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May 25, 1999

Letter of Comment No:
File Reference: 1082-194R
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Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No. 194-B (Exposure Draft – Revised) – Consolidated Financial Statements: Purpose and Policy.

Dear Mr. Lucas:

3M is pleased to have the opportunity to comment on the aforementioned ED that was issued by the Board on February 23, 1999. We strongly object to the Board's continued pursuit of a consolidation standard based upon control without a concurrent requirement for an ownership interest.

We believe that control and level of ownership are two separate and necessary conditions of consolidation. The draft is troubling to us because there is no explicit requirement for the controlling entity to have a significant equity interest in the subsidiary. If there is no, or a small, equity investment, there may be an irresistible temptation to consolidate amidst questionable fact patterns. How do management and investors distinguish between assets they legally control (and can use without restriction) versus those that are not legally owned? As an analogy, we believe proportional consolidation is an oxymoron; you shouldn't consolidate cash or investments that you don't legally control.

The draft has moved the consolidation threshold from an easily understandable one (majority ownership) to where the "yes" or "no" consolidation decision is based on less tangible considerations. Present practice arguably works because there are clear guidelines. Instead of the philosophy of the ED, the FASB should provide needed guidance for any situations not in existence or contemplated at the time ARB 51 was developed (e.g., special purpose entities, joint venture arrangements and strategic business alliances) rather than continue the protracted and inconclusive dialogue with its various constituencies as to what constitutes "control."

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From the September 1991 DM to publication of this ED, seven and one-half years have elapsed. We think this long gestation period is instructive about the complexity and ambiguity that will confront preparers and their auditors.

Further, we think that consolidation policy will become the third module in a triumvirate of questions directed to, and guidance requested from, the SEC Staff and the Board. We predict the level of activity will rival that for business combinations and derivatives – a level that has allegedly frustrated the SEC Staff for years in the former case and helped justify a one-year extension on the effective date of the latter. We would urge you to form a consolidation-policy implementation group comparable to the DIG and prepare for substantial demands on your staff's resources.

#### **Issues with the Definition of Control**

The ED attempts to marshal logic to support its conclusions using both simplistic summaries and complex illustrations. For example, paragraph 195 makes the point that "The Board understands that objective, quantifiable criteria may be easier to apply in practice, but to consolidate a controlled entity that is 51 percent owned and not consolidate another controlled entity that is 49 percent owned does not result in comparability." It's hard to argue with the two-point spread when control exists in both cases. Contrast this easy example with the very detailed Example 5 in Appendix A. Here there is so much detail that we are uncertain what information is critical to the assessment of control and what is not. The need for interpretative guidance will be driven by the "gray scale" in the shape of a bell curve – the 49% control situations will be at the beginning and end of the curve, leaving you and the SEC to deal with a host of issues.

Paragraph 18 provides that the existence of control shall be presumed if an "entity has a large minority voting interest in the election of a corporation's governing body and no other party or organized group of parties has a significant voting interest." On EITF Issue 96-16, the Task Force agreed to clarify that an assessment of the probability that a minority shareholder will exercise their veto right is *not* relevant in determining whether participating rights have substance. If the FASB agrees with this point, then it is illogical for control to rest on the presumption that other parties will remain passive, not become organized into more cohesive groups, or vote with more frequency.

We simply can't embrace the concept of negative assurance – "that there is no evidence that demonstrates that Company C does not have the ability to dominate the nomination and election of directors of Company D." Consolidation should rest on the ability to control, supported by confirming evidence, and not on presumptions and expectations with regard to future events.

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The FASB should define some of the operational considerations as to when the assessment of control will be made - as of the date of the financial statements? When they are issued (we assume this is the date of filing with the SEC)? And on what basis does management represent (see discussion in paragraph 91) to its auditors that "there is no evidence or reason to believe that any group is attempting to obtain a controlling interest or to mobilize existing shareholders to vote against Company A's nominees?"

On the issue of convertible securities or other rights that are currently exercisable at the option of the holder, what are the parameters for registrants to prove that the benefits of converting those securities or exercising those rights exceed the cost of doing so? What guidance does the Board intend to provide regarding the potential volatility in the fair value of convertible securities from general conditions in the financial markets, interest rate changes, or company specific factors?

