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Regarding: Revenue Recognition Project
Constraints-Minimum Requirements (Recognition of Variable Consideration)

As the Boards have recently shown a desire to re-consider the accounting principles regarding recognition of a minimum amount of variable consideration based on recent discussions regarding Alternatives 2A, 2B and 2C, we are writing this letter to express our opinion on the subject.

First, and foremost, accounting must always reflect economic reality. Since 1959, with the issuance of ARB No. 50, gain contingencies, which include sales-based royalties that are an example of contingent consideration, have not been recognized prior to their realization. Recognizing any amount of revenue before it is realized creates misleading implications to users of financial statements as to the likelihood of realization of those revenues. We strongly believe any amount of minimum revenue recognition prior to the recognition of the underlying market performance factor that creates a legal obligation to transfer assets is not appropriate and does not reflect economic reality. Financial reporting should capture market performance after it has occurred. This has been a benchmark accounting principle for as long as we can remember, and we don't see why the Boards would ever consider modifying that principle, given the history of fraudulent financial reporting around the world. To reflect on past history, we are certain that if the smartest Enron people were still assembled and sitting in the room, they would be very much in favor of recording contingent consideration in advance of the actual occurrence of the underlying market performance, based on their ability to predict future economic activity using good, internally-developed predictors. Their mantra might well be, "Book it, Baby, book it!"

On another front, let's consider an example of the accounting for sales-based contingent royalty revenues from the out-license of technology. If minimum royalty revenues were to be recognized by the licensor in advance of the actual underlying sales that obligate the licensee to pay the royalties, there will be a major theoretical disconnect between the recognition of contingent revenues and expenses. The licensee will not record any royalty expense until the underlying sales are recognized and the obligation to pay royalties is incurred, but the licensor will recognize predicted future royalty revenues by the licensee even though there exists no legal obligation to pay them. Generally, in isolation, accounting theory requires expenses to be recognized before revenues can be recognized. But in the proposed accounting principles regarding the minimum recognition of variable consideration, the opposite will occur, revenue will be recognized before expenses. The lack of symmetry here is more than confusing. We find it difficult to support a theory where we will teach accounting students that you are allowed to recognize contingent revenue associated with a licensing agreement using a method that is a "good predictor" when the underlying third-party sales that generate that revenue have not occurred. We have asked this

question to many of our non-accounting type business associates and friends, and the response has been unanimous, "Why would you ever recognize royalty revenue before it becomes payable to you under the agreement? You can't count on it until you know for sure."

Another out-license example may be a situation where an up-front payment is received by a licensor and deferred and amortized because the licensed benefits are considered to be delivered to the licensee over the life of the license. However, there are also future royalty payment obligations based on future net sales by the licensee due in connection with this same license that can be recognized immediately based on the current proposed accounting principles. We find those different theoretical recognition patterns for the two elements of the same transaction to be clearly at odds with each other.

With respect to forecasting (prediction) theory and practice, forecasting Gross-to-net adjustments for future sales (not past sales) of licensed products, especially in the pharmaceutical industry, are not stable and can change dramatically as a result of future contract negotiations with the three major U.S. wholesalers, group purchasing organizations, Medicare Part D plans and large institutional buyers, legislative actions affecting rebates for government supported medical programs, unilateral international and domestic government austerity measures, changes in commercial sales and incentive rebate programs, licensee responses to other competitive product actions and the risk of generic product introductions. All of these types of pricing risks may be significant enough to trip up the concept of achieving a "high level of certainty" that these predicted revenues will not be subject to significant future reversals.

One final thought to consider is the possibility of where this type of "good predictor" theory might lead to next. What other types of pending transaction assets should be recognized along with corresponding revenue using analogous reasoning? Should a company recognize sales for committed annual minimum purchase commitments in advance of the actual sales? What about the potential revenue stream from significant, committed order backlogs? Where do you draw the line once one theory unlocks the possibility? Maybe one should consider the use of Other Comprehensive Income (OCI) recognition as the answer for these types of contractual asset values where the benefits will be recognized but the income statement deferred in OCI until the uncertainty is resolved.

Based on the above arguments, we strongly recommend that the Boards use a common sense approach to dealing with sales-based royalties by reinstating the theory expressed in paragraph 85 as originally worded regarding sales-based royalty arrangements, as follows:

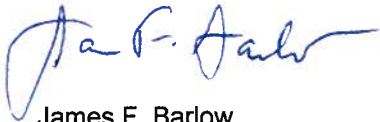
Notwithstanding the requirements in paragraphs xx-xx, if an entity licenses intellectual property to a customer and the customer promises to pay an additional amount of consideration that varies on the basis of the customer's subsequent sales of a good or service (for example, a sales-based royalty), the entity is not reasonably assured to be entitled to the additional amount of consideration until the uncertainty is resolved (that is, when the customer's subsequent sales occur).

If the Boards are dead-set against reinstating paragraph 85 regarding sales-based royalty arrangements, we strongly recommend that the language for Alternative 2C be changed to the following wording that requires a higher standard for recognition than originally drafted:

Predictive value approach, that is, if an entity believes it can make a reliable estimate of the amount of the consideration it will be reasonably assured to receive, it should record that estimate, otherwise it should record none of the variable consideration.

"Reliable estimate" and "reasonably assured" is a higher standard than "good predictor" and "entitled to," and connotes that it can be audited with reasonable certainty and reliability. The U.S. Securities Commission and the PCAOB will certainly challenge these estimates, any upfront recognition and the auditing of these estimates, so the estimates need to be predictive at a reliable, reasonably assured level of certainty, or none of the variable consideration should be recorded.

Thank you for your consideration.



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