

# Anthony (Buddy) Piszel Corporate Controller

**The Prudential Insurance Company of America** 213 Washington Street, Newark NJ 07102-3777 Tel 973-802-9398 Fax 973-802-9065

May 24, 1999

Letter of Comment No: 43
File Reference: 1082-194R
Date Received: 5/26/99

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P. O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed Statement of Financial Accounting Standards, "Consolidated Financial Statements: Purpose and Policy" (File Reference 194-B)

Dear Mr. Lucas:

Prudential appreciates the opportunity to comment on the Exposure Draft referenced above. We support the Board's objectives of improving the standards of financial accounting and reporting and recognize that the criteria for consolidation proposed in the February 1999 Exposure Draft (ED) seek to address situations where, under the guidance of current accounting literature, an incomplete financial presentation results from failure to consolidate entities where there is in substance a controlling financial interest.

However, we believe that application of the presumptions of control leading to consolidation under the proposed guidance, absent a test of significant economic interest, will compromise the overall relevance of the financial statements. We are also concerned that certain elements of the proposed guidance will be difficult to apply in practice, and recommend that the scope be clarified to exclude insurance company Separate Accounts based on their unique attributes. Lastly, we request that the Board consider modification of the proposed effective date and transition provisions in view of the need to collect significant new information in order to implement the standards and the timing issues relevant to "Year 2000" compliance of data processing systems.

Our comments and positions on some of the key issues in the ED are presented below.

#### Scope

The unique nature of life insurance company Separate Accounts was recently discussed by the FASB's Derivatives Implementation Group (DIG) in considering the accounting under Statement of Financial Accounting Standards No. 133 for variable life insurance and annuity contracts that are supported by Separate Accounts. Following review of background materials prepared by the AICPA's Insurance Companies Committee on Separate Accounts, the DIG concluded in Issue B-7 that traditional variable annuity contracts and the related Separate Accounts have "unique attributes" that are not analogous to other structures.

We also note that the Accounting Standards Executive Committee is addressing Separate Accounts as part of its project on accounting by life insurance enterprises for certain non-traditional long-duration contracts. We suggest that this project is the appropriate forum for the consideration of accounting for Separate Accounts in view of their particular attributes and that the ED should accordingly exclude these Separate Accounts from its scope.

## Assessment of Control

While we agree that there are situations in which control is present despite a current level of ownership of less than a majority of the outstanding voting shares of an investee, we believe that the concept expressed in ARB 51 and reiterated in FAS 94 that consolidated financial statements are "primarily for the benefit of shareholders and creditors of the parent company" should be paramount in the determination of which entities to consolidate.

In our view, the usefulness of financial statements to these constituencies (and to management) is best served by consolidation of only those operations over which there is a true controlling financial interest which implies substantive economic risks and rewards. We further believe that the consolidation based on the presumptions of control in paragraphs 18b and 18c of the ED, absent a clear demonstration of actual control and economic interest, will compromise the relevance of the financial statements to these users.

Accordingly, we suggest an approach that requires the reporting entity to evaluate whether situations of large minority ownership and convertible security positions imply effective control (as defined in paragraph 6a of the ED) and non-shared decision making ability (as defined in paragraphs 11a and 11b) in order to determine if consolidation is appropriate, rather than the presumptive approach proposed by the ED. Further, we believe that the presence or absence of economic interest in the controlled cash flows on the part of the parent company is essential to the appropriateness of consolidation and accordingly, that a substantive interest in risks and rewards of the investee be coupled with control as a condition for consolidation in these cases. While these tests will require

professional judgment, we believe this will be no more difficult to apply than many other evaluations required in practice and that the benefit of limiting consolidation only to entities for which it is appropriate outweighs the burden of this assessment.

We are concerned about the potential results of the presumption contained in paragraph 21 that control of a limited partnership rests with a sole general partner if "no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the limited partner." If a company assumes an economically insignificant general partnership interest in fee-based activities, perhaps coupled with a relatively minor co-investment interest, the standard of ability to increase benefits and limit losses under paragraph 10 may be satisfied and this presumption could result in consolidation with a 99% minority interest.

This consolidation of entities whose assets, liabilities and cash flows are not relevant to shareholders and creditors of the reporting entity may disconnect financial reporting from the business economics of the relationship, compromising the usefulness of the financial statements. Considering these fee-based asset management activities, we would question the premise of paragraph 217 that there is no "economic incentive to control" if there is not at least an equivalent potential for deriving benefits from an ownership or residual interest in the partnership assets. As discussed below under "Operational Issues and Practical Considerations," we also have concerns as to the ability to determine, at a given point in time, whether there is an "organized group" of limited partners that can act in concert to remove a general partner.

#### **Operational Issues and Practical Considerations**

We believe that, in cases where consolidation is required based on "presumed" control rather than an actual controlling interest (ie., majority ownership of voting shares or contractual control), there will be considerable practical difficulties in obtaining adequate financial information to permit the preparation of consolidated GAAP financial statements, including all required footnote disclosures.

For example, as discussed in paragraph 99 of the ED, a reporting entity may conclude that it must consolidate an investee based on the premise that it will be able to dominate an election and gain control in a future period. However, the investee would be under no obligation to furnish financial information required for the prospective parent company to prepare its GAAP financial statements, including all required disclosures, on a timely basis. Additionally, such an investee could not be compelled to adopt accounting policies that are consistent with those of the reporting company or to quantify the impact of any such differences in accounting policies.

