January 15, 1996

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

Re: File Reference 154-D

Dear Sir:

We are writing in response to the October 16, 1995, Exposure Draft (ED), Consolidated Financial Statements: Policy and Procedures ("the ED").

We are troubled by the ED, and believe that it should not be issued in its present form on grounds that it has not resolved the issues that it addresses. Recognizing the significant effort that the Board has expended in this project, we have constructed our recommendations so as to enable the Board to issue a consolidations Statement without reexposure. While a few our recommendations represent substantive changes to the ED, they are presented in the spirit of being the minimum level of change necessary to achieve a document that can be applied with consistency.

The Board seems to believe that a Statement containing the ED's provisions will have a modest effect, probably consolidating a few additional entities that are now accounted for on the equity method. Our view is quite to the contrary. We have acknowledged that practice appears to have certain lack of comparability, and we also acknowledge that there is one instance (the 49 percent ownership in bottling operations with 51 percent held by the public) in which some user complaints could, and probably should, be satisfied. But we believe the present problems with comparability are almost entirely the consequence of attempts by certain auditors to impose "just say 'No' accounting" by creating almost surrealistic barriers to consolidation — barriers that stand so sharply in conflict with normal business realities that they are viewed by business, legal and user professionals with incredulity.

Fortunately, these barriers seem not to have been widely adopted, and the FASB can serve a useful end by stopping their spread.
Unfortunately, we have been unable to determine what the ED means to normal business situations.

Overview
As some aspects of this response will surprise some readers, a few introductory comments appear to be in order.

(1) Need for Greater Clarity of Guidance. We shall press our urgent plea for an absolutely clear statement of conditions that require consolidation. Because the ED is sometimes vague, internally inconsistent on significant points, and is almost completely devoid of substantive treatment of the control matters that are relevant to "real world" decisions, its issuance will perpetuate diversity. We have included a simple suggestion that "control" would be a powerful concept indeed if it were defined to apply only to "ordinary course of business" matters, but that view is only a preference and pales in comparison with our belief that the final pronouncement must be prepared to enable reasonable professionals to reach similar conclusions in similar circumstances.

(2) Economic Entity. We have reconsidered and softened our resistance to one aspect of the economic entity approach. We recognize that those who study our response will accurately characterize our new view to be more inspired by Machiavelli than by sudden enlightenment. We are hopeful that, when you tabulate our response, you will reflect the fact that our enthusiasm is conditional, and solely a result of enthusiasm for the possibility of a free option to charge goodwill against equity. In contrast to the urgent need we see for specific guidance on consolidation criteria, where we believe more clarity is absolutely necessary, we will welcome the ability to achieve vast, selective reductions in future goodwill, and encourage you to provide only minor clarification regarding step acquisitions.

(3) Deconsolidation. We shall spare you reiteration of our oft-stated position about consolidating finance affiliates into non-finance parents. We have not softened our view on this matter, but believe the magnitude of the deficiencies in the ED completely overweighs what we continue to view as less-than-helpful display. As we will illustrate several of our positions by showing how the ED could be employed selectively to defeat consolidation of finance (or other) affiliates, it will be helpful for you to keep the extent of our distaste for that consolidation firmly in mind. While selective deconsolidation is a potential problem, we are as concerned about unexpected deconsolidations that will arise from circumstances in which parties having legal but not "effective" control are now consolidating subsidiaries. One clear example of impending deconsolidation is a wholly-owned subsidiary that has issued a non-transferable warrant or convertible stock position to a financial institution in order to enhance that institution's returns. The financial institution carefully avoids interfering in management in order to protect its
security positions, meaning that the majority ownership position "controls" operations of the investee. We think the Board should not accept this deconsolidation.

Problems with the ED's Consolidation Criteria

In the paragraphs that follow, we shall elaborate on our view that the ED has failed to provide a blueprint for deciding whether or not consolidation is appropriate. That conclusion is based on study of the 83 paragraphs (including 28 paragraphs used to elaborate on the seven examples) in which control is discussed in the ED. After studying this material, we are disappointed at not being able to provide dependable answers about how the most routine factors affect consolidation. The ED contains absolutely unqualified, blanket statements that stand in perfect conflict with other unqualified, blanket statements. Moreover, some of this otherwise clear guidance is muddled by qualifying words such as "generally."

