A. COMMENTS AND OBSERVATIONS

A.1 Audit Observations and Recommendations

1. **Insufficient capital and continuous losses from 2006 to 2011 cast doubt on the viability of the Corporation to continue its operation and perform its mandate.**

1.1 Pursuant to Executive Order No. 442 dated July 4, 2005, the Philippine International Trading Corporation (PITC), a majority-owned subsidiary of the National Development Company (NDC), was designated as the lead coordinating agency to make quality medicines affordable, available and accessible to the greater masses of Filipinos. The PITC created a pharmaceutical operation/division to handle the implementation of the program.

1.2 For more efficient and effective implementation of the program, the Management of PITC and NDC decided to create a corporate vehicle to handle the pharmaceutical program under Executive Order 442 focusing on the expansion of its Botika ng Bayan accredited retail outlets, as well as strengthening institutional linkages with key government agencies and local government units. The Producers Venture Capital Corporation (PVCC), NDC wholly-owned subsidiary was identified to be the said corporate vehicle to be utilized for the purpose. On November 9, 2005, the Security and Exchange Commission approved the Amended Articles of Incorporation and By-Laws of PVCC changing its corporate name to PITC Pharma, Inc. (the "Corporation").

1.3 The Corporation has an authorized capital stock of P100 million. The subscribed and paid up capital is P37.5 million; P22.5M by PITC and P15 million by NDC, making PITC the major stockholder of the Corporation. The Corporation became the subsidiary of PITC to which the pharmaceutical operation was transferred in 2006.

1.4 The Corporation's primary purpose is to engage in the business of research, development, production, manufacture, packaging, sale and/or distribution of pharmaceutical products and/or investment and/or management of investments in pharmaceuticals and related commercial ventures such as those involving chemical or biological substances for medical or veterinary use, including prescription, generic and over the counter drugs; vitamins and nutritional supplements; drug delivery systems and diagnostic substances, and related products, equipment and services.

1.5 Furthermore, Section 1, Rule 16, Chapter III of the Implementing Rules and Regulations of Republic Act 9502, otherwise known as the Cheaper Medicines Law, PITC Pharma Inc. was mandated to undertake the centralized importation of pharmaceutical products for the government.

1.6 In six years of operation, it was observed that there were events and conditions that affected the Corporation's viability to continue its operations, as follows:

a. Heavy losses were incurred from 2006 to 2011 as shown below:

	2006	2007	2008	2009	2010	2011
Sales	29,831,926	260,773,147	123,652,119	159,610,598	121,567,626	154,222,927
Cost of Sales	(21,146,231)	(203,465,098)	(94,581,125)	(126,427,811)	(96,235,358)	(112,529,013)
Gross Profit	8,685,695	57,308,049	29,070,994	33,182,787	25,332,268	41,693,914
Operating & Other Expenses	(40,960,276)	(98,526,883)	(111,068,273)	(81,619,391)	(86,872,418)	(60,736,491)
Loss	**(32,274,581)**	**(41,218,834)**	**(81,997,279)**	**(48,436,604)**	**(61,540,150)**	**(19,042,577)**

b. It was noted that the Corporation has insufficient capital. In 2006, PITC and NDC invested P22.5M and P15M respectively, as start up capital of PPI. Since then, however, there was no additional capital coming from either PITC or NDC even with the heavy losses incurred and deficiencies in capital from 2007 to 2011, as shown below:

	2006	2007	2008	2009	2010	2011
Capital Stock	37,500,000	37,500,000	37,500,000	37,500,000	37,500,000	37,500,000
Retained Earnings	(31,933,589)	(73,152,423)	(155,149,702)	(203,586,306)	(262,193,695)	(281,236,272)
Equity/ (Deficiency)	**5,566,411**	**(35,652,423)**	**(117,649,702)**	**(166,086,306)**	**(224,693,695)**	**(243,736,272)**

c. The Corporation failed to meet its current and long term obligations. It was not able to pay its loan with the National Development Company (NDC) in the amount of P185,000,000 which matured last December 26, 2009. Likewise, payable to suppliers were not paid on time. Of the total Accounts Payable – Trade in the amount of P23,369,509.99, the amount of P6,021,837.33 or 25.76 percent were over 120 days past due and prior years outstanding accounts, with details in Annex A.

This inability to settle the obligations may adversely affect the PPI's relation with the suppliers in the procurement of medicines and may result in problems in the availability of stocks.

d. Stocks were inadequate to meet the orders. As of December 31, 2011, the Merchandise Inventory net of allowance for inventory loss amounted to only P2,902,209 or 2.64 percent of the total asset. With this inventory on hand, the Corporation would not be able to cater to the needs of its clients. Annex B showed the purchase orders of the clients that PPI could not completely serve because the medicines that were ordered were not available. Hence, the purpose for which PPI was created- to make cheaper medicines available to the masses, was defeated.

