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# Grant Thornton &

June 9, 1999

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Lucas:

We appreciate the opportunity to comment on the proposed Statement, Consolidated Financial Statements: Purpose and Policy. We support the FASB in its project to improve financial reporting for consolidated financial statements. However, we do not support the proposed Statement unless certain significant revisions are made. In addition, we suggest certain other modifications to the proposed Statement.

# Changes Needed to Achieve Meaningful and Consistent Application of Proposed Statement

# Significant Financial Interest

The most essential change affects one of the characteristics required for consolidation. The discussion of the control characteristic pertaining to benefits in paragraph 10(b) and elsewhere in the proposed Statement is vague and provides little guidance for determining when a benefit would satisfy the control characteristic. Does paragraph 10(b) mean that if one entity receives any type of benefit from its ability to exercise nonshared decision-making over another entity, the first entity should consolidate the other entity? We believe varied interpretations of paragraph 10(b) would result in different implementation decisions in practice for similar situations. Consolidation determinations resulting

from interpretations of paragraph 10(b) are also likely sources of contention between an entity's management and its independent auditor and/or the SEC staff.

In addition, consolidating the assets, liabilities, and profit or loss of another entity without having a significant financial interest in those attributes does not enhance financial reporting, or the usefulness of financial statements to investors, creditors, and other financial statement users. We therefore believe that, in addition to the parent's nonshared decision-making ability to guide the ongoing activities of its subsidiary, the consolidation decision should include a requirement that the parent have a significant financial interest in the subsidiary. A significant financial interest would exist if a parent derives significant benefits or incurs significant losses from the current and continuing operations of the subsidiary and has an interest in the residual value of the subsidiary. If consolidation is not appropriate because one entity does not have a significant financial interest in the other entity, the disclosure requirements of Opinion 18, *The Equity Method of Accounting for Investments in Common Stock*, may be appropriate.

#### Presentation Guidance

The examples of application of the definition of control to specific fact situations will be helpful in promoting consistent application of the guidance in the proposed Statement, particularly if they are expanded to illustrate application of the concept of "significant financial interest," as discussed above. However, to avoid diversity in the presentation of financial statements, a final Statement should provide presentation guidance for situations in which consolidation is required and the parent has only a small minority interest in the subsidiary's income or loss (the one percent sole general partner situation, if it is retained) and when consolidation is based on the parent's unilateral ability to obtain control through ownership of convertible securities or exercise of other rights, such as purchased call warrants.

# Specific Issues Identified in Exposure Draft

In addition to those two primary recommendations, we have additional concerns, discussed below, which should be addressed before issuance of the final Statement. The following comments address the specific issues raised in the Exposure Draft.

Issue 1: Definition of Control and Consistency in its Application
Issue 1 raises the question of whether the definition of control, the characteristics of control, and descriptive guidance help clarify when one entity controls another. The characteristic of control pertaining to guiding the ongoing activities of a subsidiary provides a more operational definition of control than the definition in the 1995 Exposure Draft. However, as discussed above, we don't think the guidance pertaining to the second characteristic of control concerning benefits is adequate.

Although the proposed Statement provides helpful guidance, we would expect consistent application of the definition of control to be difficult. This would result from entities assigning different weights to various factors involved in the concept of control. Reasonable parties could reach different conclusions. This is a serious concern because of the significance of consolidation—it affects the nature of the reporting entity.

The diversity in application could come in part from the inadequacy of the concept and guidance pertaining to the control characteristic related to benefits. Greatly enhanced guidance pertaining to that characteristic is essential for consistent application of the final Standard. The problem could also be mitigated by more explicit and detailed guidance, for example, the type of guidance provided in EITF Issues 96-16, "Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights," and 97-2, "Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements." This would be particularly helpful when control is being evaluated based on contract or other agreements or on the entity's formative documents, as well as in considering the rights of other parties, such as noncontrolling shareholders and limited partners.

### Issue 2: Rebuttable Presumptions

Issue 2 asks whether the rebuttable presumptions in paragraphs 18 and 21 provide a reasonable basis for presuming that one entity controls another.

