

CHAPTER I: INTRODUCTION

1.1 About the Report

The office of the Principal Director of Audit, Air Force and Navy (PDA/AFN) was responsible for audit of the accounts and the financial transactions related to Indian Air Force, Indian Navy, Indian Coast Guard and associated Research and Development (R&D) laboratories of the Defence Research and Development Organisation of the Ministry of Defence, linked Military Engineer Services (MES) offices and integrated Defence Accounts Department units dealing with these services. Since 01 April, 2012, this office has been bifurcated into the office of the Principal Director of Audit, Air Force [PDA (AF)] and the office of the Principal Director of Audit, Navy [PDA (N)].

The audit conducted by these offices is of three distinct types: Financial Audit, Compliance Audit and Performance Audit.

Financial Audit is the review of financial statements of an entity that seeks to obtain an assurance that the financial statements are free from material misstatements and present a true and fair picture.

Compliance Audit scrutinises 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.

Performance Audit is an in-depth examination of a program, function, operation or the management system of entity to assess whether the entity is achieving economy, efficiency and effectiveness in the employment of available resources.

This report is on matters arising from the Compliance Audit and contains findings pertaining to capital and revenue acquisitions, installation/upgradation of systems and work services. Total financial value of cases commented upon in this report is ₹2446 crore. A brief financial analysis of the expenditure incurred on the Air Force, Navy, R&D (related to Air Force

and Navy) and Coast Guard as a part of the over-all defence budget of the country has also been included.

1.2 Authority for audit

Article 149 of the Constitution of India and the Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971 govern the scope and extent of audit. Detailed methodology of audit and reporting is prescribed in the 'Regulations of Audit and Accounts, 2007'.

1.3 Planning and conduct of audit

Audit areas are prioritised through an analysis of risks so as to assess their criticality in key operating units. Expenditure incurred, operational significance, past audit results and internal control issues are amongst the prime factors which determine the severity of the risks. This exercise in turn guides the formulation of the annual audit programme. The number of units selected for audit is determined by matching the high-risk areas with available resources. Besides, high-value capital acquisitions and procurements are audited by specially constituted dedicated teams.

In general, interaction with the audited entity is encouraged from the initial stage in the auditing process. Audit findings are communicated during discussions at the end of an audit exercise and followed up in writing through local test audit reports/statements of case. The response from the audited entity is considered and results in either settlement of the audit observation or referral to the next audit cycle for compliance. Some of the more serious irregularities are processed for inclusion in the audit reports which are submitted to the President of India under Article 151 of the Constitution of India, for laying them before each House of Parliament.

At present, the audit universe of these offices comprises of 850 units. During 2010-11, audit of 254 units/formations was carried out by using 9,752 man days.

1.4 Internal control and co-ordination between Internal and External audit

The Finance Division of the Ministry of Defence is headed by the Secretary (Defence/Finance)/Financial Adviser (Defence Services) (FADS) who is responsible for financial scrutiny, vetting, advice and concurrence of all proposals of the Ministry of Defence. FADS is also responsible for internal

audit and for accounting of the defence expenditure. Internal financial advice is provided both at the Service Headquarters level as also at levels of Command Headquarters and other units. Internal financial control is further aided by periodic internal audit by the Controller General of Defence Accounts (CGDA), the Head of the Defence Accounts Department, who functions under the FADS. The Principal Controllers of Defence Accounts, Air Force and Navy functioning under CGDA are located at Dehradun and Mumbai respectively. They are responsible for internal audit, financial advice at unit level and for scrutiny, payments and accounting of all personnel claims and bills for supplies and services rendered, construction, repair works, miscellaneous charges etc. received from Air Force and Navy/Coast Guard units.

The internal audit is expected to ensure effective implementation of the rules, procedures and regulations enunciated in the Defence Procurement Procedure, Manuals, Codes, etc. The offices of PDA (AF) and PDA (N) actively seek assistance and co-operation from internal audit in audit examination and scrutiny. Internal auditors have to carry out 100 *per cent* checks. The external/statutory audit bases its audit on sample/test check. The inspection reports (IRs) generated by external audit on the basis of local audit are issued to the audited entities as well as to their internal auditors i.e. Defence Accounts Department. These IRs are pursued to their logical conclusion after ascertaining the views of the internal auditors. Draft paragraphs proposed to be included in the audit report are sent to the Defence Secretary. Simultaneously, a copy is also forwarded to CGDA. The Ministry furnishes its response only after vetting by the FADS.

