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AND THE FOLLOWING REFERENCE
QUOTED:-

June 17, 2010

The Honourable Speaker
House of Representatives
Gordon House
Kingston

Chairman
Public Accounts Committee
House o f Representatives
Gordon House

Permanent Secretary
Ministry of Energy and Mining
36 Trafalgar Road
Kingston 10

Chairman
Board of Directors
Petroleum Corporation of Jamaica
36 Trafalgar Road
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REVIEW OF SPECIAL REPORT

PETROLEUM CORPORATION OF JAMAICA (PCJ)

During the sitting of the Public Accounts Committee dated May 10, 2010 it was agreed that this Department would review the Forensic Audit report done by Papineau Consulting Inc (PCI) and the response to that report. The purpose was to assess any steps that had been taken to address the corporate governance structure and to make recommendations specifically in relation to the issues that have been highlighted in that report.

Reference is also made to a request by the Permanent Secretary of the Ministry of Energy and Mining in a letter dated March 10, 2010, to review the report with a view to verifying the matters in the report and in particular the management of the Petrocaribe Fund. The methodology, scope, findings and recommendations based on the review follows.

Background

The Ministry of Mining and Energy contracted Papineau Consulting Inc (PCI) to conduct a preliminary investigation of the operations of the Petroleum Corporation of Jamaica (PCJ) and the Petroleum Company of Jamaica Limited (PETCOM). The investigation was intended to determine whether expenditures made and contracts issued were contrary to regulations or prescribed procedures and to make recommendations to improve the policies and practices of the PCJ.

Objectives

The objectives of the Auditor General's Department (AGD) were to:

- review the special audit report done by Papineau Consulting Inc. (PCI) dated October, 2009 and response from the former Group Managing Director (GMD), dated January 25, 2010.
- make recommendations with regard to PCI's findings that weaknesses were identified in the corporate governance structure of the PCJ; and
- ascertain whether all the amounts said to be improperly taken or diverted from the Petrocaribe Development Fund (PCDF) as outlined by the forensic audit report were refunded to the PCDF;

Scope and Methodology

The audit scope was limited to reviewing the issues relating to corporate governance and the Petrocaribe Fund. Reliance was placed on the work done by PCI. The PCI's report indicated that the period audited was April 1, 2006 to March 31, 2007 and that the subject area was confined to the specific terms of reference and mandate of the PCI's engagement, that is, to focus on PCJ's expenditures and contracts for irregularities, issues of prudence and probity and any other high risk areas identified. However, with regard to the matters relating to the Petrocaribe Fund, we conducted limited audit work to confirm the information presented in the PCI report.

We did not review certain areas that the PCI report suggested should be referred to other entities for further review or examination, which I endorse. The recommendations were to refer to:

- the Contractor General - the contracting practices of the PCJ;
- the Ministry of Finance - to determine if salaries, benefits and assignment of government vehicles were appropriate compensation comparable to similar government agencies and in keeping with the government guidelines; and
- the Police - matters relating to the cash skimming scheme. With regard to this matter I would suggest the Financial Investigation Division, instead.

Findings

1. **<u>Corporate Governance Issues</u>**

   1.1 Corporate Governance is defined as the process and structure for overseeing the direction and control of a corporation. It involves the relationships among the stakeholders- the shareholders (in this instance the Government), the Board of Directors, management and employees.

1.2 Lack of Oversight and Proper Governance

The PCI report stated that, "*The audit has identified a number of significant operational deficiencies at PCJ with respect to governance in the organisation. These deficiencies may have been major contributing factors to the serious findings and issues disclosed in this audit report."* In so far as the PCI reported several deficiencies in the governance of PCJ the focus will be directed to the role of the Board of Directors.

1.2.1 **The Role of the Board of Directors**

An important principle of corporate governance is that there should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision.[1]

Information in both the report and response indicated that there was a clear differentiation between the roles of the Chairman and Chief Executive Officer. However, there were concerns as to the way it works in practice. Minutes of a board meeting dated March, 2008, revealed that the then Chairman of the Board was very involved in the day-to day operations of the PCJ. One member of the Board stated that, "The operations of the PCJ had a strong stamp of the Chairman and the Director of Administration." Another Board member expressed concerns that decisions were made by the Chairman without the knowledge of the rest of the Board and the Managing Director.

1.2.2 Recommendations

- The dichotomy of roles should not only be evident in principle but also in practise. To ensure that this is so, it is recommended that the responsibilities of both Chief Executive Officer and Chairman be clearly established, set out in writing and agreed by the board. This should be outlined in the annual report.

- Non-executive members should vigourously challenge the conduct and decisions of other members of the board and executive and hold them accountable.

- The non-executive directors should meet without the chairman present at least once annually to appraise the chairman's performance.

- The board should outline in its annual report how the performance of the board and its committees was evaluated.

