



American Council of Life Insurance

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Actuary

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Proposed Statement of Financial Accounting Standards, "Consolidated Financial Statements: Purpose and Policy" (File Reference No. 194-B)

Dear Mr. Lucas:

The Committee on Generally Accepted Accounting Principles (the "Committee") of the American Council of Life Insurance ("ACLI") took the opportunity several years ago to submit a comment letter on the previous Exposure Draft ("ED") issued in October 1995. Since then, it has closely followed developments in the FASB's project on consolidations and appreciates the opportunity to comment on the Board's current proposals. The ACLI is the principal trade association for life insurance companies, and its 493 members represent, in the aggregate, approximately 85 percent of the assets of all domestic life insurers.

While the Committee is supportive of the Board's mission to improve standards of financial accounting and reporting, we are concerned that while the criteria for consolidation proposed in the February 1999 ED may resolve what some view as egregious practices under existing literature, we believe the overall relevance of the financial statements in most cases will be compromised by presumptive consolidation absent demonstrated evidence of control and significant economic interest. Presented below are the Committee's comments and positions on some of the key issues in the ED.

SCOPE

In the Committee's comment letter on the 1995 ED, we suggested life insurance company Separate Accounts be specifically excluded from the scope of the proposed Standard on consolidations. The unique nature of Separate Accounts very recently was discussed by the FASB's Derivatives Implementation Group ("DIG") in the context of addressing accounting under Statement of Financial Accounting Standards ("SFAS") No. 133, *"Accounting for Derivative Instruments and Hedging Activities,"* for variable life and annuity contracts supported by Separate Accounts. That discussion followed the DIG's review of background materials on Separate Accounts prepared by the American Institute of Certified Public Accountants' ("AICPA") Insurance Companies Committee. As a result, the DIG concluded in Issue No. B-7 that traditional variable annuity contracts and the related contract-approved Separate Account investment options had *"unique attributes"* that should not be used as an analogy for determining the accounting under SFAS 133 for seemingly similar structures. We believe those unique attributes produce the same result in the context of the proposed consolidations model as they are not analogous to any of the economic relationships addressed or illustrated in the ED.

Additionally, and as the Board is aware, the Accounting Standards Executive Committee of the AICPA currently is addressing Separate Accounts as part of its project on accounting by life insurance enterprises for certain non-traditional long-duration contracts and for Separate Accounts. We suggest that project is the more appropriate forum for full deliberation of issues related to Separate Accounts. Accordingly, we recommend the scope of the final Standard be clarified to specifically exclude Separate Accounts.

CONTROL OF A SUBSIDIARY

Assessing Whether a Relationship Involves Control

Corporations

In the October 1995 ED, the Board had proposed to presume control coincident with ownership of a large minority voting interest approximating 40%. While we agree with the Board's elimination of that specific arbitrary percentage threshold in the current consolidations proposal, we continue to challenge the overall approach with respect to corporations that would replace an objective, verifiable ownership test that generally requires more than a 50 percent voting interest, with a subjective evaluation of the situations identified in paragraph 18 (b) and (c). Consistent with our expression of views on the 1995 ED on consolidations, we most likely could support an approach that would result in consolidation of less-than-fifty-percent-owned entities when control *clearly* is present. In fact, for public companies, this requirement already exists in Securities and Exchange Commission ("SEC") Regulation S-X Rule 3A-02. However, we believe it is inappropriate to presume control exists in the situations identified in paragraph 18(b) and (c) until it has been conclusively proven or demonstrated. While it may be true in certain fact patterns that control as defined in paragraph 6(a) may exist before it is proven or demonstrated, on

balance, we would be more troubled by the proposed presumptive guidance that could lead to consolidation when control does not exist.

In place of the presumptive approach to the situations identified in paragraph 18(b) and (c), we believe an assertive approach, taking those situations into consideration, would be more appropriate. An assertive approach would charge management with the responsibility for making appropriate assessments about the ability to control through large minority voting positions and for determining whether actions taken with respect to convertible securities provide compelling evidence of the presence of control. We believe that approach will, in practice, result in consolidation of controlled entities that are less than majority-owned, without compromising the conceptual integrity of the Board's document.

