PHARMALLY: FINANCIAL STATEMENTS ANALYSIS

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PHARMALLY: FINANCIAL STATEMENTS ANALYSIS

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EXECUTIVE SUMMARY

We reviewed and evaluated the 2020 Audited Financial Statements of Pharmally Pharmaceutical Corporation (the "Company"). In the course of our review, we have noted five (5) high-risk observations and one (1) medium-risk observation in relation to the contracts awarded to the Company by the Procurement Service-Department of Budget and Management (PS-DBM). We recommend that the company and the approving officers of the PS-DBM supply further information in response to our findings. Below is the summary of observations.

SUMMARY OF OBSERVATIONS

OBSERVATIONS	RISK RATING
• Potential under-declaration of input VAT related to purchases amounting to P402.2-M	HIGH
• Insufficient contracting capacity	HIGH
• Insufficient disclosures and details for Donations that were declared as fully deductible expenses	HIGH
• Missing and incomplete material disclosures in the 2020 Financial Statements	HIGH
• Sources of interest expense and foreign exchange gains/losses are not presented and disclosed in the 2020 Financial Statements	HIGH
• Reported amounts cannot be matched in the disclosures	MEDIUM

RISK RATING FRAMEWORK

Our framework for the risk rating criteria is presented below for the purpose of prioritizing our findings. This is our initial assessment of the likelihood and impact of the findings to result in financial losses from undeclared tax revenues or misuse of funds received from the public, breaches in regulatory compliance requirements, inability to fulfill obligations, and erosion of public trust if no further action will be taken.

Table 1. Risk Rating Framework

RATING	DESCRIPTION	FEATURES
High	Findings that are fundamental to the management of risk representing deficiencies in regulatory and reporting compliance that requires the immediate attention of management.	This is a serious risk management issue that if not mitigated, may, with a high degree of certainty, lead to: • Substantial losses from undeclared/uncollected revenues or misuse of public funds • Serious violation of regulatory requirements • Serious indicators of the company's inability to operate as a going-concern • Serious indicators of the company's capacity to fulfill contract obligations Indicators may include: • Grave non compliance with regulatory and financial reporting standards • Potential for fraud identified
Medium	Important findings that are to be resolved by management. Timely attention is warranted.	This is a risk management issue that could lead to: • Moderate losses from undeclared/uncollected revenues or misuse of public funds. • Breaches of regulatory requirements • Early indicators of the company's inability to operate as a going-concern. • Early indicators of the company's capacity to fulfill contract obligations Indicators may include: • Non compliance with regulatory and financial reporting standards that can be remediated • Possibility for fraud exists
Low	Findings that identify non-compliance with established procedures. Routine management attention is warranted.	This is a risk management issue, the solution to which may lead to the resolution or further clarification of the findings raised. Risks are limited. Findings (indicators) normally are: • Minor regulatory and compliance findings that are easily remediated • Minor non compliance with procedures/standards that are easily remediated

DETAILED REPORT

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OBSERVATION NO. 1:

Potential under-declaration of input VAT related to purchases amounting to P402.2-M

Risk Rating: High

OBSERVATIONS

Every taxpayer and importer has a basic duty to provide truthful tax returns and import declarations.

We recomputed the grossed-up amount of purchases by using the amounts presented in Note 16 disclosure, and noted differences in declared input VAT related to purchases as detailed below:

The difference could be related to the imports of certain medical goods which are exempted from all import duties and taxes in response to the COVID-19 pandemic, in accordance with CAO 07-2020. Moreover, RR No. 28-2020 implements the tax exemption provision under Section 4 (cc) and Section 18 of RA No. 11494, on the incentives for the manufacture or importation of certain equipment, supplies or goods.

However, whether purchases of Pharmally relate to exempt transactions cannot be ascertained in the note disclosures.

