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AN ANALYSIS OF THE ARMAMENTS CORPORATION OF SOUTH AFRICA'S (ARMSCOR) ANNUAL REPORT FOR THE FINANCIAL YEAR 2015/16

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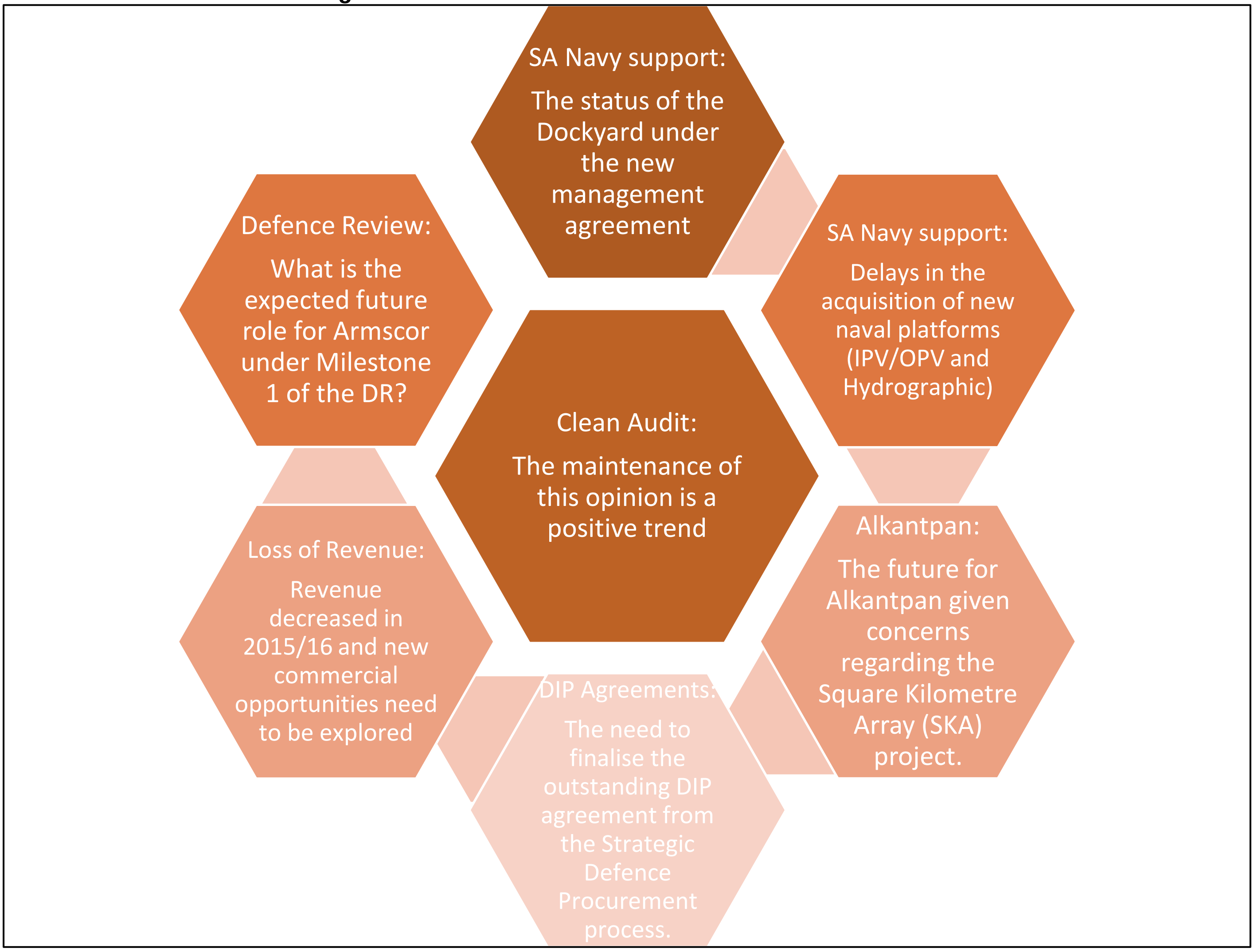
KEY FOCUS AREAS FOR THE PCDMV RELATED TO ARMSCOR

