



FINANCIAL EXECUTIVES
INSTITUTE

June 3, 1999

Director of Research and Technical Activities
Financial Accounting Standards Board
407 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Letter of Comment No: 96
File Reference: 1082-194R
Date Received: 6/8/99

Re: File Reference 194-B

Dear Sir:

The FEI's Committee on Corporate Reporting (CCR) appreciates the opportunity to respond to the Exposure Draft (ED), Consolidated Financial Statements, Purpose and Policy. We remain skeptical that problems exist with regard to the existing accounting model of a magnitude sufficient to justify discarding a long-standing and well understood accounting convention. While the model established by ARB 51, FASB 94 and various EITF decisions is itself a judgmental model, it benefits from a long history of precedents that allow for consistent application. In our view, to warrant replacing this model with another judgmental model with new and untested terms must meaningfully advance generally accepted accounting principles. We do not believe this proposal meets this standard. To the extent that the Board feels the current model is not functioning appropriately then we urge the Board to address those issues directly, within the current framework. CCR retains its longstanding position that ownership interest is a general prerequisite for consolidation. For this and the other reasons set forth herein, CCR strongly objects to the principles contained in the Exposure Draft and urges that this project be discontinued.

We are very concerned that the application of the Board's definition of control will detract from rather than enhance the usefulness of consolidated financial statements. Clearly, CCR does not dispute the underlying premise that consolidated financial information is more valuable than nonconsolidated information when assessing performance of the enterprise. But certain examples in the ED would suggest that consolidation would be required where a company may not have an actual residual interest in the underlying operating assets. We do not see how the capital providers for a

company, presumably the primary customers for the financial statements, are better served by consolidating such an interest. The company's creditors would be unable to obtain a security interest in the assets or have access to the cash flow of the affiliate. The company's equity providers would likely be more interested in how their capital is put to use, which could be obscured by commingling it with assets procured with other sources of capital and whose benefits accrue substantially to others.

Further, with the growing importance of the statement of cash flows, we are concerned that the guidance included in the ED could impair the usability of this statement. For example, if an entity is consolidated based on the ownership of convertible securities, we question how meaningful the cash flows of an entity will be if the parent does not currently have access to those flows. Additionally, we question whether consolidating an entity in which a company owns a convertible debt security provides a better accounting answer than accounting for it at fair value in accordance with FAS 133.

We also are concerned with a notion of control that is based on a theoretical ability to obtain control rather than affirmative actions to control an entity. This is manifest in the creation of a rebuttable presumption of control in the absence of actual voting control when a company owns a substantial minority interest or owns an in-the-money convertible security. We believe that absent positive actions to exert control, as distinct from influence or potential control, consolidation could be misleading and inhibit the ability of capital providers to assess the performance of management with the capital it does control.

In addition to the questionable benefits of theoretical control we believe that the concept would add unprecedented volatility with regard to which entities will be included, then excluded from consolidated financial statements, as presumptions of control are ultimately proved false. We would hope that the Board shares our view that frequent consolidation and deconsolidation, with the attendant restatement, undermines confidence in financial statements. This is especially true when it occurs without a change in the actual investment.

The notion of theoretical control inherent in the ED creates the potential for just such an occurrence. CCR has long held the view that the provision for management judgement is an integral component of a well-constructed accounting standard. However, the judgements inherent with regard to theoretical control, specifically whether future shareholders will remain diversified or whether future shareholders will choose to exercise their voting rights, seem particularly esoteric. Volatility will also be added depending on whether convertible securities are in or out-of-the-money. The fair value of convertible securities can fluctuate within a year between quarters as a result of general market conditions or company specific facts. Using guesses and hypotheses as a basis for consolidation decisions strikes us as a lot to ask of preparers.

CCR feels that EITF Consensus 96-16 provides a clear, operational framework for determining when control exists. We do not see what is gained by abandoning that

framework in favor of the non-shared decision-making framework. We believe that the ambiguous nature of this criterion will not allow for consistent application of the standard. The notion in the body of the proposed standard of non-shared decision making as exclusionary power appears to us to be contradicted in the implementation guidance where it is acknowledged in practice that a wide range of minority rights limit decision making. How limits to decision-making differ from shared decision-making remains unclear and we predict could lead to the deconsolidation of previously consolidated affiliates. For example does a veto right over the strategic plan but not over operating budgets constitute shared control or a limit on control? It could be construed to be such a limitation; however, the long-range implications of strategic decisions clearly have an impact on the long-term value of the enterprise.