Table 2. VAT recomputation

ITEM	GROSSED UP AMOUNT	BASED ON AFS	DIFFERENCE	TAX DEFICIENCY (12%)
Purchases of inventory	3,878,590,250	7,227,252,622 [1]	(3,348,662,372)	(401,839,485)
Capital goods purchases	10,955,358	13,967,862 [2]	(3,012,503)	(361,500)

RISK AND IMPLICATIONS

- To qualify for exemption, the taxpayer availing of the exemption must present a certification from the DTI that the equipment and supplies being imported are not locally available or of insufficient quality and preference. If the purchases are a mix of foreign- and locally-sourced items, then this raises the concern why importations were made if the items are locally available.
- The importation shall not be subject to the issuance of an Authority to Release Imported Goods (ATRIG) and may be released by the BOC without the issuance of an ATRIG. However, the BIR may still conduct post investigation or audit of importations released without an ATRIG.
- There could be indicators of intentional or deceitful entry in the BIR return if under-declaration is proven. A substantial under-declaration (resulting in over 30%) of taxable sales or income (or substantial overstatement of deductions) will constitute prima facie evidence of a false or fraudulent return.[3] For tax fraud cases, the Tax Code provides a higher surcharge of 50% of the tax due.
- From a customs perspective, in cases where the resulting discrepancy exceeds 30%, the discrepancy will constitute prima facie evidence of fraud.[4] In case of fraud, the fine is six times the revenue loss plus possible criminal action against the erring importer. A 20% interest per annum on deficiency duties, taxes and other charges (plus fines and penalties, if any) will likewise be imposed. Whether willfully committed or not, the offenses are also subject to provisions of Customs Memorandum Order 12-2021 with regard to imposable penalties arising from breaches of the importer's responsibilities and violations of customs laws, rules and regulations.

RECOMMENDATIONS

The company should release a copy of its monthly and/or quarterly VAT returns. Moreover, the Company must present a certification from the DTI that the equipment and supplies being imported are not locally available or of insufficient quality and preference for the imported items to be exempted from VAT and other taxes.

[1] As disclosed in Note 7 of 2020 Audited Financial Statements (AFS), Purchases of merchandise
[2] As disclosed in Note 9 of 2020 AFS, Additions to property and equipment
[3] NIRC Section 248(B)
[4] CMTA Section 1400

OBSERVATION NO.2:

Insufficient contracting capacity

Risk Rating: High

OBSERVATIONS

The mandatory documentary requirements for Negotiated Procurement under Emergency Cases only include the following:[5]

- Mayor's or Business Permit. For projects with an Approved Budget for the Contract (ABC) above PHP500,000.00
- Income Tax Returns (Annual Income Tax Return of the preceding tax year) OR Business Tax Returns (Value Added Tax or Percentage tax return covering the previous six months)
- Omnibus Sworn Statement (OSS)

The emergency situation allows for expediting purchasing without the typical bidding requirements. However, to sanity check the capability of the company to fulfill its obligations, we looked at the Single Largest Completed Contract (SLCC) or Net Financial Contracting Capacity (NFCC) as proxies to evaluate the contracting capacity of the company.

We have not found any contracts to evaluate the SLCC. There have been no significant financial operations in 2019 and the 2020 financial statements do not have any disclosures on its contracts.

According to the following sections of RA 9184 describing the Net Financial Contracting Capacity (NFCC):

23.4.1.4 The computation of a bidder's NFCC must be at least equal to the ABC to be bid, calculated as follows:

NFCC = [(Current assets minus current liabilities) (K)] minus the value of all outstanding or uncompleted portions of the projects under ongoing contracts, including awarded contracts yet to be started, coinciding with the contract to be bid.

Where: K = 10 for a contract duration of one year or less, 15 for a contract duration of more than one year up to two years, and 20 for a contract duration of more than two years.

The values of the domestic bidder's current assets and current liabilities shall be based on the latest Audited Financial Statements submitted to the BIR.

For purposes of computing the foreign bidders' NFCC, the value of the current assets and current liabilities shall be based on their Audited Financial Statements prepared in accordance with international financial reporting standards. (23.5.1.4a)

23.4.1.5 If the bidder submits a committed Line of Credit, it must be at least equal to ten percent (10%) of the ABC to be bid:
Provided, That if the same is issued by a foreign Universal or Commercial Bank, it shall be confirmed or authenticated by a local Universal or Commercial Bank.

Below are the awarded contracts to the Company from April 2020 to June 2020, signed by Lloyd Christopher A. Lao, at the time Executive Director of PS-DBM, in the Notice of Award.

