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February 26, 1996

Attn: Mr. Ron Bossio Financial Accounting Standards Board 401 Merritt 7 P. O. Box 5116 Norwalk CT 66856-5116

Dear Mr. Bossio:

Enclosed is a copy of my prepared "testimony" on behalf of the Institute of Management Accounts which, in my absence, was delivered by Mr. Mike Bohan on Wednesday, February 21, 1996.

I apologize for not being in Norwalk myself. Unfortunately, due to weather conditions, I was not able to land in time to appear at the public hearing.

Sincerely,

L. H. Rogero, Jr.

LHR:ps Enclosure

INSTITUTE OF MANAGEMENT ACCOUNTING TESTIMONY BEFORE THE FINANCIAL ACCOUNTING STANDARDS BOARD FEBRUARY 21, 1996

YES, THERE ARE <u>SOME</u> PROBLEMS WITH THE EXISTING ACCOUNTING RULES GOVERNING <u>WHEN</u> CONSOLIDATION IS OR IS NOT APPROPRIATE AND, IF APPROPRIATE, <u>HOW</u> TO EFFECT THE CONSOLIDATION. BUT, THESE SO CALLED "PROBLEMS" ARE RARE AND INSIGNIFICANT IN THE OVERALL SCHEME OF THINGS.

TO MAKE WHOLESALE CHANGES TO GUIDANCE AND PRACTICES WHICH HAVE SERVED FINANCIAL STATEMENT PREPARERS, USERS AND AUDITORS SO WELL FOR SO LONG DOES NOT, QUITE FRANKLY, SEEM NECESSARY. INSTEAD, WE RECOMMEND THAT THE BOARD WITHDRAW THE EXPOSURE DRAFT AND CONSIDER PROMULGATING SPECIFIC RULE CHANGES IN ONLY THOSE AREAS WHERE ATTENTION IS TRULY NEEDED.

LET'S FIRST LOOK AT RECOMMENDED CHANGES TO CONSOLIDATION POLICY. CONTRARY TO THE EXPOSURE DRAFT,

WE STRONGLY FAVOR RETENTION OF THE "PARENT COMPANY" CONCEPT. IN OUR VIEW. THE PURPOSE OF CONSOLIDATED FINANCIAL STATEMENTS IS TO PRESENT INFORMATION WHICH IS MEANINGFUL TO SHAREHOLDERS OF THE PARENT COMPANY. USING "CONTROL" AS THE SOLE DETERMINANT OF WHETHER OR NOT TO CONSOLIDATE IS INAPPROPRIATE. IN OUR VIEW, THE PARENT MUST ALSO HAVE A MAJORITY INTEREST IN A SUBSIDIARY'S CASH FLOWS -- POSITIVE OR NEGATIVE -- BEFORE CONSOLIDATION WOULD BE WARRANTED. USING CONTROL AS THE SOLE CRITERION FOR CONSOLIDATION IS ALSO CONCEPTUALLY UNSOUND IN THAT IT COULD RESULT IN SIGNIFICANT FINANCIAL AMOUNTS -- IN WHICH THE PARENT HAS ONLY NOMINAL BENEFICIAL INTEREST -- BEING REPORTED IN FINANCIAL STATEMENTS DISTRIBUTED TO SHAREHOLDERS. IN ADDITION, CONTROL-ONLY WOULD CREATE MANY PRACTICAL PROBLEMS GIVEN THE HIGH DEGREE OF SUBJECTIVITY INHERENT IN ITS APPLICATION. ALTHOUGH WE DO AGREE THAT A PARENT CAN HAVE "PRACTICAL" CONTROL IN THE ABSENCE OF "LEGAL" CONTROL, CONTROL MUST BE BASED UPON THE <u>UNILATERAL</u>

ABILITY OF THE PARENT. CONTROL SHOULD BE PROACTIVE AND NOT BE PRESUMED IN SITUATIONS IN WHICH OTHER SHAREHOLDERS ARE INACTIVE OR APATHETIC. BESIDES, SHAREHOLDERS CAN BECOME VERY ACTIVE WHEN ISSUES ARISE THAT ARE OF IMPORTANCE TO THEM.

