



## ORDER

### III.

On the basis of Respondent's Offer and information obtained by the Board in this matter, the Board finds<sup>1/</sup> that:

#### A. Respondent

1. Deloitte is a public accounting firm organized as a limited liability partnership under the laws of the State of Delaware and headquartered in New York City. Respondent has offices in multiple locations, including San Diego, California, and is licensed by, among others, the California Board of Accountancy (license no. 6515). Respondent is registered with the Board under Section 102 of the Act and PCAOB Rules. Its public company audit practice includes over 800 audit partners and more than 8,000 other audit professionals.

#### B. Summary

2. This matter concerns Deloitte's violations of certain PCAOB rules and auditing standards in auditing the financial statements of Ligand Pharmaceuticals Incorporated ("Ligand" or "the Company") for 2003 and the improper issuance by Deloitte of a standard report expressing the opinion that these financial statements presented fairly, in all material respects, Ligand's financial position in conformity with U.S. generally accepted accounting principles ("GAAP"). Deloitte assigned final responsibility for its Ligand audit engagements to the same partner (the "Engagement Partner") beginning with its review for the third quarter of 2000 through its review for the first quarter of 2004. Beginning in the summer of 2003 and continuing into 2004, certain members of Deloitte's management became aware of facts and circumstances that raised serious questions about the Engagement Partner's competence and proficiency as an auditor. Various Deloitte partners, including partners at the practice office level, at the regional management level, at Deloitte's national office and within its quality assurance group each were aware of certain of these facts and circumstances before Deloitte issued its report on Ligand's financial statements for 2003. During this period, Deloitte determined that the Engagement Partner should not be assigned to public company audit engagements and that he should resign from the firm. Despite these determinations and, as discussed below, the assessment that the 2003 Ligand audit

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<sup>1/</sup> The findings herein are made pursuant to the Respondent's Offer and are not binding on any other person or entity in this or any other proceeding.



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presented "greater than normal" risk, Deloitte left the Engagement Partner in charge of the engagement without taking appropriate and timely steps under the circumstances to assure that the audit was performed in accordance with applicable PCAOB rules and professional standards.

3. As discussed in more detail below, Deloitte failed to exercise due professional care in the performance of the audit and failed to obtain sufficient competent evidential matter to support the opinion expressed in the audit report. Deloitte failed to perform appropriate and adequate audit procedures related to the revenue reported by Ligand for sales of products for which a right of return existed. Deloitte failed to perform procedures that adequately took into account the existence of various factors documented in the audit work papers that indicated Ligand's ability to make reasonable estimates of product returns may have been impaired. These factors included Ligand's limited historical return experience, Ligand's limited visibility into its distribution channels, and periodic significant increases in, or excess levels of product in, Ligand's distribution channels. Moreover, in evaluating the reasonableness of Ligand's estimates of future returns, Deloitte failed to perform procedures that adequately took into account the extent to which the audit evidence indicated Ligand had consistently and substantially underestimated its product returns. Deloitte failed to perform or failed to perform adequately certain relevant planned procedures that were required by PCAOB auditing standards and incorporated into Deloitte's written audit plan. Deloitte also failed to identify and appropriately address a material departure from GAAP resulting from Ligand's policy of excluding certain types of returns from its estimates of future returns and the omission from Ligand's financial statements of any disclosure of this accounting policy.<sup>2/</sup>

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<sup>2/</sup> More than a year after the 2003 Ligand audit, Ligand announced that it would restate its financial statements for 2003 and other periods because its recognition of revenue from product sales upon shipment was not in accordance with GAAP. See Ligand's Form 8-K, filed May 20, 2005, at Exhibit 99.1. In restating for 2003, Ligand recognized approximately \$59 million less in revenues from product sales than originally recognized in that year (a decrease of approximately 52 percent), and reported a net loss more than 2.5 times the net loss originally reported. See Ligand's Form 10-K for the year ending December 31, 2004, filed November 18, 2005, which reflects adjustments for earlier periods. At the same time, Ligand restated the revenues and net loss reported in its 2002 financial statements, which Deloitte had also audited, and in quarterly reports in 2003 and 2004, which Deloitte had reviewed.



