FINANCIAL EXECUTIVES
INSTITUTE

Letter of Comment No: 36A
File Reference: 1082-154
Date Received: 1/15/96

January 15, 1996

Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference 154-D

Dear Sir:

CCR appreciates the opportunity to respond to the Exposure Draft (ED), Consolidated Financial Statements: Policy and Procedures. For reasons noted in our response to the Preliminary Views issued by the Board in 1994, we do not view the change in consolidation policy as advancing the usefulness of financial reporting. We note with regret that the Board has not responded to any of the substantive issues raised in our response to the Preliminary Views document which are summarized below.

- The proposed standard will create unparalleled instability with regard to which entities will be included in or excluded from consolidated financial statements in a given period. The most disturbing aspect of this issue is the fact that a change in the consolidation status of an entity could result solely from the actions of third parties unrelated to either the parent or the subsidiary.

- The proposed standard narrowly defines circumstances in which deconsolidation is permitted to those in which disposition of an entity is contemplated at the date of acquisition. Our experience suggests that analysts would agree that deconsolidation is the appropriate accounting treatment for subsidiaries that management intends to dispose of, irrespective of when that decision is made.

- We continue to be troubled by the lack of a requirement for the controlling entity to have a significant equity interest in the subsidiary. We do not believe that financial statement users will find consolidated statements particularly helpful if they commingle assets that can be used freely and without restriction with those that are not, and may never be, legally owned.

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- We are very concerned that the practical effect of the ED will be the replacement of the simple and operational model we have today with an ambiguous and highly subjective approach that can only lead to inconsistent reporting by entities in similar circumstances.

If the Board chooses to carry forward a control-based approach in any form in developing a final standard, it must first address the implications of noncontrolling interest veto rights on the ED's definition of effective control. This issue will not only have implications for the consolidation of previously unconsolidated entities but also on the potential deconsolidation of subsidiaries over which the parent exercises "legal" but perhaps not "effective" control as defined. The Board must consider the many ways in which noncontrolling interest veto rights are used and are effective in corporate governance, either by contract or by statute, and then decide the degree to which such rights are permitted to limit the controlling entity's power over the assets of the subsidiary before the criteria for effective control are no longer met.

CCR finds the Board's conclusions on consolidation procedures equally perplexing. We acknowledge that the Board's decisions in this area are consistent with an "economic entity" view of the enterprise. Nevertheless, the approach will produce many counterintuitive accounting results and will have significant adverse consequences for the usefulness of consolidated financial statements. We believe that the parent company approach to procedures which has formed the bedrock of practice for the last 50 years has served both users and preparers satisfactorily and the Board's new approach, with all of its flaws, offers no compelling reasons for change.

CCR believes that a final standard based on the ED's conclusions constitutes a radical change from present practice in this area—one that constituents will need to weigh and measure carefully. We suggest that the Board needs to move with caution and incrementalism in areas in which dramatic changes are being considered. Comprehensive revolutions, such as that proposed by the ED, are by their very nature unpredictable and may well lead to significant unintended consequences for financial statement users and preparers alike.

Our detailed response on specific issues are discussed in greater detail in the attachment to this letter. The chair of the CCR committee that developed this response is Philip D. Ameen of General Electric. Should you have any questions, please contact him at (203) 373-2458.

Sincerely,

Susan Koski-Grafer

Consolidation Policy

Definition of control

The ED defines control as power over another entity's assets -- the power to use or to direct the use of the individual assets of the other entity in essentially the same way as the controlling entity can use its own assets. We believe that it is axiomatic that whenever noncontrolling shareholders are involved that condition can never be fully met. As the rights of noncontrolling shareholders to veto specific actions by the "controlled" entity become more robust and pervasive, the ability of the parent to control must diminish. We recognize the difficulty of the task of defining where on the continuum of noncontrolling interest veto rights the effect is so significant that effective control no longer exists. However, we believe it is imperative that the relationship between control and noncontrolling interest veto rights be addressed before a final standard is issued.

Without the successful completion of that exercise, one of the more significant consequences of adopting the final standard is likely to be the deconsolidation of a number of legally controlled entities from consolidated financial statements.

