Auditing armament projects – the industry perspective

Klaus Neumann | Head of Accounting | Luxembourg | 15 May 2019
Auditing armaments projects - the industry perspective

Agenda

01 Rheinmetall Group

02 Audit and financial control overview

03 Financial controls on projects

04 Practical challenges for defence companies
01 Rheinmetall Group
01 Rheinmetall Group

About Rheinmetall

Rheinmetall was established in 1889 as Rheinische Metallwaaren- und Maschinenfabrik Aktiengesellschaft.

Today, Rheinmetall AG, publicly listed and based in Düsseldorf, is a powerful, internationally successful corporation and is the management holding company of the Rheinmetall Group. As an integrated technology group, Rheinmetall is a market leader in the areas of environmentally friendly mobility and threat-appropriate security technology.

The group’s operating activities are split into the two corporate sectors, Rheinmetall Automotive and Rheinmetall Defence.
01 Rheinmetall Group
Mobility and security under one umbrella

Rheinmetall Group

<table>
<thead>
<tr>
<th></th>
<th>Sales (€ million)</th>
<th>Operating Result (€ million)</th>
<th>Employees</th>
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<tbody>
<tr>
<td>Rheinmetall Automotive</td>
<td>2,930</td>
<td>492</td>
<td>12,855</td>
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<tr>
<td>Rheinmetall Defence</td>
<td>3,221</td>
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<td>11,832</td>
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01 Rheinmetall Group

Key facts 2018 Rheinmetall Defence

<table>
<thead>
<tr>
<th>Metric</th>
<th>Value</th>
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<tbody>
<tr>
<td>Sales €Million</td>
<td>3,221</td>
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<tr>
<td>Operative Result €Million</td>
<td>254</td>
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<tr>
<td>Capital Expenditure €Million</td>
<td>101</td>
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<tr>
<td>Employees</td>
<td>11,832</td>
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<tr>
<td>Order Backlog €Billion</td>
<td>8.6</td>
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<tr>
<td>R&amp;D Intensity %</td>
<td>4.4</td>
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## 01 Rheinmetall Group
### Leading European Defence Company

<table>
<thead>
<tr>
<th>Weapon and Ammunition</th>
<th>Electronic Solutions</th>
<th>Vehicle Systems</th>
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<tbody>
<tr>
<td>Weapon and Munition</td>
<td>Air Defence &amp; Radar Systems</td>
<td>Logistic Vehicles</td>
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<tr>
<td>Propulsion Systems</td>
<td>Integrated Electronic Systems</td>
<td>Tactical Vehicles</td>
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<tr>
<td>Protection Systems</td>
<td>Technical Publications</td>
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Auditing armaments projects - the industry perspective

May 2019
# 01 Rheinmetall Group

## Rheinmetall Defence - Divisions

<table>
<thead>
<tr>
<th>Corporate sector</th>
<th>Division</th>
<th>Areas of activity</th>
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<tbody>
<tr>
<td>Defence</td>
<td>Vehicle Systems</td>
<td>Armored tracked vehicles</td>
</tr>
<tr>
<td></td>
<td></td>
<td>NBC protection systems</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Turret systems</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Wheeled logistics vehicles</td>
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<tr>
<td></td>
<td></td>
<td>Wheeled tactical vehicles</td>
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<td>Weapon and ammunition</td>
<td>Large and medium caliber weapons and</td>
<td>Large and medium caliber weapons and their ammunition</td>
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<tr>
<td></td>
<td>their ammunition</td>
<td>Weapon stations</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Protection systems</td>
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<tr>
<td></td>
<td></td>
<td>Propellants and powder</td>
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<tr>
<td>Electronic solutions</td>
<td>Air defence systems</td>
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<td></td>
<td>Soldier systems</td>
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<td></td>
<td>Command, control and reconnaissance</td>
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<tr>
<td></td>
<td>systems</td>
<td></td>
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<tr>
<td></td>
<td>Fire control systems</td>
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<tr>
<td></td>
<td>Sensors</td>
<td></td>
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<tr>
<td></td>
<td>Land simulation, flight simulation,</td>
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<tr>
<td></td>
<td>maritime and process simulation</td>
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02 Audit and financial control overview

Practical challenges for defence companies
02 Audit and financial control overview
Financial communication to stakeholders

Shareholders

Financial Report

AGM

Analysts and Investors

Earnings Call

Road Shows

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<th></th>
<th>2019</th>
<th>Q1</th>
<th>Q2</th>
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<td>Analysts and Investors</td>
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<td>Earnings Call</td>
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<td>Road Shows</td>
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</table>
02 Audit and financial control overview

Three lines of defence

Supervisory Board

Executive Board

1st Line of Defence*
- Central Functions Rheinmetall Group
- Automotive/Defence

2nd Line of Defence
- Risk management
- Compliance Management
- Internal Control System

3rd Line of Defence
- Internal Audit

* Responsibility: Ensuring compliance with requirements; Implementation of control measures

Auditing armaments projects - the industry perspective
02 Audit and financial control overview

Internal and external audits

- **External auditors**
  - Group audit
    - 2018 FY
    - 2019 FY
  - Statutory audit
    - 2018 FY
    - 2019 FY

- **Tax office**
  - Tax audit
    - Continuously (for past years)