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### C. Deloitte Failed to Comply With Certain PCAOB Auditing Standards

4. Ligand is a corporation organized under the laws of the State of Delaware with headquarters in San Diego. Its common stock is registered with the Securities and Exchange Commission ("Commission") under Section 12(b) of the Securities Exchange Act of 1934 and is listed on the NASDAQ Stock Market LLC. Ligand's public filings disclose that, at all times relevant to this matter, it was in the business of discovering, developing, and marketing pharmaceutical drugs. At all relevant times, Ligand was an issuer, as that term is defined by Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii). As of June 30, 2004, the end of the last reporting period for which Deloitte served as its auditor, Ligand disclosed that its market capitalization was approximately \$1.27 billion.

5. Deloitte was Ligand's independent auditor from October 31, 2000, until its resignation effective August 5, 2004. In an audit report dated March 10, 2004, Deloitte expressed an unqualified opinion on Ligand's consolidated balance sheets as of December 31, 2003 and 2002, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2003. Deloitte's audit report stated that, in the firm's opinion, the Company's financial statements presented fairly, in all material respects, the Company's financial position in conformity with GAAP.

6. Deloitte's audit engagements for Ligand were performed by personnel located in its San Diego office. Deloitte's audit personnel included the Engagement Partner, a concurring review partner, an advisory partner, an audit manager, an audit senior and other staff auditors, each of whom was an associated person of a registered public accounting firm as that term is defined in Section 2(a)(9) of the Act and PCAOB Rule 1001(p)(i) at all relevant times. Deloitte's San Diego office audit practice was under the supervision of a Managing Partner for Audit and Enterprise Risk Services (the "San Diego Audit Managing Partner"), who reported to the Regional Managing Partner for Audit and Enterprise Risk Services for Deloitte's Pacific Southwest Region ("Regional Audit Managing Partner"), located in Los Angeles, California, and who in turn reported to the National Managing Partner of Audit and Enterprise Risk Services ("National Audit Managing Partner"), located in New York City. In addition, Deloitte's Professional Practice Director for its San Diego office ("San Diego Office PPD") was responsible for concurring in the assignment of engagement partners and for monitoring compliance with Deloitte's audit policies and procedures.

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### Deloitte Failed to Staff the 2003 Ligand Audit Engagement Appropriately

7. PCAOB rules require that registered public accounting firms and their associated persons comply with the Board's auditing and related professional practice standards.<sup>3/</sup> Among other things, PCAOB auditing standards require that auditors "be assigned to tasks and supervised commensurate with their level of knowledge, skill and ability so that they can evaluate the audit evidence they are examining."<sup>4/</sup> The auditor with final responsibility for the audit should know, at a minimum, the relevant professional accounting and auditing standards and should be knowledgeable about the client.<sup>5/</sup> Deloitte failed to staff the 2003 Ligand audit engagement in accordance with these requirements.

8. Deloitte assigned responsibility for the conduct of all audit professional services for each of its audits and reviews for Ligand through the quarter ended March 31, 2004, to the Engagement Partner, whom Deloitte designated as its "Lead Client Service Partner," or "Engagement Partner." The responsibilities Deloitte assigned to the Engagement Partner in this role were set forth in Deloitte's Accounting and Auditing Practice Manual Series (the "AAPMS") which stated, among other things, that:

It is the responsibility of the Engagement Partner to form the audit opinion, or to disclaim an opinion, on the financial statements. The Firm delegates to the Engagement Partner the necessary authority to fulfill that role....

The Engagement Partner has the final responsibility for the planning and performance of the audit engagement, including the assignment, on-the-job training, and audit work of professional staff, and the implementation of decisions concerning matters that have been the subject of consultation....

The knowledge and skills of an Engagement Partner should be matched with the needs and characteristics of the engagement.

The Engagement Partner led Deloitte's audit engagement team, had final responsibility for the audit as that phrase is used in AU § 311, *Planning and Supervision*, and authorized the issuance of the March 10, 2004, audit report.

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<sup>3/</sup> See PCAOB Rules 3100, 3200T.

