

ORDER

III.

On the basis of Respondent's Offer and information obtained by the Board in this matter, the Board finds^{2/} that:

A. Respondent

1. Fazio, 46, of San Diego, California, is a certified public accountant licensed by the California Board of Accountancy (Certificate No. CPA 51182). At all relevant times, he was a partner in the San Diego, California office of the registered public accounting firm of Deloitte & Touche LLP ("Deloitte") and 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).

B. Respondent Failed to Comply with Certain PCAOB Auditing Standards in Auditing the Financial Statements of Ligand Pharmaceuticals Incorporated for 2003

Summary

2. This matter concerns Respondent's failure to perform appropriate and adequate audit procedures related to the revenue reported by Ligand Pharmaceuticals Incorporated ("Ligand" or "the Company") with respect to sales of products for which a right of return existed, and his failure to supervise others adequately to ensure the performance of such procedures. Respondent neither performed nor ensured the performance of procedures that adequately took into account the existence of various factors indicating that Ligand's ability to make reasonable estimates of product returns may have been impaired, such as Ligand's limited historical return experience, Ligand's limited visibility into its distribution channels, and periodic significant increases in, or

^{2/} The findings herein are made pursuant to Respondent's Offer and are not binding on any other person or entity in these or any other proceedings. The sanction that the Board is imposing in this Order may be imposed only if a respondent's conduct meets one of the conditions set out in Section 105(c)(5) of the Act, 15 U.S.C. § 7215(c)(5). The Board finds that Respondent's conduct described in this Order meets the condition set out in Section 105(c)(5)(A), which provides that such sanctions may be imposed in the event of "intentional or knowing conduct, including reckless conduct, that results in a violation of the applicable statutory, regulatory, or professional standard."



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excess levels of product in, Ligand's distribution channels. Moreover, in evaluating the reasonableness of Ligand's estimates of future returns, Respondent neither performed nor ensured the performance of procedures that adequately took into account the extent to which Ligand had consistently and substantially underestimated its product returns. In auditing Ligand's reported revenue, Respondent failed to evaluate these factors with the due care and professional skepticism required under the circumstances. He also did not identify and appropriately address issues concerning Ligand's policy of excluding certain types of returns from its estimates of future returns and the adequacy of Ligand's disclosure of this accounting policy.^{3/}

The 2003 Ligand Audit

3. Ligand is a Delaware corporation based 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).

4. Deloitte was Ligand's independent auditor from October 31, 2000, until it resigned effective August 5, 2004. Respondent was the engagement partner for each of Deloitte's audits and reviews of Ligand's financial statements through the quarter ended March 31, 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

^{3/} 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 reported (a decrease of approximately 52 percent), and reported a net loss more than 2.5 times the net loss originally recognized in that year. 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 Respondent had also audited, and in quarterly reports in 2003 and 2004, which Respondent had reviewed.



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(deficit), and cash flows for each of the three years in the period ended December 31, 2003. Deloitte's audit report stated that the Company's financial statements presented fairly, in all material respects, the Company's financial position in conformity with U.S. generally accepted accounting principles ("GAAP"). Respondent 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.

5. In connection with the preparation or issuance of an audit report, PCAOB rules require that associated persons of registered public accounting firms comply with the Board's auditing standards.^{4/} Under these 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.^{5/} 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, evaluate subsequent events, and supervise assistants.^{6/} Respondent failed to comply with these standards in connection with the audit on which the March 10, 2004, audit report was based (the "2003 Ligand audit").

6. At the time of the 2003 Ligand audit, Deloitte's written policies and procedures required engagement risk to be assessed annually as normal, greater than normal, or much greater than normal. The engagement team assessed the engagement risk for the 2003 Ligand audit as greater than normal. As documented in the audit work papers, the elevated risk assessment was "due to events related to product sales and sales returns." Among other things, the engagement team noted that in some instances management's estimates regarding sales returns and reserves had not been sufficient to cover the actual returns that were processed. In response to the elevated risk, the written audit plan called for the engagement team to perform "focused

^{4/} See PCAOB Rules 3100, 3200T.

^{5/} See AU § 508.07, *Reports on Audited Financial Statements*.

^{6/} See AU § 150.02, *Generally Accepted Auditing Standards*; AU § 230, *Due Professional Care in the Performance of Work*; AU § 311, *Planning and Supervision*; AU § 326, *Evidential Matter*; AU § 560, *Subsequent Events*; AU § 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.



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procedures" and increase their professional skepticism to address the specifically identified risk associated with Ligand's estimates of future returns. In several respects, however, Respondent failed to perform necessary audit procedures adequately or to ensure that they were adequately performed by others under his supervision.

