CHAPTER I: INTRODUCTION

1.1 Foreword

This report relates to matters arising from the compliance audit of the financial transactions of the Ministry of Defence and its following organisations. :

- Army;
- Ordnance Factories;
- Defence Research and Development Organisation and its laboratories dedicated primarily to Army and Ordnance Factories
- Inter Service Organisations; and
- Defence Accounts Department.

The report also contains the results of compliance audit of the transactions of the Border Roads Organisation under Ministry of Road Transport and Highways.

Compliance audit refers to examination of the transactions relating to expenditure, receipts, assets, and liabilities of the audited entities to ascertain whether the provisions of the Constitution of India, applicable laws, rules, regulations and various orders and instructions issued by the competent authorities are being complied with.

The primary purpose of the report is to bring to notice of the legislature important results of audit. Auditing standards require that the materiality level for reporting should be commensurate with the volume and magnitude of transactions. The findings of audit are expected to enable the executive to take corrective actions as also to frame policies and directives that will lead to improved financial management of the organisations, thus contributing to better governance and improved operational preparedness.

This chapter, in addition to explaining the planning and extent of audit, provides a synopsis of the significant audit observations followed by a brief analysis on the expenditure of the above Organisations. Chapter II onwards, present detailed findings and observations arising out of the compliance audit of the Ministry and the aforementioned Organisations.

1.2 Auditee Profile

Ministry of Defence at the apex level, frames policies on all defence related matters. It is divided into four departments, namely Department of Defence, Department of Defence Production, Department of Research and Development and Department of Ex Servicemen welfare. Each department is headed by a Secretary. The Defence Secretary who is the Head of the Department of Defence also coordinates the activities of other departments.

Army is primarily responsible for the defence of the country against external aggression and to safeguard the territorial integrity of the nation. It also renders aid to the civil authorities at the time of natural calamities and internal disturbances. It is, therefore, incumbent upon the Army to suitably equip, modernize and train itself to meet the challenges.

DRDO, through its chain of laboratories is engaged in research and development primarily to promote self reliance in Indian defence sector. It undertakes research and development in areas like aeronautics, armaments, combat vehicles, electronics, instrumentation, engineering systems, missiles, materials, naval systems, advanced computing, simulation and life sciences.

The Inter Service Organisations like Armed Forces Medical Services, Military Engineer Services (MES), Defence Estates, Quality Assurance, etc. serve the Defence Forces in the fields which are common to the Army, Navy and Air Force. They are responsible for development and maintenance of common resources in order to economize on costs and provide better services. They function directly under Ministry of Defence.

Ordnance Factory Board (OFB) functions under the administrative control of the Department of Defence Production and is headed by Director General, Ordnance Factories. 39 factories are responsible for production and supply of Ordnance stores to the Armed Forces.

1.3 Integrated Financial Advice and Control

Ministry of Defence and the Services have an internal financial control system in place. With fully integrated Finance Division in the Ministry of Defence, the Financial Advisor, Defence Services and his/her officers scrutinize all proposals involving expenditure from the Public Fund. FADS is responsible for providing financial advisory services to Ministry of Defence and the Services at all levels and also for treasury control of the Defence expenditure.

Being Chief Accounting Officer of the Defence Services, FADS is also responsible for the internal audit and accounting of Defence expenditure. This responsibility is discharged through the Defence Accounts Department with the Controller General of Defence Accounts as its head.

1.4 Authority for Audit

The authority for our audit is derived from Articles 149 and 151 of the Constitution of India and the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971. We conduct audit of Ministries/Departments of the Government of India under Section 13[1] of the

[1] Audit of (i) all expenditure from the Consolidated Fund of India (ii) all transactions relating to Contingency Funds and Public Accounts and (iii) all trading, manufacturing, profit & loss accounts & balance-sheets & other subsidiary accounts.

