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Internal Control and Audit Failure at Valeant Pharmaceuticals

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Abstract: This paper analyzes the audit failure and events leading up to the financial restatements at Valeant Pharmaceuticals. Valeant, a pharmaceutical firm headquartered in Laval, Quebec, trades on both the New York (NYSE) and Montreal Stock Exchanges under the ticker symbol VRX. Valeant was a high flying stock that rose about 1000% in a short span of five years. The firm grew primarily through acquisition, having acquired nearly 100 companies, including Bausch and Lomb — a leading manufacturer of contact lenses. In October 2015, shortly before the firm's third quarterly earnings announcement, Southern Investigative Research Foundation (SIRF) published an article about a federal lawsuit filed by R&O Pharmacy in California highlighting accounting irregularities. This paper examines the events leading up to the accounting irregularities and the internal control and audit failures at the firm. Valeant is currently under SEC investigation.

Key words: COSO; revenue recognition; auditor responsibility; tone at the top; internal control
JEL codes: M, K, A

1. Brief History of the Company

Valeant Pharmaceuticals is a multi-national pharmaceutical firm headquartered in Laval, Quebec. The company's common stock trades on both the New York (NYSE) and Montreal Stock Exchanges under the ticker symbol VRX. Valeant grew out of a U.S.-based drug company, ICN, and was renamed Valeant Pharmaceuticals in 2003 after a series of mergers. In 2010, Valeant and Biovail, a Canadian drug company merged, retaining the name Valeant and incorporating in Canada. At the time of the merger, Biovail was using offshore subsidiaries in Barbados and Luxembourg to pay as little tax as possible. Through this merger, Valeant acquired the lowest tax rate of any pharmaceutical company in the world — less than 5 percent (Farrell, 2015). The merged company grew aggressively through acquisitions, and in 2013, it acquired Bausch and Lomb, a leading manufacturer of contact lenses.

On February 22, 2015, Valeant Pharmaceuticals offered $158 per share for every share of Salix Pharmaceuticals to acquire Salix' robust pipeline of gastrointestinal drugs including Xifan, Uceris and Apriso, in a deal ultimately valued at $11.1 billion. In acquiring Salix, Valeant continued its aggressive growth strategy by purchasing companies with established drugs and moving quickly to reduce costs, thus avoiding the risks of product development and launch[1]. In March 2015, Valeant floated a secondary offering, successfully selling 7,286,432 shares at $199 per share to raise $1.45 billion to help finance the Salix acquisition. Pershing Square

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[1] http://www.wsj.com/articles/valeant-raises-salix-offer-price-1426507294.

Capital LLP, a U.S. hedge fund, bought three million shares of the offering raising its stake in Valeant to above 5%. In March 2015, Valeant was ranked #2 (or a "Buy") by Zacks Investment Research[2]. On March 16, 2015 Valeant traded for $202.45, and by August 6, 2015 VRX stock traded for as much as $263. 81 per share.

One of the strategies Valeant used to fuel the growth of its stock price was to buy companies with successful drugs and aggressively increase drug prices following the acquisition. In early 2016, the U.S. Congress investigated a sharp increase in drug prices by several companies including Valeant. Documents released by the Congressional committee reported that aggressive price increases of drugs the company "did not invent" was a key component of Valeant's business model. Two examples often cited include the heart drugs, Nitropress and Isuprel, that the company allegedly acquired with the intention of increasing the price. Ultimately, Valeant tripled the price of Nitropress and increased the price of Isuprel by more than 500% percent. The Pharmaceutical Research and Manufacturers of America, the trade group representing the drug industry, distanced itself from Valeant, saying its strategies more closely resembled a hedge fund than a pharmaceutical company."[3] The New York Times reported in 2015, "Valeant raised prices on its brand name drugs an average of 66% and about five times as much as its closest industry peers."[4] The table below shows price increases for some drugs acquired by Valeant.

