UNITED TECHNOLOGIES

United Technologies Building
Hartford, Connecticut 06101
203/728-7000

Letter of Comment No: 101
File Reference: 1082-154
Date Received: 1/18/96

January 15, 1996

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

Re: File Reference 154-D

Dear Sir:

We appreciate the opportunity to respond to the Exposure Draft (ED), Consolidated Financial Statements: Policy and Procedures. We believe, however, that the ED is trying to solve a problem that does not exist. While additional guidance on the criteria for consolidation under existing GAAP would be useful, we believe this ED goes well beyond any real or perceived deficiency in current practice. In trying to accommodate too many ownership interests in consolidated financial statements, the ED loses a principal audience, that being the parent company's shareholders.

The Board is radically changing the reporting entity from one owned by the parent's shareholders to an enterprise concept with no single ownership constituency. This includes reporting minority interest equity in shareowners' equity and related net income in total reported income. It also includes significant changes in the criteria for reporting gains and losses on sales of subsidiary interests and in purchase accounting for step acquisitions.

We believe the presentation of minority interest on the balance sheet and income statement is a real sleeper in the ED and has been obfuscated in the Board's communications preceding the ED and in the ED itself. For example, the Notice for Recipients in the ED says, "This proposed Statement sets forth standards for when entities should be consolidated and how consolidated financial statements should be prepared." We note with dismay that there is absolutely no mention in the Notice for Recipients of the fundamental changes in the reporting entity and, the related impacts on recognizing gains and losses on sales of investments and on purchase accounting for step acquisitions that are contemplated in the ED. We seek assurances from the Board that the investor and security analyst community has been appropriately apprised of this result and their input, as users of financial statements, has been fully considered.

Because of these fundamental changes, we strongly recommend that the Board satisfy itself that financial statement preparers and users understand the full scope of this ED. For the same reasons, <u>we believe it may be necessary for the Board to circulate a second ED before issuance of a final pronouncement</u>.

In addition to the general comments above we have the following specific on particular areas of the ED.

DEFINITION OF CONTROL

Existing GAAP presumes control when there is ownership of a majority interest absent certain other circumstances. An improvement to existing GAAP would be an extended enumeration of facts and circumstances that are evidence in support contrary to such a presumption.

The provisions of the ED suggest that where ownership of less than a majority interest presumes effective control absent a significant interest by another party or organized group of parties. We agree that the determination as to whether to consolidate an entity should not be solely formula-based. However, we believe the ED fails to address a number of existing facts and circumstances which are determining factors in assessing control. Consequently, the ED leaves wide latitude for subjectivity which will result in inconsistent application and incomparable results.

For example, while effective control may exist when there is ownership of less than fifty percent, such control is often <u>tenuous</u> and based only on the other owners' continuing satisfaction with the controlling party's performance. Additionally, a change in the composition of the other owners could impact the "controlling" party's power. Consequently, a need to deconsolidate an entity would depend upon the actions of other owners. That would seem to be <u>evidence of lack of control</u>. Therefore, the decision to consolidate when there is less than majority ownership must be undertaken with great care and should only be made when it is determined that such control is <u>permanent</u> enough in nature so as to permit consistent results over a substantial period of time.

The determination of control can also be complex in the reverse situation where majority ownership is greater than fifty percent. In an increasingly global economy, companies are frequently investing in various locations abroad for the first time. Given the diverse political and economic environments which exist around the world, a minority partner is frequently enlisted to facilitate entry into a new market. While this third party may own less than a majority of the voting stock, it commonly has the investee's business and political relationships within the country and often the key management positions. Indeed the minority shareholder could be an agency of the local sovereign government. These circumstances could lead to a presumption of control by the minority owner even though the parent may have the majority of the votes. The ED does not address such a situation.

The ED requires a more comprehensive discussion as to a) what powers are indicators of control and b) what limits on those powers preclude the presumption of effective control. Specifically, the ED should address the extent to which possession of the ability to execute decisions concerning the following matters constitutes effective control:

a) dividend policy;
b) capital expenditures;
c) investments and divestitures;
d) operating budgets;
e) execution of contracts and employment agreements;
f) financing and changes in the investee's capital structure;
g) debt covenants and guarantees;
h) product development;
i) the acquisition or sale of technology;
j) tax elections;
k) initiation and settlement of litigation; and
l) accounting policies.

Joint venture agreements often set forth limits of authority governing each of these areas.

In summary, we believe that the Board should begin with the basic premise that control is a presumption of majority legal ownership absent compelling evidence to the contrary. A certain amount of subjectivity will be inherent in any assessment of control. However, the risk that such subjectivity will produce inconsistent results can be minimized by a concise discussion of facts and circumstances which constitute such evidence including those matters referred to above.

TEMPORARY CONTROL

With respect to the issue of temporary control, the ED excludes an entity from consolidation when the entity has been newly acquired and management intends to dispose of the subsidiary within one year of acquisition or where the entity alone constitutes a segment and is therefore subject to the provisions of APB 30. Where management intends to dispose of an existing entity, that entity is presumably subject to consolidation up to the date of sale. While this is not a significant change to existing GAAP, we disagree with the inconsistency of accounting treatment of newly acquired entities, existing entities and business segments expected to be disposed of. We believe that the exception for temporary control should be extended to apply to all entities which management intends to dispose of within one year as such information would be more relevant to financial statement users in assessing the consolidated entity's potential for earnings going forward.

PRESENTATION OF THE NON-CONTROLLING INTEREST

We strongly disagree with the inclusion of the non-controlling interest in equity. Our principal responsibility in reporting consolidated financial results is to report to our shareowners. Equity is a traditional measure of a public company's shareowners' investment. The definition of a public company's equity should not extend to ownership interests of third parties with interests in individual entities included in the consolidated financial statements.

