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EQUITABLE

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Mr. Timothy S. Lucas  
Director, Research and Technical Activities  
Financial Accounting Standards Board  
File Reference 154-D  
401 Merritt 7  
P.O. Box 5116  
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Dear Mr. Lucas:

The Equitable Companies Incorporated appreciates the opportunity to comment on the FASB's Exposure Draft (ED) of the proposed Statement of Financial Accounting Standards entitled Consolidated Financial Statements: Policy and Procedures. As a large insurance and financial services company, we support the Board's mission to improve standards of financial accounting and reporting in consideration of the relative costs and benefits of the resulting information. However, we are concerned that while the proposed criteria for consolidation may resolve what some view as the more egregious practices under existing literature, it is our opinion the overall relevance of the financial statements will be diminished by consolidation when the parent company has a relatively insignificant beneficial interest in the "subsidiary's" assets, liabilities, revenues, expenses, gains, and losses, consolidation of entities which merely are investments, and virtual elimination in consolidation of specialized industry accounting practices. Presented below are brief comments outlining our positions on some of the key proposals in the ED.

## **CONSOLIDATION POLICY**

### **Control of an Entity - Assessing the Existence of Control**

#### *Ownership of a Large Minority Voting Interest*

We do not subscribe to the fundamental precept in the ED that control alone is a sufficient and appropriate condition for requiring consolidation. Rather, it is our opinion control and some level of ownership together indicate a parent-subsiary relationship -- that is, ownership demonstrates a parent's beneficial interest in the net assets of a subsidiary, without which we believe consolidation is inappropriate. While we most likely could

support consolidation of less-than-fifty-percent-owned entities in the presence of control, the presumption of control at “*approximately 40 percent*,” as suggested in paragraph 14(a) of the ED, appears to be an arbitrary benchmark. In the absence of any conceptual basis for proposing “*approximately 40 percent*” ownership as the presumptive threshold for consolidation, we suggest control continue to be presumed only in the presence of “*legal control*” -- that is, majority ownership -- and an “*assertive approach*” be applied when there exists a large minority voting interest. We believe that approach more appropriately charges management with the responsibility for making the appropriate assessments about the ability to control through large minority ownership positions and will result in consolidation of less-than-majority-owned controlled entities without compromising the conceptual integrity of the Board’s document. Simply lowering the consolidation threshold to “*approximately 40 percent*” will result in transactions structured at the 39.9 percent level to overcome the presumption of control.

*Sole General Partnership Interest in a Limited Partnership*

We object to consolidation of a limited partnership by a general partner having only a small equity interest. In addition to sharing the view as expressed by one Board member in paragraph 142 of the ED that the powers of a 1 percent general partner in a limited partnership investment arrangement may be identical to those of a mutual fund manager who specifically is excluded from the proposed consolidation requirements, we also fail to see the value-added of consolidating the assets, liabilities, revenues, expenses, gains, and losses of a limited partnership when there is a 99 percent (or similarly significant) “*non-controlling*” interest.

Use of the equity method of accounting by a general partner having a de-minimus equity interest in a limited partnership has been accepted accounting practice for many years, and we do not believe users of financial statements have pressed for change. Although we are aware the Board studied “*real*” situations in which less-than-majority-owned controlled entities in practice currently are excluded from consolidation and believe we could support consolidation in some of those “*examples*,” it is our opinion the ED’s premise that control alone is sufficient to require consolidation inappropriately takes existing generally accepted consolidation practice too far down the ownership spectrum to preserve the relevance to users of consolidated financial statements.

