



American Accounting Association

5717 Bessie Drive • Sarasota, Florida 34235-2399 • Tel: (813) 921-7747 • Fax (813) 923-4093

January 14, 1996

Letter of Comment No: 27A

File Reference: 1082-154

Date Received: 1/16/96

Financial Accounting Standards Board
File Reference 154-D
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Response to the October 16, 1995 Exposure Draft, "Proposed Statement of Financial Accounting Standards—Consolidated Financial Statements: Policy and Procedures."

To the Members of the Board:

The Financial Accounting Standards Committee of the American Accounting Association is charged with responding to documents issued by standard-setters relating to financial reporting. The Financial Accounting Standards Committee has met and discussed the Exposure Draft (ED), "Proposed Statement of Financial Accounting Standards—Consolidated Financial Statements: Policy and Procedures." The opinions expressed in this comment letter reflect the views of the individuals comprising the Committee and are not those of the American Accounting Association.

In general, the provisions of the ED are consistent with the Committee's recommendations on the Preliminary Views and Discussion Memorandum.¹ In particular, we concur with the economic unit concept of consolidated financial statements and the broader definition of effective control as a basis for consolidation. As noted in the ED, the changes are consistent with recent international trends and represent an important step toward harmonization of accounting standards. Further, we agree with the basic consolidation procedures identified in the exposure draft related to intercompany items, changes in ownership and minority interests.

Our primary concerns relate to implementation. An advantage of the effective control notion is that it is more flexible and is not primarily governed by an arbitrary criterion such as ownership percentage. However, the fact that the definition of effective control is ambiguous and that firms may have incentives to behave opportunistically suggests the importance of implementation guidelines. Although Appendix B is useful, we would

¹ Accounting Horizons, 1994, Vol. 8, No. 2, pp. 120-125, and Accounting Horizons, 1995, Vol. 9, No. 2, pp. 80-82.

recommend that the guidance be expanded, particularly as it relates to special purpose entities.

The Committee specifically discussed the interplay and consistency between this ED and other proposed standards. In particular, we are concerned about the relation between the effective control notion in the consolidation ED and the financial-components approach in the ED on "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities." Except for footnote 6 in the ED on asset transfers, there is no explicit link between the two standards. Because the importance of accounting for asset and liability transfers in many cases hinges on whether the transferee is consolidated with the transferor, the two ED's cannot be viewed in isolation.

A primary concern, for example, is whether assets and liabilities could be transferred to a special purpose entity which could possibly avoid consolidation. As an illustration, suppose a corporation wished to effectively borrow money without reflecting the liability in its consolidated financial statements. One arrangement that could be problematic involves a bank (or some other party) that creates an entity which would borrow from the bank and use the proceeds to purchase assets from the corporation. The debt would be repaid by the revenues from the transferred assets, with a guarantee from the selling corporation for any short-fall. Because the corporation did not create the special purpose entity and does not violate any other indicators of control, consolidation would not appear to be required. Furthermore, the existence of a debt guarantee would not preclude accounting for the transfer as a sale.

Related Research

Although there is no research that bears directly on the ED proposal there is research on consolidation more generally, particularly with regard to Statement 94, which might be useful to the Board in its deliberations. One issue with the effective control approach is that it potentially provides discretion that management might use opportunistically. Prior to Statement 94, firms had discretion over consolidating financial subsidiaries and there was concern that they used that discretion to understate fixed claims on their balance sheets. Research into the determinants of consolidation decisions for financial subsidiaries suggests that consolidation choice was driven primarily by the level of interdependency between the entities and provides no evidence that managers behaved opportunistically to understate debt on their balance sheets.² Research on Australia's experience with discretion in consolidation requirements provides similar conclusions—consolidation policy appears to have been driven primarily by the underlying economics rather than by opportunism.³ Although there are differences in the environments

² Mian, S. L. and C. W. Smith, "Incentives for Unconsolidated Reporting," *Journal of Accounting and Economics*, 1990, Vol. 12, No. 1-3, pp. 141-171.

³ Whittred, G., "The Derived Demand for Consolidated Financial Reporting," *Journal of Accounting and Economics*, 1987, Vol. 9, No. 3, pp. 259-285, and Whittred, G. and I. Zimmer, "Contracting Cost Determinants of GAAP for Joint Ventures in an Unregulated Environment," *Journal of Accounting and Economics*, 1994, Vol. 17, No. 1-2, pp. 95-111.

considered in these studies and in the ED, the evidence suggests that management will not necessarily use discretion with respect to consolidation opportunistically.

