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Letter of Comment No: 159 File Reference: 1082-154

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

Dear Tim:

In the attached comment letter, we have described the consolidation issue that I discussed on the phone with you a couple of weeks ago. The letter also includes a couple of other matters concerning the Exposure Draft.

Sorry we could not get the letter to you by the comment period deadline. However, we thought the issue might be of interest to the Board in its redeliberation of the Exposure Draft, and so thought a letter at this late date might still be useful.

Sincerely,

Edward E. Nusbaum **National Director**

Accounting and Auditing

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File Reference No. 154-D

Dear Mr. Lucas:

We appreciate the opportunity to comment on the FASB's Exposure Draft, Consolidated Financial Statements: Policy and Procedures.

Definition of Control

In theory we support the concept that control should be the basis of consolidation, but the definition of control in paragraph 10 of the Exposure Draft is too broad and will result in unintended and misleading results.

If control as defined in paragraph 10, whether legal or effective, is not combined with an interest in the economic benefits of the controlled entity—

- it could be misleading in some cases to include the assets and liabilities of the controlled entity in the financial statements of the controlling entity
- in some situations, consolidating the controlled entity would not improve financial reporting.

The following situations, which are included as presumptions of effective control in paragraph 14, could result in consolidating the assets and liabilities of controlled entities when the controlling entity does not necessarily derive an economic benefit from its ability to direct the assets of the controlled entity, resulting in an overstatement of the resources of the controlling entity:

- general partner of a limited partnership
- holder of sufficient convertible securities to obtain unilateral control through conversion

Mr. Timothy S. Lucas Financial Accounting Standards Board File Reference No. 154-D

• unilateral ability to dissolve the entity.

Even if control is legal control resulting from a majority ownership of voting stock, if the controlling entity does not exercise control and does not receive economic benefit from its interest in the subsidiary, consolidating the subsidiary results in misleading financial statements. In certain industries, Company A may establish a wholly owned subsidiary as an accommodation to Company B (an entity with which Company A does business), because for tax reasons, Company B cannot control a subsidiary. Typically, Company B directs the use of the subsidiary's assets and receives all but a nominal amount of the economic benefits of the subsidiary. However, Company A's control over its subsidiary is not limited by the Articles of Incorporation or other agreements or contracts. Under paragraph 10 of the Exposure Draft, Company A has elected not to exercise its control over the subsidiary, but should nonetheless consolidate it. Including the assets and liabilities of the subsidiary in the consolidated financial statements of Company A does not provide useful information to users of Company A's financial statements. shareholders of Company A receive almost no benefit from those assets and are not likely to in the future, because the subsidiary is, in substance, a vehicle for certain operations of Company B. This set of facts is unusual, yet it is one example of an actual corporate structure that, under the accounting proposed in the Exposure Draft, would result in a misleading presentation. There are no doubt other examples where, as described in paragraph 10, a controlling entity delegates its control or elects not to exercise it, and if that situation is combined with the controlling entity receiving an immaterial amount of the economic benefit of the controlled entity, consolidation is misleading. A remedy for this situation is to require that control be coupled with significant economic benefit, such as benefit from directing the use of the assets or a share in the net profit.

The illustrated situation is a case in which requiring consolidation when legal control exists can result in financial statements that distort the substance of a reporting entity. Such situations are even more likely to occur if consolidation is required because of the existence of presumptions of control listed in paragraph 14 or indicators of control described in paragraph 158. If consolidation is based on effective control, there should be evidence that effective control can be maintained for a meaningful period. Otherwise, control may be temporary; consolidation, followed by potential deconsolidation resulting from circumstances beyond the control of the "controlling entity," does not provide useful information to investors. For example, the holder of a large minority voting interest may be required to consolidate the entity whose securities are held. If the holder decides to try to redirect use of the assets of the investee so that their use is more advantageous to the investor, other shareholders may organize to gain control of the investee. The result would be that effective control was illusory and deconsolidation would be necessary. The requirement to consolidate because of a presumption of control should be coupled with evidence that the investor can direct use of the assets and control is likely to be retained for a reasonable period. Thus presumptions and indicators of control must be coupled with an economic interest and the likelihood that the situation of control is not likely to be temporary.

Mr. Timothy S. Lucas
Financial Accounting Standards Board
File Reference No. 154-D

Presentation of Noncontrolling Interests in Subsidiaries

The presentation of minority interest in the financial statements is problematic. The current method of presenting it as something between a liability and shareholders' equity is neither clear nor satisfactory. However, it is not misleading. It does not overstate total shareholders' equity.

A preferable presentation would be to change the caption of the stockholders' equity section if some subsidiaries are not wholly owned. The section would become, for example, Stockholders' Equity and Unowned Equity in Subsidiaries. Stockholders' equity would be presented as under current GAAP, with a subtotal for total stockholders' equity. That subtotal would be followed by a separately captioned line item, such as Unowned equity in subsidiaries. The total amount, including noncontrolling interests in subsidiaries, would be captioned, for example, as Total stockholders' equity and unowned equity in subsidiaries. Such a presentation would retain the presentation of an amount of stockholders' equity that is comparable among entities regardless of whether they own less than 100 percent of some subsidiaries. It also makes it possible to determine ratios using stockholders' equity without problems of defining whether such equity includes unowned or uncontrolled interests in subsidiaries.

Sincerely,

Edward E. Nusbaum National Director

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