

## Appendix B

### BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEW

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## **Appendix B**

### **BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEW**

#### **Introduction**

165. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

#### **Background Information**

166. The Board is addressing consolidation policy as part of a broad multiphase project that is intended to cover all aspects of accounting for affiliations between entities and several other matters that raise similar or potentially related issues. The Board undertook the project in 1982 to address numerous questions raised by constituents, including the Accounting Standards Executive Committee of the AICPA, the staff of the SEC, and certain issuers and users of financial statements. That multiphase project has been reconsidering issues relating to Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, and FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*. The reconsideration of Statement 14 was completed in June 1997 with the issuance of FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*.

167. This Statement addresses only the consolidation policy portion of the project; however, it results from the Board's efforts to address significant questions that have been raised about both consolidation policy and consolidation procedures. Those questions stem mainly from three AICPA Issues Papers, *Reporting Finance Subsidiaries in Consolidated Financial Statements* (1978), *Accounting in Consolidation for Issuances of a Subsidiary's Stock* (1980), and *Certain Issues That Affect Accounting for Minority Interest in Consolidated Financial Statements* (1981). Those questions include:

- a. Is the practice of not consolidating finance subsidiaries appropriate, given the diversity of lines of business undertaken by many modern corporations?
- b. Should special-purpose entities created by a sponsor but owned by parties other than the sponsor be consolidated by the sponsor if contractual provisions cause it to serve primarily or exclusively the sponsor's purposes?
- c. Should an entity controlled by another entity through a substantial minority voting interest be consolidated by the entity that controls it?
- d. Should an entity controlled by another entity through management contracts or other contractual relationships be consolidated by the entity that controls it?
- e. How should the noncontrolling (minority) interest's share of acquired assets and assumed liabilities be accounted for in consolidated statements at the date of acquisition of a subsidiary by a parent?
- f. How should a subsidiary's issue or reacquisition of its own stock be accounted for in consolidation if it changes the parent's percentage of ownership of voting or residual interest in the subsidiary?
- g. To what extent should intercompany receivables, payables, sales, purchases, profits, and losses be eliminated in consolidated statements, and how should the effect of those eliminations be attributed to controlling and noncontrolling interests in the affiliates?
- h. How should the noncontrolling interest be displayed in the consolidated balance sheet and income statement?
- i. Should alternative accounting methods that are generally accepted and used in the separate financial statements of a parent or a subsidiary be modified in consolidated financial statements?

168. The first question was considered by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, which was issued in October 1987. Among other things, Statement 94 amended ARB 51 to eliminate the so-called nonhomogeneity exception that

resulted in the exclusion of some finance, insurance, and other subsidiaries from consolidated financial statements. It requires consolidation of all subsidiaries in which a parent owns a majority voting interest unless control is likely to be temporary or does not rest with the owner of the majority voting interest. At that time, the Board had not yet reached agreement on some significant underlying issues, including how to determine if an entity is controlled by means other than majority ownership and what techniques of consolidation best report the effects of noncontrolling interests. The Board decided, however, that it could proceed with requiring consolidation of majority-owned subsidiaries because that decision would not affect resolution of the remaining issues.

169. After issuing Statement 94, the Board continued its consideration of consolidation issues and in September 1991 issued the FASB Discussion Memorandum, *Consolidation Policy and Procedures*. That document discussed the issues listed in paragraph 167 and related secondary issues about the consolidation of business enterprises. It also invited respondents to comment on consolidation policy and procedure issues unique to consolidation of not-for-profit organizations and the implications of alternative recommendations. Approximately 100 letters of comment were received in response to the Discussion Memorandum.

170. The Board deliberated the issues raised in the Discussion Memorandum and expanded the scope of its considerations to include related issues for partnerships, trusts, and not-for-profit organizations. It also considered standards for consolidation issued by other standard-setting bodies, including those in Australia, Canada, and the United Kingdom, and the AICPA's guidance on consolidation policy for colleges and universities, voluntary health and welfare

organizations, healthcare providers, and other not-for-profit organizations. In August 1994, while continuing its consideration of consolidation procedures, the Board issued its Preliminary Views, *Consolidation Policy*, to seek comments on its tentative definition of control of an entity, description of temporary control, and proposal that all entities consolidate all their subsidiaries unless control is temporary at the time that entity becomes a subsidiary. Eighty-seven respondents provided letters of comment on the Preliminary Views. In March 1995, the Board met with its task force to discuss the major issues and its tentative conclusions on both consolidation policy and consolidation procedures and the comments on the Preliminary Views.

171. In October 1995, upon completing its deliberations on the Discussion Memorandum and the Preliminary Views, the Board issued an Exposure Draft, *Consolidated Financial Statements: Policy and Procedures*. One hundred and sixty-two organizations and individuals provided written comments to that Exposure Draft. In February 1996, 23 respondents presented their views at 3 days of public hearings. In addition, two multinational corporations tested the application of the proposed definition of control of an entity to their specific relationships with other entities and discussed the results of their confidential tests with individual members of the Board and staff. Following the public hearings, the Board met in a series of public meetings to redeliberate the issues and to consider concerns raised by respondents, test participants, and others.

172. In June 1997, the Board met with members of its Consolidations Task Force, Emerging Issues Task Force (EITF), and two of the EITF's working groups that had been considering related issues. That meeting focused primarily on a revised working definition of control and

related guidance. The Board also discussed the status of the consolidation procedures portion of the project and sought participants' views, including views about alternatives for addressing concerns about the Exposure Draft's proposed accounting for purchased goodwill.

173. In August 1997, the Board reconsidered its priorities and alternatives for proceeding with the issues of consolidation policy and procedures, including their relationship to issues being considered in other projects.<sup>14</sup> At that time, the Board decided to focus first on completing the consolidation policy portion of the project, including the definition of control of an entity and the implementation guidance. Given that decision, this Statement does not consider issues about consolidation procedures that were addressed in the initial Exposure Draft. The Board intends to consider information obtained through its business combinations project and the efforts of others, including other standard-setting bodies,<sup>15</sup> before deciding how to address consolidation procedures.

174. The Board also met with its advisory council in July and October 1997 to discuss its project plans, priorities, and tentative decisions, including the relationship of those decisions to international standards. The Board and Council also discussed the possibility of expanding the consolidation policy part of the project to address how to account for rights and obligations that stem from a relationship with a limited-purpose or special-purpose entity that is not controlled

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<sup>14</sup>A separate project on business combinations was added to the Board's agenda in August 1996. That project is reconsidering APB Opinions No. 16, *Business Combinations*, and No. 17, *Intangible Assets*. Among other things, that project is considering certain fundamental issues surrounding the accounting for purchased goodwill and other identifiable intangible assets in connection with a business combination that may have implications for future considerations of consolidation procedures.

<sup>15</sup>In June 1998, the Institute of Chartered Accountants of New Zealand issued Exposure Draft ED-84 & Discussion Paper, *Consolidating Investments in Subsidiaries*, that is considering issues of consolidation policy and procedures similar to those addressed by the Board's initial Exposure Draft.

and, therefore, not consolidated. The Board subsequently concluded those are matters of recognition and measurement that go beyond the scope of a Statement on consolidation policy.

## **Fundamental Conclusions underlying This Statement**

175. The Board reached certain fundamental conclusions about the purpose of consolidated financial statements and the relevance, reliability, and comparability of the information they provide. Those conclusions underlie the provisions of this Statement.

## **Purpose of Consolidated Financial Statements**

176. The Board concluded that the purpose of consolidated financial statements of business enterprises and of not-for-profit organizations is to report the financial position, results of operations, and cash flows of a reporting entity that comprises a parent and its affiliates essentially as if all of their assets, liabilities, and activities were held, incurred, and conducted by a single entity with one or more branches or divisions (paragraph 7). That conclusion affirms the conclusion of ARB 51, which focused on consolidated financial statements of for-profit companies that issue voting ownership shares. Paragraph 1 of ARB 51 said, “The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions.”

177. The Board considered the similarities and differences in the objectives of financial reporting for business enterprises and not-for-profit organizations, the informational needs of those who use financial statements, and the type of information financial statements can best provide. It also considered the current environment in which those entities operate. Based on those considerations, the Board found no compelling need for different standards for

consolidated financial statements of business enterprises and not-for-profit organizations. Rather, the similarity of the information needs of resource providers of both business enterprises and not-for-profit organizations strongly suggests that they would benefit from a common set of consolidation standards that promote completeness in the reporting of relevant, reliable, and comparable financial information by all entities.

