AUDIT OBSERVATIONS AND RECOMMENDATIONS

1. Concerns on PPI's financial position

PPI's financial position and results of operation for CY 2014 shows its inability to meet its liabilities and finance its operations due to the excess of liabilities over its assets and capital deficiencies and the losses continuously incurred from year to year, casting significant doubt on the ability of the Agency to continue as a going concern and carry out its mandated functions.

1.1 Since the start of operation in year 2006 up to the current period, PPI has been incurring consistent operating losses. As discussed in Note 3 of the Notes to financial statements, PPI ended the year 2014 with the highest recorded sales since its inception. However, despite the significant increase in sales during the last two years, PPI's financial performance did not improve. Even the highest sales did not generate gross profit that would at least cover the operating expenses. The following data show the results of operation since PPI started business in CY 2006 to CY 2014.

Results of operation: (in thousand pesos)	**2014**	**2013**	**2012**	**2011**	**2010**	**2009**	**2008**	**2007**	**2006**
Sales	559,952	344,643	63,727	154,223	121,567	159,610	123,652	260,773	29,832
Cost of sales	518,490	291,427	51,659	114,299	96,235	126,428	94,581	203,465	21,146
Gross profit	41,462	53,216	12,068	39,924	25,332	33,182	29,071	57,308	8,686
Expenses	57,108	44,706	35,894	49,798	86,872	81,619	111,068	98,527	40,960
Net income(loss)	(15,646)	8,510	(23,826)	(9,874)	(61,540)	(48,437)	(81,997)	(41,219)	(32,274)
Gross margin %	7.40	15.44	18.94	25.89	20.84	20.79	23.51	21.97	

1.2 Although the CY 2013 financial statement showed a positive result of operation, the net income of ₱8.510 million was attributed only to the gain of ₱11.918 million from the restructuring of loan with the National Development Company (NDC). Without considering the gain from loan restructuring, PPI would still have an operating loss of ₱3.408 million.

1.3 Despite of the highest sales performance during the current year, gross profit of 7.40 per cent of sales or ₱41.462 million was at the lowest. This was even lower than CY 2013 gross profit of ₱53.216 million.

1.4 Conversely, the current year's operating expenses of ₱57.108 million was higher than the previous year of ₱44.706 million or higher by 27.74 per cent.

1.5 With a gross profit of 7.40 per cent of sales, the operating expenses of ₱57.108 million was at 10.19 per cent of sales or 137.73 per cent of gross profit, thus resulting in net loss of ₱15.646 million in CY 2014.

1.6 After nine years in operation, PPI was not able to manage business effectively to improve its financial position. Details of the financial position of PPI are presented on the next page.

Financial position: (in thousand pesos)	2014	2013	2012	2011	2010	2009	2008	2007	2006
Total assets	292,596	194,371	46,094	109,908	134,214	172,172	227,542	291,778	290,521
Composed mainly of:									
Cash	8,318	43,474	3,918	18,428	23,822	27,225	59,469	36,968	116,861
Receivables-net	254,680	92,858	28,849	83,502	73,443	77,203	62,270	111,897	96,331
Total liabilities	600,154	486,283	358,201	353,644	361,841	338,259	345,191	327,431	284,894
Composed mainly of:									
AP-Trade	238,740	151,752	23,418	23,369	55,082	53,769	38,332	60,853	62,255
Long-term loan	291,795	291,795	295,522	276,972	258,472	240,500	224,466	203,500	185,000
Interest payable	12,623								
Stockholders' Equity / (Capital deficiency)	(307,558)	(291,912)	(312,107)	(271,627)	(224,694)	(166,086)	(117,649)	(35,652)	5,567

1.7 PPI has problems on liquidity due to excess liabilities over the assets and capital deficiencies. The quick ratio was computed at 1:1.78 which means that PPI has only P1.00 of liquid asset to cover every P1.79 of current liability, as shown below:

Current Assets	(Cash and Receivables)	= ₽263.002
Current Liabilities		= ₽329.467
Current ratio		= 1:1.79

The current cash position is insufficient to meet the operational requirements of the Agency. The cash in bank balance of ₽8.318 million is not enough to support operations for two months or meet the monthly average operating expenses of ₽4.759 million, much more to pay its trade creditors. Further, even if the receivables of ₽254.680 million would be collected, this will not be sufficient to meet the current liabilities amounting to ₽329.467 million, of which ₽238.740 million pertains to trade payables. The total liabilities of ₽600.154 million is more than twice the total assets of ₽292.596 million.

