

REPORT OF THE AUDITOR-GENERAL ON KENYA LEATHER DEVELOPMENT COUNCIL FOR THE YEAR ENDED 30 JUNE 2018

REPORT ON THE FINANCIAL STATEMENTS

Qualified Opinion

I have audited the accompanying financial statements of Kenya Leather Development Council set out on pages 1 to 25, which comprise the statement of financial position as at 30 June 2018, and statement of financial performance, statement of changes in net assets, statement of cash flows and statement of comparison of budget and actual amounts for the year then ended, and a summary of significant accounting policies and other explanatory information in accordance with the provisions of Article 229 of the Constitution of Kenya and Section 35 of the Public Audit Act, 2015. I have obtained all the information and explanations which, to the best of my knowledge and belief, were necessary for the purpose of the audit.

In my opinion, except for the effect of the matters described in the Basis for Qualified Opinion section of my report, the financial statements present fairly, in all material respects, the financial position of Kenya Leather Development Council as at 30 June 2018, and of its financial performance and its cash flows for the year then ended, in accordance with International Public Sector Accounting Standards (Accrual Basis) and comply with the Kenya Leather Development Council Order, 2011.

Basis for Qualified Opinion

1. Property, Plant and Equipment

1.1 Training and Production Centre for the Shoe Industry (TPCSI) in Thika

As previously reported, the property, plant and equipment balance of Kshs.256,748,032 as at 30 June 2018 excludes an undetermined value of land and other assorted equipment which the Council acquired from Kenya Industrial Research and Development Institute (KIRDI) at the time of handing over of Training and Production Centre for the Shoe Industry (TPCSI) in Thika. Some of these assets were bought at the inception of the Centre in 1994 and earlier years and are operational while others are dysfunctional and obsolete. The handing over report did not disclose the values of these equipment. In addition, the following were observed;

- i) The Centre was initially managed by a Board of Trustees who transferred it to the then Ministry of Industrialization in 2011. Subsequently, the Ministry handed over the management of the Centre to KIRDI who undertook management of the facility until 18 November 2015 when it was handed over to the Kenya Leather Development Council (KLDC).
- ii) According to the handing over report, the TPCSI in Thika sits on 0.1096 hectare (0.271 acre) of land, LR No.4953/23/7 and registered in the land title registry as L.R. No.40506/4 as per Trustee Deed made on 25 February, 1994 and certificate of title issued on 25 April 1996. The whereabouts of the title deed could however not be

established and therefore the ownership of the land could not be confirmed. Further, no valuation report for the parcel of land was availed for audit review.

1.2 Construction of Modern Common Effluent Treatment Plant at Kenya Leather Park - Kenanie, Machakos Country

KLDC in joint venture with Export Processing Zone Authority (EPZA) each 50% entered into a contract with EPCO Builders Ltd on 17 February 2017 (Contract No. KPL/KLDC-EPZA/01/2016-2017) at a contract sum of Kshs.2,265,324,226 for the above mentioned project.

As a result, a feasibility study was done by MS Repcon Associates which was procured by EPZA and a feasibility report issued in April 2016. Our audit on procurement and management of this contract raised the following concern;

- (i) The contractor was to commence work within 28 days of awarding of the contract. During the last audit inspection at the site, a comparison of the work plan and the targets revealed that the work is far below the expectations. The value of work certified by the Engineers of the State Department for Public Works as at 20 February, 2018 was estimated at Kshs.123,746,991 being apportioned as Kshs.90,000,000 to KLDC and Kshs.33,746,991 to EPZA.
- (ii) The total budget for this project that was approved by the Board and the Ministry has not been availed for audit review which raises concern as to why the resources were committed before the budgetary approval was given.
- (iii) The management made an advance payment of Kshs.385,105,119 on 12 June 2017 followed by another one of Kshs.90,000,000 on 1 February 2018 for certificate No.2 dated 20 February 2018. On 20 March 2017, the contractor issued a performance security bond of Kshs.453,064,846 being 20% of the contract sum in favour of KLDC and EPZA as per clause 13.2.1 of the contract agreement that expired on 20 March 2018.
- (iv) Clause 13.2.2 of the contract indicate that, the amount of performance security shall be reduced in proportion to the value of the facility/ work executed by and paid to the contractor from time to time and shall become void when the full amount of the security has been recovered by the employer. Contrary to clause 13.2.2 of the contract, the Council paid Kshs.90,000,000 for certificate No.2 instead of recovering from the advance payment whose security has already expired. This leaves the Council being exposed to the extent of Kshs.385,000,000 held by the contractor without any valid security.
- (v) Both KLDC and EPZA claim 50% stake in the project. However, KLDC made a payment of Kshs.385,105,119 over and above the 50% cost of the joint venture which is equivalent of Kshs.226,532,435.
- (vi) The project has currently stalled because of the uncertainty of the site where it was being constructed. The State Department of Public Works has

recommended the project be relocated in another suitable site and works should commence afresh. This would amount to wastage of resources already paid to the contractor and cast doubt as to whether the environmental assessment by NEMA had initially been conducted and implemented.

