DUTY FREE PHILIPPINES CORPORATION
ANNUAL AUDIT REPORT FOR CY 2011

EXECUTIVE SUMMARY

Introduction

Under Section 1.2 of Tourism Administrative Order (TAO) No. 89-04, in relation to the exclusive authority granted to the Philippine Tourism Authority (PTA) to operate duty free shops, the Duty Free Philippines (DFP) was established as a sector of Philippine Tourism Authority to exclusively manage and operate the stores and shops that would sell tax and duty free merchandise, goods and articles, among others.

Under RA 9593, known as The Tourism Act of 2009, the Duty Free Philippines was reorganized into Duty Free Philippines Corporation (DFPC). This Tourism Act provided for the mandate of DFPC which shall be a body corporate to operate the duty and tax-free merchandising system in the Philippines to augment the service facilities for tourists and to generate foreign exchange and revenue for the government as established by the Department of Tourism under Executive Order No. 46.

In the performance of its functions, the DFPC shall have all the general powers of a corporation established under the Corporation Code, in furtherance of its charter. Under Sec. 93 of The Tourism Act of 2009, the DFPC shall have an authorized capitalization of five hundred million pesos (P500,000,000), which shall be fully subscribed by the national government.

Also Sec. 93 of RA No. 9593 requires that a minimum of fifty percent (50%) of the annual net profits of the DFPC shall be automatically remitted to the Office of the Secretary of the DOT to fund tourism programs and projects in lieu of the statutory remittance to the national government under RA No. 7656, seventy percent (70%) of which shall be given to the Tourism Promotion Board (TPB).

On November 12, 2009 the Implementing Rules and Regulations (IRR) of The Tourism Act took effect upon its publication in newspapers of general circulation. However, DFP is still in the transition from a sector of PTA to a corporate entity, as stated in Sec. 140 (a) of the IRR:

> *"To ensure the smooth transition into the new organization structure, all officers and employees under the Department, the PCVC, the PTA and the DFP shall continue to function under their present mandates until such time as the new staffing pattern and manning shall have been approved and funded by the DBM for the Department and respective governing Boards for the TPB, the TIEZA and the DFPC. "*

With the enactment of RA 101491, the function of developing and establishing the Compensation and Position Classification System which shall apply to all officers and employees of GOCCs was transferred from the DBM to Governance Committee for GOCCs (GCG). DFPC has submitted its proposed Organizational Structure and Staffing Pattern and Compensation Package to GCG for review and approval.

The DFPC is headed by the Chief Operating Officer and governed by a Board of Directors. As of December 31, 2011, DFPC has total workforce of 1,004 composed of 840 regular, 20 probationary, 140 casual/ contractual, and four on job order.

The DFPC is operating stores located at the Fiesta Mall in Paranaque, NAIA Terminals, Resort World in Pasay City, Manila Ocean Park, Laoag International Airport, Mactan International Airport in Cebu City, and Davao International Airport.

Financial Profile (In Million Peso)

Shown below are the comparative financial position and financial performance of DFPC for CY 2011 and CY 2010, as well as financial performance versus Corporate Operating Budget (COB).

Comparative Financial Position

Particulars	2011	2010	Increase (Decrease)
Assets	2,890.522	2,175.652	714.870
Liabilities	2,406.692	2,550.236	(143.544)
Equity	483.830	(374.585)	858.415

Comparative Financial Performance

Particulars	2011	2010	Increase (Decrease)
Gross Profit	2,069.989	1,860.534	209.455
Other Income (Loss)	46.670	63.740	(17.070)
Total Operating Income	2,116.659	1,924.274	192.385
Operating Expenses	1,493.388	1,429.943	63.445
Net Income	**623,271**	**494.331**	**128.940**

Financial Performance vs. COB

Particulars	Actual	COB	Over (Under)
Gross Profit	2,069.989	1,981.994	87.995
Other Income (Loss)	46.670	64.600	(17.929)
Total Operating Income	2,116.659	2,046.594	70.065
Operating Expenses	1,493.388	1,544.935	(51.547)
Net Income	**623.271**	**501.659**	**121.612**

Scope of Audit

The audit covered the accounts and operations of the DFPC for calendar year 2011. It aimed to ascertain the fairness of the presentation of the financial statements. Our audit was also made to assess the propriety of the financial transactions of DFPC in accordance with laws, rules and regulations.

