Dear Mr. Lucas:


AcSEC observes that the ED expresses consolidation policy views that are fundamentally similar to those expressed in both the FASB’s Preliminary Views *Consolidation Policy* and FASB’s October 16, 1995 Exposure Draft of the proposed Statement of Financial Accounting Standards, *Consolidated Financial Statements: Policy and Procedures* (1995 ED). Although AcSEC continues to support FASB’s consolidations project and the concept of effective control, we are unable to support the ED, as presently drafted, for the reasons enumerated below.

Like its predecessors, the ED proposes significant, fundamental changes to long-standing consolidation policy and practices. Those changes have been opposed repeatedly by a significant majority of respondents addressing policy issues, including AcSEC. AcSEC believes the revised document is unpersuasive in addressing the overall concerns previously raised by respondents. Understanding that the standards setting process does not necessarily reflect the consensus of its constituents, AcSEC nevertheless believes the concerns previously expressed by respondents warrant FASB’s further consideration.

AcSEC’s primary concerns about the ED are discussed below. A more complete response to the Board’s specific questions as well as additional comments on the ED are included in the attached Appendix.

**Definition and Criteria**

AcSEC believes that including the ability to increase benefits or limit losses from the activities of another entity as a characteristic of control is an improvement over the 1995 ED’s definition of control. However, AcSEC recommends that the Board’s definition of control be clarified to emphasize the requirement that the current ability to control must exist, as opposed to the...
potential future ability to obtain control. Additionally, we believe the concept of beneficial interest should itself be a criterion for consolidation, separate and apart from control. AcSEC notes that in paragraph 19 of the ED the Board recognized the importance of assessing the risks and rewards of ownership for corporations where there is either no governing body or the elected or appointed governing body has limited authority. AcSEC believes that both control and beneficial interest are essential criteria in all circumstances in assessing whether consolidation is appropriate. We believe a separate beneficial interest criterion is particularly relevant for not-for-profit entities and partnerships and in situations where ongoing control may be nonsubstantive (for example, a special purpose entity (SPE) controlled by an “autopilot” mechanism).

**Presumptions**

AcSEC is concerned that the consolidation policy approach proposed by the ED may result in inconsistent application of consolidation policy in substantially similar situations, particularly because of its emphasis on presumptions of control as a basis for consolidation. AcSEC continues to believe that legal control should be the only situation leading to a presumption of control. AcSEC may also be able to support the presumption that a sole general partner in a limited partnership has control and therefore should consolidate, but only if additional recognition is given to the beneficial interest criterion discussed above. AcSEC does not support presumptions of control in the remaining two situations described in paragraphs 18(b) and 18(c). Rather, AcSEC believes that in those two situations the burden of proof should be on the preparer of the financial statements to demonstrate the existence of a current ability to control. AcSEC would prefer a model utilizing indicators of control, focused primarily on an entity’s current ability to control another. AcSEC believes indicators of control could include the two situations described in paragraphs 18(b) and 18(c). While AcSEC acknowledges that this model would rely more on judgement, we believe it is preferable to an approach based on presumptions and expect that it would result in improved application of the ED’s definition of control.

**Not-for-Profit Entities**

AcSEC agrees that the ED should be applied to both for-profits and not-for-profits (NPOs). AcSEC believes, however, that the ED focuses primarily on for-profit issues and situations. Specifically, AcSEC notes that key NPO concepts (for example, a parent’s ability to increase benefits from directing subsidiaries to carry out its mission) are not contemplated in the ED’s guidance in paragraph 14 concerning the ability to increase benefits and limit losses. Rather, guidance in this area is provided only in Appendix A as part of the implementation guidance. AcSEC recommends expanding the discussion regarding NPOs in the body of the Statement itself, supplemented by additional implementation guidance. We believe additional guidance in this area is needed to improve the proposed Statement’s operational effectiveness for NPOs.

**SPEs**

AcSEC believes that the ED has not effectively addressed SPEs and qualified SPEs (QSPEs) and is concerned about the resulting perceived overlap with existing standards (for example, FASB Statement No.13, Accounting for Leases, and Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and several EITF consensuses).
Although it is presently unclear how the overlaps might be resolved, AcSEC recommends that the Board expand its discussion in this area, perhaps in a separate section. Although the ED includes some SPE examples, it does not address prevalent SPE structures involving financial assets or leased assets other than real estate (for example, ships, airplanes, and other equipment). AcSEC believes that, in the absence of additional guidance in this area, comparability may lessen significantly from that currently achieved under present guidance. The International Accounting Standards Committee’s Standing Interpretations Committee has issued Interpretation SIC 12, Consolidation – Special Purpose Entities (SIC 12). AcSEC recommends that FASB consider SIC 12 both for international convergence and as a source of indicators of control for those kinds of arrangements.

