## AUDIT OBSERVATIONS AND RECOMMENDATIONS

### Financial and compliance audit

**1. The non-maintenance of proper subsidiary records, non-approval of some recorded transactions and errors in booking up the cost of items sold resulted to the discrepancies in the balances between the general ledger, subsidiary records and inventory count of Merchandise Inventory. Thus, the validity and accuracy of the inventory balance of P28.469 million is doubtful.**

1.1 The correctness of Merchandise Inventory account with a balance per books of P28.469 million is doubtful since the three-way reconciliation of balances per general ledger, subsidiary records and inventory count disclosed discrepancies as shown below:

| | In Millions |
|---|---|
| Subsidiary Records | P 28.751 |
| General Ledger | 28.469 |
| Difference | .282 |
| Subsidiary Records | 28.751 |
| Inventory Count | 28.114 |
| Difference | .637 |
| Inventory Count | 28.114 |
| General Ledger | 28.469 |
| Difference | P .355 |

Comparison of the balance per books amounting to P28.469 million and the physical inventory count with an adjusted balance of P28.114 million disclosed a discrepancy of P.355 million which could not be accounted for.

Subsidiary records with a balance of P28.751 million were not properly maintained. Compared with balances per books and inventory count, discrepancies of P.282 million and P.637 million, respectively, were noted.

There were at least 378 types of inventory items but the records which were manually maintained in an Excel file were not updated.

The inventory count was not supported by a schedule that would have been the basis for the physical inventory, since the subsidiary records were not updated and the balances therein could not be correctly established. The inventory team performed the physical inventory on January 3, 2014in the storage area by merely counting the items on hand. Likewise, the balances per inventory count could not be correctly established and it could not be determined whether there was an actual shortage or an overage.

The adjusted balance of the inventory count of P28.114 million was obtained after adding back to the initial inventory report amounting to P9.782 million, the cost of sales in the total amount of P18.331 million, which were cancelled/reversed in 2013 since it pertained to CY 2014 sales. Initially the inventory report in the amount of P9.782 million tallied with the balance per books.

1.2 Moreover, we noted erroneous entries in the subsidiary records. For instance, the record of inventory item *aciclovir 200mg tablet* showed that the acquisition cost of 3,800 units was P8,312.50. Upon sale however, the cost of the said 3,800 units was credited in the amount of P7,772.73, leaving a balance of P539.77,although the items were fully sold.

1.3 Postings in the subsidiary records did not include necessary data/references such as Purchase Orders, suppliers' invoices or name of supplier ,to determine the correct costs. The references included only Receiving Reports (RR) for debit entries and Withdrawal Reports (WR) for credit entries, which contain only the description of items and corresponding quantities.

1.4 PPI uses the Weighted Average Method of determining the cost of ending inventory and cost of sales. However, due to the absence of information and references, the correctness of the cost information indicated in the subsidiary records could not be validated.

1.5 The subsidiary records also lacked information such as PPI sales invoices or delivery receipts which are necessary to determine the movement of the inventories. The client/customer to whom the items were delivered could not be determined. Also, it could not be checked from the credit entries as evidenced by the WR, whether or not the corresponding sale was recorded.

1.6 Credit entries to the Merchandise Inventory account for COS were not supported by approved documents. While the accounting entries for the sale per sales journal were supported by duly approved Sales Invoices and Delivery Receipts, the entries for the cost of sales were not supported by any approved document. Thus, the validity and correctness of the recorded cost of sales and the credits to the Merchandise Inventory account cannot be established.

1.7 PPI uses the Perpetual Method of recording inventories. The Merchandise Inventory account is debited for every purchase of inventory for sale and credited for the cost of every sale. Considering the Agency's manual accounting system and the numerous inventories of pharmaceutical products, this method is not advisable because the process of recording is too tedious and prone to errors. Audit samples of recorded credits to the account for the cost of merchandise sold showed errors because the recorded costs were higher than the amount of sale as shown under Table I below.

