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CONTROLLERS

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Mr. Timothy S. Lucas  
Director of Research and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7, P.O. Box 5116  
Norwalk, CT 06856-5116

RE: **Consolidated Financial Statements:  
Policy and Procedures**  
(File Reference No. 154-D)

Dear Mr. Lucas:

We appreciate the opportunity to respond to the above referenced Exposure Draft. We agree with the Board's decision to use the concept of "control" as the basic criterion for consolidation. Control is a long-standing concept under ARB No. 51, as amended by FAS No. 94, and best fits the generally accepted concept of why consolidated financial statements are prepared in the first place--to report the financial position, results of operations, and cash flows of a parent and its subsidiaries essentially as if all of the resources of the affiliates were held and their activities were conducted by a single entity with one or more branches or divisions. Because branches and divisions obviously are controlled by the parent entity, control as the basic test for consolidation is a natural result of the stated purpose of presenting consolidated financial statements. Alternatives to the control concept, such as a majority-of-risks-and-rewards approach, would be incapable of consistent application in practice and would have the potential of combining both controlled and non-controlled operations in consolidated financial statements, a result that we believe would lead to less useful financial statements.

However, while we do support the concept of control as the basic consolidation test, we do have certain concerns about the guidance that is provided in the Exposure Draft. Our concerns fall into four areas: (1) inability of general practice to consistently interpret the concept of "control" as defined, (2) the notion that one entity may have to consolidate another entity even though its ownership interest may be zero or very low, (3) the unclear nature of two of the presumptions of control, and (4) Illustrative Example 5 that attempts to apply the presumptions and indicators of control to a fact situation involving a special-purpose leasing entity created to benefit its creator. These concerns are described in more detail in the attachment to this letter.

*"Consolidated Financial Statements: Policy and Procedures"*

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Our primary concern is that we believe the proposal needs a clearer statement of the Board's perception of problems in current consolidation practice. This vagueness of intent makes it very difficult to interpret this subjective standard and could lead to inconsistent interpretation in practice. If the Board decides that further clarity is unachievable, we would prefer that all of the proposed consolidation policy guidance be deleted. Any perceived inconsistencies in practice regarding interpretation of FAS 94 could be addressed on a narrow case-by-case basis, either by the Board in an Interpretation or by the Emerging Issues Task Force.

While we do have concerns with the proposed guidance on consolidation policy, we do support the proposed guidance on the presentation of non-controlling interests on the balance sheet and income statement. We agree with the Board's conclusion that the non-controlling interests in subsidiaries are part of the equity ownership structure of the consolidated entity and thus should be presented as part of the stockholder equity structure in the consolidated financial statements. This new guidance on consolidation procedure should be issued in the final standard, regardless of what happens in the final standard to the guidance on consolidation policy.

Very truly yours,

PHILLIPS PETROLEUM COMPANY

A handwritten signature in cursive script, appearing to read "L. F. Francis".

L. F. Francis  
Controller

## ATTACHMENT

### **(1) Inability of general practice to consistently interpret the concept of "control" as defined**

On its face, the concept of control described in the Exposure Draft does not appear to change the essence of the consolidation concept that is already described in the existing authoritative literature. ARB 51, as amended by FAS 94, states that all companies in which "a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest" shall be consolidated. The notion of control in FAS 94 is similar to the notion of "legal" control in the Exposure Draft. Because the basic consolidation criterion does not appear to be significantly changed in this proposal, the Board apparently believes that current practice is not appropriately analogizing the concepts of FAS 94 to situations where voting interests do not exist. Otherwise, issuing new guidance on the fundamental criteria for consolidation would not be warranted.

Because aspects of control can be present in a variety of ways and in different combinations, and because control can have varying levels of restrictions placed upon it, coming up with a new consolidation policy accounting model that is understandable and subject to consistent application in practice is admittedly a formidable challenge. The presumptions, indicators and examples in the document do provide some structure to the concept of control and indicate some lines of thought that would represent a change in present practice. However, those lines of thought usually end abruptly and vaguely. Also, it is not clear whether the listed presumptions and indicators should be considered an all-inclusive list or whether there are other factors that may need to be considered. While we agree that it is impossible for the standard to address all possible situations and that the management of a company will have to use its best judgment to determine if it controls another entity, the document does need a clearer statement of the Board's intent regarding what factors or combination of factors would typically require consolidation. Managements will naturally lean toward interpretations that support their desired financial reporting and, as a result, we believe there needs to be a clearer statement of the Board's intent in order to help ensure consistent interpretation in practice.

Adding to our concern over the vagueness of intent is the disjunctive structure of the document itself. Too often when reviewing the Exposure Draft, we found ourselves trying to piece together various key points made throughout the document. Such structural and grammatical difficulties compound the difficulty of interpreting this subjective standard.

