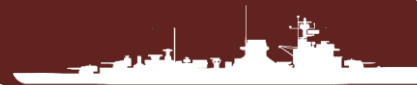


Frauds in Aerospace & Defence sector

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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



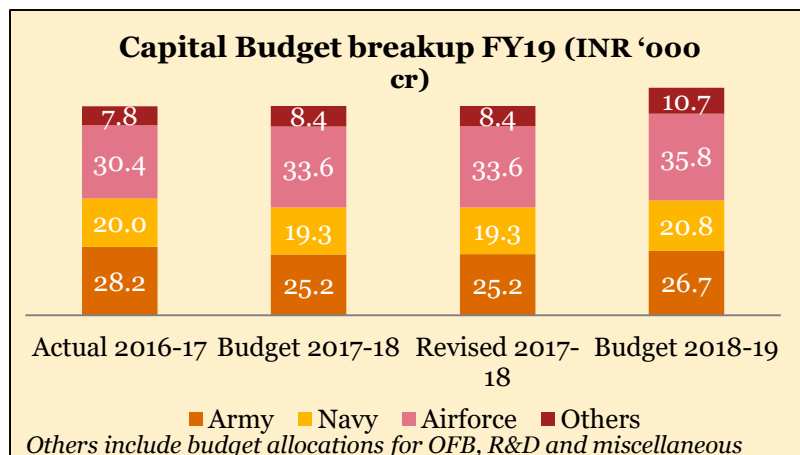
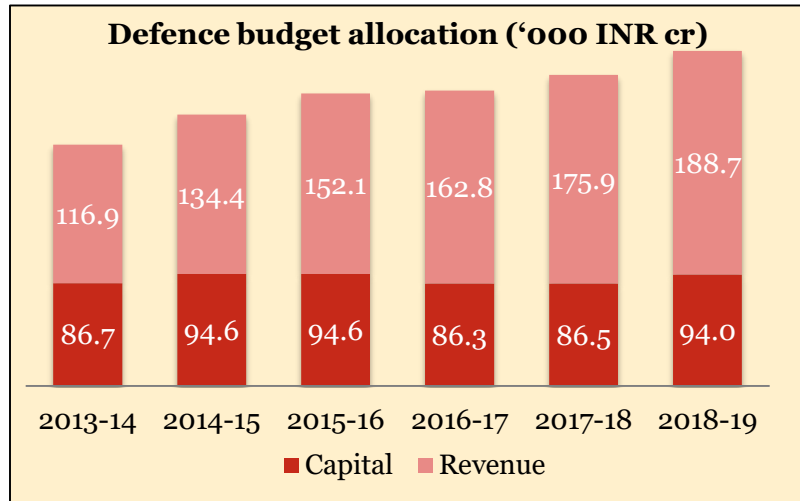
Government has continuously focussed on making procurement transparent, but challenges remain



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

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 (~35% is capital outlay)
- Defence budget for 2018-19 has seen a marginal increase of 5.8% over the last year and accounts for 10.74% of the total allocation
- Capital expenditure has been increases by ~8.7% over the last year's revised estimates, that significantly exceeds that of revenue
- New defence production policy and two defence industrial production corridors were announced
- Allocation of INR 9,734 crores towards Research and Development (R&D) is an y-o-y increase of 29%
- INR 130 crores allocated for assistance in prototype development under the make procedure for Indian Army projects

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, Kalyani; Reliance new entrant
- Mid sized and small players like Dynamatic, Aequs, Technologies, Maini Group, TAAL, Samtel, India Forge, Axis Aerospace building capabilities/diversifying products to cater to a larger value chain

IT/ENGINEERING COMPANIES

- Active in the field of aerospace engineering and design
- 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

- Auto ancillary companies looking to enter
- Key pain points – access and cost of capital, building capability, accreditation
- Special focus by the government on 5,000 companies operating in niche areas, supplying primarily to DPSUs

Government is working to build a facilitative environment in the A&D sector...

