

REPORT OF THE AUDITOR-GENERAL ON KENYA ORDNANCE FACTORIES CORPORATION FOR THE YEAR ENDED 30 JUNE, 2019

REPORT ON THE FINANCIAL STATEMENTS

Qualified Opinion

I have audited the accompanying financial statements of Kenya Ordnance Factories Corporation set out on pages 1 to 62, which comprise the statement of financial position as at 30 June, 2019, 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 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, 2019, 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 Public Finance Management Act, 2012 and the State Corporations Act, Cap 446 of the laws of Kenya.

Basis for Qualified Opinion

1. Cash and Cash Equivalents

The statement of cash flows reflects cash and cash equivalents balance of Kshs.146,822,437 as at 30 June, 2019 whereas the corresponding Note 17 to the financial statements indicates a balance of Kshs.139,822,437. The resulting variance of Kshs.7,000,000 has not been reconciled or explained.

2. Property, Plant and Equipment

2.1 Land

The statement of financial position reflects property, plant and equipment net book value balance of Kshs.2,986,420,609 as at 30 June, 2019. However, as reported in previous years, the Corporation only has title documents for land measuring 727.7 hectares on which the factory stands.

Available information indicates that the Corporation requested the Government to allocate it additional 908 hectares to enable it to 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 informal settlers 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.

Further, all the 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 the financial statements.

2.2 Assets Register

As disclosed in Note 14 to the financial statements, the property, plant and equipment net book value balance of Kshs.2,986,420,609 as at 30 June, 2019 comprises buildings and civil works, water lines, work in progress, plant equipment and machinery, motor vehicles, furniture and fittings and computers with a historical total cost of Kshs.4,778,789,200 as also reflected in the assets register.

However, as reported in previous years, details of the buildings, civil works, waterline plant, equipment and machinery, furniture and fittings were not provided for audit verification. The 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 and Physical Planning to value all the Corporation assets including land so that the same could be properly documented. However, no documentary evidence was provided in support of this explanation.

Consequently, the existence and ownership of the property, plant and equipment, and accuracy and completeness of the related balance of Kshs.2,986,420,609 could not be confirmed.

3. Trade and Other Receivables

3.1 Tax Recoverable

As disclosed in Note 18 to the financial statements, the statement of financial position reflects a tax recoverable balance of Kshs.12,859,976 as at 30 June, 2019. As reported in the previous years, the amount relates to Value Added Tax (VAT) refunds due from the Kenya Revenue Authority (KRA) which has been outstanding for the last eighteen (18) years. Although the collectability of this amount is doubtful, the Corporation has not made a provision to cover the uncertainty in recovering the claim.

3.2 Claimable Value Added Tax

Included in the receivables from exchange transactions balance of Kshs.451,287,584 is an amount of Kshs.111,957,288 relating to claimable value added tax. The latter balance includes an amount of Kshs.73,098,600 due from Ministry of Defence. However, no documentary evidence was 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 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 while the claim was filed by the Corporation using the Corporation PIN. However, there was no evidence to indicate that the two entities were jointly registered for VAT refund at that time.

Although the Corporation has now indicated that the above 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, the Kenya Revenue Authority has indicated 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 had engaged a tax consultant to follow up the claim, there has been no indication of the progress made in recovering the claim.

Under the circumstances, the recoverability of the claimable Value Added Tax amount of Kshs.111,957,288 is doubtful.

4. Trade and Other Payables - Prepayment by Ministry of Defence

The statement of financial position reflects trade and other payables' balance of Kshs.506,899,280 which, as disclosed in Note 21 to the financial statements, include trade payables of Kshs.277,354,628. As reported in the previous years, the trade payables of Kshs.277,354,627 relates to prepayments made by the Ministry of Defence in respect of deposits for product purchases, which have however remained unsettled or un-serviced since 2011/2012 financial year.

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 provided for audit verification.

Consequently, the accuracy and completeness of the trade and other payables balance of Kshs.506,899,280 as at 30 June, 2019 could not be confirmed.

