

# Financial Review

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# Financial Review

## Operating Results

### Net Sales

Santen Group's consolidated sales for the year ended March 31, 2006 increased by ¥5,702 million, or 6.2%, from the previous year to ¥98,398 million. Sales of mainstay prescription pharmaceuticals increased by ¥5,953 million, or 7.1%, from the previous year to ¥90,251 million. Prescription pharmaceuticals accounted for 91.7% of total sales, a rise of 0.8 percentage points from the previous year's figure of 90.9%.

Prescription pharmaceutical sales can be broken down into ophthalmics, anti-rheumatics, and other pharmaceuticals. Domestic sales of prescription ophthalmic pharmaceuticals increased by ¥2,832 million, or 4.1%, from the previous year to ¥71,215 million. This was the result of further market penetration by Santen products amid market expansion, mainly for glaucoma and corneal disorder treatments. Overseas sales of prescription ophthalmics rose by ¥2,465 million, or 34.0%, to ¥9,706 million, due to steady sales growth in Northern and Eastern Europe, Russia and Asia and the absence of trade inventory adjustments in the U.S. the previous year. Sales of anti-rheumatic pharmaceuticals for the year increased by ¥688 million, or 8.2%, from the previous year to ¥9,041 million, reflecting growth in sales of *Rimatil*, *Azulfidine*, and *Metolate*. Sales of other pharmaceuticals fell by ¥32 million, or 10.0%, from the previous year to ¥288 million.

Sales of over-the-counter (OTC) pharmaceuticals declined by ¥29 million, or 0.5%, to ¥5,248 million, despite a continued focus on sales promotion of ophthalmics for tired eyes and blurred vision.

Sales of medical devices decreased by ¥116 million, or 15.4%, from the previous year to ¥639 million. The number of cataract procedures rose slightly in Japan, but sales of intraocular lenses trended flat due to increased competition. Sales were also affected by the discontinuation of sales of surgical instruments as of December 31, 2004.

Sales in the other business segment fell by ¥106 million, or 4.5%, to ¥2,260 million, attributable to the decline in contract manufacturing sales in the United States and Europe.

### Net Sales by Business Segment

Years ended March 31	2006	2005	Change (%)
	(Millions of yen)		
Prescription Pharmaceuticals	¥90,251	¥84,298	7.1%
Ophthalmics	80,922	75,625	7.0
Anti-rheumatics	9,041	8,353	8.2
Others	288	320	(10.0)
OTC Pharmaceuticals	5,248	5,277	(0.5)
Medical Devices	639	755	(15.4)
Other Business	2,260	2,366	(4.5)
<b>Total Sales</b>	<b>98,398</b>	<b>92,696</b>	<b>6.2</b>

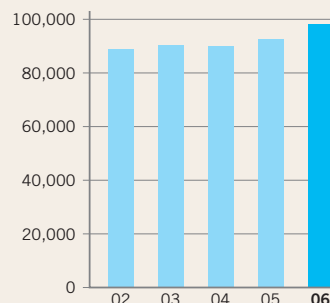
Note: Figures in parentheses indicate a decrease.

### Cost of Sales

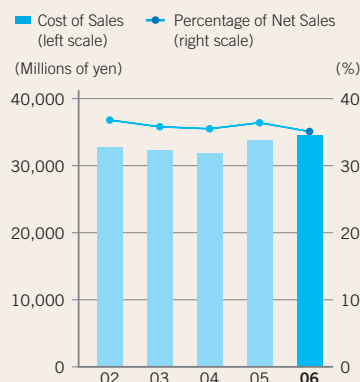
Cost of sales for the year grew by ¥825 million, or 2.4%, from the previous year to ¥34,535 million. The ratio of cost of sales to net sales fell by 1.3 percentage points to 35.1% from 36.4%, due to changes in the product mix—such as increased sales of *Hyalein*—as well as a higher operating ratio due to increased production volumes, and cost reductions.

### Net Sales

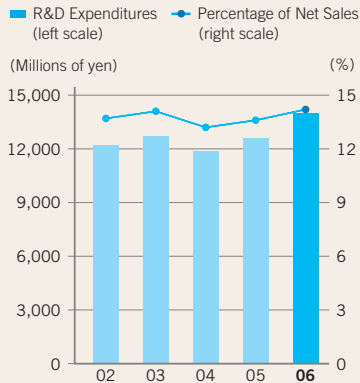
(Millions of yen)



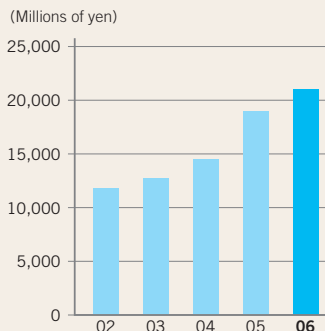
### Cost of Sales and Percentage of Net Sales



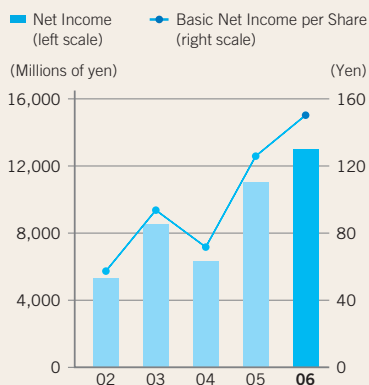
## R&D Expenditures and Percentage of Net Sales



## Operating Income



## Net Income and Basic Net Income per Share



## Selling, General and Administrative Expenses

Selling, general and administrative (SG&A) expenses for the year increased by ¥2,864 million, or 7.2%, from the previous year to ¥42,868 million. Selling expenses rose by some ¥800 million in Japan, ¥200 million in Europe, and ¥300 million in Asia, due to active efforts to disseminate medical information and defensive strategies against the competition. Moreover, R&D expenditures amounted to ¥13,971 million due to increased investment in the fields of glaucoma, corneal disorders, and retinal disorders.

## Operating Income

Operating income for the year advanced by ¥2,013 million, or 10.6%, from the previous year to ¥20,995 million. The increase in SG&A expenses was offset by growing sales of prescription pharmaceuticals and a lower ratio of cost of sales to net sales. As a result, the ratio of operating income to net sales improved by 0.8 percentage points to 21.3% from 20.5% in the previous year.

## Other Income and Expenses

Net other expenses for the year totaled ¥653 million.

Other income totaled ¥1,077 million, decreasing due to the absence of the gains recorded the previous year from the transition to the new retirement benefit program and the establishment of a retirement benefit trust, as well as almost no gains on the sale of fixed assets in the year under review.

Other expenses amounted to ¥1,730 million, decreasing due to the absence of costs from structural improvements at the U.S. business. On the other hand, Santen recorded impairment losses on land and property used in logistics operations accompanying the outsourcing of our logistics operations, and a special retirement premium for staff at Santen Distribution Co., Ltd.

## Income Taxes

Income taxes for the year decreased slightly to ¥7,319 million compared with the previous year. The effective tax rate declined to 36.0%, from 40.2% in the previous year, as a result of improved profit at our overseas subsidiaries and the effect of a preferential tax system for domestic research spending.

## Net Income

Net income expanded by ¥2,000 million, or 18.1%, from the previous year to ¥13,023 million. The ratio of net income to net sales improved by 1.3 percentage points to 13.2% from 11.9% in the previous year, primarily due to increased income reflecting growth in net sales and a reduction in the cost percentage. Basic net income per share rose by ¥24.41 to ¥150.26 from ¥125.85 in the previous year, and diluted net income per share rose by ¥24.3 to ¥150.01 from ¥125.71.

## Net Income per Share, Dividend and ROE

	(Yen)		
Years ended March 31	2006	2005	2004
Net Income per Share — basic	¥150.26	¥125.85	¥71.65
Net Income per Share — diluted	150.01	125.71	71.64
Dividend	60.00	50.00	40.00
ROE (%)	11.5	10.4	6.3

## Financial Condition

### Assets

As of March 31, 2006, total assets were ¥150,458 million, up ¥10,478 million, or 7.5%, from the previous year-end. Current assets increased by ¥11,158 million, or 13.5%, to ¥93,893 million, reflecting an increase in cash and cash equivalents due to an increase in income before income taxes. The ratio of current assets to total assets rose by 3.3 percentage points to 62.4%, from 59.1% in the previous year. Net property, plant and equipment at year-end decreased by ¥2,281 million, or 7.0%, to ¥30,395 million, due to decreases in property, plant and equipment caused by depreciation and impairment losses on real estate used for logistics operations. In investments and other assets, there was an increase in investment securities due to a rise in the value of marketable securities. Return on assets (ROA) for the year improved by 1.4 percentage points to 9.0%, from 7.6% in the previous year.

