

Letter of Comment No: 5492 File Reference: 1102-100

1111 South Arroyo Parkway 91105 P.O. Box 7084 Pasadena, California 91109-7084 U.S.A. 1,626.578.3500 Fax 1,626.578.6894

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via Email

Director of Major Projects
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, Connecticut 06856-5116
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Ladies and Gentlemen:

On behalf of Jacobs Engineering Group Inc. ("Jacobs"), I am writing to express our apprehension about the accounting proposed by the Exposure Draft, *Proposed Statement of Financial Accounting Standards – an Amendment of FASB Statements No. 123 and 95* (the "ED").

We have spent 50 years creating an ownership culture at Jacobs. Today, a significant number of our 35,000 employees own stock in our company. The behavior that resulted from this culture has provided us with a significant competitive advantage around the world, helping to make us the most respected firm in our industry according to Fortune magazine.

The tools we used to achieve this culture include a broad based employee stock purchase program (an IRC §423 plan) and an employee stock option plan. The action the Board proposes to take with regard to expensing these programs clearly places the future of this critical competitive advantage at risk. Furthermore, it has the potential of rewarding firms that do not share ownership with their employees by shifting market capital in their favor.

While we support full disclosure and transparency with our investors, we believe that the Board is going about the matter in the wrong way. You are proposing to dilute the accuracy of a critical performance metric with a formula intended to predict future investment value. The correct way to achieve your desired result is to elevate the visibility of the diluted earnings per share metric to the same status as the earnings metric. One of the unintended consequences of your proposed rule is to destroy the accuracy of the earnings metric and, in turn, completely eliminate the usefulness of the diluted earnings per share metric—a metric well understood and depended on by our investors.

We strongly urge you to reconsider. This is not merely an issue for cash poor, high-tech, start-up companies. It is an issue for many of the most respected, well established companies in our nation. All parties can win in this issue by accepting our

Financial Accounting Standards Board June 29, 2004 Page 2 of 8

alternative approach to the matter. The earnings metric will be preserved, full disclosure and transparency will be achieved and the Board's standing with the business community will be preserved.

Our specific comments to the ED follow, organized by topic:

The Granting to an Employee of an Option to Purchase Equity Securities of the Employee's Employer Does Not Give Rise to an Expense

Paragraph 80 of FASB Statements of Financial Accounting Concepts No. 6 ("Concepts 6") defines expenses as, "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations". Although this paragraph is silent as to the nature of the outflows contemplated, footnote 43 of Concepts 6 makes it clear that an expense occurs if the net assets of a business entity have been diminished or impaired.

In paragraph C13 of the ED, the Board suggests that the expense being discussed by the ED is really the consumption of an asset; specifically, the services a company receives from its employees. And, "because an entity cannot store services, they qualify as assets only momentarily unless those services are capitalized as part of another asset [and] an entity's use of an asset results in an expense, regardless of whether the asset is cash or another financial instrument, goods or services."

We believe that the Board is introducing a notion of what constitutes an asset (and therefore and expense) purely for the purpose of making the conclusion it wishes to reach. The fact of the matter is that the action of granting a stock option to an employee does not use an asset nor causes a liability to be incurred as those events have traditionally been understood in accounting, and certainly as our shareholders and stakeholders have understood those events to mean.

We would also like to point out what we believe is a flaw in the application of this unusual definition of an asset. According to paragraph 26 of the amended statement, the granting of a stock option to an employee does not give rise to an expense unless the option vests. If this is the case, then consider the situation where stock options (with identical terms, and each with five-year cliff vesting) are granted to two employees. If one employee remains employed with the company until the option vests, but the second employee terminates after, say, four years, then, under the ED, an expense is recognized for only the hypothetical cost of the options granted to the first employee. But it cannot be denied that the company benefited from the services provided by the second employee during the four years following the award of the stock option. Yet, under the ED, there is no accounting for that "cost".