*Application of the Proposed Consolidation Policy Standard to Specific Circumstances*

Although the power to control, the level of ownership interest, and the flow of benefits oftentimes are interdependent, there exist business structures that disconnect those relative relationships. In those situations, as suggested in the alternative views expressed by one Board member in paragraph 143 of the ED, we believe the absence of a “*level-of-benefits test*” leaves constituents with insufficient guidance to assess appropriately the consolidation issue. For example, it is unclear whether the proposed criteria for consolidation are intended to capture a 35-percent-owned entity (below the presumptive threshold for effective control) when a related arrangement or instrument provides a level

of benefits (i.e., net cash flows) disproportionately higher than those represented by the minority equity interest. Similarly, although paragraph 172 of the ED distinguishes a lender's ability to "*influence*" from a parent's ability to "*control*," it is unclear how to evaluate the relative aggregate power of a minority shareholder who also has extended significant credit to an entity. Such relationships particularly are prevalent in real estate transactions and are complicated further, in terms of interpreting the ED's proposals for determining the existence of control, by debt and equity holdings residing both in different legal entities within the consolidated group and in separate reporting entities subject to GAAP and SEC requirements.

Although not explicitly identified in paragraphs 160-172 of the ED under "*relationships that generally do not result in control of an entity*," we presume the Board would concur with exclusion of insurance company Separate Accounts from the proposed requirements for consolidation. As Board members are well aware, fee income is earned from the management of assets held in the Separate Accounts, however, the investment risk and reward generally are transferred to the policyholders. Consequently, we presume the Board intended to analogize Separate Accounts to fund managers and mutual funds explicitly identified in paragraph 162 of the ED.

### **Temporary Control**

As noted in paragraph 88 of the ED, the Board decided to retain the temporary control exception to consolidation, as currently allowed both by ARB 51 and Statement 94, even though some Board members found no compelling conceptual reasons for that exception to exist. Although we support retention of the temporary control exception to consolidation, we believe the proposed one-year disposition window will burden the financial statements with information *not* central to the reporting entity's ongoing operations -- an argument not to be confused with the nonhomogeneity exception already removed from consolidation practice by Statement 94.

For example, a creditor in a troubled debt restructuring may receive a majority voting equity interest in an entity in full satisfaction of existing debt instruments, accompanied by proportionate representation on the Board of Directors to facilitate implementation of the work-out plan. Although the creditor clearly is the controlling party, we do not believe consolidation would be meaningful in that situation. The intent of the creditor is to recover its "*loan*" from the operations and ultimate disposal of its now "*unintentional subsidiary*;" in fact, insurance regulations otherwise would prohibit such investments but impose no specific time requirements for their disposal. Work-out plans typically demonstrate management's intention to exit the operations in a 3-5 year period, therefore, we believe the proposed definition of temporary control should be broadened beyond the one-year limitation. As an analogous example, the Board most recently concluded longer than a one-year horizon generally is needed for disposing of assets identified as "*held for disposal*" under FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.

In addition to significant equity positions received in loan restructuring situations, it is our understanding the Board's proposal also may bring into consolidation merchant banking portfolios not consolidated under current practice of most investment banking operations. Although the investment banking entity clearly may be the controlling entity, we do not believe consolidation would be meaningful for those equity positions as they are intended to be held for investment purposes and ultimately disposed of for profit rather than integrated into the operations as a subsidiary of the investment bank. Consequently, we share the view described in paragraph 96 of the ED and suggest the Board consider broadening its proposed definition of "*temporary control*" to encompass the intentions of management for the purpose of distinguishing investments from subsidiaries.

## **CONSOLIDATION PROCEDURES**

### **Elimination of Intercompany Transactions and Balances**

Paragraph 21 of the ED requires any gain or loss for differences in the carrying amounts of the issuer and acquirer of intercompany investments in debt securities be attributed entirely to the issuer and allocated between the controlling and noncontrolling interest based on their proportionate interests in the issuer. However, we question whether the Board intends that accounting procedure be followed when intercompany investments in debt securities exist between two subsidiaries, each having a noncontrolling interest. For example, if a 60 percent owned and controlled subsidiary purchased at a discount from a third-party a debt security issued by an 80 percent owned and controlled subsidiary of the same parent entity, we believe that intercompany transaction should be reflected by allocating 40 percent of the gain in consolidation to the noncontrolling interest of the purchasing entity. It is our opinion that accounting is more representationally faithful of the economics of the transaction.

