This 3DAdvisors Report Covers:	
	Insider Trading: Insider Trading Behavior
✓	**Accounting**: Quality of Earnings Issues
✓	**Governance:** Corporate Governance Issues

Accounting Issues and Less Than Clear Disclosure Allergan, Inc. (NYSE:AGN)

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Allergan, Inc. is a technology-driven, global healthcare company that develops and commercializes specialty pharmaceutical products for the ophthalmic, neurological, dermatological and other specialty markets. The Company is engaged in specialty pharmaceutical research, targeting products and technologies related to specific disease areas, such as glaucoma, retinal disease, dry eye, psoriasis, acne, photodamage, movement disorders, metabolic disease and various types of cancer. Within these areas, Allergan provides therapeutic and other prescription products, and, to a limited degree, over-the-counter (OTC) products that are sold in more than 100 countries worldwide.

Summary of 3DAdvisors Findings for AGN

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- **Accounting:** Pension funding issues
- **Accounting:** "Mark to market" accounting used to benefit earnings?
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Discussion of 3DAdvisors Findings

Complex "P&L sparing" deal structures

Allergan uses what some have called "P&L sparing" deal structures, which has allowed the Company to keep significant R&D expense off of its financials over the years. There is a thread of participation in these deals from an outside investor, Farralon Capital Management, which becomes an interesting study. Farallon's involvement in these R&D deals started small but has grown with each deal:

Allergan Ligand Retinoid Therapeutics Inc.: The first of such deals was between Allergan and Ligand Pharmaceuticals and was originally conceived, in '92, as an R&D joint venture entity consisting of the combined equity investments from both

Ligand Pharmaceuticals and Allergan. During that period, Allergan contributions (to the joint venture) were paid back to Allergan as R&D expenditures, which Allergan, in turn, booked as revenues. In June of '95, this entity was transformed into a special purpose vehicle called Allergan Ligand Retinoid Therapeutics Inc. (ALRT). In a subsequent public offering, outside investors bought $32.5 million in ALRT units and Allergan and Ligand contributed another $50 and $17.5 million, respectively, to the new entity. In return for their contributions, Allergan and Ligand received options to buy all the ALRT shares plus certain technologies and other assets.

In November of '97, Ligand and Allergan exercised their options to acquire the outstanding ALRT shares plus "certain assets and technologies". The purchase price was $21.97 per share, or $71.4 million. After the option exercise, both Allergan and Ligand ceased reimbursing research expenditures related to ALRT efforts, thus ALRT-related contract revenue recognition ceased as well.

Farralon Capital Management's Involvement in ALRT: In '95, Farralon Capital Management became one of the investors who had bought into the public offering for ALRT. Farralon, through buying both in the public offering and subsequently in the open market, ultimately accumulated a 30.9% stake in ALRT for a total of $15.6 million. Farralon was eventually cashed out on the deal in Sept. of '97 when Allergan and Ligand exercised their options to purchase both the ALRT shares and "certain assets" of ALRT for $21.97 per share. Farralon's piece of the deal amounted to $22.1 million, representing a healthy 42% gross return from its original $15.6 million investment just two years prior.

Allergan Specialty Therapeutics Inc.: Allergan Specialty Therapeutics Inc. (ASTI) was formed during the same time frame as the ALRT buyout and the subsequent winding down of its related R&D revenue stream. One month later, in November of '97, Allergan registered the ASTI shares with the SEC for a spin-off transaction to shareholders, which occurred on March 10, 1998. Allergan's Research & Development President, Lester Kaplan was appointed to the ASTI board. Prior to the distribution, Allergan had contributed $200 million to ASTI and retained an option to repurchase all of the outstanding 3.3 million ASTI shares. Allergan then granted "certain technology licenses" and agreed to make "specified payments on sales of certain products" in exchange for the payment, by ASTI, of a technology fee, which Allergan began recognizing as earned when received from ASTI. The process allowed for ASTI to recycle, back to Allergan, its $200 million investment. Each dollar spent by Allergan on ASTI-related R&D was billed (to ASTI) at $1.10. A recent Forbes article (April 22) estimated that Allergan's '00 earnings would have been $0.46 per share lighter had it not been for this deal. In April of '01 Allergan exercised its option to buy back the outstanding ASTI shares for $71 million in cash. At that time, the company ceased to recognize profits from revenues recorded from this R&D Vehicle.