The audit was conducted in accordance with International Standards of Supreme Audit Institutions (ISSAIs). I am independent of the Kenya Ordnance Factories Corporation Management in accordance with ISSAI 130 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. There were no key audit matters to report in the year under review.

Other Matter

1. Budgetary Control and Performance

The Corporation budgeted for revenue totalling Kshs.1,400,374,673 during the year under review. However, an amount of Kshs.1,282,244,174 was realized, resulting in a revenue shortfall of Kshs.118,130,498 or 8.4 % of the budgeted amount. Similarly, the Corporation had an expenditure budget of Kshs.1,474,049,401 while the actual expenditure was Kshs.1,509,213,573, resulting in an over-expenditure of Kshs.88,550,103 or 6% for the year ended 30 June, 2019. Reasons for the over-expenditure were not provided.

2. Financial Performance

2.1 Overall Trading Loss

The statement of financial performance for the year ended 30 June, 2019 reflects sales of Kshs.590,915,553 against the cost of sales of Kshs.1,285,262,650 resulting in a trading loss of Kshs.694,347,098 which is 117.5% of the total sales. The management explained that heavy losses incurred was due to ineffective, old and worn-out machines whose performance stands at 40%, hence could not meet the domestic demand of the products.

2.2 Financial Performance of Food Processing Factory- Gilgil

Available records show that vegetables dehydration processing plant at Gilgil spent a total of Kshs.173,320,119 during the year under review on salaries and purchase of raw materials. During the same year under review, the factory-made sales of Kshs.76,702,300 against operating expenses of Kshs.173,320,119, resulting in a net loss of Kshs.96,617,819 or 126% loss compared with the total sales. The Management attributed the poor performance to lack of market for dry foods vegetables, droughts and poor quality of raw materials.

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 Conclusion on Lawfulness and Effectiveness in Use of Public Resources 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

1. 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 loader. 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.

2. Supply and Implementation of Enterprise Resource Planning (ERP) System

Included in the property, plant and equipment historical cost of Kshs.4,778,789,200, as disclosed in Note 14 to the financial statements, is an amount of Kshs.11,743,560 for a computer software system relating to installation, testing and commissioning of Enterprises Resource Planning (ERP) which was awarded to a consultancy 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 two and a half years ago, most of the vital records such as assets register, cash books, bank reconciliations, general ledger, payment vouchers, debtors and creditors are done manually.

Further, Management did not provide for audit review 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. The Management did not also show 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, value for money has not been obtained so far on the expenditure of Kshs.11,743,560 incurred on the computer software system given that the modules are not fully functional.

3. Advance Payment

As disclosed in Note 21 to the financial statements, the trade and other payables balance of Kshs.506,899,280 includes payments received in advance of Kshs.140,000,000. The amount relates to 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 financial year. The Management explained that the delay in refund was 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. However, no indication was given as to when the new production line would be established or when the refund would be made.

4. Disposal of Scrap Metal

The statement of financial performance reflects receipts of Kshs.337,179,757 under other income which, as disclosed in Note 9 to the financial statements, includes an amount of Kshs.39,339,177 from sale of scrap metal that was sold to a private firm. It was, however, observed that the Corporation did not maintain annual asset disposal plan as required under Section 53(4) of the Public Procurement and Asset Disposal Act, 2015 which states that all asset disposals shall be planned by the Accounting Officer through an 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 Asset 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 Act which requires a technical report where an expert of the subject items for disposal takes into account the real market price and set-up a reserve price which should be the minimum acceptable price below real market value of the boarded items.

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, 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 2315 and ISSAI 2330. The standards require that I plan and perform the audit to obtain assurance about whether processes and systems of internal control, risk management and overall 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, disclosing, as applicable, matters related to going concern and using the applicable basis of accounting unless Management is aware of intention to terminate the Corporation or to cease operations.

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 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 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. 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.

- 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 Kenya Ordnance Factories 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.



Nancy Gathungu
AUDITOR-GENERAL

Nairobi

09 August, 2021