(−)]

(Rs. crore)

	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91 (R.E.)	191-92 (B.E.)
1. Depart. Comm. Undertakings*							
i. Forest	497.70	516.21	543.69	414.35	540.24	372.46	528.33
ii. Power Projects	−75.04	−93.81	−116.40	−84.19	−34.83	−54.56	−42.98
iii. Road & Water Tpt. Services	−25.65	−36.59	−110.76	−56.51	−93.21	−75.78	−64.10
iv. Dairy Development	−99.29	−40.45	−43.91	−52.38	−106.99	−72.23	−77.18
v. Industries	−14.10	−16.46	−20.51	−10.09	−159.66	−112.91	−40.04
vi. Mines & Minerals	40.06	35.05	27.02	51.83	60.62	60.43	75.26
vii. Irrigation Projects (Commercial)	−871.60	−1225.95	−1344.50	−1840.79	−1916.85	−2002.63	−2206.66
viii. Multipurpose River Projects							
2. Profit of Profit making Undertakings	537.76	551.26	570.71	466.18	600.86	432.89	603.59
3. Loss of Loss making Undertakings	−1068.68	−1413.26	−1636.08	−2043.96	−2311.54	−2318.11	−2430.96
4. Net Financial Results of Departmental Undertakings	−547.92	−862.00	−1065.37	−1577.78	−1710.68	−1885.22	−2430.96

* These do not include State Electricity Boards and Road Transport Corporations.

(Source: Financial Express, Economic Survey: 1991-92, Bombay, March 1, 1992, p. vii)

However, there are PEs which have had an unblemished profit making record. Some of these enterprises include the Oil and Natural Gas Commission, Bharat Heavy Electricals Ltd., Electronics Corporation of India Ltd., Air India, Hindustan Petroleum Corporation Ltd., Indian Petro Chemicals Ltd., Indian Oil Corporation Ltd., National Thermal Power Corporation Ltd., Steel Authority of India Ltd., Oil India Ltd. The top ten loss making enterprises as on March 31, 1990 included Hindustan Fertiliser Ltd., Fertiliser Corporation of India Ltd., Indian Iron and Steel Company Ltd., Delhi Transport Corporation Ltd., Engineering Projects Ltd., Hindustan Ship Yard Ltd., Hindustan Steel Works Construction Corporation Ltd., Cement Corporation of India Ltd., National Jute Manufacturers Corporation Ltd., and Hindustan Cables Ltd.

The dismal financial performance of PEs has resulted from sub-optimal project planning, under utilisation of capacities, lack of aggressive marketing, poor production and planning and control, unsuitable product mix and over-staffing. Externally, the failure of PEs in managing the environment to their advantage has also contributed a lot to this phenomenon.

An efficient and effective financial administration can turn the corner of the ailing PEs. One way of turning the PEs around is to resort to the introduction of the OPTIMA (optimum performance through internal management action) in PEs. This will result in commercialisation, corporatisation, restructuring and privatisation of PEs. The PEs will do well to adopt the private sector style of management. Externally, the government-PE interface needs to be made harmonious. The introduction of Memorandum of Understanding (MOU) is a step in the right direction.

The financial administration in the PEs in 1990s is expected to proceed along new lines. In the field of financing, PEs will resort increasingly to capital market. They will also make forays into international capital markets. They are likely to get listed on various stock exchanges in the country and their shares will be available for trading. The function of financial administration is expected to acquire participating orientation. The use of electronic data processing systems is likely to replace the hunch-driven decisions in the realm of finance administration. The cost of capital is expected to assume primacy in the area of financial decision making in PEs.

Check Your Progress 2

Note: i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) State the names of various institutions involved in the appraisal of investment decisions in PEs.

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2) How do PEs arrange their working capital?

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3) List the various sources of financing long-term needs in PEs.

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4) Give reasons for dismal performance of PEs in India.

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24.9 LET US SUM UP

PEs constitute an important segment of the economic system in India. Their contribution to the national economy is phenomenal. Their effective functioning is crucial for the success of the planned economic efforts. The effectiveness of financial administration, measured in terms of profitability, points out that these enterprises have lagged far behind the expectations. They can make significant improvements in respect of the three components of financial administration viz., investment management, financing and checking upon their financial performance. The function of financial administration is undergoing a sea change in PEs. These enterprises have started organising their financial organisation in a businesslike manner. They have commenced efforts to reduce their dependence on the government through the capital market. They have initiated exercises to review their investment portfolio to weed out non-operating assets. There is a great scope for toning up, further the activities pertaining to financial administration in PEs.

24.10 KEY WORDS

Assets: These are the resources owned by PEs.

ABC Analysis: It is the analysis of range of items in an organisation on cost criteria. A items are considered very important which represent high cost centre; hence need tight controls, strict and close watch, rigid estimates of requirements. B items are of intermediate cost centre which require moderate control while C items are low cost centre.

Disinvestment: Refer to Section 3.7 of Unit 3.

Economic Order Quantity: It is a method of comparing cost of keeping a certain inventory level with cost of frequency of re-ordering.

Inventory: It represents part of an enterprise's working assets consisting of raw materials to be used in manufacturing of a product, goods in process of manufacture and finished goods ready for delivery to the customers.

Internal Rate of Return: It is the yield rate or investment rate or earning power of the project.

Line Authority: An authority concerned directly with the execution or fulfilment of the objectives of the government. The line authority is responsible for controlling, regulating, directing the administration.

Net Present Value (NPV): It is the yardstick for the assessment of a project or enterprise based on discounted cashflow techniques. A positive NPV indicates a better return while a negative NPV indicates a worse return. A zero NPV indicates that the project repays the capital invested plus the minimum acceptable return.

Optimal Performance through Internal Management Action (OPTIMA): It is based on the belief that while external problems and constraints might exist, a great deal could be done through internal management, response and action (Reference: Iyer, Ramaswamy R. 1991. A Grammar of Public Enterprise: Exercises in Clarification, Rawat Publications; New Delhi).

Pay-back Period: The length of time necessary for the returns (usually measured after tax has been paid) from an investment project to equal the initial sum invested in the project.

Public Investment Board (PIB): This was set up in 1972 to speed up approval of public sector projects. All proposals for investment in public sector enterprises involving one crore or more are referred to PIB.

Privatisation: It is the transfer of PE activities partially or fully through management, ownership and financing modes.

Re-ordering Level: A stock level at which more of the stock keeping unit must order to replenish the stock.

Staff Function: It is the function of rendering advice, assistance to the line authority. For example, the U.P.S.C. in India is a staff agency which advises the government on matters of recruitment of personnel.

Value Analysis: It is the process of analysing the intrinsic value of the investments for achieving the objectives of the organisation.

24.11 REFERENCES

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24.12 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Your answer should include the following points:
   - Finance is a service function which requires the counterparts of financial administrators in other operating departments approach them to receive the requisite decisional inputs to execute the responsibilities.
   - Finance occupies the place of primacy in all stages of operation.
   - Finance is required for the implementation of projects under gestation for normal day to day running of the enterprise.
   - Finance provides resources both for current operations and execution of new projects.
2) Your answer should include the following points:
   - Investment management function
   - Financing function
   - Checking upon financial performance
   - Planning systems
   - Operating decisions
   - Control systems.

Check Your Progress 2

1) Your answer should include the following points:
   - Boards of management of PEs
   - Administrative ministry

- Finance expenditure committee
- Public investment board
- Cabinet committee on economic affairs.

2) Your answer should include the following points:
   - Cash-credits from nationalised banks
   - Internal generation of resources
   - Non-plan loans from the government.

3) Your answer should include the following points:
   - Equity from the government
   - Debt from the government
   - Grants from the government
   - Resources from financial institutions
   - Foreign participation in equity and debt
   - Public participation in equity
   - Extra budgetary resources including public sector bonds, deep discount bonds and commercial paper, etc.
   - Internal generation of resources.

4) Your answer should include the following points:
   - Sub-optimal project planning
   - Under utilisation of capacities
   - Lack of aggressive marketing
   - Poor production and planning and control
   - Overstaffing
   - Unsuitable product mix.

UNIT 25 FINANCIAL AUTONOMY AND ACCOUNTABILITY OF PUBLIC ENTERPRISES

Structure

25.0 OBJECTIVES

After reading this unit, you should be able to:

- explain the concept of financial autonomy and accountability in Public Enterprises (PEs)
- describe various tiers of financial autonomy and accountability in PEs,
- discuss the methods of ensuring financial autonomy and accountability in PEs
- examine problems pertaining to financial autonomy and accountability in PEs
- provide suggestions for improved autonomy and accountability of PEs; and
- highlight recent trends pertaining to financial autonomy and accountability of PEs

25.1 INTRODUCTION

The extent of financial autonomy and accountability has been at the heart of discussions about improving the performance of PEs. There have been conflicting views about the right mix of financial autonomy and accountability which can ensure an efficient and effective performance from these enterprises. It goes without saying that there is no well-defined formula available in this respect which can be suggested to the principals (government) and the agents (PEs). What is required is to inculcate an awareness about striking the golden mean between financial accountability and financial control among those who hold the reins of the government and PEs in their hands. The right mix will emerge as a result of the mutual understanding of the needs on the part of the principals and agents and the restraints that both will impose on each other to find an agreeable solution to the problem.

In this unit, we shall discuss the concept, various tiers and methods of financial autonomy and accountability of PEs. The problems pertaining to this aspect will be examined and suitable suggestions for improved autonomy and accountability of PEs shall be provided.

25.2 CONCEPT OF FINANCIAL AUTONOMY AND ACCOUNTABILITY IN PUBLIC ENTERPRISES

Public Enterprises (PEs) as we all know are set up wholly or substantially owned by the government for the purpose of undertaking activities of industrial, manufacturing, trading or allied nature. They are government owned enterprises functioning under both central and state governments. The PEs are corporate bodies, set up either under specific acts of Parliament or under Companies Act. The PEs since they are established with public funds, are accountable to the public i.e. through the parliament.

Autonomy in simple terms means freedom to take decisions and function accordingly while accountability refers to rendering of accounts to some higher authority. The financial autonomy given to PEs means empowering them to take decisions on their own in the areas of investment management, financing of investments and monitoring the financial performance of respective enterprises based on sound business principles and the wisdom of the financial administrators. Insofar as investments are concerned, other things remaining the same, PEs should have freedom in identifying the projects, preparing the detailed feasibility project reports, appraising the projects, making investment choices, and implementing and monitoring them. They should also be free to decide the optimal level of investments in the various items of inventory book debts and floating stock of cash. By the same principle they should be free to peg the level of current liabilities to any proportion of the current assets. The financial decisions in the normal run may be made by these enterprises as guided by the cost of capital. They should possess the freedom to choose among the various debt-equity propositions. They should be at liberty to select bankers, financial institutions and the channels of money and capital markets for financing their working fund requirements. Subject to the social constraints imposed on them by the government, these enterprises should be vested with the autonomy to develop their own costing and pricing systems, norms of profitability and monitoring mechanism to ensure the desired financial status alike any business firm in the private sector.

Prof. V. V. Ramanadham in his treatise entitled "The Control of PEs in India" discusses the concept of financial accountability. Primarily it implies the accountability of PEs to parliament in financial matters. So expressed, it is part of the general problem of amenability of PEs to parliamentary control and calls for a compromise between the democratic rights of parliament and the autonomy of the enterprises. The other aspect of financial accountability is that the maximum good results ought to be secured from the PEs. So expressed, it borders on the concept of efficiency in financial terms. The maximisation is not tantamount to an insistence on the highest possible profit from every public enterprise. The concept suggests that, subject to any set criterion of profit and social benefit, the enterprise ought to record the best possible results.