Farallon's Involvement with Allergan Increased With ASTI: Interestingly enough, Farallon did not acquire its ASTI shares in the 3.3 million-share spin-off from Allergan. Instead, it acquired a 35.8% position in ASTI entirely through purchases in the open market. Farallon began buying these illiquid ASTI shares in April of '98 and continued buying through April of '00. Language in Farallon's 13D filings differed from its past William's Act (read: 13D) fillings for other companies. In the ASTI cases, the wording read: "consistent with their investment intent, the Reporting Persons (read:

Farallon) may engage in communications with one or more shareholders of the Company, one or more officers of the Company, and/or one or more members of the board of directors of the Company regarding the Company, including but not limited to its operations".

Clearly, Farallon intended to be kept informed on the progress at ASTI. An interesting point when you consider the fact that, as Farallon's stake increased, it became more paramount that Allergan buy the shares back if Farralon were to be able to cash out profitably. Farallon's "hunch" to keep accumulating was at least as good as the information it received from Allergan. We're not willing to rule out the possibility that Farallon received crucial guidance from Allergan with regards to its (read: Farralon's) arbitrage strategy involving ASTI shares. Should this turn out to have been the case, the consequences would read "insider trading violations." Indeed, in April of '01, Allergan bought all the outstanding shares of ASTI for $71 million in cash. This move resulted in an even larger return, for Farallon, than the previous ASTI deal. Farallon's initial $13.5 million investment multiplied into a 425% gross return in the four-year period.

Bardeen Sciences becomes the Successor Deal to ASTI: After ASTI, Allergan wasted little time in creating another R&D vehicle. In April of '01, the same month that Allergan bought back the ASTI shares, Bardeen Sciences was created. There were some significant differences, however, between Bardeen and the other two R&D vehicles discussed above (ALRT and ASTI). For one, Allergan did not commit cash up front, contributing instead the rights to "certain compounds and research projects" to Bardeen. This time, Farallon interests, in the name of Farallon Pharma Investors, committed to invest $250 million (over a five year period) to Bardeen. Unlike the prior deals, where Allergan held an interest, Farallon wholly owns Bardeen. As in ASTI, Allergan's Lester Kaplan sits on the board of Bardeen. Like the other deals, however, Allergan has the option to buy back Farallon's entire (and nothing less) interest in Bardeen.

The mechanics of the Bardeen deal do not look that much different than those of ASTI's. In '01, Allergan received $27.4 million, in R&D revenues, from Bardeen and booked $25 million in associated R&D costs. The same Forbes article, mentioned above, estimates that Allergan's Q4 - '01 numbers would have been $0.09 lighter had it not been for this deal. In Q1 of '02 Allergan booked $9.5 million in Bardeen revenues and expensed $8.6 million in costs. Allergan goes to great lengths to explain how this transaction is arms length, stating that Bardeen has the right to terminate its R&D deal with Allergan and use a third-party research firm; stating that no Allergan insider owns an interest in Bardeen; stating that it is Allergan's unilateral option to exercise its option to buy Farallon out; stating that the financial risks associated with R&D have been transferred to Bardeen.

Any potential ASTI buyout, by Allergan, gets more expensive the longer the deal goes on. If Allergan had been able to exercise its buyout option at Y/E '01, the purchase price would have been about $95 million. If R&D continues as planned and Allergan exercises its option at Y/E '03, the anticipated price would be $350 million. Given the past history of Farallon's interests in Allergan's R&D vehicles, combined with its $250 million investment commitment, it is hard to imagine how the current Bardeen Sciences deal is as arms length as Allergan may like investors to believe. After all, both previous deals had paid Farallon interests handsomely upon the acquisition, of the related entity, by Allergan. Given the Farallon's unprecedented (at least with regards to Allergan) commitment to Bardeen, it would seem likely that the buyout carrot loomed large in Farallon's investment decision. Thus, it is probably not unfair to raise the question as to whether or not Allergan's claims that financial risks associated with research and development have truly been transferred to Bardeen Sciences. Certainly something the IRS, or other agencies, may be interested in.

Accounting: IRS investigation

The IRS is looking into something at Allergan and the Company is not being very forthright in providing detail. Allergan's '00 10K revealed, for the first time, that the federal income tax returns filed by Company and its domestic subsidiaries had been either audited and/or settled through statute expiration through the year 1995. The '00 10K goes on to say that: "The Company and its consolidated subsidiaries are not currently under examination".

Things changed during the course of '01, however, as the company subsequently indicated, in its '01 10K, that the returns filed by the Company and its domestic subsidiaries are under continued scrutiny: "The Company and its consolidated subsidiaries are currently under examination for years 1996 through 1999. The Company believes the additional tax liability, if any, for such years and subsequent years, will not have a material effect on the financial position of the Company."

Interestingly, Allergan chooses to state that the financial position of the company should not be materially affected but offers no assurance that earnings effects, related to the "examinations" do not lurk.

