Research Partnerships Give Irish Drug Maker Rosy Financial Glow

Elan Set Up Joint Ventures, Sold Them Licenses, Got Quick Dose of Revenue

Perfectly Legitimate, It Says

By Jesse Eisinger
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DUBLIN—Some pharmaceutical companies are known for their research excellence, others for their marketing prowess. Ireland’s Elan Corp., the world’s 20th-largest drug company, with a market value of about $12 billion, stands out for its accounting.

Consider its more than 50 research and development joint ventures. They simultaneously shift R&D research costs off Elan’s books and allow Elan to book revenue long before the ventures have developed any products to sell.

In their most typical form, Elan invests $20 million in a partner and the joint venture, and the venture immediately pays Elan $15 million for a medical-technology license. Elan books that as revenue. But the money that Elan invested doesn’t cut into its earnings because that’s an investment, and appears only on the balance sheet, where it’s an asset.

In effect, Elan converts $15 million of money it already had into new revenue.

"What’s the real substance?" asks Lynn Turner, a former chief accountant for the U.S. Securities and Exchange Commission. "I’m taking money out of one pocket and putting it into another. That is a charade," Elan firmly rejects that notion. "There is nothing inappropriate about our accounting," says its executive vice chairman, Thomas Lynch, a former partner at KPMG LLP.

Uncommon Setup

In the wake of the scandal over Enron Corp.’s misleading accounting, the ways that fast-growing companies reach their stellar numbers are drawing a closer look.

In the case of Elan, whose revenue and earnings have soared in the past decade, such scrutiny reveals some unusually structured deals that contribute to financial results, but that are difficult for investors to evaluate.

In one case, a joint venture with a small North Carolina biotech firm designed to find a treatment for ulcerative colitis, Elan booked revenue even though no cash appears to have changed hands when the venture was set up. In another joint venture, with a Canadian biotech firm, the partners hadn’t decided what research the venture would pursue before it paid all of its funds to Elan for a license.

Among Elan ventures’ other quirks: After buying a license from Elan, the ventures typically have no money left to pursue research on new drugs. Elan sometimes makes them a loan. Then they contract out the research work, often partly to Elan itself, again producing revenue for Elan.

Lately, the drug company has been selling off smaller product lines. It books the proceeds as "product revenue," although some accountants say it should be described as one-time gains, under generally accepted accounting principles.

Short-Sellers

Questions about Elan’s accounting have dogged the company for years. Short-sellers, who benefit when a stock goes down, have often criticized it. Mr. Turner, now head of the Center for Quality Financial Reporting at Colorado State University, says Elan is "too fast for the regulators and too fast for their own good. They appear to have gotten around the accounting rules, and around the system." The SEC wrote to Elan in 1999 expressing concerns about some accounting maneuvers the company was using at that time. Elan restated one year’s earnings a few months after receiving the 1999 letter, and it now says the accounting issue has been laid to rest.

Some investment professionals seem to agree. The matter “is clearly historical, and doesn’t play a significant part in the business currently,” says John Murphy, a Goldman Sachs pharmaceutical analyst. Goldman has the stock on its recommended list, its highest rating. Analysts at Merrill Lynch & Co. and 10 other brokerage firms also recommend the stock, according to Thomson Financial/First Call.

Elan’s American depositary shares trade on the New York Stock Exchange, requiring it to show its results under U.S. accounting rules. Annual revenue jumped to $1.5 billion in 2000 from $323 million in 1996. What Elan calls earnings per share before other charges rose to $1.46 in 2000 from 48 cents in 1996. Analysts estimate the 2001 figure at $1.92 and peg Elan’s 2001 revenue at $1.5 billion. Elan expects its revenue, most of which comes from sales in the U.S., to double again in the next four years.

In 2000, Elan sold a North Carolina biotech firm to Merck & Co. for $2.3 billion, and those proceeds are working their way into the books. The SEC said Elan swayed both sides of the deal when it set up the joint venture.

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Elan currently sells dozens of drug and diagnostic products. It is developing drugs for multiple sclerosis and Alzheimer’s disease, although the Alzheimer’s product recently hit a snag and trials were temporarily suspended. Besides Ireland, Elan has labs in San Diego and South San Francisco, Calif.

Elan says it currently has about 55 research joint ventures, but stopped creating new ones in mid-2001 to focus on developing their products. The ventures have more than two dozen potential drugs in human testing, but Elan says the system is "very productive," says its chief scientific and medical officer, Ivan Lieberburg. Because of this research setup, he adds, “we don’t have to do the Merck model of bringing everything inside. The advantage of that is complete control. The disadvantage is it costs a lot of money.”

