

# *Aerospace & Defence Related Crimes*

4 September, 2016



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## *Key Messages*

Key characteristics of A&D industry makes it vulnerable to economic crimes



Globally, economic crime in the Aerospace and Defence sector is one of least reported in comparison to other sectors



Government has continuously focussed on making procurement transparent, but challenges remain

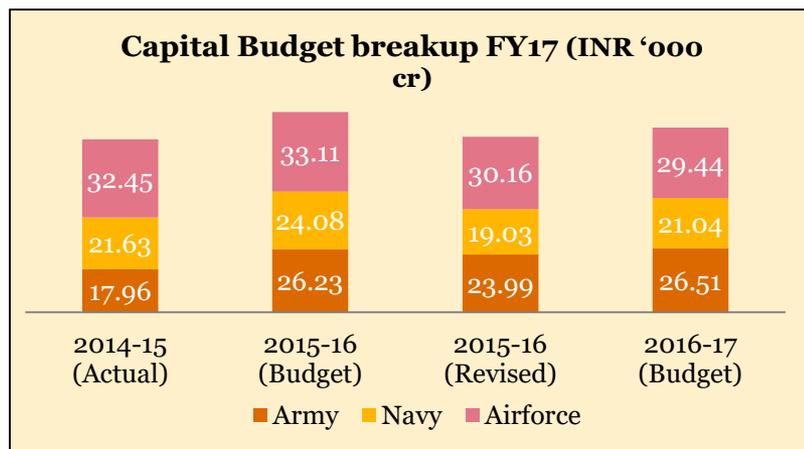
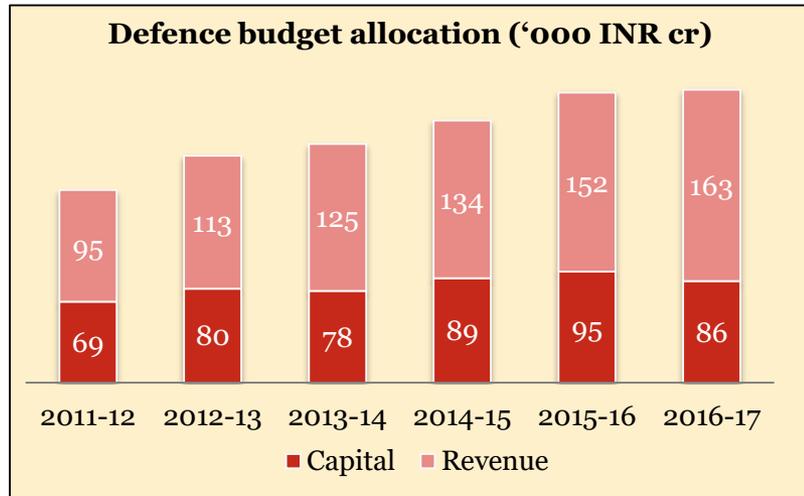


Onus on Companies to adopt zero tolerance policies and anti-fraud programmes and controls

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# *Indian A&D sector – An overview*

# India's defence capital budget has grown to INR 86k cr and we are the largest importer of armaments



## Key Insights:

- The Indian government typically spends around 2.0 % of GDP on defence related expenditure (~40% is capital outlay)
- Since 2001, on an average 40% of the budget has been allotted for the capital expenditure. However, capital budget for FY17 has been kept low at just 34.7% of total defence budget due to increase in revenue and pension allocations (due to OROP)
- The nominal defence budget allocation is **increasing YOY by around 10%**

# *Indian Defence industry supply side segmentation*

## **DEFENCE PUBLIC SECTOR UNDERTAKINGS (DPSUs) & ORDNANCE FACTORIES BOARD (OFBs)**

- Grown tremendously through protection
- Responsible for strategic requirements of armed forces
- Have developed and acquired new technologies
- Large backlog of orders
- Increased outsourcing from DPSUs & OFBs

## **OEMs & LARGE/MID SIZED INDIAN COMPANIES**

- OEMs and Tier-1s looking towards lower cost destinations - India in an attractive destination for all majors
- Aggressive capability building by big houses like Tata, L&T, M&M; Reliance new entrant
- Mid sized and small players like Dynamatic, Aequs, Technologies, Maini Group, TAAL building capabilities/diversifying products to cater to a larger value chain

