January 15, 1996

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

Proposed Statement of Financial Accounting Standards,
"Consolidated Financial Statements: Policy and Procedures"
(File Reference No. 154-D)

Dear Mr. Lucas:

We are pleased to provide our comments on the proposed Statement referred to above. We do not support the proposal and do not believe it should be issued. Consistent with our January 5, 1995 response to the Board’s Preliminary Views, we oppose the broadening of the definition of control that would expand application of consolidation to many 50 percent and less owned companies. In addition, we do not support the proposed changes to the long-standing reporting practices for minority interests.

ARB No. 51, Consolidated Financial Statements, was issued in 1959. To substantially change an accounting rule that has been in place for so many years and has been applied by so many companies should require the FASB to present a strong case that change is needed and that the proposed method is superior to the current approach. We do not believe that case has been made. Our greatest concern relates to the proposed requirements that would expand the application of consolidation to companies that are less than majority owned. We believe that replacing an objective, verifiable ownership test that generally requires more than a 50 percent voting interest, with a subjective evaluation of the facts and circumstances would lead to increased diversity in practice and, in our view, would not improve financial reporting. Further, applying subjective criteria likely would increase the cost of preparing consolidated financial statements because companies would have to reassess at least annually various factors to determine if control does or does not exist. And most important of all, we believe that expanding the definition of control to encompass circumstances where the investor in fact does not have control (e.g., an investor owning 40 percent of the voting stock) is inappropriate and would result in less meaningful consolidated financial statements for users. We believe that the current requirements for use of the equity method of accounting, in most cases, sufficiently reflects the results of operations and financial position of the parent in situations where the investee is not majority owned.

With regard to minority interests, the proposal would require that the aggregate amount of the "noncontrolling interest" in subsidiaries be reported in consolidated financial statements as a separate component of stockholders’ equity and the noncontrolling interest in income of the subsidiary be reported as a deduction after consolidated net income to arrive at net income attributable to the controlling interest. In our view, the Board also has not made a case for
making this fundamental change. We believe that minority interests are not another form of equity and the present practice for presenting minority interests on the balance sheet and income statement is well established and understood and more useful to readers of financial statements than the method being proposed.

Our views on consolidation policies and procedures are set forth below as are our comments on special purpose entities and not-for-profit organizations. In addition, our recommendations as to what we believe the Board should undertake to improve practice in certain narrow areas is discussed on page 6 of this letter under the heading Exceptions to Majority Control.

Consolidation Policy

As previously stated, to substantially change an accounting rule that has been in effect for more than 35 years should require a strong case that change is needed and that the proposed method is better than the current approach. The Exposure Draft instead simply presents the new requirements as if why they are needed and why they are better is self-explanatory. Our overall reaction is that the Board instead should modify the ARB 51 approach to reduce the possibility of abuse and to clarify the consolidation requirements for special purpose entities.

The Exposure Draft's requirements for consolidation in paragraphs 9 and 10 provide that a controlling entity shall consolidate all entities that it controls unless control is temporary at the time the entity becomes a subsidiary. For purposes of this requirement, control of an entity is power over its assets—power to use or direct the use of the individual assets of another entity in essentially the same ways as the controlling entity can use its own assets.

The Exposure Draft then establishes presumptions and indicators of control. Absent these somewhat arbitrary listings of presumptions and indicators, a preparer would be unable to apply the proposal's general requirement. The concept of power over a subsidiary's assets to achieve the parent's objectives is not otherwise operational, except in circumstances where it is objectively evident that the investor is directing the investee.

In contrast, paragraph 2 of ARB 51, as amended by FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries, states that usually a controlling financial interest is necessary to consolidate a subsidiary and:

The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition pointing toward consolidation. However, there are exceptions to this general rule. A majority-owned subsidiary shall not be consolidated if control is likely to be temporary...

An over 50 percent ownership requirement in the vast majority of instances is objective to apply and, we believe, meets the reporting needs of users. With occasional exceptions, we are unaware of users contending that consolidated financial statements prepared pursuant to ARB 51, as amended by Statement 94, have inappropriately excluded controlled entities. As a matter of fact,
the requirement of Statement 94 to consolidate finance subsidiaries was not favored by many users because they did not want to expand consolidation practices.

