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

The report also contains the results of compliance audit of the transactions of the Border Roads Organisation under the 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 the 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 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 of the expenditure of the above organisations. Subsequent chapters present detailed findings and observations arising out of the compliance audit of the Ministry and the aforementioned organisations.

1.2 Audited entity 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 safeguarding 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 these 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 such as Armed Forces Medical Services, Military Engineer Services (MES), Defence Estates, Quality Assurance, etc. serve the defence forces in the three wings of the Army, Navy and Air Force. They are responsible for development and maintenance of common resources for optimising cost-effective 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 a full-fledged internal financial control system in place. With fully integrated Finance Division in the Ministry of Defence, the Secretary (Defence Finance) and his/her officers scrutinize all proposals involving expenditure from the Public Fund. Secretary (Defence Finance) is responsible for providing financial advisory services to Ministry of Defence and the Services at all levels, and for treasury control of the defence expenditure.

Being Chief Accounting Officer of the Defence Services, Secretary (Defence Finance) 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 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] 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-sheet & other subsidiary accounts.

[2] Audit of receipt 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.

1.5 Planning and conduct of audit

Our audit process starts with the risk assessment of the organisation as a whole and of 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 2010-11, audit of 647[3] units/formations was carried out by employing 14784[4] party 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 Revenue procurements made by the Ministry of Defence and the Service Organisations form the critical area as far as the audit of Defence Sector is concerned. We have been pointing out deficiencies in the procurement process in the previous Audit Reports and the Ministry of Defence has taken several measures to improve the procedures involved. Periodical revisions of the Defence Procurement Procedure (DPP) and Defence Procurement Manual (DPM) are significant steps to evolve better practices.

The present Report highlights cases which assume importance in the light of their impact on operational preparedness and having substantial cost overrun. The Report also brings out issues regarding poor management of contract, inaccuracy in assessment of requirement, excess payments, improper inspection of execution of work etc which require immediate redressal.

The failure of the Principal Director Defence Estates Southern Command to obtain Government sanction by processing the case for levy of licence fee on the vehicles entering the Cantonment resulted in revenue loss of ₹ 4.72 crore (Paragraph 2.3).

An extra payment of ₹ 1.47 crore was made to the supplier due to adoption of incorrect base rate for computing exchange rate variation (Paragraph 2.4).

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[3] - Number of units/formations audited by O/o DGADS, New Delhi and O/o PDA(OF) Kolkata

[4] - Number of Party days employed during the financial year 2010-11 by the o/o DGADS New Delhi and o/o the PDA(OF) Kolkata

The failure of the GE Kamptee to repair/replace defective water meter and incorrect categorisation of Military Engineer Services at Hisar led to excess payment of ₹ 4.70 crore and ₹ 12.92 crore on account of water charges at Kamptee Cantonment and Hisar Military Station respectively (Paragraphs 4.1 & 4.2).

A Technology Development Project was undertaken by Defence Research and Development Organisation for development of modular charge system for 105 mm and 130 mm guns on the request of the Director General of Artillery. On completion of the project, the DG Artillery expressed lack of interest in the technology due to the likely de-induction of the guns from service resulting in unfruitful expenditure of ₹ 13.48 crore (Paragraph 3.2).

The irregular issue of NOC by the DEO Mumbai to a private party deprived the Army authorities of land valuing ₹ 5.94 crore which was in their possession since 1942, thus compromising with defence security (Paragraph 2.2).

Improper supervision by the officers of the Military Engineer Services resulted in construction of sub-standard bunkers at Sunderbani at a cost of ₹ 7.61 crore (Paragraph 4.3).

The failure of Station HQ Pune in complying with Ministry's instructions to maintain and verify the nominal rolls of conservancy staff who actually reported for duty led to overpayment of ₹ 94 lakh to the Cantonment Board on account of conservancy charges (Paragraph 3.4).

The incorrect decision of the Chief Engineer to allow the contractor to use plasticizer in the work, on payment as an additional item, resulted in an extra payment of ₹ 1.25 crore to the contractor while constructing an Ammunition Depot (Paragraph 4.4).

The Director General Border Roads in violation of Defence Procurement Manual 2006 granted undue benefit of ₹ 2.28 crore to a supplier by waiving liquidated damages and payment of enhanced statutory duties during the extended delivery period (Paragraph 5.2).

In case of Ordnance Factories, we have commented upon delayed production and issue of Pinaka rockets by Ordnance Factories and rejection of rockets and propellants aggregating ₹ 48.76 crore, production of new generation vehicles in Vehicle Factory Jabalpur, non-commissioning of a costly machine, defective manufacture leading to un-serviceability of ammunition, loss due to manufacture of detonators with vintage components, issue of rejected items to the indentors by Ordnance Factories and recovery/savings at the instance of Audit. In addition, comments on general performance on the functioning of the Ordnance Factory Organisation for the financial year 2010-11 has also been included.