RFIs already issued for:

- NUH
- NMRH
- Submarines

Strategic Partner (SP) model

- SP policy promulgated on 31 May 17.
- Government will shortlist Indian companies to be SPs to associate with OEMs
- Eligibility criteria includes, inter alia, cap of 49% on FDI & ownership and control with resident Indian citizens
- One private sector SP will be chosen for each of the 04 platforms - fighter jets, helicopters, armoured vehicles and submarines
- MoD will also select the foreign OEMs separately and simultaneously
- Will involve transfer of the requisite scope, range and depth of technology

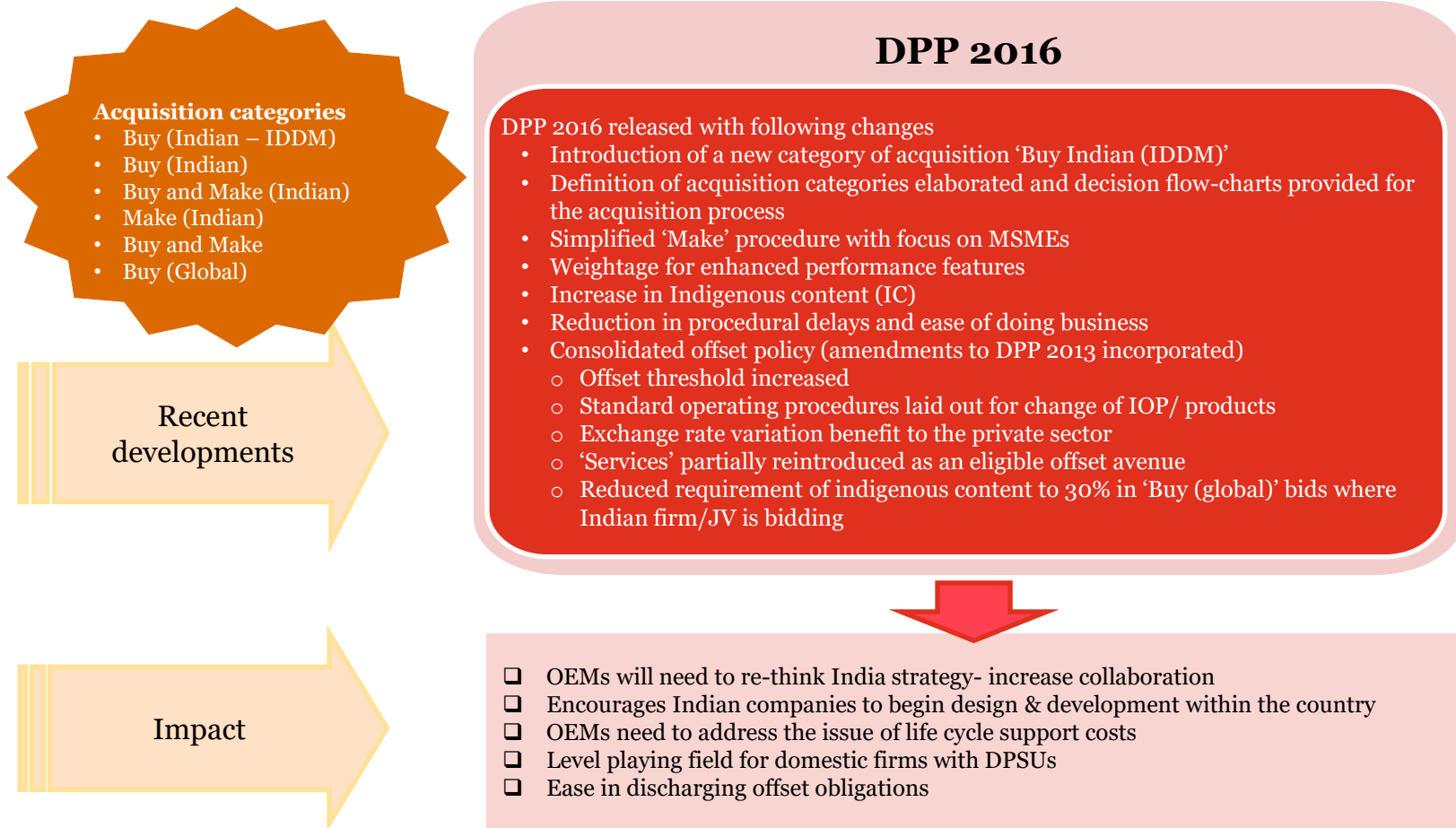
Abolition of Foreign Investment Promotion Board (FIPB) and FDI policy

