



Report of the State Comptroller of Israel | May 2022

The Government Defense Industries

**Aspects of the
Relationships
between Israel
Aerospace Industries
Ltd. and the Ministry
of Defense with an
Emphasis on
Development Projects**



Aspects of the Relationships between Israel Aerospace Industries Ltd. and the Ministry of Defense with an Emphasis on Development Projects

Background

Israel Aerospace Industries Ltd. (IAI) is a wholly government-owned company. The company operates through four business divisions in four main activity sectors: missiles and space, military electronics, military aircraft, and civilian aviation. In 2020, its sales totaled about USD 4.18 billion, of which about USD 3.33 billion were to the military market (about 79%). Since 2007, the company has been a "reporting corporate" as defined in the Securities Law, 1968¹. Accordingly, it is subject to the law's provisions and regulations.

The Ministry of Defense (MOD) is a central and dominant body in the defense acquisitions in Israel, which operates in several spheres with respect to the defense industries: it is an essential customer of them, works to increase their sales abroad, and as a regulator of defense exports. The Minister of Defense is responsible for the government's defense industries. The MOD engages with its suppliers, including IAI, by its directives, which among other things, determines economic rules for its engagements. In general, the MOD's engagement forms with its suppliers are divided into cost-plus engagements and fixed-price engagements.

In 2020, IAI's revenues from MOD acquisitions totaled about USD 993 million, about 24% of its revenues. The remaining orders from the MOD were about 20% of the company's order backlog as of December 31, 2020 (about USD 2.6 billion). In general, the IAI's research and development (R&D) activity for the MOD takes place mainly through orders received from it, part of which are combined with self-financed by the company. The R&D activity includes R&D programs at initial stages² and full-scale development projects³ (development projects).

1 A corporate that is obliged to file reports and announcements to the Securities Authority and the Tel-Aviv Stock Exchange, or only to the Securities Authority according to the securities law.

2 Up to the pre-development stage (inclusive).

3 Full-scale development (FSD) – mainly engineering adjustments and supplements that are made to a technology demonstration until reaching an operational system. Full-scale development projects sometimes also include producing an initial series of the product.



Key figures

an absolute majority

of the engagements of DDR&D⁴ with IAI and with Rafael Advanced Defense Systems Ltd. in 2017–2020 had an exemption from a tender⁵

a significant majority

of the dozens of main development projects⁶ of IAI for the MOD in 2016–2020 were done in fixed-price engagements

a few percent

the minimal operating profit margin that IAI defined in its strategic plan for engagements in fields "that are necessary for defense needs of the MOD" in contrast with other percentages in the rest of its engagements with the MOD and with other customers

190

the average annual number of deals that IAI signed with the MOD during the past three years, at an average of USD 5.2 million per deal

a certain portion

of the main development projects carried out by IAI for the MOD in 2016–2020, with an operating loss. This in contrasts with a smaller portion of the projects it carried out for foreign customers

about NIS 1 billion

the maximum debt amount of the MOD to IAI in the years 2017–2020 (this debt was in February 2020)


⁴ The Directorate of Defense Research & Development in the MOD.

⁵ During the years 2017–2020, the MOD, via the DDR&D, carried out hundreds of tender-exempt engagements with IAI and with Rafael; during these years, IAI and Rafael competed in several individual tenders and won some of them.

⁶ Projects in which there is a development component, and the revenues from them amounted to a multi-year total of 15 million dollars and up between the years 2016–2020. During 2016–2020 IAI carried out dozens of main development projects for the MOD and many dozens of main development projects for foreign customers.



Audit actions

 From October 2020 to September 2021, the State Comptroller Office examined the relationships between the IAI and the MOD with an emphasis on development projects, including the MOD's policy on ordering development projects; the IAI's policy on carrying out the said projects for the Mod; the forms of engagement in these projects; the profitability of the IAI's development activity for the MOD; the IAI's participation in the development costs of the said projects; and accounting and economic aspects of the engagements under this activity. The audit was conducted in IAI and the MOD. Supplementary examinations were done in the Ministry of Finance, the Israel Securities Authority (ISA), the Ministry of Justice, the Government Companies Authority (the Companies Authority), the Ministry of Economy and Industry, and Rafael Advanced Defense Systems Ltd. (Rafael).

This report was presented to the Prime Minister and the Knesset State Audit Committee on December 30, 2021, and was classified as confidential until the State Audit Committee's subcommittee hearing.

By the authority under Section 17(c) of the State Comptroller Law, 1958 [Consolidated Version], and after considering the government's arguments, consulting with the bodies responsible for the protection of national security information and in coordination with the Chairman of the Knesset, since the subcommittee above did not convene, it was decided to publish this report while imposing confidentiality on sections of it. These sections shall not be submitted to the Knesset, nor shall they be published.

The findings of the audit report and its recommendations are valid as of the date of its presentation.

Key findings



Form of engagement in development projects





In the MOD, including in the DDR&D, no metrics have been set for assessing the projects technological risk levels, such as TRL⁷, this among other things, to match engagements forms with project risk levels, with an emphasis on development projects.

