Letter of Comment No: 39

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May 24, 1999

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

Re: File Reference No. 194-B, Exposure Draft (Revised) - Proposed Statement of Financial Accounting Standards - Consolidated Financial Statements: Purpose and Policy, dated February 23, 1999.

Dear Mr. Lucas:

We are pleased to submit our comments related to the aforementioned proposed Statement of Financial Accounting Standards (SFAS) on behalf of the New York State Society of Certified Public Accountants (the Society). The Financial Accounting Standards Committee of the Society prepared these comments.

Overall Comments

- 1. Although there was a significant minority view, the majority of the Committee concluded that the arguments contained in the proposed SFAS do not support significantly changing the current consolidation model. Accordingly, the Committee recommends that the proposed SFAS not be issued, in its present form. The majority of the Committee believes that the proposal will not lead to a common agreement as to the meaning of control, and the application of the proposed control criteria may result in both: (a) an increase in alternative views concerning when control exists; and (b) the need for continual implementation guidance. While many have complained about a "cook book" approach to standards, the majority of the Committee believes that the numerous judgements, required by the proposed SFAS, will lead to diversity in practice.
- 2. Further, the majority of the Committee believes that, unless more convincing arguments are presented for revising the current consolidation model, the Board should consider retaining such model and providing guidance to significant practice problems related to:

- A. the consolidation of the financial statements of controlled, special purpose entities (The proposed SFAS is not clear as to when a special purpose entities must be consolidated);
- B. the consolidation of the financial statements of nonprofit organizations with those of affiliated nonprofit organizations; and
- C. the preparation of combined financial statements, which is a significant practice problem for non-public companies and their external accountants. The majority of the Committee believes that "control" can not be redefined without providing guidance as to when combined financial statements should (or must) be prepared.
- 3. If the Board decides to issue the proposed SFAS, in its present form, the majority of the Committee suggests that it reconsider the guidance related to equity accounting, as contained in APB Opinion No. 18. The Committee believes that much of the guidance in the proposed SFAS is contrary to the guidance in APB Opinion No. 18. The Committee understands that the Board has a project in process related to equity accounting. The Committee suggests that guidance related to the consolidation model be issued in tandem with guidance related to equity accounting.
- 4. The Committee is also concerned with the definition of control as it relates to nonprofit organizations. Some believe that the proposed SFAS may lead to the financial statements of fewer affiliated nonprofit organizations being consolidated with those of its "parent" nonprofit organization. This conclusion is based on the theory that the second essential element of control (a parent's ability to use its decision-making ability to increase the benefits that it derives and limit the losses that it suffers from the activities of a subsidiary) may be perceived as not being present in numerous circumstances related to nonprofit organizations. In connection therewith, attached are comments of the Not-For-Profit Organizations Committee of the Society related to the proposed SFAS.
- 5. Finally, the Committee suggests that the Board provide guidance regarding the display of the 99% interest of the limited partners in the consolidated financial statements of a sole general partner with a 1% interest in a limited partnership. Also, guidance is needed in reporting large minority interests (e.g., 75%), and large minority interests where control exists only by contract and not through equity or beneficial interests.

If the Board determines that it must go forward with the proposed SFAS, the responses of the Committee, to the specific issues enumerated in the subject Exposure Draft, are as follows:

Issue 1

A majority of the Committee disagrees with the conceptual aspect of control because it believes that the determination of control is much too judgmental. The Committee does not believe that the document adequately clarifies when one entity controls another entity. Further, the Committee suggests that the Board reconsider the guidance in paragraph 7 of Statement of Position 78-9, <u>Accounting for Investments in Real Estate Ventures</u>, in defining **control**. Finally, paragraph 6 defines control as involving a "decision-making ability that is not shared with others." Does this mean that if some, or certain, decisions were shared with others there is no control? The concept of absolute, unilateral control should be clarified.

Issue 2

The Committee believes that guidance, in the form of rebuttable presumptions, may be helpful. However, the Committee suggests that, in addition to guidance in the form of rebuttable presumptions, the proposed SFAS contain contra indicators as to when consolidation would not be appropriate, in addition to those contained in the examples contained in Appendix A.

The Committee agrees that the circumstances, described in situations (a) and (d) of Issue 2, should lead to a rebuttable presumption of control.

The majority of the Committee disagrees that the circumstances, described in situations (b) and (c) of Issue 2, should lead to a rebuttable presumption of control. The majority of the Committee believes that situations (b) and (c) require numerous significant subjective judgments, presumptions and expectations concerning possible future events, which will only add to, rather than eliminate divergence in practice and which may lead to the consolidation of the financial statements of a "subsidiary" by more than one "parent." The majority of the Committee questions the appropriateness of a presumption that requires a "parent" to anticipate future events based on past experience, e.g. voting patterns, that may have occurred under divergent circumstances. Further, the majority of the Committee believes that, until the holder of convertible securities, options, warrants, etc. takes action to exercise its rights to acquire voting shares, which may include obtaining necessary financing, which may or may not be available to the holder, there is no strong evidence or basis for presuming the presence of control.

In Situation (b), it is assumed that "organized group of parties" is defined in footnote 2. However, this footnote does not say whether companies should look at the last election (which may take place many months after the year end, or many months before the next year end), or look at an average, for example, of the last three elections.

The majority of the Committee believes that the guidance related to Situation (c) is in conflict with APB Opinion No. 18 and the determination of significant influence.