A related issue on which empirical evidence exists is the economic consequences of changes in consolidation policy. As with the current ED, Statement 94 expanded the scope of consolidation creating the possibility that some companies might be harmed by the change and might respond by restructuring their activities to mitigate the effects of the standard. Consistent with that possibility, research findings suggest that firms with unconsolidated finance subsidiaries lobbied against Statement 94, that its enactment produced negative stock returns for those firms and that, in response to the standard, they were more likely to sell, close or reorganize the subsidiary, retire debt or securitize corporate assets.⁴ Subject to the differences between Statement 94 and the ED, these results suggest that expanding the set of companies that will be required to be consolidated may result in significant cost to affected companies and potential changes in their operations. To the extent that economic consequences arise from the preferential treatment accorded certain ownership arrangements under previous standards, they may be necessary and desirable. Nonetheless, these potential economic consequences should be weighed in assessing the costs and benefits of the proposed standard.

Comments on Specific Issues

Conditions for Consolidation

The Committee supports the notion of non-temporary control over assets as the criterion for consolidation and agrees that control exists when a parent can establish, directly or indirectly, an entity's policies and budgets. The Committee supports the application of effective control rather than legal control. The difficulty with effective control is, of course, defining when it exists. We support the Board's general approach of providing conditions for presumption of control and the guidelines in Appendix B which apply the provisions to specific circumstances, subject to the concerns expressed above.

Although we agree that control should be exclusionary, there is some concern over how the conditions for presumption of control would ensure that only one entity claimed control. For example, some of the conditions in paragraph 14 (e.g., ability demonstrated by a recent election to dominate the process of nominating candidates) could potentially be satisfied by multiple entities:

Elimination of Intercompany Transactions and Balances

The Committee supports the treatment of intercompany items in the ED with elimination of all intercompany transactions and balances and all profits or losses on transactions

⁴ Mian, S. L. and C. W. Smith, "Incentives Associated with Changes in Consolidated Reporting Requirements," *Journal of Accounting and Economics*, 1990, Vol. 13, No. 3, pp. 249-266.

between affiliates of the group, and the allocation of intercompany profits and losses on assets which remain in the group based on proportionate interests in the selling affiliate. Further, the Committee supports the elimination of intercompany investments in equity securities and the treatment of intercompany investments in debt securities as effectively retired.

Reporting Noncontrolling Interests

The Committee supports the inclusion of noncontrolling interest as a component of equity on the balance sheet and the attribution of net income to the noncontrolling interest based on its proportional interest. However, it is not clear why losses in excess of the noncontrolling interest's equity would be attributed entirely to the parent. Under current accounting standards which normally treat a noncontrolling interest as a liability, treating a noncontrolling interest's deficit as an asset is troubling. However, given that the ED would include the noncontrolling interest as a component of equity, would not the noncontrolling interest's deficit best be represented as a debit balance in the noncontrolling interest account in shareholders' equity.

Acquisition of a Subsidiary

The Committee supports the accounting for an acquisition under the purchase method by assigning the purchase price to individual assets and liabilities based on their fair values, with the excess allocated to goodwill. In cases in which a parent acquires less than 100%, the Committee supports the ED's approach of reporting the noncontrolling interest at the proportional amount of the fair value of all of the subsidiary's identifiable assets and liabilities, without attributing goodwill to the noncontrolling interest.

Changes in Ownership Interest and Disposition of a Subsidiary

The Committee agrees that under the entity concept changes in interest that do not result in loss of control should be accounted for as transactions in the equity of the entity. As such, no gain or loss should be recognized and the amount of the change in the parent's proportional interest should be reported as a change in additional paid in capital and in the noncontrolling interest. The Committee agrees that if a parent loses control of a subsidiary, a gain or loss should be recognized for the difference between the proceeds from the transaction and the carrying amount of the subsidiary's assets less its liabilities, noncontrolling interest and the investment remaining in the subsidiary.

Conforming Accounting Policies and Fiscal Periods

The Committee agrees that parents and subsidiaries should apply consistent accounting policies unless GAAP permits a single entity to use different methods and that the effect of conforming should be allocated between controlling and noncontrolling interests. Further, the Committee agrees that the fiscal periods of parents and subsidiaries should conform unless not practicable.

Additional Disclosure

As noted in the response to the Preliminary Views document, the Committee believes that some additional disclosure is warranted. Specifically, in cases in which effective control exists in the absence of majority ownership, the Committee believes that the basis for concluding that effective control exists should be disclosed. Similarly, in cases in which effective control is at risk, the Board should consider requiring disclosure of that fact, circumstances under which control would be lost and summarized financial information for the consolidated entity as it would have appeared had the at-risk subsidiaries not be consolidated. Finally, disclosure of the circumstances associated with failure to consolidate due to temporary control may be warranted.

The Committee appreciates the opportunity to participate in the Board's due process and to have our view considered by the Board. We hope that our responses are helpful to the Board in its deliberations.

Sincerely,

Mark H. Lang

Terry D. Warfield, Chair
John Gribble
Mark Lang
Charles Lee
Thomas Linsmeier
Stephen Penman
D. Shores
John Smith
Ray G. Stephens