One last comment we would like to make regarding the concepts of "asset" and "expense" as defined by the ED. It occurs to us that since the ED is proposing a grant-date value approach to the issue of accounting for stock options, the Board is in essence endorsing an "expected value" approach to this accounting issue. This is a precarious position for the Board to take and should, for the sake of consistency and logic, be extended to other areas of accounting. One such area that comes to mind is the accounting for R&D expenditures. It seems to us that valuation experts could determine the expected value of in-process R&D. Applying the theory put forth in the ED to the accounting for R&D, the expected value of R&D activities should be capitalized as an

asset of the business entity that incurred the cost. However, we are not aware of the Board considering any change to the accounting for R&D expenditures. The Board is content with this apparent contradiction and has concluded in effect that although there may be value to the R&D a company incurs, that value is probably too difficult to quantify and involves too many assumptions to warrant recognition in the financial statements of a business. Yet, we would argue that such a valuation is no more difficult or subjective a value than what the ED would have us do with respect to stock options.

Current Accounting Standards Accurately Report the Cost and Economic Impact of Stock Options Granted to Employees

APB 25 – Accounting for Stock Issued to Employees ("APB 25") requires that the intrinsic value of a stock option be expensed at the time a stock option with fixed terms is awarded to an employee. SFAS 128 – Earnings per Share ("SFAS 128") requires disclosure of a company's earnings attributable to both the actual and pro forma shares outstanding (pro forma to the extent there are in-the-money common stock equivalents outstanding). We believe that these two pronouncements taken together provide clear, accurate, and important information concerning the economic consequences of issuing stock options. The consistent application of APB 25 and SFAS 128 provides meaningful trend analysis and reliable financial information to the readers of financial statements.

As discussed above, the granting of a stock option does not represent a true expense to the company that offers such contracts to its employees. There is no outflow of any asset as we understand that term, nor is there the incurrence of a liability. Therefore, recording an invented charge to earnings based on the output of an option pricing model appears to be an inherently inaccurate method of conveying information to the users of financial statements. We believe the most meaningful information to provide the readers of financial statements is information relating to the dilutive effect a company's stock option program has on its earnings and net assets. Consider the following example:

- Company X has 5,400,000 shares outstanding. It then grants options to one or more employees to purchase 500,000 shares of its common stock at \$4.00 per share when the stock is trading at \$4.00. The option agreements are not transferable, and contain fixed terms.
- A year later, Company X reports \$7.5 million of earnings, and its stock is trading at \$17 per share. Assume all 500,000 options are still outstanding.

Analysis:

Under APB 25, no cost is assigned to the grant of the stock options because there is no intrinsic value to them. Since the options are not transferable (like the stock options issued at Jacobs), there is no market for the options, and any value assigned to them would be purely speculative, based on a hypothetical call premium attached to the option (a premium, by the way, whose realizability in cash is not guaranteed).

Under SFAS 128, Company X would be required to utilize the treasury stock method and disclose its earnings per share as follows:

 Basic EPS would equal \$1.39 per share (\$7.5 million / 5.4 million shares outstanding). o For diluted EPS, the assumed proceeds from exercising all 500,000 options (\$2.0 million) plus the pro forma tax benefit (assume \$2.3 million) is used to buy-back as many shares of Company X' stock as possible; in this case, 252,900 shares (\$4.3 million / \$17 per share). Diluted shares outstanding, therefore, is 5,647,100, resulting in diluted EPS of \$1.33 (\$7.5 million / 5.647 million shares).

The \$0.06 difference between basic EPS and diluted EPS multiplied by the diluted shares outstanding produces a "cost" of \$338,800. This is the true, economic effect of Company X' stock option program to Company X' investors and the investing public. As compared to a hypothetical expense calculated in accordance with the ED, the \$338,800 cost is arguably a more relevant piece of information. It reflects the claim that option holders have to the earnings of Company X. It is in fact a superior metric to the hypothetical value produced by option pricing models because:

- (i) it is a market metric; i.e., at each reporting date, the calculation incorporates current stock prices. In other words, as the price of Company X' stock increases, so does the potential dilution;
- (ii) it is a conservative metric; i.e., the calculation includes all stock options irrespective of vesting; and
- o (iii) it is a dynamic metric; i.e., because the calculation utilizes the most current information available at each date for which it is presented, the effect of options on existing shareholders changes. In this respect it is particularly better than the approach put forth by the ED that requires a "one shot" calculation done at the grant date, resulting in a value that cannot be influenced by evolving market conditions.

