PCAOB
Public Company Accounting Oversight Board

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ORDER MAKING FINDINGS AND IMPOSING SANCTIONS

In the Matter of Ernst & Young LLP, Jeffrey S. Anderson, CPA, Ronald Butler, Jr., CPA, Thomas A. Christie, CPA, and Robert H. Thibault, CPA,

Respondents.

PCAOB Release No. 105-2012-001

February 8, 2012

By this Order, the Public Company Accounting Oversight Board ("Board" or "PCAOB") is (1) censuring the registered public accounting firm Ernst & Young LLP ("E&Y" or "Ernst & Young"); (2) barring Jeffrey S. Anderson, CPA ("Anderson") and Robert H. Thibault ("Thibault") from being associated with a registered public accounting firm;[1/] (3) censuring Ronald Butler, Jr., CPA ("Butler"), and Thomas A. Christie, CPA ("Christie"); and (4) imposing civil money penalties in the amounts of $2,000,000 as to E&Y, $50,000 as to Anderson, $25,000 as to Thibault, and $25,000 as to Butler.

The Board is imposing these sanctions on the basis of findings concerning E&Y, Anderson, Thibault, Butler, and Christie (collectively, "Respondents") for violations of PCAOB rules and auditing standards related to E&Y's audits of the December 31, 2005, 2006, and 2007 (the "relevant time period") financial statements of Medicis Pharmaceutical Corporation and subsidiaries (collectively, "Medicis" or "the Company") and a consultation concerning Medicis's accounting for product returns (the "Product Returns Consultation") stemming from E&Y's Audit Quality Review of the December 31, 2005 Medicis audit in 2006 (the "2006 AQR").

I.

On March 8, 2011, the Board instituted disciplinary proceedings pursuant to Section 105(c) of the Sarbanes-Oxley Act of 2002 ("Act") and PCAOB Rule 5200(a)(1) against Respondents. Pursuant to Section 105(c)(2) and PCAOB Rule 5203, these proceedings were not public. Pursuant to Section 105(c) and PCAOB Rule 5203, the

[1/] Anderson may file a petition for Board consent to associate with a registered public accounting firm after two (2) years from the date of this Order. Thibault may file a petition for Board consent to associate with a registered public accounting firm after one (1) year from the date of this Order.

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Board determined that good cause was shown to make the hearing in this proceeding public. As permitted by Section 105(c)(2) of the Act and PCAOB Rule 5203, the Division of Enforcement and Investigations consented to making the hearing in this proceeding public. As permitted by Section 105(c)(2) of the Act and PCAOB Rule 5203, Respondents did not consent to making the hearing public.

II.

In response to these proceedings and pursuant to PCAOB Rule 5205, Respondents each submitted an Offer of Settlement (collectively, "Offers") that the Board has determined to accept. Solely for purposes of these proceedings and any other proceedings brought by or on behalf of the Board, to which the Board is a party, and without admitting or denying the findings herein, except as to the Board's jurisdiction over Respondents and the subject matter of these proceedings, which is admitted, Respondents each consent to the entry of this Order Making Findings and Imposing Sanctions ("Order") as set forth below.[2/]

III.

On the basis of Respondents' Offers, the Board finds that:[3/]

A. Respondents

1. E&Y is, and at all relevant times was, a public accounting firm organized as a limited liability partnership under the laws of the state of Delaware and headquartered in New York, New York. E&Y has offices in multiple locations, including Phoenix, Arizona, and is licensed by, among others, the Arizona State Board of Accountancy (license No. 967-B). E&Y is, and at all relevant times was, registered with the Board pursuant to Section 102 of the Act and PCAOB rules. E&Y has been Medicis's independent auditor since 1990.

[2/] The findings herein are made pursuant to the Respondents' Offers and are not binding on any other persons or entities in this or any other proceeding.

[3/] The Board finds that each Respondent's conduct described in this Order meets the conditions set out in Section 105(c)(5)(A) of the Act, 15 U.S.C. § 7215(c)(5), which provides that certain sanctions may be imposed in the event of (A) intentional or knowing conduct, including reckless conduct, that results in a violation of the applicable statutory, regulatory, or professional standard; or (B) repeated instances of negligent conduct, each resulting in a violation of the applicable statutory, regulatory, or professional standard.

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2. Jeffrey S. Anderson, 56, of Paradise Valley, Arizona, is a certified public accountant licensed to practice under the laws of Arizona (license No. 4662-R), Colorado (license No. 24518), and New Mexico (license No. 4997). At all relevant times, he was a partner working from the Phoenix, Arizona office of E&Y, 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). Anderson was the auditor with final responsibility[4/] for E&Y's audits of Medicis's financial statements for the fiscal years ended June 30, 2003, 2004, and 2005, the six months ended December 31, 2005, and the year ended December 31, 2007.[5/] In that capacity, he supervised E&Y's audit engagement teams and authorized the issuance of E&Y's audit reports for the foregoing financial statements. Anderson also participated in the 2006 AQR and the Product Returns Consultation.

3. Robert H. Thibault, 65, of Blaine, Washington, is a certified public accountant licensed to practice under the laws of California (license No. 56568). Thibault's license is currently inactive. He was the independent review partner for E&Y's audits of Medicis's financial statements for the six months ended December 31, 2005, and the year ended December 31, 2006. In that capacity, Thibault exercised the responsibilities of a "concurring or reviewing partner" under Regulation S-X, 17 C.F.R. § 210.2-01(f)(7)(ii)(B). Prior to July 1, 2005, Thibault was E&Y's Professional Practice Director for the Pacific Southwest Sub-Area. From July 1, 2005 until his retirement from E&Y, effective June 30, 2007, Thibault remained a member of E&Y's Professional Practice Group for the Pacific Southwest Sub-Area. Thibault participated in the Product Returns Consultation. At all relevant times, he 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).