- Union Cabinet approved abolition of FIPB on 24 May'17
- Processing of applications for FDI will now be handled by Department of Defence Production (DDP) for defence equipment and by MHA for small arms in consultation with Department of Industrial Policy & Promotion (DIPP)
- DIPP issued Standard Operating Procedure (SOP) for processing of applications
- Liberalization of FDI cap - Foreign investment up to 49% will be under automatic route
- Proposals for FDI beyond 49% will be considered by MoD /MHA on a case-to-case basis

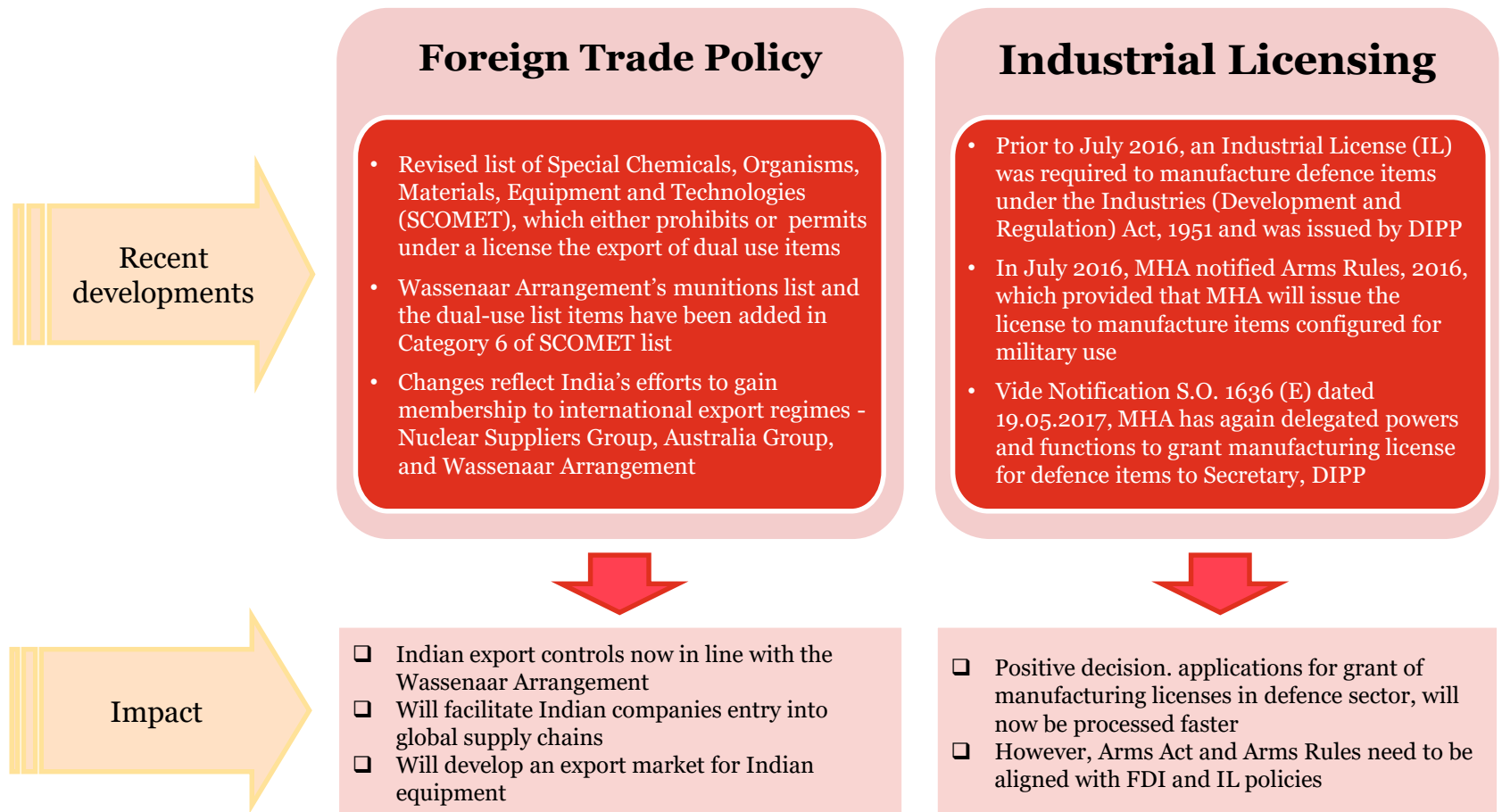
Impact on A&D sector

- Will encourage investments by assuring selected domestic companies of future orders
- Will give impetus to building a domestic supply chain
- OEMs allowed to interact with all shortlisted SPs
- Changes in FDI policy bring defence at par with other sectors by allowing portfolio investments up to the sectoral caps
- Delays in MoD & MHA might vitiate achieving the objective

...to build a domestic industrial base and promote indigenisation...



...to achieve selfreliance in defence



Corporate fraud – an overview

Introduction

Fraud is defined as:

- Act, omission, concealment of fact or abuse of position by any person;
- With an intention to deceive or injure the interests of the Company, its shareholders, Creditors or any other person

Corporate Fraud

- Corporate fraud consists of activities undertaken by an individual or company that are done in a dishonest or illegal manner, and are designed to give an advantage to the perpetrating individual or company.
- Corporate fraud schemes go beyond the scope of an employee's stated position, and are marked by their complexity and economic impact on the business, other employees and outside parties.

Regulatory legislations covering fraud

