

**ALZA CORPORATION:
AN ILLUSTRATION OF FORM OVER SUBSTANCE**

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Abstract

Before merging with Johnson & Johnson in 2001, ALZA Pharmaceuticals Corporation was on the cutting edge of both drug delivery systems and creative financial arrangements. This paper explains the creation of two spin-off corporations by ALZA for the purpose of funding research and development (R&D) activities to be carried out primarily by and for the benefit of ALZA. The agreements between ALZA and its two spin-offs are outlined, the financial statement impact for ALZA is examined, and the disclosures made regarding the arrangements are critiqued. Results show that existing GAAP was circumvented to enhance revenue and net income over a period of eight years. Finally, the paper discusses the potential efficacy of a principles-based accounting standard in preventing the overstatement and circumvention of GAAP and argues for the continuing need for detailed guidance in the standard-setting process.

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I. INTRODUCTION

ALZA Pharmaceuticals Corporation was incorporated under the laws of the State of California on June 11, 1968. Its founder, Alejandro Zaffaroni, was a member of the scientific team that invented the birth control pill¹. By the mid 1980's the company had developed into a leading provider of controlled-dosage drug delivery systems ranging from skin patches to low-current electric devices that administer drugs through the skin. ALZA is responsible for such world-class delivery systems as "the patch" for Nicoderm CQ, the leading smoking cessation drug. Other drugs utilizing ALZA's technology include Procardia XL, an oral angina/hypertension treatment, and Sudafed 24, an over-the-counter allergy medication.

Prior to the 1990's ALZA's revenues consisted solely of royalties from sales of other companies' products that used ALZA's delivery systems. Early in the decade, ALZA devised a plan to complement its already existing drug delivery systems by developing its own drug products thereby becoming a fully integrated pharmaceutical company. To accomplish its objective, ALZA conducted two R&D arrangements through spin-off corporations. These were Therapeutic Discovery Corporation (TDC) created in the early 1990's and Crescendo Pharmaceuticals Corporation (Crescendo) created in the late 1990's.

The following paragraphs explain the details of the TDC and Crescendo arrangements, illustrate and critique the methods used by ALZA to report the results of the two corporations, compare ALZA's accounting and reporting practices to GAAP applicable at the time of the arrangements, and illustrate how GAAP was circumvented to overstate ALZA's revenues throughout the 1990's. Then, subsequent new GAAP is reviewed, and the impact of its application on R&D arrangements such as ALZA's is summarized. Finally, the Security and Exchange Commission's (SEC's) and Financial Accounting Standards

¹ Zina Moukheiber, "Putting a Spin on R&D," *Forbes*, Vol. 163:3 (February, 1999), 111.

Board's (FASB's) efforts toward principles-based accounting are discussed briefly, and conclusions are drawn as to whether the present rules-based accounting standards contributed to the misleading presentation of financial results.

II. REVIEW OF THE TDC AND CRESCENDO ARRANGEMENTS

The TDC Arrangement

In late 1992 and mid 1993, ALZA created TDC, a development-stage company, by paying \$250 million for the new corporation's common stock. That stock consisted of two classes, 100 shares of Class B Common Stock and approximately 7.7 million shares of Class A Common Stock. ALZA retained ownership of TDC's Class B Common Stock (which carried certain blocking rights) and distributed all of TDC's Class A Common Stock to ALZA shareholders as a special dividend of units. Each unit consisted of one share of TDC Class A Common Stock and one warrant to purchase one-eighth of one share of ALZA common stock. The TDC Class A Common Stock and the ALZA warrants were listed and traded independently on the NASDAQ stock market. TDC's 1993 Form 10-K, filed with the SEC, stated that the value of the units was \$44.9 million and that the value of TDC's stock apart from the units could not be ascertained.

TDC's Form 10-K further stated that TDC was required to use the entire \$250 million received from ALZA, plus any investment income earned thereon less organization costs and administrative expenses, on the development of TDC products. The products to be considered for development would be proposed by ALZA, and ALZA would provide the R&D activities. Therefore, the \$250 million would flow back to ALZA as ALZA performed the R&D activities. ALZA maintained the right to determine whether to patent TDC products. If ALZA chose not to patent, TDC was prohibited from doing so. TDC's 1993 10-K stated that TDC owned no facilities and leased corporate offices from ALZA.