4. Ronald Butler, Jr., 42, of Phoenix, Arizona, is a certified public accountant licensed to practice under the laws of Arizona (license No. 10380-E). He was the second partner, supervised by Anderson, for E&Y's audits of Medicis's financial statements for the fiscal years ended June 30, 2004 and 2005, and the six months ended December 31, 2005. While not a direct participant in the Product Returns Consultation stemming from the 2006 AQR, Butler concurred with, and documented, the results of the consultation. He was the auditor with final responsibility for E&Y's audit of Medicis's financial statements for the year ended December 31, 2006. In that capacity, he supervised E&Y's audit engagement team and authorized the issuance of E&Y's audit report for the 2006 financial statements. At all relevant times, he was an

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[4/] See AU § 311, *Planning and Supervision*.

[5/] Medicis changed from a June 30 to a December 31 year-end effective December 31, 2005.

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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).

5. Thomas A. Christie, 50, of Phoenix, Arizona, is a certified public accountant licensed to practice under the laws of Arizona (license No. 6501-E) and California (license No. 70718). Christie joined the Medicis engagement team in or about September 2007. He was the second partner, supervised by Anderson, for E&Y's audit of Medicis's financial statements for the year ended December 31, 2007. At all relevant times, he 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).

B. Issuer

6. Medicis Pharmaceutical Corporation is a Delaware corporation with principal executive offices located in Scottsdale, Arizona. The Company's common stock is registered pursuant to Section 12(b) of the Securities Exchange Act of 1934 and is listed on the New York Stock Exchange (ticker symbol "MRX"). At all relevant times, Medicis was an "issuer" as that term is defined by Section 2(a)(7) of the Act and PCAOB Rule 1001(i)(iii).

C. Summary

7. 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 ("replacement cost"). 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* ("SFAS 48") 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.[6/] 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.

[6/] See Medicis Pharmaceutical Corp. Form 10-K/A, filed November 10, 2008.

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8. In connection with the December 31, 2005 audit, Anderson, Thibault, and Butler 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 ("GAAP") resulting from Medicis's reliance on the exchange exception.[7]

9. 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* ("SFAS 5"). 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

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[7] 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. See AU § 508.07, *Reports on Audited Financial Statements*. PCAOB standards require an auditor to perform audit procedures sufficient to evaluate the issuer's adherence to GAAP. See, e.g., AU § 110.01, *Responsibilities and Functions of the Independent Auditor*. 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 Securities and Exchange Commission ("Commission") has considered or made any determination concerning the issuer's compliance with GAAP.

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cost in 2005, 2006, and 2007. As a result, Anderson, Thibault, and Butler failed to identify and appropriately address a material departure from GAAP.[8/]

10. 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 Christie failed to appropriately test, or ensure the performance of adequate procedures to test, key assumptions underlying management's new estimation methodology.[9/] Furthermore, notwithstanding contradictory audit evidence, they placed undue reliance on management's representation that the assumptions were reasonable.[10/]

11. Finally, this matter also involves the failure to adequately consider whether Medicis needed to disclose in its financial statements its practice of reserving for product returns at replacement cost, its application of the analogy to warranty accounting in 2006, and significant changes in its returns reserve estimation methodology in 2006 and 2007.

12. In connection with a 2008 inspection of E&Y's audits of Medicis, the PCAOB inspection staff questioned E&Y's acceptance of Medicis's use of replacement cost to calculate its returns reserve. After the PCAOB staff questioning, E&Y's National Accounting Group determined that Medicis's use of replacement cost was not appropriate. Additionally, E&Y made internal inquiries of audit partners in relevant practice groups to determine whether any of its other audit clients or other pharmaceutical companies reserved for product returns at replacement cost. E&Y was unable to identify any other comparable companies that accounted for their returns reserve as Medicis did. Ultimately, E&Y concluded that Medicis's reserving at replacement cost was not in conformity with GAAP and the Company was required to restate its accounting for its returns reserve.

13. On November 10, 2008, Medicis filed with the Commission an amended annual report on Form 10-K/A, restating the Company's financial statements for the years ended December 31, 2007 and 2006, the six months ended December 31, 2005, and the fiscal year ended June 30, 2005. In the restatement, Medicis's returns reserve increased $94.6 million (585%) as of December 31, 2005, $52.1 million (148%) as of December 31, 2006, and $58.9 million (600%) as of December 31, 2007. E&Y audited

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[8/] See AU § 110.01.

[9/] See AU § 342.11, *Auditing Accounting Estimates*.

[10/] See AU § 333.04, *Management Representations*; AU § 326.25, *Evidential Matter*.

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Medicis's restated financial statements for the foregoing periods and issued an audit report dated November 6, 2008, in which E&Y expressed an unqualified opinion that the restated financial statements presented fairly, in all material respects, Medicis's financial position and results of operations in conformity with GAAP.

D. Background

Medicis's Policy of Providing Customers With a Right to Return Expired Product for Which They Would Receive a Full Credit for the Sales Price

14. At all relevant times, Medicis sold pharmaceutical products that were time-dated. Medicis primarily sold its products to wholesale distributors and retail chain drug stores, which resold Medicis's products to others. Medicis's standard "Return Goods Policy," in effect at all relevant times, gave customers the right to return product if the product was returned within four or six months before expiration or up to 12 months after expiration (collectively, "expired product"). The majority of the Company's products had a shelf life of 18 to 24 months.

15. When customers returned expired product, Medicis's Return Goods Policy provided that Medicis would give customers a full credit by issuing a credit memo in the amount of "the original purchase price or pricing one (1) year prior to the date the warehouse receives the return."

