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TO:

Director of Research and Technical Activities Financial Accounting Standards Board File Reference No.154-D 401 Merritt 7 P.O.Box 5116 Norwalk, CT 06856-5116

RESPONDENT:

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SUBJECT:

Exposure Draft on Consolidated Financial Statements: Policy and Procedures

The difference between the parent company approach and the economic unit approach is that they give different answers to the question, "What is the reporting entity in consolidated statements?" The answers given affect the proper display and understanding of the accounts "noncontrolling interest in net assets" and "noncontrolling interest net income", but the answers do not dictate anything about the way that the net assets of the subsidiary should be valued on the consolidated statements. Hence, the FASB is wrong in paragraphs 109 and 110. is purchase accounting, and not either the parent company approach or the economic entity approach, which dictates how the net assets of the subsidiary should be valued on the consolidated statements.

Suppose P acquires 60% of the stock of S and purchase accounting is used. The essence of purchase accounting is that P is treated as purchasing 60% of S's net assets even though in reality stock is purchased.

What is the rationale for any sort of new basis of S's net assets? The rationale emanates from purchase accounting. When net assets are purchased, given the principle of historical cost accounting, the net assets purchased should be recorded at their cost at date of purchase. If cost at date of purchase is fair value at date of purchase, then the net assets purchased should be recorded at fair value at date of purchase. Purchasing the net assets of another company is not just purchasing individual assets and liabilities, but is also purchasing

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the synergy (goodwill) resulting from the fact that the net assets are working together in an ongoing company. It is purchase accounting that justifies a new basis (including goodwill) for the net assets purchased.

P purchases 60% of S's stock, but is treated as purchasing 60% of S's net assets. Given what was said above, since P is only purchasing 60% of S's net assets, there is only a justification for giving a new basis to 60% of S's net assets. The noncontrolling interest in S is not purchasing anything, so there is no justification whatsoever for giving a new basis to 40% of S's net assets.

If P purchases 60% of the stock of S and purchase accounting is used, then the net assets of P at date of acquisition of the stock consist of the following:

- (P1) P's net assets, exclusive of the stock investment in S.
- (P2) 60% of the net assets of S valued at fair value and 60% of the synergy of S's net assets working together.
- (P3) The FASB also envisions that P pays a "premium to gain control" of S. This premium would also seem to be an asset of P. (The premium is discussed in paragraph 116.)

The net assets of S are as follows (remember that 60% of S's net assets at date of acquisition are treated as P's, not S's):

(S1) 40% of S's net assets valued at book value.

Now, let us compare the ways that financial statements should be prepared under both the parent company approach and the economic unit approach.

Under the parent company approach, P is the reporting entity. 100% of S's net assets appear on the balance sheet, since the parent company approach does not involve proportionate consolidation. Given that 100% of S's net assets appear on the balance sheet and that P is the reporting entity, there must be a deduction of 40% of S's net assets. This deduction is properly displayed after liabilities and before equity, since it is a deduction from net assets = assets - liabilities. This deduction is not an asset, a liability, or an element of equity. It is no argument to say that such a deduction

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cannot be allowed because it is not discussed in CON6. (Paragraph 106 tries to make this argument.) deduction is similar to a valuation allowance, and CON6 does discuss valuation allowances. This deduction is called "noncontrolling interest in net assets". Combining (P2) and (S1) above, the net assets of S are recorded at 60% fair value + 40% book value. The amount of "noncontrolling interest in net assets" should therefore be 40% x S's net assets at book value. Similarly, in the statement of earnings, 100% of S's net income appears. So, there must be a deduction of 40% of S's net income to obtain the net income of S that belongs to P. deduction is called "noncontrolling interest net income". The FASB does not seem to have a problem with recognizing a deduction on the earnings statement in the same way that it has a problem with recognizing a deduction on the balance sheet.

Now let us consider what the consolidated statements should look like under the economic unit approach. the economic unit approach, P+S is the reporting entity. 100% of S's net assets appear on the balance sheet. Since (P2) and (S1) above follow from purchase accounting and not from any prejudgment about the parent company approach vs. the economic unit approach, the net assets of S should still be recorded at 60% fair value + 40% book value. There is absolutely no reason to justify a new valuation of the noncontrolling shareholders' interest in S simply because P has obtained control. "Noncontrolling interest in net assets" is taken to be an element of equity, and represents the 40% of the book value of S's net assets owned by the noncontrolling shareholders. There is a flaw with the economic unit approach, and it concerns the display of "noncontrolling interest in net assets" as a single line. (The single-line display is endorsed by the FASB in paragraph 22.) If the interest of the noncontrolling shareholders is truly a part of equity, then it is not one element but (at least) two: retained earnings and capital. There is no justification for the aggregation of the noncontrolling interest in a single line on the balance sheet. On the statement of earnings "noncontrolling interest net income" is an allocation of 40% of S's net income to the noncontrolling interest. There is nothing wrong with this income statement account, given that the controlling interest and noncontrolling interest are distinguished in some way on the balance sheet. is another problem with the economic unit approach that does not arise under the parent company approach. problem concerns P's assets and not S's. (P3) above is the asset of P resulting from P's paying a premium to gain control of S. (P3) seems to be an asset of P, so it can