Partnerships

In the Committee's comment letter on the 1995 ED, we objected to consolidation of a limited partnership by a general partner having only a small equity interest. Use of the equity method of accounting by a general partner having a non-substantive residual equity interest in a limited partnership has been accepted practice for many years, and we do not believe that users of financial statements have pressed for change. We believe the resulting "*gross-up*" in the financial statements for the assets, liabilities, revenues, expenses, gains and losses relating to the 99 percent "*non-controlling*" interest is inappropriate as it would seem to result in reducing rather than increasing the usefulness of the affected financial statements.

Consistent with our views as expressed above in regard to corporations, the Committee also objects to the general presumption that control resides with the sole general partner in a limited partnership. We share the views expressed by one Board member in paragraph 255 of the ED that the powers of a sole general partnership interest obtained for a nominal investment may be substantially similar to those of a manager until such time as the limited partners may choose to "*test*" the general partner's ability to control the partnership. Consequently, we believe the preponderance of relationships between a sole general partner and the limited partners in limited partnership structures in which the sole general partner has only a nominal financial stake will possess many of the same characteristics as the relationship between the manager of a mutual fund and the fund and for which the proposal would not require consolidation by the fund manager.

Ability to Increase Benefits and Limit Losses

Although the power to control, the level of ownership interest, and the flow of benefits oftentimes are interdependent, business structures exist that disconnect those relative relationships. In fact, in paragraph 10 of the ED, the Board recognizes "*those interrelated characteristics generally stem from a single source....but they may stem from multiple sources.*" In those situations, the absence of a "*level of economic benefits threshold*" could result in consolidation when the ultimate net cash inflows or outflows from those assets and liabilities do not inure substantially for the benefit of, or detriment to, investors in the *parent*

company. We believe that result would be contrary to the purpose of consolidated financial statements as expressed by the Board in paragraphs 7 and 8 of the ED.

The Board's conclusion with respect to the purpose of consolidated financial statements affirms the conclusion of Accounting Research Bulletin No. 51, which states they are "...*primarily for the benefit of the shareholders and creditors of the **parent company**....*" [emphasis added]. We believe inclusion of a separate condition for consolidation that would require the controlling entity to possess a certain level of economic benefits would be more consistent with the stated purpose of consolidated financial statements and better serve the needs of the primary users. Furthermore, that approach more appropriately would result in consolidation of less than majority owned, controlled entities only if the parent company is exposed to a majority of that entity's net cash flows.

It is our understanding that many respondents to the three FASB documents on consolidations preceding this ED – that is, the Discussion Memorandum, Preliminary Views, and 1995 ED – advocated that control *plus* some specified level of economic benefits together should be the basis for requiring consolidation. Paragraph 215 of the ED indicates those respondents posed suggestions for determining when "*enough*" benefits would be present to require consolidation, such as (a) majority of benefits, (b) majority of risks and rewards, and (c) significant (more than de minimus) risks and rewards or economic benefits. It is our understanding those suggestions were rejected, in part, as being too subjective to be made reasonably operational in practice. We would suggest, however, the level of guidance and professional judgment for determining the appropriate level of benefits to require consolidation, would be no less subjective or onerous than proposed by the ED for determining the existence of control. Furthermore, we believe the benefits of introducing into the consolidations proposal either an arbitrary bright-line test (i.e., more than 50%) or additional subjectivity with respect to the level of economic benefits would provide a higher level of "*general acceptability*" for consistent application and far outweigh the "*cost*" of reporting irrelevant, and perhaps misleading, information in the primary consolidated financial statements.

TEMPORARY CONTROL OF A NEW SUBSIDIARY

While the Committee continues to support retention of the temporary control exception to consolidation, we also continue to assert that, in certain situations, the proposed one-year disposition window will burden the financial statements with information not central to the reporting entity's ongoing operations.

