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File Reference No. 154-D  
Consolidated Financial Statements: Policy and Procedures

Dear Mr. Lucas:

The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants and its Consolidation Policy and Procedures Task Force appreciate the opportunity to comment on the FASB's October 16, 1995 Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Consolidated Financial Statements: Policy and Procedures* (ED).

AcSEC observes that the ED substantially mirrors the FASB's Preliminary Views, *Consolidation Policy* (PV). AcSEC continues to believe that in the absence of legal control, control should be presumed not to exist and that, with respect to consolidation procedures, the final standard should follow the parent company approach.

The ED and PV propose significant fundamental changes to long-standing consolidation practices. Furthermore, a significant majority of respondents, including AcSEC, opposed the conclusions reached in the PV. Considering the substantial changes to current standards and practice and negative response, AcSEC does not believe the FASB has been persuasive in responding to concerns raised by respondents as cited in the ED's Basis for Conclusions. Understanding that the standard setting process does not necessarily reflect the consensus of the constituents, AcSEC nevertheless believes the concerns expressed by the respondents warrant additional consideration.

AcSEC continues to support the FASB's project on consolidations and related matters. However, AcSEC believes if the ED were issued in final form as currently proposed, the significant fundamental changes would be incorporating what AcSEC believes is as yet unclear guidance and would likely result in inconsistent application of the standard in similar situations-- particularly, the emphasis on effective control and control alone as a consolidation requirement.

Accordingly, AcSEC again asks the FASB to consider the report of the AICPA Special Committee on Financial Reporting, Improving Business Reporting -- A Customer Focus (the Report). The Report noted that, in general, users are comfortable with the current framework provided by financial statements and believe that the basic form and content of financial statements should be retained. Users did not identify specific problems with the current consolidation policy. Additionally, before issuing a final standard, AcSEC recommends that the FASB perform field tests to study the impact of implementing the ED.

## **CONSOLIDATION POLICY**

### ***Present Practice and Focus of the ED***

The ED appears to reflect, at least in part, an assumption that large minority holders are attempting to avoid consolidation. However, some companies whose growth comes primarily through a variety of partially-owned entities seek to justify control and consolidation.

### **Control Without Risks and Rewards of Ownership**

Paragraphs 83 through 87 of the ED address control and reject arguments communicated in the comment letters that some level of economic benefits is required as a condition for consolidation. However, many of the PV respondents, including AcSEC, (1) did not agree that the ED's definition of control is appropriate or operational for business enterprises or (2) believe the guidance as currently drafted may result in inconsistent application. AcSEC believes the FASB should investigate this issue further before issuing a final standard.

AcSEC continues to disagree that control alone is a sufficient basis for consolidation. As further discussed below, AcSEC believes that in the absence of legal control, there should be a presumption (which may be overcome) that control does *not* exist. A user of financial statements should be able to expect that the reporting entity has the risks and rewards of ownership of the assets and liabilities included in consolidated financial statements. Accordingly, a significant level of participation in those risks and rewards also should be required for consolidation of a business enterprise. Generally, such participation would require a significant equity or other financial interest in the earnings and cash flows of the enterprise, an exposure to the net cash outflows of the entity, or both.

Mr. Timothy Lucas

February 2, 1996

Page 3

The ED makes little distinction between a business enterprise and a not-for-profit organization (NPO). AcSEC believes there is a significant distinction in many instances and that such distinction should be addressed in the ED as part of the process of determining the existence of control. Part of this distinction is the need for an economic interest as a prerequisite of consolidation.

For NPOs, AcSEC believes control and an economic interest, as described in SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, should be prerequisites to consolidation. The need for economic interest as a prerequisite for consolidation should be discussed in detail or the final standard should incorporate the definition of economic interest set forth in SOP 94-3.

AcSEC believes the final standard should include examples of economic interests of NPOs, such as those cited in SOP 94-3, which are similar to indicators of control in paragraph 158f. of the ED.

