Financial Accounting Standards Board  
File Reference #154-D  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116  

Gentlemen:

This letter is in response to FASB's Exposure Draft (ED), "Consolidated Financial Statements: Policies and Procedures." As you are aware, our company has been following the progress of this project with great interest. Early last year, we met with several Board and staff members to express our views with the direction of the project. At that time, our primary focus related to the proposed changes relating to SAB 51 transactions and the direct sale of subsidiary shares. Because of our unique and very successful corporate structure, we felt that those aspects of the project would lead to accounting that would not properly reflect the economics of the underlying transaction and, therefore, harm our stockholders. After studying the ED, however, we believe that the harm to our stockholders will primarily come from other aspects of the proposal which undermine public confidence here and abroad in the integrity of the financial statements of all U.S. corporations. In what follows, I will first outline the mechanisms that could lead to misrepresentation of companies' reported incomes in the future.

Thermo Electron's strategy is to grow by means of both internal developments and strategic acquisitions. We have made over 50 acquisitions over the past five years and over 100 since 1980. The total goodwill in our balance sheet is $800 million. Several of these companies were acquired in two or three step transactions. We plan to continue making many such acquisitions in the future. Moreover, from time to time, we carry minority interest in other public companies.

The accounting distortions of the proposed procedures on financial statements will derive from four sources. First, the added goodwill and the corresponding amortization of all acquisitions made in more than one step will be smaller than normal. Second, when we decide to divest any of such acquisitions, the reported profit would be significantly greater than the real economic profit we would have had to report in the past. In fact, if we did restate the past, we have business units (previously acquired in two steps) such that if we were to dispose of them at an economic loss we would report a substantial profit that bears no relation to reality.
Third, we would have the opportunity to record a profit at will by increasing our ownership of a publicly traded company from below 20% to above 20% whenever the stock price increased to more than what we paid initially. Finally, we would be able to dispose of investments in two-step transactions and record a profit higher than the real economic profit. Such divergence of accounting from economics can be further increased by requiring from the buyer of the majority part to pay a premium over what was paid for the minority part, an economically justifiable request.

These opportunities will be afforded to us without any intent to abuse the system. Nevertheless, the proposal provides enormous opportunities for abuse. This fact concerns us on two counts. First, these opportunities will be available to our less scrupulous competitors. Second, and more importantly, it will over time undermine the credibility of the U.S. accounting system not only in this country, but also abroad.

Thirty five percent of Thermo Electron's stock is held overseas. Currently, the superior reputation of the U.S. system has permitted us to compete favorably for funds in foreign markets because accounting in other countries contain provisions that frequently distort economic reality. If we introduc a system so inconsistent with the underlying economics as to provide the possibility to sell a subsidiary for less than its purchase price and book a gain when the sale actually resulted in an economic loss, even if such an event rarely happens, the integrity of the U.S. financial reporting system will be seriously compromised. In fact, the inconsistency between the proposed model and the underlying economics can be so great as to result in transactions more outrageous than any described by Walter Schuetze a few years ago in his now famous "Incredible Accounting" speech.

In paragraphs 69 and 70 the Board states, "The Board believes that harmonization of U.S. Standards with those in other countries is desirable and helpful in improving the comparability of financial information. That harmonization is especially important as entities in the United States and elsewhere compete for scarce resources in a global marketplace. The Board concluded that this Statement not only improves the quality of consolidated financial statements but also is a positive step toward international harmonization. In many important respects, its definition of control, its requirement to include controlled entities in consolidated financial statements, and its description of the purpose of consolidated financial statements are consistent with recent trends in other countries." We totally disagree with the Board as to what the international harmonization effects of the new standard will be. We believe that accounting that is so dramatically inconsistent with the economics of the transactions can only damage international harmonization of accounting standards.

If the Board were to proceed with its proposed changes, we would be morally and legally forced to disclose the true economics to our stockholders in some other way. The only practical way that can be done and understood by our stockholders is to prepare alternative financial statements. If we only provide the footnotes required to state all the facts, such as the goodwill that is not recorded or amortized, the economic gains from sale of stock that are not recorded and the economic losses
resulting from the sale of a subsidiary that are not recorded, the financial package will be very confusing and totally useless to investors.

