Commentary

Reforming Financial Management in Defence

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The Government of India and the Ministry of Defence (MoD) have initiated several reforms in the areas of budget and accounting. The reforms are ongoing and take into account the changes in other similar systems abroad and international best practices. The focus all over the world is to operate in a continuum of long-term plans, medium-term plans, annual plans, on the one hand, and allocations, targets and outputs on the other so that stability in budgetary allocations, accountability of the budget-holders and transparency in the processes can be ensured. The budget and accounting systems in India would have to undergo further and significant reforms if they are to attain international best practices standards.

The Budgetary System

The Defence Services and Departments compile assessed fund requirements for the ensuing Financial Year (1st April to 31st March) and project the same to the MoD (Finance) for allocation. Projections in respect of Locally Controlled Heads (LCHs) are formulated by the Defence Services in consultation with the Command Headquarters and local Controllers/ Principal Controllers of Defence Accounts/Integrated Financial Advisers. On the other hand, the projections pertaining to Centrally Controlled Heads (CCHs) such as pay and allowances and modernisation schemes are formulated by the respective Directorates of the Service Headquarters and are forwarded to MoD (Finance).

The projections of Service Headquarters, after vetting by MoD (Finance), are then forwarded to Ministry of Finance, which, based on estimated overall availability of resources and projections of MoD, allocates funds for Defence Services and Departments. The allocations so made are

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distributed among six Demands for Grants[1] of the Defence Services/ Departments and are sub-allocated to Major Heads, Minor Heads and other heads for expenditure under Revenue and Capital, voted and charged, on a gross basis. The allocations to Services/Departments are strictly need-based and are not dependent on any pre-determined percentages and form part of the non-Plan expenditure of the Government of India. They provide for the obligatory charges, essential maintenance requirements, committed liabilities and prioritized new modernisation schemes.

As per Article 114 of the Constitution of India[2], amounts under various Grants must not exceed the provisions of the Appropriation Bill of that Financial Year. Also, funds provided are to be spent for the purpose for which they have been allocated. Unspent funds lapse to the Consolidated Fund of India on the closing of a Financial Year.

In effect, the primary focus of the entire budgetary process is on resource allocation. This process does not establish a direct linkage between the allocation of funds and the capabilities these funds can create. From the budgetary allocations, it is not possible to directly deduce the capabilities that such expenditure can buy[3] or ascertain the value for money. Similarly, it is not easy to quantify the co-relation between the increase/reduction of allocations on the operational efficiency, training, etc. of the Defence Services.

Accounting System

The Accounting System followed in Government of India is cash-based. In this system, an expenditure is recorded in the accounts when cash is paid out and receipts are recorded when reported by the collecting agencies. The cash-based system ignores all non-cash transactions, whether they involve liabilities or creation of assets or inter-unit free issue of goods and/ or services, etc. The accounting system does not also cater for re-valuation or consumption of assets through depreciation in respect of most organisations except probably some production agencies e.g. Defence Ordnance Factories.

The existing system provides for submission of audited Appropriation Accounts[4] to Parliament on completion of a Financial Year so as to reflect compliance between the allocations made by the Parliament and the expenditure incurred by the Executive giving reasons for significant variations between (i) the Original Grant and Modified Appropriation, and

(ii) the Modified Appropriation and the Actual expenditure in that Financial Year.

Under the cash-based system, the currency transactions, pertaining to a Financial Year, are available till the closing of accounts. Once the accounts are closed, past transactions do not become readily available. In this system, committed liabilities incurred do not get recorded in the accounts at the time of their occurrence. Therefore, for commitment control, such information has necessarily to be generated through additional reports. If the committed liabilities are not available, the possibility of over or under committing resources vis-à-vis available funds in a Financial Year cannot be ruled out. The accounting system also does not generate information for the decision-makers to know whether the money is being spent on core or peripheral activities. Due to the principle of lapse, the Executive tends to spend the earmarked funds during the month of March, sometimes also referred to as 'March rush', in order to avoid surrender of unspent funds.