As the sole holder of TDC's Class B Common Stock, ALZA was entitled to vote separately as a class to prevent any merger or liquidation of TDC or the sale, lease, exchange, transfer or other disposition of any substantial asset of TDC. In addition, ALZA held options to purchase all of TDC's Class A Common Stock at a price stipulated in TDC's Restated Certificate of Incorporation. ALZA exercised this option in 1997 when TDC had exhausted most of its funds.

The Crescendo Arrangement

The TDC arrangement proved to be very successful and, seeking to duplicate that success, ALZA created Crescendo Pharmaceuticals Corporation, another development-stage company, in mid 1997 by paying \$300 million for Crescendo's common stock. As with TDC, Crescendo had two classes of stock, 1,000 shares of Class B Common stock and approximately five million shares of Class A Common Stock. ALZA maintained ownership of the Class B stock and distributed the Class A Common Stock to holders of ALZA's common stock and convertible debentures. The Crescendo Class A Common Stock was traded on the NASDAQ stock market separately from the ALZA stock. Crescendo's 1997 Form 10-K listed the value of the Class A Common Stock as approximately \$57.7 million.

Crescendo and ALZA entered into a number of agreements, including a technology license agreement, a license option agreement, and a development agreement. Under the technology license agreement, Crescendo was granted a worldwide license to use ALZA technology to develop Crescendo products. ALZA received a monthly one million dollar technology fee from Crescendo for three years. The license option agreement granted ALZA the option to license each Crescendo product developed under the development agreement. The development agreement stated that ALZA would conduct product development and other related activities on behalf of Crescendo. According to the development agreement, work plans and cost estimates were provided by ALZA and approved by Crescendo. Crescendo was

required to spend the \$300 million contributed by ALZA (plus investment earnings less Crescendo's administrative costs and other fees) on activities under the development agreement. The initial products under the development agreement were products started under the TDC collaboration. Crescendo's Form 10-K for fiscal year ended December 31, 1997 filed with the SEC revealed that Crescendo had one employee, owned no facilities, leased corporate offices from ALZA, received administrative services from ALZA, and was dependent on ALZA for its operating and accounting systems.

As in the TDC arrangement, Crescendo's Restated Certificate of Incorporation prohibited Class A stockholders from taking or permitting any action that might impair ALZA's rights or increase Crescendo's authorized capitalization without ALZA's permission. In addition, Crescendo was prohibited from licensing its products to any company other than ALZA. ALZA held an option to purchase all of Crescendo's Class A Common Stock at a price stipulated in Crescendo's Restated Certificate of Incorporation.

ALZA's accounting and reporting for its arrangements with TDC and Crescendo involved several areas of GAAP. The following section reviews and evaluates the methods used by ALZA to record its investment in TDC and Crescendo and its related R&D activities.

III. ALZA'S ACCOUNTING AND REPORTING FOR TDC AND CRESCENDO

ALZA's financial reports disclosed its relationship with TDC and Crescendo, the amounts invested in each, and revenue received from each. To record the contribution of \$250 million to TDC's capital and the distribution of TDC stock to ALZA shareholders, ALZA reduced Retained Earnings by \$36.6 million and reduced Paid-in-Capital by \$213.4 million. Therefore, earned equity and contributed equity were reduced.

When Crescendo was formed, however, the accounting was somewhat different. ALZA reduced Retained Earnings by \$49.1

million and reduced current earnings with a one-time charge labeled "Contribution to Crescendo" for \$247 million. This resulted in a reduction of earned equity and a significant charge to ALZA's 1997 net income. Since the investment in Crescendo was \$300 million, there must have been a charge to another account for the remaining \$3.9 million. The financial statements do not specifically disclose the account charged, but the income statement does reveal an \$8 million distribution to debenture holders. Since some of the Crescendo stock was distributed to debenture holders, the remaining \$3.9 million needed to make the entry balance may have been included in that amount.