Table 1

| Sales Invoice No. | Amt. of Invoice | Recorded Cost | Loss |
|---|---|---|---|
| 15014 | P 92,245.00 | P 97,533.48 | P 5,288.48 |
| 10074 | 22,650.00 | 35,714.29 | 13,064.29 |
| 9892 | 19,000.00 | 20,089.29 | 1,089.29 |
| 9796 | 13,945.00 | 30,035.78 | 16,090.78 |

1.8 The verified cost for Sales Invoice No. 9796 showed that the correct amount should only be P7,650.89 instead of P30,035.78, thus the recorded cost is overstated by P22,384.89 or 292.58 per cent.

1.9 On the other hand, compared to the recorded cost, the cost per audit of another sample of sales invoices revealed discrepancies with high percentages of error, resulting in the overstatement of Merchandise Inventory by P389,274.83 as shown under Table 2 below:

Table 2

| Sales Invoice No. | Recorded cost credited to MI | Verified cost | Understatement of credits to MI | Percentage of error |
|---|---|---|---|---|
| 9883 | P 4,507.86 | P 45,078.57 | P 40,570.71 | 899.99 |
| 9916 | 1,126.96 | 11,269.64 | 10,142.68 | 900.00 |
| 9991 | 16,592.51 | 101,464.29 | 84,871.78 | 511.50 |
| 10025 | 11,269.64 | 112,696.43 | 101,426.79 | 900.00 |
| 10101 | 80,879.88 | 173,805.36 | 92,925.48 | 114.89 |
| 15087 | 19.75 | 59,357.14 | 59,337.39 | 300,442.48 |
| Totals | P114,396.60 | P503,671.43 | P389,274.83 | |

In view of the absence of a computerized system and PPI's limited manpower, the Periodic Method of recording inventories instead of the Perpetual Method, could have minimized errors and avoided the process of computing and recording the cost of every sale. Under the Periodic Method, the entries to the Merchandise Inventory account would only be the beginning and ending balances. The cost of sales would only be recorded at the end of reporting period or at balance sheet date after the ending inventory has been established by the inventory count.

**1.10 We recommended that Management –**

**1.10.1 Reconcile the balances between the general ledger, subsidiary records and the inventory count and account for the discrepancies.**

**1.10.2 Maintain a complete and updated subsidiary record for each of the inventory item traded by the Agency. Each record should contain all necessary information relative to the inventory items such as:**

**a. date of every transaction**

**b. references such as name of supplier, purchase order number, receiving reports, sales invoices or delivery receipts numbers and withdrawal reports**

**c. quantity and amount per transaction**

**d. balances as to quantity and amount.**

**1.10.3 Support all transactions to be recorded in the Merchandise Inventory account with complete and properly approved documents.**

1.10.4 **Adopt an accounting system for inventories and cost of sales depending on available resources such as manpower and equipment.**

2. **Discrepancy in the amount of P.936 million was noted in the balance per books against the computed balance per audit of the Cost of Sales (COS)account due to errors in recording, resulting in the understatement of the COS and overstatement of Income account by the said amount.**

2.1 The COS account per books has a balance of P291.426 million as of December 31, 2013.Our audit computation, however, showed that the cost of sales should be P292.363 million, thus, resulting in a discrepancy of P.936 million as shown below:

| | |
|---|---|
| Merchandise inventory, beginning | P 514,086 |
| Add: Total purchases of merchandise during the year | 307,521,647 |
| Total merchandise available for sale | 308,035,733 |
| Less: Merchandise inventory, ending | 28,113,957 |
| Balance | 279,921,776 |
| Add: INPUT Tax closed to cost of sales | 9,789,603 |
| Over-reversal of accruals for Jan-Nov | 2,651,734 |
| Cost of sales per audit | 292,363,113 |
| Cost of sales per books | 291,426,733 |
| Understatement of recorded cost of sales | P 936,380 |

The difference, therefore, understated cost of sales by P.936 million or 3.22 per cent of the outstanding balance and overstated Net Income before tax by the same amount or 7.47 per cent.