We offer the following guidance to the Board as a starting point for its analysis. We would suggest that the core elements of control are: (1) day to day management control of the entity, (2) a significant voting interest, and (3) control of the Board of Directors. We would then suggest that noncontrolling interest veto rights be permitted to exist in a controlled entity for transactions that potentially threaten the noncontrolling party's fundamental economic interests. For example, most would consider the following types of rights to be essential to the noncontrolling interest in protecting the value of its investment: substantial changes in the operations of the enterprise, amendments to the certificate of incorporation/charter/by-laws, changes in the enterprise's name or headquarters location, and the ability of the entity to structure transactions with the controlling entity or related parties. We would expect that the noncontrolling interest would always be permitted the right to veto decisions in those areas without jeopardizing the consolidation decision. In other instances where the noncontrolling shareholders often have veto rights, we believe a less absolute approach would be more appropriate, such as permitting veto rights for significant transactions.

We believe that the major areas to be addressed by such criteria should include the following: the entity's business and strategic plan, dividends, acquisitions and dispositions of assets, refinancings and other changes in the entity's capital structure. The Board may also wish to consider within that same framework areas such as litigation (the ability to commence or settle), tax elections, incurrence of liens, dismissal/compensation of management, and selection of accounting policies.

Temporary Control

The Board has addressed the issue of temporary control very narrowly by restricting its guidance to conditions in existence at the date of acquisition. The far more substantive issue is the appropriate policy for subsidiaries that are intended to be closed or sold, but do not represent a full segment or line of business. It is our view, given how analysts approach this question, that the fundamental information needs of users at the point in time that the decision is made to sell a subsidiary are two-fold: (1) How is the company doing in its ongoing business? and (2) What will the enterprise look like without the business that is to be closed or sold? We believe that the ED principles must be responsive to those information needs and that the clearest answer to those questions is an APB 30 approach, under which "sell or close" activities are extracted from activities that will continue with the business. There can be no doubt that consolidation based on management intent will necessarily result in deconsolidation of loss operations. However, we believe that the opportunity to provide extraordinarily useful information justifies this cost, and we believe that supplemental disclosures can cover the questions from those who want to see what happens if management's intent is not realized.

Consolidation Procedures

We disagree with the Board's decision to take an economic entity approach to consolidation procedures. While the Board may find the conceptual consistency of that model intuitively appealing, the negative effect of the approach on the comparability and representational faithfulness of reported financial results clearly indicate that the changes to practice in this area will not improve financial reporting. In addition, certain of the proposed changes to procedures would create a number of practical difficulties for preparers of financial statements.

Display of Noncontrolling Interest in Financial Statements
We concur with the Board's conclusion that noncontrolling interests do not meet the conceptual definition of a liability. However, the Board's decision to include it as a separate component of equity also lacks support under the conceptual framework, since noncontrolling shareholders do not have an ownership interest in the parent. We believe that the equity of the consolidated enterprise should represent parent shareholders' equity interest in the residual interest of the subsidiary. We are also unaware of any expressed user desire for noncontrolling interest to be commingled with the ownership interests of the controlling entity. If the Board decides that the existing practice for the display of noncontrolling interest is unacceptable, it may wish to pursue an amendment to its concepts statements to recognize a different kind of equity that is essentially mezzanine financing.

We also do not agree with the Board's proposal to allocate net income between controlling and noncontrolling interests. This presentation will be confusing to the typical shareholders of the company, who are simply interested in that portion of net income that is available to them as shareholders in the parent.

Acquisition of Subsidiaries
We disagree with the Board's conclusion that 100 percent of the acquired entity's assets and liabilities should be reflected at fair value. The Board's decision appears to follow from the economic entity approach, which we reject in its entirety. The current practice of revaluing the parent's proportionate share is consistent with a parent company perspective and is a well established practice that financial statement users are comfortable with.

Step Acquisitions
The Board's approach would require the purchase of additional shares of a controlled entity to be accounted for as though they are treasury stock transactions. Accordingly, goodwill on those purchases would be charged to additional paid-in capital instead of goodwill. As one might expect, this approach will create significant comparability problems in practice: two acquisitions that are otherwise similar in nature will differ substantially in terms of the accounting applied simply because one was accomplished in steps while the other was consummated in a single purchase transaction. In most cases, the Board's approach to step acquisitions will understate an enterprise's goodwill and overstate its net income in future periods.