The company offers no explanation as to what this investigation centers on. It would seem that their exposure lies in two potential areas. At first, we suspected that the examination may be concentrated on the large balance of $611 million of expatriated income (explained below) that the Company had not provided withholding and U.S. taxes for: "Withholding and U.S. taxes have not been provided on approximately $611.3 million of unremitted earnings of certain non-U.S. subsidiaries because such earnings are or will be reinvested in operations or will be offset by appropriate credits for foreign income taxes paid. Such earnings would become taxable upon the sale or liquidation of these non-U.S. subsidiaries or upon the remittance of dividends. It is not practicable to estimate the amount of the deferred tax liability on such unremitted earnings. Upon remittance, certain foreign countries impose withholding taxes that are then available, subject to certain limitations, for use as credits against the Company's U.S. tax liability, if any."

Upon further investigation, it would seem that the IRS could also be looking into the above-mentioned R&D vehicles as well, especially in light of the increasingly inter-twining interests of Allergan and Farallon, and possible indications of insider information passing between the two entities. The persistence of the IRS efforts, which have continued for at least a year, could indicate that there is a risk that these IRS "examinations" evolve into full-blown investigations that could have spillover effects with other agencies such as the SEC.

Accounting: Cash position not as strong as it seems

At year-end, Allergan sported a Cash and Equivalent position totaling $782 million. This cash position, however, has strings attached. The company's 10K states: "A substantial portion of the Company's existing cash and equivalents are held by non-U.S. subsidiaries. These funds are planned to be utilized in the Company's operations outside the U.S. The company has approximately $611.3 million (as of 12/31/01) in unremitted earnings outside the U.S. for which withholding and U.S. taxes have not been provided. Tax costs could be incurred if these funds were remitted to the U.S."

That $611 million total is up from $500 million in '00. Interestingly enough, Allergan's total cash position at Y/E '00 was $774 million, not far from the total at Y/E '01 so this expatriated portion of the company's cash position represents a larger portion of the total than the prior year. Clearly, the forces that have created this situation continue to be very much in effect. Another sidebar to this disclosure is that it only shows up in the Liquidity and Capital Resources section of the Company's 10K with nary a mention of the situation in the corresponding section of any of the interim "Q" filings.

Since the company is apparently free to bring the cash back at any time, it seems odd that the IRS would let them, in effect, defer the tax on that much income. At the very least, if Allergan were to bring any part of the cash back to the U.S., there seems to be a possibility that the IRS may take the position that the entire amount would be taxable immediately, whether remitted or not. Particularly, that is, if there has been no foreign income tax paid on the earnings.

Clearly, the lion's share of the Company's cash position is not usable in the U.S. without significant consequences. Should it become necessary to draw upon a significant amount of this resource, within the States, the current reported Cash and Equivalent balance should be regarded as overstated. Should the IRS determine that withholding and/or back taxes need to be remitted, earnings restatements could loom.

Accounting: Pension funding issues

Allergan contributed $45 million to its defined benefit pension plans in '01. The relative size of this contribution is really large when you consider that the fair value of the plan's assets at year-end stood at only $186 million. Thus, the contribution represented 24% of the Plan's assets. Even this amount, however, was insufficient to satisfy the under-funded status of the Plan. In Q1 of '02, the Company again contributed to the Plan, this time funding another $36 million for the quarter, bringing the level of the total contributions to an enormous 44% of the Plan's assets. We have never seen such a large contribution, relative to Plan size, in such a short time frame. The fact that the Company spread the contributions between year-end and Q1 of the following year gives the appearance of an attempt to hold cash balances as high as possible at year-end, possibly to satisfy debt covenants. It is rare to see such disclosure of Plan contributions in a company's first quarter. The Q1 contribution, among other things, contributed to a dent in the company's cash position, which dropped from $782 million (Y/E total) to $680 million during the period.

The Pension Fund has also provided an opportunity for management to craft its numbers. The Plan utilizes a 10% expected rate of return on its Assets (up from 9% in '99). The Plan being as small as it is, the high rate contributed only $12.2 million to offset against Plan costs. Consequently the Plan did not generate income but the higher rate of Expected Return utilized in the periodic benefit cost calculation helped keep the Net Plan Expense lower for the period, positively affecting EPS from the cost side. Due to actuarial smoothing, it is difficult to estimate the precise amount, however. It is safe to assume, however, that Allergan will find it difficult to maintain that high (10%) Expected Rate of Return on Plan Assets going forward: In '01 the Plan experienced a net loss of ($19.8) million vs. an expected gain of $12.2 million.