25.3 TIERS OF FINANCIAL AUTONOMY AND ACCOUNTABILITY IN PUBLIC ENTERPRISES

Financial autonomy is a phenomenon external to the organisation. In other words, it flows from the environment governing the functioning of PEs. Thus there are six tiers of financial autonomy. These include the parliament, the government, the Comptroller and Auditor General (CAG) of India, the Courts of Law i.e. the Supreme Court of India and the High Court, the mass media and the citizen. All these six institutions can have an explicit policy about the financial autonomy they may like to provide to PEs in order to enable them to operate efficiently and effectively. As the enterprises under discussion are both 'public' and 'enterprise', these institutions cannot be overjealous in controlling each and every aspect of financial business of PEs. The respect for the corporate status of these enterprises will have to be maintained by these institutions. While saying so we do not deny the need for exercising checks and balances on the financial decision making in these enterprises. The main point is that these institutions should be selective in exercising the financial controls on PEs. PEs may enjoy autonomy in the day-to-day financial decision making which in its ambit may include matters such as normal purchases, cost allocations, evolving suitable price structures, selection of suitable sources and mix of finance, installation and operation of the financial information systems, and preparation and finalisation of accounts, etc. On the other hand, the six institutions may however intervene in the policy aspects of the financial decision making. For instance, if the parliament so desires, it may discuss the financial performance, financial position, pricing, financial aspects of foreign collaborations and the position of internal financing in PEs, etc. The government may reserve the right to approve the appointments of executives drawing salaries above certain levels and issue directives to PEs to provide certain services at particular prices, even if they are not economical. The CAG can give directions to PEs to follow a specific format for the presentation of their accounts and disclosure of the financial information. The various courts of law may direct PEs to alter their financial decisions if the fundamental rights of the citizens are affected. The mass media and the citizens may criticise certain financial decisions by PEs and as a result the PEs may have to reconsider the matter. Such decisions may include matters relating to pricing, and selection of suppliers of plant and materials which may attract public resentment. At times public enquiry can be carried out on certain decisions taken by the management of P.E.'s. For instance in 1970, on the recommendations made by the Committee of Public Undertakings, a one man commission was set up to enquire into award of contract for laying some pipelines to an American firm by the Indian Oil Corporation.

The financial accountability of P.E.'s pertain to:

Major Accounting Decisions: These include: an increase in depreciation, changes in tender procedures, stores valuation and replacements.

Matters of Internal Organisation: These include internal audit, procedures for ordering materials, delegation of powers, watch and ward supervision over financial transactions, provisions relating to disciplinary matters etc. These are examples of matters which may be left to be properly evolved within the enterprise itself.

Broad Financial Policies: These are fundamental aspects of financial accountability. They require plans between those evolved by the board and the socioeconomic aims set by the parliament. These may include matters pertaining to self-financing, outlines of capital expansion programmes and the rates of dividend, repatriation of foreign funds or consultancy fees and so on.

PEs may owe an accountability to various institutions in respect of financial results, productivity and growth. The memorandum of understanding (MOU) is emerging as an important instrumentality whereby PEs are required to spell out their objectives and the targets they are expected to achieve during a given financial year.

25.4 THE METHODS OF ENSURING FINANCIAL AUTONOMY AND ACCOUNTABILITY IN PUBLIC ENTERPRISES

To ensure financial autonomy, both external and internal methods have been resorted to. Externally the government spells out the financial freedom of the PEs in regard to several aspects in their articles of association. The limits for investment, commercial borrowings, working capital borrowings, salaries offered to employees and powers of recruitment, etc., are specified in the articles of association of PEs. The provisions regarding business budgeting, costing and pricing etc. are also contained therein.

The government indicates the extent of autonomy to PEs in respect of pricing, investment and profitability, in the MOU. In the articles of association as well as the enabling acts under which public corporations have been set up the government exercises self-restraint on itself not to interfere in the day to day working of PEs including matters pertaining to financial functioning.

Internally PEs ensure autonomy at different levels of functioning by enforcing delegation and decentralisation of financial powers. In many a PE, there is a healthy tradition to hold group meetings which are also known as communication meetings. In these meetings the departmental heads are the invitees. The workers' representatives are also invited. The problems are discussed and decisions are taken then and there. These meetings deal with the decisions regarding procurement, plant acquisition, investment of funds and acceptance of tender. This instrument provides a great deal of financial autonomy to the executives and work force.

The methods of ensuring financial accountability may be divided broadly into two categories: organisational methods and the external methods. The former may take the shape of arrangements which may enable a PE to give a good financial account of itself. The external means may be a sequel to the autonomous organisation of a PE, created for ensuring that the managers, to whom it does not belong, behave responsibly vis-a-vis the parliament.

The organisational means of financial accountability are as follows:

a) Clear financial procedures.
b) Efficient internal audit.
c) Commercial audit by private auditors.
d) Proper internal organisation of the enterprise, based on optimal criteria and decentralisation.
e) Appointment of a Financial Advisor of the enterprise by the government or under governmental approval.
f) Governmental control is exercised through the Board of Directors of the PE. The Chief Executives and full-time Directors of the PEs are appointed by the government. In most of the enterprises government's representatives on the boards in the form of nominee directors are present. They are from the concerned Administrative Ministry and Ministry of Finance serving in an ex-officio capacity on the board.
g) Reservation of certain financial matters for government approval, under the Articles of Association or under the Act governing a public enterprise.
h) Audit of PEs by the Comptroller and Auditor General is another means of financial accountability. In PEs there is a system of double audit. The accounts of PEs are first audited by the statutory auditors of the enterprise. After this is passed by the Board of Directors of the enterprise, then the supplementary audit is conducted by the office of the C & AG.

Check Your Progress 1

Note: i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) What do you understand by financial autonomy of PE?

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2) List six institutions which can explicitly lay down policy relating to financial autonomy of PEs.

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3) Point out the areas of financial accountability of PEs.

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4) Discuss the methods of ensuring financial accountability of PEs.

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25.5 STATUS OF FINANCIAL AUTONOMY AND ACCOUNTABILITY IN PUBLIC ENTERPRISES

Though financial autonomy is a much talked about phenomenon, there are a number of constraints on PEs imposed by the diktats from the parliament and the administrative ministry. For example the DVC Act makes it obligatory on the Damodar Valley Corporation to report on ten financial matters, obtain approval on fifteen financial matters and receive directions from the Minister on five financial matters. As discussed earlier, in the guise of serving the public interest, a minister can always issue a formal directive to PEs. There have been cases of frequent lunch-table directives to PEs by the government. One of the reasons as to why PEs have missed linking costs with prices can be found in the undue interference by the government in their working. The guidelines issued by the Department of Public Enterprise (then Bureau of Public Enterprises) corroborate this assertion. There are more than 200 guidelines on financial matters. These guidelines range from the rate of interest which PEs should pay on their borrowings to the dividend pay-out ratio which they must maintain while deciding about the retention of profits. Though these are said to be guidelines, they are in a sense virtually the orders of the government.

Parliament directly exercises control in as much as its prior approval is required for certain investments in PEs and in certain cases periodic reports are to be submitted to it. This however applies only to new services, that is, for new activities, taken up for the first time. Further, such approvals are only financial and not administrative. If the parliament is not in session, the money may, in case of emergency be provided out of the contingency fund and the sanction of parliament is obtained at a later date.

The systems and procedures designed to ensure the financial accountability in PEs are very detailed and elaborate. The parliament debates the financial issues relating to PEs at the time of the budget discussions and the question hour. Further, to look into the financial performance of PEs and to check upon their commercial and business prudence, the Committee on Public Undertakings (COPU) a standing committee on PEs set up by the parliament, also helps PEs on a continuing basis to develop a proper perspective in relation to the financial matters of these enterprises. We have already discussed the role of this committee in Unit-19 of Block 6 of this course. The COPU has, submitted to the parliament about 600 reports. It has also carried out a number of horizontal studies. Some of these studies have been on financial aspects the prominent of which include "Financial Management in PEs", "Role and Achievements of PEs", "Inventory Management in PEs", "Project Management in PEs", and "Galloping Expenditure on foreign travels in PEs" etc. Government controls on PEs make the financial accountability a very painful task. The reports and returns submitted on financial aspects are monthly, quarterly and annual in nature. If these enterprises incur losses, then they have to get even their revenue budget approved by the administrative ministry. The CAG carries out not only financial but also efficiency and propriety audits for these enterprises. The annual reports place these enterprises in a disadvantageous position vis-a-vis their counterparts in the private sector on account of time overruns and poor quality of financial disclosure.

24.6 PROBLEMS PERTAINING TO FINANCIAL AUTONOMY AND ACCOUNTABILITY IN PUBLIC ENTERPRISES

The financial autonomy and accountability of PEs occupy an important place in a democratic country such as ours. However, as things stand, these are treated as two separate facets of the personality of PEs and often the perceptions of the government and PEs on the issues relating to autonomy and accountability differ. An important problem in this context is the government's insistence to get matters referred to it on the various financial issues and the aversion of PEs to disclose the requisite financial information to their principals i.e. the respective administrative ministries. Whereas the government continues to treat these enterprises as its extensions, the PEs do not or cannot make concerted efforts to come out of the gravitational pull of the government. The parliament, the administrative ministry, the CAG and the Courts are considered as the trustees of public funds and are prompted, therefore, to impose a variety of controls on these enterprises. They do not want to take any risk with the public money, but prefer safety and security.

Prof. Ramaswamy Iyer in his book "A Grammar of Public Enterprises—Exercises in Clarification" has identified some frequently heard complaints regarding government's interference in public enterprise managements. The circulars issued by the Bureau of Public Enterprises at times relate to certain unimportant and even trivial matters. Excessive monitoring by the government is also another problem. Also during the course of the annual plan discussions, the entire investment programme of a PE comes under review and questions are raised about investment decisions which are within the corporate powers of the public enterprise. And the economy instructions which are issued from time to time by the government applies to PEs abridging their powers. There is a gap between the powers that are formally possessed by PEs and those that are actually exercised by them.

25.7 SUGGESTIONS FOR ENSURING IMPROVED AUTONOMY AND ACCOUNTABILITY OF PUBLIC ENTERPRISES

A number of suggestions can be offered to ensure improved financial autonomy and accountability in PEs. To begin with, these enterprises should be commercialised. This will enable PEs to charge economic rates for the goods and services provided to their users. This will result in the generation of adequate internal resources and consequent reduction of financial support from the government to fund their operation and expansion needs. In turn, the government control on financial matters will decline drastically. Corporatisation of these enterprises is another suggestion. This will transform the systems, structure and strategy of PEs and resolve many thorny problems with regard to financial autonomy and accountability.

A large number of PEs have been complaining about lack of autonomy to them as they do not have adequate powers to procure the requisite amount of materials, stores and supplies etc. On the contrary, the government is of the view that the inventories in these enterprises should be rigorously controlled as there is a heavy over-investment in this component of assets in PEs. The government's suspicion cannot be questioned as many a PE do not have materials management manual. The absence of such a manual has encouraged them to procure materials disproportionate to their needs.

The CAG in his various audit reports has commented upon the non-preparation of the budget, cost, internal audit, Research and Development and capital expenditure manuals. Many PEs do not have even the budget manual. The enhanced delegation and decentralisation of financial powers within PEs is a must. In order to achieve this objective well defined structures must be developed. The boards of management in PEs should specify the financial powers vested in each functionary. Similarly, the various executives in PEs should be encouraged to delegate financial powers to their junior colleagues. The government, on its part should instead of putting limits on investments, expenditure, borrowings, etc, issue only suggestive guidelines. In case a PE exceeds the suggested ceiling, it may be required to report the matter to the government. The principle of management-by-exception should be followed. The government should intervene only in such cases where it is necessary to do so in the larger public interest.

PEs should formulate clearly financial strategies and goals which should be both unambiguous and quantifiable. For instance, PEs could specify proposed rate of return on their capital employed, declare a specified dividend on their equity, finance their expansion programmes largely through internal generation of resources and approach the capital market to finance the rest of their expansion needs. A clarity in financial objectives will enable PEs to acquire the necessary financial autonomy from the government. It will also lead to self-imposed controls. This will eliminate the need for the government to clamp ,financial controls on them. There must also be a sincere application of the Management by Objectives (MBO) for attaining financial objectives.

It is desirable to eliminate the multiple audits in PEs which are mostly unproductive. It has to be noted that the counterparts of PEs in the private sector are not required to undergo so many audits. The audit approach needs to undergo a change in order to yield the desired results. The auditors must be made conversant with the operations and philosophy of PEs.

The annual reports can serve as an important medium to satisfy the autonomy and accountability needs. They can be a good instrument to win greater autonomy for PEs and fulfil, at the same time, the control needs of the parliament, CAG and the Courts. An analysis of the annual reports of PEs shows that they are not brought out in time. The time lag in their finalisation and presentation to the parliament ranges from one year to ten years. Secondly, in many cases they are either sketchy or lack important information relating to the trends in output, productivity, prices, profitability, comparative performance and so on. Necessary steps must be taken to improve the practices pertaining to the preparation and presentation of the annual reports by PEs.