178. This Statement also affirms the conclusions reached in FASB Concepts Statements No. 1, *Objectives of Financial Reporting by Business Enterprises*, and No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, which identify the primary users of financial statements, their information needs, and the objectives of financial reporting.<sup>16</sup> Paragraph 40 of Concepts Statement 1 and paragraph 43 of Concepts Statement 4 explain that to help satisfy users' informational needs, financial reporting should provide information about an entity's economic resources, the claims to those resources, and the effects of transactions, other events, and circumstances that change its resources and interests in those resources. Paragraph 9 of Concepts Statement 4 also notes similarities in the information needs of users of financial statements of all entities.

The objectives [of financial reporting by not-for-profit organizations] stem from the common interests of those who provide resources to [not-for-profit] organizations in the services those organizations provide and their continuing ability to provide services. In contrast, the objectives of financial reporting [by business enterprises] stem from the interests of resource providers in the prospects of receiving cash as a return of and return on their investment.

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<sup>16</sup>Present and potential shareholders, creditors, donors, and other resource providers of a parent are the primary but not the only users of financial information that benefit from consolidated financial statements. Other users include present and potential noncontrolling shareholders and creditors of affiliates of a parent, as well as rating agencies, regulators, and public policymakers that often also are interested in information that is useful in assessing the financial position of the parent and its affiliates as a group.

Despite different interests, resource providers of all entities look to information about economic resources, obligations, net resources, and changes in them for information that is useful in assessing their interests. All such resource providers focus on indicators of organization performance and information about management stewardship. [Footnote reference omitted.]

### **Relevance, Reliability, and Comparability of Information**

179. To achieve the purpose of consolidated financial statements, the Board concluded that those statements must report as faithfully as possible the financial position, results of operations, and cash flows of a reporting entity that comprise a parent and its subsidiaries. Underlying that conclusion is the need of resource providers for relevant, reliable, and comparable financial information that is helpful to them in assessing an entity's financial position and performance and in comparing information with similar information for other periods and with similar information about other entities. The Board concluded that information about all of the economic resources that an entity controls and all of its activities usually is essential to a fair assessment of its performance. That conclusion affirms that of ARB 51 that states, "There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies" (paragraph 1).

### **Importance of Completeness to Relevance and Reliability of Information**

180. The Board concluded that the ability of users of financial information to assess the financial position and performance of an entity—a parent and its subsidiaries—is significantly impaired if its consolidated financial statements omit relevant information about the entity's assets, liabilities, revenues, expenses, gains, losses, and cash flows. FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, defines completeness as "the

inclusion in reported information of everything material that is necessary for faithful representation of the relevant phenomena” and explains that completeness is a significant aspect of both the relevance and reliability of information.

Freedom from bias . . . implies that nothing material is left out of the information that may be necessary to insure that it validly represents the underlying events and conditions. Reliability implies completeness of information, at least within the bounds of what is material and feasible. . . .

. . . Relevance of information is adversely affected if a relevant piece of information is omitted, even if the omission does not falsify what is shown.  
[paragraphs 79 and 80]

181. Paragraph 25 of FASB Concepts Statement No. 6, *Elements of Financial Statements*, defines assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events” (footnote reference omitted). Paragraph 26 of Concepts Statement 6 describes the essential characteristics of an asset and explains that “. . . although the ability of an entity to obtain benefit from an asset and to control others’ access to it generally rests on a foundation of legal rights, legal enforceability of a claim to the benefit is not a prerequisite for a benefit to qualify as an asset if the entity has the ability to obtain and control the benefit in other ways.” One way to obtain the benefits from an asset is to control the entity? subsidiary? with the asset. Thus, to faithfully represent the aggregate amount of assets that a parent controls, assets controlled through separate legal entities must be added to assets held directly by the parent.

182. This Statement also reaffirms Statement 94’s conclusions that majority-owned subsidiaries, including “nonhomogeneous” subsidiaries, should be consolidated and that accounting by the equity method is not a substitute for information provided by consolidated

financial statements. The equity method, which is described in Opinion 18, reported a parent's equity in the net assets of its majority-owned subsidiaries as a single line item in a consolidated statement of financial position and generally reported the parent's share of the subsidiaries' reported net income as a single line item in a statement of consolidated net income of a business enterprise or statement of activities of a not-for-profit organization. The information it provided about assets, liabilities, and operations of affiliates was significantly different from the information provided by consolidated financial statements, except for reported net income.

183. Information about the components of net income, about retained earnings, and about the assets and liabilities that result in stockholders' equity of a business enterprise are important factors in assessing the enterprise's performance and its financial position. The relative amounts of various assets, liabilities, revenues, and expenses and their relationships to other items in the consolidated financial statements also generally are essential factors in the analysis of a business enterprise. FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, says:

Although . . . simplifications, condensations, and aggregations are both necessary and useful, the Board believes it is important to avoid focusing attention almost exclusively on "the bottom line," earnings per share, or other highly simplified condensations. Summary data, such as the amounts of net assets, comprehensive income, earnings, or earnings per share, may be useful as general indicators of the amount of investment or overall past performance and are often used in efforts to compare an entity with many other entities. But, in a complex business enterprise, summary amounts include many heterogeneous things and events. Components of a financial statement often reflect more homogeneous classes of items than the whole statement. The individual items, subtotals, or other parts of a financial statement may often be more useful than the aggregate to those who make investment, credit, and similar decisions.  
[paragraph 22]

The Board concluded that the same conclusions apply to not-for-profit organizations. Only consolidated statements provide complete information about affiliated not-for-profit organizations as well as about affiliated business enterprises.

184. The usefulness of information about amounts of various assets, liabilities, revenues, expenses, gains, and losses and most summary indicators (for example, current ratio, receivables turnover, inventory turnover, times interest earned, and return on total assets) are affected by whether a subsidiary is consolidated or accounted for by the equity method. For example, the debt-equity ratio is much lower if highly leveraged special-purpose subsidiaries are accounted for by the equity method rather than consolidated. That effect is an aspect of off-balance-sheet financing that has been criticized because transactions between affiliates and intercompany receivables and payables often make it unlikely that “do-it-yourself” consolidation can adequately approximate debt-equity ratios in consolidated financial statements provided by the entities themselves.

185. Consolidated financial statements that include all subsidiaries also result in more relevant, representationally faithful, and comparable statements of cash flows. Although the equity method and consolidation may report the same net income and net assets, they do not report the same cash or the same cash receipts and payments related to operating, investing, and financing activities. Potentially significant information about how an entity generates cash through operations, as well as information about its financing and investing activities, is not provided unless subsidiaries are consolidated.

186. Use of the equity method for subsidiaries that are significant parts of an entity diminishes the usefulness of and raises questions about the credibility of consolidated financial statements as those subsidiaries grow in significance. As entities become more diversified, the number and variety of their subsidiaries often increase. Thus, the amounts that would be reported as single line items under the equity method in consolidated financial statements not only become larger but also the information they convey is diminished? the resulting consolidated financial statements provide less and less information about the entity to its stockholders, members, donors, and creditors. Prior to Statement 94, consolidated financial statements of some entities excluded more assets and liabilities than they included. Although Statement 94 mitigated that problem by rejecting the use of the equity method of reporting for majority-owned subsidiaries, it did not consider the conditions for consolidation of subsidiaries controlled by means other than majority ownership, nor did it consider similar consolidation issues for not-for-profit organizations, as this Statement does.

187. The Board also considered and rejected the concept of proportionate consolidation for subsidiaries, which was described in paragraphs 114–118 of the Discussion Memorandum.<sup>17</sup> Proportionate consolidation, also referred to as *pro rata consolidation*, includes in consolidated financial statements only a portion? based on a parent's ownership interest? of a subsidiary's assets, liabilities, revenues, expenses, gains, and losses. Although proportionate consolidation is not current practice for consolidated financial statements, some believe that that

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<sup>17</sup>This Statement does not consider accounting for joint ventures and other unconsolidated entities over which another entity can exercise significant influence. Accordingly, the Board has not considered whether the proportionate consolidation method, equity method, or other methods of accounting and reporting may be most appropriate for those relationships.

method is a possible alternative to full consolidation. That method received little support from respondents to the Discussion Memorandum and to the initial Exposure Draft. Because a controlling entity has the power to direct the use of the assets of a controlled entity, not merely a portion of each of its assets, omitting part of a subsidiary's assets from the consolidated financial statements would not be representationally faithful. Similarly, a parent has the ability to guide a

controlled entity's activities, including, for example, the production levels and pricing of the goods and services it provides, not merely a portion of each good or service it produces or sells. Thus, omitting part of the revenues, cost of sales, or cash flows related to activities surrounding the production, delivery, and sale of goods and services from the consolidated financial statements would not be representationally faithful. The Board rejected the proportionate consolidation method because it is inappropriate for essentially the same reasons as previously noted for the equity method.