Respondent Did Not Adequately Assess Whether Ligand Had the Ability to Reasonably Estimate Future Product Returns

7. According to Ligand's public filings, in 1999 and 2000 Ligand began selling four oncology products: ONTAK, Panretin Gel ("P-Gel"), Targretin Capsules ("T-Caps"), and Targretin Gel ("T-Gel"). Ligand began selling a fifth product, a pain medication called AVINZA, in the second quarter of 2002. Ligand sold most of its products to three large wholesalers, who in turn sold the product to hospitals, pharmacies, and other retailers. Ligand's 2003 financial statements disclosed that it recognized revenue upon product delivery, net of allowances for, among other things, product returns.

8. To evaluate whether Ligand's recognition of revenue upon product delivery complied with GAAP, Respondent needed 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.^{7/} 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.^{8/} In Ligand's case, Respondent was aware of the existence of each of these factors but did not adequately analyze whether they impaired Ligand's ability to make reasonable estimates of returns. Consequently, Respondent did not have a sufficient basis to support the conclusion that Ligand's recognition of revenue upon product delivery was appropriate.

^{7/} 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.

^{8/} See SFAS No. 48 at ¶ 8; SAB Topic 13.A.4(b) Question 1, 4.



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9. First, Respondent knew Ligand had little historical experience upon which to base estimates of future returns. For example, Ligand did not begin receiving returns on its 2002 initial AVINZA shipments until the third quarter of 2003, and these AVINZA lots^{9/} were not closed to returns until April 2004. Ligand also had limited historical return data for its oncology products. As of December 31, 2003, Ligand had complete return data for only a small number of closed lots for each oncology product.^{10/}

10. Second, Respondent knew that Ligand had limited visibility into its distribution channels at all times relevant to the 2003 Ligand audit. For example, according to the audit work papers, Ligand experienced episodes of significant unexpected product returns in 2002 and 2003. Ligand attributed its failure to have anticipated those returns to incomplete or inaccurate data about the quantity and expiration dates of product not yet sold to end users and therefore remaining in its distribution channels.^{11/}

11. Third, Respondent was aware of periodic significant increases in, and excess levels of product in, Ligand's distribution channels. Ligand regularly announced price increases in advance and offered wholesalers payment and other incentives before these increases took effect. This practice resulted in significant increases of product levels in Ligand's distribution channels at the end of Ligand's quarterly financial reporting periods. For example, the audit work papers show that during the fourth quarter of 2003, Ligand recorded gross product sales of \$1.1 million, \$3.3 million, and \$43.4 million for the months of October, November, and December, respectively. Similar patterns were evident from prior period work papers. In addition, according to

^{9/} Ligand manufactured its products in lots, with each lot constituting product that was manufactured at the same time and that shared the same expiration date.

^{10/} Ligand generally shipped its products at least 12 months before expiration. Ligand generally permitted returns during a period beginning three or six months before the expiration date, depending on the product, and ending six months after the expiration date. As used in this Order, the term "closed lot" refers to a lot for which the return period had ended.

^{11/} As early as 2002, a Deloitte partner assigned to the Ligand audits in an advisory role informed Respondent and others that an analysis of the expiration date(s) of wholesalers' inventories was essential for Ligand to make a reasonable estimate of future product returns.

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the audit work papers, Ligand's policy was to maintain a six month's supply of inventory in its distribution channels. But Respondent had available to him information indicating that in many instances Ligand's distributors had more than six months' supply of product on hand, and in some instances, more than one year's supply.^{12/} Respondent requested and received from Ligand explanations for Ligand's excess levels of channel inventory, but he improperly relied on these explanations without performing other audit procedures sufficient to evaluate them.^{13/}

Respondent Did Not Adequately Evaluate the Reasonableness of Ligand's Estimates of Future Returns

12. Even if Ligand's policy of recognizing revenue upon product delivery had been consistent with GAAP, Respondent still needed to evaluate the appropriateness of the amount of revenue that Ligand recognized. When Ligand recognized the revenue on these transactions, GAAP required Ligand to accrue costs or losses that it expected in connection with returns and to reduce reported sales revenue and cost of sales to reflect the estimated returns.^{14/} Accordingly, Respondent needed to evaluate the reasonableness of Ligand's return estimates,^{15/} among other things, to assess the appropriateness of Ligand's reported revenue.^{15/}

13. Under PCAOB standards, an auditor is responsible for, among other things, evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole,^{16/} which normally should

^{12/} In fact, the amount of product in Ligand's distribution channels was significantly more than that reflected in the information Ligand's management made available to Respondent at the time of the 2003 Ligand audit. See ¶ 18 below.

