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Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
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Dear Tim:

As you know, the topic of consolidation policy was on the agenda during the entire time I served on the FASB. In fact, it was added to the agenda in January 1982, well before I was appointed to the Board. And one of the documents that I read just before I joined the organization was the draft research report on the concept of the reporting entity, prepared by Reed Storey (still unpublished as far as I know).

So it is fair to say that I invested a fair amount of time and effort in the consolidation project, including the Discussion Memorandum and initial Exposure Draft that led to the current ED. Thus, it seemed appropriate for me to read the current ED and offer my views.

It probably will come as no surprise to those with whom I debated these issues for many years that I do not support the ED. In my opinion, it will not result in an improvement in financial reporting. I also believe it will lead to numerous unpleasant and unproductive arguments among corporations, auditors, and the SEC on how to interpret the very subjective guidelines included.

Introduction

It is interesting to list in one place the four definitions of control that have been developed so far on this project, as quoted in the Basis for Conclusions.

Discussion Memorandum - The power of one entity to direct or cause the direction of the management and operating and financing policies of another entity.

Preliminary Views - Power over its assets - power to use or direct the use of the individual assets of an entity to achieve the objectives of the controlling entity.

Initial Exposure Draft - 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.

Current Exposure Draft - The ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities.

A lay reader of this evolving definition might well ask, "What's different?" Perhaps the biggest difference in the latest draft is that "...the Board decided to modify the definition of control to make clear the notion of benefit that was already implicit in the initial Exposure Draft's proposed definition." However, as explained further below, although the notion of benefit is now explicit, the Board does not believe that significant economic benefits must flow to the "parent" in order to justify consolidation. Beyond this one change that the Board itself says is not consequential, the rest of the words are pretty similar, with some amount of "rearranging the deck chairs."

Scope

The decision to deal only with consolidation policy at this time is understandable. The consolidation procedures proposed in the initial ED were extremely controversial and significant questions were raised about the usefulness of many of the Board's conclusions. If the Board is unable to resolve the policy matter, the procedures questions are moot. On the other hand, applying the consolidation policy called for by the ED using today's consolidation procedures is apt to lead to unusual answers in some cases.

For example, a real estate operator will now have to consolidate all of the limited partnerships in which it serves as the general partner, even when its interest in each partnership is only 1%. Thus, the consolidated financial statements may show large amounts of assets, liabilities, and "minority interest" and only a small amount of stockholders' equity. The income statement may show large revenues, expenses, and then a line called "less minority interest" to arrive at a small amount of net income. The statement of cash flows apparently would show all of the cash receipts and disbursements of the limited partnerships, even though nearly all of the consolidated cash wouldn't be available to the "parent."

As another example, how should stockholders' equity and minority interests be calculated and shown in the financial statements when control is deemed to exist in spite of no current ownership interest by the parent?

Perhaps the Board already has considered the above and any other procedural issues where some parties would perceive the resulting information to be unhelpful to users of financial statements. My concern is that many readers of the ED will become buried in the details of the guidelines of how to define control and may not focus on the financial reporting that would ensue. At a minimum, I suggest the Board should review all of the consolidation procedures identified in the earlier ED and make sure it is comfortable that the results are meaningful using existing consolidation procedures.

Usefulness

As noted above, I question the usefulness of financial statements that consolidate large amounts of limited partnerships. Additionally, consolidation of other less-than-majority-owned entities could result in a loss of information to users.

At present, 20-50%-owned entities generally are accounted for using the equity method of accounting. APB Opinion No. 18 states that it may be necessary to present summarized information for equity investments that are material. More importantly, the SEC has objective rules for presenting summarized information or even separate financial statements depending on the materiality of the investment. That separate information would no longer appear if these investments were considered to be controlled under the ED's guidelines.

I suggest that the Board prepare illustrative financial statements that consider the above matters (consolidation of limited partnerships and elimination of disclosures about equity investments that become consolidated). These illustrations should be discussed with financial analysts, bank lending officers, and other users to determine their views of whether the results are more or less useful than present practice. If the Board has already done something like this, it should be added to the Basis for Conclusions to support the reasoning in the ED.

Benefits

As noted in the Basis for Conclusions, one of the most controversial matters in the Board members' internal debate has been whether consolidation should be based solely on control or on control and some level of benefits derived from that control. As noted above, the latest definition explicitly mentions benefits, although the ED argues that this was always implicit in Board members' thinking about control. Further, paragraph 212 explains that control alone isn't sufficient but control must provide the ability to increase benefits or limit losses that can be derived from control. (As an aside, investors have the ability to increase benefits or limit losses in many investments that don't lead to consolidation questions.)

Notwithstanding the explicit treatment now given to benefits, it is my view that the ED (particularly paragraphs 214-218) gives lip service to benefits without substantively changing how the definition of control would be applied from the initial ED. Further, the ED does not adequately distinguish situations where similar levels of benefits may be present but different consolidation conclusions are called for.

Paragraph 216 argues that requiring a specified level of benefits "...would introduce irrelevant as well as arbitrary and unnecessary conditions for consolidation." Specific guidelines always are arbitrary to a degree, but the Board has used them often in order to cause reasonably consistent application of a given standard. Even if one acknowledges that specific guidelines would be at least somewhat arbitrary, I do not understand the Board's statement that they would be irrelevant or unnecessary. In fact, such specificity is necessary, in my opinion, to avoid the wide range of practice that will result from the subjective guidance in the ED.