- Indian Contract Act 1872.
- Indian Penal Code 1860.
- Prevention of Corruption Act 2013.
- Prevention of Money laundering Act 2012.
- The Companies Act 1956& 2013.
- Information Technology Act 2008.
- Prohibition of Insider Trading.

Fraud repercussions: individual punishment...(i)

- As Per Section 447 of Companies Act 2013, imprisonment for a **term not less than 6 months and up to 10 years and fine**, which shall **not be less than the amount involved in the fraud** and may extend to **thrice of such amount**.
- **If the fraud involves public interest, the minimum imprisonment to be awarded shall be 3 years.**
- As per Prevention of Money laundering Act 2012 if any person convicted offence in this act, there can be punishment of imprisonment **up to 3-7 years with fine up to 5 lakh rupees**.
- As per Indian Penal Code 1860, punishment of offences, every person shall be liable to punishment under this Code and not otherwise for every act or omission contrary to the provisions thereof, of which he shall be guilty within India.
- As per Section 66F (Acts of cyber terrorism) of Information Technology Act 2002, If a person denies access to authorized personnel to a computer resource, accesses a protected system or introduces contaminant into a system, with the intention of threatening the unity, integrity, sovereignty or security of India, then he commits cyber terrorism and **he is liable for Imprisonment up to life**.

Fraud repercussions: Impact on reputation ...(ii)

➤ ***Blacklisting***

➤ ***Financial loss***

Fines assessed for misleading investors, civil suits to recoup investor and creditor losses and the unwillingness of companies to extend credit to the business in the future all add up to a severe financial loss for the company.