<sup>4/</sup> AU § 230.06, *Due Professional Care in the Performance of Work*.

<sup>5/</sup> Id.



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9. Deloitte's policies and procedures further provided that, particularly where audit engagement risk is assessed as greater than normal, the firm needed to ensure that the partners assigned to the audit engagement possessed the requisite skills and experience. Deloitte assessed the engagement risk for its 2002 and 2003 Ligand audit engagements as greater than normal.

10. Months before Deloitte issued its audit report for the 2003 Ligand audit engagement, certain members of Deloitte's management became aware of facts and circumstances that began to raise serious questions about the Engagement Partner's competence and proficiency as an auditor. These developments led certain members of Deloitte's management first to conclude that the Engagement Partner should be removed from public company audit engagements and ultimately to seek the Engagement Partner's resignation from the firm.

11. During the summer of 2003, Deloitte conducted an internal practice office review that included its San Diego practice office and selected one of the Engagement Partner's public company audits for review ("Engagement A"). Deloitte's personnel who conducted this review were critical of the Engagement Partner's work and relayed their concerns to the San Diego Office PPD, the Regional Audit Managing Partner and Deloitte's national office. Also in the summer of 2003, another of Deloitte's issuer audit clients that was assigned to the Engagement Partner ("Engagement B") was placed into Deloitte's Risk Management Program, which was administered by Deloitte's National Office Quality Assurance Group in Wilton, Connecticut.

12. By the fall of 2003, certain members of Deloitte's management were suggesting that the Engagement Partner be removed from his public company audit engagements. In a meeting in or around October 2003, the San Diego Audit Managing Partner informed the Engagement Partner of the concerns about his work. Nevertheless, Deloitte allowed the Engagement Partner to remain in charge of the Ligand engagement until May 2004, without any significant additional supervision or resources.

13. In February 2004, a partner responsible for Deloitte's risk management program (the "Risk Management Partner") communicated certain concerns about the Engagement Partner's work on Engagement B directly to the Regional Audit Managing Partner. Shortly after this communication, the Regional Audit Managing Partner reported the Risk Management Partner's concerns to the National Audit Managing Partner. The Regional Audit Managing Partner also communicated these concerns to the San Diego Audit Managing Partner, who in turn informed the Engagement Partner



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that he was perceived as a quality risk and counseled the Engagement Partner to resign from the firm.

14. On March 5, 2004, the San Diego Audit Managing Partner and the Regional Audit Managing Partner met with the Engagement Partner. The Regional Audit Managing Partner drafted an e-mail message to the National Audit Managing Partner summarizing the discussion at the meeting and efforts underway to counsel the Engagement Partner to resign from the firm and the reasons for doing so. Among the reasons given were the views of certain members of Deloitte's management that the Engagement Partner did not have the skills to adequately supervise public company engagements and other engagements with above-average risk profiles, and that the Engagement Partner was not suited to handling complex or risky engagements. The Regional Audit Managing Partner recommended that the National Audit Managing Partner consider an arrangement under which the firm would immediately begin to transition the Engagement Partner's clients and the Engagement Partner would resign from the firm.

15. PCAOB quality control standards emphasize the "significant responsibilities" of individuals who are responsible for supervising audit engagements and signing or authorizing the issuance of audit reports.<sup>6/</sup> PCAOB quality control standards further require firms to establish policies and procedures that "provide reasonable assurance that a practitioner-in-charge of an engagement possesses the competencies necessary to fulfill his or her engagement responsibilities."<sup>7/</sup> Deloitte's

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<sup>6/</sup> QC § 40.03, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement* (in light of such "significant responsibilities," firm's policies and procedures "should be designed to provide a firm with reasonable assurance that such individuals possess the kinds of competencies that are appropriate given the circumstances of individual client engagements"); see also QC § 40.08 ("such skills would typically include the ability to exercise professional skepticism and identify areas requiring special consideration including, for example, the evaluation of the reasonableness of estimates and representations made by management and the determination of the kind of report necessary in the circumstances.")

