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Government of Karnataka - Public Financial Management Reform Action Plan - 2014

FINANCIAL MANAGEMENT UNIT - INDIA COUNTRY OFFICE - THE WORLD BANK

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STRUCTURE OF THE REPORT

1. The Main Report comprises the following chapters:
    a. Executive Summary provides the overall view of the reform action plan.
    b. Chapter 1 outlines the background, scope and methodology for the study
    c. Chapter 2 outlines the overview of the state finances
    d. Chapter 3 describe the accomplishments made against the 2004 agreed PFMA action plan
    e. Chapter 4 provides an overview of the analysis, gaps and recommendations made in the study
    f. Chapter 5 describes the way forward for implementation of the action plan.
    g. Annex 1: PFM Reform Action Plan - 2014 contains a thematic-wise plan outlining the actions to be taken, the responsible department for the actions, and the expected timeframe for completing the actions. The detailed analysis of the issues and the logic for the action plan are provided in the respective sections of the Appendix.
    h. Annex 2: 2004 PFMA Action Plan - outlines the current status of action taken on 2004 PFMA Action Plan: This contains the action plan as proposed in the 2004 report, updated with the current status of actions in the identified areas. In case where the actions have been taken and completed by the Government of Karnataka, the impact has been documented.

2. The appendix comprises the following sections:
    a. Section 1: Theme One: Strengthening PFM Legal And Institutional Framework
    b. Section 2: Theme Two : Enhancing Comprehensiveness and Credibility of the Budget
    c. Section 3: Theme Three: Strengthening Accounting, Reporting, Controls, and Transparency
    d. Section 4: Theme Four: Improving Fiscal Assets and Liability Management System
    e. Section 5: Theme Five: Strengthening Audit and Legislative Oversight
    f. Section 6: Theme Six: Improving PFM in Local Self Governments
    g. Section 7: Theme Six: Improving PFM in Public Sector Undertakings (State Owned)
    Each section describes the various areas of public financial management in the Government of Karnataka grouped into thematic reform areas. Each proposed reform area has a discussion of the background, the reform actions proposed in the 2004 PFMA Action Plan, the progress of reforms over the last decade, the issues presently identified, and the rationale for the reform actions proposed.
    h. Section 8: 2014 Action plan: This section describes the action plan with next steps to be followed under each activity of the action plan.

ACRONYMS

AG (A&E)	Accountant General (Accounts and Entitlement)
ALMC	Asset Liability Management Cell
AMS	Audit Monitoring System
C&AG	Comptroller and Auditor General (India's Supreme Audit Institution)
CCO	Chief Controlling Officer
CoLB	Committee on Local Bodies and Panchayati Raj Institutions
CoPA	Committee on Public Accounts
CSS	Centrally sponsored schemes
CTD	Commercial Taxes Department
DCB	Demand Collection Balance
DDO	Drawing and Disbursing Office
DMA	Directorate of Municipal Administration
DoFP	Delegation of Financial Powers
DPAR	Department of Personnel & Administrative Reforms
DPE	Department of Public Enterprises
DOT	Directorate of Treasuries
DRSC	Departmentally Related Standing Committees
DMTFP	Departmental Medium Term Fiscal Plan
DSA	Debt Sustainability Analysis
EIU	Economic Intelligence Unit
FD	Finance Department of GOK
FMRC	Fiscal Management Review Committee
FY	Financial Year
GoI	Government of India
GOK	Government of Karnataka
GP	Gram Panchayats (Village-level Rural Local Government)
HRMS	Human Resource Management System
IFA	Internal financial advisors
IFMIS	Integrated Financial Management Information System
IGAS	Indian Government Accounting Standards
KBM	Karnataka Budget Manual
KFC	Karnataka Financial Code
KFRA	Karnataka Fiscal Responsibility Act
KII	Khajane II
KIPA	Karnataka Institute of Public Auditors
KLAC	Karnataka Legislative Assembly Council
KSAD	Karnataka State Accounts Department
KTTP	Karnataka Transparency in Public Procurement Act
LFAFRA	Local Fund Authorities Fiscal Responsibility Act
MIS	Management Information Systems
MPAS	Model Panchayat Accounting System
MTFP	Medium Term Fiscal Plan
NLTA	Non-Lending Technical Assistance
OBB	Off Budget Borrowings
PAC	Public Accounts Committee
PEFA	Public Expenditure and Financial Accountability
PMS	Project Management Software
PRI	Panchayat Raj Institutions (Rural Local Governments)
PSU	Public Sector Undertakings
PWD	Public Works Department
RBI	Reserve Bank of India
RDPR	Department of Rural Development and Panchayati Raj
RE	Revised estimates
SOE	State Owned Enterprises
PFMA	State Finance Accountability Assessment
SPV	Special Purpose Vehicles
TP	Taluk Panchayats (Block level Rural Local Government)
UC	Utilization Certificates
UDD	Urban Development Department
ULB	Urban Local Bodies (Urban Local Governments)
WRD	Water Resources Department
ZP	Zilla Panchayats (District-level Rural Local Government)

EXECUTIVE SUMMARY

BACKGROUND

1. **The Government of Karnataka (GOK) is a reform-oriented state and proactive in undertaking several initiatives to improve governance, accountability, and transparency through a mix of reforms in administration, service delivery, and public financial management (PFM)**. GOK has implemented various reforms like *Sakala* (Karnataka Guarantee of Services to Citizen Act 2011) for ensuring timely service delivery to citizens; has adopted a results framework as a tool to measure the outcomes of the funds used by the State; has implemented the Karnataka Fiscal Responsibility Act (KFRA) 2003 for fiscal consolidation and better fiscal management; and has ushered in transparency in procurement through implementation of the Karnataka Transparency in Public Procurement Act, 1999 and e-procurement system across the state. GOK has carried out e-governance initiatives in Commercial Taxes, Excise, Stamps and Registrations, Urban Local Bodies (ULBs), and Gram Panchayats (GPs) besides automating the Treasury and human resource functions to provide faster and hassle-free service to the end users and also to strengthen PFM systems. The objectives of the above reforms and e-governance initiatives are not only to improve the efficiency and effectiveness of service delivery to the citizens, but also to increase transparency in the process, reduce paperwork and time taken for responses, and to eliminate discretionary actions that can be carried out in a manual environment. The reforms undertaken by GOK have been recognized at various fora for their effectiveness in improving service delivery.

2. GOK has been carrying out fiscal reforms and PFM modernization since 2001, which is one of the strategic core elements of the overall GOK reform strategy[1] — to improve transparency and service delivery in the state. The action plan[2] developed as part of the Public Financial Management and Accountability Study (Karnataka, February 2004),[3] carried out by the World Bank in active collaboration with GOK, provided the necessary impetus for GOK to initiate PFM reforms. **While GOK carried out reforms in many of the strategic areas highlighted in the 2004 study, there are areas in which significant challenges remain unaddressed**.

3. **GoK intends to address these challenges and further strengthen the PFM systems and enhance the accountability mechanism in the State**. To achieve this objective several reforms are underway such as : (a) development and roll out of an upgraded Integrated Financial Management Information System across the state (Khazane II); (b) implementing an e-payment system to ensure quick and transparent disbursements; (c) upgrading its human resource management system; (d) strengthening financial reporting to make them real time and support decision making; (e) computerizing pension payment systems; (f) strengthening the State Accounts Department; (g) strengthening Internal Financial Advisor system; and (h) providing training and capacity building to all finance and accounts officers of the State. In this context, the GoK requested the Bank's support to prepare a holistic PFM Reform Action Plan which it can implement in the medium term. Bank agreed to support this initiative through non-lending technical assistance (NLTA). The Bank along with the GOK took stock of the 2004 reform action plan and developed a PFM reform action plan, taking into account the various actions and initiatives currently under implementation. The output of the NLTA is the **PFM Reform Action plan 2014**.

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[1] *Karnataka State Planning Board, Karnataka: A Vision for Development, December 2008.*

[2] *Action Plan to Improve Public Financial Management and Accountability assessed the nature and degree of PFM risk, and the key actions to be taken to mitigate such risks.*

[3] *This study examined Karnataka's PFM system and covered the following key areas: (a) budget development, budget execution and monitoring; (b) fiscal transparency; (c) accounting; (d) financial reporting; (e) internal controls; and (f) external controls including auditing and legislative oversight.*

OVERVIEW OF STATE FINANCES

4. **The GOK state finances have experienced a noticeable improvement since introduction of the Karnataka Fiscal Responsibility Act (KFRA).** The KFRA has set fiscal targets (numerical rules) which have been achieved by GOK within the stipulated time frame and continues to maintain these targets over the years (Table 1).

Table 1: Numerical Rules in Karnataka Fiscal Responsibility Act and status of compliance

Numerical Rule	Target/Limit	Remarks
Deficit Rules	Revenue Deficit[4] to be nil by 2006	Revenue surplus achieved since 2004/05
	Reduce Fiscal Deficit[5] to be no more than 3 percent of GSDP	Fiscal Deficit maintained below 3 percent except during 2009/10 (with legislative approval), but reverted back to less than 3 percent in 2010/11[6]
Debt Rules	Guarantees not to exceed 80 percent of Revenue Receipts of second previous year	Limit achieved since 2000
	Reduce Total Liabilities[7] as a percentage of GSDP and bring it to no more than 25 percent of GSDP by 2015	Achieved since 2010/11

5. In the recent past, the state government has improved its capabilities of estimation of expenditure and revenue, and the revenue and expenditure outturns have improved over the years. The variance has been less than 5 percent in two years on the expenditure side and less than 10 percent on the revenue side (Table 2).

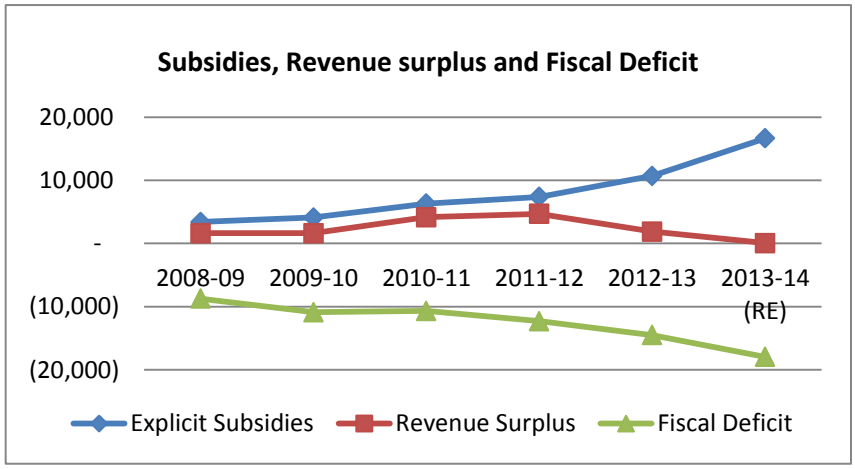
Table 2: Expenditure and Revenue out-turns

Particulars/Year	2012-13	2011-12	2010-11
Actual Expenditure Deviation (as a percent of budget estimates)	93.7%	101.5%	104.1%
Actual Revenue (Tax revenue and non-tax revenue) as a percent of budget estimates	105%	106%	107%

6. GOK's fiscal position is largely influenced by the revenue side as two-thirds of the state's revenue is from own sources. Simplification and rationalization of tax structure, along with simplification of process of filing tax returns and extensive use of technology, has ensured effective mobilization of resources from various taxes, which have helped GOK to maintain a better fiscal position. Though tax revenues have been consistently growing, GOK has not improved revenues on the non-tax front, which continues to decline. The state's Fiscal Management Reform Committee has recognized this issue and suggested departments to be more proactive in identifying and collecting their non-tax revenue.

[4] *Defined as difference between revenue expenditure and revenue receipts*
[5] *Defined as total disbursements from the Consolidated Fund (excluding debt repayment) over total receipts into the Consolidated Fund (excluding debt receipts)*
[6] *The Legislature permitted the numerical rule in respect of fiscal deficit to be exceeded during three consecutive years 2008/09 to 2010/11 following amendments made to the KFRA. However, GoK actually exceeded the statutory rule only in one year 2009/10*
[7] *Defined as the sum of liabilities under the Consolidated Fund and the Public Account of the state*

7. **In terms of expenditure, generally the revenue expenditure has been below the revenue receipts leading to revenue surplus, which was used as one of the sources to fund capital expenditure.** Over the years, revenue expenditure has been increasing mainly due to subsidies, which reduced the revenue surplus, and affected the outlay available for capital expenditure. Subsidies have increased from Rs.3,399 crore in 2008-09 (8 percent of the revenue receipts) to Rs.16,661 crore, which is 18 percent of the revenue receipts in the 2013-14 (revised estimate). The revenue surplus for the corresponding period declined from Rs.1,635 crore (which is 3.8 percent of revenue receipts) in 2008-09 to Rs.64 crore in 2013-14 (revised estimate), which is 0.1 percent of the revenue receipts. With the increasing coverage of subsidies, there are demands beyond the provisions made in the budget; most often these have to be accommodated through supplementary estimates. GOK's Medium-Term Fiscal Plan (MTFP) 2014/18 recognizes that the challenge lies in ensuring that these subsidies do not become a permanent source of additional support and thereby deter sectors from undertaking reforms. GOK acknowledges that expenditure on subsidies needs to be moderated in the medium-to-long term to make them fiscally sustainable through improving systemic efficiencies in sectors like energy, rationalize cross-subsidization of costs, providing incentives to sectors to perform rather than increasing their dependence on subsidies, and also effective identification and targeting of beneficiaries. [8]**Moreover, most of the revenue expenditure is in the nature of committed revenue expenditure like salaries, pensions, interest, subsidies, etc., which affects the maneuverability of the state to prioritize expenditure in this space.** The state Fiscal Management Review Committee has advised GOK to re-evaluate expenditure commitments as well as relook at the subsidies and work on providing more target-based subsidy.



8. GOK has to create fiscal space for public investment spending (capital expenditures) [9] through the budgetary processes but within overall fiscal constraints which include - (a) budget envelope available after meeting revenue expenditure; (b) limits to fiscal deficits mandated by the KFRA; and (c) restrictions on gross public debt. Increasing revenue expenditure, reducing revenue surplus, and statutory limitations on borrowings affects the fiscal outlay available to the GOK for carrying out capital expenditure. The Fiscal Management Review Committee suggested that all approvals for new initiatives and works requiring implementation over multiple years should be based on fiscal sustainability of the total expenditure and its overall impact on the fiscal position of the state and that GOK should ideally move to medium-term (3 to 5 years) appraisal and approval cycle for the schemes. Going forward, GOK needs to prioritize capital expenditure to achieve their fiscal targets as well as manage their public investment funding more systematically by adopting the above suggested approach.

[8] *During 2013-14 (revised estimate), 94 percent of the receipts are expected to fund committed revenue expenditure and only 6 percent is left for the GOK to fund other revenue expenditures.*
[9] *GOK Capital spending has been about 40% of total government spending, and as compared to other states is relatively higher*

ACCOMPLISHMENT OF 2004 ACTION PLAN

9. A Public Financial Management and Accountability Assessment (PFMA) was carried out by the World Bank in active collaboration of the Government of Karnataka (GoK) in 2004. Drawing on the analysis and recommendations presented in the PFMA, *GoK and the Bank jointly developed an Action Plan to improve PFMA* (referred to as the 2004 PFMA Action Plan) *to continue and deepen GOKs Public Financial Management (PFM) improvement program with the objective to improve PFM and Accountability for making government more effective, accountable and responsive*). The PFMA Action Plan was categorized into six strategic segments – Budget preparation and implementation, financial computerization and MIS, Accounting, Audit/PAC responsiveness and follow up, PFM in other Public Sector Agencies and Institutional Arrangements and Capacity Building – with several actions under each to achieve the objectives. The work done by GoK in terms of preparing the vision for the reforms, the strategy for planning and implementing the reforms is commendable. GoK accepted and addressed majority of the actions outlined in the action plan. The major areas of accomplishment which emanated from the 2004 report are summarized below:

- Improved fiscal discipline and budget outturns;
- Improved fiscal transparency in terms of availability of budget and other financial documents to public;
- Implemented Computerized Treasury across the State which improved the overall decision making and control environment on the budget, cash flow and treasury management leading to better cash management and reducing the short term loans by the State.
- Implemented e-governance initiatives in commercial taxes which have helped in improving revenue collections as well as to provide faster service to the users.
- Implemented Human Resource Management System (HRMS) which has helped in timely payment of salaries and better control over this expenditure
- Implemented e-procurement across the state which has improved competition as well as increased saving to the government;
- Improved timelines in completion of accounts and audit reports
- Improved recording and reporting of fiscal assets and liabilities of the government and
- Implemented Fund based computerized accounting system in ULBs and Double entry based computerized accrual accounting system in Gram Panchayats (GPs) to improve local self-governments maintenance of accounts and completion of audits.
- GoK has issued new cadre and recruitment rules for KSAD staff covering both entry-level qualifications and mandatory training for promotions which in the medium term will provide qualified staff at all levels and a training curriculum has been developed for accounting, financial and auditing training, currently under implementation.
- Liberalized delegation of financial powers for release of funds to prioritize the funds release and usage
- Phased out LOC payments and have made Treasury payments compulsory for all Departments

10. GOK has been a pioneer in the area of PFM reforms and has been pushing the boundaries to the next level in most of the PFM areas. GoK embraced reforms that included the 2004 PFMA Reform Action, as part of its strategy to improve PFM and accountability and gradually introduced necessary changes in systems and procedures to achieve its objective. They continue to improve PFM by strengthening their systems which includes policies, process, and people and are embarking on upgrading its PFM computerized systems (such as Khajane and HRMS) and GOK recognizes that still there are challenges in its pursuit for a strengthened PFM. These have

brought in significant changes, but this was not accompanied with a comprehensive review of the PFM and accountability framework and its actual working to ascertain the current situation. An assessment of implementation of the 2004 PFMA Reform Action Plan (*ibid)* indicates accomplishments in some areas while calling for a need for further efforts in implementing reforms in others.. GoK, therefore, intends to build up an updated reform action plan to further strengthen PFM and accountability. For this purpose, a detailed understanding of the current PFM structures and the accompanying strengths, weaknesses, opportunities and threats (SWOT) has been done as part of this study (description, findings and analysis are detailed in the Appendix to this report). The assessment has been conducted at two levels: one, at the policy level and two, at the implementation level. The SWOT analysis was used as the base line for developing a new PFM reform action plan by GoK. The ongoing reforms, challenges, and opportunities have been duly recognized in the 2014 PFM reform action plan which is outlined below.

SWOT ANALYSIS

11. **The GOK PFM system presents both strength and weakness**. The PFM framework can be examined at two broad levels: one at the policy level and another at the implementation level. On the assessment of the framework at both the levels, there are strengths and areas of improvement which are summarized below.

12. **The PFM Framework in the state is guided by a set of acts, manuals, rules, and procedures supplemented through Government Orders issued from time to time**. These manuals and handbooks are outdated; and with the imminent introduction of the modernized integrated financial management information system (IFMIS), Khajane II (KII), all the manuals and codes, including certain acts, need to be aligned with the revised business processes as planned in Khajane II. This is an opportune moment for GOK to update and revise its financial manuals taking into account the requirements of the state.

13. **Capacity constraints in the finance cadre of the state inhibit implementation of the PFM framework.** Internal Financial Advisors (IFA) were envisaged to play a major role in implementing the PFM framework in the state and supporting the departments (particularly large spending departments) in carrying out PFM tasks – however they are not being effectively utilized due to capacity constraints. The Karnataka State Accounts Department (KSAD), which is a key PFM institutional pillar at the state level and supports state accounting function to a large extent, is also affected with capacity constraints that influence the state's overall PFM implementation. KSAD, therefore, needs to be strengthened as part of the reform strategy for improving the PFM framework. Recruitment of IFAs can preferably be from KSAD, and suitable officers have to be identified, trained, and groomed for this purpose. An extensive human resource and skills mapping exercise in KSAD should be carried out to identify skill gaps and develop strategy for enhancing competencies for taking up challenging tasks; organizational structure of KSAD has to be reviewed particular in terms of staffing and skill sets to carry out the accounts and audit function both timely and efficiently and staff to be identified and skilled to carry out the functions of PFM practitioners in the Finance Department.

14. **The well-established budget preparation and approval processes still need to be strengthened**. GOK presents the budget before the start of the year, but obtains approval on a Vote on Account for the first four months; the full budget is passed well within the fiscal year. GOK should aim to pass the entire budget before the beginning of the fiscal year as a good practice and to enhance predictability of availability of funds.