In the circumstances, it has not been possible to ascertain that contractor is executing his work as per the contract agreement and whether value for money, commensurate with the work already done by the contractor will be obtained. Further, the Council is at risk to the extent of Kshs.385,000,000 held by the contractor without any valid security since the security deposited in the bank by the contractor matured and has not been renewed.

1.3 Construction of Precast Boundary Wall at Kenya Leather Park

The Council entered into a contract with Lirona Construction Limited in 2016 for the construction of Precast Boundary wall at Kenya Leather Park- Kenanie in Machakos County at a contract price of Kshs.108,057,543. The project was planned to commence on 24 March 2016 and anticipated completion date being 2 October 2017.

The total payment to the contractor as at 30 June 2018 amounted to Kshs.94,958,801 and the retention amount of Kshs.11,890,587 held in a deposit account. Physical inspection conducted on the project revealed that there were no construction activities since part of the wall had collapsed as a result of floods experienced in early 2018. A section of the perimeter wall which had collapsed appeared to be the one erected on swampy areas, pointing to a possibility that geotechnical survey may not have been carried out before commencement of works.

Unless the project is completed, the Council is likely not to realize its planed objective of safeguarding the Kenya Leather Park land.

2. Management of a Contract

As previously reported, the Council entered into a contract with local company in 2015/2016 for the supply, delivery, installation and training of footwear and leather goods manufacturing equipment at a total cost of Kshs.83,038,539. Although the management had indicated that there was a concept paper as well as a Memorandum of Understanding (MoU) on the project, no evidence was availed for audit review on the number, nature of machines and location where they were to be installed. Further, a deposit equivalent to 20% Kshs.16,607,708) of the contract value was paid to the supplier in 2015/2016.

During the financial year 2016/2017, the Council made a further payment of Kshs.59,787,745 to the supplier before the equipment were installed, commissioned and training of users contrary to the terms in the signed contract.

In addition, during the year 2015/2016, the Council engaged another local company at a contract price of Kshs.17,390,148 for supply, delivery, installation and training of foot wear and leather goods manufacturing equipment/machines, resulting into a total cost of the said equipment of Kshs.100,428,687. During the year under review, the Council made a further payment of Kshs.15,651,133 to the latter local company even before the

equipment procured from the first local company were delivered, installed, commissioned and users trained on how to operate. Though all the machines were eventually delivered and the Council paid a total of Kshs.92,046,586 out of Kshs.100,428,687, these equipment have been stored at the Council premises for more than two years without being installed, tested and put to the intended purposes hence raising concern of the equipment going to waste.

Consequently, the value for money in respect of the two local companies with a paid sum Kshs.92,046,586 could not be confirmed.

The audit was conducted in accordance with International Standards of Supreme Audit Institutions (ISSAIs). I am independent of Kenya Leather Development Council in accordance with ISSAI 30 on Code of Ethics. I have fulfilled other ethical responsibilities in accordance with the ISSAI and in accordance with other ethical requirements applicable to performing audits of financial statements in Kenya. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my qualified opinion.

Key Audit Matters

Key audit matters are those matters that, in my professional judgment, are of most significance in the audit of the financial statements. Except for the matters described in the Basis for Qualified Opinion section. I have determined that there are no Key Audit Matters to communicate in my report.

Other Matter

1. Staff Shortage

As was reported in the previous year, the Council has been relying on staff members deployed from the parent Ministry with the exception of the Chief Executive Officer. Although the Board has put a strong justification to the parent Ministry to enable it employ its own staff, nothing appears to have been achieved during the year under review. Consequently, the Council does not have full control of staff members, a situation that has hampered the service delivery and execution of its mandate. It is however noted that the National Treasury has seconded an internal auditor as well as two accountants to enhance accountability in the Council's operations.

2. Memorandum of Understanding (MoU)

The Council entered into a Memorandum of Understanding (MoU) with the Export Processing Zones Authority (EPZA) on 8 December 2015 for the establishment of a leather industrial park in Machakos County. The MoU provided that the park was to be built on a portion of plot LR No.23961 measuring 301.1ha belonging to EPZA located at Kinanie. However, the actual acreage of the land to be alienated for the purpose was not indicated and the MoU did not outline the specific roles to be performed by each party and the agreed time frame. The manner in which the park was to be managed and the revenues that are expected to be generated therefrom and how they would be shared

were not defined. In addition, it was not clear which of the two institutions was to incorporate in its books of account the operations and the ownership of the industrial park.

