REPORT OF THE AUDITOR-GENERAL ON GEOTHERMAL DEVELOPMENT COMPANY LIMITED FOR THE YEAR ENDED 30 JUNE, 2021

PREAMBLE

I draw your attention to the contents of my report which is in three parts:

A. Report on the Financial Statements that considers whether the financial statements are fairly presented in accordance with the applicable financial reporting framework, accounting standards and the relevant laws and regulations that have a direct effect on the financial statements.

B. Report on Lawfulness and Effectiveness in Use of Public Resources which considers compliance with applicable laws, regulations, policies, gazette notices, circulars, guidelines and manuals and whether public resources are applied in a prudent, efficient, economic, transparent and accountable manner to ensure Government achieves value for money and that such funds are applied for intended purpose.

C. Report on Effectiveness of Internal Controls, Risk Management and Governance which considers how the entity has instituted checks and balances to guide internal operations. This responds to the effectiveness of the governance structure, the risk management environment, and the internal controls developed and implemented by those charged with governance for orderly, efficient and effective operations of the entity.

An unmodified opinion does not necessarily mean that an entity has complied with all relevant laws and regulations, and that its internal controls, risk management and governance systems are properly designed and were working effectively in the financial year under review.

The three parts of the report are aimed at addressing the statutory roles and responsibilities of the Auditor-General as provided by Article 229 of the Constitution, the Public Finance Management Act, 2012 and the Public Audit Act, 2015. The three parts of the report, when read together constitute the report of the Auditor-General.

REPORT ON THE FINANCIAL STATEMENTS

Adverse Opinion

I have audited the accompanying financial statements of Geothermal Development Company set out on pages 30 to 70, which comprise of the statement of financial position as at 30 June, 2021, 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, because of the significance of the matters discussed in the Basis for Adverse Opinion section of my report, the financial statements do not present fairly, the financial position of the Geothermal Development Company Limited as at 30 June, 2021, and of its financial performance and its cash flows for the year then ended, and do not comply with the Public Finance Management Act, 2012 ,the International Financial Reporting Standards (IFRS) and the Companies Act, 2015..

Basis for Adverse Opinion

1.0 Misrepresented Balances

1.1 Trading Revenue Recognized as Capital Grants

The statement of profit or loss and other comprehensive income reflects steam charges revenue totalling Kshs.1,033,399,000, as detailed in Note 5 to the financial statements. The Note indicates that the Company earned Kshs.3,028,849,000 from steam-charges during the year under review but, in with its accounting policy, reported Kshs.1,995,450,000 of the earnings as capital grants applied to fund development projects.

However, no satisfactory explanation was provided by Management for capitalization of a portion of revenue.

In the circumstances, the accuracy, completeness and validity of the revenue totaling Kshs.1,033.399,000 could not be confirmed.

1.2 Pending Grants Recognized as Revenue

The trade and other receivables balance includes grants totalling Kshs.82,680,000 listed in the general ledger as receivable from the National Government. No explanation was provided why the grants, which had not been received by the end of the year under review on 30 June, 2021, was recognized as income in the year under review contrary to requirements of International Accounting Standards (IAS) 20 - Accounting for Government Grants and Disclosure of Government Assistance, and the prudence concept of accounting.

In the circumstance, the financial statements do not comply with International Financial Reporting Standards on Government grants and Government assistance, and further, the other receivables balance totalling Kshs.2,396,127,000 is not fairly stated.

2. Unconfirmed Balances

Several balances reflected in the financial statements were not supported with sufficient appropriate records or information, as explained in the following paragraphs:

2.1 Administration Expenses

The statement of profit or loss and other comprehensive income reflects administration expenses totalling Kshs.2,133,856,000, as further disclosed in Note 8 to the financial statements. However, the following anomalies were noted in regard to the balance:

2.1.1 Unexplained Apportionment of Employees Benefits Expenditure

Administrative expenses on employee benefits totalling Kshs.523,473,000 reflected in Note 8 to the financial statements were comprised of salaries and wages totalling Kshs.491,772,000 and retirement benefits totalling Kshs.31,701,00, as indicated in Note 10. However, examination of the payroll data indicated that salaries and allowances paid to employees totaled Kshs.651,224,010, out of which only Kshs.491,544,000 or 75% was expensed as recurrent expenditure. Management did not provide documentary evidence, including accounting policies, to explain the basis for the apportionment of 25% of the costs totalling Kshs.162,806,003 to capital expenditure.

In the circumstance, the accuracy, completeness and fair statement of employee benefits expenses totalling Kshs.523,473,000 reported to have been incurred in the year under review could not be confirmed.

