

REPORT OF THE AUDITOR-GENERAL ON KENYA PIPELINE COMPANY LIMITED FOR THE YEAR ENDED 30 JUNE 2018

REPORT ON THE FINANCIAL STATEMENTS

Qualified Opinion

I have audited the accompanying financial statements of Kenya Pipeline Company Limited set out on pages 50 to 92, which comprise the statement of financial position as at 30 June 2018, and the statement of profit or loss and other comprehensive income, statement of changes in equity, 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 effects 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 Pipeline Company Limited as at 30 June 2018, and of its financial performance and its cash flows for the year then ended, in accordance with International Financial Reporting Standards(IFRS) and comply with the Companies Act, 2015.

Basis for Qualified Opinion

1. Unrecognized Contingent Liability Under Trade and Other Receivables

The Statement of financial position for the year under review reflects trade and other receivables amounting to Kshs.14,390,380,116 (2017: Kshs.12,048,271,443). As similarly reported in 2016/17 included in this amount is Kshs.4,292,949,798 (2017: Kshs.4,314,146,056) due from an Oil Marketing Company (OMC) which, however, the OMC has disputed. The arbitrator appointed to help resolve the dispute ruled against the Company in 2016 and awarded the OMC US\$.19,758,595, equivalent to Kshs.1,996,606,025 at the exchange rate ruling on 30 June 2018. Thereafter, the Company lodged a Court appeal against the arbitrator's decision. Determination of the appeal was pending at the time of finalizing this audit. However, the contingent liability resulting from the arbitrator's ruling has not been recognized in the financial statements and further, no provision has been made by the Company in relation to the doubtful debt owed by the OMC.

In view of these omissions, the trade and other receivables balance of Kshs.14,390,380,116 may be overstated by Kshs.4,292,949,798. Further, the decision that the Court shall make on the Company's appeal will determine whether the contingent liability amounting to US\$19,758,595 (Kshs.1,996,606,025) resulting from the award made by the arbitrator to the OMC will materialize.

2. Incomplete Budgeting System Project

The property, plant and equipment balance of Kshs.104,869,093,834 (2017 98,091,185,918) reflected in the statement of financial position as at 30 June 2018 includes Kshs.3,822,570,903 (2017 Kshs.54,559,440,075) under capital work-in-progress which in turn includes a sum of Kshs.26,498,339 (Euros 227,338) paid in advance to a vendor for supply, implementation and commissioning of an electronic budgeting system in 2015. The payment represented 51% of the contract sum. The contract's delivery timeline was six (6) months. However, at the time of finalizing the audit for the year under review, the system had not been supplied even though 33(thirty-three) months had lapsed since the signing of the contract. Further, in spite of the system having not been completed or put to use, the Company had paid the vendor annual software licence, software maintenance and user training fees totaling Euros 35,361, or Kshs.4,132,188 at the exchange rate ruling on 30 June 2018.

The Company has since terminated the contract with the vendor. However, no provision or write-off has been made against the budgeting system as it is still recognized as capital work-in-progress in the financial statements of the Company. In addition, it is not clear why annual software licence and maintenance fees as well as training costs were paid to the vendor before the whole system was supplied and commissioned. Further, the option of recovering the amounts advanced to the vendor by recalling the contract's performance bond is no longer available to the Company as the bond expired in November 2015. From the foregoing, value-for-money and propriety of expenditures totaling Kshs.30,588,934 incurred on the budgeting system cannot be confirmed.

The audit was conducted in accordance with International Standards of Supreme Audit Institutions (ISSAIs). I am independent of Kenya Pipeline Company Limited 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.

Emphasis of Matter

1. Lands Without Title Deeds

As similarly reported in my report for 2016/17, the leasehold land balance of Kshs.4,999,883,570 (2017 Kshs.5,167,287,314) disclosed under note 17, includes parcels of land valued at Kshs.1,928,677,778 which have no title deeds. Available information indicates that titles for Plots No.LR.9042/225 and 114/113/114 carried in the books at Kshs.869,759,420 and Kshs.130,257,924 respectively and in which the Company's Embakasi and Mombasa depots are situated, are issued in the name of Kenya Airports Authority (KAA) who are the legal owners of the larger piece of land from which the two parcels were hived-off. Although, management have explained that, the National Lands Commission (NLC) has written to KAA to surrender the original title to facilitate the issuance of sub-titles for the two parcels, the titles have not been surrendered as yet.