While we were considering means of demonstrating lack of clarity in the ED, FASB Staff supplied the perfect illustration. The case arose in preparation for the EITF Agenda Committee's January 8, 1996, conference call. In addition to many routine noncontrolling veto rights, the case presented an option to acquire the remaining 50% interest at then-fair value — an option to which Black Scholes would clearly assign no value. FASB staff seemed to have decided that control over "ordinary course of business" decisions (a similar approach to the one we recommend below) was the appropriate consolidation criterion under the ED, and that staff read the ED to require consolidation. None of the other Committee members had reached a similar conclusion. We found it interesting that it was necessary for Staff to "interpret" the ED for this seasoned audience, not to mention that Staff's answer was different than that reached by the Committee. How the Board's constituents are ever expected to arrive at similar conclusions from the words of the ED is mystifying.

One of the difficulties of the ED is the apparently bright line that is presumed to be associated with control. As some would interpret the control criterion, "noncontrolling" parties are entitled to nothing — not "less" or "relatively little" but, literally, nothing. The position appears to some to be a bright line — an illusion that vaporizes when the proponents define inevitable exceptions. To select from the multitude of examples, "unilateral ability" proponents somehow believe their criterion still to be met despite a veto by the noncontrolling interest over dispositions of enormous blocks of assets, such as 95 percent of assets of the entity. One problem these proponents have is that their selective exceptions indicate that this position is capricious and arbitrary rather than conceptual. A more serious problem is that, in many legal jurisdictions, the law provides noncontrolling interest protection that far exceeds what this literal concept would permit. With only a sound byte for guidance, answers for specific circumstances differ sharply within this camp, and answers become arbitrary.
Following are examples of what seems to be troublesome or conflicting language in the ED:

- Paragraph 10, especially 10(a) and the penultimate sentence of the paragraph, demand that the controlling interest control capital budgets and financings. Leaving aside the question of why financings is a use of existing assets, it is puzzling whether any controlling interest can ever be expected to have this measure of authority. Logically, this would seem to require that a noncontrolling interest permit the controlling interest to change the nature of business operations — rare indeed is the minority investor who would permit GE to transform a controlled manufacturing operation into an eleemosynary one, the purpose of which would be to fund charitable activities designated by GE. Obviously, laws and contracts will normally prohibit such actions by the controlling party, but how those controls should be interpreted under paragraph 10 is unclear.

- In paragraph 12 we first see the recurring superficial treatment of the idea that legal restrictions on control do not block consolidation. This is hardly a concept, and threatens to result in similar circumstances yielding different consolidation decisions depending on the legal jurisdiction. It is important to recognize that there are sharp differences between different legal jurisdictions for minority shareowner protection. Nevada, for example, provides essentially no protection; New York's provisions are reasonably comprehensive; Brazil provides sweeping prohibitions against broad classes of actions by the majority shareowner. If a shareowners' agreement for a Nevada corporation provided, by contract, protection identical to that provided by statute in New York or Brazil, the irrelevance of this legal restriction concept becomes apparent. However, as the ED is written, some will interpret the statutory provisions in Brazil not to be factors for consideration, while the identical factors in a contract might block consolidation. Depending on what rights one believes are acceptable for a minority interest, there may be jurisdictions in which consolidation would be required based on the language in paragraph 12, but a minority interest holding the same rights by contract would not be deemed "controlled." The final Statement simply must decide what minority protections are important, and must delineate those so that contractually-provided provisions do not depend on the situs of the corporation.

- Paragraph 14(c), which seems to be designed to cause consolidation based on holdings of convertible security positions, is unclear. Perhaps the most striking illustration of this problem is the EITF case to which we referred above, where the FASB staff member concluded that consolidation would be required under this paragraph. We do not see many straightforward solutions to the implementation questions that must be resolved before the Statement is issued. Perhaps the only way to ensure that there is consistency in applying this requirement is to consider substantive control actually exercised over decisions by the holder of the convertible securities before the securities are converted.
Paragraph 147 contains a stunning observation, application of which will be very problematic: "Control of a subsidiary enables a parent to obtain future economic benefits from the assets of its subsidiary in ways that are not available to noncontrolling shareholders or others." This appears to be a very rigid requirement that precludes consolidation unless there has been an enormous risk transfer from the controlling to the noncontrolling interest. The economic risk that exists in real world minority interest positions almost mandates noncompete agreements; without them, the controlling interest would be able to abscond with the customer lists and sales force (to which, by definition, it must be entitled), depriving noncontrolling interest of any economic benefit. Can a controlling entity that is subject to a noncompete agreement comply with the requirement of the first sentence of paragraph 147? If the answer is that it can, the final Statement needs to clarify how. For an additional example, consider what requirements would apply to a manufacturer's acquisition of "control" of a product distributor. In this case, the routine unrestricted means of "obtaining future economic benefits" would be by means of inflated transfer pricing. Leaving aside questions of legality, the economic risk almost mandates an agreement with minority shareholders that the manufacturer not be capable of stripping disproportionate value in this fashion.

