Proposed Statement of Financial Accounting Standards,
"Consolidated Financial Statements: Purpose and Policy"
(File Reference No. 194-B)

Dear Mr. Lucas:

We are extremely disappointed that despite significant and widespread opposition to the initial proposal, the FASB is still pursuing a proposed consolidation standard that, if adopted, would result in added complexity and significantly greater diversity in practice. As stated in our three previous response letters dated December 3, 1998 on the working draft, January 15, 1996 on the 1995 Exposure Draft, and January 5, 1995 on the FASB’s Preliminary Views, we oppose the direction of the FASB’s consolidation project. Other constituents, including the AICPA, accounting firms, and representatives from corporate America have shared concerns similar to those we have expressed. While those comments have led the FASB to make modest changes to each of those prior publications, the FASB has not addressed, nor has it cured, what many constituents see as the fundamental flaws in the proposal. In this regard, it appears that the FASB is predisposed to changing the existing consolidation rules, notwithstanding the lack of support from a significant segment of its constituency. We sincerely hope this is not the case, and that the FASB still is willing to reconsider its views and consider withdrawing this proposal.

We believe the existing consolidation framework established by ARB 51 is serving the financial reporting community reasonably well (and, for that matter, has done so for the seventeen years that this project has been on the FASB’s agenda) and provides both an objective and verifiable standard to determine when control exists for financial reporting purposes. We agree with the concept that entities that actually are “controlled” should be consolidated, and believe that control should be objectively determinable and should be presumed when a company owns a majority of the voting interest of an entity (sometimes referred to as “legal control”). In the absence of owning a majority voting interest, it should be presumed that the entity is not controlled. In our view, replacing ARB 51 with a standard that necessitates highly subjective evaluations based on presumptions that do not provide for control based on a majority voting ownership interest simply is not justifiable. In the absence of owning a majority voting interest, an attempt to apply the proposal’s presumptions of control would only lead to a significant diversity in practice.
and a corresponding lack of comparability in financial reporting. Furthermore, requiring the consolidation of an entity when little or virtually no financial interest is involved would serve to produce financial statements that are not meaningful.

We also have significant reservations as to how many of the evaluations required by the proposal would be subject to independent verification. Because of the impact that such a pervasive issue as consolidation has on financial reporting, it is critical that the control decision be supported by both objective and verifiable evidence. While we are not advocating the elimination of reasoned judgment, the use of presumptions that require subjective evaluations as to whether control exists inevitably will result in instances where the judgments of companies, independent auditors, other investor groups, and, for public companies, the staff of the Securities and Exchange Commission, will differ. The increased potential for restating previously issued financial statements would be an unacceptable result from a financial reporting and capital market perspective.

In conclusion, we do not believe the revised proposal represents an improvement to the existing standard and, accordingly, do not believe the FASB should finalize it. For the overwhelming majority of investments, ARB 51, FASB Statement 94, and the rules promulgated by the SEC provide appropriate consolidation guidance. In view of the significant growth in recent years of special purpose entities, joint ventures, strategic alliances, and other unique business arrangements, all of which have raised issues not contemplated when ARB 51 was promulgated, we believe the FASB should drop the current project and redirect its efforts to address these narrower areas for which guidance is clearly lacking.

A more detailed discussion of our views, which are consistent with those previously communicated to you, is attached to this letter. We hope the FASB will carefully consider our views, as well as those of other constituents. We believe that our views are consistent with a large segment of the FASB’s constituency and are concerned that while differences of opinion will always exist in the standard setting process, differences to the degree that exist on such a pervasive issue as consolidation are troublesome. We are available to discuss any aspect of our letter with Board members or the FASB staff.

Very truly yours,

Ernst & Young LLP
Our more detailed views on the FASB’s proposal, *Consolidated Financial Statements: Purpose and Policy*, are described below.

**Consolidation Policy**

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. We do not believe the FASB has made that case nor do we believe that existing practice supports the need for the changes of the type contemplated by the proposal.