1.8 The above data also showed poor collection efficiency on accounts receivable. Of the total sales of ₽559.952 million, 91.93 per cent or ₽514.794 million pertained to sales to DOH. Only the amount of ₽274.725 million or 53.37 per cent was collected from DOH while the amount of ₽240.068 million or 46.63 per cent remained unpaid.

1.9 The one-year grace period for the quarterly payment of the restructured loan with NDC expired on June 30, 2014, and PPI was unable to pay the current portion of the loan amounting to ₽51.183 million and interest of ₽12.623 million.

1.10 In view of the significant amount of payables by PPI, suppliers were constrained to deliver their products, thus, deliveries to customers were likewise delayed. As a result of insufficiency of working capital, PPI incurred penalties enforced by customers due to late deliveries of ordered products.

During the year, penalties imposed by customers for late deliveries totaled ₽72,732.24. However, there were also penalties which were deducted by customers from payments but were not recorded by PPI, thus, the corresponding amount remained under accounts receivable. Samples of penalties not taken up in the books were as follows:

Payment by customer		Customer	Amount
OR No.	Date		
0274	05/30/2014	CHD-CAR, Baguio City	₱ 3,645.18
0268	06/02/2014	DOH	64,536.82
0351	07/04/2014	CHD-IV-A	77,520.00

1.11 Considering the above-mentioned conditions, there is the risk that PPI may not sustain its operations and carry out its mandated functions under Executive Order No. 442 and RA 9502 or the Cheaper Medicines Law.

1.12 **We recommended that Management -**

a. conduct an assessment of the conditions affecting the unfavorable operating performance, such as the following:

a.1 evaluation of pricing methods so that gross margin would be more than enough to cover operating expenses;

a.2 reduction of administrative and selling costs;

a.3 periodic review of operating performance with concern on the volume of sales and the results as to whether PPI has gained profit or not; and

a.4 evaluation of existing internal controls for improvements in the different stages of operations.

b. establish business plans and strategies to address the uncertainties and identify areas in the operations for streamlining, to increase sales, reduce costs and avoid losses.

c. intensify collection and initiate more effective and efficient strategies to recover trade receivables.

d. explore opportunities for possible sources of funds such as subsidy from the National Government.

1.13 Management agreed to implement the recommendations.

2. Misstatement of the Cost of Sales and Merchandise Inventory accounts

The balance of the Cost of Sales (COS) account amounting to ₱518.490 million is understated by ₱0.503 million while the Merchandise Inventory (MI) account totaling ₱4.358 million has unrecorded amount of ₱0.512 million, due to errors in booking up the cost of merchandise and the absence of properly maintained subsidiary records for inventories.

<u>On errors in balances of accounts</u>

2.1 Analysis of sample transactions affecting the COS and MI accounts, particularly the series of accounting entries affecting voucher nos. VP2014-02-021 and VP2014-03-026, disclosed errors that resulted in the understatement of COS by ₱0.503 million and unrecorded MI of ₱0.512 million, as follows:

<u>On COS account</u>

Balance per books	₱518,490,225
Effect of errors: under(over)statement	
VP2014-02-021	180,179
VP2014-03-026	322,810
Balance per audit	518,993,214
Understatement of COS	₱ 502,989

<u>On MI account</u>

Balance per books	₱ 4,357,708
Effect of errors: under(over)statement	
VP2014-02-021	(180,179)
VP2014-03-026	(322,810)
Balance per audit	₱ 3,816,707

Balance per audit	₱ 3,816,707
Actual inventory count	4,328,965
Unrecorded MI	₱ 512,258

If the errors from VP2014-02-021 and VP201-03-026 are corrected in the books, the adjusted balance of MI would be ₱3.816 million. Comparing the adjusted balance of ₱3.816 million with the actual inventory count of ₱4.328 million, there was an unrecorded MI of ₱0.512 million. Likewise, the COS would have amounted to ₱518.993 million instead of ₱518.490 million.