^{13/} PCAOB standards provide that "representations from management are part of the evidential matter the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit." AU § 333.02, *Management Representations*.

^{14/} See SFAS No. 48, at ¶ 7.

^{15/} See AU § 342.04, *Auditing Accounting Estimates*.

^{16/} See id.



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include consideration of the issuer's historical experience in making past estimates.^{17/} Respondent planned audit procedures to evaluate the reasonableness of Ligand's return estimates. Respondent failed to assure, however, that these procedures were performed with the due care and professional skepticism required by PCAOB standards, and he failed to assure that certain procedures were performed at all. The procedures that were performed generated audit evidence suggesting that Ligand's estimates of future returns were not reasonable, but, as described below, Respondent did not adequately analyze or follow up on that evidence.

14. The audit work papers indicate that in 2003, Ligand's estimates of future returns for its products at the time of sale ranged from 1.5 percent to five percent of gross sales, but the work papers also indicate that Ligand in fact experienced significantly higher actual return rates. For example, as of December 31, 2003, Ligand had experienced a 12 percent overall return rate on closed lots of T-Caps (with returns for individual closed lots ranging from three percent to 41 percent) and a 25 percent overall return rate on closed lots of T-Gel (with returns for individual closed lots ranging from seven percent to 54 percent). As of December 31, 2003, no AVINZA lots were yet closed to returns, but the audit work papers reflected that Ligand had already experienced a 13 percent overall return rate on AVINZA (with returns for one lot exceeding 20 percent), well above Ligand's initial 2.5 percent estimate of future returns. Despite this historical experience, in the fourth quarter of 2003 Ligand reduced its returns estimates for recently sold lots of AVINZA from 2.5 percent to 1.5 percent^{18/} and reduced its estimate of future returns for one of its three open T-Gel lots from 16 percent to three percent.^{19/}

^{17/} See 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).

^{18/} This change, standing alone, resulted in a reduction of Ligand's returns reserve equal to approximately 11 percent of Ligand's originally reported net income for the fourth quarter of 2003.

^{19/} This change, standing alone, resulted in a reduction of Ligand's returns reserve equal to approximately 10 percent of Ligand's originally reported net income for the fourth quarter of 2003.

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15. On various occasions the engagement team requested and received from Ligand explanations for why actual return rates on certain lots were so much higher than estimates of future returns. Some of these explanations were documented in the work papers, in some cases along with other contradictory audit evidence. Respondent improperly relied on these explanations without adequate investigation.^{20/}

16. Although Respondent's audit plan for the 2003 Ligand audit provided for the performance of a "retrospective review" of prior period estimates, the engagement team did not perform this procedure.^{21/} Respondent did not adequately address whether Ligand's estimates of future returns were reasonable in light of the actual product returns experienced. Respondent also failed to address incomplete and contradictory data about product returns that appeared in the audit work papers. For example, the audit work papers include an analysis by Ligand of the balance accrued for future returns as of December 31, 2003, that reflected December sales of AVINZA but did not reflect any December returns of the product. In addition, the audit work papers include a lot-by-lot analysis by Ligand of its December 2003 return reserve that reflected significantly lower actual returns (through November 2003) for three AVINZA lots than the supporting data contained in the audit work papers.

17. In addition, Respondent failed to evaluate adequately certain events that occurred after the December 31, 2003, balance sheet date, but before the issuance of the audit report, that provided additional evidence concerning the estimates of future

^{20/} PCAOB standards provide, "If a representation made by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of the representation made. Based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of the financial statement is appropriate and justified." AU § 333.04, *Management Representations*. See also AU § 333.02, *supra* note 13.

^{21/} AU § 316.64, *Considerations of Fraud in a Financial Statement Audit*, states that an 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 a possible bias...."

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returns.^{22/} Ligand's actual returns data for January and February 2004, which were available before the March 10, 2004, issuance of the audit report, showed that by the end of February 2004 Ligand had already exceeded the December 31, 2003, accruals for future returns from 20 of 26 lots that were open for returns at year-end.^{23/} Respondent, however, failed to assure that appropriate procedures to evaluate subsequent events were performed before the audit report was issued, even though the written audit plan specifically called for the performance of such procedures.

Respondent Did Not Adequately Address the Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

18. In April 2004, during Deloitte's interim review of Ligand's financial statements for the first quarter of 2004, Respondent had available to him information about the significant January and February 2004 product returns described above. He also learned that one or more wholesalers were returning a significant amount of AVINZA that was not included in the distribution channel data relied upon during the audit. PCAOB standards required Respondent to consider whether this information would have affected the audit report had Respondent 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.^{24/} As described below, Respondent did not address this issue adequately.

