

ALLERGAN, INC.

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Director of Research and Technical Activities  
File Reference No. 194-B  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116

via e-mail to: director@fasb.org

Re: Proposed Statement of Financial Accounting Standards, Consolidated  
Financial Statements: Purpose and Policy

Dear Sir:

I am writing you in response to the *Proposed Statement of Financial Accounting Standards, Consolidated Financial Statements: Purpose and Policy* (the Draft) you issued on February 23, 1999. I am writing on behalf of Allergan, Inc. (Allergan). Allergan is a multi-national manufacturer of pharmaceutical and other health care products headquartered in Irvine, California. In 1998, Allergan's sales totaled \$1.26 billion. Allergan, and Ligand Pharmaceuticals Incorporated (Ligand) formed Allergan Ligand Retinoid Therapeutics, Inc. (ALRT) in 1994. ALRT was subsequently acquired by Ligand in 1997. In addition, Allergan formed a new subsidiary, Allergan Specialty Therapeutics, Inc. (ASTI), in 1997, and distributed the Callable Class A common stock of ASTI to existing Allergan stockholders in March 1998. Both ALRT and ASTI represent entities of the type discussed in Example 5 of the Draft at paragraphs 115 to 123. In addition to my position of Senior Vice President, Controller and Principal Accounting Officer of Allergan, I have also served as Chief Financial Officer of ALRT and ASTI.

I am providing comments to state my disagreement with the conclusions reached in Example 5. I consider the structure of the relationship between Allergan and ASTI as representative of the types of entities discussed in Example 5. For purposes of discussion, entities such as Allergan are referred to as Sponsors (Company BT in Example 5), and entities such as ASTI are referred to as Research Companies (Company RD in Example 5).

#### Alternative Proposals

The fact pattern described at Example 5 is one in common use. Sponsor companies involved in such activities should be required to disclose the

relationships with Research Companies including terms of future acquisition rights. In addition, Sponsors should provide summary information on operations and the financial position of Research Companies along with a summary of transactions between the two companies. Readers of statements could then make their own assessments and calculations of the effects of combination of the entities.

Many Sponsor companies disclose a number of items stated above as such Sponsor companies view Research Companies as related parties. The existence of control may not be determinable in absolute terms. As a result, the Draft should contain language that companies with many but not all attributes of control should be subject to the disclosures stated above.

The Financial Accounting Standards Board may also wish to consider differentiating the risk in various types of Research Companies. New Research Companies are being formed in areas outside pharmaceutical research. Activities in such Research Companies are not subject to human clinical trials and approval by regulatory agencies such as the Food and Drug Administration. The outcome of activities in other business endeavors may be much more predictable than pharmaceutical research, thus warranting a different standard for consolidation.

#### Requirement for Restatement

Allergan does not agree with the requirements for implementation of this Draft as stated in paragraph 26. Allergan has accounted for ASTI in accordance with the written agreements it reached with the Securities and Exchange Commission (SEC) prior to formation of ASTI on accounting for and disclosure of ASTI in Allergan's financial statements. Allergan would prefer to continue to follow such requirements rather than restate previously issued financial information.

Entities of the type discussed in Example 5 have been formed by Sponsor Companies with the view that the Sponsor Companies will determine at a future date whether they wish to gain control of the Research Company or not. Such view is consistent with past SEC accounting guidance. Since the Research Companies that are the subject of Example 5 generally have a limited life before they are acquired by Sponsors, or the Sponsors elected not to acquire the Research Company, a transition approach that requires all new Research Companies to be consolidated would appear to be more appropriate. Research Companies currently in existence will all probably disappear with five years. I don't believe there is a benefit in taking the readers of financial statements through another version of the same transactions that have resulted in huge one-time charges in the past.

If Research Companies had unlimited life, I would support the requirements of paragraph 26. Since the entities in Example 5 generally have a limited life, I would recommend that existing Research Companies be excluded from restatement requirements.