### Liabilities

Total liabilities amounted to ¥31,821 million, an increase of ¥81 million, or 0.3%, from the previous year-end. Current liabilities rose by ¥1,889 million, or 8.5%, to ¥24,111 million. This was primarily due to an increase of ¥1,532 million, or 44.9%, in income taxes payable compared to the previous fiscal year-end.

Noncurrent liabilities decreased by ¥1,808 million, or 19.0%, from the previous year-end to ¥7,710 million. The main factor was a decrease of ¥1,168 million in long-term debt. Interest-bearing debt declined by ¥1,268 million, or 18.4%, from the previous year to ¥5,614 million, reflecting the early repayment of long-term debt and other factors.

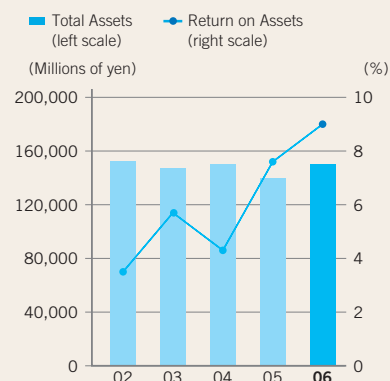
### Shareholders' Equity

Shareholders' equity increased by ¥10,397 million, or 9.6%, from the previous year-end to ¥118,637 million. This was due to an increase in retained earnings reflecting growth in net income, as well as an increase in the value of other marketable securities. The shareholders' equity ratio improved by 1.6 percentage points to 78.9% from 77.3%, due to total liabilities trending flat. Return on equity (ROE) rose by 1.1 percentage points to 11.5% from 10.4%, mainly due to an increase in net income. Shareholders' equity per share at year-end increased by ¥118.95, or 9.5%, from the previous year-end to ¥1,368.27.

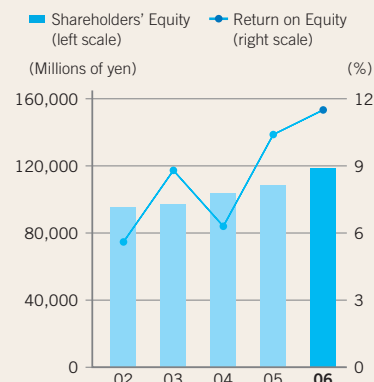
### Capital and Liquidity

Santen Pharmaceutical is striving to maintain a healthy balance sheet and ensure the Company has appropriate liquidity and the necessary funds for its business activities. Net working capital—defined as the difference between current assets and current liabilities—increased by ¥9,269 million, or 15.3%, from the previous year-end to ¥69,782 million, while the current ratio improved by 17 percentage points to 389% from 372% at the previous year-end. Cash and cash equivalents at year-end increased by ¥13,724 million, or 42.4%, from the previous year-end to ¥46,105 million. Cash generated by operating activities totaled ¥20,879 million, of which ¥1,330 million was used for investing activities and ¥5,900 million for financing activities.

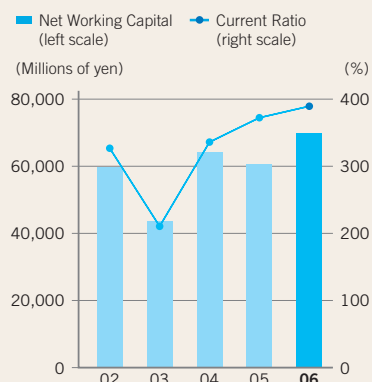
### Total Assets and Return on Assets



### Shareholders' Equity and Return on Equity



### Net Working Capital and Current Ratio



Note: Net working capital is the difference between current assets and current liabilities, and reflects a company's ability to make payments in the short term.

## Cash Flows

### Cash Flows Summary

Years ended March 31	(Millions of yen)		
	2006	2005	Change
Cash Flows From Operating Activities	¥20,879	¥ 6,619	¥14,260
Cash Flows From Investing Activities	(1,330)	(2,907)	1,577
Cash Flows From Financing Activities	(5,900)	(12,712)	6,812
Cash and Cash Equivalents at End of Year	46,105	32,381	13,724

Note: Figures in parentheses indicate a decrease.

### Cash Flows From Operating Activities

Net cash provided by operating activities increased by ¥14,260 million, or 315%, from the previous year to ¥20,879 million. This was due to a ¥1,906 million increase in income before income taxes, a ¥1,407 million decrease in trade receivable, and a significant decrease of ¥6,507 million in corporate tax payments.

### Cash Flows From Investing Activities

Net cash used in investing activities decreased by ¥1,577 million to ¥1,330 million, compared with ¥2,907 million the previous year. This was due to reduced payments on the acquisition of property, plant and equipment and on the acquisition of investment securities.

### Cash Flows From Financing Activities

Net cash used in financing activities decreased by ¥6,812 million, or 53.6%, to ¥5,900 million. Despite the increase in the dividend payment, expenditure decreased because of the absence of the early partial repayment of syndicated loans in the previous year and the reduced expenditure on the repurchase of treasury stock.

## Risks Related to Our Business

### Forward-looking Information and Factors That May Affect Future Results

Oral and written statements that we make in our annual report and through other public vehicles, other than historical facts, contain forward-looking information based on our business plans and assumptions at the time of disclosure. Such forward-looking information includes, but is not limited to, our expected growth strategies, projected operating results, market forecasts and anticipated timing for developing, obtaining approval and bringing products to market. These forward-looking statements represent our best estimates based on our awareness of market conditions and may differ substantially from actual results. Our business, as well as each product we develop and market, is subject to various risks and uncertainties beyond our control.

Risks and uncertainties that could affect the Company's future results and financial conditions include, but are not limited to, the factors described below.

### External Factors

#### Regulatory Controls

We conduct business under government regulatory controls for healthcare programs and drug prices in Japan and other countries, and therefore future results could be affected by changes in any of these regulations. Our financial performance, in particular, relies heavily on Japan's prescription pharmaceuticals market, which represents 80% of our consolidated net sales. Biennial National Health Insurance (NHI) drug price revisions or other healthcare reforms that may take place beyond the scope of our anticipated projections may also affect our operating and/or financial results. In April 2006, NHI drug price revisions went into effect resulting in an average 6.7% reduction for the prescription ophthalmic pharmaceuticals industry, which translated into an average 5.3% reduction for our total prescription pharmaceuticals sales.

We continue to face a variety of regulatory controls and government pressures for drug price reduction in other countries and markets where we manufacture and sell our products.

### Social and Economic Conditions and Changes in the Law

Santen's future results may be affected by political and economic changes in worldwide markets where we operate. Our anticipated performance and financial conditions may also be affected by changes in applicable accounting principles, and laws and regulations concerning taxes, product liability, antitrust, environmental controls and other factors.

### Foreign Exchange

Overseas sales and expenses, as well as assets of overseas subsidiaries, affect our sales, profits and financial conditions depending on foreign exchange fluctuations. Overseas sales for the year ended March 31, 2006 accounted for 11.8% of our consolidated net sales.

## Competition

### Effects of Generic Pharmaceuticals

Sales of generic pharmaceuticals in Japan and abroad may affect Santen's overall business results.

While our mainstay products—including *Cravit*, *Rescula* and *Livostin*—are protected by patents, generic pharmaceuticals for products such as *Hyalein* and *Tarivid* have already been introduced into the Japanese market by other companies. Market analysis leads us to expect that generic competition will increase.

### Competition From Other Branded Products

We have noted the launch of new branded products in the anti-infective market in Japan and overseas, and expect this trend to continue in the near future. These new products directly compete with our *Cravit* and *Quixin* products and may affect future performance.

## Dependency on Specific Products and Business Partners

### Dependency on Mainstay Products

*Hyalein* and *Cravit* each generate annual sales of over ¥10 billion, together representing 30% of Santen's consolidated net sales for the year ended March 31, 2006. Sales of these products are critical to our ongoing success, and any unanticipated negative influences, such as patent expiration and complications, potential product defects or newly discovered side effects, could affect our financial performance significantly.