CAG's (DPC) Act. Major Cantonment Boards are audited under Section 14[2] of the said Act. Principles and methodology of compliance audit are prescribed in the "Regulations of Audit and Accounts, 2007".

1.5 Planning and Conduct of Audit

Our audit process starts with the assessment of risk of the Organisation as a whole and each unit based on expenditure incurred, criticality and complexity of activities, level of delegated financial powers, assessment of overall internal controls and concerns of stakeholders. Previous audit findings are also considered in this exercise. Based on this risk assessment, the frequency and extent of audit are decided. An annual audit plan is formulated to conduct audit on the basis of such risk assessment.

After completion of audit of each unit, Local Test Audit Reports (LTARs) containing audit findings are issued to the Head of the unit. The units are requested to furnish replies to the audit findings within a month of receipt of the LTARs. Whenever the replies are received, audit findings are either settled or further action for compliance is advised. Important audit observations arising out of these LTARs are processed for inclusion in the audit reports which are submitted to the President of India under Article 151 of the Constitution of India.

During 2008-09, audit of 950 units/formations was carried out by employing 38052 man days. Our audit plan ensured that most significant units/entities, which are vulnerable to risks, were covered within the available manpower resources.

1.6 Significant Audit Observations

Capital and the Revenue Procurements made by the Ministry of Defence and the Service Organizations form the critical area as far as the audit of Defence Sector is concerned. Audit has been pointing out the deficiencies in the procurement process in its previous reports and the Ministry of Defence has taken several measures to improve the procedures involved. Periodical revisions of the Defence Procurement Procedure (DPP) latest in 2008 and Defence Procurement Manual (DPM) in 2009 are a step to evolve better practices. Despite the same, significant deficiencies exist in the process of procurement, which have been summarized in the report.

The present report highlights cases which assume importance in the light of their impact on operational preparedness and the considerable financial implications. The report also brings out cases which underscore systemic deficiencies like inadequacy in trial and quality inspections, poor management of contracts, inaccuracy in assessment of requirements and non-responsive functioning which require immediate redressal.

[2] Audit of receipts and expenditure of bodies or authorities substantially financed by grants or loans from the Consolidated Fund of India or of any State or of any Union Territory.

An illustration of defective procurement of Capital nature is the Multi Barrel Rocket Launcher System, SMERCH (Paragraph 2.1). The system was imported at a cost of Rs 2633 crore, but had critical defects in its sub systems, which were revealed during its exploitation. The deficiencies impacted it adversely in effective operationalisation. Non availability of Buyer Furnished Equipments further impaired the functioning of the system. Another typical case of defective purchases was the procurement of Integrated Oxygen and Communication Mask Helmets (Paragraph 2.5). The masks were procured to alleviate the problems related to supply of pressurized oxygen in high altitude areas to Helicopter Pilots of Army. The procurement was done without trial evaluating the masks at high altitudes. On their utilization, users experienced serious defects like erratic and insufficient supply of oxygen, severe headache etc., which forced the withdrawal of the masks. Non adherence of the laid down procedures was very much apparent in the case of procurement of spares for L-70 guns (Paragraph 3.1) where the spares valuing Rs 4.99 crore were accepted by the Army without the mandatory pre-dispatch inspection. On receipt, those were found to be non- compatible for the guns and as a result are lying unused. While cases of receipt of defective ammunition had been highlighted in the previous reports as well, yet the Ministry does not appear to be serious about their implications. As a follow up of a paragraph on receipt of defective ammunition valuing Rs 273.75 crore, reported in the year 2003, Audit found that no concrete action was taken by the Ministry to get the defects rectified. Even after six years, 67453 rounds of the ammunition valuing Rs 245.28 crore were still lying in the segregated state. (Paragraph 2.3).