➤ ***Loss in external confidence***

Once a fraud has been uncovered, the company faces an ongoing problem of public trust in the organization

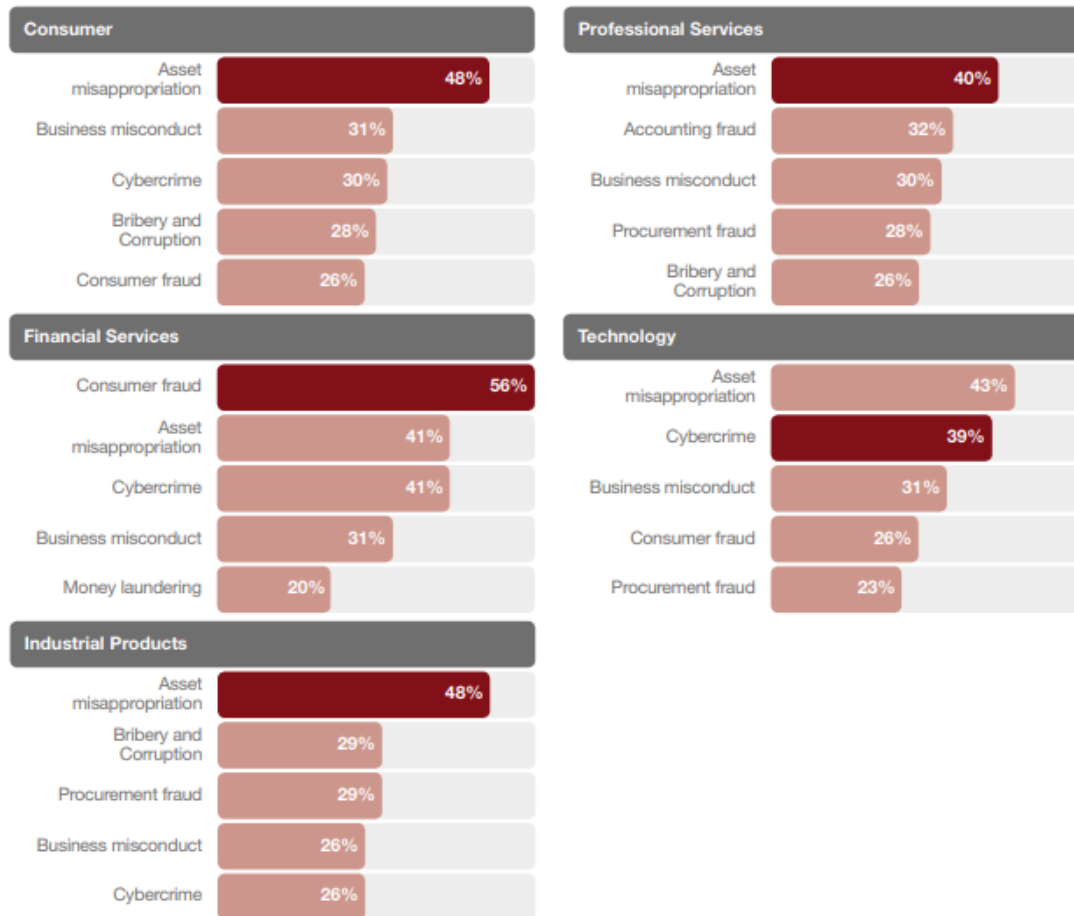
➤ ***Negative impact on company morale***

The effect of fraud on a company's culture and morale can be shattering.

➤ ***Reputational loss***

Frauds in the A&D industry

Asset misappropriation, consumer fraud and cybercrime were the most frequently reported frauds across industries



■ Indicated as most disruptive fraud

Key insights

- Fighting fraud has become a core business issue
- 49% of organisations globally said they've been a victim of fraud and economic crime – up from 36%
- 52% of all frauds are perpetrated by people inside the organisation
- 31% of respondents that suffered fraud indicated they experienced cybercrime
- 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.

