

FARALLON CAPITAL MANAGEMENT, L.L.C.

One Maritime Plaza, Suite 1325  
San Francisco, California 94111

Telephone 415/421-2132  
Facsimile 415/421-2133

May 20, 1999

Via Email and U.S. Mail

Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

**Letter of Comment No:** 24  
**File Reference:** 1082-194R  
**Date Received:** 5/25/99

Re: Exposure Draft No. 194-B (Consolidated Financial Statements)

Ladies and Gentlemen:

We are an investment manager that manages approximately \$4 billion of discretionary capital for individuals and institutions. We are writing in reference to *Consolidated Financial Statements: Purpose and Policy, Exposure Draft No. 194-B*, and in particular, your "Example 5—Ability to Acquire a Majority Voting Interest through a Purchase Option."

Investment partnerships and accounts managed by us and our affiliates currently hold more than \$93 million in private and public securities of companies formed to conduct research and development related to biotech and other products, which we refer to in this letter as "R&D companies". In many of these companies we are the largest shareholder. Our publicly-disclosed holdings currently include Crescendo Pharmaceuticals, Inc. (23.2% of the Class A Shares), Allergan Specialty Therapeutics, Inc. (29.7%), Axogen Limited (14.2%), Momentum Business Applications, Inc. (10.3%), Intelligent Polymers Ltd. (14.2%), Clinichem Development Inc. (9.9%) and Spiros Development Corp II Inc. (17.7%). In addition, we were substantial shareholders in Allergan Ligand Retinoid Therapeutics, Inc. (30.9%), Perseptive Technologies II Corporation (9.3%), Advanced Therapeutic Systems (3%), Therapeutic Discovery Corp. (11.9%) and Cytorad, Inc. (9.6%).

Your Example 5 suggests that you believe consolidation should be the standard approach to accounting for a R&D company where a company sponsoring the formation of a R&D company holds a purchase option allowing it to acquire a majority interest in the R&D company. Your conclusion is premised on the assumption that sponsor companies effectively control R&D companies because of, among other things, the purchase option, board membership and contractual arrangements. Our experience investing in these companies shows that consolidation on this basis is inappropriate because such a control relationship does not exist. We expect, and the law requires, our R&D companies to act independently of their sponsors and to act in the best interests of their shareholders, even if the shareholders' interests are different than those of the sponsor company. In fact, the boards of our R&D companies tend to be comprised of a majority or supermajority of directors independent of the sponsor company. Moreover, it is our experience that R&D companies' boards and management understand very clearly that their fiduciary obligations run to the R&D companies and their shareholders, and not to the sponsors. As evidence of this point, disputes between R&D companies and their sponsors are known to have occurred on numerous occasions, relating to matters like which products should be developed, the amount of royalties owing on particular products, how the sponsor and the R&D company should share the proceeds from sale of a technology, how money should be spent on development, and the use of available funds generally. In one acrimonious dispute, Cytorad refused to continue developing technology with available funds.

Moreover, we are concerned that the subjective nature of the new standard is confusing and likely will be applied inconsistently from company to company and even by the same company from period to

period. Control is an amorphous concept that is hard to define and this will make this proposal difficult to implement. In Paragraph 84(c), you propose creating a presumption that control is established where a purchase option allows a company to purchase the right to appoint a majority of the corporation's governing body unless the expected cost of exercising the purchase option exceeds its expected benefit. Applying this presumption to determine whether the purchase option is likely to be exercised will be difficult and subjective, considering that expected costs and benefits may vary substantially over short periods (for example, in cases where a development-stage drug's prospects are speculative or vary from study to study or where changes in a sponsor company's financial circumstances alter its cost/benefit analysis). Indeed, the market struggles to make this determination and assigns huge and widely varying returns as a result. R&D companies' shares trade at prices that imply 20% to 80% internal rates of return to the exercise of the purchase option. These are very variable returns and indicate the difficulty the market has in assessing the probability that the options will be exercised. They are also very high rates of return and indicate the significant risk that the purchase options will not be exercised. Presumably the opinions of auditors and management will reflect a similar degree of variability and subjectivity.

Finally, we are concerned that the application of the principles in your proposal will confuse rather than clarify financial statements of sponsor companies. Consolidation ignores the fact that third party investors, and not sponsor companies, bear the economic risk of failure of the products under development. A common characteristic of the contractual arrangements relating to R&D companies is the ability of the sponsor company to walk away from the technology that the R&D company has developed, leaving the purchase option to expire unexercised. Actual experience confirms that in reality, sponsor companies feel that they have no obligation to repurchase technology unless it is squarely in their interests to do so. Two out of five sponsor companies holding purchase options in our companies (Perceptive Technologies and Cytorad) declined to exercise their purchase options on the expiration date. Also, as described above, the market assigns high and widely varying returns to the shares of R&D companies, indicating that it considers there to be real risk that the purchase options will not be exercised. Consolidation implies that the risk of non-exercise does not exist; this is blatantly false and at odds with the market reality.

Under these circumstances, it is misleading for a sponsoring company to consolidate the results of an unaffiliated company for which it has a purchase option. This becomes particularly apparent in the circumstance where the purchase option is not exercised. In such a case, the sponsor company's income statement has shown expenses that were never borne by it, since the funds expended by the R&D company came from capital provided by third party investors like ourselves, either in a private placement or through secondary market purchases of the R&D company's stock. The sponsor company's income statement could show net income (typically from royalties or interest income on cash assets) earned by the R&D company that in reality was distributed to the R&D company's shareholders. Finally, the sponsor company's balance sheet would show a significant cash asset that belongs to the R&D company and its shareholders, a matter of particular concern to third party creditors who may assume incorrectly that the cash is available to satisfy liabilities. In situations where outside investors bear the risks of speculative new technologies, consolidation misrepresents the business reality and results in misleading financial statements.

In short, we would ask you to reconsider your consideration of control as it relates to rights to acquire a majority interest in R&D companies in Example 5.

Thank you for allowing us to share our views on your Exposure Draft. We would be happy to discuss any of the issues raised in further detail.

Sincerely,



David I. Cohen



Mark C. Wehrly