

REPORT OF THE AUDITOR-GENERAL ON KENYA ORDNANCE FACTORIES CORPORATION FOR THE YEAR ENDED 30 JUNE 2017

REPORT ON THE FINANCIAL STATEMENTS

Qualified Opinion

I have audited the accompanying financial statements of Kenya Ordnance Factories Corporation set out on pages 12 to 66, which comprise the statement of financial position as at 30 June 2017, and the 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 Ordnance Factories Corporation as at 30 June 2017, and 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 State Corporations Act, Cap 446 of the Laws of Kenya.

In addition, 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 and Other Matter sections of my report, I confirm that, nothing has come to my attention to cause me to believe that public money has not been applied lawfully and in an effective way.

Basis for Qualified Opinion

1.0 Property Plant and Equipment

1.1 Assets Register

The statement of financial position reflects property plant and equipment figure of Kshs.2,987,593,272 as at 30 June 2017 comprising of building and civil works, water line and civil works, work in progress, plant equipment and machinery, motor vehicles, furniture and fittings and computers with total cost of Kshs.4,549,761,722 as disclosed in note 11 to the financial statements. However, assets with total cost of Kshs.810, 360,413 were not recorded in the fixed asset register. Further as reported in the previous years, a schedule with details of the buildings, civil works, waterline, plant, equipment and machinery, furniture and fittings has not been provided for audit verification. Although management explained that the register indicates the block figures that were obtained from the records of the contractor and that the Ministry of Defence is working with the government chief valuer of the Ministry of Lands Housing

and Settlement to value all the corporation assets including land so that the same can be properly documented, no documentary evidence has been provided in support. It is therefore not known when the process of valuing of the assets shall be completed and the register updated.

Consequently, the accuracy, validity and existence of the assets' balance of Kshs.2,987,593,272 could not be confirmed.

1.2 Land

The statement of financial position as at 30 June 2017 and note 11 to the financial statements reflects non-current assets figure of Kshs.2,987,593,272. However, as reported in previous years, the Corporation only has title documents for land measuring 727.7 hectares on which the factory stands. The Corporation further requested the Government to allocate it additional 908 hectares to enable it attain the required safety distance for the factory, subsequent to which an allotment letter for additional land was issued. The process of surveying the additional 908 hectares started in February 2011 but stalled due to squatters who could not allow surveyor's access to the land in the buffer zone which is necessary to ensure safety of the people in the neighbourhood and security of the factory in accordance with International Standards.

In addition, all parcels of land including land registration numbers Kakamega /Sango/1970, LR No.27206/1 and LR No.27206/2 measuring 0.48 hectares, 2545 hectares and 727.1 hectares respectively have not been valued and included in these financial statements.

Consequently, the accuracy and completeness of the non-current assets' balance of Kshs.2,987,593,272 could not be confirmed.

1.3 Idle Machinery

Available information revealed that the Corporation has in its records idle property, plant and equipment with an unknown value which were either installed, partially installed or not installed at all comprising of anvil piecing machines (2No), prima cap manufacturing machine (1No), prima polishing machines (5No) and a tracer bullet loading. The machinery has been lying idle from the time the factory was built. This is contrary to the provisions of Section 72(1) (a) of the Public Finance Management Act, 2012 which states that the accounting officer for a national government entity shall manage the assets of the entity in a way which ensures that the national government entity achieves value for money in acquiring, using and disposing of those assets.

Consequently, the Corporation has not obtained value for money in respect of the idle machinery that have not been put to use since the factory was established.

2.0 Trade and Other Receivables

2.1 Claimable Value Added Tax

As previously reported, the statement of financial position reflects trade and other receivables' figure of Kshs.437,758,058 as at 30 June 2017 which includes claimable value added tax amount of Kshs.109,476,090 as disclosed in note 16 to the financial statements and which is indicated as Kshs.73,098,600 due from Ministry of Defence and Kshs.36,377,490 due from Kenya Revenue Authority. However, no record has been provided for audit verification to ascertain how the amounts were arrived at. Information available indicates that the amount of Kshs.73,098,600 includes Kshs.68,861,381 which was ascertained when the corporation filed a VAT claim of Kshs.81,000,000 with the Kenya Revenue Authority (KRA) for the period September 2013 and July 2014 in November 2014 which was however long after the due date. Records reviewed indicated that the input tax on imported raw materials was paid by the Ministry of Defence on behalf of the corporation using its PIN No P051098785V while the claim was filed by the corporation using the Corporation PIN No P051121081J but there was no evidence to indicate that the two entities are jointly registered for VAT refund. Although the Corporation has now indicated that the amount is due from the Ministry of Defence, there has been no documentary evidence to show that the Ministry of Defence is pursuing the claim on behalf of the Corporation and if the amount is still recoverable.

