

HALE AND DORR

C O U N S E L L O R S A T L A W

60 STATE STREET, BOSTON, MASSACHUSETTS 02109
617-526-6000 • FAX 617-526-5000

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Director of Research and
Technical Activities
Financial Accounting Standards Board
File Reference 154-D
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Comments on Exposure Draft on Consolidated
Financial Statements: Policy and Procedures

Dear Director:

We have reviewed the Board's Exposure Draft on Consolidated Financial Statements: Policy and Procedures dated October 16, 1995 (the "Exposure Draft") and have the following comments:

I. The Exposure Draft Distorts Legal Reality. The Exposure Draft adopts a concept that a noncontrolling interest in a subsidiary is part of the ownership equity of the single economic unit comprising the parent and the subsidiary. For reasons described below, this view, if adopted, will further distort the commonly accepted legal notions of separateness of parent and subsidiary. New accounting rules should result in more, not less, harmonization between legal and accounting models in the financial reporting context.

From a legal perspective, the stock of a subsidiary is an asset of the parent. The underlying assets of the subsidiary are not assets of the parent. Creditors of the parent can force a sale of the stock of the subsidiary held by the parent, but not the underlying assets of the subsidiary. Similarly, creditors of the subsidiary can only reach the subsidiary's assets, not the parent's. The notion that the two companies are part of one economic unit does not comport with legal reality.

Moreover, the parent company's access to cash flow of the subsidiary is limited by a fiduciary duty the parent company owes to the subsidiary's other shareholders. Securities rating agencies, when analyzing the parent's ability to service its debt, do not view the consolidated whole as a single entity.

Parent companies in certain situations choose to submit to a vote of the subsidiary's shareholders certain related party transactions, such as mergers. This so-called "neutralized" voting does not count the parent's shares in the subsidiary, further highlighting the differences between the status of a parent's ownership interest and the minority shareholders' interests.

The concept advanced by the Exposure Draft is further flawed because minority shareholders of a subsidiary have no interest in the parent. The subsidiary's financial performance and stock price is completely independent of the parent's. By concluding that a minority shareholder owns a residual interest in the combined enterprise, the Exposure Draft contradicts the legal and economic reality of an investor's investment in a subsidiary.

Relevant legal and accounting rules are designed to ensure that the parent does not subsidize or penalize the subsidiary. All transactions must be on an arm's length basis, so as to preserve the integrity of the parent's and the subsidiary's financials. The Exposure Draft, with its concept of a single economic unit, is not consistent with these long-standing rules.

In short, the economic unit model advanced by the Exposure Draft will widen the gap between financial reporting and legal reality.

II. Serious Economic Misrepresentations Made Possible by the Exposure Draft. The following scenario has been brought to our attention, as an example of the type of economic misrepresentation made possible by the Exposure Draft:

Company A buys 51% of the shares of Company B for \$10 million. Assume that the fair value of the net assets of Company B is \$1 million. Company A records amortizable goodwill of \$9.49 million.

At a later date, Company A acquires the rest of Company B's shares for \$50 million. According to the Exposure Draft, no further

goodwill is recorded and, therefore, Company B is carried in Company A's books for \$10.49 million.

In a third transaction, Company A sells all the shares of Company B for \$20 million. The rules advanced by the Exposure Draft result in a book profit to Company A of \$9.51 million when, in fact, Company A actually lost \$40 million.

The type of transaction described above provides an easy formula for creating book profits while actually losing money. If these transactions were to be carried out by public companies, there will be confusion at best, and fraud at the worst, in the financial markets, as investors struggle to understand the nature of these illusory profits.

This accounting result is such a staggering departure from economic reality that we doubt that any amount of disclosure in footnotes or MD&A would prevent the inevitable spate of lawsuits when companies using this technique run out of cash to fund these economic losses, despite simultaneously reporting earnings from the same deals.

For the above reasons, we respectfully request that the Board reconsider the Exposure Draft. The current consolidation procedures work fine and have not, to our knowledge, generated any abuses that need to be addressed in such a sweeping fashion as the Exposure Draft. We also are hereby repeating our earlier request to address the Board in person during the February 20-21 hearings.

If you have any questions or concerns with respect to this letter, please contact David E. Redlick, Esq. of this Firm at (617) 526-6000.

Very truly yours,


HALE AND DORR