Table 3. List of Awarded Contracts to Pharmally April-June 2020

UID	SUPPLIER	AWARD DATE	ABC	NOA AMOUNT
20200414-000002227	Pharmally Pharmaceutical Corporation	4/14/2020	62,400,000.00	54,000,000.00
20200420-000002218	Pharmally Pharmaceutical Corporation	4/20/2020	225,000,000.00	220,000,000.00
20200423-000002144	Pharmally Pharmaceutical Corporation	4/23/2020	760,000,000.00	688,000,000.00
20200423-000002144	Pharmally Pharmaceutical Corporation	6/5/2020	3,846,000,000.00	3,820,000,000.00
20200608-000002145	Pharmally Pharmaceutical Corporation	6/8/2020	2,877,300,000.00	2,877,300,000.00
20200610-000002213	Pharmally Pharmaceutical Corporation	6/10/2020	245,846,016.00	245,846,016.00
TOTAL			**8,016,546,016.00**	**7,905,146,016.00**

[5] Form Resolution Nos. 04-2020 AND 05-2020 (GPPB)

Review of the Statement of Cash Flows and the Statement of Financial Position shows that capitalization was grossly insufficient to warrant the awarding of P7.9B worth of contracts from April 2020-June 2020. Below is the computation of the NFCC from available information in the 2020 Financial Statements.

NFCC Computation

Current assets, beg 2020	P	599,450[6]
Current liabilities, beg 2020		0
Current net assets, beg 2020		599,450
Multiply by: NFCC factor		10
NFCC		5,994,500
Less: Uncompleted contracts[7]		0
Total NFCC	P	5,994,500

Based on the resulting NFCC figure, the Company will need to have at least P6.24M in current working capital to reach the minimum NFCC of P62.4M for its first awarded contract on April 14, 2020. The available funds of P599,450 are insufficient to reach the required NFCC. In lieu of the available working capital, the Company can present a Line of Credit from a Universal or Commercial Bank. Upon further inspection of the Statement of Financial Position, there are no line items or disclosures that reflect the existence of liabilities or any Line of Credit. The Statement of Cash Flows does not show any increases in cash from the receipt of loan proceeds.

The NFCC became increasingly insufficient as six (6) days after the awarding of the first contract, a P225M ABC was bid (P220M awarded), and three (3) days later a P760M ABC was bid (P688M awarded).

RISKS AND IMPLICATIONS

While meeting the NFCC is not a mandatory requirement, it is worth looking into this figure to approximate a company's ability to fulfill its contractual obligations. Our review of the Company's Financial statements does not inspire confidence that the company has the financial capacity to fulfill the P7.9B worth of contracts awarded in a short period of time. The risk of default and insolvency is very high, and is quite a gamble given the volume and urgency of the items for procurement. Should the Company be unable to deliver on its commitments, the government will be assuming the risk of default.

RECOMMENDATIONS

The company should disclose in its financial statements the sources of funding to shore up the needed capital to fulfill the contract requirements. We also recommend that the approving signatory and agency release the documents and explain the rationale behind the approval of the contracts despite the insufficient contracting capacity.

[6] As presented in the Statement of Cash Flows
[7] There are no disclosures in the 2020 Financial Statements about the nature and status of any contracts.

OBSERVATION NO.3:

Insufficient disclosures and details for Donations that were declared as fully deductible expenses

Risk Rating: High

OBSERVATIONS

We noted in the 2020 Statement of Comprehensive Income that Pharmally reported Donations of P33,131,341 or 78.6% of general and administrative expenses. Deductions for charitable contribution can only be deductible with proper documentation (i.e. certificate of donations from BIR accredited donee institutions). These details were not shared in any of the disclosures in the financial statements.

RISKS AND IMPLICATIONS

There needs to be sufficient documentation on the declared Donations to ensure that the recipient organizations are duly accredited by the BIR to be deemed deductible. Absence of these disclosures poses the risks that:

- The recipient organizations are not accredited by BIR. This would remove the donated figures as a deductible expense, resulting in higher taxable income and income taxes for the company. The variance of the potential uncollected taxes would result in lost tax revenues.

- The recipient organizations are not duly registered or accredited to receive funding from donors, or they were hastily registered as vehicles to release cash and revenues received from public funds to unauthorized or fraudulent beneficiaries.

