OPINION | WALL STREET

Valeant Sold Some Drugs Twice

Double counting usually isn't a great idea.

By Matt Levine

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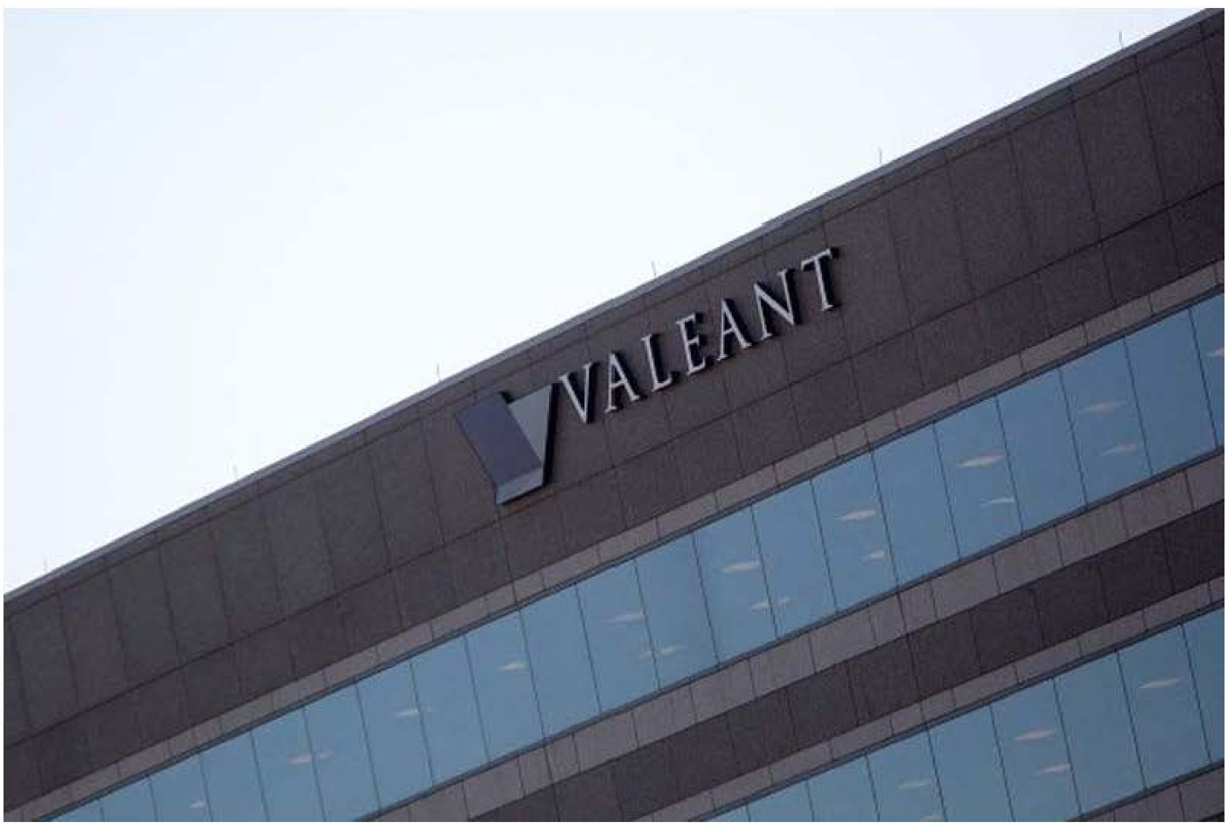

Everyone's having too much fun to leave. Photographer: Michael Nagle/Bloomberg

The crazy news out of Valeant continued this morning with a wild press release <https://www.sec.gov/Archives/edgar/data/885590/000119312516511157/d164248dex991.htm> announcing, among other things, that Chief Executive Officer J. Michael Pearson is going to leave, but not yet, and that the board asked former Chief Financial Officer Howard Schiller to resign from the board, "but Mr. Schiller has not done so."

