

Interview

12:57  
31.07.2018

**Zgurovsky: A financial audit of Ukroboronprom will answer the question about the past, a strategic audit – about the future of the concern**

21 min read



Interview of the Head of the Supervisory Board of the state concern Ukroboronprom Mykhailo Zgurovsky by the Kyiv-based Interfax-Ukraine news agency

**IF-UA: In July, it will be half a year from the moment of your election to the head of the Supervisory Board of Ukroboronprom, it will be**

**logical to sum up the first results of the work done by the Supervisory board in this period. What, in your opinion, can be attributed to an asset that has not yet been achieved?**

**MZ:** First of all, it should be noted that together with the new management of Ukroboronprom we monitored the activities of state concern enterprises - before they were 134. And it turned out that about 30 enterprises are engaged in activities that are not directly related to the defense industry. In this connection, the advisory board and the administration of the state concern decided to transfer them to the State Property Fund (SPF) subordination for further use by designation. Today, the management of the state concern is about 100 enterprises engaged directly in defense production.

The analysis also showed that enterprises of the state concern do not operated in a coordinated manner. There is duplication in their activities. In such a situation, they are not capable of creating large complex types of weapons. This is how the idea of creating specialized clusters arose: groups of enterprises close in the lines of activity with coordinating centers for the qualitative solution of complex rearmament tasks. Based on the needs of the defense industry complex and the specialization of enterprises, five clusters were formed: aviation, armored, shipbuilding and naval equipment, precision weapons and ammunition, as well as radar, radio communication and electronic warfare equipment.

The analysis also showed that the fixed assets of defense state enterprises are obsolete and inadequate. We understand today's limited capacity of the state to update them and transfer to a new technological level. In order to ensure the need to attract additional capital for the technical re-equipment of the defense industry, it was decided to corporatize the industry's enterprises and increase their investment attractiveness.

A key condition for attracting investments is the task of increasing investor confidence in the defense industry and Ukroboronprom, in particular. This followed a long period of intense discrediting of the state concern in terms of corruption and other negative

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developments in the defense sector. An international audit of the Ukroboronprom is to help establish the truth on this issue and restore confidence in the state concern. The tasks of retraining and raising the level of professional skill of the top management of the enterprises of Ukroboronprom and other power departments, scientific support of defense projects, organization of innovative mechanisms for creating new types of weapons were also topical. For this purpose, a special program for the enterprises of Ukroboronprom, the Defense Ministry, and the League of Defense Enterprises of Ukraine was created and is already being implemented.

**IF-UA: Can you specify, in the course, the specialization of enterprises transferred to the SPF? And also when is it planned to complete this process?**

**MZ:** Their specialization is different: this is the release of civilian products of a broad profile that do not have a direct relationship to military equipment and weapons.

**IF-UA: Is there a preliminary vision, what is the estimated amount of funds Ukroboronprom plans to receive from the transferred SPF, as should be understood, for the subsequent privatization of state-owned enterprises? Probably, these funds are planned to be directed to the goals of the reform of the defense industry and state concern? No?**

**MZ:** There are no such financial relations with the SPF. These enterprises belong to the form of state property. In this case, there is no purpose for attracting additional capital.

**IF-UA: But this is a question of sources of financing for the technical re-equipment of the defense industry. As you know, this information was repeatedly voiced by officials earlier - the wear and tear of the fixed assets of the defense industry exceeded 80% for many years. Taking into account the declared goal of the Ukrainian defense industry's transition to NATO standards, the question of sources of financing of technical re-equipment is more than relevant.**

**MZ:** I agree. And this goal, rather, is responsible for the corporatization of industry enterprises with the aim of attracting additional capital to their fixed assets and transforming them to models of defense companies of the advanced countries of the world. Corporatization in the future will mean their transfer to public joint-stock companies with the right to issue and sell their shares through exchanges. In this case, investors, who under Ukrainian law are determined on a transparent, competitive basis, can be both national and foreign leading companies. The volumes of attracting additional capital, of course, will depend on brands and on the credibility of these or those enterprises, their current status. It is these extra capitals that should be sent to the renewal of fixed assets of the enterprises of the industry. Investments can be carried out in concrete, defense projects. These and other steps will allow us to solve a number of tasks on the technical renewal of the defense industry.