### Consequences of Adoption of Example 5

If Example 5 were adopted, it could create pressure on Sponsors to alter their relationships with Research Companies. One Sponsor has already announced publicly that if Example 5 is enacted, the Sponsor will re-acquire the Research Company. The subject Research Company is in its late stages of activity. The Sponsor has apparently concluded that, if consolidation were required, the Sponsor would be no worse off if it owned the Research Company.

At the other extreme, a Sponsor could renounce its right to acquire the Research Company to avoid consolidation. Sponsors would put their ability to acquire the technology at risk in exchange for avoidance of a negative impact on the Sponsor's stock price. This action would also have a serious negative impact on the value assigned to the stock of such Research Companies, and create some disorder in the process of pharmaceutical research.

### Basis for Disagreement

In the Draft, you have stated that a parent should consolidate entities it controls. Control is embodied First in a "decision-making ability that is not shared." This ability "must enable the parent to: a. Direct the use of and access to another entity's assets, generally by having the power to set policies that guide how those assets are used in ongoing activities."

Second, the parent has the "ability to increase benefits and limit losses" to the parent.

Third, evidence exists pointing toward the existence of control.

### Decision-making Ability That Is Not Shared

Example 5 at Paragraph 121 states that "Company BT, through the development and service agreements, is able to (a) guide the ongoing activities of Company RD." Further, Paragraph 122 states that "In this case, the contractual arrangements between Company BT and Company RD leave the board of directors of Company RD with little decision-making ability over its ongoing activities". At the time of formation of a Research Company, the activities of the Research Company are clearly limited. Once formed, however, the independent board of directors is clearly in control of the assets of the Research Company. The Sponsor cannot dictate to the Research Company board of directors that they must spend funds on particular R&D projects. The Sponsor must propose projects for approval by the Research Company board of directors. Before approving such projects, the board of directors of the Research Company must reach its own independent conclusion that the proposed research would be of value.

In my experience with two Research Companies, the board of directors of the Research Company has withheld funding of research pending receipt of additional data. In addition, the board demanded that the Sponsor proceed with research at a faster pace than proposed. In these and other instances, I have seen Research Company boards of directors play an activity role in deciding on the use of the assets they control.

The board of directors of the Research Company has a single fiduciary duty to the shareholders of the Research Company including taking action that benefits the Research Company and serves to the detriment of the Sponsor. The primary objective of the board of directors of the Research Company is to ensure maximum economic return to the shareholders. This return is generally achieved by management of the use of the limited funds of the Research Company to perform research with the highest probability of creation of an asset of value to the Sponsor. As a result, the probability increases that the Sponsor will buy back the Research Company and acquire the technology placed in the Research Company.

Contrary to the view inherent in the Draft, boards of directors of Research Companies view their duties as completely independent of Sponsors. It is the duty of the Sponsor to convince the board of directors of the Research Company that the research proposed by the Sponsor is of value. In today's litigious environment, members of boards of directors of Research Companies can not, and do not, take their independent fiduciary duties lightly. Such directors will challenge the Sponsor to provide substantial information to demonstrate the value of the research proposed by the Sponsor.

#### Ability to Increase Benefits and Limit Losses

Example 5 at Paragraph 123 states that "Because Company RD is required to use its available funds to pay for research and development activities performed by Company BT, Company BT receives essentially all of Company RD's net assets in the form of 'payments for service.' In essence, the IPO proceeds that did not bolster Company BT's revenues via the technology license and service agreements flow to Company BT as payments for its research and development work." Implicit in this argument is the notion that the Sponsor benefits from performance of research for the Research Company. In the case of Allergan, the research performed would not have occurred had the Research Company not supplied the funds. The funds Allergan receives as Sponsor exceed the cost of the research performed by a nominal amount, which reimburses Allergan for general corporate overhead. In 1998, Allergan received \$34.4 million in research service revenues and spent \$32.1 million to perform such research. These amounts are disclosed in Allergan's income statements. The net excess of revenues over expense of \$2.3 million is immaterial to Allergan's results of operations. Allergan is not in the business of performing contract research for others. In addition, the Sponsor receives no direct benefit from research performed for the Research Company since the product is the property the Research Company.