Articles 12 and 14 of the Indian Constitution have been extended to PEs whereby these enterprises have been considered as State. The 'State' as defined in Article 12 of the Constitution, is to include "the government and Parliament of India and the government and legislature of each of the states and all local or other authorities within the territory of India or under the control of the government of India". Though originally PEs were excluded from the purview of the 'State' as defined in Article 12 of the Constitution, slowly, bodies performing quasi-governmental functions, statutory corporations, government companies, have been brought within the purview of the state. The High Courts and the Supreme Court have accepted many writ petitions which have a financial impact on PEs. Some of these relate to the procurement of materials and payment of pension etc.

As discussed earlier, PEs contain not only 'public' but the 'enterprise' element. Thus to enable PEs function without any handicaps in the present competitive atmosphere, there is a need to introduce an amendment in the Indian Constitution to take PEs out of the purview of Articles 12 and 14.

25.8 FINANCIAL AUTONOMY AND ACCOUNTABILITY OF PUBLIC ENTERPRISES: RECENT TRENDS

The PEs in India have been set up to speeden up the process of industrial development. It goes without saying that, they will be able to achieve efficiency, contribute towards maximum production of goods and services with minimum wastage of resources, only if sufficient functional autonomy is provided. They should have freedom of decision-making within broad guidelines or policies. A suitable balance needs to be struck between autonomy and accountability.

There has of late, been a lot of discussion about the question of autonomy and accountability of PEs, its relationship with the government. The Arjun Sengupta Committee set up by the Government of India in 1984, went into various aspects of public enterprise management like relations between government and PEs, managerial autonomy of PEs, financial powers in regard to their investments and capital budget and so on. It recommended that the government should be primarily concerned with overall strategic planning and policy rather than day-to-day functioning of PEs which should be left to the enterprises concerned. The responsibility of the government is to ensure that public money invested in the enterprises earns an appropriate rate of return and that their functioning is consistent ,with plan objectives including those related to employment, fair pricing, efficient use of scarce resources etc. The Committee was of the opinion that enterprises functioning in the core sectors like power, steel coal and lignite etc. have to interact with the ministries with regard to matters like investment planning, price fixation and financial management. Their plans will have to be integrated with the national plans. But financially viable non-core public enterprises can finance their requirements, by raising funds from the public through deposits or debentures or borrowing from ,the financial institutions, without being subjected to any process of governmental clearance.

Regarding accountability of PEs to Parliament, the Committee recommended that Parliament questions on day-to-day operation and management may be avoided. The debate on the Demands for Grants of the concerned Administrative Ministry could be used for the purpose of a debate on the performance of PEs under the control of the Ministry.

The Economic Administration Reforms Commission which was set up in 1981 headed by late L.K. Jha, also went into this aspect of autonomy and accountability of PEs. According to the Committee, in the name of public accountability numerous checks and controls are introduced at every stage which hinder executive action, concentrates decision-making powers in the Ministry and infact dilutes the accountability of the management. The accountability concepts and ,instrumentalities which have come to prevail over the years are in need of careful reconsideration with a view to ensuring that (a) they do not erode the autonomy of PEs and thus hamper the very objectives and purposes for which they ought to be accountable and (b) that what is sought to be secured is accountability in the wider sense of answerability for the performance of tasks and the achievement of results, rather than in the narrow sense of responsibility for the correctness and propriety or individual actions or decisions or confirmity to rules and procedures.

The Committee recommended, apart from certain statutory controls which apply to both public and private sector units, they should not be subject to any other constraints on their autonomy. Also once the investment decisions of PEs have been approved and necessary funding provided for, the management should be allowed to go ahead without seeking any further clearances except those which apply to all undertakings like those relating to industrial licensing, foreign exchange releases etc. Also the number, scope and coverage of the governmental guidelines and instructions to PEs should be thoroughly reviewed and drastically reduced and only those concerned with major objectives and/or performance parameters can be retained.

There is no denying the fact that the government is convinced about providing more autonomy to PEs and reducing the wide-randing financial controls on them. The approach outlined in the budget speeches of the Finance Minister in 1991-92 and 1992-93, the observations made in the economic survey of 1991-92 and the letter on development policy sent by the Finance Minister to the World Bank President describe the various steps the government proposes to take ,in this regard.

The government proposes to classify PEs as competitive and non-competitive units. About 140 units at the central level have been identified as competitive PEs. These enterprises will be guided by the market forces in their financial matters. The government proposes to refrain from issuing guidelines or directives. The PEs may be allowed a free hand to decide their financing, pricing and costing policies. They will be at liberty to develop suitable systems and structures to achieve the overall financial objectives. The enterprises which are non-core in nature will not receive any budgetary support. They will have to finance their needs through the internal generation of resources and mobilisation of money from capital markets. There will be a disinvestment of equity in these enterprises to the extent of 20 per cent. The number of the government nominees on the board of directors of PEs will be reduced to 'one'. Multiple audits may be eliminated or scaled down.

The government is taking appropriate steps to improve the quality of financial reporting in PEs through their annual reports. The various state governments in the country are giving a top priority to streamlining the preparation of annual accounts and annual reports in the State Level Public Enterprises.

Check Your Progress 2

Note: i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

1) Highlight the problems pertaining to financial autonomy and accountability in PEs.

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2) What suggestions would you offer to strike a balance between financial control and financial autonomy in PEs?

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3) Discuss the measures taken by the government in recent times to provide financial autonomy to PEs.

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25.9 LET US SUM UP

Adequate financial autonomy is a necessary condition for the successful working of PEs. This autonomy should not only flow from the government but it should further percolate from the top to the bottom in the PEs themselves. The financial controls are an important phenomenon in a democratic set up. These controls should not, however, be regressive. Whereas there is an over emphasis on financial accountability, PEs have failed in using whatever little leverage they have in respect of the financial autonomy.

25.10 KEY WORDS

Articles of Association: These are regulations for the management, internal arrangement of a company. It lays down the terms and conditions on which the shareholders, agree amongst themselves, as to how the business of the company shall be carried.

Capital Market: It refers to various institutions, arrangements concerned with the purchase, sale and transfer of stock, bonds etc.

Depreciation: Dimunition or reduction in the value of an asset due to use and/or lapse of time.

Debt-Equity Ratio: This ratio measures a company's financial leverage. It is calculated by dividing debt of the company (both short and long term) by the entire equity capital.

Contingency Fund: Refer to Section 8.5 of Unit 8.

Dividend: It is share of profits earned from a company either by the government or any individual as holder of shares in that company.

Manuals: Documents in respect of the various subjects detailing the process and the duties of the executives in carrying out various activities.

Management by Exception: It involves concentrating on those areas that are not functioning according to plan rather than on areas of operation which are running smoothly.

Management by Objectives: It involves managers and subordinates in jointly establishing specific objectives and periodically reviewing progress towards meeting those targets.

Marketisation: It denotes the governance of PEs by market forces in respect of demand, supply and investment.

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25.12 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Your answer should include the following points:

   Financial autonomy of PEs means:

   - financing decisions
   - laying down financial objectives
   - investment decisions
   - developing costing and pricing systems, norms of profitability and monitoring mechanism.

2) Your answer should include the following points:

   - Parliament
   - Government
   - Comptroller and Auditor General of India
   - Courts of Law

- Mass Media
- Citizen

3) Your answer should include the following points:

   - Major accounting decisions like increase in depreciation, changes in tender procedures, stores valuation etc.
   - Matters of internal organisation like internal audit, delegation of powers, disciplinary matters etc.
   - Broad financial policies pertaining to self-financing, capital expansion programmes, rates of dividend etc.

4) Your answer should include the following points:

   - Clear financial procedures
   - Efficient internal audit
   - Commercial audit by private auditors
   - Appointment of a Financial Adviser of the enterprise by the government or under government approval
   - Exercise of government control through Board of Directors of the enterprise
   - Audit by the C & AG.

Check Your Progress 2

1) Your answer should include the following points:

   - Detailed and elaborate systems and procedures to ensure financial accountability of PEs
   - Government's insistence to get matters referred to it on various financial issues and the aversion of PEs to disclose the requisite financial information to the respective administrative ministries
   - Frequent guidelines issued by the Bureau of Public Enterprises pertaining to unimportant, trivial matters
   - Review of investment programmes of PEs during annual plan discussions.

2) Your answer shoulu include the following points:

   - Corporation, Commercialising and restructuring of PEs
   - Enhanced delegation, decentralisation of financial powers within PEs through well defined structures evolved within the organisation
   - Clarity in financial objectives
   - Application of Management by objectives for attaining financial objectives
   - Elimination of multiple audits in PEs
   - Government intervention only in larger public interest.

3) Your answer should include the following points:

   - Proposal to classify PEs as competitive and non competitive units
   - PEs to be allowed a free hand to decide their financing, pricing and costing policies
   - Enterprises in non-core sectors to finance their needs through internal generation of resources and mobilisation of money from capital markets
   - Multiple audits to be scaled down or eliminated
   - Improvements in quality of financial reporting of PEs
   - Autonomy in investment decisions
   - Autonomy in day-to-day matters pertaining to financial functioning.

UNIT 26 FINANCIAL ADMINISTRATION OF URBAN GOVERNMENTS

Structure

26.0 OBJECTIVES

After studying this Unit, you should be able to:

- explain the major divisions and the machinery concerned with financial administration
- discuss the ecology and principles of urban local finance
- explain the sources of municipal revenue and expenditure pattern
- describe the budgetary process and the system of accounting and auditing
- highlight the methods of state control over municipal finance; and
- evaluate the causes of gap between the municipal services and resources and make suggestions to bridge the gap.

26.1 INTRODUCTION

Local Government means the management of local affairs by the representatives of the locality itself. It deals with the problems, chiefly of local concern. It plays an important role in solving the local problems of the people. It provides the foundation on which the democratic structure of a country stands. It is in and through these institutions that the citizens get training and necessary experience for running higher representative institutions such as the State Legislatures and the Union Parliament.

De Tocquaville, a noted French writer pronounced "A nation may establish a system of self-government, but without the spirit of municipal institution it cannot have the spirit of liberty". Former Prime Minister of India, the late Jawahar Lal Nehru remarked "Local self government is and must be the basis of any true system of democracy. We have got rather into the habit of thinking of democracy at the top and not so much below. Democracy at the top will not be a success unless you build on its foundation from below." Thus local institutions constitute the strength of a free nation.

At the local level, India is governed by two different sets of institutions, namely, the Rural Governments and the Urban Local Governments. The former covering the rural population, comprises a three-tier structure from the village to the district. It was recommended by Balwantrai Mehta Committee. It is formed on democratic principles and organically linked. The urban local governments cover urban population. The requirements for an urban area are;

a) a minimum population of 5,000

b) a population density of not less than 400 per sq. km., and

c) three-fourth (75%) of the occupations of the working population should be outside agriculture.

The urban local governments are of mainly six types, namely:

a) Municipal Corporation
b) Municipalities
c) Notified Area Committee
d) Town Area Committee
e) Improvement Trust
f) The Cantonment Board

The first five are created under state Municipal laws while the Cantonment Boards are established under central Act, called Cantonment Act, 1924. Since local government is a state subject (entry 5, state list, seventh schedule of the Constitution of India), local bodies are created by the respective state governments. The pattern of local governments, therefore, varies from state to state. Even within the state all the six types are not found in every state. But municipalities are found everywhere.

Financial administration in urban governments is as important as finance. It consists of those operations the object of which is to make the best use of available resources and channelling them into proper fields of expenditure. Under democratic government, the elected institutions (i.e., Municipal councils in case of Municipalities) vote the taxes and authorise expenditure. It has to ensure that these representative institutions do not place more tax burden on the people and the money voted by them for expenditure is used according to their wishes with due regard to economy and efficiency. An ill-organised financial administration can be a handicap resulting in inadequate finances.