2.2 Further review of sample transactions affecting COS account showed that deficiencies noted during the previous year have not been addressed, such as:

a. Certain products were sold at a loss since the cost of the product is higher than the sales revenue, and

b. Discrepancies in the recognized COS against the verified cost of the product resulting in overstatement or understatement of the recorded COS and MI.

c. COS pertaining to a specific sale was recorded twice, resulting in the overstatement of COS.

d. Amounts pertaining to vaccines administration fee were erroneously credited to MI instead of Accounts Payable.

Similar to previous year's action taken on the recommendations, Management simply prepared the adjustments of the errors presented in the audit samples but did not review entire COS transactions and determine/address causes of errors.

2.3 The current year COS was overstated by the correction of prior year error. In CY 2013, a debit to COS amounting to ₱7,577,742.76 was erroneously debited to Merchandise Inventory (MI) account. The prior year error was corrected in the current year with the following entry:

	Debit	Credit
Cost of sales	7,577,742.76	
Merchandise inventory		7,577,742.76

To correct the error made in previous entry per VP No. 2013-011-020.

2.4 Aside from overstating the current year COS, the correcting entry showed that the CY 2013 GL balance of the MI account of ₱28,469,147 was not correct as it was overstated by ₱7,577,742. Therefore, the CY 2013 inventory report that tallied with the GL balance was likewise incorrect.

<u>On accounting system and procedures</u>

2.5 The physical count of the Merchandise inventory amounting to ₱4,328,965, which was conducted on January 5 and 6, 2015, was not supported by a previously prepared MI schedule based on subsidiary ledger (SL) balances which should have been the basis for the count. During the scheduled count on January 6, 2015, we were furnished with a subsidiary ledger that is not correctly maintained and with balances as of October 31, 2014 only.

a. There were no defined procedures for the inventory count. From inquiry, we gathered that a staff of the Distribution Department made a pre-count of the existing inventory during the last working days of December 2014 and prepared a count sheet which was used as basis for the count by the inventory team. The inventories at the warehouse in Taguig City were not also supported with inventory records. In view of the absence of SL, the balances of the inventory could not be validated and the inventory report cannot be relied upon.

b. Sometime in April 2015, Management submitted a revised SL with a total amount that tallied with the inventory count. The SL, however, could not be relied upon due to the following:

b.1 The SL has incomplete document reference and does not contain basic information such as quantity and unit cost, thus, the correctness of the debit and credit entries that were stated in total amounts could not be verified.

b.2 There were products that indicated negative beginning balances amounting to ₱4,613,592.

2.6 The Receiving Reports (RR) prepared by the Distribution Department which is the basis for recognizing accruals for the items delivered by suppliers contain information as to quantity and description of the products received, but do not have information as to the corresponding costs of the products. Some errors occurred in recording the accrual, due to erroneous pick up of quantity from the RR or unit cost from the Purchase Orders (PO), resulting in the over or under accrual of MI.

a. Receipt of items purchased and the responsibility for checking the items delivered are part of the procurement process, hence, should be performed by the Procurement Department. The function of the Procurement Department, however, ends with serving the PO to suppliers, since the receiving of items delivered by suppliers is performed by the Distribution Department who also takes charge of the suppliers' sales invoices and delivery receipts. The Procurement Department is no longer informed as to whether the items in the PO were completely delivered in accordance with specifications or delivered on time. The suppliers' sales invoices and delivery receipts are then transmitted by the Distribution Department to the Procurement Department for the preparation of Request for Payment which shall be submitted to the Accounting Department.

b. Upon delivery of the items to PPI clients/customers, the Distribution Department who already has custody of the items is the same department who prepares the Withdrawal Report (WR). Therefore, the signatory in the RRs and the WRs is the same personnel in the Distribution Department. In this case, since there is no separation of duties and functions on the receipt and withdrawal of items, the levels of accountabilities were not established.