If the reporting company is an SEC registrant, it will also require information for Management's Discussion and Analysis under Regulation S-K, Item 303 and Market Risk Disclosure under Regulation S-K, Item 305. While there may be contractual

arrangements requiring GAAP financial data sufficient to permit equity basis accounting, in many situations it may not be feasible to obtain the additional information required for a consolidated entity because it is not prepared by the investee and/or the investee cannot be obligated to provide it.

We also believe that certain elements of the proposed guidance will be difficult to apply in practice, or contain ambiguities that may increase diversity in practice and, as a result, reduce the comparability of financial statements from one entity to another.

In order to apply the guidance in paragraph 18(b) of the ED, which creates a presumption of control where an entity has a "large minority voting interest" and "no other party or organized group of parties has a significant voting interest," a reporting entity must determine whether or not there are such organized groups of voting interests. This may present great challenges in situations such as those involving institutional investors, where their intent and ability to collaborate on voting decisions is unclear. Also, we share the concern expressed by a Board member in paragraph 252 that reliance on the degree to which votes are "typically" cast may be inappropriate in cases where current or future circumstances are different from those in which the past voting patterns emerged.

The guidance in paragraph 18(c), which creates a presumption of control where an entity holds convertible securities that can lead to a majority voting interest or Board majority and the expected benefit from converting the securities exceeds the expected cost, could be interpreted to require consolidation in many situations where convertibles become "in the money" even if the investor has no intent to convert or gain control, or lacks the ability to do so as a result of cash flow or other considerations. In determining whether the presumed control under this criterion is supported or contravened by facts and circumstances, we believe that financial statement preparers will need to consider these intent and ability issues and may reach inconsistent conclusions from period to period for a particular entity. Additionally, convertible securities may move from "in the money" to "out of the money" from one period to another for reasons unrelated to control, such as interest rate changes, causing this presumption to operate inconsistently.

In order to apply the guidance in paragraph 33, a reporting company with a "large minority" holding where there is wide dispersion of all other voting interests, must evaluate whether it can "dominate the process of nominating and selecting" the members of the investee's Board. It may be difficult to judge whether or not the reporting company can dominate such a process, and this judgment will require assumptions as to the behavior of third parties that may not be possible to evaluate objectively and may lead to diversity in practice. For example, if more than one party solicits proxy votes from the shareholder population at large, will each of those parties need to evaluate its probability of success in dominating the process? Could more than one party conclude that consolidation is required?

We concur with the statement in paragraph 41 of the ED that the distinction between shared decision making powers and limits on a parent company's discretion in exercising control "may be obscure in practice" in various joint venture and partnership situations, particularly those involving a limited number of institutional investors. While there may be no veto powers, as a practical matter decisions on major transactions may be developed by consensus and the preparer of financial statements will need to decide whether the would-be "parent," as a non-majority investor, could effectively act without such a consensus.

In order to determine whether a general partner has control of a limited partnership under the guidance of paragraphs 63 and 64, a reporting company must evaluate the ability of the limited partners to remove the general partner, considering whether there are "numerous and widely dispersed limited partners." This may be difficult to interpret in practice, especially where the limited partners are institutions rather than individuals and may be motivated to act in concert under certain circumstances that may or may not be reasonably possible in a given reporting period. For example, if results of a limited partnership become unfavorable, an unrelated group of institutional investors that might have been considered "widely dispersed" may seek to act together to remove the general partner, if the appropriate rights are present.

## Effective Date and Transition

The proposed requirement that the new standards be implemented for annual periods beginning after December 15, 1999, and that the implementation commence during the first quarter of the year of adoption, causes us to be concerned as we consider the need to assure that data processing systems are Year 2000 ("Y2K") compliant. We expect the implementation of the new standards to require significant systems modifications, including the development of data "feeds" to incorporate financial data for perhaps a large number of newly-consolidated entities.

Considering the comprehensive regulatory reporting requirements facing life insurance companies, the National Association of Insurance Commissioners ("NAIC") has adopted a "Year 2000 Compliance Moratorium Resolution" which states that the NAIC "will refrain, to the extent possible, from adopting or recommending an effective date during the time period from July 1, 1999 to June 30, 2000 in any model laws or regulations, accreditation standards, annual statement instructions, or other NAIC matters that would require regulated entities to devote resources significant enough to impede their ability to achieve substantial Y2K compliance." We understand that the SEC has announced a similar moratorium on the implementation of new SEC rules that would require major reprogramming of computer systems by SEC-regulated entities between June 1, 1999 and March 31, 2000.

In view of the difficulties that will be faced in attempting to obtain the required data during a short period of time, compounded by these Y2K concerns, we request that the Board consider a one year delay in the required implementation date.

We understand the benefits of comparability that result from restatement of previous financial statements as proposed by the ED. However, we note that in addition to basic financial statement data, this would require a reporting entity to obtain information sufficient for restatement of all required footnote disclosure and other disclosure as mentioned above, such as Management's Discussion and Analysis, that must be consistent with the consolidated financial statements. As a practical matter, this data may not have been prepared for prior periods by the newly consolidated entities, who may not have been subject to public reporting requirements, and may involve significant time and expense to reconstruct.

Accordingly, we request that the Board consider an approach such as that contained in Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information," which provides in paragraph 34 that where changes in organizational structure cause reportable to segments to change, restatement of information presented for prior periods is required "unless it is impracticable to do so" with appropriate disclosure.

We would be pleased to discuss our comments with you, other members of the FASB staff, and Board members.

Sincerely,

Bully Visge