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January 15, 1996

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
File Reference No. 154-D
401 Merritt 7
P.O. Box 5116
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Dear Mr. Lucas:

**FASB Exposure Draft of the
Proposed Statement of Financial Accounting Standards:
Consolidated Financial Statements: Policy and Procedures**

We appreciate the opportunity to comment on the FASB's Exposure Draft of the Proposed Statement of Financial Accounting Standards: *Consolidated Financial Statements: Policy and Procedures* (ED).

We do not support the issuance of the ED as a final financial accounting standard because we believe the approach in the ED will result in major changes to financial reporting that are not necessary, will not effectively solve the practice problems that caused this project to be added to the FASB's agenda and will result in less useful financial reporting. There are issues (for example, special purpose entities, minority interest veto rights, 50/50 arrangements, disguised ownership and non-corporate forms) that need to be resolved in this project. However, we do not believe the resolution of the issues require the major changes proposed in the ED.

The comments that follow reflect our general agreement with the alternative view described in paragraphs 139-144 of ED. Historically, consolidated financial statements for a business enterprise have been intended to serve the needs of the shareholders of the parent, which we will refer to herein as the "parent shareholder focus." We are not aware of any significant issues raised by either the user or preparer communities requiring the abandonment of that focus. We do not believe the harmonization of accounting approaches with certain other countries or the elimination of an accounting item (minority interest) that does not fit into the elements of financial statements as discussed in Concepts Statement No. 6 is sufficient justification for the change in focus.

We oppose the ED also because we believe the ED's emphasis on effective rather than legal control will create significant operational and audit issues. Example 1 of Appendix B presents a situation where effective control is deemed to exist because Company A was able to influence other shareholders to vote for Company A's board nominees and thus have its nominees control the board of directors. How are we, as auditors, supposed to determine whether or not the success of "Company A's nominees" is attributable to the "influence" of Company A? We do not believe



the concept of effective control, despite its conceptual and theoretical appeal, will be operational and we believe it will create more practice issues than what we currently face.

We also believe that there are differences in the needs of the preparers and issuers of financial statements of not-for-profit and for-profit entities which is reflected in certain differences in accounting and reporting models. For this reason, we do not believe it is necessary for consolidation policies and procedures to be the same for both types of entities. Consequently, our comments are segregated into two sections: the first section addresses our views regarding the application of the ED to for-profit entities, and the second section addresses our views regarding the ED's application to not-for-profit entities.

Application of ED to For-Profit Entities

Consolidation Policy

Parent Shareholder Focus

As indicated in the ED, a majority of the input the FASB received from the issuance of the Discussion Memorandum and the Preliminary Views document expressed the view that control *and* a majority or significant ownership interest was appropriate criteria for consolidation. We are part of that majority. We stated in response to the Discussion Memorandum and continue to believe that:

Control demonstrates that a parent-subsidary relationship exists. Significant ownership gives the parent's stockholders a beneficial interest in the subsidiary (i.e., right to share in profits, receive dividends, and recover one's investment through resale of stock or liquidation of assets). The existence of both control and significant ownership justifies combining the assets, liabilities, revenues, expenses, gains and losses of the subsidiary on a line-by-line basis with those of the parent in consolidated financial statements.

Furthermore, we believe the parent shareholder focus is the appropriate model for financial reporting.

We do not believe it is particularly meaningful for an entity to consolidate the assets and liabilities of another entity to which it is entitled to an insignificant amount of the risks and rewards of ownership even if it has control over those assets. Obviously, the smaller the percentage ownership, the less meaningful that consolidated information becomes. Furthermore, we do not believe the consolidated information is particularly meaningful to the minority shareholders of the consolidated entity. Example 2 in the ED discusses a situation in which an entity should consolidate a limited partnership because of control. We agree that the entity that is the general partner in a limited partnership needs to appropriately reflect its involvement in the limited partnership in its financial statements and that in certain situations that involvement may lead to consolidation. However, we believe an insignificant ownership interest of the general partner makes a display other than consolidation more useful in most cases. The FASB's inactive project on Unconsolidated Entities should deal with this area.

Effective Control

As indicated earlier, we are opposed to the fundamental principle of the ED that all entities over which a controlling entity has effective control should be consolidated. Our opposition is based on two premises. The first reflects our view that the parent shareholder focus is the appropriate

focus of consolidated financial statements. Therefore, we believe that consolidation should be required when there is a combination of control and the existence of significant participation in the economic risks and rewards of ownership of the investee.

