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Mr. Timothy S. Lucas  
Director of Research and Technical Activities  
Financial Accounting Standards Board  
File Reference No. 194-B  
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Dear Mr. Lucas,

**Re: Consolidated Financial Statements: Purpose and Policy (dated February 23, 1999)**

We appreciate the opportunity to comment on the FASB's Exposure Draft of the Proposed Statement of Financial Accounting Standards entitled *Consolidated Financial Statements: Purpose and Policy* (hereinafter referred to as the "Exposure Draft").

We do not support the issuance of a final standard based upon the revised Exposure Draft for the following two major reasons.

First, we believe that the proposed standard would increase diversity in practice and reduce the comparability and transparency of financial statements while providing little useful guidance for resolving the difficult and contentious consolidation issues relating to joint ventures and special purpose entities. While we agree with the Board's efforts to incorporate the use of judgment in the proposed standard, we are concerned that the approach in the Exposure Draft does not take into account the dynamic environment in which these issues arise and in which they are resolved.

In the vast majority of cases, the question of whether an entity should consolidate or be consolidated by another entity is not controversial under current consolidation standards and it will not be controversial if the Exposure Draft is issued as a final standard. However, the effectiveness of a new standard should not be measured by the extent to which it enables preparers of financial statements to resolve routine consolidation problems. Rather, the test of the effectiveness of a new standard should be the extent to which it provides practical guidance that preparers can apply confidently and



consistently to address and resolve the non-routine consolidation issues. Some of these issues arise with respect to transactions and entities carefully structured to achieve a desired accounting result – be it consolidation or non-consolidation. Measured against this standard, we believe that the proposed Exposure Draft will be found to be deficient and ineffective.

Consolidation of one entity by another is, by definition, an all or nothing proposition. While the examples appended to the Exposure Draft provide useful guidance with respect to the Board's intended application of the new standard, their ultimate usefulness is likely to be limited in practice because of their inherently static nature. The environment in which investment structures and entities are engineered to achieve a specified consolidation result is dynamic and interactive. Based on our experience in addressing consolidation problems under the existing standards, the difficult consolidation issues that preparers of financial statements and their auditors face relate not to whether an existing entity should be consolidated or not consolidated but, rather, to the nature and extent of changes that need to be made to an existing or to-be-formed entity to produce the opposite result. Under these circumstances, we believe that the Board's efforts to replace so-called bright-line tests with judgment-based fuzzy-line tests will fail to produce the intended result. Instead, we predict that this approach will lead initially to inconsistent application of the standard and routine second-guessing of judgments by regulators only to be followed by increased rule-making by lower level standard-setters in an effort to restore more bright-line type guidance to reduce diversity in practice.

Second, we agree control should be a necessary condition for consolidation. We also agree that the proposed definition of control in the revised Exposure Draft represents an improvement over the definition in the previous Exposure Draft because it places the focus of consolidation policy on control of the entity itself and not on the entity's assets. However, we continue to believe that the proposed presumptions of effective control in the revised Exposure Draft are not operational because they ignore the inherent nature of control and they include a logical inconsistency.

The inherent nature of control over an entity is that it only matters when there are conflicts or disagreements among interested parties about the future policies or strategies to be pursued by the entity. Only if one shareholder or partner can resolve such conflicts unilaterally by imposing its will on the entity, notwithstanding the active opposition of all other interested parties, can that party be said truly to control the entity. This simple truth leads us to the conclusion that control over an entity should be

presumed only when one party has the unilateral legal right or the currently exercisable unilateral ability to obtain the legal right to impose its will on the management and/or governing board of the entity with respect to its future financing and operating policies.

In our view, there should be no room in the definition of control for a notion of “effective control” that depends upon the assumed continuing forbearance or apathy of a party or parties holding the majority voting interests in an entity. In that regard, we agree with the statement in paragraph 31 of the revised Exposure Draft that a “parent need not demonstrate its decision-making ability to possess that ability.” However, we fail to understand why that same statement should not apply to every other group of shareholders that, collectively, holds a majority voting interest in the entity, including shareholders who do not bother to vote as long as they are satisfied with management’s performance. We encourage the Board to remove this logical inconsistency from any final standard by eliminating the presumption of control based on the holding of a large minority voting interest.