Effect on Other Standards

As noted above, the ED does not adequately address the effect it will have on other standards. For example, the ED refers to various EITF consensuses, such as EITF Issues No. 96-16 and 97-2, but it does not indicate the Board’s view as to their ultimate disposition. Will some be retained while others are superseded? How will the proposed Statement interact with AICPA Statement of Position 94-3, Reporting of Related Entities by Not-for-Profit Organizations, and several other EITF issues, including EITF Issues No. 87-11, 90-15, 96-20, and 96-21? Without a more complete understanding of how these issues will be resolved, it is difficult to assess the full effect of the ED and the numerous implementation issues and questions that will arise.

Consolidation Procedures

AcSEC continues to support retaining the parent company approach for consolidation procedures. Accordingly, we support the Board’s decision to defer the procedures portion of the consolidations project. AcSEC, however, is concerned that application of the ED’s revised consolidation policies under current consolidation procedures requirements may result in unintended complications. For example, in paragraph 18 (c) (that is, a situation in which the investor is presumed to have the unilateral ability to control through the ownership of convertible securities), what would be the appropriate accounting in consolidation for the “controlled entity”? Should the acquisition of the convertible securities result in new-basis accounting? If so, under what circumstances and how should the “purchase price” be determined? Should the parent’s ownership interest in, for example, convertible debt be expressed assuming conversion as well? In other words, if the parent presently owns a 40 percent interest with the ability to obtain an additional 20 percent through conversion of its investment in convertible debt, is the ownership interest 60 percent or 40 percent? What would the accounting be if conversion does not occur? Further, how should the interest payments on the debt be characterized in consolidation—as interest or as a dividend? Accordingly, AcSEC recommends that the Board consider including guidance on specific consolidation procedures issues (such as the ones discussed above) to address practice issues resulting directly from the ED’s revised consolidation policies.
Request for Test Cases

AcSEC commends the Board on its recent attempts to obtain real-life examples to test the ED’s definition of control. We believe the results of the field tests will be critical in determining whether the ED’s revised definition and presumptions of control will produce the consistent results that the Board anticipates. To the extent that the tests reveal operational issues or produce inconsistent results, AcSEC urges the Board to weigh those findings carefully before issuing a final standard.

Representatives of AcSEC would be pleased to discuss our comments with the FASB or its representatives.

Sincerely,

David B. Kaplan, CPA
Chair
Accounting Standards
Executive Committee

Joseph H. Cappalonga, CPA
Chair
Consolidations Policy and
Procedures Task Force
APPENDIX

RESPONSES TO THE SPECIFIC ISSUES FOR COMMENT IN THE ED

Definition of Control and Its Implementation Guidance

**Issue 1:** This proposed Statement would define control as "the ability of an entity to direct the policies and management that guide the ongoing activities of another entity so as to increase its benefits and limit its losses from that other entity's activities. For purposes of consolidated financial statements, control involves decision-making ability that is not shared with others" (paragraph 6). In certain respects, that definition differs from the October 1995 proposed Statement that focused on decision-making powers for another entity's "individual assets" rather than its policies and management that in turn are used to direct activities, including the use of assets. The revised definition also encompasses a more explicit condition that the decision-making powers must provide the controlling entity with the ability to increase the benefits and limit the losses that it can derive from that decision-making power. (That latter revision is similar to the explicit condition included in definitions of control adopted in the United Kingdom and by the International Accounting Standards Committee.) Does the revised definition, together with the discussion of the characteristics of control (paragraphs 10–14) and descriptive guidance (paragraphs 15–23 and 30–47), help clarify when one entity controls another entity? Will the revised definition and guidance lead to common understandings and application of this Statement's definition of control?

Paragraphs 188–196 and 205–213 provide the basis for the Board's conclusions.

AcSEC believes the current ED's revised definition of control and descriptive guidance are improvements over the 1995 ED. However, AcSEC still believes the proposed Statement should place more emphasis on the importance of assessing the existence and extent of a beneficial interest in determining whether to consolidate another entity. Further, the ED's revised definition of control is focused largely on for-profit corporations, with little guidance as to its direct application to NPOs.