The second reason for our objection to the fundamental principle of the ED is that we do not believe the concept of effective control is operational; in fact, we have significant concern regarding the auditability of the application of the concept of effective control.

We do not believe control should be presumed because one or more of the characteristics described in paragraph 14 of the ED exists. We believe control should be presumed when an entity owns over 50% of the voting shares of another entity. That presumption should be evaluated and rejected if there are conditions that would prohibit the majority shareholder from exercising control over an entity. For example, the ability of a minority shareholder to veto the vote of the majority shareholder for significant corporate matters (e.g., acquisition/disposition of assets, issuance of debt or equity instruments) may preclude the majority shareholder from exercising control.

Some of the conditions discussed in paragraph 14 represent circumstances that should be considered in assessing whether or not the presumption of control is overcome. We believe, however, that a situation must currently exist for the presumption to be overcome. For example, if the ability to convert a minority voting interest into a majority voting interest exists only if certain financial parameters are not met, then we do not believe that condition should be considered in the event the conversion right has not been triggered.

We are also concerned that the presumptions of effective control can change over time without the involvement of the so called "controlling" entity. Therefore, it appears that the reporting entity may be constantly changing. We do not believe the FASB adequately deals with this aspect in its proposed approach.

Temporary Control

We agree that a parent that has the intention or obligation to divest itself of voting control at the time control is initially established should not consolidate the investee.

Consolidation Procedures

Parent Shareholder Focus

We do not support consolidation procedures that strictly follow the economic unit focus that is proposed by the Board. We believe that current practice, which follows principally a parent company focus is appropriate. Consequently, we do not support the display of minority interest as a component of equity. We believe shareholders' equity should represent the interests of the parent company's shareholders.

Acquisition of a Subsidiary

We do not agree with the ED's requirement to record tangible assets and identifiable intangible assets acquired and liabilities assumed at 100% of fair value when a parent acquires less than a 100% interest in a subsidiary. This change from the predominant practice of recording a step acquisition will result in a distortion in the income statement relating to the amortization of the

step up to fair value for the percentage of the minority stockholders interest, which, in turn, is offset by the minority interest charge or credit to earnings.

Also, acquisitions of shares held by minority shareholders should not be recorded as treasury stock transactions (since minority interest is not recorded as a part of shareholders' equity). We understand that the ED's proposed treatment of the acquisition of stock of subsidiaries held by minority shareholders is consistent with recording minority interest as an element of capital. For those companies wishing to minimize the amortization of goodwill, the ED would create a significant incentive to purchase subsidiaries in more than one transaction. We do not believe the ED's requirements in this area results in a representationally faithful presentation of the acquisition of a subsidiary, regardless of the consistency of the required reporting to the ED's new accounting model. Also, we do not believe the FASB adequately considered or provided sufficient guidance with respect to planned or linked transactions to acquire control of investees.

Reductions in Parent's Ownership Interest

We do not agree with paragraph 29 of the ED, since we believe the parent shareholder focus is more appropriate. Sales of stock by a subsidiary is tantamount to selling stock held directly by the parent, and as such, gain/loss recognition is appropriate, unless as currently required by Staff Accounting Bulletin No. 51, realization of the gain is in doubt.

Unrealized Holding Gains/Losses

We do not agree with the ED's provision to recognize in earnings unrealized holding gains and losses on earlier investments carried at fair value and classified as available-for-sale securities. We do not believe the purchase of a controlling interest is an event that should be viewed as an appropriate trigger for gain recognition.

Conforming Accounting Policies and Fiscal Periods

We do not agree with the ED's requirement to eliminate in consolidation specialized industry accounting procedures that a subsidiary appropriately follows. Such an effort would be costly (the specialized industry subsidiary would need to maintain two sets of accounting records) and would not result in the most relevant financial reporting since the specialized industry subsidiary's activity would not be presented following the procedures that were developed to communicate that activity in the context in which it is being undertaken.

With respect to the requirement to conform accounting policies for similar transactions and events, we generally agree that this should be required to the extent practicable for certain policies. However, we believe many policy differences fall within the LIFO/FIFO type situation.

Special Purpose Entities

Accounting for special purpose entities is one practice area that we believe should be addressed specifically in a final document. The ED only addresses special purpose entities through the application of the ED's general provisions. We believe the application of the general provisions of the ED are subject to significant differences of judgment; consequently, we do not believe the ED will be particularly helpful in addressing the issues currently encountered with special purpose entities.