In addition to payments for research services, Allergan receives a technology fee. In return, ASTI received the technology. The value of the fee is a bargained purchase of an intangible asset. If Allergan does not buy back ASTI, the technology is an asset ASTI can sell to a third party. As a result, Allergan has received a value for an asset it has given to ASTI. Allergan has a fiduciary duty to obtain value for assets it distributes to the Research Company. As a result, Allergan was compensated for the asset, but it was not enriched.

Allergan will have to pay for the stock of ASTI to re-acquire this asset. At the end of its life cycle ASTI will either sell the asset acquired by the technology fee, or Allergan will pay for and re-acquire such asset.

### Existence of Control

According to the Draft, existence of control is (paragraph 18): “in the absence of evidence that demonstrates otherwise, the existence of control of a corporation shall be presumed if an entity (including its subsidiaries): ... c. Has a unilateral ability to ... (2) obtain a right to appoint a majority of the corporation’s governing body through ... rights that are currently exercisable at the option of the holder and the expected benefits from ... exercising that right exceeds its expected cost.” In Example 5, the Sponsor has the right to acquire all the outstanding voting stock of the Research Company. Based upon this right, the Sponsor is required to consolidate the Research Company. In fact, Example 5 is titled “Ability to Acquire a Majority Voting Interest through a Purchase Option.”

Sponsors do have the right to acquire Research Companies by buying the outstanding stock at prices stated in agreements when Research Companies are formed. Contractual rights do not, however, create contractual obligations. Research Companies must spend their limited resources on activities that will create value in order to maximize return to the shareholders of the Research Company. In the case of most Research Companies, the activities are limited to pharmaceutical research. The outcome of such activities is unpredictable. When a sponsor forms a Research Company, it does not “share” the risk as stated in Example 5, it transfers the risk. It remains to be seen if the Sponsor will later exercise its right and re-acquire the Research Company.

Historical evidence compiled by a third party presents the results of 20 Research Companies including ALRT and ASTI. Six Research Companies remain in active operation. Of the other fourteen, eight were re-acquired, five were acquired at a negotiated price, and one was repurchased in pieces. As a result, this data would suggest that it is far from assured at inception that a Sponsor will re-acquire a Research Company. As a result, I am extremely concerned that consolidation of Research Companies with Sponsors will create a false sense that a future re-acquisition is assured when history indicates that only eight of fourteen Research Companies were acquired by the Sponsors under the terms of agreements put in place at the formation of such Research Companies.

Further to this point, I would refer to the comment letter you received from Messrs. David I. Cohen and Mark C. Wehrly of Farallon Capital. As they indicate, the market does not value the stock of Research Companies as if there is a strong probability the Research Companies will be re-acquired. These gentlemen have invested substantial amounts of funds in these Research Companies, and they use very sophisticated modeling techniques to evaluate risk. I recommend you contact them to gain further insights into these Research Companies from a stock market and risk perspective.

The reality of the relationship between Sponsors and Research Companies is that the sponsor can refuse to exercise its re-acquisition rights, and then submit an offer to buy the stock of the Research Company at a lower price. The Sponsor risks losing the technology to a competitor using this strategy, and Sponsors would not take this risk if the technology were valuable. This brings us back to the earlier point that it is unknown at the time of formation if the research efforts of the Research Company will be successful. As a result, there is no strong basis in theory (or fact based upon past performance) that Research Companies will be reacquired by Sponsors. As a result, the whole premise of Example 5 is incorrect because it has converted a possible event into a probable event. Example 5 would require a method of accounting that would create a false appearance of assurance of a future buy back of a Research Company when no such assurance exists.

I support the efforts of the Financial Accounting Standards Board to provided direction and accounting standards. I have provided my comments in this letter in order to enhance your understanding of the issues addressed from the point of view of a company that would be required to implement the requirements of the Draft. I would be pleased to provide further input at a time and in a manner we would find mutually agreeable.

Sincerely yours,

Dwight J. Yoder  
Senior Vice President, Controller  
And Principal Accounting Officer