If a parent does not own over 50 percent of the voting stock of an entity, we believe it usually does not have the power to control the entity’s assets to achieve the parent’s objectives. The potential to obtain control at some future date, whether by unilateral action or by occurrence of some other specific event, generally does not mean that the investor currently has control. We believe that the presumptions and indicators of control outlined in the Exposure Draft do not, by themselves, provide sufficient evidence that control exists absent a majority interest. Because of the diversity and complexity of the circumstances encountered in practice, we believe that no one listing of indicators could ever be complete or workable. As an illustration of the complexity of some agreements, it was reported in the press that a major business combination could not be consummated because the minority shareholders of a majority owned subsidiary of one of the combining companies would not approve the transaction. The parent had control, except it did not have the right to vote on merger issues. Thus, the group with “control” on this single issue was the minority shareholders.

Another concern we have with the Exposure Draft’s approach is that in situations where there is not a majority ownership, decisions about consolidation would have to be extremely subjective and therefore difficult to audit. For example, paragraph 10 of the Exposure Draft states that control enables a parent to use or direct the use of the assets of a subsidiary by establishing the controlled entity’s capital and operating budgets and to enforce its decisions by selecting, determining the compensation of, and terminating personnel responsible for implementing its decisions. How is the auditor to know if a 40 percent investor really has this ability? And will form rather than substance be created in some situations just to meet certain of the indicators? We believe it is difficult to envision all the practical problems that will arise if the objective test of majority ownership is dropped.

It is also interesting to think about whether the Board’s proposed approach would be consistent with the management approach for segment reporting. The CEO of the 40 percent owned investee would likely not report to the CEO of the investor. Would the consolidated investee be excluded from segment reporting because top management of the investor does not manage the minority owned investee? Another practice issue likely to arise is whether the 40 percent investee would be precluded from entering into a pooling of interests business combination because it would no longer be considered autonomous under APB Opinion No. 16, Business Combinations.

Presumptions and Indicators

In paragraph 14 of the Exposure Draft, the Board lists six circumstances that would make control highly probable even though there is no majority ownership of the voting stock. If any of those circumstances exists, effective control would be presumed to exist and consolidation likely would be required. Our view is that with certain exceptions (discussed in the next section of this letter), these circumstances should not lead to a presumption of control and therefore consolidation. Our reasoning is set forth below. (Special purpose entities and not-for-profit entities are discussed separately.)
Circumstance a) *Ownership of a large minority voting interest (approximately 40 percent) and no other party or organized group of parties has a significant interest.*

In this circumstance, the Exposure Draft would require consolidation of a 40 percent owned entity based on the presumption that the investor has effective control because less than 80 percent of the eligible votes are typically cast. This situation ignores the fact that a number of shareholders may not have viewed the nomination of board members to be a substantial issue. Not casting a vote should not be presumed to be an indication of an inability to vote. The shareholders who chose not to vote on this issue may have very strong views on other issues on which they would vote. For example, certain shareholders may not cast a vote until they disagree with the board. Other shareholders may only elect to vote on significant issues such as a change in control. A 40 percent shareholder can be outvoted. In the situation described in the Exposure Draft for circumstance (a), the investor may appear to have temporary control but in fact, it exists only as long as enough other shareholders support the decisions made by the minority. We do not believe that this type of so-called "control" without legal authority should result in consolidation.

Circumstance b) *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.*

We believe that the second circumstance results in an even less supportable presumption of effective control. In such a case, the Exposure Draft would require consolidation based on the presumption that a less than 40 percent owner was able to convince other shareholders to cast their votes for its nominees. This situation presents even more practical problems than the first circumstance. Would a company assume that every time a shareholder voted the same way as the company that it controlled the shareholder? The alternative ignores the fact that the shareholders may support the company’s plans for the operations of the investee for the time being. However, that support may last only as long as those plans are successful. In fact, some shareholders vote only when they are in disagreement with the present board or if a major issue is proposed. We do not believe that this situation (i.e., a temporary support of similar views) should result in control.

We believe that circumstances (a) and (b) highlight the practical implementation problems with the views expressed. The requirement to consolidate without having a majority equity interest is too subjective a test to apply in most situations and likely would be costly as companies periodically reassess these factors. The proposal also does not explicitly address the accounting after subsequent elections if the number of voting and non-voting shareholders fluctuates or if there is a significant issue to be voted on such as a takeover and there is a drastic change in the number of votes cast. In our view, including a less than majority owned subsidiary in the consolidated financial statements in one year and then excluding it the next, based on these factors would make the financial statements less useful.

