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Director of Major Projects—File Reference No. 1102-100
Financial Accounting Standards Board (“FASB”)
Of the Financial Accounting Foundation
P.O. Box 5116
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Via email: director@fasb.org, File Reference No. 1102-100

Dear Sir,

Alcon, Inc. appreciates the opportunity to comment on the FASB's Exposure Draft (“ED”) and Proposed Statement of Financial Accounting Standards entitled *Share-Based Payment – an amendment of FASB Statements No. 123 and 95*. Although the International Accounting Standards Board has issued International Financial Reporting Standard 2, which is very similar to the ED, and FASB members have indicated publicly their personal support of the positions in the ED, we hope the FASB will review our comments with an open mind to the issues and observations we present below.

We would like to express the opinion that we disagree with the position that reporting entities should be required to expense equity-settled share-based payments, in particular employee stock options, under the “fair value” method. We disagree based on the following points.

- **There is no expense to the corporation for stock options granted with an exercise price equal to the market price on the date of issuance. The value of the option is in the possible appreciation in the market price of the underlying stock and an efficient market will factor the presence of stock options into the appreciating or declining market price.**

At the date the option is issued, the value of the option is zero in that there is no current intrinsic value that accrues to the option holder. Value only accrues to the option holder as the market price for the underlying stock increases in response to the future operations of the company issuing the option.

Clearly, stock options are issued in anticipation of some increase in value of the underlying stock. However, the appreciation in market value of the underlying stock is tempered by the probability that some additional shares will be issued at a price that is at a discount to the then current market price.

In other words, an efficient market will anticipate the exercise of stock options and will factor any discounted shares into the market price. In this manner, the shareholders directly absorb the cost of options as a reduction in the appreciation of stock value.

- **The “fair value” method provides no “relevant attribute measurable with sufficient reliability,” as required under Statement of Financial Accounting Concepts No. 5, paragraph 63.**

In Paragraph C16 of the ED, “The Board concluded that it is not feasible to measure directly the fair value of employee services received in exchange for employee share options or other equity instruments, that is, the amount for which the services would be exchanged in the marketplace. Thus, the amount of the related compensation cost must be based on the fair value of the instruments issued as compensation for those services.” Therein lies the problem—the “fair value” of the instruments cannot be measured with sufficient reliability.

Most employee stock options are written to prohibit the employees from selling, trading or redeeming the stock options in any manner otherwise than exercising them. Accordingly, because the options cannot be freely exchanged, there is no market, and no fair market value can exist for employee stock options. If by their very terms there is no fair market value for employee stock options, the “fair value” cannot be measured with sufficient reliability. Option pricing models that were designed to value options that are freely exchanged in public markets cannot reliably be substituted to value employee stock options that are not freely exchanged.

Although the FASB specifically addresses in paragraph C22 of the ED that it is not persuaded by the above argument, the FASB has endorsed options-pricing devices for valuing an item for which the devices were not intended and are ill-equipped to measure. While many estimates are used in accounting that are derived from a number of models, formulas, and assumptions, none are as ill-fitted for their purpose as these models are for employee stock options. The FASB even recognizes that for nonpublic entities the intrinsic model makes more sense. Employee stock options, which are not readily exchanged, are no more suited for these option-pricing models than are options granted by nonpublic entities.

- **Incorporating the “fair value” method in the basic financial statements provides no relevant information that “is capable of making a difference in user decisions,” as required under Statement of Financial Accounting Concepts No. 5, paragraph 63.**

In “Much Ado About Stock Options—Act Two”, an editorial by regular columnist Holman W. Jenkins, Jr. featured in the August 7, 2002 edition of *The Wall Street Journal*, Mr. Holman observes,

“Studies galore show that stock prices already behave as if investors understand what options cost them in terms of potential dilution of their ownership stakes. The issue has been fully aired and the proposed rule, if adopted, would have no impact on share prices.”

Educated, price-setting investors take into account all publicly available information, including footnote disclosures and relevant non-financial information in arriving at the valuation of shares. Full disclosure in the footnotes of facts and information regarding the options provides better information than cluttering the basic financial statements with abstract attempts to quantify transactions that are not reliably measurable. Since 1995, knowledgeable investors have developed the ability to evaluate investments in companies that use the two different methods of reporting stock options, much the same as those investors have for companies that use differing methods for inventory valuation or depreciation.

In addition, relevance dictates that accounting information must relate to the reporting entity that is affected by the activity. An employee stock option is an opportunity to transfer ownership from existing shareholders to the employee, not a performance measure of operating the reporting entity. The real measure of employee stock options already is recorded and disclosed to investors through the diluted earnings per share and diluted weighted average shares.

- **Incorporating the “fair value” method in the basic financial statements provides no reliable information that “is representationally faithful, verifiable, and neutral,” as required under Statement of Financial Accounting Concepts No. 5, paragraph 63.**

The “fair value” method, as discussed above, is not sufficiently faithful in its representation of the underlying resource or effects of events and is not sufficiently free from error and bias to be useful to investors and other users. For example, under the ED, when the market price of the employer’s stock falls such that the employees’ stock options outstanding go “underwater,” the “fair value” would continue to be expensed, when in fact those options become worthless. How can this accounting be representationally faithful or neutral?

We believe that measuring employee stock options with the “fair value” method never becomes sufficiently reliable at a justifiable cost to recognize them in the basic financial statements.

- **If new shares are issued for the exercise, the employer should recognize no expense because there is no cost basis gain or loss to the corporation for the exercise of an option.**

In the event that the corporation issues new stock to satisfy an option that is exercised, there is no income impact. Cash is received upon exercise at an agreed-upon price and stockholders equity should be increased only by the amount received.