Continuing in paragraph 147, the second sentence stands in striking contrast to the first, despite the fact that the first sentence is unqualified. The second sentence introduces the notion of protection for noncontrolling interest against any adverse effect of actions by controlling interest. This issue is at the heart of this debate, and is perhaps the most important single factor that simply must be clarified. Adverse effects on other investors arise from almost any potential actions by the controlling interests, and these actions are routinely controlled by contract and by law. Among other things, adverse effects can arise from recapitalizations, refinancings, any related party transactions or any change in the nature of business operations. If our conditions permit remedies or protection against adverse effect on noncontrolling interests, as they must if any less-than-total ownership position is to be consolidated, the final Statement simply must specify what those permitted protections are.

We shall set forth a broad outline of what we believe to be important consolidation factors based on our experience. When making decisions about these matters, the Board should keep in mind the extent to which there is peril in overbalancing towards either more or less consolidation. Inevitably following this project, consolidation criteria will change present practice — a result of attention having been drawn to the present diversity. We believe that it is important for the Board to publish this explicit guidance, not naively to await some other "interpretations" of the Board's position.

First, we believe that the most important distinction is between a controlled entity and a joint venture. Much of the current strain associated with consolidation decisions would be relieved by
a rigorous definition of "joint venture" — a definition that captures the unusual aspects of a certain type of business relationship in which two or more associated enterprises operate as equals. We understand that the Board intends to provide this definition later in the consolidations project. We believe that the entire consolidations project is stymied without that definition. In our view, the definitive characteristic of a joint venture relationship is the absence of a mechanism for resolution of disputes. It is absence of such a provision that results in a requirement that the entities permit the venture to resolve its own problems when the investors' interests differ. Joint ventures do not permit vetoes of matters by one party; rather, when vetoes are provided, each party maintains equal rights. For example, it would be customary for either party to be able to block a change in the nature of business or capital structure. In this case, mutual vetoes are reasonable evidence that neither party can initiate such actions.

If we have defined joint ventures satisfactorily, then we need to be very explicit about what "rights" may and may not be held by a noncontrolling interest. This is extremely difficult and tedious, but the Board simply must work its way through the questions if any consistency in practice is to be achieved. Using some of the principles set out in the ED, a reasonable approach would be to determine control based on which, if any, party makes "ordinary course of business decisions." As an exception, we would permit a veto by the noncontrolling interest regarding transactions between the controlling party and the subsidiary. Related party veto will be required in order to permit necessary protection with respect to transfer pricing and management fees. We would also permit veto of any matter outside the "ordinary course of business."

Why, it will be asked, should an enterprise consolidate assets that it cannot sell or refinance? We believe that the "use benefit" of operating assets is realized by use in the ordinary course of business. Noncontrolling interests have a fundamental interest in seeing proportionate economic interests protected, and when consolidation criteria, like those in the ED, can be read to imply that controlling interests be able to achieve disproportionate benefit, the population of consolidated entities diminishes enormously. It is the proportionality of shared economic interest that the accounting must respect, even though some of the only mechanisms available for achieving that equitable result restrict the controlling party's actions. Matters that present an overwhelming economic case for noncontrolling interest veto include related party transactions, refinancings, capital calls, acquisition or disposition of facilities, and changes in strategy. No simple bright line with which we are familiar delineates other than an arbitrary level of acceptability of such protections. Clearly, there are certain actions that, while legal, will never be permitted by a minority, and attempts to impose a majority's will would be met with instant

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1As in life, we are not considering divorce to be a resolved dispute. Indeed, joint venture agreements sometimes provide quite elegant mechanisms for terminating the relationship at fair value. The business reasons for negotiating such provisions in advance of a dispute are to motivate good faith future efforts at resolution. Thus, a divorce provision will place neither party in a relatively advantageous position.
litigation. Therefore, we believe that the most operational criterion is to permit vetoes, and to consider such vetoes to be simply the proportionate protection to which the noncontrolling interest must be entitled.

We have considered carefully all of the alternatives, and believe that, to the extent the accounting fails to respect underlying economics, it will provide some extraordinary financial engineering opportunities. Just to pick a random example, consider possibilities for the manufacturing enterprise that seeks to deconsolidate its financial services operation. Following, say, a billion-for-one stock split, the enterprise would change its finance company bylaws so that 100% of shares would need to vote in favor of disposition of a single asset that exceeded 94% of total assets (or, if you prefer, 90%, or 85% — even 1% for a single asset is not much of an operating concession for a reasonably large financial services enterprise). Without regard to the fact that no such single asset exists, this veto right would absolutely preclude consolidation! With trivial engineering, it is not even necessary to grant Board of Directors representation to the single share.