16. The Return Goods Policy did not require customers to purchase the same or similar product as a condition of receiving or using a credit from Medicis for returning expired product. Medicis's customers, however, routinely applied return credits to purchases of the same or similar products as the products that were returned due to expiry. Moreover, most subsequent purchases occurred during the same quarter in which the return credit was issued.

Medicis's Revenue Recognition and Returns Reserve and Applicable GAAP

17. At all relevant times, SFAS 48 applied to Medicis's revenue recognition for its product sales because Medicis gave its customers the right to return expired product. Under SFAS 48, a company, which sells product subject to a right to return, may recognize revenue from those sales transactions at the time of sale only if certain conditions, including the ability to estimate the amount of future returns, are met.[11/] If those conditions are not met, revenue recognition must be postponed. If they are met,

[11/] SFAS 48 ¶ 6.

sales revenue and cost of sales reported in the income statement must be reduced to reflect estimated returns.[12]

18. At all relevant times, Medicis represented to E&Y that it recognized product revenue at the time of sale in accordance with SFAS 48. Because its customers had the right to return expired product, Medicis also recorded estimates of future product returns at the time of sale. Medicis used these estimates to establish a sales returns reserve that reduced revenue reported in its financial statements.

19. For accounting purposes, Medicis referred to product returns where the customer used the return credit to purchase, in whole or in part, the same or similar product in the same quarter in which the return occurred as "returns replaced in quarter" or "returns replaced." Expired product returns where the return credit was used in subsequent quarters for purchases of different product or the same or similar product were referred to as "returns not replaced in quarter" or "returns not replaced." For its sales returns reserve, Medicis reserved for returns replaced at replacement cost and returns not replaced at gross sales price. Medicis's Return Goods Policy did not distinguish between returns replaced and returns not replaced. To the contrary, under Medicis's business policy, customers received a full credit in the amount of the gross sales price for product returns regardless of when customers used their credit to buy "replacement product."

20. At all relevant times, 97% of all of Medicis's product returns were for expired products, and returns replaced were the predominant share of expired product returns. For example, in performing the 2006 audit, the E&Y engagement team determined that "approximately 72% of all expired products returned were replaced in the same quarter" during 2006.

21. The audit evidence obtained by Respondents indicated that SFAS 48 applied and that Medicis needed to reserve for estimated returns due to expiry at gross sales price with an offsetting reduction to revenue. By reserving at replacement cost for most of its estimated returns, Medicis recorded its 85% gross margin as revenue at the time of sale even though it would issue a credit for the gross sales price when the product was eventually returned months or years later. Audit evidence obtained by Respondents indicated that reserving at replacement cost, and not at gross sales price, had a material impact on Medicis's returns reserve estimate. For example, information contained in E&Y's 2005 audit work papers demonstrated that, if Medicis reserved for all estimated returns at gross sales price versus using both gross sales price and replacement cost, Medicis's reserve would have increased by over $54 million.

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[12] Id. ¶ 7.

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22. As discussed in more detail below, over the relevant time period, Medicis's accounting rationale supporting reserving for returns replaced in quarter at replacement cost and its methodology for calculating its returns reserve changed significantly. Specifically, in 2005, Medicis relied on the exchange exception in footnote 3 of SFAS 48 to support replacement cost, but, in 2006, Anderson, Thibault, and other E&Y personnel concluded in the Product Returns Consultation that an analogy to warranty accounting supported the use of replacement cost to reserve for product returns. Medicis, with E&Y's concurrence, thereafter utilized the warranty analogy to support the continued use of replacement cost in establishing its sales returns reserve. Additionally, beginning at year-end 2006, Medicis applied a different reserve methodology that relied on significant assumptions that were inconsistent with Medicis's historical return patterns. Respondents failed to comply with PCAOB standards in evaluating and accepting Medicis's returns reserve accounting policies and estimation methodologies during the relevant audits.

E. Respondents Failed to Comply with Certain PCAOB Rules and Auditing Standards

23. 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. Among other things, these standards require that an auditor exercise due professional care, exercise professional skepticism, and obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements.[13/] Respondents failed to comply with these and other standards in connection with the 2005, 2006, and 2007 Medicis audits, and the Product Returns Consultation stemming from the 2006 AQR.

The December 31, 2005 Audit

24. E&Y audited Medicis's financial statements for the six month transition period-ended December 31, 2005 and issued an unqualified opinion that the financial statements presented fairly, in all material respects, Medicis's financial position and results of operations in conformity with GAAP. Anderson led the audit and authorized the issuance of E&Y's audit report. Butler was supervised by Anderson and acted as second partner on the audit. Thibault was independent review partner (*i.e.*, concurring review partner) for the audit.

[13/] See AU § 150, *Generally Accepted Auditing Standards*; AU § 230, *Due Professional Care in the Performance of Work*; AU § 326.

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25. During the six months ended December 31, 2005, Medicis's internally documented accounting policy relied on footnote 3 of SFAS 48 to support the use of replacement cost for estimated returns replaced. Footnote 3 creates an exception to the general rule of reserving for expected future product returns at the gross sales price and deferring the recognition of an equal amount of revenue. Specifically, footnote 3 of SFAS 48 provides:

> Exchanges by ultimate customers of one item for another of the same kind, quality, and price (for example, one color or size for another) are not considered returns for purposes of this Statement.

26. In performing the audit of Medicis's financial statements for the six months ended December 31, 2005, Anderson, Thibault,[14/] and Butler violated PCAOB standards by accepting Medicis's conclusion that the exchange exception to SFAS 48 supported reserving for estimated returns replaced at replacement cost.

27. At the time of the December 31, 2005 audit, Anderson, Thibault, and Butler were aware that Medicis made the majority of its product sales to resellers, not "ultimate customers." They knew or should have known that Medicis's returns were not returns of products in exchange for products of "the same kind, quality, and price," as required by footnote 3. Rather, Medicis's returns were of unsalable product for which a credit equal to the original gross sales price was issued. Moreover, the credit received was often applied to the purchase of new product priced differently from the original gross sales price of the returned product.