RECOMMENDATIONS

The company should provide sufficient and competent documentation to support the deductibility claims and present the details of the Donations.

OBSERVATION NO.4:

Missing and incomplete material disclosures in the 2020 Financial Statements

Risk Rating: High

OBSERVATIONS

The Philippine Financial Reporting Standards (PFRS) for Small-to-Medium Enterprises (SMEs) and the Corporation code require companies to disclose and report relevant information for material line items in its financial statements.

We noted insufficient disclosures and on the following items for the 2020 Financial Statements:

1. **Donations.** Donations amounting to P33,131,341 or 78.6% of all General and administrative expenses, do not have disclosures in the notes to financial statements. Section 8 of the PFRS for SMEs requires that material amounts should have relevant disclosures.
2. **Related party relationships.** There is failure to disclose the nature of the related party relationships (Section 33 of PFRS for SMEs). There are two entities registered in the SEC system containing the name "Pharmally" and the relationship between these two companies can't be established without the appropriate disclosure.

SEC Registration Number	Company Name
CS201735401	PHARMALLY BIOLOGICAL COMPANY PH, INC.
CS201954923	PHARMALLY PHARMACEUTICAL CORPORATION

3. **Loans and special agreements.** The company's beginning cash of P625,000, is insufficient to support the fulfilment of P7.9-B awarded contracts by the Philippine Government from April 2020-June 2020. We have not seen disclosures for loans or special agreements that would provide the company the necessary cash to purchase the requirements of the awarded contracts for testing kits, PPEs, and surgical masks. If these agreements were entered into, the company should disclose the nature of the loans to include maturity date, interest rates, terms and conditions, covenants and warranties. These are required disclosures under Section 11 of PFRS for SMEs.

4. **Sales and revenues.** We noted incomplete disclosures on Sales and Revenues amounting to P7,485,401,046, i.e., the qualitative and quantitative information on its contracts with customers; the significant judgements, and changes in the judgement as of the end of the reporting period. (PFRS for SMEs). The Notes to Financial Statements also failed to disclose the contracts awarded by the Philippine government and whether or not the company is acting as principal or agent on its contract obligations. Without sufficient disclosures about the significant agreements, including delivery details and timeline, revenue recognition issues may arise and could result to the following:
   - recording revenue prematurely;
   - recording fictitious revenue or sales that did not take place;
   - recording revenue prior to completion of deliveries/ shipment; and
   - recording revenue for products that are not required to be purchased.

5. **Foreign currency transactions.** The company reported Unrealized forex gains of P63,232,031 and Effect of exchange rate changes on cash of P3,605,102 in the Statement of Cash Flows. We noted incomplete disclosures on Foreign Currency Transactions for the items reported, i.e., the amount of exchange differences recognized in profit or loss during the period and their relevant sources. (Sec. 30.25 of PFRS for SMEs).

- **Appropriated retained earnings.** The Statement of Changes in Equity did not present a line item on Appropriated Retained Earnings. Note 11 of the Notes to Financial Statements indicated that "On December 1, 2020, the Board of Directors approved the appropriation of P239M for additional working capital requirements and expansion. The appropriated amount is planned to be released from retained earnings in the second half of 2021." The P239-M should be presented in the Statement of Changes in Equity and the notes should provide further details on the working capital requirements and expansion - the timeline of the project, nature and purpose of the expansion (PAS 1 and Sec. 43 of the Corporation Code).

RISKS AND IMPLICATIONS

The external auditor issued an Unqualified Opinion despite the missing and incomplete disclosures. Disclosures are critical to inform the public about the nature of the material transactions of Pharmally because they were awarded government contracts worth P7.9-B.

There could be a risk of fraudulent financial reporting, particularly related to concealment of material financial transactions. Fraudulent financial reporting generally includes:

- Manipulation, falsification or alteration of accounting records or supporting documents from which financial statements are prepared;
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information;
- Misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

International Standard on Auditing (ISA) 240 "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements" states that *an auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error* (para.21).

Accordingly, both the Company and the auditors have responsibilities for fraud and error. This standard expects auditors to approach their audit with an attitude of skepticism, with ISA stating (para.23): "*The auditor plans and performs an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated*". Due to the characteristics of fraud, the auditor's attitude of professional skepticism is particularly important when considering the risks of material misstatement due to fraud.

