

Letter of Comment No: 2/File Reference: 1082-194R Date Received: 5/25/99

May 21, 1999

Director of Research and Technical Activities Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: File Reference No. 194-B

Ladies and Gentlemen:

Dura Pharmaceuticals, Inc. is a publicly traded company engaged in the marketing, distribution and development of pharmaceutical products. We appreciate the opportunity to comment on the Exposure Draft of the Proposed Statement of Financial Accounting Standards, "Consolidated Financial Statements: Purpose and Policy" (the "ED"). Our comments are focused on the consolidation policy set forth in the ED as well as Example 5 of the ED's implementation guidance (Appendix A), "Ability to Acquire a Majority Voting Interest through a Purchase Option". Dura is also the sponsor of Spiros Development Corporation II, Inc., a separate, publicly traded entity formed to carry out certain research and development activities ("SDC II"). The relationship between Dura and SDC II is similar to that of the two entities described in Example 5.

## **Consolidation Policy**

We concur with the basic policy that a parent company should consolidate an entity that it controls and with the definition of control as set forth in paragraphs 6 and 10 of the ED. The application of this policy in practice is often difficult, requiring judgment and a careful assessment of the specific facts and circumstances. To help assess whether a particular relationship involves control and to minimize inconsistencies in practice, paragraph 18 of the ED sets forth certain situations for which control is presumed to exist. While we agree with the conclusion that item (a) of paragraph 18 creates a presumption of control, we do not agree that either items (b) or (c) should result in this presumption.

The reasons for our disagreement on items (b) and (c) are articulated in paragraphs 248 to 256 of the ED, which discuss an alternative view of one of the Board members. We

concur with those comments. The situations described in items (b) and (c) of paragraph 18 are too broad to lead to a presumption of control. In addition, we believe this guidance would be difficult to apply in practice. For instance, item (c) refers to a situation where one company can obtain the right to appoint a majority of another entity's governing body through the ownership of convertible securities or other currently exercisable purchase options. The ED states that, in such a situation, control is presumed to exist if "the expected benefit from converting those securities or exercising that right exceeds its expected cost". Measuring the expected benefit of an option is often very subjective, and the expected benefit may change significantly during the option period. Accordingly, control may come and go during the option period requiring the entity to be consolidated and de-consolidated as this assessment changes. Clearly, this would make the investor's financial statements inconsistent from period to period and difficult for users to understand. It is inappropriate to consolidate an investee based solely on an ability to obtain control. Until that ability is acted upon, control does not exist. As stated in paragraph 7 of the ED, it is one company's decision-making authority over another that binds separate legal entities together. The existence of this authority, not its potential existence, makes consolidated financial statements meaningful.

With respect to item (b) of paragraph 18, we concur with the comments contained in paragraphs 251-253 of the ED regarding minority ownership. Applying this principle in practice would be very difficult as practitioners try to determine what level of minority interest constitutes a presumption of control. Footnote 2 in the ED suggests assessing the significance of a minority voting interest be based on, for example, a comparison to the percentage of eligible shares historically voted in shareholder votes. However, the historical voting patterns of a company's shareholders may not be indicative of future voting patterns. Until the investor attempts to unilaterally exercise control over the decision making process of the investee, it is difficult to assess whether its current minority ownership interest results in control of the investee.

In summary, the situations described in items (b) and (c) of paragraph 18 are too general to lead to presumptions of control. Rather, we believe that they represent factors that must be considered along with all other facts and circumstances to assess whether one entity controls another.

## **Implementation Guidance**

Example 5 of Appendix A addresses the consolidation of a special purpose entity formed to fund research and development of a sponsoring entity. The ED concludes that, under the circumstances described in the example, the sponsoring entity controls the research and development ("R&D") entity and, therefore, should consolidate it. We strongly disagree with this conclusion. The facts and circumstances described in Example 5 are generally consistent with the research and development arrangements involving special purpose R&D entities that exist today. For the reasons outlined below, we do not believe

that the sponsor controls the R&D entity in situations similar to Example 5, based on the definition of control set forth in the ED.

Prior to discussing the basis for our conclusion, we would like to provide some background information regarding the use of special purpose R&D entities. Dura has utilized special purpose R&D entities (such as SDC II) under arrangements similar to that described in Example 5. The primary reason for establishing these entities is to share the risk of development of our technology with a group of independent shareholders. In addition, utilizing other investors to fund certain development projects allows us to proceed with those projects at a more rapid pace than we would be able to achieve with our own resources.

Since 1988, we are aware of 20 publicly held entities formed for the purpose of funding research and development activities under arrangements similar to that described in Example 5. Six of those companies are still operating. Of the remaining 14 entities, 6 of the sponsor companies holding purchase options elected not to exercise their options. These results demonstrate the degree of risk assumed by the investors of R&D entities. This risk is reflected in the rates of return generally demanded by investors. It is also reflected in the quoted stock prices of research and development entities. Currently, the stock price of SDC II is trading at a discount of over 50 percent from the implied value based on the initial offering price and the rate of return assumed in the option pricing schedule. We are concerned that consolidation of R&D special purpose entities by their sponsors implies that development risk has not been transferred to a separate group of shareholders. This premise is inconsistent with the realities of the market.

