

April 29, 1999

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Financial Accounting Standards Board Comment Letter No. 54 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856

File Reference: 1082-194R Date Received: \$\forall 4/\sqrt{9}\$

Dear Friends:

Your Exposure Draft "Consolidated Financial Statements: Purpose and Policy" is a most remarkable document; manifesting Solomonic Wisdom. Thus, you have cut in half vour 1995 Exposure Draft "Consolidated Financial Statements: Policy and Procedures" and provided us with the half without "guts".

In response to the current ED, I first submit herewith a copy of my November 22. 1995, letter commenting on the earlier ED. On reflection excepting for the first complete paragraph on page 2, that earlier critique is fully applicable to your current promulgation. In fact the intervening years have provided additional examples of distortions of "economic reality" by the misapplication of ostensible standards.

Going back to your earlier ED, in response to my letter, you requested that I appear before the Board at a February 1996 session considering the ED. The request was motivated by my position regarding the SAB 51 issue referred to in that page 2 paragraph. It appeared that my testimony was required to strengthen the Board's position on that issue.

I attended the hearing and expressed my deeply-held views. At the hearing, there were others testifying regarding SAB 51, asserting that they needed the additional income injection in order to support their stock prices on Wall Street - as if that cynical view should matter in determining a standard for financial accounting. Be that as it may the February 1996 hearing was followed immediately by the departure of several Board members, providing an extended hiatus during which a new supermajority could not be reached regarding the "Procedure" phase of the 1995 ED hence only the "gutless" version is now exposed for deliberation.

Regrettably, the SEC has not evidenced greater intrepidity. Thus, the SEC Staff accounting bulletin which permits the prevailing hype was promulgated in 1983 to provide interim guidance until your Board would complete its long-standing project on consolidation and equity accounting; sixteen years have now elapsed and the Commission has not been able to bring itself "to grab the nettle."

Should you believe that there is anything further that I can do to help advance professional standards <u>qua</u> standards, please feel free to advise.

Sincerely,

Abraham J. Briloff, Ph.D. CPA Emanuel Saxe Distinguished Professor Emeritus

P.S. Because my June, 1992 <u>CPA Journal</u> article referred to in my 1995 letter might not be conveniently available to you. I am also including a copy herewith.



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November 22, 1995

Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Gentlemen:

I am pleased to acknowledge, and comment on, your Exposure Draft "Consolidated Financial Statements: Policy and Procedures" dated October 16, 1995 (the "ED"). First by way of a general observation:

The document does not, to my mind, represent a "standard"; instead, it is a book of rules endeavoring to provide a most detailed road map to account for affiliated enterprises. To the extent your promulgations provide such specificity you detract from the auditor's professional responsibility to exercise his, her or its professional judgment, and permit management, - frequently with the active participation of the independent auditors, contrive transactions which will somehow accommodate the rules -- all the while perverting economic reality.

Further, the Nation's mood presently calls for deregulation; this demands that a greater degree of responsibility for our conduct must move to the local, the particular, venue, i.e., the interface between the enterprise and the independent auditor. One might well hope that such an independent auditor would "grab the nettle" suggested by the Kirk report and accordingly demand that the "most appropriate" rather than the "merely acceptable," accounting alternative be implemented in a particular

situation.

By way of a positive observation, I am pleased to note (paragraph 29) that the ED would abort the SAB 51 Scam. My views regarding this absurdity were set forth in several contexts, e.g., my (New York) <u>CPA Journal</u> article "Alice's Misadventures in SAB 51's Dirty Pool (June 92) (attachment a); it was also the subject of my critical comment in an analyses of Conseco's accountings (see, e.g., pages 12-14 of Attachment b).

Turning to the Consolidation issue generally, I suggest that, a standard, if it were truly a standard, would obviate a nexus of unfair and misleading accounting practices which would be perpetuated under your ED.

I will take as my point of departure for this commentary paragraph 54, captioned "Relevance, Reliability, and Comparability of Information," to wit:

. . . the Board conlcuded that consolidated financial statements must report as completely and faithfully as possible the "financial position, results of operations, and cash flows of a reporting entity that comprises a parent and its subsidiaries essentially as if all of the resources of the affiliates were held and all their activities were conducted by a single entity with one or more branches or divisions."

This would be entirely appropriate if all of the resources of the Parent and subsidiaries were, in fact, fungible; this, in turn, would imply that the resources of the subsidiaries were essentially freely available to the parent to meet the latter's direct obligations. This condition does not prevail where the parent is precluded from freely tapping the subsidiaries' resources where, for example when the latter is a highly regulated enterprise, or is very heavily encumbered with various debt covenants.