Some of the discussion/rationale raises questions for us. As an example, paragraph 11(b) provides that a parent's decision-making power must be the non-shared ability to "hold the management of that other entity accountable for the conduct of its ongoing activities . . . generally by having the power to select, terminate, and determine the compensation of the management responsible for carrying out the directives of the parent". Paragraph 40 then describes a potential illustration wherein the majority owner grants another party the right to veto candidates for the COO position. Control still exists if the majority owner still has the non-shared ability to hold the management accountable for the conduct of the corporation's on-going activities - by having the ability to appoint an interim COO as an example. While arguably intellectually correct, we believe assessment of the facts and circumstances in these situations will become inordinately arduous tasks for both preparers and auditors.

Paragraph 44 postulates that the ability of others to veto increases or (reductions) in the compensation of a subsidiary's management "would not by itself contravene this Statement's definition of control if the potential parent is otherwise able to hold that management accountable . . ." How can the requirement for non-shared decision-making ability as described in paragraph 11 then be diluted as in these examples without contravening the definition of control? We believe the draft is slicing and dicing the concept of control into narrower and narrower snippets that will not meet the objective of providing a sufficiently clear basis for making measured judgments in practice.

Beginning in Paragraph 11, and expanded in paragraph 45, there is a discussion of the parent's decision-making powers. We strongly recommend that FASB incorporate into the text of the Standard its philosophy on participating and protective rights. Some components of protective veto rights are discussed in the footnote 7 to paragraph 45.

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Because the relationship between control and non-controlling-interest veto rights is so important, we believe participating and protective rights ought to be explicitly listed and fully discussed in the body of the Statement and not in the footnotes.

# **Temporary Control**

The footnote to paragraph 24 indicates that the Statement does not require that a formal plan exist on the acquisition date. We think this Statement should either leave the provisions of ARB 51 in place (see next paragraph) or should not be issued until the limited-scope project addressing the implementation of the provisions of SFAS 121 is completed and issued. The current language in paragraph 24 is not acceptable.

We believe that the definition of temporary control in the amendments of paragraphs 2 and 3 of ARB 51 remains highly persuasive: "if control is likely to be temporary or it does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy or operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary." Absent these kinds of contingencies, we think the only basis for not consolidating a newly acquired subsidiary should be a legally enforceable/binding obligation to relinquish control within one year.

Following one or more periods of consolidation, does commitment to a plan to relinquish control require de-consolidation?

- \* If not, what is the rationale for allowing commitment to a plan to preclude consolidation but not require de-consolidation?
- \* If yes, this logic is asymmetrical with paragraph 9: "Once a subsidiary is consolidated, it shall continue to be included in the consolidated financial statements until the parent ceases to control it." (This language infers that some action has been taken or transpired versus having a plan approved and in place).

We also remain unsure of the outcome of the current debate over whether management approval of a plan can create a liability - in restructuring for example - or drive a consolidation decision. Finally, if the Board wishes to stay with the commitment-to-a plan concept, we suggest that the Standard specifically address how this relates to an APB 30 approach.

## **Special Purpose Entities**

In paragraph 242, we read that "Although the Board decided that it would be desirable to

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expand on the guidance provided by this Statement's examples, it concluded that it was not necessary to craft presumptions of control specifically targeted at the varied and complex circumstances surrounding special-purpose entities." How is that different from the varied and complex circumstances surrounding regular entities as evidenced by all the detail in Example 5? We believe the Board's original insight ("expand on the guidance provided by this Statement's examples") was correct and the final conclusion has left gaps in the guidance which the Board and staff will spend months dealing with in the future.

Further, we believe that the Board should require unique disclosure, short of combined financial statements, where the activities of an entity result in the residual benefits of those activities accruing to the entity's creator or sponsor. The Board has not marshaled significant logic to convince us that defining "creator or sponsor" is any more difficult than defining control without ownership.

## **Disclosure**

Has the Board completed its work on disclosure requirements? Other than the stipulation in paragraph 27 that the financial statements in year of adoption shall disclose the effect of any restatement, we found no disclosure requirements. We would think that entities would have had to disclose the basis for the "presumptions" supporting the existence of control. Put another way, when consolidation takes place based on control, with less than 50% ownership interest, will disclosure of the "evidence" be required?

#### In Conclusion

If control is not majority ownership or a management contract, we submit that diversity in practice is likely to grow rather than be mitigated. We believe that promulgation of a new Standard based on the contemplated definition of control will only be another challenge to the ingenuity of preparers, financiers, lawyers, and investors involved in formulating corporate structures.

Sincerely,

Ronald G. Nelson

Vice President and Controller