Finally, we disagree with the Board's requirements that prior periods be restated upon adoption of the financial statement. The Board has provided an exception if retroactive application is not practicable. We agree with this provision which probably would apply to us. Nevertheless, even if restatement were practicable, as probably is the case for other companies, to require restatement of net income may result in a perception by the investing public that the previously reported results were inaccurate or arrived at using less preferable accounting practices, thus adversely affecting the reputation of the company that was abiding by the rules. Certainly in our company, if the rules were different in the past, our activities and actions relating to R&D and acquisitions would have been significantly altered. The harm caused by the negative perception of the investing public could be material and long lasting.

In the analysis that follows, which was reviewed with our independent public accountants, Arthur Andersen, we discuss all the issues raised above in more detail.

The Board has identified a number of important issues about the procedures used in preparing consolidated financial statements including the reporting of (a) noncontrolling interests in consolidated financial statements, (b) assets and liabilities of acquired subsidiaries, (c) changes in parent's interest in a subsidiary, and (d) intercompany transactions and balances. From our discussions with the FASB, we believe that the first issue, presentation of noncontrolling interests in consolidated financial statements, is a driving force behind the consolidation procedures portion of the project. The debate with respect to the presentation of noncontrolling interests centers around the economic unit model vs. the parent company model.

**Economic Unit Model — Legal and Economic Realities**

From a theoretical perspective, we do not believe that the economic unit model reflects the economic and legal realities surrounding parent ownership of subsidiaries for the following reasons:

1. ARB 51 originally set forth the purpose of consolidated financial statements. We note that the Board has reaffirmed the conclusions of ARB 51 in the ED: "The purpose of consolidated financial statements is to report, primarily for the benefit of the shareholders, creditors, and other resource providers of a controlling interest (parent), the financial position, results of operations, and cash flows of a reporting entity that comprises a parent and its subsidiaries essentially as if all of the resources of the affiliates were held and all their activities were conducted by a single entity with one or more branches or divisions." With this purpose as a starting point, it is difficult for us to understand why the Board would then support the economic unit model. If everyone is in agreement that the primary purpose of consolidated financial statements is for the benefit of the shareholders, creditors and other resource providers of the parent, then should not our objective be to make those statements as easy to understand for that constituency?
The financial information needs of the noncontrolling or minority shareholders of a consolidated subsidiary should be met primarily by the subsidiary’s separate financial statements. To somehow try to meet the information needs of the shareholders of the parent and the shareholders of a subsidiary in one set of financial statements will be at best, confusing, and at worst, misleading. We see no better way to assist shareholders of a subsidiary than to provide them with that subsidiary’s financial statements. We see absolutely no benefit to those shareholders to call their investment in the subsidiary “equity” at the parent company level and then provide them with consolidated financial statements that include their investment as “equity.” To most shareholders, what else could such a presentation imply but that this shareholder has an equity interest in all of the assets and liabilities of the consolidated parent? However, nothing could be further from the truth. Minority shareholders of a subsidiary only hold an equity interest in the subsidiary. Again, at best, such presentation is confusing, and at worst, it is misleading.

And what about the controlling shareholders? If the consolidated financial statements are for the primary benefit of these shareholders, shouldn’t the statements clearly indicate that there is an encumbrance on certain of the consolidated assets? Increasing net worth by including the minority interest within equity certainly does not seem to be the appropriate manner to present such an encumbrance. Again, at best, such presentation is confusing, and at worst, it is misleading.

2. We believe the economic unit model also distorts the legal realities surrounding minority interest. From a legal perspective, stock of a subsidiary is an asset of the parent, as opposed to the parent owning the underlying assets of the subsidiary. In bankruptcy or other legal proceedings against the parent, creditors can force a sale of the stock of the subsidiary, but cannot force the sale of the underlying assets of the subsidiary. While the legal profession and the rating agencies view consolidated entities as comprising distinct, separable, legal entities, the accounting profession is the only group that requires consolidation of entities. However, current consolidation practices, while not necessarily consistent with the legal model, are based on the same parent company model as is used by the legal profession and accordingly, the parent’s investment in its subsidiary is viewed as an asset. Adoption of the economic unit model will widen the gap between financial reporting and the legal view and economic substance of parent ownership of subsidiaries.

