June 2, 1999

Mr. Timothy Lucas  
Director of Research and Technical Activities  
Financial Accounting Standards Board  
File Reference No. 194-B  
401 Merritt 7, P.O. Box 5116  
Norwalk, Connecticut 06856-5116  


Dear Mr. Lucas:

The Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR) is pleased to comment on the Financial Accounting Standards Board’s (FASB) exposure draft (ED) on the purpose and policy of consolidated financial statements. The FAPC is a standing committee of AIMR charged with maintaining liaison with and responding to the initiatives of bodies which set financial accounting standards and regulate financial statement disclosures. The FAPC also maintains contact with professional, academic, and other organizations interested in financial reporting.

General Comments

The FAPC believes that the current ED provides a clearer definition of control (i.e., a better view of the facts and circumstances that give an enterprise control over another) than the one proposed in the 1995 ED, which focused on an enterprise’s decision-making power over another enterprise’s assets. Nevertheless, as it is currently drafted, the FAPC does not believe the proposed standard is operational. We still have significant concerns about whether the revised definition of control will:

1. be rigorously interpreted,
2. lead to a common understanding, and
3. be consistently applied by a particular company over time or by different companies.
The fact that the situations and conditions that encompass the relationships among entities are not always distinct, clear-cut, or comprehensively disclosed makes it difficult to determine, by means other than majority ownership, if and when one entity has control over another entity. Similarly, it is also often unclear if and when such control has been relinquished. Therefore, it is incumbent upon those with sufficient information about these relationships (i.e., management as well as those who audit the financial statements) to carefully evaluate the conditions and facts surrounding these relationships to determine whether the reporting entity has or retains control.

Unfortunately, financial analysts and other users of financial statements rarely have access to such information (in terms of either quantity or timeliness) to determine whether control exists and, hence, whether consolidation or de-consolidation is appropriate. However, such information is essential for users because it has a significant impact on the valuation of the reporting entity. We have found, based on our research, that the disclosures related to de-consolidations are rarely adequate for users to develop an understanding of the reasons for a de-consolidation or to assess its impact on the reporting entity.

Furthermore, we believe that the Emerging Issues Task Force (EITF) consensus on Issue No. 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," has not ameliorated the situation. Rather, the EITF consensus has resulted in an increase in de-consolidations of many highly leveraged and significantly integrated investments of affiliated entities that we are not convinced were appropriate. Therefore, the true nature of the reporting enterprise’s operations and financial position may be distorted.

**Issue 1: Definition of Control**

*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?*

In practice, we believe the revised definition will be inadequate and will not lead to either a common understanding or application. Although we believe that the revised definition of control and the additional descriptive guidance is an improvement over the 1995 ED definition, we are concerned that it will not lead to rigorous interpretation and consistent application by either individual enterprises over time or by different enterprises. As we mentioned in our general comments, relationships among various enterprises are often very complicated and it is often very difficult to draw definitive, unambiguous conclusions as to where control resides. Furthermore, we believe that determining whether control exists will be difficult to accomplish without a careful, complete, and honest assessment of these relationships by the enterprise’s management. Perhaps, most importantly, auditors must be willing to scrutinize and sometimes contradict management’s judgment and make difficult decisions if this judgment is not adequately supported.

We believe it will be difficult, if not impossible, for analysts and investors to predict or anticipate the impact of implementing this proposed standard because management has not been
completely forthcoming about the facts and circumstances surrounding their relationships with other enterprises. Hence, these relationships are not always transparent in the reporting entity’s financial statements. As an illustration of this lack of transparency about inter-company relationships and our inability to understand how management determines when control exists, we provide the following examples:\(^2\): (1) The Coca-Cola Company and Coca-Cola Enterprises and (2) Ashland, Inc., and Arch Coal, Inc.

(1) Coca-Cola and Coca-Cola Enterprises

Under the proposed definition of control, it is widely believed that because The Coca-Cola Company (KO) has a large minority voting interest (i.e., 40%) in CCE and no other party or organized group has a significant voting interest, KO will be required to consolidate Coca-Cola Enterprises (CCE). This presumption of control is further supported by the fact that CCE was originally created to be a wholly-owned subsidiary of KO. However, KO management has been quoted in the Wall Street Journal as saying that the definition of control in this ED will not require KO to consolidate CCE. In trying to understand KO’s position on this issue, we cite a footnote in the ED which states that “generally, a minority voting interest is large when it exceeds 50 percent of votes typically cast in a corporation’s election of directors.” If one relies on the qualifier “generally” in this footnote (in combination with Example 1 in the ED showing a relationship similar to the one between KO and CCF), one must conclude that management has strong evidence (not currently obvious to the public) with which to rebut the presumption of control.