As it stands now, the ED's definition makes a parent's ability to increase benefits and limit losses a characteristic of control. While this is an improvement, AcSEC believes that the beneficial interest concept should be strengthened and made an additional criterion that must be assessed separately in determining whether to consolidate another entity. For example, Company A forms an SPE whose cash flows are essentially fixed upon formation and whose charter serves to benefit primarily Company A. After formation, Company A may appear to be relinquishing control to other entities. Due to the fact that the operations of the SPE have been fixed, however, Company A has created an entity to serve its own purposes despite its lack of legal control of the predetermined ongoing operations. In this and similar situations, AcSEC believes that meaningful control exists only at formation and that ongoing control of the entity is nonsubstantive. Accordingly, the decision to consolidate should be a function of determining the entity that has the ongoing risks and rewards of ownership.
AcSEC acknowledges the Board’s efforts to address this situation in paragraph 19. AcSEC agrees conceptually with paragraph 19, which, in some respects, addresses the importance of assessing risks and rewards to the exclusion of the presumptions of control. AcSEC supports that concept but believes that control and beneficial interest are both important criteria that should be evaluated separately. AcSEC supports a broad concept of beneficial interest that would include a significant direct or indirect equity or other financial interest in the earnings and cash flows of the entity, an exposure to the net cash outflows of the entity, or both, as well as mission accomplishments for not-for-profit organizations as discussed below. AcSEC believes that the level of beneficial interest required to support consolidation needs to be significant, a level referred to in paragraph 19.

AcSEC also has concerns about application of the ED’s definition of control to NPOs. For example, AcSEC notes that the Board includes key concepts such as a parent’s ability to increase benefits from directing subsidiaries to carry out its mission in its discussion of NPOs in paragraph 57, but does not address this concept directly as part of the ED’s guidance in paragraph 14 on what is meant by the ability to increase benefits and limit losses. AcSEC recommends that the Board expand its discussion of beneficial interest in paragraph 14, particularly in the context of NPOs. Specifically, the Board should discuss various factors to consider in applying the definition of control to NPOs, such as: (1) establishment of the organization, (2) appointment of the board, (3) transfer of assets, (4) assignment of functions, (5) performance of program, (6) control of name or purpose, and (7) recipient of assets in the event of dissolution. Many of these concepts are presently included in SOP 94-3.

**Issue 2:** This proposed Statement would provide guidance for applying its definition of control. That guidance includes certain situations, which are identified in paragraphs 18 and 21 of this proposed Statement, that would lead to rebuttable presumptions of control. They are those circumstances in which an entity:

- **a.** Has a majority voting interest in the election of a corporation’s governing body or a right to appoint a majority of the members of its governing body
- **b.** Has a large minority voting interest in the election of a corporation’s governing body and no other party or organized group of parties has a significant voting interest
- **c.** Has a unilateral ability to obtain a majority voting interest in the election of a corporation’s governing body or obtain a right to appoint a majority of the corporation’s governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost
- **d.** Is the only general partner in a limited partnership and no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner.
Will guidance in the form of rebuttable presumptions of control be necessary? Do the circumstances described in each of the situations above provide a reasonable basis for presuming that one entity controls another entity in the absence of evidence that demonstrates or proves otherwise? Are they sufficiently clear and operational? Are additional presumptions of control necessary for specific circumstances? (If so, please identify those circumstances.)

Paragraphs 238–241 provide the basis for the Board’s conclusions and paragraphs 248–256 provide an alternative view on the use of rebuttable presumptions to provide guidance for applying the proposed Statement’s definition of control.

With the exception of situation (a), AcSEC is not in favor of retaining the ED’s situations leading to rebuttable presumptions of control. AcSEC would support the last situation (d), but only if it includes further recognition of the beneficial interest criterion discussed above in Issue 1.

AcSEC believes that control is factual, rather than predicated on apathy on the part of the owners of the majority voting interest. In situation (b), a company possesses a large minority voting interest, and it is deemed to have effective “control.” Maintaining that control, however, is totally dependent on the action or inaction of the owners of the majority voting interest. If the owners of the majority voting interest are content with the large minority voting interest owner’s management, then they may be unlikely to attempt to exercise control. If the owners of the majority voting interest become dissatisfied with the large minority voting interest owner’s management, however, legal mechanisms exist under which they can veto or otherwise negate the large minority voting interest owner’s previous effective control. Further, AcSEC notes that this is the only one of the Board’s situations leading to a presumption of effective control in which the unilateral ability to control on the part of the investor does not exist. AcSEC is concerned that shifts of effective “control” with respect to this presumption could result in subsidiaries moving in and out of consolidated groups in circumstances where the level of actual control has not changed. For example, an investor holding a 40 percent voting interest might consolidate if historically only 75 percent of the shareholders vote. However, if 85 percent vote in an upcoming year, consolidation may not be deemed appropriate. A drop to the historical voting levels again in the following year could point back to consolidation. AcSEC believes relevance and comparability will suffer.