2.2 The understatement of the COS account balance was due to errors in the recorded amounts of cost of sales, its accruals and the subsequent reversal of the accruals.

2.3 Samples of recorded COS for specific references of sale were reviewed and errors of understatement and overstatement of costs were disclosed. Analysis showed that such errors were caused by the following:

2.3.1 As discussed in paragraph 1.7, the PITC Pharma, Inc. uses the perpetual method of recording cost of inventories sold. For every sale transaction or every issued Sales Invoice, the COS account is debited and the Merchandise Inventory account is credited. Using the same sample for the Merchandise Inventory account under Table No. 2of item 1.9, the errors also affected the COS account. Thus, the overstatement of P.389 million in merchandise inventory also resulted in the understatement of COS and overstatement of net income by the same amount.

2.3.2 Inadequate/absence of records, documents, established policies and system of procedures, and/or programmed information system were noted, discussed as follows:

a. Improperly maintained subsidiary records for the merchandise inventory.

As discussed in Comments and Observations No. 1, subsidiary records for the inventory items were neither properly maintained nor updated. Thus, the amount of the recorded COS could not also be verified.

b. No approved documents as basis for recording cost of sales.

While Sales per Sales Invoices (SI) are recorded in the Sales Journal, the corresponding cost of sales is also recorded for the items sold and withdrawn from the inventory. However, there were no approved documents as basis for the recorded COS. The concerned personnel that recorded the SI merely determined the amount of COS from document reference such as PPI Purchase Orders.

c. Lack of specific sales references for the accruals of cost of sales as recorded in the Journal Vouchers.

In most instances, the suppliers of PPI directly deliver the pharmaceutical products to PPI customers/clients. This sale transaction is called "dropshipped sales".

For dropshipped sale transactions, the costs of merchandise were no longer recorded as Merchandise Inventory but debited outright to COS account. At the coordinated date and time of delivery by the supplier of PPI to its client/customer, a representative of PPI goes to the place of delivery to document the transaction. The representative issues the accomplished and approved PPI SI and Delivery Receipt to the customer and receives the supplier's sales invoice and delivery receipt at the same time.

Since the accomplished and approved SI was already recorded in the books, the corresponding cost of sale also had to be recorded. In this regard, the cost was initially accrued/recorded based on the Purchase Orders issued by PPI to its suppliers. The accruals of cost, however, did not contain information/reference as to the specific sale such as the SI number. There were no documents attached to the Journal Voucher pertaining to sale of the products, thus, the recorded amounts could not be validated.

The process of recording accruals of cost for "dropship" sales in a Journal Voucher and subsequently reversing the accruals upon recording the actual cost in the Vouchers Payable Journal, eventually caused errors in the cost of sales.

There were accruals that were not fully reversed and/or zeroed out and reversals that exceeded the accruals.As shown in paragraph 2.1, there was over-reversal of the accruals for January to November 2013 in the amount of P2.651 million. The under and over reversal of accruals would result in the misstatement of COS, which could not be easily reviewed due to the absence of specific sales references.

d. Lack of a computerized system on accounting for costs and inventory.

As previously discussed, PPI uses the Perpetual Method of recording inventories under a manual accounting system. For every sale transaction, the Merchandise Inventory account is credited and the COS is recognized. Considering the Agency's numerous sales transactions and inventories in pharmaceutical products, the process is too tedious and prone to errors.