In each of these joint ventures, Elan holds a 19.9% interest and its partner the rest. The ventures, several based in Bermuda, have few or no employees. This system contrasts with a more common way pharmaceutical companies link up with small biotech firms, which is to acquire equity in the small firms in gradual steps as the research advances, and receive co-marketing rights to any drug produced.

Cross Receipt

Though Elan doesn’t announce the joint ventures’ financial results, some details can be gleaned from SEC filings by the company or its partners, such as Incara Pharmaceuticals Corp. of Research Triangle Park, N.C. According to a securitization purchase agreement filed by Incara with the SEC last January, Elan invested $2.385 million in this joint venture and $16.015 million in Incara stock and a warrant. Incara, the majority partner, then put $12.015 million into the joint venture, bringing the venture’s funding to $15 million.

The SEC filing said Elan would pay Incara the $16.015 million by wire transfer. But in Incara’s subsequent quarterly filings with the SEC, its statements of cash flow don’t show a receipt of this cash in financing activities, nor do they show any payment from Incara to the joint venture in investing activities. Yet SEC filings say the joint venture bought a $15 million technology license from Elan.

Asked why the quarterly filings showed no payments of cash, Elan says in a written response that “cash was transferred by way of a cross receipt,” which it calls a “legal mechanism under which amounts owing under different contracts are amalgamated with the resulting amount being settled by wire transfer.” Elan says it is “not aware of how Incara disclosed the movement in cash.” Incara declines to comment on its accounting for the transaction.
Assuming Elan did pay the $15 million to Incara, it would still seem that all the money the joint venture used to pay a license fee to Elan had come from Elan itself. Asked if this doesn’t amount to what accountants call “round-trip revenue,” Elan’s Mr. Lynch rejects the characterization, noting that “we end up owning equity” in the majority partner. Incara says its venture with Elan has started a late-stage clinical trial in ulcerative colitis patients.

A Year Ahead

One joint venture brought revenue to Elan 12 months before the partners had even mapped out a research program. Formed a year ago, it involved Generex Biotechnology Corp. of Toronto. Generex’s CEO, Anna Gluskin, says the venture paid Elan a $15 million license fee for drug-delivery technology. Yet the partners didn’t know which chemical compound they would develop or even which disease they would target. In an SEC filing at the time, Generex said the “partnership” in the majority partner. Incara says the joint venture-which, like Incara’s, is based in Bermuda—could afford to pay that much for a license “based on the potential for coming to market sooner than other” competing drugs. She says the partners estimated that the market for whatever drug was eventually developed would be at least $500 million a year.

How could they decide a year in advance that the medical technology was worth $15 million—all the money the joint venture had? Elan says the price of its licenses is based on what the technology is worth, not on the use of it. Ms. Gluskin says the joint venture—which, like Incara’s, is based in Bermuda—could afford to pay that much for a license “based on the potential for coming to market sooner than other” competing drugs. She says the partners estimated that the market for whatever drug was eventually developed would be at least $500 million a year.

But actually, “we don’t know what the market will be. It’s all assumption,” she acknowledges, adding that “any products that sell over $500 million would justify the payment” of $15 million for the license. The largest-selling drug Elan has ever had, Zanaflex for muscle spasms, sells only a little over $150 million annually. This month, Generex announced the joint venture’s project: formulating morphine to be absorbed through the inside of the cheeks.

Elan used to book the full license fee from new joint ventures as revenue right away. But the SEC ruled in 1999 that companies shouldn’t immediately book revenue from agreements in which they have continuing involvement, but should book it over the life of the agreement. In response, a year ago Elan announced a $344 million retroactive charge against earnings. The seemingly adverse SEC ruling has actually made Elan’s later growth look better, because, having reversed the premature booking of revenue, Elan became able to record this revenue in the future.

Joint Ventures’ Losses

All of the joint ventures run losses, Elan says. Just how these losses affect Elan’s earnings isn’t very clear.

If a company’s stake in a joint venture is below 20%, as Elan’s are, it may use “cost” accounting and needn’t reflect a share of the investment’s losses on its own profit-and-loss statement. But, as Elan points out, if a company has significant influence over the investment, it ought to use the “equity” method of accounting and record its share of the losses in a line on its P&L statement, reducing its earnings.

In Elan’s typical arrangement with joint ventures, it has veto power over research, 50% board representation and a right to raise its 19.9% financial stake to 50%. Yet Elan’s P&L statements don’t break out any losses from the ventures. The Center for Financial Research & Analysis Inc. in Rockville, Md., a firm that analyzes companies’ books for big investors, has said in a report that Elan appears to be using cost accounting.