What is it about Valeant that has this effect on people? Every Valeant catastrophe seems to cause Bill Ackman [1] to increase his ties <http://www.bloombergview.com/articles/2015-11-24/bill-ackman-found-a-cheap-way-to-buy-more-valeant-stock> to the company; today's press release also mentioned that Ackman is joining the board himself. [2] Pearson got so sick <http://www.bloomberg.com/news/articles/2016-03-11/valeant-ceo-says-no-more-surprises-in-meeting-with-top-execs> last year that he "was learning to walk again" when he came back to the company a few weeks ago, but he plans to stick it out as CEO until his successor is appointed. And the board asked Schiller to leave after finding that he engaged in "improper conduct" as CFO, but Schiller denies it <http://www.bloomberg.com/news/articles/2016-03-21/valeant-s-schiller-says-company-incorrect-about-conduct> , and so has "respectfully declined the request from the company's board to resign from the board." (Those will be some fun board meetings!) No matter how bad things get, Valeant can't get rid of anybody. The rats are fleeing *toward* the ship.

In addition to the personnel news, today's press release <https://www.sec.gov/Archives/edgar/data/885590/000119312516511157/d164248dex991.htm> and Form 8-K <https://www.sec.gov/Archives/edgar/data/885590/000119312516511157/d164248d8k.htm> provide some insight into Valeant's accounting troubles. These troubles are ... honestly they do not seem like Valeant's main problem? Except indirectly, since if Valeant can't figure out its accounting and file its annual report by late April, it will be in default under its credit facility, [3] and its creditors are getting nervous <http://www.wsj.com/articles/valeant-focus-shifts-to-talks-with-debtholders-1458515615> . The accounting problems are certainly strange, though.

The basic issue is that Valeant sold some of its drugs through a specialty pharmacy company called Philidor. In December 2014, Valeant acquired an option to buy Philidor for zero dollars, which is pretty darn close <http://www.bloombergview.com/articles/2015-10-26/valeant-s-pharmacy-relationships-were-complicated> to owning Philidor outright; from then on, Valeant (properly) treated Philidor as just a part of Valeant for accounting purposes, consolidating it into Valeant's financial statements and booking revenue on drugs sold through Philidor only when Philidor sold them to patients, not when Valeant sold them to Philidor. But *before* Valeant acquired the option, it treated Philidor as an independent company; in particular, it booked revenue on drugs as soon as it sold them to Philidor, without waiting for Philidor to sell them to customers.

That all sounds pretty normal: When Philidor was independent, Valeant treated it as a separate company; when Valeant effectively bought Philidor, it consolidated it. The problem is that when Philidor was "independent," before December 2014, it already had some ties to Valeant. Some very strange ties to Valeant. For instance: A number of Valeant employees worked at Philidor under fake names <http://www.wsj.com/articles/valeants-ties-to-pharmacy-scrutinized-1445817449> . Good lord, that really happened:

> *The Valeant employees were placed at Philidor while the pharmacy was in its infancy, to provide help on "structures and processes," said a Philidor spokeswoman. She said in a statement that the Valeant employees set up*

> *separate Philidor email accounts, under "clearly distinguishable names," to keep "their internal Philidor communications separate from the Valeant communications, primarily to reduce the risk of incorrectly sharing either company's proprietary information."*

The fake names included Peter Parker, Jack Reacher and Brian Wilson, though a "Philidor spokeswoman said the Valeant employees' 'real identities were well known to the other Philidor employees,'" which is only modestly reassuring.

Anyway, given that Valeant was involved in setting up Philidor, using fake names, you might conclude that the relationship between Valeant and Philidor wasn't entirely arm's length and independent even before December 2014. Valeant seems eventually to have concluded something like that. From today's 8-K <https://www.sec.gov/Archives/edgar/data/885590/000119312516511157/d164248d8k.htm> (emphasis added):

> *Prior to consolidation, revenue on sales to Philidor was recognized by the Company on a sell-in basis (i.e., recorded when the Company delivered product to Philidor). In connection with the work of the Ad Hoc Committee,* **the Company has determined that certain sales transactions for deliveries to Philidor in 2014 leading up to the option agreement were not executed in the normal course of business and included actions taken by the Company in contemplation of the option agreement**. *As a result of these actions, revenue for certain transactions should have been recognized on a sell-through basis (i.e., record revenue when Philidor dispensed the products to patients) prior to entry into the option agreement rather than incorrectly recognized on the sell-in basis utilized by the Company. Additionally, related to these and certain earlier transactions, the Company also has concluded that collectability was not reasonably assured at the time the revenue was originally recognized, and thus these transactions should have been recognized on a sell-through basis instead of a sell-in basis. Following the consolidation of Philidor at the option agreement date, the Company began recognizing revenue as Philidor dispensed product to patients.*