Circumstance c) *A unilateral ability to obtain a majority voting interest through ownership of securities or other rights that may be converted into a majority voting interest at the option of the holder without assuming risks in excess of the expected benefits of the conversion.*
We do not support circumstance (c) as a general presumption of effective control (although as discussed later there can be situations where consolidation would be warranted to avoid perceived abuses). Under this presumption, an entity owning minimal equity of an investee but holding convertible debt would consolidate an investee while the company holding substantially all the voting stock would not consolidate it. In most circumstances, we believe the actual conversion is the event that results in a change of control. As acknowledged in APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, a convertible debt holder can either collect the principal or convert into common shares—it cannot do both. Conversion requires the creditor to forgo receiving a significant cash inflow which makes the likelihood of conversion uncertain. The rights of the debt holder significantly change upon its election to convert and until a transaction actually occurs consolidation generally would not provide more useful information to users of financial statements. Until the convertible debt holder actually obtains a majority voting interest, it generally does not have power over the individual assets of the investee and, therefore, it does not have effective control.

Another concern relating to circumstance (c) relates to the subjectivity of evaluating whether risks would exceed expected benefits. For example, assume Company A has the unilateral right to obtain a majority voting interest in Company B by exercising its convertible debt holdings. However, because Company B is a named party in a major environmental lawsuit, Company A concludes not to consolidate Company B because the “risks assumed would be in excess of the expected benefits from the conversion.” However, in a subsequent year, assume the risk of an unfavorable outcome is significantly reduced. Would Company A now consolidate Company B? What if the assessment changes again the following year?

Circumstance e)  A unilateral ability to dissolve an entity and assume control of its individual assets, subject to claim against those assets, without assuming economic costs in excess of the expected benefits from that dissolution.

We do not believe that the presence of a unilateral ability to dissolve an entity by itself results in a presumption of control of another entity. In many respects, primary lenders may have similar abilities under loan agreements in situations where the borrower is experiencing financial difficulties.

Circumstance f)  A sole general partnership interest in a limited partnership.

Our concern with this presumption is that it could result in a company consolidating entities in situations when it actually owns only an insignificant equity interest. We do not support the consolidation by a one percent general partner of the 99 percent minority interest provided in Example 2—Creation of a Limited Partnership with a Single General Partner in Appendix B of the Exposure Draft (paragraphs 182-187). We believe it generally would be inappropriate to consolidate an investment in which a company only has an insignificant level of equity and an insignificant residual interest. Our view is consistent with current practice under SOP 78-9, Accounting for Investments in Real Estate Ventures, which has worked reasonably well with regard to general partners. In the example in the Exposure Draft, the maximum residual interest that the general partner has is 25 percent (after the limited partners get a significant return) and we do not believe that this is a sufficient level for consolidation. In general, an approach that
could result in a company consolidating an entity that it only has a one percent interest in would seem to result in reducing rather than increasing the usefulness of financial statements.

The Exposure Draft (paragraph 158) also contains nine indicators of effective control. We believe they are, for the most part, not helpful or appropriate for entities to apply in making consolidation decisions. In our view, it would be the unusual exception that these indicators would demonstrate that a company has power over the investee’s assets, absent majority ownership.

Exceptions to Majority Control

While we do not support the Exposure Draft, we do believe the Board could improve practice in certain narrow areas. Consistent with our January 5, 1995 comment letter on Preliminary Views, we recommend that the Board abandon its proposed approach and redirect its efforts to modifying ARB 51 to provide some guidance as to when less than majority owned entities should be consolidated. We recognize the difficulty in developing guidelines that would have the objective of consolidating minority owned entities in those circumstances where perceived abuses need to be cured while not requiring consolidation in the vast majority of other cases.

The exception to majority ownership could be based on the SEC’s judgmental approach set forth in Rule 3A-02 of Regulation S-X which states:

In other situations, consolidation of an entity, notwithstanding the lack of technical majority ownership, is necessary to present fairly the financial position and results of operations of the registrant, because of the existence of a parent-subsidiary relationship by means other than record ownership of voting stock.

We believe that some of the examples developed from the presumptions of control can be used to develop a list of exceptions to the current majority ownership requirements. In our view, the following circumstances are indicative of when consolidation would be appropriate.

Investor owns 49 percent of the voting stock and holds an option to buy 2 percent at a relatively nominal amount. A majority of management and board members of the investee are also officers and board members of the investor.