2.1.2 Unsupported Overtime Allowance

Examination of monthly payrolls indicated that the Company paid overtime allowances totalling Kshs.6,232,390 to employees in the year under review. However, the Company's policy on payment of overtime allowances, approvals for the payments, timesheets completed by the payees and the payment rates applied were not provided for audit.

As a result, the occurrence, validity and measurement of overtime allowances totalling Kshs.6,232,390 could not be confirmed.

2.2 Cash and Cash Equivalents

The statement of financial position reflects cash and cash equivalents totalling Kshs.887,789,000 held in various bank accounts as at 30 June, 2021. However, examination of bank reconciliation statements indicated that the balance included an unpresented cheque totalling Kshs.1,804,659 drawn on 13 January, 2014 and which had since become stale. In view of the failure to reverse the cheque in the cashbook, the cash and cash equivalents balance was not fairly stated.

In the circumstances, the accuracy and completeness of bank and cash balances totalling Kshs.886,289,000 could not be confirmed.

2.3 Trade and Other Receivables

The statement of financial position reflects trade and other receivables totalling Kshs.2,396,127,000 as further disclosed in Note 13 to the financial statements. However, the following anomalies were noted in relation to the balance:

2.3.1 Long Standing Interest on Receivables

The trade and other receivables balance includes Kshs.31,658,983 being interest receivable on late payment of invoices by Kenya Electricity Generating Company Limited (KenGen) for steam power sales made in the year 2018. In view of the failure to collect the long-standing debt, its recoverability is doubtful.

Further, the receivables balance includes additional debts totalling Kshs.1,144,866,125 owed by KenGen. However, KenGen's financial statements for the year under review reflect debts totalling Kshs.1,059,884,000 as owed to the Company. No reconciliation was provided by Management for the difference of Kshs.84,982,125 and as a result, the actual amount owed by KenGen could not be confirmed.

2.3.2 Value Added Tax Recoverable

The trade and other receivables balance further includes Value Added Tax (VAT) receivable totalling Kshs.598,671,000. However, no supporting records were provided for withholding VAT totalling Kshs.31,298,573 included in the balance.

In view of these anomalies the accuracy and extent of recoverability of the trade and other receivables balance totalling Kshs.2,396,127,000 could not be confirmed.

2.4 Current Income Tax Liability

The statement of financial position reflects a Nil current income tax liability . However, the audited financial statements for 2018/2019 financial year, indicated there were unpaid taxes totalling Kshs.4,042,976,000 that had accrued from 2014/2015 to 2018/2019 financial years. However, change in the Company's accounting policy on steam charges revenue in the year 2019/2020 reduced the outstanding corporation tax and related penalties outstanding as at 30 June, 2019 by Kshs.2,512,581,000 to Kshs197,853,000.The balance had, however, not been agreed with the Kenya Revenue Authority (KRA) as at 30 June, 2021.

In the circumstance, the accuracy of the Nil current tax liability balance reflected in the financial statements could not be confirmed.

2.5 Current Income Tax

The statement of financial position reflects current income tax recoverable totalling Kshs.131,501,000. However, records on tax payments indicated that withholding taxes paid included Kshs.42,045,806 for the months of July, August, December, 2019 which therefore related to the 2019/20 financial year and not the year under review.

In the circumstance, the current income tax balance totalling Kshs.131,501,000 may not be fairly stated.

2.6 Property, Plant and Equipment

The statement of financial position reflects property, plant and equipment with a net book values totalling Kshs.44,641,491,000, as further disclosed in Note 17 to the financial statements. However, the following anomalies were noted in relation to the balance:

2.6.1 Material Differences Between Fair Value of Assets and the Carrying Amounts

The assets totalling Kshs.44,641,491,000 are stated at historical cost less depreciation in line with the Company's policy on valuation of property, plant, and equipment. However, the Company's assets reflected carrying amounts that were materially different from their fair values. Further several assets that were fully depreciated were in use and in good working condition but were, contrary to International Accounting Standard No.16-

Accounting for Property, Plant and Equipment, not revalued and their wear and tear charged against revenues for the year.

In addition, the Company's assets register reflected freehold land and buildings located in Nakuru County acquired more than ten years earlier. Although their market values had since risen, the assets had neither been revalued nor the variance between their fair and book values disclosed in the financial statements as required by IAS 16.

In the circumstances, the valuation of the property, plant and equipment net book balance totalling Kshs.44,641,491,000 could not be confirmed.