You might think that this is mostly a matter of timing, not amounts: The revenue was booked too early, but eventually Philidor sold the drugs to patients, so all of this washes out somewhere in Valeant's late-2014 and early-2015 earnings. And that is roughly true, for Valeant's net income. [4] Amusingly, though, it is not true for *revenue*: Because Valeant sold drugs to Philidor, booked revenue, then bought Philidor, sold the drugs to patients, and booked revenue again, it ended up booking revenue twice for the same sales. [5]

> *The revenue that is being eliminated from 2014 does not result in an increase to revenue in 2015 as a result of the Company having previously also recognized that revenue in 2015. Under the sell-in method previously utilized by the Company prior to the consolidation of Philidor in December 2014, revenue was recognized upon delivery of the products to Philidor. At the date of consolidation, certain of that previously sold inventory was still held by Philidor. Subsequent to the consolidation, Philidor recognized revenue on that inventory when it dispensed products to patients, and that revenue was consolidated into the Company's results.*

Lots of companies have accounting scandals that involve recognizing revenue earlier than they should have, but Valeant is breaking some new ground in recognizing that revenue *twice*. Here is the stylized math [6] :

	Sell-in	Sell-through	Why not both?
Valeant sells drug to Philidor for $100	Valeant recognizes $100 revenue	-	Valeant recognizes $100 revenue
Philidor sells drug to patient for $150	Philidor recognizes $150 revenue	Valeant recognizes $150 revenue	Valeant recognizes $150 revenue
Total Valeant revenue	**$100**	**$150**	**$250**

The proper accounting was the approach labeled "Sell-through." Valeant's approach was some combination of "Sell-in" and "Why not both?" Oops!

The amounts involved are relatively small, it all happened in 2014, and the accounting misdeeds are somewhat technical. Still, it is ... not a great look. For one thing, it again highlights the strangeness of the Philidor relationship. Philidor was a specialty pharmacy effectively owned by Valeant, but that ownership was weirdly furtive. Why? Well, one early theory <http://www.citronresearch.com/wp-content/uploads/2015/10/Valeant-Philador-and-RandO-final-a.pdf> was that it was to allow for accounting tricks; the fact that Valeant *did* get the Philidor accounting wrong seems to support that theory. But it seems to me that the more worrying theory is that the Philidor subterfuge was about getting insurance companies to pay high prices for Valeant drugs with cheap substitutes, by submitting reimbursement requests from different pharmacies whose relationships with each other, and Valeant, were unclear. [7] The accounting tricks were relatively small, and in the somewhat distant past (2014 is ages ago in Valeant time), and are anyway just accounting. The reimbursement stuff is, or at least was, more central to Valeant's business model.

Also, though, when you accuse your former CFO and former corporate controller of "improper conduct," you probably have some cultural issues to work out. [8] Valeant characterizes those issues somewhat strangely:

> *As part of this assessment of internal control over financial reporting, the company has determined that the tone at the top of the organization and the performance-based environment at the company, where challenging targets were set and achieving those targets was a key performance expectation, may have been contributing factors resulting in the company's improper revenue recognition.*

You hear this idea a lot, [9] but it always strikes me as absurd. It can't *really* be the case that a culture "where challenging targets were set and achieving those targets was a key performance expectation" is itself a culture that encourages cheating. What a disappointing view of human excellence and ambition: Honest achievement is impossible, so a "performance-based" culture that demands achievement is really just code for a cheating-based culture that demands accounting manipulation.

On the other hand, it is not hard to imagine a culture, a "tone at the top," that *would* encourage cheating. For instance, if the view from the top is that success in the pharmaceutical industry isn't so much about developing good new drugs through fundamental research, but is rather about financial engineering and insurance gamesmanship, then you could see how that might lead to accounting problems. Financial engineering and accounting manipulation are very different activities, sure, but they share a certain family resemblance that is lacking in, say, basic drug research. They demand some of the same skills, and attract similar personality types. It can't be a total surprise that a drug company built on financial optimization would founder on accounting problems.