Thus, Taking my Conseco commentaries, (Pages 3-4 of Attachment B) I believe that inasmuch as the insurance subsidiaries resources cannot be utilized by the parent as though they were its own, consolidation should be proscribed -- even if Conseco were to own 100 percent of such subsidiaries.

In sum, the enormous pools of securities and cash flows of the

insurance enterprises cannot be tapped at will by Conseco; as a consequence full consolidation produces information which is essentially irrelevant, unreliable, and lacking in comparability. This was, in fact, my direct assertion in my July 19, 1976 article in <u>Barron's</u>, "Whose Deep Pocket?" Impeaching the consolidation of Leasco with its Reliance Insurance, subsidiary. That assertion was central to the litigation against Barron's and myself -- terminated by summary judgment against Reliance in September 1977. Your file would undoubtedly dislose that I set forth this very argument at the time Statement of Financial Accounts Standard No. 94 was in gestation. Regrettably the Board determined to ignore my views.

The "control via general partner" phenomenon (Paragraph 14F) produces a corresponding absurdity in situations like Conseco (Pages 9-11 of Attachment B). It may well be that it's general partner status gives Conseco a key to the insurance enterprises' vaults; Conseco might even be able to rearrange the packets of valuables; but then, Conseco would be constrained to walk out as empty handed as "in it went."

Mind you. I am not oblivious of the abuses which can be perpetrated via partnerships or other controlled-entities, with the potential for off-balance sheet liabilities; but here I assert again, I would expect the truly independent, truly competent, truly committed auditor to ferret out such possibilities and thereby abort the misbegotten plans of management -- This is precisely what the CPA imprimatur implies, at least for me.

Similarly, the ED field rules for "temporary" (paragraph 16) are too limited in their scope and implication. (e.g., Pages 7-9 of Attachment B)Again, I point to my Conseco articles and assert that its Consolidation practices should be proscribed because experience demonstrates that the parent enterprise does not contemplate a "Bonding" commitment with its acquired enterprises. The very nature of Conseco's relationships with its capital providing partnerships, CCP-I and CCP-II, should make the only temporary relationship self evident; nonetheless, the ED rules would not reach those circumstances -- and, accordingly, would produce information which is essentially irrelevant, unreliable, and lacking in comparability.

True. the notion of temporary vs. Permanent is tenuous -- nonetheless, as Justice Potter Stewart observed regarding pornography. "I may not be able to define it, but I believe I can recognize it when I see

it."

Once again, I would expect the truly independent, etc., auditor, to discern the situations which are temporary and accordingly eliminated from a consolidation.

In any event, I recommend that the annual report at the very least, include a set of financial statements for the parent and all subsidiaries where the resources and cash flows are in fact fungible -- all other subsidiaries, regardless of the percentage of ownership should be accounted for under the equity method.

I would, of course, be pleased to respond to any questions or comments you may have regarding the foregoing and the related attachments. I would also welcome an invitation to present my views at any hearings that might be scheduled.

By way of a Coda:

Paragraph 26 of the ED does a very nice job of summarizing the provisions of APBO 16 insofar as a purchase transaction is concerned; this would imply that the Board has no misgivings with respect to the business combinations issue as presently implemented in practice. In my view such confidence is entirely unwarranted.

Very truly yours,

Emanuel Saxe Distinguished

Professor Emeritus

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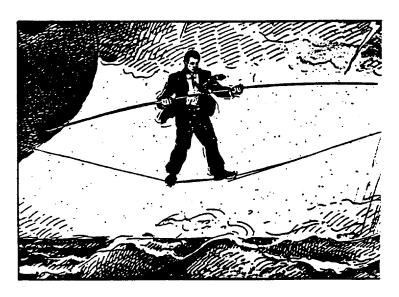
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Alice's Misadventures in SAB 51's Dirty Pool

By Abraham J. Briloff

Wonderful results in increased earnings per share that can be created from ingenious transactions spawn real numbers when little or no cash is involved. A loophole hig enough for Alice—large or small—and all her gang to slip through.

was lying under my spreading beech, brooding over AT&T's tortured endeavors to pull NCR into a pooling-of-interest when I let out with an ecstatic "Eureka!" That cry of exultation was prompted by my recognition of the spectacular consequences which can result from the linkage between the pooling accounting phenomenon and my discourse on SEC Staff Accounting Bulletin (SAB) 51 in my "Waste Management: Recycled Accounting" article in Barron's, August 6, 1990. That article included the following:

"In 1989, net income included a nontaxable gain of \$70.8 million, stemming from its Chemical Waste Management subsidiaries public offering that October of five million shares of common.