1.7 Persistent irregularities in Defence Estates management

Cases of poor management of defence land have been highlighted in various Reports of the Comptroller and Auditor General of India on Defence Services, the latest of which is the Performance Audit Report No 35 of 2010-11 on Defence Estates Management. The cases relating to misuse/exploitation of defence land and building for commercial and other unapproved purposes, unauthorised use of land and building for educational institutions run by the Army Welfare Education Society (AWES), delay in renewal of leases, irregular sub-leasing by the lessees, misuse of old grant sites/ bungalows, etc. continued to persist as reported in Paragraphs 2.1, 2.2, 2.7, 3.1 and 3.3. Corrective steps need to be taken urgently in this regard.

1.8 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 January 2012 and June 2012 through letters addressed to them personally.

The Ministry of Defence did not send replies to 16 Paragraphs out of 24 Paragraphs featured in Chapters II to VII. Ministry of Defence did not send reply to any of paragraphs (July 2012) included in Chapter VIII of this Report. However, the response of Ordnance Factory Board, wherever received, had been suitably incorporated in the paragraphs included in Chapter VIII.

1.9 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 July 2012 indicated that ATNs on 90 paragraphs included in the Audit Reports up to and for the year ended March 2010 remain outstanding, of which the Ministry had not submitted even the initial ATNs in respect of 35 Paragraphs as shown in **Annexure-IA,** and 28 ATNs are outstanding for more than 10 years. With regard to Ordnance Factory Board, as of July 2012, Ministry of Defence had not submitted ATNs in respect of three Paragraphs included in the Audit Reports for the year ended March 2003 to March 2010 even for the first time as per **Annexure-IB**. Further, we could not vet ATN in respect of other two Audit Paragraphs, as per the details given in the **Annexure-IC**, for want of revised ATN based on our observations.

1.10 Financial aspects/ Budgetary management

What is commonly known as Defence Expenditure comprises expenditure under six Grants. Grant No. 22 authorizes expenditure on Army, Inter Service Organisations and others viz. Inspection Organisation, NCC, Rashtriya Rifles and includes Stores and Transportation etc. Grant Nos. 23 and 24 relate to Navy and Air Force, Grant No. 25 authorises expenditure on Ordnance Factories, Grant No. 26 relates to expenditure for Defence Research and Development Organisation and Grant No. 27 authorises Capital Outlay on all the Services.

Defence Outlays can broadly be categorised into Revenue and Capital. Revenue Outlays cover pay and allowances, stores, transportation etc. Capital Outlays cover expenditure on acquisition of new weapons and ammunitions and replenishment of obsolete stores with their modern versions. Much of the modernisation of the Services takes place under Capital expenditure.

A detailed analysis of the budgetary provision (Voted portion) on Defence Services showing Revenue and Capital, respectively is as follows:

(₹ in crore)

Sl. No.				
1.	**Budget provision on Defence Services(Voted) for the year 2008-09**	**Budget provision on Defence Services(Voted) for the year 2009-10**	**Budget provision on Defence Services(Voted) for the year 2010-11**	**Increase in Provision (in terms of *per cent*) from 2008-09 to 2010-11**
	125358.64	148359.74	155992.08	24
2.	**Revenue Budget provision (Voted) 2008-09**	**Revenue Budget provision (Voted) 2009-10**	**Revenue Budget provision (Voted) 2010-11**	**Increase in *per cent* (2008-09 to 2010-11)**
	77382.54	93580.12	95215.87	23
3.	**Capital Budget Provision (Voted) for 2008-09**	**Capital Budget Provision (Voted) for 2009-10**	**Capital Budget Provision (Voted) for 2010-11**	**Increase in *per cent* (2008-09 to 2010-11)**
	47976.10	54779.62	60776.21	27
4.	**Actual Revenue Expenditure (Voted) 2008-09**	**Actual Revenue expenditure (Voted) 2009-10**	**Actual Revenue expenditure (Voted) 2010-11**	**Increase in *per cent* (2008-09 to 2010-11)**
	77074.06	94645.46	96625.32	25
5.	**Actual Capital Expenditure (Voted) 2008-09**	**Actual Capital Expenditure (Voted) 2009-10**	**Actual Capital Expenditure (Voted) 2010-11**	**Increase in *per cent* (2008-09 to 2010-11)**