- An audit of the corporate governance practices of the PCJ should be undertaken by the Internal Audit Unit

[1] The Combined Code on Corporate Governance, July 2003 – Principle A.2

1.3 Weaknesses in Internal Control

1.3.1 Internal control is an integral process that is effected by an entity's management and personnel and is designed to address risks and to provide reasonable assurance that in pursuit of the entity's mission, the following general objectives are being achieved:

- Executing orderly, ethical, economical, efficient and effective operations;
- Fulfilling accountability obligations;
- Complying with applicable laws and regulations; and
- Safeguarding resources against loss, misuse and damage.[2]

1.3.2 The audit disclosed several instances of breaches of the principles of good internal control.

1.3.3 Inadequate Supporting Documents and Authorisation of Transactions

The auditors determined that payments for goods and services were not adequately supported as requisitions and purchase orders were frequently not used. Further, only one signature was seen approving the transactions and *"the majority of PCJ's expenditure were approved by the former Director of Administration or the former Financial Controller*." This indicated that the internal checks over those transactions were woefully inadequate and facilitated the perpetration of fraud.

1.3.4 Poor Segregation of Duties

Our review disclosed that the chain of command was clear in the organisation chart and job descriptions. The Director of Administration/Corporate Secretary's (DOA) job description states that the incumbent would report to the Group Managing Director (GMD). The duties of the Director of Administration/ Corporate Secretary included the following:

- Responsible for directing and coordinating administrative matters.
- Overall responsibility for Accounts, Personnel and Office services Departments.
- Corporate Secretary-custodian of all documents.
- Member of the Procurement Committee.
- Member of the Management Committee.

However, this has created a concentration of authority and responsibility as one person had overall responsibility over processes and procedures in administration, accounts and personnel as well as custodian responsibilities.

1.3.5 The GMD's response to the report stated that the former DOA circumvented the chain of command by reporting directly to the Chairman of the Board. One Director of the Board stated that "*the actual running of the PCJ was performed by the Director of Administration and the Chairman*."

[2] INTOSAI – Guidelines for Internal Control Standards for the Public Sector, page 65.

1.3.6 The PCI's report also identified inadequate segregation of duties in the area of contract administration as one person performed the under-mentioned duties:

- Drafts bid proposal and prepares the tender document.
- Sole evaluator of bids and make recommendations for the award of contract.
- Project Management - certifies work done and recommends payment.

This facilitated corruption and fraud as the tender and payment processes could be manipulated.

1.3.7 **Corrective Action Taken**

The response given by the GMD provided evidence that some corrective action was taken both by her and the Board of Directors as under:

- First by imposing limits of authority and then by requesting that all payments be approved by her. Information was not available to determine whether the directives of the GMD were responded to.
- The Director of Administration/Corporate Secretary was removed from office.

1.3.8 **Recommendations**

In view of the foregoing, the following are recommended to strengthen the system of internal control:

- A job analysis should be done to ensure that the duties are adequately segregated and to prevent any one person from having control over too many functions. In the absence of that, steps must be taken to put other compensating control in place, such as more stringent supervision.
- All payments for goods and services must be supported by adequate documentation. The documents should include a requisition and purchase order, prepared by the authorised personnel, indicating that the good or service is required and is appropriate for the entity and then authorised by a designated senior member of staff.
- Payments must be authorised by at least two persons acting within the limits of their authority.
- The actions of Direct Reports should be monitored by supervisors to ensure that the controls are not being circumvented.
- The required disciplinary action should be taken for breaches of the guidelines and procedures.

1.3.9 Limits of Authority

The Guidelines for Internal Control advised that authorisation and execution of transactions and events should only be done by persons acting within the scope of their authority. Authorisation is the principal means of ensuring that only valid transactions and events are initiated as intended by management.[3]
PCI reported that, *"The PCJ organisation and the PETCOM organisation lacked written limits of authority for expenditures or entering into contracts. There were no written policies or guidelines relating to spending limits and expenditure."*

1.3.10 Up to 2007 there was no evidence of limits being imposed. However, written limits were imposed by the GMD from February 2008. The GMD provided evidence that an accounting manual, dated May 2008 was prepared that outlines limits of authority for expenditure and contracts. This was approved by the Board of Directors in December 2008.

1.3.11 While the authorisation procedures were documented in the accounting manual we could not comment on whether the information therein was clearly communicated and whether all levels of employees were aware of its directives.