2.6.2 Work-in-Progress

The property, plant and equipment balance includes work in progress costed at Kshs.5,103,387,000. In addition, the work-in-progress balance included works costing Kshs.815,701,000 which had been completed but not capitalized as at 30 June, 2021. Further, projects costed at Kshs.751,740,000 included in the work-in progress balance were unchanged from the previous year which implied that their execution may have stalled. No explanation was provided for the anomaly.

In the circumstances, disclosures made in respect to the work-in-progress balance are not sufficient.

2.6.4 Stalled Fuel Management System Project

The work-in-progress balance further includes works costing Kshs.59,433,640 on design, supply, installation, and commissioning of an information management system.

Examination of records on the project indicated that the Company contracted an international company in December, 2014 to install a fuel management system at a cost of Kshs.344,523,712. However, implementation of the project stalled in 2015 after the first works certificate valued at Kshs.59,433,640 was paid to the contractor. The procurement execution of the contract was thereafter put under investigation by the Ethics and Anti-Corruption Commission (EACC).

In view of the lapse of the contract period and delay in execution of the project whose completion has since become doubtful, the expenditure totalling Kshs.59,433,640 incurred on the unused assets of the stalled project ought to have been impaired in accordance with International Accounting Standard No. 36 - Impairment of Assets.

In the circumstance, the work-in progress balance totalling Kshs.5,103,387,000 may not be fairly stated.

In view of these matters, the valuation, completeness and fair presentation of the property plant and equipment balance totalling Kshs.44,641,491,000 could not be confirmed.

The audit was conducted in accordance with International Standards of Supreme Audit Institutions (ISSAIs). I am independent of the Geothermal Development Company Limited 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 audit of financial statements in Kenya. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my adverse 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

Prior Year Issues

The audit report for the year ended 30 June, 2020 raised several issues in relation to the balances reflected in the financial statements, lawfulness and effectiveness in use of resources and effectiveness of internal control, risk management and governance. Management's report on progress made in following up on the Auditor's recommendations indicates that some of the issues had been resolved as at 30 June, 2021. The actual status of the issues shall be confirmed after they are discussed by Parliament.

Other Information

The directors are responsible for the other information. The other information comprises the report of directors as required by the Companies Act, 2015, and the Statement of the Directors' responsibilities which are obtained prior to the date of this report, and the annual report which is expected to be made available after that date.

My opinion on the financial statements does not cover the other information and I do not express an audit opinion or any form of assurance thereon.

In connection with the audit of the financial statements, my responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements, or the knowledge obtained in the audit, or otherwise appears to be materially misstated. Based on the work I have performed on the other information obtained prior to the date of this auditor's report, if I conclude that there is material misstatement of this other information, I am required to report that fact. I have nothing to report in this regard.

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, because of the significance of the matters discussed in the Basis for Conclusion on Lawfulness and Effectiveness in Use of Public Resources section of my report, I confirm that public resources have not been applied lawfully and in an effective way.

Basis for Conclusion

1. Losses Related to Drilling Rigs

1.1 Vandalized Drilling Rigs

In the year under review, an arbitrator appointed by the Nairobi Centre for International Arbitration awarded a security services firm Kshs.50,027,187 comprised of Kshs.46,518,501 for unpaid claims for services rendered to the Company and Kshs.3,508,686 for arbitration costs. Review of documents provided for audit indicated that assorted electric cables, batteries, and electronic components for four (4) of the Company's rigs were stolen between 31 December, 2017 and 01 January, 2020. The Company had put the aggregate value of the vandalized items at Kshs.51,038,525 and attributed the loss to laxity by the security firm which it had contracted to secure the rigs.

Management had withheld payments due to the firm and thereafter lodged a claim against it citing losses totalling Kshs.2,896,488,313. The claim cited the stolen parts and loss of business after the four rigs were reportedly put out of service for two years. However, the Arbitrator dismissed the compensation claim after ruling that the Company withheld the firm's payments without following due process.

Audit inspections at the locations of the rigs in February, 2022 indicated that Management had not established new measures to prevent similar losses.

In the circumstances, failure to establish effective security measures for the Company's key assets may have resulted in the losses totalling Kshs.2,896,488,31 cited by the Company.

1.2 Under Used Drilling Rigs

Fixed assets records indicated that the Company owned seven geothermal drilling rigs with a net book value of Kshs.7,732,797,598 as at 30 June, 2021. The rigs were bought at an aggregate cost of Kshs.15,937,787,572 several ago. However, review of records on their use indicated that four (4) of the rigs years with a net year book value of Kshs.4,249,024,110 as at 30 June, 2021 and purchase cost of Kshs.8,963,025,527 had not been used in the previous four financial years.