For the above reasons, we believe the proposal needs a more clear and grammatically concise statement of the Board's perception of problems in current consolidation practice. Until such a clarification is made, it is difficult for us to make specific suggestions on how to improve the document. If the Board decides that further clarity is unachievable, we would prefer that all of the proposed consolidation policy guidance be deleted and have the document focus only on the procedural matters related to consolidation. Under such an approach, any perceived inconsistencies in practice regarding interpretation of FAS 94 could be addressed on a narrow case-by-case basis, either by the Board in an Interpretation or by the Emerging Issues Task Force.

**(2) The notion that one entity may have to consolidate another entity even though its ownership interest is zero or very low**

We agree with the dissenting views expressed by one Board member in paragraph 139 that control alone is not sufficient to consolidate another business enterprise. Having to consolidate an entity that is perceived as controlled when there is zero, or very low, ownership interest in that entity, would result in reporting essentially all of the assets, liabilities, revenues and expenses of that entity and then reporting line items in stockholders' equity and below net income to offset those reported amounts. In addition, the consolidated cash flow statement would report essentially all of the operating and investing cash flows of that entity with an offsetting financing cash outflow to the true beneficiaries of the cash flows from that entity. We believe that such a dramatic gross-up of the financial statements would result in less useful reporting.

The absence of some type of ownership interest requirement in the consolidation criteria also raises questions about possibly having to consolidate outsourcing contractors and supply vendors. In many situations, an outsourcing contractor or supply vendor depends almost solely on one's business and, as a result, will structure their business operations to meet those needs. If we want such a contractor to expand or change his services to serve changing needs, he usually will do so in order to keep that business. In these situations, some of the listed indicators of effective control could be present, but we find it hard to believe that the Board intends for companies to consolidate these types of commonly-found situations. One fix to this unclear issue is to change the consolidation criteria in the standard to require, in addition to the notion of control, some substantive level of ownership interest in the other entity. Even if the Board ultimately decides not to change the consolidation criteria in this manner, the standard should still include the issue of outsourcing contractors and supply vendors in the section that describes certain relationships that generally do not result in control of an entity.

**(3) Unclear nature of two of the presumptions of control**

Paragraph 14c provides that a presumption of control exists when an entity has the unilateral ability to obtain a majority voting interest through ownership of securities or other rights that may be converted into a majority voting interest at the option of the holder. This provision is unclear regarding situations where an entity has the unilateral ability to take control, but that right is not exercisable until, for example, some specified future date is reached or when other investors achieve some specified rate of return. Paragraph 158 does provide some interpretive guidance on this question by stating that "an ability to obtain control in the future might not constitute current control if it depends on conditional conversion rights that require other future *and* uncertain events." We find the choice of the conjunctive "and" confusing. For example, what if that future right to unilaterally take control depends only upon a certain amount of time elapsing? An example would be preferred stock that is convertible into common stock at a specified future date. In this preferred stock situation, the conversion right is a future event, but it is not uncertain. What was the intent of the Board in this type of situation? We believe that a right that is not exercisable today should not result in a presumption of control until such time as the right does become exercisable. One way to clarify this issue would be to change the above conjunctive in paragraph 158 to "or" instead of "and."

The other presumption that is unclear is paragraph 14d which provides that "a presumption of control exists when one entity has a relationship with another that it has established that has no voting stock or member voting rights and that has provisions in its charter, bylaws, or trust instrument that (1) cannot be changed by entities other than its creator and (2) limit the created 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." While we agree that there can be situations where an entity should consolidate a special purpose entity, we find the wording of this presumption difficult to interpret. First, the lead-in phrase ("that has no voting stock or member voting rights") would seem, by definition, to exclude all corporations and partnerships from being covered by this presumption since those entities do have voting rights. It is not clear whether the Board intended that this presumption apply only to trusts, the only type of entity that does not have voting rights. It would be helpful if the standard clearly stated the Board's intent on this point.

Second, paragraph 14d is unclear due to its focus on who "creates" the entity. In special purpose leasing entity situations, the lessee is the party with access to the individual physical assets but it usually is the lessor who wanted to form the special purpose leasing entity as a way of obtaining non-recourse, possibly off-balance-sheet, financing. As a result, it is unclear who "created" the special purpose entity. Also, what if there are two or more co-creators of another entity, instead of just one? For example, there can be situations where two parties want to co-lease an asset and are involved in forming a trust that will hold title to the asset being leased. How should paragraph 14d be interpreted in these situations?