Elan says it uses the equity method “where appropriate.” It adds in a written statement that it “expenses its share of the operating losses of all business ventures regardless of whether the equity method or cost method is used. Such amounts are included, in full, in net interest expense.”

“Why in the world would they put this in interest expense? That doesn’t make any sense at all,” says J. Edward Ketz, an associate professor of accounting at Penn State, when told of Elan’s statement. “What they are doing is not consistent with either cost-method or equity-method accounting. I don’t see how, under U.S. GAAP, that would be.” In addition, the interest-expense table in Elan’s SEC filings doesn’t seem to show such losses.

Elan’s auditor, KPMG, declines to comment, citing client confidentiality. Elan is managed by a former KPMG partner, Donal Geaney, who has been at Elan for 14 years and chief executive since 1995. Mr. Lynch, the executive vice chairman, came over from KPMG in 1993, and Elan’s chief financial officer, Shane Cooke, also is a former KPMG partner.

A couple of the businesses with which Elan has formed research partnerships were tiny firms that were running out of cash. Celtrix Pharmaceuticals Inc. had dismissed 90% of its payroll and was down to fewer than 10 employees when Elan formed a research joint venture with it in April 1999, generating $10 mil-
Elan Shares
Weekly closing American depositary shares price in New York

With this particular sale, there are other reasons that listing the proceeds as product revenue could give investors an exaggerated impression of Elan's sales. First of all, an Elan affiliate lent $45 million to the buyer, Amarin. Secondly, Elan has extensive ties to Aman. It owns about 43% of the buyer, on a fully diluted basis. Aman's CFO, Nigel Bell, maintained an e-mail address featuring an Elancorp.com suffix until several weeks ago. Five Aman directors or executives are current or former Elan employees. Aman's chairman is Mr. Lynch, the Elan executive vice chairman, who says he engineered a rescue of Aman in 1993.

Related Party?
The following year, Aman paid Elan $25 million for 15 product lines. But Elan hasn't listed Aman as a "related party" in its SEC filings. The Financial Accounting Standards Board, which creates accounting standards, says this label should be applied to transactions with affiliates, owners or management, or wherever one party "might be prevented from fully pursuing its own separate interests" because of the other party's influence. The label can help investors to evaluate a corporate transaction.

Asked whether Elan will list the Permax sale to Aman as a related-party transaction, Elan says it "disclose the transaction ... in accordance with the appropriate accounting literature" in its filings for 2001.

Occasionally, a company that buys a product line from Elan relies on Elan itself for the money to do so. Last June Elan sold Midrin, a headache drug, to Women First Healthcare Inc. of San Diego for $15 million. In the same transaction, Elan invested $4 million in Women First shares and $11 million in promissory notes.

Xcel Pharmaceuticals Inc. of San Diego bought two epilepsy product lines from Elan last year. Xcel's filing for an initial public offering says the net price was $150 million, $39 million of which it borrowed from Elan, while Elan also put $15 million into equity of the buyer. Xcel had no operations before it bought the Elan product lines. Elan says Xcel, whose board includes one Elan executive and one former one, made the best bid in a competitive auction.

SEC Letter
Mr. Lynch says Elan's sales of product lines accounted for just 15 cents of its 2001 per-share earnings, which analysts peg at about $1.92 in all. Some outsiders who have studied Elan think the product-line sales are a bigger factor than that. Ian Sanderson of SG Cowen Securities estimates they accounted for 40 cents of Elan's 2001 earnings. Maverick Capital, a New York hedge fund, estimates 50 cents, based on its analysis of product-line sales throughout the drug industry. Cowen rates Elan stock a buy. Maverick won't disclose its position in the stock.

Some of the product lines Elan is now shedding came to it through a spate of 1990s acquisitions. The company's acquisition accounting was one of the topics of the critical letter the SEC sent Elan in 1999. The SEC objected to Elan's taking huge write-offs for acquired companies' research, sometimes even more than the acquisition price. The move ensured that "goodwill" — the difference between an acquisition price and the acquired firm's net worth — could never burden Elan earnings.

The SEC also criticized some of Elan's off-balance-sheet R&D vehicles, which it said "may materially inflate reported earnings," and questioned whether Elan had accounted properly for its joint ventures. After several months, Elan made a small restatement of 1997 earnings.

All the controversy over accounting gets wearying for some of Elan's staffers. "It's frustrating," says Dr. Lieberburg, the chief scientific officer. "It's a concentration on the wrong issue that, as a scientist and physician, I don't see as relevant. At some point, I want to wake up and say, 'We've cured Alzheimer's and multiple sclerosis.'"