2.7 Errors occur because of double entries to the MI account per Journal Voucher (JV) for the accrual and Voucher Payable (VP) document for the payment but without the corresponding reversal of accrual.

a. As a procedure, Merchandise inventory is accrued monthly through a JV by debiting MI and crediting Accounts Payable (AP). When a Voucher Payable (VP) document for the payment to supplier is prepared, the MI account is again debited and AP is credited and then another JV is prepared to reverse the accrual entry in previous JV. In the preparation of the Check Voucher (CV) AP-Trade is debited and Cash in bank is credited.

b. The reversal entries are not necessary upon preparation of the VP document so as to avoid errors and misstatement of the MI account. Instead of a debit to MI in the VP document, *Accounts Payable* may be debited while *Voucher Payable* account is credited. Thus, the MI account will only be debited once in the accrual JV while the *Accounts Payable* is zeroed out in the VP document. The *Voucher Payable* account will then be debited and zeroed out in the CV document and Cash in bank is credited.

c. Since the preparation of the VP document is initiated by the Procurement Department through the Request for Payment, the preparation of JV by the Accounting Department for reversal entry is sometimes overlooked. Moreover, since the reversal of accruals is recognized in the succeeding month, any error in the accrual for the month of December will affect the year-end inventory count as well as the MI account.

2.8 Similar to the MI account, the COS is accrued monthly and debited twice in the accrual JV and the VP and credited in the reversal JV while the Accounts Payable-Trade is also credited twice in the accrual JV and the VP and debited in the reversal JV and the Check Voucher (CV).

In view of the entry in the VP which repeated the entries in the accrual JV, reversal of the accrual has to be recognized in another JV.

a. Review showed that the reversal entries are not necessary for the preparation of the VP document. To avoid the possibility of misstatement of the COS or MI account and for effective check and monitoring of the payable account, *Accounts Payable* can be debited in the VP document instead of COS and the *Vouchers Payable* account can be credited instead of Accounts Payable. Since *Accounts Payable* was already recognized in the accrual JV, it will be zeroed out in the VP document. The *Vouchers Payable* account will also be zeroed out in the CV document. The reversal entry, therefore, can be eliminated.

b. Partial reversal of the accruals because of partial payments to suppliers also cause more errors in the COS and payable accounts.

2.9 The COS is recognized monthly through a JV using the Withdrawal Report (WR) which is paralleled with every Sales Invoice as the document reference.

a. Our review showed that, although the WR indicated the unit cost of products withdrawn, there is no reference document/record for unit cost such as the supplier's PO or the name of the supplier of the product. Moreover, as discussed above, there is no subsidiary ledger where product cost may be validated. This inadequacy of records and information is another cause of errors.

b. Considering the manual accounting system of PPI, the absence of a correct and reliable SL and the errors cited due to a weak and inadequate internal control system, the GL balance of *Merchandise Inventory* account and the inventory count amounting to ₱4,328,965 is doubtful.

2.10 We recommended that Management –

a. maintain correct, complete and updated subsidiary record of each inventory item which include information necessary to validate the recorded amounts such as quantity, unit cost, PO No., RR No., WR No. and other reference documents.

b. review the correctness of transactions to the COS and MI accounts and prepare the necessary adjusting journal entries to recognize corrections.

c. **consider the following recommended procedural accounting entries.**

The MI and COS accounts be debited only in the JV for accrual while the Accounts Payable account is credited. In the VP document, debit Accounts Payable instead of MI/COS and credit *Vouchers Payable* account to avoid the unnecessary reversals and the misstatement of the MI/COS account. In this case, *Accounts Payable* is zeroed out in the VP document and *Voucher Payable* will be debited and zeroed out in the Check Voucher document. The reversal entry therefore can be eliminated.

d. **require the Procurement Department to receive items delivered by suppliers and accomplish the Receiving Reports.**

e. **inasmuch as the received items already have definite client/customer, the Procurement Department can immediately turnover same items to Distribution Department. The Distribution Department may prepare the WR for the withdrawal of items from the Procurement Department.**

f. **maintain proper filing of copies of used accountable forms including RRs, WRs and DRs and ensure completeness of copies on file.**

g. **institute policies and procedures that would –**

   - ✓ **improve accounting and administrative controls to ensure reliable accounting data;**
   - ✓ **improve efficiency; and**
   - ✓ **promote a system of accountability.**

h. **require the Internal Audit Department to review existing internal control system, identify weaknesses and recommend measures for improvement.**

2.11 We also reiterate our prior year recommendation to adopt an automated inventory system.

2.12 Management agreed to implement the stated recommendations.

3. Unrefunded Performance/Bidders Bond

Performance/bidders bond payable in the total amount of ₱18.802 million as of December 31, 2014 classified under Other Current Liabilities, have not been refunded to suppliers and bidders contrary to Sections 27.5, 28.1, 39.4 and 39.5 of RA 9184.