**IF-UA: Allow me, nevertheless, to return to the very delicate question of the renewal of the fixed assets of the military industrial complex. For many years, including the newest history, many international investment conferences are held in Ukraine, including those devoted to attracting investments in the defense sector. Nevertheless, I can not recall a single correct estimate of the approximate need for investment in the technical re-equipment of the defense industry. I understand that this is not an easy question, nevertheless, there must be at least some close or distant horizon of such calculations?**

**MZ:** I do not think there is an accurate assessment to date. According to the estimates of some major defense enterprises, such as the state-run Antonov enterprise or the OJSC Meridian, we are talking about tens of billions of hryvnia for each of them. If we talk about the indicator in the scale of the industry, I think that hundreds of billions of hryvnia will not be enough. Re-equipment must be carried out on an ongoing basis, at an accelerating

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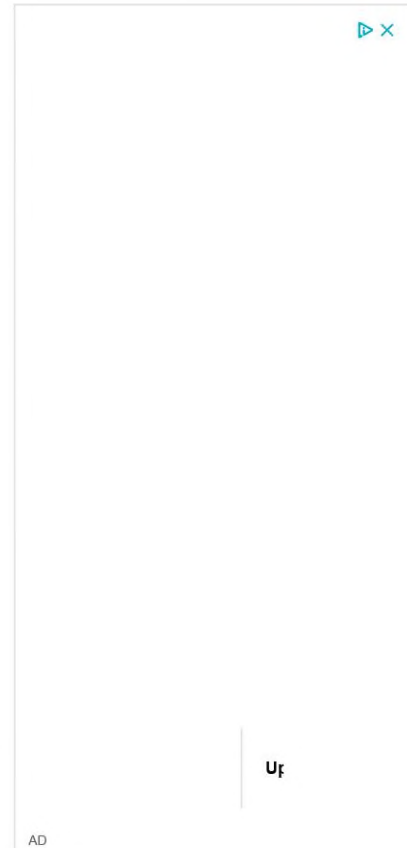


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pace, through a strategy for attracting additional capital, both to statutory funds and to projects.

**IF-UA: Concerning corporate plans: is there a vision of a better and worst scenario for the completion of the necessary regulatory and legal framework for its implementation? According to the previously announced information, some bills on this issue have already been prepared, including by the state concern.**

**MZ:** At best, I would like to pass through the Ukrainian parliament the basic laws on the reform of Ukroboronprom already this year. Whether the political process in the country will begin to interfere with this, the near future will show. In the worst case, the completion of the reform will take place after the end of the political process, at the end of 2019 or early 2020.

**IF-UA: Please formulate the key priorities of the Supervisory Board of the Ukroboronprom for today**

**MZ:** First of all, it is assistance to the complex reform of the defense industry. The beginning of the military conflict in the east of Ukraine found the defense industry in a deplorable state with an outdated control system. Then the leadership of the state concern was not up to the reforms: the defense industry needed to produce weapons for the army and fill the country's budget through defense exports. We must pay tribute to the previous leadership of the state concern that managed to ensure the solution of these tasks in a new and extremely difficult situation for Ukraine and Ukraine. Today, Ukroboronprom already finds a resource not only for resolving the priority tasks for the production of defense products, but also for rethinking its promising activities and reforming the concern in order to adequately respond to new challenges. The Supervisory Board in this process takes on an analytical, prognostic, coordinating function, as well as solving the tasks of building up international cooperation.

**IF-UA: Do you share the opinion, including in the corporate environment, that wartime is not the most successful for carrying out structural reforms of the defense industry and attracting investments. Given the objectively long-term nature of the new challenges to Ukraine's defense capability, how, in your opinion, is it expedient to solve this task?**

**MZ:** I agree that carrying out many reforms and, in particular, corporatization of the defense industry in a particular period brings additional risks. And we need to be very careful about the development of the criteria for corporatization. First of all, all-round thoughtful procedures for the issue of shares in defense enterprises are needed, as well as evaluation criteria and requirements for entities that can acquire them. Already today we are confronted with a misunderstanding of the general defense policy by certain minority shareholders of some enterprises of the Ukroboronprom. And very often the management of these enterprises has to overcome the misunderstanding of these shareholders, which hinders the development and implementation of the strategic tasks of the industry. It is extremely important to avoid this at the next stage of corporatization, when the state will give its controlling stake in the hands of, in fact, new owners. And the role of the Supervisory Board in developing such a criterion basis for corporatization, which will predetermine the further work of the enterprises of Ukroboronprom, is very important.