Other legal aspects of parent ownership of subsidiaries include:

a. The parent’s access to cash flow of a subsidiary is limited. Rating agencies certainly do not view the consolidated whole as a single entity.

b. Minority shareholders of a subsidiary have no ownership interest in the parent. To show such shareholders within the “equity” section of the parent would be to contradict the legal reality of such ownership.
c. Creditors of the subsidiary can only reach the subsidiary's assets, not the parent's. Again, to show the minority shareholders within the parent's equity section would lead one to believe that these shareholders have some form of ownership interest in all of the consolidated assets and liabilities.

d. Parent companies in certain situations choose to submit to a vote of the subsidiary's minority stockholders certain related party transactions such as mergers. This so-called "neutralized" voting does not count the parent's shares, further highlighting the differences between the status of a parent's ownership interest and the minority stockholders' interest.

Based on the above legal and economic analysis, we continue to believe that today's parent company model is the more appropriate consolidated financial statement model. We are very concerned with the fact that the proposed economic unit model appears to ignore the legal and economic realities surrounding parent company ownership of a subsidiary.

Economic Unit Model — A Framework for Misrepresentations and Abuse

Gains and Losses Recorded Upon Equity Accounting or Control

Under the ED, APB Opinion No. 18 will be amended. This amendment relates to a situation where an entity has held marketable equity securities which are being accounted for as "available for sale" under SFAS 115 with fair value adjustments being recorded in equity. Upon obtaining "significant influence" (practice being twenty percent or greater ownership), the unrealized holding gains and losses previously recorded in equity would then be recorded in the income statement. The same accounting would result if an entity increased its ownership from a SFAS 115 investment directly to control and consolidation.

First, we continue to have difficulty understanding how an entity can record gains upon the purchase of assets. In paragraph 122 of the ED, the Board has attempted to justify these gains by analogy to APB Opinion No. 29, Accounting for Nonmonetary Transactions. The Board claims that there has been some sort of nonmonetary exchange in that the "investment asset (the Board's reference to the investment prior to obtaining control) is 'transferred,' 'converted,' or 'given up' to obtain control of the assets and liabilities of the acquired entity." This is one of the most bizarre analogies we have ever heard. An exchange, by definition, requires two parties. In this transaction, who is the other party? To whom has the "investment asset" been transferred? The entity acquiring control owned the "investment asset" prior to obtaining control and owns it after obtaining control, therefore, how can the asset have been "transferred, converted or given up"?
Even if one were to agree with this concept that something substantive happens to the previous investment upon obtaining control, how can the Board extend this to obtaining significant influence? The justification in paragraphs 121 and 122 are based on "control." However, in paragraph 125, the Board casually extends such amazing accounting to situations where entities go from SFAS 115 to the equity method. The importance of obtaining control as outlined in paragraphs 121 and 122 seems to have been forgotten.

If for a moment one agrees with the theory put forth by the Board, one must be troubled by the potential for misrepresentation. An entity owns a portfolio of SFAS 115 investments, all of which fall into the available for sale category. The entity has no desire to "obtain significant influence" and perform equity accounting on any of these investments. However, at the end of any given quarter, the entity’s operating results are falling short of analysts’ expectations or it is faced with a potential covenant violation on its outstanding debt. The simple solution in the future will be to go out and purchase an asset and solve an operating profit shortfall or covenant violation.

If the entity owns nineteen percent of one of the companies in its portfolio, all it has to do is go out on the open market and purchase one percent more in order to obtain "significant influence" and record in its income statement any previously unrealized gain. The more the price of the investee’s stock has gone up, the more expensive it will be for the entity to obtain the significant influence. But that means more of a gain to record! And since the entity had no desire to obtain significant influence in the first place, it may sell the one percent it purchased and, as a result, only be on the equity method for a short period of time. So the only "cost" of recording the gain is having to invest and be exposed on the one percent. Realistically, this is not much of an exposure given the short timeframe. And what happens if the investee’s stock price drops while the entity holds the twenty percent? The entity will only have to record a loss on the one percent it subsequently sells. While the gain it recorded on the nineteen percent may have evaporated in reality with the decline in stock price, it is not required to record an offsetting loss upon going from equity to SFAS 115.

We understood one of the Board’s major objectives during the deliberations of SFAS 115 was to deal with the issue of gains trading—selectively selling winners when needed but holding losers. Ultimately, the Board was not able to agree on an approach that effectively addressed this issue. Under the guidance provided for in the ED, the Board is proposing a new standard that will increase gains trading. The gains trading will be triggered by an event entirely within the investor’s control, the subsequent purchase of an asset.