The example in the Committee's comment letter on the 1995 ED is still relevant. A creditor in a troubled debt restructuring might receive a majority voting equity interest in an entity in full satisfaction of existing debt instruments, accompanied by proportionate representation on the board of directors to facilitate implementation of the work out plan. Although the creditor thus becomes the controlling party, we do not believe that consolidation is meaningful in such a situation. The intent of the creditor is to recover its "*loan*" from the operations and ultimate disposal of its now "*unintentional subsidiary.*" Work out plans

typically demonstrate management's intention to exit the operations in a 3-5 year period. Accordingly, we believe that the proposed definition of "*temporary control*" should include the situation described in this paragraph.

The Committee also continues to recommend that the Board consider broadening its proposed definition of "*temporary control*" to distinguish investments from subsidiaries. It appears that the Board's proposal might bring into consolidation merchant banking portfolios not consolidated under current practice of most investment banking operations. Although the investment banking entity clearly might be the controlling entity, we do not believe that consolidation would be meaningful for those equity positions because they are intended to be held for investment purposes and ultimately disposed of for profit rather than integrated into the operations as a subsidiary of the investment bank.

OPERATIONALITY

We believe there will be practical difficulties in obtaining adequate financial information to permit the preparation of consolidated financial statements in accordance with Generally Accepted Accounting Principles ("GAAP"), including all required footnote disclosures, for entities that are required to be consolidated as a result of presumed control rather than actual controlling interest. 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 currently 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 preparer 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, there may be many situations where the additional information required for a consolidated entity cannot be obtained 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:

- The 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,*" as stated in paragraph 18(b) of the ED, would require a reporting entity to determine whether or not there are such organized groups of voting interests, which 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 (end note 2 to paragraph 18 (b)) may be inappropriate in cases where current or future circumstances are different from those in which the past voting patterns emerged.

- The 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, as stated in paragraph 18(c) of the ED, may imply a requirement to consolidate in many situations where convertibles become *"in-the-money"* but 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.
- Paragraph 33 of the ED indicates that a *"large minority"* holding together with wide dispersion of all other voting interests, may be indicative of *"control"* (leading to consolidation) if the entity can *"dominate the process of nominating and selecting"* the members of the investee's Board. This subjective concept may lead to diversity in practice as judgment is applied as to who can dominate such a process, and requires assumptions as to the behavior of third parties that may not be possible to evaluate objectively. 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.
- Paragraphs 63 and 64 of the ED indicate that determination of whether a general partner has control of a limited partnership depends on 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

We would anticipate that implementation of new consolidation standards will require significant systems modifications, including the development of data "*feeds*" to incorporate financial data for perhaps a large number of newly-consolidated entities. 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. Given the comprehensive regulatory reporting requirements facing life insurance companies, the National Association of Insurance Commissioners ("NAIC") has adopted a "*Year 2000 Compliance Moratorium Resolution*." This resolution 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 these Y2K concerns, which compound the general concerns relative to obtaining the required data during a short period of time, we request that the Board consider a one year delay in the required implementation date.

The Committee supports the FASB's recognition of the pervasive and complex nature of Y2K readiness issues, as evidenced by the Board's very recent decision to expose a proposal to delay the effective date of SFAS No. 133. While our recommendation to defer the proposed implementation date of new standards on consolidation policy closely follows the timing of the Board's action to delay the effective date of SFAS No. 133 and for substantially similar reasons as related to Y2K matters, we believe those reasons have equal merit and relevance in the context of this ED. We are concerned that "*makeshift*" systems designed in an attempt to accommodate new standards on consolidation policy prior to closure of Y2K matters could result in less-than-adequate implementation and reporting of financial information produced by systems not adequately tested.

With respect to transition, while we understand the benefits of comparability that result from restatement of previous financial statements as proposed by the ED, 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, which may not have been subject to public reporting requirements, and may involve significant time and expense to reconstruct. We request that the Board consider an approach such as that contained in SFAS No. 131, *"Disclosures about Segments of an Enterprise and Related Information,"* which provides in paragraph 34 that where changes in organizational structure cause reportable 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.

Very truly yours,



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