1.5 Profile of audited entities

1.5.1 Organisation – Key responsibilities

The Ministry of Defence at the apex level frames policies on all defence related matters in consultation with the Finance Division. The Ministry 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 functions as the Head of the Department of Defence and is also responsible for coordinating the activities of other departments.

The Indian Air Force is headed by the Chief of the Air Staff. Air Headquarters (Air HQ) is the apex body and chief management organisation

of the Indian Air Force. The ultimate and overall administrative, operational, financial, technical maintenance and control of IAF rests with Air HQ. Operational and maintenance units of IAF normally consist of wings and squadrons, signal units, base repair depots and equipment depots.

The Indian Navy is headed by the Chief of the Naval Staff. Naval Headquarters (NHQ) is the apex body and chief management organisation and is responsible for command, control and administration of the Indian Navy. Operational and maintenance units of Indian Navy consist of warships and submarines, dockyards, naval ship repair yards, equipment depots and material organisations.

The Coast Guard was created to protect the country's vast coastline and offshore wealth. The Director General, Coast Guard exercises general superintendence, direction and control of the Coast Guard.

Military Engineer Services (MES) is one of the largest Government construction agencies. Engineer-in-Chief is the head of the MES. The MES is responsible for conclusion of contracts, execution of work services and maintenance of existing buildings of the Armed Forces. It works under the Engineer-in-Chief Branch of Army Headquarters.

The Defence Research and Development Organisation undertakes design and development of weapon systems and equipment in accordance with the expressed needs and the qualitative requirements laid down by the services. Certain laboratories are dedicated exclusively to Air Force and Navy like the Gas Turbine and Research Establishment (GTRE), Electronics and Radar Development Establishment (LRDE), Centre for Airborne System (CABS), Naval Science and Technological Laboratory (NSTL), Naval Physical and Oceanographic Laboratory (NPOL) and Naval Materials Research Laboratory (NMRL), etc. These organisations also render scientific advice to the Service Headquarters. They work under the Department of Defence Research and Development of the Ministry of Defence.

The Defence Accounts Department is headed by the Controller General of Defence Accounts who provides services to the armed forces in terms of financial advice and accounting of defence services receipts and expenditure as well as defence pensions.

1.6 Significant audit observations

We have, over the years, commented on many critical areas of defence pertaining to Indian Air Force, Indian Navy, Indian Coast Guard and dedicated R&D projects. The Ministry of Defence, on its part, has taken several measures in response to these observations. An important step taken to

improve procurement procedures has been the introduction of Defence Procurement Procedure and Defence Procurement Manual and their regular updation.

The present Audit Report points out significant deficiencies/shortcomings in the procurement processes followed - both under the capital and revenue heads - by the Ministry of Defence as well as by the Services. The report highlight cases where there have been deviations from the prescribed procedures. In the case of offsets, out of 16 offset contacts worth ₹18,444.56 crore concluded between 2007 and 2011, in five offset contracts worth ₹3,410.49 crore ready built equipment without any value addition through the Indian Offset Partners (IOPs) were accepted as offsets, which was not in consonance with the offset provisions as prescribed in the Defence Procurement Procedure. This was largely due to varying interpretation of various authorities about the legitimacy or otherwise of the offsets being offered (Paragraph 2.1). In the case of procurement of 12 Air Cushion Vehicles worth ₹223.26 crore for the Indian Coast Guard, procurement was made in deviation of the prescribed procedure which denied a level playing field to the prospective vendors (Paragraph 5.1).