### Dependency on In-licensed Products

Many of the products we sell are in-licensed from other companies. We hold exclusive rights to manufacture and sell ophthalmic formulations of *Cravit* and *Detantol*. We also have sales rights in Japan for *Timoptol*, *Timoptol XE* and *Livostin* and exclusive sales rights for *Azulfidine EN* and *Rescula*. Should changes be made in the terms and conditions of these agreements or should the agreements not be renewed, our financial results may be affected.

### Dependency on Specific Business Partners

As of February 16, 2004, we entered into an exclusive distribution agreement with Johnson & Johnson Vision Care, Inc. (JJVCI) in the U.S. In the event that JJVCI cannot achieve sufficient sales per our agreement, our financial results may be affected.

Some raw and processed materials, such as bulk pharmaceuticals for *Cravit* and containers for over-the-counter (OTC) pharmaceuticals, are dependent on specific business partners. If supply of these materials is interrupted or discontinued for any reason, our pharmaceutical production and financial performance may be adversely affected.

The percentage of our business executed with the top 10 wholesalers in Japan reached 70% of our consolidated net sales. If our wholesale partners experience bankruptcy leading to lending loss, we may be adversely affected.

## Research and Development Activities

### Uncertainty in New Product Development

Years are required to bring new drugs from initial research and development to final approval and marketing. Factors exist at every stage along the way that can sidetrack a new product and either delay or prevent it from reaching the marketplace. It is difficult for us to accurately predict when new products, indications, or formulations under development will reach the approval stage and be ready for launching.

Forecasting a precise timeline for project development and completion depends on a number of variable factors, including, but not limited to, delayed government reviews, conflicting or unusable clinical data, safety and efficacy concerns, unexpected side effects, discontinued development, and delayed product launches, negatively affecting projected sales of new drugs.

### Potentially Insufficient Returns on R&D Investment

The creation and development of new pharmaceuticals, as well as the development of new indications and formulations, are critical for the future growth of Santen. Every year, we invest significantly in research and development, and there is a possibility future investments will not result in sufficient sales of new products.

### Issues of Alliances

Forecasts for new pharmaceuticals include various assumptions of alliances in development and/or sales. Actual determination of these alliances may affect our overall results and financial conditions.

## Other Factors

### Production Interruptions or Delays

The interruption or delay of production activities due to natural disasters or other catastrophes such as fire, may affect our financial performance and conditions. Certain products are only manufactured at one location. If a specific plant is forced to stop production, supply of some products may be negatively affected.

### Cancellation of Sales and Product Withdrawals

If sales of products are cancelled, or if we withdraw products due to a batch defect, unexpected side effects, tampering or other causes, our overall financial results may be negatively affected.

### Litigation

Our main business involves production and sales of prescription pharmaceuticals. The nature of our business makes us vulnerable to litigation related to patents, product liability, violation of antitrust law, consumer-related issues, and environmental concerns. If such legal actions take place, the proceedings may affect our overall performance and financial conditions. Currently, we are involved in no litigation that substantially impacts the management or performance of our company.

## Ten-year Summary of Selected Financial Data

Years ended March 31

	2006	2005	2004	2003
<b>For the year:</b>				
Net sales	¥ 98,398	¥ 92,696	¥ 89,858	¥ 90,253
Cost of sales	34,535	33,710	31,859	32,272
Selling, general and administrative expenses	42,868	40,004	43,475	45,284
Operating income	20,995	18,982	14,524	12,697
Interest expense	94	182	366	480
Income before income taxes	20,342	18,436	13,775	9,947
Income taxes	7,319	7,413	7,454	1,444
Net income	13,023	11,023	6,321	8,503
Capital expenditures	2,106	4,907	3,226	7,046
Depreciation and amortization	4,824	4,750	4,521	4,311
R&D expenditures	13,971	12,620	11,853	12,719
<b>Per share data (yen and U.S. dollars):</b>				
Net income — basic	¥ 150.26	¥ 125.85	¥ 71.65	¥ 93.67
Net income — diluted	150.01	125.71	71.64	85.97
Shareholders' equity (BPS)	1,368.27	1,249.32	1,176.83	1,104.21
Cash dividends, applicable to period	60.00	50.00	40.00	20.00
<b>Cash Flows:</b>				
Net cash provided by operating activities	¥ 20,879	¥ 6,619	¥ 23,196	¥ 15,808
Net cash (used in) provided by investing activities	(1,330)	(2,907)	5,246	(9,951)
Net cash (used in) provided by financing activities	(5,900)	(12,712)	(12,122)	(6,507)
Interest coverage ratio (times)	218.7	36.1	70.6	34.5
Debt amortization period (years)	0.2	1.0	0.5	1.5
<b>At year-end:</b>				
Current assets	¥ 93,893	¥ 82,735	¥ 91,231	¥ 83,431
Net property, plant and equipment	30,395	32,676	37,237	40,850
Total assets	150,458	139,980	150,238	147,148
Long-term debt	5,614	6,882	12,686	23,047
Total shareholders' equity	118,637	108,240	103,500	97,126
Return on equity (ROE) (%)	11.5	10.4	6.3	8.8
Return on total assets (ROA) (%)	9.0	7.6	4.3	5.7
Shareholders' equity ratio (%)	78.9	77.3	68.9	66.0
Shareholders' equity ratio on stock price basis (%)	163.0	142.3	101.8	68.7
Price earnings ratio (PER) (times)	18.8	18.3	24.3	12.3
Issued shares (thousands)	86,751	86,659	87,963	90,704
Number of employees	2,312	2,308	2,335	2,500

Notes: 1. U.S. dollar amounts have been translated from yen, solely for the convenience of the reader, at the rate of ¥117.47 to U.S.\$1 prevailing on March 31, 2006.

2. See Notes 2. 14) and 11) of Notes to Consolidated Financial Statements in respect of per share data.

3. Net sales in the six years ended March 31, 2006 to 2001 include royalty income which was presented as "Other, net" in "Other income (expenses)" through the fiscal year ended March 31, 2000.

Millions of yen						Thousands of U.S. dollars
2002	2001	2000	1999	1998	1997	2006
¥ 88,966	¥ 88,449	¥ 83,577	¥ 79,639	¥ 77,957	¥ 75,216	\$ 837,643
32,701	33,385	32,195	32,746	31,278	27,552	293,986
44,475	38,546	33,894	30,294	30,535	27,984	364,932
11,790	16,518	17,488	16,599	16,144	19,680	178,725
465	430	462	588	654	624	796
12,679	15,521	14,422	15,969	14,917	18,913	173,164
7,373	7,807	6,481	7,864	7,594	9,915	62,309
5,306	7,714	7,941	8,105	7,323	8,998	110,855
6,586	4,943	2,510	3,443	5,898	16,725	17,931
5,334	5,683	5,725	6,314	6,674	4,202	41,073
12,187	10,511	9,221	7,335	7,731	6,213	118,935
¥ 57.34	¥ 81.32	¥ 83.54	¥ 85.27	¥ 77.06	¥ 105.32	\$ 1.28
53.07	75.01	77.04	78.63	71.01	99.87	1.28
1,048.51	1,022.99	1,006.48	935.71	862.88	877.12	11.65
20.00	20.00	12.00	12.00	12.00	12.00	0.51
¥ 6,941	¥ 6,832	¥ 9,372	¥ 16,339	¥ 11,535	¥ 16,181	\$ 177,737
(6,374)	(3,172)	837	(8,305)	(9,537)	(28,259)	(11,322)
(5,684)	(7,193)	(3,817)	(3,857)	(1,677)	18,610	(50,227)
14.9	16.8	20.3	27.8	21.6	32.8	—
3.5	3.7	2.7	1.7	2.7	2.0	—
¥ 86,064	¥ 88,025	¥ 82,218	¥ 78,018	¥ 70,892	¥ 69,065	\$ 799,290
42,159	36,684	37,416	39,638	43,425	47,278	258,755
152,103	153,243	149,968	144,913	138,822	140,226	1,280,824
24,467	25,482	26,491	27,496	31,168	31,807	47,791
95,101	94,834	95,669	88,950	81,998	75,759	1,009,938
5.6	8.1	8.6	9.5	9.3	11.9	
3.5	5.1	5.4	5.7	5.2	6.4	
62.5	61.9	63.8	61.4	59.1	54.0	
86.6	134.3	139.4	145.0	106.1	131.8	
25.3	27.3	26.3	25.9	20.1	21.6	
90,704	92,721	95,075	95,075	95,075	86,410	
2,463	2,167	2,093	2,037	2,010	1,910	