Changes in a Parent’s Ownership Interest in a Subsidiary and Step Acquisitions

Under the Board’s economic unit model, once control is obtained, any transactions between the controlling and noncontrolling shareholders are equity transactions among shareholders and, therefore, only the equity accounts of the reporting entity are impacted. This results in the following anomalies and potential abuses:
1. After obtaining control, any subsequent purchases are recorded in equity. Therefore, any subsequent purchases result in a decrease in net worth of the investor. Again, we are left with a very difficult concept to understand; an entity purchases something (in our view, and we believe most shareholders’ views, an asset has been purchased despite the Board’s view that this is not the acquisition of an asset), and net worth decreases. This will lead to situations where the accounting will drive operating decisions instead of the reverse. An entity could be considering the acquisition of a part or all of one of its minority interests at a price that it believes to be in the best interests of its shareholders. It runs all the appropriate cash flow and other economic analyses and determines that this is the correct decision. However, if the company proceeds with this transaction, it faces a decline in book value and a potential net worth covenant violation on its outstanding debt caused by the decrease in the entity’s net worth.

How can the Board make any sense of such a situation? If its answer is that lenders will have to adjust covenant calculations for this change in accounting, then that implies that lenders do not agree that minority interest is a part of equity to begin with (which is what we believe lenders’ views to be). If its answer is that entities will have to request waivers before entering into such transactions, then this makes no sense either. Waivers are generally required when an entity does not perform up to expectations, that is, under negative circumstances. The Board should not be proposing accounting that will require entities to obtain waivers before entering into purchase transactions that management believes are in the best interest of its shareholders.

2. If the Board’s proposal survives, we will have witnessed the end of single step acquisitions as we currently know them. Today, step acquisitions are more the exception. In the future, they will become the norm. What acquiror would not structure an acquisition in two or more steps in order to avoid recording 49% of the goodwill? Why should companies make acquisitions in single transactions and record much more goodwill when the FASB provides a viable alternative which only requires recording 51% of the goodwill? We find it hard to believe that the intent of the FASB is to have companies only record 51% of the goodwill in 100% acquisitions; however, this will be the result.

In fact, a few years ago, Merrell Dow structured a transaction to achieve just this result, that is, only having to record a portion of the goodwill. While the SEC originally allowed the transaction to proceed, the EITF put an end to these transactions as they saw it for what it was—-an abuse of the system.

Given our current historical cost concept, we cannot think of any justification for the following two scenarios resulting in drastically different results.
Scenario A

Co. A acquires 100% of the stock of Co. B for $10 million. The fair value of Co. B's net assets is $4 million. As a result, Co. A records $6 million of goodwill which it amortizes over 10 years at $600K per year.

Scenario B

Co. A acquires Co. B in two tranches. In total it pays the same $10 million as in Scenario A, except it pays $5.1 million for the first 51% of Co. B and $4.9 million for the remaining 49% of Co. B. As a result, Co. A records only $3.06 million of goodwill which it amortizes over 10 years at $306K per year.

In both cases, Co. A has acquired 100% of Co. B for $10 million. However, the balance sheet result of Scenario A as compared to Scenario B is higher goodwill of $2.94 million and higher net worth of $2.94 million. Additionally, the income statement effect is lower net income of $294K for ten years in Scenario A vs. Scenario B. Given today's historical cost model, we have a hard time reconciling the results between Scenarios A and B, since the only difference between the two is that Co. B was acquired in one transaction vs. two transactions. We believe the Board is putting too much emphasis on the transaction that results in control at the expense of sensible, accurate financial reporting.

3. The accounting moves even further from the economics as we proceed down the slippery slope that the FASB is creating. How about selling a subsidiary for less than you paid for it and recording a gain on the transaction? Consider the following transaction. Assume the same facts as Scenario B above. Co. A acquires Co. B for a total of $10 million in a two step transaction. However, because of the two steps, Co. A only records $3.06 million of goodwill. The net assets of Co. B after the buyout of the minority interest are $7.06 million (tangible assets of $4 million and goodwill of $3.06 million). For simplicity purposes, ignore the effects of goodwill amortization and let's assume that Co. B breaks even for two years and Co. A sells Co. B for $8 million. The result is that Co. A will record a gain of $940K upon the sale even though it incurred an economic loss of $2 million (total cost of the purchase of $10 million less the sales proceeds of $8 million). Again, it is extremely difficult for us to understand why the FASB is comfortable putting forth a proposal that not only will encourage such accounting, but will require it!