As ALZA provided R&D activities first for TDC then for Crescendo, ALZA recorded inflows from the two companies as R&D revenue. In addition, ALZA recorded R&D Expense for its costs of those R&D activities. The notes to ALZA's 1996 financial statements claimed that, because ALZA's R&D revenues represented reimbursement of ALZA's R&D costs, those activities did not contribute significantly to operating results². Furthermore, the Management Discussion and Analysis of the 1996 financial report stated that:

If ALZA were to exercise its purchase option [of TDC], ALZA would need to fund any continuing development expenses for TDC products. If ALZA were to choose not to exercise the Purchase Option, but to license some or all of the products, ALZA would need to fund the additional product development activities necessary to complete the licensed products. If ALZA were to use its own funds to cover these expenses, the product development activities would result in research and development expenses without the

² Securities and Exchange Commission, ALZA Pharmaceuticals Corporation, SEC Forms 10-K, 1997, at Note 1.

corresponding research and development revenues previously provided by TDC³.

This paper contends, however, that ALZA's disclosures were not entirely truthful for two reasons. First, TDC's (and Crescendo's) funds were not separate from ALZA – indeed ALZA provided those funds when the investment was made in the two spin offs. Second, recording both revenue and expense did not reflect economic reality. Rather, the effect was to overstate both revenue and income. In other words, without the TDC and Crescendo arrangements, ALZA's financial statements would have shown only R&D expense, which would have reduced net income. By recording R&D revenue from TDC and Crescendo, however, ALZA was able to avoid reducing income by the amount of R&D expense. This conclusion is supported in Table 1.

TABLE 1
Effect of ALZA Spin-offs on Net R&D Expense and Net Income

Panel A
Net R&D Expense Calculated From Items Reported in
ALZA Financial Statements
(in millions)

	1993	1994	1995	1996	1997	1998	1999	2000	Total
Total R&D Expense	\$53.1	\$76.1	\$103.4	\$141.6	\$156.8	\$182.8	\$183.6	\$190.8	\$1,088.2
*Total R&D Revenue	<u>46.8</u>	<u>68.7</u>	<u>104.0</u>	<u>131.2</u>	<u>135.0</u>	<u>124.4</u>	<u>120.8</u>	<u>100.1</u>	<u>831.0</u>
Net R&D Expense	<u>\$ 6.3</u>	<u>\$ 7.4</u>	<u>\$ (.6)</u>	<u>\$ 10.4</u>	<u>\$ 21.8</u>	<u>\$ 58.4</u>	<u>\$ 62.8</u>	<u>\$ 90.7</u>	<u>\$257.2</u>
<i>*Total R&D Revenue includes the following amounts from TDC and Crescendo:</i>									
TDC & Crescendo Revenue	\$ 4.9	\$31.6	\$ 70.1	\$100.7	\$ 97.5	\$ 95.0	\$ 90.5	\$68.3	\$558.6

³ Securities and Exchange Commission, ALZA Pharmaceuticals Corporation, SEC Forms 10-K, 1997, at Management Discussion and Analysis.

Panel B
Revised Net R&D Expense After Eliminating R&D Revenue
Received from TDC and Crescendo
(in millions)

	1993	1994	1995	1996	1997	1998	1999	2000	Total
Total R&D Expense	\$53.1	\$76.1	\$103.4	\$141.6	\$156.8	\$182.8	\$183.6	\$190.8	\$1,088.2
Outside R&D									
Revenue	<u>41.9</u>	<u>37.1</u>	<u>33.9</u>	<u>30.5</u>	<u>37.5</u>	<u>29.4</u>	<u>30.3</u>	<u>31.8</u>	<u>272.4</u>
Revised Net R&D									
Expense	<u>\$11.2</u>	<u>\$39.0</u>	<u>\$69.5</u>	<u>\$111.1</u>	<u>\$119.3</u>	<u>\$153.4</u>	<u>\$153.3</u>	<u>\$159.0</u>	<u>\$815.8</u>

Panel C
ALZA Net Income as Reported v.
Net Income After Eliminating R&D Revenue from TDC and Crescendo
(in millions)

	1993	1994	1995	1996	1997	1998	1999	2000	Total
Net Income	\$45.7	\$58.1	\$72.4	\$92.4	\$(261.1)	\$108.3	\$91.0	\$223.3	\$430.1
As Reported									
Less: TDC & Crescendo	4.9	31.6	70.1	100.7	97.5	95.0	90.5	68.3	558.6
Plus: Crescendo									
One-Time Charge	—	—	—	—	<u>247.0</u>	—	—	—	<u>247.0</u>
Revised									
Net Income	<u>\$40.8</u>	<u>\$26.5</u>	<u>\$2.3</u>	<u>\$(8.3)</u>	<u>\$(111.6)</u>	<u>\$13.3</u>	<u>\$0.5</u>	<u>\$155.0</u>	<u>\$118.5</u>