## Consolidated Balance Sheets

Santen Pharmaceutical Co., Ltd. and Subsidiaries  
As of March 31, 2006 and 2005

ASSETS	Millions of yen		Thousands of U.S. dollars (Note 3)
	2006	2005	2006
<b>Current assets:</b>			
Cash and cash equivalents (Note 4)	¥ 46,105	¥ 32,381	\$ 392,481
Short-term investments (Note 4)	180	914	1,533
Trade receivables:			
Notes	309	398	2,632
Accounts	34,115	35,227	290,407
Less allowance for doubtful receivables	(1)	(18)	(6)
Net trade receivables	34,423	35,607	293,033
Inventories (Note 6)	9,838	9,827	83,747
Deferred tax assets (Note 14)	1,651	1,625	14,060
Other current assets	1,696	2,381	14,436
Total current assets	93,893	82,735	799,290
<b>Property, plant and equipment (Notes 7 and 8):</b>			
Land	9,064	9,487	77,159
Buildings and structures	40,289	40,257	342,976
Machinery and equipment	10,982	11,036	93,491
Tools, furniture and vehicles	10,452	10,609	88,977
Construction in progress	275	182	2,338
Total	71,062	71,571	604,941
Less accumulated depreciation	(40,667)	(38,895)	(346,186)
Net property, plant and equipment	30,395	32,676	258,755
<b>Investments and other assets:</b>			
Investment securities (Note 4)	17,716	14,314	150,811
Goodwill	709	1,015	6,039
Other intangibles	2,242	2,303	19,083
Deferred tax assets (Note 14)	380	1,052	3,231
Other assets	5,123	5,885	43,615
Total investments and other assets	26,170	24,569	222,779
Total assets	¥150,458	¥139,980	\$1,280,824

See accompanying notes to consolidated financial statements.

LIABILITIES AND SHAREHOLDERS' EQUITY	Millions of yen		Thousands of U.S. dollars (Note 3)
	2006	2005	2006
<b>Current liabilities:</b>			
Current portion of long-term debt (Note 9)	¥ 168	¥ 268	\$ 1,430
Trade accounts payable	5,631	6,123	47,934
Other payables	9,308	8,578	79,239
Accrued expenses	3,417	3,214	29,087
Income taxes payable (Note 14)	4,946	3,414	42,107
Other current liabilities	641	625	5,454
Total current liabilities	24,111	22,222	205,251
<b>Noncurrent liabilities:</b>			
Long-term debt (Note 9)	5,446	6,614	46,361
Retirement and severance benefits (Note 10)	1,707	1,858	14,529
Deferred tax liabilities (Note 14)	20	23	172
Other liabilities	537	1,023	4,573
Total noncurrent liabilities	7,710	9,518	65,635
<b>Shareholders' equity:</b>			
Common stock (Notes 11 and 12):			
Authorized — 151,493,354 shares (151,493,354 shares in 2005)			
Issued — 86,751,203 shares (86,658,703 shares in 2005)	6,319	6,248	53,795
Additional paid-in capital (Notes 11 and 12)	7,014	6,943	59,710
Retained earnings (Note 11)	104,134	95,902	886,472
Unrealized holding gains on securities (Notes 4 and 11)	3,996	2,049	34,016
Foreign currency translation adjustments	(2,736)	(2,827)	(23,288)
	118,727	108,315	1,010,705
Treasury stock at cost (Note 11):			
45,090 shares in 2006 and 39,660 shares in 2005	(90)	(75)	(767)
Total shareholders' equity	118,637	108,240	1,009,938
<b>Contingent liabilities (Note 15)</b>			
Total liabilities and shareholders' equity	¥150,458	¥139,980	\$1,280,824

## Consolidated Statements of Income

Santen Pharmaceutical Co., Ltd. and Subsidiaries  
For the years ended March 31, 2006, 2005 and 2004

	Millions of yen			Thousands of U.S. dollars (Note 3)
	2006	2005	2004	2006
Net sales	<b>¥98,398</b>	¥92,696	¥89,858	<b>\$837,643</b>
Cost of sales	<b>34,535</b>	33,710	31,859	<b>293,986</b>
Gross profit	<b>63,863</b>	58,986	57,999	<b>543,657</b>
Selling, general and administrative expenses	<b>42,868</b>	40,004	43,475	<b>364,932</b>
Operating income	<b>20,995</b>	18,982	14,524	<b>178,725</b>
Other income (expenses):				
Interest and dividend income	<b>262</b>	249	240	<b>2,228</b>
Gain on insurance received	<b>74</b>	114	1,712	<b>634</b>
Dividends received from investment limited partnership	<b>136</b>	—	—	<b>1,156</b>
Interest expense	<b>(94)</b>	(182)	(366)	<b>(796)</b>
Gain on sale of investment securities	<b>0</b>	1	675	<b>0</b>
Gain on sale of fixed assets	<b>3</b>	341	5	<b>27</b>
Net gain on the change of the retirement benefits program (Note 10)	<b>—</b>	316	—	<b>—</b>
Gain on marketable securities contributed to employees' retirement benefit trust (Note 10)	<b>—</b>	211	—	<b>—</b>
Loss on impairment of fixed assets (Note 8)	<b>(909)</b>	(823)	(377)	<b>(7,745)</b>
Loss on valuation of investment securities	<b>—</b>	(51)	(201)	<b>—</b>
Retirement benefit under the carrier development support program	<b>—</b>	—	(719)	<b>—</b>
Restructuring charge for the logistics operations	<b>(149)</b>	—	—	<b>(1,267)</b>
Loss on discontinued operations of affiliates	<b>—</b>	—	(855)	<b>—</b>
Restructuring charge for the U.S. business	<b>—</b>	(441)	(386)	<b>—</b>
Other, net	<b>24</b>	(281)	(477)	<b>202</b>
Income before income taxes	<b>20,342</b>	18,436	13,775	<b>173,164</b>
Income taxes (Note 14):				
Current	<b>7,999</b>	6,447	8,751	<b>68,095</b>
Deferred	<b>(680)</b>	966	(1,297)	<b>(5,786)</b>
	<b>7,319</b>	7,413	7,454	<b>62,309</b>
Net income	<b>¥13,023</b>	¥11,023	¥ 6,321	<b>\$110,855</b>

	Yen			U.S. dollars (Note 3)
	2006	2005	2004	2006
<b>Per share data:</b>				
Net income — basic	<b>¥150.26</b>	¥125.85	¥ 71.65	<b>\$ 1.28</b>
Net income — diluted	<b>150.01</b>	125.71	71.64	<b>1.28</b>
Cash dividends, applicable to the period	<b>60.00</b>	50.00	40.00	<b>0.51</b>

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Shareholders' Equity

Santen Pharmaceutical Co., Ltd. and Subsidiaries  
For the years ended March 31, 2006, 2005 and 2004

	Millions of yen			Thousands of U.S. dollars (Note 3)
	2006	2005	2004	2006
<b>Common stock</b> (Notes 11 and 12):				
Balance at beginning of year	¥ 6,248	¥ 6,214	¥ 6,214	\$ 53,187
Exercise of stock options	71	34	—	608
Balance at end of year	¥ 6,319	¥ 6,248	¥ 6,214	\$ 53,795
<b>Additional paid-in capital</b> (Notes 11 and 12):				
Balance at beginning of year	¥ 6,943	¥ 6,909	¥ 6,909	\$ 59,101
Exercise of stock options	71	34	—	609
Balance at end of year	¥ 7,014	¥ 6,943	¥ 6,909	\$ 59,710
<b>Retained earnings</b> (Note 11):				
Balance at beginning of year	¥ 95,902	¥91,845	¥90,552	\$816,393
Net income	13,023	11,023	6,321	110,855
Cash dividends paid	(4,766)	(4,397)	(1,758)	(40,563)
Bonuses to directors and corporate auditors	(25)	(21)	(30)	(213)
Retirement of treasury stock	—	(2,548)	(3,240)	—
Balance at end of year	¥104,134	¥95,902	¥91,845	\$886,472
<b>Unrealized holding gains on securities</b> (Notes 4 and 11):				
Balance at beginning of year	¥ 2,049	¥ 1,426	¥ 294	\$ 17,442
Net change	1,947	623	1,132	16,574
Balance at end of year	¥ 3,996	¥ 2,049	¥ 1,426	\$ 34,016
<b>Foreign currency translation adjustments:</b>				
Balance at beginning of year	¥ (2,827)	¥ (2,854)	¥ (3,566)	\$ (24,062)
Net change	91	27	712	774
Balance at end of year	¥ (2,736)	¥ (2,827)	¥ (2,854)	\$ (23,288)
<b>Treasury stock at cost:</b>				
Balance at beginning of year	¥ (75)	¥ (40)	¥ (3,277)	\$ (635)
Repurchase of treasury stock, net	(15)	(2,583)	(3)	(132)
Retirement of treasury stock	—	2,548	3,240	—
Balance at end of year	¥ (90)	¥ (75)	¥ (40)	\$ (767)