Armscor has succeeded in maintaining its clean audit without findings from the Auditor General. This is representative of its high levels of corporate and financial discipline. Furthermore, it managed to increase its surplus from R84 million in 2014/15 to over R200 million in 2015/16. Nonetheless, the reduction in revenue is a concern. The future pressures on Armscor will most likely stem from the reduced spending capacity of the DOD, which is its primary client. As such, the search for commercial opportunities is important to offset the loss of income from the DOD. The following focus areas may be considered as priorities for the PCDMV:

Figure 1: Possible Armscor focus areas for the PCDMV



1. INTRODUCTION

The Armaments Corporation of South Africa Ltd (Armscor) was established in terms of the Armaments Production and Development Act (No. 57 of 1968) to satisfy the requirements of the South African National Defence Force (SANDF) in respect of Defence Matériel. In 2015/16, Armscor continued to provide this support to the Department of Defence (DOD) as its primary client. Given the reduced spending capability of the DOD, Armscor is coming under increased financial pressure. Despite these challenges, the 2015/16 surplus increased. Nonetheless, revenue collection remains a concern and may impact on future service delivery to the DOD if not managed well. Key to the future of Armscor is the implementation of Milestone 1 of the Defence Review as this is expected to not only boost the DOD, but also Armscor.

This document analyses Armscor's major operations, including Acquisitions, Defence Industrial Participation (DIP), Research and Development, and the Armscor Dockyard. It also

A Review of the legislative framework for performance assessment:

The Constitution vests the National Assembly with the power of oversight over their respective executives, in addition to their legislative and other powers. Furthermore, the Money Bills Amendment Procedure and Related Matters Act, 2009 (Act 9 of 2009) stipulates the procedure to be followed by Parliament prior to the introduction of the national budget. Section 5(1) states that the National Assembly, through its committees, must annually assess the performance of each national department, with reference to the following:

- The medium term estimates of expenditure of each national department, its strategic priorities and measurable objectives (APP), as tabled in the National Assembly with the national budget (ENE);
- prevailing strategic plans;
- the expenditure report relating to such department published by the National Treasury in terms of section 32 of the Public Finance Management Act (quarterly expenditure);
- the financial statements and annual report of such department (Annual Report);
- the reports of the Committee on Public Accounts relating to a department; and
- any other information requested by or presented to a House or Parliament.

The outcome of the performance assessment process followed by Committees is to annually submit a **budgetary review and recommendation reports (BRRR)** for tabling in the National Assembly, as per Section 5(2) of the Money Bills Amendment Procedure and Related Matters Act. The BRRR -

- Must assess the department's service delivery performance given available resources;
- Must provide an assessment on the effectiveness and efficiency of the departments use and forward allocation of available resources; and
- May include recommendations on the forward use of resources.

The *PCDMV* should keep the above-mentioned outcomes of the BRRR in mind during its deliberations with Armscor on its Annual Report in order to deliver a substantial BRRR. Furthermore, **the ambitions of Milestone 1 of the 2015 Defence Review should be kept in mind during engagements and the impact thereof on Armscor considered.** While the Defence Review Implementation Plan has not been presented to Parliament, the possible roles of Armscor during this Milestone and the financial implications thereof needs to be considered.

provides an overview of the current human resources situation and an overview of concerning Key Performance Indicators (KPI). It concludes with an analysis of financial statements.

2. ACQUISITIONS

Acquisitions for the SANDF and other government departments reflect Armscor's core function. During the 2015/16 financial year, Armscor achieved the following in terms of contract management:[1]

- R5.631 billion in terms of contracts relating to maintenance and support (This is slightly less than the R6.58 billion managed in 2014/15).
- R6.315 billion in terms of capital equipment acquisition (This is higher than the R4.5 billion managed in 2014/15).