Defence Public Sector Undertakings were established to provide the Armed Forces state of the art equipments and to enhance country’s self reliance in defence production. In a distinct case of role reversal, the Ministry procured outdated Missiles of 1970s vintage worth Rs 587 crore in 2008 merely to favour Bharat Dynamics Limited. The Missiles procured were not only of lower capabilities in terms of the range but also did not meet the Army’s long term objective of acquiring third generation missiles which were available in the market (Paragraph 2.2).

Assessment of accurate requirement before any procurement action is extremely important. Nevertheless, Audit found the matter to have been grossly neglected. The report brings out the instances where Army paid a sum of Rs 98.59 lakh for maintenance of Unmanned Aerial Vehicles, which were not even held by it (Paragraph 2.6).The incorrect assessment was also manifest in the purchase of batteries and battery chargers where it resulted in excess procurement worth Rs 5.30 crore (Paragraph 2.4). Procurement of short life drug in excess of requirement led to non-consumption of the drug costing Rs 2.13 crore during its shelf life (Paragraph 3.3). Another instance of inaccuracy in assessment was detected in the provisioning of ammunition for AK-47 rifles, where the assessment was made on the basis exaggerated figures given by the DGOS despite knowing the actual entitlement of the weapons (Paragraph 3.4).

This report includes a case which reflects the gross insensitiveness in the functioning of the Ministry even in emergency procurements. Assault Boats, which were required urgently by the Army, could not be procured for over six years despite the availability of all the ingredients like urgency, availability of budget, adequate number of vendors etc required for speedy decision making (Paragraph 3.5).

Audit of MES works has always been an area of importance. This report also highlights a case of construction of Golf club building under the garb of repair of buildings for which sanctions were actually accorded (Paragraph 4.1). Cases of avoidable expenditure, additional expenditure due to delay in execution of works have also been highlighted in this Chapter.

Irregularities related to working of the Border Roads Organization have been reported separately in Chapter V. The chapter presents two cases demonstrating as to how costly a delay in opening of bids can prove to the exchequer and also as to how inconsiderate functioning could lead to misappropriation of government stores. An instance of unplanned procurement of segregators (Paragraph 5.1) resulting in non utilization of the equipment procured at a cost of Rs 4.55 crore is also a useful disclosure.

The report also brings out issues which depict inadequacies in the functioning and management of R&D Organisation. Instances like creation of assets without ensuring desired power supply for its operation, loss due to damage to imported equipment, poor planning of works services, loss due to lack of coordination in procurement of a life saving item are highlighted in Chapter VI.

In case of Ordnance Factories, Audit has commented on the injudicious sanction of Rs 408.01 crore for setting up a new factory at Korwa without actually finalizing the new generation cabines to be manufactured, opportunity savings of Rs 13.33 crore foregone by two ordnance factories owing to their failure to maintain power and load factor to a desired level while receiving electricity from the electric companies. Special mention is made of the case in paragraph 7.10 in which vendors received reimbursement of customs duty of Rs 1.19 crore allegedly paid by them in import of machinery for Ordnance Equipment Factory Kanpur. Cross checking by Audit with Customs indicated that the said duty had not actually been paid by the vendors. It would appear that letter head and rubber seal of the factory had been used by the vendors in the forged Customs Duty Exemption Certificate produced by them to the customs authorities. This point to strong possibilities of involvement of personnel of the factory.

1.7 Response of the Ministry/Department to Draft Audit Paragraphs

On the recommendations of the Public Accounts Committee, Ministry of Finance (Department of Expenditure) issued directions to all Ministries in June 1960 to send their response to the Draft Audit Paragraphs proposed for inclusion in the Report of the Comptroller and Auditor General of India within six weeks.

The Draft Paragraphs are forwarded to the Secretaries of the Ministry/departments concerned drawing their attention to the audit findings and requesting them to send their response within six weeks. It is brought to their personal attention that in view of likely inclusion of such Paragraphs in the Audit Reports of the Comptroller and Auditor General of India, which are placed before Parliament, it would be desirable to include their comments in the matter.