### **Comparability of Information**

188. The Board concluded that consolidation of subsidiaries will improve comparability between entities. Paragraph 111 of Concepts Statement 2 explains that

Information about an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises and with similar information about the same enterprise for some other period or some other point in time. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark.

Resource allocation decisions result from comparing alternative opportunities for investing, lending, or contributing economic resources.

189. Concepts Statement 2 (paragraphs 113–119) also notes that comparison involves identifying, understanding, and assessing both similarities and differences. To the extent that similarities and differences stem from financial reporting rather than from the enterprises themselves, financial reporting hinders rather than helps investors, creditors, donors, and other resource providers in making decisions. A significant problem that existed in practice under ARB 51 was that large differences between consolidated financial statements of different entities

often resulted merely from different consolidation policies rather than from differences between the entities. Statement 94 and AICPA Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, took major steps to reduce that problem, and, more recently, the FASB's EITF reached consensuses on certain specific issues that provided additional guidance to reduce that problem.<sup>18</sup> This Statement is another step in improving the comparability of information provided by consolidated financial statements.

190. The Board believes that the consolidation policy required by this Statement, which applies to economic activities of all entities, is likely to lead to greater comparability and neutrality<sup>19</sup> of information provided by all entities. The Board recognizes that the means of achieving control of a subsidiary often vary with its legal form (corporate, partnership, trust, or other arrangement). The Board believes, however, that by focusing on the relationships between entities, this Statement improves both the comparability and the neutrality of information included in consolidated financial statements. The Board concluded that standards for determining the conditions that result in a parent-subsidiary relationship need not depend on an entity's form or whether an entity uses its assets to produce goods and services at a profit.

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<sup>18</sup>EITF Issues No. 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights," and No. 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements."

<sup>19</sup>Concepts Statement 2 says, "Neutrality means that either in formulating or implementing standards, the primary concern should be the relevance and reliability of the information that results, not the effect that the new rule may have on a particular interest" (paragraph 98). It also explains that "neutrality does not mean 'without purpose,' nor does it mean that accounting should be without influence on human behavior. Accounting information cannot avoid affecting behavior, nor should it. If it were otherwise, the information would be valueless? by definition, irrelevant. . . . It is, above all, the predetermination of a desired result, and the consequential selection of information to induce that result, that is the negation of neutrality in accounting. To be neutral, accounting information must report economic activity as faithfully as possible, without coloring the image it communicates for the purpose of influencing behavior in *some particular direction*" (paragraph 100).

191. The Board also believes that, to the extent feasible, harmonization of U.S. standards with those in other countries is desirable and helpful in improving the comparability of financial information. That harmonization is especially important as entities in the United States and elsewhere increasingly compete for scarce resources in a global marketplace.

192. The Board concluded that this Statement not only improves the quality of consolidated financial statements but also is a positive step toward international harmonization. In many important respects, its definition of control, its requirement to include controlled entities in consolidated financial statements, and its description of the purpose of consolidated financial statements are consistent with recent trends in other countries. For example, in 1992, the United Kingdom's Accounting Standards Board issued Financial Reporting Standard No. 2, *Accounting for Subsidiary Undertakings*, which says:

The objective of this FRS is to require parent undertakings to provide financial information about the economic activities of their groups by preparing consolidated financial statements. These statements are intended to present financial information about a parent's undertakings and its subsidiary undertakings as a single entity to show the economic resources controlled by the group, the obligations of the group and the results the group achieves with its resources. [Paragraph 1, footnote references omitted.]

Also in 1992, the Australian Accounting Standards Board issued AASB 1024, *Consolidated Accounts*, which says:

The purpose of this Standard is to: (a) identify . . . parent entities and subsidiaries; and (b) prescribe the circumstances in which consolidated accounts are to be prepared and the financial information to be included in those accounts; so that the consolidated accounts reflect the performance, financial position and financing and investing of a group of related entities as a single economic entity. [paragraph 7]

193. In addition, the Board noted that both FRS 2 and AASB 1024 adopted a consolidation policy based on a broader notion of control than Statement 94's notion of majority-voting interest. Both adopted a definition of control that includes the notion of obtaining an economic benefit from the activities of the controlled entity, and neither requires that a controlling entity obtain the majority or other specified level of benefits as a prerequisite of consolidation. However, where FRS 2 permits exceptions to consolidation for control that is temporary and permits nonconsolidation of "nonhomogeneous" operations, AASB 1024, which applies to business enterprises, and Australian Accounting Standard AAS 24, *Consolidated Financial Reports*, which applies to not-for-profit organizations, do not allow exceptions to consolidation.

194. Respondents to the initial Exposure Draft that commented on the objective of increasing comparability of consolidated financial statements expressed differing views about whether that objective could be achieved. Many of those respondents expressed the view that the proposed definition of control of an entity was ambiguous and would lead to inconsistent application in practice. Some suggested the Board clarify the definition, expand on the implementation guidance, or both. As discussed in paragraphs 211 and 212, the Board decided to clarify the definition of control to make clear the notion of benefit that was already implicit in the initial Exposure Draft's proposed definition.<sup>20</sup>

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<sup>20</sup>The explicit inclusion of a benefit notion in the definition of control is compatible with definitions of control in FRS 2, which defines control as "the ability of an undertaking to direct the financial and operating policies of another undertaking *with a view to gaining economic benefits from its activities*," and International Accounting Standard IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, which defines control as "the power to govern the financial and operating policies of an enterprise *so as to obtain benefits from its activities*" [emphasis added].

195. Other respondents to the initial Exposure Draft that expressed similar concerns about inconsistent application said that there is no need for consolidation standards based on a broader definition of control. Some said that “bright-line” rules or consolidation based on legal control (for example, ownership of a majority-voting interest) works satisfactorily in present practice. The Board understands that objective, quantifiable criteria may be easier to apply in practice, but to consolidate a controlled entity that is 51 percent owned and not consolidate another controlled entity that is 49 percent owned does not result in comparability. The Board continues to believe that to omit information about the economic resources and activities of a controlled entity from consolidated financial statements (or include economic resources and activities of a majority-owned investee that is not controlled) is neither satisfactory nor acceptable.

196. The Board understands those concerns of respondents and acknowledges that this Statement will require the exercise of judgment. The Board believes, based on information gained from respondents to the initial Exposure Draft, test participants, members of FASB’s task force on consolidations, its advisory council, and others, that an entity’s managers and others assessing the circumstances will seldom interpret similar facts and circumstances in significantly different ways when applying this Statement’s definition of control. The Board acknowledges that occasionally an entity’s managers and others assessing the circumstances will differ in their initial interpretations of facts and circumstances surrounding a potential control relationship. However, in those circumstances, discussions among those parties usually leads to better understandings of those facts and circumstances and about how each of the parties weighed the various factors. The Board believes those discussions (and, if necessary,

consultations with others) usually will lead to common understandings and ultimately to common application of this Statement's definition of control.

### **Benefits and Costs of This Statement**

197. The mission of the Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. In fulfilling that mission the Board strives to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Present and potential investors, creditors, members, and donors all benefit from improvements in financial reporting; however, the costs to implement a new standard may not be borne evenly by all parties. Because there is no common gauge by which to judge objectively the costs to implement a standard against the need to improve information in financial statements, the Board's assessment of the costs and benefits of issuing an accounting standard is unavoidably subjective.

198. The Board believes that this Statement fills a significant need by providing a framework for assessing and determining whether a particular relationship between two entities involves control of one entity by the other entity. More specifically, the Statement's definition of control of an entity and guidance for identifying control relationships provide the basis for resolving longstanding problems in practice, including those identified in paragraph 167(b), (c), and (d). The Board believes the framework will improve the completeness and thus relevance and reliability of information provided by consolidated financial statements of business enterprises

and not-for-profit organizations. The Board concluded that the relevance and representational faithfulness of the information provided by consolidated financial statements will be increased by reporting all of the assets a parent controls, the claims to those assets, and the effects of transactions and events that change those assets and liabilities.

199. The Board also believes that this Statement will help constituents identify relationships in which control is shared rather than nonshared and thus reduce instances of inappropriate consolidation of investees. Defining control of an entity also should help the Board and others in future efforts to address issues raised by the Accounting Standards Executive Committee of the AICPA and others about the accounting and reporting for investments in joint ventures and other unconsolidated investees.

