When accounting gets too creative

Analysts have long complained about how aggressive Biovail has been with its books

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For much of the past decade, a small group of contrarian analysts have criticized **Biovail Corp.'s** accounting practices, alleging the company has been overaggressive and deliberately opaque.

Now regulators have given weight to the criticisms, levelling a string of allegations yesterday against the company and some top executives relating to its accounting between 2001 and 2004.

Toronto analyst ***Anthony Scilipoti,*** who has written reports for years criticizing Biovail's accounting and its use of off-balance sheet companies, said charges laid by the U.S. Securities and Exchange Commission (SEC) and the Ontario Securities Commission (OSC) are a form of vindication for years of warnings about improper accounting.

"I'm happy to see that people are taking notice," he said.

Mark Rosen, an analyst at Accountability Research Corp. who has written several critical reports about Biovail, said the SEC's allegations show some of the myriad of ways accounting can be abused.

"It underlined how you can play with the numbers," Mr. Rosen said. "It really hammered home how sensitive the company could be to some of these assumptions and how the accounting all worked."

One of the schemes alleged by regulators, involving foreign exchange costs in 2003, was elegant in its simplicity. The SEC alleged Biovail just kept using an outdated exchange rate for Canadian dollar conversions to U.S. dollars, because the prior year's exchange rate was more favourable.

The SEC alleges Biovail used the 2002 exchange rate by mistake in the first quarter of 2003. But while preparing the second-quarter financial statements, the SEC said two staff members pointed out to controller John Miszuk that the accounting needed to be adjusted to the exchange rate at June 30, 2003. Regulators alleged he ignored the advice because the change would have increased the company's loss in the quarter by 80 per cent.

The SEC alleges Biovail did not correct the error until early 2004, and then misled investors by explaining it had just noticed the exchange-rate issue in the course of preparing the year-end financial statements.

Another scheme alleged by the SEC and OSC involved the well-worn practice of recording phony sales at the end of a quarter to ensure the company meets earnings estimates.

In Biovail's case, the SEC alleges the company created a phony bill-and-hold sales scheme in the second quarter of 2003, allowing it to book a big sale of its Wellbutrin drug on the last day of the quarter.

The "phony" sale did not meet several of the financial tests required to book it as revenue, the SEC alleged, and the deal was ultimately voided two months later.

The SEC called it a "sham" transaction and said it allowed the company to understate its losses for the quarter by 80 per cent.

For analysts, however, one of the most significant allegations levelled yesterday involved a mysterious company called Pharmaceutical Technologies Corp., an off-balance-sheet company created by Biovail in 2001 but only revealed to shareholders long afterward.

Regulators alleged yesterday the so-called "special purpose entity" was created to allow Biovail to shift $47-million of research and development expenses and $51-million in liabilities off the books in 2001 and 2002.

According to the allegations, the supposedly independent company had only one unnamed shareholder who invested $1-million to own the company.

The SEC and OSC said Pharmatech did not qualify as a legitimate special purpose entity because, among other things, Biovail's former chief financial officer Brian Crombie had given assurances to Pharmatech's bankers that Biovail would guarantee its debts.

Regulators said that meant the company was not really independent of Biovail and could not qualify as an off-balance-sheet entity.