Source: PwC's Global Economic Crime and Fraud Survey 2018

Strong correlation between economic development and fraud

- Our survey reveals some interesting nuances about global approaches to fraud, which could offer valuable pointers for nation states as they continue on the path of economic development.
- In developing countries, 58% of companies involved in money movement (and/or any of the following lines of business: financial institutions, mutual funds, money service businesses, broker dealers, insurance companies, or dealers in precious metals, stones or jewels) told us they had experienced anti-money laundering (AML) regulatory enforcement or inspection in the last two years. The equivalent figure in developed countries was just 48%.
- In developing countries, 15% of companies told us they expect to significantly increase funding for anti-fraud investments in the next 24 months. The equivalent figure in developed countries was just 9%.
- In developing countries, respondents told us that economic crime is more often committed by internal actors (59%). The equivalent figure in developed countries was just 39%.

Source: PwC's Global Economic Crime and Fraud Survey 2018

Defence sector does not have perfect competition: Inherent distortions make it susceptible to economic crime

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

India has had its fair share of controversial deals in defence

Acquisition Programme	Year	Deal amount	Alleged Kickback amount	Status	Blacklisted companies
Jeeps for Army	1948	INR 80 L	Not available	Case closed	
HDW submarines	1981	\$ 330 mn	\$ 23 mn	Case closed	
Bofors 155 mm howitzers	1986	\$ 285 mn	\$ 12 mn	Case closed	
Denel rifles	1999	\$ 386 mn	\$ 49.2 mn	Case closed	Denel
Barak missile	2000	INR 1150 crores	INR 175 crores	Trial ongoing	
Scorpene submarine	2005	INR 18,798 crores	INR 500 crores	Trial ongoing	
Ordnance Factories Board	2009	INR 10,000 crore	INR 600 crore	Conviction	IMI; Rheinmetall Air Defence; Corporation Defence
AgustaWestland VVIP helicopters	2010	INR 3600 crores	INR 362 crores	Investigation ongoing	Finmeccanica; AgustaWestland
Tatra –BEML	2012	INR 3000 crores	Not available	Investigation ongoing	

India's blacklisting policy

Policy

- Blacklisting has been a hurdle in procurements in the past and led to long delays
- MoD, in Nov 2016, issued guidelines for penalties in business dealings with entities
- New policy provides for levy of financial penalties and / or suspension / banning of business dealings with entities, seeking to enter into contract with / having entered into a contract for the procurement of goods and services by the MoD
- Aimed to move from a blanket approach to a process driven approach
- Now, a company can be blacklisted for a maximum of 10 years
- Provision to do business with a blacklisted firm for support of critical spares and maintenance in view of national security

PwC comments

- Crime is committed by an individual and not by a body corporate
- Individuals must be punished while companies may be fined
- National Interest for defence procurements should prevail
- Blacklisting the firms limit the options for defence procurements

Onus on companies to take preventive measures

CEOs AND BOARDS OF DIRECTORS

- Ensuring a robust ethics and anti-corruption programme. Encouraging periodic independent review
- 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