Investor holds convertible debt that upon conversion would result in ownership of 97 percent of the voting stock. The current 100 percent shareholder paid a minimal amount for the stock and is an employee of the investor. The investee is incurring operating losses which are being funded by the proceeds from the debt. There is management and board overlap.

An investor owns 5 percent of voting common stock and 100 percent of the preferred stock resulting in it obtaining 99 percent of the economic benefits from the investee. The investee provides services to only one customer, the investor. The balance of the voting stock is held by related parties and there is common management and board membership.
In these examples, even though the investee is not majority owned, ownership is necessary to reflect the substance of the transactions. We recognize that it is not practical to have an all-inclusive list of exceptions and that judgment will be necessary. However, because these situations are relatively rare, we believe this approach would be far more workable in actual practice than attempting to apply the presumptions and indicators of the Exposure Draft. In addition, see our comments on page 9 on special purpose entities.

**Consolidation Procedures**

**Presentation of Minority Interest**

The proposal also would change long-standing reporting practices relating to minority interest. The prevailing practice of displaying minority interest between liabilities and equity in the statement of financial position is accepted in practice because minority interest has not been viewed as a liability or equity of the parent. We support the parent company concept and, accordingly, believe minority interests should be presented between liabilities and equity and that consolidated net income should represent the income attributable to the controlling interest (i.e., investors in the parent company). Under the parent company concept, the noncontrolling investors in a subsidiary do not have an ownership interest in the subsidiary’s parent and, thus, from that perspective the noncontrolling (minority) interest is not owners’ equity. We do not believe the adoption of the economic unit concept would improve financial reporting and we are not aware of any overwhelming support for a change in the classification of minority interest in either the statement of financial condition or the income statement. The Board’s proposed overall treatment of noncontrolling interests also gives rise to various other consolidation procedures that are discussed below and that we also do not agree with.

**Changes in a Parent’s Ownership Interest in a Subsidiary**

The Exposure Draft provides that changes in a parent’s ownership that occur after a subsidiary is acquired that do not result in a loss of control would be accounted for as transactions in the equity of the consolidated entity. Again, we oppose this change because we do not believe these are equity transactions of the consolidated group.

We believe, for example, that if a company owning 60 percent of a subsidiary acquires an additional 20 percent, this represents a purchase of an additional investment in the subsidiary and not an acquisition of treasury stock. Likewise, if a company owns 100 percent of a subsidiary and sells 30 percent, we believe that transaction represents a sale giving rise to a gain or loss, not an equity transaction. Once again, we do not believe the Board has made a case justifying changing those long-standing practices that are well accepted and understood by users of financial statements.

**Acquisition of a Subsidiary**

The proposal provides that in a purchase business combination, “if a parent acquires less than a 100 percent interest in a subsidiary the purchase price should be assigned to each of the
identifiable assets acquired and liabilities assumed based on the full amount of their fair values."
In practice today, the write up of assets to fair value generally only is done for the percentage of
the subsidiary acquired and predecessor cost is used for the noncontrolling interest (parent
company concept). We believe the existing accounting model for acquisitions of less than a 100
percent interest in a subsidiary should be retained because it best represents the cost of the net
assets acquired.

In accounting for step acquisitions, the proposal would require that if a parent acquires a
controlling interest in a subsidiary in more than one transaction, the sum of the carrying amounts
of earlier investments plus the amount paid for the investment that results in control should be
deemed to be the purchase price (cost of the acquisition). Unrealized holding gains or losses on
earlier investments that are carried at fair value and classified as available-for-sale securities in
accordance with FASB Statement No. 115, Accounting for Certain Investments in Debt and
Equity Securities, would be recognized in earnings at the date control is obtained notwithstanding
that a purchase transaction occurred. We do not agree with the Board’s
conclusion that such gains and losses are, in essence, realized and, as such, should be recognized
in income. We believe that the unrealized holding gains or losses at the date control is obtained
should be accounted for as an adjustment of the cost basis of the investment. When a parent
obtains control of a subsidiary through the purchase of an additional equity interest, this event is
not the culmination of the earnings process. For the same reasons, we do not agree with the
Board’s conclusion that a step acquisition resulting in using the equity method under APB
Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, should
result in recognizing in income any unrealized holding gains or losses included in equity.

Conforming Accounting Policies and Fiscal Periods

The proposal would require conforming the policies of subsidiaries operating in a specialized
industry with those of the reporting entity. We believe that the specialized accounting policies
should be retained in consolidation because those accounting policies presumptively present the
most meaningful financial information to users. The proposal’s requirements to conform policies
also raises significant cost/benefit issues that, in our view, do not justify the proposed
requirement.