<u>Accounting: "Mark to market" accounting benefits earnings?</u>

Allergan's senior management bonus plan is largely tied to EPS growth. Bonuses that can match already-high salaries are rewarded upon achievement of targets. This provides clear motive for near-term management of earnings, sometimes at the expense of long run benefits. It's hard to see, for instance, how the $164 million spent for stock repurchases in Q1 of '02 (which contributed a penny to EPS for the period - see below) was the best and most efficient use of capital, capital that may be dearly needed in periods to come.

Company management has chosen to forego Hedge Accounting for its risk management efforts in lieu of Mark to Market accounting. We say "chosen" because of the language used in the company 10K: "the Company's management decided not to designate the foreign currency option contracts and foreign currency forward contracts as accounting hedges." The alternative utilization of Mark to Market Accounting, with regards to currency risks, allows for more earnings management opportunities as subjectively measured unrealized gains and losses flow directly to the income statement. The gamble paid off in '01 as the Company realized $6.6 million in earnings, related to foreign currency option contracts and foreign currency forward contracts, during the period. After taxes, this gain represented 3.3 cents of Allergan's '01 EPS numbers.

Those Mark to Market gains faded in Q1 of '02 as the dollar gained strength. In spite of its needs to aggressively fund the Pension Plan during the period, Allergan picked up the slack by aggressively increasing its Share Repurchase Program during the period, buying 2.3 million shares for $164 million (about $71.08 per share). The move looks to be the most aggressive for any past quarter and contributed a penny to Q1 - '02's $.34 per share earnings.

There seems to be no motive for this aggressive buyback move other than boosting EPS. First of all, employee stock option exercises were down rather significantly in '01: After exercising options for $148 million worth of stock in '00, Allergan employees exercised only $31 million in options during '01. This trend held in Q1 of '02 as well where employee stock option exercises totaled just $4 million, down from the already-low $13.5 million from Q1 of '01. So with option-related stock demand so low, what then would prompt the company to buy back $164 million in treasury shares during the quarter? To us, it looks as if they needed that penny per share in order to hit targets.

Governance: Company's disclosures seem less than forthcoming

We have seen in Allergan what is to us a troubling pattern of carefully controlling disclosure and what sometimes appears to be the clouding of facts that should be important to investors. Taken in isolation, some of these would seem to be fairly innocuous, but taken as a whole, we get the queasy feeling that this management has more than a few things it would rather not have the investor community know. Consider the following:

- CFO Eric Brandt entered the picture in '99, as much of the upper management strata underwent a shakeup in '98. Pre-Brandt CFO, A.J. Moyer, moved on to QAD and took a senior financial person, Valerie Miller, with him. There were other defections as well, many of which came from the finance area. One of the outcomes of the management restructuring was the designation of six people who would be the only ones permitted to deal with the investor community regarding the company. Brandt became the key "go to guy" for the media. Interestingly enough, he underwent media training in the process. I learned this fact though the web site of the company that provided the training, not from Allergan sources. Not too unusual in itself but the effort, combined with some of the other disclosure issues mentioned in this report, contributes to our impression that the company is expending plenty of effort to control its perceived image.

- Prior to the management restructuring, Allergan insiders reported Form 3's and 4's in a timely fashion via Edgar. After the shakeup, they discontinued using Edgar, for Section 16 submissions, and switched back to paper. Over the years, we have become accustomed to companies going the other way (read: shifting from paper filings to Edgar). Though subtle, Allergan's move has the flavor of slowing down disclosure.

- Allergan's disclosure of Bardeen Sciences has been rather begrudging. Formed in April of '01, Bardeen Sciences existence is not mentioned in any company financial until the Y/E '01 10K (which was filed on 3/1/02). At that time, the name of the "Investor" owning Bardeen sciences (read: Farallon) was not disclosed. This did not occur until a brief mention in the Q1 '02 10Q. This one-time, mention of Farralon was the key to steering us towards deeper research in the prior two R&D deals where we discovered the earlier Farallon involvement as well. We don't think this Farallon connection is very well known in the investment community.

- Allergan's use of Pro-Forma reporting, in earnings releases, continues in spite of the increased negative attention, by the media and the SEC, this practice continues to receive. Allergan's recent Q1 '02 release hypes "earnings up 32.4%, Excluding One-Time Items." The problem is that earnings, including those one-time items, were actually down 17% for the quarter. Of course Allergan is not alone in this shameful practice, but what is most glaring in their case is that they excluded the negative one-time items, but conveniently forget to exclude the positive one-time or non-operating items that actually bolstered EPS such as R&D project revenues, Pension Income effects and associated earnings and the EPS effect of the large share buyback.