Draft paragraphs proposed for inclusion in this Report were forwarded to the Secretaries concerned between June 2009 and October 2009 through letters addressed to them personally.

Ministry of Defence did not send replies to 11 out of 25 Paragraphs featured in Chapters II to VI. Department of Defence Production also did not send reply to 08 out of 10 Paragraphs included in Chapter VII of this Report. However, the response of Ordnance Factory Board, wherever received, had been suitably incorporated in the paragraphs in Chapter VII.

1.8 Action taken on earlier Audit Paragraphs

With a view to enforcing accountability of the executive in respect of all issues dealt with in various Audit Reports, the Public Accounts Committee desired that Action Taken Notes (ATNs) on all paragraphs pertaining to the Audit Reports for the year ended 31 March 1996 onwards be submitted to them duly vetted by Audit within four months from the date of laying of the Reports in Parliament.

Review of ATNs relating to the Army as of April 2010 indicated that ATNs on 80 paragraphs included in the Audit Reports up to and for the year ended March 2008 remain outstanding, of which the Ministry had not submitted even the initial ATNs in respect of 20 Paragraphs as shown in **Annexure-IA**. 28 are outstanding for more than 10 years. With regard to Ordnance Factory Board as of March 2010, Ministry of Defence had not submitted ATNs in respect of 12 Paragraphs included in the Audit Report for the years ended March 2007 to March 2009 even for the first time as per **Annexure-IB**. Further, Audit could not vet ATN in respect of other 11 Audit Paragraphs, as per the details given in the **Annexure-IC**, for want of revised Action Taken Note based on Audit's observations.

1.9 Financial Aspects/ Budgetary Management

What is commonly known as Defence expenditure comprises expenditure under six Grants. Grant No. 21 authorises expenditure on Army, Inter Service Organisations and others like Inspection Organisations, NCC, Rashtriya Rifles including Stores and Transportation etc. Grants No. 22 and 23 relate to Navy and Air Force Grant No. 24 authorises expenditure on Ordnance Factories.

Grant No. 25 relates to expenditure for Defence Research and Development Organisation. Grant No. 26 authorises Capital Outlay on all Services.

Defence Outlays can broadly be categorized into Revenue and Capital. Revenue Outlays cover Pay and Allowances, Stores, Transportation etc. Capital Outlays cover expenditure on acquisition of new weapons and ammunitions, replenishment of obsolete stores with modern variety. Much of the modernization of Services takes place under Capital expenditure.

The budgetary provision (Voted portion) on Defence Services has increased from Rs. 92170.05 crore in 2006-07 to Rs. 125358.64 crore in 2008-09-an increase of 36 *per cent*. The increase on the revenue side (Voted segment) was 41 *per cent* – an increase from Rs. 54725.80 crore to Rs. 77382.54 crore during the period primarily due to revision of pay of defence forces on the recommendations of Sixth Pay Commission. The Capital Outlay was increased by 28.13 *per cent* from Rs. 37444.25 crore to Rs. 47976.10 crore.

The actual Revenue expenditure increased by 41 *per cent* from Rs. 54827.49 crore in 2006-07 to Rs. 77074.06 crore in 2008-09. The increase in the Capital expenditure was 21 *per cent* from Rs. 33791.20 crore in 2006-07 to Rs. 40894.97 crore in 2008-09. The unspent provision under Capital had increased from Rs 3653.05 crore in 2006-07 to Rs. 7081.13 crore in 2008-09-an increase of 93.84 *per cent*. This would indicate the lack of capacity in the Ministry to process acquisitions in a timely manner.

1.10 Analysis of Revenue Expenditure of Army

For the year 2008-09, the Voted portion of the Original Grant of the Army for Revenue Expenditure was Rs 37662 crore. Another Rs 12199 crore was sanctioned in the Supplementary Grant making the Final Grant of Rs 49861 crore. As against this, the expenditure recorded was Rs 49053 crore registering an unspent provision of Rs 808 crore. In the earlier financial year of 2007-08, there was an excess expenditure of Rs 71 crore.