Audit Opinion

We rendered unmodified opinion on the fairness of the presentation of the financial statements of DFPC for the year ended December 31, 2011, with other matter regarding the identified areas that need improvement in the attainment of DFPC's operational, compliance, and financial reporting objectives, which were discussed in Part II-A.2 of this Report.

Financial Performance

The DFPC reported significant financial accomplishments that contributed largely to the tourism programs of the government, with details in Part II-A.1 of this Report.

1. DFPC registered significant increase in sales of P933,317,564 or ten percent from P8,939,698,391 in 2010 to P9,873,015,955 in 2011. This contributed largely to the increase in net operating income of P128,940,066 or 26 percent from P494,331,490 in 2010 to P623,271,556 in 2011.

2. With the increase in net income, the mandatory contributions of DFPC to DOT under RA 9593 also increased by P54,153,232 from P 244,460,910 in 2010 to P298,614,232 in 2011. Likewise the share of Tourism Promotion Board (TPB) for tourism promotion activities also increased by P37,907,325.

3. DFPC has also achieved the budgeted revenues and maintained the expenditures within the budget limits.

Audit Observations and Recommendations

Below is a summary of significant audit observations and recommendations with details discussed in Part II-A.2 of this Report:

1. The reconciliation of the physical count of Merchandise Inventory with the balances in Merchandise Monitoring System (MMS), and in the books did not fully establish the accuracy and completeness of the book balance of P185.269 million at year-end.

   We recommended that the Accounting Department and the System Operations and Administrative Department (SOAD):

   (a) Establish the accuracy of the MMS balances before using the same in the reconciliation with the physical count, and subsequently the physical count with the books.

   (b) Prepare the necessary adjustments in the MMS so that the Epicor cost balances will be correctly substantiated by balances in quantity and costs in the MMS.

   Management explained during the exit conference that the variance between the MMS balances used by the Accounting Department and those of the SOAD was caused by the timing difference. The Accounting Department computed the balances based on the freeze balances as of the date of the count (Jan. 4, 2012 in Manila and Jan 9, 2012 in Cebu) plus/minus work back data retrieved from MMS. On the other hand, SOAD data is the back up file as of Dec. 31, 2012, real time excluding the sales and inventory adjustments pertaining to 2011 transactions.

Responding to our recommendation, the Accounting Department and the SOAD immediately conducted further verification and validation of the variance in MMS balances used in the reconciliation, and submitted the results showing the reduced variances.

The Accounting Department also committed to verify and validate further the remaining variances.

2. Inadequate measures to address the Purchase Orders (POs) with partial and without reports of shipments/ deliveries on the importation of merchandise may bring about unauthorized use of the DFPC POs for duty-free importation of merchandise, and may result in loss of revenues to the government in terms of duties and taxes.

   We have recommended in 2010 Annual Audit Report that Management:

   (a) Incorporate in the MMS a routine to generate a report on status of POs with adequate information on the expected delivery date, actual delivery date and the amount and quantity delivered at any given time; *and*

   (b) Determine/analyze the causes of incomplete and undelivered POs, and immediately take appropriate action to ensure that all purchase orders for importation of merchandise are completely accounted for.

   Management submitted that there are reports, which are now in place that can be used for control and monitoring of open POs in the MMS. IAD further assured that said reports will be used accordingly in the monitoring functions of concerned departments. Moreover, the ITD together with the Merchandising Division, Warehouse Operations Division (WOD) and IAD will continually explore procedures to further improve the reporting systems and put in place the controls and monitoring of POs.