Furthermore, we do not understand why the results of previous shareholder votes should be presumed to be indicative of future votes. If this presumption is not eliminated, we are concerned that entities could be in and out of consolidation based solely on the level of interest shareholders have in the election of the entity’s governing body. We do not believe that changing shareholder voting patterns should trigger consolidation any more than we believe that increased shareholder participation should result in deconsolidation. We are particularly concerned in this regard because the convergence of powerful and inexpensive communication technology (e.g. the Internet) is already altering the ability of outside shareholders to communicate with each other and to act in concert in ways and to a degree that we cannot possibly foresee at this time.

Our response to the specific questions asked in the Exposure Draft and other comments are attached.

Very Truly Yours,

KPMG LLP

## **Response to Specific Questions Asked in the Exposure Draft and Other Comments**

### **Issue 1:**

We agree that the revised definition of control is an improvement over the definition in the previous Exposure Draft. However, as stated in our reasons for not supporting the approach in the revised Exposure Draft, we do not believe it will result in consistent application of the proposed consolidation policy.

Additionally, we continue to believe that: Control demonstrates that a parent-subsi-dary relationship exists. Significant ownership gives the parent's stockholders a beneficial interest in the subsidiary (i.e., the right to share in profits, receive dividends, and recover one's investment through resale of stock or liquidation of assets). The existence of both control and significant ownership justifies combining the assets, liabilities, revenues, expenses, gains and losses of the subsidiary on a line-by-line basis with those of the parent in consolidated financial statements.

### **Issue 2:**

We agree that operational guidance must be provided in a consolidation standard to achieve its effective application. However, as stated in our reasons for not supporting the approach in the revised Exposure Draft, we do not believe the presumption related to effective control is appropriate.

We agree that operational guidance to deal with disguised control is necessary and that the presumption that involves the unilateral ability to obtain a majority voting interest or obtain a right to appoint a majority of the corporation's governing body is an appropriate start. However, this presumption needs to be more fully developed. Additional guidance is needed for the "benefits and expected costs consideration" and how that provision will not result in periodic changes of the consolidation/non-consolidation conclusion. Additional guidance is also needed for the "currently exercisable" condition since the period of convertibility/exercisability can be delayed and available at different times and under different conditions.

We agree that there is a need for additional operational guidance to deal with non-corporate arrangements. The proposed presumption involving a single general partner in a limited partnership is a step in the right direction. However, unless this

presumption is combined with a requirement that the general partner hold a significant beneficial interest in the limited partnership, in many instances, we believe that a standard requiring a general partner to consolidate its limited partnerships will significantly reduce the transparency and usefulness of the consolidated financial statements of the entity acting as the general partner from the perspective of the entity's shareholders and creditors without improving the usefulness or transparency of the information provided to the limited partners (who would receive separate financial statements on their individual partnerships in any case).

Consider the following example:

Company A is in the business of raising capital to be invested in real estate or equipment to be leased to others. A subsidiary of Company A acts as general partner in a series of limited partnerships formed by Company A and capitalized with limited partner equity. This subsidiary contributes \$100 to each limited partnership in exchange for its one percent general partner interest. The general partner's interests in the profits and cash flows of the partnership increase to 20 percent after the limited partners have received a specified minimum compound return on their equity investment.

Another subsidiary of Company A acts as manager of the assets acquired by the limited partnership. As such, this subsidiary acquires assets, arranges financing, leases and releases the assets to users, bills and collects rentals, pays debt service, property taxes insurance and maintenance expenses, maintains the books of the partnership, prepares tax returns and provides periodic financial statements to be distributed to the limited partners and to creditors. Any financing arranged is without recourse to the general partner.