(2) Ashland and Arch Coal

The relationship between Ashland (ASH) and Arch Coal (ACI) reflects another situation where arguments can be made both for and against consolidation depending on which (1) sections of the ED and (2) facts and circumstances management decides are most applicable and relevant. Our understanding of the facts and circumstances are as follows:

(1) In July 1997, ACI was created as a result of a merger between Ashland Coal and Arch Mineral. ASH owns 55% of ACI and seven of ACI’s twelve-member board of directors (58%) are affiliated with ASH. These seven members include the Chairman and CEO of ASH.

(2) ACI’s bylaws require an affirmative vote of at least two-thirds of the board of directors in order to (a) approve the annual budget and operating plan, (b) make employment decisions regarding the CFO, COO, and CEO positions, and (c) declare dividends.

(3) ACI’s certificate of incorporation requires an affirmative vote of at least two-thirds of the outstanding common shares voting thereon to approve a merger or consolidation and other fundamental actions involving or affecting control of ACI.

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\(^2\) Pat McConnell, CPA, Janet Pegg, CPA and David Zion, CPA, CFA; Bear, Stearns & Co. Inc; FASB Exposure Draft on Consolidation Policy: To Consolidate or Not to Consolidate; Accounting Issues; May 9, 1999; pp. 8-10.
In accordance with the EITF Issue 96-16 consensus, ASH does not currently consolidate its investment in ACI because its voting interest would not enable it to ensure a two-thirds vote. However, given the following two pieces of guidance in paragraph 45 of the ED, we believe it is unclear whether ASH has lost control of ACI as a result of ACT's bylaw requirement:

"Those protective veto rights, however, generally do not enable them (non-controlling shareholders) to initiate policies or share in a parent's decision-making for the ongoing activities of its subsidiary. Examples include provisions...that require a supermajority vote (for example, two-thirds) of shareholders...to approve fundamental corporate acts, such as amendments to articles of incorporation, mergers, or sale of substantially all corporate assets. Similarly, veto rights granted by a majority shareholder to a minority shareholder...that enables that other party to block such corporate actions, by themselves, would not negate control by the majority shareholder."

"Generally, the right to block an individual corporate act is not equivalent in power to a right to initiate or otherwise participate in policy decisions that guide how an entity uses its assets in conducting its ongoing activities."

**Impact of EITF Consensus on Issue 96-16**

Contrary to expectations, we have not seen companies consolidating equity method investees as a result of the EITF consensus on Issue No. 96-16. Rather, we are concerned that its application has led, and will lead, to more de-consolidations of highly-leveraged and significantly integrated subsidiaries and other affiliated entities. As a result of these de-consolidations, less information will be available to users of financial statements regarding an enterprise's significant investments in affiliated entities. After de-consolidation of an investee, the consolidated financial statements will no longer provide detailed information about the investee's assets, liabilities, results of operations, and cash flows. Other key information provided in notes to the consolidated financial statements, such as segment data, pension plans, debt, contingencies, and other off-balance sheet items, will also be unavailable.

**Disclosures**

In the current proposal, detailed information about changes in accounting methods relating to investments in affiliated entities is not required. We believe that this reflects a significant deficiency in the ED. We strongly recommend that the proposed standard be modified to require disclosures that detail the impact of such accounting changes on key components of the financial statements. Financial analysts and other users of financial statements need these additional disclosures to assess properly the effect of these changes on the reporting entity's operations and financial position.

Specifically, we recommend that comprehensive disclosures be required to explain the impact on the financial statements of:

(1) consolidation of any entity during the current reporting period that was reported in
the prior period under the equity or cost method; and, conversely,

(2) de-consolidation of any entity that was consolidated in the prior reporting period but is currently reported as an investment under the equity or cost method.