We are also concerned that the Board does not fully appreciate the fiduciary responsibility of the officers and board of directors of R&D entities to their shareholders. Example 5 seems to imply that the board of directors, although controlled by independent board members, is a "rubber stamp" for the sponsoring company. Our experience suggests otherwise. The independence of SDC II is clearly evident through Dura's interaction with the SDC II board of directors and officers. The board of SDC II regularly challenges the research priorities and spending plan proposed by Dura to ensure that its funds are utilized to create the most value for the SDC II shareholders. The interests of Dura's shareholders and SDC II's shareholders are not always aligned and disputes do arise over research priorities and how SDC II's funds are to be spent. The board of directors and officers of SDC II recognize their fiduciary responsibility and act accordingly.

One of our primary concerns with the Board's conclusion in Example 5 is that we were not able to clearly identify the connection between the definition of control set forth in the front section of the ED with the facts and circumstances in the example. Frankly, after reading the definition of control and the fact pattern set forth in Example 5, we expected the conclusion to be that control did not exist because some of the major characteristics of control did not appear to exist. Regardless of the outcome of the Board's final consideration of the ED, we suggest a more complete discussion linking the consolidation policy with the fact patterns of the implementation examples be provided.

With respect to the specifics of Example 5, the conclusion that BT (sponsoring entity) controls RD (special purpose R&D entity) appears to be based on the assumption the contractual agreements between the companies and RD's charter, which requires BT's approval for various capital transactions, leaves the board of directors of RD with limited decision making ability over its ongoing activities. We did not read anything to suggest that the ability of BT to acquire a majority voting interest in RD through its purchase option created a presumption of control. Rather, this appears to be only one fact that contributed to the conclusion that BT controls RD.

As stated above, we do not believe that the relationship between BT and RD involves control. Paragraph 11 of the ED states that the first essential characteristic of control is that a parent must have the ability by itself to make decisions that guide the ongoing activities of another entity and that this decision-making ability cannot be shared. We do not believe this unilateral decision lies with BT. While it must approve certain operating decisions for RD, BT cannot unilaterally direct the activities of RD. The approval of RD's board is also required. BT cannot direct RD to issue stock, pay dividends, or change the research and development activities performed by RD without the board's agreement. The policies that guide the operations of R&D entities are normally set at the time the entity is funded. These guidelines are established through the R&D entity's charter and agreements with the sponsoring entity and are set to protect both the sponsoring entity as well as investors in the R&D entity. Both parties must approve changes to these policies. Further, while the development agreements referred to in Example 5 generally direct the nature of the research and development activities to be performed, they also require that the RD board approve the annual research plan and budget. BT cannot unilaterally determine how RD's funds will be spent. This is a shared decision that ultimately requires approval of the RD board of directors. Based on these facts, we do not believe BT has the ability to unilaterally make decisions regarding the RD's activities and, therefore, a control relationship does not exist.

The second essential characteristic of control discussed in the ED is the ability of the parent to increase its benefits and limit its losses from the ongoing activities of the subsidiary. In Example 5, the only benefit available to BT, absent the successful development of the technology, is the receipt of payment from RD for research and development services provided. Performing research and development services on a contract basis for another company is not unusual. The accounting for these relationships is well established. The payments received by BT are for services provided in accordance with a development agreement agreed to by BT and RD's investors at the time of its funding. To characterize the receipt of these service payments as BT's opportunity to increase the benefit from its relationship with RD is not consistent with our reading of the guidance on this topic in paragraphs 14 and 36 through 38 of the ED.

As neither of the essential characteristics of control exist and BT's purchase option does not create a presumption of control, we believe the relationship between BT and RD does not involve control. We believe that the consolidation of RD's assets, liabilities, and

results of operations into BT's financial statements would be misleading to the users of those statements.

## **Other Comments**

It is our understanding that the purpose of this ED is address consolidation policy and not consolidation accounting. We are concerned that implementing the policies outlined in the ED without further guidance on consolidation accounting will lead to inconsistent application of these policies and, in fact, confuse rather than clarify practice in this area. For example, the ED clearly provides for circumstances in which consolidation would occur even though the parent entity may currently hold no ownership interest in the subsidiary. Further, the potential consolidation of special purpose entities such as those described in Example 5 create several accounting issues that are not currently addressed. Informal discussions we have held with other sponsors of research and development special purpose entities confirmed our concern that there are many questions as to how these issues should be addressed and how the special purpose entity's assets, liabilities, equity, revenues, expenses, and minority interest should be reflected in the sponsor's consolidated financial statements.

We suggest the Board carefully consider what implementation and accounting issues will be created by changes to the current consolidation policies and that the resolution of those issues be considered in establishing an effective date for any new standard.

\*\*\*\*\*\*\*\*

Thank you again for the opportunity to comment on your Exposure Draft. We would be happy to discuss any of the issues raised in further detail at your convenience.

Sincerely,

Michael T. Borer

Sr. Vice President and Chief Financial Officer

Michael J. Borer / CK

End Mat

Vice President, Finance