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Cash Flows

Santen Pharmaceutical Co., Ltd. and Subsidiaries  
For the years ended March 31, 2006, 2005 and 2004

	Millions of yen			Thousands of U.S. dollars (Note 3)
	2006	2005	2004	2006
<b>Cash flows from operating activities:</b>				
Income before income taxes	¥20,342	¥18,436	¥13,775	\$173,164
Depreciation and amortization	4,824	4,750	4,521	41,073
Loss on impairment of fixed assets (Note 8)	909	823	377	7,745
(Decrease) increase in retirement and severance benefits	(212)	(2,551)	43	(1,807)
Interest and dividend income	(262)	(249)	(240)	(2,228)
Gain on insurance received	(74)	(114)	(1,712)	(634)
Interest expense	94	182	366	796
Decrease (increase) in trade receivables	1,407	(3,082)	(315)	11,979
(Increase) decrease in inventories	(18)	595	1,342	(154)
(Decrease) increase in trade accounts payable	(495)	1,066	(441)	(4,217)
Other, net	571	(2,263)	1,046	4,860
Subtotal	27,086	17,593	18,762	230,577
Interest and dividend income received	266	247	233	2,264
Interest expense paid	(95)	(183)	(329)	(813)
Insurance received	129	198	3,003	1,102
Income taxes paid	(6,507)	(11,236)	(453)	(55,393)
Income taxes refunded	—	—	1,980	—
Net cash provided by operating activities	20,879	6,619	23,196	177,737
<b>Cash flows from investing activities:</b>				
Capital expenditures	(2,106)	(4,907)	(3,226)	(17,931)
Purchase of investment securities	(58)	(3,230)	(511)	(490)
Proceeds from sale of investment securities	20	1,059	1,074	172
Proceeds from sale of property, plant and equipment	29	2,488	3,770	249
Purchase of short-term investments	(804)	(6,048)	(7,022)	(6,844)
Proceeds from sale of short-term investments	1,547	7,722	11,520	13,169
Other, net	42	9	(359)	353
Net cash (used in) provided by investing activities	(1,330)	(2,907)	5,246	(11,322)
<b>Cash flows from financing activities:</b>				
Proceeds from long-term debt	—	—	10,000	—
Repayment of long-term debt	(1,268)	(5,804)	(416)	(10,794)
Redemption of convertible bonds	—	—	(19,945)	—
Repurchase of treasury stock, net (Note 11)	(15)	(2,583)	(3)	(131)
Dividends paid	(4,760)	(4,393)	(1,758)	(40,518)
Other, net	143	68	—	1,216
Net cash used in financing activities	(5,900)	(12,712)	(12,122)	(50,227)
Effect of exchange rate changes on cash and cash equivalents	75	(42)	49	642
Net increase (decrease) in cash and cash equivalents	13,724	(9,042)	16,369	116,830
Cash and cash equivalents at beginning of year	32,381	41,423	25,054	275,651
Cash and cash equivalents at end of year	¥46,105	¥32,381	¥41,423	\$392,481

See accompanying notes to consolidated financial statements.

# Notes to Consolidated Financial Statements

Santen Pharmaceutical Co., Ltd. and Subsidiaries

## 1 Basis of Presentation of Consolidated Financial Statements

The accompanying consolidated financial statements have been prepared in accordance with the provisions set forth in the Japanese Securities and Exchange Law and its related accounting regulations, and in conformity with accounting principles generally accepted in Japan (“Japanese GAAP”), which are different in certain respects as to application and disclosure requirements of International Financial Reporting Standards.

The accounts of overseas subsidiaries are based on their accounting records maintained in conformity with generally accepted accounting principles prevailing in the respective countries of domicile. The accompanying consolidated

financial statements have been restructured and translated into English (with some expanded descriptions and the inclusion of consolidated statements of shareholders’ equity) from the consolidated financial statements of Santen Pharmaceutical Co., Ltd. (the “Company”) prepared in accordance with Japanese GAAP and filed with the appropriate Local Finance Bureau of the Ministry of Finance as required by the Securities and Exchange Law. Some supplementary information included in the statutory Japanese language consolidated financial statements, but not required for fair presentation, is not presented in the accompanying consolidated financial statements.

## 2 Summary of Significant Accounting Policies

### 1) Principles of consolidation

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries (the “Companies”). All significant intercompany balances and transactions are eliminated on consolidation.

Investments in affiliated companies are stated at cost, because the Companies’ equity in earnings of these companies is not significant.

### 2) Use of estimates

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

### 3) Short-term investments, investment securities and golf membership rights (see Note 4)

The Company and all domestic subsidiaries have adopted “Accounting Standard for Financial Instruments” which was issued by the Business Accounting Council in Japan. In accordance with this standard, securities are classified into three categories: trading, held-to-maturity, or other securities.

Based on this classification, all trading securities and any held-to-maturity and other securities with a maturity of less than one year are included in current assets. All other securities are included in investment securities as non-current assets.

Those classified as other securities with an available market value are reported at fair value with unrealized holding gains, net of related taxes reported in equity. Realized

gains and losses on sales of such securities are determined by the moving average cost method. Other securities with no available market value are carried at cost, which is determined by the moving average cost method.

In addition, this standard also requires the recognition of an impairment loss on golf membership rights, included in other assets, on the consolidated balance sheets, when the market value shows a substantial decline and does not appear to be recoverable.

### 4) Derivative instruments (see Note 5)

Derivative instruments are stated at fair value, and accounted for using deferred hedge accounting. Deferred hedge accounting requires unrealized gains or losses to be deferred as assets or liabilities. Foreign exchange contracts that meet the criteria are accounted for under the allocation method. The allocation method requires recognized foreign currency receivables or payables to be translated using the corresponding foreign exchange contract rates. Interest rate swaps that meet the criteria are accounted for under the special method, as regulated in the accounting standard, as if the interest rates under interest rate swaps were originally applied to underlying borrowings. The Company has also developed a hedging policy to control various aspects of derivative instruments including authorization levels and transaction volumes. Based on this policy, the Company hedges the exposure risk arising from fluctuations in foreign currency exchange rates, interest rates, and prices of securities. The Company evaluates hedge effectiveness by comparing the cumulative changes in cash flows from hedged items and corresponding changes in hedging derivative instruments.

**5) Allowance for doubtful receivables**

Allowance for doubtful receivables is provided principally at an amount computed based on the actual ratio of bad debts in the past and the estimated uncollectible amounts based on the individual analysis of certain receivables.

**6) Inventories (see Note 6)**

Inventories are stated at cost, determined principally by the average method.

**7) Property, plant and equipment**

Property, plant and equipment is stated at cost. Depreciation of buildings, acquired prior to April 1, 1998, and other property, plant and equipment is computed over the estimated useful lives of the assets by the declining-balance method for the Company and all domestic subsidiaries. Buildings (other than leasehold improvements), which were acquired on or after April 1, 1998, are depreciated using the straight-line method for the Company and all domestic subsidiaries. Depreciation is computed over the estimated useful lives of the assets by the straight-line method for all overseas subsidiaries.

The principal estimated useful lives are as follows:

Buildings and structures	31 to 50 years
Machinery and equipment	7 years
Tools, furniture and vehicles	4 to 10 years

**8) Goodwill**

Goodwill, which represents the excess of purchase price over the fair value of net assets acquired, is amortized on a straight-line basis over a period of ten years.

**9) Leases (see Note 7)**

In Japan, finance leases other than those that are deemed to transfer the ownership of the leased assets to lessees are accounted for by a method similar to that applicable to ordinary operating leases.