#### ***An Entity Can Be Controlled by Only One Other Entity***

The ED states that control is an exclusionary power. For example, if entity A consolidates entity B, no other entity can consolidate entity B. AcSEC agrees with this conclusion. However, paragraph 153 of the ED states in part that “[i]f an entity has effective control through conversion rights, no other entity can control that corporation, even one that presently owns a majority of the currently outstanding voting shares”. AcSEC disagrees with this conclusion. AcSEC believes that the entity that has a majority of the currently outstanding voting shares should be presumed to have control. To overcome that presumption, the holder of the conversion rights would need to have control in fact (see page 4, paragraph 14c. discussion ).

#### **Legal vs. Effective Control**

##### ***Control: Factual, Not Presumptive***

AcSEC believes that control is a matter of fact, not presumption, and generally should be legally enforceable as a condition for consolidation. AcSEC recognizes that there may be instances in which effective control may exist without legal control and consolidation may be appropriate. However, in the absence of legal control, AcSEC believes there is a presumption that control does not exist. A high threshold should exist for successfully asserting effective control in the absence of legal control. Accordingly, AcSEC believes that the circumstances identified in paragraph 14 of the ED should not, by themselves, result in the presumption of effective control.

AcSEC believes a pervasive flaw in many of the paragraph 14 presumptions of effective control is the potential short-term nature of those presumptions. In many instances, the conditions underlying the presumptions are outside of the investor’s control and are prone to fluctuations from period to period and, thus, may lead to inconsistent reporting of the consolidated group. AcSEC believes that circumstances which lead to consolidation should be within the investor’s

control and of a more stable or long-term nature, such as actual ownership of a majority of the voting stock.

The majority of AcSEC members believe the circumstances in paragraph 14a. and b. are irrelevant in determining whether there is control, because those circumstances depend on the action or inaction of other parties. Those circumstances may indicate only that currently passive owners of a majority of the voting stock are not dissatisfied with the actions taken by the significant minority interest holder. However, if the owners of a majority of the voting stock disagree with the significant minority owner, they have the ability, through proxy challenges and other mechanisms, at least to veto or otherwise temper the actions of the significant minority owner. Some AcSEC members believe that veto powers held by owners and control powers that are effectively delegated should preclude consolidation by the holder of a large minority interest. Other members believe those circumstances are at most indicators of effective control.

In addition, with respect to the individual presumptions in paragraph 14, AcSEC recommends the following:

14a. *Large minority voting interest.* This circumstance -- even if it is retained only as an indicator of control -- should be more restrictive. AcSEC is particularly concerned that application of this circumstance to determinations of effective control could result in relatively frequent changes in the entities included in the consolidated group depending on the periodic concentrations of holdings by other owners or their level of activity.

14b. *Dominating the election of board members.* This circumstance is at most an indicator of effective control. An ability to dominate a recent election should not result in a presumption (and, in the absence of unusual circumstances, may not even indicate) that future elections also may be dominated.

14c. *Conversion rights.* This circumstance should be retained as an indicator, rather than as a presumption of effective control, and should be modified as follows. The indicator should be clarified to require consideration of the existence of similar options held by others that might raise questions about the substance of the option held by the potential parent and that the assumed risks should include the conversion costs. In addition, the indicator should specify that the holder of the right has the financial ability to exercise that right and that exercise is economically beneficial to the holder. Economically beneficial means more than just, for example, "in the money" options. It may be an uneconomic act to exercise rights to obtain control when, for example, an entity has a preferred position or creditor status, and the associated priority of dividends or interest, outweighs the benefits of control. Also, the magnitude of a cash payment to exercise a right may, of itself, be an uneconomic act due to the lack of availability or consequences associated with increasing debt to raise the required funds.