   We reiterated our recommendation that Management determine/analyze the causes of incomplete and undelivered POs, and immediately take appropriate action to ensure that all purchase orders for importation of merchandise are completely accounted for.

   We also recommended that Management continuously evaluate the effective implementation of the above reports in the MMS, and see to it that appropriate actions are immediately taken on the exception reports, particularly the Overdue PO Report so that the causes/reasons for the partial and no shipments of POs could be identified and addressed accordingly. Management should also consider conducting an investigation on these Open POs mentioned above, including those noted in 2009 and 2010.

3. Rental of Integrated Warehouse was not covered with perfected contract that could be disadvantageous to DFPC for the absence of binding terms and conditions on the use of the warehouse.

We recommended that Management:

(a) Expedite the on-going evaluation and review of the warehouse options; and

(b) Facilitate the documentation of the terms and conditions of the rental of warehouse determined to be most advantageous to DFPC by entering into lease contracts after the conduct of public bidding or negotiated procurement, guided by Government Procurement Policy Board (GPPB) Resolution 019-2007 dated 29 June 2007 adopting the Implementing Guidelines for Lease of Privately-Owned Real Estate (Annex F).

Management explained that:

- Notwithstanding the delay in the negotiation for the renewal of the contract of lease, management was able to negotiate the rental of the said premises on a month to month basis without any increase, thus, the payment was still based on the 2003 contract rate per square meters. In addition, DFGPC was able to negotiate also for the reduction of the rental cost which is equivalent to the cost of the unutilized area/space resulting to a cost savings in monthly rental of P458,325.72 effective in 2005.

- There is continuous negotiation with the GLY Development Corporation for further reduction of DFPC rental costs through the sustained rationalization of the utilization of the warehousing facilities. The result thereof translating into terms and concessions more advantageous to DFPC shall be incorporated in the subsequent documentation of the Lease Rental Agreement, which shall be facilitated with dispatch. The renewal of the contract for the lease of Integrated Warehouse is now under review of the DFPC Bids and Award Committee (BAC).

4. DFPC continued to incur significant amount of P32 million for the overtime services of BOC personnel during the year because of the payment of meals and transportation allowances of P14.917 million which under DBM Circular No. 10 was not allowed.

We have recommended in 2010 Annual Audit Report that DFPC implement the guidelines on payment of overtime services as set forth under DBM Budget Circular No. 10; implement its policy of charging the concessionaires of all costs pertaining to the delivery of the merchandise covered by the purchase order to the selling area; and establish a mechanism that would allow a reasonable allocation of overtime pay between DFPC and the concessionaires.

Management explained that DFPC did not implement our previous audit recommendations because of the following considerations:

a. The Chief of the Customs Duty Free Shops Division (CDFSD) took exception from the coverage of DBM Circular No. 10 and maintained that it is Customs Administrative Order (CAO) 3-87 and CAO 2-82 as amended by CAO 1-2005 which that should prevail based on the following reasons:

   - The nature of the duty and tax-free merchandising operation of DFPC requires close supervision and control by DFPC of the customs bonded warehouse. In order to efficiently and effectively perform this mandate, the CDFSD has to resort to overtime services because of the inadequacy of personnel;

   - CAO 3-87 provided that all expenses of the BOC in the supervision and control of the operations of the duty and tax-free bonded warehouse and sales outlets shall be paid by DFPC. These expenses include the overtime pay, meals and transportation allowances.

b. Charging the BOC overtime pay, meals and transportation allowances to the concessionaires will adversely affect the merchandising pricing scheme as the concessionaires will have no choice but to impute the same as added cost to the supplied merchandise, translating into higher selling price that is less competitive both in international and local market.

c. The DFPC and the CDFSD have agreed to reduce the overtime expenses though closer coordination of the offices for the proper scheduling of shipments traffic such that the opening of containers and unloading of merchandise are generally undertaken during regular officer hours. Also, the concessionaire/supplier shall be billed for overtime expenses when such concessionaire/supplier requests for overtime services to avoid losses/demurrage to which importation of DFPC may imminently exposed by his fault.