28. Anderson, Thibault, and Butler's acceptance of Medicis's reliance on footnote 3 of SFAS 48 not only conflicted with the plain language of the exchange exception, it also conflicted with E&Y's internal accounting literature. Specifically, E&Y's internal guidance stated:

> "[E]xchange" transactions, as defined in footnote 3 of Statement 48, are limited to transactions with the "ultimate customer" and not the reseller as demonstrated in the following examples:
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> * * *
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> 2. Returns by resellers for later versions of the same product (i.e. software and other computer or technology related products)

[14/] Thibault's 2005 violations relate to his role as independent review partner. In that role, Thibault was aware of the same material facts as Anderson and Butler.

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should be accounted for as a right-of-return. Exchange accounting would not apply to a reseller in any situation.

3. Arrangements where vendors only allow returns for credits against future purchases and returns for other products fall within the scope of a sale with a right-of-return, as opposed to an "exchange." The fact that there will not be a net reduction in revenue after the sale of the first product is not relevant; the first product is, in fact, being returned.

4. A common example of an exchange with the ultimate customer is one when a consumer exchanges a red sweater for a blue sweater.

29. Although Anderson, Thibault, and Butler knew that Medicis reserved for returns replaced at replacement cost and for returns not replaced at gross sales price, they failed to adequately consider whether Medicis needed to disclose this practice in its financial statements for the six months ended December 31, 2005, and the notes thereto.[15/] They also knew that Medicis relied on footnote 3 of SFAS 48, but failed to adequately consider whether this reliance should be disclosed by Medicis in its financial statements.

30. For the reasons given above, Anderson, Thibault, and Butler failed to obtain, or ensure the performance of procedures to obtain, sufficient competent evidential matter supporting the conclusion that estimated returns replaced were eligible for the exchange exception to SFAS 48. They were aware of contradictory audit evidence indicating that returns replaced were not eligible for the exchange exception to

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[15/] GAAP provides that "all significant accounting policies of the reporting entity should be included as an integral part of the financial statements." APB No. 22, Disclosure of Accounting Policies, ¶ 8. 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 "[u]nusual or innovative applications of [GAAP]." Id. ¶ 12. While use of replacement cost for returns replaced was neither supported by the audit evidence obtained nor consistent with GAAP, even if Anderson, Thibault, and Butler had properly concluded that it was, PCAOB standards required them to consider whether Medicis needed to disclose the policy in its financial statements, which they failed to do. See AU § 431, *Adequacy of Disclosure in Financial Statements*.

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SFAS 48, but failed to appropriately consider, or ensure the performance of audit procedures to consider, such contradictory audit evidence.[16]

31. As a result of E&Y, Anderson, Thibault, and Butler's failure to comply with PCAOB standards, Anderson, with Thibault's and Butler's review and approval, improperly authorized the issuance of E&Y's audit report dated March 10, 2006, on Medicis's financial statements for the six months ended December 31, 2005, which incorrectly expressed an unqualified opinion that the financial statements presented fairly, in all material respects, Medicis's financial position and results of operations in conformity with GAAP.[17]

The 2006 E&Y Audit Quality Review of the December 31, 2005 Audit

32. In May 2006, the December 31, 2005 Medicis audit was the subject of an E&Y AQR. The AQR program was administered and overseen at a National Office level within E&Y and was part of E&Y's system of quality controls and procedures. AQRs were, among other things, designed to identify any deficiencies in selected E&Y audits and to require engagement teams to remediate such deficiencies. In this instance, the AQR appropriately identified the 2005 audit team's acceptance of Medicis's reliance on the exchange exception to SFAS 48 to justify the use of replacement cost as a deficiency. However, rather than appropriately remediating the deficiency by requiring Medicis to reserve for all returns at gross sales price, Anderson, Thibault, and other E&Y personnel concluded that a new equally deficient rationale supported Medicis's continued use of replacement cost.[18]

33. The E&Y personnel responsible for the AQR had no prior involvement with the Medicis engagement. The AQR identified Medicis's use of the exchange exception to SFAS 48 for product returns as a potential AQR finding, and asked the engagement team to consider whether Medicis's reliance on footnote 3 of SFAS 48 to reserve for returns replaced in quarter at replacement cost complied with GAAP.

34. By e-mail message dated May 9, 2006, the AQR Team Leader informed a representative of E&Y's National AQR group (the "National AQR Member") as follows:

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[16] See AU § 333.04; AU § 326.25.

[17] See AU § 508.07.

[18] Thibault served in a National office role as a consulting resource even though he was also the independent review partner for the 2005 audit. While firm guidelines allowed him to serve in both roles at the time, E&Y's consultation policy and guidelines no longer permit personnel to do so.

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> [Medicis] applies the exchange provisions of SFAS 48 which provides that for estimated exchanges of a product for a similar product, the reserve should only be for the cost related to the return and not for the sales value of the product returned. *In the case of Medicis, the margins are huge, so the difference in reserving sales value as a return vs. cost as an exchange is material* … SFAS 48 specifically precludes exchange accounting for sales to resellers, and also is clear that the exchange must be for a similar item with the same functionality (e.g. a red sweater for a blue sweater). In this case, the sales are to resellers and the customers are exchanging expired products with no use/functionality with new, unexpired products with full use/functionality.
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> I have not discussed this with the partners on the engagement yet, as I wanted to discuss with you and determine if we need to get National PPD [Professional Practice Director] involved. There was no technical memo with PPD approval on this, however, this issue was in the SRM [Summary Review Memorandum] and the IRP [Independent Review Partner Thibault] is the Area PPD.

[Emphasis added.]

