



Letter of Comment No: 97
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Director of Research and Technical
Activities
Financial Accounting Standards Board File
Reference: 154-D
401 Merit 7
P.O. Box 5116
Norwalk, CT 06856-5116

**Re: Proposed Statement of Financial Accounting Standards - Consolidated
Financial Statements: Policy and Procedures**

Dear Sir:

The National Association of Real Estate Companies (the "Association") is composed of representatives from companies engaged in a broad range of real estate activities, as well as independent accountants, lenders and others associated with the real estate industry. One of the major objectives of the Association is to define and promote the use of sound accounting and financial reporting principles and practices that reflect the economic realities of the real estate business. In such regard, the Association has presented views to the Board on a variety of topics in the past including the Board's preliminary views on Consolidation Policy. Therefore, the Association is pleased to respond to the Board's request for comments on the Exposure Draft for the Consolidations project. "(Exposure Draft")

The Association is strongly opposed to the issuance of the standard as proposed in the October 16, 1995 Exposure Draft. Although the proposed statement indicates that preparers and users have raised numerous questions about consolidation policy, the Association is not aware of a general call for a re-evaluation of these concepts. The Association believes that existing guidance is adequate and not in need of massive overhaul or refinement. The Association does not share the Board's view that ARB 51 (as amended by SFAS #94) does not adequately address the unique concerns of non-corporate forms of business. Members of the Association have been successfully extending the concepts in the current literature to their forms of organization (primarily partnerships) for many years and see no need for a conceptual change in this area.

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The Association supports the alternative view (paragraphs 139-144 of the Exposure Draft) that states that control alone is not sufficient for one business enterprise to consolidate another business enterprise. The Association believes that consolidated financial statements are intended to serve the needs of the shareholders of the parent. Only assets and liabilities which substantially benefit the equity owners of the entity should be presented in consolidated financial statements. The Board even states this view in paragraph 53 by reaffirming the conclusion of ARB 51 that "The purpose of consolidated statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, (emphasis added) the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches and divisions".

Current practice requires the consolidation of all majority owned subsidiaries. The Exposure draft would require the consolidation of minority owned investments resulting in the grossing up of assets and liabilities of the combined entity with a commensurably large non-controlling interest account while obscuring the real performance of net assets that ultimately inure to the benefit of shareholders. A simple example is cash on hand. If substantially all of the cash on hand for a consolidated entity is held by a controlled joint venture where the controlling entity, though it has absolute discretion as to the timing and amount of total distributions, is restricted to distribute the cash in ownership ratios, consolidation gives a distorted view of the controlling entity's ability to satisfy its current obligations. Rather, in such a situation, the Association would favor presenting the controlled entity on the equity method where cash not unilaterally available (i.e. the controlled entity's cash) to satisfy the parent's liabilities would not be presented on the balance sheet and the currently required disclosure of a significant equity investment's operations and share of ownership would show what portion of the investee's cash may additionally be available to the controlling entity's equity holders.

The Association's opposition to the procedures proposed in the Exposure Draft stems specifically from the Board's definition of control in paragraph 11. The Exposure Draft states that "a controlling entity can use or direct the use of the individual assets of its subsidiary in ways that enable it (i.e., the controlling entity) to obtain the service potential or future economic benefit inherent in those assets. By way of example, the Exposure Draft (in Example 2- paragraphs 182-187) indicates that a controlling entity can increase its own future net cash flows by the strategic structuring of transactions involving the subsidiary's assets without adversely affecting the rights of the non-controlling equity holders. Specifically, the Board believes that a sole general partner "need not use them (i.e. the limited partnership assets) in ways that benefit the limited partners proportionately". This would be a specific violation of virtually all agreements of limited partnership which govern those arrangements as well as conflicting with the provisions of the Uniform Partnership Act and, if publicly syndicated, various Securities and Exchange Act laws.

Generally, the rights of the non-controlling equity holders include the rights to a specified share of the net assets of the subsidiary. Therefore, a controlling entity would be constrained by those rights from initiating transactions involving the subsidiary's assets which converted those assets to yield a disproportionately increased share of the controlled subsidiary's assets to the controlling entity. Absent such a conversion, the controlling entity can select between alternative uses of the subsidiary's assets based upon which option would result in more favorable returns on its own assets. Only if the alternative use selected had a net return to all of the equity holders no worse than any other possibility would the controlling entity be protected from a breach of contract, criminal action, or a conflict of interest breach of fiduciary interest claim as described above. In essence, fiduciary responsibilities generally require the controlling entity to act to maximize the benefits to all the equity owners and to sacrifice the best options for personal aggrandizement is certainly a breach of the intent of those responsibilities. If the maximum return alternative happens to benefit the controlling entity's personal assets, it is a happy consequence to the controlling entity but does not justify adding the controlled entity's assets to the parent's. Consolidated statements under the Board's proposal would not distinguish between assets that can be used or converted unilaterally from those that happen to act in concert with the parent.

