REPORT OF THE AUDITOR-GENERAL ON KENYA ORDNANCE FACTORIES CORPORATION FOR THE YEAR ENDED 30 JUNE 2018

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 71, which comprise the statement of financial position as at 30 June 2018, and the statement of financial performance, statement of changes in net assets and statement of cash flows 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 effects of the matter 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 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 State Corporations Act, Cap 446 of the laws of Kenya.

Basis for Qualified Opinion

1.0 Property Plant & Equipment

1.1 Land

The statement of financial position as at 30 June 2018 and note 11 to the financial statements reflect non-current assets figure of Kshs.3,062,990,916. 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 surveyors 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, 2,545 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.3,062,990,916 as at 30 June 2018 could not be confirmed.

1.2 Idle Machinery

As previously reported, 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.

In the circumstances, the accuracy and completeness of the non-current assets' balance of Kshs.3,062,990,916 could not be confirmed as at 30 June 2018.

1.3 Assets Register

The statement of financial position reflects property plant and equipment figure of Kshs.3,062,990,916 as at 30 June 2018 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.4,761,588,611 as disclosed in note 11 to the financial statements. The assets register availed for audit review reflects total assets as shown below;

Asset Description	**Total Cost as at 30 June 2018 Kshs.**
Building and Civil Works	880,330,641
Waterline and Civil Works	476,737,242
Work-In-Progress	190,949,523
Plant Equipment, Machinery	3,010,330,448
Motor Vehicles	129,815,489
Furniture and Fittings	25,075,650
Computers	48,349,619
Total	**4,761,588,611**

However, as reported in 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.3,062,990,916 could not be confirmed.

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.586,917,820 as at 30 June 2018 which includes claimable value added tax amount of Kshs.111,957,288 as disclosed in note 16 to the financial statements and which is indicated as Kshs.73,098,600 due from Ministry of Defence. 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 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.111,957,288 is an amount of Kshs.36,377,490 claimable for the year 2003. However, letter Ref No. KRA/DTD/AM&RD/007 dated 22 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.111,957,288 is doubtful and the accuracy of the trade and receivables balances of Kshs.586,917,820 as at 30 June 2018 could not be confirmed.

2.2 Other Exchange Debtors

Included also in the trade and other receivables figure of Kshs.586,917,820 is other exchange debtors' figure of Kshs.75,704,695 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.75,704,695 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 the information available indicates that a Board of Officers (BOO) was constituted in August 2017 to investigate the matter, a report of this investigation 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 2018 as disclosed in note 17 to the financial statement in respect of Value Added Tax (VAT) due from Kenya Revenue Authority (KRA) which has been outstanding for the last 17 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, the recoverability of the amount of Kshs.12,859,976 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 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 matter(s) described in the Basis for Qualified Opinion section, I have determined that there are no other key audit matters to communicate in my report.

Other Matter

1.0 Financial Performance

During the year under review, the Corporation recorded a loss of Kshs.258,692,444 which reduced the retained earnings to Kshs.(716,612,604) from Kshs.(457,920,160) as at 30 June 2017. Although the Corporation recorded positive working capital of

Kshs.1,399,028,252 as at 30 June 2018, if strategies are not put in place to reverse the loss trend, the Corporation's future operations are likely to be affected adversely by the loss making trend.

2.0 Financial Performance of Food Factory- Gilgil

Available records show that vegetables dehydration processing plant at Gilgil spent a total of Kshs.88,848,668 on salaries, purchase of raw materials and insurances services. During the same period under review, the factory made sales of Kshs.1,617,556 against operating expenses of Kshs.88,848,668 resulting to a net loss of Kshs.87,231,112 as at 30 June 2018. The management attributes the poor performance to lack of market for dry foods vegetables, droughts and poor quality of raw materials.

In the circumstances, the Corporation may not be able to meet its obligations to pay its suppliers of raw materials and pay salaries and wages leading to closure or insolvency of the factory.