200. The benefits of including assets, liabilities, revenues, expenses, gains, losses, and cash flows of subsidiaries in consolidated financial statements (and excluding those of entities that are not controlled) will come at a cost? principally, the cost to reassess current consolidation policy for those economic relationships with other entities for which the presence or absence of a parent-subsidiary relationship may be in doubt. Changes in a consolidated entity that result from those reassessments that lead to consolidation of a previously unconsolidated subsidiary also may result in incremental costs to revise existing reporting systems to comply with the new requirements. However, because most entities already consolidate most of their subsidiaries, the requirements of this Statement are not expected to add significantly to the number of entities to be consolidated. Moreover, the Board believes that most entities that will be added to consolidated financial statements as a result of this Statement have internal reporting systems

that provide most, if not all, of the information needed for consolidation by a parent, because those previously unconsolidated subsidiaries (a) have been accounted for under the equity method or (b) regularly provide information about their resources and activities to help managers of their parent exercise their stewardship responsibilities or (c) both. Therefore, the Board believes that the incremental cost to comply with this Statement generally will not be significant.

201. The Board also believes that the reassessment cost of initially applying this Statement is reduced by not requiring a parent to retroactively consolidate entities (a) that were sold or (b) for which management has committed to a plan to sell or is obligated to do so and that sale is likely to occur within one year of the fiscal year-end in which this Statement is first applied. The Board concluded that the overall benefits of the information provided by applying this Statement justify, and will exceed, the costs of complying with these standards.

202. The Board acknowledges that many respondents to the initial Exposure Draft questioned whether the overall benefits of the proposed consolidation policy justify the cost of imposing new standards. The Board continues to believe that this Statement, like Statement 94, is a significant step in improving the completeness and comparability of information provided by consolidated financial statements. Moreover, this Statement's definition of control is needed to help keep standards current, reflecting changes that have occurred and are likely to continue to occur in the ways entities organize and do business. Business enterprises and not-for-profit organizations have become more diverse and complex. They often carry out and finance a significant part of their economic activities through subsidiaries, joint ventures, investees, and

complex strategic arrangements. Undefined terms, such as *controlling financial interest*, and simplistic examples, such as ownership of majority voting rights, are no longer adequate in distinguishing between complex relationships that involve control of one entity by another entity and those that do not involve control.

### **Conditions for Consolidation**

203. The Discussion Memorandum requested comments on three possible conditions for consolidation: (a) a parent's level of ownership in another entity, even if not controlled by the parent, (b) control of an entity by a parent without a specified level of ownership, or (c) control *and* a level of ownership as two separate and necessary conditions. Nearly all respondents to the Discussion Memorandum agreed, at that time, that control is a necessary condition for consolidation and rejected the first possibility? ownership without control. A majority of the respondents to the Discussion Memorandum supported the third possibility and indicated that both control and a significant level of ownership should be necessary conditions for requiring consolidation of a parent-subsidary relationship. Most of those respondents suggested an ownership level of 50 percent or more. As discussed in paragraphs 214–218, the Board rejected that alternative.

204. The Board agreed with other respondents that said that control alone provides a parent with the ability to obtain significant benefits from the assets of a controlled entity and thus control alone—the second possibility—is a sufficient and appropriate condition for requiring consolidated financial statements. The Board concluded that a definition of control that encompasses a capacity to benefit from the ability to direct the assets and activities of another

entity is the appropriate condition for requiring consolidated financial statements. That conclusion underlies the consolidation policy reflected in the Board's Preliminary Views, the requirement proposed by its initial Exposure Draft, and the consolidation requirement of this Statement.

### **Defining Control of an Entity as the Condition for Consolidation**

205. This Statement defines control of an entity as “the ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities” (paragraph 6). The Board concluded that the ability of one entity to direct another entity's assets and activities is the underlying reason for viewing those entities as a single entity and thus the basis for consolidated financial statements. Economic resources or assets and changes in them are central to the existence and operations of an entity whether it is organized as a single legal entity or as an entity comprising two or more affiliated entities (Concepts Statement 6, paragraphs 11 and 24). The ability to obtain and direct the use of assets? exchange them for cash or other assets or use them to produce needed or desired goods and services? is essential to the economic functioning of all entities, whether they are corporations or partnerships that seek to earn profits on the goods and services they produce or organizations that seek to provide needed goods or services to their members or members of society for reasons other than to earn a profit or its equivalent.

206. This Statement's definition of control is similar in certain respects to the working definition of the Discussion Memorandum, which defined *control* as “the power of one entity to direct or cause the direction of the management and operating and financing policies of another entity.”

Most respondents generally supported that working definition, including many that did not support control as the sole condition for consolidation. This Statement's definition of control, however, adds an explicit benefit notion—the clause *so as to increase its benefits and limit its losses from that other entity's activities*—that was absent in the Discussion Memorandum's working definition of control.

207. This Statement's definition of control also is similar in certain respects to the proposed definitions of the Board's Preliminary Views and the initial Exposure Draft. The Preliminary Views defined control of an entity as “power over its assets? power to use or direct the use of the individual assets of an entity to achieve the objectives of the controlling entity.” At the time, the Board believed the restrictive phrase *to achieve the objectives of the controlling entity* encompassed a benefit notion that would provide for consideration of differences in objectives between business enterprises and not-for-profit organizations that may be relevant to their financial reporting. The Board also noted that that phrase was included in the definitions of control in both AASB 1024 for business enterprises and AAS 24 for not-for-profit and governmental entities.

208. For purposes of consolidated financial statements, the Preliminary Views defined the objective of a business enterprise as providing net cash inflows to its owners by enhancing the value of the enterprise or by distributing cash or other assets to its owners, and the objective of a not-for-profit organization as providing needed goods and services to its beneficiaries or other constituents. Respondents generally found the objectives appropriate for both business enterprises and not-for-profit organizations. However, respondents were almost evenly divided

about the usefulness of that distinction for determining which entities should be included in a set of consolidated financial statements. For example, the Healthcare Financial Management Association, which represents financial managers of healthcare organizations in both the for-profit and not-for-profit sectors, said:

Consistency and comparability in financial reporting should be paramount. Both [business enterprises and not-for-profit organizations] provide goods or services, and both need to generate a net cash inflow. Specifically, business enterprises provide goods or services to generate a net cash inflow and not-for-profit organizations generate a net cash inflow to provide goods or services. We believe that this minor distinction in “objectives” has no impact on financial reporting. [We] recommend deleting the description of these “objectives.” It does not assist the preparer with the application of the control concept, nor does it enhance the comprehension of the financial statements.

Moreover, some respondents that supported using control as the sole condition for consolidation suggested that the Board more clearly emphasize that a controlling entity also must have the right to enjoy the benefits derived from the control of assets of another entity.

209. The Board considered those suggestions and decided that distinguishing between the objectives of business enterprises and the objectives of not-for-profit organizations was neither necessary nor helpful in establishing the conditions for consolidation. The Board also decided that while a definition of control must encompass a parent’s ability to benefit from its control of another entity, the conditions for consolidation need not be based on a specified level of benefits (paragraphs 214–218). At that time, the Board decided to modify the Preliminary Views’ proposed definition and related discussion of control to clarify and emphasize that the ability to derive service potential or future economic benefit from directing the individual assets and activities of a controlled entity is the fundamental reason for including a controlled entity in

consolidated financial statements. Thus, the initial Exposure Draft's definition of control emphasized a parent's ability to benefit from its power to direct the use of a subsidiary's individual assets. It proposed to define control of an entity as "power over its assets? power to use or direct the use of the individual assets of another entity in essentially the same ways as the controlling entity can use its own assets."

210. Several respondents said that focusing on an entity's "individual assets" could lead to misunderstandings and unintended consequences. They noted that restrictions often exist on particular assets or asset groups that may impede or limit a parent's use of some subsidiary assets without depriving the parent's overall ability to direct the subsidiary's assets and ongoing activities. For example, the Financial Accounting Policy Committee of the Association for Investment Management and Research agreed that power over another entity's assets is the "essence of control" but also noted that there was a wide range of disagreement within its Committee as to how the definition can be operationalized. The Committee also expressed its concern that

. . . the presence of veto powers in the hands of minority shareholders could have an effect contrary to the intention of the definition. If, for example, minority shareholders have the ability to veto significant asset sales as a protection of their property rights, would the majority owner really have the "power to use or direct the use of the individual assets of another entity in essentially the same ways as the controlling entity can use its own assets?" We are concerned that exceptions like this could cause incremental de-consolidations rather than the broadening of consolidations intended by the proposal.

211. The Board considered those concerns of respondents and similar concerns expressed by members of FASB's EITF and concluded that defining control in terms of "individual assets"

could lead to unintended misinterpretations of the proposed definition of control. The Board continues to believe that decision-making power over another entity's assets and the ability to obtain benefits from that power are fundamental characteristics of control, but it concluded that to narrowly focus on directing individual assets is neither necessary nor desirable. Rather, the Board decided that control should be more broadly defined in terms of decision-making powers that enable one entity to guide the ongoing activities of another entity, which encompasses the direction of its assets in carrying out those activities.