Conversely, situation (c) presumes that the ability to obtain control is effective control, despite a lack of current control. AcSEC believes this situation should be considered to be an indicator of control, in the context of all other relevant circumstances, and that it should not by itself result in a presumption of control. For example, a closely held, well-established corporation might seek outside financing to expand current operations. The investor may require convertible securities to provide it with the unilateral right to obtain a majority-voting interest, primarily as an exit strategy. If the expected benefits from conversion were deemed to exceed the expected cost, the investor would be required to consolidate the closely held corporation although it likely will never exercise the conversion right. AcSEC is concerned about the usefulness and operationality of this presumption, particularly the potential volatility that could result if, for example, a conversion price moves in and out of the money, potentially even on a quarterly basis. Further,
AcSEC believes that, in addition to demonstrating that the benefits of conversion outweigh the costs, the holder of the convertible security must also have the economic ability to convert. AcSEC recommends that, in addition to changing this presumption to an indicator, the concept in paragraph 18 (c) be clarified to reflect these points.

AcSEC is also troubled by the apparent inconsistency in the logic regarding situations (b) and (c). For example, AcSEC believes the presumption that an investor that meets the conditions of paragraph 18(b) has control is largely dependent on future voter apathy on the part of the owners of the majority voting interest, while the presumption that an investor that meets the conditions of paragraph 18(c) with only convertible securities has control ignores lack of current control on the part of that investor. Future action on the part of the owners of the majority of the voting securities is ignored in situation (b), but in situation (c) future action on the part of the convertible securities owner is presumed.

If the Board continues to believe items (b) and (c) are essential in assessing control, AcSEC suggests that they be viewed as indicators of control, rather than situations leading to presumptions of control. At a minimum, we believe a decision to retain items (b) and (c) as situations leading to presumptions of control should also include providing guidance regarding how those rebuttable presumptions might be overcome to improve the operationality of the standard.

Paragraph 9 states that "once a subsidiary is consolidated, it shall continue to be included in the consolidated financial statements until the parent ceases to control it." AcSEC believes that additional guidance is necessary with respect to the frequency that control needs to be assessed. For example, once a company is presumed to control under paragraph 18(b), should control continue to be presumed until something (for example, a change in the board's composition or an adverse vote) indicates that control has been lost? Or should the presumptions be tested each reporting period? Similar questions exist for holders of convertible securities.

AcSEC also has concerns about situation (d), where a single general partner is presumed to control the limited partnership and, unless the presumption can be overcome, should consolidate its assets. This situation perhaps best illustrates AcSEC's desire for beneficial interest to be a separate criterion for consolidation. For example, is it meaningful to require a general partner that is presumed to control a partnership to consolidate that entity if its total economic interest is only 1 percent? Presumably, the general partner would reflect a 99 percent "minority" interest in its financial statements. AcSEC questions whether this information would be either relevant or useful to the investors of the general partner.

Further, AcSEC encourages the Board to clarify its comment in paragraph 21 regarding removal of the general partner. Although we presume the Board is referring to the ability to remove the general partner's powers to control, rather than to force the general partner to divest, and is referring only to situations involving removal without cause, we suggest this be clarified in the proposed Statement.
Transition and Implications for Interim Reporting

**Issue 3:** This proposed Statement would be effective for financial statements for annual periods beginning after December 15, 1999, and all interim periods in the year of adoption. With certain exceptions, it would be applied by restatement of comparative financial statements for earlier periods. Are the benefits of complete and comparative financial statements for all interim periods in the initial year of application sufficient to justify requiring, rather than permitting, that the provisions of this Statement be applied for the first and each subsequent interim period in the year of adoption? Are there specific circumstances surrounding the application of this proposed Statement that would justify delaying its application to interim periods in the year of adoption?

Paragraphs 245–247 provide the basis for the Board’s conclusions.

We agree with the ED’s conclusion that comparative information should be required for all interim periods. However, AcSEC has a larger concern regarding the proposed effective date of the ED. Specifically, AcSEC believes that an effective date of December 15, 1999 will not give the preparer community sufficient time to implement the proposed Statement.

The implementation of the proposed Statement will require companies to assess relationships with perhaps hundreds of affiliated entities. Besides requiring retroactive restatement based on the results of those assessments, some companies will wish to readdress or cure issues relating to their relationships with these affiliates, while others will need to cure potential violations of existing debt covenants. Still other companies will be required to obtain additional financial information that they neither needed nor desired in the past. For example, companies currently reporting certain convertible investments in accordance with the provisions of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* or utilizing the cost method may not have sufficient time to make assessments about control or, for that matter, have the information needed to determine the adjustments required to consolidate their investments in these entities should that become necessary under the new Statement.

