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PCAOB Action Illuminates Returns Accounting

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A recent disciplinary action against Ernst & Young provides a review lesson for corporate accounting executives and auditors alike on how *not* to push accounting logic to improve reported financial results.

The Public Company Accounting Oversight Board imposed its biggest enforcement action ever on Feb. 8 against Ernst & Young and four of its audit partners, alleging they failed to reject aggressive accounting at Medicis Pharmaceutical Corp. The board fined Ernst & Young $2 million and handed out various penalties to the four auditors for allowing Medicis to bend accounting rules related to product returns in a way that inflated revenue—even after E&Y determined internally that the accounting may not be supported by the facts. Medicis ultimately restated more than three years' worth of financial statements to correct the problem.


Pinnell

The enforcement action revolves around a long-standing area of accounting, says Wayne Pinnell, managing partner of audit firm Haskell & White, yet one where judgments can get tricky. “It's simple in theory, but you can have difficulties in practical application,” he says. “It can be subject to different viewpoints.”

Preparers and auditors can learn a great deal by reviewing the case, says Denise Moritz, senior manager at audit firm WeiserMazars. “It seems like there was a breakdown in the audit function and internal control issues,” she says. “Things have gotten better with Sarbanes-Oxley, but we are still going to see some of these issues. Auditors need to not be pushed around by their clients. It's a challenge when you have a client that wants to do something one way and the rules say something else.”

According to the PCAOB's enforcement order, Medicis sells pharmaceutical products to wholesale distributors and retail drug chains and gives customers a right to return products that are expired or nearly expired. Most of the company's products have a shelf life of only 18 to 24 months. The right of return doesn't require customers to purchase replacement products, although most often returned products are replaced with fresh ones during the same quarter that Medicis issues return credits.

Financial Accounting Statement No. 48, *Revenue Recognition When Right of Return Exists,* is the accounting standard that Medicis and Ernst & Young would have followed in 2005, the year covered by the financial statements that first caught the PCAOB's eye during a routine audit inspection. (The same standard is still in place today, but it is now codified under the Accounting Standard Codification Topic 605, *Revenue Recognition.)*

FAS 48 says a company can recognize revenue on sales when customers have a right to return products, but the company must be able to estimate how much of the sale is likely to come back as a return and then must book a reserve to reflect that estimate. The reserve acts as an offset to revenue, to reflect the likelihood that some portion of the revenue ultimately will not hold up and flow to earnings.

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The PCAOB says Ernst & Young's auditors gathered evidence that indicated Medicis needed to establish a reserve for the returns of expired products based on the gross sale price for the products. Medicis, however, reasoned that with its whopping 85 percent gross margin on the products, it could book the reserve based on the cost to replace expired products rather than the gross sale price. After all, most returns were replaced with fresh products, allowing the company to retain 85 percent of the gross sale price. Medicis contented that the returns were more like an exchange of like-kind merchandise or a warranty replacement, rather than a full retreat on the sale, and E&Y allowed that reasoning to stick.

Medicis developed its own methodology for booking reserves based largely on this line of thinking, the PCAOB said—that is, using replacement cost for returns that were refreshed with new products in the same quarter, but gross sale price for returns that were not replaced. That approach reduced the company's reserve by more than $54 million in 2005 alone, according to the PCAOB's enforcement order, which had the effect of allowing that amount to show up in revenue.

Playing the Standard Straight

SUMMARY OF CASE

Below is an excerpt from the PCAOB's order against E&Y summarizing details of the case:

This matter concerns respondents' failures to properly evaluate a material component of Medicis's financial statements—its sales returns reserve. Specifically, respondents failed to comply with PCAOB auditing standards in evaluating Medicis's sales returns reserve estimate, including evaluating Medicis's practice of reserving for most of its estimated product returns at the cost of replacing the product. The audit evidence available to respondents indicated that, at all relevant times, Statement of Financial Accounting Standards No. 48, *Revenue Recognition When a Right of Return Exists* applied to Medicis's product sales subject to a right of return due to expiration and required Medicis to reserve for all of those estimated returns at gross sales price. Reserving for most of its estimated returns at replacement cost, rather than gross sales price, resulted in Medicis's reported sales returns reserve being materially understated and its reported revenue being misstated. Overall, respondents' approach to evaluating Medicis's sales returns reserve methodology and estimate was inconsistent with their obligations to exercise professional skepticism as the company's independent auditor.