Table 1 Valeant Product Price Changes after Drug Acquisition

Name of Drug	2013 Price before acquisition by Valeant	2015 Price after acquisition by Valeant
Edecrin per vial	$460	$4600
Glumetza, Ninety1000 mg tablets	$896	$10,020
Syprine, Hundred 250 mg capsule	$1395	$21,267
Cuprimine, Hundred 250 mg capsule	$888	$26,189
Meyphyton per tablet	$9.37	$58.76
Isuprel, Twenty five 0.2 ml ampule	$4489	$36,811

Source: *New York Times*

2. Control/Audit Issues

In October 2015, Andrew Left drew attention to Valeant's connection to a specialty drug retailer, Philidor RX, drawing parallels between Valeant Pharmaceutical and Enron. Left made reference to Boyd (2015) wherein Boyd uncovered the true nature of Valeant's relationship with Philidor RX. Created in June 2013, Valeant is Philidor RX's only client. Philidorfills, ships and obtains insurance approvals for prescriptions for complex drugs made by Valeant. Valeant CEO Mike Pearson acknowledged in a July 2015 conference call that 40% of its business flowed through specialty pharmacies (like Philidor RX). "Specialty pharmacies are exempt from reporting the drugs they sell to IMS Health, the tracking service used by companies and analysts to monitor drug sales and inventory channels" (Boyd, 2015). Philidor was effectively owned by Valeant but as Boyd (2015) reports Philidor went "to great lengths to conceal its ownership [and] ….and not every state looked kindly upon the way Philidor went about securing out-of-state pharmacy operation privileges." (Boyd, 2015). In a striking similarity to how Enron named its Special Purpose Entities — those used to hide its fraudulent accounting —

2 https://www.zacks.com/stock/news/168185/valeant-vrx-prices-shares-to-finance-salix-acquisition.
3 http://www.chicagotribune.com/business/ct-congress-drug-price-hike-turing-valeant-20160202-story.html.
4 http://www.nytimes.com/2015/10/05/business/valeants-drug-price-strategy-enriches-it-but-infuriates-patients-and-lawmakers.html?_r=0.

Raptors 1-1V which were named after the velociraptors in Jurassic Park, all of Valeant's captive firms (KGA fulfilment, B6Q Media, Philidor and Isolani) have names related to the game of chess. It appears that in states where Philidor was denied a non-residency permit to compound pharmacy sales, it created a controlled entity to buy a local pharmacy and sought transfer of the local pharmacy license to the controlled entity. To get approval for a prescription with an insurance company "that Philidor did not have a relationship" the company would use the local pharmacy's NPI (National Provider Identifier) code. Litigation documents from one such captive pharmacy (R & O Pharmacy) and Philidor revealed that during the process of obtaining these captive pharmacies, Philidor employees provided "inaccurate answers and false statements of fact … in a bizarre attempt to circumvent California regulations. Philidor's use of these captive pharmacies was a vital revenue stream for Valeant" Boyd (2015) noted that research showed that as many as 23,000 prescriptions were processed by Philidor weekly via its network of captive pharmacies to get out-of-state insurers to reimburse prescriptions for Valeant's high priced drugs. In the second quarter of 2015 Valeant reported sales of $2.73 billion vs sales of $2.04 billion in the previous quarter. Of the $0.69 billion increase in sales, $0.39 billion came from acquisitions and the rest was described as "organic revenue". Two captive pharmacies in California, West Wilshire and R&O accounted for as much as 40% of the organic revenue per Boyd's (2015) investigation.

Following the questions in its October earnings call, Valeant management formed an ad hoc board committee to look into the firm's relationship with specialty pharmacy retailer Philidor and the alleged accounting irregularities. Following the board investigation, the firm acknowledged that it had "one or more 'material weaknesses' in its internal controls — flaws in its policies or procedures that would have made it harder to prevent errors on its financial statements." Management also acknowledged that the "tone at the top" of the company, and its practice of expecting its executives to hit challenging financial targets, "may have been contributing factors in the company's improper revenue recognition" (Rappaport, 2016). The firm acknowledged that it would have to "restate past earnings because it should have waited to recognize $58 million in revenue through Philidor", which it said it incorrectly recorded when delivered to Philidor rather than when Philidor dispensed it to customers. Much of that amount should have been booked in 2015 rather than 2014. Furthermore "when Valeant consolidated Philidor in December 2014, the pharmacy was still holding inventory for which Valeant had already recognized the revenue, under the old delivery-to-Philidor method. After the consolidation, Philidor itself recognized revenue from that inventory when the products were dispensed to patients, and that revenue was consolidated into Valeant's" financial statements so some revenue was double counted (Rappaport, 2016).