35. On or about May 12, 2006, E&Y personnel took part in a consultation regarding the sales returns reserve issue that arose in the AQR (the Product Returns Consultation). The participants included, among others, Anderson, Thibault (in his National Office role), and another National Office partner. Butler did not participate in the Product Returns Consultation.

36. The participants in the Product Returns Consultation determined that Medicis's reserving for returns replaced in quarter at replacement cost could not be supported by the exchange exception, but could be supported by reference or analogy to warranty accounting under SFAS 5. On or shortly after May 12, 2006, E&Y's National Director of Area Professional Practice orally concurred with the warranty accounting rationale.

37. Information available to the E&Y personnel participating in the Product Returns Consultation showed that returns replaced were not analogous to a warranty, as they did not involve returns of products that were defective or failed to meet their specifications, pursuant to a product warranty. Instead, the returns to Medicis were solely due to expiry.

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38. The participants in the Product Returns Consultation accepted the analogy to warranty accounting without adequately considering whether such a rationale had general acceptance and was appropriate in the circumstances.[19/]

39. Having concluded that the exchange exception to SFAS 48 did not apply to returns replaced in quarter, Anderson, Thibault, and the E&Y personnel who participated in the Product Returns Consultation failed to appropriately address why they believed SFAS 48 itself did not require full gross sales price deferral when revenue was recognized on Medicis's product sales subject to a right to return the product. Indeed, before reaching a conclusion that an analogy to warranty accounting was appropriate, they needed to address why they believed SFAS 48 itself did not require full gross sales price deferral. However, they neglected to gather appropriate evidence to support a conclusion that SFAS 48 itself did not require full gross sales price deferral and disregarded significant audit evidence to the contrary.

40. A consultation memorandum regarding the warranty accounting rationale (the "Consultation Memorandum") was prepared on or about May 12, 2006. The Consultation Memorandum was reviewed by Anderson and signed by him on May 15, 2006. Thibault, in his National Office role, also reviewed and approved the Consultation Memorandum and signed it on May 16, 2006.

41. The Consultation Memorandum stated in part:

> By allowing its customers to send back expired product the Company is essentially offering a "warranty" on products sold. This means that the economic cost to the Company of "guaranteeing freshness" of the product is the cost basis of the product.

42. This statement was contradicted by E&Y's internal accounting guidance, with which Respondents were familiar, which provided: "Warranty provisions differ from right-of-return provisions because the ultimate customer is returning a defective product."

43. The Consultation Memorandum provided that returns replaced in quarter were reserved for differently than returns replaced in subsequent quarters, but failed to address why different accounting for the returns was appropriate for sales made of the same products to the same distributors under the same returns policies. In fact, the Consultation Memorandum stated that "[p]ast experience has shown that the majority of

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[19/] See AU § 230; see also, AU § 411.04, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

expired products returned are replaced by customers in the same quarter with the balance almost always replaced through orders in the subsequent quarter." The memorandum failed to provide any authoritative basis for accounting for the returns differently.

44. The Consultation Memorandum also failed to address the applicability of SFAS 48. For example, it did not address that SFAS 48 applies where "product may be returned … for a credit applied to amounts owed or to be owed for other purchases, or in exchange for other products."[20/] Moreover, the Memorandum was silent as to SFAS 48 specifically excluding "sales transactions in which a customer may return defective goods, such as under warranty provisions," but not returns due to expiry.[21/] Nor did the Memorandum address SFAS 48, Appendix A, ¶ 13, which makes clear that SFAS 48 applies to circumstances in which a "customer has not been able to resell the product to another party."

45. When Anderson and Thibault signed the Consultation Memorandum, and when Butler reviewed it, they knew that the warranty accounting rationale set forth in the Consultation Memorandum differed from Medicis's rationale that the SFAS 48 exchange exception supported reserving for returns replaced in quarter at replacement cost during the six months ended December 31, 2005. Only two months before, Anderson, Thibault, and Butler had concurred with the SFAS 48 exchange exception in connection with the December 31, 2005 audit.

46. While E&Y, Anderson, Thibault, and other E&Y personnel accepted the warranty analogy to resolve the deficiency identified during the 2006 AQR, upon receiving the Consultation Memorandum, the AQR Team Leader sent an e-mail dated June 1, 2006 to the National AQR Member, with a copy to the AQR Reviewer, forwarding the Consultation Memorandum and stating as follows:

> Are you guys available to discuss this? While the memo is factually correct, it is quite different than the Company's policy, which assessed this issue based on exchange accounting, and not as a warranty. The memo does not even mention SFAS 48, which is what the Company's internal accounting policy is based on, and what the audit workpapers include. It's as if we are saying the client got the accounting right, but for the totally wrong reason and rationale.

[20/] SFAS 48 ¶ 3.

[21/] Id. ¶ 4.

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> [National E&Y AQR Member], we probably need some guidance on this. Also, I thought it was understood that there would be PPD sign off, and it sure seems like this is a new policy, or at least a policy the company never knew it was following.[22/]

47. During the December 31, 2005 audit and at the time of the 2006 AQR, Medicis had no documentation setting forth a warranty accounting rationale for reserving at replacement cost. E&Y did not inform Medicis of the warranty accounting rationale for reserving at replacement cost before E&Y concluded that the rationale was appropriate. It was not until the 2006 audit procedures (performed in the first quarter of 2007) that Medicis provided E&Y with any documentation setting forth a warranty accounting rationale for reserving at replacement cost.

48. Anderson, Thibault, and Butler added the Consultation Memorandum to E&Y's audit documentation for the December 31, 2005 Medicis audit. Butler wrote a memorandum to the audit file, dated June 29, 2006, that he and Anderson signed, explaining the addition of the Consultation Memorandum to the audit documentation. Anderson, Thibault, and Butler knew that Medicis's accounting for product returns remained the same due to Medicis's application of the warranty accounting rationale. They also knew or should have known that if replacement cost could not be supported by an appropriate accounting basis, Medicis would have to reserve for returns replaced in quarter at the gross sales price, and reduce revenue accordingly, pursuant to SFAS 48. Finally, they knew or should have known that such a change would have had a material effect on Medicis's financial statements and required it to restate its December 31, 2005 financial statements.