**IF-UA: Is there a political decision to date that a controlling stake in the corporatization of the Ukrainian defense enterprises will be transferred to the shareholders? After all, according to the current regulatory framework, the controlling stake is in the government of the state. As it is known, in May last year the government supported the Ministry of Economic Development and Trade (MEDT) proposal on corporatization of two well-known enterprises of the Ukroboronprom airbase – Antonov and the state enterprise 410 Civil Aviation by transforming them into private joint-stock companies with 100% of shares owned by the state. Should we understand that Ukraine is reconsidering approaches to this issue?**

**MZ:** Actually, the meaning of corporatization consists in turning enterprises with a controlling stake in the hands of the state into public joint-stock companies with subsequent corporatization, i.e. distribution of shares between the founders of the enterprise or its investors, in accordance with their contributions. Of course, before implementing such corporatization, it is necessary to take a political decision regarding the enterprises that shall remain under the state control, and the rest, which are appropriate to be fully shared. After that it is necessary to adopt the appropriate laws. This is very difficult and responsible work. The Supervisory Board initiated it, being absolutely sure that there is no alternative to this path for Ukraine.

In favor of this solution, there are many arguments. First, the defense industry of many developed countries of the world, with the best armies, is organized exactly like this. In the opinion of many of our foreign partners, in the defense industry management system the state should perform a slightly different function: not management, and not operational management, where it is not an effective player. The state should engage in the development of defense industrial policy and the creation of conditions for its implementation.

The second important argument for us is the effective activity of the League of Defense Enterprises of Ukraine. Such private defense enterprises that have joined the League are now about 50, and they take up to 50% of defense orders with a significantly smaller number of full-time employees. Ukroboronprom employs 80,000 people, while there are less than 5,000 employed by the League. Efficiency is approximately equal. Thus, it can't be stated that there is no understanding of public policy and strategy in the private sector of the military industrial complex.

**IF-UA: One of the key stages of Ukroboronprom reform is the international audit of the State Concern that you mentioned before. In June, the State Concern prolonged until the end of September the deadline for submitting applications for participation in the tender for auditing, taking into account the wishes of a number of its potential foreign participants, to conduct another revision of the tender documentation. Can you specify what revisions are considered?**

**MZ:** As for the changes in the tender documentation. At the suggestion of a number of potential foreign companies, and these are authoritative international audit companies, including ones from the United States, a tender committee together with the Supervisory Board in May approved a number of changes to the tender documentation in terms of its closer approach to international standards and audit tasks. However, even such an authoritative team of international experts who prepared these changes did not take into account some details that proved to be an obstacle to participation in the tender of authoritative international auditors. In particular, this concerns the requirement of mandatory availability of an MBA for experts who will conduct an audit and a number of other technical requirements. Therefore, at the suggestion of a number of audit companies, such as Baker & McKenzie, Ernst & Young, Baker Tilly and others, the tender committee of the State Concern extended the deadline for applications for auditing until September 28 with a view to finalizing the terms.

**IF-UA: Are there any preferred companies for Ukraine among the potential bidders?**

**MZ:** This is a contest, and until September 28, the tender is open to everyone who wants to participate in it. As expected, it will be an alliance of the most authoritative companies, including those from the U.S., Israel the EU countries. Who is preferable? For example, in the "strategic audit" lot, it would be very useful for Ukraine to have strategic expertise of companies from Israel, which in recent years has participated in the reform of the army of their country. My private opinion, which can not in any way affect the tender procedure, is that the experience of such companies that helped the Israeli army to be transformed, as well as their strategic expertise, would be very useful for Ukraine, given the similarity of the conditions in which Ukraine and Israel are located.

**IF-UA: The audit will be held in three stages: legal, economic and strategic, part of which will be technical audit. All these stages of the audit will be carried out by different companies?**

**MZ:** Yes, the audit will be conducted by the groups of successful tendered audit firms for individual lots. Of course, for us a financial lot is very important in order to remove suspicions and raise the level of trust to the Concern from international partners. My private opinion, which has developed over these several months of work in the Supervisory Board, is that the accusations of Ukraine and Ukroboronprom, in particular, in corruption, are greatly exaggerated. And they are exaggerated by those opponents who would like to represent Ukraine, through accusations of corruption, as a failed state. Therefore, it is very important that authoritative international audit companies tell the whole world: this was it, but this was not. We draw conclusions, punish perpetrators, eliminate the conditions for the appearance of corruption, and move on, working transparently. This concerns the financial audit.

