

Merck & Co., Inc.  
One Merck Drive  
P.O. Box 100  
Whitehouse Station, NJ 08889-0100



June 25, 2004

Ms. Suzanne Bielstein  
Director of Major Projects and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, CT 06856-5116

**Letter of Comment No: 4261**  
**File Reference: 1102-100**

Re: File Reference No. 1102-100

Dear Ms. Bielstein:

Merck & Co., Inc. is a New Jersey based corporation with its principal place of business at One Merck Drive, P.O. Box 100, Whitehouse Station, New Jersey 08889-0100. The Company is a global research-driven pharmaceutical products organization that discovers, develops, manufactures and markets a broad range of innovative products to improve human and animal health. We are pleased to provide you with our comments on the Exposure Draft (ED) "Share-Based Payment" and look forward to participating in the roundtable discussions scheduled for June 29, 2004 in Norwalk, Connecticut.

Employee services received in exchange for equity instruments give rise to compensation cost and such compensation cost should be recognized in the financial statements. Grant-date fair value of the equity instruments exchanged is the relevant measurement date and measurement attribute for recognizing the transaction. Furthermore, although the ED's conclusion regarding the attribution methodology for expensing graded vested options introduces additional complexity, this approach more closely aligns the accounting expense recognition with the underlying economics of such awards and is, therefore, rational and appropriate. As outlined below, our concerns on the ED focus on the areas of valuation methodology and the accounting for income tax consequences of share-based payment arrangements.

**Valuation Methodology**

Consistency, objectivity and verifiability of any compensation expense recorded will be best achieved by one valuation approach. We appreciate the flexibility of the lattice model and recognize that it is a theoretically sound approach that, when given perfect information and foresight applied to a sufficient number of time steps, will yield an accurate value. However, given perfect information and foresight, a closed-form solution, such as the Black-Scholes model with an expected life assumption, likely will yield an accurate value as well, but will do so in a

manner that requires fewer subjective assumptions and in a way that is more easily calculated and verified. Considering that both approaches use the same underlying historical support and data for assumptions taken, we question whether the additional complexity and flexibility afforded by the lattice's multiple assumptions, are in fact preferable or even desirable.

The lattice model introduces significantly more assumptions into the valuation exercise than a closed-form solution such as Black-Scholes. The current Black-Scholes approach in the ED requires four assumptions (volatility, expected life, risk free rate, and dividend yield) when valuing an employee stock option grant. The lattice approach would complicate the assessment of these variables by requiring volatility, risk free rate, and dividend yield estimates for each time period of the lattice and by replacing the expected life assumption with correlations of exercise behavior with share price and time for each time period of the lattice model (two assumptions for each time step). Since the same data sets are referenced in determining the assumption inputs for both the lattice and Black-Scholes valuation approaches, if done correctly, both approaches should yield similar results. However, what once involved four assumptions under the Black-Scholes approach for a 10 year option with three year vesting, now would require 44 assumptions using a ten period lattice model. The number of lattice assumptions would further multiply as companies tried to improve the accuracy of the lattice result by shortening the time period used in the binomial tree. For example, if a company were to use quarterly time steps for a ten year option vesting in three years, 176 assumptions would be required for each option granted during a year. For a company with 25 grants per year, 4,400 specific assumptions would be required. If graded vesting terms applied equally each year of the vesting period, the number of unique assumptions would further increase to 4,800. By contrast, only 300 assumptions would be needed when using the Black-Scholes expected life approach. Identifying assumptions for each time step of the lattice would be difficult, time-consuming, and introduce increased subjectivity and potential for error. Furthermore, varying lattice assumptions for each step of the binomial tree might suggest an assumption for a larger time period that might be inconsistent with, or not easily verifiable by, independently validated assumptions in the market place.

The added complexity and expanded assumptions and subjectivity of the lattice approach may exacerbate inconsistency among companies, and make calculations less comparable and verifiable by users of financial statements. A closed-form valuation solution is preferable over the lattice approach because it will yield a similar result when using carefully considered assumptions. Furthermore, a closed-form solution would require fewer subjective inputs and be a more practical approach in valuing the economic consequence of granting equity based payments to employees. Given this, Merck suggests that the Board consider the Black-Scholes expected life approach as the only valuation approach when valuing employee stock options under normal circumstances.

### **Income Taxes and Cash Flows**

Under FAS 109's asset and liability method for computing deferred income taxes, the goal is to measure the future tax impact of future taxable income or deductions that are implicit in the balance sheet. The principles underlying FAS 109 require that temporary differences exist, as evidenced by a difference between a book asset or liability versus a tax asset or liability, before a deferred tax asset or liability is established. Because the pre-tax charge to the income statement for share-based compensation expense is offset in the balance sheet by an increase to equity, specifically to additional paid-in capital, and ultimately the expense reduces retained earnings, again another equity account, overall, on a pre-tax basis, the book balance sheet is unaffected during the vesting period. Additionally, there are no assets or liabilities established for tax

purposes either. Therefore, the establishment of a deferred tax asset during the vesting period would not be conceptually consistent with the tenets of FAS 109.

However, in recognizing the view that share-based payments comprise two transactions, the first being the compensation event and the second being the equity event, it is reasonable to conclude that the tax consequence of the compensation transaction be recognized in the same period as the compensation expense. Nevertheless, rather than artificially increasing the balance sheet by establishing a deferred tax asset, the offset should go to additional paid-in capital, consistent with the treatment for the pre-tax compensation expense discussed above. Subsequently, when awards are exercised, all tax benefits or shortfalls would go directly to additional paid-in-capital. This approach would significantly simplify the accounting for the income tax consequences of share-based payment arrangements and would represent a more logical deviation from FAS 109.

In addition, the ED concludes that tax impacts be bifurcated in the statement of cash flows between cash flows from operating activities and financing activities, such that excess tax benefits are recorded as financing activities. This approach is inconsistent with the treatment of all other financing and investing tax related impacts, such as taxes paid on a gain on sale of a business, where cash flows from the gain are shown in investing activities, but the taxes paid are reported in operating activities. Whether recognizing all tax impacts from share-based payments as operating cash flows, which would be consistent with the original conclusions in FAS 95, or recognizing all such tax impacts as financing activities, which would be consistent with the views discussed above regarding the classification on the balance sheet, either presentation has merits, but bifurcation does not.

#### Summary

Inherent in the ED is the introduction of additional complexity and detail, for example the proposed attribution methodology for graded vested options, the preferred valuation approach of the lattice and the contemplated accounting for the income tax consequences of share-based payment arrangements. While certain complexity is justifiable, such as the attribution methodology for graded-vested options, so that the presentation represents the underlying economics of the transaction, adding complexity in the valuation approach does not achieve this same objective. Considering the surrogate nature of the valuation, in that it will never ultimately be validated by a market-based transaction or a measurable cash outflow by the company, the most important elements of the valuation should be focused on objectivity, comparability and practicality, which are better accomplished in most situations by the Black-Scholes with expected life method.

We look forward to discussing our comments with you on June 29, 2004.

Sincerely,

/s/ Richard C. Henriques

Richard C. Henriques  
Vice President, Controller  
Merck & Co., Inc.

cc: J.C. Lewent - Executive Vice President & Chief Financial Officer, President, Human Health Asia  
C. Dorsa - Vice President and Treasurer