**Economic Entity Theory**

As we stated in our overview, there is one aspect of the economic entity theory that, when applied to financial statements, appears not to be as bad as we had feared — treatment of acquisition of unidentified intangible assets of a controlled enterprise in a step acquisition as a distribution of paid-in capital.

We would refine this application to prevent some detrimental results. We believe these refinements can be achieved without too gross a violation of the basic theory, although we do not profess to understand that theory completely. Following are those refinements:

- Dispositions modify the economic unit, and it is imperative that these very real gains and losses be measured and reported as they are incurred. Sale of parent holdings of one percent of a consolidated affiliate change the "mix" of holdings for the parent and, for consolidated financial statements to have any meaning whatsoever, the gain or loss must be reported. This means that paid-in capital reductions from step acquisitions, for example, need to be allocated pro-rata to the affiliate investment, added to basis, and reinstated to capital when those interests are sold. Clumsy, yes, but the blatant misrepresentation that will arise under any alternative dictates this answer.

- The concept underlying SAB 51, that changes in an investor's relative interests in an investee arise from affiliate capital transactions, has resulted in too much confusion for too long. Whether or not one subscribes to the theory that sales of stock by and of an affiliate are identical, the recordkeeping burden that attaches to these transactions so far outweighs any
relevant benefit that we have concluded that it is time for a simple, new compromise. We
strongly urge that we look to the tax law for help, and admit that the best we can do is to
reflect the debits and credits for capital retirements and issuances, respectively, only as
adjustments to the noncontrolling interest capital account. When sufficient capital has been
sold to cause the formerly controlling investor to drop below the threshold of having
significant influence, we would change the net carrying amount to a cost basis investment.
Today's alternative requires some outrageous assumptions and estimates about fair values for
investments in enterprises that, for example, routinely purchase and issue shares for
employee plans.

- The earnings display specified in paragraphs 24 and 107, where net earnings (including
  noncontrolling interests) is divided between controlling and noncontrolling interests on the
  face of the earnings statement is inconsistent with the economic entity theory. We strongly
disagree with the Board's decision to divide earnings in this fashion without any indication of
how assets or, more important, cash flows are associated with the differentiated ownership
interests. The solution, of course, is not a wholesale revision to the cash flow statement. We
believe that the Board should either abandon this theory or should treat net earnings as net
earnings. Allocation of earnings to classes of equity is not clarifying. If such allocation is to
be required (other than the obvious requirement for allocation to determine earnings per
share), earnings allocable to each class of equity must be displayed, including separate
display for preferred stock. We reiterate to the Board our firm belief that, unlike preferred
stock investors, a noncontrolling interest cannot conceivably learn anything from a
controlling entity's financial statements, so the display of aggregate earnings allocable to
noncontrolling interests should not be afforded much prominence.

We trust that the Board understands that the three modifications above are absolutely conditions
of our support for economic unit reporting, and that we otherwise view that accounting with
sharp disdain. Economic unit reporting reflects the aspect of the Conceptual Framework that is
most feared by those who hold financial statements in relatively high regard — sacrifice of
relevant communication. Aside from the opportunities for reporting goodwill in step
acquisitions, using those interests to wreak mayhem in financial results reported to parent
investors is a quick descent to the lowest denominator of reporting.

With respect to goodwill, we trust that the Board will understand that step acquisitions will
become the routine technique for business combinations. If one assumes that a control premium
is incurred at the 50 percent level, and assumes that accounting "control" arises at 40 percent
(weird, but consistent with the ED), structuring the final 60 percent as a second step will relieve
more than 60 percent of the transaction's goodwill — sufficient motivation to pay for a lot of
structure advice. We shall be pleased to undertake these transactions without further assistance
from the Board, of course, but would endorse clarification of two particular matters:
• Date at which a "step" is deemed to be initiated. Without this guidance, enterprises will seek to bifurcate transactions simply by delaying a second closing, even when no price adjustment can arise between the first and second closing.

• Clear reminder that acquiring enterprises have a burden to identify all target intangible assets. In a stock transaction, little motivation presently exists to turn every stone to identify all intangibles\(^2\) since there is seldom much difference between useful lives of a customer list versus useful life of goodwill, and future earnings will therefore be essentially the same with and without having incurred the costs of an appraisal.