"Waste Management had owned approximately 81% of Chemical Waste Management's common immediately prior to the public offering. After the transaction, it held approximately 78%, but the book value of its stake was enhanced—to the tune of \$70.8 million—when Chemical Waste Management collected the proceeds of its offering.

"In fact, Waste Management's determination to book that \$70.8 million imputed gain in 1989 was, in and of itself, a

manifestation of liberal accounting. The company's authority for so doing is derived from the SEC's SAB 51, issued in 1983. In that instance, the SEC staff tackled the question of how a parent company might account for gains arising from a subsidiaries' sale of stock.

"The SEC had previously insisted that such appreciation be deemed part of capital and not an item to be passed through the income statement. But in 1983, the agency's staff grudgingly decided to go along with an earlier AICPA position paper that would permit inclusion of such gains in income in certain limited circumstances. Even so, the SEC stressed in its 1983 ruling that its dispensation was interim guidance only; its expectation was that the FASB would soon get its act together and conclude a long-standing project on consolidation and equity accounting that was to address this issue among many others.

It is noteworthy that seven years after SAB 51 was promulgated and 10 years after the AICPA spoke, the FASB has yet to address the issue on which SEC staff offered interim guidance."

The Magic of Pooling

As it happened, I had considered pooling-of-interests accounting most intimately in *Barron's*, October 8, 1990. That article, entitled "Muddying the Waters: Accounting's Magic Wand," dealt with the pooling proclivities of Allwaste, Inc., thus:

"What really makes Allwaste remarkable is its acquisitive bent—and the way that the company's galloping growth is reflected in its published financials. According to its 10K 'During fiscal 1989, the company acquired nine companies in transactions accounted for as poolings-of-interest Aggregate consideration consisted of 8.6 million shares of the company's stock. Yet it is via the accounting for its acquisitions that Allwaste works its magic—with tricks, moreover, that are all perfectly okay by the good book of GAAP.

"At then-prevailing market prices, the shares Allwaste exchanged for companies it acquired during fiscal 1989 were worth over \$70 million. Yet—under pooling-of-interests accounting rules—Allwaste recorded only a tiny fraction of that cost on its balance sheet. And, thanks to those same accounting rules, its reported earnings doubled.

"The critical rule regarding poolingof-interests is APBO 16: The pooling-ofinterest method accounts for a business
combination as the uniting of the ownership interest of two or more companies by exchange of equity securities.
Ownership interests continue and the
former bases of accounting are retained.
Income of the combined corporation
includes income of the constituents for
the entire fiscal period in which the
combination occurs. The reported income of constituents for prior periods is
combined and restated as income of the
combined corporations.

"What that means in practice is that, because its acquisitions were accounted for as poolings, the company's revised balance sheets and income statements reflect the pooled companies as though they were part and parcel of Allwaste at all times during their respective lives. And the existence of that revised data permits a nosy analyst to extract a summary balance sheet, as of August 31, 1988, for the nine companies acquired and pooled by Allwaste during its subsequent fiscal year.

"Two audited balance sheets, both as of the same date, can then be placed side-by-side. In this instance, the first is the one that was certified by Allwaste's auditors and appeared in the 10K it filed for the year ended August 1988. The second is the balance sheet for the same date that was included—for comparative purposes—in the 10K Allwaste filed for

the succeeding year. According to the accountants' book of rules on poolings, the second balance sheet was made to reflect the assets, liabilities and shareholders' equity, as of the fiscal 1988 year-end, of the nine companies pooled during the subsequent year.

"The difference between the two balance sheets derived from this exercise indicates that the combined shareholders' equity of those nine acquisitions was only \$4.3 million. For which Allwaste, as noted, issued shares worth over \$70 million, but-following the dictates of poolings-of-interest accountingthe only cost entered onto Allwaste's books was the \$4.3 million increase in its shareholders' equity. In other words, well over 90% of the cost of Allwaste's fiscal 1989 acquisitions got lost-and will remain so to eternity."

Stepping Through the Looking Glass

With that apperceptive base, I turn to a most exhilarating game plan, one which integrated the two distorting practices permitted by our profession's Good Book of GAAP—a combination that provides a distortion potential multiplied exponentially.

Now hold onto your hats, you're heading for a rough ride, thus:

Assume that Hypothetical Waste Management ("HWM") has 500 million shares outstanding, and earns \$500 million (EPS \$1). Its shares sell at \$30, hence, a P/E of 30.