### **Reporting Noncontrolling Interest in Subsidiaries**

The Board's proposal would require minority interest to be relabeled, "*for example, as non-controlling interest in subsidiaries,*" and classified in the balance sheet as a separate component of total shareholders' equity. In addition to changing the balance sheet display of minority interest, the proposed standard would eliminate the current practice of reporting net income attributable to the minority interest as a deduction in measuring consolidated net income and instead require its display as an allocation of consolidated net income. We agree those changes to current practice for reporting minority interests in the balance sheet and income statement are consistent with the single economic entity concept underlying the ED. However, we are concerned about and sensitive to the potential for confusion that may arise from use in the financial statements of the terms "*total shareholders' equity*" and "*consolidated net income*" to describe amounts long-understood in practice as attributable only to the controlling interest. Introduction by the FASB of new terminology required to be used to describe the total controlling and non-controlling interests in the equity and net income of the consolidated entity clearly would

be one approach to mitigating our concern but we would assert the Board's more detailed consideration of this issue may produce other equally viable alternatives.

### **Changes in a Parent's Ownership Interest in a Subsidiary**

The Board concluded in paragraph 9 of the ED "*once a subsidiary is consolidated, it shall continue to be consolidated until the parent's control ceases to exist.*" As illustrated in Example 1 of Appendix B of the ED, it is made clear when an entity loses "*legal*" control of a subsidiary -- that is, the right to cast a majority of the eligible votes -- consolidation must be maintained absent evidence to overcome the presumption of "*effective*" control. However, we believe except in the most simplistic circumstances in which the parent's ownership is reduced below 50+ percent (such as the alternatives presented in Example 1), the presumptive approach may continue consolidation of entities when such practice is inappropriate and defer recognition of gain or loss. For example, the process of nominating and electing directors may not take place until a reporting period subsequent to closing the transaction producing the change in the parent's ownership interest. If that process does not substantiate effective control, it is our opinion the subsidiary should have been deconsolidated and gain or loss recognized in the prior reporting period when the change in the parent's ownership interest made questionable its *ability to maintain* control over the subsidiary.

### **Conforming Accounting Policies and Fiscal Periods**

#### *Conforming Accounting Policies*

Paragraph 31 of the ED would require subsidiaries using specialized industry accounting practices to conform those policies to those of the "*reporting entity*" when preparing consolidated financial statements. Although the Board's objectives for imposing that requirement are not immediately obvious from the ED, it appears to be directed at eliminating in consolidation the ability to select from acceptable accounting methods available as a result of the legal structure and form "*chosen*" for the operations of specialized industries. While we do not dispute the merits of achieving comparability for specialized industries included in consolidated financial statements, we question the Board's approach to this issue. It is our opinion specialized industry accounting practices were developed and have been supported in practice because they are believed to be the appropriate methodologies for those specific business operations irrespective of their legal form (i.e., branches, divisions, separate legal entities, etc.). Therefore, we believe there should be a requirement to adopt specialized industry accounting practices in consolidation.

Requiring the use of specialized accounting practices in consolidation also would address our concern that the Board's proposal would introduce noncomparability in accounting in consolidation for the same operations dependent upon the accounting practices of the parent company. For example, we believe under the Board's proposal the same broker-dealer operation would be subject to different accounting requirements in consolidation

dependent upon whether its parent company was a broker-dealer or a manufacturing entity. It is our interpretation implementation of the requirements of paragraph 31 of the ED virtually would eliminate the use in consolidation of specialized industry accounting practices except in rare circumstances in which the parent company operates in the same specialized industries. We believe that result will confuse users of financial statements to the extent specialized industry practices used in preparing separate financial statements of public subsidiaries produce different results than practices used to account for those operations in the consolidated financial statements and to the extent segment disclosures may apply a basis of accounting different from that used in the consolidated financial statements.