Further, included in the claimable VAT amount of Kshs.109,476,090 is an amount of Kshs.36,377,490 claimable for the year 2003. However, letter Ref no. KRA/DTD/AM&RD/007 dated 22nd February 2017 from Kenya Revenue Authority indicates that the Withholding VAT Refund of Kshs.36,377,490 is not payable as the claim was submitted late and therefore time bared. Although, the Corporation has indicated that it has engaged a tax consultant in March 2018 to follow up the claim, there has been no indication of the progress made in recovering the claim.

Consequently, the recoverability of the claimable VAT amount of Kshs.109,476,090 is doubtful and the accuracy of the trade and receivables balance of Kshs.437,758,058 as at 30 June 2017 could not be confirmed.

2.2 Other Exchange Debtors

Included also in the trade and other receivables figure of Kshs.437,758,058 is other exchange debtors figure of Kshs.154,704,695 out of which an amount of Kshs.2,416,450 is in respect of a prepayment made to a South African firm in 2010/2011 and which has remained outstanding since then. Although the management has indicated that the issue is being pursued by the Kenya's Defence Attaché in South Africa, no documentary evidence has been provided to show the progress made and when the amount shall be recovered from the firm.

In addition, the other exchange debtors figure of Kshs.154,704,695 includes an amount of Kshs.9,088,067 owed by Engineers Brigade out of a total of Kshs.45,063,592 advanced to it between 2013 and 2015 to produce bottled water on behalf of the Corporation. Water supplies with an amount of Kshs.35,975,525 were made. Although information available indicates that a Board of Officers (BOO) was constituted in August 2017 to investigate the matter, a report of this instigation was not provided for audit review.

Consequently, the recoverability of the prepayment balance of Kshs.11,504,517 could not be confirmed.

2.3 Tax Recoverable

As reported in the previous years, the statement of financial position reflects tax recoverable balance of Kshs.12,859,976 as at 30 June 2017 as disclosed in note 17 to the financial statements in respect of Value Added Tax (VAT) due from Kenya Revenue Authority (KRA) which has been outstanding for the last 16 years. Although the collectability of this amount is doubtful, the Corporation has not made a provision to cover the uncertainty in recovering the claim.

Consequently, recoverable of the amount of Kshs.12,859,976 could not be confirmed.

3.0 Trade and Other Payables

3.1 Trade Payables

The statement of financial position reflects trade and other payables' balance of Kshs.515,566,684 which includes trade payables' figure of Kshs.277,354,628 as disclosed in note 20 to the financial statements. As reported in the previous years, the trade payables figure of Kshs.277,354,627 was in respect of prepayment made by the Ministry of Defence in respect of deposits for product purchases which have however remained unsettled or un-serviced since 2011/2012. Although the management has explained that the Corporation and the Ministry of Defence reached an agreement for the Corporation to issue a credit note for the outstanding balance, the agreement has not been availed for audit verification.

3.2 Payments Received in Advance

The trade and other payables' balance of Kshs.515,566,684 also includes payments received in advance of Kshs.140,000,000 as disclosed in note 20 to the financial statements, being cash advance from the Ministry of Defence which was to be refunded in form of ammunition or cash but has remained outstanding since 2011/2012. Although the management has explained that the delay in refund has

been due to frequent breakdown in machines and that with the establishment of a new production line, the corporation shall be in a position to service the order or refund the money, no indication has been given as to when the new production line will be established or when the refund will be made.

4.0 Sale of Scrap Metal

The statement of financial performance for the year ended 30 June 2017 reflects other income figure of Kshs.230,595,493 which includes income from sale of scrap metal of Kshs.37,892,242 as disclosed in note 6 to the financial statements that were sold to a single firm. Records available indicates that the corporation's sale of scrap contract with the firm expired on 30 June 2016 but the firm requested for extension of the agreement for another two years commencing 1 July 2016. According to inter-office memo dated 30 June 2016, the management approved the extension of the sale agreement (KOF/001/15-16) and asked the buyer to review the current price of brass scrap at Kshs.208.80 per Kilogram and stainless steel at Kshs.58 per kilogram to which the firm reviewed the price to Kshs.232 for assorted brass per kilogram and retained the price of stainless steel at Kshs.58 per kilogram.