HWM identifies an entity dubbed Ac-

counting Waste Management ("AWM") which owns dump sites with certified values aggregating \$1 billion. AWM's historical earnings are about \$50 million annually, with 10 million shares outstanding.

HWM proceeds to acquire AWM for 33.3 million of its shares (i.e., \$1 billion worth of its shares) and accounts for the acquisition by applying pooling-of-interests accounting.

Now, since AWM's book value is but \$100 million, that is the number entered into HWM's books as its cost. Further, under the pooling rules, HWM restates its EPS at \$1.03 (\$550 million of consolidated earnings divided by 533.3 million



shares now outstanding). For completeness, it should be noted that the market price is correspondingly boosted to \$31.

In order to obtain operating resources, AWM proceeds to a public offering of two million newly-created shares at \$100 each, i.e., equivalent to the same per-share price paid by HWM. AWM's balance sheet would now sport an aggregate equity of \$300 million, i.e., the original \$100 million plus the \$200 million of newly-garnered equity; this \$300 million is represented by 12 million shares—the 10 million in HWM's hands and two million with the public.

Now, HWM's proportional stake in the \$300 million amounts to \$250 million. Since this amount is \$150 million greater

than the \$100 million on its books, it follows like night follows SAB 51 that HWM's income statement scoops up a plus of \$150 million. Its income now zooms to \$692 million, i.e., the historical \$500 million plus the SAB 51 \$150 million plus \$42 million (5/6 of AWM's \$50 million). When that \$692 million is divided by its 533.3 million shares outstanding, the EPS escalates to \$1.30 per share.

But Wait, You Haven't Seen Anything Yet

Moving along, HWM finds that its subsidiary has more dump sites than might reasonably be required for their opera-

tions, whereupon AWM sells off 10% of its sites for \$100 million, precisely one-tenth of the "certified" billion dollar value. Then AWM's accounting may then calculate the gain on that sale, ordinary income, of course, to be \$90 million, i.e., the \$100 million proceeds less \$10 million, representing one-tenth of the entire cost shown by the company's books. But then that \$90 million had to be scaled down by the income tax, reckoned at \$30 million; the net was but \$60 million.

Assuming nothing further, AWM's income would be stated at \$105 million, representing \$45 million (9/10 of the historic \$50 million plus the \$60 million booked on the sale). But wait, we have forgotten something; thus, the \$200 million garnered on the public offering was invested to yield \$12 million net after tax—so that its income for the

fiscal period is really \$117 million; since there are 12 million shares outstanding, AWM's EPS is now \$9.75. Wall Street's Gnomes remember AWM's P/E of 20 and therefore put a price of \$195 on the company's shares.

Let us now shift our focus to HWM's consolidated income statement for the year, factoring in the foregoing. Thus, its income would be \$747.5 million determined as follows (in \$ millions):

Its basic income	\$500.00
The SAB 51 injection	150.00
5/6 of AWM's income	
of \$117 million	97.50
Total	\$747.50
Its EPS would be	\$ 1.40

That \$1.40 is a dramatic increase over the \$1 per share earned historically; but even if the P/E is not revised a single iota, the market price for HWM's shares would escalate to \$42.

With that kind of coin available for circulation, why HWM could repeat the foregoing cycle time and time again. In addition, since the share price of its AWM lode is also on an upward trajectory, that subsidiary can proceed with further public offerings all to the added glory of HWM's bottom line—thanks to SAB 51.

Before concluding this glorious entertainment, let us go back to AWM's sale of the tenth of its dumpsites, the transaction which induced a \$60 million profit-of which \$50 million floated upward into HWM's income statement. A moment's reflection would inform us that there was, in fact, an economic loss. Note that the portion sold generated \$70 million in net proceeds, i.e., the \$100 million minus the \$30 million tax. This means that the entire property had a net cash flow value of \$700 million-something for which HWM paid with its own stock worth \$1 billion. Clearly, HWM either ignored or overlooked the fact that its billion dollar outlay notwithstanding, the tax basis of the property acquired remained \$100 million. As a consequence, the \$60 million AWM gain, but even more so, the \$50 million portion which was consolidated into HWM's bottom line, were most incongruous and were nought but distortions of logic.

Intentional Absurdity!

This SAB 51 pooling parable, is of course, absurd. This was intentional! It is hoped that by this *reductio ad absurdum*, the SEC staff will see fit to abort its misbegotten SAB 51 and, even more hopefully, that the solons at the FASB will consign the pooling-of-interests accounting ploy to one of the March Hare's holes. Ω

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