In connection with the Dec. 31, 2005, audit, [Jeffrey Anderson, at all relevant times, partner with Phoenix, Ariz. Office of E&Y], [Robert Thibault, the independent review partner for E&Y audits of Medicis financial statements], and [Ronald Butler, second partner, supervised by Anderson for E&Y audits of Medicis financial statements] failed to obtain sufficient competent evidential matter supporting Medicis's conclusion that an "exchange" exception to SFAS 48's general rule of reserving at gross sales price supported Medicis's reserving for most of its product returns at replacement cost. They concurred with this conclusion notwithstanding contradictory audit evidence indicating that the product returns in question were not eligible for the exchange exception to SFAS 48. Therefore, they failed to identify and appropriately address a material departure from U.S. Generally Accepted Accounting Principles resulting from Medicis's reliance on the exchange exception.

Merely two months after Anderson, Thibault, and Butler had concurred with the application of the SFAS 48 exchange exception, E&Y personnel responsible for the 2006 AQR questioned Medicis's reliance on the exchange exception and, with Anderson, Thibault, and Butler concluded that the exchange exception did not support Medicis's use of replacement cost. Rather than appropriately addressing this material departure from GAAP, Anderson, Thibault, and other E&Y personnel decided that a different accounting rationale supported Medicis's reserving at replacement cost for most of its estimated product returns. They concluded that Medicis's existing accounting result was supported by reference or analogy to warranty accounting under Statement of Financial Accounting Standards No. 5, *Contingencies*. Butler did not participate in formulating the analogy to warranty accounting, but concurred with the warranty rationale. At all relevant times, however, respondents understood that the product returns at issue were not returns of defective products pursuant to a warranty and that customers returning the products to Medicis were not relying on a warranty in making such returns. Instead, customers were returning products because Medicis provided them with a right to return expired products. After the product returns consultation, Medicis, with E&Y's concurrence, relied on the flawed warranty accounting rationale to continue reserving for most of its product returns at replacement cost in 2005, 2006, and 2007. As a result, Anderson, Thibault, and Butler failed to identify and appropriately address a material departure from GAAP.

This matter also involves the failure to comply with PCAOB standards in auditing Medicis's new "units-in-channel" methodology for calculating its year-end returns reserve estimate in 2006 and 2007. Anderson, Butler, and [Thomas Christie, second partner, supervised by Anderson, for E&Y audit of Medicis financial statements] failed to appropriately test, or ensure the performance of adequate procedures to test, key assumptions underlying management's new estimation methodology. Furthermore, notwithstanding contradictory audit evidence, they placed undue reliance on management's representation that the assumptions were reasonable.

Source: PCAOB.

Gould

While the standard doesn't explicitly require companies to follow gross sale price for establishing a reserve, the practice is still considered a given, says Dee Mirando-Gould of consulting firm MorganFranklin. "The guidance requires you to reduce revenue for returns," she says. "It's understood you would use the gross price for those items you expect to be returned."

Giugliano

Greg Giugliano, national partner-in-charge of assurance services for audit firm Marcum, says the accounting erred in treating returned products as exchanged products. "The company accepted returns for expired and short-dated products, and replaced those products with currently dated, similar products," he says. "To be treated as an exchange, the products would have to be of similar quality and price. Clearly a currently dated product is not similar in quality and price to an expired product." The effect on financial statements, all else being constant, would be to overstate sales and overstate gross profit, he says.

The Medicis maneuver is not the most common trouble spot in FAS 48, says James Comito, a shareholder with audit firm Mayer Hoffman McCann, but the standard itself is "deceptively easy." More often, if companies are going to run into trouble applying FAS 48, it's because they assume they can make estimates where they really can't, he says.

If a company can't reasonably estimate returns, then it is not allowed to book revenue until returns are settled. That's a harsh outcome companies would prefer to avoid, Comito says. When companies introduce new products or begin selling into a new geographic region or a new customer channel, relying on historical data for similar products or customer experiences to establish return estimates is difficult, because it may not adequately reflect the new circumstances. "This is something accountants and auditors have to be very careful about," he says.

The PCAOB says it learned through its inspection process that Ernst & Young even flagged the accounting during an internal review, but subsequently allowed it to pass nevertheless. The PCAOB spotted the problem during a 2008 inspection, then launched an enforcement action in March 2010. The action remained private, however, under Sarbanes-Oxley rules that allow auditors to litigate PCAOB disciplinary in secret until resolved.

The PCAOB has said the secrecy gives audit firms incentives to litigate unnecessarily, to delay public knowledge of serious audit problems. The board has lobbied Congress to amend the law to allow its enforcement actions to be made public. Yet this particular action, addressing audit problems that date back to 2005, was not contested by E&Y and therefore not prolonged by aggressive litigation. The firm settled the matter with the board within a year of the board's. Neither the PCAOB nor E&Y would discuss the timing around the events.