Financial administration in urban governments falls into the following divisions:

i) Preparation of the budget i.e., estimates of revenue and expenditure for ensuing financial year

ii) Getting budget passed by the Municipal council or other competent authority

iii) Regulation of the expenditure and raising resources according to it

iv) Custody of funds raised and their disbursement

v) Rendering of the accounts by the Executive Officer and the audit of these accounts

The machinery concerned with financial administration in urban governments varies from state to state. But generally it comprises the following components:

i) The Municipal council

ii) Executive Officer along with the departments concerned mainly with financial administration

iii) The main financial officers in the administrative departments

iv) Examiner, Local Fund Accounts (Audit Department)

v) The committees of the municipalities particularly the committee on Finance and Taxation

We shall be discussing the functions of each of these in the subsequent sections.

26.2 ECOLOGY OF URBAN LOCAL FINANCE

The form of local polity, size and level of local units, local functions, government control and the economic conditions of local inhabitants are important factors which contribute to determining the ecology of local finance. The financial position of the local government is significantly determined by the form of local polity. A decentralised pattern of local government helps the local authority to determine its financial position because it enjoys greater degree of financial independence to levy, assess and collect taxes along with sufficient freedom to formulate, legislate and execute budgetary proposals. Whereas, a deconcentrated pattern of local government may not help the local government to augment its financial resources because it allows a lesser degree of financial autonomy in regard to various facets of its financial activities. In this type of local polity, local government heavily depends on the government for finances. It may also not command better public image and enjoy better position in relation to government when compared with local government in a decentralised polity.

Another important factor which determines the adequacy of local finance is the size of the local authority. A local unit, big in terms of its area and population, has a better financial position in comparison to the one that is comparatively small in terms of physiography and human settlement. Take for example, in comparison to a Municipal Corporation, a Notified Area Committee has limited sources of income because of its small area and population. Such types of local authorities look to upper levels of government for help to keep themselves financially in a viable condition.

Responsibilities given to the local government are yet another prominent factor for determining the local finance. The government allocates resources to the local governments commensurate with their functions. Where the local government fails to carry out its responsibilities within the available resources, the government has to either provide extra revenue or withdraw such responsibilities. In India, for example primary education is a local function. But sometimes inadequate local finance does not permit most of the local authorities to perform this function inviting government intervention. Moreover, when new responsibilities are assigned to local bodies, adequate funds are made available to the local government in the form of government grants.

The financial control exercised by the government is also an important factor in determining the scope and scale of local finance. The government provides a broad base for local finance through local government Act in respect of sources of income, pattern of expenditure (compulsory and optional), mode of preparation, enactment, and execution of budgetary proposals, custody of funds, accounts and audit. At times, the government comes to the rescue of the local governments for the performance of their responsibilities, in case of insufficient local resources as well as for their involvement in national obligations. Besides, government also helps the local authority to raise loans, to meet their needs of capital expenditure such as land and heavy machinery.

Last but not least the general poverty of our people is undoubtedly a potent factor in the matter of local finance. People in our country have very little taxable capacity. A simple study of the annul national per capita incomes of countries like — UK, USA, Canada and Japan and that of India will amply prove the point. Thus, general poverty of people may not help to contribute much towards local revenues.

26.3 PRINCIPLES OF URBAN LOCAL FINANCE

The principles which should govern urban local finance are discussed briefly as under:

Independence and Responsibility

The principle of independence means that urban governments must have freedom of financial operations for fulfilling their obligations. The cannon of responsibility which flows from independence implies that the responsibility for raising and spending money should be with the same authority. The authority which has the pleasing job of spending money should also do the unpleasant job of raising it. Taxing autonomy and spending autonomy must go hand in hand.

Adequacy and Elasticity

The principle of adequacy means that the resources of the urban governments should be sufficient for discharging the assigned duties. Elasticity means that the resources should expand in proportionate to their ability to pay taxes. By uniformity, we understand that the financial system in urban governments should be such as to enable each urban government to provide an adequate level of public services without resort to rats of taxation substantially higher than those of other urban governments.

Integration and Coordination

The entire financial system of urban governments should be well-integrated and all fiscal arrangements should combine into a consistent whole. The integration of central, state and local revenue and expenditure should be done in such a way that promotes development. The coordination of central, state and local finance should not only be in taxation but should also cover the current budget, capital outlay programmes, credit operations of the various authorities and should be accompanied with a coordination of their administrative activities as well.

Public Accountability

In a democratic system, the principle of public accountability means that government should be accountable to the elected representatives who represent the citizens of the country, or the state or the locality as the case may be, for its taxing and spending decisions. After executing the budget, there should be an audit of it by an independent authority and all acts of omissions and commissions by administrative agencies or the executive, if there be any, should also be dealt with severely.

Simplicity

It means procedures concerning preparation, enactment, execution, custody and disbursement of funds, accounts, audit, etc., should be simple and understandable for taking timely action which is essential for efficiency and economy. The absence of simplicity, promptness with caution, regularity of working affects the vitality of financial administration.

Effective Municipal Personnel Management

It means that personnel policies in matters of recruitment, training, promotion, conditions of service, security of service, conduct and discipline, political neutrality etc., should help on toning up the efficiency of personnel which is essential for managing financial operations.

Fiscal Access

The fiscal arrangements should be such that they give to urban governments an access to new financial resources. There should be no bar in developing new sources of income within their own prescribed fields to meet the growing financial needs. The resources should grow as the responsibilities increase, hence, the need for exploiting new sources of revenue.

26.4 MUNICIPAL GOVERNMENT: SOURCES OF REVENUE

In India, finance is the basic problem of urban governments. Adequate finances constitute the life-blood of the whole system of local government. Without sufficient finances, urban governments become mere subordinate units of state government and fail to cater to the civic needs of the community. Their income is derived from local taxation, enterprises, or the wealth of the citizens, located within the limits of municipal body. Direct taxation is common in municipal fiscal administration. In addition, they impose special levies, commonly termed as "betterment levies" charged for improvements on property made by them. Besides, they receive assistance from state and central governments for discharging their obligatory duties. International agencies through state governments also provide financial assistance for projects of urban development, such as, water supply, housing, roads etc.

Sources of income of urban governments may be grouped under:

i) Tax-revenue
ii) Non-tax revenue
iii) Grants-in-Aid, and
iv) Loans.

These sources are briefly discussed as below:

Tax-Revenue

The major proportion of income of urban governments flows from taxes. It ranges between two-fifths and three-fourths of total income. The main taxes are:

a) Octroi or terminal tax
b) House tax
c) Tax on trades, professions
d) Tax on dogs
e) Tax on advertisements other than those published in the newspaper
f) Bazar tax
g) Tax on vehicles
h) Tax on theatres
i) Toll tax.

Non-tax Revenue

It includes receipts from rents of municipal property, interest on investments, profit from public utility undertakings like—water supply, passenger transport, electricity supply, fee for issuing licences or permits, fines realised for offences against municipal bye-laws, rules, regulations etc. For example in Punjab and Haryana this source of revenue fetches about 30 per cent of revenue. The national average of the proceeds from this source is a little above 30 per cent.

Grants-in-Aid

It is another important source of income of urban governments in India. Grants represent subsidies given by the state government in aid of certain services rendered by urban governments. Grants can broadly be divided into two categories, namely, recurring and non-recurring. The former are provided by the State Government to meet the gap in their recurring expenditure. The latter are given to municipalities to meet the initial cost of some specific projects such as water supply, school buildings, health centre etc. The amount of grant is determined on the basis of the matching formula, per capita income and expenditure etc.

Loans

Urban governments also meet their needs of capital expenditure such as purchase of land, heavy machinery and long-term projects by raising loans. Borrowings are regulated by the central law known as Local Authorities Loans Act, 1914. Loans are raised with prior sanction from the state government. In certain cases, the permission of the central government is also needed. The urban governments are permitted to borrow loans from banks, Life Insurance Corporation and other financial institutions. All proposals concerning loans from open market or LIC are required to be cleared by the Reserve Bank of India. For all practical purposes, urban governments except municipal corporations have to depend largely upon loans from their respective state governments. Every loan has its own rate of interest, term, mode of repayment, measures of utilisation etc.

26.5 MUNICIPAL GOVERNMENT: EXPENDITURE PATTERN

A municipality can spend on the services permitted to it under the law which may be contained in a public Act of Parliament or State Legislature in a local Act. Besides, the state government may, in the name of public interest, declare any other expenditure to be a legitimate charge on municipal funds. Though the responsibilities of municipal bodies in our country are more or less similar, yet there are wide variations among the states in the matter of per capita expenditure on different heads or services. The important heads of municipal expenditure are as under:

General Administration, Establishment and Collection Charges

This expenditure includes charges like salaries of employees, maintenance of the office, charges for the collection of revenue and the construction of office building and octroi. The other charges which fall under this head also include litigation expenditure such as lawyer's fee, court and witness fee, election expenses for preparing voters list, ballot papers, audit fee for auditing accounts etc.

Public Education

The responsibility of providing free and compulsory education for children until they complete the age of fourteen years is as a matter of fact to be borne by the state governments. (Article 45 of the Constitution of India). But in some states, like Punjab, Bihar, Haryana, Uttar Pradesh, this is being shared by urban governments. These states extend financial aid to urban governments to meet the expenditure. The expenditure on public education falls under two heads, viz., (1) running schools, and (2) setting up and operating public libraries and reading rooms.

Medical and Public Health

Protection of public health is one of the primary functions of urban governments. The public health activities are divided into two parts:

i) provision for medical relief and administration of preventive medicines and

ii) maintenance of public health.

Water Supply

Pure drinking water is essential for good health. The provision of pure, clean and adequate water supply is, therefore, an important function of urban governments. Expenditure on this head is usually quite heavy because tanks, reservoirs, engines, pipes, taps and other works may have to be constructed and maintained. Besides, the water is supplied at no-profit no-loss basis, in other words, the water is supplied at a less rate than the cost of production.

Municipal Works

It is one of the important items of the municipal budget. Under this head, the urban government's maintenance of roads, bridges, markets, slaughter-houses, lanes and bye-lanes and any such other works concerning with the physical beautification and development of the city or a town, are covered.

Maintenance and Reserve for Unforeseen Emergency

Maintenance expenditure covers property repairs, dismantling unauthorised structures etc. Reserve for unforeseen emergency includes expenditure on public safety such as fire services, protecting public against stray and dangerous dogs, and any such other emergency which is unpredictable.

Check Your Progress 1

Note : i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

1) Discuss the important factors which contribute for determining the ecology of local finance.

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2) Describe briefly the principles which should govern the local finance.

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3) Explain the sources of income of urban government.

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26.6 URBAN FISCAL MANAGEMENT

It includes budgetary process, procedure for assessing and collecting revenues, custody and disbursement of funds, stores, accounting and auditing. These are discussed as under:

Budgetary Process and Authorisation

A budget is not nearly a statement of revenue and expenditure, it is something more than that. The whole policy of the municipal body is reflected in the budget. It is a tool of management. In Punjab, the Executive Officer is responsible for preparing the municipal budget. In the month of December, the spending and earning departments send to the Accountant their annual estimates containing the (a) actuals of the previous year; (b) actuals of the current year; (c) revised estimates of the current year; (d) estimates of the ensuing year. After receiving the estimates from the different departments, the Accountant consolidates them and sends the consolidated budget to the Executive Officer for examination. After careful scrutiny of the estimates, the Executive Officer submits proposal to the Finance Sub-committee. After receiving the recommendations from the Finance Sub-committee, the budget is placed before the Committee of the whole house for discussion and approval.

Assessment and Collection of Revenues

The Executive Officer is responsible for the assessment and collection of taxes. But in actual practice, the Tax Superintendent assisted by the Tax Inspector prepares the assessment list. An appeal against the assessment of taxes lies with the Deputy Commissioner. The Jurisdiction of the Civil Courts is debarred in matters of assessment. But on points of law the Deputy Commissioner may make a reference to the High Court.

Custody and Disbursement of Funds

In the Municipal Committees, the income received by different departments is credited every day into the Municipal Treasury. The power of withdrawal of the money rests with the Executive Officer.

At the end of each day, the balance is drawn in cash book which must tally with the day's transactions entered in the cash book and the balance of amount in hand. This means practice of the single-entry system, that is, the revenue side is credited when any amount is received and debited when paid out.

Stores

Urban Government's stores are divided into two parts, namely, (a) Special stores and (b) General Stores. Special stores consist of article required by a particular department. These are purchased directly according to the requirements of the department. General stores consist of articles which are of general use and are required by general departments. Such stores are purchased through the central stores department. In this way the purchase of wholesale quantity is made at the lowest rate and much saving is effected in cost as well as in establishment charges.