## **IT/ENGINEERING COMPANIES**

- Active in the field of avionics
- Big players have separate aerospace vertical: Wipro, Infosys, HCL
- Offer complete solutions ranging from Product Design and Development, Embedded Systems and Avionics to Product Lifecycle Management services
- Have capability to undertake, sustain and verify activities in several aircraft subsystems

## **MSMEs**

- 5000 companies operating in niche areas, supplying primarily to DPSUs
- Auto ancillary companies looking to enter
- Key pain points – access and cost of capital, building capability, accreditation

# *The government is working to build a facilitative environment for Indian private sector entry*

## **Market Attractiveness**

- Obsolescence of military equipment requiring immediate upgrades
- Largest importer: 70% requirement met through imports
- Fastest growing civil aviation market
- High defence & commercial aircraft demand
- Strong domestic manufacturing capabilities
- IT competitiveness
- Growing R&D and design base
- Cost advantages
- Vast talent pool of engineers
- Well-educated talent pool
- Abundant low cost skilled workforce

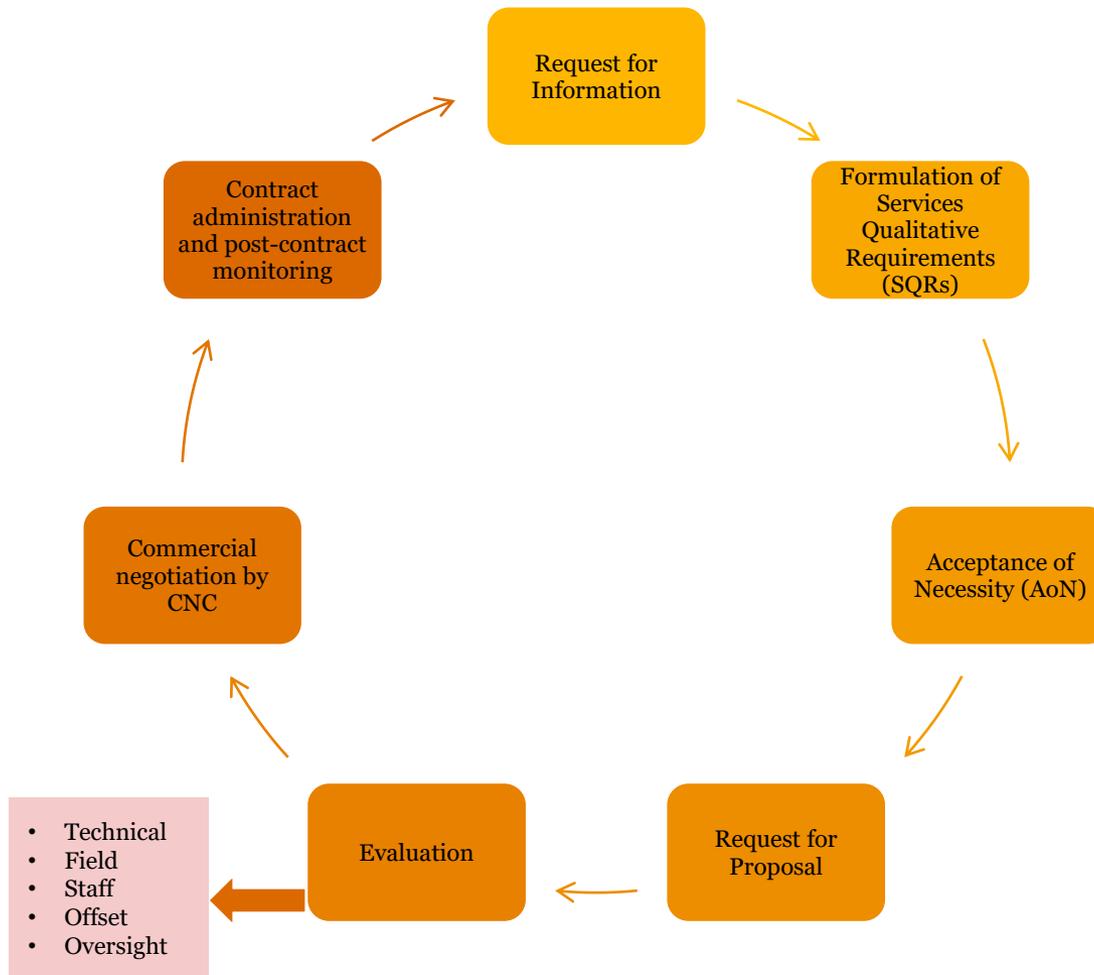
## **Government Initiatives**

- Modernization of armed forces a priority
- Push for private participation at highest level- levelling playing field
- Make in India campaign
- FDI beyond 49% now permitted through government approval route
- Streamlining of licensing regulations
- Security Manual Issued
- DPP 2016 released with revamped Offset Policy- enhanced financial powers to service chiefs
- Foreign Trade Policy 2015-20 unveiled
- Strategy for export of defence products notified
- National Policy on Electronics includes Avionics
- Enhancement of MSME financing and financial empowerment of service chiefs

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# *Procurement Procedure in India*

# Defence Procurement Procedure – A glimpse



DPP – First formulated in 2002. Six revisions

## **Scope**

Covers all capital acquisitions undertaken by MoD

## **Objective**

- Expeditious and cost effective procurement
- Development of indigenous defence sector
- Conformity to highest standards of transparency, probity and public accountability