Armscor managed acquisition in terms of a number systems, of which the following should be noted:

Maritime systems. A Hydrographic vessel is being purchased for the SA Navy. By June 2015, offers have been received and the navy is in the process of reviewing its budget to determine affordability. Three Inshore- and three Offshore Patrol Vessels are also being acquired. Offers were received by September 2015, and the navy is in the process of reviewing its budget to determine affordability. Armscor successfully assisted in the acquisition of two new Tug Boats for the SA Navy which has since been operationalised.

Airborne systems. The communication and navigation equipment on the SA Air Force's Oryx Helicopter fleet has been completed with 39 aircraft delivered to the Air Force. The A-Darter Air-to-Air missile has also been completed and an order placed for large-scale production. The first batch of missiles is expected to be delivered by the 3rd Quarter of 2016.

Landward acquisitions. The most significant acquisition in the landward defence environment is Project Hoefyster which relates to the purchasing of new Infantry Fighting Vehicles for the SA Army to replace the ageing Ratel fleet which has been in service since 1976. The majority of the new fleet will be constructed in South Africa and a locally designed and manufactured turret is used. It is expected that the first batch of 45 vehicles will be delivered by June 2018. This takes into consideration a current nine month delay on the project.

Communication systems. Significant progress was made in the completion of a new tactical communication system for the SANDF. Initial orders have been placed and the first units delivered.

Questions

- The purchase of the Navy's new hydrographic as well as Patrol Vessels has been a lengthy process. It has been at least 17 months since the offers from the industry were received for the Hydrographic Vessel and 12 months for the Patrol Vessels and no decision has been forthcoming. Given the years of planning on these projects, it would

[1] Armscor. (2016). p. 29

be expected that funds were allocated over time to fund these acquisitions. What are the reasons for this delay and when can an announcement be expected?

- Will the hydrographic vessel and Patrol Vessels, or at least large parts thereof, be produced locally?
- When can full integration of the A-Darter missiles with the Hawk Aircraft be expected?
- Are there any other nations interested in purchasing the A-Darter missile? Will the project bring in significant funds to Armscor/Denel in future?
- What are the reasons for the nine month delay on the new Infantry Fighting Vehicles for the SA Army? Are there any cost implications due to this delay?
- What percentage of new communication units have been deliver to the SANDF?
- When will the complete overhaul of the tactical communication systems of the SANDF be completed?

3. DEFENCE INDUSTRIAL PARTICIPATION

Defence Industrial Participation (DIP) relates to the obligation of a foreign supplier to reciprocate defence related business in South Africa as a result of a Defence acquisition. No new DIP agreements were entered into during the period under review, while Armscor continues to manage 16 such agreements. The DIP Policy was revised in October 2015.

One DIP agreement related to the 1999 Strategic Defence Procurement remains under the management of Armscor. This refers to an agreement with MBDA (A European based missile developer and manufacturer). The 2011/12 Annual Report indicated that MBDA had an outstanding obligation of R946 million,[2] while the 2012/13 Annual Report indicates an outstanding obligation of R933 million. As such, only R13 million (1.37 per cent) of the obligation was covered during 2012/13.[3] Since then no additional part of the obligation has been covered. In fact, the 2014/15 Annual Report indicates that it is unlikely that MBDA will fulfil its DIP obligations before the final deadline of March 2016. The 2015/16 Annual Report indicated that the DIP agreement will be extended to 2019 to allow for the identification of new projects to offset the DIP.

There are currently 13 DIP projects related to projects under the Special Defence Account to the value of R7.076 billion and one DIP project related to police contracts to the value of R184 million.

Questions

- The fact that there is still an outstanding DIP agreement from the 1999 Strategic Defence Procurement process is of major concern. DIP projects are essential to skills transfers to South Africans and reinvesting in the country. The Committee should ask for a comprehensive explanation of the MBDA DIP agreement and reasons for the fact that obligations are likely not to be met. Furthermore, are there any penalties in place should MBDA fail to meet its DIP obligations?
- The PCDMV may request an explanation as to how Armscor will ensure that new DIP agreements are realised and that pitfalls experienced in the past are circumvented.

