Association for Investment Management and Research



January 15, 1996

Mr. Timothy Lucas
Financial Accounting Standards Board
File Reference 154-D
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1/17/96

Re: Exposure Draft, Proposed SFAS, Consolidated Financial Statements: Policy and

Procedures

Dear Mr. Lucas:

The Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR)¹ is pleased to respond to the Financial Accounting Standards Board's Exposure Draft, Consolidated Financial Statements: Policy and Procedures. The Financial Accounting Policy Committee is a standing committee of AIMR charged with maintaining liaison with and responding to initiatives of bodies which set financial accounting standards and regulate financial statement disclosures. The FAPC also maintains contact with professional, academic, and other organizations interested in financial reporting.

Because AIMR members deal primarily with equity and other securities traded in public markets, the committee's deliberations and the comments that follow pertain only to the implications of this proposed standard for business enterprises.

Definition of Control

The Exposure Draft prescribes an economic unit concept of consolidation based on control as opposed to majority ownership. The FAPC has supported this concept in the past: our December 22, 1994 response to the Preliminary Views, Consolidation Policy and our September 16, 1992 response to the Discussion Memorandum Consolidation Policy and Procedures reflect that support. In the past we have expressed our concern that consolidated financial statements may result in the loss of information that would be important to both equity and credit analysts. These concerns are particularly troubling where diverse capital structures between parent and

¹AIMR is a global not-for-profit membership organization with more than 50,000 members and candidates comprised of investment analysts, portfolio managers, and other investment decision-makers employed by investment management firms, banks, broker-dealers, investment company complexes, and insurance companies. AIMR members and candidates manage, directly and through their firms, over six trillion dollars in assets. The Association's mission is to serve investors through its membership by providing global leadership in education on investment knowledge, sustaining high standards of professional conduct, and administering the Chartered Financial Analyst (CFA[®]) designation program.





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subsidiaries are involved. Our preference for the presentation of information was, and still is, for consolidating financial statements.

We agree with the essence of the Board's definition of control - that "control of an entity is 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." There is a wide range of disagreement within the FAPC as to how this definition will be operationalized. One member feels it is a completely unattainable ideal which will result in the loss of valuable information. Another member is concerned that some companies might be responsible for liabilities without having control of assets (e.g., transfers of receivables with recourse); and thus, escape consolidation. Therefore, we strongly emphasize that the work on this project should be closely coordinated with the project on Transfers and Servicing of Financial Assets and Extinguishment of Liabilities. The committee believes that the two projects contemplate a definition of control that should at least be consistent, even if the two projects differ in the degree of specificity contained in each project's definition of control. With regard to the definition in the consolidation policy exposure draft, the committee believes more precision needs to be added to the definition of control, so that unintended consequences - such as non-consolidation or de-consolidation - will be avoided.

Another aspect of the definition of control troubles us. We are concerned 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. Greater emphasis on the concept of control relative to ordinary business operations might help in thwarting de-consolidation moves that invoke minority rights, even though these rights might only be exercisable in narrow or unlikely circumstances, or instances such as the winding-up of an entity. The winding-up of an entity is not the context in which general-purpose financial statements are prepared. Regardless, we strongly urge the Board to study further the legal ramifications of minority rights (in various legal jurisdictions) on its definition of control and change that definition accordingly.

Disclosure

Further, we recommend that the existing requirement for disclosure of consolidation policy be amended rather than eliminated. We recognize that SFAS No. 94 eliminated the previously existing consolidation alternatives, reducing the footnote on accounting policy to little more than a statement that all majority-owned subsidiaries are consolidated. However, while the proposed standard does not reintroduce alternatives, it does inject subjectivity (and volatility) into a firm's decision to consolidate.

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For less than majority-owned companies that are consolidated, it is important for investors to know the name, percentage ownership and the primary indicator of control. For majority-owned companies that are not consolidated, we recommend disclosure of the name, percentage ownership and the reason that control over assets does not exist. Disclosure of such information would result in market scrutiny of managements' decisions to consolidate.