These disclosures, preferably in a schedule format, should provide users of the financial statements with sufficient information to assist them in determining the impact on the enterprise’s operations, financial position, and cash flows caused by changing the accounting methods used to report these investments. At a minimum, these disclosures should include the following detailed information for each change:

(1) the effects of consolidation or de-consolidation on the financial position of the enterprise, such as changes in total assets, liabilities, and stockholders’ equity;

(2) the effects of consolidation or de-consolidation on the results of operations of the enterprise relating to revenue and expenses;

(3) the effects of consolidation or de-consolidation on the enterprise’s cash flows relating to operating, investing, and financing cash flows; and

(4) management’s rationale for changing the method of accounting for any investment in a subsidiary or affiliated entity from the prior reporting period to the current reporting period. For example, management should indicate the facts and circumstances which have changed and which justify different reporting for these investments from the previous reporting period.

Due to the ambiguity of the definition of control in the current ED, we believe it is possible for one enterprise to consolidate a minority-owned financial entity simply to mask its own financial problems. To reduce the incentive for abuse and to make the impact of consolidating entities with very different financial characteristics (such as leverage ratios and operating margins) more transparent to users of financial statements, we strongly recommend that separate financial statements be required for a consolidated affiliate or subsidiary whenever consolidation of that entity alters the key financial ratios of the reporting entity. In our view, General Motors Corporation, General Electric Company, and Caterpillar, Inc., are examples of “best practices” for separately disclosing relevant information about significant, non-homogeneous consolidated subsidiaries.

In addition, we are very concerned that the proposed ED will lead to frequent changes in accounting methods for investments in affiliated entities and, thereby, impair the consistency and comparability of a single enterprise’s financial statements from one reporting period to another as well as across different enterprises. We believe disclosure of the detailed information we recommend will help alleviate this problem and allow users of financial statements to prepare relevant and meaningful cash flow projections and financial analyses. Investors use these data for (1) determining and assessing an enterprise’s overall value and (2) making informed investment
decisions.

To illustrate our concerns about disclosure shortcomings, we offer the following example of a disclosure provided by an enterprise that de-consolidated a 75%-owned affiliated entity that had been consolidated in the previous year.

Equity Interest in Lyondell Methanol Company, L.P. - Lyondell Methanol was formed in December 1996 by the Company [Lyondell Chemical Company] and MCN Investment Corporation ("MCNIC") to own and operate the methanol facility at the Company’s Channelview, Texas, facility. At formation, the Company sold an undivided 25 percent interest in the facility to MCNIC, creating Lyondell Methanol, a Texas limited partnership owned by subsidiaries of the Company and MCNIC. The Company owns the remaining 75 percent interest and serves as managing partner. Since December 1, 1997, Equistar has served as operator of the methanol facility. Lyondell Methanol sells all of its products to Equistar. In accordance with the guidance in Emerging Issues Task Force Issue No. 96-16 issued in May 1997, the Company began to account for its investment in Lyondell Methanol using the equity method of accounting, effective January 1, 1998.

During 1998 and 1997, Lyondell Methanol revenues were $104 million and $165 million and net income was $8 million and $58 million, respectively.3

The above disclosure does not provide users with sufficient data and background to analyze and assess the impact on Lyondell Chemical’s operations, financial position or cash flows caused by de-consolidating Lyondell Methanol. Based on the information provided in this disclosure and other disclosures in the annual report, it is unclear to us what justification Lyondell Chemical had for changing its method of accounting for its 75% ownership in Lyondell Methanol. The only support for this change that we can surmise is that it is in accordance with the consensus of EITF Issue 96-16. Unfortunately, Lyondell Chemical did not provide separate summarized financial statements for Lyondell Methanol4 so that we could determine the discrete effects of the de-consolidation on the Lyondell Chemical’s financial statements.

Lyondell Chemical did provide summarized financial statements for the other investee, Equistar, mentioned in the disclosure. Lyondell Chemical owned 57% of Equistar until May 1998 with Millennium Chemicals, Inc. holding the remaining 43%. Equistar was consolidated in Lyondell Chemical’s 1997 financial statements but was not consolidated in 1998 because (1) "the partners jointly controlled certain management decisions," and (2) in May 1998, Lyondell Chemical’s ownership interest in Equistar had declined to 41%. (Millennium and Occidental Chemical Company each owns a 29.5% interest.)

3 Lyondell Chemical Company - Note 6 to the December 31, 1998 consolidated financial statements.

4 Lyondell Chemical does provide selected financial data (revenues, COGS, SG&A, R&D, EBITDA, capital expenditures, net interest expense, operating income, and net income) about Lyondell Methanol in a separate publication mailed to shareholders with the Annual Report.

