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Valeant: An Accounting Pioneer, Too

Three ways the drugmaker's books look very different from those of its peers

Valeant Pharmaceuticals, based in Laval, Quebec, has an unconventional business model for a drugmaker. *PHOTO: CHRISTINNE MUSCHI/REUTERS*

By

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Valeant Pharmaceuticals International Inc. didn't just pioneer a new way of running a drug company—it has an unusual way of accounting for one, too.

The approach flows in part from Valeant's unconventional business model for a drugmaker, focused more on acquiring and selling drugs than on discovering them. As with its business, the Canadian company's books look very different from those of its peers, appearing in some ways more complex and opaque.

Valeant's accounting stands out for its heavy use of tailored earnings metrics that strip out a wide range of expenses; favorable accounting for its acquisition and research-and-development costs; and a less-granular view of its business lines than rivals provide, analysts and investors say.

Drug industry iconoclast Valeant Pharmaceuticals has polarized Wall Street, delivering blockbuster share performance for years while also attracting vocal naysayers.

For years, even as some critics complained of Valeant's complexities, investors didn't seem to care, sending the stock up more than 1,000% over five years. Since August, though, shares have dropped—at one point more than 70%—as Valeant faced a barrage of questions including about its accounting, which it has defended, and its close ties to a mail-order pharmacy that for nearly a year it hadn't revealed to Wall Street. Its shares were up 17% midday Tuesday after the company announced drug pricing and distribution agreementswith Walgreens Boots Alliance Inc.
The recent questions about Valeant fanned anxieties that critics had previously raised, analysts and investors say: whether the company is transparent enough with investors and whether it gives them enough information.

"The very big problem about Valeant is that it's a trust-me story," said Evan Lorenz, an analyst for Grant's Interest Rate Observer newsletter, which has been critical of Valeant since 2014.

Valeant says it gives investors more information than required. It acknowledges it is a complex, unconventional company but says it aims to provide a clear picture of its business. As for the mail-order pharmacy, Valeant has said it wasn't material to its finances.

Chief Executive Michael Pearson recently said Valeant is "committed to transparency," and has promised that the company would "listen more to critics" and enhance its investor relations.

Valeant also hopes to reassure Wall Street at an investor day Wednesday, where it is expected to update its financial outlook.

Here is a look at some of the accounting methods at Valeant that have attracted investor questions:

Custom-Made Earnings Measurement

Valeant uses its own customized earnings measure, "cash earnings per share," that shows far better results than those it also reports under standard accounting rules intended to help investors compare companies.

Many companies use tailored metrics. They are allowed under securities rules as long as companies explain how they got from the number under the standard rules—known as generally accepted accounting principles, or GAAP—to their tailored metric.

Data show an unusually wide gap between Valeant's GAAP earnings and its cash-earnings figure. Under GAAP, the company posted $70 million in net income for the first nine months of 2015. Under its own cash-earnings measure, the company reported a profit of $2.7 billion. The cash-earnings measure strips out a host of costs, including acquisition expenses, inventory adjustments and stock payments to employees.

Strip-outs accounted for 97% of Valeant's adjusted income over the first three quarters of this year, compared with 35% for the median of Valeant's self-selected peer group, a Wall Street Journal review of filings shows. Only at Allergan PLC, another highly acquisitive company, did adjustments account for a bigger chunk of adjusted financial metrics. Allergan declined to comment.

Bonuses for Mr. Pearson and other top Valeant executives are tied to the cash-earnings figure, filings show.

Valeant says in filings its metric gives investors "a meaningful, consistent comparison" of its results over time.

The Valeant metric is "a ridiculous number," said J. Edward Ketz, an associate professor of accounting at Penn State University. He says it isn't legitimate for a serial acquirer such as Valeant to strip out big acquisition-related expenses from its adjusted earnings. Valeant has excluded more than $300 million in deal-related expenses in each of the past four years from its cash-earnings-per-share figure. The consistency of those expenses suggests they are core to Valeant's business, Mr. Ketz and other critics say, and not the one-time or unpredictable items that companies often exclude from adjusted figures.

Valeant "is using non-GAAP numbers that were never intended for companies like Valeant," said ***Dimitry Khmelnitsky***, a forensic accountant with ***Veritas Investment Research*** in Toronto.

Research and Development

Valeant's approach to research and development also leads to favorable accounting treatment.

When drug companies spend on research in-house, they record quarterly expenses that eat into profits. But research gained through acquisitions is treated as an intangible asset that can sit on companies' balance sheets indefinitely at full value.

That means that by buying, rather than creating, most of its drugs, Valeant can avoid recording big quarterly R&D expenses, thus lifting its earnings.

If the research leads to a marketable drug, Valeant must amortize the R&D cost, recording expenses each quarter to gradually write down its value over time. But Valeant then strips those costs out of its cash-earnings metric, filings show. In summary, its earnings don't reflect the cost of its R&D up front, and when it does incur costs on its purchased R&D, it excludes them from its preferred measure of earnings.

For example, when Valeant bought Salix Pharmaceuticals Ltd. earlier this year, it acquired Salix R&D valued at $5.4 billion, most of it on Xifaxan, a drug to treat irritable bowel syndrome. After Xifaxan received regulatory approval for a new treatment area in May, Valeant indicated it would record costs at the rate of $120 million each quarter to write down the Xifaxan R&D, filings show. That expense, however, is stripped out of Valeant's cash-earnings measure.

There is nothing wrong with buying growth through acquisitions, said Mr. Lorenz of Grant's. But he said it is "disingenuous" to exclude the costs of doing so.

Business Segments

Investors have also questioned how Valeant organizes its business segments.

As recently as 2012, Valeant reported detailed results across five segments, including some that tracked specific therapeutic areas such as U.S. neurology and U.S. dermatology, as many peers do.

Since then, Valeant has reduced that number twice. It now reports in two segments: developed markets and emerging markets. Valeant is the only one of its self-identified peers to use strictly geographic segments, filings show.

Valeant has said its reporting segments reflect how Mr. Pearson runs the business. The company breaks out revenue by therapeutic area each quarter.

Some investors say that by winnowing the number of reporting segments, Valeant makes it difficult to see which parts of the company are growing and by how much. Some point to the 2012 acquisition of Medicis, primarily a North American dermatology company. Rather than being tracked as part of a dermatology segment, the business was included in Valeant's broader sales in the U.S. and Canada.

Even one of Valeant's biggest supporters and shareholders says the company needs to be more open about its business. William Ackman, the hedge-fund billionaire whose Pershing Square Capital Management LP owns 10% of Valeant, has urged Valeant to "do a better job going forward explaining their business." Anything less than complete transparency "makes the company vulnerable," he said on an October conference call.