3. Affected Shareholders

Valeant shares peaked in August 2015 at $259.98 per share. As questions were raised about the legitimacy of the company's internal controls and accounting practices, the firm has lost $72.5 billion in market value. On June 21, 2016 the stock traded for a mere $21.64 per share — less than 10% of its peak value. Robbins Geller Rudman & Fown LLP announced a shareholder lawsuit against Valeant seeking class action status on behalf of buyers of Valeant common stock between February 23 and October 20, 2015. "Allegations in the complaint are centered around Valeant's utilization of a network of specialty mail-order pharmacies to prop up sales of its high-priced drugs to prevent patients and insurance companies from switching to less costly generic alternatives. The complaint questions the nature of the relationship between Valeant and these specialty pharmacies, the use of which was never before disclosed by Valeant management."[5]

The Sequoia Fund, highly ranked by Morningstar, was another of Valeant's major institutional investors. Sequoia lost $1 billion on its Valeant investment. Following the loss, the Fund was downgraded by Morningstar and lost its gold rating. Given that Morningstar ratings are widely followed by investors and investment advisors, the downgrade will certainly impact the Sequoia Fund's ability to attract investors going forward.

Pershing Square Capital, LLC held a 9% stake in Valeant. Pershing Square Holdings Limited is the publicly traded stock of the Pershing Square Hedge fund. Bloomberg reported "Standard & Poor's on March 17 warned it may cut Pershing Square Holdings' BBB credit rating to near junk-bond status, putting the company on watch for a potential downgrade" (Bloomberg, 2016). Valeant sold over seven million shares at $199 per share, and raised an additional $14.5 billion through debt to partially fund its acquisition of Salix Pharmaceuticals in the first half of 2015. Laughlin (2016) reports that 753 funds with over 103 portfolio managers own Valeant debt. Creditors invested in Valeant debt relying on fraudulent financial statements. At the time the debt was issued, Valeant stock traded above $200 and the firm had a high credit rating. In October 2016, Valeant stock traded close to $21 per share and the firm had $30 billion of debt on its balance sheet. This severely and adversely impacted its credit rating and hurt the creditors who were also stakeholders in the firm.

4. Ultimate Resolution

On April 29, 2016 Valeant filed its much delayed 10K annual report for the year ended December 31, 2015 to avoid triggering a default provision with its creditors. The Company also "restated certain unaudited quarterly results related to the three months ended December 31, 2014, the three months ended March 31, 2015, the six months ended June 30, 2015 and the nine months ended September 30, 2015, and revised certain unaudited results for the three months and nine months ended September 30, 2014." The firm "identified misstatements that would reduce previously-reported fiscal year 2014 revenue by approximately $58 million, net income attributable to Valeant by approximately $33 million, and basic and diluted earnings per share by $0.09. A substantial part of the earnings impact of these misstatements reverses in the first quarter of 2015 because revenues that were incorrectly booked in December 2014 would be accounted for in the first quarter of 2015. The Company has also identified misstatements in the first quarter of 2015, consisting primarily of the reversing effect on earnings of the 2014 misstatements, which would reduce revenue by approximately $21 million (due to timing of recognition of managed care rebates), increased net income attributable to Valeant by approximately $24 million and increase basic and diluted earnings per share by $0.07." (Source: Valeant Investor Relations).

5. Analysis of Auditors Role

As a publicly traded company, Valeant is subject to SEC regulation and the provisions of the Sarbanes-Oxley Act. Valeant's external auditor, was responsible for providing opinions on the effectiveness of internal controls. Valeant has admitted to the existence of material weakness and that its disclosure controls and procedures were inadequate. It is apparent that the auditors missed this in their 2013 and 2014 audits. Johnstone Gramling and Rittenberg (2014) write "Effective capital markets require quality financial reporting (p. 6) the overall objective of an audit is to obtain reasonable assurance about whether the financial statements are free from material

[5] http://www.classactionreporter.com.