- **Internal Audit**
  - Annual Audit Plan
    - Continuously

<table>
<thead>
<tr>
<th>Year</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td></td>
<td></td>
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</tbody>
</table>
03 Financial controls on projects
02 Audit and financial control overview

Project reviews at group level

Continuous review process

Audit Committee
- Financial Report
- Major Project Report
- Performance Report
- Key Project Reviews

Executive Board
- Financial Report
- Major Bid Approval

Defence Board
- Performance Review
- Material Bid Approval

Performance Report
- Key Project Reviews

2019 Q1 Q2 Q3 2020

As required

As required
03 Financial controls on projects
Audit focus of external auditors - illustrative

- Determination of percentage of completion
- Identification and valuation of offset obligations
- Commissions and other contract acquisition costs
- Onerous contracts
- Penalties and variable consideration
- Warranties
- Project financing incl. interest and FX
03 Financial controls on projects
Audit approach by external auditors

<table>
<thead>
<tr>
<th>Preparation</th>
<th>Internal Control Environment</th>
<th>Revenue and Projects</th>
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<tr>
<td>Risk Assessment</td>
<td>Audit Instructions</td>
<td>Gain Understanding</td>
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<tr>
<td>Control Testing</td>
<td>Journal Testing</td>
<td>Project Reviews</td>
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<tr>
<td>Audit Conclusion</td>
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</tbody>
</table>

- 2019  -  Group Audit Team
- 2019  -  Local Audit Team
- Group
- Entity

- Sample
- Preliminary
- Following multi year plan
- Update
- Report

- 2019 FY
- 2019 - Sep
- 2019 - Oct
- 2019 - Nov
- 2019 - Dec
- 2020  - 2020
- Jan

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04 Practical challenges for defence companies
04 Practical challenges for defence companies
Case Study: Australia – Land 400 Phase 2 – Overview

What is LAND 400?

The Commonwealth of Australia is Rheinmetall’s customer for LAND 400, a program that will deliver the next generation of armoured fighting vehicles for the Australian Army.

It is the biggest and most expensive acquisition project in both the Army’s and Rheinmetall’s history, as well as the first truly ONE Rheinmetall program – bringing together all elements of the Rheinmetall Group to make the most of our collective competencies and improve collaboration.

Phase 2 of LAND 400 is the Combat Reconnaissance Vehicle or CRV.
04 Practical challenges for defence companies

Case Study: Australia – Land 400 Phase 2 - Product

**Lethality:**
- MK30-2/ABM main cannon (200 rounds)
- MAGS8 7.62 coax machine gun (620 rounds)
- Air Burst Munition functionality

**Mobility:**
- 38.5 ton Drive Module (interim)

**Sustainability:**
- Crew of 3 (Cdr, Gnr, Drv) and 4 dismounts
- Local Situation Awareness System (LSAS)
- RECON Mission Kit and CES
- BOXER JTS Ballistic Protection
- Applique Armour
- Mine deflector (KMW)

**C4I:**
- Radio fit (Harris & Raytheon)
- Battle Management System (Elbit & Thales)
- SOTAS intercom (Thales)

**FIGHTABILITY:**
- Situational Awareness System (6x SCM 60)
- SEOSS P/S (obsolescence-cleaned)
- LWS (Laser Warning System)
- ROSY (Rapid Obscuring System)
- ASLS (Acoustic Shooter Locating System)

**Survivability:**
- BOXER JTS Ballistic Protection
- Applique Armour
- Mine deflector (KMW)
04 Practical challenges for defence companies
Case Study: Australia – Land 400 Phase 2 – Organisation

Project Management

Auditing armaments projects - the industry perspective
04 Practical challenges for defence companies

Case Study: Australia – Land 400 Phase 2 – Challenges

For the complex contract and project setup ...

- Customer contract in five currencies
- Significant contribution of ten Rheinmetall entities in four countries with three currencies
- Ten different accounting systems
- Four different local GAAP
- Four different tax regimes
- Project specific costing concept that is different to existing costing systems
- Complex technical accounting topics (revenue recognition, hedge accounting, leasing, government grants, ...)

... ensuring transparency is challenging

- All information needs the context of the relevant reporting framework in order to be correctly understood.
- Group wide view of financial performance requires additional specific information to
  - eliminate intra-group profits on consolidation
  - determine the group wide percentage of completion
04 Practical challenges for defence companies

Limited standardization and project complexity lead to additional costs

Accounting and Tax

- **Accounting**
  - Harmonised standard for group reporting
  - Local GAAP different in all countries

- **Tax**
  - Regulations differ in all countries
  - Transfer pricing follow harmonised standards but regarding detailed negotiations especially for multi year contracts

Customer requirements

- **Procurement and project management**
  - Divergence in procurements practices
  - Divergence in project management requirements

- **Product specifications**
  - Different product specifications for basically identical products (e.g. for some ammunition)
  - Different product specifications for products that basically serve the same purpose (e.g. vehicles)

- **Offset and local industrial content**
04 Practical challenges for defence companies

Limited standardization: Focus on ammunition

Standards (e.g. NATO) exists for
- Ammunition types
- Ammunition colour coding

But ...
- countries have additional specific additional requirements for (colour) coding of ammunition
- countries have specific requirements for ammunition lots, e.g. size of lot, number of fuse lots in one ammunition lot.
- countries require audits of the production process during the production of their ammunition

As a consequence preproduction even of components is not possible. This leads to long lead time and additional costs.