In the circumstances, it is not possible to confirm that the Company owns the two parcels of land in its possession, and whether indeed the carrying values of the parcels stated in the financial statements as at 30 June 2018 are correct.

2. Pending Contract Variation Claims

The property plant and equipment balance amounting to Kshs.104,869,093,834 reflected in the statement of financial position as at 30 June 2018 and analyzed in note 16 to the financial statements includes an amount of Kshs.51,416,165,547 incurred on cost of works on a new Mombasa-Nairobi Oil Pipeline commonly referred to as Line 5. The balance was transferred from work-in-progress during the year under review. Construction of Line 5 started on 1 July 2014, following the award of the tender at a cost of US\$ 484,502,887 equivalent to Kshs.48,474,513,784 at the ruling exchange rate of 30 June 2018. As at 30 June 2018, the project engineer had submitted eight (8) variation orders totaling to US\$ 38,109,717 (Kshs.3,812,877,186). The variation orders are reported to have resulted from change of design specifications and omission of works in the initial contract. Of the aggregate variation amount, a sum of US\$. 17,445,639 (Kshs.1,745,436,145) was approved for payment.

In addition, the contractor submitted five (5) Extension of Time (EoT) claims amounting to US\$. 204,511,827 (Kshs. 20,461,408,302). However, the claims were contested by the Project Engineer resulting in the appointment of an independent expert scheduler to verify the claims. As at 30 June 2018, the expert scheduler had assessed the total amount payable to the contractor for the four EoTs to be US\$. 44,019,0125 (Kshs.4,404,103,425) down from the contractor's claim of US \$ 189,290,732 (Kshs. 18,938,537,727). The fifth EoT claim of US \$ 15,221,095 (Kshs. 1,522,870,576) had not been reviewed by the expert scheduler.

Construction of the pipeline (Line 5) was completed and the line commissioned during the year under review. Until the matters related to the contract variation and extension of time are resolved, it is not possible to confirm that the carrying value of the pipeline reflected in the financial statements as at 30 June 2018 is true and fair.

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 other key audit matters to communicate in my report.

Other Matter

1. Irregular Supply of Hydrant Pit Valves

As reported in my report for 2016/2017, the Company awarded a US\$6,409,492 (Kshs.647,679,167) contract for the supply of hydrant pit valves - C/W isolation valves and spare parts for two years' operations to a vendor through direct procurement, contrary to the requirements of the Public Procurement and Asset Disposal Act, 2015. Although the management has indicated that the United States of America-based vendor was

invited to bid for the tender on account of being the original manufacturer of the equipment, no evidence has been made available to validate this assertion. Therefore, the basis for the award of the tender to the vendor cannot be confirmed. In addition, no plausible explanation has been provided by management for procurement of spares parts to cover two years of operations. At the time of concluding this audit, the matter was under prosecution in Court after investigation by the Ethics and Anti-Corruption Commission.

In the circumstances, I am not able to confirm the Company's compliance with procurement procedures, and whether it obtained value- for-money on the contract sum of Kshs.655,880,009 paid to the vendor for supply of the hydrant pit valves.

2. Unutilized New Kisumu Oil Jetty

The statement of financial position as at 30 June 2018, reflects property plant and equipment with a net book value of Kshs.104,869,093,834. The balance includes assets valued at Kshs.1,937,515,726 being construction costs for the Kisumu Oil Jetty transferred from work-in-progress during the year under review. Construction works on the jetty were executed from May 2017 to March 2018 when they were completed and handed over to the Company by the contractor. The assets were thereafter capitalized and depreciated by Kshs.11,037,699 for the year under review. The jetty was constructed under the Northern Corridor Integration Projects portfolio of the East African Community with a view to improve the distribution of refined petroleum products to Uganda and other neighboring countries. However, it has remained unutilized due to lack of infrastructure for receipt and storage of the products in Uganda. Although management has indicated that some progress has been made in construction of one of the two planned similar jetties on Uganda side, it is not certain when all the facilities due for construction in Uganda will be completed and operationalized.

