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ADENOSINE THERAPEUTICS LLC: ACCOUNTING FOR A DIFFERENT COMPENSATION METHOD

To lead the world in discovering, developing, and commercializing novel therapeutic compounds acting on the adenosine receptor subtypes in order to save and improve the lives of our patients.

—Company Mission Statement

It was a beautiful, early spring afternoon. As Bill Stilley, chief financial officer (CFO) for Adenosine Therapeutics (AT) walked his firm's outside auditors to the door, Stilley wondered how their earlier discussion might affect the young biotechnology company. The accounting firm's auditors had asked some hard questions about the accounting method Stilley used for the creative compensation method in place at AT. The auditing team had concluded its audit and wanted to be sure that any salary-related liabilities were accurately and fully reported. Stilley wondered how any changes in AT's accounting approach would affect the company's financial picture, which was a key marketing tool used in attracting private funding.

Company Background

Founded in 1999, Adenosine Therapeutics was a world leader in adenosine research focused on the discovery and development of novel therapeutic products that targeted adenosine receptor subtypes. Adenosine is a naturally occurring molecule that plays an important role in numerous human biochemical processes. For example, adenosine triphosphate (ATP) supplies the energy to contract a muscle or to send a message between nerve cells. Adenosine also regulates certain cell functions and physiological responses, such as heart rhythm, blood flow, vessel tone, wakefulness, and urine production.

Adenosine mediates its effects by activating receptors in a cell's membrane. Scientists had identified four such adenosine receptor subtypes: A_1, A_{2A}, A_{2B}, and A_3. Depending on the location and distribution of the receptor subtype, adenosine could modulate a variety of physiological responses by affecting the cells surrounding the site of its release. However, the

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This case was prepared by Lisa Evans (MBA '07) under the supervision of Professor Mark Haskins. It was written as a basis for class discussion rather than to illustrate effective or ineffective handling of an administrative situation.

usefulness of adenosine as a therapeutic agent had been limited because there had not been a convenient way to deliver adenosine to specific sites or to prevent it from activating untargeted receptors, which could produce adverse or undesired effects.

Adenosine Therapeutics developed a process for creating small molecules that acted as selective agonists (receptor activators) or antagonists (receptor blockers) for specific adenosine receptor subtypes.[1] These molecules can activate physiological responses or block the activation of receptor subtypes by endogenously produced adenosine. AT's goal was to develop products that evoked a subtype-specific pharmacodynamic effect without producing undesired outcomes that could result from interactions with other subtypes of adenosine receptors.

The firm was cofounded in 1999 by a University of Virginia professor, Joel Linden, and a successful entrepreneur, Robert Capon. Linden was one of the world's leaders in understanding the adenosine receptor. He devoted over 25 years to the study of the pharmacology, physiology, and molecular biology of adenosine and its receptor subtypes, and co-authored over 120 papers and 15 book chapters on the subject. Robert Capon was an entrepreneur who had been at the helm of four successful companies, including having founded a public biotechnology company. Through a licensing agreement with the University of Virginia Patent Foundation, AT had exclusive, worldwide rights to the university's adenosine-related patent[2] portfolio.

The company employed 22 people and maintained a chemistry laboratory at a location a few miles from its main office in Charlottesville, Virginia. AT's intellectual property portfolio consisted of over 50 patents issued or pending in the adenosine field. The company's potent and selective adenosine A_{2A} agonists, A_{2A} antagonists, and A_{2B} antagonists offered potential commercialization opportunities across a range of therapeutic areas, several of which represented multibillion dollar markets. Current program areas included cardiac imaging, acute inflammation, asthma, diabetes, arthritis, and cancer. Led by an experienced management team, AT had its lead drug, Apadenoson, in Phase III clinical[3] trials as a cardiac imaging agent with approval projected for 2009. Additionally, Apadenoson, a potent and selective A_{2A} agonist, has successfully completed human safety testing for use as an anti-inflammation drug, and the current focus of clinical development resources is on the development of Apadenoson as an infused anti-inflammatory agent, targeting sickle cell disease as the first therapeutic indication. Sickle cell disease is an inflammatory disease in which patients experience damaging and painful

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[1] An agonist promotes certain kinds of cellular activity by binding to a cell's receptor. An antagonist prevents certain types of cellular reactions by blocking other substances from binding to the cell's receptor.

[2] A patent was a property right granted by the U.S. Patent and Trademark Office to an inventor to exclude others from making, using, offering for sale, or selling the invention for a limited time in exchange for public disclosure of the invention when the patent was granted. A "composition of matter" patent protected a company's ownership of a drug's chemical or biological properties; a "use" patent allowed the holder to manufacture and market the drug for a specific therapeutic purpose. AT had patents that fell under both classifications. Under rules established by the World Trade Organization, new pharmaceutical patents extended for 20 years from their application date.

[3] The word "clinic" or "clinical" meant human testing or use, whereas "nonclinical" or "preclinical" meant testing in animals.

inflammatory overactivation or "crisis." The company had shown that activation of the A_{2A} receptor produced potent inhibition of the inflammatory response and the resulting damage in many nonclinical models, including nonclinical models of sickle cell crisis. Management believed that its A_{2A} agonists could eventually be targeted against a host of inflammatory diseases, such as organ rejection, serious infection, and arthritis. The company also had a promising pipeline of preclinical drugs to drive growth well into the future, including oral A_{2B} antagonist drugs for the treatment of asthma and diabetes.