1.7 Due to the above-mentioned critical conditions, the viability of the Corporation to continue its operations and effectively carry out its functions was uncertain.

1.8 The Philippine Standard on Auditing No. (PSA) 570, states the Management's Responsibility on the financial statements, to wit:

> "*The going concern assumption is a fundamental principle in the preparation of financial statements. Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business."*

1.9 In the case of PPI, the going concern assumption goes beyond the realization of assets and discharge of liabilities as stated in the above-mentioned PSA. Since PPI is operating for public interest, that being a government vehicle in making cheaper medicines accessible to the public, it is expected to continuously operate efficiently and effectively in achieving the purpose for which it was created.

1.10 Hence, Paragraph 23 of the Philippine Accounting Standards (PAS) 1, "Presentation of Financial Statements provides useful guidance, as follows:

> "*When preparing the financial statements, management shall make an assessment of an entity's ability to continue as going concern. Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. <u>When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties shall be disclosed.</u> When financial statements are not prepared on a going concern basis, that fact shall be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern."* (Underscoring supplied)

1.11 Thus, Management should adequately disclose the results of the above assessment for the financial statements not to mislead the users that PPI can continue to operate in the normal course of business and contribute in government's program of making quality medicines affordable, available and accessible to the greater masses of Filipinos.

1.12 ***We recommended that Management***:

a. **Conduct an assessment of the conditions affecting the ability of PPI to continue as a going-concern entity; and discuss in the Notes to Financial Statements the identified uncertainties that may cast significant doubts on the PPI's ability to continue its operations and carry out the mandated functions, together with the business plans and strategies of PPI in addressing these uncertainties, in accordance with the above-cited accounting and auditing standards;**

b. **Seek financial assistance from parent corporations for additional capital, in accordance with Section 3 of the Shareholder Agreement between PITC and NDC that states that:**

> “***The unsubscribed portion of the corporation’s authorized capital stock may be subscribed and paid up by PITC or such other parties as may be approved by the Board of Directors in accordance with the Corporation’s business and financial plans as may be approved by the said Board of Directors.”***

c. **Make representation with NDC for rescheduling of loan repayment or restructuring of loan; and**

d. **Identify areas in the operations for streamlining to reduce costs and increase sales, and minimize losses.**

1.13 Management commented that with the recent changes in the organization of the Board of Directors, they are hopeful that PPI will be able to get the necessary support for the Corporation to reverse the losing trend that it has been experiencing over the past years.

1.14 Management also commented that aside from continuing to make quality and cheaper healthcare products and services available and accessible on a timely manner, the Corporation has identified the following PPI’s goals which would help eradicate PPI’s capital deficiency over the next few years

a. *Strengthened Organization Capacity* –

The PPI shall:

i. Institute concrete improvements in the different stages of operations from procurement to delivery by systemizing operational processes;

ii. Establish an organizational development program aimed to increase professional effectiveness;

iii. Develop a fully integrated and automated system that will link PPI with its service providers and hopefully with clients to improve monitoring and generate on-time report and data necessary for informed decision-making.

b. *Improved Financial Performance* –

The PPI shall:

i. Work for capital reorganization which would entail a debt to equity conversion, and the restructuring of the remaining debt with a lower interest rate and longer repayment period;

ii. Boosting Working capital by:

- Partnering with private companies for joint venture arrangements in the areas of supply of medicines, toll manufacturing and distribution;

- Securing a bridge financing arrangement with the National Development Company for big purchase orders from institutional accounts e.g. Department of Health and Philippine Charity Sweepstakes Office;

- Lobbying with the national government for subsidy since PPI is operating for public interest; and

- Exploring short-term financing schemes such as fund transfer arrangements for institutional accounts, e.g. Philippine Army, Philippine Coast Guards and the Bureau of Corrections and IRA-intercept arrangement for local government accounts.

1.15 Further, Management commented that with access to additional working capital, an improved professional organization and the support of the shareholders, there is hope that PPI would be able to overturn its present predicament and be a relevant vehicle that would help the government in the fulfillment of one of its social goals.

A.2 *Status of Unsettled Audit Disallowances, Charges and Suspensions*

For CY 2011, the Audit Team has not issued any Audit Disallowance, Charges and Suspensions. There were also no unsettled Audit Disallowances, Charges and Suspensions as at December 31, 2011.