The FASB, in support of its position, has included a quote in paragraph 128 of the ED from an organization representing lending officers. The quote refers to SAB 51 gains and states, "We believe that recording gains and losses on such transactions is inappropriate to such an extent that some might even consider it fraudulent." We can only wonder what this organization would think of the transaction where an entity can sell a subsidiary for less than it paid for it.
and record a gain. If this transaction is not fraudulent, we do not know what is. SAB 51 transactions clearly have economic reality to support the gain, where there is absolutely no economic reality to support the gain recorded in this transaction.

4. Let's continue down the slippery slope. Let's assume that Co. X owns 100% of Co. Y and the net worth of Co. Y is $50 million. Co. X performs SFAS No. 121 realizability analyses on Co. B and based on expected gross cash flows, there is no indication of impairment. However, the fair value of Co. Y is actually $45 million and Co. X desires to sell Co. Y. Most would expect that Co. X will record a $5 million loss on the sale of Co. Y. However, Co. X can permanently avoid 49% of the $5 million loss by selling Co. Y in two steps. First, sell a 49% minority interest. The loss on that sale of $2.45 million does not get recorded as a loss on sale, but is recorded directly to equity. Then Co. X sells the remaining 51% and records only a loss of $2.55 million. As discussed later, this example could be even more extreme if the company received higher proceeds on the second sale perhaps to the point where no loss or even a gain could result. This is totally plausible when one considers the impact of the value of a control premium. At first glance, one might think that once a portion of Co. Y is “held for sale” that Co. X would have to take a fair value writedown. But because the FASB does not view the sale of 49% of a wholly owned subsidiary as the sale of an “asset,” there is no “asset” held for sale and, therefore, no writedown required.

Combining Scenario B in point 2 above (from the buyer’s perspective) with the scenario described in point 4 above (from the seller’s perspective) will result in a three step transaction always used when a company wants to sell a subsidiary but will incur a loss. The three step transaction will meet the objective of both the purchaser (to minimize goodwill) and the objective of the seller (to minimize its loss on sale) and will work as follows. The first step will be to sell 49% of the subsidiary. This will work to minimize the seller’s loss. The buyer will record goodwill on the 49% acquisition, and the seller will record no loss in its income statement for the 49% sale. The next step will be to sell an additional 2% to the same buyer. By buying and selling only an additional 2%, this will provide control to the buyer and, therefore, lock in his goodwill. This serves to meet his objective of minimizing goodwill. The two parties then complete the purchase and sale of the remaining 49% which results in no additional goodwill being recorded by the buyer and only 51% of the loss being recorded by the seller. It's a win-win situation. Both sides are able to meet their objectives.

If the above transaction is not troubling enough, consider what happens if both parties agree to do step one of the transaction at below market value and step three of the transaction at above market value; however, the total consideration does not change. By doing step one below market value, the buyer records less goodwill than he otherwise would and the seller avoids a larger portion of his loss. In fact, if structured appropriately, we could have another situation where we can turn an economic loss into a book gain.
One of the factors that drives “arms length” transactions is the countervailing force associated with the assumption that both parties are attempting to get the best deal for themselves. In this case, however, both sides get the best deal for themselves by working together to structure the three step transaction.

5. Another issue relates to SAB 51 gains as well as gains related to direct sales of the parent’s shares of its subsidiary. We do not agree with the Board’s economic unit model for the legal and economic reasons previously stated. These reasons become even more important in dealing with sales of the stock of a subsidiary, either directly or through a SAB 51 transaction. Because we view the ownership of a subsidiary as the ownership of an asset, we strongly believe that if an entity currently owns 100% of an entity and sells 49% of the entity, it has sold an asset and gain or loss should be recognized. The other party has purchased an asset which represents 49% of the subsidiary. If this sale were all to one party, that party would have an equity method investment on its books as an asset, would clearly view this as an asset, and we do not think anyone would argue with this view. However, how can the buyer purchase an asset if we have not sold an asset? If we have not sold an asset, what have we sold? Our shareholders and analysts clearly view this as an asset that the shareholders previously owned. If someone paid us for this asset, then we must have a gain or loss on the sale. In our view, to not give gain or loss recognition to such a transaction again entirely ignores the economics of the transaction.

