

May 19, 1999

Letter of Comment No: 36
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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

File Reference No. 194-B

Dear Mr. Lucas:

McDonald's Corporation is disappointed with the FASB's Exposure Draft on consolidation policy. We do not believe that the direction the Board is pursuing represents an improvement over the current, objective practice that generally requires the consolidation of an entity controlled through voting rights or their equivalent. In our view, an existing fundamental accounting standard such as ARB No. 51, *Consolidated Financial Statements*, should be revised only if there is an overwhelming rationale for change. In this case, we believe not only is there no rationale for change, but there are compelling accounting and economic reasons for opposing the proposed rules.

If the Board decides to go forward with this project, there are practical accounting implications of the proposed rules that we believe need reconsideration. The Board has proposed that "a parent shall consolidate each entity that it controls . . ." and has defined *control* as "the ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities." The Board has also indicated that one of the essential characteristics of control is that a company must have the nonshared decision-making ability "to:

- a. Direct the use of and regulate access to another entity's assets . . . , and
- b. Hold the management of that other entity accountable for the conduct of its ongoing activities, including the use of that entity's assets, generally by having the power to select, terminate, and determine the compensation of the management responsible for carrying out the directives of the parent."

The effect of all of these changes to the existing accounting literature would be to replace a consistent objective approach that has been used for over thirty-five years with a highly subjective evaluation regarding a company's ability to direct the policies and management of another entity. In fact, in paragraph 41, the FASB acknowledges that while the distinction between a parent-subsidary relationship and a joint venture, in which two or more partners share the decision-making powers, is clear in concept, this distinction may be obscure in practice. We agree that it would be obscure in practice and feel this will undoubtedly lead to diversity of practice in determining whether to consolidate an entity. Clearly, this would not enhance the financial reporting model that exists today and most likely would confuse users of financial statements due to the lack of comparability between companies.

The proposed rules also establish certain situations that would lead to a presumption of control. One of these situations, noted in paragraph 18b, is where 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." Since the term "significant" is not defined, there will likely be various interpretations in determining whether to consolidate an entity. In addition, we do not believe that this condition provides sufficient evidence to presume that control exists.

For example, the footnote to paragraph 18b indicates that if typically 60% of eligible votes are cast in the election of directors, a minority holding of 35% would be deemed large and presumably the 35% holder would consolidate the investee. We do not believe that consolidation would be appropriate in this circumstance since the party owning 35% can still be outvoted on all issues by the other shareholders. This would surely seem to indicate that the 35% owner does not, in fact, have control and, therefore, consolidation accounting would not be appropriate. The proposed rules assume that public shareholders are a disorganized group with no power or authority. We disagree with this presumption as there have been numerous examples of public shareholder groups that band together *when necessary* to achieve a specific strategic objective.

In addition, future voting patterns cannot be assumed to be the same as historical voting patterns. If shareholders agree with the current voting patterns being cast, they may have little reason to vote. However, if an important matter was subjected to a vote and the shareholders felt strongly about the matter, they would likely vote to express their views. Therefore, the party owning a 35% interest does not have the nonshared decision making ability to guide the ongoing activities of the other entity, because the control that the party is currently experiencing only exists as long as enough other shareholders support the decisions made by it. In other words, it does not have the unilateral authority to make decisions and be assured that those decisions will be carried out even if the other 65% of shareholders disagree with the decisions.

We also disagree with paragraph 18c, which indicates that control should be presumed if one party has the ability to obtain a majority voting interest through ownership of convertible securities or other rights that are currently exercisable at the option of the holder, and the expected benefit from converting or exercising those rights exceeds its expected cost. We do not believe that control exists until the rights are actually exercised since the party is not able to

direct the policies and management of an entity merely by holding the securities. We believe it is the conversion of the securities or exercise of rights that results in a change of control. In addition, applying a provision such as determining when the expected benefit exceeds its cost is highly subjective and could result in changes from year to year in a given circumstance. Does this mean that an entity could consolidate another entity in one year and not consolidate that same entity the next year if the expected benefits no longer exceed its cost? This provision will undoubtedly lead to diversity in its application and will not enhance the quality of financial reporting.