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 Compliance with Lawfulness and Effectiveness in Use of Public Resources sections 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. Irregular Payment to a Contractor

During the year under review a payment of Kshs.24,651,296 in excess of the contract sum was made to a firm contracted to carry out environmental clean-up works along the Company's oil pipeline. The payments were for additional invoices raised by the firm for the months of March to June 2017 which period was, however, within the original contract timeline. According to the contract agreement, the contractor was to undertake the works for 18 Months at a revised contract sum of Kshs.147,129,771. However, the contractor

invoiced the Company after the full contract sum was paid in March 2017 thus resulting in the nugatory payments totaling Kshs.24,651,296.

2. Irregular Purchase of Motor-Vehicle Accessories

The motor vehicle expenditure of Kshs.72,872,587 includes Kshs.9,096,935 spent on purchases of motor vehicle accessories which included chevrons, car mats, stripes, reflectors, life savers and key tags. The items were purchased as low-value procurements through petty cash payments and reimbursement claims lodged by the Company's staff. Since the purchases occurred on a regular basis, the total value of the items for the year exceeded the threshold for low value procurement, set out in Section 107 of the Public Procurement and Disposal Act, 2015. Further, the quantities of the accessories purchased exceeded, the Company's fleet requirements and in addition, were bought at prices that exceeded, by as much as 350% similar purchases made during the year under review. Further, only a small number of the items were confirmed to have been issued for use in the Company's fleet of vehicles and none could be found in the Company's stores.

In the circumstances, the purchases were made irregularly and receipt and use of the majority of the items for the Company's benefit cannot be confirmed.

3. Irregular Payment of Overtime Allowances

The staff costs reflect an amount Kshs.5,841,187,761 for the year ended 30 June 2018 which includes overtime allowance payments of Kshs.306,955,912 paid to 1,080 staff members. Of this amount, Kshs.97,661,089 was paid contrary to the Company's Staff Rules and Regulations to 231 staff who were earning responsibility allowances. In addition, overtime allowance payments totaling Kshs.171,919,296 made to 164 employees exceeded 25% of their respective annual gross salaries with fourteen (14) of the staff having drawn overtime allowances in excess of their annual salaries. In some instances, the annual overtime allowances paid were as high as 250% of annual gross salaries payable, implying that the claimants worked for more days than were available in the financial year.

In the circumstances, it has not been possible to confirm the regularity and probity of Kshs.269,580,385 incurred on the allowances.

4. Non-adherence to SRC Guidelines on Subsistence Allowances

Subsistence allowance payments totaling Kshs.509,631,611 made to travelling Company staff during the year under review were based on identical rates across towns for various job cadres contrary to rules issued by the Salaries and Remuneration Commission (SRC). The rules prescribe a three-cluster town classification system applicable for daily subsistence allowance payments to both national and county government employees. Since no approvals were granted by the Commission for the identical allowance rates paid to staff by management, the resultant payments were irregular.

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 comply, 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 procedures performed, except for the matter described in the Conclusion on Effectiveness of Internal Controls, Risk Management and Governance 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

1. Incomplete Accounting for Product Gains and Losses

Transport and Storage Agreements (TSA) between Kenya Pipeline Company (KPC) and Oil Marketing Companies (OMCs) provide that KPC shall apportion to the OMCs, any product gains and losses based on each OMC's total quarterly receipts for a specific grade of product on a moving-average against the total industry receipts for the same grade. The TSA also provides that KPC shall be liable to and shall indemnify OMCs for losses of products where such losses exceed 0.25% of the volume of products handled.

During the year under review, the Company reported product losses totaling 23,878 m³ being the difference between book stocks shown as 653,284 m³ and physical stocks amounting to 629,406 m³. Of these losses, a balance of 11,646 m³ was attributed to spillage and pilferage, and 8,584 m³ to normal losses. The remainder 3,647 m³ was disputed by OMCs with 3,110 m³ subjected to further examination by management and 537 m³ forwarded to an independent consultant for scrutiny. At the time of conclusion of the audit, the 537 m³ of losses had been reconciled and agreed with one OMC leaving 3,110 m³ unreconciled.