Municipal Accounts and Audit

Accounts mean a record of money transactions. It may be described as a procedure by which a local body puts all its business transactions on record to coordinate the data in these records, so that they may be used intelligently. Accounts not only enable the local bodies to regularise its administration but also help them in the exercise of proper control over the finances. In Punjab the general methods, the structure of accounts and the manner in which the accounts are to be kept are prescribed in the Municipal Accounts Code, 1930. The instructions of the Examiner, Local Fund Accounts are to be complied with, in respect of details to be furnished by the urban government.

Inseparable from the maintenance of proper accounts of the municipalities is the necessity of their audit. It is of two types, namely, pre-audit and post-audit. The former is conducted before the expenditure is incurred on any item. The latter is done after the financial transaction has already been made. In India both types of audit are in operation in Municipalities. As a matter of fact it is the municipality which decides the mode of audit in a municipality. The accounts of the municipalities are audited annually by the Examiner, Local Fund Accounts. The cannons of financial propriety are clearly laid down in the Municipal Accounts Code. The main purpose of audit is as under:

a) To ensure that the same amount has been spent which was sanctioned in budget.

b) To see that the amount has been spent according to rules and regulations.

c) To confirm that the amount has been spent for the purpose for which it was granted i.e. the amount sanctioned for the purpose of education has not been spent for public works.

d) Check the financial propriety i.e. money has been spent economically and efficiently.

e) To see that the amount has been spent with the prior sanction of the competent authority.

26.7 STATE CONTROL AND SUPERVISION

Urban local bodies are not sovereign bodies. As mentioned earlier, local government is a state subject and as such state government is empowered to legislate on various aspects of local bodies. It determines their structure, powers, functions, financial resources etc. In fact, urban local bodies are regularly controlled, supervised, directed and occasionally penalised by the State Government for their acts of omission and commission. In India, the forms of government control over urban bodies are many and varied. Such control is of four broad varieties, namely, (a) legislative, (b) judicial, (c) administrative, and (d) financial. In this unit, we are mainly concerned with financial control. Government control over the finances of urban governments may be grouped under the following heads.

Control over Taxation

The government is empowered to exempt any person or property from the payment of any tax. Every resolution of a municipality increasing or decreasing or abolishing an existing tax, requires the approval of the state government and in certain cases, of central government as well. For example, in case of tax on profession, the Constitution of India had prescribed a limit of Rs. 250 per annum in 1949. In view of the price rise and other factors some state governments when demanded by local bodies, had to request the centre to revise the ceiling. The rate was, therefore, enhanced to Rs. 2,500 per annum in 1988 by the Sixtieth Amendment Bill of the Constitution. The state government is empowered to suspend or prohibit, or remedy a tax unfair in incidence or injurious to the interests of the general public.

Besides, the state government can direct a municipal body to impose octroi on a particular item, at a particular rate. For example, in Punjab the state government instructed Ludhiana Municipal Corporation in 1986 to levy octroi on man-made fibres like nylon and terene and hand knitting yarn made out of nylon fibre at the rate of rupees 2.10 per 100 rupees.

State government may allow urban bodies to add supplementary rates to the existing government taxes. For example, in India, when state governments had abolished octroi, they permitted the urban governments to impose a surcharge on the sales tax which is a state tax. Besides, a local tax may be administered by the government, although it is actually enjoyed by the urban governments. For instance, in Andhra Pradesh entertainment tax which is basically a local tax is imposed by the government but the entire proceeds are given to urban governments after retaining the collection charges amounting to Rs. 5 per unit of the collections. Similarly, from motor vehicle tax, which was formerly a local tax in India, certain percentage of the collections are made over to the urban authorities by the state governments.

Control over Municipal Expenditure and Fund

The state government is empowered to regulate municipal expenditure by fixing limits on expenditure to be incurred on various items, laying down regulations and procedures for incurring expenditure. If the work involved exceeds a particular limit of expenditure, the urban bodies are required to obtain administrative and technical sanction from the competent authorities as determined by the state government. It can also require a municipal body to pay for any service. The purposes to which municipal fund can be applied are specified by the State Government through an Act and its application to any other purpose requires the government approval.

Control over Budget

The urban bodies are required to prepare their budgets in the manner and form as determined by the state government from time to time. The budget approved by the municipality cannot be executed without the prior sanction of the state government which in turn has the power to make alterations in budgetary proposals. As mentioned in the preceding section if municipality does not agree with the modifications made, the decision of the state government is final and binding on the municipality. In some states, the budget is not subject to the sanction of the state government. In such states the approval is needed only in those cases where municipalities are indebted. Besides, prior sanction of the state government is also needed for re-appropriation from one head to another head of the budget, that is, the money granted for education can be put to use for public works with government approval.

Control over Loans

As mentioned earlier, the borrowing powers of urban bodies are regulated by the central law known as the Local Authorities Loans Act, 1914. Before approving any proposal to borrow, the state government thoroughly examines the scheme, reviews the entire financial position of the urban local body, fixes the period of repayment, determines the mode of borrowing etc. For example, the Uttar Pradesh Nagar Mahapalika Adhiniyam, 1959, lays down the following restrictions:

a) No loan can be raised unless the state government has approved the purpose, amount, rate of interest, date of floatation, period of repayment and method of repayment of loans.

b) The period within which the loan is to be repaid shall, in no case exceed 30 years.

c) Without the prior sanction of the Government no part of the amount borrowed shall be applied to any purpose other than that for which it was borrowed.

d) No portion of the sum borrowed shall be applied to the payment of salaries or allowances of any municipal officer or servant other than those who are exclusively employed on the work for construction for which the money was borrowed.

e) No loan can be raised for the execution of any work other than a permanent work.

Control over Grants

Grants-in-aid are the most effective instrument of state control over the finances of municipal bodies in India. The state government ensures that the grants are properly utilised and not misappropriated or diverted to unapproved purposes. The grants can be reduced, suspended, and withheld if the accompanying conditions are not fulfilled by a municipal body.

Control over Accounts and Audit

Accounting and auditing are important instruments of state control over municipal finances. The municipal bodies maintain accounts in the form and manner as prescribed by state government. As stated earlier, in Punjab, the municipal bodies are required to follow the Punjab Municipal Accounts Code, 1930, which lays down detailed procedures for all sorts of financial transactions. Any departure from the form and manner requires the sanction of the state government. Besides, the state government may at any time direct special examination and conduct audit of municipal bodies by Auditors appointed by the state government. The main aim of the state government control through an audit is to ensure that public money is properly utilised and no amount is paid for any expenditure without the proper authority and provisions of the funds in the budget.

26.8 GAP BETWEEN MUNICIPAL SERVICES AND RESOURCES

The municipal resources are mainly based on the distribution of functions between the State Government and the Local Government. The functions of the urban governments are specified in the Act under which they are established. The municipal functions are categorised as compulsory and optional. In order to discharge obligatory functions budgetary provision is made for them. If urban bodies fail to perform obligatory functions, the state government helps them either by providing grants-in-aid or arranging long-term loans to meet the needs, subject to their repayment. However, an analysis of the municipal resources shows that there is a wide gap between the municipal services and resources.

In India, the entire field of municipal resources, remarks one commentator "is replete with outmoded principles of political economy, with stultifying checks and with consequential discouragement." There is an overall lack of appreciation of the fact that adequacy of financial resources and efficiency of financial management are determinants of the tone of municipal administration. The causes of inadequate municipal resources are of varied character. The entire machinery of municipal tax administration suffers from serious defects such as poor collection, heavy arrears, leakage of revenue, corruption, evasion in taxes, improper assessment of taxes etc. Further, the municipal personnel are low-paid and lack necessary training and experience. It has been observed that the local staff concerned with the assessment of taxes is generally not fair and the principle of equity is often disregarded. For instance, the Tax Superintendent being responsible to the members of the municipal committee is generally inclined to assess the houses of influential persons and the members at a low rate.

In spite of the audit of municipal accounts, the audit has remained ineffective and inefficient. Except in big municipalities, audit is not conducted regularly. It is generally in the nature of post-mortem examination which is sometimes dubbed as "locking the stable after the horse is stolen." Again audit objections and reports remain uncared for, at year's end. Thus the very purpose of the audit is frustrated. The borrowing powers of the urban local bodies in India are also limited. The term of re-payment and the rate of interest on loans are unfavourable in comparison to developed countries of the World.

Further, most of the sources assigned to municipal bodies for taxation are inelastic and cannot provide the required services for the growing activities of these bodies. For example, taxes like octroi, terminal and property which constitute the backbone of municipal finance are quite inelastic as the proceeds from them do not grow in proportion to the growth in financial requirements. The rules and procedures governing the imposition of taxes etc. are very elaborate, cumbersome, time consuming and leave very little financial independence to municipal bodies. Besides, the powers of the Indian local bodies to levy is limited by the Constitution of India.

For instance, Art. 285(2) of the Constitution exempts the Central Government properties from the levy of local tax by municipalities.

One of the contributing factors to the poor municipal resources is that the government grants are utterly inadequate, unrelated to needs, irregular, unsystematic and uncertain in their release to municipal bodies. In some states, like Punjab and Haryana, government has taken over some of the municipal functions or the administrative control thereof as in the case of education and fire-brigade but the expenditure pertaining to these functions is largely borne by the municipal bodies. This is wholly unfair and unbusinesslike.

Another significant reason for inadequate financial resources is the unwillingness of municipal bodies to mobilise their resources to the admissible limit and to exploit even the limited powers of taxation that they have. They have, generally, shown utmost reluctance in increasing the existing taxes or in imposing new ones even where advisable and feasible, especially the direct taxes, for fear of people's anger and resentment.

Apart from the above mentioned causes for the unsatisfactory position of municipal resources the other reasons are: underdeveloped trading enterprises, increased population pressure, general poverty in India, increased responsibilities, increased cost of municipal services because of eversoaring prices of the material and enhanced wages of the municipal personnel, and so on.

If the municipal government is to play its role commensurate with the expectations and aspirations of the people, a serious effort is to be made to ensure its financial soundness so that the gap between the municipal services and resources is reduced.

A number of committees and commissions have examined the question of the adequacy of municipal resources in India since independence. It has been suggested that the prevalent reluctance of municipalities to introduce taxes has to be overcome. The local Finance Enquiry Committee (1949-51) rightly recommended "Local bodies which do not utilise their existing power of taxation can have no claim on the financial resources of the state, where a local body is unwilling to impose tax at an adequate rate, the state government should have the right, in first instance, to give friendly advice and if the local body fails to carry it out, the state government should in the last resort, have the power to impose or raise the taxes. To augment the resources of municipalities, the financial management of these bodies needs to be streamlined, by selecting municipal personnel on merit, imparting them adequate training, paying them competitive salaries etc. Apart from this, there should be a strict check on the corrupt and defaulting employees. Efforts should also be made for the proper assessment and collection of taxes. Incentives may be offered for prompt payment of taxes and heavy fines may be imposed on the tax defaulters. Besides, audit should be conducted more regularly and special provisions even punitive in nature should be made for the speedy disposal of audit objections.

The suggestion of the Rural-urban relationship Committee (1963-66) to set up a Municipal Finance Corporation in each state to provide loans to the municipal bodies for developing municipal enterprises such as city transport, milk supply etc., needs serious consideration by the State Government. Keeping in view the suggestion of Central Council of Local Self Government it is in the fitness of things to appoint a Municipal Financial Commission on the pattern of Finance Commission at the national level to examine in detail the financial requirements of municipal bodies, laying down the principles of sharing certain taxes between the state and municipal bodies. The financial obligations arising from the recommendations of the Municipal Finance Commission may be placed before Central Finance Commission, appointed by the President under Art 280 of the Constitution. A number of State Governments have set up Municipal Finance Commissions, Maharashtra (1973) being the first followed by Orissa (1975). A state where such a commission has not been set up should consider this suggestion as early as possible.