	40894.97	51019.42	62011.53	52
6.	**Unspent provision Under Capital Expenditure (Voted) 2008-09**	**Unspent provision Under Capital Expenditure (Voted) 2009-10**	**Excess under Capital Expenditure (Voted) 2010-11**	**Increase/decrease in *per cent* of unspent provision of Capital expenditure** (2008-09 to 2009-10 and 2009-10 to 2010-11)
7.	**(-)** 7081.13	**(-)** 3760.20	(+) 1235.32	2008-09 to 2009-10 - 47 **(decrease)** 2009-10 to 2010-11 –133 (**decrease**)

The increase on the Revenue side (Voted segment) was primarily due to revision of pay of defence forces on the recommendations of Sixth Central Pay Commission. The increase on the capital side was mainly due to modernisation of services/additional requirement/outgo for new schemes, etc. From the above table, it would also be evident that the increase in the *percentage* of unspent provision under capital segment indicated a declining trend during the period 2008-09 to 2009-10 but during 2010-11, the trend reversed to excess expenditure of ₹ 1235.32 crore.

1.11 Analysis of Revenue Expenditure of Army (Voted)

For the year 2010-11, the Voted portion of the Grant of Revenue Expenditure for the Army was ₹ 62138 crore. As against this, the expenditure recorded was ₹ 65002 crore which translated to an excess expenditure of ₹ 2864 crore. In the earlier financial year of 2009-10, the excess expenditure was ₹ 2464 crore.

Pay and allowances for the Army constituted 53 *per cent* (₹ 34683 crore) of the total Revenue expenditure of ₹ 65002 crore in 2010-11. If pay and allowances for Civilians (₹ 3051 crore) and Auxiliary Forces (₹ 763 crore) are added, the Pay and Allowances component would constitute 59 *per cent of* the total Revenue expenditure. Stores (₹ 12144 crore; 19 *per cent*), transportation (₹ 1871 crore; 3 *per cent*) and works (₹ 5308 crore; 8 *per cent*) were other significant components of expenditure.

Within the Grant, significant excess expenditure took place in almost all the heads, especially the ones involving pay and allowances of Army (₹ 2261 crore), Rashtriya Rifles (₹ 15 crore), stores (₹ 247 crore), transportation (₹ 340 crore), pay and allowances of Auxiliary Forces (₹ 170 crore), Civilians (₹ 175 crore), and Military Farms (₹ 21 crore). Savings occurred in works (₹ 8 crore), National Cadet Corps (₹ 234 crore), other expenditure (₹ 143 crore) and Ex-Servicemen Contributory Health Scheme (₹ 6 crore).

The savings in Minor Head 113-NCC and 800-'Other Expenditure' were due to non-materialisation of contracted supplies, expected claims and miscellaneous payments.

The excess amount and savings indicated above were arrived at by considering only the Budget provision (i.e. Original /Supplementary grant excluding any re-appropriations with the actual expenditure).

The Army revenue budget during 2011-12 showed a marginal increase at ₹ 64251.55 crore in comparison to ₹ 57326.99 crore in 2010-11. As against the budget estimates of ₹ 34543.67 crore for 2011-12 for Pay and Allowances for Army, the revised estimates stand at ₹ 40114.45 crore. The budget estimates for 2012-13 for these are at ₹ 45027 crore.

1.12 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 gives the picture:

(₹ in crore)

Year	Expenditure (as furnished by the Ordnance Factory Board)	Recoveries from supply to Armed Forces	Receipt on supply of surplus stores[5]	Total receipts	Net receipt
1	2	3	4	5(3+4)	6(5-2)
2006-07	6191.89	5147.77	1384.52	6532.29	340.40
2007-08	7125.63	5850.65	1464.12	7314.77	189.14
2008-09	9081.28	6123.38	1474.54	7597.92	(-)1483.36
2009-10	10812.10	7531.08	1545.01	9076.09	(-)1736.01
2010-11	10903.21	9824.99	1665.78	11490.77	587.56

Unlike the previous two years, Ordnance Factory Organisation generated surplus of receipts over expenditure. During 2010-11, the total receipts had registered an increase of ₹ 2414.68 crore as compared to the deficit of ₹ 1736.01 crore of 2009-10. There was an ultimate surplus of receipts amounting to ₹ 587.56 crore i.e. 5.38 *per cent*. However, our examination revealed that the total receipts were overstated by ₹ 2210.48 crore in 2010-11 due to incorrect practice of debiting the Armed Forces and other indentors for issues without actual physical issue of the items during the year ended 31 March 2011. This had consequently inflated the surplus amount for the year to the same extent.

In the revised estimates for 2011-12, net budgetary support from the Consolidated Fund of India after adjustment of Deduct Recoveries and Revenue Receipts has been pegged at ₹ 356.59 crore. For the year 2012-13, the net budgetary support has been estimated at ₹ (-) 535.09 crore, which is a surplus in accounting parlance.