As for the strategic audit, its most important component is the technical audit. Because a financial audit will answer the question of what happened in the past, while a strategic audit will answer the question of the future. Naturally, the legal audit is also important: how to build a legislative and regulatory framework for reforms. As a result of the audit, we would like to receive not only fixation and ascertaining of any inconsistencies in each component of the audit, but also the expertise: what to do and how we should transform the defense industry in each direction.

**IF-UA: Do you share the opinion of a member of the Supervisory Board, the foreign advisor of the State Concern Anthony Tether, recently announced in media, that an American company working with the US defense sector should conduct an audit of Ukroboronprom? In your opinion, what component of the audit - economic, legal, strategic, he could have in mind?**

**MZ:** We did not discuss this topic with him. But it seems to me that we should proceed from the fact that the tender winner should be determined by the tender committee. I suppose that among the winners will be the American companies. Will it be companies from other countries, say, Israel, or EU countries, will show the results of the tender.

**IF-UA: Has the issue of audit financing been resolved to date? Given that it will be carried out by well-known world auditing companies, we are talking about sufficient costs. According to the data available in the defense sector, at the beginning of the year the U.S. side voiced its readiness to support the audit financing. Correct me if I am wrong.**

**MZ:** If we talk about the financial assistance of the American side in conducting the audit, I do not know anything about this. My personal opinion is that Ukraine will pay for these services. And this is just because it needs to know the truth about corruption issues and with the help of international experts to work out a strategy for reforming the defense industry complex. It's worth it. The audit is not cheap: its costs \$5 million, or UAH 130 million. Since the international audit as part of the defense reform is a political goal of Ukraine related to the possibility of reforming the entire Ukrainian defense industry and integration into the same NATO bloc, it must be paid for. It is important that a large-scale and costly international audit has practical positive results for the reform of the Ukrainian defense industry.

**IF-UA: Since 2016, the corporate environment has been discussing plans to create a Ukrainian analogue of the U.S. Defense Advanced Research Projects Agency (DARPA) – dubbed GARDA (the General Advanced Research and Development Agency) in the defense sector, which, according to the guidance of Ukroboronprom, announced earlier this year, will be based on the National Technical University of Ukraine "Igor Sikorsky Kyiv Polytechnic Institute" (KPI) . Was the process already started? How would you comment on the recently announced opinion in the media of Mr. Tether, who is the**

**former head of DARPA, about the mistakenness of creating GARDA on the basis of the KPI?**

**MZ:** First of all, it should be clarified that no decision was made to create GARDA on the basis of the KPI. Indeed, the idea was submitted to the discussion of the Supervisory Board, but after an exchange of views, it was withdrawn. Then Mr. Tether, who headed this very authoritative and strategically important organization for the United States from 2001 to 2009, voiced his opinion on this issue in public. I absolutely agree with him.

Indeed, such an agency should be a government body and be financed from the country's budget. Following the results of a comprehensive analysis of the issue of creating a Ukrainian analogue of DARPA with the management of Ukroboronprom, we came to the conclusion that Ukraine already has an agency close to this model. This is the state-run State Finance Institution for Innovations (SFII), which operates in the system of the Ministry of Economic Development and Trade of Ukraine (MEDT). The charter of this institution has no restrictions on the nature of the projects it supports, regardless of their attitude to the civil or defense spheres. Today, Ukroboronprom has already started the consultations with SFII on preparing the addendums to the regulations of this in situation, taking into account the specifics of defense projects.

**IF-UA: Obviously, this issue will be submitted to the government for approval? Has the Supervisory Board of Ukroboronprom already supported this decision?**

**MZ:** Yes, the Supervisory Board considered the feasibility of creating the analogue of DARPA. But his concrete model has not been confirmed yet. And this, by the way, is already beyond the powers of the Supervisory Board. I repeat that Mr. Tether voiced his opinion that the Ukrainian analogue of DARPA should be a state structure subordinated to the Ukraine's Cabinet of Ministers and be financed from the state budget to support the best innovative ideas and projects in the field of creating new types of weapons. This opinion was taken into account by the Supervisory Board.