Company A and its subsidiaries' revenues consist entirely of syndication fees, property acquisition and leasing fees, management fees and incentive fees all paid by the limited partnerships in which it acts as general partner. Under these circumstances, we agree with the observations of the dissenting Board member expressed in paragraph 255 of the Exposure Draft that this general partner is nothing more than a manager for the limited partners.

However, if the limited partnerships are included in the consolidated financial statements of the entity that owns the general partner, all of the revenue information that is relevant to an understanding of the financial performance of the manager would be "eliminated" in consolidation against the corresponding expenses of the limited partners.

The resulting consolidated financial statements would provide a hopeless jumble of information concerning the combined financial position and operating results of the limited partnerships in which the owners and creditors of the parent entity and its subsidiaries have almost no direct interest. Such financial statements would be of little use to the real users of those statements, i.e. the shareholders, creditors and prospective investors and creditors of the entity. We fail to understand how such a result could ever represent progress in financial reporting.

Finally, we believe that the issues surrounding the questions of when and why an entity should consolidate another entity formed solely to facilitate a single transaction or activity are among the most important that this consolidation project was designed to resolve. However, we do not believe that the proposed guidance and examples in the Exposure Draft with respect to SPEs are adequate to address the serious need for meaningful guidance in this area. It should be apparent by now, given the Board's recent experiences in trying to develop operational guidance with respect to the consolidation of SPEs formed to facilitate securitization transactions, that SPEs pose a unique and different set of problems that do not lend themselves to traditional analysis and solutions. Yet it appears to us that the analyses accompanying the examples in the Exposure Draft ignore this basic fact.

Based upon our reading of the "reasoned judgments about control" articulated in those examples, in many instances, the conclusion to consolidate or not to consolidate a given SPE appears to turn primarily on the inclusion or exclusion of provisions or rights in the transaction documentation that have little substantive relevance to the owners and creditors of an entity that, whatever its governing documents do or do not say, exists for the sole purpose of facilitating a single transaction or activity between or among entities. If we are correct in our reading of the examples, we predict that the proposed standard will provide what amounts to a free choice with respect to the consolidation of SPEs - i.e. those who want to consolidate a transaction will include or exclude the appropriate provisions and those who do not want to consolidate will do the opposite, confident in either case that the inclusion or exclusion of the magic language will have little or no practical economic effect on the transaction in which they are planning to engage. We fail to understand how such a result could ever be described as an improvement in financial reporting.

**Issue 3:**

We believe the effective date should be changed to fiscal years beginning after December 15, 2000. The later effective date is necessary because of the need to not interfere with dealing with the unexpected year 2000 problems that may arise and to allow entities time to obtain information and make the necessary judgments to apply the standard as of the start of a fiscal year. We recognize that this probably will be the amended effective date for calendar-year entities for Statement No. 133. Although it would be better not to have two (or more) major standards with the same effective date, there does not appear to be a way to avoid that situation.

We also suggest that additional guidance be provided concerning the “plan to relinquish control” and that the “likely to occur” condition be changed to “probable to occur.”

**Other Comments**

**Not-for-Profit Organizations**

We believe that the definition of control set forth in the Exposure Draft is operational for most not-for-profit organizations when considered with the information included in the implementation guidance and the examples. However, we believe that certain matters related to the examples should be addressed to make them more useful to not-for-profit organizations and practitioners. In general, the examples need to be clearer in differentiating between the key facts supporting the determination to consolidate or not to consolidate and the less relevant information.

As we indicated in our comment lettered dated January 15, 1996, we believe that the discussion of federations, membership organizations and other associations needs to be clarified. We believe that the Exposure Draft makes certain presumptions about the nature of the relationships of these types of organizations that are not always valid. Paragraphs 77 and 78 could be read by many of these types of organizations as a general exemption from consolidation. We recommend inclusion of additional examples that result in consolidation based on an evaluation of specific facts and circumstances.