However, the Corporation did not maintain an annual asset disposal plan as required by Section 53 (4) of Public Procurement and Assets Disposal Act,2015 which states that all asset disposals shall be planned by the accounting officer concerned through annual asset disposal plan in a format set out in the Regulations. Further, the Corporation did not provide clearance from the Cabinet Secretary in line with Section 90 (5) of the Public Procurement and Assets Disposal Act, 2015 which states that the procuring entities that deal with classified items shall agree annually with the Cabinet Secretary on the category of classified items to be included in the classified list of procurements or disposals to be applied. In addition, there is no evidence that the current prices were determined by a technical committee in accordance with Section 164 (3) of the same Act.

Consequently, the management breached the law and the accuracy of the scrap metal income of Kshs.37,892,242 for the year ended 30 June 2017 could not be confirmed.

The audit was conducted in accordance with International Standards of Supreme Audit Institutions (ISSAIs). I am independent of Kenya Ordnance Factories Corporation 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 judgement, are of most significance in the audit of the financial statements. Except for the matters described in the Basis for Qualified Opinion and Other Matter sections of my report, I have determined that there are no Other Key Audit Matters to communicate in my report.

Other Matter

1.0 Governance Framework

1.1 Lack of Independent Internal Audit Function

Although the Corporation had established an internal audit unit to oversee the governance mechanism and promote transparency and accountability in the management of the corporation's resources, the unit operated without an audit charter detailing the scope, responsibilities and purpose of internal audit function. Although the management stated that the unit shall adopt and customise the Ministry of Defence internal audit charter, there is no indication as to when this shall be done and availed for audit review. Further, the internal audit function had only two officers who reported both administratively and functionally to the Managing Director instead of reporting functionally to the Audit Committee contrary to Section 155(1) of the Public Finance Management Regulations, 2015.

Consequently, the unit lacks operational independence and guiding tool to execute its mandate and which is against the law.

1.2 Failure to Establish Audit Committee

The Corporation has not established an audit committee contrary to Section 73 (5) of the Public Finance Management Act, 2012 which states that every national government public entity shall establish an audit committee whose composition and functions shall be as prescribed by the regulations. Although the management explained that the Board was in the process of establishing an audit committee and that the names have been proposed awaiting approval to commence work, no documentary evidence was availed in support of this or an indication as to when the process shall be completed.

Consequently, the management is in breach of the law.

2.0 Failure to Observe One Third Staff Establishment Rule

Audit of the payroll for the month of June 2017 showed that Kenya Ordnance Factories Corporation had a staff establishment of 267 (two hundred and sixty seven) other permanent and pensionable staff out of whom 130 (one hundred and thirty) or

49% were from the dominant ethnic community leaving 137 (one hundred and thirty seven) or 51% from other communities as analysed below:

Structure	No	Dominant Ethnic Community No	Dominant Ethnic Community %	Non Dominant Ethnic Community No	Non-Dominant Ethnic Community %
Board of Directors	11	0	N/A	11	100
Senior Management	12	0	N/A	12	100
Other permanent and Pensionable Staff	267	130	48.7	137	51.351.3

This is contrary to Section 7 (1) and (2) of the National Cohesion and Integration Act, No. 12 of 2008 which requires all public establishments to seek to represent the diversity of the people of Kenya in employment of staff and that no public establishments shall have more than one third of its establishment from the same ethnic community.

Consequently, the management has contravened the one third ethnic diversity rule on staff establishment.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

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 such 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.

In preparing the financial statements, management is responsible for assessing the Corporation's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the applicable basis of accounting unless the management either intends to liquidate the Corporation or 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.

Those charged with governance are responsible for overseeing the Corporation's financial reporting process.

Auditor-General's Responsibilities for the Audit of the Financial Statements

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.

As part of an audit conducted in accordance with ISSAIs, I exercise professional judgement and maintain professional scepticism 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.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances and for the purpose of giving an assurance on the effectiveness of the Corporation's 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 going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Corporation's ability to continue as a going concern or to sustain its services. 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 Corporation to cease as a going concern or to continue 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 Corporation 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

11 July 2018