It is difficult for the majority of the Committee to determine how assets and liabilities of another entity should be consolidated in the financial statements of a holder of convertible securities, options, or warrants when the event that will give rise to actual ownership may take place in the future.

Issue 3

The Committee believes that the effective date should be postponed at least one year and be initially effective for annual periods beginning no earlier than December 15, 2000. The Committee has significant concern with an earlier effective date due to the needs of many entities, particularly privately owned companies and nonprofit organizations, to deal with the year 2000 Issue, the implementation of other accounting standards, and the need to renegotiate loan agreements, etc. In addition, the Committee believes that significant implementation guidance, related to display and disclosure, should be supplied by the Board prior to the effective date.

The Committee concluded that the benefits of complete and comparative financial statements for all interim periods in the initial year of adoption, are sufficient to justify requiring, rather than permitting, that the provisions of the proposed SFAS be applied for the first and each subsequent interim period in the year of adoption.

Other Comments

Paragraph 6 (d) uses the phrase "under common control" in defining "affiliate." The Committee suggests that the Board define and differentiate "under common control" and "companies under common management."

Paragraph 7, in discussing the purpose of consolidated financial statements, states that consolidated statements "report the financial position . . . as if <u>all</u> of their assets, liabilities, and activities were held . . . by a single entity . . . " The Committee questions the accuracy of this statement when there exists a substantial minority interest.

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We hope these comments are helpful to the Board in its deliberations. If you wish to pursue these items further, please so inform us, and we will request that a member of the Committee contact you.

Very truly yours,

John J. O'Leary, CPA Chair, Financial Accounting Standards Committee

COMMENTS OF THE NOT-FOR-PROFIT ORGANIZATIONS COMMITTEE OF THE

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS RE: File Reference No. 194-B, Exposure Draft (Revised) Consolidated Financial Statements: Purpose and Policy

The following comments reflect certain of the views of the Not-For-Profit Organizations Committee of the Society.

Specific Comments on the Issues

<u>Issue 1:</u> Most of the members of the Committee agree that the proposed guidance in the Exposure Draft does not adequately clarify the application of the Exposure Draft's concept of control to not-for-profit organizations. In addition, we believe that there should be more meaningful implementation guidance for the presentation and disclosure of consolidated financial information of not-for-profit organizations.

In our opinion, there are several reasons why the Exposure Draft fails to provide clearly understandable and useful guidance to determine the control issue for not-for-profit organizations:

- Imbedded in the Exposure Draft's definition of control ("...increase its benefits and limit its losses...") is a presumption of a financial goal that correlates tightly with the mission of for-profit companies. Extending that definition to multiple, allied not-for-profit organizations with different service missions may not be possible in any reasonably comprehensive fashion. We believe that applying the concept of control in the not-for-profit environment differs in important ways from the for-profit environment. There is some confusion in understanding and applying the concepts of "decision making ability that is not shared" as opposed to the "protective rights of outsiders" in the not-for-profit environment. Situations viewed as "protective rights" in the for-profit environment are seen by many in the not-for-profit environment as "shared decision making ability." We realize that the Board has concluded that, for the purposes of this Statement, that the two environments are not different enough to warrant separate consideration.
- In those cases of control in the not-for-profit environment where a parent/subsidiary relationship exists, we find the guidance in the Exposure Draft helpful. However, there are many instances where not-for-profit organizations align in various ways, but do not create parent/subsidiary relationships. We read the Exposure Draft to imply that consolidation would not be required in this instance, but that combined financial statements may be permitted. We recommend that the Board develop criteria to identify control in circumstances commonly encountered by not-for-profits. Alternatively, a follow-up project to address these issues would be helpful.

- The Exposure Draft does not adequately distinguish between governing boards and management of not-for-profit entities. These distinctions may not be significant in applying control concepts to for-profit organizations because all are aligned by the profit motive. However, in not-for-profit organizations, the entity's specific mission, restrictions placed on contributions and grants by state and Federal statutes and regulations, and restrictions placed on contributions by donors bring complicating elements into the concept of control. The antecedents of the not-for-profit corporation are in the charitable trust traditions, rather than in the business corporation traditions. Frequently, not-for-profit corporations have interests, organized in the form of other not-for-profit corporations, that in substance are the same as the trusts discussed in Example 10. (Please note that we endorse the treatment detailed in Example 10 as it relates to the accounting for split interests.) We agree that the substance of the economic relationships, rather than their legal form, should be the basis of financial reporting. We, therefore, recommend that the Board give specific consideration to such issues of substance and form in the Final Statement beyond the acknowledgement that these situations are complex and require careful judgment after considering all the facts and circumstances.
- We recommend that the Board give specific guidance in the application of its concept of control to religious organizations.

There are several situations where we would like to see guidance on how to implement the provisions of the Exposure Draft, assuming consolidation is appropriate. Some of those situations are:

- How should the financial statements of a sole general partner, with a 1% interest in a limited partnership, be presented with regard to the 99% limited partners' interest?
- What disclosures are necessary to prevent the consolidated or combined financial statements of affiliated not-for-profit entities from being misleading when their net assets are legally restricted to different mission?
- <u>Issue 2:</u> Additional guidance is needed as to the rebuttable presumptions of control in the case of not-for-profit organizations.
- <u>Issue 3:</u> Given the difficulties we foresee in understanding and applying the Board's concept of control in specific non-profit situations, we request that there be an extension of the implementation period to annual periods beginning no earlier than December 15, 2000.