15. **The budget outturn for revenue and expenditure has significantly improved over the years, but there are substantial compositional variances and large savings in budget allocations due to significant adjustments through supplementary budgets.** There are multiple in-year adjustments by way of three supplementary budgets and re-appropriation of significant amounts. Supplementary budgets are not "fiscally neutral" as required by the KFRA; and commitments of significant amounts are included as a part of these estimates, which affects the budget-execution process. Too many supplementary budgets could affect fiscal discipline as over-reliance is placed on the supplementary budget rather than the original budget. GOK should aim to reduce the number of supplementary estimates passed through the year to ideally one and also have enhanced control over increasing re-appropriations. There is therefore a need to improve budget credibility in these areas. Predictability in availability of funds has improved by way of enhanced delegation of powers in respect of providing sanctions at the departmental level, and release of funds without repeated recourse to the finance department with good success in improving pace of spending and some reduction in rush of expenditure at the year end.

16. **Budgeting could be further improved by a review of the manner in which provisions are made for certain items such as salaries, capital commitments and public investment funding**. GOK should move toward providing budget only for filled posts and planned additional recruitment, which could release unnecessary budget provision of around Rs.1,000 crore, which can be utilized to budget for other productive purposes in the original budget itself thus avoiding in-year adjustments. GOK needs to have better control on the capital commitments since internal control in this area is weak and leads to unfunded commitments and unpaid bills that affect the fiscal situation of the state. Budget priority should be made for payment of arrears, then for completion of ongoing works, and lastly for adding new works. During the past two years, the Public Works Department (PWD) has accumulated more than Rs.1,000 crore (~US$200 million) of unpaid bills. Full provision for payment arrears if made could adversely affect the fiscal indicators of GOK. Over-commitment without adequate budget leads to arrears, which is not in line with the KFRA. PWD also required significant supplementary provisions, about 40 percent of original budget estimates during 2010/11 and 2011/12 and 80 percent during 2012/13. GOK needs to develop a strategy to clear the outstanding arrears of payment and control them in future through better monitoring of commitments for capital works. In case of capital commitments, GOK needs to follow the recommendation of Fiscal Management Review Committee for moving to medium-term (3 to 5 years) appraisal and approval cycle for the schemes and prioritize capital expenditure based on fiscal sustainability of such schemes. GOK needs to ensure that no new capital commitments or ad hoc arrears payments are proposed in the supplementary budget, except in case of natural disasters; as such additions distort the fiscal management of the state. It would be prudent if MTEF (rolling forecast) was introduced in PWD and a proper scheduling of works is carried out to work out the budget requirements. Going forward, GOK has to link the budget process with the procurement plans, monthly programme implementation calendar and also move towards performance based budgeting/results based budgeting and align the budgeting process with the results framework document.

17. **There exists appropriate controls on transaction-level expenditure, which are largely exercised**. Most of these controls are documented in the various manuals and handbooks, updated and supplemented through Government Orders as required by the GOK from time to time, and also automated through the Treasury system. The GOK accounting and reporting systems primarily revolve around the framework applicable nationally, and automation of the Treasury function has strengthened the accounting, reporting, and control framework over the years. Yet, there are weak areas such as reconciliation, compliance with controls, and accounting treatment that need mitigation. While the details are available from treasury on a timely basis, reconciliation is not being timely.

These systemic issues are also highlighted in the audit findings that need to be followed up and addressed so that the system in these areas can be improved. Accounting issues such as reversal of earlier year expenditure as well as reversal of amounts from public deposit (to the consolidated fund) need to be addressed. The GOK in consultation with Accountant General (AG) needs to develop the policy and procedures for such reversals.

18. **The recent change in fund flow mechanism of centrally sponsored schemes through the state budget as to various implementing agencies would require changes and strengthening to the state accounting and reporting requirements.** GOK needs to rework the fund flow arrangement with GOI and envisage using state treasury system/public deposit accounts in place of the bank accounts being used by the implementing agencies which would provide enhanced control and better cash management for the state.

19. **GOK has implemented HRMS integrated services register and pay bill software which has improved the payroll process and system in the state**. GOK is now upgrading the Payroll system to HRMS II within the next two years. GOK needs to ensure that data validation of all the records is completed and payroll audit is carried out across the state, before the data is migrated to HRMS II. In case of procurement, GOK has successfully implemented KTTP across the state as well as the e-procurement function has been rolled out in more than 200 departments across the state. In case of e-procurement, though the functions have been automated though there are issues in the underlying control mechanisms and data validation; these need to be addressed. The key actions for strengthening e-procurement are (a) CAG IT audit of the e-procurement software and (b) implementation of contract management module.

20. **GOK is in an advanced stage of implementing an integrated financial management information system** Khajane II (KII). KII is planned to be implemented in two phases: phase 1 covering 12 core treasury modules, and phase 2 covering functionalities of other departments. Piloting of the core treasury modules is expected to be completed by September 2014, all modules are expected to go live from FY15 and rolled out across the state. Key features include budget preparation through the system, electronic payments as a default mode, computerization of the functions of the Drawing and Disbursing Officers (DDO) and bill processing through the system, control over works commitment and payment, accounting for other state owned entities which are not using treasury systems and complete accounting hitherto done on the systems of the Accountant General. Of significant note, the Accountant General is an internal stakeholder and will have access rights to KII. As a system KII is expected to address several of the state's current reconciliation and accounting issues. In case of way forward a data migration strategy, change management strategy, HR strategy, training plan, and rollout plan has to be developed and implemented by GOK. A GO outlining the timelines and the transition process has to be issued by GOK. Uncoordinated development of various applications across departments using a fragmented approach has proliferated, and there is a need to integrate these to K II so that these are mainstreamed and used for decision-making process.

21. **There are improvements in the asset and liability management by GOK with setting up of the dedicated Asset Liability Management Cell (ALMC) for collecting, collating, and maintaining data on guarantees, investments, and loans, and advances** The ALMC, however, has staffing, capacity and data constraints that affect its functions. Appointing core finance professionals or staff from Finance Department and training to existing staff would strengthen this cell handling a significant portfolio. A stronger linkage with and more frequent reporting to the Finance Department would ensure that issues are discussed and resolved more frequently. There are serious reconciliation and data integrity issues in investment in public companies and loans

and advances provided by GOK – an amount of Rs. 21,287 crore is yet to be reconciled between the records maintained by the state and its agencies and the finance accounts published by the Accountant General. This could affect the overall asset portfolio of the Government and needs to be resolved on a priority basis – a strategy to address these could include: constituting dedicated teams for working on the reconciliation exercise, and focusing on the "big ticket" items starting with the latest accounts and going back to earlier years. As a part of the asset-liability management, GOK needs to setup a dedicated integrated office to for cash and debt management functions of the state. The level of unencashed cheques have been increasing, and has reached Rs. 6,820 crore (March 2013); accumulation of such cheques adversely impacts the adequacy of internal controls and is open for potential misappropriation. GOK needs to review and clear the public account as well as work out a strategy to address the issue of unencashed cheques.

22. **Controls in the area of loans and advances are weak.** This is characterized by loans made without finalizing terms and conditions; further loans given despite default in repayment of old loans; and, in most cases, the data on loans and advances are not readily available. A policy decision is needed for addressing loans to government entities that have neither repaid the loans nor the interest on such loans and where the possibility of recovery of such amounts is very limited due to the precarious financial situation of such entities. The GOK needs to decide on a case-to-case basis if such loans should be allowed to exist in the books or should be converted either into equity or grant.

23. **The well-established system of external audit of the state's accounts and local self-governments and legislative scrutiny can be made more effective through enhanced responsiveness and compliance of audit findings.** External audit by the Supreme Audit Institution (SAI) is now more comprehensive and regular with a good proportion of performance and IT audits. Reports are now also available on a timely basis - the audit report for FY 2012/13 has been published and submitted to the Legislature by February 2014. On the other hand, the audits for local bodies (ULBs and Gram Panchayats, the third tier of rural local bodies) are delayed due to, capacity constraints of Karnataka State Accounts Department (KSAD) as well as non-submission of accounts by GPs. The effectiveness of audit is undermined due to weak follow up on the audit reports and legislative committee reports by the auditee who more often fail to provide responses on a timely manner. An Audit Monitoring System has been established for the external audit reports of the SAI, but its use is limited taking into consideration that it has only quantitative details; qualitative/systemic details are not captured; and data, particularly with respect to action taken, are not regularly updated. GOK needs to strengthen the audit compliance mechanism and also enhance the Audit Monitoring System to capture data for all audits and systematic data so as to analyze and take actions on them. Going forward, GOK needs to work with State AG to facilitate them to carry out audit of the state accounts through KII system and issue audit reports through the system.

24. **Legislative scrutiny of audit reports has seen significant enhancement.** External audit reports are tabled in the state Legislature and are subject to scrutiny by the separate legislative committees on state accounts (including departments), public sector entities and local bodies. The committees are well functioning and have adopted the approach of taking up the latest reports first and simultaneously clearing the backlog of the department taken up for hearings. Audit findings taken up for examination are selected on basis of materiality, contemporary relevance and systemic issue. However, noncompliance to the recommendations by the departments undermines the efficiency of this review process.

25. **KSAD's role as auditor needs to be strengthened to improve its efficiency and effectiveness**. Audit practices followed by KSAD are not modern and the audit institution suffers from staff capacity. KSAD should implement modern audit practices including risk based audit, co-sourcing, along with implementation of the audit software to improve the timeliness and quality of the audit. KSAD needs to be strengthened through continuous training and capacity building measures to perform the role of auditor in a faster and efficient way. KSAD audit capacity has to be augmented by recruiting staff, continuous training, IT implementation, and outsourcing in the short run to address arrears of audit.

26. **Internal audit mechanism in the state is highly dispersed, lacks leadership and its effectiveness is virtually absent.** The function is woefully short of staff (in particular skilled staff) and uses antiquated audit techniques not conducive for audit in a highly automated environment in Karnataka. A ray of hope is the system of IT and risk-based review mechanism instituted in the Commercial Tax Department as an example of "proxy internal audit" - its principles could be replicated in other departments. There is, therefore, a need for a formal modern Internal Audit system, at least in the high revenue-earning and high spending departments, to promote effective internal controls contributing to improved level of compliance and better expenditure management.

27. **Local Self Governments every year handle around Rs.22500 crores, making it imperative that these institutions have strong PFM systems – but assessments often find gaps in PFM framework and compliance.** The respective legislation underlying these institutions and accompanying manuals define the PFM environment. Significant efforts have been directed towards strengthening PFM in local self-governments (particularly accounting reforms) for ULBs and GPs, and a similar strategy is needed for ZPs and TPs. Delayed completion of audits; low revenue collection ratio; a not-so-strong system of internal controls, including internal audit; and low capacity and shortage of finance staff are key areas that need immediate attention. Own source revenue can be improved by encouraging e-payments and collection through banks to improve controls and collection efficiency as well as preparing Demand Collection Balance and carrying out timely reconciliation. Effective and adequate internal controls, including internal audit and timely audit compliance are areas that must be part of an improvement agenda and these must be institutionalized in these organizations. While ULB's have up to date accounts, audits are pending due to capacity constraints of the auditors – KSAD which needs to be addressed at the earliest. ZPs and TPs have up to date accounts as well as audits have been completed by the CAG. GPs suffer from backlog of accounts and audits, though the situation can be controlled with concerted effort, and the priority area therefore is clearance of backlog of accounts and audits for GPs. Accounting reforms in local self-governments are underway, which needs to be completed and mainstreamed into the overall system. GOK has to review the accounts and finance staffing in these institutions both in terms of staff numbers and skill sets and has to develop a strategy for recruiting them.

28. **State Owned Enterprises contribute to 7.2% of the GSDP and GOK investments in them are Rs.69,810 crores and the budgetary support for the FY 12-13 was Rs.15,059 crores.** The SOEs handle substantial public funds by way of share capital, loans and grants/subsidies besides the GoK providing guarantees for borrowings of these SOEs. Hence, these SOEs should have a strong PFM system to account for and report on the use of public funds but assessments often find gaps in PFM framework and compliance. While the scenario has improved in comparison to 2004, the following issues are persistent: (a) delay in completion of accounts and audits; (b) lack of effective internal audit; (c) lack of response to systemic audit issues and reconciliation problems; (d) non adoption of a corporate governance framework; and (e) absence of a nodal office to monitor and support the SOEs. A stronger corporate governance framework for government companies and corporations must be established - the

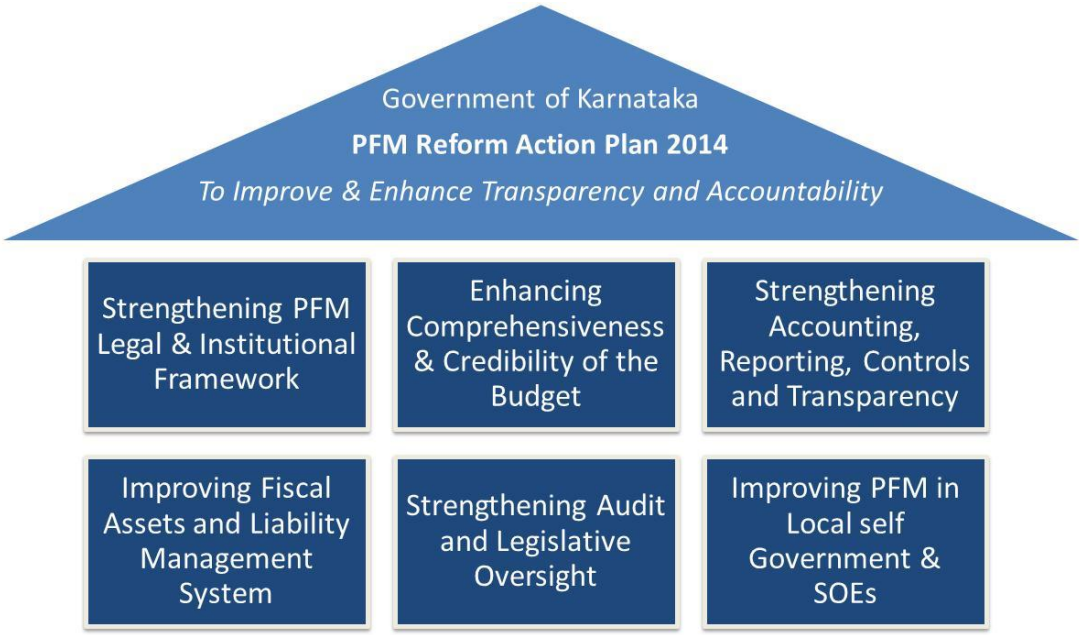
model code of corporate governance prescribed for central public sector undertakings could be adopted. Effective and adequate internal controls, including internal audit and timely audit compliance are areas that must be part of an improvement agenda and these must be institutionalized in these organizations. Another priority area is to have a concentrated effort for clearance of backlog of accounts and audits which can be achieved within a short timeframe with external technical assistance as well as consider accounting reforms for entities which are yet to move to computerized accounting. Institutionalizing a stronger nodal agency would benefit the GOK to support and monitor the SOEs.

PFM Reform Action Plan - 2014

29. **The overall objective of the 2014 PFM Reform Action Plan is to improve and strengthen public financial management so that it efficiently and effectively promotes accountability and transparency and thereby improves service delivery.** This Action Plan would support GOK to further accelerate reforms in the PFM arena in order to improve and enhance transparency and accountability. The Reform Action Plan recognizes the fact that Karnataka is not in the early stages of reform process but has over the past decade undertaken a range of reforms.

30. ***The Action Plan revolves around a thematic approach***. Six themes have been identified as priorities for PFM reforms over the next five years. These themes and their elements relate to legal and institutional framework, budgeting, accounting and reporting, management of financial assets and liabilities, auditing and legislative oversight besides reforms in the government enterprises and local self-governments (Figure 1). All these themes are interlinked and the benefits of change in one theme would support better performance in another theme, leading to overall improvement in the PFM of the state.

Figure 1: Thematic Approach to PFM Reforms in Karnataka



31. **Each reform area that is proposed has been discussed in the Analysis Report (Part II)**. The Analysis Report provides the background, the reform actions proposed in the 2004 Action Plan, the progress of reforms over the last decade, the issues presently identified, and the rationale for the reform actions proposed. For the purpose of comparison of the status of the various PFM areas, the status in GOK has been (broadly) benchmarked against the good practices under the Public Expenditure and Financial Accountability (PEFA) Assessment tool and good practices followed by GOI and other Indian states. The Action Plan takes cognizance of the ongoing reforms and, their linkages and dependencies with the proposed reform actions. For each reform area, the priorities of the proposed action points and the responsible department/agency that will spearhead and implement the reform/s have been suggested. It is also suggested that the reforms be mainstreamed with GOK's own work processes so as to ensure sustainability.

32. **Client engagement and ownership**: GoK constituted a high level committee headed by the Principal Secretary (Finance) to oversee this study and has appointed nodal officer to support this activity. The counterpart team was fully involved in the study and they supported the Bank team in all aspects of the study. Most of the comments and suggestions from the study have emanated from various officers in GoK and the Bank team has been acting a facilitator and sounding board to discuss and deliberate these suggestions and finalize them in as the reform action plan.

KEY ACTIONS

33. The detailed action plan is provided in the following section of this report. Some of the key actions proposed for GOK are outlined below.

34. ***Short-term action.*** Immediate action to be completed within one year:

- Pass full budget before fiscal year and make budget provision for only filled posts;
- Carry out one time exercise to resolve reconciliation issues, clean public account, clear unencashed cheques, and reconcile investments, loans and advances, and debt;
- Develop a rollout plan for Khajane II, including data migration, change management, switchover to computerized accounting, and training plan;
- Develop strategy to clear unpaid bills;
- Move toward e-receipts/collection through banks for local self-governments;
- Clear the backlog of accounts and audits in various sectors;
- Develop disclosure guidelines for amounts devolved and utilized by the local self-governments.
- Initiate special audit in the area of loans and advances maintained by the department to review the controls and compliance mechanisms; and
- Develop guidelines for accounting and disclosing amounts received, transferred and spent on centrally sponsored schemes.

35. ***Medium-term actions*** to be completed within next three years:

- Enhance internal financial advisor, KSAD, and ALMC capacity through recruitment and training;
- Improve budget realism by reducing compositional variance and reducing number of supplementary budgets, including the quantum of additional budget sought;

- Review subsidies and introduce targeting of subsidies through mechanisms for specific identification of beneficiaries and a system of tracking and monitoring to provide fiduciary assurance;
- Move to medium-term appraisal and approval cycle for the schemes/capital works and prepare rolling forecast of the works for budgeting purpose;
- Develop and implement medium-term expenditure projections in large departments like Public Works Department.
- Implement Khajane II and carry out the switchover to computerized accounting across the state;
- Develop and implement contract management module across the state;
- Develop and implement a guarantee policy for the state;
- Set up a combined debt and cash management office for the state;
- Develop and institutionalize internal audit for high-spending departments to improve the quality of spending;
- Capacitate KSAD to provide internal financial advisor and PFM professionals in the future;
- Conduct study on corporate governance and consider application of the framework for state-owned enterprises; and
- Switchover to computerized accounting in urban local bodies and Gram Panchayats (village-level rural local government).

36. The GOK has already started taking action on some suggestions along with the progress of the study. A couple of key actions already taken by GOK are:

- Disclosing additional information on the Finance Department Website;
- Withdrawing provision for unfilled posts in urban local bodies;
- Approved audit cell creation in DMA;
- Approved a central audit monitoring cell in KSAD;
- Reviewing the need for vacant post provisioning for the state; and
- Reviewing of fund flow differences in urban local bodies and Panchayat Raj Institutions..

INSTITUTIONAL ARRANGEMENTS FOR IMPLEMENTING THE PFM REFORM ACTION PLAN

37. The next step would be to have stakeholder consultations to agree on the action plan, sequencing the reform, and institutionalizing the Reform Action Plan.

38. **The 2014 Action Plan needs to be approved by the GOK and included in the Medium-Term Fiscal Plan of the Government.** This will provide the necessary mandate for implementation and the instrument for disseminating the Plan, as well as review of the implementation on an on-going basis.

39. **A high-level committee needs to be formed at the level of Principal Secretary (Finance) so that reforms can be reviewed on a regular basis and coordination across departments can be achieved.** The prioritization of the actions and the timelines needs to be reviewed on a holistic basis by GOK and the sequencing of reforms needs to be worked out as most of the reforms are interlinked and benefits would accrue if related reforms are addressed simultaneously. A quarterly progress report on the achievements made and challenges faced should be presented to the committee for their monitoring and advice. Considering the magnitude of the reform actions, a

system of continuous monitoring is essential to ensure that the implementation goes as planned and course corrections are identified, approved, and applied in a timely manner.

