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(412) 553-3494



EARNEST J. EDWARDS  
Vice President and Controller

January 12, 1996

Director of Research and Technical Activities  
Financial Accounting Standards Board  
407 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

Letter of Comment No: 65  
File Reference: 1082-154  
Date Received: 1/15/96

Re: File Reference 154-D  
Consolidated Financial Statements: Policy and Procedures

Dear Sir:

Alcoa appreciates the opportunity to respond to the Exposure Draft (ED) - Consolidated Financial Statements: Policy and Procedures. We are deeply troubled by the direction the Board is taking by such a radical departure from current practice. The present system works well and just needs some clarification of partnerships, limited liability companies and joint ventures.

We are particularly concerned because the Board has failed to provide clear evidence of deficiencies in current policies that warrants proposing a standard that appears to be full of land mines. We envision substantial inconsistencies related to inclusion or exclusion of entities from consolidated financial statements because of the highly subjective approach the Board has taken.

We are hopeful that the Board proceeds with great caution and trepidation in this area. We are concerned with the unpredictable nature of this ED and its potentially damaging consequences to both preparers and users.

Our detailed responses on specific issues are attached. If you have any questions, please contact me at (412) 553-3494 or William G. Nichols, our Assistant Controller, at (412) 553-3366.

Sincerely,

A handwritten signature in cursive script that reads "Earnest J. Edwards".

Earnest J. Edwards, Controller  
Aluminum Company of America

Aluminum Company of America

REVIEW OF PROPOSED STATEMENT OF FINANCIAL ACCOUNTING STANDARDS:

“Consolidated Financial Statements: Policies And Procedures”

Attachment

**Paragraphs 13 through 15** define a new standard for consolidation based on the concept of control, expressed as the ability to direct and utilize the assets of the subsidiary in essentially the same manner as the parent's assets. We believe this standard to be overly exclusive in the case of majority owned subsidiaries and partnerships. As an example, this approach, when applied to our current 51% ownership of Alcoa Fujikura, arguably will result in deconsolidation, since the minority shareholder's approval is required for any capital or investment expenditures over \$50,000, and debt issuance. Similarly, under the terms of certain of Alcoa's various partnership agreements requiring the agreement of both partners for financing, capital investment, and distributions, deconsolidation could become an issue. We are deeply troubled that the choice of a particular legal structure, which is typically driven by taxation implications, can result in consolidation for a subsidiary and equity accounting for a partnership, despite essentially identical economic substance of the affiliate being formed.

**Paragraph 21** states that all debt issued by one subsidiary to a third party and subsequently acquired by another subsidiary should be accounted for as constructively retired. This standard, when applied to Alcoa's purchase in the late 1980's of a Brazilian subsidiary's debt on the open market at about 50% of face value, would have resulted in recognition of a greater than \$100 million gain immediately upon purchase. We view this result as totally inappropriate, and strongly urge the Board to require amortization of any differences in carrying values over an appropriate period.

**Paragraphs 22 through 25** require reporting noncontrolling interests' share of the consolidated statements as a separate component of equity and an “allocation” of net income. We disagree with the Board's attempt to force fit minority interests into the existing conceptual model. Minority interests are not part of shareholders' equity; nor, as the Board correctly concluded, are they a liability. They are in fact a discrete component of financial statements falling between liabilities and equity, and the conceptual model should be modified to recognize them as such. As discussed below, we believe the shareholders' equity section of consolidated financial statements must be equivalent to the shareholders' equity section of the ultimate parent in the consolidation.

The exercise to “allocate” net income between controlling and noncontrolling interests can most kindly be described as rampant Pollyannaism. We consider it a foregone conclusion that users of financial statements will continue to correctly view the “allocation” as a deduction in calculating net income. More importantly, as discussed below, this approach fails completely from a theoretical point of view, since it creates a permanent difference in accounting between the minority interest's books and the consolidated financial statements. This approach should be abandoned immediately.

**Paragraph 29** states that any change in ownership interest percentage that does not result in loss of control should be accounted for as a transaction within equity, with no gain or loss recognition

permitted. Such an approach means it will no longer be possible to calculate minority interest based on the subsidiary's financial statements, or perform consolidation eliminations based on the investment balances and the subsidiary financial statements. Memo accounts will probably have to be created and maintained forever to perform an otherwise simple consolidation.

We are appalled at some elements of the conclusions expressed in Paragraph 29 of the proposed standard. Although theoretically inconsistent with other accounting standards, we can understand the motivation for considering transactions in a subsidiary's stock, **initiated and controlled solely by the subsidiary and its parent(s)**, as equity transactions with no effect on net income. With respect to the sale of a less-than-majority ownership of a subsidiary to an independent third party (or the purchase of an additional interest held by an independent third party), we can see absolutely no theoretical or practical justification in turning a realized gain or loss (or additional investment basis) into a misstatement of the parent's capital accounts.

Assume the sale of a 30% interest in a subsidiary with net worth of \$1,000,000 for \$400,000. The Board's proposal would result in recording a \$400,000 noncontrolling interest and a \$100,000 reduction in the parent's capital accounts. From the moment this transaction is completed, the actual realizable value of the noncontrolling interest's equity is \$300,000, while the shareholders' equity of the parent has not changed. On the noncontrolling interest's books, under the equity method, amortization of this \$100,000 investment difference will begin, and reduce net income. Assuming the purchase of additional interest, the noncontrolling seller would record an immediate gain or loss, and the consolidated financial statements should amortize this investment difference to income over time.

We cannot support a change from the current practice that is inconsistent with the accounting treatment followed by the noncontrolling interests, and converts the shareholders' capital accounts of a consolidated balance sheet from balances identical to those of the parent company to some vague theoretical abstraction. This does a grave disservice to the shareholders, whom you purport to benefit with this change.

Finally, we also note that the Board has, at least to this point, consistently deemed reductions in noncontrolling interests to be investing activities, again inconsistent with the proposed standard and rationale therefore.

We have seen insufficient evidence from the Board of current problems and deficiencies with the existing standards to even consider such a radical departure from current practice. We believe the Board should proceed with great caution and trepidation in this area, keeping in mind a critical principle: Over time, consolidated financial statements will yield the same net income as those where all subsidiaries are accounted for on the equity method. We cannot support the Board's abandonment of this accounting linchpin.

**Paragraph 36** retains the disclosure requirements around unconsolidated subsidiaries now consolidated as a result of adopting SFAS #94. We believe that six years of common basis historical financials is enough; particularly given subsequent organizational changes. It's time to eliminate this requirement.

**Paragraph 37** requires restatement of all comparative statements presented, including restatement of earnings if appropriate, although it allows an exception if this is "not practicable". Although possible, (and thus practicable under the standard), restatement of the Selected

Financial data table required by S-K Item 301, or the 10 or 11 years of data included in most annual reports, will require months of effort at a minimum. We cannot imagine that such an effort is cost-justified. We strongly urge the Board to expressly limit restatement to the most recent three years presented.