14d. *Special-purpose entities (SPEs)*. The application of this circumstance to SPEs and sponsoring business enterprises is unclear. AcSEC believes that the issues related to SPEs are complex and overlap the Exposure Draft of the Proposed Statement of Financial Accounting Standards, *Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Accordingly, AcSEC suggests that the Board expand and clarify its views concerning the consolidation of SPEs.

14e. *Ability to dissolve an entity and assume control*. This circumstance is at most an indicator of effective control. AcSEC views this circumstance as being equivalent to a significant creditor that can foreclose on debt and effectively take over an entity.

14f. *Sole general partner*. Being a sole general partner in a limited partnership generally allows the general partner to exercise sufficient control to meet the control requirements established in the ED. However, AcSEC believes that the general partner also should have a significant economic interest in the partnership, which could take the form of a significant expected residual interest. The Board should require some level of economic interest on the part of the general partner as a criterion for consolidation.

If the ED's presumptions of control are characterized as indicators of control, the ED's indicators of effective control in paragraph 158 should be described differently. The ED presents these indicators as items that management should take into account in carrying out its responsibility of assessing whether an entity controls any other entity in which it has an investment or other relationships that give it the right to future economic benefits. AcSEC believes that most of these circumstances would only rarely, if ever, result in a conclusion that effective control exists. They might be better described as examples of circumstances that may exist if there are ED paragraph 14 indicators of effective control.

### **Temporary Control**

AcSEC agrees with the concept of temporary control as described in the ED and the requirement to continue consolidation until the parent's control ceases to exist. Although the parent may have the intent to dispose of a newly acquired subsidiary within one year, when the ability to do so is not within the control of the parent, non-consolidation and classification of the subsidiary as held for sale may not be appropriate. For example, if regulatory approval is required then non-consolidation may be appropriate only if such approval has been received or is considered perfunctory.

The ED would require that a subsidiary continue to be consolidated until the parent ceases to control it. AcSEC believes that the final standard should clarify that loss of control is actual, not presumptive.

## **Trusts**

Paragraphs 165 and 166 of the ED indicate that a trustee that has no beneficial interest in a trust and a beneficiary of a trust that does not control the trust's individual assets should not consolidate the trust. Example 7, particularly paragraph 211, illustrates that trustees that have control over the trust's assets and are beneficiaries of the trust should not consolidate the trusts, but should recognize, as an asset, their right to receive future cash flows.

AcSEC agrees that beneficiaries of trusts that do not control the trust's assets should not consolidate the trusts and that unconditional rights to receive future cash flows from trusts should be recognized as assets. However, AcSEC believes that for trusts in which the entity is both a beneficiary and the trustee, such as certain split interest agreements, the entity should consolidate the trust and record any liabilities to other beneficiaries. A fiduciary responsibility to other beneficiaries should not preclude consolidation if the entity is the trustee and also a beneficiary.

AcSEC notes that its view is consistent with Chapter 6, "Split-Interest Agreements", of the April 14, 1995 Exposure Draft of the proposed Audit and Accounting Guide, *Not-For-Profit Organizations*. Most of the guidance in that chapter, particularly provisions requiring recognition of liabilities associated with split interest agreements, conflicts with the guidance proposed in the ED.

## **Creation of an Entity by and for the Benefit of Another NPO**

Example 4 (paragraphs 190 to 194) of the ED states that in circumstances in which one NPO establishes another and appoints its officers or board members as the initial board, the creating entity may be able to elect future board members through its influence on the existing board members. AcSEC believes the example should be revised to clarify that appointing the initial board with no authority to appoint subsequent boards would not lead to a presumption of control. Significant judgment would be required to determine whether there is subsequent effective control based on the facts and circumstances, including the mission of the entity, the economic relationship between the entities, the history of the operations of the entities, and the likelihood that this history will continue.

## **Federations, Membership Organizations, or Other Associations and Their Members**

The discussion of federations, membership organizations, or other associations and their members in the ED is in the context of relationships that generally do not result in control (and thus should not be consolidated). The final standard should clarify that circumstances may exist in which control and economic interest exist, in the relationships described above, and consolidation is required.

