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Comment Letter No. 6
File Reference: 1082-194R
Date Received: 5/17

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
401 Merrit 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed Statement of Financial Accounting Standards Consolidated Financial Statements: Purpose and Policy File Reference No. 194-D

Dear Mr. Lucas:

We welcome this opportunity to express our views on the Board's Exposure Draft.

We agree with the definition of control in paragraph 6. We also share the Board's goal of improving comparability among entities. However, we believe the significantly broadened complexity of the criteria for consolidation will result in different conclusions in similar fact patterns, thereby failing to meet the goal of comparability. For this fundamental reason, we do not support the ED.

Our more detailed views with respect to this and other issues are described below.

Scope

Not-for-profit organizations comprise numerous types of organizational structures and, as such, they should be considered as part of a separate project rather than in the context of this document. We believe the guidance in SOP 94-3 and its definition of economic interest provides appropriate practical guidance in this area and need not be superseded.

Consolidation Policy

The examples of control are couched in terms that are too broad and subject to various interpretations in substantially similar fact patterns.

SFAS 94 has provided clear and useful guidance for consolidation in the overwhelming majority of cases and we perceive no outcry for superseding it. In those special cases where the "bright-line" rules in that standard have not been sufficiently clear, other literature (e.g., SOP No. 78-9 and various EITF consensuses) has been satisfactory. While we acknowledge that entities' structures and business arrangements have grown more diverse since the issuance of SFAS 94, we believe that interpretative guidance should be developed, as needed, to

address any resulting consolidation issues on a case by case basis, such as for special purpose entities, unincorporated entities like partnerships and some joint ventures, rather than through the elimination of the practical underpinnings of SFAS 94.

In rebutting the argument for "bright-line" rules or consolidation based on legal control (e.g., ownership of a majority voting interest), the Board argues (paragraph 195) that consolidating a 51 percent owned controlled entity and not consolidating another controlled entity that is 49 percent owned does not achieve comparability. However, this rebuttal appears to use circular reasoning and omits the critical factor of **voting** ownership. Since control is the essential element for consolidation, it is a truism to state that omitting certain controlled entities from consolidation would result in lack of comparability. The real question is what characteristics constitute control. If the ownership percentages of the aforementioned entities related to voting interests, there is compelling evidence of control with respect to the 51 percent interest, but not the 49 percent interest. A two percentage point difference in interests can indeed be substantive, resulting in comparability, because such "bright-line" rules are likely to be applied relatively consistently (similar to those relating to the 20 percent "significant influence" criterion of APB Opinion 20).

We are particularly concerned with the high degree of subjectivity inherent in the presumptive control indicators specified in paragraphs 18 (items b and c) and 21. Because of the lack of specificity in these indicators, preparers (and their auditors) are likely to interpret control differently in similar fact patterns. Moreover, a particular entity might even interpret its specific control indicators differently over time, resulting in changes in its consolidation policy without the occurrence of a financial transaction (e.g., purchase or sale of voting stock, spinoff, transfer of net assets to joint venture).

The ED indicates, in paragraph 196, that information gained from a variety of sources caused the Board to believe that "an entity's managers and others will seldom interpret similar facts and circumstances in significantly different ways when applying this Statement's definition of control." We have not seen this input, so we cannot comment on how it might impact our belief as to the consistency with which the definition of control is applied. However, we are extremely skeptical that such consistency will abound in practice. The Board provides an inkling of the lack of definitiveness in the ED's guidance when it states, in paragraph 196, that the discussions between a company's managers and others may involve "consultation with others." Due to the flexibility of the guidance, registrants and their auditors are likely to be cautious about concluding on complex consolidation issues without first consulting with the SEC staff. Given that the strain on SEC staff consultation resources was an element in the movement to abandon pooling of interests accounting, we can easily envision a similar strain resulting from adoption of the ED.

The complexities surrounding the presumptive control indicators in paragraphs 18 and 21 are exacerbated with the caveat in paragraph 17 that "those situations represent only a few of the most common ways that consolidation of an entity might be achieved." It is difficult enough to evaluate the presumptive control indicators in those paragraphs without having to deal with the potential for an infinite number of additional ones.

Following are specific comments we have on certain of the presumptive control indicators listed in paragraphs 18 and 21:

- Paragraph 18, Item b – The guideline for what constitutes a large minority voting interest may be subject to differing interpretations. For instance, Example 1 in Appendix B has a scenario where the 35% minority voting interest was deemed to have effective control when combined with the outcome of recent Board elections and other circumstances. This raises an interesting possibility that even lower percentages of ownership could result in consolidation. Also, the criterion for no other party or organized group with a significant interest does not seem to address separate institutional holdings, nor does it even define "significant," except in the example itself. We can envision circumstances where such holders could quickly become sufficiently organized to overcome the presumption of control.

  Moreover, election history does not necessarily portend future board domination. A policy that relies on inaction on the part of other shareholders is fragile. Future events can influence these other shareholders to unite (if not literally, then at least through common beliefs) against the current board. As such, control may be denied to the current parent and consolidation would no longer be appropriate.