- Fair competition

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## ***Provisions in DPP to promote transparency***

### Relevant Issues

- **Integrity Pact:**

- An 'Integrity Pact' is signed between government department and the bidders for all procurement schemes over INR 20 crore – not to accept/offer bribes during the procurement process
- As per Article 22 of Standard Contract document, *“giving or offering of any gift, bribe or inducement or any attempt at any such act on behalf of the SELLER towards any officer/employee of the BUYER or to any other person in a position to influence any officer/employee of the BUYER for showing any favour in relation to this or any other contract, shall render the SELLER to such liability/penalty as the BUYER may deem proper, including but not limited to termination of the contract, imposition of penal damages, forfeiture of Bank Guarantee and refund of the amount paid by the BUYER.”*
- Violation of the above provisions – Cancellation of the contract (all or any other contracts with the seller) and recovery of the amount of any loss arising from such cancellation

- **Agents/Technical consultants/Authorized vendors:**

- Confirmation/declaration that no individual or firm, has been engaged to intercede, facilitate or in any way recommend to the government to the award of the contract to the Seller; nor has any amount been paid, promised or intended to be paid to any such individual or firm in respect of any such intercession, facilitation or recommendation.
- Required to give an undertaking to disclose all payments made in connection with the contract in question to anybody (including agents and other middlemen)

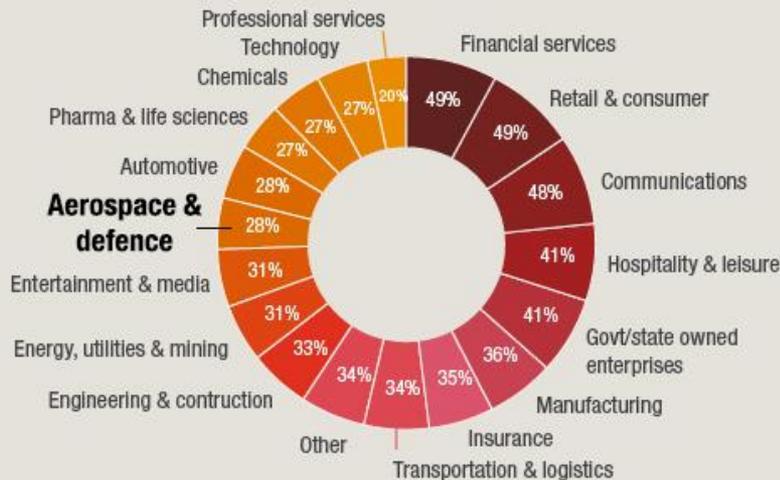
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# *Economic Crimes in the A&D industry*

# *Economic Crime in the Aerospace and Defence sector is one of the least reported*

## **Economic crime status (industry-wise)**

By industry, economic crime is most commonly reported in the financial services, retail and consumer, and communications sectors. Nearly 50% of respondents in each said they had been crime victims.