[2] Armscor. (2012) p. 45.
[3] Armscor. (2013a) p. 41

4. DEFENCE MATERIEL DISPOSAL[4]

Armscor also manages the disposal of defence equipment such as vehicles, vessels, ammunition and other equipment for the DOD. During 2015/16, contracts for sales worth R41.2 million were placed.

Questions

- Are the funds generated from the sale of defence equipment returned to the DOD or is it returned to the fiscus?
- Can the sale of redundant defence equipment realistically aid the DOD in the implementation and funding of Milestone 1 of the 2015 Defence Review?
- During oversight visits, the PCDMV has noted significant delays in the auctioning of old vehicles. These vehicles often remain in military bases for years before being auctioned, thus losing significant value during such delays. Can Armscor contribute to a more efficient system of selling of these vehicles and raising funds?

5. RESEARCH AND DEVELOPMENT[5]

The 2015/16 Annual Report indicates that both the *Gerotek* and *Alkantpan* test facilities as well as *Hazmat protective systems* continued in efforts to attract international investors and contributed the most to the Research and Development's commercial income. During the year, 30.5 per cent of the total operating budget of R457 million was achieved through commercial means. For the *Alkantpan* test range, 64 per cent of its sales came from commercial streams. Concerns are raised, however, regarding the future of *Alkantpan* as it falls within the Square Kilometre Array (SKA) project's radio frequency bounds which may affect future operations.

The management of technology development programmes saw funding of R590 million distributed between various roleplayers. The Defence Industry received the most (54 per cent) while the CSIR received 27.4 per cent and Armscor's own research facilities 16 per cent. Universities received only 2.6 per cent.

Other defence science technology institutes that receive the bulk of their funding from the DOD include:

- *Armour Development*: Conducting of defensive and reactive armour development. Funded by the Research and Development Board. In 2015/16 it was contracted to evaluate body armour for the SANDF.
- *Protechnik laboratories*: Focus on chemical and biological defence. In 2014/15 the laboratory delivered 89 per cent of its research/development services to the DOD, 9.5 per cent to other government departments and 1.5 per cent to the private sector. This breakdown was not provided in the 2015/16 Annual Report.

[4] Armscor. (2016). p. 33
[5] Armscor. (2016) p. 34

- *Ergonomics technologies*: Focus on integrating ergonomics into the SANDF. In 2015/16, research expanded to include human-computer interaction.
- *Hazmat protection services*: Production of respiratory products to government and commercial clients. For 2015/16, 100 per cent of Hazmat's income was from private clients.
- *Institute for Maritime Technology*: Provision of techno-military expertise to support naval decision-making. In 2015/16, 93 per cent of its total sales of R89.3 million was funded by the DOD. This Institute has worked on several successful projects during 2015/16, some of which include the testing of an off-board active decoy to divert missiles fired at naval vessels; conducting a joint international experiment on underwater electro-optic sensor performance; and, the successful operationalisation of the Ultrasonic Broken Rail Detector.
- *Defence division support institute*: Provision of decision support to the DOD.
- *Flamengro*: Computer aided engineering centre of excellence.

Questions

- What is the current status of Alkantpan and how will future operations be affected by the Square Kilometre Array (SKA) project?
- Universities receive only 2.6 per cent of the allocation for technology development programmes (R590 million). Is this amount reflective of the work done by universities? Would it not be beneficial in terms of skills development to provide more funding to universities?
- What is the timespan of the Armour Development's evaluation of body armour for the SANDF and what will the cost be?
- What is the breakdown of Protechnik's services (percentage funds raised from the DOD, other Departments and private clients)? Are there ways to increase its commercial viability?
- The Hazmat facility should be lauded for its ability to remain commercially viable and self-funded despite difficult economic times.
- Are there ways to expand the commercial viability of the Institute for Maritime Technology? Have any other local or international partners besides Transnet been approached to sell the Ultrasonic Broken Rail Detector?