1.3.12 Recommendations

Although the limits were established and documented this does not mean that the directives will be adhered to, therefore, the following are recommended:

- Management should ensure that the limits are properly communicated to all concern. This should include the specific conditions and terms under which authorisations are to be made.
- The limits should be subjected to periodic review to ensure that they remain relevant.
- There should be monitoring of transactions by an appropriate level of management to ensure that the guidelines are being adhered to.
- Appropriate sanctions should be applied where there are flagrant breaches.
- These lapses should not have gone unnoticed by the internal auditor who should make reports on the weaknesses to an audit committee, which in turn should report them to the board of directors.
- The annual report of the corporation should include a report that the board has conducted a review of the effectiveness of the group's system of internal controls. The Combined Code on Corporate Governance states, "Directors should, at least annually, conduct a review of the group's system of internal control and should report to shareholders (in this case, the Portfolio Minister and the Minister of Finance) that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management."[4]

[3] INTOSAI – Guidelines for Internal Control Standards for the Public Sector, page 29, para.1

[4] The Combined Code n Corporate Governance – Principle C.2

1.4 Ethical Lapses

Ethical values enable a decision maker to determine what an appropriate course of behaviour is. These values should be based on what is "right," which may go beyond what is legally required. (COSO 1992)[5]

1.4.1 The audit disclosed several instances of lapses in ethical behaviour. These include the following:

- PCI determined that PCJ operated a canteen using PCJ's resources (premises, utilities, furniture and equipment). Rental was not charged for the use of these facilities. Further the canteen's employees were paid by PCJ and funds were transferred from PCJ into the canteen's bank account. However, the financial transactions of the canteen were not included in the accounts of the PCJ.
- It is alleged by the auditors that a cash skimming scheme was taking place that was facilitated by the former Director of Administration and the Financial Controller. This involved the removal of cash from the canteen account through PETCOM.
- Excessive salary and benefits were granted to management staff and increases made, although the approval of the Ministry of Finance was not obtained.

1.4.2 Recommendations

- Values and ethics standards, that is, a code of conduct should be developed to guide the activities and behaviour of managers and other employees. These should be embedded in the culture of the Corporation and understood by all.
- Managers should set the example in making ethical decisions and in its conduct, that is, 'the tone at the top.'
- The employees should be sent a clear message that unethical behaviour will not be tolerated.

2 Petrocaribe Development Fund (PCDF)

2.1 Background Information

The Petrocaribe Development Fund (PCDF) was formulated by Cabinet Decision No. 2/06 dated January 16, 2006, which sets out a framework for managing the loan proceeds from the Petrocaribe Agreement. From the period of inception until June 2007 the Petroleum Corporation of Jamaica (PCJ) was charged with the responsibility to manage the resources of the Fund. The Fund was established by an Act to amend the Petroleum Act dated, December 22, 2006.

Since the inception of the Fund in 2006 monies received from Petrojam were lodged into a PCJ/ NCB account number 352434116(No. 116). The Permanent Secretary directed the PCJ to open a separate interest bearing account for the lodgement of proceeds of the Fund in a

[5] INTOSAI – Guidelines for Internal Control Standards for the Public Sector, page 63.

letter dated February 16, 2006. PCJ explained that this directive could not have been complied with, as the Fund was not yet established as a separate entity until December 2006. However, up to June, 2007 the PCJ did not comply. The Ministry of Finance and Planning instructed that the management of the Fund be transferred to the Development Bank of Jamaica (BDJ), June 1, 2007. However, the proceeds continued to be sent to the PCJ up to February, 2008.

2.2 Review of Special Audit Report – Papineau Consulting Inc (PCI)

2.2.1 The PCI audit report stated that there was an "*inappropriate transfer of $9.5M of PCDF monies to PCJ's main operating bank account. PCJ's records indicate that these funds were to reimburse Petrojam Limited for monies advanced to PCDF in March 2007, however, Petrojam had already been reimbursed by PCDF in March 2007 and therefore no monies were owing by PCDF. PCJ also never forwarded these funds to Petrojam."*

2.2.2 The PCI also reported that the following amounts of PCDF monies were improperly deposited into PCJ's main Bank account:

Deposit Date	Amount ($)	Particulars
June 26, 2006	480,000.00	No justification given for these transfer to Account No. 108
May 29, 2007	9,500,000.00	As above in paragraph 2.2.1
Total	**9,980,000.00**	**Amount owing to PCDF**

2.2.3 Our review determined that Petrojam advanced an amount of $9.5M to PCJ, March 14, 2007, on the understanding that the equivalent would be withheld from the next payment due under Petrocaribe. The cheque received was lodged to the PCJ/NCB account No. 116 on May 14 then removed and lodged into PCJ's main bank account, NCB account No. 352434108 (No. 108), on May 29, 2007.

2.2.4 There was no evidence that a cheque payment was made to reimburse Petrojam, however, the records indicated that the amount was recovered from monies disbursed by Petrojam to the PCJ on March 21, 2007. Petrojam also charged interest of $23,424.66. Therefore, the PCJ should refund a total of $9,523,424.66 to the PCDF ($9.5M+$23,424.66).