We also disagree with eliminating the three month time period between the parent company’s
year-end and the year-end of its subsidiaries. While we agree that technology has made
significant strides in the area of information transfer, we are not aware that there have been any
significant problems in this area. In some situations, we also believe that there could be other
cost/benefit considerations to justify retaining the current flexibility.

Entities Reporting on a Fair Value Basis

We believe entities that in accordance with generally accepted accounting principles (GAAP)
carry substantially all of their assets, including investments in controlled entities, at fair value
with changes therein reported in income, should not consolidate those investments. For example,
venture capital firms and investment companies typically own investments with a wide range of
voting stock ownership in various investees. The long-standing practice of those entities
reporting their investments at fair value and not consolidating entities even if they own more than 50 percent (or not using the equity method where there is a 20-50 percent ownership interest) provides the most relevant information to users of those entities' financial statements. However, the Board has proposed to exempt only those entities that in accordance with GAAP record substantially all of their assets and liabilities at fair value. Although venture capital companies typically do not borrow to finance acquisitions and, thus, would meet the exemption, those that do incur debt generally carry such amounts on a historical basis. In our view, the mere fact that some companies find it necessary to incur debt should not cause the consolidation of entities that otherwise would not be consolidated in the absence of the debt. Accordingly, we believe no change in consolidation practice is necessary for entities such as venture capital firms and investment companies.

**Special Purpose Entities**

The use of special purpose entities often results in practice problems and guidance from the FASB would be useful. We recommend that SPEs be addressed by the Board in a separate narrower project (see page 6 of this letter, *Exceptions to Majority Control*) and offer several points for the Board’s consideration. The Exposure Draft would establish the following presumption of control for special purpose entities:

Circumstance d) A relationship with an entity that it has established that has no voting or member voting rights and has provisions in its charter, bylaws, or trust instrument that (1) cannot be changed by entities other than its creator (sponsor) and (2) limit the entity, including the powers of its board of directors or trustees, to activities that the creating entity can schedule (or can initiate) to provide substantially all future net cash inflows or other future economic benefits to its creator.

We support the objective of circumstance (d) in paragraph 14 of the Exposure Draft that would require consolidation of special purpose entities (SPEs) with their sponsor when the sponsor continues to control the entity. We believe that in these cases, the creation of one entity by another in such a way as to enable the creator to continually control the subsidiary should result in consolidation. However, we believe focusing solely on the creator of the SPE, in many instances, is too narrow. In many situations it is not clear who is the creator of the SPE. For example, in some leasing transactions it is not at all clear if the creator is the lessor or the lessee. Guidance now exists in EITF No. 90-15 that discusses lessors and SPEs and includes conditions that would require consolidation. We believe that this guidance is useful in illustrating the possession of substantive control of the leased assets and the EITF will be addressing several implementation issues.

Paragraph 14(d) appears to be applicable to SPEs that have no voting rights, however, paragraph 154 in discussing paragraph 14(d) refers to corporate entities that apparently would have voting shares. Thus, it is unclear what the Board’s intent is with respect to voting rights.

We believe that the proposal’s reference to “activities that the creating entity can schedule (or can initiate) to provide substantially all future net cash inflows or other future economic benefits
to its creator" is unclear and does not provide useful implementation guidance with respect to the broad range of SPE structures and transactions that exist in practice and may be developed in the future. As previously stated, we believe that additional analysis of this issue as part of a separate agenda project would be the most appropriate approach for the Board to pursue.

For securitizations, the application of circumstance 14(d) also is unclear because of the lack of guidance on how this requirement would interact with the proposed guidance in the Exposure Draft, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

**Not-for-Profit Entities**

We believe that our overall views that are included in this letter have applicability to not-for-profit entities and, in many respects, are consistent with the requirements of SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, which became effective in 1995. We also note that the Exposure Draft does not contain any background discussion comparing the Board's views with those in SOP 94-3, therefore making it more difficult to assess the impact of the proposal. We do not believe that it is necessary (in light of the issuance of SOP 94-3) to make further changes in the consolidation requirements for not-for-profit entities at this time.

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We appreciate the opportunity to present our views and would be pleased to discuss any aspect of our letter with the FASB or its staff.

Very truly yours,

[Signature]