At present, the Board is making no distinction between direct sales of a parent’s shares in its subsidiary and issuances of additional shares by the subsidiary. If the Board ultimately changes its views on direct sales and allows gain or loss recognition on such transactions, we believe that no distinction should then be made between direct sales and SAB 51 transactions, since the net effect is essentially the same to the parent company. From a shareholder’s perspective, we would hope that a company would not be forced to go the direct sales route and incur an income tax charge that otherwise would be deferred under the SAB 51 scenario in order to reflect in their income statement the true economics of the transaction since this would greatly increase the cost of capital.

It also is important to note that while we acknowledge that SABs 51 and 84 were interim guidance when issued, subject to the FASB deliberating the broader issue of consolidation procedure, they appear to have withstood the test of time and the test of new transactions. We believe the SEC has placed appropriate “fences” around such transactions to prevent abuse. Such fences include the prohibition of gain recognition when such a transaction is part of a broader corporate reorganization or in situations involving a newly formed, nonoperating company, or a research and development, start-up or development stage company. In addition, the SEC has specific rules related to repurchases of a subsidiary’s stock and requires consistent treatment of all such transactions as either capital or income statement related.
An expected response to the potentials for abuse as outlined above would be the implementation of appropriate “fences” to minimize or eliminate such abuses. However, first of all, a number of these potential abuses involve the always difficult issue of “intent.” The Board struggled significantly with this issue in the deliberations of SFAS 115 and ultimately acknowledged that it did not meet all of its planned objectives in that standard because of the difficulty of developing accounting standards that address the issue of intent. So, we should not underestimate just how difficult it would be to develop practical, workable fences. Moreover, suppose there was initially no intent to abuse. Is divergence from economic reality justifiable? More importantly, the fact that significant fences would be required to be developed prior to implementation of a new standard should call into question the relevance and appropriateness of the new standard in the first place. This is especially true when the current model is not broken, as is the case with today’s consolidation procedure model. Today’s model has none of the potential mispresentations and abuses that the new proposal has as outlined above. Given this, why would we consider developing a new model, which is fraught with potential for abuse, and then have to go and develop fences to try to curb the abuses? This appears to us to be a total waste of everyone’s limited time and resources.

Possible Alternatives

We believe the most appropriate step for the Board at this time is to separate the policy part of the project from the procedures part of the project. There is room for improvement with respect to consolidations policies and these improvements can be made without increasing the potential for abusive transactions. With respect to the procedures portion of the project, we believe that if something is not broken, don’t break it! It is our belief that the present accounting rules are working fine, and are fully understood by our shareholders, creditors and other resource providers. Therefore, it is incomprehensible to us as to why the Board would consider a new standard that will significantly increase the potential for abuse and cause irreparable harm to the U.S. financial reporting system.

If, however, the Board believes that it must make some changes with respect to consolidation procedures, we offer the following alternatives.

Address Only “Hybrid” Accounting for Partial Acquisitions

It appears from the discussion in Appendix A of the ED that one of the major concerns of the Board and several respondents to the Discussion Memorandum is the “hybrid” accounting we have today for partial acquisitions whereby each asset is recorded at an amount that represents partial fair value and partial carryover basis. If this is a primary concern, this could be corrected without having to cause all of the anomalies and potentials for abuse as outlined above. The Board’s proposed accounting for partial acquisitions could be implemented whereby all assets except goodwill are recorded at full fair value with a higher minority interest being recorded than is recorded today. We see some merit in this change and can understand some of the concerns over the mixed bases used today. This change could be implemented without having to address the theoretical debate of the economic unit model vs. the parent company model and without raising all of the potentials for abuse.
Implement a Hybrid Model

Another possibility is to not "stay true" to the economic unit model throughout. While we understand that it is difficult for the FASB to not stay consistent with a model once it is selected, we would point out that the Board acknowledged in the Discussion Memorandum that all of the conclusions reached do not necessarily need to conform exclusively to one or the other of the concepts. "To the contrary, the Board recognizes that addressing and resolving the specific consolidation policy and procedures issues in this phase of the broad project on consolidations and related matters could lead to a hybrid concept of consolidated financial statements that embraces some features of both the parent company and the economic unit concepts."

While we do not agree with any aspect of the economic unit model for legal and economic reasons, a reasonable hybrid approach would be to use the economic unit model for balance sheet purposes, that is include minority interest within the equity section. This would solve the Board's dilemma over minority interest not fitting within its conceptual framework. The Board could also include the full fair value model discussed above under "Address Only 'Hybrid' Accounting for Partial Acquisitions" in order to resolve concerns over mixed bases of accounting. Neither of these changes would result in anomalous answers or potentials for abuse. For all other aspects of consolidation procedure, today's parent company model would be retained.