6. THE ARMSCOR DOCKYARD[6]

The Armscor Dockyard serves as the primary maintenance supplier to the SA Navy. As was noted in a number of previous years, the 2015/16 financial year was marred by **several major concerns**, including:

- A lack of funding. The funding gap results in the baseline support capability not being achieved.
- A lack of capacity. Manpower levels are well below the minimum capability levels required.

[6] Armscor. (2016) p. 42.

Based on these challenges, the Minister of Defence took a decision to change the management of the dockyard. Subsequently, she called or a "harmonious approach"[7] to management comprising Armscor, Denel and the SA Navy. In this arrangement (as approved by the Council on Defence), Armscor will become the contracting agent, Denel will manage and operate the Dockyard and the SA Navy will have sovereign control of the Dockyard.

In 2015/16, repair and maintenance were done on a number of SA Navy vessels, including submarines, frigates, tug boats and patrol vessels. The Armscor Annual Report notes that the Dockyard achieved 97.35 per cent in ensuring milestone planned dates as approved in the project plan against a target of 90 per cent. However, the DOD Annual Report notes that the SA Navy was not able to achieve its sea hours for 2015/16 due to, inter alia, limited dockyard capacity.[8]

Questions

- Members should request a full explanation of the current status of the management of the Dockyard under the new "harmonious" agreement between the SA Navy, Armscor and the Dockyard.
- How will the shift of the Dockyard away from Armscor affect Armscor's income?
- Under the new management agreement, are there opportunities to explore commercial avenues for the Dockyard? (Members should note that commercial opportunities may assist with funding and upkeep of the Dockyard as there are limited dockyards available in South Africa. A balanced approach is required, however, as the Sa Navy should always remain the primary client and be prioritised as such).
- Members may ask Armscor to elaborate on the statement in the DOD Annual Report that the lack of Dockyard capacity contributes to the limited sea-hours achieved.

7. HUMAN RESOURCES MANAGEMENT AND TRANSFORMATION[9]

The 2015/16 Annual Report indicates that Armscor, including the Armscor Dockyard, has a staff complement of 1 383, which is lower than the 2014/15 figure of 1 437. In terms of representation, a target was set to increase black employees from 64 to 66 per cent and performance of 75 per cent was achieved. Female employees now comprise 34 per cent of Armscor. A limited number of black females were added to the system, but the realignment of racial representation was mostly due to the reduction of while male personnel from 294 in 2014/15 to 264 in 2015/16. Of concern, however, is that this loss relates mostly to the loss of 21 personnel in the Professionally Qualified and Experienced Specialist and Mid Management Level which may result in skills losses. Not all these mid-management level positions were filled during 2015/16.

The following table is a demographic display of the staff component of Armscor, including the Armscor Dockyard, as at 31 March 2015.

[7] Armscor. (2016) p. 23.
[8] DOD. (2016) p. 40.
[9] Armscor. (2016). p. 48.

Table 1: Staff profile of Armscor, including Armscor Dockyard[10]

	African		Coloured		Indian		White		Total		Grand total
BB	**M**	**F**	**M**	**F**	**M**	**F**	**M**	**F**	**M**	**F**	
EX	6	2	0	0	0	0	2	0	8	2	**10**
SU	16	13	2	0	2	1	21	2	41	16	**57**
MP	95	47	21	4	20	3	172	32	308	86	**394**
STS	77	93	34	12	6	9	36	63	153	177	**330**
AS	82	113	175	26	0	5	32	20	289	164	**453**
OS	49	34	47	7	1	0	1	0	98	41	**139**
Totals	**325**	**302**	**279**	**49**	**29**	**18**	**264**	**117**	**897**	**486**	**1383**

