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Director of Research and Technical Activities
Financial Accounting Standards Board
407 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference 194-B

Dear Sir:

Following are GE's comments on the Exposure Draft (ED), *Consolidated Financial Statements: Purpose and Policy*.

This project should be dropped.

Some of us reside in an accounting world that is struggling with inadequate resources, inconsistent regulators, exponential complexity and incredulous management. Into this world, you are threatening to launch a difficult and ambiguous pronouncement that will drag a fairly straightforward set of display decisions into the hopeless sea of complexity in which income taxes, securitizations and financial instruments are foundering.

Let us stipulate that consolidations is an area in which financial statement users are badly served. We do not believe this to be the case, but we stipulate that for purposes of this discussion. In that case, what would we recommend? The best answer, clearly, is for the Board to leave existing guidance in place.

A more sweeping consolidation answer is not required in the current circumstances. Indeed, what the ED threatens is two adverse outcomes – consolidation of entities that should not be consolidated, and confusion as to whether or not a given relationship requires consolidation. If the Board must change practice, the change should at least build on and reconcile itself to EITF 96-16, as we have discussed below.

Ideally, a Statement on consolidations should be one that management can understand in less than 30 minutes, and on which we can have informed debate, reaching conclusions that have better than a coin toss chance of surviving regulator review. Perhaps it is pride of authorship, but we believe that EITF 96-16 marginally meets that criterion. The ED is not close. In our view, the ED's principles are so vague that the judgments of preparers are likely to be reversed frequently by both auditors and regulators – with obvious negative consequences for financial reporting.

To our distress, one can infer from language in the ED that this likely eristic is intentional. Paragraph 196 provides a view of how the Board envisions the we and our management will spend our futures:

The Board acknowledges that occasionally an entity's managers and others assessing the circumstances will differ in their initial interpretations of facts and circumstances surrounding a potential control relationship. However, in those circumstances, discussions among those parties usually leads (sic) to better understandings of those facts and circumstances and about how each of the parties weighed the various factors. The Board believes those discussions (and, if necessary, consultations with others) usually will lead to common understandings and ultimately to common application of this Statement's definition of control

We trust that the Board understands that folks just have better things to do than to hold discussions that, at best, usually lead to common understandings.

Finally, although it is unclear how these questions will ultimately be decided, we believe that consolidation of entities that are not legally controlled will become an embarrassment to the financial reporting world. We have discussed these and other significant flaws with the ED below. Our responses to specific issues are provided in Attachment 1.

Definition of Control

We believe that the definition of control is internally inconsistent and is not operational. The ED states that control embodies a parent's ability "by itself" to make the decisions that guide the ongoing activities of another entity. Yet a key presumption of control stated in paragraph 18 is that an investor that has a large minority voting interest is presumed to control its investee. The former condition requires the unilateral ability to enforce the parent's will on the subsidiary – no matter what anyone else does. The latter requires that the "parent" can enforce its will on the subsidiary so long as the majority investors are apathetic. These are two very different concepts. The voting percentage test in footnote 2, while admirable in its simplicity, completely fails in the case in which it is important – that is, when the minority interest is trying to acquire some disproportionate advantage from the relationship.

EITF 96-16 provides a comprehensive framework for resolving issues related to the impact of minority veto rights on control, including specific examples of participating and protective rights as well as a basis for assessing whether participating rights are substantive. Little of this guidance is carried forward in the ED, much to the detriment of the ED. We are also confused

about the future status of EITF 96-16. We would have expected it to be superseded, but footnote 7 raises significant doubts. Two points:

- We believe that the idea of “decisions in the ordinary course of business” has proven to be critical in determining whether veto rights are participating or protective.
- We are perplexed that the idea of “participating” rights was dropped from the ED. We understand that the Board did not intend to change the basic conclusions under EITF 96-16, but sought rather to use Conceptual Framework terms. While that is perhaps gratifying for the Board, a more appropriate goal would be a Statement that constituents can understand and apply with confidence.

Simply, we see no reason that the ED should not use all of the guidance in EITF 96-16 as is. To do otherwise, as the Board has attempted, imposes substantial costs on entities to reconsider their previous decisions under EITF 96-16 and will almost certainly lead to different consolidation answers.

Presumptions of Control

Paragraph 18 provides a list of presumptions of control, including circumstances in which an entity has the unilateral ability to gain control through the exercise of convertible securities. The ED assumes that if the expected benefit from conversion/exercise exceeds the expected cost, the implied “parent” has the ability to make decisions that guide the ongoing activities of the faux subsidiary. That paragraph further states that in the rare case in which one entity has legal control while another entity has the unilateral ability to gain control through such devices, the latter party should be presumed to be in control, absent “conclusive” evidence to the contrary.