40. **A dedicated 2014 Reform Action Management Cell needs to be constituted by the GOK to implement these reforms**. The cell would be headed by Principal Secretary (Finance) with his team of Secretary (B&R), Secretary (Expenditure), and Secretary (FR) and secretaries from the respective Administrative departments. The office of the Secretary (Fiscal Reforms) can be nominated to co-ordinate and follow up on agreed action points. This office needs to be strengthened with adequate resources – human, financial, and IT as well as provided with sufficient powers to monitor the reform.

41. **The Finance Department needs to exercise strong leadership in implementing the PFM reform**. This is especially pertinent for activities relating to budget formulation and execution, accounting, financial reporting, auditing, and internal controls. PFM reforms needs to be led by the Finance Department, but it involves all departments like the Public Works Department (PWD), Rural Development and Panchayat Raj Department (RDPR), Urban Development Department (UDD), Water Resource Department (WRD), the Directorate of Municipal Administration (DMA), and the Department of Public Enterprises Reform and Disinvestment (DPE). All departments will need to cooperate for PFM modernization to happen. As a part of further actions, **GOK can consider institutional review of key departments (PWD, RDPR, WRD, and UDD) and support them in strengthening their institutional framework, which would help improving the overall PFM framework of the state to a large extent**.

42. Once the report is accepted by the GOK, based on the requirements of the GOK, a technical assistance project to support the dissemination and implementation can be developed. As a part of further dialogue, the possibility to carry out assessments like PEFA review, Public Expenditure Review, and other detailed economic assessments can be discussed with GOK.

43. **In conclusion, Karnataka's performance compares favorably to that of other Indian states and indeed scores well on the international PEFA measurement framework.** This is due to the continued PFM reforms carried out by GOK during the last decade and other initiatives which are under progress. Karnataka is fortunate to have a strong bureaucracy, a reforming political leadership, and a demanding civil society. Continued progress on the PFM agenda will pay rich dividends for Karnataka by making the government in the state more effective, accountable, transparent, and responsive.

Chapter 1: BACKGROUND, SCOPE AND METHODOLOGY

1.1 BACKGROUND

1. The Government of Karnataka (GoK) is reform oriented, and has been actively engaged in Public Financial Management (PFM) modernization from 2001 in co-ordination with donor agencies. The GoK and the Bank in 2004 jointly prepared the State Financial Accountability Assessment (PFMA) report and a comprehensive PFM action plan[10]. This report and action plan paved the way for many reforms in Karnataka. Most reform actions outlined in the PFM action plan have been implemented or are underway. GoK intends to further strengthen PFM and accountability of the State and to achieve this objective has initiated various reforms. Reforms in governance and PFM have been at the forefront in Karnataka and some of the key reforms undertaken are outlined below:

a. ***Implemented Sakala*** (Karnataka Guarantee of Services to Citizens) Act, 2011 for ensuring timely service delivery to its citizens.
b. Enacted and implemented the ***Karnataka Fiscal Responsibility Act***, 2003, and that heralded a rule-based system which GoK has been following it for fiscal consolidation and better fiscal management.
c. Ushered in ***transparency in procurement*** through enactment and implantation of The Karnataka Transparency in Public Procurement Act, 1999 which enabled implementation of e-procurement system across the state presently covering 227 departments/agencies handling procurement worth Rs.1,61,300 crore cumulatively ($ 27 billion). GoK has made it mandatory for all its departments and organizations to procure goods and services exceeding Rs.5 lakhs in each case on the e-procurement portal.
d. ***Implemented e-governance initiatives in commercial taxes*** (e-administration of the underlying legislation) across the state which has helped in improving revenue collections as well as to provide faster service to the users. Vendors can register and pay their taxes online and also file their returns online with the Department.
e. ***Implemented Khazane I (Computerized Treasury) across the State***: The state treasuries have been computerized and treasuries now handle all Budget allocation, Treasury bill processing and payments, issue of cheque, e-payments, budget control and reallocation. Treasuries are rendering monthly compiled accounts to the State's Accountant General, as well as provide monthly reports to the officers responsible for financial accountability and reconciliation. Khajane improved the overall control environment on the budget, cash flow and treasury management.
f. Implemented electronic receipts of government dues for major revenues including commercial taxes and excise. For specified payments, this mechanism has been made mandatory.
g. Implemented ***Human Resource Management System (HRMS)***: HRMS a centralized web based application has been implemented across the state which covers all employees of the state government. Service Registers of all employees are now available in electronic form and pay bill is generated by the system. E-payments of salaries have been implemented in 15 districts.
h. Improved audit compliance through institutionalizing and maintaining a transparent ***web based Audit Monitoring System***
i. ***Improved fiscal discipline and budget outturns:*** The budgeting process has improved in line with the 2004 report and the GoK has achieved good budget outturns in the recent years. The revenue receipts are generally more than the budgeted amount while expenditure has been around the budgeted amount.

[10] *The study assessed the nature and degree of PFM risk, and the key actions to be taken to mitigate such risks*

j. Adopted ***RFD (Results Framework Document)*** as a tool to measure the outcomes of the funds used by the State.

k. ***Improved timelines in completion of accounts and audit reports:*** With Khajane I, the accounting and reporting timelines to AG have improved which has resulted in faster completion of accounts by AG (A&E) and completion of audit by the AG (Audit). The audit reports are normally placed before the Legislature around 9 months from the end of the financial year (FY).

l. ***Phased out LOC payments and have made Treasury payments compulsory for all Departments.***

m. ***Liberalized delegation of financial powers for release of funds*** to the Principal Secretaries\Secretaries of the administrative department which would help the departments to prioritize the funds release and usage.

n. ***Implemented Fund based computerized accounting system in ULBs*** and ***Double entry based computerized accrual accounting system in Gram Panchayats (GPs)*** to improve local self-governments maintenance of accounts and completion of audits.

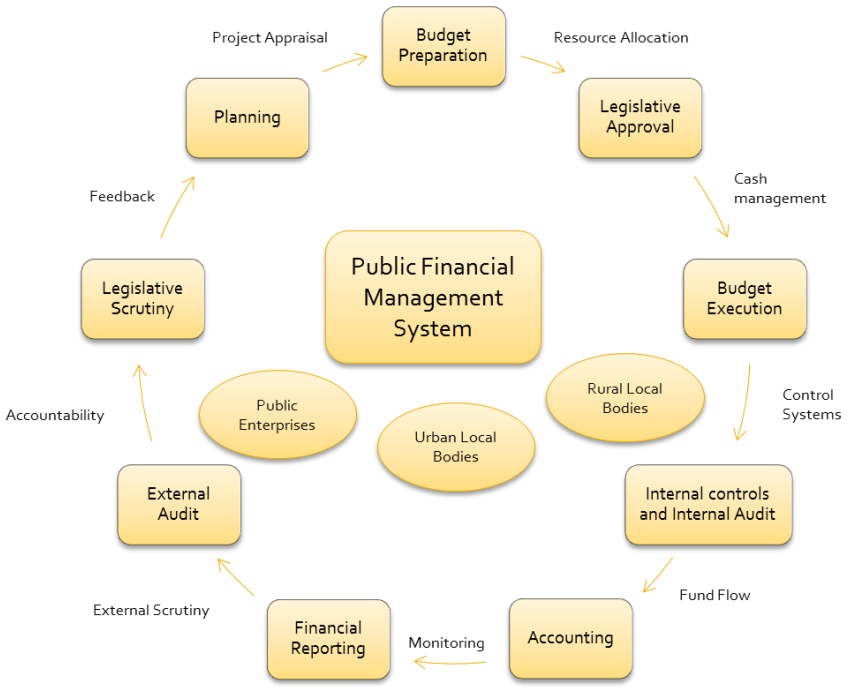
o. Regularized expenditure aggregating of Rs. 9565 crore in excess of the budget approved by the state Legislature through Public Accounts Committee (PAC) which is considered a significant achievement compared to other states.

2. **GoK intends to further strengthen the PFM systems and enhance the accountability mechanism in the State**. To achieve this objective several reforms are underway such as : (a) development and roll out of an upgraded Integrated Financial Management Information System across the state (Khazane II); (b) implementing an e-payment system to ensure quick and transparent disbursements; (c) upgrading its human resource management system; (d) strengthening financial reporting to make them real time and support decision making; (e) computerizing pension payment systems; (f) strengthening the State Accounts Department; (g) strengthening Internal Financial Advisor system; and (h) providing training and capacity building to all finance and accounts officers of the State. In this context, the GoK requested the Bank's support to prepare a holistic PFM Reform Action Plan which it can implement in the medium term. Bank agreed to support this initiative through this NLTA.

1.2 SCOPE AND METHODOLOGY

3. The scope of the NLTA was to review the core state government PFM functions such as (a) budget development and execution, (b) budget and accounts related fiscal transparency, (c) financial reporting and accounting, (d) treasury systems, (e) internal controls, (f) external auditing, (g) legislative review of budget execution, and (h) procurement. The next step was to suggest a suitable medium-term PFM reform action plan for the state. The components of the PFM system examined for developing the PFM Reform Action Plan are depicted in Figure 2: Public Financial Management System.

Figure 2: Public Financial Management System



4. The methodology for developing the Medium term PFM Reform Action Plan (Figure 2) is as follows:

a. ***Current situation analysis*** was carried out through fieldwork (discussions/interviews, data collection); and desk reviews of materials.[11] The information collected was validated with the key stakeholders.

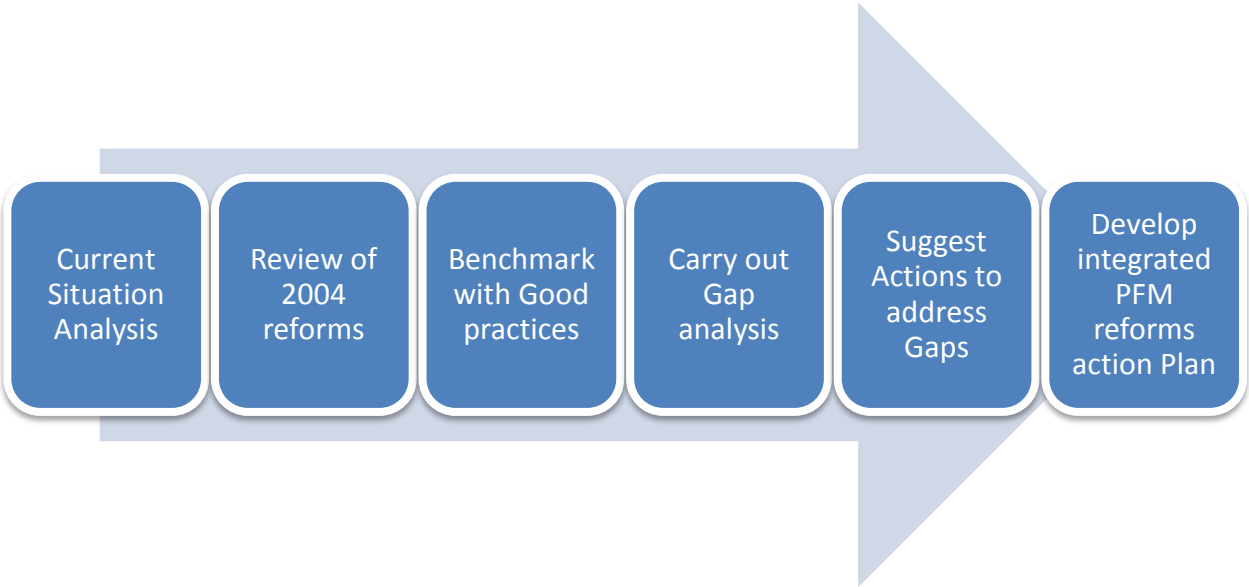
b. ***Review of 2004 reforms.*** Details of reforms carried out by the state were collected through discussion with key stakeholders, which were compared with the recommendations of 2004 PFMA report. These reforms were assessed against the actions taken, sustainability, continuation, and quality. The reforms were categorized into following areas and were used as the baseline for the 2014 action plan:
    i. Reforms which have been successfully implemented and continuing in the field;
    ii. Reforms which have been implemented but have been discontinued; and
    iii. Reforms which have never been taken up and the relevance of these reforms in the present PFM context.

c. ***Benchmarking, gap analysis and suggested actions.*** For the purpose of comparison of the status of the various PFM areas, the status in GOK was (broadly) benchmarked against the good practices under the Public Expenditure and Financial Accountability (PEFA) Assessment tool and good practices followed by the Government of India (GOI) and other Indian states. Based on the above review, the issues identified both at policy level and at implementation level were discussed and deliberated with stakeholders and suitable actions to address the gaps were developed in coordination with the stakeholders.

[11] *Reports of the CAG, State Budget, and MTEF; various Government financial manuals such as Financial Rules, Treasury Codes, Budget Manual, Account Code, Acts; Accounts and Audit Reports; and existing Government studies.*

d. ***Develop PFM action plan***. Based on the above, an action plan for each area of discussion was developed, which was later grouped into themes so that the inter-linkages and benefits across the various PFM areas could be understood and harnessed. The individual actions were prioritized and integrated into a medium-term action plan, with clear roles of responsibility and timelines.

Figure 3: Methodology for developing PFM Reform action plan



5. **Client engagement and ownership**: This study emanated from GoK since they were moving to IFMIS and they wanted this study to complement their reform agenda. GoK constituted a high level committee headed by the Principal Secretary (Finance) to oversee this study and has appointed nodal officer to support this activity. The counterpart team was fully involved in the study and they supported the Bank team in all aspects of the study. Most of the comments and suggestions from the study have emanated from various officers in GoK and the Bank team has been acting a facilitator and sounding board to discuss and deliberate these suggestions and finalize them in as the reform action plan. GoK has been continuously apprised of the study and notes and findings have been constantly shared with the client. Some of the reforms mentioned in the report have already been initiated by the GoK. Once the report is accepted by GOK, they would make it a formal document by adopting the reform action plan as a part of the MTFP.

Chapter 2: OVERVIEW OF STATE FINANCES

6. The state government has been on the fiscal consolidation path since passing of Fiscal Responsibility Legislation such as the Karnataka Ceiling on Government Guarantee Act, 1999 and the Karnataka Fiscal Responsibility Act 2002 (KFRA). KFRA mandates the State to gradually eliminate the revenue deficit and limit the Fiscal deficit to the extent of 3 percent of GSDP while the guarantee act mandates limiting of contingent liabilities such guarantees to 80 percent of Revenue Receipts of the previous year and ensuring that the government places the details of Contingent liabilities and Statement of Public Debt in the Legislature for scrutiny. KFRA provides for a mandatory Medium Term Fiscal Plan (MTFP), which sets forth the fiscal policy of the state government for at least next three years.

7. Karnataka state finances have experienced a noticeable improvement consequential up on introduction of rule based Fiscal Correction Mechanism by the state government. The fiscal targets, fiscal and revenue deficits have been achieved well within the stipulated time frame. The global slowdown has not spared Karnataka and the economy has experienced a slight slowdown in the real estate market and registration of vehicles. However the state has experienced satisfactory fiscal recovery. The summary overview of state finances is outlined in Table 3 and Table 4 which follow.

Table 3: Summary Overview of State Government Finances: Flows (Rs. in crores)

Particulars	2012/13	2011/12	2010/11
RECEIPTS			
Own tax revenues	53,754	46,476	38,473
Own non-tax revenues	3,966	4,087	3,358
Share of central government taxes	12,647	11,075	9,506
Grants from central government	7,809	8,168	6,869
Net borrowings (excluding off-budget borrowings)	9,738	6,038	3,907
TOTAL RECEIPTS	87,914	75,844	62,113
DISBURSEMENTS			
Revenue expenditure (including interest Rs. 6,833 cr, Rs. 6,062 cr, Rs. 5,641 cr)	76,293	65,115	54,034
Capital expenditure (net of receipts)	15,445	15,417	13,283
Loans and advances (net of repayments)	944	1,576	1,577
TOTAL DISBURSEMENTS	92,682	82,108	68,894
Revenue (current) surplus	1,883	4,521	4,172
Fiscal deficit (excludes impact of off-budget borrowings)	(-) 14.506	(-) 12,302	(-) 10,688

Source: Government of Karnataka, Finance Accounts

Table 4: Summary Overview of State Government Finances: Stocks (Rs. in crores)

Particulars	As of 31-Mar-13	As of 31-Mar-12	As of 31-Mar-11
BORROWINGS (on-budget)			
Borrowings from GoI and financial institutions	75,052	65,315	59,277
Borrowing from employees' Provident and Insurance Funds	15,914	14,182	12,784
Borrowings from other Public Account	36,270	32,299	25,550
FINANCIAL ASSETS			
Cash and Bank	10,511	9,609	7,667
Capital Expenditure and Investments in government companies/corporations, other companies, and Cooperative Societies and Banks	119,513	104,035	88,525
Loans made by the State Government	12,143	11,198	9,623
DEBT GUARANTEES PROVIDED (to government companies /corporations, urban local governments, Co-operative Banks and Societies, other companies, Boards/Authorities and universities)	6,688	6,515	6,618

8. Karnataka has been a revenue surplus state for a considerable period due to adherence of KFRA, buoyancy in revenues particularly in VAT, and prudent fiscal management. Fiscal deficit of Karnataka has been continuously below 3 percent of GSDP for the last five years except for the year 2009-10. Though it has been a revenue surplus state, the revenue surplus has reduced from 1.39 percent of GSDP to 1.08 percent of GSDP between 2007-08 and 2011-12. Decline in revenue surplus and tab of 3% on fiscal deficit has limited the capital expenditure to around 3.5 percent of GSDP. The global crisis though affected the state of Karnataka as well; the impact was limited only to one year (2008-09). The state started recovering from a dip in its fiscal indicators in 2008-09. The crisis affected its revenues to decline from 15.17% of GSDP in 2007-08 to 14.33% in 2008-09 to marginally recover in 2009-10 to 14.64%. The finances came back to original position of 2007-08 in 2010-11. Improvement in finances of Karnataka in 2009-10 was mainly due to increase in revenues from the federal government than its own revenues.

Table 5: Finances of GoK based on Accounts (as a percentage of GSDP)

	2007-08	2008-09	2009-10	2010-11	2011-12
Revenue Receipts	***15.17***	***14.33***	***14.64***	***15.28***	***16.07***
Own Revenues	***10.82***	***10.20***	***10.10***	***10.98***	***11.64***
Tax Revenue	*9.58*	*9.15*	*9.11*	*10.10*	*10.70*
Non tax Revenue	*1.24*	*1.05*	*0.99*	*0.88*	*0.94*
Shared Revenues	***4.35***	***4.13***	***4.54***	***4.30***	***4.43***
Tax Devolution	*2.50*	*2.37*	*2.19*	*2.50*	*2.55*
Grants In Aid	*1.85*	*1.76*	*2.35*	*1.80*	*1.88*
Revenue Expenditure	***13.78***	***13.79***	***14.16***	***14.19***	***14.99***
Interest Payments	*1.66*	*1.50*	*1.55*	*1.48*	*1.40*
Capital Outlay	***3.19***	***3.27***	***3.61***	***3.51***	***3.57***
Net Lending	***0.26***	***0.22***	***0.13***	***0.41***	***0.36***
Gross	*0.28*	*0.24*	*0.29*	*0.46*	*0.42*
Recoveries	*0.02*	*0.02*	*0.17*	*0.04*	*0.06*
Total Expenditure	***17.23***	***17.28***	***17.90***	***18.11***	***18.93***
Revenue Surplus/ Deficit	***1.39***	***0.54***	***0.48***	***1.10***	***1.08***
Fiscal Deficit	***-2.06***	***-2.95***	***-3.26***	***-2.82***	***-2.85***
Primary Deficit	***-0.40***	***-1.45***	***-1.71***	***-1.34***	***-1.46***
GSDP (Rs. Million)	2712460	3021460	3357470	3808710	4342700

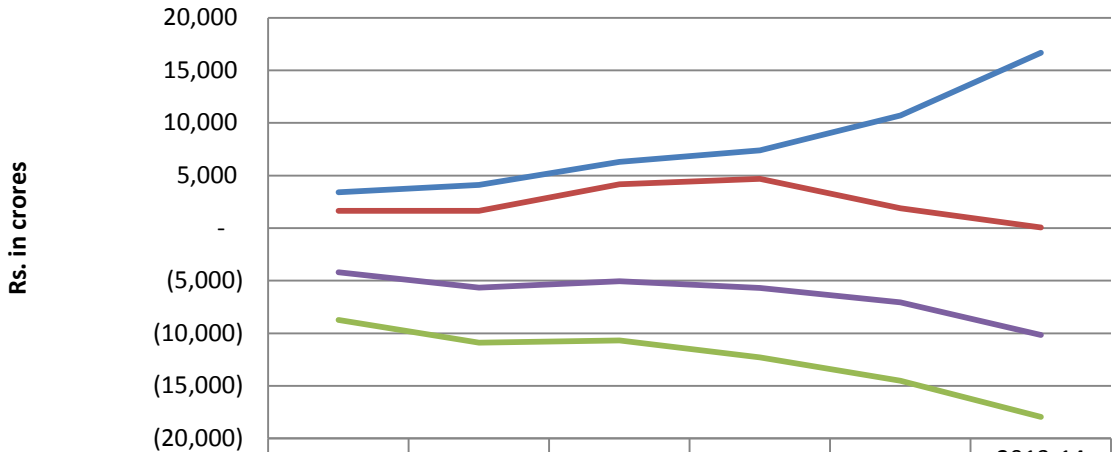
Source: Budget Documents, GoK, Study of State Budgets, RBI and MTFP statements of GoK (various Years).