To improve the financial position of municipal bodies, government grants should be adequate, related to needs, regular, systematic, certain and be made available to them over the next five years or over the plan period. The borrowing conditions should be liberalised in certain ways such as longer terms of repayment, cheaper interest rates, extension in purposes and permission with adequate safeguards to borrow in the open market. This will go a long way to meet most of the pressing needs of the capital nature for funding long-term and costly projects like water works, slum clearance etc. Last but not the least, the other suggestions such as a centralised purchasing, simplification of tax-imposing procedures, over-handling taxation structure, development of municipal enterprises, eradication of general poverty, and the proposal of the late Mr. Rajiv Gandhi, former Prime Minister of India to grant Constitutional status to municipalities should also be kept in mind. All the above mentioned suggestions need the sincere and serious considerations of the State Government and if accepted and implemented will surely help to bridge the gap between the municipal services and resources. The sooner it is done, the better it would be.

Check Your Progress 2

Note : i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

1) What are the steps involved urban fiscal management ?

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2) What are the various methods of state control over municipal finance ?

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3) Critically evaluate the gap between municipal services and resources.

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26.9 LET US SUM UP

In a democratic political system, local government means management of local affairs by the elected representatives of a locality which stands for restricted area like a village, a group of villages, a town, a city. It acts as a nursery for future leaders. It serves as an ideal channel of communication between the local community and the higher levels of the government. Knowledge of ecology and principles of local finance is essential for managing the financial operations of urban local bodies. The major task of financial administration in local bodies is to make the best use of the available resources and channelling them into proper fields of expenditure. To meet their expenditure on different heads or services, the urban local bodies have been empowered to derive their income from several sources such as tax revenue, non-tax revenue, government grants, share of government taxes and the loans. Budgeting offers an opportunity for an assessment of the matching of functions and resources.

The Executive Officer is responsible for preparing and placing the budget before the municipal committee for approval. He is also responsible for the proper assessment and collection of taxes, safe custody and disbursement of fund etc. Apart from this, proper maintenance and timely submission of accounts to audit is another important function of the Executive Officer. Urban local bodies in India do not have adequate automony. The state government exercises a considerable degree of control over municipal fund, budget, taxation, borrowing, accounts, audit and grants-in-aid. The working of the urban local bodies in India shows that they do not have adequate municipal financial resources to provide services to the community. The more prominent causes for the insufficient municipal financial resources may be identified as the faulty system of devolution of funds, limited financial autonomy, political reluctance to impose taxes, defective tax administration, ineffective audit, limited borrowing powers, faulty grants system, undeveloped trading enterprises, increased population pressure and so on. After Independence in India, a number of commissions and committees have been set up at the centre and the states to examine the finances of urban local bodies. These committees and commissions have made innumerable suggestions to enhance the municipal financial resources. All these suggestions if implemented will definitely augment the finances of these bodies which in turn may make sincere efforts to narrow the gap between the municipal services and resources.

26.10 KEY WORDS

Cantonment Boards: These are set up under the Cantonments Act 1924, which is a Central government legislation. These Boards are set up for the administration of the civic affairs of the Cantonment areas, which are delimited areas where the military forces and troops are permanently stationed. The board looks after the health, medical affairs, education, electricity, water supply etc. of these areas.

Deconcentrated Pattern

In a deconcentrated pattern, a government or an organisation unit or a superior delegates to another, the power to act in its or his or her name without transferring the authority. It reserves its authority to withdraw it at any time, or issue directions and even to reverse the decisions. In fact, the delegated authority is not a right but a derived concession that also can be exercised at the pleasure of the delegating authority. Thus, in this type of pattern, the local authorities merely act as agents of Central or State Government.

Decentralised Pattern

In a decentralised pattern, there is devolution of powers from one government to another by means of either a statute or Constitution. It is just an extension of the democratic principle — extension of people's right to manage their own affairs in a local area without any undue interference from central or state government. Thus, in this pattern, local authorities have a right and not a concession of independent existence and functions.

Ecology

The word 'ecology' is borrowed from biology where it suggests the interdependence between an animal species and its natural environment. In public administration, the concept of ecology means the study of interdependence or interaction between public administration and its environment. Since, local government is a part of the public administration, it cannot escape from the effects of environment in which it develops.

Notified Area Committees: These are set up to meet the civic needs of the developing towns, which do not fulfil the statutory conditions for the constitution of a municipality. These are entirely nominated bodies and such provisions of the State Municipal Act apply to them as are specified by the state through a notification.

Octroi Tax

It is a tax on goods which are brought into the municipal limits for consumption, use or sale therein.

Terminal Tax

It is imposed on goods arriving in a city or town by rail. It is realised by the railway on behalf of the municipality, on commission basis.

Town Area Committees : These Committees are of smaller size. These exist in smaller towns and are entrusted with limited civic functions. These are governed under special statute.

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26.12 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Your answer should include the following points:
   - Form of local polity,
   - Size and level of local units,
   - Financial control exercised by the government,
   - Responsibilities given to the local government,
   - Economic conditions of the local inhabitants.

2) Your answer should include the following points:
   - Independence and responsibility,
   - Adequacy and elasticity,
   - Integration and coordination
   - Public accountability
   - Simplicity
   - Effective municipal personnel management
   - Fiscal access

3) Your answer should include the following points:
   - Tax-revenue
   - Non-tax revenue
   - Grants-in-Aid
   - Loans

Check Your Progress 2

1) Your answer should include the following points:
   - Budgetary process and authorisation
   - Procedure for assessing and collecting revenues
   - Custody and disbursement of funds
   - Stores
   - Accounting and auditing

2) Your answer should include the following points:

   The control exercised by the State Government over municipal finances extends to the following activities:

   - Taxation
   - Municipal expenditure and fund
   - Budget
   - Loans

- Grants-in-Aid
- Accounts and audit

3) Your answer should include the following points:
   - In elastic sources of taxation
   - Elaborate, cumbersome, time consuming rules and procedures governing the imposition of taxes
   - Limited borrowing powers of the urban local bodies
   - Inadequate, irregular, unsystematic, uncertain grants-in-aid provided by the government
   - Ineffective, inefficient system of audit
   - Unwillingness, reluctance on part of local bodies to mobilise their resources to the admissible limit and exploit their limited powers of taxation.

UNIT 27 FINANCIAL ADMINISTRATION OF RURAL GOVERNMENTS

Structure

27.0 OBJECTIVES

After studying this unit, you should be able to:

- describe the machinery concerned with financial administration in rural governments
- discuss the concept of rural development and the principles of rural local finance
- examine the sources of revenue and expenditure pattern of rural local authorities
- explain the various aspects of rural fiscal management
- evaluate the forms of state control and supervision over Panchayati Raj finances; and
- highlight the gap between the rural services and resources and suggest remedial measures to narrow the gap.

27.1 INTRODUCTION

In India, Rural Local Government covers the rural population. It is created, sustained, regulated and even abolished by the State Government. It consists of three-tier structure, namely, Village Panchayat at the village level, the Panchayat Samiti at the block level, and the Zila Parishad at the district level. It was recommended by the Balwantrai Mehta Committee and is based on the concept of democratic decentralisation which was later on termed as Panchayati Raj in preference to Rural Government.

Keeping in view the importance of local self-government in free India, a provision was made in the Constitution for the growth and development of Gram Panchayats. Article 40 lays down: "The state shall take steps to organise village Panchayats and endow them with such powers and authority as may be necessary to enable them to function as units of self-government". Apart from this, Article 246 also empowers the State Legislatures to make laws with respect to any matter pertaining to local self-government. The extent and form of democratic decentralisation, therefore, varies from State to State. At present, there are various models of Panchayati Raj operating in the country. Some states like for example, Andhra Pradesh (from 1959 to 1983), Rajasthan had adopted the three-tier structure of Panchayati Raj as recommended by Balwantrai Mehta Committee. But in Andhra Pradesh, on the basis of Asoka Mehta Committee recommendations, a four-tier structure came into existence since 1983, with Mandal Praja Parishads coming in place of Panchayat Samitis. In Maharashtra too, the pattern of Panchayati Raj is unique, wherein instead of block, district has been made the unit of planning and development, while Panchayat Samiti acts as a statutory committee of the Zila Parishad. In Karnataka since 1985, changes were brought about in the earlier prevailing three-tier structure. Now there are Village Panchayats/Town Panchayats at the base, the Taluka Development Boards in the middle and the District Development Council for each district at the top.

The 1980s saw the resurgence of rural local bodies in India, particularly in Andhra Pradesh, Karnataka and West Bengal. The Union Government had also come up in May 1989, with a bill in favour of a Constitutional amendment for the resurrection of Panchayati Raj, backed by the slogan "Power to people" and got it passed in the Lok Sabha. The bill could not become an act as the sponsors failed to muster the required support in the Rajya Sabha. Again in 1990, the 74th Constitutional amendment was introduced by the National Front government which lapsed due to the dissolution of Lok Sabha.

Financial administration in Rural Local Government involves operations designed to generate, regulate and distribute the financial resources needed to provide services to the community. These operations are performed by the following agencies:

i) The Executive Wing which prepares the budget

ii) The Legislative Wing which alone can grant funds

iii) The executive, which controls the expenditure of funds sanctioned by the Legislative Wing

iv) The Audit Department

v) Standing Committees especially the Standing Committee for Finance and Taxation.

27.2 CONCEPT OF RURAL DEVELOPMENT

The term 'rural' means an area characterised by non-urban style of living, greater inter-dependence among people, more deeply rooted community life and a slow moving, rhythm of life based on faith and conviction in religious ethics and themes. Occupationally it is based on crop farming, tree crops and related activities like plantation, agriculture, modern dairying, fish farming, sheep rearing etc. The growth and development of urban areas has been at the expense of rural areas and with the emergence of city centres, the rural areas were neglected. This was much more true so far as the rural population in developing countries was concerned. When the umbrella of colonial regime was lifted from the third world nations, most of the planners and administrators of these newly independent nations, got concerned with the development of the rural areas of their nations. This concern was largely because a majority of the population was living in rural areas under abject poverty, malnutrition and insanitary living conditions. Ignorance and poverty were two stumbling blocks in their development and their removal was the main objective of the independent nations. The commitment of the leaders of these nations was to bring in prosperity and improve the quality of life of the people in rural areas, constituting a big resource for them as electorates in the elections. Invariably, this commitment becomes a prime mover with them at the time of elections and its tempo gets diminished in due course of time. Some piece-meal programmes or projects on rural development are brought to the people in the rural areas and these are in many cases not in consistence with their need structure. The adhocism in the planning of these programmes and half-baked implementation strategies have raised the basic issue of what is required to be developed in these areas. This brings in the problem of conceptualising rural development.

A comprehensive concept and method of rural development has been suggested by the World Bank. Rural development has been defined as a "strategy to improve the economic and social life of a specific group of people that is the rural poor including small and marginal farmers, tenants and the landless". A national programme of rural development should include a mix of activities including projects to raise agricultural output, create new employment, improve health and education, expand communications and improve housing...... The nature and content of any rural development programme or project will reflect the political, social and economic circumstances of the particular country or region......" Since Independence, rural development has been the main thrust of national development effort. The guiding principles of planning are growth, equity, social justice, self-reliance, improved efficiency and productivity. A number of development programmes from Community Development Programme to Jawahar Rozgar Yojna were started to change the scenario in the rural areas in India. These programmes have been of some help in solving the problem of migration of people to urban areas to some extent. This is evident from the fact that the percentage of rural population to total population dropped only moderately from 82.7 per cent in 1951 to 80.09 per cent in 1971. Green Revolution of the sixties and White Revolution of the early seventies seem to have changed the gloomy outlook of a large chunk of rural population. However, it is an irony of fate that because of the population growth and rising expectations not much of development is visible.

27.3 PRINCIPLES OF RURAL LOCAL FINANCE

The principles of urban local finance mentioned in Unit 26 are also applicable to rural local finance. (Refer to Section 26.3.)

27.4 RURAL GOVERNMENT: SOURCES OF REVENUE

All governmental programmes would remain mere paper items in the absence of adequate financial resources. As a matter of fact, government cannot achieve any of its social and economic goals without requisite finances. Thus, it can safely be concluded that finances are sine qua non for the success of Panchayati Raj. The pattern of revenues of Panchayati Raj varies from State to State. But the sources of revenue of Panchayati Raj Institutions, in general, may be grouped under: (i) Tax Revenue, (ii) Non-Tax Revenue, (iii) Grants-in-aid, (iv) Loans, (v) Share of State Taxes, and (vi) Donations and Contributions.