Our detailed responses on the specific issues raised in the ED are discussed in greater detail in the attachment to this letter. The CCR committee member that coordinated this response is Stephen F. Reeves of The Black & Decker Corporation. Should you have any questions, please contact him at (410) 716-2118.

Sincerely,

Susan Koski-Grafer
Vice President-Professional Development
and Technical Activities

Definition of Control and Its Implementation Guidance

Issue 1:

Does the revised definition, together with the discussion of the characteristics of control (paragraphs 10-14) and descriptive guidance (paragraphs 15-23 and 30-47), help clarify when one entity controls another entity?

No. We believe that affirmative controlling actions, including a controlling equity interest, are a prerequisite for control. Presumed control in the absence of affirmative evidence is a dangerous precedent and is unlikely to reflect a consensus view of control.

Will the revised definition and guidance lead to common understandings and application of this Statement's definition of control?

No. As mentioned in our cover letter, determining the line where limitations on control and shared control meet is likely to be arbitrarily applied. If the Board were to continue to pursue this framework, we strongly urge the Board to adopt the guidance provided in EITF Consensus 96-16. Additionally the Board should elaborate on what it means by "benefits" in the context of the ability to increase benefits and limit losses inasmuch as the Board appears to dismiss the significance of residual benefit of assets.

Additionally, we believe that when the accounting does not follow the economics or management structure that it is unlikely that a clear consensus will develop in practice. As stated previously the result of applying the standard as drafted would likely result in degradation in the quality of financial reporting. Therefore prudent management will likely strive to interpret the standard in a manner which more closely approximates the economics rather than as the Board intends.

Issue 2:

Will guidance in the form of rebuttable presumptions of control be necessary?

As previously stated, CCR disagrees with the fundamental notion of presumed control and is much more comfortable with demonstrated control.

Do the circumstances described in each of the situations above provide a reasonable basis for presuming that one entity controls another entity in the absence of evidence that demonstrates or proves otherwise?

No. The issue of the significance of minority rights discussed above which has significant impact on control is discussed above. In addition, we are of the opinion that predicting the voting patterns of unrelated parties, which would be little more than a guess, is not a sound basis for consolidation. Additionally, the existence of convertible securities, in and of itself, is not indicative of control. Exercising control and actually placing capital at risk remain significant considerations. Some incorporation of management's intentions with regard to the existing investment in such convertible securities seems appropriate.

Are they sufficiently clear and operational?

No. As stated above the interaction of minority rights on control is unclear. Additionally as stated above several of the judgements to be made by management will be arbitrary. When consolidation is based on ownership of a convertible security how will earnings be allocated between the controlling and noncontrolling interests, based on existing ownership interests or potential ownership interests. Other procedural issues will become evident if controlled but not majority-owned entities have to be consolidated.

Are additional presumptions of control necessary for specific circumstances?

No additional presumptions of control are necessary.

Transition and Implications for Interim Reporting

Issue 3:

Are the benefits of complete and comparative financial statements for all interim periods in the initial year of application sufficient to justify requiring, rather than permitting, that the provisions of this statement be applied for the first and each subsequent interim period in the year of adoption?

Inasmuch as CCR is unclear on what problem the ED is attempting to solve, this question is difficult to answer. Since we fundamentally believe that the framework proposed in the ED is a step backward from current practice the answer would have to be no. Additionally, we call your attention to the operational points raised below.

Are there specific circumstances surrounding the application of this proposed Statement that would justify delaying its application to interim periods in the year of adoption?

Assuming a fourth quarter, 1999, final standard we believe compelling a first quarter, 2000 implementation accompanied by the restatement of the corresponding quarter of 1999 is unreasonable. From a corporate perspective there potentially are investments not carried on the equity basis that could require consolidation. While presumably some financial information will exist for the vast majority of investments which both qualify for consolidation and are material, there is no assurance that it will be based on U.S. GAAP. Additionally, very little time will be available to conform accounting policies and accounting years and identify intercompany balances for elimination all of which will need to be performed for both the current period and retroactively for public companies. This will be complicated further in those situations where the potential for control exists but is not actively occurring.

Additionally, given the proposed timing, corporations will be unlikely to have incorporated the ramifications of the standard into their budgeting process and communication plans.