9. The GOK fiscal position is largely influenced by the revenue side. Two-thirds of the state's revenue is from own sources. Simplification and rationalization of tax structure, along with simplification of process of filing tax returns and extensive use of technology, has ensured an effective mobilization of resources from various taxes, which have helped the GOK to maintain a better fiscal position. Though tax revenues have been consistently growing, GOK has not improved revenues on the non-tax front, which continues to decline. The state's Fiscal Management Reform Committee has recognized this issue and suggested departments to be more proactive in identifying and collecting their non-tax revenue.

10. **In terms of expenditure, generally the revenue expenditure has been below the revenue receipts leading to revenue surplus, which was used as one of the sources to fund capital expenditure.** Over the years, revenue expenditure has been increasing mainly due to subsidies, which reduced the revenue surplus, and affected the outlay available for capital expenditure (Figure 3). Subsidies have increased from Rs.3,399 crore in 2008-09 (8 percent of the revenue receipts) to Rs.16,661 crore, which is 18 percent of the revenue receipts in the 2013-14 (revised estimate). The revenue surplus for the corresponding period declined from Rs.1,635 crore (which is 3.8 percent of revenue receipts) in 2008-09 to Rs.64 crore in 2013-14 (revised estimate), which is 0.1 percent of the revenue receipts. With the increasing coverage of subsidies, there are demands beyond the provisions made in the budget; most often these have to be accommodated through supplementary estimates. The GoK Medium-Term Fiscal Plan (MTFP) 2014/18 recognizes that the challenge lies in ensuring that these subsidies do not become a permanent source of additional support and thereby deter sectors from undertaking reforms. GoK acknowledges that expenditure on subsidies needs to be moderated in the medium-to-long term to make them fiscally sustainable

through improving systemic efficiencies in sectors like energy, rationalize cross-subsidization of costs, providing incentives to sectors to perform rather than increasing their dependence on subsidies, and also effective identification and targeting of beneficiaries.

Figure 4: Revenue surplus, subsidies and fiscal deficit



	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14 (RE)
Explicit Subsidies	3,399	4,118	6,303	7,390	10,709	16,661
Revenue Surplus	1,635	1,629	4,172	4,691	1,883	64
Fiscal Deficit	(8,732)	(10,875)	(10,688)	(12,300)	(14,507)	(17,959)
Primary Deficit	(4,200)	(5,662)	(5,047)	(5,696)	(7,053)	(10,159)

11. **Moreover, most of the revenue expenditure is in the nature of committed revenue expenditure like salaries, pensions, interest, subsidies, etc., which affects the maneuverability of the state to prioritize expenditure in this space.** During 2013-14 (revised estimate), 94 percent of the receipts are expected to fund committed revenue expenditure and only 6 percent is left for the GOK to fund other revenue expenditures. The state Fiscal Management Review Committee has advised GOK to re-evaluate expenditure commitments as well as relook at the subsidies and work on providing more target-based subsidy.

12. The public investment spending (capital expenditures) [12] are ones that have sustainable impact on growth and income generation provided they are made effectively. GOK has to create fiscal space for public investment spending through the budgetary processes but within overall fiscal constraints which include - (a) budget envelope available after meeting revenue expenditure; (b) limits to fiscal deficits mandated by the KFRA; and (c) restrictions on gross public debt. Increasing revenue expenditure, reducing revenue surplus, and statutory limitations on borrowings affects the fiscal outlay available to the GOK for carrying out capital expenditure. The GOK needs to prioritize the capital expenditure requirements of the state and ensure that the capital expenditure proposals are reviewed and approved with a view on their overall impact on the fiscal position of the state. The Fiscal Management Review Committee suggested that all approvals for new initiatives and works requiring implementation over multiple years should be based on fiscal sustainability of the total expenditure and that GOK should ideally move to medium-term (3 to 5 years) appraisal and approval cycle for the schemes. Going forward,

[12] *GOK Capital spending has been about 40% of total government spending, and as compared to other states is relatively higher*

GOK needs to prioritize capital expenditure to achieve their fiscal targets as well as manage their public investment funding more systematically.

13. **Fiscal Marksmanship**: Fiscal Marksmanship essentially reflects the degree of accuracy between the estimate and actual expenditure of the budget data. It is desirable that the finance department has good fiscal marksmanship while forecasting the revenues and expenditures for the next fiscal year. The state government has improved in recent past in their estimation of expenditure and revenue. Many times the revenues and expenditures realized are closer to the estimated ones. The expenditures have overshot the estimates sometimes marginally due to allocations in supplementary budgets which are not included in the budget estimates. Increases in expenditures are mainly due to including large expenditure commitments, subsidy payments and payments of arrears in supplementary budgets which are not included in the original budget. FMRC has advised the GoK not to encourage new capital commitments in the supplementary except in case of natural calamities; as such additions distort the fiscal management of the state. The budget outturn for revenue and expenditure has significantly improved over the years, yet there are substantial compositional variances and large savings in budget allocations indicating the need to improve "budget realism". Good buoyancy in tax revenues and central transfers has ensured that the macro aggregates such as revenue deficit and fiscal deficit are closer to the estimated one.

14. Fiscal scenario in Karnataka reveals that, the state finances have improved particularly due to implementation of KFRA. Though major indicators are sound, the state has to balance the requirement of providing adequate funds to critical sectors of the economy while adhering to fiscal targets. GoK needs to give more emphasis on reducing less productive expenditures and prioritizing capital expenditure.

Chapter 3: ACCOMPLISHMENTS OF 2004 PUBLIC FINANCIAL MANAGEMENT AND ACCOUNTABILITY ACTION PLAN

15. **Karnataka had a foundation for a satisfactory basic PFMA system** substantially built on centralized, detailed, input-based controls. This system was working reasonably well and derived its strengths from a well-established and sound legal framework for PFMA, a robust fiscal policy framework for aggregate fiscal management, tight control over departmental spending through the annual budget, an independent auditor and well-established framework of legislative approval of budget execution.

16. **The state had initiated several important improvements to strengthen its PFMA system - yet significant challenges remained.** In this environment**,** a Public Financial Management and Accountability Assessment (PFMA) was carried out by the World Bank in active collaboration of the Government of Karnataka (GoK) in 2004. Drawing on the analysis and recommendations presented in the PFMA, *GoK and the Bank jointly developed an Action Plan to improve PFMA* (referred to as the 2004 PFMA Action Plan) *to continue and deepen GOKs Public Financial Management (PFM) improvement program with the objective to improve PFM and Accountability for making government more effective, accountable and responsive*)**.**

17. The 2004 PFMA Action Plan was developed in the backdrop of: a not so impressive record of budget implementation; low predictability of flows to department with cash rationing and economy drives being common; a cash management system constrained by limited cash flow smoothing options and lumpiness in inflows from the central government; significant off-budget borrowings; lack of timely and reliable information from the accounting system to facilitate fiscal monitoring and transparency, cash management, and departmental budget monitoring; there was a need for strengthening budgetary and internal controls and enhancing effectiveness of audit and legislative review through enhanced follow up of audit reports and legislative reviews.

18. **The 2004 PFMA Action Plan was categorized into six strategic segments – Budget preparation and implementation, financial computerization and MIS, Accounting, Audit/PAC responsiveness and follow up, PFM in other Public Sector Agencies and Institutional Arrangements and Capacity Building – with several actions under each to achieve the objectives.** The PFMA and the 2004 Action Plan were officially recognized by GoK in the Medium Term Fiscal Plan of 2006-2010.

19. **There was, however, no review of the implementation of the 2004 PFMA Action Plan.** The current study endeavors to take stock of the progress of implementation of these measures during the last decade since 2004 and its impact on PFMA largely based on the situation during the 3-4 most recent years. The status of implementation of each of the activity included in the 2004 PFMA Action Plan is briefed in Section 10 of the Appendix. A summary of reforms implemented and continuing, reforms implemented but could not be sustained and reforms not carried out though remaining relevant as of today are outlined below.

20. **Budget preparation and implementation:** The key reform actions envisaged in this segment were: ensuring budget passage at start of fiscal year, phasing out off-budget borrowings, improving budgetary realism, introducing departmental budgeting for more accountability and flexibility, strengthening performance orientation of departments, improving budgetary expenditure allocation and screening process, simplification of budget implementation and improving cash flow, strengthening internal controls and increasing fiscal transparency.

21. ***Significant achievements were made in implementing many of the reform activities for strengthening budget preparation and implementation.***

a. GoK's record of implementing the budget has shown significant progress since the 2004 PFMA – wide variations from budget estimates in both revenues and expenditures at that time has now largely been contained – revenue and expenditure outturn has been within 5-7% variation in the recent years.
b. Significant sophistication has been built in the framework of revenue forecasting which has helped in cash planning providing greater predictability during budget execution. To achieve more efficiency in revenue forecasting and realization, the Commercial Tax Department is presently in the process of setting up an Economic Intelligence Unit, akin to a Fiscal Intelligence Unit in Finance Department as suggested in the 2004 Action Plan. Efforts, however, are still needed to enhance non-tax revenues.
c. GoK has curtailed its Off Budget Borrowings and has been successful in reducing the outstanding and interest costs (to Rs. 1,455 crore and Rs. 166 crore, respectively by 2013) – the 2004 Action Plan targeted eliminating this item at the earliest opportunity – but still, this is a significant achievement. Also, approval of borrowings and issue of guarantees have now been centralized with the Finance Department.
d. Significant progress has been made to enhance individual clearance limits and delegation of powers both (a) for release of funds without recourse to the Finance Department and (b) internal delegation to HoDs – this was to strengthen predictability of availability of funds, avoiding year-end rush of expenditure and improving quality of expenditure. These have been gradually enhanced and GoK departments can release funds for the first three quarters, subject to some restrictions. Contribution was also made through revision of re-appropriation powers. Actual expenditure data indicates more increased expenditure outturn (pace of expenditure) during the first two quarters of the financial year, and significant decline in rush of expenditure during the last month of the financial year from 26% in 2002 to 19% in 2014 (including in Plan expenditure), although expenditure during last quarter at 1/3rd of total can be further evenly spaced.
e. Fiscal transparency has improved. Budget documentation continues to be comprehensive disclosing significant information and full set is made available to the public as compared to only Overview of the Budget and Budget Speech earlier. Monthly accounts and fiscal indicators are now available more timely, a half-year review of state finances is published and available in public domain (done up to September 2013), audit findings and responses are available on the web (though not up to date and full reports of the Legislative Committees are yet to be placed on the web), year-end financial statements are now tabled in Legislature immediately in the next session from receipt and are more easily available to the public and stock of pending bills for on-going works is available in the Finance Accounts.

22. Some actions were taken up but could not be sustained or are still underway and further efforts are needed to implement them.

a. GoK was the first state to introduce Departmental Medium Term Fiscal Plans and in 2002/03. This was implemented in 20 departments and continued with this exercise till 2009/10. But due to

various reasons, this could not be sustained and was discontinued and presently just one department prepares the medium term fiscal plan.

b. In 2003, GoK endeavored to reduce the number of schemes and budget detailed codes and some success in rationalization was achieved at the time. The PFMA suggested enhanced budget flexibility to departments for better performance through reduced dependency on overly detailed line budgeting and large number of schemes and budget heads restricting moving towards this goal. The number of schemes, however, showed increase over the years and a system of periodic review was not instituted – as on date there are over 1800 active schemes (out of total over 15000).

c. In respect of management of public funding of investments (as detailed through an Appendix E), the 2004 PFMA Action Plan made two recommendations – (a) give priority in budgeting to payment of arrears, then for completion of ongoing works and lastly for adding new works and (b) computerization of such works and tracking committed liabilities for better budget control and implementation. The situation as of now is by and large the same as prevailing at the time of the 2004 assessment and the recommendations remain relevant today. Though GoK has put in place these instructions, yet compliance is wanting resulting in payment arrears which is not strictly in line with the fiscal responsibility legislation which requires timely payment of current dues and a formal and clear definition of payment arrears is required as suggested in the PFMA. Timeliness and adequacy of Appendix E still falls short of expectations and action point for computerization of Appendix E remains to be taken up.

d. The PFMA_suggested basing expenditure projects on realistic scenarios particularly in case of budgeting for salaries[13]. It suggested that each department should project salaries in line with recruitment rules and plans, instead of budgeting for vacant posts which are unlikely to be filled. This practice continues and budget includes substantial lump sum provision for the entire sanctioned staff strength though not all of these posts would have been planned for recruitment during the year – which is also not in accordance with the Budget Manual. This not only resulted in substantial savings, but also required a supplementary budget for transferring required budget to the concerned demand for grants. Most importantly, such hidden provisions not utilized restricted provision for developmental expenditure. While GoK has discontinued this practice in urban local bodies, it continues to pursue this for the government sector.

23. And there is unfinished agenda that needs to be pursued.

a. GoK continues to obtain Vote on Account although a full budget is present in the Legislature in February/March, and the situation remains as in 2004. The full budget is passed only during June/July when the Legislature meets again. If GoK ensures passing of budget before start of the year, it will be at par with over 20 other states that have achieved this.

b. Reliance on supplementary budgets is maintained and the number of supplementary budgets presented continues to be three every year, like in 2004. The quantum of supplementary estimates has increased from about 8% at the time of 2004 report to 18% now, and is higher compared to many other Indian states. Many schemes and expenditure are introduced in-year outside the

[13] *This, however, was not included in the 2004 PFMA Action Plan.*

budget cycle. This coupled with the situation that the unutilized budget ("savings" i. e. actual expenditure falling short of revised budget) being more than the supplementary undermines the budget realism in GoK. The supplementary budgets are also not fiscally neutral and significant supplementary estimates remain unfunded. Large supplementary budgets also affects the original expenditure composition.

c. Not much progress is visible in legislative scrutiny of the budget. The Committee of Estimates continues to be inactive and the Subject Committees constituted to examine budget proposals are no longer in existence. The Legislature spends less time on discussions and voting.

d. 2004 Action Plan recommended revision of the core PFM documents (the budget manual, treasury code and financial rules). A revised Treasury Code was prepared along with the implementation of Khajane (computerized treasury system). However, it was not formally adopted and notified by the GoK – the aim now is to re-revise the KTC incorporating the changes warranted due to implementation of upgraded Khajane. Although the Local Fund Authorities Fiscal Responsibility Act was passed in 2003, it had to be operationalized and this was an action in the 2004 PFMA Action Plan which is to be pursued and hence the objective of prudent PFM in a number of ways in the local bodies is yet to be realized.

24. **Financial Computerization and MIS**: Treasury computerization (Khajane), Capital Works Control (Appendix E) computerization, Payroll computerization, computerization of Drawing and Disbursing Officers (DDO), and accelerating Monthly Accounts preparation schedule were the key reforms envisaged under this segment. ***This segment has exhibited marked progress and many of the reform actions were implemented while others are underway /planned***.

a. Treasury computerization (Khajane) was achieved in 2004 and core functions of GoK were computerized, all Treasuries networked and non-bank treasuries were also phased out. This led to improvement in overall controls, reduced delay in submission of periodic reports to the Departments and the Accountant General, availability of daily fund position and expenditure reports and introducing passing of bills on first-in first-out principle. Following the action included in the 2004 Plan, GoK phased out the Letter of Credit system and brought all public works departments within the direct purview of the Treasury and the latter is now single payment point. GoK is now upgrading Khajane to include computerization of the office of the Drawing and Disbursing officers and the function of capital works, actions included in the 2004 PFMA Action Plan. Risk audit of Khajane has been conducted providing inputs for upgrading process of Khajane.

b. A significant achievement of GoK is full automation of its payroll (integrating service register and pay bill) - a centralized web based application (the Human Resource Management System HRMS) has been successfully implemented and covers nearly all employees of the state government (almost 26% of state's revenue expenditure excluding debt servicing) thereby strengthening controls in this area. GoK is now pursuing upgrading this application to the next level HRMS II and also integration with Khajane.

c. Although not part of the 2004 Action Plan, it is pertinent to note that the initial implementation of the Karnataka Transparency in Public Procurement Act, 1999 that enabled e-Procurement was further expanded across all government departments and organizations and now barring some exceptions, all goods and services are under the ambit of e-Procurement – this is a progressive step and e-procurement platform is being further strengthened.

25. **Accounting:** Two key reforms were planned: Public Account clean up and Reconciliations against the backdrop of arrears in reconciliation, non-adherence to accounting controls, weaknesses in systems for recording, reporting and monitoring of fiscal assets and liabilities, and reporting of transfers of other public sector entities. Many of these are relevant for implementation even today, not because GoK did not take steps to implement them, but because these items have built-up over time in terms of volume and there is basic shortcoming in compliance and inadequate reconciliation process. Some major achievements and areas that remain a challenge follow – many of these are expected to be addressed with the planned rollout of the next level of Khajane.

- While GoK has achieved more than 90% in terms of reconciliation of revenue figures, achievement in terms of reconciliation of expenditure is only 58% and there is slippage over the last few years – implementation of Khajane II is likely to address this issue.

- The quantum of outstanding Abstract Contingent Bills has been contained at a reasonable level and showing a decreasing trend over the years in both outstanding as well as fresh drawls during the year. Similar achievement has been made in reducing backlog of obtaining Utilization Certificates and submission of those currently due and suspense accounts have been significantly cleaned up – the challenge is to sustain these achievements.

- Control over personal deposit accounts requires another round of tightening of controls - significant balances are carried forward, nearly half of the accounts are inoperative while some have adverse balances and reconciliation of balances with the Treasury and the Accountant General is in backlog. Similarly, control over reserve funds and booking of large amounts under miscellaneous heads of account still requires particular attention.
- The PFMA identified that reliable information on the amount of unencashed cheques was not available (at that time) as bank accounts were not reconciled regularly and full information was not available. GoK targeted to reconciled these and do one-time clean up and included this as an actionable point in the 2004 Action Plan. This is a challenge that remains to be addressed – the level of unencashed cheques has not only increased substantially (outstanding as of March 2013 was Rs. 6,820 core as compared to Rs. 1,160 crore in 2001/02), but there are significant information gaps and the process of reversing such cheques is not pursued.
- There has been good progress since 2004 in recording and reporting of fiscal assets and liabilities covering loans and advances, guarantees and investments in government entities, as well as debt. For the first three items, a dedicated cell has been formalized under Finance Department for data collection, collation, reconciliation and reporting. Yet, significant challenges remain in loans and advances and investments in terms of reconciliation issues (this is work in progress) and accounting and reporting controls have not kept pace with the significant increase in the portfolio. Accounts of loans and advances

maintained at departmental level are inadequate and there are differences in investments between Finance Accounts and investee records.

- The PFMA concluded that practically there was no internal audit system in GoK (including local governments) barring internal audit wings (IAW) in some revenue earning departments. Introducing a small, focused internal audit function to improve the effectiveness of the system was suggested. GoK has not travelled far in strengthening the internal audit arrangements in government and no significant reform interventions are visible in this vital function. Other than the Commercial Tax Department, no other department has shown any visible initiative to establish or strengthen this function.

26. ***Audit and PAC responsiveness and follow up***: The PFMA expressed concern over lack of responsiveness to external audit reports and legislative reviews and identified it as the single biggest problem undermining the effectiveness and impact of audit and legislative review. **This continues to be an area of challenge for GoK as progress has not been very satisfactory** – this is still categorized by inadequate and delayed response by the auditees – the executive needs to effectively implement the audit recommendations. The online Audit Management System has been established, but data updating is in backlog and the system is yet to be institutionalized. A significant achievement since 2004 has been regularization of expenditure in excess of Legislative approval that had been pending since 1989-90 aggregating over Rs. 9,000 crore. Implementation of measures to improve the effectiveness of the Legislative committees has progressed well – there is much improvement in the working of the Legislative committees with increased number of meetings and larger number of reports taken up for review, and a change in approach by taking up recent reports first and selection of observations for review on the basis of materiality and risk, contemporary relevance and systemic issues.

27. ***PFMA in Local self-government and Public sector entities:*** The 2004 PFMA Action Plan also had several measures for public sector entities (other than department). Significant progress has been made so far as the local bodies are concerned, but improvement in the PFM of government companies and corporations needs to be pursued further.