Pay and Allowances for the Army constituted 49 per cent (Rs 24276 crore) of the total expenditure in 2008-09. If Pay and Allowances for Civilians (Rs 2378 crore) and Auxiliary Forces (Rs 480 crore) are added, the Pay and Allowances component would constitute 55 per cent, Stores (Rs 10972.47 crore; 22 per cent) Transportation (Rs 1384 crore; 3 per cent) Works (Rs 4445.66 crore; 9 per cent) were other significant components of expenditure.

While comparing the expenditure within the Grant, significant savings took place in almost all the heads, especially the heads involving Stores (Rs 260 crore), Works (Rs 163 crore) and Pay and Allowances of Army (Rs 92 crore), Auxiliary Forces (Rs 79 crore) and Civilians (Rs 25 crore). The savings in Stores took place due to reduction in rates of superior kerosene oil (SKO), drawal of less quantity of food in North East region due to bird flu, non-drawal of Tetra packed milk, SKO, non-conclusion of annual maintenance contract of UAV and non-delivery of UAV spares. Savings in Works was mainly due to reduced expenditure in maintenance, special repairs, other revenue works, reduced usage of electricity consumption, non-completion of the ongoing projects, non-supply of office equipment by Vendors in time due to natural calamities and social disturbances.

Unlike the sharp increase witnessed in 2008-09 in the Army's revenue budget due to implementation of the recommendations of the sixth Pay Commission, the trend indicated a nominal decrease during 2009-10. As against the budget estimates of Rs.33126 crore for 2009-10 for Pay and allowances for Army, the revised estimates stand at Rs.33048 crore. The budget estimates for 2010-11 for these are at Rs.31599 crore.

1.11 Analysis of Revenue Expenditure of Ordnance Factories

The bulk of expenditure of Ordnance Factories is met by "deduct recoveries" for supplies to Army, Navy and Air Force. In addition, Ordnance Factories also do Civil Trade and sell stores to para-military forces and to the public. These are booked as Receipts into the Consolidated Fund of India. The following table will give the picture:

(Rupees in crore)

Year	Expenditure	Deduct Recovery	Receipt on supply of surplus stores	Net Receipt
2004-05	6389.89	5330.35	1264.63	205.09
2005-06	6847.13	5701.31	1537.81	391.99
2006-07	6191.89	5147.77	1384.52	340.40
2007-08	7125.63	5850.65	1464.12	189.14
2008-09	9081.28	6123.38	1474.54	(-)1483.36

The trend of generating surplus of receipts over expenditure in Ordnance Factory Organisation has been reversed in 2008-09 mainly due to cost increase in manufacturing resulting from increase in pay and allowances, payment of arrears of pay on implementation of recommendations of Sixth Central Pay Commission (CPC) and non-materialisation of certain CKD/SKD* items.

In the revised estimates for 2009-10, net budgetary support from the Consolidated Fund of India after adjustment of Deduct Recoveries and Revenue Receipts has been pegged at Rs 2187.32 crore. For the year 2010-11, the net budgetary support has been estimated at Rs 246.19 crore. In large number of cases the issue prices are less than the actual cost of production.

While, till 2007-08, the Ordnance Factories had been able to maintain negative charge to the Consolidated Fund of India, supplies to the Services have never

* CKD/SKD – Complete Knocked Down/Semi Knocked Down

been able to match the budget provision indicating less supply than anticipated. Against the budgeted supply of Rs 6597 crore in 2008-09, the supplies booked were at Rs 6123 crore registering a shortfall of Rs 474 crore. In 2007-08, the shortfall was of Rs 594 crore and in 2006-07, it amounted to Rs 633 crore.

Overall performance of ordnance factories for the year 2008-09 has been analysed at Paragraph 7.1 in this report.