WE DO AGREE THAT IN THOSE INSTANCES WHERE A
COMPANY HAS A SOLITARY, <u>CURRENT</u> RIGHT TO OBTAIN A
MAJORITY VOTING INTEREST, THE FINANCIAL CAPABILITY TO
EFFECT THAT RIGHT, THE INTENT, AND THE EXERCISE OF THAT
RIGHT WOULD BE ECONOMICAL, CONSOLIDATION MAY BE
APPROPRIATE.

THERE ARE ISSUES SURROUNDING SPECIAL PURPOSE
ENTITIES, AND MORE GUIDANCE FROM THE FASB WOULD BE
HELPFUL. HOWEVER, RATHER THAN DEAL WITH THAT MATTER IN
THIS EXPOSURE DRAFT, A SEPARATE, MORE NARROWLY
FOCUSED PROJECT SHOULD BE CONSIDERED BY THE FASB. THE
EXPOSURE DRAFT DEALS WITH SPECIAL PURPOSE ENTITIES
THROUGH THE ED'S GENERAL PROVISIONS. LIKE OTHERS, WE
BELIEVE THE APPLICATION OF THE ED'S GENERAL PROVISIONS IS

SUBJECT TO MAJOR DIFFERENCES IN JUDGMENT. FOR THAT REASON, WE FEEL THE EXPOSURE DRAFT WILL NOT BE VERY HELPFUL IN COVERING ISSUES CREATED BY SPE'S.

ONE FINAL MAJOR COMMENT ON CONSOLIDATION POLICY. WE RECOMMEND THAT CONSIDERATION BE GIVEN TO THE IMPLICATIONS OF MINORITY VETO RIGHTS ON THE EXPOSURE DRAFT'S DEFINITION OF EFFECTIVE CONTROL. MORE DEFINITION IS NEEDED IN THIS AREA OF RESTRICTIONS ON CONTROL TO **ENABLE PREPARERS AND THEIR AUDITORS TO WEIGH THE** POTENTIAL EFFECTS OF MINORITY VETO RIGHTS. THE BOARD SHOULD CONSIDER WAYS IN WHICH MINORITY VETO RIGHTS ARE USED IN CORPORATE GOVERNANCE AND PROVIDE GUIDANCE ON THE DEGREE TO WHICH SUCH RIGHTS ARE PERMITTED TO LIMIT THE PARENT'S POWER OVER THE ASSETS OF THE SUBSIDIARY BEFORE THE CRITERIA OF EFFECTIVE CONTROL IS NO LONGER MET.

AS REGARDS CONSOLIDATION <u>PROCEDURES</u>, WE ARE NOT CONVINCED CHANGES ARE REALLY NECESSARY. PREPARERS, USERS AND AUDITORS ARE NOT CLAMORING FOR CHANGE, AND,

EXCEPT FOR THE FACT THAT MINORITY INTEREST DOES NOT

NEATLY FIT INTO THE FASB'S CONCEPTUAL FRAMEWORK, WE

CANNOT FIND ANY RATIONALE FOR THE SUGGESTED CHANGES.

AS I MENTIONED EARLIER, WE SUPPORT THE PARENT COMPANY VIEW, AND, CONSEQUENTLY, FAVOR CONSOLIDATION PROCEDURES WHICH, IN THE MAIN, ARE CONSISTENT WITH THAT VIEW. CONSOLIDATION PROCEDURES CONSISTENT WITH THE PARENT COMPANY CONCEPT ARE, GENERALLY SPEAKING, THE PRACTICES ADVOCATED BY CURRENT ACCOUNTING RULES.

NEXT, LET'S LOOK AT SOME SPECIFIC PROCEDURAL ISSUES.

WE AGREE WITH THE BOARD'S DECISION TO CONTINUE

REQUIRING ALL INTERCOMPANY ASSETS, LIABILITIES, REVENUES

AND EXPENSES TO BE ELIMINATED IN FULL. WE ALSO AGREE

WITH THE BOARD THAT THE ENTIRE AMOUNT OF UNREALIZED

INTERCOMPANY PROFIT OR LOSS SHOULD BE ELIMINATED AND

ALLOCATED PROPORTIONATELY AMONG CONTROLLING AND

NON-CONTROLLING SHAREHOLDERS.