212. The Board also concluded that a definition of control of an entity should explicitly encompass the condition that the decision-making powers of the controlling entity must provide it with the ability to increase the benefits and limit the losses that it can derive from that decision-making power. It also decided that further guidance about the required linkage between the decision-making powers and ability to increase benefits and limit losses would be desirable (paragraphs 36–38).

213. The Board further concluded that it would be desirable to expand the initial Exposure Draft's guidance that explained that restrictions on individual assets that result from laws, regulations, debt covenants, and other contractual rights and obligations do not necessarily deprive a majority owner of the ability to control a majority-owned corporation (subsidiary). This Statement expands on that guidance and also draws on the more recent work of the EITF (Issue 96-16) to help explain how restrictions, including veto rights granted to minority shareholders, relate to this Statement's definition of control (paragraphs 39–47).

## **Consideration of Control and Level of Economic Benefits as a Condition for Consolidation**

214. This Statement affirms the conclusions in the Preliminary Views and the initial Exposure Draft that control is the appropriate condition for consolidation and rejects the arguments that an additional and separate condition is needed based on some specified level of ownership or economic benefits. Paragraphs 14 and 36–38 discuss the ways in which a controlling entity may derive benefits from the assets and ongoing activities of a subsidiary other than the benefits it obtains through an ownership or residual interest in its earnings or net assets.

215. Most respondents to the Discussion Memorandum, the Preliminary Views, and the initial Exposure Draft that advocated adding a separate condition suggested that the criteria for consolidation should be control plus (a) majority of ownership or benefits, (b) majority of risks and rewards, or (c) significant (more than *de minimus*) risks and rewards or ownership or economic benefits. They suggested that the consolidated financial statements of a business enterprise would not be meaningful if they included subsidiaries in which the parent's level of benefits is less than 50 percent or is not "significant." In addition to differing on the specified level of benefits, those respondents did not suggest a common definition or description of the types of benefits to be measured. Requiring consolidation based on some level of rights to dividends or to residual interests, as suggested by some respondents, is arbitrary. The Board acknowledges that the level of ownership interest bears directly on an entity's reported earnings or change in net assets and that earnings is an important measure of the performance of a business enterprise. The Board concluded, however, that unless ownership confers voting or

decision-making rights, the level of ownership itself does not affect whether the parent controls a subsidiary.

216. The Board believes that it is important to avoid focusing attention only on highly simplified condensations, such as earnings, earnings per share, or change in net assets. Information about the amounts of an entity's assets and liabilities, revenues and expenses, gains and losses, and its cash flows is relevant to users of consolidated financial statements in assessing an entity's financial position and performance. If an entity controls another entity, it can direct the use of its assets, regardless of the level of its direct ownership interest. To omit information from consolidated financial statements about a parent's and its subsidiary's assets, liabilities, and so forth, merely because a parent's ownership interest does not exceed some specified level of benefits, would introduce irrelevant as well as arbitrary and unnecessary conditions for consolidation. Its effect would be to render consolidated financial statements incomplete.

217. Furthermore, because of the stewardship responsibilities and risks associated with being in control of an entity, the Board believes that an entity rarely acquires control of another entity without obtaining significant opportunities to benefit from that control. For example, a sole general partner of a limited partnership assumes risk for all partnership liabilities. There would be no economic incentive to control that type of entity if the controlling entity did not have at least an equivalent potential for deriving benefits from its ownership or residual interest, from its ability to gain access to and use of the service potential inherent in the partnership assets, or from both.

218. Moreover, to not require consolidation of subsidiaries with interests below 50 percent or some other specified level would be a significant step backward in the evolution of consolidated financial statements. Consolidation practice reflected in ARB 51 has long been to consolidate subsidiaries in which the parent has legal voting control but has substantially less than a 50 percent equity interest. Examples include (a) a subsidiary in which a parent holds a majority interest in voting stock but less than a 50 percent equity interest in the total voting and nonvoting stock outstanding and (b) a multitiered (pyramid) organization in which each successive “parent” owns slightly more than a 50 percent interest. In addition to the benefits it derives from its equity interest in each of those cases, a parent is able to obtain other benefits from its ability to gain access to and direct the use of its subsidiary’s assets and its activities. That result often is a principal reason for acquiring control of an entity.

#### **Exception to Consolidation for Temporary Control**

219. This Statement precludes consolidation of a subsidiary if a parent’s control is temporary at the date it is acquired (paragraph 24). Both ARB 51 and Statement 94 allowed this exception to consolidation, and the Board decided to retain it. Board members noted that although consolidation generally provides more meaningful information, they believe that other forms of reporting may be more useful if consolidation would be short-lived because control is temporary. The Board concluded that the accounting method used for assets held for sale provides information that is relevant and representationally faithful if a parent intends to dispose of a newly acquired subsidiary within a short period of time. That accounting also would avoid frequent changes in the composition of the consolidated group stemming from short-term activities that are not central to the reporting entity’s ongoing operations.

220. Because neither ARB 51 nor Statement 94 defined temporary control or described the circumstances under which control is deemed to be temporary, the Board decided that this Statement should specify control that is deemed to be temporary. Among other things, that decision avoids the possibility that an entity could avoid consolidation of a subsidiary merely by asserting that its control is temporary. The Preliminary Views proposed limiting the exception for temporary control to newly acquired subsidiaries for which the parent (a) is obligated to relinquish control within a certain time or (b) has otherwise relinquished control before the balance sheet date for the period that control was obtained.

221. Respondents that commented on the description of temporary control generally supported retaining an exception limited to newly acquired subsidiaries. Many of those respondents suggested, however, that the Board make the exception for temporary control less restrictive by including management's intent as part of the definition. Some also suggested that to require control of a subsidiary to be relinquished by the end of an entity's fiscal year could have an unnecessarily uneven effect. For example, if both a subsidiary acquired early in the fiscal year and one acquired late in the fiscal year were sold within six months of the date of their acquisition, consolidation would be precluded for the first subsidiary but required for the second.

222. The Board considered those suggestions as well the consensus in EITF Issue No. 87-11, "Allocation of Purchase Price to Assets to Be Sold," and its requisite conditions. In its initial Exposure Draft, the Board decided to broaden the proposed description so that control of a new subsidiary also could be considered temporary if at the date of acquisition the parent is

obligated to relinquish control within one year or management has decided to dispose of that newly acquired subsidiary and has a plan for and a reasonable expectation of disposition within one year. The Board also decided to provide an exception to that one-year rule for extenuating circumstances beyond management's control, such as dispositions required by regulatory agencies that are likely to require more time to complete. Those provisions are carried forward in this Statement.

223. Some respondents to the Preliminary Views asked the Board to clarify the implications of its decision to limit the temporary control exception only to newly acquired subsidiaries and its requirement that once a subsidiary is consolidated, it should continue to be consolidated until the parent's control ceases to exist. They expressed concern that those provisions might be misinterpreted as requiring continued use of full consolidation in circumstances in which they believe that the provisions of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, might be more appropriate. In its initial Exposure Draft, the Board clarified that the display provisions of Opinion 30 and its criteria apply to consolidated financial statements.

224. The Board also considered whether to require disclosure of summarized information, such as total assets, liabilities, revenues, expenses, or net income or change in net assets, for subsidiaries not consolidated because control is temporary. The Board decided not to require that additional information. It believes that the reporting and disclosure provisions for assets to

be disposed of in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, are appropriate.

### **Scope**

225. This Statement generally applies to all business enterprises and not-for-profit organizations. However, the Board decided to exclude from its scope entities that in accordance with generally accepted accounting principles carry substantially all of their assets, including investments in controlled entities, at fair value with changes in value reported in a statement of net income, if required, or a statement of financial performance. Under present accounting principles, pension plans, mutual funds, and many other investment companies are likely to be excluded from applying the provisions of this Statement in preparing their financial statements.

226. Paragraph 5 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, says, “The primary objective of a pension plan’s financial statements is to provide financial information that is useful in assessing the plan’s present and future ability to pay benefits when due” (footnote reference omitted). To achieve that objective, Statement 35 requires financial statements to include investment assets measured at their fair values, and those assets often are the only significant assets of the plan. The Board concluded that although there is a longstanding presumption that consolidated financial statements are usually necessary, the objectives of financial reporting by pension plans, their operating environment, and accepted practices are sufficiently different from those of business enterprises and not-for-profit organizations. Furthermore, unless all of the assets and liabilities of a subsidiary were measured

at their fair values, to include them on a fully consolidated basis would not be compatible with the objective of reporting the amount of the plan's net assets available to pay benefits. Thus, the Board concluded that this Statement should not apply to pension plans.