Panel A of Table 1 shows the amounts of ALZA's total R&D expense and total product development revenue (R&D revenue) as those results were presented in the consolidated financial statements submitted as part of ALZA's Form 10-K required by the SEC. As shown, the **net** R&D expense reported on the face of the income statement for the eight-year period totals \$257.2 million. Note that Panel A also discloses the amount of R&D revenue from TDC and Crescendo. These amounts were disclosed in the notes to the financial statements.

The problem with the numbers presented in ALZA's consolidated financial statements is that R&D revenue includes the intercompany revenue received from TDC and Crescendo. Panel

B of Table 1 shows what ALZA's net R&D expense would have been if the intercompany revenue had been excluded. The R&D revenue shown in Panel B includes only revenue received from outside parties. It is computed by subtracting the R&D revenue received from TDC and Crescendo from total R&D revenue. As shown, when the intercompany R&D revenue is excluded, net R&D expense totals \$815.8 million over the eight-year period.

Panel C of Table 1 shows the amount of net income after removing the R&D revenue from TDC and Crescendo. First, ALZA's net income as reported for each of the eight years 1993 through 2000 is shown. Then, the intercompany revenue is subtracted to show the actual net income for those years. Notice that the one-time charge against ALZA's net income in the year Crescendo was formed has been added back to 1997 when computing revised net income. Eliminating intercompany revenue significantly reduced ALZA's net income in the years affected. In fact, rather than cumulative earnings of \$430.1 million over the eight years, the company actually had cumulative earnings of \$118.5 million.

Table 1 shows that the TDC and Crescendo arrangements effectively allowed ALZA to avoid recognizing the full impact of R&D expense on net income. In addition, ALZA overstated total revenue by \$558.6 million, the amount received from TDC and Crescendo. Net income was overstated by a total of \$311.6 million (Reported Net Income of \$430.million minus Revised Net Income of \$118.5 million) over a period of eight years. ALZA's accounting for its R&D arrangements allowed the company to take funds off its balance sheet, place them in controlled investment vehicles, and then bring them back into the company recognizing them as revenues to offset current R&D expenses.

Since the SEC allowed the TDC dividend to be charged to paid-in capital and retained earnings, the arrangement essentially turned cash into retained earnings by overstating income for 1993 through 1997. The effect of R&D expense for certain projects was erased from earnings. Not only did ALZA's bottom line remain intact (as opposed to decreasing for the R&D expense), its top line

actually improved because of its own cash flowing back as revenue.

The SEC required the Crescendo agreement to be recorded as a one-time charge to income⁴. Therefore, ALZA was forced to record a large earnings reduction in the year of Crescendo's creation, but that reduction was recovered through overstated earnings from 1997-2000. To the extent analysts tend to disregard one-time charges; the 1997 charge may not have been a severe penalty for ALZA. Clayman⁵ suggests that companies with infrequent one-time charges are not necessarily penalized in the market and, depending on the nature of the charge, may outperform the broad index.

IV. COMPARISON OF ALZA'S ACCOUNTING TO THEN-EXISTING GAAP

ALZA may have used the TDC and Crescendo arrangements to overstate income, but did the company violate GAAP in effect during the time the two companies operated? According to SFAS No. 2 all R&D costs must be charged to expense when incurred because of the difficulty of identifying and valuing future economic benefit received from R&D expenditures.⁶ Technically, ALZA did record and report R&D expense. SFAS No. 68 requires that a liability must be recorded if an enterprise is obligated to repay funds provided by another party of an R&D contract regardless of the outcome of the R&D⁷. In ALZA's case, the parties obligated to repay funds were TDC and Crescendo, not

⁴ L.J. Sellers, "Alza Delivers: Ernest Mario takes the Company to a New Level," *Pharmaceutical Executive*, (November, 2000), 44-56, at 47.

⁵ Michelle Clayman, "One-Time Charges: Never Having to Say You're Sorry," *Financial Analysts Journal*, Vol. 51:5 (Fall, 1995), 57-60, at 60.