Tax-revenue

Every unit of Panchayati Raj is empowered to impose obligatory or discretionary taxes under the authority of law. These are the following:

i) Chula or House Tax
ii) Local rate
iii) Tax on profession or trade, or employment
iv) Tax on animals and vehicles
v) Pilgrimage Tax
vi) Tax on public entertainments
vii) Toll (on new bridges)
viii) Lighting Tax
ix) Water Tax

Non-tax revenue

The non-tax revenue of Panchayati Raj consists of:

a) fees at fairs, agricultural shows etc.,
b) fees for use or benefits derived from public hospitals, dispensaries, markets etc.,
c) licence fees
d) Judicial fines
e) remunerative assets
f) rents and profits accruing from property vested in or managed by Panchayati Raj Institutions and
g) income from trusts, endownments, gifts.

Grants-in-aid

In all the States, the Panchayati Raj Institutions depend heavily upon the grants from the state governments. Grants-in-aid given by the States are ad hoc and discretionary in nature depending largely on the availability of funds with the States. These can broadly be divided into two categories—general purpose grant and specific purpose grant. The former is released to Panchayati Raj Institutions to meet their general expenditure. The latter grant is earmarked for certain specific purposes such as water supply, flush type latrines, sewerage system etc. In India, the pattern of grants-in-aid varies from state to state. In Punjab, the Panchayat Samitis receive the following grants from the State Government:

1) Compensatory grants in lieu of abolition of tax on profession, country liquor, cattle pounds.
2) Grants for implementing Community Development programmes.
3) Grants for the performance of agency functions.
4) Ad hoc and matching grants.
5) Grants from other departments such as animal husbandary, education, health and family welfare.

Loans

Panchayati Raj Institutions raise loans to meet the capital expenditure involved in satisfying the increasing local needs which are developmental in character. In India, local borrowings are regulated by an All-India Act known as the Local Authorities Loan Act of 1914. The State governments may impose different forms of restrictions on Panchayati Raj Institutions to raise loans which vary from State to State.

Share of State Taxes

Some of the state governments share the proceeds of some specified taxes such as land revenue, local cess, sales tax etc., with the Panchayati Raj Institutions. For example, 40 per cent of the total land revenue collected in the village is given to Gram Panchayats in Punjab.

Donations and Contributions

Apart from the above sources of revenue, Panchayati Raj Institutions also derive income from other sources. For example, Gram Panchayat earns income from Shamlat (common) Land given on rent for cultivation or grazing purposes. Besides, they also receive donations and contributions from All-India bodies and institutions for specific purposes like adult literacy, cottage, village and small scale industries. The income from these sources is negligible now.

27.5 RURAL GOVERNMENT: EXPENDITURE PATTERN

An analysis of the expenditure pattern of Panchayati Raj Institutions shows that it is on the increase. Population growth, inflation, and the involvement of these institutions with the nation-building activities on agency basis are some of the factors responsible for rapid increase in expenditure. A look at the budget of Panchayat Samiti shows that the expenditure is divided under two heads i.e. plan and non-plan. The plan expenditure involves the expenditure for which the provision is made in the State Plan Schemes, Centrally Sponsored Schemes and Central Plan Schemes. The Panchayati Raj Institutions generally depend upon grants, borrowings, subsidies etc., to finance this type of expenditure. The non-plan expenditure includes salaries, travel expenses, office expenses, medical reimbursement, contingency etc. The major heads of expenditure shown in the budget are: health and rural sanitation, education, communications, animal husbandry, family welfare, salaries of the staff, audit fee, law charges, repayment of loans etc. Table given below shows the expenditure on different heads, incurred by the Panchayat Samiti in Chandigarh during the year 1987-88.

Expenditure Pattern of Panchayat Samiti in Chandigarh

Head of Account	1987-88 (In Rupees)
Establishment	2,35,000
Health and Rural Sanitation	22,00,000
Schemes purely executed from Panchayat Samiti Fund—Family Planning, Family Welfare	55,000
Education	15,00,000
Social Education	20,000
Grants-in-aid to Panchayats for development work	20,000
Law charges	15,000
Fairs and shows	15,000
House Building Advance to Staff	20,000
Repayment of loans	37,500
Refund of Interest to Bank	1,667

Check Your Progress 1

Note : i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) What operations are involved in financial administration of rural local government? How are these performed?

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2) Discuss the important principles that govern rural local finance.

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3) Point out the sources of revenue of Panchayati Raj Institutions.

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27.6 RURAL FISCAL MANAGEMENT

Since governments spend public money for public purposes, economical and efficient use of public money is a very important task of fiscal management. It is suggested that a government which has worked out a satisfactory system of fiscal management has gone a long way towards putting the administration of its affairs upon an efficient basis. The fiscal management involves a continuous chain of operations such as budget preparation and its approval by competent authority, assessment and collection of revenues, custody and disbursement of funds, maintenance of proper accounts and their audit. These are described briefly as under:

Budget preparation and its approval

In Panchayati Raj Institutions, budgeting is one of the major processes by which the use of the public resources is planned and controlled. The budget plays a very important role in the social and economic life of a community. In India, the long-term objectives of the Five Year Plans of the Government influence the revenue and expenditure pattern of Panchayati Raj Institutions as shown in the annual budget.

Every year, the Gram Panchayat prepares its budget towards the year-end. The Sarpanch and the Panchayat Secretary in consultation with Panchayat members attempt to frame the budget which is placed before the Gram Sabha at its Sawani meeting for consideration and suggestions. In case, a Gram Panchayat fails to prepare the budget, the respective Panchayat Samiti prepares the budget and places it before a specially convened meeting of the Gram Sabha concerned for necessary action. It may be clearly noted that Gram Sabha has only to consider the budgetary proposals placed before it. It does not have the power to formally pass them. Generally it is passed in the form of a resolution and sent to the respective Panchayat Samiti for its sanction. Thus, it can be said that if Gram Panchayat defaults, the respective Panchayat samiti is the formal authority to frame and finalise its own budget.

The budget estimates of receipts and expenditure of Panchayat Samiti are drawn up by the Executive Officer (B.D.P.O.). These estimates contain the (a) actuals of the previous year, (b) budget estimates for the current year, (c) revised estimates of the current year, and (d) budget estimates of the next year. The Executive Officer endeavours to prepare the estimates as accurate and realistic as possible and keeps in view amounts which are expected to be received by the Panchayat Samiti from the Government by way of grants-in-aid for Community Development Programme and schemes transferred by other departments of the State Government. After careful scrutiny of the budget estimates by the Executive Officer, it is submitted to the Standing Committee on Finance and Taxation for its close scrutiny or any modification as it may consider fit. After the scrutiny by the Committee, the budget is again submitted to the Panchayat Samiti for consideration, which may approve the budget with or without any modification. The budget so approved is sent to the Zila Parishad which may or may not suggest any alteration in the budget. In Punjab, in case of difference of opinion, the decision of the Zila Parishad is final and binding on the Panchayat Samiti. But the situation differs from state-to-state. Even in the case of Punjab, the differences are generally resolved at the political level.

The Secretary of the Zila Parishad prepares the budget every year and places it before the Standing Committee for finance and taxation. After having considered the estimates of receipts and expenditure, the standing committee submits the budget to the Zila Parishad for approval. As soon as it is passed by the Zila Parishad, it is sent to the government so that it can be scrutinised with a view to pointing out any misuse or abuse of funds placed at the disposal of the Zila Parishad. Thus, it is clear that the budget as passed by the Parishad is final.

Apart from this, it is important to note that the departments concerned prepare the District-wise statement of funds to be placed at the disposal of the Zila Parishads and the Panchayat Samitis and pass on the same to the State Government before the prescribed date each year. The Government communicates to each Zila Parishad the allocation of funds for schemes earmarked to the Zila Parishad as well as Panchayat Samitis. The Zila Parishad then meets immediately and decides block-wise allocation of funds and conveys its recommendations to the government. Keeping in view the recommendations of the Zila Parishad, the government communicates to each Panchayat Samiti the allocation of funds allotted to it for the schemes to be executed by it during the next financial year. On receipt of the intimation of the allocation of funds, the Panchayat Samiti prepares its budget and submits it to Zila Parishad for approval as mentioned earlier.

Assessment and collection of taxes

Assessment of taxes involves the preparation of a list of persons liable to pay the tax, and determining the amount of tax that has to be paid by them. The procedure for the assessment and collection of taxes varies from State to State. In Punjab, the Sarpanch assisted by Panchayat secretary, the Executive Officer of Panchayat Samiti or the secretary of Zila Parishad is primarily responsible to ensure that all taxes are collectively, promptly and regularly assessed and realised. He has also to see that taxes collected are brought to account and there is no leakage.

In order to collect taxes, a fresh Demand Register is prepared every year. The nature of demand, name and address of persons by whom tax is payable etc. are entered in the register. If an assessee feels that an assessment of his liability to a tax is not correctly and fairly made, he is entitled to make objections within a prescribed period, usually before the assessing officer himself. If he is not satisfied with the decisions on his objections, he is usually entitled to appeal to some higher officer. The detailed procedure in regard to arrears, refund of taxes, receipt of payment by cheque etc. is laid down in rules framed by the State Government.

Custody and disbursement of funds

All taxes realised by the Panchayati Raj officials are credited to the account of the fund of Gram Panchayat, Panchayat Samiti and Zila Parishad. The drawing and disbursing officer while incurring or authorising expenditure out of the fund shall observe the cannons of financial propriety which are given below:

1) Every officer incurring or authorising expenditure on behalf of the Panchayat Samiti or Zila Parishad should be guided by cannons of financial propriety. He is responsible for enforcing financial order of strict economy at every step.
2) Every officer is expected to exercise the same vigilance in respect of expenditure incurred out of the fund as a person of ordinary prudence would exercise in respect of expenditure of his own money.
3) The expenditure should not prima facie be more than the occasion demands.
4) No authority should exercise its power of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
5) Money out of the fund should not be utilised for the benefit of a particular person or section of the community unless:
    a) the amount of expenditure involved is insignificant, or
    b) a claim for the amount could be enforced in a court of law, or
    c) the expenditure is in pursuance of a recognised policy or custom.
6) The amount of allowances granted to meet expenditure of a particular type should be so regulated that the allowances are not on the whole a source of profit to the recipients. Money indisputably payable should not, as far as possible, be left unpaid.

Stores

The term 'Stores' includes all articles and materials purchased or otherwise required for the use of or in the service of Panchayat Samiti or Zila Parishad, whether these are consumable like articles of stationery etc., or non-consumable like instruments, furniture etc. Detailed rules have been framed for the procurement, custody and issue of stores.

Accounts and audit

After the budget has been approved by each unit of Panchayat Raj, the process of public expenditure and revenue collection starts. Since a lot of public money is spent by the Panchayati Raj officials, maintenance of proper accounts and audit of expenditure assume great importance. It is only through systematic accounts supported by vouchers and receipts that the legality and honesty of the transactions can be determined.

In Gram Panchayats, Sarpanch helped by Panchayat secretary is responsible for the maintenance of accounts. Similarly, the accounts of the Panchayat Samiti are maintained by the Executive officer and that of the Zila Parishad by the Secretary. All the accounts of receipts and expenditure have to be kept in a manner and form determined by the State Government from time to time.

The Secretary to Government, Finance Department and Examiner Local Fund

Accounts are responsible for the examination and audit of the accounts of receipts and expenditure of Gram Panchayats, Panchayat Samitis and Zila Parishads who in turn make suitable arrangements to enable the auditor for conducting audit. The purpose of the audit is to ensure that the money has been spent with honesty, efficiency and economy. Further it has to see that the money has been spent according to the rules, regulations and sanction of the concerned authority. It has also to point out whether budgetary grants have been exceeded or whether there was any case of misappropriation or waste of public funds.

The Examiner, Local Fund Accounts prepares an audit report on the annual accounts of Panchayat Samitis and Zila Parishads. This report brings out the true financial picture as on the last working day of the financial year to which it pertains. The audit report along with the annual accounts is placed before the Panchayat Samiti and Zila Parishad for necessary action. Further, the annual accounts along with the audit report of Panchayat Samitis is examined and discussed by the Public Accounts Committee of Zila Parishad. Similarly, the audit report of the accounts of Zila Parishad is also examined and discussed by the Public Accounts Committee separately constituted at the divisional level. The recommendations of these committees are of binding nature.