- **If treasury shares are issued for the exercise, there is no cost basis gain or loss to the corporation for the exercise of an option.**

In the event that treasury stock is used to satisfy the option, shares are reissued from the treasury stock holdings. Treasury stock transactions do not give rise to earnings or losses under existing accounting principles.

- **Comparable compensation methods do not have an income impact.**

An alternative to the issuance of stock options would be the sale of common stock financed by a ten year recourse loan from the corporation. The loan would be secured by the common stock and if not paid by the ten year maturity date could be satisfied by the surrender of the common stock.

At the time the stock is issued, the entry would be:

Stock subscriptions receivable	xxx	
Stockholders' equity		xxx

At the end of the ten years on the maturity date:

- a) If the market price exceeds the initial issue price of the stock, the employee pays off his loan to free the lien on the shares. The Company records:

Cash	xxx	
Stock subscriptions receivable		xxx

No gain or loss is recognized other than the interest income on the loan.

or

- b) If the market price is below the initial issue price of the stock and the employee surrenders his common shares to satisfy the loan, the Company records:

Treasury stock or Common stock	xxx	
Stock subscriptions receivable		xxx

The Company writes off its interest receivable for a net income (or loss) impact over the ten years of zero.

This transaction would result in no gain or loss to the Company (other than minor interest income on the note). Why, then, should stock options be recorded any differently?

- **The ED does not simplify U.S. GAAP.** Two of the reasons cited in the ED for eliminating the APB Opinion No. 25's intrinsic value method is that the proposed statement would:
 1. Improve "the comparability of reported financial information through the elimination of alternative accounting methods" and
 2. "Simplify the accounting for share-based payments. The Board believes that U.S. GAAP should be simplified whenever possible."

Based on this logic, can we anticipate that the FASB will require all companies to use Last-In, First-Out ("LIFO") for valuation of inventories, since various methods are presently employed by numerous companies and, like lattice models, LIFO is generally

more difficult to administer? Can we also expect that the FASB will soon require all plant and equipment to be depreciated using Sum-of-the-Years'-Digits for determining the periodic charges, since other methods presently are used widely?

We seriously doubt that any of the enterprises that have not adopted this ED voluntarily or a majority of the knowledgeable users of financial statements, given the number of assumptions that they will need to understand, would agree that this ED either significantly improves comparability or simplifies U.S. GAAP.

- **The use of the “fair value” method of accounting for employee stock options, although available since 1995, is not “generally accepted.” Evidently, only 7% of the over 6,600 companies registered on the New York, American and NASDAQ Exchanges generally accept the “fair value” method as preferable.**

In 1995, the seven members of the FASB adopted Statement 123, indicating their express preference for the “fair value” method of accounting for stock options over the intrinsic method prescribed in Accounting Principles Board (“APB”) Opinion No. 25. However, Statement 123 permitted use of either the “fair value” method or the intrinsic value method. Therefore, reporting entities were free to convert to the “fair value” method if they felt that it accomplished all that the background information of Statement 123 purported.

The overwhelming majority have continued to use the intrinsic method. Since 1995, according to one 2004 report, only 483 of over 6,600 public companies had adopted or announced their intention to adopt the “fair value” method of accounting for employee stock options. On the basis of only 7% adoption, the “fair value” method would not appear to be “generally accepted,” except by the FASB and a few companies.

Certainly a new FASB statement is not necessary to allow the minority to report employee stock options on the basis that it believes more fairly presents their results. (This alternative is already permitted under Statement 123.) Because the majority of reporting entities did not voluntarily adopt the “fair value” method, the FASB seems intent on forcing reporting entities to use its preferred method, although the intrinsic value method has been generally accepted for more than 30 years.

The FASB has permitted alternative accounting principles where widely held positions accepted varying accounting standards. We believe that the magnitude and intensity of differing views expressed on the issues in this ED support that the accounting for employee stock options should not be limited to the “fair value” method.

We would not argue that no economic value is exchanged in the grant of stock options. However, a number of economic values are not reflected in traditional cost-based financial statements. For instance, the economic benefits of value increases in fixed assets and inventories are not reflected. As long as the costs of long-lived assets are “recoverable”, impairments are not recognized. Debt obligations are not written up or down to the fair values based upon changes in credit ratings. Statement of Financial Concepts No. 5, paragraph 60, acknowledges that “some events that result in future benefits, for example,

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creation of product awareness by advertising and promotion, may perhaps never be recognized as separate assets.” Likewise, we believe that the subjective future economic value of stock options should not be included in paid-in capital.

Knowledgeable investors understand there are limitations inherent in the current financial reporting structure. They understand that the financial statements are based primarily upon cost and some fair values, where they can be obtained in verifiable markets. Using economic models that were not designed to value an instrument and prescribing their use to record transactions that may or may not be consummated can only serve to confuse users of the financial statements. Because of the number and range of assumptions made in the options-pricing models, the financial statements become not more simplified, but more complex for a user to understand.

Stock options are issued to align the interest of the employee with that of the corporation and, as such, represent that employee's opportunity to share in the growth in the value of the company. Once issued, the market will factor this sharing of the growth into the price per share. In effect, the "cost" of these options is incurred directly by the other shareholders in the form of a reduced portion in the increase in the value of the company, as a portion is shared with the holders of stock options, and is reflected in the diluted earnings per share calculation. To additionally reflect a fictitious expense in the company's U.S. GAAP income statement is inappropriate.

Very truly yours,

Jeff Stratton
Vice President, Group Accounting & Reporting