In order to address skills shortage, Armscor continues to provide skills development through a number of programmes, the following of which are noteworthy:

- Armscor management and leadership programmes: 42 students completed training in 2015/16
- International Training Programmes. Five Armscor employees are studying at the Naval Post Graduate School in the USA in engineering, combat systems and cyber security.
- Talent Development Programme. A total of 30 candidates were included in this graduate training programme. This is a welcome improvement from the 20 candidates included in 2014/15.
- Bursaries. 55 Bursaries were made available to undergraduate students at various universities.
- SA Navy training. The Dockyard provided technical training to 31 SA Navy electrical engineer students and two mechanical engineer students.
- Apprenticeships. Through a MOU with the Department of Economic Development and Tourism, the Dockyard trained 77 apprentices in 2015/16. Of these, 44 were Armscor apprentices and 33 formed part of the Departmental contingent.

Questions

- What were the figures of Armscor staff per age group?
- Will the loss of personnel at Professionally Qualified and Experienced Specialist and Mid Management Level impact on the skills-sets available to Armscor and its operations?
- How has the overall reduction in personnel affected Armscor?
- Does Armscor have the ability to replace the previously reported ageing technical workforce through its training initiatives?
- How long is the practical training for SA Navy students in the Dockyard? When are they set to finish training and how will this address the medium-term concerns related to the Dockyard?
- The Artisan Training programme at the Dockyard should be lauded. Are there ways to expand this capacity to other departments?

[10] Armscor. (2015). p. 54.

8. PERFORMANCE OVERVIEW: UNDER ACHIEVEMENTS AND CHALLENGES[11]

Armscor's Three-year Corporate Plan includes two groups of performance indicators. The first of these groups relate to performance against Armscor's functions as defined by the Service Level Agreement (SLA) with the Department of Defence and Military Veterans (DODMV). The second group measures performance against the set strategic objectives of the group.[12] *A total of 43 Key Performance Indicators (goals) were set for 2015/16. Armscor managed to achieve 36 of these, which is a success rate of 83.7 per cent.*

The KPIs not achieved were as follow:

Table 2: Selected Key Performance Indicators not achieved during 2014/15

Objective	KPI	Goal	Achieved	Performance against goal
Objective 3: Resourcing of Armscor Capabilities	Establish a Service Level Agreement with the SAPS	31 March 2016	-	A draft SLA was supplied but not finalised.
Objective 3: Resourcing of Armscor Capabilities	Establish a Service Level Agreement with Correctional Services	31 March 2016	-	Not achieved
Objective 3: Resourcing of Armscor Capabilities	Increase revenue from other departments (e.g. SAPS and Correctional Services to reduce the budget deficit	Conclude service agreement allowing charging of fees	No income generated	SLAs not finalised and no income generated from other departments.
Objective 3: Resourcing of Armscor Capabilities	Establish implementation plan for the Dockyard Modernisation Study	13 December 2015	-	This initiative was not taken further due to the changes in management of the Dockyard prompted by Ministerial intervention.
Objective 3: Resourcing of Armscor Capabilities	Implement HR, Payroll and Budget Modules	31 March 2016	-	Tender process and contracting took longer than expected.
Objective 3: Resourcing of Armscor Capabilities	Implement data leakage prevention solution	31 March 2016	-	Objective only partially achieved

[11] Armscor. (2016) p. 77
[12] Armscor. (2013b) p. 83

Objective 4: Industry sustainability	Increase the percentage of local industry spend in respect of the Special Defence Account and General Defence Account managed by Armscor	2 per cent improvement	-6.6 per cent	Actual local spending represents 79 per cent of total spending in 2015/16 compared to 85.59 in 2014/16.

Questions

Armscor should be lauded for its high percentage achievement against set targets for 2015/16.