A Change in Accounting Will Violate Our Shareholders' Understanding About How Our Stock Option Plans Affect Our Financial Results

For many years now, the adoption of stock option plans have required the approval of our shareholders. Stock option plans, therefore, hold a unique place in the relationship that our shareholders have with us. From the various financial reports we file with our shareholders and the SEC, our shareholders understand how existing and proposed stock option plans will be accounted for. We believe this understanding is a critical factor our shareholders consider when deciding whether or not to vote for a new stock option plan or to authorized additional shares under existing plans.

This concept is not new. We understand that many opponents of the requirement to expense stock options argue that the act of granting a stock option to an employee is fundamentally a transaction between shareholders (current and prospective) and therefore does not represent an expense to the company. Although we are not commenting on the merits of that argument, we believe that the Board's attempt to expense stock options unilaterally changes an essential element of stock option plans which our shareholders have relied upon when approving plans. If it is relevant to understand what the Board believes a stock option to be, it is equally relevant to understand what our shareholders believe it to be.

The ED should not be issued in final form on this basis alone.

The Results Produced by Current Option Pricing Models Are Unprovable and Hence, Fundamentally Flawed

The option pricing models currently used by companies to compute the theoretical expense required by SFAS 123 are very complicated. These models were developed for use with traded options and, accordingly, should not be applied to stock options for which there is no ready market. These models are dependent on the use of assumptions which can vary widely from reporting period to reporting period, and may cause wild swings in the values that companies will record in their financial statements.

In paragraphs C21 and C22 of the ED, the Board dismisses this argument. It's interesting, however, to note the words used by the Board:

"C22 The Board did not find persuasive assertions that the estimated fair value of employee share options based on currently available valuation techniques would be <u>so unreliable</u> [emphasis added] as to impair the credibility and comparability of financial statements. To the contrary, the Board believes that the use of the intrinsic value method has and would continue to impair not only the relevance of and reliability, but also the credibility of financial statements . . . "

The Board concedes that option pricing models are inherently unreliable. The only question is their <u>degree</u> of unreliability. It's as if the Board is saying that a little bit of inaccuracy in a set of financial statements is O.K. provided the reason for the misstatement is sufficiently worthy. To our knowledge, this will be the first accounting standard issued by the FASB in which the standard acknowledges that the basis behind the values to be recorded in accordance with the standard is flawed.

The Board goes on in paragraph C22 to analogize the uncertainties inherent in the estimation process required by the ED to the estimation processes currently required of companies to establish loan loss reserves, other valuation reserves, and pension liabilities.

But the Board's analogy is flawed. With respect to loan valuation reserves, pension liabilities, and every other type of reserve we can think of, there is eventually a day of reckoning. A loan will either be collected, or it won't. When a company decides to shut-down a manufacturing plant, it may very likely record a provision reflecting its estimate of what it will cost to exit that particular activity. When the plant is finally shut down, the amount of cash actually spent can be compared to the estimate that was initially recorded; the actual cost incurred will either be more, less or equal to the estimate. Even the ultimate cost of a pension plan (something that, by its nature, has a very long life span) will eventually be known and reflected in the books of the company that sponsors the plan. No such comparisons or reconciliations are possible under the accounting proposed by the ED.

In contrast, the ED requires companies to record an amount as an expense in their income statements which:

- Does not relate to either an asset or liability in the corresponding balance sheet;
- Can never be proven based on actual cash disbursements or transfers of other assets;
- 3. Can never be reversed even in situations where options expire worthless;
- 4. Can never be taken as a deduction for tax purposes.

The Board, in this one ED, seeks to change too many basic rules of accounting which our shareholders, creditors and other stakeholders understand and rely on in reading our financial statements.

There is another aspect to the accounting proposed by the ED which the Board needs to consider. The inherent unreliability of the information required by the ED is diametrically opposed to the accuracy required by Section 302 and 906 of the Sarbanes-Oxley Act of 2002.

We believe that much of the impetus for changing the way we account for stock options relates to the scandals of corporate greed and recklessness that gave birth to SOX. Some people believe that the mere requirement to record an expense for issuing stock options will somehow increase corporate responsibility and decrease corporate fraud.