- In respect of the rural local governments, accounting reforms and computerization were two key areas for reforms included in the 2004 action plan - there has been significant progress in these areas, yet challenges remain. Double entry accrual basis of accounting has been introduced in both Village Panchayats and urban local bodies and accounting is now done on computerized applications (Panchatantra for Panchayats and e-Gov Financials for urban bodies) supported by respective manuals. However these systems have not been mainstreamed and are being maintained parallel to the current manual system. The accounts and audit of the Zilla and Taluk Panchayats are now up to date (with some delay) and this is a significant improvement since 2004. Yet, accounts and audit of Village Panchayats are perennially in backlog. Computerization of ZP/TP has not happened over the years and the situation is the same as it existed at the time of 2004 PFMA. Payment and reconciliation of electricity dues still remains an area of concern.
- Progress in implementing recommendations made by the 2004 report on state owned enterprises to address major shortcomings has not been very effective and several of these remain relevant even as on date – the areas of concern included timely preparation and audit of annual financial statements, unreliable and inconsistent public sector data, inadequate responses and follow up of external audit reports and legislative Reports, weak monitoring and enforcement of PFM requirements and issue in governance.

28. ***Institutional Arrangements and Capacity Building***: The 2004 PFMA Action Plan envisaged recruitment of qualified *Internal Financial Advisors* (IFA) in equal numbers from the office of the Accountant General, Karnataka State Accounts Department (KSAD) and the Secretariat – GoK has mandated this rule though in actual practice, majority of the IFAs are from the Secretariat and some from KSAD. Also, IFAs have been deployed in the major spending department. The quality of the skills set of the IFAs drawn from other than KSAD leaves much to be desired and effective utilization of the IFAs has been hampered.

29. The PFMA identified strengthening the capacity of KSAD. In terms of capacity enhancements of KSAD staff, GoK has issued new cadre and recruitment rules (2011) covering both entry-level qualifications and mandatory training for promotions which in the medium term will provide qualified staff at all levels and a training curriculum has been developed for accounting, financial and auditing training, currently under implementation. Further, GoK has mandated computer literacy for all staff under a State Training Policy (2011) and Computer Literacy Rules (2012). Fiscal Policy Institute has been nominated as a key training institute on PFM and frequent trainings to staff of other departments have organized. These are recent steps and effect would be visible later. However, it is important that capacity building measures are continued in the full PFM domain.

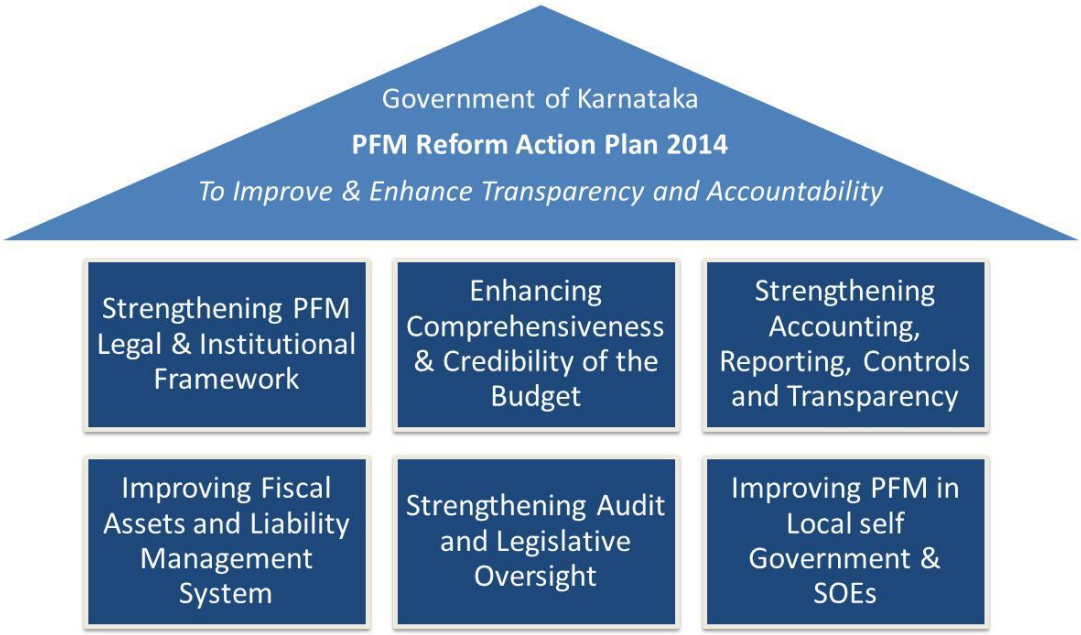
30. **In conclusion**, the current study factors in the achievements made in implementing the 2004 PFMA Action Plan, and builds upon the reforms actions that are relevant today by taking forward the unfinished agenda. The study also proposes reform actions that are needed to further GoK's objective of strengthening PFM and accountability. The details of achievement against 2004 PFM reform action plan is outlined in Annex 2.

Chapter 4: ANALYSIS, GAPS, AND RECOMMENDATIONS - 2014

31. The overall objective of the 2014 PFM Reform Action Plan is *to improve and strengthen public financial management so that it efficiently and effectively promotes accountability and transparency and thereby improves service delivery*. This Action Plan would support GOK to further accelerate reforms in the PFM arena in order to improve and enhance transparency and accountability. The Reform Action Plan recognizes the fact that Karnataka is not in the early stages of reform process but has over the past decade undertaken a range of reforms.

32. The Action Plan revolves around a thematic approach. Six themes have been identified as priorities for PFM reforms over the next five years. These themes and their elements relate to legal and institutional framework, budgeting, management of financial assets and liabilities, accounting and reporting, auditing and legislative oversight besides reforms in the government enterprises and local self-governments (Figure 4). All these themes are interlinked and the benefits of change in one theme would support better performance in another theme, leading to overall improvement in the PFM of the state.

Figure 4: Thematic Approach to PFM Reforms in Karnataka



44. **Each reform area that is proposed has been discussed in the Analysis Report (Part II)**. The Analysis Report provides the background, the reform actions proposed in the 2004 Action Plan, the progress of reforms over the last decade, the issues presently identified, and the rationale for the reform actions proposed. For the purpose of comparison of the status of the various PFM areas, the status in GOK has been (broadly) benchmarked against the good practices under the Public Expenditure and Financial Accountability (PEFA) Assessment tool and good practices followed by GOI and other Indian states. The Action Plan takes cognizance of the ongoing reforms and, their linkages and dependencies with the proposed reform actions. For each reform area, the priorities of the proposed action points and the responsible department/agency that will spearhead and implement the reform/s have been suggested. It is also suggested that the reforms be mainstreamed with GOK's own work

processes so as to ensure sustainability. The synopsis of each theme along with the key reform objectives and actions are outlined below.

Theme 1: Strengthening PFM Legal and Institutional Framework
Overall Reform Objective: To ensure relevant and updated PFM legal framework supported by adequate and effective institutional mechanisms to implement them.

33. The PFM framework is embodied in the state's budget manual, treasury code and financial rules guided by the principles embodied in the Constitution of India. These are supplemented by legislations such as the KFRA and KTTP Act. An institutional framework to implement the PFM is also in place. This is a cross-cutting theme that would impact the working of PFM across all stakeholders.

34. The major issues under this theme are: (a) compliance in certain areas that are not in line with the Acts, (b) capacity constraints in the finance cadre of the state which inhibits implementation of the PFM framework, and (c) updated PFM manuals and codes to reflect the changes in the PFM environment of the state.

35. The key actions proposed are:
    a. Revise PFM manuals and codes to make it contemporary particularly to take into account the changes in business processes brought about by major revamp of its financial information systems (for instance, treasury computerization, e-payments, and online HR management).
    b. Strengthen the capacity of the IFAs to provide leadership in public financial management, act as a support to the head of offices in discharging their fiduciary responsibilities at the departmental level, and providing expertise to the Finance Department in the discharge of functions at the state level.
    c. Strengthen the capacity of KSAD and ALMC cell to support the PFM functions of the state.
    d. Operationalize LFARA and improve compliance to meet the requirements of the fiscal law in areas such as for instance timely payment of current liabilities and minimizing fiscal risks in public sector undertakings.

36. It is envisioned that implementing the reform activities in this area would lead to achieving the following:
    - Up to date and modernized PFM manuals and codes in place, and implemented, that would be contemporary incorporating the changed circumstances brought about by the automation of major PFM systems
    - A stronger institution of IFAs with skills set that match the current and planned PFM environment and the enhanced responsibilities that are associated with sophisticated systems
    - Meeting the requirements of the fiscal responsibility legislation in all material aspects (included in respective thematic area)

Theme 2: Enhancing Comprehensiveness and Credibility of the Budget
Overall Reform Objective: To ensure an efficient and effective budgeting formulation and execution process, including system for in-year review and amendments, with effective and timely legislative scrutiny

37. GoK's budget processes flow from its Budget Manual based on the principles in the Constitution of India supplemented by annual budget circulars. Budget documentation is comprehensive. The fiscal responsibility legislation binds GoK to budget within certain fiscal rules that GoK has followed and legislative approvals for deviations have been obtained and status quo maintained after the event has passed. The budget outturn for revenue and expenditure has significantly improved over the years. Predictability in availability of funds has improved by way of enhanced delegation of powers in respect of providing sanctions at the departmental level, and release of funds without repeated recourse to the finance department with good success in improving pace of spending. The major issues under this theme are:

a. GoK presents the budget before the start of the year, but obtains approval on a Vote on Account for the first four months - the full budget is passed well within the fiscal year.
b. There are multiple in-year adjustments by way of supplementary budgets and re-appropriation of significant amounts.
c. Supplementary budgets are not "fiscally neutral" as required by the fiscal responsibility legislation.
d. There are substantial compositional variances and large savings in budget allocations indicating the need to improve "budget realism".
e. Budgeting could be further improved by a review of the manner in which provisions are made for certain items such as salaries and capital commitments/public investment funding.
f. Departmental budgeting commenced earlier but was discontinued and schemes rationalization has not been carried out periodically.
g. Legislative scrutiny is another area that needs strengthening.

38. The key actions proposed are:

a. Pass the full budget before beginning of the financial year.
b. Reduce the number of SEs presented to GoK every year from 3 to 2 (and to 1 in the long term).
c. Supplementary Budgets should be Fiscally Neutral in accordance with the KFRA.
d. Reduce expenditure composition variance from the present high level in phases.
e. Integrate salary estimation with actual salaries as per HRMS and make budget provision for filled posts along with recruitments to be made during the year.
f. Introduce capital commitments, MTEF, for large spending departments and ensure arrears are paid first, then existing works are budgeted, and finally new works are taken up in the budget.
g. Introduce departmental budgeting with more flexible budgets in line items for larger departments to link it with the results framework document of the state.
h. Implement Departmentally Related Standing Committee mechanism and legislature to devote more time on discussion and voting of grants.

39. It is envisioned that implementing the reform activities in this area would lead to achieving the following:

- Passing the budget before the start of the fiscal year
- Reducing the number of supplementary budgets and achieving more judicious supplementary and re-appropriation
- Ensuring fiscal neutrality in supplementary budgets
- Adopting analytical tools and strengthening capacity to achieve better budget estimation such as use of revenue forecasting and public works project management software, and following pre-defined principles particularly in case of salaries and capital commitments

- Introducing Departmental Budgeting/MTFP
- Enhancing the legislative scrutiny of the budget by strengthening the institution of sub-committees for budget scrutiny, and increased time devoted to discussions

Theme 3: Strengthening Implementation of Financial Rules in Accounting, Reporting and Controls and Enhanced Transparency
Overall Reform Objective: To ensure accurate and timely accounting and reporting, compliance with and strengthening related controls, including payroll and procurement controls, and to improve transparency of fiscal information

40. The accounting and reporting systems in GoK primarily revolve around the framework applicable nationally, based on the principles in the Constitution of India and guidelines issued by the Government of India. Around these principles and guidelines, GoK has developed its systems with controls, checks and balances imbibed in its PFM legal framework. Significant adoption of IT systems has strengthened the accounting, reporting and control framework over the years, and GoK continuously strives to upgrade and modernize these applications. GOK can consider taking over the responsibility of ownership of accounts gradually and also prepare consolidated statements for all tiers of government. Going forward, GOK can decide to implement accrual accounting and adopting new chart of accounts based on the recommendations of the GOI. There are weak areas such as reconciliation, compliance with controls, and accounting treatment that need to be mitigated. These recurring features also indicate the need for better compliance with the audit findings in these areas. Many of these issues are expected to be addressed by KII after its implementation and hence these issues are transitory in nature and needs to be attended in the short term. Payroll and procurement functions have been automated though there are issues in the underlying control mechanisms and data validation, and these needs to be plugged. Uncoordinated development of various financial applications using a fragmented approach has proliferated, and there is a need to integrate these to the Khajane II so that these are mainstreamed and used for decision making process.

41. The key issues under this theme are as follows:
    a. Delay in timeliness of reconciliation of expenditure with the AG, submission and reconciliation of utilization certificates.
    b. Change in CSS funding mechanism which requires reworking budget, fund flow, accounting and disclosure requirements related to CSS and ULBs transfers, expenditure, and balance.
    c. Khajane II implementation would require data migration and change management strategy. Also standalone software's needs to be integrated and mainstreamed with KII.
    d. A cash management and forecasting tool has not been developed and implemented.
    e. Issue in tracking and monitoring subsidies.
    f. Issues in HRMS data validation and audit paras to be addressed before migration to HRMS II.
    g. Non implementation of contract management module, non-availability of certain functionalities of e-procurement and its comprehensive IT evaluation.

42. The key activities under this theme are as follows:
    a. Designate a central nodal office for monitoring of utilization certificates and improve reconciliation of expenditure.
    b. Develop guidelines and disclosure norms for CSS projects along with change in the fund flow to manage funds through the treasury rather than bank accounts.

c. Develop a data migration strategy, change management strategy, HR strategy, training plan, and rollout plan for implementation. A GO outlining the timelines and the transition process has to be issued by GOK. Also integrate all other software's used by the government with KII.
d. Carry out study on cash and debt management practices, develop a cash forecasting model for monitoring cash management and integrate with MPIC and KII.
e. Create web based information system for tracking and monitoring of subsidies linked to KII.
f. Ensure data validation of all the staff and payroll records is completed and payroll audit is carried out across the state, before the data is migrated to HRMS II.
g. Develop and implement contract management module as part of KII and enhance the functionalities of e-procurement software. Carry out IT audit of the software through AG office.

43. This theme seeks to build upon reforms underway and address weaknesses in accounting and reporting and strengthen internal controls. It is envisioned that implementing the reform activities in this area would result in a stronger PFM environment and systems exhibiting the following characteristics:

- An effective system of identification of old outstanding balances and a regular system of reconciliation and adjustment of differences
- Enhanced compliance with the financial rules as for instance timely submission of utilization certificates, adjustment of advance bills, reversal of amounts in public account balances, management of reserve funds
- Proper classification of government transactions to reflect the correct fiscal position and indicators
- Strengthened controls in IT systems and integration of the multiple financial applications to the Khajane II to form one coherent eco-system
- Enhanced transparency and disclosure in the financial statements
- Enhance transparency and disclosure in procurement

Theme 4: Strengthening Fiscal Assets and Liabilities Management, Recording, Reconciliation and Monitoring Systems
Overall Reform Objective: To strengthen the systems of management, recording, reconciliation and monitoring of fiscal assets and liabilities

44. The theme envisages resolving the challenges associated with the present systems of management, recording, reconciliation and monitoring of fiscal assets and liabilities, which have significant shortcomings and thereby strengthen the institutional and staff capacity to improve efficiency, allow for correct reporting and remove backlog. A related outcome would be better knowledge of and control over fiscal risks.

45. The key issues under the theme are:

a. Non availability of a government guarantees policy.
b. Reconciliation issues in case of Investments, Loans and advances and Debt data.
c. Capacity constraints in the asset liability management cell handling this portfolio.
d. Loans issued without prescribed terms and non-repayment of loans and interest taken by GOK entities.
e. Issues in monitoring of arrears of payments.
f. Reconciliation issues and backlog in case of unencashed cheques.

46. The following key activities are provided n this theme to significantly improve the systems:

a. Develop policies and guidelines such as a Guarantee Policy and Operational Guidelines for Investments.
b. Prioritize reconciliation efforts on big ticket items of investments, loans and advances, debt pertaining to recent years and carry out a focused reconciliation exercise with support from external consultants.
c. Appoint core finance professionals or staff from Finance Department and train existing staff of the asset liability management cell.
d. Develop a policy for addressing loans to government entities.
e. Establish a Cash and Debt Management Office and deploy adequate resources in term of manpower support and IT systems.
f. Establish of more formal and established procedures for monitoring and accounting arrears of payments.
g. Initiate a special study to identify the causes for accumulation of unencashed cheques and carry out one time special exercise to clear the backlog of unencashed cheques.

47. It is envisioned that implementing the reform activities in this area would result in a PFM environment with the following characteristics:

- Existence of formal and consolidated procedures for management, recording, reporting and monitoring of fiscal assets and liabilities
- A more robust and empowered institutional mechanism to carry out these functions
- Clearance of backlog of differences and reconciliation between memorandum records and state accounts
- Availability of updated and validated database of assets and liabilities
- Improved compliance with financial rules and the fiscal responsibility legislation

48. The benefits achieved under this theme will also accrue to Theme 3. GoK is currently upgrading its integrated financial management system (Khajane to Khajane II) and this system can be effective only if the legacy data is updated and clean and the level of compliance with financial rules is enhanced. Themes 3 and 4 are also expected to contribute to the migration of data with high level of integrity to Khajane II and to ensure that the weaknesses in the current system do not replicate in Khajane II.

Theme 5: Strengthening Audit Institutions and Systems, Enhancing Responsiveness to Audit Reports, and Improving Effectiveness of Legislative Oversight
Overall Reform Objective: To ensure accountability and oversight of public resources through stronger audit institutions, timely compliance and effective legislative oversight

49. External audit by the Supreme Audit Institution (SAI) is now more comprehensive and regular with a good proportion of performance and IT audits. Reports are now also available on a timely basis - the audit report for FY 2012/13 has been published and submitted to the Legislature by February 2014. Legislative scrutiny of audit reports has seen significant enhancement. External audit reports are tabled in the state Legislature and are subject to scrutiny by the separate legislative committees on state accounts (including departments), public sector entities and local bodies. The committees are well functioning and have adopted the approach of taking up the latest reports first and simultaneously clearing the backlog of the department taken up for hearings. Audit findings taken up for examination are selected on basis of materiality, contemporary relevance and systemic issue.

50. The effectiveness of audit is undermined due to weak follow up on the audit reports and legislative committee reports by the auditee who more often fail to provide responses on a timely manner. An Audit Monitoring System has been established for the external audit reports of the SAI, but its use is limited taking into consideration that it

has only quantitative details; qualitative/systemic details are not captured; and data, particularly with respect to action taken, are not regularly updated. GOK needs to strengthen the audit compliance mechanism and also enhance the Audit Monitoring System to capture data for all audits and systematic data so as to analyze and take actions on them. Going forward, GOK needs to work with State AG to facilitate them to carry out audit of the state accounts through KII system and issue audit reports through the system.

51. Audit practices followed by KSAD are not modern and the audit institution suffers from staff capacity. KSAD should implement modern audit practices including risk based audit, co-sourcing, along with implementation of the audit software to improve the timeliness and quality of the audit. The audits for local bodies (ULBs and Gram Panchayats, the third tier of rural local bodies) are delayed due to, capacity constraints of Karnataka State Accounts Department (KSAD) as well as non-submission of accounts by GPs.

52. Internal audit mechanism in the state is highly dispersed, lacks leadership and its effectiveness is virtually absent. The function is woefully short of staff (in particular skilled staff) and uses antiquated audit techniques not conducive for audit in a highly automated environment in Karnataka. There is a need for a formal modern Internal Audit system, at least in the high revenue-earning and high spending departments, to promote effective internal controls contributing to improved level of compliance and better expenditure management.

53. The key issues under this theme are:

a. Internal audit is highly dispersed, lacks leadership and its effectiveness is virtually absent.
b. Audit compliance is not timely to both the audit reports as well as the legislative scrutiny
c. Audit monitoring system does not cover the qualitative issues and the entire process of audit settlement
d. KSAD capacity constraints affects the PFM functions of the state and outdated audit methodology affects the timeliness of audit for the third tier of governments

54. The key focus of this thematic area will be on strengthening audit and oversight functions in the state through

a. Conduct a situational analysis of the internal audit system, develop and implement risk based internal audit in high spending departments
b. Improve effectiveness of audit via higher responsiveness and follow up on audit reports.
c. Enhance the functionality of the audit monitoring systems to cover all audits, generate qualitative classification of audit, and capture the entire process of audit from inspection report to the final resolution of the audit by PAC.
d. Strengthen KSAD through continuous training and capacity building measures, and augment capacity by recruiting staff, IT implementation, and outsourcing in the short run to address arrears of audit. Introduce modern audit practices like risk based audit, co-sourcing of audit, auditing through systems in KSAD to improve the overall audit timelines and quality.