**10) Impairment of fixed assets (see Note 8)**

In accordance with "Accounting Standard for Impairment of Fixed Assets" which was issued by the Business Accounting Council in Japan, fixed assets, such as property, plant and equipment and intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset, or group of assets, to estimated undiscounted future cash flows expected to be generated. If the carrying amount of an asset, or group of assets, exceeds its estimated future

cash flows, an impairment charge is recognized for the amount by which the carrying amount of the asset exceeds the greater of its net realizable value or value in use.

**11) Retirement and severance benefits (see Note 10)**

Employees of the Company and all domestic subsidiaries are generally entitled to lump-sum severance and, in certain cases, annuity payments on retirement, based on current rates of pay, length of service and certain other factors.

The Company and all domestic subsidiaries have adopted "Accounting Standard for Retirement Benefits" which was issued by the Financial Accounting Deliberation Council. In accordance with this standard, the allowance for retirement benefits for employees is provided based on the estimated retirement benefit obligation and the pension assets. Actuarial gains and losses are amortized, from the year in which the actuarial gains and losses are incurred, using the straight-line method, over the estimated average remaining service years of employees. Prior service cost is expensed as incurred.

In January 2005, due to the enforcement of the Defined Contribution Pension Plan Act in Japan, the Company has abolished its qualified pension plan and introduced a new retirement benefit scheme, which is a combination of lump-sum severance plan, cash balance and defined contribution pension plan and has adopted the Financial Accounting Standards Implementation Guidance No. 1 "Accounting for Transfers between Retirement Benefit Plans" which was issued by the Accounting Standards Board of Japan. The Company also established the retirement benefits trust in March 2005.

In addition, the Company has an unfunded retirement benefit plan for directors and corporate auditors. The amounts required under the plan have been fully accrued. Accrued severance indemnities for the members of the board and corporate auditors of the Company are provided based on internal regulations. The accrued provision for severance indemnities for members of the board and corporate auditors is not funded.

Certain overseas subsidiaries have defined contribution plans covering substantially all of their employees. The amounts contributed under the plans are charged to income.

**12) Foreign currency translation**

All monetary assets and liabilities denominated in foreign currencies are translated at the rate of exchange prevailing on the balance sheet date, except for those items covered by forward exchange contracts.

The Company and all domestic subsidiaries have adopted "Accounting Standard for Foreign Currency Transactions" which was issued by the Business Accounting Council in Japan.

Financial statements of overseas subsidiaries are translated into Japanese yen at year-end rates for all assets and liabilities and at weighted average rates for income and expense accounts. Adjustments resulting from the translation of financial statements are reflected under the caption, "Foreign currency translation adjustments," in shareholders' equity.

### 13) Research and development and computer software (see Note 13)

Research and development expenditures are charged to income when incurred.

Expenditures relating to computer software developed for internal use are charged to income when incurred except if they contribute to the generation of income or to future cost savings. Such expenditures are capitalized as an asset and are amortized using the straight-line method over their estimated useful life, five years.

### 14) Net income and dividends per share (see Note 11)

The computation of basic net income per share is based on the weighted average number of shares of common stock outstanding during each period. The average number of shares used in the computation is 86,662 thousand, 87,390 thousand and 87,931 thousand for the years ended March 31, 2006, 2005 and 2004, respectively.

The diluted net income per share assumes the dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common

stock or resulted in the issuance of common stock. The average number of shares used in the computation is 86,808 thousand, 87,485 thousand and 87,942 thousand for the years ended March 31, 2006, 2005 and 2004, respectively.

Cash dividends per share shown in the accompanying consolidated statements of income are the amounts applicable to the respective years.

### 15) Income taxes (see Note 14)

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, operating loss carryforwards and foreign tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

### 16) Cash and cash equivalents

Cash and cash equivalents mainly include cash on hand, readily available deposits and all highly liquid debt investments, generally with a maturity of three months or less, that are readily convertible to known amounts of cash and are so near maturity that they present insignificant risk of changes in value.

## 3 Translation Into United States Dollars

The accompanying consolidated financial statements are expressed in Japanese yen and, solely for the convenience of the reader, have been translated into United States dollars at the rate of ¥117.47=US\$1, the approximate exchange rate

prevailing on March 31, 2006. The translation should not be construed as a representation that the Japanese yen have been, could have been, or could in the future be converted into United States dollars at that rate or any other rate.

## 4 Short-term Investments and Investment Securities

The following is a summary of held-to-maturity debt securities and other securities with a market value at March 31, 2006 and 2005:

	Millions of yen							
	2006				2005			
	Held-to-maturity debt securities				Held-to-maturity debt securities			
Book value (Carrying amount)	Gross unrealized gains	Gross unrealized losses	Estimated fair value	Book value (Carrying amount)	Gross unrealized gains	Gross unrealized losses	Estimated fair value	
Bonds and debentures	¥ 1,000	¥ 9	¥ —	¥ 1,009	¥ 1,000	¥ 12	¥ —	¥ 1,012

	Millions of yen							
	2006				2005			
	Other securities				Other securities			
	Cost	Gross unrealized gains	Gross unrealized losses	Book value (Estimated fair value)	Cost	Gross unrealized gains	Gross unrealized losses	Book value (Estimated fair value)
Equity securities	¥ 8,796	¥ 6,647	¥ —	¥15,443	¥ 8,789	¥ 3,576	¥ (114)	¥12,251

	Thousands of U.S. dollars			
	2006			
	Held-to-maturity debt securities			
	Book value (Carrying amount)	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Bonds and debentures	\$ 8,513	\$ 78	\$ —	\$ 8,591

	Other securities			
	Cost	Gross unrealized gains	Gross unrealized losses	Book value (Estimated fair value)
	Equity securities	\$74,876	\$56,585	\$ —

Maturities of investments at March 31, 2006 and 2005 are as follows:

	Millions of yen				Thousands of U.S. dollars	
	2006		2005		2006	
	Bonds and debentures	Other securities	Bonds and debentures	Other securities	Bonds and debentures	Other securities
Cash equivalents	¥ 9,300	¥ —	¥ 7,500	¥ —	\$79,169	\$ —
Due within one year	—	—	5	—	—	—
Due after one year through five years	1,000	—	1,000	—	8,513	—
	¥10,300	¥ —	¥ 8,505	¥ —	\$87,682	\$ —

## 5 Derivative Instruments

The Company principally utilizes derivative instruments such as foreign exchange contracts, interest rate swaps, currency interest rate swaps, currency options and equity options to hedge the exposure risk arising from fluctuations in foreign currency exchange rates, interest rates and market price of securities.

The Company is exposed to the risk that the counterparties will not be able to fully satisfy their obligations under contracts, but the Company believes that such risk is mitigated by the high credit ratings of the counterparties.

There is no outstanding derivative transaction for which hedge accounting was not applied at March 31, 2006 and 2005.

## 6 Inventories

Inventories at March 31, 2006 and 2005 consist of the following:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Merchandise	<b>¥2,680</b>	¥2,295	<b>\$22,811</b>
Finished goods	<b>5,151</b>	5,159	<b>43,852</b>
Work in process and semi-finished goods	<b>749</b>	854	<b>6,377</b>
Raw materials and supplies	<b>1,258</b>	1,519	<b>10,707</b>
	<b>¥9,838</b>	¥9,827	<b>\$83,747</b>

## 7 Leases

Finance leases, except for those in which ownership is deemed to be transferred to the lessee, are accounted for as operating leases.