⁶ Financial Accounting Standards Board, *Accounting for Research and Development Arrangements*, Statement of Financial Accounting Standards No. 2 (Norwalk, CT: FASB, 1974), at paragraph 12 and 49.

⁷ Financial Accounting Standards Board, *Research and Development Arrangements*, Statement of Financial Accounting Standards No.68 (Norwalk, CT: FASB, 1982), at paragraph 5.

ALZA. Therefore, ALZA's accounting for R&D expense was in accordance with SFAS No. 2 and SFAS No. 68.

Should ALZA have included TDC's and Crescendo's operating results in its consolidated financial statements? The answer to that question rests on whether ALZA controlled TDC and Crescendo. According to Accounting Research Bulletin (ARB) No. 51, the purpose of consolidated financial statements is to present the results of operations and the financial position of a parent and subsidiary as if they were one entity⁸. ARB No. 51 states that, usually, controlling interest is evidenced when one company owns a majority voting interest in the other⁹. The Bulletin states, however, that consolidated financial statements should be presented when one company *directly or indirectly* [emphasis added] owns a financial controlling interest in the other¹⁰. While it is true that voting interests were held by owners of Class A Common Stock, it is also true that ALZA controlled the operations of TDC and Crescendo. ALZA selected the projects for research and development, maintained the right to patent resulting products, and prohibited TDC and Crescendo from patenting rejected products. ALZA shared employees with TDC and Crescendo. Both companies owned no facilities, leased corporate offices from ALZA, received administrative services from ALZA, and were dependent on ALZA for their operating and accounting systems. TDC and Crescendo were prohibited from licensing their products to any company other than ALZA. Finally, as sole owner of Class B Common Stock, ALZA could block any action that might impair ALZA's rights or increase TDC's or Crescendo's authorized capitalization without ALZA's permission. Finally, ALZA held an option to purchase all of TDC's and Crescendo's Class A Common Stock. The conclusion must be drawn that, even though ALZA did not technically possess voting control of TDC

⁸ American Institute of Certified Public Accountants (AICPA) Committee on Accounting Practices, Consolidated Financial Statements, Accounting Research Bulletin No.51 (New York: AICPA, 1959), at paragraph 1.

⁹ ARB No.51, at paragraph 2.

¹⁰ ARB No.51, at paragraph 1.

and Crescendo, it clearly controlled TDC and Crescendo. Combining the results of TDC and Crescendo would have eliminated the intercompany revenue and the overstatement of net income.

V. GAAP SUBSEQUENT TO TDC AND CRESCENDO FORMATION

During the last year of Crescendo's existence the FASB's Emerging Issues Task Force completed discussion on *EITF 99-16: Accounting for Transactions with Elements of Research and Development Arrangements*. The Issue prescribes the accounting for arrangements such as those ALZA made with TDC and Crescendo. The Issue specifically addresses transactions where a sponsor (such as ALZA) capitalizes a new company with cash and technology rights in exchange for Class A and Class B stock. The Class A stock is distributed to the sponsor's shareholders subject to a purchase option, while the Class B stock is retained which carries no voting rights but does carry certain blocking rights. The sponsor subsequently performs research and development activities for the new company.

The Task Force concluded that the sponsor should treat the cash paid for the new company Class A stock as restricted cash. The distribution of the new company Class A stock should be treated as a dividend to common stockholders of the sponsor based on the fair value of the stock at the time of distribution. The new company Class A Common Stock should be presented on the sponsor's balance sheet in a similar manner as minority interest¹¹. Had EITF 99-16 been in effect at the time of the formation of TDC and Crescendo, ALZA would have debited restricted cash for \$250 million and \$300 million respectively. At the same time, the company would have debited dividends and credited an account similar to minority interests in the amount of each stock's fair

¹¹ Financial Accounting Standards Board, EITF 99-16, *Accounting for Transactions with Elements of Research and Development Arrangements* (Norwalk, CT: FASB, 1999), at paragraph 5.

market value (\$44.9 million for TDC and \$57.7 million for Crescendo).