<sup>7/</sup> QC § 40.06; see also QC § 20.13, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (policies and procedures should provide "reasonable assurance that . . . [w]ork is assigned to personnel having the degree of technical training and proficiency required in the circumstances.")

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quality control system did not function effectively to cause the 2003 Ligand audit to be appropriately staffed and led by a practitioner-in-charge with the necessary competencies. As a result, despite the conclusions reached by Deloitte's management personnel about the Engagement Partner's competence and proficiency as an auditor, Deloitte left the Engagement Partner in charge of the 2003 Ligand audit without taking appropriate steps to assure that the audit was performed in accordance with applicable PCAOB rules and professional standards.<sup>8/</sup>

### Deloitte Failed to Comply With PCAOB Auditing Standards in Performing the Audit of Ligand's Financial Statements for 2003

16. Under PCAOB auditing standards, an auditor may express an unqualified opinion on an issuer's financial statements only when the auditor has formed such an opinion on the basis of an audit performed in accordance with PCAOB standards.<sup>9/</sup> Among other things, these standards require that an auditor exercise due professional care, exercise professional skepticism, obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements and evaluate subsequent events.<sup>10/</sup> Deloitte failed to comply with these standards in connection with the 2003 Ligand audit.<sup>11/</sup>

17. Ligand's public filings disclosed that, at times relevant to this matter, the Company sold most of its products to three large wholesalers, who in turn sold the

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<sup>8/</sup> Deloitte performed a concurring partner review of the 2003 Ligand audit. But this concurring partner review was not sufficient under the circumstances to provide the firm with reasonable assurance that its personnel complied with PCAOB standards.

<sup>9/</sup> See AU § 508.07, *Reports on Audited Financial Statements*.

<sup>10/</sup> See AU § 150.02, *Generally Accepted Auditing Standards*; AU § 230, *Due Professional Care in the Performance of Work*; AU § 326, *Evidential Matter*; AU § 560, *Subsequent Events*; AU § 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

<sup>11/</sup> See *In the Matter of James L. Fazio, CPA*, PCAOB Release No. 105-2007-006 (December 10, 2007) for related findings concerning failures to comply with PCAOB standards in connection with the 2003 Ligand audit.

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product to their customers, including retail outlets such as pharmacies and prescribing facilities such as hospitals. In its 2003 financial statements, Ligand disclosed that it recognized revenue upon product delivery, net of allowances for, among other things, product returns. To evaluate whether Ligand's recognition of revenue upon product delivery complied with GAAP, Deloitte was required to assess, among other things, whether Ligand had the ability to make reasonable estimates of future product returns. Without this ability, companies that sell products with a right of return cannot, consistent with GAAP, recognize revenue from these sales until the right of return substantially expires or a reasonable estimate of the returns can be made.<sup>12/</sup>

18. As documented in the audit work papers, Deloitte assessed the engagement risk for the 2003 Ligand audit as greater than normal "due to events related to product sales and sales returns."<sup>13/</sup> Deloitte's audit personnel planned to perform "focused procedures" and to increase their professional skepticism to address this risk. As described below, Deloitte's audit personnel either failed to perform certain of the planned procedures or performed them without the due care and professional skepticism required by PCAOB standards.

19. Various factors, such as the newness of a product, lack of actual return history, limited visibility into distribution channels, and significant increases in or excess levels of inventory in a distribution channel, may impair an issuer's ability to make reasonable estimates of future product returns.<sup>14/</sup> In Ligand's case, Deloitte's audit personnel documented the existence of each of these factors but did not adequately analyze whether they impaired Ligand's ability to make reasonable estimates of returns.

20. In addition, Deloitte's audit personnel failed adequately to evaluate the reasonableness of Ligand's product return estimates.<sup>15/</sup> Certain procedures planned to

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<sup>12/</sup> See Statement of Financial Accounting Standards ("SFAS") No. 48, *Revenue Recognition When Right of Return Exists* ¶ 6; Codification of SEC Staff Accounting Bulletins ("SAB"), Topic 13.A.4(b), Question 5.

<sup>13/</sup> Deloitte's written policies and procedures required engagement risk to be assessed annually as "Normal," "Greater than normal," or "Much greater than normal."