- What is causing the delays in the signing of SLAs with the SAPS and the Department of Correctional Services? What will be the expected income to Armscor following the signing of these SLAs?
- No income was generated from other departments. What plans are in place to approach other departments or even commercial clients to conduct generate increased income?
- Will the Dockyard Modernisation Strategy be transferred to the new management of the Dockyard?
- What is the current status of the Implement HR, Payroll and Budget Modules?
- What is the current status of the implement of the data leakage prevention solution?
- The decrease in local spending is of a major concern. However, related to some weaponry bought from abroad, it may be understandable that local spending in certain years will be lower. What contributed to the reduced local spending in 2015/16? What can be done to enhance this in 2016/17?

9. FINANCIAL STATEMENTS AND REPORT OF THE AUDITOR-GENERAL

The net value of the Group increased from R1.995 billion in 2014/15 to R2.192 billion. The total comprehensive income of the Group also increased from R84.2 million in 2014/15 to R200.1 million in 2015/16. However, of concern is the reduction in revenue which decreased from R1.525 billion in 2014/15 to R1.395 billion in 2015/16. This is largely due to:

- A R30 million reduction in the sale of goods and services
- A R54.6 million reduction in the allocation from the state budget
- A R8.6 million reduction in finance income
- A R41.4 million reduction in other income

The following additional financial matters should be noted:

- Total revenue declined by 7.6 per cent while expenditure increased by 13.1 per cent.
- A loss of R139.5 million is noted due to the settlement made to members of the Armscor Medical Benefit Fund.
- There was a major increase in the fees and committee remuneration for non-executive members of the Armscor Board which increased from R833 375 in 2014/15 to R3.365 million in 2015/16.

- The total payment to the executive directors increased from R4.661 million in 2014/15 to R5.799 million in 2015/16.
- An amount of R1.668 million relating to **unrecoverable debts** was written off during the year.
- **Fruitless and wasteful expenditure** amounting to R823 was incurred as a result of interest paid on late. This is similar to the R790 Fruitless and Wasteful expenditure in 2014/15.

Armscor had R13.2 million in **irregular expenditure** in 2015/16, which is lower than the R34.5 million in 2014/15. This relates to Armscor's 25% black equity selection criterion as a requirement. However, as this selection criterion was deemed to be in conflict with the PPPFA, the total value of contracts was considered as irregular. Armscor has engaged with National Treasury on this matter.

Finally, as was the case in 2014/15, Armscor received a **clean audit with no qualifications** from the Auditor General of South Africa for 2015/16.

Questions

- Given the reduction in the Group's total comprehensive income, how long will the Group still be able to operate without significant increases in funding requirements from the state budget?
- What contributed to the reduction of the sale of goods and equipment?
- What contributed to the R41.4 million reduction in "other income"?
- Members should ask for further explanations as to the R139.5 million loss due to the settlement made to members of the Armscor Medical Benefit Fund.
- What is being done to reduce the figure for future unrecoverable debts?
- What is the status of discussions with National Treasury regarding the application of Armscor's 25% black equity selection criterion?
- What contributed to the non-executive board members' increase in payment from R833 375 in 2014/15 to R3.365 million in 2015/16?
- What contributed to the executive director's total payments from R4.661 million in 2014/15 to R5.799 million in 2015/16?

Armscor should be lauded for the continued achievement of a clean audit from the AG an encouraged to maintain this status.

10. CONCLUSION

Armscor has succeeded in maintaining its clean audit without findings from the AG. This is representative of its high levels of corporate and financial discipline. Furthermore, it managed to increase its surplus from R84 million in 2014/15 to over R200 million in 2015/16. Nonetheless, the reduction in revenue is a concern. The future pressures on Armscor will most likely stem from the reduced spending capacity of the DOD, which is its primary client. As such, the search for commercial opportunities is important to offset the loss of income from the DOD. This also relates to the Dockyard where, under the new management agreement, such opportunities can be explored. However, Armscor, along with its management partners in the SA Navy and Denel, should maintain the status of the SA Navy as a primary client at the Dockyard and ensure unparalleled service delivery to the Navy.

REFERENCE

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