1.12 Analysis of Army Capital Expenditure

In 2007-08, Army could spend Rs. 11912 crore against a Capital Outlay of Rs 11864 crore leading to an excess expenditure of Rs 48 crore. In 2008-09, however it spent Rs 10611 crore against an allocation of Rs. 10947 crore. However, detailed analysis indicates that there are several areas where money has remained unutilized as would be evident from the following table:-

(Rupees in crore)

	2007-2008				**2008-2009**			
	O	**R**	**FG**	**Actual**	**O**	**R**	**FG**	**Actual**
Aircraft & Aero engines	1040.49	(+) 513.78	1554.27	1560.62	426.70	(+) 108.55	535.25	602.61
Heavy & Medium Vehicles	719.19	(+) 670.21	1389.40	1378.61	1285.26	(-) 58.48	1226.78	1114.86
Other Equipment	6616.47	(-) 555.87	6060.60	6136.31	8345.33	(-) 2179.50	6165.83	5965.81
Rolling Stock	72.00	(-) 46.96	25.04	25.35	114.80	(-) 74.96	39.84	(-) 0.18
ECHS	57.00	(-) 48.90	8.10	9.65	60.00	(-) 50.50	9.50	7.57
Rashtriya Rifles	72.95	(-) 48.40	24.55	26.47	21.98	(+) 4.36	26.34	26.41
Construction Works	2932.77	(-) 178.56	2754.21	2758.16	2992.25	(-) 86.92	2905.33	2855.00

O-Original Grant; R-Re-appropriations; FG-Final Grant; ECHS-Ex Servicemen's Contributory Health Scheme

The increase in Appropriation of Rs 109 crore for Aircraft and Aero Engines was mainly due to seeking of additional amount against advanced light helicopter. The increase of Rs 4 crore under Rashtriya Rifles was mainly due to variation in cost of ECM JAMMERS, payment and adjustments of pending bills for Light Vehicle Based Direction Finder. Much of the savings have taken place in Heavy and Medium Vehicles, Other Equipments, Rolling Stock, construction works and Ex-servicemen Contributory Health Scheme. The savings were mainly due to allocation of more funds, non-payment for PINAKA due to non-completion of Joint Receipt inspection, non-release of payment against 4 new schemes for want of bank guarantees by the Vendors/non-submission of bills, reduction in targets by Director General Ordnance Factories, non-clearance of bills by Director General Operational Logistics till end of Financial Year due to design defects/modification, non-materialisation of supply order in time, reduced expenditure in New Works etc.

Capital Budget Outlay for Army in 2009-10 was Rs.18020 crore. In the Revised Estimates in the year, it has been brought down to Rs 12816 crore. The trend of under-utilisation of capital outlay is expected to continue.

1.13 Capital expenditure of Ordnance Factories and DRDO

The capital expenditure of Ordnance Factories during 2008-09 was Rs 323.99 crore. Normally, expenditure on renewal and replacement in the ordnance factories are met from the renewal and replacement fund created out of the revenue expenditure. During the year 2008-09, the amount transferred to the renewal and replacement fund was Rs 271 crore and the expenditure incurred from it was Rs 276 crore.

In the case of DRDO, the capital expenditure during 2008-09 was Rs 3855 crore. Of this, expenditure on machinery and equipment was Rs 3442 crore and it constituted 89 *per cent*. The capital expenditure on DRDO nearly equalled the revenue expenditure during the year, which stood at Rs 3876 crore.

1.14 Rush of expenditure in the last quarter of the financial year and in particular, in the month of March

Ministry of Defence (Finance/Budget) has from time to time, issued instructions to maintain an even pace of expenditure through the year. Such instructions had, however, little effect on the pace of expenditure. 62 *per cent* of the annual Capital expenditure for all services to Budget Estimates was spent during the last quarter of 2008-09. 43 *per cent* of the expenditure to Budget estimates took place in the month of March, at the fag end of the year.