

Chapter IX: Internal Control

Audit objectives

Whether the existing internal control system was adequate and effective.

Source of audit criteria

- *Minutes of the meetings of the OFB; and*
- *Management Information System/Internal Audit Manual.*

9.1 General

Presence of and adherence to a robust internal control system minimise risk of errors and irregularities in operational and financial matters and provides assurance in matters relating to accounting, financial reporting and overall efficiency of the factories' operations. Important facets of existing controls in OEFG are as under:

- Review and monitoring of activities by the GM of the factory, OEF HQ and OFB;
- Management information system;
- Internal Audit; and
- Vigilance.

Apart from the weaknesses pointed out in Chapters III to VIII, the following additional instances substantiate the control weaknesses in OEFG.

9.2 Control failure in manufacture

Paragraph 601 of DAD OM requires Ordnance Factories to prepare standard estimate which provides the quantum of material and labour hours required to manufacture certain quantity of an item inclusive of an allowance for unavoidable rejection in manufacturing process. As per Paragraph 621 of DAD OM, General Manager is required to issue 'manufacture and material warrant' to the production shop concerned for manufacture of an item by drawal of labour and material as per estimate and the ordered quantity. The warrant is required to be executed and closed within a period of six months. Further, Paragraph 57 of DAD OM provides that the warrant along with the standard estimate forms the main instrument for control over utilisation of labour and material on an individual job or batch.

We observed failure of such controls in OEFG resulting in irregular booking of labour and material, concealment of rejections, non-regularisation of losses. Significant instances of such deficiencies are discussed in the succeeding paragraphs.

9.2.1 Irregular booking of labour charges

Scrutiny of closed warrants revealed that there were irregular booking of labour and proportionate overhead expenditure even after closure of the warrants during 2008-09, 2009-10 and 2011-12 in OCFS, OCFA and OEFH and during 2008-09 and 2009-10 in OEFC and OPF as summarised in Table-39.

Table-39: Excess booking of labour and overhead

Factory	Number of closed warrants	Expenditure booked after closure of warrants (₹ in crore)		
		Labour	Overhead proportionate to labour	Total
OEFC	375	4.11	6.37	10.48
OCFS	664	2.94	4.25	7.19
OCFA	139	7.10 (including overhead)	Break-up not available	7.10
OPF	47	0.48	0.73	1.21
OEFH	21	0.36	0.61	0.97
Total	1246			26.95

The excess and irregular booking of expenditure of ₹26.95 crore towards labour and overhead in respect of 1246 closed warrants reflects failure of internal control mechanism, as the computer system allowed booking beyond the warrant quantity after its closure and the officers responsible to monitor the system failed to plug this loopholes. The Accounts Office (AO) of OPF had pointed out (January 2011) this irregularity to the General Manager and impressed upon him to examine the matter and intimate the reasons for such irregular practice. However, General Manager did not examine the matter nor did he place on record the corrective action taken to stop this irregular practice.

Justifying the booking of labour and overhead charges, the Ministry stated that Planning, Production and Control (PPC) system did not allow booking of excess labour/material than the authorised quantity and further booking was not allowed on closed warrants. The contention is not acceptable because

audit evidence in support of irregular booking of labour /overhead in factory accounts after closure of warrants disproves the contention of the Ministry.

OCFS paid (May-September 2010) ₹17.45 crore to the piece workers for 14.70 lakh SMH against 599 manufacturing warrants which were non-existent as per records of Accounts Office. Despite this being pointed out repeatedly by AO, OCFS, the factory management had not taken any corrective action to set right this deficiency as well as to recover the excess payment made to the piece workers (PW).

Justifying the payment to the piece workers, the Ministry stated that sometimes PW payment of current month reflects the warrants issued in the starting of the month over and above the old warrants.

The reply does not reflect seriousness of the Ministry as the practice of making payment of PW wages against non-existent warrants was persisting despite repeatedly being pointed out by AO, OCFS. Being a matter of serious concern, it needs in-depth examination/ investigation by OFB/ factories to fix the responsibility for the continued irregularity.