3.0 Trade and Other Payables

3.1 Trade Payables

The statement of financial position reflects trade and other payables' balance of Kshs.518,637,645 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

Trade and other payables' balance of Kshs.518,637,645 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.

REPORT ON LAWFULNESS AND EFFECTIVENESS IN USE OF PUBLIC MONEY

Conclusion

As required by Article 229(6) of the Constitution, based on the procedures performed, except for the matter described in the Conclusion on Compliance and Effectiveness section 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 conclusion

1.0 Late Submission of Financial Statements

Kenya Ordnance Factories Corporation management submitted its financial statements for the year ended 30 June 2018 to the Auditor General on 15 October, 2018, a period of 2 weeks after the end of the financial year contrary to provisions of section 164(4) of the Public Management Act 2012 which require financial statements to be submitted before or on 30 September at the end of every financial year.

Consequently, the management has contravened section 164(4) of the Public Finance Management Act, 2012.

2.0 Property, Plant and Equipment

2.1 Supply and Implementation of Enterprise Resource Planning (ERP) System

Included in the Property, Plant and Equipment figure of Kshs.3,062,990,916 as disclosed in note 11 to the financial statements is transfers(capitalized) figure of Kshs.11,743,560 from work in progress to Computers relating to installation, testing and commissioning of Enterprises Resource Planning(ERP) which was awarded to a technology firm on 8 January 2016. The duration of the project was six (6) months. The commissioning of the project was done on 23 February 2017. The contract entailed installation of 8 (eight) modules that is, the production, quality assurance, procurement security, human resource, finance maintenance and commercial department. Although the system was commissioned more than one and half years ago, most of the vital records such as assets register, cash books, bank reconciliations, general ledger, payment vouchers, debtors and creditors ledgers are done manually.

Further, the management has not availed a plan, time frame and the processes the entity uses to convert transactions such as fixed assets, debtors, creditors and stocks from manual to electronic system. It has not also showed the percentage of conversion from manual system to electronic system on various modules such as general ledger, warehouse, finance, human resource, procurement among others.

In addition, the ERP system in place does not interlink with other systems such as integrated payroll and personal Database(IPPD) and the management does not have proper back up system which can be used to restore data in case of a disaster within the entity.

Consequently, the corporation has not obtained value for money on the expenditure of Kshs.11,743,560 for the year ended 30 June 2018 since not all the modules were functional.

3.0 Other Income

3.1 Scrap metal

The statement of financial performance for the year ended 30 June 2018 reflects other income figure of Kshs.234,301,130 which include income from sale of scrap metal amounting to Kshs.28,239,880 as disclosed in note 6 of the financial statements that were sold to a single firm. It was observed that the corporation did not maintain an annual asset disposal plan as required by section 53 (4) of the 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, there was no evidence that the corporation complied with Section 90 (5) of the Public Procurement and Assets Disposal Act, 2015 which requires procuring entities that deal with classified items to 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 was also no evidence that the review of prices for brass scrap metal during the year was in accordance with Section 164 (3) of the same Act which state that there shall be a technical report where the appropriate relevant expert of the subject items for disposal takes into account the real market price and in so doing, the technical expert shall set up a reserve price which shall be the minimum acceptable price below real market value of the boarded items.

The management was therefore in breach of the law.

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, GOVERNANCE AND RISK MANAGEMENT SYSTEMS

Conclusion

As required by Section 7 (1) (a) of the Public Audit Act, 2015, based on the procedures performed, except for the matter 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.
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 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.

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

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 money is applied in an effective manner.

Those charged with governance are responsible for overseeing the Corporation'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 review is planned and performed to express a conclusion with limited assurance as to 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 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. The nature, timing and extent of the compliance work is limited compared to that designed to express an opinion with reasonable assurance on the financial statements.

Further, in planning and performing the audit of the financial statements and review 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 Corporation's 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 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 to continue as a going concern or 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

10 April 2019