The Sarbanes-Oxley Act of 2002 was Congress' response to the issue of failed corporate governance. And Sections 302 and 906 of SOX subjects public companies and their CEOs and CFOs to penalties for filing inaccurate financial statements. More than that, these sections require CEOs and CFOs to attest to the fairness of the information included in their companies' public filings. The ED will require companies that continue to issue stock options to record material amounts of expense in their financial statements. Regardless of whether or not a CEO or CFO fundamentally believes that the amount of expense recorded is accurate, or fairly calculated, or even meaningful for a reader of the financial statements in order for the reader to understand the company, the CEO and CFO is required by law to attest to the fairness of the information. And no matter how unreal the expense that is being recorded, the obligations and penalties imposed by SOX are very real. The Board needs to consider the risk to which it is subjecting companies and their executive officers by mandating the accounting proposed by the ED.

The Change in Accounting as it will Affect IRC §423 Plans is Patently Unfair

The ED will require companies to record an expense for stock issued to employees under broad-based, IRC §423 stock purchase plans unless such plans sell stock with terms and conditions, "that are the same as those available to all holders of the same class of shares" (paragraph C76). This requirement will reverse decades of practice and will cause us to modify our stock purchase plans in such a way as to dramatically reduce, or eliminate entirely, the discount our employees currently enjoy. Accordingly, we believe the Board should not change current accounting practice in issuing any final standard.

Financial Accounting Standards Board June 29, 2004 Page 7 of 8

We understand that a blanket exemption for IRC §423 plans in any final standard will perpetuate, albeit to a very limited degree, the current situation of having two accounting treatments for transactions that the Board believes are substantially the same, and that this is something the Board does not like.

Nevertheless, the Board needs to understand that any change in accounting standards as it applies to IRC §423 plans will have real economic consequences. With respect to Jacobs Engineering, we are the only publicly-traded E&C company that sponsors an IRC §423 plan. We believe that if we were required to record an expense for the plan, we would be placed at a competitive disadvantage. We have no way of knowing how clients, vendors and subcontractors will react to a decrease in out earnings (everything else being equal). We also believe that any amendment to our stock purchase plans simply to comply with new accounting standards will cause confusion within our workforce, and reactions the results of which are unpredictable.

The Board attempts to address this issue in paragraph C34 saying, "The Board's operating precepts require it to consider issues in an evenhanded manner, without attempting to encourage or to discourage specific actions. That does not imply that improved financial reporting should have no economic consequences. To the contrary, a change in accounting standards that results in financial statements that are more relevant and representationally faithful, and thus more useful for decision making, presumably would have economic consequences."

The Board's reasoning is completely predicated on the premise that stock options somehow represent a real cost to the issuer and therefore should be expensed. Of course, this is the question in dispute, and cannot be assumed to be factually correct.

It also cannot be assumed that market forces have been at work all along in our industry that have caused our competitors who do not have IRC §423 plans to pay additional salary or other benefits to their employees in order to compensate them for the lack of such a plan. And therefore, by requiring Jacobs to record a cost for its stock purchase plans creates better comparability of the financial results of the companies within our industry. Such an assertion would be absurd and would assume a market for engineers and designers so perfect that it could only be achieved in a laboratory.

The accounting for stock issued to employees as proposed in the ED is bad accounting. For the reasons cited above, it is theoretically unsupported, confusing, and

will detract from, rather than enhance, the usefulness of financial statements.

We appreciate the fact that the Board feels compelled to do something about stock options. Time and time again the Board has concluded that stock options represent value to the recipient (or a cost to the issuer, or both). However, no model exists which can truly measure the amount of such, hypothetical "cost", nor attribute it properly to the accounting periods in which it is "expended". And as we discussed above, the accounting as proposed by the ED seems to be contrary to the way companies must account for other activities that inarguably add value to the enterprise.

Financial Accounting Standards Board June 29, 2004 Page 8 of 8

We therefore urge the Board not to adopt the ED in its current form. If the Board concludes otherwise, then we would strongly urge that an exemption be created for broadbased, IRC §423 plans where the consequences of the Board's actions clearly outweigh the theoretical value added.

Should you have any questions concerning this letter, please feel free to call me at (626) 578-6803.

Very truly

JACQBS ENGINEERING GROUP INC.

By:

John W. Prosser, Jr/ Executive Vice President Finance and Administration