It is also important for the Board to understand that consolidation at a 40 percent investment level is likely to be consolidation below the point at which the market has charged for control, and therefore a disproportionate amount of goodwill (namely the portion containing the control premium) is likely to be charged to equity in the Board's approach. We recommend that the Board consider control premium carefully in determining when control is acquired, perhaps by investing some Board time with seasoned transactions advisers. In the ED's context, a perfect market would attach a cost or premium to the last share necessary for "control" that exactly equals the value of economic advantage the control party has removed from noncontrolling interests. The Board seems to acknowledge this fact in paragraph 116, but fails to follow the thought through to the correct conclusions. In a world without noncontrolling interest protection, the hypothetical fifty-first share (of 100 outstanding) would cost exactly 50% of the total equity value, the sum of total equity interest not previously owned. Why? Because in this case, any consideration later transferred to the minority interest would be strictly the result of controlling interest charity — and charity is not reliably a predominant attribute of some investors. Rather, our perfect market can only price the transaction assuming that the controlling party will transfer all of the remaining economic value to itself by any of a number of means\(^3\) leaving nothing for the minority. This phenomenon would be evidenced by a very high control premium. The relatively modest control premiums that one sees in the market are striking evidence that the minority retains very significant rights.

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\(^2\)This observation does not hold for asset acquisitions as tax incentives ensure that few specific assets will be overlooked.

\(^3\)The simplest means of accomplishing this transfer is management fees, but transfer prices for goods and borrowings are trivial means of achieving this objective.
Other Matters

We believe that whether or not one requires consolidation of entities held for sale is essentially arbitrary, and are willing to live with the preference of users. We strongly suspect, however, that the only constituents who favor continued consolidation are auditors, and suspect that their basis for this view is reluctance for potentially significant display matters to depend on management representation. The cost, of course, of continued consolidation is that the market is systematically deprived of an enlightening view into the enterprise that will remain following the disposition. Accordingly, expectations and, ultimately, performance, cannot be judged. We understand that the Board must weigh verifiability when making decisions, but the toll exacted by continued consolidation in this case is sufficiently high that we believe meaningful financial statements must take precedence over audit concerns. Perhaps a reasonable compromise would be to prepare the basic financial statements with one-line accounting for the held-for-sale business, but to supplement the basic financial statements with pro forma disclosure of the consolidated entity's financial highlights.

Appendix B, Example 5, is troubling as it suggests that a lease is an agreement that is capable of providing a lessee control over a lessor. This seems to be inconsistent with paragraph 82 of Statement 13, which documents why the Board declined to consider whether a lessor "lacks independent economic substance" as a factor in Statement 13's conclusions. Given that all leases convey some measure of control over assets, it is unclear to us exactly how one determines which lessors must be consolidated and into which lessees. For this example to be operational, the Board should, at a minimum, provide explicit guidance. A definition of "special purpose legal entity" would also greatly facilitate review of particular transactions. Finally, we urge that this provision, if it is retained, apply only to leases entered into after the issuance date of the final Statement.

One of the reasons given for abandoning the economic interest criterion is a so-called "pyramid" structure that theoretically permits consolidation of entities in which there is a negligible economic interest. Our experience with such structures is that they have essentially no economic appeal, and therefore are, at best, rare. To justify a radical change in consolidation theory by reference to cases that appear only in theory seems to undermine the credibility of the ED.

We believe the conformity of accounting policies required in paragraph 31 is unnecessary. With appropriate disclosure of those policies, we see little to be gained from application of this requirement, and do not believe the costs are readily determinable.

Paragraph 51 lists costs that the FASB considered in evaluating the costs and benefits of the ED's approach. The costs include eloquent treatment of minutia, but do not discuss the enormous costs that arise from consolidation — costs of concealed data. Using SFAS 94's consolidation of financial services entities as an example, GE inventories are sufficiently small to be considered
"other assets" in the consolidated financial statements. That is, as we have said many times, the result of combining financial statements of an entity whose asset turnover is about once annually with financial statements of a financial services entity whose asset turnover, because of the nature of the business, is once in about seven years. Data are lost when these financial statements are combined, and users are entitled to know why the Board believes costs associated with this deprivation of information are justified. This paragraph also presumes that additional entities will be consolidated. We are not aware of an analysis that the Board has done to support this hypothesis. Further, it is our view that there are enterprises holding majority voting stock facing minority veto over certain unusual events that would not be permitted to consolidate under the ED, but were providing consolidated financial statements under SFAS 94. Thus, we suggest that this paragraph should address both deconsolidation as well as added consolidation costs.

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We appreciate the opportunity to share our views on this important question, and welcome the opportunity to discuss any questions you have at the public hearings.

Sincerely,

Philip D. Ameen

cc: D. D. Dammerman
J. R. Bunt
CCR Executive Subcommittee