9.2.2 Manufacture with excess or without drawal of material

Factory manufactures an item by drawing material as per standard estimate which provides the quantum of material required to manufacture certain quantity of the item with an allowance for unavoidable rejection (UAR). A test check of records revealed instances of manufacture of certain items with excess drawal of materials or without drawal of material. Details of a few such cases are discussed below:

- At OEFC, three items (two types of fabric and aluminium alloy tube) valuing ₹4.60 crore were drawn in excess over the authorised quantity provided in the warrants for manufacture of Tent 4M though the involved warrants (29 numbers) showed no excess booking.
- OCFS manufactured 21,621 shirts (PV DD OG) and 1000 coats (ECC) in March 2011 against four manufacture warrants even without drawal of certain input materials and issued the items to the Army also by March 2011, which is practically impossible.

- OCFS manufactured 4883 blanket barrack (natural grey) during April, November 2011 and March 2012 against 12 warrants without drawal of any material and issued to the Army by March 2012.

The Ministry/OFB's replies and our comments are given in Table-40.

Table- 40: Ministry/OFB's replies and Audit comments

Ministry/OFB's reply	Audit comments
<p>At OEFC, materials drawn in excess were transferred to complete other warrants of smaller quantity of the Tents through transfer vouchers.</p> <p>At OCFS, 3 warrants for shirt PW PV DD OG were shown in the list of semi warrants for 2011-12. Cut components available against other warrants were drawn on sectional D-Note and utilised for production on these warrants. For Coat ECC, warrant is still outstanding for price issue voucher/despatch leaving it operational for 2011-12.</p>	<p>No document was made available to Audit regarding preparation of transfer vouchers on or before the closure of the warrants. Besides, the transfer voucher was for subsequent adjustment. Hence, it can no way justify over-drawal of stores due to lapses in material control.</p> <p>The reply itself indicates that all the items were not actually manufactured in the targeted year 2010-11 but the same were projected as manufactured and issued (even without drawing the materials).</p>

9.2.3 Non-regularisation of losses

We came across instances of lack of documentation in regard to losses due to rejection, non-monitoring of wastages, *etc.* in two factories, which are attributable to inadequate internal control by the factory managements and Accounts Offices. A few cases are discussed below:

- There was no provision of UAR percentage in the estimate of Socks Men Wool Heavy Khaki at OPF. Our examination for the period 2008-11 showed that 8,500 kg unserviceable socks wool worth ₹23.36 lakh were returned by the production shop for disposal. Based on average requirement of 0.1729 kg wool for one pair socks, at least 49,161 pair socks worth ₹56.54 lakh could have been manufactured, had the wool not been declared unserviceable during manufacturing process.
- During April 2008 to December 2010, OPF had generated a reported wastage of 9000 kg yarns as against the permissible quantum of 2538.38 kg as per estimate. Hence, wastage of 6461.62 kg yarn worth ₹21 lakh had been generated over the prescribed limit. No action was taken to investigate the circumstances leading to excess wastage.

- OCFS manufactures blanket using yarn 450 Texture (+50/-25) procured from trade. There were instances of excess consumption of the yarn (costing ₹4.79 crore) during 2006-07. A fact finding inquiry (FFI) had in 2007 found that incorrect material estimate and manufacture of overweight blanket were a few reasons for the excess consumption leading to shortage of 5.81 lakh kg yarn. Subsequently, the factory resorted to excess (10 *per cent*) provision of yarn instead of procuring yarn with 425±25 count as recommended by the FFI team in 2007. The excess provision of yarn involved extra expenditure of ₹11.95 crore during 2009-11.

The Ministry stated that there was no failure of internal control at OCFS and that none of the materials was drawn in excess over the authorised quantity in respect of blanket. It added that loss statement for regularisation of shortage of 2.62 lakh kg yarn was awaiting concurrence of the Accounts Office. However, the Ministry did not specify the reasons for the variation in the actual loss as worked out by FFI and by the factory management.