Bill Stilley

Bill Stilley served as the chief operating officer (COO) and CFO of Adenosine, having joined the company in 2002. His background was as an experienced operational and finance entrepreneur, including an interim CFO position at a public company and as the COO and CFO of a number of private companies. He also had experience advising both public and private companies on financing and merger and acquisition (M&A) transactions. Before entering the business community, Stilley served as an officer in the U.S. Marine Corps. He received his MBA degree from the Darden Graduate School of Business Administration and had a BS in Commerce/Marketing from the McIntire School of Commerce, both at the University of Virginia.

Financing and Compensation

Like many small, biotech, start-up firms, AT's operations were supported by private investments, grants, and partnership arrangements. Grants and partnerships enabled the company to make substantial progress in its scientific, clinical, and patenting programs without significant dilution of its equity. Because the company experienced large gaps in the time between grant and equity infusions, it was frequently concerned with cash flow. This led the company to develop a creative compensation package so that it did not dilute equity, but also so that it did not have to use its constrained cash. To reward and provide incentives to employees, AT used an accrued payroll system whereby salary raises were accrued and not paid until a specific company "milestone event," such as private equity financing or a large partnership deal was consummated. Stilley, and the executive team, felt that this method was fair and provided a creative solution to their continuously tight cash position.

The accrued payroll system worked in the following way. When an employee got a salary raise (typically during an annual or bi-annual review), the increased portion of the salary was proportionately accrued on a monthly basis, but not paid at each pay period going forward. When a milestone event occurred, the employee received a one-time check for the full amount accrued since the raise was announced. Additionally, the employee's increased salary level was then set

as the baseline amount going forward. As an example (ignoring taxes),[4] assume an employee earned $60,000 per year. In her yearly review, she was awarded a $15,000 raise, which was to be accrued until a milestone event occurred. If the event occurred exactly two years after her raise, she would receive a one-time payment of $30,000 (amount accrued) on the day of the transaction. Going forward, she would be paid a salary of $75,000 ($60,000 + $15,000) per year. If the employee left AT for any reason before the event, she forfeited her accrued salary in full. In the history of AT, only three employees had ever left, and they left for reasons unrelated to compensation. In fact, Stilley had never heard anyone openly complain about the accrued payroll approach to raises.

All employees at AT understood how compensation worked at the company. **Exhibit 1** shows a sample letter for an employee salary increase. While most of the employees had received that type of raise, many had never experienced a "payday." In fact, the last milestone event had occurred well over a year earlier. Stilley worried that some employees might not appreciate their compensation increases, since they saw no immediate increase in their monthly paycheck. He wanted to make sure AT could continue to retain and recruit the best people under such a salary system.

Accounting Methods

Up to the time of the current audit, AT accounted for the salary increases by expensing the accrued amount each month and by booking a commensurate balance sheet current liability. Stilley felt that this was the most conservative approach and avoided a large one-time charge in the future when a milestone event occurred. He felt it made the future financial picture very positive. He also felt this was consistent with the conservatism principle he had learned during his time at the Darden school. But the auditors had challenged the current accounting practices related to expensing accrued salary raises. They said that recent aggressive expense recognition by some now-notorious public companies had required auditors to ensure that their clients were not inflating future earnings by over-expensing in current years. The alternatives were:

1. Continue with AT's current practice;
2. Not expense the unpaid-but-earned raises and simply provide a footnote to the financial statements describing the aggregate unpaid raises as a contingent liability;
3. Probability weight the unpaid-but-earned raises and record that expected value as an expense and a balance sheet liability. The remaining unpaid-but-earned raises would be disclosed in a footnote to the financial statements as a contingent liability; or

[4] Employees did not have to pay taxes on their accrued salary increase because the increase was at risk because it was forfeited if the employee left before the milestone event occurred. Under IRS tax code, since the compensation was at risk, there were no tax implications. Taxes were paid only when the money was received and no longer at risk.

4. Record a monthly expense and commensurate increased current liability over the expected time frame until payment (i.e., until a milestone event occurred) of the raise (for example: if an employee had a $1,000 monthly accrued raise this month, and it was projected to be paid in 24 months, 1/24th of the $1,000 would be expensed each month for the next 24 months).

Stilley was concerned about the material effect those alternative accounting treatments could have on AT's balance sheet and earnings. Would the recording of a significant liability make it more difficult to secure funding? Would having better earnings now be helpful or would the future earnings offset be even worse? Importantly, Stilley always wanted to make sure he was doing the right thing and making a full and meaningful disclosure to the readers of the company's financial statements.

Additionally, now that the accountants had made Stilley think about the company's compensation method, he also found himself thinking about how the current compensation plan affected the employees and the company as a whole.

Exhibit 1

ADENOSINE THERAPEUTICS LLC:
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Sample Employee Salary-Increase Letter

January 24, 2007

XXX

Dear XXX:

It is with great pleasure that I extend to you an increase in your salary to an annual rate of **$70,000** effective **February 1, 2007,** payable monthly per Adenosine Therapeutics' ("AT") standard payroll practices. Your increased salary is subject to the following terms and conditions:

- Until such time as AT completes raising the sum total of $2.5 million or more in new capital through one or more investment, merger, or partnering deals, or any combination thereof (the "Transaction"), **$10,000** of your salary will not be paid, but accrued.
- If, upon consummation of the Transaction you are still employed by AT, then you will be paid all of the accrued salary and then continue to receive, without accrual, the full amount of your new salary rate from that time forward.
- If your employment with AT is terminated for any reason prior to the consummation of a Transaction, then you will immediately forfeit any accrued salary you have at that time.

Thank you again for the outstanding job you are doing. Please sign below that you understand and accept the terms of this letter.

With warmest regards,

Robert Capon, CEO

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Employee Signature & Date