The Government has the power to determine a system of pre-audit or test check in consultation with the Examiner, Local Fund Accounts in respect of the accounts of Panchayat Samitis or Zila Parishads. The decision of the government in this respect is final.

27.7 STATE CONTROL AND SUPERVISION

Panchayati Raj Institutions like urban local bodies are non-sovereign entities. Though authority and responsibility have been transferred to these institutions, under democratic decentralisation, they do not enjoy absolute autonomy to manage their own affairs. They function under varied forms and degrees of control exercised by the respective state governments. Had they not been under any control, they would not have been local authorities, but sovereign states. The main purpose of the government control is to assist, guide and direct these institutions so that they do not make mistakes. This is what Mehta Committee observed. "It must not be cramped by too much control by the government or government agencies. It must have the power to make mistakes and to learn by making mistakes, but it must also receive guidance which will help it to avoid making mistakes" State Legislature exercises legislative control government departments, exercise administrative control, and the courts, exercise judicial control. In his Section, we will examine the financial control exercised by the government or government agencies over these institutions.

Financial control is one of the most effective instruments of government control over Panchayati Raj Institutions. This type of control is more or less similar in almost all the states and is exercised in matters relating to taxes, budget, grants-in-aid, loans, accounts and audit. The taxation powers of the Panchayati Raj Institutions are strictly controlled by the government. Every resolution of each unit of Panchayati Raj to increase or decrease the rate or even to abolish an existing tax needs the approval of State Government. In Punjab, the government is empowered to permit Panchayat Samitis to impose tax on any subject of the state list. The government may even suspend or abolish a tax which it considers to be unfair in its incidence or injurious to public interest.

In all the states, detailed accounting procedures have been laid down in matters pertaining to itemisation of receipts and expenditure, custody and disbursement of funds, stores, periodical scrutiny of accounts by the appropriate authorities, and so on. Besides, the accounts are also subject to government audit which is an important instrument through which control and supervision is exercised, deficiencies located and loopholes plugged to ensure financial discipline. As mentioned in the preceding section, there is also a provision for pre-audit or test check of the accounts of Panchayati Raj Institutions by the auditors appointed by the State Government. The State Government has a financial stake in Panchayati Raj Institutions. It provides financial assistance in the form of grants to these institutions. It is, therefore, but natural that the provider or guarantor of funds has a responsibility to ensure that they are not misused or diverted to unapproved schemes. Thus one who pays the piper calls the tune. Besides, every proposal to raise loan requires approval by the state government. Before government gives the green signal to borrow, it examines the scheme in detail, reviews the entire financial position of the unit of Panchayati Raj concerned, fixes the period of repayment, determines the mode of borrowing etc. Budgets are to be prepared by the Panchayati Raj Institutions in the manner and form as prescribed by the state government, which may also frame rules in regard to the time schedule for the submission of budget to higher authorities. In some states, it is the superior tier of the Panchayati Raj that has the power to sanction the budget. For instance, the budget of the Gram Panchayat is approved by the Panchayat Samiti and Samiti's budget by the Zila Parishad. The system of supervision within the three-tier structure is an important feature of democratic decentralisation envisaged by the Balwantrai Mehta Committee which also recommended that village panchayats should be supervised by the Panchayat Samitis, the Samitis by the Zila Parishad and the Zila Parishads by the State Government. All this was to be in addition to the powers of the Deputy Commissioner and other State officials who exercise similar powers of supervision. Last but not the least, the state government is empowered to either supersede or dissolve the Panchayati Raj Institutions on the grounds of persistent maladministration, corruption, misappropriation of funds etc. It is the ultimate weapon in the armoury of the state government to put the Panchayati Raj on rails.

27.8 GAP BETWEEN RURAL SERVICES AND RESOURCES

A review of the working of Panchayati Raj shows that it has not come up to the expectations of the people. There are many problems that have made Panchayati Raj Institutions ineffective in accomplishing their basic purpose. It is generally the view that part of the inability of these institutions in performing their functions satisfactorily lay in their weak financial resources. The problems of Panchayati Raj finance are of varied character. In the first place, it has been noticed that in spite of wide taxation powers, Panchayati Raj Institutions have not utilised them fully. The Asoka Mehta Committee's findings reveal that these institutions have rarely utilised their taxation powers. It observes : "In spite of all the exhortations on the need to raise their own resources by way of taxation, there is a general resistance by the Panchayati Raj Institutions to imposing taxes. This reluctance is visible not only in the case of Panchayats which are in face-to-face contact with the people but also in the case of the Zila Parishads even in such states as Maharashtra where they are performing a variety of developmental functions and need additional resources". This unwillingness to mobilise the resources is due to the unpopularity of the measure and the representatives fear of their being unseated at the next election. There is no exaggeration that the minimum that an elective body can do to alienate the sympathies of its constituents and to ensure the defeat of its sitting members at the next polls is to give the people heavier doses of taxation. Various committees which have examined, from time to time, the problem of local finance, have drawn pointed attention to this factor. Hence, the Asoka Mehta Committee recommended that some of the local taxes should be made compulsory. It observed, "The thesis 'no taxation, only representation' should be discouraged. Representation involves inescapable responsibility of raising resources for development and welfare work". Further, the borrowing facilities available to Panchayati Raj units are too restrictive. The Local Authorities Loans Act, 1914 under which these units can raise loans is not much suited to the needs of the modern times and requires a complete overhaul. It has been suggested that the scope of the purposes for which loans can be raised, the period and other conditions of repayment should be liberalised keeping in view the rural poverty. The establishment of a new financing body like a Panchayati Raj Finance Corporation in the states of Uttar Pradesh and Bihar to provide loans to Panchayati Raj Institutions to enable them to take up different types of remunerative enterprises has not been favoured by Asoka Mehta Committee. The Committee was of the opinion that it is not likely to add to the total availability of the credit. What is required in this context is a greater rural orientation to all the financial institutions to

Apart from this, the present system of grants-in-aid suffers from certain shortcomings. The grants are unrelated to the needs, these are irregular, uncertain and their release is sometimes based on political considerations. To fill up the gap between revenue and expenditure, the grants should be made available to these institutions on time and their release on political considerations should be avoided.

Though there is a provision for government audit of Panchayati Raj Institutions, yet there are serious gaps in actual practice. It has been noticed that the accounts, especially, of Village Panchayats, have remained unaudited for years at times. Panchayati Raj units have not cared to consider or remove the audit objections within the stipulated period. Hence, audit should be conducted regularly and the impression of its dispensibility should not be allowed to gain ground. The persons found guilty of misuse of funds should be given exemplary punishment and shown no leniency. In order to ensure that weaker sections of the society derive maximum benefits from the various plans, the Asoka Mehta Committee suggested that there should be an independent authority to carry out 'Social Audit' of the funds and programmes earmarked for the Scheduled Castes and Scheduled Tribes and to ensure that projects designed for them are implemented in a way that the desired impact is not diluted. Improper distribution of sources of income between the state and rural local bodies, limited financial autonomy, undeveloped trading enterprises, increased population pressure and functions etc., are some of the reasons for inadequate financial resources of Panchayati Raj Institutions. To improve the financial conditions of local bodies, creation of a separate tax-zone was strongly recommended by the Local Finance Enquiry Committee (1949-51) and the Taxation Enquiry Commission (1953-54). There is nothing new in this arrangement. It was practised during the period 1921-37 under the Government of India Act, 1919. The committees and commissions set up at the centre and the states have also suggested simplification of tax-imposing procedures, development of trading enterprises, appointment of State Finance Commission on the pattern of Central Finance Commission. Centralised purchasing, streamlining of financial management etc. are some of the remedial measures to augment finances of local bodies in India. If the suggestions described above are given a serious and fair trial, there is no reason why the shape of Panchayati Raj finances will not improve. These suggestions, when pursued, will go a long way in bridging the gap between needs and present supply of funds, putting Panchayati Raj finances on an even keel.

Check Your Progress 2

Note: i) Use the space given below for your answers.
ii) Check your answers with those given at the end of the unit.

1) Highlight the steps involved in rural fiscal management.

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2) Examine the financial control exercised by the government or government agencies over Panchayati Raj Institutions.

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3) The problems of Panchayati Raj finance are varied in nature—Discuss.

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27.9 LET US SUM UP

The existing set-up of rural government in India is based on the concept of democratic decentralisation as envisaged by Balwantrai Mehta Committee. The major purpose of rural development is to improve the social and economic life of those residing in the rural areas. In fact, the focus of development is the 'Rural Poor'. The revenue and expenditure pattern of Panchayati Raj Institutions is described in the Act under which these institutions are created. The system of fiscal management differs from state to state. In case of Gram Panchayat Sarpanch is responsible for the preparation of the budget. The budget of the Panchayat Samitis is prepared by the Executive Officer and that of the Zila Parishad by its secretary. These functionaries are also responsible for the assessment and collection of taxes, safe custody and disbursement of funds maintenance of accounts and their audit. Like urban bodies, Panchayati Raj Institutions are also regularly controlled and supervised by State Government. A review of the functions and financial sources of these bodies by the various committees and commissions reveals that there is a wide gap between the revenue and local expenditure. These committees and commissions have made a number of suggestions to bridge the gap between the two . If these suggestions are sincerely pursued and given a fair trial, they will definitely help the Panchayati Raj in improving its financial position which in turn will help in fulfilling their obligations towards rural community.

27.10 KEY WORDS

Centrally Sponsored Schemes : Plan schemes sponsored by the Central Ministries on subjects falling in the State list with usually fifty per cent financing by the Centre.

Community Development Programme : The programme was started in 1952 under the first five year plan. It aimed at changing the outlook of villagers, making them self reliant, inculcating among them a feeling of cooperation through better utilisation of resources.

Gram Sabha : It is the lowest administrative body at the village level, consisting of all persons residing in the area whose names are included in the voters list. It meets atleast twice a year to review and scrutinise the work done by the Panchayats.

Green Revolution : The strategy, adopted in the 1960s for rapid growth in agricultural production through intensive use of high-yielding variety of seeds, water and fertilisers.

Mandala Praja Parishad : The new structure of Panchayati Raj introduced in Andhra Pradesh since 1986 consists of four-tiers. Gram Panchayat is the lowest tier. The Mandala Praja Parishads cover population of 35 to 50,000. Above it is the district peoples council or Zila Praja Parishad. The fourth-tier is the District Development Review Board or Zila Abhivrudhi Sameeksha Mandal.

Toll : Money paid for the use of a road, bridge, harbour etc.

White Revolution : Efforts made in the 1970s for increasing milk production in the country through adoption of improved dairying practices.

27.11 REFERENCES

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27.12 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Your answer should include the following points:
   - Operations in financial administration in rural local government are those designed to generate, regulate and distribute the financial resources needed to provide services to the community. These operations are performed by :
   - The executive wing which prepares the budget.
   - The legislative wing which alone can grant funds.
   - The executive controls the expenditure of funds sanctioned by the legislative wing.
   - Audit department
   - Standing Committee

2) Your answer should include the following points:
   - Independence and responsibility
   - Adequacy and elasticity
   - Integration and coordination
   - Public accountability
   - Simplicity
   - Effective personnel management
   - Fiscal access

3) Your answer should include the following points:
   - Tax revenue
   - Non-tax revenue
   - Grants-in-Aid
   - Loans
   - Share of State Taxes
   - Donations and contributions

Check Your Progress 2

1) Your answer should include the following points:
   - Budget preparation and its approval
   - Assessment and collection of taxes
   - Custody and disbursement of funds
   - Procurement, custody and issue of stores
   - Accounts and audit

2) Your answer should include the following points:
   - Strict control exercised by the government on the taxation powers of the Panchayati Raj Institutions.
   - Centralised accounting procedures
   - Accounts subjected to government audit
   - Pre-audit/test check of the accounts of Panchayati Raj Institutions by the auditors appointed by the state government.
   - Control exercised by the government with regard to grants-in-aid, loans provided to the Panchayati Raj Institutions, by way of approval, review etc.
   - Powers of supersession or dissolution of Panchayati Raj Institutions, vested with the government.

3) Your answer should include the following points:
   - Improper utilisation of taxation powers
   - Unwillingness on the part of institutions to mobilise the resources

- Restricted borrowing facilities of Panchayati Raj Institutions
- Present system of grants-in-aid which is uncertain, irregular and unrelated to the needs of the institutions
- Irregularities in the system of audit.