Finally, in the Exposure Draft, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," the Board concluded that a qualifying special purpose entity set up to securitize a financial asset should not be consolidated by the entity transferring the financial assets. The notion of a "qualifying" special purpose entity in the financial asset securitization proposal focuses on whether the special purpose entity has transferrable beneficial interests it issues to others and whether it has a standing at law distinct from the transferor. We find it odd that the Board used a narrow, legalistic notion of special purpose entities in the financial asset securitization proposal but used a broad, vague notion of special purpose entities in the consolidation proposal. In order to make the consolidation proposal more workable, we believe that paragraph 14d should be changed to a legalistic notion similar to the financial asset securitization proposal. This could be done by providing that a presumption of control exists only if a special purpose entity has either not issued transferrable beneficial interests to others or does not have a standing at law separate from its creator. Because presumptions are so difficult to overcome, they should only be provided in the standard if they are clear and subject to consistent application in practice. Taking a more narrow, legalistic approach to the special purpose entity presumption in paragraph 14d would help significantly in this regard.

**(4) Illustrative Example 5 that attempts to apply the presumptions and indicators of control to a fact situation involving a special-purpose leasing entity created to benefit its creator**

The fact pattern in Illustrative Example 5 is a special purpose entity that was formed to build and lease retail stores to one lessee, the lessee designs the stores, the financing is arranged to carefully meet the substantive residual equity capital requirements of EITF Issue No. 90-15, the lessee has a purchase option at the end of the lease term, the lessee provides a residual value guarantee that is carefully set at a level sufficient to meet the 90% present value test in FAS 13, and the lessee gets to retain any excess sales proceeds if the purchase option is not exercised and the stores are sold. In that example, the Board concluded that the lessee should consolidate the special purpose entity because (1) the lessee can design, construct, and occupy the stores just as it could if it owned the stores outright, (2) the lessee controls all of the potential residual benefits from the ultimate sale of the property, if it chooses that course of action and (3) the lessee is exposed to all or most of the risks. Thus, the Board concluded that in addition to being able to direct and use the individual assets of the special purpose entity, the lessee derives the service potential inherent in the assets.

The type of situation described in Illustrative Example 5 is commonly referred to as a "synthetic" or "structured" lease and we know that certain constituencies of the Board believe these types of situations are an inappropriate interpretation of the lease accounting rules in FAS 13 and EITF Issue 90-15. Apparently, the Board is attempting to address those concerns through this illustrative example. However, we are concerned that the inclusion of this example in the consolidations standard raises significant questions about analogizing its conclusions to other situations that may have not been intended by the Board.

For example, one possibly unintended analogy of this example would be to conclude that any lease of an asset with a purchase option from a special purpose entity should result in consolidation of the special purpose entity, even if the provisions of the lease are of a "plain vanilla" variety. Or, taking the analogy of this example even further, one possible conclusion is that any asset subject to a long-term lease with a purchase option should be consolidated, even if no special purpose entity is involved, because any lessee obviously controls the use of an individual leased asset during the lease term and has certain aspects of control over the individual asset at the end of the lease term through the purchase option. We do not believe the Board intended for Illustrative Example 5 to be analogized to this extreme, but the inclusion of the example does beg the question.

Another concern with Illustrative Example 5 is the portion of paragraph 202 that states that the Board's conclusion in the example should also be applied to situations where the lessor entity is not prevented in its charter or bylaws from conducting similar activities for other entities, but presently is not doing so. Paragraph 202 asserts that the important point is not whether one entity has *assured* its ability to perpetuate its control of another; rather, it is whether it *presently* controls the other. We believe this assertion in paragraph 202 is conceptually inconsistent with the line of reasoning in paragraph 10 where it is asserted that a controlling entity may delegate its control to a manager or another entity, or it may elect to not exercise its control, but neither decision reduces its status as a controlling entity. If latent control in paragraph 10 was perceived

as still being control, even if it presently is not being exercised, then the above assertion in paragraph 202 appears to be inconsistent. Why wouldn't a latent ability to conduct similar activities for other entities be considered substantive enough to differentiate that situation from one where this latent ability does not exist?

Finally, we have seen evidence that the leasing industry is already developing structures that would enable lessees to avoid the special purpose entity trap of Illustrative Example 5 by having a financial institution, instead of a special purpose entity, be the legal title holder and lessor of the asset. This seems to be a fairly easy and non-substantive way to avoid the technicalities of Illustrative Example 5. As a result, if the Board perceives a significant problem in practice with structured lease accounting, Illustrative Example 5 probably will not be effective in addressing that concern.

If the Board believes the issue of structured lease accounting should be addressed, it would be more appropriate, for the reasons noted above, to address that issue as a separate project. Therefore, we strongly recommend that Illustrative Example 5 be deleted in its entirety from any final standard on consolidation accounting.