EITF 99-16 requires that, as R&D activities are performed by the sponsor, R&D expense is recognized. Rather than recognizing revenue from the new company, however, the sponsor credits restricted cash. If this EITF had been in effect, therefore, ALZA would not have credited R&D revenue, and the overstatement of revenue and income would have been avoided. The Task Force noted that the accounting prescribed has essentially the same effect as requiring consolidation of the new company by the sponsor. Therefore, had EITF 99-16 been in effect during the years of TDC's and Crescendo's existence, operating results would have been the same as those presented in Panel C of Table 1.

VI. RULES-BASED V. PRINCIPLES-BASED ACCOUNTING STANDARDS

The results of such financial wranglings as ALZA's are evidenced by the ever-increasing volume of FASB Statements and Interpretations. Because of the growing tendency to emphasize form over substance when reporting financial relationships, the SEC and the FASB have recently begun a drive toward a principles-based approach to U.S. Standard Setting. In fact, Section 108 of the Sarbanes-Oxley Act of 2002 requires the SEC to study the adoption of a principles-based system including the extent to which the U.S. system is currently principles-based, the time required to change to such a system, its feasibility, and an economic analysis of its implementation. A principles-based approach would provide standards with an appropriate level of specificity where few, if any, exceptions are included¹². Percentage tests, or "bright-lines," would be avoided since they

¹² Securities and Exchange Commission, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, (<http://www.sec.gov/news/studies/principlesbasedstand.htm>, 2003), at Section I.C.

allow financial engineers to achieve technical compliance with standards while evading their intent. According to the FASB, the principles-based approach would be similar to that used to develop International Accounting Standards and in other countries, such as the United Kingdom¹³.

Schipper argues that current U.S. GAAP is already based on a set of principles stemming from the FASB's Conceptual Framework¹⁴. Because these standards contain detail, explanations, and prescriptions, however, they lead some to believe they are rules based. The amount of detail, complexity, and rules to include in a particular standard are the standard-setter's dilemma:

Having provided a principle that clearly states the intent of a standard, how much additional explanation should be provided? How many terms should be defined, and at what level of detail? How much prescriptive explanation about how to apply the standard, such as numerical examples should be included?¹⁵

Those who advocate a principles-based approach believe it will result in more transparent financial statements that would more closely convey the economic substance of transactions and events¹⁶. But, is it possible that a principles-based approach will achieve that goal? Can standards be developed that will eliminate the need for detailed and complex accounting rules? Sir David Tweedie, Chairman of the International Accounting Standards Board, who explained his support for such an approach before the

¹³ Financial Accounting Standards Board, Principles-Based Approach to U.S. Standard Setting, Proposal of the Financial Accounting Standards Board (Norwalk, CT: FASB, 2002), 1-23, at 10.

¹⁴ Katherine Shipper, "Principles-Based Accounting Standards," *Accounting Horizons*, Vol. 17:1 (March, 2003), 61-72, at 62.

¹⁵ Shipper at 63.

¹⁶ Financial Accounting Standards Board 2002 at 9-10.

U.S. Senate Committee on Banking, Housing, and urban Affairs stated:

We favour an approach that requires the company and its auditor to take a step back and consider whether the accounting suggested is consistent with the underlying principle... Our approach requires both companies and their auditors to exercise professional judgment in the public interest. Our approach requires a strong commitment from preparers to financial statements that provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressures. ***It will not work without those commitments*** [emphasis added].¹⁷

The FASB reiterated Sir Tweedie's opinion about the need of commitments on the part of all parties involved in the financial reporting process. The Board stated:

... if adopted, a principles-based approach to standard setting would require changes in the processes and behaviors of all participants in the U.S. Financial accounting and reporting process, not just the FASB and other standard-setting bodies. ***Thus, in order for that approach to work, all participants must be equally committed to making those changes.***¹⁸

Is it a realistic expectation that financial statement preparers and auditors will make these commitments? Recent history shows countless examples where complicated transactions are concocted to achieve an accounting objective. Then, accounting firms audit the financial statements that contain them. The distributions of the TDC and Crescendo shares to the ALZA

¹⁷ Financial Accounting Standards Board 2002 at 4.