The report highlights cases involving substantial expenditure in which either the procurement has been delayed or has failed to achieve its objective. In the case of procurement of 336 RWRs (Paragraph 2.2), IAF failed to derive intended benefits out of an investment of ₹521 crore as the performance of the integrated RWRs was found unsatisfactory leading to a decision to integrate these RWRs as an interim measure till development of an advanced system. In another case, the Indian Navy could derive no tangible benefits from an investment of ₹167.64 crore made about a decade back, on procurement of a system for commissioning on board four submarines. Only two of these systems could be commissioned in 2011, which, in turn, impacted the operational preparedness of the Indian Navy (Paragraph 2.3). Delays in processing the case for procurement of Electro Optic Devices for Dorniers of the Indian Navy led to an avoidable expenditure of ₹10.95 crore (Paragraph 2.4).

Instances of violation of contractual terms and disregard of instructions have also been reported. Failure of the IAF/MoD to adhere to the contractual provisions under an option clause for procurement of spares resulted in an extra expenditure of ₹9 crore (Paragraph 3.3). Indian Navy failed to correctly

indicate the part number of a Navigation Computer for helicopter 'A' which led to procurement of two unsuitable Navigation Computers costing ₹2.28 crore (Paragraph 4.1).

Several cases have been highlighted where greater vigil on the part of the department was required. For instance, failure to synchronise creation of a critical test facility with the procurement of equipment led to continuous disuse of equipment worth ₹10.72 crore for over three years (Paragraph 4.4). Delay in finalising the contract for overhaul/total technical life extension of an aircraft resulted in an extra expenditure of ₹87.52 crore besides hampering the operational capability of IAF (Paragraph 3.1). A recovery of ₹28.78 crore was effected from Cochin Shipyard Limited at our instance (Paragraph 2.6).

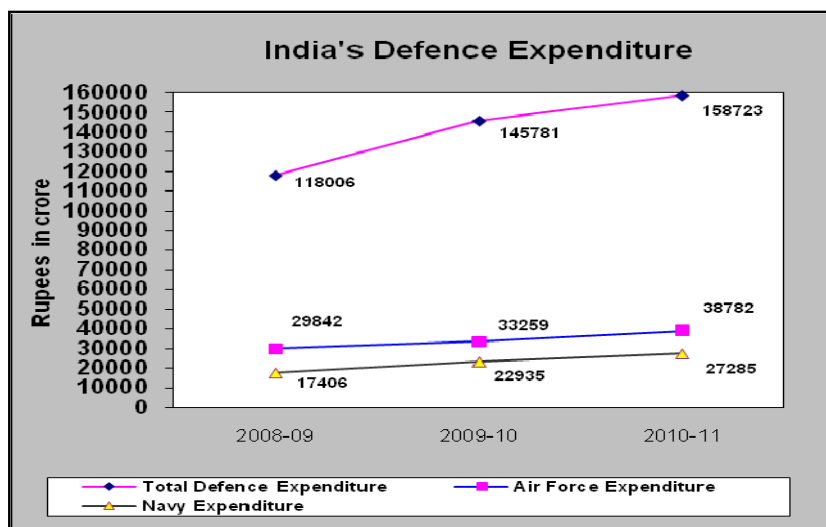
1.7 Financial aspects relating to Air Force and Navy

India's defence budget is broadly categorised under revenue and capital expenditure. While revenue expenditure includes pay and allowances, stores, transportation and work services, capital expenditure covers expenditure on acquisition of new weapons and ammunition and replacement of obsolete stores with current items.

The defence expenditure increased by 8.87 *per cent* from ₹1,45,781 crore in 2009-10 to ₹1,58,723 crore in 2010-11. The share of the Indian Air Force and the Indian Navy in the total expenditure on Defence Services in 2010-11 was ₹38,782 crore and ₹27,285 crore respectively, which together constituted approximately 41.62 *per cent*.

1.7.1 Defence Expenditure

The defence expenditure, as depicted above, does not include the expenditure on the pension paid to retired defence personnel and expenditure incurred on Defence Accounts Organisation, Defence Estates Organisation, Secretariat of the Ministry of Defence, Defence Canteens and the Coast Guard Organisation. As a percentage of GDP, the defence expenditure has shown slight downward trend during this period from 2.34 *per cent* to 2.12 *per cent* as shown in the following graph.