1. And other die-hard investors like Ruane Cunniff & Goldfarb <http://www.bloomberg.com/news/articles/2016-03-15/bill-ackman-loses-about-1-billion-on-valeant-worst-ever-drop> , which added to its Valeant holdings in the fourth quarter.
2. One of Ackman's previous bouts of paradoxical enthusiasm for Valeant led to him appointing <http://www.businesswire.com/news/home/20160315006331/en/Pershing-Square-Holdings-LTD.-Sends-Communication-Investors> Steve Fraidin -- Pershing Square's Vice Chairman, and my former M&A law professor -- to the board.
3. Strictly, it will be in default as of next week, but there's a 30-day cure period <https://www.sec.gov/Archives/edgar/data/885590/000119312516511157/d164248dex991.htm> :

> *If Valeant does not file its Form 10-K by March 30, 2016, there will be a default under the credit facility. The company will have 30 days, or until April 29, to cure this default by filing its Form 10-K.*
>
> *Valeant expects to file its Form 10-K and become current on its financial filings by April 29, 2016 (within the curing period) but to be prudent, the company also announced that it intends to seek a waiver from the lenders under its credit facility. The waiver that the company is seeking will include a request to extend the deadline to file its Form 10-K for December 31, 2015 and the deadline to file its Form 10-Q for the quarter ended March 31, 2016.*

4. From the 8-K:

> *The Company has identified misstatements to date 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 $.09 (as compared to the previously reported amounts of $8,264 million for revenue, $914 million for net income attributable to Valeant and $2.72 and $2.67 for basic and diluted earnings per share respectively). A substantial part of the earnings impact of these misstatements will reverse in the first quarter of 2015. The Company has 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 (timing of recognition of managed care rebates), increase net income attributable to Valeant by approximately $24 million and increase basic and diluted earnings per share by $.07 (as compared to the previously reported amounts of $2,191 million for revenue, $74 million for net income attributable to Valeant and $.22 and $.21 for basic and diluted earnings per share respectively).*

5. This was fine, or fine-ish, or would have been fine but for the weird understandings between Valeant and Philidor:

> *As long as those pre-consolidation sales transactions were in the normal course of business and not entered into in contemplation of the option agreement, the Company's historical accounting for this revenue was in accordance with generally accepted accounting principles and consistent with its independent auditors' published guidance on this topic. Now that the Company has determined that certain sales transactions for deliveries to Philidor, leading up to the option agreement, were not executed in the normal course of business and included actions taken by the Company in contemplation of the option agreement, the revenue recorded in 2014, prior to the option agreement, is now being reversed.*

6. All numbers are of course made up; I have no idea what the actual margins looked like.

7. Thus <http://www.bloomberg.com/news/articles/2015-10-29/valeant-s-philidor-used-back-

door-tactics-to-boost-payments> :

> *Philidor Rx Services LLC, which fills prescriptions for Valeant Pharmaceuticals International Inc., instructed employees to submit claims under different pharmacy identification numbers if an insurer rejected Philidor's claim -- to essentially shop around for one that would be accepted.*
>
> *Employees were to first submit paperwork with Philidor's national provider identifier, or NPI, and if that didn't work were to then try with the NPIs of partner pharmacies, according to a Philidor training manual. "We have a couple of different 'back door' approaches to receive payment from the insurance company," said the manual, dated October 2014.*

And <http://www.bloomberg.com/news/articles/2015-10-29/philidor-said-to-modify-prescriptions-to-boost-valeant-sales> :

> *A specialty pharmacy that fills prescriptions for Valeant Pharmaceuticals International Inc. has altered doctors' orders to wring more reimbursements out of insurers, according to former employees and an internal document.*
>
> *Workers at the mail-order pharmacy, Philidor RX Services LLC, were given written instructions to change codes on prescriptions in some cases so it would appear that physicians required or patients desired Valeant's brand-name drugs -- not less expensive generic versions -- be dispensed, the former employees said.*

8. Especially when that former CFO won't leave the board! On the other hand <https://www.sec.gov/Archives/edgar/data/885590/000119312516511157/d164248dex991.htm> , "In connection with the Ad Hoc Committee's work to date, certain remediation actions have been recommended and are being implemented by the company, including placing the company's former Corporate Controller on administrative leave."
9. It is thrown around a lot to explain the insider trading at notoriously tough SAC Capital, and it is sometimes mentioned in discussions of rogue trading and market manipulation scandals at banks. The cultures demanded excellence, the story goes, so of course

employees were pushed to cheat.

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