**IF-UA:** So far, for today, we come out of the following: creating a new public administration body from scratch is a long, difficult and may be inappropriate. At the same time, the option of using SFII for solving the same problems seems to be the fastest and economically feasible solution. After the drafting of the draft amendments to the regulations and the charter of this organization, we will come up with the relevant proposal for the country's leadership. At once I will make a reservation, that preparation of such additions is not a difficult job, it's a matter of a month or two. By autumn, I think, you can already make a decision at the government level.

**IF-UA: And when can the formation of a new structure be completed? Will it be more a state institution, a scientific or financial institution? What kind of specialists will it employ? To whom will it be directly subordinated?**

**MZ:** Today in SFII there is a quite modern team. We did not think about the staff, because this is the competence of the government. If you look at the American DARPA, it is a state institution with a very high level of competence and expertise, to which the inventors come, the bearers of new ideas, new projects. These people offer projects on a competitive basis for the subsequent transformation into finished military products. I think that the expert environment of the Ukrainian DARPA can be scientists, designers, engineers from different scientific and educational institutions. The participation of foreign specialists, of course, is also desirable. If it is SFII, then it is a part of MEDT, which now oversees the defense industry, so everything is logical here. MEDT is subordinate to the first vice-premier. Who will supervise the new structure, the government will decide, this is their question.

**IF-UA: Thus, the expected participation of the authoritative KPI to create a Ukrainian analogue of DARPA - GARDA did not take place. You do not mind?**

**MZ:** On this occasion, I can note the following: KPI created an innovative ecosystem - Sikorsky Challenge. Today it has already gone beyond the KPI and covers 9 regions

of Ukraine, in which its branches operate. At this stage, this ecosystem includes 110 high-tech companies, 20 of them from the US, about the same number of EU countries, but most of them from Ukraine. There are companies from Israel, South-East Asia and other regions of the world. The innovative ecosystem also includes five enterprises of Ukroboronprom and two enterprises of State Mortgage Company, 28 investors and venture funds.

Interacting with each other the ecosystem participants are engaged in creating "high-tech" by attracting new critical knowledge, private capital, high business competencies. As part of the ecosystem, the start-up school Sikorsky Challenge, which helps investors become entrepreneurs. According to this model over the last 11 years, more than 100 start-up projects and technologies have been brought to the market. One third of them are military and dual-purpose projects, for example, purchased for the APU and exported UAV Spectator, cybersecurity systems and other technologies. It is important that the volume of investments in start-ups grows with good dynamics: in 2012, \$22,000 was invested in two projects. The year 2014 brought already \$ 2 million of investments in six projects, 2015 - \$26 million, and further on increasing. In our opinion, apart from the state funding source for innovative defense projects through the future GARDA, it is advisable for Ukraine to attract private capital through a model similar to the Sikorsky Challenge. We do not want to compete with GARDA - it is created by another model, taking into account the experience of the U.S., Japan, Russia and other countries. We only suggest that the defense industrial complex to take advantage of a parallel source of non-state investment in innovative, defense projects. This model already works well.

**IF-UA: Is it possible, in your opinion, to expect further staffing of the Supervisory Board of Ukroboronprom, given the availability of another free vacancy in the government's quota? Are the replenishment plans for the staff of the National Assembly, which were voiced in 2017, the experts of the defense sector of the states - the western allies of Ukraine?**

**MZ:** The request for the additional composition of Ukroboronprom's Supervisory Board over the government quota was sent to the Cabinet of Ministers in late 2017. In April, this year, the government introduced Mr. Tether to the Supervisory Board. The updated Supervisory Board once again appealed to the government to complete the additional composition. We did not propose concrete candidates: it is the responsibility of the government. We need a competent person with good experience in the defense sector of either our country or one of the developed countries friendly to Ukraine with a powerful army. Such a specialist would be extremely needed. Unfortunately, this vacancy is not filled yet.

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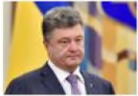
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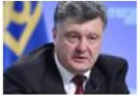
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## Head of Ukroboronprom: Ukraine's defense industry is adapting to the global security environment

By: Pavlo Bukin 📅 December 9, 2018

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In 2014, the international security environment was fundamentally transformed when Russia invaded Ukraine. Moscow's illegal annexation of Crimea and subsequent hybrid warfare in eastern Ukraine shifted defense postures and relationships across the globe. The Ukrainian army passed a test of strength in the face of Russian military aggression. It has restored combat readiness and begun to qualitatively upgrade its capabilities.