Also, paragraph 171 discusses religious organizations and some of their various organizational structures and characteristics. The fact pattern in paragraph 171 of the ED is not necessarily representative of usual fact patterns for religious organizations. For example, the ED states in

part that "...a judicatory usually is not able to establish a congregation's operating and capital budgets or otherwise direct how its individual assets are used. Rather, as protection against undue judicatory interference, denominational rules and policy usually establish a congregation as an entity in its own right with certain rights and protections that can be upheld in ecclesiastical courts or similar denominational processes, if not in civil courts as well." The assertion that those facts are usual overstates the uniformity of the organizational structures and characteristics of religious organizations.

## **CONSOLIDATION PROCEDURES**

### ***Parent Company Concept***

AcSEC believes the final standard should conform to the parent company approach. The broad application of the parent company concept more closely follows current practice which, though not flawless, would not be remedied by applying the provisions of the ED. More importantly, the ED, as currently drafted, may lead to anomalies such as in the guidance on allocating goodwill in step acquisitions that would allow for different amounts of goodwill to be recorded, depending on how the acquirer acquires another entity. For example, a company could purchase a 51 percent interest in another entity and have legal control. The ED provides that no goodwill would be recorded for the 49 percent minority interest. Subsequently, that company could acquire the remaining 49 percent minority interest. Under the ED, the subsequent purchase would be accounted for as an equity transaction and result in no goodwill ever being associated with the 49 percent purchase. However, if the same business combination were consummated in a single transaction, the ED would require that the full amount of goodwill be recorded.

Another anomaly arises with a decrease in ownership interest in a subsidiary when control is retained (e.g., 80 percent to 70 percent). As currently drafted, the ED would require that this increase or decrease be reported as an equity transaction. AcSEC believes that when there has been a decrease in ownership, the culmination of the earnings process has taken place and the result should, therefore, be reported in the income statement.

Further, the ED would provide the opportunity to recognize earnings or losses in a step acquisition. For example, an entity could purchase just enough additional stock to obtain a significant interest and thus be able to recognize unrealized holding gains or losses previously recorded in equity in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, without ever actually realizing such gains or losses. AcSEC believes purchases do not result in the culmination of the earnings process.

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

A majority of AcSEC believes that the preparers of consolidated financial statements should not be required to conform alternative accounting policies in consolidation, if such policies are specifically required in an industry in which a subsidiary operates. For example, to require an

Mr. Timothy Lucas  
February 2, 1996  
Page 8

investment company subsidiary of a manufacturer to conform accounting policies would misrepresent the true financial position of the consolidated unit and create an economic burden for the subsidiary to account for its investments under two policies.

A minority of AcSEC believes accounting policies should usually be conformed in consolidation. Since, with few exceptions (e.g., LIFO), alternative methods for similar transactions or balances may not be employed in the preparation of a single entity's financial statements, the minority believes that similar conformity should be required in consolidated financial statements. Adjustments should be allocated between controlling and noncontrolling interests.

AcSEC also believes that while it may be preferable to conform the fiscal period of a subsidiary to its parent's in consolidation, differences of no more than about three months should continue to be permitted. AcSEC is not aware of any significant problems in this area and believes this flexibility has provided companies with a practical approach for reporting multi-location activities.

#### ***Other Comments***

#### **Disclosure about Formerly Unconsolidated Majority-Owned Subsidiaries**

AcSEC believes this disclosure requirement is no longer useful and should be eliminated.

#### **Effective Date and Transition**

Due to certain overlapping considerations and requirements for this ED and the ED on the Proposed Statement of Financial Accounting Standards, *Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, AcSEC believes the effective dates should be conformed.

Representatives of AcSEC would be pleased to discuss these comments with the Board or its representatives.

Sincerely,



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Chair  
Accounting Standards  
Executive Committee



Joseph H. Cappalonga, CPA  
Chair  
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