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Date Received:

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January 17, 1996

Director of Research and Technical Activities Financial Accounting Standards Board 401 Merritt 7 Post Office Box 5116 Norwalk, Connecticut 06856-5116

Subject: File Reference 154-D

Dear Sir:

The Edison Electric Institute (EEI) appreciates the opportunity to respond to the Financial Accounting Standards Board's (FASB) Exposure Draft on Consolidated Financial Statements: Policy and Procedures (Exposure Draft).

EEI is the association of the United States investor-owned electric utilities and industry affiliates worldwide. Its U.S. members serve 99 percent of all customers served by the investor-owned segment of the industry. They generate approximately 79 percent of all the electricity generated by electric utilities in the country and service 76 percent of all ultimate customers in the nation.

EEI commends the FASB in their drafting of the Exposure Draft and agrees with most of the positions taken therein. Our primary concerns are as follows.

Presumption of Effective Control

The FASB's proposal statement would require a controlling entity to consolidate all entities over which it has legal or effective control, unless control is temporary when the entity becomes a subsidiary. Since the FASB's proposed definition of control encompasses the concept of deriving economic benefits from the assets of the subsidiary, EEI supports consolidation based on these

two categories of control. We agree that legal control typically results from majority ownership of shares in a corporation, giving the parent the unconditional right to elect a majority of the governing board, while effective control can result from owning a large minority voting interest together with other favorable circumstances. In both situations, the parent's ability to direct the subsidiary's management and establish its policies and budgets must ensure that the parent derives significant economic benefits from the subsidiary's assets.

Paragraph 14 of the Exposure Draft lists six circumstances that lead to the presumption of effective control. One such circumstance is an ability demonstrated by a recent election to dominate the process of nominating candidates for another entity's board and the ability to cast a majority of votes in an election of board members. EEI does not believe that this circumstance is a conclusive indication of effective control. Paragraph 152 of the Exposure Draft states that this situation is a "confirming circumstance in that an ability to exercise effective control may have been present before the election occurred, but that it was not sufficiently evident from the percentage of voting rights owned to make a conclusive judgment before that election." This statement is true; control may have been previously present. However, it may not have been present nor does this situation, in and of itself, indicate that control will continue to be present in future board elections. This Exposure Draft appears to be expanding the scope of entities subject to consolidation to situations where control is probable. EEI is concerned that the criteria established in paragraph 14 of the Exposure Draft may not allow management enough judgment in assessing control in this particular circumstance, and that entities may be required to consolidate an entity based on a recent board election and then not consolidate in the future if a subsequent election does not confirm control. This would create volatility in financial statements that is not representational of the underlying relationships.

This criteria should be considered as an "indication" of control but not a circumstance that would require evidence to the contrary to avoid presumption of control. Rather it should be a circumstance that when combined with one or more other indications of control may create effective control. This statement should allow for management judgment in this circumstance.

Changes in a Parent's Ownership Interest in a Subsidiary

The proposed statement would require that changes in a parent's ownership interest in a subsidiary that do not result in a loss of control be accounted for as equity transactions with no gains or losses recognized. EEI opposes this change to existing requirements. We concur with the position taken by the Accounting Principles Board in Opinion No. 18, which requires that a gain or loss be recognized when a parent sells stock of a subsidiary. Further, we concur with the American Institute of Certified Public Accountants and the Securities and Exchange Commission which have supported recognition of gains or losses when a subsidiary issues stock to other than the parent.

In EEI's opinion, there are several persuasive reasons why the parent company should recognize a gain or loss when it sells stock of a subsidiary. First, this accounting is consistent with the *parent company approach* to consolidated financial statements, which focuses on the interests of the parent's shareholders. The majority of respondents to the FASB's 1991 Discussion Memorandum favored the parent company approach and recognition of a gain or loss on the sale of subsidiary stock. This Exposure Draft also supports the parent company approach. However, the proposed accounting for sales of subsidiary stock is inconsistent with that approach because the proceeds from such a sale are not capital contributions from the parent company's shareholders. The noncontrolling shareholder has purchased an ownership interest in the subsidiary, not in the parent nor in the reporting entity represented by the consolidated financial statements.

Second, the parent's earnings process is culminated when it has sold subsidiary stock in an arm's-length transaction to a third party. Such a transaction is comparable to the parent's sale of tangible property, inventory, or any other assets. Moreover, the substance of this transaction is the same regardless of whether the parent has retained a controlling interest in the subsidiary.

In EEI's opinion, the accounting for a change in the parent's ownership interest in a subsidiary should not depend on whether the parent or the subsidiary enters into the transaction. From the viewpoint of the parent company shareholders, a subsidiary's issuance of additional shares has the same result

as the parent's sale of stock in the subsidiary. In both cases, the parent decides to sell the stock and controls the cash proceeds. Moreover, the parent should not be able to choose alternative accounting treatments simply by designating the subsidiary instead of itself as the party to the transaction. For these reasons, we believe that it is appropriate for the parent to recognize a gain or loss when a subsidiary issues stock.

Conforming Accounting Policies

The proposed statement would require a parent and its subsidiaries to apply a consistent accounting policy for similar transactions or events unless generally accepted accounting principles (GAAP) permit a single entity to use different accounting methods for the same type of transactions or events. In EEI's opinion, conforming the accounting policies of a parent and subsidiaries should be permitted but not required. This was the majority view of respondents to the 1991 Discussion Memorandum in which the FASB stated: "Few accountants would go so far as to require conformity of a subsidiary's accounting policies to those of its parent in preparing consolidated financial statements."

According to Accounting Principles Board Opinion No. 22, the application of GAAP requires that judgement be exercised as to the relative appropriateness of acceptable alternative policies in specific circumstances of diverse and complex economic activities. The fact that enterprises within a consolidated group are organized as separate legal entities often implies that their economic activities differ significantly, and that different accounting policies may best reflect the results of these activities. This is frequently the case when only one entity within a consolidated group is regulated, or when the group's regulated entities operate in jurisdictions which mandate different accounting practices in setting rates. For these reasons, EEI believes that management should be allowed to choose the most appropriate accounting policy for each legal entity that the parent controls, provided the policy is permitted by GAAP and is adequately disclosed.

Conclusion

EEI appreciates the opportunity to respond to this Exposure Draft and allowing us to provide input into the standard setting process. We hope our comments

will be helpful as the FASB finalizes its work on this phase of the consolidations project.

Sincerely,

David K. Owens

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