<sup>14/</sup> See SFAS No. 48 at ¶ 8; SAB Topic 13.A.4(b) Question 1, 4.

<sup>15/</sup> See AU § 342.04, *Auditing Accounting Estimates*.



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evaluate the reasonableness of Ligand's estimates of future returns were not performed, were not performed with the due care and professional skepticism required by PCAOB standards, or generated audit evidence suggesting that Ligand's estimates of future returns were not reasonable. Deloitte's audit personnel did not adequately address the significant disparities between historical actual returns and Ligand's estimate of future returns. They also failed to compare Ligand's prior return estimates with subsequent results,<sup>16/</sup> even though this procedure was part of the audit plan and the audit work papers showed that Ligand had consistently and substantially underestimated its product returns. The audit plan provided for the evaluation of subsequent events to be performed before the audit report was issued. But the evaluation performed by Deloitte's audit personnel failed adequately to consider returns through completion of the audit.<sup>17/</sup>

21. According to the audit work papers, when Ligand learned in 2002 that one of its wholesalers was holding product nearing expiration and intended to make substantial returns, Ligand agreed to replace the returned product with new product at no additional charge. The work papers reflect that similar incidents occurred during 2003 and that Ligand's position was that it would replace product held by wholesalers that was approaching expiration with new product having a later expiration date (Ligand's "Replacement Policy"). According to the work papers, returns from such transactions during 2002 and 2003 totaled more than \$17 million, or ten percent of the net product sales revenue Ligand originally reported during the same period. Deloitte's audit personnel understood that Ligand that did not treat such transactions as returns in

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<sup>16/</sup> See AU § 316.64, *Consideration of Fraud in a Financial Statement Audit* (auditor "should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate possible bias...."); AU § 342.09 ("The auditor normally should consider the historical experience of the entity in making past estimates...."); AU § 342.06e ("Comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates" is a relevant aspect of internal control).

<sup>17/</sup> If events occurring after the balance sheet date, but prior to the issuance of the financial statements, provide additional evidence about conditions that existed at the balance sheet date and affect the estimates inherent in the process of preparing the financial statements, an auditor must evaluate the information. See AU § 560.02-.03, *Subsequent Events*.

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accordance with SFAS No. 48<sup>18/</sup> and did not reduce revenue recognized at the time of sale by an estimate of future returns from such transactions.<sup>19/</sup> Deloitte's audit personnel failed to identify and appropriately address this apparent departure from GAAP.<sup>20/</sup>

22. GAAP provides that "all significant accounting policies of the reporting entity should be included as an integral part of the financial statements."<sup>21/</sup> In particular "the disclosure should encompass important judgments as to appropriateness of principles relating to recognition of revenue," those principles "peculiar to the industry," and "unusual or innovative applications of [GAAP]."<sup>22/</sup> Ligand did not disclose its Replacement Policy in its financial statements. Even if Deloitte's audit personnel had properly concluded that Ligand's Replacement Policy and related accounting was consistent with GAAP, PCAOB standards required them to consider whether Ligand was required to disclose the policy in its financial statements, which they failed to do.<sup>23/</sup>

23. In April 2004, during Deloitte's interim review of Ligand's financial statements for the first quarter of 2004, Deloitte's audit personnel were informed that

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<sup>18/</sup> With certain exceptions not relevant here, SFAS No. 48 applies to, among other things, sales in which a product may be returned in exchange for other products. See SFAS No. 48 at ¶ 3.

<sup>19/</sup> See SFAS No. 48 at ¶ 7.

<sup>20/</sup> An auditor's opinion that an issuer's financial statements are presented in conformity with GAAP must be based on an audit performed in accordance with PCAOB standards. PCAOB standards require an auditor to perform audit procedures sufficient to evaluate the issuer's adherence to GAAP. This Order's description of audit failures relating to GAAP departures in an issuer's financial statements necessarily reflects the Board's judgment concerning the proper application of GAAP. Any such description of GAAP departures, however, should not be understood as an indication that the Commission has considered or made any determination concerning the issuer's compliance with GAAP.

