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Director of Research and Technical Activities
Financial Accounting Standards Board
File Reference 154-D
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Dear Sir:

Texaco Inc. wishes to submit the following comments concerning the Exposure Draft for "Consolidated Financial Statements: Policy and Procedures."

Texaco concurs with the overall objective of codifying and improving accounting standards relative to consolidation. However, the proposed standard as presently written will not result in improved financial reporting. The most important issue in this document is the definition of "control" for purposes of determining which entities are to be consolidated. The definition proposed based on "power" over assets may be intellectually appealing to some, but it is over-reaching and difficult to apply in practice due to the subjectivity involved. We are disturbed by the tone conveyed in paragraph 15 of the document, which implies that a finding of control does not require highly probable evidence of such control: "Absence of legal control or circumstances that make the presence of effective control so probable that control can be presumed does not lead to a conclusion that control does not exist." This implies that a finding of the existence of control is possible even when evidence is inconclusive. The consolidation decision in those cases thus is reduced to a highly subjective judgment, which, given the examples in Appendix B, is intended to be tilted in favor of a conclusion of control. We find this unacceptable. Accounting standards should attempt to decrease subjectivity, not increase it. Only on this basis can greater consistency of application among preparers be achieved.

Consolidation Policy

Texaco believes that consolidation should be required based on control, but control should be defined as a right to a majority of the residual equity of the entity, either through legal voting control or other contractual rights (e.g., a partnership agreement). The only case where control should be presumed absent contractual rights is when a special purpose entity established for the purpose of leasing or other business activity with a single party does not have at least three percent equity on a continuous basis, in accordance with the criteria of EITF Issue 90-15. The preceding basis will provide a consistent basis of application.

The ED's concept of "power" over assets as a definition of control is over-reaching, because it ignores the legal contractual relationships inherent in leasing and purchase commitment transactions. Long-term commitments of these types may well involve "power" over assets in the form of leased usage or purchase of manufactured output of assets. However, these contracts were not entered into for the purpose of "controlling" an entity. The lessee's ability to use or benefit from the assets is inherent in the contractual rights of the lease or purchase agreement. To claim that this condition alone could require consolidation by the lessee or output purchaser is to create conditions for avoiding consolidation which are impossible to satisfy other than by dissolving the entity which owns the assets.

In the case of special purpose leasing entities, the entity is not necessarily "created" by the lessee, as is implied in Example 5 in Appendix B (paragraph 195). Rather, a lessor holding company will create the entity and syndicate the financing for an asset which the lessee wishes to lease. One of the effects of a special purpose entity is to legally segregate the leased assets from the lessor consolidated entity's other assets, so that the lessee has no risk of loss in the event of bankruptcy by the lessor parent entity. Were it not for this consideration, such transactions could be done directly on the balance sheet of the parent lessor company. In that case, there would be no consolidation issue of control involved since the leased assets would constitute a minor portion of the lessor's total assets. We do not find it reasonable that leasing entities with economic substance, which were established at least partly for the purpose of bankruptcy risk protection, should have to be consolidated by the user of the assets who has no residual ownership in the entity itself. Because the ED's criterion of "power" over assets does encompass such a situation, it is clearly over-reaching.

Since the concept of "power" over assets does not require any legal ownership interest, it is quite possible under the ED that the same entity would be consolidated twice, by two unrelated "parents." The equity owner of a special purpose leasing corporation with a single lessee would have to consolidate the entity based on the legal ownership of the assets by the investee, the investee's receipt of benefits therefrom in the form of rentals, and the equity owner's right to residual equity upon liquidation of the investee. The lessee would also have to consolidate the special purpose company based on its possession and exclusive use of the assets via the lease agreement.

The concept of "effective control," which is used as the basis for the ED's examples, is too subjective and nebulous to be a valid criterion for consolidation. Except for very limited specific exceptions, control should be based on contractual ability, not hypothetical supposition. To do otherwise is to introduce an unacceptable degree of subjectivity into the consolidation process.

Therefore, Texaco does not agree with the ED's concept that ownership of a 40 percent interest should generally constitute control if no other significant individual interests exist. Likewise, we do not agree that control is to be confirmed based on number of shares actually voted rather than number of shares outstanding. To have control determined by factors not under the power of the parent entity creates the possibility of inconsistent consolidation from year to year. Clearly, this result is not improved financial reporting. Are the assets and goodwill of an entity which ceases

being a consolidated entity under such a case to be revalued under purchase accounting each time it is re-consolidated, even if only one year later?