misstatement (p. 7).” The Financial Reporting Council (FRC) of the UK and the AICPA require the audit engagement team to exhibit professional skepticism during the audit. Boyle and Carpenter (2015) discuss the importance of demonstrating professional skepticism. Investors rely on auditors to identify and report errors, misstatements and fraud by management and controlling shareholders (Newman, Patterson & Smith, 2005). In the relationship between Valeant and Philidor, all three elements of the Fraud Triangle (Murdoch, 2008) appear to have been present. Murphy and Dacin (2011) develop a framework that identifies three psychological pathways to fraud, supported by multiple theories relating to moral intuition and disengagement, rationalization, and the role played by negative effect. Although good leadership can go a long way toward preventing fraud (Bryan, 2012; Gartland, 2015), that did not happen here. It appears that Valeant went to great lengths to avoid disclosing that it effectively owned Philidor before it decided to consolidate Philidor’s financial statements with its own. The nature of Philidor’s ownership, and the fact that Valeant was its only major customer was concealed from auditors, and not sufficiently questioned by auditors who appear to have shown insufficient professional skepticism. Valeant’s rationalization for the fraud is that it helped the firm show higher “organic growth” which helped boost Valeant’s stock price. The higher the stock price of Valeant rose, the more the firm was able to borrow via credit markets to fund its acquisition spree. The more firms Valeant acquired, the more drugs it had under its control. This allowed the company to sharply raise prices to collect higher reimbursements from insurance companies via its Philidor related activities.

Perhaps the biggest audit failure in Valeant comes in Phase II — performance of risk assessment. The auditors appear to have misjudged both inherent and control risk. Auditing Standard #12 addresses the responsibility of the auditor to understand the company and its environment; the nature of the company; and key supplier and customer relationships. As part of obtaining an understanding of the company as required by Paragraph 7, the auditor should consider performing the following procedures as well as the extent to which the procedures should be performed:

- Reading public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and, in an integrated audit, the effectiveness of the company’s internal control over financial reporting, e.g., company-issued press releases, company-prepared presentation materials for analysts or investor groups, and analyst reports;
- Observing or reading transcripts of earnings calls and, to the extent publicly available, other meetings with investors or rating agencies;[6] It appears the engagement team lacked professional skepticism and failed to perform risk assessment procedures to properly assess inherent and control risk that resulted in material misstatement of financial reporting. It also appears that the engagement team did not properly gauge the “tone at the top” (Patelli & Pedrini, 2015; Shafer, 2015).

There also appears to be failure in Phase III of the audit process — obtaining evidence about internal control operating effectiveness. Auditing Standard #5 requires the external auditor to “perform an audit of management’s assessment of the effectiveness of internal control over financial reporting”.[7] With management belatedly admitting failure of effective internal controls it is clear that external audits in 2013 and 2014 failed to meet auditing standard #5.

Failure is also apparent in Phase IV of the audit related to “obtaining substantive evidence about accounts,

[6] https://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_12.aspx.
[7] https://pcaobus.org/Standards/Auditing/pages/auditing_standard_5.aspx.

disclosures and assertions". If the engagement team had been more vigilant they could have asked more questions about Philidor and R&O Pharmacy as SIRF and Citron Research did.

6. Identification and Discussion of Internal Controls Circumvented & Auditing Standards Not Followed

Not much is known about Valeant's internal audit department. Given the company's size, a department staffed with several auditors with expertise in various aspects of internal audit would be required to ensure compliance with Sarbanes Oxley.

Valeant states on its website that:

> "Valeant has established and oversees an effective and comprehensive compliance program in accordance with federal, state, and industry guidelines including the "Compliance Program Guidance for Pharmaceutical Manufacturers", published by the Office of the Inspector General (OIG), U.S. Department of Health and Human Services and the Pharmaceutical Research and Manufacturers of America's (PhRMA) "Code of Interactions with Healthcare Professionals".
>
> There has been a significant amount of effort that has been dedicated to implementing a comprehensive compliance program at Valeant including checks and balances to prevent and detect violations of law or Company policy.

Key elements of the Valeant Compliance Program include:

- The Appointment of a Chief Compliance Officer.
- A fully functioning Risk and Compliance Committee of Valeant's Board of Directors.
- A Code of Conduct that promotes the highest ethical standards and behaviors for business practices.
- A Code of Professional Conduct for Senior Finance Executives to ensure the highest ethical standards in the area of financial management.
- Extensive policies and procedures contained in the Healthcare Compliance Manual.
- A variety of training and educational activities offered through many mediums.
- Targeted auditing and monitoring of business activities.
- Anonymous reporting along with other communication mechanisms to raise compliance concerns.
- Well-publicized disciplinary guidelines.