The proposal’s requirements for consolidation in paragraphs 9 and 10 provide that a controlling entity should 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 requires the presence of: (a) a parent’s nonshared decision-making ability that enables it to guide the ongoing activities of its subsidiary and (b) a parent’s ability to use that power to increase the benefits that it derives and limit the losses that it suffers from the activities of that subsidiary.

The proposal discusses the application of the definition of control to different forms of entities, and establishes specific presumptions of control. Because of the highly subjective nature of the control definition, application of the proposal would be dependent on presumptions as to when control exists. Absent such presumptions, a financial statement preparer would find it extremely difficult to apply the proposal’s general control requirement described in the preceding paragraph. We do not believe that the proposal represents a step forward and, further, we believe that the current guidance, including EITF 96-16, *Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*, provides relatively objective guidance in determining whether or not an entity should be consolidated. Further, it is not clear how the proposal interacts with the guidance from this and other EITF issues dealing with consolidation (such as EITF 97-2 dealing with physician practice management entities).

There are numerous instances in the proposal where the FASB acknowledges that application of the proposal is highly judgmental. For example, paragraph 83 states:

*The conclusions reached in those examples [in the paragraphs that follow] are not necessarily “right.” Rather, they are reasoned judgments about control based on the available evidence at a point in time.* [Emphasis added.]

Another example of the difficulty underlying the FASB’s control concept is provided in paragraph 34, which states:
The existence of decision-making ability that results from effective control, although often known to a parent’s managers, sometimes will not be apparent or certain until those managers take actions that provide evidence of control. Nonetheless, whether an entity has the ability to control another entity by legal means or by less-visible effective means, the result of being in control is the same—the controlling entity has the ability to direct the policies and management that guide the ongoing activities of the controlled entity so as to increase its benefits and limit its losses from the controlled entity’s activities. [Emphasis added.]

We are at a loss as to how to conclude that “effective” control exists when such control is not apparent and the investor’s management has not taken any action to indicate that control exists. We also are troubled by the possibility of changing the accounting for an investment based on management actions that do not result in an objectively measurable change in voting interests.

In contrast, paragraph 2 of ARB 51, as amended by FASB Statement 94, 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.

If a parent does not own over 50 percent of the voting stock of an entity, we believe it generally 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, does not equate to the existence of control.

Presumptions of Control

The definition of control that is included in the proposal is conceptual in nature and lacks one essential ingredient to make it operational in practice—an objective and verifiable standard on which to make a determination as to whether control exists. The subjective nature of the discussion in the basic standard and the frequent need to refer to examples in the Appendix in an attempt to understand how such provisions would be applied in practice only serve to highlight our concern about the proposal’s operationality. While we agree with the concept that entities that actually are “controlled” should be consolidated, we believe that control must presently exist. Accordingly, control only should be presumed when a company owns a majority of the voting interests of another entity (as
described in paragraph 18a of the proposal). It should be presumed that the investor does not control the investee in the absence of this majority voting ownership interest.

We disagree with the presumption of control in the circumstances described in paragraphs 18b, 18c, and 21 of the proposal, for the reasons discussed below. If the FASB continues to proceed with the presumptions of control in the situations described in paragraphs 18b and 18c, the FASB, at a minimum, should include examples of factors that should be considered in determining whether the presumption of control could be overcome.

We also are troubled by paragraph 17 of the proposal, which states in part:

However, those situations [the presumptions described in paragraphs 18 through 21] represent only a few of the most common ways that control of an entity might be achieved. The absence of one of those specific situations does not lead to a presumption that control is not present.

The provisions of paragraph 17 only serve to amplify the impracticalities of attempting to implement the proposal. For example, in the absence of the presumptions described in paragraph 18, what circumstances would lead the FASB to conclude that consolidation is required? What circumstances would lead others to conclude that consolidation is appropriate? We believe that disagreements will arise among companies, their auditors, and the SEC regarding the presumptions of control that are described in the proposal. The level of disagreement regarding other factors relating to control that are not identified (but apparently contemplated) in the proposal will be even greater, and make it exceedingly difficult to apply the standard in practice.