49. A final 2006 AQR findings report was issued and transmitted to E&Y's National AQR group. The report was signed by Anderson on July 6, 2006 and also signed by members of the AQR team. The report found that Medicis's use of footnote 3 to SFAS 48 to justify reserving at replacement cost was not appropriate because "the company's customers are distributors (i.e. resellers), and returned goods are medicines near or beyond the expiration date, while replacement goods are the same medicines significantly prior to the expiration date." The report also found that "the company's disclosures in the footnotes are not transparent/complete regarding its policy by indicating that 'exchanges for expired product are established as a reduction of product sales revenues at the time such revenues are recognized.'"

[22/] There is no evidence how, if at all, E&Y responded to the concerns expressed by the AQR Team Leader in his June 1, 2006 e-mail to the National AQR Member.

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50. Butler made a presentation concerning the 2006 AQR and the Product Returns Consultation to the Audit Committee of Medicis on July 10, 2006 and explained that the exchange exception to SFAS 48 did not apply to Medicis's returns replaced in quarter. No explanation was given as to why SFAS 48 did not require a full gross sales price deferral for returns replaced in quarter. Nor was any such explanation shared with the Audit Committee prior to issuance of E&Y's 2006 audit report dated February 26, 2007.

51. At the time of the Product Returns Consultation, Anderson, Thibault, and Butler knew or should have known that Medicis's reserving for returns replaced in quarter at replacement cost was not prescribed by any GAAP literature identified in AU § 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*.

52. At the time of the Product Returns Consultation, Anderson, Thibault, and Butler knew that Medicis's disclosure in its December 31, 2005 Form 10-K/T, regarding its usage of SFAS 48 to account for product returns, differed from the warranty accounting rationale. Despite this knowledge, they failed to appropriately re-assess the adequacy of the disclosures in the December 31, 2005 financial statements; failed to appropriately re-assess whether E&Y's previously issued unqualified audit opinion on the December 31, 2005 financial statements remained appropriate; and failed to adequately consider whether any action was required to safeguard against future reliance on E&Y's audit report on the December 31, 2005 financial statements.[23/]

The December 31, 2006 Audit

53. E&Y audited Medicis's financial statements for the year-ended December 31, 2006 and issued an unqualified opinion that the financial statements presented fairly, in all material respects, Medicis's financial position and results of operations in conformity with GAAP. Butler led the audit and authorized the issuance of E&Y's audit report.[24/] Thibault was independent review partner for the audit.

54. During 2006, Medicis continued to rely on the analogy to warranty accounting to support its sales returns reserve estimate but developed a new methodology, at year end, to estimate the sales return reserve for newer products. As a result of over $17 million of unexpected returns during the fourth quarter of 2006,

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[23/] See AU § 230; see also, AU § 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

[24/] There was no second partner on the 2006 audit.

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Medicis significantly changed its methodology for calculating its year-end returns reserve estimate. With Butler and Thibault's consultation and concurrence, Medicis implemented a new methodology for determining its sales returns reserve for a portion of its expired product returns.

55. At year end, Medicis broke its reserve into two categories: (1) products launched within the last four years ("non-legacy products") and (2) products launched more than four years earlier ("legacy products"). For legacy products, Medicis used the same methodology as in 2005 which utilized historical return rates and lag times and reserved for returns replaced at replacement cost ("historical method"). For non-legacy products, the returns reserve was based on estimating the total units of inventory in the distribution and retail channels and comparing that total estimate to an estimate of the units of inventory in the channels that would not be returned for expiry due to product demand. Medicis reserved for the difference between these two estimates at gross sales price. This methodology was based on several new key assumptions not considered under the historical method. (The new methodology is hereinafter referred to as the "units-in-channel methodology" or "units-in-channel method").

Failure to Appropriately Audit the Legacy Returns Reserve Estimate

56. As part of the 2006 year-end audit procedures, Medicis prepared a memorandum dated March 1, 2007, documenting its reliance on the SFAS 5 warranty accounting rationale, as determined in the Product Returns Consultation, as support for reserving for legacy product returns replaced at replacement cost under the historical method. Butler and Thibault concurred with Medicis's reliance on the warranty accounting rationale and incorporated this memorandum into the work papers for the December 31, 2006 audit. In performing the audit, Butler and Thibault failed to obtain sufficient competent evidential matter supporting the conclusion that an analogy to warranty accounting supported reserving for legacy product returns replaced at replacement cost and was an appropriate application of GAAP.

57. Butler and Thibault knew or should have known that the application of warranty accounting to legacy product returns was not prescribed by any GAAP literature identified in AU § 411.

58. Based on the audit evidence available to them in performing the December 31, 2006 audit, Butler and Thibault knew or should have known that reserving for returns at gross sales price (whether replaced in quarter or otherwise), and reducing revenue accordingly was the generally accepted accounting treatment pursuant to SFAS 48.

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59. In performing the 2006 audit, Butler and Thibault failed to adequately consider whether Medicis needed to disclose in its Form 10-K: (1) its practice of reserving for legacy returns replaced in quarter at replacement cost; (2) its reliance on a warranty accounting rationale as support for that accounting practice; and (3) its change from relying on the SFAS 48 exchange exception to an analogy to SFAS 5 warranty accounting.[25/]

Failure to Appropriately Audit the
Units-In-Channel Non-Legacy Returns Reserve Estimate

60. During 2006, Butler encouraged Medicis's management to improve its sales returns reserve estimation process. As a result of the fourth quarter material unforeseen returns, consistent with Butler's prior encouragement, management incorporated new information into its reserve methodology. Specifically, for the first time management considered channel inventory information and forecasted prescription ("script") demand data in its returns reserve methodology. However, instead of incorporating this data into its existing methodology that considered historical returns experience, Medicis developed the units-in-channel methodology.