55. It is envisioned that implementing the reform activities in this area would bring the following changes and benefits to GoK:

- Establishment of a formal Internal Audit System, at least in the revenue and high spending departments, for promote effective internal controls.

- Increased level of responsiveness to audit reports particularly at the initial stages of audit (half margin or inspection reports), faster compliance to audit reports, including substantial clearance of arrears, and reduction in the stock of outstanding audit observations.
- Improved functionality and capability of the audit monitoring application including coverage of all audit reports and compliances and availability of updated audit database to improve the monitoring capability of the controlling officers.
- Emergence of a strengthened and modernized state auditing institution, KSAD with increased efficiency in its work and effectiveness of its function undertaking its activities in a more meaningful manner.
- High level of Legislative scrutiny of budget and audit reports to effectively undertake PFM oversight functions and enforce accountability.
- Overall improvement in transparency by placing audit reports and action taken in public domain.

Theme 6: Improving PFM systems in Government Enterprises and Local Self Governments
Overall Reform Objective: To improve PFM in government enterprises and local self-governments through strengthening governance, improving internal controls including internal audit, and enhancing timeliness of accounts and audit to manage fiscal risks arising from these bodies

56. **Local Self Governments every year handle around Rs.22500 crores, making it imperative that these institutions have strong PFM systems – but assessments often find gaps in PFM framework and compliance.** The respective legislation underlying these institutions and accompanying manuals define the PFM environment. Significant efforts have been directed towards strengthening PFM in local self-governments (particularly accounting reforms) for ULBs and GPs, and a similar strategy is needed for ZPs and TPs. The key issues under this area are:

a. Low revenue collection ratio and weak control over own source revenue;
b. Backlog of accounts in GPs and audits in ULBs and GPs
c. A not-so-strong system of internal controls, including internal audit; and
d. Low capacity and shortage of finance staff are key areas that need immediate attention.

57. The key activities proposed under this area are:

a. Improve Own source revenue by encouraging e-payments and collection through banks to improve controls and collection efficiency as well as preparing Demand Collection Balance and carrying out timely reconciliation.
b. Develop and implement strategy to clear backlog of accounts and ensure full migration from manual systems of accounting to computerized systems.
c. Design and implement effective and adequate internal controls, including internal audit.
d. Review the accounts and finance staffing in these institutions both in terms of staff numbers and skills sets and develop a strategy for recruiting them.

58. **State Owned Enterprises contribute to 7.2% of the GSDP and GOK investments in them are Rs.69,810 crores and the budgetary support for the FY 12-13 was Rs.15,059 crores.** The SOEs handle substantial public funds by way of share capital, loans and grants/subsidies besides the GoK providing guarantees for borrowings of these SOEs. Hence, these SOEs should have a strong PFM system to account for and report on the use of public funds but assessments often find gaps in PFM framework and compliance. While the scenario has improved in comparison to 2004, the following issues are persistent:

a. Delay in completion of accounts and audits;
b. Lack of effective internal audit, Lack of response to systemic audit issues and reconciliation problems;
c. Non adoption of a corporate governance framework; and
d. Absence of a nodal office to monitor and support the SOEs.

59. The key activities proposed under this area are:
    a. Conduct specific studies on corporate governance and establish a stronger corporate governance framework for government companies and corporations - the model code of corporate governance prescribed for central public sector undertakings could be adopted.
    b. Clear backlog of accounts and audits through external technical assistance as well as consider accounting reforms for entities which are yet to move to computerized accounting.
    c. Review external audit findings, including functioning of internal audit and audit committee
    d. Institutionalize a stronger nodal agency would benefit the GOK to support and monitor the SOEs.

60. It is envisioned that implementing the reform activities in this area would result in a strengthened PFM environment:

- A stronger corporate governance in case of companies and corporations
- Clearance of backlog of accounts, and a system in place to ensure timely preparation of accounts
- A system of effective and adequate internal controls including internal audit in place
- Clearance of backlog of audits, and a system in place to ensure that accounts are rendered timely for audit
- A system for timely follow up of audit compliance.

61. The detailed PFM reform action plan for 2014 is outlined in the annex 1.

Chapter 5: WAY FORWARD

62. GOK has been a pioneer in the area of PFM reforms and has been pushing the boundaries to the next level in most of the PFM areas and continue to improve PFM by strengthening their systems which includes policies, process, and people and are embarking on upgrading its PFM computerized systems (such as Khajane II and HRMS). Implementing the PFM reforms will require substantial commitment and sustained effort. Karnataka's strength is that it has already embarked on a major fiscal and governance reform process, and has initiated several PFM improvements. It has the potential to go a long way, and become a pioneer in this field for India. This section outlines critical factors that are equally important for implementing the PFM reform action plan.

63. **The 2014 Action Plan needs to be approved by the GOK and included in the Medium-Term Fiscal Plan of the Government.** This will provide the necessary mandate for implementation and the instrument for disseminating the Plan, as well as review of the implementation on an on-going basis.

64. **A high-level committee needs to be formed at the level of Principal Secretary (Finance) so that reforms can be reviewed on a regular basis and coordination across departments can be achieved.** The prioritization of the actions and the timelines needs to be reviewed on a holistic basis by GOK and the sequencing of reforms needs to be worked out as most of the reforms are interlinked and benefits would accrue if related reforms are addressed simultaneously. A quarterly progress report on the achievements made and challenges faced should be presented to the committee for their monitoring and advice. Considering the magnitude of the reform actions, a system of continuous monitoring is essential to ensure that the implementation goes as planned and course corrections are identified, approved, and applied in a timely manner.

65. **A dedicated 2014 Reform Action Management Cell needs to be constituted by the GOK to implement these reforms**. The cell could be headed by Principal Secretary (Finance) with his team of Secretary (B&R), Secretary (Expenditure), and Secretary (FR) and secretaries from the respective Administrative departments. The office of the Secretary (Fiscal Reforms) can be nominated to co-ordinate and follow up on agreed action points. This office needs to be strengthened with adequate resources – human, financial, and IT as well as provided with sufficient powers to monitor the reform.

66. **The Finance Department needs to exercise strong leadership in implementing the PFM reform**. This is especially pertinent for activities relating to budget formulation and execution, accounting, financial reporting, auditing, and internal controls. PFM reforms needs to be led by the Finance Department, but it involves all departments like the Public Works Department (PWD), Rural Development and Panchayat Raj Department (RDPR), Urban Development Department (UDD), Water Resource Department (WRD), the Directorate of Municipal Administration (DMA), and the Department of Public Enterprises Reform and Disinvestment (DPE). All departments will need to cooperate for PFM modernization to happen. As a part of further actions, **GOK can consider institutional review of key departments (PWD, RDPR, WRD, and UDD) and support them in strengthening their institutional framework, which would help improving the overall PFM framework of the state to a large extent**.

67. ***Capacity*** is limited and needs to be developed. The capacity of the Finance Department needs to be developed both to manage the PFM system and to support departments implement their own PFM-strengthening activities. This includes the capacity of all parts of Finance dealing with budget development, implementation

and monitoring, the Controller (Accounts Management)'s office, KSAD, and the Treasury. Capacity in other departments also needs to be enhanced. Attention needs to be paid to meet the capacity constraints through the use of existing staff, hiring new staff, or the retention of consultants. Training, study tours, exposure visits, and the recruitment of finance, accounting and economics professionals will all help to develop capacity.

68. Technical assistance will likely be required to help in implementing this agenda. A "process consultancy" arrangement may be useful, i.e., a small team of specialists could be engaged to provide continuous support to the Finance Department. This team could prepare the necessary detailed technical papers and documents, carry out the necessary background work for the improvements, and help to progressively move the improvement agenda forward. The Bank could partner and potentially help in this regard.

69. Partnerships. Establishing a close working relationship with various national and state-level institutions is important. Many of the reforms may have to be led at the national level; others may involve coordination or consultation with national-level institutions. Such institutions include the CAG's office, the Controller General of Accounts (CGA) of the Central Government, the Government Accounting Standards Advisory Board, and the Legislative Secretariat and Legislative Committees of the State Government. Partnerships with various agencies or organizations outside Government would be helpful in moving the reform agenda forward. They could include organizations such as the Institute of Chartered Accountants of India, National Institute of Public Finance and Policy, National Institute Financial Management, Institute for Financial Management Reforms and Institute of Public Enterprises. The specific areas of partnership could be worked out in consultation with these organizations. These partnerships will also help promote the demand for good PFM.

70. Learning from the Government of India's practices and experiences and reforms in other states, in addition to other countries, is particularly important. Peer to peer learning workshops between state and study tours would help and support the process of PFM improvements. Several other states are implementing improvements in various aspects of the PFM agenda, which is outlined in the relevant sections. More advanced countries (e.g., South Africa's public financial accountability reforms, Brazil's model of consolidation and disclosure practices, Korea's IFMIS implementation and open budget data, Russia IFMIS implementation and data disclosure) offer a variety of models of PFMA reforms and practices and also offer lessons and ideas. At the same time Karnataka has much to offer to other states. The various initiatives that Karnataka has taken are good examples to be shared with other Indian states.

71. Annual plans indicating the initiatives that would be implemented during each year should also be prepared, and performance targets and indicators to monitor the implementation of the agenda developed. Such an action plan should cover both the technical and institutional improvements (as discussed in previous sections) and the aspects previously discussed in this section. Ideally, it would be integrated into the Medium Term Fiscal Plan published by GoK and updated every year.

ANNEX 1: PROPOSED PFM REFORM ACTION PLAN - 2014

This section contains the thematic-wise PFM Reform Action Plan, proposing the actions to be taken, the responsible department for the actions, and the expected timeframe for completing the actions. The detailed analysis of the issues and the logic for action plan are provided in the respective sections in the Appendix to this Report. Based on this, GoK may decide the actions to be implemented and their sequencing.

Priority area/ objective	*Strategy*	*Priority*	*Timeframe*	*Responsibility*	*Target*
Theme 1: Strengthening PFM Legal and Institutional Framework (Section 1 of the Appendix)					
Strengthen fiscal responsibility legislation and update core PFM documents	***Strengthen implementation of fiscal responsibility legislation*** • Create awareness and ownership amongst all departments towards Karnataka Fiscal Responsibility Act (KFRA) • Operationalize the Local Fund Authorities Fiscal Responsibility Act (LFAFRA)	High	March 2015	Finance Department (FD)	
		High	March 2015	FD Urban Development Department (UDD) Rural Development and Panchayati Raj Department (RDPR)	LFAFRA operationalized
	Revise and update core PFM Manuals and implement them • Revise Karnataka Budget Manual (KBM), Karnataka Financial Code (KFC), Karnataka Treasury Code (KTC), Manual on Contingent Expenditure	High	March 2016	FD	KBM, KFC, KTC and MCE revised/updated and approved
Strengthen institutional capacity of Internal Financial Advisors (IFA) and Asset Liability Management Cell	***Provide Legal Mandate*** • Include IFA and ALMC roles and responsibilities in the KFC and KBM so that Departments recognize their roles	High	March 2016	FD	Roles and responsibilities included in the updated KFC and KBM
	Appoint skilled staff • Recruit IFAs from KSAD • Address resource constraints in ALMC through training and appointing finance personnel from FD	High	Ongoing	FD	Majority of IFAs deputed from KSAD in all major departments and IFAs providing high-level PFM services in FD
	Provide capacity building to staff • Provide extensive training to IFAs and ALMC including computer skills	Medium	Ongoing	FD	

Priority area/ objective	*Strategy*	*Priority*	*Timeframe*	*Responsibility*	*Target*
	• Provide staff and IT support to IFA and ALMC • Monitor work of IFA and ALMC and provide time to time guidance				
Theme 2: Enhancing Comprehensiveness and Credibility of the Budget (Section 2 of the Appendix)					
Strengthen Budget Process	***Pass the full budget before beginning of the financial year.***	High	Budget Year 15-16	FD and State legislature	Full budget passed before start of year
	Reduce the number of Supplementary Budgets to at least two (from the present three) and to one in the long term	Medium	Budget year 2015-16	FD	Supplementary budgets reduced to two
	Enhance Budget Credibility • Reduce the expenditure composition variance, from the present high level, in phases say over a two-year period to bring it close to original approved budget • Establish Economic Intelligence Unit in major revenue departments and Implement a Revenue Forecasting Tool in Finance Department	Medium	Budget year 2016-17	FD Commercial Tax Dept. (CTD). Excise Dept. (ED)	Expenditure composition variance reduced to less than 10% in phase 1 and to less than 5% in phase 2
	Strengthen supplementary process through enhanced disclosure • Prepare Supplementary Budgets which are Fiscally Neutral and in accordance with the KFRA and present Fiscal Neutrality table • Provide details of actual expenditure and surrenders per demand in the Supplementary Budgets	Medium	Budget year 2015-16	FD	No unfunded expenditure in supplementary budgets
Improve predictability of availability of funds	***Rationalize re-appropriation process*** • Identify reasons for high level of re-appropriation orders (including injudicious and defective) and develop strategy to control the rising trend • Review and revise re-appropriation delegation to more contemporary levels	High	March 2015	FD	Re-appropriation orders gradually reduced to half of 2013 level
	Provide capacity building to staff • Organize workshops to disseminate rules and procedures of re-appropriations and Delegation of Financial Powers (DoFP) on fund releases	High	Annual	FD	
	Enact DoFP as rules • Issue DoFP as rules on the lines followed by GOI and some states • Consider rush of expenditure as breach of financial propriety and include provision in KFC	High	March 2015	FD	Provision included in KFC
Estimate budget	***Improve budget process for salaries estimation***	Medium	Budget year	HRMS Cell	Appendix B

Priority area/ objective	*Strategy*	*Priority*	*Timeframe*	*Responsibility*	*Target*
provision of salaries on realistic basis	• Integrate Appendix B [14] preparation with the Human Resource Management System • Estimate salary for actual filled posts based on HRMS and posts expected to be recruited during the year		2015-16	FD	generated from HRMS
Improve budget process and controls over capital works	***Strengthen commitment controls by management of capital works*** • Prepare Appendix E[15] timely, fully and submit along with budget for legislative approval and include all works covering all major heads • Prepare Appendix E on a rolling forecast model for 3 years • Introduce MTEF in major spending departments (e.g. PWD)	Medium	Budget year 2015-16	FD, Public Works Department (PWD) Water Resources Department (WRD)	Commitment control established Full Appendix E generated and tabled in Legislature along with budget
	Implement Project management software in works departments • Develop capability in project management software (PMS) to prepare Appendix E • Mainstream PMS and integrate with upgraded Khajane (KII)	High	Budget year 2015-16 KII implementation plan	FD, PWD, KII team	Appendix E generated from PMS
Institute system for periodic rationalization of Schemes	Review the process of schemes, merge schemes and weed out nonexistent scheme heads on a regular basis	High		FD Administrative departments	
Implement Departmental MTFP	***Implement DMTFP and results based budgeting in larger departments*** • Adopt DMTFP in larger departments like PWD • Provide departments with more flexible budgets • Link budgets to RFD and desired results	Desirable			
Enhance Legislative scrutiny of budget	***Strengthen legislative scrutiny of budget*** • Implement Departmentally Related Standing Committee (DRSC) mechanism • Build capacity of the Legislative Committee on Estimates and provide adequate technical support • Legislature to devote more time on discussion and voting of grants	Medium	Budget 2016/17	Finance Department/ Karnataka Legislative Secretariat	DRSCs constituted and functioning
Theme 3: Strengthening Accounting, Reporting, Controls and Transparency (Section 3 of the Appendix)					
Strengthen Accounting and	***Provide Capacity building to staff*** • Reiterate the requirements and rules of KFC for areas identified in the	High	Ongoing	FD	

[14] *Appendix B is the budget document that contains full details of sanctioned, filled and vacant posts and estimation of salaries*

[15] *Appendix E is the budget document that contains details of ongoing works and those planned during the year by the Irrigation and Public Works Departments. Only works that are administratively approved are included*

Priority area/ objective	*Strategy*	*Priority*	*Timeframe*	*Responsibility*	*Target*
Reporting for enhanced PFM compliance	report • Provide regular training to accounts staff on requirements of the acts and rules				
	Strengthen monitoring and reconciliation of utilization certificates • Designate a nodal office with adequate staff to collate and monitor compliance of submission of Utilization Certificates (UC) with the concerned departments and agencies • Plan one-time exercise to clear and clean up the backlog of reconciliation of expenditure, and UCs • Reduce the periodicity of submission of UCs	High	Ongoing	FD	
	Strengthen accounting process and disclosure requirements for CSS • Clarify roles and reporting requirements of GOI, GOK and Implementing agencies in respect of CSS funds routed through the state budget • Disclose transfers and actual expenditure of each centrally sponsored scheme • Move CSS projects funds to Public Deposit accounts instead of Bank accounts (in consultation with GoI)	High	March 2016	FD	
	Strengthen accounting process and disclosure requirements for ULBs and PRIs • Constitute MIS cell to collect financial data • Disclose grants released to and expenditure incurred by urban and rural local bodies (ULB/PRI) and PSUs • Take policy decision on fund II balance treatment for Zilla and Taluk Panchayats (ZP/TP) • Prepare link documents using uniform object codes	High	March 2016	Finance Department DMA RDPR	
	Implement recommendations of the Central Finance Commissions on disclosure as outlined in the report	Desirable		Finance Department	
	Adopt accrual based accounting system Develop a roadmap for transition from cash based accounting to accrual accounting	Desirable		Finance Department	
	Include all public sector entities in fiscal reports as sub-sectors of GoK	Desirable		Finance Department	
Enhance Treasury processes, controls and reports through implementation of Khajane II	***Implement Khajane II (KII) with full computerization at the level of Drawing and Disbursing Officers (DDO)***	Ongoing			K II rolled out
	Develop implementation plan for KII • Develop a roll out plan for KII and cutoff date for completing the switchover and withdrawal of manual books • Develop and implement a data migration strategy to capture legacy	High	March 2015	KII team	

Priority area/ objective	*Strategy*	*Priority*	*Timeframe*	*Responsibility*	*Target*
	data in key areas • Develop a HR staffing plan, change management strategy and training plan for all DDOs, Chief Controlling Officers and Treasury officials				
	Build capability in Khajane II to • Integrate/link the software's outlined in the report • Develop modules outlined in the report	High	As per KII implementation plan		
Improve cash management	• Carry out a study on cash management practices and debt scheduling. • Develop a cash forecasting model for monitoring cash management and integrate with KII. • Integrate cash balance and forecasting mechanism with debt scheduling decision • Link cash management projections with the Monthly Programme Implementation Calendar and procurement plans	High	As per KII implementation plan	Finance Department	Cash forecasting module developed and implemented
Enhance controls over Subsidies	***Create web-based information system for tracking and monitoring of subsidies and interlink to KII***	High	As per KII implementation plan	KII team/FD/Administrative departments	
Enhance interface capability, scalability, and integrity of the Human Resource Management System application	***Upgrade HRMS to advanced version of HRMS II***		Ongoing	HRMS Cell	HRMS II rolled out
	Address systemic audit issues and initiate payroll audit • Analyze C&AG audit report on HRMS and prepare mitigation plan • Initiate a comprehensive payroll audit for validating the database prior to migration to and roll out of HRMS II	High	Before roll out of HRMS II	HRMS Cell	Payroll audit conducted
	Roll out e-payment of salaries across all districts.	High	March 2015	HRMS Cell FD	100% e-payment of salaries
Strengthen e-Procurement systems	***Provide capacity building to departments on KTTP and e-procurement*** • Conduct capacity building programs, trainings and workshops for staff across departments • Provide user guidance manual and share with the procuring entities working on KTTP and e-procurement	Medium	March 2016	E-procurement Cell (DPAR) FD E-procurement Cell (DPAR)	
	Address systemic audit issues and conduct IT audit • Analyze C&AG audit report on procurement and prepare mitigation plan for issues noted in case of violation of KTTP/e-procurement • Initiate audit of the e-procurement software by C&AG	High	March 2015		
	Enhance functionalities of e-procurement software Include: • Online Bid Evaluation Process • Issue of work order in the system (or this function needs to be	Medium	March 2016		Functionalities included in the software

