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May 24, 1999

Financial Accounting Standard Board Attn: Director of Research and Technical Activities P.O. Box 5116 Norwalk, CT 06856-5116

Letter of Comment No: 50 File Reference: 1082-194R Date Received: 5/26/99

File Ref. No. 194-B Re:

> Exposure Draft (Revised) Dated 2/23/1999 Proposed SFAS—Consolidated Financial Statements: Purpose and Policy

### Dear Sirs:

We are writing to provide comments on the Proposed Statement of Financial Accounting Standards—Consolidated Financial Statements: Purpose and Policy, exposure draft issued February 23, 1999 (the "Proposed Statement"). These comments are submitted by a drafting group composed of members of the Committee on Law and Accounting, Section of Business Law, American Bar Association. They reflect the overall views of the drafting group and views expressed during a recent meeting of the Committee. However, this letter does not represent an official position of the ABA, the Section or the Committee and does not necessarily reflect the views of every member of the drafting group.

### Introduction

The Proposed Statement would supercede important elements of ARB No. 51 which, as amended by SFAS No. 94, has largely governed consolidation issues since 1959.

ARB No. 51 generally would require consolidated financial statements where one company has a "controlling financial interest" in another company, and in that connection provides that "[t]he usual condition for a controlling financial interest is ownership of a majority voting interest" (the "Majority Voting Ownership Test"). Although ARB No. 51 does not, by its terms, imply that a "controlling financial interest" could not be achieved in some manner other than

by meeting the "Majority Voting Ownership Test"; it is our understanding that issuers of financial statements and their auditors have, in practice, ordinarily treated the Majority Voting Ownership Test as a bright line for determining whether consolidation is required. The Proposed Statement would replace the Majority Voting Ownership Test with one which focuses on control as defined in paragraphs 6 through 10 (paragraph references herein, where no document is cited, are to paragraphs in the Proposed Statement).

Although we are not necessarily convinced that the disadvantages of a bright-line test (e.g., road map to design around) are outweighed by the advantages (e.g., certainly and comparability), we believe that the Proposed Standard's core provisions in paragraphs 6 through 10 set forth a coherent set of concepts for deciding consolidation questions through functional judgments relating to the purposes intended to be achieved by consolidation. In the case of a business enterprise which conducts parts of its activities through organizational structures more complex than the majority-owned subsidiary, we think that the analysis, by focusing upon the ability to direct policies and management so as to increase the parent's benefits and limit its losses, is a significant and accurate examination of the reality, as opposed to the form, of the business organization which is constitutive to the enterprise.

Somewhat surprisingly, after setting forth this framework for a functional analysis, the Proposed Statement retreats to bright-line tests—now called "presumptions"—in four areas: a slightly reworded version of the Majority Voting Ownership Test (paragraph 18.a); public corporations where a majority is widely held and there is a predominant, though minority, voting interest held by another entity (paragraph 18.b); potential to obtain a majority voting interest through convertible securities or options (paragraph 18.c); and limited partnerships with a sole general partner (paragraph 20). Paragraph 85 restates these for bright-line presumptions in one place.

Respecting the second presumption, we think that the dissenting position in paragraph 251—which focuses on showing of actual power rather than assumptions as to the existence of power—is better integrated, from a theoretical standpoint, with the concepts in paragraphs 6 through 10. Nevertheless, the guidance in footnote to paragraph 18 would probably have the result that cases falling within the presumption would be ones where there is actual power to control; and so the presumption can be regarded as a reasonably workable implementation of the control concept.

Our remaining comments relate to the third and fourth presumptuous (and, therefore, respond to Issue 2 identified in the preamble to the exposure draft). In the case of the third presumption (convertible securities and options), our comments are directed to whether the presumption correctly applies the functional analysis of control set forth in the Proposed Statement: we suggest that it does not and so constitutes an exception to the control analysis, an exception which we do not believe has been justified. In the case of the fourth presumption (limited partnership with one general partner), our comments are governed by our conviction that the control analysis has been applied in too mechanical a

fashion and that in a significant proportion of instances could result in accounting that is neither useful nor relevant.

# Presumption as to Convertible Securities and Options

Under paragraph 180-c, control of a corporation shall be presumed if an entity [h]as a unilateral ability to (i) obtain a majority voting interest in the election of a corporation's governing body or (2) obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected

In the "absence of conclusive evidence that demonstrates otherwise," that entity will be deemed to be in control rather than an entity which currently meets the Majority Voting Ownership Test (the first presumption).

Creating a presumption out of the potential—not actual—ownership of rights which, if exercised but only if exercised, would give voting control does not fit very readily into the functional analysis of paragraphs 6 through 10, which is focused upon decision-making power.

There are undoubted cases where the holder of such options does, in fact, make the control decisions. Paragraph 15 requires a judgment as to the existence of control based upon an "assessment of the surrounding facts and circumstances"; and the possession of such an option (because it creates the potential for actual control) should be a factor to be weighed along with others in determining whether the holder has control. Accordingly, we do not object to the results in the two examples in respect of this presumption (paragraphs 109 through 114 and paragraphs 115 through 123); but we believe that those examples neither illustrate nor provide justification for the presumption because the totality of facts and circumstances in each of these cases strongly suggests that the structure was set up for the purpose of ensuring control. If, however, the structures in those examples, except for the existence of the option rights, were stripped away and the only remaining one was the possession of a potential to control, it would no longer be apparent that a preconceived plan of control was the purpose and effect to the structure. Accordingly, the presumption in paragraph 18.c should be viewed as an exception to the general control analysis rather than as an implementation of it. We find nothing in the Proposed Statement which sets forth a theoretical justification for such an exception.