Special purpose entities are frequently used for the following types of operations: leasing of buildings or equipment, securitization of receivables, research and development activities and start-up operations. Because of the unique issues and existence of specific accounting requirements in each of these areas, we believe the Board should address each major type of SPE separately.

We do not believe this ED should be used to effectively change the leasing rules for a certain category of lease, as it does through Example 5 of Appendix B. Example 5 of Appendix B would require the consolidation of Company J. However, if Company I were to enter into a similar lease transaction with an existing company directly or with an SPE established by another company, it would treat the lease as an operating lease. Effectively, the same transaction from Company I's perspective would get very different accounting treatment depending on whether or not an SPE was used and who is considered to be the creator of the SPE.

Application of ED to Not-for-Profit Entities

As indicated earlier, we believe there are significant differences in the needs of preparers and users of financial statements of not-for-profit and for-profit entities; consequently, our views regarding the application of the ED to not-for-profit entities differs from our views regarding its application to for-profit entities.

We believe the ED's requirement to consolidate all entities that a not-for-profit entity controls is an improvement over the requirements of the AICPA's Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (SOP 94-3). We believe the "economic interest" criteria of SOP 94-3 have created significant practice issues and potentially may create differences in financial reporting, not because of differences in circumstances, but rather because of differences in the exercise of judgment in applying SOP 94-3. Furthermore, the concept of "economic interest" is a difficult one to apply in a not-for-profit since, by their very nature, not-for-profit entities do not exist to provide cash returns to shareholders, but rather to use the resources they acquire for the established purposes of the not-for-profit entity. We believe a not-for-profit entity with an "X" purpose that controls another entity with a "Y" purpose is, in reality, a not-for-profit entity with both an "X" and a "Y" purpose and, therefore, we believe reporting consolidated information is a more representationally faithful presentation of the controlling entity, regardless of the legal distinction and separation of assets of the two entities.

Effective Control

We believe that the definition of control set forth in the ED generally is operational for not-for-profit entities when considered in relation to illustrations provided in Appendix B. We are concerned that certain illustrations in Appendix B have shortcomings which must be addressed to make them useful to not-for-profit entities and practitioners in applying the ED. Our major concerns include the following:

1. Paragraph 170 includes broad generalizations and characterizations about the relationships between local organizations affiliated with a national organization. These characterizations lead to a presumption that no power exists over the individual assets of the local organizations, and therefore, consolidation is not required. The structure and relationships of national and related local organizations is varied, and in many cases more power over individual assets exists than is assumed in this example. We recommend that this example be

broken into two situations, one that requires consolidation and the other that does not lead to consolidation.

2. Paragraph 171 needs to be clarified. This paragraph is included in a section (paragraphs 166-172) of the ED that describes relationships between entities that generally are not relationships between a controlling entity and a controlled entity and is being read by many as a general exemption for religious organizations from consolidation requirements. We do not believe this was intended. Therefore, we recommend the ED be expanded to include an example of a religious organization requiring consolidation and one that does not require consolidation.
3. Paragraph 193 implies that the University's appointment of the initial board of directors of the Foundation provides strong evidence of control in addition to the other factors discussed in the example. We do not believe there is strong evidence of control through the appointment of the initial Board without the ability to appoint members in the future.
4. Paragraph 211 is inconsistent with the treatment of split-interests in the AICPA's proposed audit and accounting guide, *Not-for-Profit Organizations*, which the Board cleared for issuance in April of 1995. The proposed AICPA Audit Guide would record assets of a split interest held in trust gross and record any liability to the beneficiary of the trust for future income payments. Such recording is tantamount to consolidating such a trust. Paragraph 211 would require that only the net interest (gross assets - liability) held by charity in the split interest trust be reflected in its financial statements. The Board should clarify its position on this point and ensure that its final consolidation standard and the final AICPA Audit Guide address such situations consistently.

Conforming Accounting Policies and Fiscal Periods

The ED's discussion of consolidation procedures provides guidance that is currently lacking in SOP 94-3 on conforming accounting policies and fiscal periods. The conformance of accounting policies and fiscal periods will be an issue for not-for-profit organizations that have for-profit subsidiaries such as insurance companies. As indicated earlier in the section relating to for-profit entities, we believe the final standard should allow specialized industry practices of subsidiaries to be reported at the consolidated level.

Other Comments

The scope limitation in paragraph 4 is appropriate. However, it should focus on assets at fair value and not liabilities. Also, it should be made clear that the exclusion applies even if the reporting entity is a subsidiary of another entity to which the exclusion does not apply.

Very truly yours,

KPMG Peat Marwick LLP

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