## **Key insights:**

- One in three organizations reports being hit by economic crime.
- The highest levels of economic crime are consistently reported by respondents in Africa (50%) and North America (41%).
- According to PwC's Global Economic Crime Survey 2014, economic crime has been reported by 28% respondents in the Aerospace and Defence sector
- According to Trace International, aerospace and defense industry members have accounted for approximately 12% of the world's anticorruption enforcement actions since 1977, second only to the extractive industries like oil and mining.
- Transparency International (TI) describes the defence sector as one of the most secretive, and one in which it is difficult to openly discuss corruption issues
- Aerospace and defence companies have unique risks due to the large scale and value of contracts, fierce competition and the complexity of the regulatory and compliance environment.

# *The defence market does not have perfect competition: Inherent distortions make it susceptible to economic crime*

Characteristics	Impact
Highly regulated <ul style="list-style-type: none"> <li>• Manufacture</li> <li>• ToT</li> <li>• Sales – domestic &amp; export</li> </ul>	Large number of sanctions/approvals required Raises entry barriers – restricts number of players
Information asymmetry	Suppliers – Specifications, true price Buyers – Long term demand
Monopsony- single buyer and L1 basis	Win-lose situation
Close knit buyer group	Fewer people to influence, scope for middlemen
Cutting edge technology – complex specs	Difficult to comprehend
Shrinking budgets	Intense competition
Limited suppliers and frequent complaints	Limited buyer options
High transaction costs	Greater risks
Large deal size	Increases financial stake for suppliers
Grey market – very lucrative	Increased temptation to violate laws
Lack of transparency in procurement	Greater scope
Conviction difficult	Encourage agents
Very high capex in R&D and Production	Very high stakes for suppliers



Economic Crime
<ul style="list-style-type: none"> <li>• <b>Unauthorised receipts and expenditures</b> <ul style="list-style-type: none"> <li>○ Bribery – Government officials; Commercial vendors and suppliers</li> <li>○ TINA violations</li> <li>○ Falsification of records</li> <li>○ Improper cost allocations</li> </ul> </li> <li>• <b>Financial statement manipulation</b> <ul style="list-style-type: none"> <li>○ Improper revenue/expenditure booking</li> <li>○ Fictitious transactions</li> </ul> </li> <li>• <b>Misappropriation of assets</b> <ul style="list-style-type: none"> <li>○ Theft of intellectual property</li> <li>○ Espionage</li> <li>○ Cyber Crime</li> </ul> </li> <li>• <b>Disclosure fraud</b></li> <li>• <b>Aiding and abetting</b></li> <li>• <b>Fraud by senior management</b></li> <li>• <b>Speed Money:</b> US allows (after disclosure)</li> <li>• <b>Money Laundering</b></li> <li>• <b>Smuggling</b></li> </ul>