3.1 The account *Other Current Liabilities* included the total amount of ₱18.802 million consisting of performance bond of ₱7.927 million and bidders bond of ₱10.875 million posted by suppliers and bidders. These amounts were broken down to applicable periods as follows:

Date / Periods	Total	Performance Bond	Bidders Bond
CYs 2009 to 2013	₱ 8,694,527	₱ 6,164,790	₱ 2,529,737
CY 2014	10,107,880	1,762,864	8,345,016
	₱18,802,407	**₱7,927,654**	**₱10,874,753**

3.2 PPI has not returned the bid and performance securities to respective bidders and suppliers even after the lapse of their validity periods and despite claims by bidders and suppliers for refund/return, contrary to the requirements of RA 9184, resulting in the accumulation of liabilities amounting to ₱18.802 million that remained in the books.

3.3 Sections 27.5 and 28.1 of RA 9184 on the return of the bid security provides –

"Sec. 27.5. In no case shall the bid security be returned later than the expiration of the bid validity period …

Sec. 28.1. Bids and bid securities shall be valid for a reasonable period …, but in no case shall the period exceed one hundred twenty (120) calendar days from the date of the opening of bids."

3.4 Further Sections 39.4 and 39.5 of RA 9184 on the return of the performance security states–

"Sec. 39.4. The performance security shall remain valid until issuance by the procuring entity of the final Certificate of Acceptance.

Sec. 39.5. The performance security may be released by the procuring entity after issuance of the Certificate of Acceptance, subject to …"

3.5 During CY 2014, PPI refunded only the amount of ₱3.858 million performance and bid securities, of which ₱2.934 million pertained to CY 2014 while ₱0.924 million pertained to prior years, as follows:

	CY 2014	Prior years	Total
Performance bond	₱ 327,612.00	₱ 905,605.91	₱1,233,217.91
Bidders bond	2,606,156.18	18,368.00	2,624,524.18
Total	**₱2,933,768.18**	**₱923,973.91**	**₱3,857,742.09**

3.6 The latest posting of bid security in CY 2014 was on September 29, 2014 amounting to ₱0.678 million. Therefore, had PPI returned to respective bidders the bid securities in the amount of ₱10.196 million, only the amount of ₱0.678 million will be outstanding as of December 31, 2014.

3.7 These are liabilities which are not part of the operating funds. With the current cash position of ₱8.318 million as of December 31, 2014, PPI may not meet its obligation to return the performance and bid securities amounting to ₱18.802 million. Non-payment of these liabilities, upon demand by suppliers, may result to legal problems on the part of PPI.

3.8 We recommended that Management –

a. refund/return the bid securities of ₱10.875 million and performance securities of ₱7.927 million if the suppliers' obligations have been complied with and the Certificate of Acceptance have been issued.

b. arrange for schedule/plan of payment for the refunds.

c. for subsequent posting of bid and performance security, comply with the requirements of Sections 27.5 and 28.1 on the return the bid security and Sections 39.4 and 39.5 on the return of the performance security and avoid the accumulation of such liabilities.

3.9 Management took note of the recommendations and committed to return all securities to bidders and suppliers who have completed the projects as soon as enough funds are available, hopefully within the year 2015.

4. Gender and Development (GAD)

PPI formulated a GAD plan with a budget of ₱2.1 million, however, only two activities with a total cost of ₱.133 million were conducted.

4.1 Although Management is aware that the Agency's unfavorable financial condition cannot provide the needed amount for its GAD activities, PPI provided a budget of ₱2.1 million for its GAD Program/Activity/Projects.

4.2 Considering the insufficient cash position as discussed in Audit Observation No. 1, only two out of six activities were conducted with the total amount of ₱133,445 as follows:

	GAD Activity	Cost
a.	Team Building at Antipolo City	₱ 75,895
b.	Annual Physical Exam of PPI employees	57,550
	Total	₱133,445

4.3 We recommended that Management ensure the formulation and implementation of a doable annual GAD plan, allocate budget according to financial capacity and exert best efforts to comply with DBM-NEDA-NCRFW Joint Circular No. 2004-1.