⁷ TRL – Technology Readiness Level. A world standard set by NASA (the National Aeronautics and Space Administration), which is customary for rating development risks in projects according to their level of readiness.




MOD directives regarding setting the profit ratio in development projects


 In its directives, the MOD defined uniform profit margins for all of its engagements in all of its areas of activity and with all of its suppliers (5.3%–9.8⁸ by the engagement form). It did not define different profit margins for development projects, despite their unique characteristics and especially due to the technological risks in their implementation.

 Despite the risks inherent in development projects and the impact of their occurrence on timetables and the costs of projects – the MOD, in its directives to the defense industries, including IAI, does not enable them to include a component of unexpected costs in price quotes for carrying out projects. It should be noted that IAI includes unexpected costs in its internal calculations.


IAI's policy regarding its activity in development projects for the MOD

 In its strategic plan, IAI defined a certain minimum operating profit margin for future engagements in activity "that is necessary for a defense need of the MOD" in contrast with other minimum profit margins for the rest of its engagements with the MOD and with other customers, without having based this on calculations to examine the operating profit margin necessary for providing it with sufficient profit margins to prevent losses to the company carrying out these projects.

IAI profitability in development projects for the MOD

 The State Comptroller Office analyzed profitability in the IAI's main development projects for the MOD and foreign customers, including development projects that are losing money, and raised findings on these issues.




The participation of the defense industries in financing development projects for the MOD

 In its directives, the MOD has not determined rules regarding the extent of the participation and the level of the commercial discount it demands from its suppliers. The defense industries participate in the development costs of projects for the MOD in significant amounts totaling hundreds of millions of USD. The continued application of the MOD's policy, according to which the defense industries will be asked to significantly participate in the development costs of projects, could influence their business situation in the long term and, as a result – also on their ability to provide optimal technological solutions to the defense system in the future.


8 In a fixed-price contract, an additional 0.5 is given that is contingent on the length of the contract and the existence of risks arising from the length of the engagement




Payments by the MOD to IAI

-  The Ministry of Finance's control procedure, including the head of the Finance Department and accountant⁹ of the MOD's control of the MOD's engagements, did not allow to ensure all budgetary sources for paying its liabilities on time.
-  In 2017–2020, the MOD did not pay all of its debts to the IAI and Rafael on time¹⁰; this trend worsened in 2020. In February 2020, the MOD's debts to IAI totaled over NIS 1 billion; and in March 2020, its debts to Rafael totaled about NIS 694 million. The MOD did not pay the interest due to the delays in these payments, which is not in line with its directives.
-  The delay in the MOD's debts payments to the major defense industries is not compatible with the rules of good governance, and it causes them cash flow uncertainty and harms their operating activities' cash flow, exposing them to the risk of not meeting financial covenants to financial corporations and bondholders, and harms the relationship with their suppliers. This is in addition to financing and factoring costs¹¹, which have harmed the profits of governmental defense industries and the dividend that they would pay to the state from these profits. The IAI estimated the costs of financing in 2017–2020 due to delayed payments in the tens of millions of NIS, out of which about 42% are due to financing costs to external sources.

IAI payments to its suppliers

-  In 2018–2020 IAI did not pay its suppliers on the payment dates in accordance with the provisions of the Law on the Delivery of Payments to Suppliers, 2017 (no later than 45 days from the date when the invoice has been submitted to it or 30 days from the end of the month when the invoice has been submitted to it). In 2020, the credit period for payment to suppliers reached 81 days.

Accounting aspects regarding IAI development projects for the MOD

-  The accounting records of fixed assets and intangible assets in the financial reports of the MOD are based on figures that are reported by its various units, which are not uniform in terms of the R&D costs attributed to asset categories, meaning – the records are lacking, and are not systematic and uniform, and they are not in line with governmental accounting standards.

⁹ The head of the Finance Department also serves as the accountant of the MOD.

¹⁰ Except during the months May 2018 – July 2019, in which the MOD paid its debts to Rafael on time.

¹¹ Current financing in exchange for future repayment, minus agreed interest and fee.



IAI transactions with controlling shareholders¹²



The IAI's procedure on transactions with interested persons¹³ has not been updated since 2014, even though changes have occurred in the examining criteria of transactions with the controlling shareholder¹⁴, as shown in the company's reports to the Securities Authority and the Tel Aviv Stock Exchange Ltd.



The State Comptroller Office commends the MOD's actions to establish an export team and to improve procedures of export licenses and GTG activity¹⁵ and the examination process regarding various aspects of the Ministry's activity interfaces with the defense industries as part of establishing an industries team.

Key recommendations

The MOD's directives regarding setting the margin ratio in development projects



It is recommended that the MOD comprehensively examine the profit components in its engagements with the industries vis-à-vis the risk inherent in them, among other things, by carrying out international comparisons and analyzing accepted industry yields.