In addition to implementation problems that might hinder companies in their attempts to comply with the proposed Statement, the effective date leaves little time for the FASB to receive, analyze, and summarize the results of its recent request for test cases. Further, the proposed effective date would require companies to adopt the Statement in the first quarter of the year 2000, compounding their year 2000 issues and forcing them to divert resources away from other projects like early implementation of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.* AcSEC also notes that FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries,* which proposed far less sweeping changes to consolidation policy, allowed a fourteen-month implementation period.

Accordingly, AcSEC suggests postponing the effective date for two years to annual periods beginning after December 15, 2001.
COMMENTS ON OTHER ISSUES

Scope

Paragraph 5 states that the ED does not apply to entities that "...in accordance with generally accepted accounting principles carry substantially all of their assets, including investments in controlled entities, at fair value..." AcSEC is concerned that the ED's scope paragraph could be misinterpreted and lead to misapplication by NPOs. Specifically, AcSEC is concerned that, because many NPOs have minimal property and equipment and may have substantially all assets reported at fair value, a supporting foundation, community foundation, or other NPO could conclude that the standard does not apply to them. Accordingly, AcSEC suggests that the Board clarify the proposed Statement's scope to explain that it does not exclude NPOs or others, unless they are presently covered under investment company, pension, or other specialized standards that require substantially all assets to be reported at fair value.

Trusts and Other Arrangements

We believe paragraphs 22 and 23 should be modified to clarify that a trustee receiving fees for services does not meet the ED's control definition because the second characteristic of control—the ability to increase benefits and limit losses—is not present. However, AcSEC believes that a trustee that is also the beneficiary, such as might exist in a split interest arrangement, does meet that definition. AcSEC believes the point is best illustrated in paragraph 163 of Example 10 - Creation of a Charitable Trust to Benefit a Charitable Organization. In that example, the NPO is both the trustee and a remainder beneficiary. The ED concludes that, because the NPO, as trustee, must serve the needs of the income beneficiary first, the NPO does not control. AcSEC disagrees with that conclusion. Although AcSEC acknowledges that the NPO has a joint fiduciary obligation to both the income beneficiary and the charitable interest, AcSEC believes the NPO controls the trust and derives benefits from it sufficient to warrant consolidation. The NPO should disclose the limitations imposed and its obligations to other beneficiaries, but it should consolidate the trust.

Grant-making Foundations and their Sponsors

The ED discusses a grant-making foundation (paragraphs 75 and 76) sponsored by a for-profit corporation. It concludes that consolidation is not required because law precludes the sponsor from deriving future economic benefit from the foundation's assets, despite the fact that the sponsor retains a majority voting interest. AcSEC notes that, in this example, the ability to increase benefits appears limited to economic benefits and does not, as might be the case for an NPO, include an assessment of whether or not the foundation is carrying out the charitable mission of its for-profit parent. AcSEC believes the distinction between this example and one involving a foundation established by a not-for-profit corporation is unclear. AcSEC believes that the Board intended that an NPO would be required to consolidate a foundation it establishes to carry out its mission. If that is the Board's intent, AcSEC recommends that the Board provide support for the differing interpretations in its basis for conclusions, and clarify paragraphs 75 and 76 to state that they cannot be applied by analogy to a foundation established by an NPO.
Federations, Membership Organizations, and Other Associations and their Members

As stated in our comment letter to the 1995 ED, the discussion of federations, membership organizations, and other associations and their members, currently in paragraphs 77 and 78 of the ED, is in the context of relationships that generally do not result in control and thus should not be consolidated. AcSEC continues to believe that there are circumstances in these kinds of relationships in which control (and a significant beneficial interest) does exist and consolidation should be required. AcSEC recommends that the ED be clarified to reflect the possibility of this situation.

Appendix A: Example 6 – Creation of a Special-Purpose Corporation to Benefit the Creator-Sponsor

AcSEC believes that this example is not representative of most NPO situations and therefore may be unrealistic for common practice application. Specifically, the example includes the unilateral ability to dissolve the foundation and retain the assets as an essential factor. Such an overriding control factor undermines the usefulness of using other factors and explaining how those other factors should be considered in determining whether to consolidate. AcSEC recommends that (1) an ability to dissolve and retain the assets of the foundation be taken out of the example because it is not a common ability among NPOs and (2) the relevance of the remaining factors be explained more clearly in that revised context.