We recommended that Management:

(a) Refer to the Department of Budget and Management (DBM) the issue of exempting the payment of overtime pay, meals and transportation allowances to BOC personnel based on CAO 1-2005 from the DBM Budget Circular No. 10, for clarification and guidance.

(b) Revisit Section 6 of the DFPC's Operating Standards on the Supply and Delivery of Merchandise that provided that the "supplier shall shoulder all other costs pertaining to the delivery of the merchandise covered by the purchase order to the selling area".

(c) Sustain the joint efforts of DFPC and BOC to reduce the overtime expenses so that the potential savings could be utilized in other areas of operations of DFPC.

5. The DFPC continued to grant the existing salary rates, allowances and benefits, which were adopted by DFPC in its Table of Organization and Compensation Package, as a merchandising entity operating in a retail industry which was considered not comparable to the government sector, as the Governance Commission has not developed a Compensation and Position Classification System for GOCCs. Likewise, with the pending reorganization of the DFPC, the release of the capitalization from the national government was delayed.

   We recommended that Management continuously maintain close coordination and representation with the Governance Committee for GOCCs to facilitate the review of the DFPC's proposed Table of Organization and Organization Structure and Staffing Pattern and with the DBM for the release of the authorized capitalization for additional funds for operations.

6. Approval of foreign travels based on the DFPC Board Resolution delegating the authority to the COO did not conform to the requirements of Executive Order No. 459. On local travels, the reimbursement of actual expenses with inadequate control measures could result in excessive expenditures.

   We recommended that Management:

   (a) Comply with EO 459 and seek post approval of the foreign travels from the DOT Secretary. Management may initiate the revision of Resolution No. 01-4-27-11 dated 27 April 2011 relative to authority limits, particularly on the approval of foreign travels granted by the DFPC Board of Directors to the Chief Operating Office; and.

   (b) Enjoin compliance with the allowable travel expenses. In cases where the expenses exceeding the allowable rates are absolutely necessary as determined by the Chief Operating Officer, formulate guidelines that set the reasonable amounts for hotel/lodging, meals and incidental expenses, as well as the transportation to and from residence to airport, considering the circumstances and locations of travels.

   Management mentioned during the exit conference that DFPC has submitted a foreign travel plan for 2012 for approval of the Board of Directors, which is headed by the Secretary of the Department of Tourism as the Chairman.

   Also, to comply with the recommendation of COA and in order to avert excessive expenditures, Management shall direct the Management Information Services Department (MISD) to formulate guidelines that set the reasonable amounts for hotel/lodging, meals and incidental expenses as well as transportation expenses to and from residence to airport, considering the circumstances and locations of travel.

7. Reimbursable allowances of DFPC Officers for representation expenses were not supported with receipts and documents supporting payments.

   We recommended that Management require the submission of receipts and/or other documents that would support the disbursements for representation expenses.

   Management agreed with the recommendation.

8. DFPC conducted a number of Gender and Development (GAD)-related activities in CY 2011, which the corporation did not incur costs as these were conducted jointly with the different suppliers/sponsors.

Status of Implementation of Prior Year's Audit Recommendations

Of the twenty-two audit recommendations embodied in the CY 2010 Annual Audit Report, four were implemented, twelve were partially implemented, and six were not implemented. Details were presented in Part II-B of this Report.

COA Audit Team Composition

The DFPC was audited by Team 1 under Audit Group I – Trading and Promotion Group headed by **Ms. Cora D. Marquez,** State Auditor IV and OIC-Supervising Auditor. The Audit Team was composed of the following:

Name/Position	*Designation*
Cora D. Marquez, SA IV	Audit Team Leader
Marine P. Orbista, SA III	Audit Team Member
Roberto I. Angeles, SA II	Audit Team Member
Eupritis B. Miag-ao, SA II	Audit Team Member
Josefina P. Pinlac, SA II	Audit Team Member
Teodorica M. Ranan, SA II	Audit Team Member