<sup>21/</sup> APB No. 22, *Disclosure of Accounting Policies*, at ¶ 8.

<sup>22/</sup> *Id.* at ¶ 12.

<sup>23/</sup> See AU § 431, *Adequacy of Disclosure in Financial Statements*.

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Ligand had experienced significant, unexpected product returns during the period and that one or more wholesalers were returning a significant amount of product that was not included in the distribution channel data relied upon during the audit. PCAOB standards required Deloitte to consider whether this information would have affected the audit report had Deloitte known about it at the report date and whether persons currently relying or likely to rely on the financial statements would attach importance to the information.<sup>24/</sup> Deloitte's audit personnel did not address this issue adequately, relying on an analysis that was known to be incomplete, and inappropriately relying on management representations to conclude that Ligand's failure to make reasonable estimates of product returns did not cause Ligand's 2003 financial statements to be materially misstated.

### IV.

24. Deloitte has represented to the Board that, since the events described in this Order, it has established and implemented the following changes to its quality control policies and procedures for identifying and addressing potential audit quality concerns regarding the performance and deployment of audit partners and directors:

- a. Deloitte has established a Leadership Oversight Committee, consisting of senior members of its audit practice and firm leadership to address at the national office level deployment and supervision issues relating to audit partners and directors about whom quality or other audit performance concerns have been identified through Deloitte's quality control procedures or otherwise. This Committee has the responsibility and the authority to subject personnel to special oversight of their audit work, to refer individuals for counseling or additional training, to restrict individuals from serving audit clients in specific capacities (including, if necessary, to restrict the individual from performing any audits), or to seek an individual's separation from the Firm.
- b. Deloitte also has changed its policies and procedures for initially identifying audit performance issues with audit partners and directors in an effort to better assure that potential audit quality issues will be brought to

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<sup>24/</sup> See AU § 561.05, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. If, after considering these two factors, an auditor concludes that action should be taken to prevent future reliance on the audit report, the auditor should take certain additional steps. See AU § 561.06-.09.

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the attention of the leadership of its audit practice and the Leadership Oversight Committee on a timely basis. Among other things Deloitte has made changes to its quality ratings system for audit partners and directors and has taken steps to further centralize its internal inspection program at the national office level.

**V.**

In view of the foregoing, and to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports, the Board determines it appropriate to impose the sanctions agreed to in Respondent's Offer. Accordingly, it is hereby ORDERED that:

- A. Pursuant to Section 105(c)(4)(E) of the Act and PCAOB Rule 5300(a)(5), Deloitte is hereby censured;
- B. Pursuant to Section 105(c)(4)(D) of the Act and PCAOB Rule 5300(a)(4), a civil money penalty in the amount of \$1,000,000 is imposed. All funds collected by the Board as a result of the assessment of this civil money penalty will be used in accordance with Section 109(c)(2) of the Act. Deloitte shall pay this civil money penalty within 10 days of the issuance of this Order by (a) United States postal money order, certified check, bank cashier's check or bank money order; (b) made payable to the Public Company Accounting Oversight Board; (c) delivered to the Controller, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006; and (d) submitted under a cover letter which identifies Deloitte & Touche LLP as a respondent in these proceedings, sets forth the title and PCAOB Release number of these proceedings, and states that payment is made pursuant to this Order, a copy of which cover letter and money order or check shall be sent to Office of the Secretary, Attention: J. Gordon Seymour, General Counsel and Secretary, Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, D.C. 20006; and
- C. Pursuant to Section 105(c)(4)(G) of the Act and PCAOB Rule 5300(a)(9), Deloitte shall maintain records in sufficient detail to describe its quality control policies and procedures for identifying and addressing potential audit quality concerns with regard to the performance and deployment of its audit partners and directors as described in paragraph 24 above and to

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evidence the application of such policies and procedures and the results thereof, including the nature of such concerns, the actions taken to address such concerns and the names of the affected individuals (which records will be available to the Board in response to any request made pursuant to the Board's authority under Section 104 or Section 105 of the Act).

ISSUED BY THE BOARD.

/s/ J. Gordon Seymour

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J. Gordon Seymour  
Secretary

December 10, 2007