Historically, revenue expenditure accounts for the bulk of the defence budget. Out of the total defence expenditure, the share of revenue expenditure has gone down from 65.32 per cent in 2008-09 to 60.90 per cent in 2010-11, while the share of capital expenditure has gone up from 34.67 per cent to 39.09 per cent during the same period as shown in the following table.

Defence Expenditure

(₹ in crore)

Year	Annual Expenditure			Percentage increase over previous year	Expenditure as percentage of CGE	Expenditure as percentage of GDP
	REVENUE	CAPITAL	TOTAL			
2008-09	77,088	40,918	1,18,006	24.09	12.72	2.15*
2009-10	94,669	51,112	1,45,781	23.53	13.88**	2.34*
2010-11	96,667	62,056	1,58,723	08.87	13.29**	2.12**

CGE - Central Government Expenditure

* - Revised Estimates

** - Budget Estimates

1.7.2 Air Force and Navy Expenditure

The total expenditure incurred by the Indian Air Force and Navy during 2008-2011 ranged between 40.03 and 41.62 *per cent* of the total defence expenditure. In the year 2010-11, while the expenditure of the Indian Air Force rose by 16.60 *per cent* from ₹33,259 crore to ₹38,782 crore, the expenditure of the Indian Navy increased by 18.96 *per cent* from ₹22,935 crore to ₹27,285 crore, as compared to the previous year. The distribution of defence expenditure is depicted in the following table.

(₹ in crore)

Year	DISTRIBUTION OF DEFENCE EXPENDITURE						Total
	Army	Air Force	Navy	Ordnance Factories	R&D	Others	
2008-09	59,688	29,842	17,406	3,309	7,761	Nil	1,18,006
2009-10	77,556	33,259	22,935	3,521	8,510	Nil	1,45,781
2010-11	80,830	38,782	27,285	1,532	10,197	97	1,58,723

1.7.3 Air Force Expenditure

A broad summary of the expenditure of the Indian Air Force is given in the table below.

Air Force Expenditure

(₹ in crore)

Year	Total	Percentage change over previous year	As a percentage of total Defence Expenditure	Revenue	Capital
2008-09	29,842	(+)24.08	25.29	13,244	16,598
2009-10	33,259	(+)11.45	22.81	14,708	18,551
2010-11	38,782	(+)16.60	24.43	15,179	23,603

1.7.3.1 Capital Expenditure

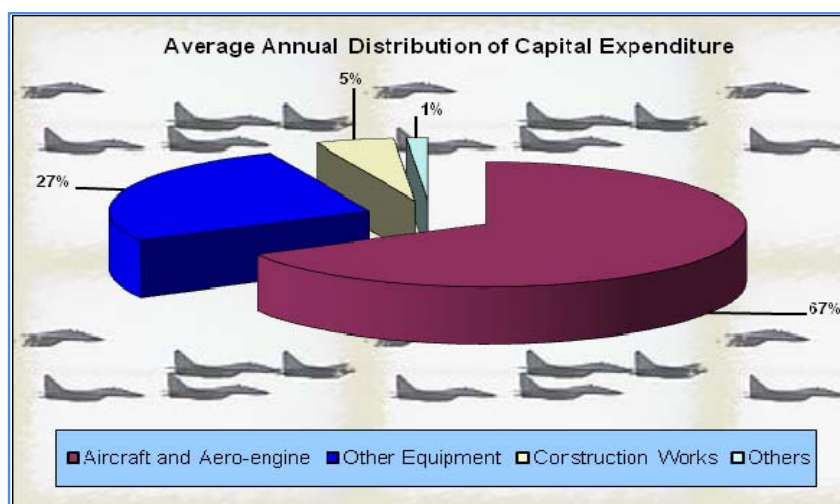
The capital expenditure on the Indian Air Force rose by nearly 42.20 per cent during 2008-09 to 2010-11. In absolute terms, capital expenditure increased from ₹16,598 crore in 2008-09 to ₹23,603 crore in 2010-11.

The capital expenditure of the Indian Air Force was mainly incurred on acquisition of new aircraft and modernisation/upgradation of the existing aircraft. The average annual distribution of expenditure over the different categories for the last three years is depicted below in the table as well as in the graph.