  We also agree with the arguments set forth by one Board member in paragraphs 251–253 of the ED (which also relate to the control criteria in paragraph 18 and the criterion in paragraph 21), i.e.:

  1. "[I]t is unreasonable to require evidence that demonstrates or proves that control is not present in circumstances in which an entity has taken no action to attempt to effectuate a perceived ability to direct the policies and management of another entity."

  2. "[A] presumption that forces one to anticipate future events based on past experience (voting patterns) that occurred under different conditions is questionable."

  3. "[T]he requirement to consolidate an entity where control results from less than a majority voting interest must be based on evidence of the ability to control rather than on the presumption and expectation about future events." In that regard, we also agree with that Board member, as expressed in paragraph 253, that the presumption of control in paragraph 99 of Example 2 should not be stated in the negative but rather should be based on positive evidence of the ability to dominate board nomination and election.

- Paragraph 18, Item c – The scenario created in Example 4 of Appendix B is, in our view, an extremely narrow and obvious set of circumstances, which are substantially different from numerous other situations contemplated by this Item. What constitutes "the expected benefits…exceeds its expected cost" is subject to multiple interpretations. For example, if a company holds convertible debt issued by a highly profitable company, the debt yields a fair rate of interest, and the conversion price is equal to the quoted market price of the stock, should ultimate conversion be presumed? Perhaps the holder is comfortable with the

steady interest stream. Perhaps market interest rates are projected to change significantly, causing the holder to change its investment decision. Perhaps the market price of the stock will decrease, mitigating against conversion. Also, in another scenario, if a company has a slightly below-market option to purchase sufficient shares to establish an over 50% voting interest, should exercise of the option be presumed?

These are only two examples out of a virtually unlimited array of possible circumstances, many of which would call for significant judgments as to the probability of economic decisions by the investor, including obtaining the financing necessary to exercise options and similar rights. Moreover, an investor's perceptions regarding the risks and rewards of alternative forms of its investment are likely to change over time as a result of changes in macro-economic and investee-specific changes, as well as changes in the investor's business strategy. This type of fluid environment makes control judgments similarly fluid and extraordinarily complex. Periodic changes in these judgments which result in changes in the components of a consolidated entity could confuse the users of financial statements. In addition, if one assumes conversion by the holder of the instrument, it is not clear what assumption should be made regarding the non-control holders and how this assumption would impact the decision to consolidate. Finally, we agree with the view of the Board member as stated in paragraph 254 that "it is equally as inappropriate to presume control before the ability has been demonstrated as it is to deny the existence of control after the ability has been demonstrated."

- Paragraph 21 – We are also concerned that as low as a 1% general partner interest, often obtained for a nominal investment, could trigger consolidation, which differs substantially from existing practice and which would not be meaningful to users. In addition, as argued in paragraph 255, the ability of limited partners to remove the general partner may be untested in many instances, so their "current ability" may not be a valid precursor to their potential ability. As such, the sole general partner may not be able to "direct the use of the assets and activities of the partnership in ways that increase the benefits and limit the losses of the general partner without the ongoing cooperation or acquiescence of the limited partners."

The amorphous nature of the judgment process to determine whether control exists in any particular situation is further highlighted by the symbiotic relationships discussed in paragraph 83 where "control is gained (or lost) through a combination of factors that by themselves do not provide conclusive evidence of control but together confer or *appear to confer* effective control" (emphasis added). Control either exists or it does not. "Appearance" of control should not be presumptive of its existence. Paragraph 83 goes on to state that the conclusions reached in the examples in paragraphs 87–164 may not be "right," but rather are reasoned judgments. This lack of specific guidance leaves the door open for second-guessing by those who consider their evaluation of control, rather than that of the reporting entity, to be "right," even when the circumstances are strongly analogous to those in the examples.

Temporary Control

The vague guidance for determining control stands in stark contrast to the strict application of the temporary control exception to those situations existing only at the date of acquisition. We do not understand the logic (or agree with the conclusion) that a plan adopted subsequent to acquisition to dispose of a subsidiary should not cause deconsolidation, whereas the same plan existing at the acquisition date would have the opposite effect. If the nature of the plans is identical, so should the accounting treatment (i.e., deconsolidation). Otherwise, a user could be faced with the irrelevant display of consolidated financial statements where the company's only subsidiary (not a separate segment) is sold shortly after the balance sheet date.

Effective Date and Transition

If the ED is adopted, we would favor postponing the effective date by one year. As stated above, the flexibility with which control may be evaluated may involve many highly complex judgments, which may include consultation with the SEC staff. In addition, computer systems concerns related to the Year 2000 as well as the euro may present hurdles for earlier implementation, particularly because many entities have placed a moratorium on any systems changes between October 1999 and March 2000, other than to ensure Year 2000 compliance. We do not believe the proposed effective date suitably reflects these practical issues.

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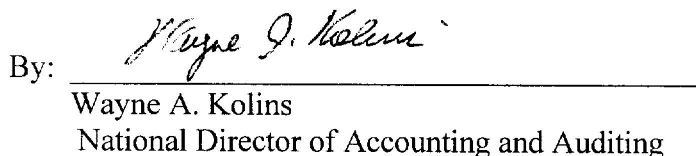
We would be pleased to discuss our views with members of the Board or its staff. Please contact us if you have any questions concerning our comments.

Very truly yours,
BDO Seidman, LLP

By: 

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