Ownership of Minority Interest

The proposal concludes that an entity is presumed to control another entity when it owns a minority voting interest that represents a majority of the voting interests that normally vote in the election of that entity’s governing body and no other party or organized group of parties has a significant voting interest in the entity (paragraph 18b). For example, the footnote to that paragraph suggests that if only 60% of the votes are typically cast, a 35% minority holder would be deemed large, and presumably would consolidate the investee. We disagree with the FASB’s conclusion that control should be presumed in such circumstances for the following reasons:

1. We believe that whether or not a shareholder elects to cast a vote in an election is not relevant to control. The shareholder has the power to cast a vote and failure to vote in the past does not affect the shareholder’s ability to vote in the future. Not casting a vote should not be presumed to be an indication of an inability to vote. In the situation described in the footnote to paragraph 18b, the minority shareholder does not presently possess the ability to control the entity. Our view that whether other
shareholders exercise their right to vote is not relevant to the determination of control is consistent with paragraph 31 regarding one of the requirements for control, which states:

The definition of control requires a controlling entity to have decision-making ability over the controlled entity. The existence of that ability is a matter of fact. That is, whether an entity presently has the required decision-making ability does not depend on whether and how an entity with the required decision-making ability (parent) chooses to use that ability or whether a parent's managers intend to perpetuate, sell, or transfer that decision-making ability. Moreover, while a parent's use of its decision-making ability usually provides observable evidence that demonstrates its existence, a parent need not demonstrate its decision-making ability to possess that ability. [Emphasis added.]

We believe that the same principles apply to voting interests, and control requires the ability to cast a majority of all eligible votes, not just a majority of actual (or expected) votes. There are many reasons that a shareholder may not vote in director elections, including the fact that a shareholder does not object to the proposed slate of director candidates (which in a significant majority of cases are approved by a wide margin). An abstention from voting may, in effect, be a vote in favor of the director candidates. The fact remains that a relatively significant minority shareholder can be outvoted. Accordingly, the minority shareholder is not in control.

2. We are concerned that a presumption involving the number of votes actually cast in the election of directors could lead to changes in the accounting for an investee in situations where the voting interests have not changed by a single share, but the number of shareholders actually voting has changed. For example, if an investor owns 35% of an investee and 71% of the shareholders normally vote, the definition of "large minority voting interest" included in footnote 2 to paragraph 18b of the proposal (which likely will be perceived to be a newly established "bright line"—i.e., 50% of the votes cast) suggests that the entity would not be consolidated because the minority interest represents less than 50% of the votes cast. However, if over the last five years, the percentage of shareholders voting was 72%, 70%, 70%, 69%, and, most recently, 68%, should the investor consolidate the investee? If the investor must currently consolidate because the change in the number of shareholders voting, should that change be applied retroactively or prospectively? Is the answer (i.e., retroactive versus prospective application) the same if the change is the reverse, that is, from consolidation to the equity method of accounting?

These questions highlight the lack of operationality of this presumption. Inherent in this presumption is the belief that future voting patterns will mirror past patterns. In our view, this is not realistic nor a reliable basis on which to consolidate another
entity. Future voting patterns are not subject to prediction and to presume control in this situation is illusory.

3. This presumption requires an investor to assess whether the investee’s shareholders have relationships that would lead them to vote as a group. The investor may not know this information until the time that investee shareholders actually act as a group. Further, the investor may not even know the identities of other shareholders.

Example 1 in the Appendix to the proposal, which illustrates the application of the presumption described in paragraph 18b, goes even further and suggests that consolidation continues to be appropriate even after the ownership interest is reduced to less than half of the shares that historically have voted (35% ownership when 80% of votes normally are cast) because:

In this case, based on the facts and the weight of the evidence, the 35 percent voting interest, the strong ties to the directors of Company B, and the continuing success of Company B’s operations under its control, collectively give Company A the ability to dominate the nomination and election of Company B’s directors.