We strongly object to this conclusion. Accounting for hypothetical events (exercise of the conversion feature to gain legal control) is a course that undermines financial statements, with no discernable improvement in reporting results. In fact, these potential circumstances for which we shall be forced to account often will never occur. Consider that there are a number of reasons why a company like GE might hold options, warrants or convertible securities of another entity. Obtaining control over that entity’s activities is rarely high on the list. GE Capital Services (GECS) will sometimes obtain options or warrants in connection with commercial lending and structured financing transactions as a means to participate in a debtor’s upside potential, thereby enhancing financing yields. However, GECS has never exercised such an option in order to obtain voting control of the debtor. GE also has used convertible securities as a means to facilitate possible future business transactions – with no guarantee that those deals would ultimately occur. Two recent examples of such transactions may be instructive:

- In connection with the negotiations regarding the potential divestiture of a significant voting interest in GE Sub A, a wholly-owned subsidiary and operating division of GE, GE Sub A issued a 2.9% four-year convertible debenture to Possible Partner B. As a result of the transaction, GE benefited from below-market financing and, if converted, GE Sub A would be engaged in a promising joint venture. Possible Partner B obtained the unilateral ability to acquire a controlling voting interest in GE Sub A as well as certain participating rights upon

conversion, which would allow it to broaden the scope of its business in a new strategic direction. The benefits of conversion to Possible Partner B were dependent, in part, on the occurrence of regulatory events unrelated to the debt transaction, which were expected to be resolved favorably. If the ED had been in place, we would have concluded that those future events were essentially certain to occur – otherwise the business purpose for the transaction would have been suspect. Four years later, those regulatory events did not materialize, and the debt was repaid by GE Sub A. The conversion feature expired.

- As part of a financing package for Troubled Co, a public enterprise in financial distress, GECS obtained call options for a controlling interest in Troubled Co. Without the rescue package, Troubled Co faced a long and difficult path through bankruptcy, from which it was unlikely to surface as a viable entity. As part of the financing package, the call options provided a fair potential return for GECS. As Troubled Co's financial situation improved, GECS negotiated a settlement with management and terminated the call options.

Although the application of the ED's requirements in both of these cases is difficult to assess with certainty (since we have not engaged the dialectic), we believe it is likely that the ED would have required GE's deconsolidation of GE Sub A and consolidation of Troubled Co. In neither case would the financial statement presentation – or the subsequent reversal of that presentation – have made sense to users. In neither case did actual decision-making change as a consequence of the financing deals. We believe that these examples illustrate that there is a significant difference between holding a security that provides the potential to gain legal control and holding a majority voting interest that provides actual control. It seems obvious to us that the only meaningful presentation is consolidation based on actual control, not hypothetical positions.

Other Implementation Issues

If the ED's approach is pursued there will be many difficult implementation issues that will need to be resolved. For example:

- How does one assess whether the benefits of conversion exceed the costs? Do we infer correctly that paragraph 16a requires this assessment be made every time the percentage of the conversion feature changes, for example, when stock options are exercised by employees of Target? Example 1 implies that every SAB 51 transaction triggers reassessment. This constant state of reevaluation imposes costs on preparers that may be far from nominal. Even if the Board decides to impose these costs, the reevaluation expectations need to be spelled out more clearly than they are in the ED's paragraph 16a.
- How should earnings of the faux subsidiaries be allocated between the parent and non-controlling interests? Should the current ownership percentage or the pro forma percentage be used? If the pro forma percentage, are distributions to real share owners of this hypothetical earnings a cost? What if that pro forma percentage is contingent, and thus not set until some future date?
- Should securities that are convertible into a significant but noncontrolling minority interest require equity method accounting under APB 18? If not, why not?

We also believe that the financial reporting implications of the ED's presumptions of control are adverse. Given that most, if not all, of the positions affected by this pro forma analysis are derivatives, the Board has apparently decided that financial statement users are better served by consolidation than by marking these derivatives to market through income – a very curious conclusion. Certainly, consolidation will be used to avoid mark-to-market provisions of Statement 133. We trust that the Board will enlighten us as to its thinking on this result given its oft-stated commitment to fair value accounting.

If the effects of consolidation of faux subsidiaries on the income statement, balance sheet and notes are confusing, the information provided by the statement of cash flows is worse. Seldom will the "parent" have legal rights to even a portion of such cash flows except by selling or liquidating its interest. Yet, a user of financial statements will realize this only upon the parent's having difficulty. Historically, the SEC has been quite concerned about restrictions on capital flows within a consolidated entity that are not visible to investors in the parent company. Consider the specter of parent company insolvency with cash flow positive subsidiaries from which payment of dividends requires exercise of a warrant, then election to the Board of Directors, then declaration and payment of a dividend. Without further information, consolidated financial statements containing this cash flow will be very strange. The SEC's enactment of Rule 4-08(e) of Regulation S-X addressed this issue by requiring registrants to provide extensive disclosures about dividend restrictions. We envision that similar requirements will be necessary for entities that are consolidated under the hypothetical exercise provisions of the ED. Indeed, this is one more example of our case that consolidation is a mixed benefit.