To the Association, this distinction raises the threshold issue: Whose financial statements are being presented? Existing standards and current practice are clear that the financial statements presented show the net assets and liabilities that substantially inure to the equity holders of the parents. The Exposure Draft would yield financial statements labeled as those of the parent's but where the benefit of the net assets would go to a group of equity holders of which the parent would likely be a minor economic participant. Such an aggregation may be interesting and show the financial "muscle" under the direction of the controlling entity but would show little insight on the resources actually available to the controlling entity's equity holders. Current practice (as specified in APB 18 - paragraph 20 (d)) already requires the disclosure of the operations of significant equity investments. Therefore, the Association sees no need to modify the concept of the reporting entity to achieve disclosure which, if significant, is already required.

The Board argues in paragraph 85 that to omit reporting on a "subsidiary's" assets and liabilities because the parent's ownership is below some specified level is to render the statements incomplete. The Association would agree to do otherwise would render the statements meaningless to the parent's equity holders. Lenders and other users of financial statements already desire substantial supplemental information from Association members. The Exposure Draft would only increase the amount and cost of satisfying user needs as the information about the assets and liabilities that substantially impact the parent equity holders (i.e. what current GAAP requires in the base financial statements) would have to be presented supplementally for users to properly evaluate the performance of the parent.

The Board asserts in paragraph 86 that no entity would take on the general partners' risks without a commensurate share of the rewards. Therefore, the Board assumes that general partners with nominal economic interests do not exist. The limited partnership syndication industry [with approximately \$200 billion in equity capital raised—the majority in real estate (Chicago Tribune—May 16, 1995)] have general partnership interests structured precisely in this way. These general partnership interests are economically analogous to mutual fund managers which are precluded from consolidation in paragraphs 161 and 162. The Association believes implementation of the Exposure Draft will significantly alter practice for significant number of reporting entities with no practical economic benefit.

The Board has also asked that respondents test the application of the proposed provisions to their own circumstances. The Association has members who, under the proposed procedures established by the Exposure Draft, would consolidate the general partner interests (through affiliates, effectively the sole general partner) of numerous of their previous public and privately syndicated limited partnerships. With dozens of these "controlled" limited partnerships, each with assets ranging from \$50 - 400M, the syndicator's wholly owned portfolio would soon become obscured and potentially immaterial. Additionally, the syndicator's sole revenues are typically in the form of various fees for services rendered to the "managed" or sponsored partnerships. Elimination of these fees in consolidation as required by the proposed standard would eliminate presentation of the sole revenue stream of the parent/syndicator. Again, existing GAAP with disclosure requirements for equity investments and significant "customers" would achieve more informative financial statements about the syndicator than a consolidated aggregation of sponsored limited partnerships.

Paragraphs 22 & 23 specify the accounting treatment of a non-controlling interest in consolidated financial statements. There is one aspect of this guidance which is troubling to the Association. The guidance indicates that when losses would be otherwise allocable to the non-controlling interest that would be in excess of its equity, such losses would be re-allocated to the controlling entity. This re-allocation would occur whether or not the non-controlling partner is, in fact, legally liable or otherwise committed to fund those losses. To arbitrarily reallocate such losses where the non-controlling investor may be reporting a liability (represented by a negative investment in venture on the equity method in accordance with current literature and practice) misrepresents the true allocation of the benefits of the consolidated assets. In effect, the Exposure Draft rejects the concepts of joint venture allocation recently adopted by the Accounting Standards Executive committee of the AICPA in its consideration of its proposed statement of Position on the accounting for investor's interests in unconsolidated real estate joint ventures.

The Board has acknowledged that a majority of respondents to the Preliminary views suggested that the criteria for consolidation should include some level ownership. The fact that the respondents could not agree on the appropriate ownership level does not

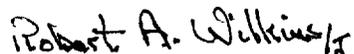
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justify the Board's decision to ignore the ownership criteria entirely. The alternative view endorsed by the Association requests comment as to what the appropriate minimum level of ownership rights would be to preclude consolidation and how it would be defined to be operational. The Association believes that the current practice of generally using the equity method of accounting for less than 50% owned entities, with the currently required disclosure in the footnotes, provides a better basis for analyzing operations as they relate to the parent company's equity holders.

The further question raised is, regardless of the minimum ownership threshold used, how should the ownership percentage be assessed in agreements where the ratio of initial investments, the rights to operational cash flows or dividends and the allocation of residual interests in liquidation may differ. At inception, each investor has a concept of their expected returns as a percentage of the total expected returns from the investment in the entity. Unfortunately, calculation of this percentage in sufficient precision to use against a fixed threshold is impossible. To achieve a measurable percentage, the Association would recommend using the percentage of benefits which would inure to the investing entity in an assumed liquidation in accordance with GAAP immediately following the inception of the investor's investment. This calculation will be, by definition, different from the investor's own implicit percentage but would be used solely for the purposes of applying any specified, necessary but not sufficient, condition for consolidation.

The Association welcomes the opportunity to comment on the Exposure Draft. Although we understand that all time slots for speakers at the public hearing on February 20-21 have already been assigned, we would be happy to discuss any or all of our opinions further with the Board either at the hearing or at whatever other mutually convenient opportunity.

Sincerely,



Robert A. Wilkins
Chairman, Financial Accounting Standards Committee-National Association of Real Estate Companies