Capital Expenditure

(₹ in crore)

Year	Aircraft and Aero-engine	Construction work	Other equipment	Others	Total
2008-09	11,268	817	4,304	209	16,598
2009-10	12,097	905	5,317	232	18,551
2010-11	16,094	1,158	6,039	312	23,603



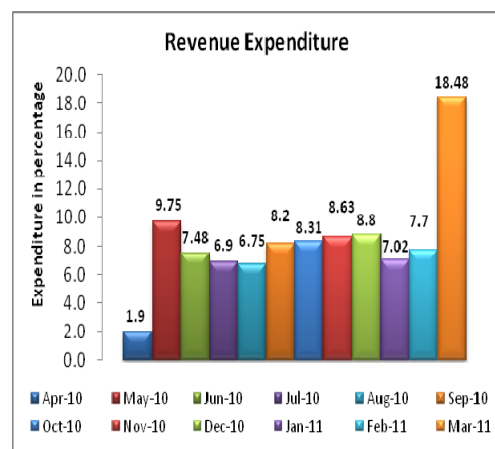
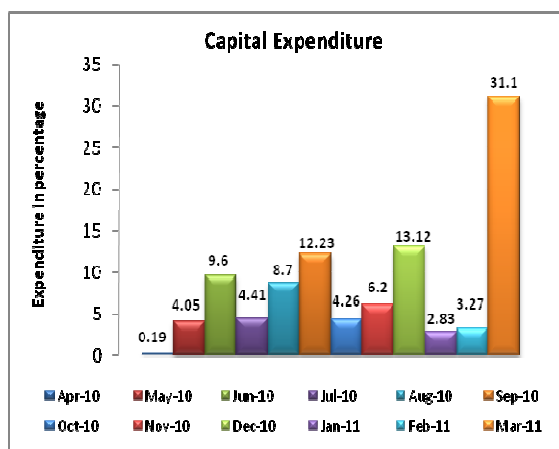
1.7.3.2 Revenue Expenditure

During the last three years, revenue expenditure of the Indian Air Force increased by 14.61 *per cent* from ₹13,243 crore in 2008-09 to ₹15,179 crore in 2010-11. The revenue expenditure of the Indian Air Force was mainly incurred on stores and special project, transport, works and pay and allowances. The average annual distribution of expenditure over different categories for the last three years is depicted below.

Revenue Expenditure
(₹ in crore)

Year	Pay and allowances	Stores and special project	Works	Transport	Others	Total
2008-09	4,681 (35%)	6,820 (52%)	1,317 (10%)	249 (2%)	176 (1%)	13,243
2009-10	6,971 (47%)	5,640 (38%)	1,560 (11%)	358 (3%)	179 (1%)	14,708
2010-11	6,856 (45%)	5,775 (38%)	1,692 (11%)	620 (4%)	236 (2%)	15,179

The flow of capital and revenue expenditure during the year 2010-11 is indicated below.



Scrutiny of expenditure revealed that there was a substantial increase in the capital expenditure of the Indian Air Force in the month of March 2011. The Indian Air Force incurred about 31.10 *per cent* of the capital expenditure in

the month of March 2011 alone and 37.21 per cent of the capital expenditure in the last quarter of the financial year. This shows poor expenditure management by the Air Force and is in deviation from the Guidance of the Ministry of Finance which enjoins that expenditure during the month of March should be limited to 15 per cent of budget estimates, and the last quarter spending should not be more than one third of the budget. The flow of revenue expenditure also fluctuated considerably over the months.

1.7.4 Indian Navy Expenditure

A broad summary of the expenditure of the Indian Navy is given in the table below.