Priority area/ objective	*Strategy*	*Priority*	*Timeframe*	*Responsibility*	*Target*
	captured in KII) • Provisions for Expression of Interest • Contract Management Module				
Enhance Fiscal Transparency	Disclose information on all major contracts awarded on the e-Procurement website.	High	March 2015		Major Contracts awarded, as defined, in public domain
Theme 4: Improving Fiscal Assets and Liability Management System (Section 4 of the Appendix)					
Enhance controls over Guarantees	***Strengthen Controls over Issuance, Recording and Reporting of Guarantees*** • Develop Government Guarantee Policy • Operationalize Guarantee Redemption Fund • Strengthen guarantee database and reconciliation efforts • Establish system for tracking, recording and reporting	High	March 2016	ALMC/FD	Guarantee Policy issued
Phase out Off Budget Borrowings	***Further enhance controls over Off-Budget Borrowings*** • Ensure that budgetary funds directed towards debt servicing are utilized for the intended purposes by the PSU/SPV. This will ensure better cash management • Make adequate disclosure of OBB on account of ULBs in the Budget document and MTFP, include the amount outstanding for the computation of Total liabilities • Phase out Off-budget borrowings	High	Annual	FD	Off-budget borrowings gradually phased out
Strengthen system of Recording, Consolidation, Reconciliation and Reporting of the Investment Portfolio	***Government's Investment Portfolio is reconciled to reflect correct position*** • Develop Operational Guidelines, in consultation with the AG to provide clear norms for determination, timing of accounting and reporting of investments • Issue clear-cut Government orders indicating intent when authorizing investment • Strengthen efforts for identification and reconciliation of differences between state accounts and investee-company accounts	Immediate	March 2015	Asset Liability Management Cell (ALMC) FD	Differences up to March 2013 gradually reconciled and no current reconciliation issues are allowed to accumulate
Institutionalize Debt Management, Recording and	***Institutionalize the function of debt management, strengthen debt data recording and reporting*** • Set up a combined Cash and Debt Management Office for cash and debt management recording and reporting.	High	March 2015	FD	Integrated Cash and Debt Management office

Priority area/ objective	*Strategy*	*Priority*	*Timeframe*	*Responsibility*	*Target*
Reporting functions	• Reconcile debt data with the AG on priority • Disclose debt data and DSA on the website of the Finance Department.				functional
Strengthen system of Recording, Consolidation, reconciliation and Reporting of Loans and Advances	***Strengthen system of Recording, Consolidation and Reporting*** • Initiate special audit of detailed records of loans and advances maintained departmentally • Strengthen efforts for identification and reconciliation of differences between state accounts and balance maintained by GOK • Develop strategy to address significant arrears in repayment of loans • Disseminate rules governing sanction and monitoring of loans and advances and ensure compliance	High	March 2016	CCO/ALMC	Differences up to March 2013 gradually reconciled and no current reconciliation issues are allowed to accumulate
Decline in stock of Arrears of Payment	***Strengthen system of Recording, Consolidation and Reporting and Monitoring*** • Develop a strategy for clearance of arrears as on a cut-off date • Provide a formal definition of payment arrears for its due recognition • Institute a system for recording and reporting arrears across GOK • Disclose expenditure payments outstanding in the mid-year report and budget documents.	High	March 2016	FD	Arrears, as defined, reduced to not more than 2% of total expenditure
Strengthen internal controls, accounting, reporting and adjustments over Unencashed Cheques	***Institute measures to clear backlog and avoid recurrence*** • Initiate a special study to identify the underpinning causes • Formulate and implement a strategy to clear backlog • Commence monthly reporting of lapsed cheque to AG and finalize accounting treatment of cancelled cheques • Reduce the periodicity of cancellation of unencashed cheques to 3 months	High	September 2016	Finance Department/ Directorate of Treasuries	Unencashed cheques as of March 2013 reverted and no current build up are allowed to accumulate
Theme 5: Strengthening Audit and Legislative Oversight *(Section 5 of the Appendix)*					
Institutionalize Internal Audit in GOK	***Strengthen and modernize internal audit to improve internal controls*** • Conduct a situational analysis of current internal audit arrangements in GOK departments • Develop risk-based strategy for implementing internal audit function in the State; • Carry out categorization of departments and initiate internal audit in high spending departments and implement gradually	High	March 2016	Finance Department with support from select high spending revenue and spending departments	Strategy for internal audit function developed

Priority area/ objective	*Strategy*	*Priority*	*Timeframe*	*Responsibility*	*Target*
	• Develop and implement Internal Audit Manual				
Improve Responsiveness to *External Audit*	***Strengthen mechanisms for follow up of external audit findings and recommendations*** • Re-iterate the seriousness of non-compliance with audit paras and prescribe action for continuous failure to take action • Strengthen the institution of Ad Hoc committee at department level and Apex Committees at state level • Clarify and enhance role of the IFA in follow up of audit reports • Take measures to ensure expeditious recovery of revenue at least in cases accepted by the Department	High	March 2016	FD	Outstanding replies to Inspection Reports and Audit Paras as of March 2013 submitted
	Enhance functionality of the Audit Monitoring System for effective monitoring of compliance • Mandate data input in the Audit Monitoring System as compulsory and Controller to monitor on a frequent basis • Integrate Audit Monitoring System with database maintained by CoPA • Include KSAD audit reports and response in the system • Include qualitative aspects to assess systemic issues	High	March 2015	Controller Accounts Management	AMS data, including responses, up to December 2014 updated by March 2015
Strengthen KSAD to improve PFM services	***Develop strategy and carry out one time reduction of audit arrears***	High	March 2015	KSAD	Audit of FY 2013/14 completed by March 2015
	Enhance staffing and improve skill sets through capacity building • Increase cadre strength of KSAD • Organize training for KSAD staff on commercial accounting and modern audit practices • Identify train and groom core group of KSAD staff to take up role of IFAs and enhance their PFM capabilities to take up enhanced role to support FD	High	Ongoing	KSAD	Number of staff deputed to IFA, Finance Department for PFM services
	Enablers for improving audit effectiveness and efficiency • Enact KSAD Audit Act to provide a legal status to KSAD • Develop and implement a comprehensive audit manual • Monitor and improve compliance through a Centralized Audit monitoring cell	High	March 2016	KSAD FD	Audit Act and Manual implemented
	Implement modern audit practices to improve efficiency • Risk based audit • Co-sourcing	High	March 2016	KSAD	

Priority area/ objective	*Strategy*	*Priority*	*Timeframe*	*Responsibility*	*Target*
	• Financial Attest Audit • Audit Management software • Audit of ULBs and GPs through their computerized systems				
Strengthen Legislative Scrutiny of External Audit Reports	***Strengthen effectiveness of Legislative Committee*** • Prescribe strict timelines for response to reports of the Legislative Committee by the departments, and action for delayed or non-compliance • Increase the technical human resources at the disposal of the Committee on Public Accounts (CoPA) • Place the Action Taken Reports in public domain after they are laid before the State Legislature	High	March 2016	FD AG Legislative Secretariat	Action Taken Reports outstanding as of March 2013 submitted
Theme 6: Improving PFM in *Local Self Governments and PSUs (Section 6 and 7 of the Appendix)*					
Improve PFM in Local Self Governments	***Enhance controls to increase Own Source Revenue*** • Update Demand Collection Balance Register to monitor and reconcile own source revenue • Move towards e-receipts and collections through banks for all taxes	High	March 2015	UDD and DMA RDPR GPs ULBs	Progressive increase in own tax collections by a specified % each year Increase in e-collections
	Improve timeliness of accounts in ULBs and GPs • Develop and implement strategy to clear backlog of accounts • Ensure full migration from manual systems of accounting to computerized systems	High	March 2016	UDD and DMA RDPR GPs ULBs	All accounts for FY 2015/16 submitted for audit by Jun 2016 All ULBs and GPs fully migrated to computerized accounting
	Enhance integrity of accounts in ZPs and TPs • Carry out one time cleanup of old balances and suspense account, bank accounts and closure of inactive accounts • Include MPAS reports and reports on banking transactions in the financial statements through amendment in Municipal Financial Rules	High	March 2016	RDPR FD	
	Improve timeliness and responsiveness of audits in ULBs and GPs • Develop and implement strategy to clear the backlog of pending audits in ULBs and GPs	High	March 2016	KSAD UDD and DMA RDPR	All audits up to FY 2015/16 completed by

Priority area/ objective	*Strategy*	*Priority*	*Timeframe*	*Responsibility*	*Target*
	• Constitute Audit Cell in DMA and RDPR for audit follow up and management				September 2016
	Institute internal audit to strengthen internal controls • Set up an internal audit wing with mandate and staff • Finalize and establish Internal Audit structure in TPs (based on study already completed)	High	March 2015	UDD and DMA RDPR FD	Audit Wings established within UDD/DMA and RDPR
Strengthen PFM and Corporate Governance in State Owned Enterprises	***Enhance accounting and auditing*** • Develop and implement strategy to clear the backlog of accounts • Review external audit findings, including functioning of internal audit and audit committee	High	March 2015	Department of Public Enterprises Concerned Administrative Departments State Owned Enterprises (SOE)	Clear all backlog of all accounts by FY 2015.
	Establish effective nodal agency for SOEs • Enhance the role of the DPE as an effective nodal agency for State Owned Enterprises	High	March 2015		DPE designated as nodal agency for SOEs
	Enhance corporate governance framework • Conduct a SWOT analysis of existing corporate governance practices in GOK and develop strategy for improving corporate governance considering the extant framework applicable to central PSUs	High			Central Model Code of Corporate Governance implemented in 10 major companies

ANNEX 2: 2004 - PFMA ACTION PLAN ACCOMPLISHMENTS AND CURRENT STATUS

This section contains the action plan as proposed in 2004 report, updated with the current status of actions in the identified areas. In case where the action have been taken and completed by the GoK, the impact has been documented. The 2004 baseline and the reforms carried out are documented in the Analysis Report under respective sections.

2004 Action Plan – Accomplishment and Current Status

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
I. Budget preparation and implementation			
(a) Ensure budget passage at start of fiscal year			
Present budget in early Feb so that it can be passed by end-March.	Issue revised budget calendar	The budget is presented by March of the previous year, but only a Vote on Account is passed before the start of the Financial Year (FY).	The full budget is passed in June/July during the second phase of the budget session that is 3-4 months into the FY. This action needs to be implemented by GoK.
	Revise MTFP production schedule to finalize by time of budget passage (2004-05) or presentation (2005/06). Include MTFP production in revised budget calendar.	MTFP is presented along with the budget (since 2008). Instructions to provide inputs to the MTFP are detailed in the budget calendar.	
(b) Phase out off-budget borrowing (OBB)			
Reduce off-budget borrowing every year, and eliminate at earliest opportunity	Reduce to Rs 1,140 crore in 2004-05 and Rs 720 crore in 05/06, as per MTFP. Eliminate in 06/07.	There were no fresh OBBs during 2008/09 to 2010/11 and fresh OBBs raised during 2011/12 and 2012/13 were less than the repayments. The outstanding OBB as at the close of FY 2012/13 was Rs. 1,455 crore reduced from Rs. 5,582 in 2008/09.	The total fiscal liabilities, including OBB, are within the limits prescribed by the XIIIth Central Finance Commission.
(c) Improve budget realism			
Improve tax forecasting	Prepare pro forma for tax forecasts to quantify impact of growth and reform for all tax departments	The budget circulars require Estimating Officers to present a 3-year forward estimate revenue and assumptions made. The circulars provide guidance on estimating revenues.	
	Publish pro forma tax forecasts with budget	Tax forecasts for the next three years are outlined in the MTFP.	
	Fiscal intelligence cell to be established in FD.	The Commercial Tax Department (CTD), the biggest revenue department has floated	This recommendations needs to be followed by GoK

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
		consultancy tender for setting up an Economic Intelligence Unit to improve *inter alia* the analytical capabilities of CTD	
Base budget on realistic resource envelope.	Start budget process with updating and agreement on total resource envelope (realistic revenue & affordable borrowing) for the budget, approved by Government, and stick to this.	This practice is being followed during budget preparation. However, there are significant in-year budget amendments.	
Base budget on realistic expenditure estimates	Line Departments and Finance to prioritize and fully-fund existing commitments (e.g. electricity payments, retained schemes) over new programs during budget preparation. Ensure schemes announced in the Budget are properly screened and fully budgeted.	Arrears of payments including electricity are not being budgeted fully while drawing up the budget and the outstanding is increasing over the years. Data on arrears are partially available. There are also incomplete projects. In respect of schemes, the Finance Department has issued guidelines for their approval and for making budgetary provisions.	This recommendations needs to be followed by GoK
Limit Supplementary Budgets and schemes introduced outside the budget cycle	Develop Pro forma for all supplementary budget requests and new policy initiatives coming to Cabinet to indicate off-setting fiscal measures as per FRA	Pro forma for collecting the revised estimates for supplementary is issued along with the budget circular, which is followed.	
	From next supplementary budget on, include "fiscal neutrality" table showing, per grant, amount funded through tied grants, adjustments, expenditure cuts, revenue increases etc.	The position in respect of SEs remains the same as was the situation in 2004. The percentage of aggregate SEs to original estimates has increased from 8-10% then to between 14-18% now. Fiscal neutrality table is not explicitly shown per grant and it is displayed at an aggregate level. Though the SEs provides overall sources of financing, this includes "cash outgo" and the impact of the SEs is not offset through reduction of expenditure or revenue augmentation. This is apparent as such details are not provided in	The impact on the fiscal indicators is not stated in the SE. This is not strictly in line with the KFRA Act.

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
		the SE document. Some of the departments show significant requirements of supplementary demands.	
	Reduce number of supplementary budgets to 1	Each year three SEs are prepared and presented to the State Legislature.	A heavy reliance on supplementary budgets undermines the discipline and sanctity of the budget process. Even now these estimates come without offsets in other expenditures to ensure that deficit targets were met.
(d) Introduce Departmental budgeting for more accountability and flexibility			
Consolidate Plan and non-Plan budget allocations into Departmental resource envelopes.	Finance and Plan to agree on Departmental ceilings (both Plan and non-Plan) to be issued for each Department at start of budgetary process (to be included in new budget calendar). DMTFP ceilings to be used as starting point for next year's budget negotiations	Plan and non-plan ceilings are worked out by Finance and Plan and agreed, DMTFP are presently not being developed to guide the discussion.	GoK should target implementing DMTFP at least in high spending departments like PWD, WRD and RDPR so that budgeting and MTFP can be drawn more realistically and departmental ceilings can be fixed by the FD.
Reduce number of line-items (schemes, and object heads) in budget	Further reduction in schemes in 2003-04	While object heads has been reduced, the numbers of schemes have not reduced –there are still some 1600 schemes presently.	FD should review the number of schemes with each administrative department and reduce the number of schemes. This exercise should be carried out at least once in every three years. Department of Agriculture carried out such an exercise and significantly reduced the number of schemes.
Budget by broad departmental programs (groups of related individual schemes) and by broad expenditure categories (groups of related object heads).	Prepare dummy budget along program lines for 2003-04, and then prepare and present 04-05 budgets along these lines.	Such an exercise has presently not been adopted.	
Treasury MIS to report to Departments by	Reporting by grants	Such a reporting system has been	

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
Grants and Program	Reporting by programs	implemented.	
(e) Strengthen performance orientation of Departments			
Evaluate performance of department against agreed output/outcome targets	Hold workshops to evaluate departmental performance with DMTFPs as basis.	Departments commenced preparation of the DMTFPs but have since been discontinued	
	DMTFPs to be produced with budget and submitted to Subject Committees		
Incentivize Departments to raise revenue (non-tax revenues, and CSS expenditures)	Introduce performance against non-tax revenue and CSS expenditure targets as performance criteria for DMTFPs, with monthly monitoring using Treasury data. Reward Departments with good revenue performance through increased allocation.		
(f) Improve budgetary expenditure allocation and screening process			
For civil works departments, prioritize non-salary spending in order of: (i) arrears; (ii) maintenance; (iii) existing capital projects (in order of degree of completion); (iv) new capital projects	Include full maintenance requirements as committed expenditure in the budget. For capital projects, give priority in budget to arrears and ongoing projects over new projects	Guidelines on such lines are provided in the budget circular. However, in actual practice this is not being strictly followed in view of significant arrears of payments. This issue is still relevant and the practice has broadly remained the same as assessed in 2004.	GoK needs to give priority in budget to arrears and ongoing projects over new projects
Avoid spreading capital funds thinly	Budget only to include only capital projects which are (i) fully funded; (ii) have passed cost-benefit analysis; and (iii) have received administrative approval. No projects in Appendix E with token provision. Include in Appendix E expected completion dates.	Instructions have been issued by GoK on these lines and norms for budget provisions have also been determined. However the delay in preparation and clearance of Appendix E (list of works) is negating the benefits of these changes.	GoK to ensure Appendix E is submitted to the Legislature with the budget and only those works approved by the Legislature is executed and paid
Avoid introduction of new schemes unless well-justified and fully-funded.	Budget only to include new schemes which (i) have been approved by Expenditure Review Committee and (ii) are fully funded.	As above. This issue is still relevant and the practice has not changed.	
(g) Simplify budget implementation and improve cash flow			

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
Reduce financial clearances required post-Budget approval	FD to further enhance individual clearance limits. Departments to enhance delegation of financial powers of Heads of Departments (HODs)	Individual clearance limits (powers for financial sanction and also release of funds) have been continuously enhanced since 2006 and departments now have more flexibility in terms of release of funds without recourse to the Finance Department and more clarity on different types of funds flow. Powers at the level of HoDs and below have also been enhanced and codified and power to re-appropriate at the level of HoD has also been enhanced.	There is a perceptible improvement in the pace of expenditure, and decline in rush of expenditure during the last quarter/month thus improving the quality of public expenditure.
Improve cash flow management to avoid payment delays.	Budget cuts, if required, to be issued early. Review recommendations of Box 6 of PFMA report on cash flow requirements	There have been no significant budget cuts during the last few years.	
(h) Strengthen internal controls			
Strengthen budgetary controls over outlays and commitments	Treasury to provide and Departments to use monthly receipts and payments MIS to monitor budgets. Quarterly review of expenditure vis-à-vis budget by Expenditure Committee. IFAs to be strengthened to support budget monitoring and internal controls (see VI).	Treasury provided monthly statements to the departments which can be used for monitoring budget. However the issue is that departments don't do reconciliation on a regular basis.	
	Strengthen control over capital works by capital works (App. E) computerization, and extension of Treasury computerization to include LoC.	LoC system has been withdrawn and all payments are being made through treasury. Appendix E computerization has not been done. PWD has started implementing works software from last year and the results are yet to be seen.	*Computerization of Appendix E is a suggestion which is relevant even today and GoK needs to develop and implement software in this regard.*
	Computerization of DDOs (see II d) to enable commitment controls.	This is planned under the upgraded Khajane (KII) new IFMIS system under development	
Remove open-ended obligation in power sector.	Implementation of purchaser-provider model.		

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
Revision of Treasury Code, Financial Code, Budget Manual and related Codes/Manuals to modernize, and simplify	Revise Financial Code.	This action is yet to be done	
	Revise other Codes and Manuals	This action is yet to be done	
Strengthen borrowing and guarantee controls	All Departments to refer all borrowings to FD for prior approval.	All debt is now raised centrally by the FD. Debt is now raised with the approval of the FD and monitored. Individual departments do not have the power to negotiate loans directly.	
	Strengthen guarantee controls	GoK has centralized the maintenance of the data in respect of Guarantees with DSS in 2005. The DSS collects annual information on guarantees from the respective institutions on whose behalf the guarantee was issued in prescribed form and updates its database that is presently maintained on spreadsheets.	A database of Guarantees is available with GoK The process of recording and reconciliation of Guarantees has been institutionalized and reporting of Guarantees has been formalized.
	FD to sign guarantee issuance to enable control over guarantees.	FD issues the concurrence for giving of Guarantees through a GO and authorizes the Principal Secretary/ Secretary of the concerned Administrative Department to sign the guarantee document.	This action is deemed complete as the authority to sign the guarantee has been formalized.
(i) Increase fiscal transparency			
Make more fiscal data available to public.	Table Finance Accounts in Assembly session following their receipt from AG.	During the last three years (2009-2012) the audited Finance Accounts were placed before the Legislature within 2-3 months (the next session of the Legislature) as compared to one year in 2004.	Timely scrutiny of the finance accounts by the PAC, leading to faster action and faster availability of information to the public. Reduction of time lag by 9 months.
	Place Finance Accounts and Accounts at a Glance on the Web and make available in electronic form (CD) .	Finance Accounts is available on the website of AG Karnataka after they are tabled in Legislature	
	Publish full budget on Web and in electronic form (CD).	Full set of budget documents are available on the website of Finance Department after they are presented in the State Legislature	

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
	Ensure monthly data on Web up to date.	Monthly Accounts at Glance and Monthly Civil Accounts are available on the website of AG Karnataka The monthly reports are available within 1-2 months.	
Publish half-yearly review as per FRA	Prepare review for April-September 03 and table in Assembly	The mid-year review is done regularly and tabled in the Legislature and available in public domain within 2 months from the close of the half-year.	
Treasury to establish Web with MIS	Underway.	This action has been completed. Treasury provides all the MIS reports	
Publish data on stock of pending bills.	Publish on FD website stock of pending Treasury bills on monthly basis.	This is presently not being done.	
Ensure bills paid on first-in, first-out (FIFO) principle	Monitor queue jumping in Loc bills by publishing individual pending and paid bills on Finance Website in dated order. Extend Treasury computerization to include LoC payments	These actions have been completed by GoK	
Put audit reports and responses on the Web	Place PAC reports on the Web Consider placing audit responses on the Web	Full reports of the Legislative oversight committees [16] are not placed on the Web. However, parts of the reports in respect of which an Action Taken Report is required from a department, are available on the Audit Monitoring System.	*This action is relevant now also and GoK needs to put the reports and response in the Web.*
II. Financial Computerization and MIS			
(a) Treasury computerization (Khajane)			
Use Treasury computerization to develop Treasury as single-point payment agency, and to develop financial MIS. Phase out LoC system	Review and improve MIS reports (e.g., Departmental expenditure monitoring reports, exceptions/ variance reports)	All these reports are available with treasury and departments.	
	Introduce computerized receipt for bills (tokens).		

