

E & Y LLP

October 1, 2003

Director, TA&I-FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

**Proposed FASB Staff Positions on Certain Issues Related to FASB Statement
No. 150, *Accounting for Certain Financial Instruments with
Characteristics of both Liabilities and Equity***

In a letter dated September 22, 2003, we submitted comments on the above-referenced proposed FASB Staff Positions (FSPs). Subsequent to the submission of our comment letter, we became aware of a significant financial reporting result arising from the application of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, that we believe is inappropriate. The issue deals with a form of mandatorily redeemable equity interests that raises similar issues to those addressed in the proposed FSP No. FAS 150-b: "Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount that Differs from the Book Value of Those Shares, under FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*."

We believe this inappropriate accounting result warrants the FASB's immediate attention, before many companies begin to report earnings for the quarter ended September 30, 2003. We strongly encourage the FASB to amend Statement 150, in connection with its previously proposed FASB Staff Positions, to defer application of the Statement to those liabilities that represent residual interests with the right to participate in the final liquidation of the net assets of an entity that is included in the consolidated financial statements. Such a deferral should provide the FASB with sufficient time to address the reporting and implementation issues that arise from measuring the liabilities at their settlement value, and to give preparers and auditors sufficient time to deal with the challenging measurement issues associated with measuring these obligations at settlement value. Although this issue only recently surfaced, we believe that even if the issue had been identified earlier, the compressed transition period in Statement 150¹ would not have provided preparers sufficient time to perform the valuations (in some cases, of the assets of hundreds or even thousands of partnerships) necessary to implement the Statement.

Pursuant to paragraph 9 of Statement 150, instruments that are redeemable only upon liquidation or termination of the *reporting entity* continue to be treated as equity instruments. This is true even if the reporting entity is a limited-life entity in which liquidation is expected or required at some future date. However, if the instrument is redeemable upon liquidation or termination of an issuing subsidiary that has a limited-life, that instrument is considered mandatorily

¹ Statement 150 was issued on May 15, 2003 and is effective for pre-existing instruments as of July 1, 2003, for calendar-year companies.

redeemable in the financial statements of the parent and must be classified as a liability in the parent's consolidated financial statements (this requirement is clarified in footnote 13 of Statement 150).

In addition, Statement 150 requires that when the amount to be paid upon redemption of mandatorily redeemable shares varies, the shares should be carried at the amount that would be due if the instrument were settled on the reporting date, with a charge or credit to income for the change in carrying value during the period. Specifically, paragraph 22 of Statement 150 requires that these changes in value be recognized in the statement of operations as "interest cost."

Many partnerships, limited partnerships, and limited liability corporations contain a contractual provision requiring liquidation of the entity (i.e., through either a distribution of the net assets of the entity based on their fair values or a sale or settlement of the assets and liabilities of the entity and distribution of the resulting proceeds) by a specified date. When an entity with such a contractual liquidation provision is included in the consolidated financial statements of its parent, Statement 150 will produce the anomalous result of requiring the liability (i.e., the partnership interests) to be adjusted to settlement value based on the fair value of the partnership's underlying assets that continue to be carried at historical cost-based amounts in the financial statements.

This aspect of Statement 150 will have a dramatic and illogical impact on the financial position and results of operations of companies with limited-life subsidiaries that own appreciated assets (or that own assets that have maintained their value while the subsidiary has taken significant depreciation charges). While we recognize that a number of industries could be impacted by this issue, for purposes of this letter we will use a real estate partnership as a (common) example of the impact of this issue. For example, assume a consolidated real estate partnership owns a building that on the date of adoption of Statement 150 has a carrying value (depreciated cost) of \$9,000,000, but a fair value of \$19,000,000. Other assets and liabilities have a net positive (asset) carrying value of \$1,000,000, which approximates their fair value. Accordingly, the carrying value of the subsidiary's net assets is \$10,000,000, and the fair value of those net assets is \$20,000,000. Assume the parent owns 60% of the subsidiary's residual interest and a third party owns the remaining 40%. Prior to the adoption of Statement 150, the carrying value of the minority interest in the subsidiary would be \$4,000,000. However, upon adoption of Statement 150, the liability represented by the minority interest in the subsidiary would have a liquidation value of \$8,000,000 (40% of \$20,000,000), requiring the company to recognize a cumulative effect charge upon the adoption of Statement 150 of \$4,000,000. Further, if in the future the fair value of the building increases (or declines by less than recognized depreciation), additional "interest cost" must be recognized to adjust the minority interest liability to its liquidation amount.

The above example addresses the potential impact of one relatively small real estate partnership. Some real estate companies currently consolidate hundreds, or even thousands, of partnerships and similar entities, and may consolidate even more as a result of the application of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*. Accordingly, the impact of Statement 150 on the accounting for noncontrolling interests in limited-life subsidiaries, which we have confirmed with the FASB staff, will be dramatic for many companies – and will detract from the objective of complete, clear, and faithful financial reporting.

