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# Valeant should be answering on materiality and disclosure

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Among the numerous assertions that embattled Valeant Pharmaceuticals International Inc. has made in its defence in recent weeks, I note one in particular: The company's outside counsel has met with the U.S. Securities and Exchange Commission to request it investigate Andrew Left, the short seller whose report on Valeant has been a big part of the stock's recent tumble.

I think Valeant's starting a dialogue with the SEC is a wonderful idea – because it will give U.S. securities regulators ample opportunity to ask Valeant about its views on materiality and disclosure.

Specifically, how Valeant's relationship with "specialty pharmacy" Philidor Rx Services LLC was unknown to the markets before investigative reporters, and then Mr. Left, laid out what they knew, and what they suspected, for all investors to see.

Pennsylvania-based Philidor distributed Valeant's drugs to their end users; Valeant was its sole client. In its Oct. 19 earnings call, Valeant chief executive officer Michael Pearson revealed that Valeant had bought an option to acquire Philidor in late 2014, and that the pharmacy's financial results were now "consolidated," or included, with Valeant's.

On Oct. 26, responding to a wave of reports and accusations over the previous week, Mr. Pearson said Valeant paid $100-million (U.S.) for the option. And Valeant tried to explain why its shareholders had never heard of Philidor before. When the Philidor purchase option was signed in December, 2014, Valeant said, the pharmacy's year-to-date net sales were $111-million, versus more than $8-billion in revenue for Valeant.

"Philidor is not considered material to Valeant's business for reporting purposes …," Valeant said in a slide from its investor presentation. "The [U.S. accounting] requirement for disclosing sales to large customers is 10 per cent of revenue; revenue from the smallest customer disclosed in 2014 was $0.9-billion," Valeant said.

Alas, Valeant's defence here is incomplete, to be charitable; arguably, it's wrong.

Materiality is a concept of what is important to investors, and therefore what a company should disclose or correct in its financial statements if it discovers an error. It is part of accounting and financial reporting, but it's also a matter of law, as these disagreements often find themselves settled in the courts.

What Valeant cited – a threshold requirement for disclosing large customers in an annual report – has little to do with materiality. And the courts and regulators have long rejected the idea that something is plainly immaterial if it does not reach the threshold of 10 per cent of revenue or company assets.

In 1999, the SEC issued a Staff Accounting Bulletin that warned companies about using a bright-line test such as 5 per cent or 10 per cent of revenue or assets to avoid disclosing information that investors would find relevant. Said the SEC: “Exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law … . Materiality concerns the significance of an item to users of a registrant’s financial statements. A matter is ‘material’ if there is a substantial likelihood that a reasonable person would consider it important.”

In a 2000 U.S. federal court case that pitted shareholders versus a utility company, a panel of judges rejected the company’s defence that its undisclosed, one-time fee income that boosted earnings was immaterial because it amounted to only 1.7 per cent of the company’s annual revenue. The judges noted that the U.S. Supreme Court had expressly rejected a bright-line rule for materiality.

Interestingly, Valeant has disclosed other transactions involving companies similarly sized to Philidor either in securities filings, press releases or earnings calls. The analysts at ***Veritas Investment Research*** note that Valeant discussed the $100-million in annual sales for PreCision Dermatology, acquired in February, 2014, and Solta Medical, which had $150-million in sales in the 12 months prior to its acquisition by Valeant.

***Veritas’s Dmitry Khmelnitsky*** says that since Philidor was considered a “variable interest entity” – a company that Valeant had control over – Valeant should have used the accounting standards that apply to these entities. And that accounting guidance, he says, “does not have any materiality thresholds that companies could use to avoid disclosure.”

A spokesman for Valeant says the company considered the SEC’s guidance in making its disclosure decisions, but “determined at the time that the disclosure was sufficient and that the Philidor option purchase agreement did not meet either the quantitative or subjective tests of materiality … . Obviously, any current assessment of materiality would be based on a very different set of facts than the company was evaluating back then.”

Also, he said, “Valeant often mentioned certain deals on conference calls when discussing business performance or strategies, but not because they were material.”

Companies disclose these things, actually, because relatively small acquisitions can still move the needle in terms of a company’s ability to hit quarterly earnings-per-share targets and post robust year-over-year growth.

Consider what Philidor contributes to Valeant’s all-important growth numbers: The company now says Philidor (which has recently been shuttered) accounted for 5.9 per cent of its 2015 year-to-date net revenue, or approximately $450-million. Valeant has reported a year-over-year gain of about $1.7-billion in revenue through the first three quarters, which means Philidor has been a big contributor to those investor-pleasing gains. The analysts at ***Veritas*** figure that sales through Philidor account for seven percentage points, or 55 per cent of Valeant’s reported 13 per cent “organic growth” rate.

Or just consider how Valeant stock has fared since Oct. 16, the day before the Philidor revelations started: The shares have now fallen 54 per cent, erasing $42-billion (Canadian) of market capitalization. Substantial likelihood that a reasonable person would consider Philidor important, I’d suggest.