A Google search revealed that on June 23, 2016, Valeant listed Seanna Carson as its Chief Compliance officer. In June 2016 on Linkedin, Seanna Carson self-identified as, SVP, Chief Compliance Officer at Valeant Pharmaceuticals International, Inc. York, Ontario, Canada. Yet a simple Google Image search for the question "Who is Tanya Carro?" produced the same image as that of Seanna Carson on Linkedin. Per media reports Tanya Carro is the former controller of Valeant accused by Valeant of the financial misrepresentation and who has since been put on administrative leave. Tanya Carro however was listed on Linkedin in June 2016 (with no photo) as Vice President of Financial Planning and Analysis for Biovail Corporation (a firm acquired by Valeant), from February 2009 to present.[8] This is something that should have been discovered and questioned by even the least professionally skeptical external auditor.

This preliminary analysis of Valeant suggests that adequate internal controls may have existed only on paper — not in reality. Valeant's website is highly opaque on the matter of internal audit. It also appears that the firm was not in compliance with internal audit standards of the Commission of Sponsoring Organizations of the Treadway Committee (COSO). At a minimum, the COSO standards that appear to be violated include:

[8] https://www.linkedin.com/in/tanya-carro-9846303.

(1) Commitment to Integrity and Ethical Values (COSO Principle 1)

(2) Board of Directors Exercises Oversight Responsibility (COSO Principle 2)

(3) Organization Enforces Accountability (COSO Principle 5)

(4) Management Identifies and Analyzes Risk (COSO Principle 7)

(5) Management Assesses Fraud Risk (COSO Principle 8)

(6) Management Identifies and Analyzes Significant Change (COSO Principle 9), when Philidor was formed in 2013 it clearly represented a significant change in internal conditions for Valeant.

(7) Management Selects and Develops Control Activities (COSO Principle 10).

(8) Very little is known about the type of internal control technology that Valeant implemented if at all so it is unclear if the firm was in compliance with COSO Principle 11 — Management Selects and Develops Controls over Technology.

(9) Management Uses Relevant Information (COSO Principle 13).

(10) Clear Internal Communication that internal control responsibilities need to be taken seriously (COSO Principle 14).

(11) Management communicates externally — where a vendor can communicate directly with the internal audit department or other party if the vendor finds any inappropriate action (COSO Principle 15). If this had existed, the R&O Pharmacy lawsuit may have been avoided.

(12) Conducts Ongoing and Separate Evaluations (COSO Principle 16).

(13) Evaluates and Communicates Deficiencies (COSO Principle 17) — this was done only after the internal investigation forced on Valeant by the accusations by SIRF and Citron Research.

“The Sarbanes Oxley Act of 2002 requires public company management to annually report on the design and operating effectiveness of the organization’s controls. The U.S. Securities and Exchange Commission (SEC) has provided guidelines to assist management in this evaluation of the effectiveness of internal controls over financial reporting.” (Johnstone, Gramling & Rittenberg, 2014, p. 91). In October 2016, Valent still faced an SEC investigation.

“The SEC has requested information about Valeant’s now-terminated relationship with drug distributor Philidor Rx Services LLC, and Valeant has submitted emails, financial documents and other data to comply with the request, according to a person familiar with the matter. In addition, said people familiar with the matter, a finance executive, Tanya Carro, left in the wake of an internal review that found Valeant had booked some revenues from Philidor too early in 2014. One person said she was on paid administrative leave. In October, Ms. Carro was one of several Valeant executives who addressed Valeant’s relationship with Philidor on a conference call with analysts. There was no reply to a request for comment made via LinkedIn or one left at a residence believed to be hers on an answering machine with a message that used her last name.” (McNish & Rappaport, 2016).

Valeant is laying the blame for its accounting irregularities and failure or lack of internal controls at the door of two of its executives — former CFO Howard Schiller and former controller Tanya Carro. Mr. Schiller served as interim CEO during the time that former CEO Mike Pearson was hospitalized. Ms. Carro was reportedly placed on administrative leave and Schiller was asked to step down from the board. Schiller, however, denies any wrongdoing. It has been suggested that Valeant is being strategic by singling out these employees to defend the firm from government action because “According to guidelines first laid out in a 2001 SEC report known commonly as the Seaboard Report, companies can be credited for their efforts to discipline wrongdoers and self-report problems." (Reuters, 2016).

7. Conclusion

The Valeant saga underscores the importance of "*Tone at the Top*", ethical leadership, necessary compliance with COSO Principles, and sound and effective internal control at the firm level to avoid accounting irregularities. The case also highlights the importance of professional skepticism by auditors and the importance of carefully assessing the nature of the company and the inherent and control risks in the audit.

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