61. To calculate the returns reserve for non-legacy products under the units-in-channel methodology, management had to estimate (1) future product demand, (2) actual inventory levels in the channel, and (3) the level of inventory in the channel below which returns would not occur. PCAOB standards required E&Y and Butler to obtain and evaluate sufficient competent evidential matter to support Medicis's significant accounting estimates, including its non-legacy returns reserve estimate.[26/] Butler, however, failed to perform, or ensure the performance of, sufficient audit procedures to support the reasonableness of key assumptions underlying management's units-in-channel methodology, including the level of inventory in the channel below which management assumed returns would not occur.[27/] Consequently, they did not obtain

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[25/] See AU § 420, *Consistency of Application of Generally Accepted Accounting Principles*; AU § 431. The failure to adequately consider the sufficiency of the disclosure was exacerbated by the fact that, in connection with the 2006 AQR, E&Y developed an "Action Plan" which stated, in part, that "the Company's disclosures in future filings with the SEC . . . should include even greater transparency in the accounting for such returns."

[26/] See AU § 342.01.

[27/] See id. at .09.

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sufficient competent evidential matter to support the returns reserve estimate calculated by the units-in-channel methodology.

62. Management concluded that 12 weeks of projected script demand was the appropriate level of inventory in the channel ("the 12-week assumption"). In other words, management assumed that no returns would occur if channel inventory levels were below 12 weeks of total forecasted script demand. Management premised their 12-week assumption on eight weeks of inventory in the wholesale distribution channel and four weeks of inventory in the retail channel. The greater the number of weeks of inventory that management assumed was appropriately in the channel, the smaller its reserve — and the smaller the reduction to net revenue reported in the income statement.

63. Butler concluded that the 12-week assumption was reasonable based primarily on discussions with E&Y personnel and management's representation that Medicis's use of contract manufacturers caused production lead times to be up to 20 weeks. Butler knew or should have known that such evidence did not support the assumption that all sales below 12 weeks of script demand would not be returned. Butler failed to appropriately consider, or gather sufficient evidence to support, the contention that manufacturing lead times were a relevant factor in determining if a product in the channel was likely to be returned for expiry.[28/] Additionally, Butler was aware of audit evidence indicating that 12 weeks of channel inventory was above industry average and that, as documented in the work papers, each additional week of channel inventory assumed not to be returned decreased the estimated returns reserve by approximately $4.2 million.[29/] Butler was also aware that Medicis had not previously tracked the amount of inventory in the distribution channel, so there was no historical evidence against which to compare the 12-week assumption. Notwithstanding these facts, Butler failed to obtain sufficient competent evidence supporting that 12 weeks was a reasonable estimate for this key assumption.[30/]

64. A work paper reviewed by Butler contained information showing that the combined legacy and non-legacy reserve was approximately 10% ($3.4 million) larger than if the Company had continued to use its historical methodology at December 31, 2006 (*i.e.*, the methodology that priced the majority of reserved units at replacement

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[28/] See id. at .11b.

[29/] Tolerable error for individual account balances for the 2006 audit was $2.175 million.

[30/] See AU § 342.11b.

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cost instead of at gross sales price). Butler knew or should have known that this work paper did not provide evidence supporting the reasonableness of the units-in-channel methodology and that, if all returns under the historical method calculation had been reserved for at gross sales price as in the units-in-channel calculation, the reserve would have been materially higher due to the significant difference between cost and sales price resulting from Medicis's 85% gross margins on product sales.

65. In performing the 2006 audit, Butler failed to adequately consider whether Medicis needed to disclose in its Form 10-K its change to the units-in-channel methodology for non-legacy product returns.[31/]

66. As a result of E&Y, Butler, and Thibault's failure to comply with PCAOB standards, Butler, with Thibault's review and approval, improperly authorized the issuance of E&Y's audit report dated February 26, 2007, on Medicis's financial statements for the year ended December 31, 2006, which incorrectly expressed an unqualified opinion that the financial statements presented fairly, in all material respects, Medicis's financial position and results of operations in conformity with GAAP.[32/]

The December 31, 2007 Audit

67. E&Y audited Medicis's financial statements for the year-ended December 31, 2007 and issued an unqualified opinion that the financial statements presented fairly, in all material respects, Medicis's financial position and results of operations in conformity with GAAP. Anderson led the audit and authorized the issuance of E&Y's audit report. Christie was supervised by Anderson and acted as second partner on the audit.

68. Over the course of 2007, Medicis continued to change how it estimated its sales returns reserve estimate. For the first two quarters, it developed the estimate as it had at 2006 year-end – by using units-in-channel for non-legacy products and the historical method for legacy products.

69. In the third quarter of 2007, Medicis began reserving for all estimated returns under the units-in-channel methodology. Thus, for the first time, Medicis reserved for all returns at gross sales price. However, like at year-end 2006, Medicis compared the reserve estimate calculated under both the units-in-channel and historical methodologies to determine if the transition was appropriate. The historical method produced a legacy product reserve 81% higher than the units-in-channel method —

[31/] See AU § 431.

[32/] See AU § 508.07.

even though the historical method reserved for most estimated legacy returns at replacement cost instead of gross sales price. The fact that the historical method at replacement cost produced a reserve nearly double the units-in-channel method at gross sales price should have caused Anderson and Christie to question the continued reasonableness of the units-in-channel methodology. Instead, based on this comparison, they accepted management's decision to record a reserve equal to the mid-point between the two estimates at September 30, 2007.