REGARDING REPORTING NON-CONTROLLING INTEREST IN
SUBSIDIARIES, WE AGREE WITH THE BOARD THAT SHOWING SUCH

AN INTEREST AS A LIABILITY HAS NO CONCEPTUAL SUPPORT BECAUSE IT DOES NOT MEET THE DEFINITION OF A LIABILITY AS DEFINED IN CONCEPTS STATEMENT NO. 6. BUT, WE DO NOT AGREE THAT SHOWING SUCH AN INTEREST AS A COMPONENT OF EQUITY IS APPROPRIATE EITHER. THE SHAREHOLDERS OF THE PARENT DO NOT HAVE AN INTEREST IN THE MINORITY INTEREST AND VICE VERSA. WHY NOT LEAVE THE MINORITY INTEREST WHERE IT HAS BEEN FOR YEARS....BETWEEN LIABILITIES AND EQUITY.

AS REGARDS THE ACQUISITION OF A SUBSIDIARY, WE ARE NOT IN AGREEMENT WITH THE BOARD'S PROPOSAL TO FAIR VALUE ALL ASSETS AND LIABILITIES OF THE SUBSIDIARY AT THE DATE THE PARENT-SUBSIDIARY RELATIONSHIP IS ESTABLISHED.

WE BELIEVE THE ASSETS ACQUIRED IN AN ACQUISITION SHOULD REFLECT FAIR VALUES TO THE EXTENT OF THE PARENT'S OWNERSHIP PERCENTAGE; THE PORTION REPRESENTING THE MINORITY'S INTEREST SHOULD CONTINUE TO BE CARRIED AT HISTORICAL COST.

FOR THOSE SUBSIDIARIES ACQUIRED IN STEPS, WE BELIEVE THE CURRENT ACCOUNTING FOR STEP ACQUISITIONS -- CALLING FOR RETROACTIVE APPLICATION OF THE EQUITY METHOD AND TREATING EACH ACQUISITION AS A SEPARATE LAYER --PRODUCES MORE MEANINGFUL INFORMATION IN THAT IT RECOGNIZES THE PARENT'S "TRUE" COST OF ACQUIRING THE SUBSIDIARY. RETROACTIVE APPLICATION OF THE EQUITY METHOD ALLOWS FOR THE SAME ULTIMATE CARRYING AMOUNTS OF THE SUBSIDIARY'S ASSETS AND LIABILITIES, REGARDLESS OF HOW THE ORIGINAL PRE-CONTROL INVESTMENT WAS ACCOUNTED FOR. IN THIS REGARD, WE DISAGREE WITH THE BOARD'S POSITION THAT ANY UNREALIZED GAINS OR LOSSES PREVIOUSLY RECORDED IN EQUITY FOR PRE-CONTROL INVESTMENTS BE RECOGNIZED IN EARNINGS AT THE DATE CONTROL IS OBTAINED. SUCH UNREALIZED GAINS/LOSSES SHOULD BE ELIMINATED AT THE DATE CONTROL IS OBTAINED, AND THE EQUITY METHOD SHOULD BE RETROACTIVELY APPLIED TO THE INVESTMENT.

THE BOARD'S APPROACH IS ALSO INCONSISTENT IN THAT IT IS STILL REQUIRING RETROACTIVE APPLICATION OF THE EQUITY METHOD IN SITUATIONS WHEN AN ENTITY HAS, FOR EXAMPLE, A 10% INVESTMENT IN ANOTHER COMPANY ACCOUNTED FOR ON THE COST BASIS, AND THAT INVESTMENT IS SUBSEQUENTLY INCREASED TO A LEVEL WHERE SIGNIFICANT INFLUENCE IS OBTAINED. THIS POSITION, COUPLED WITH THE BOARD'S PROPOSAL OF THE ACCOUNTING FOR STEP ACQUISITIONS, COULD LEAD TO ABUSES, AS THE STRUCTURE OF TRANSACTIONS CAN BE MANIPULATED DEPENDING ON THE DESIRED RESULTS: FOR EXAMPLE, TRANSACTIONS MIGHT BE EXECUTED IN STRATEGIC STEPS TO MINIMIZE THE AMOUNT OF RECORDED GOODWILL.

THE BOARD IS FURTHER PROPOSING TO ACCOUNT FOR ANY ADDITIONAL PURCHASES BY A PARENT AFTER CONTROL IS OBTAINED AS CAPITAL TRANSACTIONS. WE RECOMMEND THAT, IF THE BOARD ELECTS TO MOVE FORWARD WITH THE PROPOSED STATEMENT, IT PROVIDE GUIDANCE TO MINIMIZE ANY POTENTIAL ABUSES.