It is unclear how “strong ties” and “continuing success” affect whether or not an entity is controlled. In this circumstance, because the investor does not cast at least a majority of the votes typically cast, many would apply the concepts in the proposal and conclude that the investor does not control the investee. Further, if characteristics such as “strong ties” and “continuing success” must be considered, we do not understand how such qualitative characteristics would be subject to independent verification. In this example, would the proposal require one to review only past operating results to assess “continuing success,” or would one be expected to project future operating results and conclude that those operating results can affect the determination of whether the investee is controlled? If the operating results are projected to deteriorate in the future, would the conclusion as to control change? What constitutes “strong ties”? Would this require the company to examine potential relationships between each investee director and the investor’s senior management and directors? Would the company be expected to assess the attitudes of investee director’s towards the investor and its management?

Control Based on Assumed Conversion of Securities into Voting Securities

The proposal concludes that control should be presumed if an entity has the unilateral ability to (1) obtain a majority voting interest in the election of a corporation’s governing body or (2) 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. That is, control should be presumed where a company currently does not have a majority voting interest in an
investee, but can convert currently owned securities or debt instruments or exercise an option to obtain a majority voting interest. We disagree with this presumption because, until the conversion occurs or the right has been exercised, the holder of such rights does not have the present ability to direct the policies and management of another entity. While we acknowledge that an entity might have significant influence over the investee, to presume that control of that entity exists simply is not factual. As highlighted by the following questions, we also have significant concerns about the operationality of the presumption.

1. The determination of whether expected benefits of conversion will exceed expected costs is highly subjective. Would companies be required to forecast future events? What happens if events change in the future such that the initial determinations with respect to the benefits of conversion are no longer valid?

2. How would one assess the investor's ability to exercise? For example, if a substantial cash payment is required to exercise an option to obtain a majority voting interest, how should the investor assess its ability to secure the necessary funds at a reasonable cost?

3. For purposes of analyzing convertible securities, should the investor also consider potential conversions by others as well? How would the investor determine which shareholders or shareholder groups own convertible securities and whether the economic benefits from the potential exercise of such securities exceed the expected costs? How does an investor's ability to convert securities to obtain a majority voting interest meet the FASB's condition for control described in paragraph 11 of the proposal—nonshared decision making ability—when there is another shareholder that owns a majority of the current voting interests? It would appear in this circumstance that, at best, the convertible security holder shares decision making ability.

4. In the event that an investor determines that a convertible security must be "in-the-money" for the expected benefit of converting the security to exceed the expected cost, how should the investor account for the investment when the convertible security is in-the-money in one reporting period, and then out-of-the-money in a subsequent reporting period?

5. If an investor consolidates an entity based on its ownership of convertible securities and currently has only a minimal equity or residual interest, should it allocate profits and losses based on its actual equity ownership or its assumed equity ownership after conversion under the theory that it is in control of those earnings? If the investor recognizes its hypothetical share of earnings, the excess of such earnings over interest or dividends received on the security could be viewed as a contingent gain that should
not be recognized prior to conversion of the security. If the convertible securities are debt, would the interest received be considered a dividend?

While we do not agree with the FASB’s broad presumption regarding convertible securities, we do agree with the FASB’s view in Example 4 of Appendix A that the holder of the convertible securities should consolidate the investee given that the equity investor has a nonsubstantive investment because the investor (an employee of the convertible security holder) made a nominal investment and all the investee’s losses are being funded by the convertible security. However, we believe that the FASB can address such substance over form situations in a narrow scope project that deals more directly with such issues.

Partnerships

The proposal concludes that a significant equity or residual interest in an entity is not a prerequisite to consolidation. While we agree that, in some cases, a general partner with a nominal equity interest may control a partnership, we believe that having a substantive residual interest should be a prerequisite to consolidate an entity. For example, under the FASB’s proposal, a general partner with a 1% interest in a limited partnership with $100 million in assets and $90 million in debt likely would have to consolidate those assets and liabilities even though its net investment is only $100,000. To assert that the financial statements are improved by consolidating the financial position and results of operations of the limited partnership in this example is, in our view, not appropriate and would produce financial statements that are not relevant or useful because they would not satisfy one of the fundamental objectives of financial reporting as described in Concept Statement No. 1 — to provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows. In this example, we believe that financial information presented on an equity basis coupled with disclosure of summarized financial information for significant equity investments (as presently required by existing standards) provides more relevant information for financial statement users.

