

May 24, 1999

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Letter of Comment No:

File Reference: 1082-194R

Date Received:

5/27/99

Dear Tim:

Alcoa welcomes the opportunity to respond to the exposure draft on "Consolidated Financial Statements: Purpose and Policy", dated February 23, 1999 (ED).

General Analysis

RE: File Reference 194-B

It is difficult to argue with the theoretical basis that assets and liabilities an entity controls should be included in the entity's consolidated financial statements. However, we are concerned with the practical application of this purely theoretical model. The concepts in the ED are very subjective and focus on potential control, rather than intent. Accordingly, entities may be required to consolidate and then deconsolidated subsidiaries based on subjective interpretations that can change over time. At worst, an entity may be constantly deconsolidating and reconsolidating an entity it has no intention of ever controlling, based solely on quarterly changes in the market price of a convertible debt instrument. This subjectiveness leads to significant practical implementation issues, increases the potential for abuse of the accounting standard itself, and reduces the perceived credibility of the consolidated financial statements. We believe that in the vast majority of for-profit entities, controlling ownership should still be a prerequisite for an entity to consolidate another company in its financial statements.

It is unclear to us what specific issue or issues the Board is trying to address with this ED. As noted above, we believe a majority ownership in a for-profit entity in fact would give the majority owner a controlling interest in the entity. We would encourage the Board to address the specific situations that may be allowing companies to not consolidate controlled companies under the current accounting principles. From our standpoint, the issues that may need to be addressed include Special Purposes Entities related to leasing and other activities and certain not-for-profit arrangements.

Earnest J. Edwards Senior Vice President and Controller

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Fax: 1 412 553 3640 earnie.edwards@alcoa.com In addition, it appears that the intent of the proposed standard is to address a perception that current practice does not reflect consolidation of all those entities that should be consolidated. Our review of the proposed standard was a non-event regarding consolidation of additional entities. Rather, the items that required review were all concerned with possible deconsolidation of currently consolidated entities. This mainly occurred because we view a majority interest in a general partnership as requiring consolidation, while the proposed standard assumes the opposite, absent specific facts and circumstances indicating control. We believe that EITF 96-16, supplemented with additional clarification, is adequate in addressing the reputable presumption that a majority ownership results in a controlling interest of an entity.

We encourage the Board not to adopt this THEORETICAL model. Generally Accepted Accounting Principles should consider and allow for practical application while ensuring consistency. This ED does not allow for the former and opens the door for more abuses of the latter. The ED adds significant complexity and little benefit to an area that we to do not believe is broken.

If the Board elects to adopt this ED, we urge the Board to address the following two technical issues.

Specific Issues and Recommendations

The first issue is the guidance in paragraph 31, where the Board states that "...a parent need not demonstrate its decision-making ability to possess that ability." This raises operational difficulties in application whenever the entity in question has a government or government agency as a minority owner, particularly in newly developing countries. The proposed standard contains an implicit assumption of a stable and objective legal system. However, there are clearly cases where a country's government can act unilaterally to control an entity created under that country's laws. Under a strict interpretation of the proposed standard as it is currently written, any historical instance of such a governmental action would preclude consolidation of any entity formed under the laws of that country. We recommend that paragraph 31 also include additional language noting the implicit assumption regarding the underlying legal system, and provide an exception to the "need not demonstrate" conclusion requiring that governmental intervention actually occur, rather than be presumed.

The second issue is the treatment of undivided interests in joint ventures created solely by contractual agreements, with no underlying entity. In paragraph 187, the Board has explicitly rejected pro rata consolidation for an entity that should be consolidated; a conclusion we fully support. In the footnote to paragraph 187, the Board has explicitly not addressed the appropriate accounting for undivided interests in joint ventures when those entities are not consolidated. In paragraph

23, the Board alludes to this issue, characterizing it as one of "...accounting for and control of its asset". Although we can understand this position based on a rigid definition of scope, we believe the proposed standard would be far more complete and operationally effective if this issue were addressed. This is particularly true since the existing authoritative pronouncements (at least as promulgated by the SEC for public companies) are both contradictory and theoretically inconsistent.

The applicable accounting literature is Interpretation No. 2 of APB No. 18 and paragraph 52(d) of the AICPA Issues Paper issued in 1979 July. Both sources indicate "pro rata consolidation" would be appropriate for the undivided interests described above. Current guidance from the SEC is that all joint ventures (regardless of whether or not there is an underlying legal entity) must be consolidated or accounted for using the equity method, depending upon percentage of ownership interest. Obviously, these approaches conflict. In addition, the SEC guidance could mandate equity accounting for a nonexistent entity, posing theoretical conflict and practical problems. Finally, in the case where there is a new entity formed to hold the joint venture with unanimous agreement of the venturers still required, the SEC guidance and this proposed standard conflict.

We believe it is both appropriate and necessary to complete the model created by the proposed standard, and include in the proposed standard a statement that for "virtual" entities, such as the undivided interests described above, each venturer should continue to account for its assets and liabilities. We believe the standard should acknowledge that in such circumstances what has been termed pro rata consolidation is, in fact not a consolidation at all; it is the subsidiary accounting for its assets and liabilities.

If the Board or its staff would like clarification or amplification of any of the above issues, we would be happy to provide it.

We thank the Board for the opportunity to express our position on these issues.

Sincerely,

Earnest J. Edwards

Senior Vice President and Controller