Application to Qualifying Special Purpose Entities

We believe the Board has inadvertently created confusion about consolidation of qualified special purpose entities (QSPEs). It will certainly be a surprise to most constituents that the ED will require consolidation of assets for which SFAS 125 prescribes sale treatment. We acknowledge that the Board has considered this issue in defining the scope of the ED, as paragraph 232 of the ED states:

[T]here is no basis for presuming that substantially all entities with limited purposes or lives could not be controlled entities. Moreover, the Board believes it would not be evenhanded to provide an exemption to certain types of entities merely because difficulties may be encountered in assessing whether they are controlled.

But surely this important issue deserves to be tackled more directly by the Board. We understand that the Board intends to address the QSPE issue through its amendment of SFAS 125. We believe that the appropriate way to resolve the current state of affairs is to exclude QSPE's from the scope of the consolidations project and thus to continue the guidance in EITF Issue 96-20 until such time as the SFAS 125 amendment is finalized.

Temporary Control

The ED establishes a “bright line” of one year for a plan of disposition to be completed except when the delay is attributable to circumstances beyond management’s control. The underlying conclusion for non-consolidation in this case is that the acquirer does not intend to retain the entity in question. This is a good decision by the Board, but its limitations are less than persuasive. We urge that the one-year limit be extended to include any business that will be disposed of in one year. As we have stated previously, users have but one interest in these businesses – how much cash will they bring and how soon. If there is a secondary issue, it surely has to do with whether management made the correct decision in electing the disposition. But assessing the undifferentiated operations of such a business in the consolidated whole is impossible, and the Board’s commitment to consolidating these irrelevancies is perplexing.

Quality of the Exposure Draft

The ED falls short of the Board’s historically admirable writing standards. The ED is repetitive, confusing and internally inconsistent on critical concepts. By the Board’s own admission, the extraordinarily complex examples are loaded with extraneous facts that leave the reader wondering whether different such facts would lead to different conclusions. At best, users will ignore the extraneous information, wasting only time. At worst, they will mistakenly use those facts in reaching an erroneous decision about control. If the Board proceeds with this project, we urge that the document be rewritten from scratch with the sole objective of clarity. Although we care deeply about what the answer is, we care even more deeply about being able to reach a defensible decision – and the ED is far short of that objective.

One final thought. The Board should use extreme caution in interpreting responses to this ED. Reading and analyzing this ED requires significant time and effort, and we suspect that too few will have undertaken that effort. One cannot, of course, presume what positions those who did not respond would have taken, but a high level of skepticism about whether responses are indeed representative of views is in order for this ED.

I shall be pleased to answer any questions on our views.

Sincerely,

Philip D. Ameen

Attachment 1 Responses to Specific Issues

Definition of Control and Its Implementation Guidance

Issue 1: Does the revised definition, together with the discussion of the characteristics of control (paragraphs 10–14) and descriptive guidance (paragraphs 15–23 and 30–47), help clarify when one entity controls another entity? Will the revised definition and guidance lead to common understandings and application of this Statement’s definition of control?

We are confident that we can find justification for our consolidation decisions – whatever they are – in the swamp of this document. Sadly, we are equally confident that auditors and regulators will find equally compelling support for different positions. This ED is the worst conceivable outcome, and one that the Board simply cannot afford.

Issue 2: Will guidance in the form of rebuttable presumptions of control be necessary? Do the circumstances described in each of the situations above provide a reasonable basis for presuming that one entity controls another entity in the absence of evidence that demonstrates or proves otherwise? Are they sufficiently clear and operational? Are additional presumptions of control necessary for specific circumstances? (If so, please identify those circumstances.)

We think appropriate presumptions have potential. However, the proposed algorithm for convertible securities and the proposal for assigning “control” to minority positions based on historic shareowner apathy fall considerably short of appropriateness. These presumptions inevitably are going to lead to consolidation of positions that would be much better accounted for on the equity method, and, yes, even at market value under Statement 133. You will appreciate how little appeal the ED’s approach has when it reduces us to endorsing fair value as a preferred alternative.

Transition and Implications for Interim Reporting

Issue 3: Are the benefits of complete and comparative financial statements for all interim periods in the initial year of application sufficient to justify requiring, rather than permitting, that the provisions of this Statement be applied for the first and each subsequent interim period in the year of adoption? Are there specific circumstances surrounding the application of this proposed Statement that would justify delaying its application to interim periods in the year of adoption?

Given that consolidation affects disclosures as well as the financial statements, we believe it would be usual for enterprises to apply this Standard first to a full set of financial statements. That approach seems to be permitted in the ED, and thus the ED’s position is acceptable to us. Perhaps we are just fatigued from the wearisome journey through this

incredible document, but the third sentence of paragraph 26 has yet to register. How does one restate the financial information for the period of adoption?