## *Increasing alignment of and cooperation in anti-corruption laws and prosecution, led by OECD convention*

United States - matured	United Kingdom	Other BRIC Countries	India - evolving
<ol style="list-style-type: none"> <li>Foreign Corrupt Practices Act, 1977 <ul style="list-style-type: none"> <li>•Anti-bribery provisions –Prohibits offering, paying, or giving anything of value</li> <li>•Accounting records provision – requires companies to maintain accounts properly</li> <li>•Speed money allowed to be disclosed</li> <li>•Deferred prosecution</li> <li>•Non-prosecution agreement</li> </ul> </li> <li>Truth in Negotiations Act</li> <li>Procurement Integrity Act</li> <li>Sarbanes-Oxley Act</li> <li>SEC and PCAOB Rules: “Control person”</li> </ol>	<ol style="list-style-type: none"> <li>UK Bribery Act, 2010 <ul style="list-style-type: none"> <li>•Covers corruption in public and private sector</li> <li>•Does not require proof of corrupt intent</li> <li>•Creates a new form of corporate liability for failing to prevent bribery and provides for only one defense—that an organization had “adequate procedures” in place to prevent bribery.</li> </ul> </li> </ol>	<ol style="list-style-type: none"> <li>China amended its criminal code to make paying bribes to foreign government officials a crime.</li> <li>Russia introduced measures that impose criminal sanctions on companies and individuals who make corrupt payments to foreign public officials.</li> </ol>	<ol style="list-style-type: none"> <li>Black Money (Undisclosed Foreign Income and Assets) and Imposition of Tax Act, 2015</li> <li>Benami Transactions (Prohibition) Amendment Bill, 2015</li> <li>Amended Companies Act, 2015</li> <li>SEBI listing agreement</li> <li>Prevention of Money Laundering Act, 2002</li> <li>Prevention of Corruption Act, 1988 <ul style="list-style-type: none"> <li>•Act enacted to combat corruption in government agencies and public sector businesses in India</li> <li>•Applies to bribe taker, giver of bribe and any middlemen</li> <li>•Offence punishable with imprisonment with fine</li> </ul> </li> <li>Indian Penal Code, 1860 <ul style="list-style-type: none"> <li>•Offence of bribery punishable with imprisonment and fine</li> </ul> </li> </ol>

### Select example of corrupt practices

Florida based defense company IAP Worldwide Services Inc paid US\$7.1 million to settle a U.S. investigation into an alleged conspiracy to bribe Kuwaiti officials to win a government contract

Rheinmetall Defense Electronics, a subsidiary of German defence contractor Rheinmetall, has settled a foreign bribery investigation with Bremen’s public prosecutor and agreed to pay a €37 million penalty.

Safran was convicted and ordered to pay 500 000 euros in penalties by a Paris court for bribes paid by Sagem to Nigerian officials.

## *India has had its fair share of controversial deals in defence*

<b>Acquisition Programme</b>	<b>Year</b>	<b>Deal amount (original year figure)</b>	<b>Alleged Kickback amount</b>
Jeeps for Army	1948	INR 80 L	Not available
HDW submarines	1981	\$ 330 mn	\$ 23 mn
Bofors 155 mm howitzers	1986	\$ 285 mn	\$ 12 mn
Denel rifles	1999	\$ 386 mn	\$ 49.2 mn
Barak missile	2000	INR 1150 crores	INR 175 crores
Scorpene submarine	2005	INR 18,798 crores	INR 500 crores
AugustaWestland VVIP helicopters	2010	INR 3600 crores	INR 362 crores
Tata –BEML	2012	INR 3000 crores	Not available

*Source: Media Reports, International Journal, Article by Surojit Chakraborty*

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# ***Onus on companies to take preventive measures***

## **CEOs AND BOARDS OF DIRECTORS**

- Ensuring a robust ethics and anti-corruption programme.
- Encouraging periodic review and independent Audit Committee reporting and oversight
- Disclosing the programme fully on your company's website.
- Speak up strongly against corruption inside the company and in public fora.
- Conduct a fraud risk assessment

## **INVESTOR ENGAGEMENT TEAMS, PORTFOLIO MANAGERS, AND ANALYSTS**

- Explaining the ethics and anti-corruption programme.
- Showing the results of independent reviews .

## **PROCUREMENT CHIEFS IN ARMS IMPORTING COUNTRIES**

- Formulating effective ethics and anti-corruption programmes and making them public
- Explaining Ministry of Defence (MoD) regulations on the subject to all concerned
- Standardize processes for incident investigation and remediation