Although we noted that paragraphs 127-129 were revised from the previous Exposure Draft, we still do not agree with the conclusions reached in Example 6. Paragraph 58 indicates that existence of self-perpetuating boards generally would not lead to consolidation. However, Example 6 seems to contradict that conclusion. Paragraph 128

indicates that the composition of the initial Board suggests that the university would continue to dominate the foundation even with subsequent boards. The conclusion in paragraph 128 is based on the assumption that the initial Board would elect like-minded future Boards; therefore, the university would remain in control. We believe that all self-perpetuating boards would do the same thing; therefore, we believe that the apparent inconsistencies between paragraphs 58 and 128 need to be reconciled. We do not believe that there is strong evidence of control through the appointment of the initial Board without the ability to appoint members in the future.

As we indicated in our comment letter dated January 15, 1996, we believe that the conclusion in Example 10 is incorrect and is inconsistent with the guidance in the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations* (Guide). Example 10 would have the not-for-profit organization record charitable remainder trusts at the net amount that the not-for-profit organization will receive as the remainderman; however, the Guide indicates that the total assets held should be recorded together with a related liability to the income beneficiary. We believe that, even considering the duty that the not-for-profit organization owes to the income beneficiary, the not-for-profit organization controls the trust. We also do not understand the reasons for including paragraph 164 as we do not believe the situation described in that paragraph exists in practice.

We also recommend that the Board consider including examples relating to the creation of a political action committee by a trade association and the creation of a foreign affiliate by an international not-for-profit organization.

#### **Interaction with Other Authoritative Literature**

A final statement should be clear in how it relates to, supersedes or amends other authoritative literature such as Statements of Position and Guides issued by the AICPA and the various issues addressed by the EITF. Additionally, example 5 should discuss Statement No. 68 and examples 7 and 8 should discuss Statement No. 13 and EITF Issues 90-15 and 96-21.

#### **Procedures Related to Paragraph 18; Presumption C**

Application of the presumption related to convertible debt or the ownership of options or warrants presents a number of business combination and consolidation procedure questions. These need to be fully identified and guidance provided.

### **Potential Modification of Other Literature**

Statement No. 109 paragraph 33 addresses investment in a “more-than-50-percent-owned domestic subsidiary.” This paragraph effectively uses this description to address a control type notion. If control is changed in a final consolidation statement, the guidance in Statement No. 109 probably should be modified.

APB Opinion No. 18 uses ownership of 20% of voting securities as a presumption of significant influence. If a final consolidation statement uses convertible debt and options and warrants to determine control, the guidance in APB Opinion No. 18 should also be reconsidered.

### **A New Standard Will Not Eliminate Accounting Engineering**

In dealing with accounting standards that result in an all or nothing treatment (one entity is consolidated or not, a lease is an operating lease or a capital lease, revenue is recognized or not.), the structuring of arrangements or transactions to achieve a desired accounting result is inevitable. The structuring is not wrong nor is it preventable. Replacing a consolidation standard that has a more bright-line approach for a more judgment-based approach that is based on a difficult judgment area will not eliminate the effort to create structures that are very close to the “all” decision or the “nothing” decision. Therefore, we disagree with the comments suggesting that a standard that uses a bright-line approach is inferior to a standard that does not use such an approach.

### **Guidance Needed for When to Evaluate Whether Control Exists**

Although paragraph 9 states that consolidation should begin at the date control is acquired or otherwise obtained and should cease when it no longer exists, it is not clear when the judgment that leads to consolidation or deconsolidation should be made. We do not believe the comments in paragraph 16 are adequate. We hope that the intent is not to have the consolidation policy be applied such that there will be frequent switches between consolidation and non-consolidation. Also, if there are switches, procedures for accounting for the switches should be developed.

### **Subsidiaries or Affiliates**

We believe the term “subsidiaries” should be used in place of the term “affiliates” in paragraphs 7 and 8. Otherwise stand-alone subsidiary financial statements would appear to be precluded since the subsidiary’s parent would need to be included in the financial statements.