Although we can see the rationale for de-consolidating Equistar, we find the Lyondell Methanol de-consolidation decision more difficult to understand for several reasons:

(1) Lyondell Chemical owns 75% of Lyondell Methanol;
(2) Lyondell Chemical owns 41% of Equistar, Lyondell Methanol's operator; and
(3) Lyondell Methanol sells all of its products to Equistar, which in turn has significant intercompany transactions and various service and cost-sharing arrangements with Lyondell Chemical.

**Issue 2: Application of the Definition of Control**

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.)

We believe guidance in the form of rebuttable presumptions is necessary. Rebuttable presumptions provide important additional language by which to clarify the definition of control. We believe they will help minimize any uncertainty regarding application of the definition. For this standard, the rebuttable presumption is that control exists and consolidation is required whenever one or more of the situations, described in paragraph 18 for corporations and paragraph 21 for partnerships, prevails unless there is significant evidence to the contrary. We believe this is an appropriate presumption.

With respect to limited partnerships, the rebuttable presumption is that control exists if an entity is the only general partner and no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner. We do not agree with this presumption. It is not reasonable to require a general partner with a 1% interest to consolidate the limited partnership or venture into its financial statements in all cases simply because it is the only general partner. Consolidation should only be required when the general partner’s decision-making power enables it to augment its own cash flows in some manner beyond what would be reasonable for a 1% interest in the partnership’s results.

We believe that an important element inherent in the definition of control relates to the ability of the general partner to have control over cash flows or other assets that provide it with cash flow, fees, or other benefits that exceed its 1% interest in the partnership’s net income. We believe this element should be added to the conditions of the rebuttable presumption. Furthermore, general partners who only manage the limited partnership and have no other economic relationship with the limited partnership (as is the case in some real estate partnerships) should not be consolidated.

We recommend that an additional rebuttable presumption of control be added to the proposed standard for the following situation:
e. The owner of the company is the sole contract operator providing a majority of the seconded labor for the company and no other owner or group of owners has the current ability to dissolve the company or otherwise remove the contract operator or seconded labor.

In the oil and gas pipeline business, it is common for a company to have no staff of its own and to be operated by one of its owners. In such situations, the contract operator effectively has control because it has exclusive decision-making authority over the company's operations and has the ability to use that authority to increase the benefits it derives, and to limit the losses it suffers, from the operations of that company. We suggest this situation is similar to the limited partnership illustrated in the Lyondell Chemical Company example.

We also believe that the following factors are essential for assessing, as well as applying, the definition of control and should be added to the proposed standard:

1. the degree of economic interest held by the enterprise in the investment of an affiliated entity;
2. the degree of integration of financial and operating activities between the two entities;
3. the existence and substance of guarantees of reported and off-balance sheet debt; and
4. the existence and substance of support agreements for dividend and interest payments.

Issue 3: Transition and Implications for Interim Reporting
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 which would justify delaying its application to interim periods in the year of adoption?

With respect to the transition and effective date, we have traditionally supported a single effective date and believe a single date is appropriate in this case as well. The effective date should occur as soon as it is feasible after the accounting policy is promulgated and a final statement is released in order to promote comparability across different enterprises' financial statements. For this SFAS, we strongly support adoption at the beginning of the fiscal year.

We prefer that adoption be required at the beginning of the fiscal year because interim reports for that year would provide information with better predictive quality than if the information was only required in year-end reports. Adoption at the beginning of the fiscal year and disclosure of information during the year eliminates the year-end "surprise" that is often caused by a change in accounting treatment. This surprise factor can be significant when an entity or entities that were
previously reported as equity investments are consolidated because they now qualify for consolidation under the revised definition of control. Every element of the financial statements would be affected, as well as most financial ratios and other valuation measures, such as free cash flow, leverage ratios, and earnings before interest, taxes, depreciation and amortization (EBITDA).

We believe that there should be no delay in the implementation of this standard once all of the issues and concerns we raised have been resolved. Furthermore, we do not believe implementation of the standard will impose a significant burden for preparers because most of the information needed to consolidate the financial statements should be readily available.

**Concluding Remarks**

The Financial Accounting Policy Committee appreciates the opportunity to express its views on the exposure draft on the purpose and policy of consolidated financial statements. If you, the Board, or its staff have questions or seek amplification of our views, we would be pleased to answer any questions or provide additional information you might request.

Respectfully yours,

Gabrielle U. Napolitano, CFA
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Ashwinpaul C. Sondhi
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Consolidated Financial Statements

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