It also is unclear whether the proposed standard would amend other literature dealing with partnership investments not described in Appendix C. For example, paragraph 64 of the proposal indicates that the right of a minority investor to veto the sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of a limited partnership would be considered a protective right and would not otherwise negate control by a sole general partner. However, SOP 78-9, Accounting for Investments in Real Estate Ventures, states that “majority ownership may not constitute control if major decisions such as the acquisition, sale, or refinancing of principal partnership assets must be approved by one or more of the other partners.” As another example, paragraph 68 of the proposal describes a common form of physician practice management entity and
states that the “EITF reached [a] consensus that in those circumstances the PPM is in control of the physician practice.” However, the proposal gives no indication whether or not that conclusion is consistent with the FASB’s proposal.

*Special Purpose Entities*

Special purpose entities, particularly those engaging in leasing transactions and structured financings, often give rise to consolidation issues that currently are being addressed in a variety of ways. For example, the Emerging Issues Task Force has provided guidance on numerous leasing transactions while the FASB, by means of the issuance of questions and answers published in a Special Report on FASB Statement 125, has addressed practice issues on SPEs that are involved with transfers of financial assets. The consolidation proposal provides little, if any, useful guidance to deal effectively with the issues that have been dealt with on an ad hoc basis by the EITF and the FASB staff. As recommended earlier, we believe that the FASB should add a separate project to its agenda to deal with the issues that arise from complex business arrangements such as SPEs, joint ventures, and other business alliances. Until such time as that project could be completed, the EITF could continue to deal with consolidation issues that arise.

We also note that Example 5 of the proposal includes an example of an entity formed solely to conduct research and development activities on behalf of a sponsor. Accordingly, the FASB would apply its control based approach to such arrangements to determine whether or not they should be consolidated. The proposed approach appears to be inconsistent with the approach of FASB Statement 68 on research and development arrangements, which requires the consolidation of an entity based on the risks and rewards that accrue to the sponsor, rather than basing consolidation on a “control” model. However, FASB Statement 68 is not included in the list of amended pronouncements in Appendix C of the proposal and, therefore, it is not clear how the proposal would affect FASB Statement 68.

*Not-for-Profit Entities*

We believe that our overall views expressed in this letter also are applicable to not-for-profit entities that apply SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, which became effective in 1995. 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.

*Effective Date and Transition*

Notwithstanding the views expressed in this letter, if the FASB decides to finalize the proposal, the effective date should be postponed until the year 2000. Many companies will require time to prepare for the adoption of the new rules, particularly in situations
where the amount of net income will have to be restated. Companies that have numerous
equity investees likely will be required to perform significant analyses to determine
whether such entities should be consolidated. Further, accumulating the information
necessary to consolidate previously unconsolidated entities could be time consuming,
particularly for public companies that present five years or, in some cases, ten years of
selected financial data in their annual reports. Given that a final standard would be issued
relatively late in 1999, and calendar year companies would be required to adopt the
standard in the first quarter of 2000, many companies will have insufficient time to
analyze the final standard’s effect on its investments to adopt the standard in time, or to
take any necessary actions to address the potential effect the new rules could have on
compliance with debt covenants and other agreements. For example, if a company is
required to consolidate a highly leveraged investee that previously was accounted for
using the equity method, consolidation conceivably could change the company’s leverage
or debt coverage ratios to an extent that would result in a violation of debt covenants. In
such situations, companies would need time to renegotiate with their lenders the terms of
their debt.

With respect to the proposal’s retroactive application requirement, we assume that if the
proposal is adopted companies would make the assessment of whether they have control
of an investee using current information at the time of adoption. To do otherwise may
not be practical for many companies that have acquired ownership interests in entities
years ago, have had changes in those interests over the years, and no longer have records
to reconstruct what the assessment would have been under different accounting
requirements. A final standard should make this application explicit.