CONSOLIDATION POLICY

Our concerns with respect to consolidation policy are more limited than our concerns with consolidation procedures. However, even with respect to consolidation policy, as drafted, we do not believe that issuance of a final statement will result in an improvement in the U.S. financial reporting system. The issues that we struggle with are the judgment calls about when to consolidate. While we do agree that there are areas for improvement in consolidation policy, we do not believe that the ED appropriately addresses these areas.

Control

The ED defines control of an entity as "power over its assets--power to use or direct the use of the individual assets of another entity in essentially the same way as the controlling entity can use its own assets." This definition can result in consolidation of entities when the controlling entity has little or no rights to any expected residual equity interests. This could result in a 100% minority interest (or noncontrolling interest depending on the outcome of the consolidation procedures section). To consolidate assets and liabilities that an entity will realize no economic benefit from is misleading to us.

This same issue results from the requirement in the ED to consolidate a sole general partnership interest in a limited partnership. While there may be extenuating circumstances, on an exception basis, that would require consolidation of a general partnership interest, to make a refutable presumption that all such interests should be consolidated does not reflect the economics of the investment. Most
such interests are for nominal (1% or less) amounts. To consolidate 100% of the assets and liabilities and show a 99% minority interest will not be an improvement in financial reporting.

We are also extremely troubled by two other presumptions of control included in the ED. First, absent evidence to the contrary, “ownership of a large minority voting interest (approximately 40 percent) and no other party or organized group of parties has a significant interest” will require consolidation. By definition, a minority voting interest cannot control an entity. Regardless of how we vote our interest, we cannot individually control the results of the vote. On some issues, some of the other shareholders may vote with us resulting in our position being approved; however, on other issues, enough of the other shareholders may vote against our position, resulting in our position not being approved. This will vary by vote and by issue. We will never know the results of any issue until the votes are in. Therefore, how can we be deemed in control?

In addition, actions by others, beyond our control, could impact our accounting. What if significant changes in stock ownership occurred that resulted in another party obtaining a “significant interest”? Would we then deconsolidate as a result of an action beyond our control? And then, if that shareholder decided to sell his interest a short time later, would we then reconsolidate again? From a practical perspective, in many cases it may be difficult, if not impossible, to know if someone else has obtained a significant interest. By implementing this standard, the Board is imposing a significant obligation on reporting entities to track such information.

A second presumption that we are concerned with is “an ability demonstrated by a recent election to dominate the process of nominating candidates for another entity’s governing board and to cast a majority of the votes cast in an election of board members” (footnote deleted). This presumption means that if in a recent shareholder vote only 50% of the eligible votes are cast, then a holder of 26% of the voting interests can cast a “majority of the votes” and, therefore, may be required to consolidate that entity. The arguments against this presumption are similar to the arguments against the large minority voting interest presumption discussed above. Our “control” is dependent on who decides to vote at an election. And again, our accounting can be impacted by an event beyond our control, in this case, a shareholder exercising his right to vote. This makes no sense to us.

We hope that the Board will reconsider, if not its entire approach to consolidation policy, at least these aspects discussed above.

EFFECTIVE DATE AND TRANSITION

We totally disagree with the Board’s requirement that prior periods be restated upon adoption of the final statement. While we acknowledge that the Board has provided an exception if retroactive application is not practicable, from a conceptual perspective, we believe it is unfair for the Board to require restatement. This standard, if implemented as drafted, will have a significant impact on the financial statements of most reporting entities. In a number of cases, this will impact previously
reported net income. In our view, to require restatement of net income in these cases will result in a perception by the investing public that the previously reported results were at a minimum less preferable and at worst wrong or inaccurate, whether it is a SAB 51 gain that is reversed or it is significantly higher research and development expense as a result of having to consolidate a previously unconsolidated R&D partnership. Entities affected in this way were following the rules in place when those transactions occurred. To change the rules midstream and require significant changes to previously recorded amounts will unduly penalize companies who were abiding by the rules. The harm caused by the negative perception of the investing public will in some cases take years to rectify, and in some cases may never be rectified.

We appreciate this opportunity to express our views to the Board and look forward to discuss these important issues in person at the public hearings.

Very truly yours,

George N. Hatsopoulos
Chairman of the Board and President

GNH/cmj

cc: G. Massaro, Arthur Andersen
S. Burlone, Arthur Andersen