These disclosures would also provide investors with some advance warning that a company may be consolidated or de-consolidated in the future based on events that may be outside management's control. For example, in the Exposure Draft in paragraphs 174-181, effective control is demonstrated by the parent's ability to dominate the process of nominating and electing officers. Effective control was the result of its past majority ownership; its ability to obtain proxies from some other stockholders and persuade still others to vote for its nominees even though it could no longer cast a majority of the votes. In future elections, the parent might not be as persuasive and its nominees not be elected, with a resulting de-consolidation through loss of effective control. Investors must be provided with sufficient information to be aware of, and assess the probability of, the potential risk of loss of control. Clearly, such an event would have economic consequences beyond the presentation of the financial information.

Other Issues

Step Acquisition

Another area of concern is the anomaly that may develop with the loss of purchase accounting in step acquisitions. We are aware that firms could structure transactions in step fashion, which would circumvent goodwill recognition on later steps of an acquisition. Because of the provisions of paragraph 29, the basis of such acquisitions could be understated. Subsequent sales of such acquisitions could lead to accounting gains where economic losses exist. We do not believe that the intent of the Board is to create income items that do not represent economic reality, and strongly urge that the Board study the circumstances that could create such anomalous results before issuing a final standard. In *Financial Reporting in the 1990s and Beyond*, we advocate that goodwill "be removed from the list of assets forthwith" (page 49), but we must emphasize that is only the second clause of a sentence that begins, "Once it has been established for the record how much was paid to acquire goodwill,..." Under the provisions of paragraph 29, the record of "how much was paid to acquire goodwill" would be incomplete.

The committee believes that there are alternatives that the board should consider in the exposure draft's treatment of step transactions. These alternatives might prevent anomalous results from

occurring, or would at least minimize their effect on the usefulness of the financial statements. Among the alternatives are:

- Recognizing all goodwill on the first step of a transaction.
- Preserving the relationship of purchase premium and additional paid-in capital as it exists in the exposure draft. Upon the full sale of any subsidiary for which this treatment has been employed, however, any accounting gains or losses would be credited or charged to the paid-in capital account so that no gain or loss is recognized on a disposition.
- For subsequent steps of a step acquisition, the application of fair value accounting to the balance sheet of the entity being acquired could prevent accounting gains from occurring if the entity is subsequently sold.
- Accounting gains might be accumulated as a separate component of comprehensive income and excluded from earnings in the periods in which they occur.

There are benefits and drawbacks to each of the suggestions above; nevertheless, the committee believes the board should explore this area more extensively.

Relation to Disaggregated Disclosures

We are also concerned that the standard could cause a lack of user information if it is not simultaneously implemented with the anticipated standard on disaggregated information. The Exposure Draft suggests that the two standards might be issued at nearly the same time with similar implementation requirements, but it does not indicate that this is a foregone conclusion. We strongly urge that the implementation dates of the two standards be coordinated to prevent the loss of information that could occur if the consolidation policy standard preceded the disaggregated information standard.

Accounting Policy Conformance

Finally, the committee believes that the accounting policies of a subsidiary should not conform with those of a parent merely for the sake of conformance. We believe that those policies that are most relevant for a subsidiary should be employed by that subsidiary, and that this becomes even more important when the subsidiary follows specialized industry practices that the parent does not employ. Forcing a parent's policies upon a subsidiary in such a case would amount to forcing square pegs into round holes, and we hope that the board clarifies its intent in this section of the exposure draft.

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AIMR's Financial Accounting Policy Committee appreciates the opportunity to express its views on the exposure draft of *Consolidated Financial Statements: Policy and Procedures*. If you have any questions or seek amplification of our views, we would be pleased to provide the additional information you seek.

Respectfully yours,

Peter H. Knutson, CPA

Chair

Jack Ciesielski, CFA, CPA Subcommittee Chair

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