International Experience

United Kingdom

The Government of UK introduced the Accrual system of accounting[5] under the Resources and Accounting Act, 2000 and made the accounting system broadly consistent with the Generally Acceptable Accounting Principles (GAAP, UK). The Government introduced statements of gains and losses, balance sheet, cash flows, net operating cost, revaluation of assets, etc, and also the concept of capital charge, i.e. interest charged on capital (in the form of net assets) held by each Department of Government of UK.

Resource accounting and budgeting was introduced in the Defence Services in 2001-02. As a result, the Army took action to generate resources through marketing their spare training capacity and disposal of surplus Defence Estates and equipments, etc. The effort in UK is, therefore, to shift emphasis from input of resources to utilisation of resources.

New Zealand

New Zealand moved to accrual accounting under GAAP with Public Finance Act, 1989[6] for the departmental expenses of the Government.

Further, with the amendments to this Act, the Government changed budgeting to accrual basis. In 2000, this was extended to the entire Government of New Zealand, including the capital expenditure. In New Zealand, expenditure constraint is applied whenever the decision to incur a liability is actioned. They, however, also prepare statements of cash flows. All Departments of Government of New Zealand provide expenditure reports to the Treasury by the 7th of each month. The Treasury, in turn, provides expenditure report to the Office of Auditor General in the next three days.

United States

In the USA, performance budgeting was introduced through the National Security Act 1949. Performance budgeting was introduced in USA on the assumption that presenting performance information along side budget amounts will improve decision-making. The country has continuously taken financial management initiatives to establish linkage between plans, targets and annual allocations. These initiatives have come in the form of Planning, Programming and Budgeting System (1965), Management by Objectives (1973), Zero Based Budgeting (1977), Government Performance and Results Act (1997), etc.

Even in the Quadrennial Defence Review[7] released in February 2006, the US is aiming to progress towards outcome oriented and capability based planning approach. The focus of the Department of Defence is to reach investment decisions through collaboration amongst the war fighting, acquisition and resources communities. The acquisition decisions are likely to be based on the technological feasibility, cost-per-increment of capability improvement and assessment of affordability. US also intends to establish 'Capital Accounts' for Major Acquisition Programmes so as to provide stability in budgeting system and accountability in acquisition. It is hoped that the proposed measures would enable senior management to implement risk informed investment strategies, reflecting joint war fighting priorities.

Initiatives in India

Performance budgeting, Management by Objectives and Zero-based Budgeting was introduced at different stages for implementation by various Departments and Ministries of Government of India. In 2003, Parliament passed the Fiscal Responsibility and Budget Management Act[8] so as to ensure better control over public finances and provide improved transparency and accountability in Government expenditure. Under the Act, the Central Government is required to lay before Parliament, Medium Term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macro economic Framework Statement, along with the Annual Financial Statement and Demands for Grants. Under the Act, no deviation is permissible in meeting the obligations of the Central Government without approval of Parliament.

In August, 2002, Comptroller & Auditor General of India set up Government Accounting Standards Advisory Board (GASAB) with the following objectives:-

- To formulate accounting standards for implementation by the Union and the State Governments
- To improve the utility of financial reports for various stakeholders to ensure comprehension, reliability, relevance, timeliness, transparency, consistency and comparability.

In July 2004, GASAB mandated D N Ghosh, a retired officer of Comptroller & Auditor General of India, to formulate a roadmap for making the transition from the existing cash-based accounting system to a more appropriate system of accounts for the Central and State Governments. According to available information Ghosh, had in his report, recommended adoption of a modified accrual accounting system.

In December 2004 the 12th Finance Commission[9] recommended gradual transition to accrual basis of accounting in the medium-term and in the interim period, to append additional statements of cash accounts on subsidies, salary expenditure, pensioners and pension expenditure, committed/other liabilities, debt, repayment schedules, increase/decrease of financial assets, implication of major policy decisions for future cash flows, maintenance expenditure, etc.

Ministry of Finance has accepted the recommendations of the 12th Finance Commission and has issued instructions for formulation of Outcome Budget 2006-07[10] for Plan funds and Performance Budget 2005-06, with additional statements, in pursuance of the 12th Finance Commission's recommendations.