Paragraph 217 notes that a general partner assumes risk for all partnership liabilities. And the paragraph goes on to assert that "There would be no economic incentive to control that type of entity if the controlling entity did not have at least an equivalent potential for deriving benefits..." It certainly is true that few organizations or people assume risk without the potential for offsetting benefits. But the Board seems to use these words to support recording the full amount of liabilities and assets of a limited partnership when the general partner's true economic risk may be quite limited and the offsetting benefits also are limited. Taken to its logical conclusion, this line of reasoning could lead to consolidation of all entities for which a reporting company has guaranteed indebtedness.

As I read the ED in its entirety, the notion of benefits plays almost no role. The Board seems to reason that if an entity is controlled, then there must be benefits arising from that relationship. Even if true, is that sufficient to justify including all of another entity's assets, liabilities, etc. in consolidated financial statements when only limited benefits may be possible? I'm not convinced that it is.

Some of the examples in Appendix A point out the problem. For example, management agreements can result in benefits to the manager that are quite similar to those received by a general partner in a limited partnership. However, in paragraph 66, the Board argues that managers don't control managed entities because a governing board can remove a manager. But the difference between that situation and the possibility of the general partner being removed in a limited partnership doesn't seem sufficient to result in dramatically different accounting. The illustration of a mutual fund manager in paragraphs 69-70 is another situation where benefits similar to the limited partnership are present but the Board reasons that control does not exist.

Operationality of the Definition of Control

The Board apparently believes that providing a general definition of control without further guidance probably would result in a great diversity of application in practice. It is unfortunate that the Board believes that the current practice environment demands such specificity. What I find most remarkable, however, are the assertions in the ED that the Board is convinced that consistency will occur with the guidance given. For example, paragraph 196 notes that, "The Board believes that those discussions (and, if necessary, consultations with others) usually will lead to

common understandings and ultimately to common application of this Statement's definition of control." And paragraph 236 states that, "...the Board is not convinced that this Statement will be applied in significantly different ways...."

My opinion is the opposite of the Board's - I believe common application is unlikely. However, that is obviously only a personal view based on my experience and the Board should receive more credible evidence from corporations that try to apply the draft guidance. Of course, if a company reads the ED and reaches a conclusion that it is comfortable it can obtain the answer it believes is correct from the wording presented, there may be no incentive for it to say anything further at this time.

I hope that individual corporations or their accounting firms will share with you specific examples where they try to apply the guidance in the ED to existing facts and circumstances. My expectation is that in many 50% or less ownership situations companies will reach the conclusion that control does not exist and consolidation is not required. But I also expect that Board members may disagree with some of those conclusions and believe that consolidation is required. Further, in the current environment of numerous good faith judgments being second-guessed by the SEC, I fully expect that the SEC would challenge those interpretations in many cases. Or, the SEC may become inundated with requests to pre-clear consolidation questions to avoid subsequent challenges.

Under Statement No. 94, there is a relatively bright line at which consolidation is required. Although there have been arguments about the effects of minority veto rights and some other practice problems, these issues have been worked out through the Emerging Issues Task Force. (The ED seems to incorporate these positions.) The ED contains so many "close calls" in the various illustrations and in the general language in the standard that much more diversity is almost certain to occur. This, of course, is only my opinion, but so is the Board's assertion to the contrary. In the final analysis, Board members have to ask themselves whether some amount of increase in the number of entities included in consolidated financial statements is worth the considerable cost involved in resolving all of the close calls in practice.

While there are several areas in the ED that seem to present opportunities to reach quite different judgments, one area that troubles me in particular

involves the percentage of shares voted at annual meetings. For example, paragraph 93 calls for consolidation to continue even when the number of shares now owned is less than the number voted at the last annual meeting. In other paragraphs the Board appears to conclude that if a company owns more than half of the number of shares typically voted at an annual meeting then control exists - a sort of "judgmental bright line." Paragraph 93 deviates from that general approach and suggests that once consolidated, always consolidated unless there is absolute assurance that control has been lost. I may be missing the point intended here, but I suspect others will as well unless even more explanation is provided.

Conclusion

As noted earlier, the Board has now been debating the control issue for well over a decade. Relatively early in my time there I remember a meeting where we discussed the project in an open meeting with SEC Commissioners. David Ruder was the new Chairman at that time. When we brought this matter up I recall Chairman Ruder saying something like, "Good luck - the SEC has been wrestling with the definition of control since the 1930's and we still aren't satisfied we've gotten it right." The FASB was convinced at that time that it "could get it right" but many years of subsequent debate have proven Chairman Ruder to be quite prophetic.

The FASB has spent far too much time on this project and few users of financial statements have expressed significant concerns about existing practices in this area. In keeping with the Board's strategic plan, this project should be discontinued and resources should be shifted to other projects of greater importance such as accounting for joint ventures.

Please let me know if you have any questions concerning the comments in this letter.

Sincerely,

A handwritten signature in cursive script that reads "Dennis R. Beresford". The signature is written in black ink and is positioned above the printed name and title.

Dennis R. Beresford
Executive Professor of Accounting

Copy: Mr. Ronald J. Bossio