These two presumptions of control do not appropriately recognize or differentiate between a company having influence over another entity and the company having control over that same entity. We believe the equity method of accounting, as currently practiced, sufficiently and accurately reflects the consolidated operations and financial position of companies who own less than 50 percent of the voting stock of another entity.

Beyond the accounting flaws in the proposed rules, there are also economic reasons for opposing the rules. Today, many sophisticated analysts and investors as well as many businesses are utilizing shareholder value measures to evaluate company performance. These valuation techniques focus on the combination of earnings performance and the efficient use of assets. As a perspective, we have been informed that over 50% of our institutional investors are "discounted cash flow" or "asset value" investors. The techniques these investors use, which include discounted cash flow analyses, return on assets, and economic value added, are based on the logical assumption that a company's income stream is produced by the related assets. For these measures to be meaningful, a company's capital investments must be appropriately matched with the related income generated by those investments.

If an investor was to consolidate an entity in which it only maintained a minor investment percentage (i.e., less than 50 percent), the consolidated balance sheet would include all of the investee's assets while the consolidated income statement would only reflect the investor's portion of the investee's income (after minority interest). These situations, which would become very common under the proposed consolidation rules, could severely distort a company's effectiveness in managing its assets and would hinder the practicability of shareholder value measures. This would result in a major step backward in the usefulness of economic analysis of companies' performance. While this situation exists today for majority-owned subsidiaries that are consolidated, they would become more prevalent under the proposed rules. Under the current equity method of accounting, the income earned from an investee is related to the investment recorded on the investor's balance sheet, therefore, the accounting treatment appropriately correlates to the economic substance.

Overall, while we agree with the Board's desire to provide relevant, reliable and comparable financial information that is helpful in assessing an entity's financial position and performance, we do not believe that the proposed rules accomplish this objective. We believe there may be a need to provide additional guidance for certain situations that were not contemplated at the time ARB 51 was issued, such as special purpose entities, limited partnerships and other complex

arrangements. However, any guidance contemplated should specifically address these narrow issues as opposed to trying to fix these issues by applying broad rules that will result in subjective interpretation and application and, therefore, unintended consequences.

Notwithstanding our lack of support for the direction of the project, we have a significant concern should the Board elect to proceed. The Exposure Draft indicates that the proposed Statement shall be effective for financial statements for annual periods beginning after December 15, 1999 and all interim periods in the year of adoption. Since the comment period deadline is the end of May, a final statement would likely not be issued until the third quarter this year. There will inevitably be companies that will have to consolidate entities not previously required to be consolidated. In these circumstances, various financial information will change and this may result in the need to amend debt or other contractual agreements, which could be a significant burden. Accordingly, we believe that implementation of a new Statement needs to provide at least one year to allow companies to evaluate the impact of the proposed Statement and make any necessary changes to existing agreements.

In summary, as we have discussed above and consistent with our previous letter in 1996, we do not believe the proposed rules on consolidation policy represent an improvement over current practice and, accordingly, we strongly oppose these rules. The subjective nature of the proposed rules could cause situations where an entity is consolidated in one year and de-consolidated the following year and this clearly would not enhance the quality of financial reporting. We believe the existing guidance that has been practiced for over three decades provides a consistent and logical framework to address accounting for consolidations and these rules provide the appropriate information to users of financial statements. If the Board wishes to provide additional guidance in certain areas, the guidance should specifically address only those narrow issues rather than attempt to apply broad rules that will result in unintended outcomes.

McDonald's Corporation appreciates the opportunity to voice our opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

A handwritten signature in cursive script, appearing to read "Chris Pieszko".

Chris Pieszko
Senior Vice President and Controller