Navy Expenditure

(₹ in crore)

Year	Total	Percentage change over previous year	As a percentage of total Defence Expenditure	Revenue	Capital
2008-09	17,406	(+) 8.44	14.75	7,949	9,457
2009-10	22,935	(+)31.76	15.73	9,587	13,348
2010-11	27,285	(+)18.96	17.19	10,145	17,140

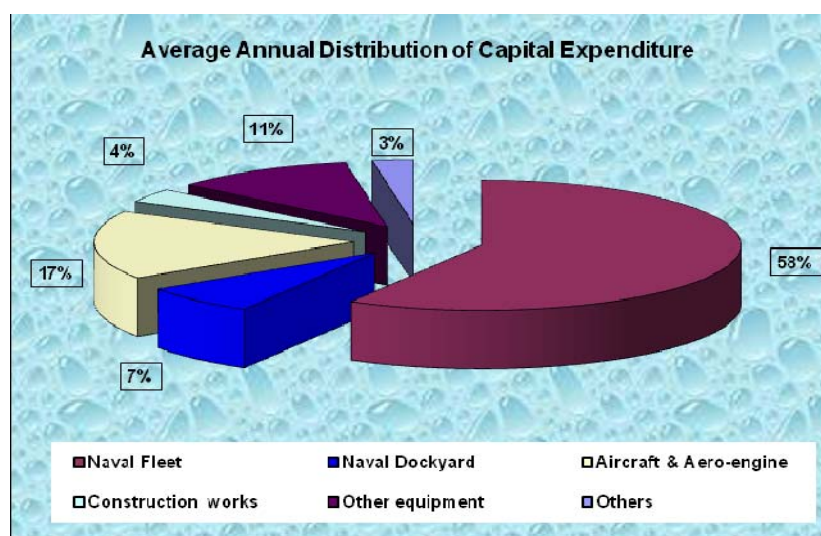
1.7.4.1 Capital Expenditure

The capital expenditure of the Indian Navy increased by 28.40 per cent primarily on account of acquisition/construction/upgradation. The average annual distribution of expenditure over different categories for the last three years is depicted below in the table as well as in the graph.

Capital Expenditure

(₹ in crore)

Year	Naval Fleet	Naval Dockyard	Aircraft and Aero-Engine	Construction Works	Other Equipments	Others	Total
2008-09	5,404	1,164	538	406	1,716	229	9,457
2009-10	7,460	720	3,603	308	868	389	13,348
2010-11	10,620	720	3,187	637	1,578	398	17,140



1.7.4.2 Revenue Expenditure

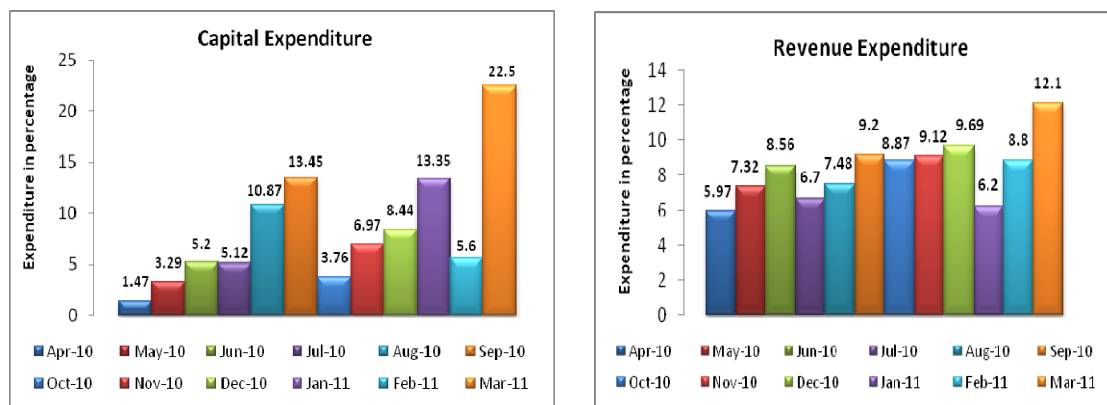
During the last three years, the revenue expenditure of the Indian Navy increased by 27.62 per cent from ₹7,949 crore in 2008-09 to ₹10,145 crore in 2010-11. The revenue expenditure of the Indian Navy was mainly incurred on stores and special project, transport, works, repairs and refit of aircraft carriers/frigates/other warships and pay and allowances. The average annual distribution of expenditure over different categories for the last three years is depicted below.