It's further noted that the company's auditor is a sole practitioner. Note 13 shows that professional fees in 2020 amounted to P1.1M. If a significant portion of these fees were paid to the auditor, this can be a potential conflict of interest. This conflict of interest may have resulted in an unqualified opinion despite the noted deficiencies and inconsistencies in the financial statements.

RECOMMENDATIONS

The company should provide sufficient disclosures on the items noted above. The auditor should also provide support for issuing the unqualified opinion despite material omissions from reporting and disclosures.

OBSERVATION NO.5:

Sources of interest expense and foreign exchange gains/losses are not presented and disclosed in the 2020 Financial Statements

Risk Rating: High

OBSERVATIONS

- As disclosed in Note 14, interest expense incurred in 2020 amounted to P1.7-M but we couldn't verify the source as only current liabilities are presented in the balance sheet. An interest expense is the cost incurred by a company for borrowed funds - bonds, loans, convertible debt or lines of credit. Note that there's no long term liability presented that could expose the company to interest rates.

- The presence of unrealized forex is an extremely curious case. As presented in the Statement of Cash Flows, the company posted unrealized foreign exchange gains amounting to P63.2-M in 2020.

A foreign exchange gain/loss occurs when a company buys and/or sells goods and services in a foreign currency, and that currency fluctuates relative to their home currency. It can create differences in value in the monetary assets and liabilities, which must be recognized periodically until they are ultimately settled. There's no huge long term liability (or any appropriate account) at the end of 2020 that could be the source of this unrealized forex gain.

RISKS AND IMPLICATIONS

There could be a risk of fraudulent financial reporting, particularly related to concealment of material financial transactions. Fraudulent financial reporting generally includes:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared;
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information;
- Misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

RECOMMENDATIONS

The company should present the accompanying documents and fully present the missing figures on the face of the financial statements. Sufficient disclosures on the notes to financial statements should also be included for the items noted above.

OBSERVATION NO.6:

Reported amounts cannot be matched in the disclosures

Risk Rating: Medium

OBSERVATIONS

- We recomputed the unrealized forex gain based on the recognized deferred tax liability as disclosed in Note 15 and found out differences of P3.6-M as shown below:

Income tax effect of unrealized foreign exchange gains[8]	17,888,078
Divided by income tax rate	30%
Grossed up amount	59,626,927
Unrealized foreign exchange gains per SCF[9]	63,232,031
Difference	**(P3,605,104)**

- We noted difference of P30M between cost of inventory reflected in Note 12 and Note 7, as shown below:

Cost of merchandise sold[10]	7,105,817,553
Cost of inventory[11]	7,075,817,553
Difference	**(P30,000,000)**

- Input VAT grossed-up amounts against related notes. (see Observation #1, page 5 for the details)

RISKS AND IMPLICATIONS

Tie-up of amounts disclosed within the financial statements is a basic step in preparing financial statements. Thus, tie-up errors could be an indicator of material financial statement errors, and/or financial statement manipulation.

Financial statement manipulation refers to the practice of using creative accounting tricks to make financial statements reflect what the company wants its performance to look like rather than its actual performance.

Throughout the review of the financial statements, there were potential indicators of financial statement manipulation, as enumerated below:

- Revenue recognition issues (see Observation #4, page 9 for the details)
  - Recording revenue prematurely
  - Recording fictitious revenue or sales that did not take place
  - Recording revenue prior to completion of deliveries/ shipment
  - Recording revenue for products that are not required to be purchased
- Failure to record liabilities (See Observation #5, page 11 for the details)
  - Failing to record expenses and liabilities when future services remain
- Inappropriate recognition of certain expenses (See Observation #3, page 8 for the details)

RECOMMENDATIONS

We recommend that the Company present the reconciliation between the subsidiary ledger and general ledger, and provide the relevant documents to prove that there's no financial statement manipulation.

[8] As disclosed in Note 15 of 2020 AFS
[9] As presented in Statement of Cash flows
[10] As disclosed in Note 7 of 2020 AFS
[11] As disclosed in Note 12 of 2020 AFS