227. Some respondents to the Preliminary Views questioned the application of the conclusion on consolidation policy to investment companies, venture capitalists, and other entities that carry investments at fair value. They said that consolidated financial statements would not provide meaningful information about investment companies because investment companies often invest in nonhomogeneous businesses and intend to profit from the ultimate disposal of the investment rather than from its operations. They suggested that the description of temporary control include consideration of management's intent to dispose of an entity (within a period of up to 10 years) or that investment companies be exempt from the proposed consolidation policy.

228. In April 1995, the Board met with outside experts, including representatives of the AICPA's Investment Companies Committee, the SEC staff, and investment companies, to discuss whether to exempt investment companies from the proposed standard. Those representatives provided the Board and staff with additional insights about the financial reporting by investment companies and the information needs of users of their financial statements. They suggested that the financial statements of investment companies that substantially use a fair value accounting model would better serve the users of their financial statements than the traditional accounting model used by business enterprises and not-for-profit organizations.

229. The Board also noted, however, that several so-called investment companies include some of their most significant assets at measures other than fair value and that there is no

sufficiently precise definition of an investment company on which to base an exemption. For example, based on the interpretations and definitions in the Investment Companies Act of 1940 (as amended) some “investment companies” would qualify for an exemption, while other entities with similar activities and objectives would not. The Board initially decided and the initial Exposure Draft proposed to exclude from this Statement’s scope only entities that follow established generally accepted accounting principles that focus on reporting substantially all assets, liabilities, and changes in net assets based on their fair values. The Board noted its belief that that approach would deal with the similar operating environment and financial reporting by pension plans, mutual funds, and similar investment companies in an evenhanded way.

230. Respondents to the initial Exposure Draft generally agreed with the proposed scope exclusions. However, some respondents suggested that the proposed requirement that substantially all liabilities also be measured at fair value could result in unintended consequence in those few instances in which an otherwise identical investment company has debt and, under present generally accepted accounting principles, is precluded from measuring that debt at its fair value. To avoid that unintended result, the Board decided to eliminate the requirement that substantially all liabilities also be measured at fair value.

231. The scope of this Statement does not include reporting of interests in employee benefit trusts subject to the provisions of FASB Statement No. 87, *Employers' Accounting for Pensions*, No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, or No. 112, *Employers' Accounting for Postemployment Benefits*. Statements 87, 106, and 112 address complex issues and resulted in relatively recent and significant

changes in practice. Consequently, the Board decided not to revisit those issues at this time. Respondents to the initial Exposure Draft did not object or express concerns about that exemption from the scope of this Statement.

232. Some respondents to the initial Exposure Draft asked the Board to exclude certain other entities or industries from the scope of this Statement. They included requests to exclude so-called special-purpose entities involved in leasing and securitization transactions, entities formed as limited partnerships, entities involved in merchant banking and venture capital activities, and not-for-profit organizations, among others. The Board acknowledges that governing instruments that limit the objectives, activities, or lives of an entity raise difficult questions about whether the degree of the limitations imposed preclude control of those entities by other entities. The Board concluded, however, that there is no basis for presuming that substantially all entities with limited purposes or lives could not be controlled entities. Moreover, the Board believes it would not be evenhanded to provide an exemption to certain types of entities merely because difficulties may be encountered in assessing whether they are controlled.

### **Combined Financial Statements**

233. The Preliminary Views noted that it did not address combined financial statements and would not amend paragraphs 22 and 23 of ARB 51. Nonetheless, some respondents to that document asked the Board to address issues about the nature, form, and content of combined financial statements and the conditions that require them. In the initial Exposure Draft, the Board acknowledged, as does ARB 51, that in certain circumstances combined financial statements may be more meaningful than separate financial statements of individual related

entities. However, the Board also noted that to determine the conditions for which combined financial statements should be required or for which separate statements of related entities should be precluded would require considerably more research, education, and deliberation than contemplated for the scope of this Statement. Furthermore, it is not clear at this time that a standard can be developed that would be a significant improvement to the judgmental approach used in present practice for determining when combined financial statements are most appropriate. Accordingly, the Board decided not to expand the scope of this Statement to reconsider the provisions of paragraphs 22 and 23 of ARB 51.

#### **Disclosures of Other Information**

234. The Board considered whether to retain ARB 51's requirement that consolidated financial statements disclose the consolidation policy being followed. At the time ARB 51 was issued, it allowed certain differing consolidation practices to continue, such as consolidating or not consolidating foreign subsidiaries or subsidiaries having a relatively large minority interest or nonhomogeneous operations. Those options have since been eliminated by Statement 94. Moreover, this Statement defines temporary control and precludes consolidation of a temporarily controlled entity, thus further restricting choices about consolidation policy. The Board concluded that there no longer is a need for a consolidation policy disclosure, and this Statement eliminates that requirement.

235. Some constituents, including both users and preparers of financial statements, questioned the desirability of eliminating rather than amending the accounting policy disclosures because of the subjectivity involved in applying this Statement. For example, an organization representing

users of financial statements suggested requiring disclosure of the name and percentage of ownership of (a) majority-owned entities not consolidated, including the reasons that control does not exist, and (b) less-than-majority-owned subsidiaries, including the primary indicator of control. It was suggested that those disclosures might provide investors early warnings about future events that might result in a change in control and “would result in market scrutiny of management’s decisions to consolidate.” A task force member also questioned whether disclosure of “evidence” might be required at some level of ownership below 50 percent.

236. The Board understands that some constituents are concerned that the provisions of this Statement may not be consistently applied and that disclosure might help “expose” questionable judgments about the existence or absence of control. As discussed in paragraphs 194–196, the Board is not convinced that this Statement will be applied in significantly different ways, nor is it convinced that requiring those disclosures would be effective. The Board acknowledges the difficulty that preparers and others assessing the circumstances face in making judgments about potential changes in control of another entity when confirming evidence is not yet available. However, the Board believes that those judgments appropriately rest with an entity’s management. The Board encourages voluntary disclosures of the circumstances surrounding changes in control when management believes that would aid in understanding the entity’s consolidated financial statements.

### **Other Comments of Respondents to the Initial Exposure Draft**

237. Respondents to the initial Exposure Draft also raised questions and made suggestions or requests that resulted in clarifications, additions, and deletions to the guidance in this Statement,

including the specified situations that would lead to a rebuttable presumption of control. Respondents' comments also led to further Board deliberations about whether special criteria are needed to require consolidation of certain so-called limited-purpose or special-purpose entities that do not fall within the proposed definition of control but that some constituents now believe should be consolidated.

### **Evidence Leading to Presumptions of Control of an Entity**

238. For purposes of implementing this Statement's definition of control, the Board decided to retain and clarify four and reject two of six situations identified in the initial Exposure Draft that would lead to a presumption of control in the absence of evidence to the contrary. The Board concluded that the circumstances described in each of the following situations, which are identified in paragraphs 18 and 21 of this Statement, provide a reasonable basis for presuming that one entity controls another entity in the absence of evidence that demonstrates or proves otherwise. They are those circumstances in which an entity (including its subsidiaries):

- a. Has a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of the members of its governing body
- b. Has a large minority voting interest in the election of a corporation's governing body and no other party or organized group of parties has a significant voting interest
- c. Has a unilateral ability to (1) obtain a majority voting interest in the election of a corporation's governing body or (2) obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost
- d. Is the only general partner in a limited partnership and no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner.

239. As discussed further in paragraphs 82–85, the Board decided that presumptions of control could serve as useful tools to help minimize implementation problems that inevitably will

arise in practice when it is highly probable that control is obtained but confirming events have not occurred that prove that control exists or otherwise make control apparent or indisputable. The Board also noted that “the existence of control is not certain merely because one of the situations in paragraph 84 exists; nor is the absence of control certain merely because none of those situations exist” (paragraph 85). Although identifying common circumstances in which control is highly probable can be useful, the Board also concluded that it would be impossible to identify all possible circumstances in which control would be highly probable or likely.

240. Most respondents to the initial Exposure Draft agreed that one or more of its six proposed presumptions of control could be helpful in providing guidance for purposes of applying the proposed definition of control. The Board acknowledges, however, that respondents held differing views about whether each of those proposed presumptions of control would provide a sufficiently strong and reasonable basis for presuming control in the absence of evidence to the contrary. Respondents generally agreed with a presumption of control in circumstances similar to that described in paragraph 238(a); however, some respondents said that should be the only presumption of control. The Board rejected that view.