Further, the inclusion of the non-controlling interest in equity will have an impact on certain ratios commonly used to measure results such as return on equity. The ED mandates that earnings per share, also a traditional measure of return for investors, should be calculated using only the earnings attributable to the controlling interest. Conversely, the return on equity would be either with or without the non-controlling interests amounts. The potential exists for two inconsistent measures of return, such inconsistency being magnified by any disproportionate profitability of individual operations with minority partners. Alternative methods of presentation only add to the complexity which confronts the financial statements user, creates non-comparable reporting of data and confuses the real measure of the Corporation and its returns.

The conceptual basis for inclusion of the minority interest in equity by default, solely because it does not meet the FASB's definition of a liability as set forth in Concepts Statement 6, is weak. The majority of respondents to the discussion memorandum supported the inclusion of the non controlling interest in the statement of financial position between liabilities and equity, the prevailing practice in the United States. The Board rejected this proposal stating that it saw no compelling reason to create a new element of financial statements for the non controlling interest. <u>We believe that the Board should revisit this conclusion</u>. Such "mezzanine" treatment is not only used in practice for the non controlling interest but also for mandatorily redeemable preferred stock. We suggest that a new element is needed for items which have characteristics of both equity and liabilities. It is our belief that this is precisely the case for the non controlling interest. While it does not meet the definition of a liability within the meaning set forth in Concepts Statement 6, neither does it meet the traditional meaning of equity in the context of ownership of the parent company.

The provision requiring the statement of consolidated income to report net income, net income attributable to non-controlling interest and net income attributable to controlling interest is less preferable than the current treatment of deducting the minority interest in arriving at net income. It will confuse the traditional interpretation of the term net income and implies that net income attributable to the controlling interest and net income attributable to the non controlling interest are of equal importance. We do not believe that this is the case for the majority of users of consolidated financial statements, particularly the current and potential shareowners.

CHANGES IN A PARENT'S OWNERSHIP OF A SUBSIDIARY

We understand that the logical extension of combining parent and minority ownership interests as equity is to treat subsequent changes in ownership between those parties as equity transactions not affecting the assets or liabilities of the combined enterprise. We simply and strongly disagree with this result.

We see no reason to distinguish between a gain or loss on the sale of a partial interest and the gain or loss on the sale of an interest that results in loss of control and deconsolidation. Doing so at best results in differing results from similar circumstances and at worst leaves room for manipulation. From the perspective of the parent company shareowners and their earnings per share, realization of any gain or loss occurs at the time any such sale is made. Failure to include income or loss from the sale of an interest of the parent's shareowners <u>misstates</u> that income and EPS!

Similarly distorted results will occur under the accounting proposed by the ED for purchases of non-controlling interests by the parent company. UTC recently acquired a 40% minority interest in a subsidiary where UTC had a long-standing 60% interest. This acquisition required purchase accounting and the reporting of goodwill under existing GAAP. More importantly, this acquisition had to pass the same hurdles for investment decisions as other investments of corporate funds. This investment impacted our UTC shareowners in net income and EPS in a manner consistent with alternative investments, e.g. fair value accounting of that incremental investment and resultant amortization of its cost to earnings. If this had been accounted for under the new ED it would have been given different treatment than similar investments of corporate funds (e.g., if those same funds were used to acquire a 70% interest in a different company).

Under the ED as we understand it, that 40% acquisition would have resulted in no change to our shareowners' EPS and goodwill for the purchase accounting. Rather, they would merely benefit in the future sharing of the earnings previously reported as minority interests. This seems to contradict concepts of GAAP relative to cost basis accounting rather than improve GAAP. Moreover, it drives a wedge between the economics of such a transaction and the accounting.

In applying the ED to the cash flow statement, presumably the acquisition in the 40% minority interest would not be reported in investment activities but as a financing cash flow. This appears to be inconsistent with the ED's view that this is a non-transaction to the enterprise.

Lastly, the resulting charges and credits to additional paid in capital are never reversed. Corporations which accomplish acquisitions and dispositions in two or more steps will have different income, retained earnings and additional paid in capital than those corporations affecting such acquisitions and dispositions in a single transaction. This appears to be reporting similar economic transactions with dissimilar accounting results, further distancing accounting from economic reality.

CONFORMING FISCAL PERIODS

Should the FASB retain the conforming fiscal periods requirements in the final pronouncement, the potential complexity of such a task should be considered in the transition period. Many multi-national corporations have hundreds of foreign subsidiaries that would need to change their year-ends, if only for reporting to their parents. Unlike other aspects of the ED, this is not a change that can be made at a corporate level. This change will impact the behavior at those many foreign locations.

Additionally, this requirement will result in statutory and tax year ends also being changed where practicable. The complexity of this task demands a reasonable period of time in which to accomplish it. Changing the US GAAP reporting period prior to changing the statutory year ends would, in most cases, require a complex and time consuming reconciliation that systems currently in place might not be able to manage. Further, many of foreign entities are located in developing countries where the communications and information systems are such that additional time will be necessary in order to affect a change of this nature. We believe that a two-year period is a more reasonable timetable for compliance with this requirement.

The one-year transition period with the "accommodation" that further delay is acceptable so long as the company makes explicit disclosure of their inability to conform is not an elegant disclosure for those corporations who are working hard to do the right thing.

We appreciate this opportunity to comment on the ED and would be pleased to discuss the comments addressed in this letter with the FASB at its convenience. If you have any questions, call me at 203-728-6364.

Sincerely,

GE Minnich

George E. Minnich
Vice President and Controller