**2.4 We recommended that Management:**

**2.4.1 Support with duly approved documents all transactions recorded in the books of accounts including the COS.**

**2.4.2 Support with complete information and document references, all transactions recorded in Journal Vouchers, such as accruals of cost of sales, reversal of accruals and adjustments of previous entries.**

**2.4.3 Discontinue the practice of accruing cost of goods sold for "dropshipped" sales. Record the Sales and COS simultaneously when properly documented after actual delivery of goods.**

**2.4.4 Institute and document policies and procedures in the recording and monitoring of transactions affecting the inventory and COS accounts.**

**2.4.6 Initiate best efforts to shift from manual accounting system to a computerized system to avoid and minimize errors.**

**Value for Money Audit**

**3. While PPI reported a net income before tax of P12 million in 2013 after seven years of losses, it still needs to exert effort to recover from capital deficiency which stood at P303 million.**

3.1 PPI achieved the best financial and operating performance during the year 2013,with the highest sales ever and the first time to register a net income during the Agency's eight years of operation when PPI had been operating on consistent losses. The sales of P344.643 million this year, however, resulted in a net income before tax of P12.536 million, which was a big turn-around from last year's sales of only P63.727 million and loss of P40.480 million.

While the current year's gross profit of P53.216 had a margin of only 15.44 per cent, the boost in sales absorbed the operating expenses of P40.680 million, thus, PPI's operations resulted in a net profit. This year's operating expenses were the lowest in eight years.

In view of the very high sales, total assets increased to P182.950 million, almost four times compared to previous year of P46.094 million. However, it is noteworthy to mention that PPI is still into a negative financial position with a capital deficiency of P303.332 million, which is next to highest since 2007.

The foregoing analysis is shown in the following data:

| | 2013 | 2012 | 2011 | 2010 | 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|---|---|---|---|
| **Results of operation: (in thousands of pesos)** | | | | | | | | |
| Sales | 344,643 | 3,727 | 154,222 | 121,567 | 159,610 | 23,652 | 60,773 | 29,831 |
| Cost of sales | 291,427 | 51,659 | 112,529 | 96,235 | 126,427 | 94,581 | 03,465 | 21,146 |
| Gross profit | 53,216 | 12,068 | 41,693 | 25,332 | 3,183 | 29,071 | 7,308 | 8,685 |
| Operating exp | 40,680 | 2,548 | 60,736 | 86,872 | 1,619 | 111,068 | 8,526 | 40,960 |
| Net income(loss) | 12,536 | (40,480) | (19,043) | (61,540) | (48,436) | (81,997) | (41,218) | (32,275) |
| **Financial position: (in thousands of pesos)** | | | | | | | | |
| Total assets | 182,950 | 46,094 | 109,908 | 135,060 | 172,172 | 227,542 | 291,778 | 290,520 |
| Total liabilities | 486,282 | 58,201 | 353,644 | 359,753 | 338,258 | 345,191 | 327,430 | 284,954 |
| Stockholders' equity / (Capital deficiency) | (303,332) | 312,107) | (243,736) | (224,693) | (166,086) | (117,649) | (35,652) | 5,566 |

3.3 **We recommended that, while PPI exerted best efforts to achieve high sales performance during the year, it should continue to pursue plans and programs to decrease its capital deficiency and eventually pave the way to its full financial recovery.**

**Gender and Development**

4. **PPI allocated a GAD budget of P.597 million, however, only the amount of P.167 million was utilized in the implementation of GAD related activities, contrary to the guidelines of DBM-NEDA-NCRFW Joint Circular No. 2004-1.**

4.1 Due to financial difficulty, PPI allocated the amount of P.597 million for Gender and Development. However, of the budgeted amount, PPI utilized only P.167 million, thus, the amount of P.430 million, equivalent to 72 per cent of budget, was not utilized.

4.2 The following GAD activities were conducted during the year:

4.1.1 Administered pneumococcal and flu vaccines to PPI male and female employees as part of the Agency's Health and Wellness Program.

4.1.2 Conducted team-building activities to strengthen the employee-employer relationship.

4.1.3 Carried out a Stress Management seminar for the employees.

4.3 **We recommended that Management utilize its allocated budget for GAD and ensure the formulation and implementation of the annual GAD plan.**