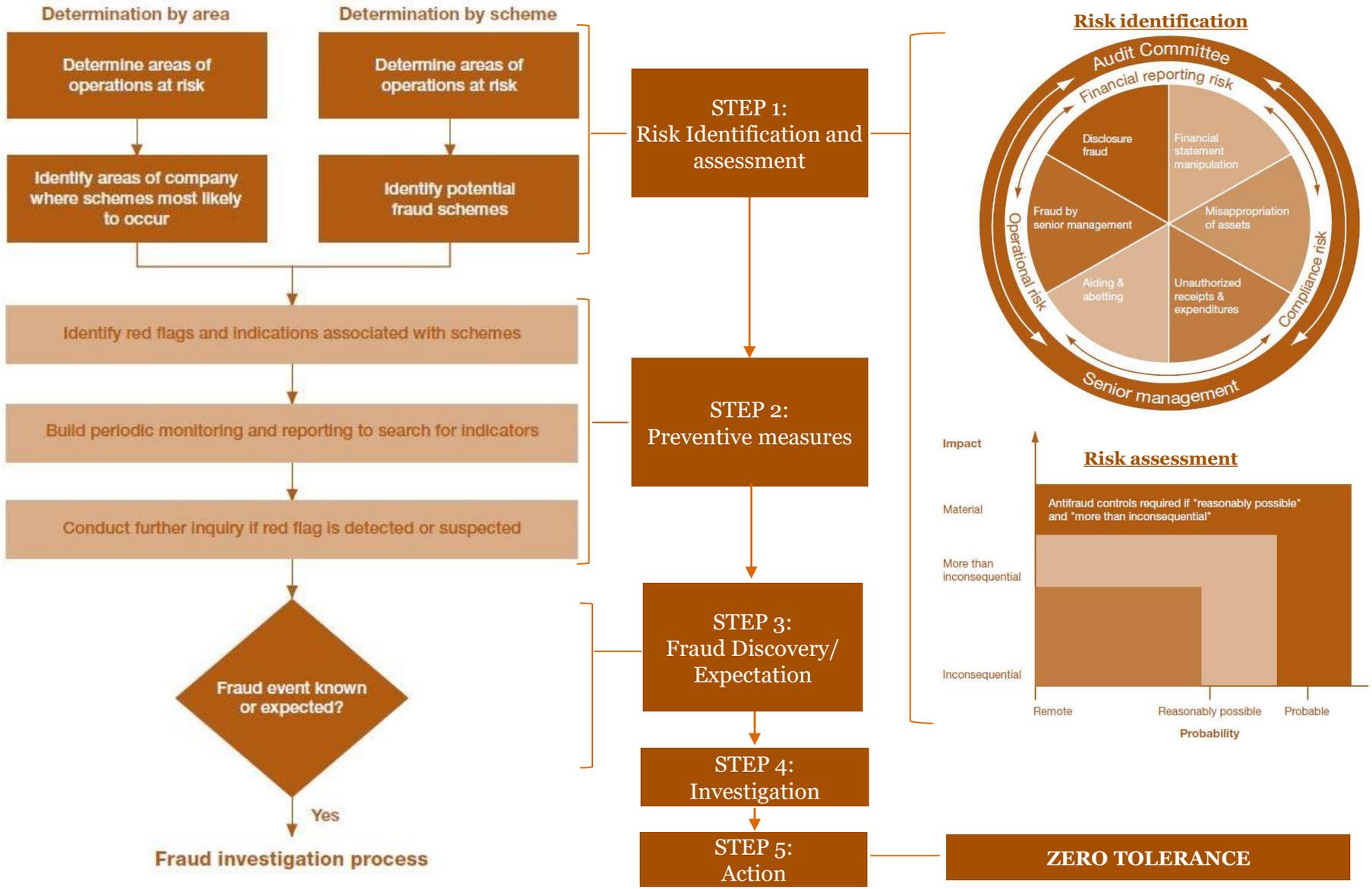
## **GOVERNMENT OFFICIALS RESPONSIBLE FOR OFFSETS**

- Encouraging bidding companies to publish their detailed offset obligations.
- Encouraging publishing of annual performance assessments of their offset obligations.

## **ARMS EXPORTING GOVERNMENTS**

- Formulating robust ethics and anti-corruption programs
- Export Controls

# Antifraud Program and controls



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# *Recommendations*

## ***Recommendations for reducing economic crime in A&D sector in India***

Create specialist procurement agency – multi-disciplinary specialists

Encouragement/protection to honest officers

Improve and speed up prosecution

Institutionalize out of court settlements

Focus on prosecuting individuals - Blacklisting of entire group company counter productive and should be resorted to as the last resort and for grave and serious offenses

Conducting due diligence of third party before engaging – work with reliable partners

Stricter corporate governance: zero tolerance policies; mandatory implementation of anti-fraud programmes and controls

Whistleblower protection

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# *Thank you*

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