70. At year-end, due in part to the comparison done at September 30, 2007, with the concurrence of Anderson and Christie, Medicis used only the units-in-channel methodology for developing its returns reserve estimate. The units-in-channel methodology resulted in a reserve of $9.6 million at December 31, 2007 – a 70% decline from the reserve recorded at December 31, 2006.

71. In addition, as shown in the audit work papers, Anderson and Christie knew that the December 31, 2006 returns reserve of $35.2 million – which was intended to cover approximately 18 months worth of future returns – was insufficient to cover the 12 months of 2007 returns alone, which totaled $53.8 million at gross sales price. And, management's December 31, 2007 returns reserve of $9.6 million was less than the actual returns in the fourth quarter of 2007 alone. PCAOB standards required E&Y, Anderson, and Christie to consider these facts and, to the extent management believed its historical return pattern would not continue, obtain sufficient competent evidential matter to support the reasonableness of the year-end reserve estimate.[33/] Anderson and Christie failed to comply with this requirement.

Failure to Adequately Test Management's 12-Week Assumption

72. In performing the audit, Anderson and Christie failed to adequately test or ensure the performance of audit procedures to test management's estimate that 12 weeks of product inventory in the distribution channel was an appropriate estimate of the number of units of product not likely to be returned. Instead, the engagement team relied on management's representation that the 12-week assumption was appropriate and on the prior year audit team's insufficiently supported acceptance of the 12-week assumption as the basis for the continued use of the assumption in 2007.

73. As noted above, Anderson and Christie knew or should have known that the December 31, 2006 reserve estimate had proven not to be sufficient to cover anticipated returns. Moreover, they knew that the third quarter comparison between the historical and units-in-channel methodologies showed that the units-in-channel

[33/] See AU § 342.09.

methodology produced a materially lower reserve estimate for legacy products even though it was based on gross sales price. These facts required Anderson and Christie to obtain additional audit evidence supporting the 12-week assumption, but they failed to do so.[34/]

Failure to Adequately Test Management's Retail Inventory Estimate

74. Anderson and Christie were aware that management did not have access to data concerning the level of product inventory in the retail distribution channel at December 31, 2007. They also knew that management estimated how much inventory was in the retail channel by assuming that all retail customers had 30 days of inventory on hand of each Medicis product. Anderson and Christie failed to perform any procedures or gather any evidence to assess the reasonableness of this assumption in violation of PCAOB standards.

75. In performing the audit, Anderson and Christie also failed to adequately evaluate whether Medicis's adoption of the units-in-channel methodology for legacy product returns required disclosure.[35/]

76. As a result of E&Y, Anderson, and Christie's failure to comply with PCAOB standards, Anderson, with Christie's review and approval, improperly authorized the issuance of E&Y's audit report dated February 26, 2008, on Medicis's financial statements for the year ended December 31, 2007, which incorrectly expressed an unqualified opinion that the financial statements presented fairly, in all material respects, Medicis's financial position and results of operations in conformity with GAAP.[36/]

IV.

In view of the foregoing, and to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports, the Board determines it appropriate to impose the sanctions agreed to in Respondents' Offers. The Board, in determining the appropriate sanctions as to E&Y, has taken into account the undertakings E&Y previously agreed to in the settlement of an unrelated Securities and Exchange Commission administrative proceeding. Those undertakings would have prohibited the independent review partner from participating in

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[34/] See AU § 333.04; AU § 326.25; AU § 342.11.

[35/] See AU § 420.

[36/] See AU § 508.07.

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the Product Returns Consultation in a National Office role and would have required greater documentation of the consultation.[37/] Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 105(c)(4)(E) of the Act and PCAOB Rule 5300(a)(5), Ernst & Young is hereby censured;

B. Pursuant to Section 105(c)(4)(B) of the Act and PCAOB Rule 5300(a)(2), Jeffrey S. Anderson 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);

C. After two (2) years from the date of this Order, Jeffrey S. Anderson may file a petition, pursuant to PCAOB Rule 5302(b), for Board consent to associate with a registered public accounting firm;

D. Pursuant to Section 105(c)(4)(B) of the Act and PCAOB Rule 5300(a)(2), Robert H. Thibault 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);

E. After one (1) year from the date of this Order, Robert H. Thibault may file a petition, pursuant to PCAOB Rule 5302(b), for Board consent to associate with a registered public accounting firm;

F. Pursuant to Section 105(c)(4)(E) of the Act and PCAOB Rule 5300(a)(5), Ronald Butler, Jr. is hereby censured;

G. Pursuant to Section 105(c)(4)(E) of the Act and PCAOB Rule 5300(a)(5), Thomas A. Christie is hereby censured; and

H. Pursuant to Section 105(c)(4)(D) of the Act and PCAOB Rule 5300(a)(4), civil money penalties in the amount of $2,000,000 payable by Ernst & Young; $50,000 payable by Jeffrey S. Anderson; $25,000 payable by Robert H. Thibault; and $25,000 payable by Ronald Butler, Jr. are imposed. All funds collected by the Board as a result of the assessment of these civil money penalties will be used in accordance with Section 109(c)(2) of the Act. Ernst & Young, Anderson, Thibault, and Butler shall pay these civil money penalties within 30 days of the issuance of this Order by (a) wire transfer in accordance with instructions furnished by Board staff, United States postal money order,

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[37/] See *Ernst & Young*, SEC Release No. 34-61196 (Undertakings C.1. and C.4.).

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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 cover letters which identify each as a Respondent in these proceedings, set forth the title and PCAOB Release number of these proceedings, and state that payment is made pursuant to this Order, a copy of which cover letters and money orders or checks 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.

ISSUED BY THE BOARD.

/s/ J. Gordon Seymour
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J. Gordon Seymour
Secretary

February 8, 2012