If after redeliberating the issues of conforming accounting policies the Board feels compelled to retain the proposed requirements, we suggest there is a significant need for implementation guidance. As currently drafted, we have been unable to locate in the ED a definition of the "*reporting entity*" or guidance for determining its identity. We believe absent such definition or more specific guidance, it is unclear what accounting policies should flow to the consolidated financial statements. For example, Equitable, like many companies, operates under the structure of a holding company not entitled to any specific specialized industry practices. Under current practice, the specialized accounting policies of each subsidiary of the holding company -- i.e., insurance, investment company, and broker-dealer -- survive to the consolidated financial statements. Under the proposed standard, it first is unclear whether the holding company is the reporting entity or whether one of its primary business operations somehow must be identified as the primary reporting entity. If the Board's intent is for the holding company to be the reporting entity, it is unclear how to implement the proposal to conform accounting policies -- that is, must all specialized industry accounting practices be reversed in consolidation or may the holding company in consolidation adopt the specialized industry practices of one or more of its subsidiaries in the absence of specialized accounting practices of its own.

While we believe further clarification by the Board is needed on the issue of conforming accounting practices, we more strongly would urge the Board to reconsider its position. It is our opinion specialized industry accounting practices are no less relevant in consolidated financial statements than in the stand-alone financial statements of those operations and do not believe that position is inconsistent in any way with the underlying concept advanced in the ED of a single economic entity. Furthermore, in the FASB Discussion Memorandum on consolidation policy and procedures issued in 1991, it was noted in paragraph 401 "*few accountants would go so far as to require conformity of a subsidiary's accounting policies to those of its parent in consolidated financial statements.*" Consequently, we believe the ED is proposing to change a long-standing generally accepted accounting practice which few perceive a need to change.

#### *Conforming Fiscal Periods*

The ED proposes to eliminate the guidance in ARB 51 allowing a difference in the consolidated financial statements of up to three-months between a subsidiary's fiscal

period and that of its parent, provided there is adequate disclosure of the effect of material intervening events. In paragraph 133 of the ED, the Board states its belief since issuance of ARB 51 in 1959 "*improvements in telecommunications and management information systems and techniques make that accommodation no longer necessary.*" While we share the belief tremendous strides have been made in the communication of financial information, it also is clear the proposed standard would require consolidation of many entities not consolidated under existing practice.

We believe elimination of the three-month lag period would impose little additional burden, if any, with respect to entities in which a parent holds a significant minority ownership position, particularly for public subsidiaries with stand-alone GAAP reporting requirements. However, the proposed standard also would require consolidation of many other types of entities, such as investment partnerships, now accounted for under the equity method and for which the three-month lag period currently is applied because of the unavailability of more up-to-date financial data. Although the ED presumes a sole general partner with a de-minimus equity interest controls a limited partnership for purposes of preparing consolidated financial statements, we believe it is unrealistic as a practical matter to presume that general partner can control the timeliness of financial information received from the limited partnership. Perhaps that point should lead the Board to reconsider whether those "*investments*" should be consolidated under its current notion of control.

It is our opinion, elimination of the three-month lag period is another example in the ED of a proposed change to a long-standing generally accepted accounting practice which few perceive a need to change. While we urge the Board to reconsider its position on the issue of conforming fiscal periods, we at least suggest the Board consider some transition provisions that allow for time to "*educate*" newly-consolidated subsidiaries of their reporting requirements. Alternatively, we suggest the Board consider amending the disclosure-only requirements of paragraph 4 of ARB 51 to require recognition in the consolidated financial statements of the effect of material intervening events that occur during the three-month lag period.

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We would be pleased to discuss our comments with you, other members of the FASB staff, and Board members.

Very truly yours,



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