Controller General of Accounts, the Principal Adviser to Government of India in accounting matters, would have to formulate the final accounting standards, in consultation with the Comptroller & Auditor General of India after obtaining inputs from the concerned accounting organisations of Government and other experts in the field. The process is yet to be completed.

As part of the ongoing reforms, an 'Outcome Budget' was presented to Parliament on August 25, 2005 for the first time by the Finance Minister. The Outcome Budget presented was aimed at making it a pre-expenditure instrument to realise the vision behind outlays. Converting outlays to outcomes is a complex process, which differs from Ministry to Ministry and programme to programme. It calls for defining outcomes, which are measurable, monitorable, and also calls for defining the intermediate outputs. The process requires standardising unit cost of delivery, bench-marking the standards/quality of outcomes and services, capacity-building for requisite efficiency at all levels, ensuring flow of right amount of money at the right time to the right level and to inculcate an outcome oriented mindset.

Defence Budget Reforms

In pursuance of the recommendations of the Group of Ministers, a Study Group on Budgetary Reforms was set up in the Ministry of Defence to examine, inter-alia, the expansion of budgetary classification to promote Programme Based Budgeting. In 2002 the Study Group recommended introduction of Programme Based Budgeting in a gradual manner and to devise mechanisms for costing of all cash and non-cash transactions. The Study Group also expanded the concept of Authority-cum-Responsibility Centre, already introduced earlier in Defence, and recommended further factorisation of allocations within the Defence Services and Defence Departments.

In 1986-87, the Director General, Defence Planning and Staff, had engaged the College for Defence Management for devising structures, formats and guidelines for introduction of Programme Based Budgeting in Defence. The Integrated Defence Staff (IDS) has also mandated the College for Defence Management to suggest methodologies and structures for implementation of Programme Based Budgeting in Defence Services in pursuance of the recommendations of the Study Group on Budgetary Reforms, mentioned above.

The Defence Accounts Department has undertaken the project 'Mission Excel IT' seeking to adapt the current computerised systems to contemporary and futuristic platforms. Substantial changes are expected to occur in the availability of accounting and financial information as a result of improvements in the system and in the working processes.

One of the systems under review is the Financial Information System. The existing system provides All India Compilation of Receipts and Expenditure of Defence Services and Departments and generates over 100 MIS reports for various stakeholders. In fact, the All India Compilation System is one of the oldest automated systems of the Central Government. The Defence Accounts Department was the first in Government to introduce data processing through Hollerith machines with the use of Punching Medium in 1931. Since then, this system has undergone many adjustments till the old COBOL based system was changed to the existing FOXPRO based system using the VSAT links with over 20 Data Distributing and Processing Centres.

Under 'Mission Excel IT', FIS is being expanded to include Liability Database, Allocation Database and Expenditure Database. It is expected that the new system would also capture additional data pertaining to contracts/supply orders, bills, vendors, consignees, etc.

Cost Accounting System – A Working Model

Defence Ordnance Factories have been following a comprehensive cost-accounting system for nearly 100 years where all inputs such as labour, material and overheads, are costed to arrive at the unit cost of the finished products as well as of the intermediate products (Inter-Factory Demands). The Financial accounts for Ordnance Factories are derived from the cost accounts. Even the budgetary projections and allocations (inputs) are directly co-related to the issue/output targets. The ordnance factories also take into account their assets and depreciation while finalising the accounts. It is felt that the cost- accounting system followed by the Defence Accounts Department in the Ordnance Factories can be considered as an in-house model towards introduction of Programme Based Budgeting, particularly in respect of works projects (e.g., Married Accommodation Project), Dockyards, Base Workshops, Canteen Stores Department, etc. with suitable modifications.

Conclusion

The focus the world over is on linking resources (both projections and allocations) and results (capabilities) taking into account the long-term, medium-term and short-term plans. The challenge for India is to devise the most pragmatic methodology suitable for local conditions. GASAB is already working in this direction for evolving a suitable accounting system. A multi-year expenditure framework in the budgetary allocations can also be considered so as to ensure stability in budget availability.

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