Perhaps the Proposed Statement reflects a belief that convertible securities or options would be employed for the purpose of avoiding consolidation; and indeed the two examples given are so devoid of any apparent business purpose for their convoluted

structures that one might be justified in concluding that those structures were motivated by accounting considerations.

In our experience, however, an investor in convertible securities or similar options is normally motivated by real business concerns and has <u>not</u> determined whether to acquire a full equity position. E.g., the holder of convertible debt probably wants to be a creditor in the downside case and the option to decide whether to be creditor or owner in the upside case, and the holder of convertible preferred stock has similar motivations. It is not obvious to us why the possession of such rights—in the absence of evidence that the possessor is in fact making owner-like decisions—should lead to consolidation.

We have made these comments without considering the effect of the condition, at the end of the presumption, that "the expected benefit... exceeds its expected costs" because we do not understand how either benefit or cost is intended to be measured. In determining whether a publicly traded convertible security or option is "in the money," one compares the market price of the security to be received with the conversion price; but these trading conventions seem to have little applicability to the holder of debt convertible into majority equity. In that case the benefit would presumably be the future returns which the holder expects to make by being able to make control decisions, while the cost is not only the payment of the conversion price but also the surrender of a fixed return, and of a creditor position in case of bankruptcy.

Although the holder must make such a calculation in deciding whether to exercise, we doubt that it is possible for the calculation to be assessed objectively. Indeed, the fact that the holder has not exercised at a given point in time should be regarded as a strong indication that the holder does not then believe that the benefit exceeds the cost.

### Presumption as to Sole General Partner in Limited Partnership

The presumption described in paragraph 20 and paragraph 84.d may be appropriate where an ongoing enterprise, requiring investment and management decisions on a regular and recurring basis, is conducted through a limited partnership rather than in a corporate structure.

In our experience, however, limited partnerships are much more commonly used to facilitate the subdivision of a discrete investment than to carry on an enterprise. Limited partnerships are commonly employed for investments in developed real estate; and although the powers of the general partner appear to be plenary under the applicable limited partnership law, a functional analysis of those powers—which in the Proposed Statement are the basis for consolidation—must also take into account the limitations on those powers set forth in the partnership agreement. Typically those limitations are not the type of veto rights required by lenders and minority investors (which under the Proposed Statement would not negate control) but are the structural means by which the limited partnership is prevented from becoming an enterprise. Thus the partnership

agreement typically places severe limitations on how the general partner can utilize the assets, the income generated from the assets and the reinvestment of proceeds from the sale of the assets.

The position of the sole general partner in such a limited partnership is, in point of fact, much more like that of a manager under a long-term contract than that of an owner. The fact that general partner normally has a very small equity interest as a limited partner—often one percent or less—does not negate that position because under the limited partnership agreement the general partner has, in effect, surrendered most of the power on how to employ the funds it has invested. (A person who controls an enterprise does not normally deprive itself of the ability to manage its investment in the enterprise.)

Furthermore, the Proposed Statement contains no analysis of the usefulness, in this situation, of consolidated financial statements in the decision-making of any party (see Statement of Financial Accounting Concepts No. 2—Summary of Principal Conclusions) or of the relevance of such statements to evaluating the financial position of the sole general partner (see Proposed Statement—paragraphs 7 and 8). Even if such an analysis were made, we doubt that such usefulness and relevance could be established in a sufficient number of cases to justify the presumption.

Very commonly the sole general partner is established by a real estate developer for a limited partnership vehicle for a discrete real estate investment, which is sold to investors in that deal and financed discretely by the assets of that deal. The successful developer will, of course, establish as many such limited partnerships as possible, each with its own general partner. Because every such general partner is an affiliate of the developer, the application of the proposed presumption would mean that all of these discrete investment vehicles would be consolidated in the developer's financial statements.

Who would use those consolidated financials? Not the investor in a discrete development vehicle, who is interested only in the underlying real estate of that vehicle (and its discrete cash flows). Not the lender to a discrete development vehicle, who normally looks only to the property and cash flows of that vehicle and whose recourse to the general partner is illusory—in this type of structure the general partner is always a corporation designed to shield the developer from any recourse to anything other than the assets of the discrete vehicle. Not the investor in or the lender to the developer because, apart from a relatively insignificant limited partnership interest, the developer typically has no interest in the investment vehicle except for payments provided for in the partnership agreement which formed the original investment package—i.e., development fees, management fees, proceeds of refinancings and final sales, etc.

Paragraph 8 states that "consolidated financial statements. . . are usually necessary for a fair presentation if one of the entities in the group of affiliates directly or indirectly controls the economic resources and activities of the other entities. We would suggest that this principle can be preserved and made to work in connection with the kind of

limited partnership structure we have been discussing if "control" of "resources" and "activities" is analyzed functionally under paragraphs 6 through 10. Such an analysis should focus on the nature of the powers of the general partner and the nature of the resources subject to such powers and consider whether those natures are such that consolidation would be meaningful. Generally, the paragraphs on implementation guidance seem to us to give too much attention to mechanical application of legal relationships for the purpose of determining whether the legal structure gives rise to an "entity" and not enough attention to considering whether that entity in any meaningful sense is an "enterprise." In any event the presumption in paragraph 20 seems to us to be supported by an inadequate analysis and, in the case of many limited partnerships, would result in bad accounting.

We believe that the presumption should be deleted or, at a minimum, qualified to be inapplicable to investment vehicle limited partnerships.

If we can provide any further elucidation on the issues we have raised, please get in touch with Marshall H. Earl, Jr. (phone: (812) 849-3675; fax: (804) 698-2044; e-mail: mhearl@mwbb.com.)

Very truly yours,

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