Accordingly, there is ample incentive for companies to structure transactions in steps in order to gain the beneficial accounting. We do not think that the Board had intended to promote accounting-motivated behavior in this area, but that would appear to be the practical effect of its decisions.

Changes in a Parent's Ownership Interest in a Subsidiary While Maintaining Control

We disagree with the Board's conclusion that any changes in a parent's proportionate interest in a subsidiary that does not result in the loss of control should be accounted for as treasury stock transactions. As with the Board's decision on step acquisitions, the practical effect of the Board's approach will be widely differing results among entities related to sales of a subsidiary's stock simply because some were structured in steps while the others were consummated in a single transaction.

Dispositions of subsidiaries

The full impact on financial reporting of the Board's approach in the areas discussed previously does not become apparent until one follows the complete cycle of a hypothetical business acquisition that is accomplished in three steps: the purchase of a controlling interest in period 1, followed by the purchase of the remaining interest period 2, and disposition of the entire subsidiary in period 3. In illustrating the accounting required by the ED, we have made the following assumptions:

- At the acquisition date, the target company had assets of $100 million and liabilities of $60 million.
- The book value of assets purchased and liabilities assumed are equal to their fair value.
- In the first step, the acquirer purchases a 40% interest for $20 million.
- No other parties have a significant interest in the target, requirements for "effective" control are met.
- In the second step, the acquirer purchases the remaining 60% for $50 million.

- Goodwill amortization is ignored.
- The acquirer subsequently sells 100% of the target for $50 million.

As we read the ED, the acquiring entity would record $4 million of goodwill on the first step of the transaction and on the second step record the excess of purchase price over the fair value of the net assets acquired ($26 million) as a debit to additional paid-in capital. When the subsidiary is sold, the company recognizes a gain of $6 million ($50 million - $44 million) even though the company has realized an economic loss of $20 million ($50 million -70 million). With regard to the issue of whether this fact pattern is realistic and likely to occur in practice, we offer the following observations: many companies do in fact make acquisitions in steps as their preferred practice and the guidance in the ED will only encourage more companies to do the same; whenever the step transaction that follows control involves "goodwill" the accounting gain or loss on the disposition of the subsidiary will not reflect the economics of the sale; under any scenario we can envision, the debits or credits to additional paid-in capital stay in equity for the life of enterprise—despite the fact that 100 percent of the subsidiary may have been sold.

Conforming Accounting Policies

We believe that the Board has gone too far in its quest for homogeneity of accounting principles in consolidated financial statements. Certainly, we would agree that a company whose business activities are essentially similar should be consistent in its choice of accounting methods across each of its business units. However, to require industry specific accounting practices to be reversed in consolidation seems unnecessary and will certainly be onerous to implement. It is reasonable to assume that industry specific GAAP developed by AcSEC and others is responsive to needs of financial statement users. We do not understand why those same accounting principles are no longer appropriate because a subsidiary's statements are consolidated with those of its parent. We think that the statements of the consolidated entity ought to reflect the attributes of the businesses that make up the whole. If the Board agrees that industry-specific GAAP is appropriate for individual entities to follow, it should also agree that to require that accounting to be reversed in consolidated statements would not be representationally faithful.

Conforming Accounting Periods

We believe that the Board is addressing different fiscal calendar year ends and not reporting lags (i.e., early cutoffs of less than one month). To the extent that this is correct, we support the Board's decision. If the Board intended this requirement to include the elimination of reporting lags, we strongly disagree with that decision. A host of real world factors combine to make elimination of reporting lags an onerous and completely unnecessary requirement. Of particular importance are the practical requirements of subsidiaries located in foreign jurisdictions. While eliminating reporting lags would be a challenge for operations located in areas such as Western Europe, the task may be all but impossible for operations in Eastern Europe or developing nations in Asia and Africa. We are of the view that a one or two week lag between reporting periods should not be of such significance that companies would need to call attention to them in the financial statements, particularly since adjustments would always be made for any material items.