241. The Board agreed with respondents that suggested that situations identified as presumptions of control should be limited to those circumstances that occur in practice with a reasonable degree of frequency and, more important, provide compelling evidence pointing toward control. Accordingly, the Board clarified and strengthened the stated presumptions of control and eliminated those that it believes failed that broad objective.

#### **Additional Guidance or Criteria for Special-Purpose Entities**

242. Some respondents to the initial Exposure Draft, including participants in a June 1997 public meeting, suggested that this Statement provide more guidance to address the complex relationships involving special-purpose entities, including examples to illustrate when control is absent. Many of those respondents, however, disagreed with the guidance that would lead to a presumption of control. Still other respondents found that guidance confusing or too limited by its focus on the creator of a special-purpose entity. Paragraph 14(d) of the initial Exposure Draft proposed that, absent evidence to the contrary, control be presumed if one entity has:

A relationship with an entity that it has established that has no voting stock or member voting rights and has provisions in its charter, bylaws, or trust instrument that (1) cannot be changed by entities other than its creator (sponsor) and (2) limit the entity, including the powers of its board of directors or trustees, to activities that the creating entity can schedule (or can initiate) to provide substantially all future net cash inflows or other future economic benefits to its creator.

The Board reconsidered that presumption of control and alternatives directed at clarifying or eliminating terms, such as *creator* and *sponsor*, that some respondents viewed as unclear or unnecessary. However, the Board found that each of the alternatives considered had similar problems. Ultimately, the Board concluded that because a special-purpose entity may be formed as a corporation, partnership, or trust, investments in or relationships with those entities should be assessed in the same ways as relationships with other corporations, partnerships, and trusts—by applying this Statement’s definition of control. Although the Board decided that it would be desirable to expand on the guidance provided by this Statement’s examples, it concluded that it was not necessary to craft presumptions of control specifically targeted at the varied and complex circumstances surrounding special-purpose entities.

243. Some respondents to the initial Exposure Draft suggested that this Statement require consolidation of a special-purpose entity that may not be controlled if it has predetermined activities that are limited and directed at providing all or a majority of the benefits (or residual benefits) that result from its activities to a single entity, such as the entity's creator or sponsor. The Board considered expanding the scope of this Statement to address whether certain special-purpose entities should be consolidated for specific reasons other than control. The Board examined several cases involving special-purpose entities in which one party receives all or a majority of the benefits (and is exposed to a majority of the risks), including some cases in which constituents suggested consolidation should be required for reasons other than control. Upon close examination of the facts and circumstances, the Board found that in some cases the existence of control was present, although not apparent. (Example 5 in Appendix A of this Statement illustrates such a case.) The Board noted that this Statement requires a careful assessment of the facts and circumstances surrounding the relationships of entities. The Board believes that in those cases in which control is present but not apparent, the existence of control is present will be determined as a result of that careful assessment.

244. Other cases in which one entity receives all or a majority of the residual benefits of a special-purpose entity that it does not control raised significant questions about the appropriateness of requiring combination of that special-purpose entity's assets and liabilities, revenues and expenses, and cash flows. The Board considered, for example, whether it is appropriate to *require* a university, hospital, or other not-for-profit organization to consolidate a split-interest charitable annuity trust that it does not control if it will receive all or most of the residual interest of that special-purpose trust. The Board concluded that those circumstances

raised questions similar to issues about when to require or permit “combined” financial statements. Although this Statement rejects consolidation of an entity that is not controlled, it reaches no conclusions about when to require combined financial statements. As discussed in paragraph 233, the Board concluded that the issues surrounding combined financial statements involve complex issues that would require considerably more research, education, and deliberation than contemplated for the scope of this Statement.

### **Transition and Effective Date**

245. The Board decided to require retroactive application of this Statement’s consolidation policy. It also decided, however, that the cost to apply this Statement could be reduced without undue sacrifice of useful comparative information by not requiring consolidation of those entities (subsidiaries or investees) that had been sold or for which there is a plan of sale when this Statement first becomes effective. Although many entities may have the necessary information to restate their prior consolidated financial statements to include or exclude the effects of changes that would have occurred had the provisions of this Statement been applied retroactively, Board members believe that retroactive application would be impractical in those instances in which a subsidiary was sold or is to be sold.

246. This Statement is effective for financial statements for fiscal years and interim periods beginning after December 15, 1999. The intervening period of time before this Statement is effective may be helpful to entities that will be consolidating certain subsidiaries for the first time as a result of this Statement. The Board also believes that intervening period will allow time for

those entities that need to renegotiate debt covenants and similar contractual constraints as a result of adding subsidiaries to their consolidated financial statements.

247. The Board also considered whether a later effective date was necessary to provide additional time for entities that (a) need to address year 2000 computer system concerns or (b) provide interim financial statements. The Board believes that most companies have or will have addressed their year 2000 problems well before this Statement becomes effective. The Board acknowledges that public companies and other entities may be required to first apply this Statement for quarterly financial statements for periods ending on or about March 31, 2000. Some Board members believe that additional time may be desirable, if not necessary, for entities that operate in industries that typically use numerous special-purpose entities for which the presence or absence of control may not be readily apparent. Other Board members believe those entities have sufficient time and generally have the information and resources needed to assess their existing relationships with other entities. Based on information available at this time, the Board is not convinced there is a need to delay the application of this Statement for year 2000 problems or for public companies and others that issue interim financial statements.

#### **Alternative View**

248. One Board member disagrees with significant elements of the guidance in paragraphs 15–23 that is to be used in applying this Statement’s definition of control of an entity. While that Board member agrees with the definition of control in paragraph 6 and the descriptive guidance in paragraphs 10–14, he disagrees that three of four situations identified in paragraphs 18 and

21 (and summarized in paragraphs 84 and 238) should lead to a rebuttable presumption of control. Those four situations are circumstances in which an entity:

- a. Has a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of the members of its governing body
- b. Has a large minority voting interest in the election of a corporation's governing body and no other party or organized group of parties has a significant voting interest (Generally, a minority voting interest is large when it exceeds 50 percent of the votes typically cast in a corporation's election of directors. For example, if typically only 60 percent of the eligible votes are cast in elections of directors, a minority holding of 35 percent would be deemed large; however, that holding would not be deemed large if typically 80 percent of the eligible votes are cast.)
- c. Has a unilateral ability to (1) obtain a majority voting interest in the election of a corporation's governing body or (2) obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost
- d. Is the only general partner in a limited partnership and no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner.

249. Specifically, that Board member disagrees with the conclusion that the facts and circumstances described in (b), (c), and (d) provide "a reasonable basis for presuming that one entity controls another entity in the absence of evidence that demonstrates or proves otherwise" (paragraph 238). He acknowledges that in those circumstances the required decision-making ability may exist before it is demonstrated or proven. However, he believes that guidance could lead to a conclusion that an entity (investor) controls another entity when, in fact, control does not exist. He is troubled that this may often occur. More important, he believes that the inclusion of the assets, liabilities, revenues and expenses, gains and losses, and cash inflows and outflows of an investee (an entity that is not controlled) in the consolidated financial statements of an investor would diminish the representational faithfulness and usefulness of the information provided by those financial statements.

250. That Board member believes that an entity's holding of a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of the members of its governing body—the facts and circumstances described in paragraph 238(a)—provides “compelling evidence pointing toward control” (paragraph 241). He believes, however, that the other three situations described in paragraph 238 do not provide “compelling evidence pointing toward control.” Rather, he prefers, as suggested by some respondents to the initial Exposure Draft, to limit the presumption of control to only circumstances described in paragraph 238(a), namely, when an entity “has a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of the members of its governing body.”

251. That Board member believes that with regard to presumptions (b), (c), and (d) of paragraph 238, it is unreasonable to require evidence that demonstrates or proves that control is not present in circumstances in which an entity has taken no action to attempt to effectuate a perceived ability to direct the policies and management of another entity. For example, situation (b) of paragraph 238 suggests it is appropriate to presume that an investor that acquires a large minority voting interest in a corporation would have the ability to dominate the election of that corporation's governing body if no other party or organized group of parties has a significant voting interest. That Board member believes that until such time as that minority investor actually attempts to change the composition or policies of the investee's governing board, there is no conclusive evidence available to demonstrate that the existing governing board will adhere to or accept policy directives or managerial changes proposed by the large minority investor. He believes that it is unreasonable and inappropriate to require consolidation based on assumptions about the inaction of other shareholders or the acquiescence of the existing

governing body of the minority-owned investee. That Board member also suggests that if a minority investor with a large voting interest has taken no action to take control, that inaction itself may suggest that that investor has significant doubt about its “ability to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity’s activities” (paragraph 6).