### Finance leases:

Equivalent purchase amount, accumulated depreciation and future minimum lease payments on an "as if capitalized" basis at March 31, 2006 and 2005 are as follows:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Machinery and equipment:			
Equivalent purchase amount	<b>¥14,236</b>	¥14,318	<b>\$121,192</b>
Equivalent accumulated depreciation amount	<b>11,498</b>	10,751	<b>97,882</b>
Equivalent balance at year-end	<b>2,738</b>	3,567	<b>23,310</b>
Tools:			
Equivalent purchase amount	<b>514</b>	623	<b>4,380</b>
Equivalent accumulated depreciation amount	<b>287</b>	298	<b>2,445</b>
Equivalent balance at year-end	<b>227</b>	325	<b>1,935</b>
Total:			
Equivalent purchase amount	<b>14,750</b>	14,941	<b>125,572</b>
Equivalent accumulated depreciation amount	<b>11,785</b>	11,049	<b>100,327</b>
Equivalent balance at year-end	<b>¥ 2,965</b>	¥ 3,892	<b>\$ 25,245</b>
Future minimum lease payments:			
Due within one year	<b>¥ 948</b>	¥ 963	<b>\$ 8,069</b>
Due after one year	<b>2,123</b>	3,045	<b>18,071</b>
	<b>¥ 3,071</b>	¥ 4,008	<b>\$ 26,140</b>

Lease payments, equivalent depreciation and equivalent interest expense for the three years ended March 31, 2006 are as follows:

	Millions of yen			Thousands of U.S. dollars
	2006	2005	2004	2006
Lease payments	<b>¥1,035</b>	¥977	¥736	<b>\$8,813</b>
Equivalent depreciation	<b>969</b>	911	692	<b>8,251</b>
Equivalent interest expense	<b>61</b>	68	55	<b>518</b>

**Operating leases:**

Future minimum rents under non-cancellable operating leases at March 31, 2006 and 2005 consist of the following:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Due within one year	¥107	¥ 97	\$ 916
Due after one year	98	147	832
	¥205	¥244	\$1,748

**8 Impairment of Fixed Assets**

The Company and all domestic subsidiaries account for impairment of fixed assets in accordance with the Financial Accounting Standard on Accounting for Impairment of Assets. The Company and all domestic subsidiaries review

the recorded value of their property, plant and equipment and intangible assets to determine if the future cash flows to be derived from these properties will be sufficient to recover the remaining recorded asset values.

The impairment losses recognized for the three years ended March 31, 2006, 2005 and 2004 are as follows:

	Millions of yen			Thousands of U.S. dollars
	2006	2005	2004	2006
Land	¥433	¥700	¥323	\$3,686
Building and structures	372	73	54	3,167
Others	104	50	—	892
	¥909	¥823	¥377	\$7,745

The Company and certain subsidiaries recorded impairment losses related to the write-down of land and buildings in connection with the logistics operations in the western area of Japan as a result of an outsourcing plan during fiscal 2006. The fair value of the land and buildings was determined by specific appraisal.

The Company decided to sell the rental land and buildings during fiscal 2005. As a result, the Company recognized an impairment loss. The fair value of the land and

buildings was determined by using a purchase price offered by a third party.

The Company recognized impairment losses on land and buildings during fiscal 2004. One of the impairment losses was related to the write-down of some unused land and the fair value was determined by estimating the market value. The other impairment loss was related to the write-down of a rental building to be sold and the fair value was determined by using a purchase price offered by a third party.

**9 Long-term Debt**

Long-term debt at March 31, 2006 and 2005 consisted of the following:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Unsecured yen syndicated loans from domestic banks, due in 2008, interest 0.50%	¥5,000	¥5,000	\$42,564
Unsecured yen loans from domestic banks, due in installments through 2009, interest 4.75%	614	1,882	5,227
Total	5,614	6,882	47,791
Less: Current portion shown in current liabilities	(168)	(268)	(1,430)
	¥5,446	¥6,614	\$46,361

In 2006, the Company entered into a commitment line contract with seven domestic banks. The maximum aggregate credit available to the Company is ¥16,000 million. The credit has not been used as of March 31, 2006.

As is customary in Japan, long-term bank loans are made under general agreements which provide that additional security and guarantees for present and future

indebtedness will be given upon request of the bank under certain circumstances, and that the bank shall have the right, as the obligations become due, or in the event of default, to offset cash deposits against such obligations due to the bank. To date, the Company has not received such a request from its banks.

The aggregate annual maturities of long-term debt at March 31, 2006 are as follows:

Years ending March 31	Millions of yen	Thousands of U.S. dollars
2007	¥ 168	\$ 1,430
2008	168	1,430
2009	5,168	43,995
2010	110	936
Total	¥5,614	\$47,791

## 10 Retirement and Severance Benefits

As discussed in Note 2, 11), the Company has abolished its qualified pension plan and introduced a new retirement benefit scheme, which is a combination of lump-sum severance, cash balance and defined contribution pension plans, since January 2005. In addition, the Company has set up an employees' retirement benefit trust in March 2005.

All domestic subsidiaries have adopted the permitted alternative treatment, accruing for 100% of the amount required if all employees were to voluntarily terminate their employment as of the balance sheet date, in accordance with the accounting standard for retirement benefits for small business entities.

The following table sets forth the details of benefit obligation, plan assets and funded status of the Companies at March 31, 2006 and 2005:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
For employees:			
Benefit obligation at end of year	¥(10,838)	¥(10,053)	\$(92,259)
Fair value of plan assets at end of year	8,939	7,694	76,094
Funded status (benefit obligation in excess of plan assets)	(1,899)	(2,359)	(16,165)
Unrecognized actuarial loss	655	904	5,576
For directors and corporate auditors:			
Accrued retirement benefit	(463)	(403)	(3,940)
Retirement and severance benefits recognized in the consolidated balance sheets	¥ (1,707)	¥ (1,858)	\$(14,529)

Retirement and severance costs of the Companies included the following components for the three years ended March 31, 2006:

	Millions of yen			Thousands of U.S. dollars
	2006	2005	2004	2006
For employees:				
Service cost	¥ 673	¥ 869	¥1,086	\$ 5,727
Interest cost	208	217	265	1,767
Expected return on plan assets	(154)	(103)	(92)	(1,310)
Recognized actuarial loss	76	111	122	651
Amortization of unrecognized prior service cost	—	572	—	—
Net gains on the change of the retirement benefits program	—	(316)	—	—
Contribution to defined contribution pension plan	770	491	—	6,551
Net periodic benefit cost	¥1,573	¥1,841	¥1,381	\$13,386
For directors and corporate auditors:				
Accrual for retirement benefit	¥ 60	¥ 6	¥ 28	\$ 513

Assumptions used in the accounting for retirement and severance benefits for the three years ended March 31, 2006 are as follows:

	2006	2005	2004
Method of attributing benefit to period of service	<b>Straight-line basis</b>	Straight-line basis	Straight-line basis
Discount rate	<b>2.00%</b>	2.00%	2.00%
Expected return on plan assets	<b>2.00%</b>	2.00%	2.00%
Amortization period for actuarial losses*	<b>14 years</b>	14 years	14 years

\* Amortized on a straight-line basis over the average remaining service period for employees in service starting from the year in which the losses occur.

## 11 Shareholders' Equity

Under the former Japanese Commercial Code ("the Code"), at least 50% of the issue price of new shares is required to be designated as stated capital. The portion which is to be designated as stated capital is determined by resolution of the Board of Directors. Proceeds in excess of the amounts designated as stated capital have been credited to additional paid-in capital.

The Code provides that an amount equal to at least 10% of cash payments for appropriation of retained earnings with respect to each fiscal period be appropriated to a legal reserve until the aggregated amount of additional paid-in capital and the legal reserve equals 25% of the stated capital. Additional paid-in capital and the legal reserve may be used to reduce a deficit by resolution of the shareholders' meeting or may be capitalized by resolution of the Board of Directors. The portion in excess of 25% of the stated capital may be used for dividend distribution. The legal reserve, which is included in retained earnings, amounted to ¥1,551 million (\$13,207 thousand) and ¥1,551 million as of March 31, 2006 and 2005, respectively.

Cash dividends charged to retained earnings during the three years ended March 31, 2006 represent dividends paid out during the periods. The accompanying consolidated financial statements do not include any provision for the year-end dividend of ¥35 (\$0.30) per share, aggregating ¥3,035 million (\$25,834 thousand) which was approved at the Company's shareholders' meeting on June 27, 2006 in respect of the year ended March 31, 2006.

Under the Code, the amount available for dividends is based on retained earnings, net of treasury stock, as recorded on the Company's books. At March 31, 2006, retained earnings, net of treasury stock, recorded on the Company's books were ¥104,615 million (\$890,569 thousand). Such retained earnings included ¥89,109 million (\$758,568 thousand) which is designated as general reserves, but is available for distribution as future dividends subject to approval of the shareholders' meeting and legal reserve requirements. Unrealized holding gains on securities, net of related taxes are not available for distribution as dividends or bonuses to directors and corporate auditors.

## 12 Stock Options

The Company has stock-based compensation plans under which stock options are granted annually to directors and corporate officers at the market price on the date they are

granted. The stock options are fully exercisable after two years and have a span of ten years from the date of grant.