REPORT ON LAWFULNESS AND EFFECTIVENESS IN USE OF PUBLIC RESOURCES

Conclusion

As required by Article 229(6) of the Constitution, based on the audit procedures performed, except for the matters described in the Basis for Qualified Opinion section of my report, I confirm that, nothing else has come to my attention to cause me to believe that public resources have not been applied lawfully and in an effective way.

Basis for Conclusion

The audit was conducted in accordance with ISSAI 4000. The standard requires that I comply with ethical requirements and plan and perform the audit to obtain assurance about whether the activities, financial transactions and information reflected in the financial statements are in compliance, in all material respects, with the authorities that govern them. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my conclusion.

REPORT ON EFFECTIVENESS OF INTERNAL CONTROLS, RISK MANAGEMENT AND GOVERNANCE

Conclusion

As required by Section 7(1)(a) of the Public Audit Act, 2015, based on the audit procedures performed, except for the matters described in the Basis for Qualified Opinion section of my report, I confirm that, nothing has come to my attention to cause me to believe that internal controls, risk management and overall governance were not effective.

Basis for Conclusion

The audit was conducted in accordance with ISSAI 1315 and ISSAI 1330. The standards require that I plan and perform the audit to obtain assurance about whether effective processes and systems of internal control, risk management and governance were operating effectively, in all material respects. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my conclusion.

Responsibilities of Management and Those Charged with Governance

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Public Sector Accounting Standards (Accrual Basis) and for maintaining effective internal control as management determines is necessary to enable the preparation of financial statements that are free from material

misstatement, whether due to fraud or error and for its assessment of the effectiveness of internal control, risk management and governance.

In preparing the financial statements, management is responsible for assessing the Council's ability to continue to sustain services, disclosing, as applicable, matters related to sustainability of services and using the applicable basis of accounting unless the Council either to cease operations, or have no realistic alternative but to do so.

Management is also responsible for the submission of the financial statements to the Auditor-General in accordance with the provisions of Section 47 of the Public Audit Act, 2015.

In addition to the responsibility for the preparation and presentation of the financial statements described above, management is also responsible for ensuring that the activities, financial transactions and information reflected in the financial statements are in compliance with the authorities which govern them, and that public resources are applied in an effective way.

Those charged with governance are responsible for overseeing the Council's financial reporting process, reviewing the effectiveness of how the entity monitors compliance with relevant legislative and regulatory requirements, ensuring that effective processes and systems are in place to address key roles and responsibilities in relation to governance and risk management, and ensuring the adequacy and effectiveness of the control environment.

Auditor-General's Responsibilities for the Audit

The audit objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes my opinion in accordance with the provisions of Section 48 of the Public Audit Act, 2015 and submit the audit report in compliance with Article 229(7) of the Constitution. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISSAIs will always detect a material misstatement and weakness when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

In addition to the audit of the financial statements, a compliance audit is planned and performed to express a conclusion about whether, in all material respects, the activities, financial transactions and information reflected in the financial statements are in compliance with the authorities that govern them and that public resources are applied in an effective way, in accordance with the provisions of Article 229(6) of the Constitution and submit the audit report in compliance with Article 229(7) of the Constitution.

Further, in planning and performing the audit of the financial statements and audit of compliance, I consider internal control in order to give an assurance on the effectiveness of internal controls, risk management and governance processes and systems in accordance with the provisions of Section 7(1) (a) of the Public Audit Act, 2015 and submit the audit report in compliance with Article 229(7) of the Constitution. My consideration of the internal control would not necessarily disclose all matters in the internal control that might be material weaknesses under the ISSAIs. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Because of its inherent limitations, internal control may not prevent or detect misstatements and instances of non-compliance. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

As part of an audit conducted in accordance with ISSAIs, I exercise professional judgement and maintain professional skepticism throughout the audit. I also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for my opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the management.
- Conclude on the appropriateness of the management's use of the sustainability of services, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Council's ability to continue to continue as a going concern. If I conclude that a material uncertainty exists, I am required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify my opinion. My conclusions are based on the audit evidence obtained up to the date of my audit report. However, future events or conditions may cause the Council to cease to sustain its services.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- Obtain sufficient appropriate audit evidence regarding the financial information and business activities of the Council to express an opinion on the financial statements.
- Perform such other procedures as I consider necessary in the circumstances.

I communicate with the management regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that are identified during the audit.

I also provide management with a statement that I have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on my independence, and where applicable, related safeguards.



FCPA Edward R. O. Ouko, CBS
AUDITOR-GENERAL

Nairobi

09 April 2019