^{22/} If events occurring after the balance sheet date 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*.

^{23/} In January and February alone, returns of each of the initial 2002 lots of AVINZA exceeded the initial 2.5 percent estimate, and for one lot, were as high as nine percent. January and February returns of a single T-Gel lot, which were estimated at 3 percent as of December 31, 2003, totaled 21 percent.

^{24/} 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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19. During Deloitte's interim review of Ligand's financial statements for the first quarter of 2004, the engagement team performed a retrospective review to assess the adequacy of the December 31, 2003, returns reserve. According to the work papers documenting this procedure, the engagement team "compared the sum of total returns as of 12/31/03 and estimated future returns as of 12/31/03, by product, to total returns [actually received] as of 3/31/04 for lots without any shipments in Q1." Based on this retrospective review, Respondent concluded that Ligand was under-reserved for product returns by \$520,190, comprised of an under-reserve of \$1,376,716 for AVINZA and an over-reserve of \$856,526 for the oncology products. This analysis, however, was significantly flawed.

20. According to the audit work papers, the engagement team's retrospective review assumed Ligand would receive no additional returns after March 31, 2004, for the lots reviewed, even though other audit work papers reflected that Ligand was, at the time of the retrospective review, projecting \$1,381,245 in post-March 31 returns for these same lots. Although the work papers acknowledged the impact of this assumption on the retrospective review, Respondent inappropriately relied on this assumption in reaching his conclusions. The work papers also reflect, without explanation, that the retrospective review excluded available information about certain product lots for which Ligand received significant returns during the first quarter of 2004. The returns received from the excluded lots and the post-March 31 returns Ligand was then projecting appeared elsewhere in the work papers. Had the retrospective review reflected this information, it would have shown that Ligand's returns reserve as of December 31, 2003, was understated not by \$520,190 but rather by more than \$3.1 million. The larger amount was equal to 66 percent of Ligand's returns reserve as of December 31, 2003. It equaled approximately 53 percent of Ligand's originally reported net income for the fourth quarter of 2003 and approximately 8.5 percent of its originally reported net loss for the year.

21. Moreover, even with respect to Respondent's inadequately supported conclusion that the extent of Ligand's under-reserve for product returns was \$520,190, Respondent did not take appropriate further steps. Instead, Respondent relied on Ligand's representations that it had approximately \$500,000 in other unused reserves that largely offset the under-reserve for product returns. On this basis, Respondent concluded that the under-reserve for product returns did not cause Ligand's 2003 financial statements to be materially misstated.

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Respondent Did Not Identify and Appropriately Address Issues Concerning Ligand's Exclusion of Certain Types of Returns from its Estimates of Future Returns

22. According to the audit work papers, when Ligand learned in 2002 that one of its wholesalers 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. Returns from such transactions during 2002 and 2003 combined totaled more than \$17 million, or ten percent of the net product sales revenue Ligand originally reported during the same period. Ligand did not treat such transactions as returns in accordance with SFAS No. 48^{25/} and did not reduce revenue recognized at the time of sale by an estimate of future returns from such transactions.^{26/} Respondent failed to identify and appropriately address this apparent departure from GAAP.^{27/}

23. In addition, Ligand did not disclose its accounting policy concerning such transactions in its financial statements. GAAP provides that "all significant accounting policies of the reporting entity should be included as an integral part of the financial statements."^{28/} In particular "the disclosure should encompass important judgments as

^{25/} 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.

^{26/} See SFAS No. 48 at ¶ 7.

^{27/} 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.

^{28/} APB No. 22, *Disclosure of Accounting Policies*, at ¶ 8.

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to appropriateness of principles relating to recognition of revenue," those principles "peculiar to the industry," and "[u]nusual or innovative applications of [GAAP]."^{29/} Even if Respondent had properly concluded that Ligand's replacement policy and related accounting was consistent with GAAP, PCAOB standards required Respondent to consider whether Ligand was required to disclose the policy in its financial statements.^{30/} Respondent failed to do so.

IV.

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)(B) of the Act and PCAOB Rule 5300(a)(2), James L. Fazio is barred from being 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); and
- B. After two years from the date of this Order, Mr. Fazio may file a petition, pursuant to PCAOB Rule 5302(b), for Board consent to associate with a registered public accounting firm.

ISSUED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

December 10, 2007

^{29/} Id. at ¶ 12.

^{30/} See AU § 431, *Adequacy of Disclosure in Financial Statements*.