Information concerning option activities and balances for the three years ended March 31, 2006 is as follows:

	Number of shares	Weighted average exercise price	
		Yen	U.S. dollars
Balance at March 31, 2003	335,000	¥ 2,000	
Granted	137,600	1,176	
Balance at March 31, 2004	472,600	1,760	
Granted	78,200	1,743	
Exercised	(46,500)	(1,450)	
Balance at March 31, 2005	504,300	1,786	\$ 15.20
Granted	<b>129,200</b>	<b>2,480</b>	<b>21.11</b>
Exercised	<b>(92,500)</b>	<b>(1,544)</b>	<b>(13.14)</b>
Balance at March 31, 2006	<b>541,000</b>	<b>¥ 1,993</b>	<b>\$ 16.97</b>

On June 27, 2006, the Company's shareholders' meeting approved that the Company's stock acquisition rights would be allotted to directors and corporate officers of the Company as stock options. These stock option rights are

exercisable from June 28, 2008 to June 24, 2016. The total number of stock acquisition rights is limited in aggregate to 102,800 common shares.

## 13 Research and Development Expenditures

Research and development expenditures charged to income for the three years ended March 31, 2006, 2005 and 2004 amounted to ¥13,971 million (\$118,935 thousand), ¥12,620 million and ¥11,853 million, respectively.

## 14 Income Taxes

The Company and its domestic subsidiaries are subject to a number of taxes based on earnings which, in the aggregate, resulted in average normal tax rates of approximately 40.4%,

40.4% and 42.0% for the years ended March 31, 2006, 2005 and 2004, respectively. Overseas subsidiaries are subject to income taxes of the countries in which they operate.

The effective rates for the three years ended March 31, 2006, 2005 and 2004 differ from the normal tax rates for the following reasons:

	2006	2005	2004
Normal tax rate	<b>40.4%</b>	40.4%	42.0%
Expenses not deductible for tax purposes	<b>1.7</b>	1.6	2.0
Change in valuation allowance allocated to income tax expenses	<b>0.6</b>	2.7	12.6
Per capita inhabitants' tax	<b>0.4</b>	0.4	0.6
Lower tax rates of subsidiaries	<b>(0.7)</b>	0.6	2.8
Tax credit for research and development expenses	<b>(6.4)</b>	(5.7)	(8.3)
Adjustments of deferred tax assets and liabilities for enacted changes in tax rates	<b>—</b>	—	0.6
Others	<b>0.0</b>	0.2	1.8
Effective tax rate	<b>36.0%</b>	40.2%	54.1%

The tax effects of temporary differences and tax loss carryforwards that give rise to significant portions of the deferred tax assets and deferred tax liabilities at March 31, 2006 and 2005 are presented below:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Deferred tax assets:			
Tax loss carryforwards	¥ 5,943	¥ 5,657	\$ 50,593
Retirement and severance benefits	1,961	1,798	16,692
Accrued expenses	1,039	1,044	8,843
Loss on impairment of fixed assets	514	148	4,375
Accrued enterprise taxes	428	298	3,646
Deferred assets for tax purposes	271	118	2,307
Loss on impairment of golf membership rights	222	230	1,893
Depreciation and amortization	191	666	1,624
Unrealized profit of other intangibles	67	92	571
Loss on valuation of securities	44	231	371
Loss on valuation of inventories	60	74	511
Other	1,368	839	11,643
Total gross deferred tax assets	12,108	11,195	103,069
Less valuation allowance	(7,152)	(6,921)	(60,880)
Net deferred tax assets	4,956	4,274	42,189
Deferred tax liabilities:			
Net unrealized holding gains on securities	(2,698)	(1,391)	(22,966)
Reserve for special depreciation	(227)	(206)	(1,932)
Other	(20)	(23)	(172)
Total gross deferred tax liabilities	(2,945)	(1,620)	(25,070)
Net deferred tax assets	¥ 2,011	¥ 2,654	\$ 17,119

Net deferred tax assets at March 31, 2006 and 2005 are reflected in the accompanying consolidated balance sheets under the following captions:

	Millions of yen		Thousands of U.S. dollars
	2006	2005	2006
Current assets — deferred tax assets	¥1,651	¥1,625	\$14,060
Investments and other assets — deferred tax assets	380	1,052	3,231
Non current liabilities — deferred tax liabilities	(20)	(23)	(172)
Net deferred tax assets	¥2,011	¥2,654	\$17,119

## 15 Contingent Liabilities

At March 31, 2006, the Company has provided guarantees to financial institutions covering employee loans totaling ¥510 million (\$4,342 thousand).

## 16 Segment Information

The Companies operate predominantly in a single industry segment: the production, sale and marketing of pharmaceuticals.

Intercompany sales between geographic areas are recorded at cost plus a markup and intercompany sales and

profits are eliminated on consolidation. Corporate assets are composed mainly of cash and cash equivalents, short-term investments and investment securities.

Information by geographic area and overseas sales are as follows:

	Millions of yen			Thousands of U.S. dollars
	2006	2005	2004	2006
<b>Geographic areas:</b>				
Net sales:				
Japan:				
External customers	¥ 89,882	¥ 85,837	¥ 79,338	\$ 765,147
Intersegment	986	549	1,018	8,392
Total	90,868	86,386	80,356	773,539
Europe:				
External customers	8,156	6,375	8,849	69,428
Intersegment	1,988	1,624	1,156	16,924
Total	10,144	7,999	10,005	86,352
Other:				
External customers	360	484	1,671	3,068
Intersegment	2,859	2,570	6,036	24,340
Total	3,219	3,054	7,707	27,408
Corporate and eliminations	(5,833)	(4,743)	(8,210)	(49,656)
Consolidated	¥ 98,398	¥ 92,696	¥ 89,858	\$ 837,643
Operating income (loss):				
Japan	¥ 22,623	¥ 22,169	¥ 20,351	\$ 192,587
Europe	951	(150)	(2,599)	8,098
Other	(708)	(743)	(550)	(6,028)
Corporate and eliminations	(1,871)	(2,294)	(2,678)	(15,932)
Consolidated	¥ 20,995	¥ 18,982	¥ 14,524	\$ 178,725
Assets:				
Japan	¥127,647	¥123,067	¥132,791	\$1,086,637
Europe	8,744	8,604	11,669	74,437
Other	5,217	5,155	6,016	44,411
Corporate and eliminations	8,850	3,154	(238)	75,339
Consolidated	¥150,458	¥139,980	¥150,238	\$1,280,824
The main countries included in Europe and Other are as follows:				
Europe: Finland, Germany and Sweden				
Other: United States of America, China, Korea and Taiwan				
<b>Overseas sales:</b>				
Europe	¥ 6,089	¥ 4,794	¥ 4,370	\$ 51,838
North America	1,916	1,704	5,814	16,310
Other	3,608	2,752	2,197	30,716
Total	¥ 11,613	¥ 9,250	¥ 12,381	\$ 98,864
Consolidated net sales	98,398	92,696	89,858	837,643
Percentage of overseas sales to consolidated net sales	11.8%	10.0%	13.8%	11.8%
The main countries included in Europe, North America and Other are as follows:				
Europe: Finland, Russia, Sweden, Germany and Norway				
North America: United States of America and Canada				
Other: Korea, China and Taiwan				
Overseas sales represent the total amount of export sales of the Company and domestic subsidiaries and sales of overseas subsidiaries (intercompany sales between consolidated subsidiaries are eliminated upon consolidation).				

## Independent Auditors' Report



**To the Board of Directors of  
Santen Pharmaceutical Co., Ltd.:**

We have audited the accompanying consolidated balance sheets of Santen Pharmaceutical Co., Ltd. and consolidated subsidiaries as of March 31, 2006 and 2005, and the related consolidated statements of income, shareholders' equity and cash flows for each of the three years in the period ended March 31, 2006, expressed in Japanese yen. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to independently express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in Japan. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Santen Pharmaceutical Co., Ltd. and subsidiaries as of March 31, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended March 31, 2006, in conformity with accounting principles generally accepted in Japan.

The U.S. dollar amounts in the accompanying consolidated financial statements with respect to the year ended March 31, 2006 are presented solely for convenience. Our audit also included the translation of yen amounts into U.S. dollar amounts and, in our opinion, such translation has been made on the basis described in Note 3 to the consolidated financial statements.

**KPMG AZSA & Co.**

Osaka, Japan  
June 27, 2006