¹⁸ Financial Accounting Standards Board 2002 at 5.

stockholders, some of the most creative dividends ever devised, provide a perfect example of this point. The TDC creation and distribution of shares was the brainchild of Merrill-Lynch. The arrangement even had a name—ARROW, which stands for asset and risk redeployment with options and warrants. For its efforts in structuring the TDC transaction, Merrill-Lynch earned a tidy \$2.5 million¹⁹. Is it likely that accounting and investment firms will commit themselves to the lofty ideal of representational faithfulness at the cost of millions of dollars of revenue? Consider that the SEC blessed the accounting for the TDC transaction, and the auditors gave both TDC and ALZA clean audit opinions.

VII. CONCLUSIONS

The creation of TDC and Crescendo did not change ALZA's fundamental R&D activities. The R&D could have been conducted by ALZA with or without the two spun off entities. Why then were the two entities created? The primary reasons for off-balance sheet financing are to make the financial statements more attractive and to manage income tax positions²⁰. The financial community is divided on whether off-balance sheet arrangements mislead financial statement users. Many creditors prepare adjustments for common off-balance sheet arrangements such as leasing. However, the TDC and Crescendo arrangements are much more sophisticated and certainly much less transparent. The TDC and Crescendo arrangements significantly enhanced ALZA's revenues and net income. In addition, ALZA received a tax benefit by sheltering royalty income on its tax return by using TDC losses²¹.

ALZA's arrangements with TDC and Crescendo represent accounting at its best and worst. Tactically, there is obvious

¹⁹ Allan Sloan, "Guaranteed Delivery," *Money*, (April, 1993), 7.

²⁰ Richard Gamble, "Shrewd (and Ethical) Tactics in Off-Balance-Sheet Financing," *Controller Magazine*, (October 1997), 30-34, at 30.

²¹ Moukheiber at 111.

creative genius in circumventing the intent of a standard while following the letter of its rules. Receiving approval for the structure, as well as the creative accounting for the arrangements from the SEC, the chief government accounting watchdog, may also be classified as brilliant. It is true that ALZA did disclose its dealings with TDC and Crescendo in detail in its notes to the financial statements; however, ALZA repeatedly stated in its 10Ks filed with the SEC throughout the years affected by the collaborations that the transactions had no significant impact on operating results. This paper has shown that these claims were misleading since revenues and net income were overstated as ALZA's investment flowed back into the company as revenue. This assertion is further supported by the conclusions drawn in EITF 99-16 that eliminated recording the payments received by the sponsor as revenue. If EITF 99-16 had been in effect during the TDC and Crescendo arrangements, its application would have more closely captured economic reality by effectively requiring consolidation of the entities, thus revealing ALZA's true R&D revenue, expense and income.

The value added by accountants and auditors has two facets. One value is to society by capturing economic reality in financial statements and providing an independent attestation to their fairness in order to aid in the smooth operation of the capital markets. The other value is to those who intend to deceive and obfuscate reality. Accountants can certainly aid in the latter purpose as evidenced by the TDC and Crescendo transactions. The obvious intent of the carefully structured transactions was to skirt the established "rules" related to consolidation of directly controlled entities while turning a blind eye to the not-so-well defined concept of consolidation of indirectly controlled entities. These transactions were conceived by investment bankers, but they were put into effect by accountants and accepted by auditors.

A principles-based approach to accounting standards may well be in order. Specifically related to the consolidation issue addressed in this paper, the AAA Financial Accounting Standards

Committee²² supports a principles-based consolidation standard with effective economic control as the basis for consolidation. However there will still be a need for rules and guidelines to apply such principles in order to aid those who seek to comply with the principles and to prevent others from circumventing the principles. We have shown how TDC and Crescendo flourished under a rules-based mentality even though the clear intent of existing GAAP under ARB No. 51 during TDC and Crescendo's existence was that entities directly or indirectly controlled should be consolidated. On the other hand, had a strictly principles-based system been in effect, those who intended to obfuscate could have claimed that, in their judgment, consolidation was not necessary. In other words, if standards with clear statements of intent and defined requirements can be circumvented by those intent on doing so, how much easier will it be to circumvent standards without defined requirements? Hence the need for rules and guidelines in applying the principles of consolidation remains.

²² American Accounting Association (AAA) Financial Accounting Standards Committee, "Comments on FASB's Proposals on Consolidating Special-Purpose Entities and Related Standard Setting Issues," *Accounting Horizons*, Vol. 17:2 (June, 2003), 161-173, at 162.