AS TO CHANGES IN A PARENT'S OWNERSHIP INTEREST IN A SUBSIDIARY WHILE MAINTAINING CONTROL, WE DISAGREE WITH THE BOARD'S VIEW THAT ANY CHANGES IN A PARENT'S PROPORTIONATE INTEREST IN A SUBSIDIARY SHOULD BE ACCOUNTED FOR AS CAPITAL TRANSACTIONS. AS PREVIOUSLY INDICATED, WE BELIEVE THAT THE PURPOSE OF CONSOLIDATED FINANCIAL STATEMENTS IS TO PROVIDE THE PARENT'S SHAREHOLDERS WITH INFORMATION ABOUT THEIR OWNERSHIP INTEREST IN THE PARENT AND ITS SUBSIDIARIES. WHEN A PARENT'S OWNERSHIP INTEREST CHANGES AS A RESULT OF TRANSACTIONS INVOLVING NON-CONTROLLING SHAREHOLDERS, SUCH TRANSACTIONS SHOULD BE VIEWED AS THIRD-PARTY TRANSACTIONS. ACCORDINGLY, WE SUPPORT THE VIEW THAT ANY INCREASES IN THE PARENT'S OWNERSHIP INTEREST SHOULD BE ACCOUNTED FOR AS ADDITIONAL PURCHASES, AND DECREASES AS SALES WITH GAIN OR LOSS RECOGNITION.

AS TO DISPOSITION OF A SUBSIDIARY, WE AGREE WITH THE BOARD THAT IF A DISPOSITION OF A SUBSIDIARY OCCURS, EVEN IF A NON-CONTROLLING INTEREST IS RETAINED, GAIN OR LOSS

ON THE DISPOSITION SHOULD BE RECOGNIZED IN THE CONSOLIDATED STATEMENTS. HOWEVER, WE WISH TO POINT OUT TO THE BOARD THAT GIVEN ITS PROPOSED ACCOUNTING FOR DISPOSITIONS RESULTING IN A LOSS OF CONTROL DIFFERS FROM DISPOSITIONS WHILE MAINTAINING CONTROL, ABUSES LIKE THOSE POSSIBLE IN STEP ACQUISITIONS COULD OCCUR.

IN ANOTHER MATTER, WE DISAGREE WITH THE BOARD THAT THE ACCOUNTING POLICIES OF THE SUBSIDIARY AND PARENT BE CONFORMED. WE BELIEVE THAT AS LONG AS AN ACCOUNTING METHOD IS U.S. GAAP FOR A SUBSIDIARY, THE SUBSIDIARY'S ACCOUNTING POLICIES CAN BE CARRIED OVER IN THE PARENT'S CONSOLIDATED FINANCIAL STATEMENTS.

IF THE BOARD, HOWEVER, PROCEEDS WITH ITS PROPOSAL
TO REQUIRE CONFORMITY, WE RECOMMEND THAT THE BOARD
PROVIDE ADDITIONAL EXAMPLES AS TO SITUATIONS WHERE
SPECIALIZED POLICIES ARE ALLOWABLE FOR A SUBSIDIARY, BUT
NOT FOR THE PARENT.

AS A FINAL COMMENT, WE AGREE WITH THE BOARD THAT
FISCAL PERIODS SHOULD BE CONFORMED UNLESS CONFORMITY

IS NOT PRACTICABLE. HOWEVER, WE RECOMMEND THAT THE BOARD PROVIDE ADDITIONAL GUIDANCE AS TO WHAT WOULD BE DEEMED "NOT PRACTICABLE."

IN CONCLUSION, NOT MUCH IS BROKEN IN THE AREA OF
CONSOLIDATION POLICIES AND PROCEDURES. MOST OF THE
ISSUES ENCOUNTERED RELATE TO SITUATIONS ON THE FRINGE
OR TO SPECIAL PURPOSE ENTITIES AND NON-CORPORATE
INVESTEES. IN OUR VIEW, THE EXPOSURE DRAFT WILL NOT
REALLY RESOLVE TODAY'S PROBLEMS AND WILL CREATE A HOST
OF NEW ONES.

IMA REPRESENTATIVES:

L. H. ROGERO, JR.

CHAIRMAN,

FINANCIAL REPORTING COMMITTEE

MICHAEL BOHAN

MANAGING DIRECTOR,

PROFESSIONAL AND TECHNICAL

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INSTITUTE OF MANAGEMENT

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