It is recommended that the MOD carry out administrative work, considering the positions of the defense industries, to examine the optimal way to include unexpected cost components in advance in its engagements with the defense industries for carrying out its projects, especially development projects with significant inherent risks; and by the findings of its examination, it should update its directives on the issue. This is to enable,

12 Control as defined in the Securities Law – the ability to direct the activity of the corporation, except for the ability that stems only from fulfilling the role of director or other position holder at the corporation. It is presumed of a person that he controls a corporation if he holds half or more of a certain kind of control means in the corporation (the right to vote at an Assembly of the General Meeting or the right to appoint directors or the CEO).

13 The procedure determines the responsibility for identifying the company's transactions with interested persons (as defined in the Securities Law), internal reporting on them and their approval, and reporting to the public on such transactions.

14 In this report – the controlling shareholder is the State of Israel via the MOD.

15 Government to government (GTG) are agreements in which the MOD signs agreements with the governments of target countries for the development and production of weapons systems. Along with the sides signing these agreements, the MOD, on behalf of the State of Israel, signs "back to back" agreements with the Israeli defense industries, in which the defense industries commit to implementing the commitments that the state has taken upon itself in the aforementioned agreements.



among other things, transparent conduct on unexpected costs between it and the defense industries, including IAI.

Tenders aspects regarding the DDR&D's engagements with IAI and Rafael

- 💡 It is recommended that the MOD's Director General advance the guidelines formulation for the DDR&D's committee of developers' considerations in choosing the engagement format – public tender, closed tender, or exemption from a tender. It is also recommended that the DDR&D establish an information system for managing the competitive procedures that it carries out so that it can present a situation report of all of the engagements it carries out via tenders and other competitive procedures, the reasons for adopting one procedure or another, and its results.

IAI's policy on its activity in MOD development projects

- 💡 It is recommended that the MOD, the Ministry of Finance, and the Companies Authority appoint a committee to examine the policy on the participation of the defense industries (governmental and other) in financing development projects, including the impact of this policy on their operating activities, their financial strength and their business situation in the medium and long term, and their ability to provide a variety of future technological solutions that will address the IDF's needs. It is also recommended that guidelines and a business model be determined and published.

IAI's policy on its activity in MOD development projects

- 💡 It is recommended that IAI examine, based on calculations, the minimum operating profit margin needed in MOD's development projects that will allow it to achieve net profits and anchor targets in this field in its updated strategic plan. It is also recommended that IAI thoroughly examine establishing a mechanism for approving engagements with the MOD, at a determined monetary extent, whose profitability is lower than the minimal profit margin set in the company's strategy. In addition, it is recommended, given the characteristics of the MOD's development projects carries out by IAI, including the large share of development in them and the risks inherent in them, that IAI examine its assessments regarding their profitability before their approval and at all stages of their implementation, referencing, among other things, to their technological level risk, especially in projects whose profitability from the start is expected to be low. It is also recommended that IAI formulate a methodology for assessing the expected benefit from projects of this kind in addition to the potential profitability, so that it can present relevant figures before their approval by the company.

MOD payments to IAI

- 💡 The MOD should abide by the payment dates determined in its directives and pay linkage differentials and interest to its suppliers in cases where it does not pay its debts on time.
- 💡 The Ministry of Finance's Accountant General and the MOD's Finance Department, in coordination with the Ministry of Finance's Budgets Department and MOD's Budgets



Department, should act to improve and strengthen the control mechanisms for the MOD's engagements to ensure that their scope and conditions match the size of its budget and that the Ministry can make the payments for them on time.



It is recommended that the Ministry of Finance bodies (the Accountant General and the Budgets Department), the MOD, and the Attorney General of Israel regulate the MOD's payment dates to IAI and the other defense industries and that they formulate agreed guidelines regarding the format of factoring and method of approving it.

IAI's payments to its suppliers



IAI must pay its suppliers on the dates determined in the Law on the Delivery of Payments to Suppliers and pay linkage differentials and interest by law on payments in arrears.

IAI transactions with controlling shareholders



It is recommended that given the conditions of the transactions between IAI and the MOD, the IAI's Board of Directors examine the need to determine updated criteria for the company's transactions with the controlling shareholder, with an emphasis on non-negligible transactions, for defining how to approve and internally report on them. Among other things, this increases its involvement in the issue, including its monitoring. In addition, it is recommended that the Board of Directors consider determining criteria for examining transactions with the controlling shareholder by divisions and by their activity level.



Summary

IAI's activity for the MOD, in general, and in development projects, in particular, has direct and indirect impacts on its business results, and it is essential for it in many aspects. The audit raised deficiencies relating to the IAI's management and control of MOD's development projects and the MOD's management and control regarding its engagements with IAI and the rest of the defense industries, with an emphasis on development projects. It was found that these issues, directly and indirectly, affected IAI's business situation, and they could influence its situation. Given the national importance of the activity of the defense industries for the MOD in defense and the economy terms, it is recommended that the MOD, the Ministry of Finance, and the Companies Authority work, in cooperation with the major defense industries, set guiding principles for the interfaces between them, while maintaining balance and transparency in the various spheres of their relationships; This to maintain the IDF's technological superiority and its strength as well as the resilience of the defense industries.