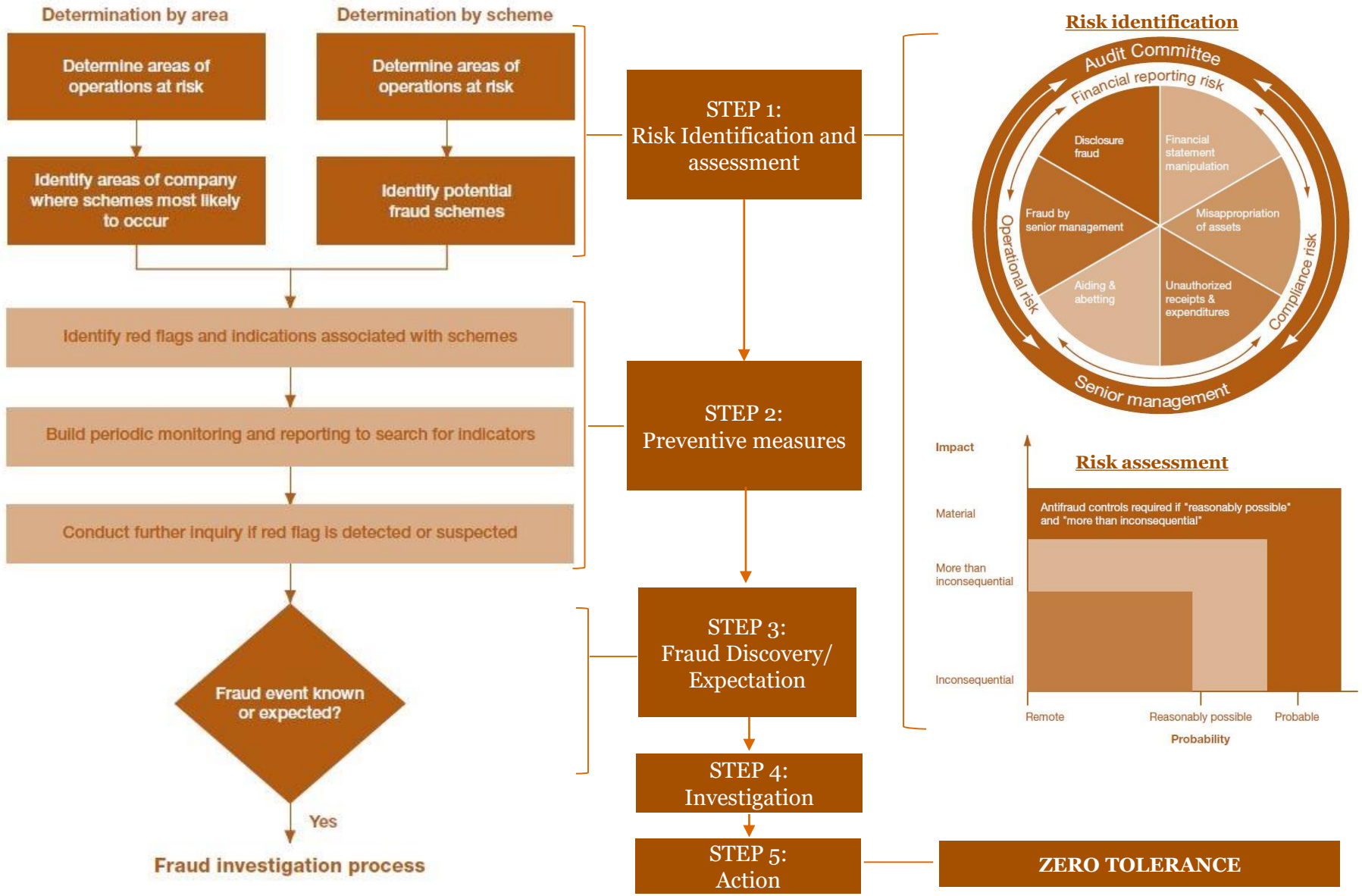
ARMS EXPORTING GOVERNMENTS

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

Measures to develop and implement an effective antifraud program

- Establish a base line
- Conduct a fraud risk assessment
- Evaluate design and validate operating effectiveness
- Address residual financial reporting fraud risks
- Standardize processes for incident investigation and remediation
- Harness the protective power of technology
- Invest in people, not just machines

Antifraud Program and controls



Recommendations

Recommendations for reducing economic crime and fraud in A&D sector in India

Create specialist procurement agency – multi-disciplinary specialists

Encouragement/protection to honest officers – abolish Section 13(1)(d) of the PCA, 1988

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

Thank you

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