We do not support the rebuttable presumption pertaining to a large minority voting interest in paragraph 18(b), although we believe a large minority voting interest is a situation that may indicate control exists. The burden of proof should be on the shareholder holding the large minority interest to prove that it has current and probable continuing control of the subsidiary.

We also believe additional guidance is needed to clarify what factors would overcome certain of the rebuttable presumptions.

There are situations when a rebuttable presumption of control would be appropriate when an entity holds a unilateral ability to obtain control through ownership of convertible securities or other rights. However, we recommend additional guidance in evaluation of such a rebuttable presumption:

• Probability Consideration: In addition to a cost/benefit consideration, the rebuttable presumption should include a probability consideration. It should be probable that the entity will exercise and hold the controlling interest or will do so if necessary to retain existing de facto control. For example, there may be an apparent cost/benefit to converting or exercising, but that may not be the

- security holder's intent because the underlying entity is not in the business the security holder is in.
- Not Temporary: The intention of conversion or exercise should be to hold the securities and control. Conversion or exercise, for example, of a purchased call, to realize immediate gain would have no relevance for consolidation. In such a situation, control, when obtained, would be temporary.

If a sole general partner in a limited partnership will derive significant benefits or incur significant losses resulting from the current and continuing operations and residual gains and losses of the limited partnership, consolidation of the limited partnership would be appropriate. Otherwise, such as in the case of a general partner receiving a fixed fee and holding a one percent partnership interest, consolidation of the partnership's assets, liabilities, and cash flows do not provide useful information to financial statement users, because the sole partner does not have a significant financial interest in the assets, liabilities, and cash flows.

#### Issue 3: Transition

The Exposure Draft would require significant changes in the nature of the reporting entity for some entities. To modify systems to accommodate such a change, particularly in the year entities are also modifying and testing systems to be prepared for the year 2000, would be a burden for many entities. We therefore recommend that the effective date of the final Statement be delayed one year to annual periods beginning after December 15, 2000.

#### Other Comments

# Not-for-Profit Organizations

The proposed Statement would apply to not-for-profit organizations, but little guidance is provided on application of the control concept to the special issues of not-for-profits. These organizations may not have voting members, may not have a board of directors, and may have complex affiliation arrangements with other entities. The proposed Statement would presumably supersede the existing guidance in SOP 94-3, Reporting of Related Entities by Not-for-Profit Organizations, without providing adequate guidance for applying the new pronouncement. For example, the section in the proposed Standard, "Assessing Whether a Relationship Involves Control" (paragraphs 15 to 23), does not address not-for-profit organizations. We suggest providing guidance in the Standard section of the proposed Statement similar to that provided in paragraphs 8 through 12 of SOP 94-3 and paragraph 57 of Appendix A of the proposed Statement. The guidance should not be focused on the 1987 Model Act, as many existing not-for-profit organizations were not organized under a statute based on that model act.

The guidance should address boards appointed by other entities, self-perpetuating boards, and control by other means, such as contract or affiliation agreements. The guidance should discuss a parent's ability to increase benefits and limit losses in the not-for-profit context, such as benefits that are not financial, but that relate to a subsidiary's contribution to its parent's mission. An example of that situation in Appendix A is also needed.

#### Combined Financial Statements

The proposed Statement does not address when combined financial statements should be required, which is a significant practice problem in preparing financial statements for affiliated private companies. We recommend that this issue be addressed by the FASB in either the current project or as a follow-on project after the consolidation issue is resolved.

### Special Purpose Entities

A significant reason that additional guidance on consolidated financial statements is needed is to provide improved guidance as it relates to special purpose entities (SPEs). The detailed illustrations of SPEs in Appendix A are helpful, but additional illustrations should be added. Examples of additional illustrations include an entity set up to obtain off-balance sheet treatment of financing or certain expenses and an entity used in a securitization of financial assets.

We would be pleased to discuss any of our comments with the Board or its staff. Please direct comments to Joseph Graziano, Director of SEC and Financial Reporting, at (212) 599-0100.

Very truly yours,

Grant Thornton LLP

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