9.3 Monitoring by top level management

The Rules for the conduct of the business of OFB stipulate that the Board would ordinarily meet once a fortnight but it would be open to the Chairman to summon a meeting at any time should he consider it necessary. Effective and viable running of factories largely depends on the efficient monitoring by the OFB. The meetings of the OFB were held once in every month to discuss the different issues related to the activities of all the ordnance factories. As stated in this Report, the OEFG suffered from persistent deficiencies *viz.* improper fixing of targets, faulty assessment of requirement while provisioning of materials, sub-optimal production performance, under-utilisation of capacity, outsourcing, absence of reliable quality control mechanism, lack of efficient pricing mechanism, recurring losses and absence of cost control. These had also adversely impacted the supply chain of GS&C items from factories to the Army depots. Despite these persistent deficiencies, we observed that in none of the 49 meetings held during 2008-12, except one, did the OFB address these deficiencies and recommend the remedial actions to overcome the shortcomings in the operation of these factories so as to ensure efficient and optimal functioning of the factories. Thus, the monitoring of the top level management was inadequate.

9.4 Audit conclusion

Ineffective internal control led to booking of labour charges on closed/non-existent warrants, drawing of excess/less input materials than that authorised for production of finished items and generating excess wastage during manufacturing process. Further, there was no adequate system in place for checking of documents relating to cost-data, financial reporting and production by the factory management/OFB for efficient functioning of factories. The monitoring by the top level management on the working of the OEFG was also inadequate.

Recommendation 17

Ministry may ensure that the OFB and the factories strengthen their internal controls and monitoring mechanisms, especially in planning and production, accounting and documentation of the related activities.

Recommendation 18

A comprehensive and effective internal control system must be put in place by the OEFG to avoid irregularities in booking of labour charges and manufacture with excess or without drawal of materials.

Chapter X: Conclusions

The Performance Audit of OEFG focussed on shortcomings in areas of production planning, procurement, manufacture and issue of GS&C items to the Services, quality control and underutilisation of resources and losses in issues. Fixing of production targets suffered from systemic deficiencies like delayed target fixation meeting, lack of coordination between DGOS and OEF HQ about flow of reliable information of item-wise capacity from factories, fluctuation of targets and their mismatch with capacity of factories. These flaws in the basic planning led to adverse impacts on the chain of activities in a cascading manner.

We also highlighted flouting of procurement norms as well as instructions of the Ministry/OFB by OEFG. This led to over-provisioning of stores, lack of transparency in procurement of stores through LTE at higher rates instead of OTE as well as procurement at higher rates beyond eight *per cent* of LPR, abnormal slippages in placing orders, failure to break the cartel among the vendors.

Shortfalls in production and issue of GS&C items by these factories have been recurring. Even after outsourcing, the issue targets were not entirely met. These factories were yet to gear up their planning and production performance to synchronise with the overall requirements of the Services and paramilitary forces.

The systemic loopholes in deployment of direct IEs not commensurate with the workload and working of machines on single shift led to payment of overtime in a routine manner as well as gross under-utilisation of machine-hours in all the factories. Inadequate quality controls by these factories resulted in significant quantum of RFR cases and final rejections of finished products at quality assurance stage. Persistent consignee end rejections and customers' complaints also highlighted failure of quality control in factories and quality assurance. These shortcomings were not addressed effectively to ensure users' satisfaction and comfort.

Existing pricing mechanism of OFB and ineffective cost control by the factories are also of grave concern as the factories incurred losses in issue of the products to the indentors every year aggregating ₹226.09 crore during 2008-12.

This Report also brings out inadequacies in top level monitoring to the extent that OFB neither addressed the deficiencies in the operations of these factories in their meetings held during 2008-12 nor did it direct the factory managements to take the corrective actions to ensure the efficient operation of these factories.

Viewed from the perspective of the Services and Paramilitary forces' requirements of GS&C items and competitive market scenario, the Ministry, OFB and the factory management should thoroughly review the present style of their functioning so as to overcome the existing deficiencies/drawbacks. There is an urgent need to take proactive action considering the recommendations made in this Report so that the OEEG can function viably and competently to meet the requirements of the indentors with due regard to quality, quantity and timeliness and also to ensure sustainable supply chain management for defence preparedness.

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