We do not agree with ED's presumption that owning the sole general partnership interest in a partnership should require consolidation whether or not the general partner is entitled to a majority equity residual interest upon liquidation. As stated previously, control in this situation by other than voting rights should be based on the residual equity interest percentage rights.

It is noted in paragraph 142 of the ED that the proposed definition of control has created inconsistencies in application under the ED. Specifically, it is stated that although mutual fund managers have power over the assets of the fund, similar to a general partner in an investment partnership, the Board has decided that the fund is not to be consolidated with the manager entity, while consolidation is required in the general partnership interest case. Texaco does not believe that the appropriate solution in cases resulting in inconsistency is to create exceptions; rather, the flawed definition of control should be modified to eliminate the inconsistent results.

Consolidation Procedures

The ED proposes to record "noncontrolling interest," presently known as minority interest, as a separate component of equity, with modifications also to the income statement. The principal effect of this conceptual change (other than balance sheet presentation) is to change the prevailing accounting for gains and losses on changes of parent company ownership interests in subsidiaries.

The Board has provided no justification for the above change, other than a belief that the existing conceptual view of minority interest based on a parent company approach is "too narrow a view of consolidated financial statements" (paragraph 104). We do not find this argument persuasive. Each portion of the noncontrolling interests legally has an equity interest only in the specific subsidiary to which it pertains. In the event of bankruptcy of other portions of the consolidated enterprise, it is possible that the noncontrolling interest may not be affected. Therefore, Texaco finds the ED's position hard to justify.

We believe the current prevailing practices for minority interest should be retained by display between liabilities and equity and as a deduction in the income statement. Under the ED, decreases in parent ownership interests in subsidiaries, not involving loss of control, would no longer result in recording of gains and losses to earnings. Instead, the amounts would be recorded to paid-in capital. The Board's rationale is that these are transactions with owners of the consolidated enterprise. This line of reasoning appears to imply that subsidiary stock is similar to treasury stock, and the sale thereof is therefore a capital transaction. In a consolidated financial statement, subsidiary stock does not exist even notionally. Therefore, we disagree with the conclusion in paragraph 128 that a residual interest, rather than an interest in assets, has been sold.

Additionally, transactions involving the sale of existing subsidiary stock by the parent company can result in current income tax effects. These are true economic effects on consolidated

enterprise cash flows and should be recognized in earnings, because the amounts are not paid to or received from owners and do not relate to parent company stock.

Conclusions

Texaco believes that consolidation policy should be based on rules which are unambiguous and minimize subjectivity. This proposal does not achieve that result. Rather, it seems to be based on an agenda of achieving maximum degree of consolidation without regard to consistency of application. Through use of the concept of "power" over assets, the contractual nature of leases and purchase commitments has been muddled and viewed as a surrogate for control of special purpose entities, whether or not those entities possess economic substance. The bankruptcy protection reason for such entities has been ignored. Texaco does not believe that FAS No. 13 and FAS No. 98 should be amended via the "back door" through a consolidation standard to effectively result in additional capitalization of lease obligations by lessees.

The concept of control of an entity should be tied to the right to residual equity interest in an entity and/or lack of independent economic substance of the entity. Whether other stockholders of an entity exercise their right to vote or are otherwise organized in a voting block should be irrelevant to the consolidation decision because these factors are outside the control of the investor. Contractual relationships involving the leasing of assets or the purchase of output from assets should be outside the scope of the consolidation process because they do not provide any rights in the residual equity of the entity itself. Therefore, these arrangements should not affect the decision to consolidate or not to consolidate. Consolidation should be the recognition of the control over residual equity of the entity. To do otherwise is to create the possibility of consolidation of the same entity by more than one party.

The ED's "economic unit" basis for defining a noncontrolling interest does not constitute a change for which there appears to be any great demand, nor has there been presented any significant conceptual rationale to justify this as a superior method. In Texaco's opinion, this method will lead to a deterioration of the quality of financial reporting, because the economic effects of current income taxes on sales of subsidiary stock by the parent will no longer be recorded to earnings.

The opportunity to comment has been appreciated.

Very truly yours,