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be included as an asset on statements prepared on the parent company approach. (P3), however, is not an asset of P+S, because there can be no asset of P+S representing the control of one part of itself by another part of itself. So, if consolidated financial statements are to be prepared properly under the economic unit approach, then the premium must be removed from goodwill on the consolidated balance sheet.

The FASB has decided to endorse the economic unit approach on the grounds that the parent company approach is "too narrow" (paragraph 104). Given the discussion above about how consolidated financial statements should be prepared under both the parent company approach and the economic unit approach, I fail to see the narrowness. The two kinds of statements are virtually identical, differing only in the display of the accounts "noncontrolling interest in net assets" and "noncontrolling interest net income", and in the fact that any premium to gain control should not be an asset on the economic unit statements. I also find it odd and somewhat contradictory that the FASB states in paragraph 53 that the consolidated statements are primarily for the benefit of the resource providers of the parent, and then goes on to endorse the economic unit approach over the parent company approach in paragraph 54.

Let us suppose that it is a fait accompli that the FASB will not change its mind about endorsing the economic unit approach. Then, given the discussion above, there are several flaws with the proposed implementation of this approach as described in paragraph 27. Since the noncontrolling interest is not purchasing anything, there is no reason to apply purchase accounting to the proportion of the net assets of the subsidiary owned by the noncontrolling interest. Even if purchase accounting were applied to the proportion of the net assets of the subsidiary owned by the noncontrolling interest, there would be no reason to avoid allocating goodwill to the noncontrolling interest. The supposed problem with the "premium to gain control" cannot be swept under the rug by allocating goodwill only to the controlling interest: a "premium to gain control" would still have to be removed from a consolidated balance sheet prepared according to the economic unit approach, since it is clearly not an asset of the economic unit that one part of that unit controls another part.

There is one feature of the FASB's proposed implementation of the economic unit approach that corporations will like, but they will like it for the wrong reasons. This is the treatment of changes in a parent's ownership interest in a subsidiary as transactions in equity as described in paragraph 29. I once consulted

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with a corporation that had acquired 90% of the stock of a subsidiary in a pooling. After a certain amount of time had passed, the corporation wished to acquire the noncontrolling interest. The corporation found to its chagrin that it had to use purchase accounting to account for the acquisition of the 10%. The corporation did not like the fact that it would have to experience income statement hits from the amortization of fair value over book value and amortization of goodwill for the 10%. Under the FASB's proposal, corporations will be able to avoid such unfavorable income statement effects. It is not the FASB's job, however, to make corporate earnings appear more favorable.

In paragraph 112 the FASB cites "an organization representing lending officers" (the RMA?) and a report by AIMR which indicate that the valuing of S's net assets at 60% fair value + 40% book value is an improper combination of differing values. Since the combination of values is dictated by purchase accounting, I do not see it as improper or misleading in any way. The proposed approach by the FASB is not any more enlightening. Suppose P has multiple subsidiaries A, B, and C, acquired in 1990, 1992, and 1994 respectively. Then, the consolidated balance sheet for 1995 under the FASB approach will still show a combination of differing values: book values (for P's net assets), amortized 1990 fair values (for A's net assets), amortized 1992 fair values (for B's net assets), and amortized 1994 fair values (for C's net assets). FASB states in paragraph 113, "Costs to the subsidiary that relate to transactions and events occurring before its entry into the consolidated financial statements are not relevant to those who use the financial statements." This is an unsupported claim and not very convincing. Why would it be any more relevant for a user of the 1995 consolidated statements to be looking at a combination of book values, amortized 1990 fair values, amortized 1992 fair values, and amortized 1994 fair values?

Paragraph 112 contains the observation that only about one third of the respondents to the DM supported the economic unit approach, and that even fewer supported the allocation of goodwill solely to the controlling interest. If the FASB wishes that more individuals and groups participate in the due process procedure by writing comment letters, then the FASB must be more serious about integrating comments emanating from sources other than the RMA and the AIMR. Chairman Beresford in a 1993 article in Accounting Horizons expressed disappointment that only the RMA and the AIMR are steadfast providers of comment letters. Perhaps others are discouraged because they think that their comments have little chance of being

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integrated into the final FASs. Since a substantial number of respondents to the DM and PV documents were supportive of the parent company approach, the FASB should realize that perhaps a case for the parent company approach can be made which is at least as good or better than the case for the economic unit approach.