Our primary concern about the impact of Statement 150 on the accounting for limited-life subsidiaries is that we believe that the resulting accounting will serve to obfuscate the consolidated results of operations and financial position of the parent company. In the above example, the application of Statement 150 will result in the parent company recognizing a \$4,000,000 cumulative loss when, because of the appreciation of the assets that are driving the liability valuation, the company has actually enjoyed an economic *gain* of \$6,000,000. Further, similar obfuscation results in the statement of financial position wherein the parent's net assets arising from the subsidiary are reduced from \$6,000,000 to \$2,000,000, when its net assets in the subsidiary on a fair value basis actually are \$12,000,000. For a company that operates primarily through subsidiary partnerships (which is common in certain industries), we believe that this accounting will make it extraordinarily difficult for financial statement users to effectively incorporate operating results and financial position reported under GAAP into their analyses, and likely lead to a further expansion of the use of "pro forma" financial information in earnings releases and other documents. While we understand that this type of inconsistency results with some regularity in our current mixed-attribute financial reporting model, we believe it is especially troublesome when the valuation of the liability in question is driven specifically by the valuation of the subsidiary's net assets.

We also believe that the guidance in Statement 150 has created considerable confusion about the accounting for minority interests. As previously discussed, a residual interest in a limited-life company may be reported as equity in the separate financial statements of the subsidiary, but require reclassification to a liability (subject to a completely different measurement basis) upon consolidation. Such a fundamental change in reporting in consolidation clearly has caught many preparers by surprise (particularly given that the discussion of this distinction was relegated to a footnote in Statement 150), and appears inconsistent with the FASB's preliminary conclusions in several different projects that noncontrolling interests in subsidiaries should be classified as equity.

We also observe that accounting for the minority interest at settlement value will result in a potential conflict with the existing accounting literature relating to the acquisition of minority interests and step-acquisitions. If the parent subsequently acquires the minority interest for a purchase price equal to its fair value, the purchase consideration and the carrying value of the minority interest likely would be equal, and the underlying assets and liabilities of the subsidiary could not be recognized at fair value without recognizing a gain or loss upon the acquisition. We believe that this accounting would not appropriately reflect the substance of the transaction and generate further confusion among financial statement users.

We also believe that there is considerable confusion about the transition guidance in Statement 150 (included in footnotes (g) and (h) to paragraph A30). That guidance appears to suggest that a different measurement attribute (the historical carrying amount) should be applied in transition if the mandatorily redeemable minority interest resulted from a purchase business combination. While we understand and agree with the FASB's desire to avoid requiring the original purchase accounting in such a transaction to be revisited upon the adoption of Statement 150, we fail to see why a book-value based measurement (consistent with normal consolidation accounting) is only appropriate for mandatorily redeemable minority interests created through a business

combination (and, perhaps, only appropriate at transition, although we await clarification of the FASB's intent on this matter from the FASB staff).

We suggest that the FASB reconsider certain aspects of its conclusions in Statement 150. First, we suggest that the Board reconsider whether an entity's obligation to distribute its net assets (or the proceeds of the liquidation of such assets) upon termination of the entity to its shareholders (including the parent company) is a liability in the financial statements of its parent. We believe that a requirement to (a) distribute the entity's net assets or (b) liquidate the net assets of a subsidiary and distribute the resulting proceeds based on the relative residual interest ownership is fundamentally different from the other liabilities addressed in Statement 150, such as mandatorily redeemable shares that are required to be redeemed prior to termination of the entity. Specifically, we note a fundamental difference because in liquidation the minority interest holders normally participate *pari passu* with the parent in the distribution of the subsidiary's net assets, which is not the case for other liabilities under Statement 150, which will receive a preferential distribution of assets compared to the rights of the parent.

While we do not necessarily agree with the FASB's conclusion on the classification of residual interests in limited-life subsidiaries as liabilities, we understand the basis for the FASB's conclusion is that with respect to such residual interests the reporting entity has an obligation to transfer to the residual interest holders assets recognized in its consolidated financial statements. Accordingly, the FASB may choose not to reconsider that accounting. As an alternative, we suggest that the FASB consider a specific measurement model for this particular class of liabilities. Specifically, this model would apply only to those liabilities that represent residual interests with the right to participate in the final liquidation of net assets of an entity that is included in the consolidated financial statements. We believe that those liabilities should be measured consistent with the assumptions used to measure the underlying assets and liabilities of the reporting entity in its financial statements. Essentially, this approach would be similar to the Hypothetical Liquidation at Book Value ("HLBV") model proposed by AcSEC in its defunct project on the accounting for equity method investments. We would be pleased to discuss this alternative with the FASB or its staff in greater detail.

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Very truly yours,

Ernst & Young LLP