Although the Company's Health, Safety and Environment (HSE) procedure manual requires the Company and OMCs to investigate and report on losses incurred through spillage and pilferage, there is no evidence to show that all the loss incidents were reported or investigated and corrective measures taken to forestall similar occurrences in future.

As a result, it has not been possible to confirm the nature, volume and cost of product losses that occurred as well as additional measures taken by management to safeguard stock owners' interests, ensure public safety and mitigate environmental impacts should the leakages recur during the year under review.

2. Overdrawn Product

Global stock entitlement data maintained by the Company shows that thirteen (13) Oil Marketing Companies (OMCs) had aggregate negative stock balances amounting to 4,435 cubic meters on their loadable sums as at 7 August 2018, an indication that the OMCs had overdrawn products beyond their entitlements, contrary to the Transport and Storage Agreements (TSA). According to the TSAs, OMCs are required to maintain sufficient product stocks to meet their daily requirements. The TSAs also require the Company to suspend deliveries to OMCs that record zero or negative entitlements.

However, there is no evidence showing that oil product supplies to any of the 13 (thirteen) OMCs that recorded negative balances were suspended at any time during the year under review.

3. Staff Matters

3.1 Unapproved Recruitments

During the year under review, the Company appointed staff to newly created positions without first seeking and obtaining approval from the National Treasury as provided for in Government circulars which require appointments in state corporations other than replacement of existing vacancies to be made only after written confirmation of availability of funds for the purpose is obtained from the National Treasury.

In addition, two new positions that did not exist in the Company's establishment were created and filled through internal advertisements. The respective job descriptions and specifications for the positions were not outlined in the Company's career guidelines handbook. It has therefore not been possible to ascertain what guided management in making appointments to the positions.

3.2 Un-procedural Appointment of Staff

During the year under review, the Company appointed several staff on promotion to positions up to seven (7) grades higher than those that the appointees occupied before the promotions. This was against the Company's Staff Rules and Regulations and Career Guidelines handbook, which require appointments on promotion to take into consideration academic qualifications, experience and seniority. Although the appointees were said to possess the requisite academic qualifications, they lacked requisite experience and seniority as defined in the Company's career progression guidelines:

- (i) Appointments made to positions in Job Grade 3 required candidates to have served for a minimum of five (5) years in managerial capacity. However, three persons appointed to the grade were serving in non-managerial Job Grades seven (7) and six (6).
- (ii) At least five candidates promoted to higher positions had been found unsuccessful in lower-level job interviews for which they had applied and were interviewed for during the same period. Some of the candidates were appointed to positions four (4) levels higher than those they had unsuccessfully applied for.

In the circumstances, I am unable to confirm whether the appointments were fair, competitive and merited.

3.3 Recruitment to Non-existent Positions

During the year under review, the Company advertised for a vacant senior position in the finance department. However, an unsuccessful applicant for the advertised position was appointed to a new position that was separated from the one advertised, whereas the successful candidate was appointed to the position advertised but with a new title. The two new positions did not exist in the Company's structure at the time the appointments were made, and further, contrary to the Company's human resource policies, they were not advertised for any interested candidates to apply. In addition, creation of the new positions was not approved by the National Treasury and State Corporations Advisory Committee as required.

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.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

As required by the Companies Act, 2015, I report based on my audit, that:

- i. 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;
- ii. in my opinion, adequate accounting records have been kept by the Company, so far as appears from the examination of those records; and
- iii. the financial statements are in agreement with the accounting records and returns.

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 Financial Reporting 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 assessment of the effectiveness of internal control, risk management and governance.

In preparing the financial statements, the directors are responsible for assessing Kenya Pipeline Company Limited'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 directors are aware of the intention to liquidate the Company or have its operations cease; or have no realistic alternative but to do so.

The directors are 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 preparing and presenting the financial statements described above, management is also responsible for ensuring that the activities, financial transactions and information reflected in the financial statements comply 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 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 comply 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.

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 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 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 Company 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 Company 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 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

30 January 2019