252. That Board member cites the following example to demonstrate the lack of relevance and lack of usefulness that may result from the presentation of consolidated statements that result from the application of the presumption of control for situation (b). Using the fact information in footnote 2 to paragraph 18(b), assume Company X acquires 35 percent of Company Y’s voting shares and, based on past experience, only 60 percent of the eligible votes are typically cast in the election of directors and no other shareholder holds a major block of ownership of Company Y. Also assume the transaction occurs in the fourth quarter of fiscal year 20X0 and that the shareholders meeting is held in the second quarter of fiscal year 20X1. There is no conclusive evidence of Company X’s ability to assume control, and reliance on past voting patterns may or may not be reasonable. Application of this proposed Statement, including its implementation guidance, would force a presumption of control and consolidation of Company Y by Company X at the end of year 20X0. That Board member believes there is a reasonable possibility that the results of voting in year 20X1 could be vastly different from the results of prior years. A post-year-end decision that the ability to control Company Y, in fact, did not exist would result in Company X shareholders’ receiving consolidated statements for fiscal year 20X0 and unconsolidated statements for year 20X1. That Board member believes that in year 20X1 the comparative statements for year 20X0 would be restated unconsolidated statements;

however, he acknowledges that this proposed Statement does not address that question and that others may hold a different view. Again, that Board member questions the appropriateness of a presumption that forces one to anticipate future events based on past experience (voting patterns) that occurred under different conditions.

253. That Board member believes the requirement to consolidate an entity where control results from less than a majority voting interest must be based on evidence of the ability to control rather than on a presumption and expectation about future events. Accordingly, that Board member also disagrees with the conclusions reached in paragraph 99 of Example 2, in which it is presumed that Company C controls Company D merely because of Company C's "holding of a large minority (45 percent) voting interest and the wide dispersion of all other voting shares." The example says that "there is no evidence that demonstrates that Company C does not have the ability to dominate the nomination and election of the directors of Company D." That Board member believes instead that there should be evidence that demonstrates that Company C, in fact, does have the ability to dominate the nomination and election of the directors of Company D.

254. That Board member rejects the presumption of control for situations (c) and (d) of paragraph 238 for various reasons. Situation (c) suggests that it is appropriate to presume that an investor that acquires a currently exercisable block of convertible securities or other rights that are sufficient to obtain a majority voting interest in a corporation would have the ability to dominate the election of that corporation's governing body if the expected benefit from converting those securities or exercising that right exceeds its expected cost. That Board

member believes that absent actions on the part of the holder of the convertible securities, there often will not be sufficient evidence available to demonstrate whether control exists. He also is troubled by the fact that options, warrants, and similar rights to acquire voting equity shares may be acquired for a rather nominal initial investment but require a significant additional investment to exercise. That Board member believes that until such time as the holder takes action to exercise its right to acquire the voting shares, which may include obtaining necessary financing, there is no compelling evidence or basis for presuming the presence of control. That Board member acknowledges that the acquisition of such convertible securities, options, or warrants may be a precursor to obtaining control, but he suggests that it is equally as inappropriate to presume control before the ability has been demonstrated as it is to deny the existence of control after the ability has been demonstrated.

255. Situation (d) of paragraph 238 suggests it is appropriate to presume that an investor that acquires the only general partnership interest in a limited partnership has the ability to direct the policies and management of that partnership if no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner. That Board member believes that, like situation (b), situation (d) is overreaching because its presumption of control depends on the assumed inaction of the limited partners in situations in which their “current ability” to remove the general partner is uncertain and untested. He also is concerned that, as in situation (c), a general partner often can obtain a sole-general-partnership interest in a limited partnership for a relatively nominal investment or financial stake in the partnership, especially if managerial expertise is the general partner’s primary contribution to the partnership. That Board member is concerned that in many of those instances in which

the limited partners have had no need to test their ability, a sole general partner may be, in substance, no more than a manager for the limited partnership; that is, with delegated powers that will be removed by the limited partners if and when the general partner directs the policies of the partnership in ways unacceptable to the limited partners. That Board member is not convinced that the sole general partner can direct the use of the assets and activities of the partnership in ways that increase the benefits and limit the losses of the general partner without the ongoing cooperation or acquiescence of the limited partners.

256. That Board member also disagrees with the conclusions in certain of the illustrative examples in Appendix A to the extent that those conclusions rely solely on the presumption of control in situations (b), (c), or (d); that is, they assume the existence of control without confirming evidence to support their conclusion.

## Appendix C

### AMENDMENTS TO EXISTING PRONOUNCEMENTS

257. This Statement supersedes paragraphs 1–3 and 5 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, and supersedes FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*. Other pronouncements issued by the FASB refer to Statement 94. All such references are hereby amended to refer to FASB Statement No. XXX, *Consolidated Financial Statements: Purpose and Policy*.

258. Other pronouncements refer to or use the terms *minority interest*, *minority interests*, *minority shareholders*, *minority stockholder*, or *minority stockholders*. All references to those terms appearing in paragraphs that establish standards or the scope of a pronouncement are hereby amended to use the term *minority (noncontrolling) interest(s)*.

259. The following sentence is added at the end of endnote 3 to ARB 51:

In XXXX 1999, the Board issued Statement XXX, which extends the consolidation procedures of this Bulletin to not-for-profit organizations.

260. APB Opinion No. 16, *Business Combinations*, is amended as follows:

- a. In the fourth sentence of paragraph 5, (*control is described in paragraph 2 of ARB No. 51*) is replaced by (*control is defined in paragraph 6 of FASB Statement No. XXX, Consolidated Financial Statements: Purpose and Policy.*)

261. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, is amended as follows:

- a. In paragraph 3(c), the second and third sentences are replaced by *Control is defined in paragraph 6 of FASB Statement No. XXX, Consolidated Financial Statements: Purpose and Policy.*

- b. Footnote 3 to paragraph 4, as amended by Statement 94, is deleted.

- c. Paragraph 14, as amended by Statement 94, is replaced by the following:

Paragraph 9 of Statement XXX requires a parent to consolidate each entity (subsidiary) that it controls unless control is temporary at the date it is acquired or otherwise obtained. Paragraphs 24 and 25 of Statement XXX describe temporary control and the accounting for a temporarily controlled entity. The equity method is not a valid substitute for consolidation. Moreover, because Statement XXX requires that the general-purpose financial statements of entities having one or more subsidiaries be consolidated statements, so-called parent-company statements are not a valid substitute for consolidated financial statements.

Footnote 4, as amended by Statement 94, is deleted.

- d. In the first sentence of paragraph 17, *even though the investor holds 50% or less of the voting stock* is replaced by *that the investor does not control*.

262. This Statement carries forward the following amendment that Statement 94 made to Opinion 18. The second sentence of paragraph 1 is amended to read:

This Opinion extends the applicability of the equity method of accounting (paragraph 6(b)) to investments in common stock of corporate joint ventures and certain other investments in common stock.

263. AICPA Accounting Interpretation 8, “Applying Purchase Accounting,” of APB Opinion No. 16, *Business Combinations*, is amended as follows:

- a. The second sentence of the fourth paragraph of the *Interpretation* section is deleted.
- b. The first sentence of the fifth paragraph of the *Interpretation* section is replaced by the following:

The fair value of the assets and liabilities of the subsidiary would be determined when control is acquired (control is defined in paragraph 6 of FASB Statement No. XXX, *Consolidated Financial Statements: Purpose and Policy*).

264. AICPA Accounting Interpretation 26, “Acquisition of Minority Interest,” of Opinion 16, is amended as follows:

- a. In the third sentence of the third paragraph of the *Interpretation* section, *see paragraph 2 of ARB No. 51* is replaced by *see Statement XXX*.

265. Footnote 27 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, is replaced by the following:

“Control” in this paragraph has the meaning defined in paragraph 6 of FASB Statement No. XXX, *Consolidated Financial Statements: Purpose and Policy*: “the ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity’s activities. For purposes of consolidated financial statements, control involves decision-making ability that is not shared with others.”

266. In paragraph 24(b) of FASB Statement No. 57, *Related Party Disclosures*, the definition of control is replaced by the following:

**Control.** The ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity’s activities. For purposes of consolidated financial statements, control involves decision-making ability that is not shared with others.

267. The second sentence of footnote 5 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, is replaced by the following:

The provisions of ARB No. 51, *Consolidated Financial Statements*, FASB Statement No. XXX, *Consolidated Financial Statements: Purpose and Policy*, and APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, apply when a mortgage banking enterprise is either consolidated or accounted for by the equity method.