[16] *Committee on Public Accounts, Committee on Public Enterprises and Committee on Local Bodies*

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
	Develop service standards for bill payment by Treasury	This has been implemented. The treasury is required to make payments on FIFO basis within 5 days of the entry of the bill in the system.	
	Eliminate non-Bank treasuries, and reliance on RBI as agency bank.	This action has been completed	
	Carry out risk audit of Khajane.	Risk and IT audit has been completed in 2009 and on the recommendations, KII an advanced IFMIS is being implemented	
	Computerize civil service payments: Develop computerized database, compute pension amounts through the computerized system, and make direct payments to the Bank accounts of individual civil pensioners	Pension computerization is under progress.	
	Extend computerized Treasury to include all LoC payments, and extend Treasury payment budgetary control module to cover Appendix E projects and non-plan civil works. Obtain and include information on non-treasury flows (e.g., direct transactions at RBI Nagpur, inter-governmental and other adjustments in AG's Office) in computerized system. Generate daily information on State Government's Bank balance from the Treasury system.	Except Appendix E all other action have been completed.	
(b) Capital Works Control (Appendix E) computerization			
Computerization to enable better control of budgeting and implementation of capital or civil works for Appendix E Departments (PWD, MI, WRD) with link to the Treasury payment system.	Develop implementation plan; complete software development and hardware procurement. 2003-04 Appendix E of budget produced using computerized system.	There is delay in preparation of Appendix E and is presently not presented in Legislature along with the budget. Appendix E is also incomplete as not all works under all major heads are being included. This budget document is not tabled in the State	*This action is relevant and needs to be carried out by GoK*

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
		Legislature. This action is yet to be done.	
	Implement in the 3 major capital works Departments.	As above. This action is yet to be done.	*This action is relevant and needs to be carried out by GoK*
(c) Payroll Computerization (linked to HR Database and Treasury)			
Computerize payroll to enable central generation of monthly payroll and payment of salaries, as well as management of employee-related accounts (e.g. insurance)	Pilot computerized payment of salaries at Secretariat level.	Development of HRMS commenced in 2005, after piloting was rolled out in the entire state in a phase manner. The secretariat was covered in 2009/10	
	Complete HR database and initiate payroll computerization (complete plan. award contracts)	A computerized Human Resource Management System (HRMS) as a centralized web based application has been implemented across the State. HRMS covers both service records and pay bill generation. It comprises the following seven modules – Service Register, Pay Bill, Transfers, Promotion, Suspension, Compliant Monitoring and Reports.	HRMS covers all employees of the state government (approximately 5.5 lacs including teachers) besides covering employees of Taluk Panchayats and urban local bodies, 70,000 employees of fully aided educational institution and of some public sector undertakings and about a lac Anganwadi workers. This is a major achievement as expenditure on salaries (excluding district and block panchayats 17) constitute about 20% of revenue receipts and about 14% of total revenue expenditure during 2011/12.18
	Start issuing cheque to individual employees rather than each DDO.	E-payments to staff directly from treasury have been rolled out in 15 districts while in other districts the payment is made by the Treasury to the DDO in form of cheque which is further handed over to the staff.	Faster payments and better internal controls thus reducing burden of data entry and reconciliation. In Khajane II, the default mode of payment is planned to be electronic transfers to the

[17] *Salary is presently part of the grants released to the Panchayats. Salary is accounted for at the district Panchayats but not included in state accounts.*
[18] *Report on State Finances for the year ended Mar 31, 2012, C &AG*

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
			accounts of the payee.
(d) DDOs computerization			
Computerize DDOs to enable commitment controls, recording and reporting; computerized bill preparation (machine readable at Treasury); receipts and payments record keeping; sub-accounts/detailed accounts for loans, advances, etc.; records and registers at DDOs; bills payable/arrears recording and reporting; fixed assets (stores and stock) registers	Initiate preparatory work (procedures study, linkages with Treasury and other systems, computerization plan)	This is being done as a part of the KII implementation	
	Initiate computerization (award contracts)	This is being done as a part of the KII implementation	
(e) Accelerating Monthly Accounts preparation schedule			
Use Treasury computerization to enable AG to accelerate production of monthly accounts.	Revise target dates for Monthly Accounts: rendering of accounts by treasury and LoC Departments to AG's Office by 10th of next month; Monthly Accounts by AG to State Government by 25th of next month.	The LoC system has been discontinued. The current target date for submission of monthly compiled accounts by Treasuries to the AG is 9th of the next month (except that State Huzur Treasury submits by 18th). There are instances of delayed submission of monthly accounts by the Treasuries[19]. Monthly Accounts by AG to the Government is usually made available between 25 to 55 days from close of the month.	This action has been completed. Accounts from treasury are share with AG (A&E) in soft copy which is imported by AG (A&E). A&E finalizes the accounts based on the treasury accounts and inputs from RBI. The Voucher level entry has been dispensed with by AG.
III. Accounting Issues			
(a) Public Account clean-up			
Reduce backlog of public accounts and prevent build-up in future.	Focus first on large funds, and take measures for one-time clean-up and to prevent build up in the future. PRI and municipal funds: one-time clean up, annual closure in the future to prevent build-up.	The balances in these accounts as at the year-end are required to be transferred back to the Consolidated Fund. This rule is not strictly being followed in Karnataka and significant balances are carried forward to the subsequent year/s. Nearly half of the PD accounts are	One time action was carried out by GoK. But this action still remains relevant and needs to be done on a periodical basis.

[19] *The AG (A&E) has reported delays in 2011-12 of up to 15 days on 294 occasions and over 15 up to 30 days on 18 occasions and over 30 days on 1 occasion. Persistent delays are from State Huzur, Bangalore (Urban) and Bangalore (Rural) Treasuries - PAG (A&E), Karnataka Report on the Annual Review of the Working of the Treasuries for the year 2011-12 (April 5, 2013).*

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
	KBJNL Deposits: Close????	inoperative, some have adverse balances and none of the Administrators have reconciled the balances with the Treasury and the AG (A&E).	
	PDAs: Backlog: Prepare break-down as on March 31, 2003 (individual item/entity wise, if necessary year-wise). Reconcile with totals in Finance Accounts. Write-back amounts as appropriate (e.g., amounts lapsed/expired, differences between totals and individual items). Prevent further build-up: Regularly prepare break-down and match with total accounts (monthly); review and close regularly (comprehensive GO to be issued)		One time action was carried out by GoK. But this action still remains relevant and needs to be done on a periodical basis.
	Reduce number of PDAs. Ban use of PDAs for budget carry-forward purposes.		One time action was carried out by GoK. But this action still remains relevant and needs to be done on a periodical basis.
	Extend above process for PDAs to other deposits and accounts		One time action was carried out by GoK. But this action still remains relevant and needs to be done on a periodical basis.
	Suspense and Miscellaneous Accounts. Backlog: Prepare breakdown for all these accounts as on March 31, 2003 and close as appropriate. Prevent further build-up: Regularly prepare breakdown (monthly), review and close (quarterly).		One time action was carried out by GoK. But this action still remains relevant and needs to be done on a periodical basis.
	Prepare monitoring database for public accounts.		**This action has not been completed and it is relevant even in today's context.**
(b) Reconciliations			
Reduce unreconciled amounts at all levels	Unencashed Checks and LoC	The procedure for identification, reporting and	The Treasuries/DDOs are not

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
of the system.	Remittance accounts • Backlog: Prepare Break-down (cheque-wise details) on March 31, 2003. Write-back and close expired cheques. Identify how differences between total amount and individual cheques if any would be addressed (e.g. write back). • Regularly reconcile from April 2003 (monthly) – match totals with individual cheques, and write-back expired cheques. • Establish and implement monitoring mechanisms to ensure that reconciliations are done regularly in all Treasury offices and LoC offices	cancellation/write-back of unencashed (lapsed) cheques prescribed in the Karnataka Financial Code appears not to be working effectively as the quantum of unencashed cheques is showing an increasing trend over the years - The outstanding as at March 2013 is at a level of Rs. 6,820 crore compared to Rs. 1,120 crore in 2001/02. This level is also considerably high when compared to some other states Such as Gujarat, MP, Odisha and Kerala. There is also a delay in requesting for Alteration Memos by the Treasuries and issue by the AG (A&E).	complying with the internal controls prescribed in this area. Unpaid cheques are not considered as part of the cash position of the state. In terms of accounting, if unpaid cheques are reversed with delay in subsequent year/s, it affects the revenue/expenditure of the year in which write-back is done. *The balance in unencashed cheques is shown in the Public Account and is not considered as cash balance of the state.* *From an internal control perspective also, it is imperative that cheques remaining unencashed should be identified, document and reversed.* *The 2004 action point has not been adequately addressed and remains relevant.*
	Matching of total accounts with individual/sub-accounts in DDOs (e.g., loans, advances, deposits). Reconciliations of CCOs with AG's numbers, and DDOs with Treasury numbers • Reiterate requirements regarding these reconciliations (issue Circular) • Establish and implement monitoring mechanisms -- develop and implement web-enabled application	While GoK has achieved more than 90% in terms of reconciliation of revenue figures, achievement in terms of reconciliation of expenditure is only 58% (FY 2013) and there is slippage over the last few years. PD accounts have not been reconciled since last several years. Issues in reconciliation of loans and advances continue.	

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
	for monitoring		
	• Improve controls over expenditure advances (AC Bills/MPWA Debits and Credits/ DC Bills) • Reiterate requirements regarding prompt submission of DC Bills and penalties for non-submission (such as no further AC bills/MPWA advances if AC Bills are not cleared) • Establish and implement monitoring arrangements	The quantum of outstanding AC Bills are contained at a reasonable level and showing a decreasing trend over the years in both outstanding as well as fresh drawls during the year - as at March 2013, the outstanding AC Bills were Rs. 122 crore of which Rs. 45 crore were drawn in March 2013 itself. AC Bills aggregating Rs. 67 crore are outstanding prior to FY 2012-13 (i. e. more than 1 year) for want of submission of DC Bills.	Settlement of AC Bills need to be followed scrupulously less they accumulate which inflates the expenditure as the amount drawn is already accounted for in the final head of account.
IV. Audit/PAC responsiveness and follow-up			
(a) Audit Reports			
Set up mechanisms to ensure prompt response to State Government audit reports and Inspection Reports	Continue to monitor using database, and follow up with Departments; develop web-enabled application. Extend database to inspection reports. Departments to identify systemic issues in the 2001-02 and 2002-03 Audit Reports and Inspection Reports, and initiate improvements to address these.	Web enabled application (Audit Monitoring System - AMS) developed and implemented. The AMS captures information on inspection reports, draft audit paras and action taken reports – this however is not complete and updated. Reports are available for all stages except inspection reports. AMS also presently does not cover the audit observations of KSAD. However the important point on identifying and reporting systemic issues has not been carried out in AMS.	A large number of audit observations including those with financial implications as well as systemic issues are pending adequate resolution. *GoK should improve AMS to capture systemic issues which would support the management in addressing thematic issues rather than individual issues. This is being addressed in the proposed audit module of KII.*
(b) PAC Reports			
Set up mechanisms to ensure prompt response to PAC Reports	Coordinate with PAC Secretariat to include PAC Reports in the audit response monitoring database; initiate development of web-enabled application.	PAC has its own database of status of audit paras, but is not linked with the AMS. This is being addressed in the proposed audit module of KII.	
	Identify systemic issues in the 2001-02 and 2002-03 PAC Reports and	The PAC is following the approach of reviewing latest audit reports first and	*This has reduced the backlog. Review of CAG report on state*

2004 Reform Plan	Agreed Action	Accomplishment/Current Status	Impact
	initiate improvements to address these	focusing more on systemic issues. The selection of audit paras for hearing is done on the basis of materiality and risk. There is more emphasis on taking up contemporary and relevant issues.	*finances up to 2009/10 has been completed. Review of ATR for 2010/11 and 2011/12 is underway. Finance and Appropriation Accounts have been reviewed till 2010/11. Civil reports are taken up department – wise. PAC has regularized excess expenditure aggregating Rs. 9565 crores up to year 2010-11.*
V. Other Public Sector Agencies			
(a) Government Companies/Corporations			
Monitor compliance with core PFMA requirements (accounts and audits, responses and follow-up on audits and COPU reports, audit committees, reconciliations, internal control issues in audit reports)	Continue monitoring of accounts and audit backlog.	The accounts and audit backlog have reduced over the years. The individual administrative departments and the AG monitor the completion of accounts and conduct of audit.	*FD should have a cell to monitor the accounts and audit backlog of the government companies.*
	Reiterate need for reconciliation of amounts relating to transfers from State Government reflected in the Companies'/Corporations' accounts and State Government's accounts; and monitor compliance (issue Circular)	ALMC has been designated to carry out the reconciliation. This issue still persists and this suggestion is relevant in the current scenario also.	Accounting and control in this area has not kept pace with the growth in the investment portfolio. The Finance Accounts may not disclose the correct investments of GoK
(b) Statutory Boards and Authorities (SBAs), and Societies			
Establish monitoring mechanisms and monitor compliance with core PFMA requirements (accounts and audits, responses and satisfactory follow-up on audit reports	Start monitoring accounts and audit backlog (C(AM)).		
	Reiterate need for reconciliation of amounts relating to transfers from State Government; and monitor compliance (issue Circular).		
	Use Local Funds Authority Fiscal Responsibility Act to develop standard PFMA framework (drawing on the Indian Companies Act framework), and make applicable for all SBAs	No steps have been taken to develop the PFMS framework as the Act has not been operationalized..	**The act has not been operationalized and needs to be implemented.**
(c) Panchayat Raj Institutions (PRIs)			

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Clear backlog of accounts and audits and ensure regularity and timeliness of accounts and audit, and satisfactory follow-up on audit reports.	Continue monitoring of accounts and audit backlog.	Since ZP/TP are audited by C&AG, RDPR monitors the accounts closure on a regular basis, the accounts and audit backlog for ZP/TP has considerably reduced. In case of GPs the accounts and audit backlog and GoK needs to prepare a strategy to address this issue.	*RDPR-IFA and ZP-Special officer should monitor the status of accounts and audit on a regular basis.*
	Stipulate preparation of TP accounts/audits at TP not ZP level; make necessary amendments to PRI Act.	This action has been carried out. Based on the 2004 report the ZP/TP accounting rules where modified and separate accounts where to be furnished by the TP. Now TPs prepares their own accounts and statements.	
PFMA modernization agenda for PRIs	Complete ZP/TP accounting computerization (linked to Treasury); GP account strengthening: (i) Finalize GP accounting rules; (ii) initiate pilots of financial audits of GPs by Chartered Accountants (under supervision of KSAD); (iii) initiate GP computerization On basis of computerized database, Scheme rationalization for PRIs as per GO (GO under modification) Operationalize RTI at local level (incl. public boards with works/beneficiary/financial info.)	ZP/TP accounting yet to be computerized and linked to Treasury. All action except financial audits regarding GPs have been completed (i) new accounting rules have been issued in 2006 (ii) computerization has been completed for all GPs across the State and (iii) RTI has been operationalized across the state.	*ZP/TP accounting is being computerized as a part of the KII implementation.* *KSAD needs to carry out financial audit which is still a relevant action.*
(d) Urban Local Governments (ULBs)			
Clear backlog of accounts and audits and ensure regularity and timeliness of accounts and audit, and satisfactory follow-up on audit reports.	Start monitoring accounts and audit status for 6 City Corporations under current statute.		
	Start monitoring accounts and audit backlog for other ULBs under current statute (clarify that accounts would be monitored using new receipts and payments statement).	New fund based accounting system has been implemented across ULBs.	

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PFMA modernization agenda for ULBs	Complete first phase accounting computerization of 32 ULBs with population greater than 1 lakh.	New fund based accounting system has been implemented across all ULBs, except in the Bangalore municipal corporation (BBMP)	
	Complete BMP FBAS ; Develop revised accounting guidelines based on BMP experience	This action has been completed	
	Improve accounting capacity by recruiting qualified accountants (initially on contract in 32 ULBs)	Accountant posts have been created recruited in nearly 140 ULBs while for 70 ULBs it is yet to be done.	
	Initiate pilots of financial audits of 6 CCs by Chartered Accountants (under supervision of KSAD)	Financial audits for all ULBs are being carried out by CA firms thought there is backlog in completion of audit.	
(e) Incentivize compliance by government bodies with accounting and audit requirements			
On selective basis, introduce compliance with basic PFMA requirements as prerequisite for release of government funds.	Operationalize Local Fund Authority Fiscal Responsibility Act	The Act is still to be operationalized	The Act was to apply to local bodies under state control and handling public funds including urban and rural local bodies. Application of the Act would also have paved the way for preparation of MTFP as every local authority would be obliged to prepare a MTFP[20]. Also, the Act would have enforced PFM principles including submission of accounts, setting up a Local Fund Audit Overseeing Authority and provide enhanced participation of the citizens in budget and planning.
	Link fund transfers to public sector agencies from State Government to adherence to stipulated PFMA		This action has not been implemented and it is still relevant for GoK to implement

[20] *The Act prescribed that the Medium Term Fiscal Plan shall be the source document for the preparation of the annual budget and shall address the prime needs of the citizens as relevant to the specific local fund authority such as water supply, construction of road, education, public health, solid waste management and the like.*

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	requirements (e.g., preparation of accounts and audits, responses and follow-up action on audits, reconciliations, other PFMA requirement in the respective statute)		this.
Require utilization certificates for government grants prior to release of further grants.	Establish mechanism to monitor submission of Utilization Certificates for institutions which receive grants from governments	Monitoring of submission of UCs is done by individual departments – a centralized mechanism for follow up is not in place. The Accountant General provides data on outstanding UCs in the Finance Accounts. Efforts to reduce the outstanding UCs have paid off as backlog has significantly reduced.	To further reinforce this achievement, GoK should establish a centralized database of outstanding UCs. A one-time
	Link fund transfers from State Government to submission of Utilization Certificates.	This has been mandated through GOs, though in actual practice, further grants may be provided pending UCs for previous releases.	
VI. Institutional Arrangements and Capacity Building			
Strengthen financial oversight of government insurance schemes.	All 3 employee insurance schemes to be handled in single office (transfer Group Insurance Scheme/Savings Fund to KGID.). Eliminate remaining accounts/audit backlog. Computerize operations. Subsequently include employee accounts maintenance in computerized payroll.	??	
Ensure better management of government bodies through competitive selection of top management)	Government to review and decide mechanism for mandatory, competitive selection of senior level executive appointments for Government Companies and SBAs and Societies – Directors, MDs and Chairmen. (e.g., Public Enterprises Selection Board as in GOI and Kerala)	Senior level executive appointments are generally made by the Administrative Department (in consultation with the concerned Minister in charge) and competitive selection is an exception.	This action has not been implemented and it is still relevant for GoK to implement this.
Develop financial management capacity within Government	Ensure IFAs qualified (apply existing rule of 1/3 from AG office, 1/3 from KSAD; 1/3 from Secretariat). Ensure	All major departments have IFAs. The existing rule of appointment is followed. However the quality of non KSAS IFA's	

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	that all major spending departments (e.g., Water Resources) have IFAs.	needs to be reevaluated by the GoK.	
	Appoint 10 Chartered Accountants for State Accounts Department (initiated).	This action has not been implemented and it is still relevant for GoK to implement this.	
	Identify other required capacity enhancements for other Departments. Review Accounts Management and modify if required.	This action has not been implemented and it is still relevant for GoK to implement this.	