Revenue Expenditure

(₹ in crore)

Year	Pay and allow- Ances	Stores	Works	Trans- port	Repair/ Refit	Others	Total
2008-09	2,714 (34%)	2,967 (37%)	632 (8%)	180 (2%)	525 (7%)	931 (12%)	7,949
2009-10	3,971 (41%)	2,957 (31%)	645 (7%)	233 (2%)	572 (6%)	1,209 (13%)	9,587
2010-11	3,731 (37%)	3,437 (34%)	701 (7%)	288 (2%)	606 (6%)	1,382 (14%)	10,145

The flow of capital and revenue expenditure during the year 2010-11 is indicated below.



Scrutiny of expenditure revealed that a substantial portion of capital expenditure was incurred by the Indian Navy in the month of March 2011. Navy incurred about 22.48 *per cent* of the capital expenditure in the month of March 2011 alone and 41.41 *per cent* of the capital in the last quarter of the financial year. This reflects poor expenditure management by the Indian Navy and is in deviation from the Guidance of the Ministry of Finance which enjoins that expenditure during the month of March should be limited to 15 *per cent* of budget estimates, and the last quarter spending should not be more than one third of the budget. Revenue expenditure also fluctuated considerably over the months.

1.8 Coast Guard Organisation

The budgetary allotments and expenditure incurred during the last three years are tabulated below.

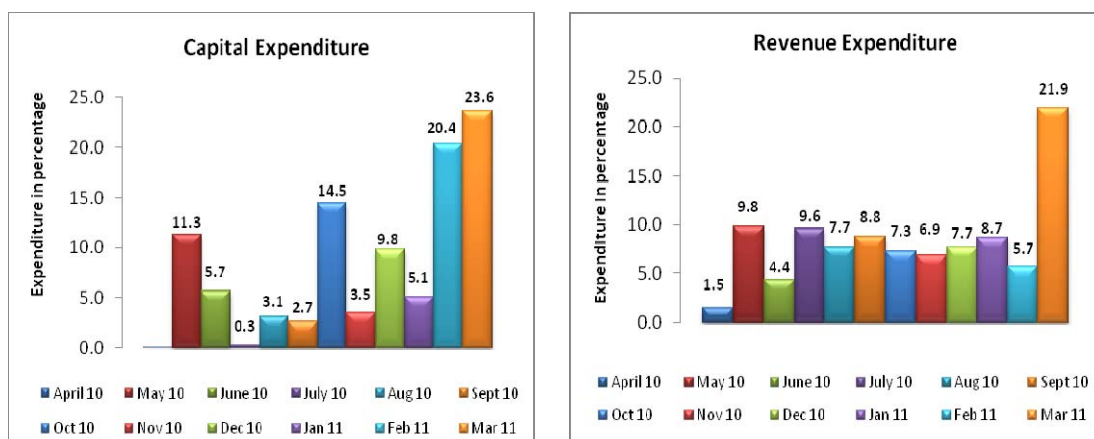
Coast Guard Expenditure

(₹ in crore)

Year	Budget Estimates			Final Grant/ Appo-Privation	Expenditure			Percent- age of BE which could not be utilised
	Capital	Revenue	Total		Capital	Revenue	Total	
2008-09	949.63	520.17	1,469.80	1,090.18	506.43	520.71	1,027.14	30.11
2009-10	1,300.42	604.37	1,904.79	1,525.72	908.05	621.10	1,529.15	19.72
2010-11	1100.00	882.45	1982.45	2,016.06	1200.78	813.57	2014.36	(-) 01.61

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The flow of capital and revenue expenditure during the year 2010-11 is indicated below.



Scrutiny of expenditure revealed that a substantial portion of capital expenditure was incurred by the Coast Guard in the month of March 2011. The Coast Guard incurred about 23.60 *per cent* of the capital expenditure in the month of March 2011 alone and 49 *per cent* of the capital in the last quarter of the financial year. This reflects poor expenditure management by the Coast Guard. Revenue expenditure also fluctuated considerably over the months.

1.9 Receipts of the Air Force, Navy and Coast Guard

The details of receipts and recoveries pertaining to the Indian Air Force and the Indian Navy and the Coast Guard during the last three years for the services that they provided to other organisations/departments are given in the table below.