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 been able to match the budget provision indicating less supply than anticipated. Against the budgeted supply of ₹ 9875 crore in 2010-11, the supplies booked

[5] Other receipts and recoveries includes receipt on account of transfer of RR funds, sale of surplus/obsolete stores, issues to MHA including Police, Central and State Governments, Civil trade including Public Sector Undertaking, export and other miscellaneous receipts.

were at ₹ 9825 crore registering a shortfall of ₹ 50 crore. In 2009-10, the shortfall was of ₹ 862 crore and in 2008-09 it amounted to ₹ 474 crore.

Review of the pattern of expenditure during 2010-11 revealed that the expenditure on Stores and Manufacture had decreased by ₹ 260 crore (4 *per cent*) and ₹ 66 crore (2 *per cent*) respectively in 2010-11 over that of 2009-10, while the same had increased on account of Other Expenditure by ₹ 75.92 crore (15 *per cent*), Works by ₹ 7 crore (15 *per cent*) and Research and Development by ₹ 8 crore (25 per cent) during the same period. During 2010-11, there was an opening balance of ₹ 98 crore at the beginning of the year under Renewal and Reserve Fund in the Public Account of India. The receipt/allocation was ₹ 600 crore and payment made was ₹ 208 crore (Minor Head 106 under Major Head 2079) and thus closing balance as on 31.3.2011 i.e unspent balance in RR Fund was ₹ 490 crore.

During 2010-11, in 21 cases, the issue prices were higher than the actual cost of production (COP), while in 12 other cases, the same were less than actual COP. These factors had direct impact on the quantum of receipts of Ordnance Factories and consequently the budgetary support. Ordnance Factory Board (OFB) needs to review the item-wise issue prices with reference to the actual COP so as to avoid situations of abnormal profits or huge deficits with consequential budgetary support. The budget provision of ₹ 11213 crore for such supplies in the year 2012-13, therefore, may prove to be very ambitious, unless prices of such supplies are revised sharply upwards.

Overall performance of Ordnance factories for the year 2010-11 has been analysed in this report at Chapter VIII.

1.13 Analysis of Capital Expenditure of Sub-Major Head-01-Army out of the Grant on Capital Outlay on Defence Services (Voted)

In 2009-10, Army spent ₹ 14796 crore against a Capital Outlay of ₹ 14562* crore leading to an excess expenditure of ₹ 234[6] crore. In 2010-11, it spent ₹ 15788 crore against an allocation of ₹ 14868 crore resulting in excess expenditure of ₹ 920[7] crore. Detailed analysis indicated that ₹ 3611.68 crore was mainly in the nature of advance payments for Akash missiles, Tatra Vehicles, Radars Schilka upgrade and two other Projects SAMVAHAK and SANJAY PH-II.

1.14 Capital expenditure (Voted) of Ordnance Factories and DRDO

The capital expenditure of Ordnance Factories during 2010-11 was ₹ 454 crore. Normally, expenditure on renewal and replacement in the ordnance factories are met from the Renewal and Replacement Fund created

*The figure adopted involves only Voted expenditure and differs from last year's report.

[6] Excess was calculated with reference to Budget estimates (i.e. Original Provision + Supplementary)-Actual Expenditure

[7] Excess was calculated with reference to Budget estimates (i.e. Original Provision + Supplementary)-Actual Expenditure

out of the revenue expenditure. During the year 2010-11, the amount transferred to the Renewal and Replacement Fund was ₹ 600 crore and the expenditure incurred from it was ₹ 208 crore only.

In the case of DRDO, the capital expenditure during 2010-11 was ₹ 4961 crore against a revenue expenditure of ₹ 5231 crore. The capital expenditure on DRDO was thus less by ₹ 270 crore (5.20%) than that of the revenue expenditure.

1.15 Rush of expenditure in the last quarter and March of the financial year

The Ministry of Defence (Finance/Budget) has, from time to time, issued instructions to maintain an even pace of expenditure throughout the year. Such instructions had, however, little effect on the pace of expenditure. The ratio of annual capital expenditure to the budget estimates for all the Services and Defence Research and Development Organisation (DRDO) was recorded at 44 and 38 *per cent*, respectively during the last quarter of 2010-11 against prescribed 33 *per cent.* 32 *per cent* of the expenditure to Budget estimates relating to Capital Outlay on Defence Services for all the services and 25 *per cent* under DRDO organisation took place in the month of March, at the fag end of the year, against the stipulated 15 *per cent*. Under Air Force and Ordnance Factory Grants, 18 *per cent* of the expenditure to Budget estimates was spent in the month of March.