2.2.5 The amount of $480,000.00 was in fact transferred from account No 116 to the PCJ's main bank account No.108. However, we were unable to determine whether it belonged to the PCDF and therefore should be refunded to the PCDF as it was not established that account No.116 contained only PCDF's monies.

2.3 The PCI charged that in April 2007, "*PCJ transferred $43M of PCDF monies into the PCJ's main operating account so that it could clear its cheque for closing the purchase of land for a PETCOM station."*

2.3.1 The audit determined that an amount of J$43M was paid from Account No.116, into which PCDF monies were lodged, to PCJ on April 2, 2007. The audit could not determine whether this account was exclusively for PCDF or that the amount was used to purchase land for a PETCOM station.

2.3.2 However, the amount of J$43M was repaid to the account on April 12, 2007.

2.4 The following amounts of Petrocaribe's income were reported to be invested by PCJ and the investment income retained:

Deposit Date	Interest Amount ($)	Principal Investment ($)	Particulars
July 31, 2007	633,147*	550,235,614	Directive to bank to deposit to Ac#108 (PCJ's Main bank account)*
August 27, 2007	352,679	572,124,393	Retained in bank account #116
October 22,2007	395,202	641,105,503	Retained in bank account #116
November 29, 2007	679,106	635,574,384	Retained in bank account #116
January 10, 2008	667,968	633,424,883	Retained in bank account #116
February 7, 2008	1,337,454	715,268,451	Retained in bank account #116
Total	**4,065,556**		

2.4.1 Our review concurred with PCI's audit report as we were able to track the listed principal amounts as coming from Petrojam for PCDF. The audit disclosed that the amounts were invested and then remitted to the Development Bank of Jamaica (DBJ) for the Petrocaribe Fund, however, the interest incomes totalling J$4 065,556 were not. All of the interest income, except one,* listed amounts were retained in PCJ/NCB account No.116. The amount of $633,147 was transferred to the PCJ's main account No. 108.

It should be noted that PCI's investigation went beyond the stated scope in order to track all the interest income up to the time when the Petrocaribe monies were sent directly to the DBJ by Petrojam.

2.5 The following interest income were said to be improperly deposited to PCJ's Canteen account (No 023):

Deposit Date	Amount($)	Principal Investment($)	Particulars
May 22, 2006	1,127,068	696,516,421	Lodged by Petrojam to 7 day Call Deposit at the rate of 12.5%
Sept. 12, 2006	1,511,582	588,509,492	Interest cheque on account No. 116
		1,285,025,913	
Sept. 14, 2006	509,296	277,864,000	Directive to bank to lodge interest to Account no. 023
Total	**3,147,947**	**1,562,889,913**	

2.5.1 Our review revealed that the Principal investments totalling $1,285,025,913.00, as illustrated, belonged to the Petrocaribe Fund and were transferred to the DBJ. It was determined that an amount equal to the interest income of $1,127,068 was deposited in PCJ/NCB account (No. 108) and a similar amount was subsequently transferred from account

(No. 108) to the PCJ's Canteen account (No.023).There was no evidence that they were subsequently transferred to the DBJ for the PCDF.

2.5.2 The principal of $277,864,000 and interest incomes totalling $ 2,020,878.00 ($1,511,582 +509,296) were not verified as belonging to the Petrocaribe Fund and we could not give assurance to the completeness of those transactions as the bank statements received were illegible.

2.6 Recommendations

It is recommended that all the amounts totalling $14,716,048.66 as listed below be refunded to the Petrocaribe Fund.

Details	Report Reference	Amount ($)
Petrocaribe Fund reduced by PETROJAM to recover PCI's advance and interest accrued thereon	2.2.3	9,523,424.66
Interest income due to PCDF from PCJ	2.5.1	4,065,556.00
As above	2.6.1	1,127,068.00
Total		**14,716,048.66**

2.7 Conclusion

The evidence indicated that there were poor corporate governance practices by the former board and senior managers of the PCJ. Weaknesses in internal controls and ethical lapses exposed the entity to the possibility of fraud and corruption. The audit further confirmed that unethical practices resulted in the withholding of monies that belonged to the Petrocaribe Development Fund by the PCJ.

The recommendations for improvement in corporate governance and the system of internal control emphasised the importance of not only documenting policies and procedures but ensuring that practice is in line with principles. This can be assured by adequate supervision of Direct Reports. Several corrective measures have been implemented and every effort should be made to continually review the system to ensure improvement in the control system and governance. The PCDF should be reimbursed all the amounts due to it by the PCJ.

It is further recommended that audits of the corporate governance practices of all public bodies be undertaken by their Internal Audit Units and reported to the Audit Committees. The results of these audits should be included in the annual reports by the chairmen of the boards of directors.

Pamela Monroe Ellis (Mrs)
Auditor General