Revenue Receipt

(₹ in crore)

Year	Receipt and Recoveries in respect of Air Force	Receipt and Recoveries in respect of Navy	Receipt and Recoveries in respect of Coast Guard
2008-09	570.50	158.02	11.60
2009-10	468.13	241.30	31.09
2010-11	592.92	175.00	13.33

1.10 Appropriation and expenditure

The summarised position of appropriation and expenditure during 2008-09 to 2010-11 in respect of the Air Force and the Navy is reflected in the table below.

Appropriation and Expenditure

(₹ in crore)

AIR FORCE									
	Final Grant	Actual Expend-iture	Total Excess/ Savings (+) / (-)	Final Grant/	Actual Expend-iture	Total Excess/ Savings (+) / (-)	Final Grant/	Actual Expend-iture	Total Excess/ Savings (+) / (-)
REVENUE	2008-2009			2009-10			2010-11		
Voted	12,632.21	13,242.58	(+) 610.37	15,271.84	14,707.05	(-)564.79	15802.41	15177.70	(-) 624.71
Charged	2.04	0.79	(-) 1.25	2.91	1.170	(-)1.74	2.13	1.00	(-) 1.13
CAPITAL									
Voted	16,539.12	16,591.21	(+) 52.09	18,624.97	18,542.76	(-)82.21	23537.99	23575.91	(+) 37.92
Charged	5.81	6.98	(+) 1.17	11.10	8.01	(-)3.09	26.77	27.66	(+) 0.89
Total	29,179.18	29,841.56	(+) 662.38	33,910.82	33,258.99	(-) 651.83	39,369.30	38,782.27	(-) 587.03
NAVY									
REVENUE	2008-2009			2009-10			2010-2011		
Voted	8,190.56	7,948.42	(-)242.14	9,435.70	9,586.21	(+)150.51	10002.52	10141.36	(+)138.84
Charged	1.63	0.36	(-)1.27	4.23	0.88	(-)3.35	7.45	3.33	(-)4.12
CAPITAL									
Voted	9,195.86	9,454.86	(+) 259.00	13,284.33	13,272.36	(-)11.97	16898.32	17136.09	(+) 237.77
Charged	8.40	2.39	(-) 6.01	74.87	75.45	(+) 0.58	6.95	4.08	(-)2.87
Total	17,396.45	17,406.03	(+) 9.58	22,799.13	22,934.90	(+) 135.77	26915.24	27284.86	(+)369.62

An analysis of the Appropriation Accounts, Defence Services for each of the three years has been included in the Report of the Comptroller and Auditor General of India for the relevant years, Union Government – Accounts of the Union Government.

1.11 Audit impact

1.11.1 Response of the Ministry to Draft Audit Paragraphs

On the recommendations of the Public Accounts Committee (PAC), the Ministry of Finance (Department of Expenditure) issued directions to all the

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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 proposed for inclusion in this Report were forwarded to the Secretary, Ministry of Defence between October 2011 and February 2012 through demi-official letters drawing attention to the audit findings and requesting a response within six weeks.

Despite the instructions of the Ministry of Finance issued at the instance of the PAC, the Ministry did not send replies to 7 Draft Paragraphs out of 20¹ Paragraphs included in this Report. Thus, the response of the Ministry could not be included in respect of these paragraphs.

1.11.2 Action Taken Notes on Audit Paragraphs of earlier Reports

With a view to enforce 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 laying of the Report in Parliament.

Review of outstanding ATNs on Audit Paragraph relating to the Air Force, Navy and Coast Guard as on 30 September 2012 showed that the Ministry had not submitted the initial ATNs in respect of 10 out of 43 paragraphs included in the Audit Reports up to and for the year ended March 2010 as shown in Annexure.

1.11.3 Outcome

Findings of earlier reports have resulted in various procedural changes in Defence Procurement Procedure as well as systemic changes in operations of the audited entities. In addition, each year's audit also results in savings and recoveries. During last three years, recoveries to the extent of ₹62.47 crore (₹28.78 crore in respect of current Audit Report) and savings to the extent of ₹6.18 crore (₹1.30 crore for current Audit Report) were effected at the instance of Audit.

¹ The introductory remarks included in Chapter I of this report were not forwarded to Ministry for their comments.