In the post-2014 global security environment, the ability of military units to be effective depends to a large extent on combat equipment and the pace of transition to new and upgraded systems. More than ever, it is about more firepower, security, mobility and team management.

In this context, Ukraine's rearmament has been meticulously planned and systematic. This past year has been a pivotal one in this regard. The army of Ukraine now receives new Ukrainian weapons, which are produced serially. These new models of Ukrainian weapons are made by both state and private enterprises, including over a hundred defense enterprises that are part of the Ukroboronprom state concern.

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Ukroboronprom has transitioned from repairing, modernizing and selling arms and military equipment of Soviet origin to the development of its own weapons systems. Since the emergence of the new global security environment in 2014, Ukraine has managed to stabilize its defense industry and create the conditions for increasing exports.

At the same time, while growing defense exports is important, the dangerous international environment necessitates that the security of the state must be ensured through the production and provision of technologically advanced arms and military equipment. Ukroboronprom has, therefore, devoted itself to an active policy of rearming the Ukrainian army, the implementation of national defense projects and the enhancement of cooperation with partners around the world.

In Ukraine, industrial renewal and the search for new technologies is taking place. This will enable Ukroboronprom and other Ukrainian defense companies, within a short period of time, to meet the needs of the army while simultaneously creating conditions for the formation of a qualitatively better and more competitive defense industry.



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**By: Joe Gould**

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Ukraine's circumstance is reflective of what is occurring globally as countries are increasingly forced to deal with hybrid threats and thus must reform their defense sectors to meet these challenges. Ukraine is on the front line of such systematic change as it defends its sovereignty and territory. To reflect this, the Ukrainian defense sector was reorganized around several clusters including aviation, armored vehicles, shipbuilding and naval equipment, precision weapons and ammunition, radar, radio communications, and electronic warfare. The key aspect to this reorganization was the development of new and original weapons systems as well as technology born out of necessity.

Given that Ukraine's security situation is defined by ongoing Russian aggression, Ukroboronprom is implementing projects that will reduce the ability of the Russian Army to threaten our country. Ukroboronprom is, for example, strengthening Ukraine's missile-artillery capabilities by developing the Neptune cruise missile, modernizing multiple-launch rocket systems, creating its own production of large-caliber artillery shells, as well as developing new high-precision munitions and anti-tank missile systems.

Another vital area that Ukroboronprom is focused on is the automation of combat control, intelligence, radar and unmanned systems. Armored vehicles, such as the BTR-4 and BTR-3, are also critical. Ukrainian weapons have acquired a newfound quality that they previously lacked. Our weapons were tested by war and military action. Our designers took into account the ongoing combat experience of the Ukrainian army and the wishes of the military. As a result, Ukraine's military technology has become more efficient and reliable.



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**By: David Larter**

Despite these advancements, and given the increasingly dangerous global security environment, Ukraine will not be able to produce all the military equipment it needs. In this context, Ukraine must explore whether to pursue joint or licensed production of weapons systems using a leasing or offset mechanism. For Ukraine, such a practice is new and it needs attention from the relevant state structures.

As Russian aggression rages on in eastern Ukraine, outdated equipment is the Achilles' heel of the Ukrainian army. The Armed Forces must possess innovative weapons and equipment. This will allow Ukraine to achieve parity with Russia and fend off further threats to its defense and security. To do this, Ukroboronprom is acquiring new competencies and creating new opportunities based on world-class solutions and technologies.

While much has been achieved indigenously, the Ukrainian defense industry understands that, in today's world, international cooperation with its friends and partners is an essential force multiplier. For this reason, Ukroboronprom has been, and will continue to be, focused on the establishment of flexible partnerships and cooperative relationships with other leading defense companies around the globe, including those from the United States, Poland, the Czech Republic and Turkey. Together, we will be able to face the growing complexities and dangers of both today's and tomorrow's global security environment.

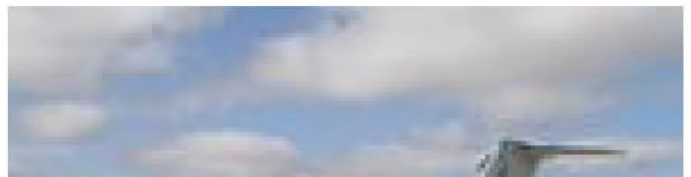
Pavlo Bukin is the director general of the Ukraine-based defense company Ukroboronprom.

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