One of the rigs was acquired and used to drill two wells in 2016 and had been idling ever since. Further, records on the rigs indicated each could drill one standard well in one hundred and twenty days (six months), or two wells per year. However, the Company's rigs averaged less than one (1) well per year, which implied that they were not used efficiently, or were idling for much of the time.

In view of the low utilization of the rigs, the Company may not have obtained value for money on public funds totalling Kshs.15,937,787,572 spent on their purchase.

2. Irregularities in Payment of Employee Expenses and Benefits

2.1 Non-Compliance with Salary Deductions Rule

Examination of payrolls for the year under review indicated that , contrary to Section 19(3) of the Employment Act, 2007 and Section C.1(3) of the Public Service Commission (PSC) Human Resource Policies, 2016, net monthly salaries paid to sixty-eight (68) employees were less than one-third (1/3) of their basic monthly pay.

As a result, Management breached the law and may have exposed the staff to financial embarrassment.

2.2 Over Extended Acting Appointments

Further review of the payroll data indicated that acting allowances totalling Kshs.7,168,205 were paid to thirteen (13) employees appointed in acting capacity for periods lasting more than six months. The appointments were contrary to Section C 14(1) of the Human Resource Policies and Procedures Manual for the Public Service issued in May, 2016 which provides that acting appointments should not last for more than six months.

Therefore by allowing the extended appointments, Management acted in breach of the law.

3. Irregular Procurement of Goods and Services

3.1 Failure to Implement e-Procurement

Regulation 49(2) of the Public Procurement and Asset Disposal Act Regulations, 2020 requires public entities to procure goods, works and services through the e-procurement system integrated to the State Portal. However, none of the Company’s procurements in the year under review was done through the state portal.

Therefore, Management was in breach of the law and the procurements done may not have been competitive enough to ensure value for money on the public funds spent on the resulting contracts.

3.2 Irregular Procurement of Legal Services

The Company’s legal records indicated that in the year under review, Management hired a private law firm to represent it in a constitutional petition filed before the Employment and Labor Relations Court by five (5) senior managers. Management used Direct Procurement Method to contract the firm on grounds that it was impractical to apply other methods as the matter was urgent. However, the direct procurement method applied did not meet the conditions set out in Section 103 of Public Procurement and Asset Disposal Act, 2015 as the Company had a list of prequalified lawyers from which a restricted tender could have been considered.

In the circumstances, the legal services were hired irregularly and may not have been competitive in price and quality.

4. Overstocking of Drilling Supplies and Equipment

The inventories movement schedule provided for audit indicated that the company held inventories of drilling supplies and equipment valued at Kshs.4,421,799,100 as at 30 June, 2021. These supplies and equipment were worth Kshs.4,248,317,567 and Kshs.173,481,581 respectively.

However, in the year under review the Company only utilized items valued at Kshs.347,921,814 or 8% of the stock. The low rate of use implied that the Company's stock management system was not economical as it had resulted in a large portion of the Company's capital being invested in slow moving stock that faced the risk of loss from obsolescence.

Further, examination of inventories records indicated that the Company did not have a comprehensive inventory management system. For example, stores records did not indicate the dates items were received in the stores and did not mark out those rendered obsolete. As a result, usability of the items in the stores could not be confirmed from the stores records and economy and efficiency in management of the stores was doubtful.

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, because of the significance of the matters discussed in the Basis for Conclusion on Effectiveness of Internal Controls, Risk Management and Governance section of my report, based on the audit procedures performed, I confirm that internal controls, risk management and governance were not effective.

Basis for Conclusion

Commingling of Company Funds

Review of bank accounts and various donor funded projects indicated that that funds for the Menengai and Bogoria Silali geothermal projects were banked together with other Company funds in spite of Management having indicated in the prior year that he funds would be separated. The comingling hampered timely reconciliation of revenue and expenditure and therefore elevated the risk of inaccurate reporting and loss of cash.

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 effective 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.

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 Company's financial statements are in agreement with the accounting records and returns.

Responsibilities of Management and the Board of Directors

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards (IFRS) and for maintaining effective internal controls 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 controls, risk management and overall governance.

In preparing the financial statements, Management is responsible for assessing the Company'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 the intention to liquidate the Company 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 resources are applied in an effective way.

The Board of Directors is responsible for overseeing the financial reporting process, reviewing the effectiveness of how the Project 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 overall 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 controls in order to give an assurance on the effectiveness of internal controls, risk management and overall 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 controls 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 controls.

- 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 Company'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 Company 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 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 controls 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.

CPA Nancy Gathungu, CBS
<u>AUDITOR-GENERAL</u>

Nairobi

07 October, 2022