

Letter of Comment No: 86  
File Reference: 1082-194R  
Date Received: 6/2/99

May 28, 1999

Timothy S. Lucas, CPA  
Director of Research and Technical Activities  
File Reference 194-B  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

**Re: Exposure Draft (revised) of Proposed SFAS, Consolidated Financial Statements:  
Purpose and Policy**

Dear Mr. Lucas:

One of the objectives that the Council of the American Institute of CPAs established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee ("TIC"). This communication is in accordance with that objective. These comments, however, do not necessarily reflect positions of the American Institute of CPAs.

TIC has reviewed the above referenced exposure draft and is pleased to provide the following comments. Our review has been supplemented by the information obtained through our participation in the consolidations case study group.

### **Issue 1**

TIC members believe that the revised definition of control, together with the discussion of the characteristics of control and the descriptive guidance provided, helps clarify when one entity controls another entity. As discussed below, however, TIC members also believe that the rebuttable presumption regarding convertible securities or other rights will be difficult to apply and lead to inconsistent application of the proposed Statement's revised definition of control.

### **Issue 2**

TIC believes that most of the guidance in the form of rebuttable presumptions is helpful in applying the proposed Statement's provisions. TIC's views on the rebuttable presumptions identified in the proposed Statement are described below.

#### *Paragraph 18 (a) – Majority Voting Interest*

The circumstance described in paragraph 18 (a) – “an entity (including its subsidiaries) has a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of the members of its governing body – is an appropriate rebuttable presumption.

### *Paragraph 18 (b) – Large Minority Voting Interest*

Paragraph 18 (b) regarding large minority voting interests should be expanded to clarify its application to closely-held corporations. This expanded discussion should be accompanied by additional examples to illustrate:

- A closely-held corporation with one 40% shareholder and six 10% shareholders. The six 10% shareholders always vote. Without evidence to indicate otherwise, it appears that in this situation the holder of the large minority voting interest does not control the corporation.
- A closely-held corporation with a key financing arrangement guaranteed by a minority interest shareholder or a shareholder with nonvoting stock. Loss of the guarantee would result in a loss of the financing arrangement and severe economic consequences to the corporation. Examples should be developed to illustrate the impact this situation could have on the assessment of whether one entity or individual controls the closely-held corporation.

### *Paragraph 18 (c) – Convertible Securities or Other Rights*

Paragraph 18 (c) regarding convertible securities or other rights may not provide a reasonable basis for presuming that one entity controls in the absence of evidence that demonstrates or proves otherwise since control does not exist currently. In addition, consolidation in this circumstance is based on numerous assumptions of the outcomes of future events that may result in incorrect conclusions.

### *Paragraph 21 – General Partner in a Limited Partnership*

Paragraph 21 regarding a single general partner in a limited partnership should be coupled with a significance test before requiring that the general partner consolidate the limited partnership. TIC members note that paragraph 8 of the exposure draft states, “consolidated financial statements are more meaningful than the separate statements of affiliated entities....” With this in mind, TIC members question the usefulness of consolidated financial statements that display a 99% minority interest. The cost for many small entities to consolidate a single general partner with a limited partnership could be significant in relation to the benefits received from consolidating these entities. Furthermore, consolidating these entities does not necessarily provide any information that would not already be available in the financial statements of the limited partnership.

### **Issue 3**

TIC members believe that the benefits of complete and comparative financial statements for all interim periods in the initial year of application are sufficient to justify requiring that the provisions of the proposed Statement be applied for the first and each subsequent interim period in the year of adoption. TIC recommends, however, that the effective date be delayed in view of the considerable research and analysis that will be necessary to apply the proposed Statement.

In addition, TIC members understand that the Board is currently addressing consolidation procedures and that the above referenced exposure draft is limited to purpose and policy. TIC believes that since practice problems are likely to emerge, the proposed Statement’s effective date

should be delayed until the project on consolidation procedures is completed. These problems include questions about what percentage to use to consolidate a subsidiary when the rebuttable presumption regarding convertible securities leads to consolidation.

### **Assessing Whether a Relationship Involves Control**

Paragraph 15 of the exposure draft indicates that “determining whether a particular relationship between two entities is a parent–subsidiary relationship requires an assessment of the surrounding facts and circumstances and a judgment about whether one entity controls the other entity.”

Paragraph 138 refers to the need to carefully evaluate the substance of the relationship, not just the form of the entity, when assessing the facts and circumstances described in example 7.

In order to increase the probability that the proposed Statement will be properly and consistently applied, TIC recommends that paragraph 15 be amended to include the need to evaluate the substance of a relationship, and not just the form of an entity.

### **Partnerships, Joint Ventures, and LLCs**

Paragraph 20 appears to indicate that except for general partner affiliates and situations in which all but one of the general partners waive their rights to participate in management, a general partner in a typical general partnership would never consolidate the partnership since authority is shared. This implies that in a general partnership, legal control is the sole factor in determining whether the partnership should be consolidated.

TIC members do not understand why consolidation would be precluded in circumstances where effective control by a general partner exists. In addition, TIC members question whether the guidelines set forth in paragraphs 20 and 60 result in the more meaningful presentation contemplated in paragraph 8. For example, consider the following:

- A general partnership in which one partner has a 80% interest and the other partner a 20% interest.
- A limited liability company (“LLC”) in which one member has a 80% voting interest and the other member a 20% voting interest.
- A corporation in which one shareholder has a 80% voting common stock interest and the other shareholder a 20% voting common stock interest.

Assuming there is no evidence to demonstrate that the 80% LLC member or that the 80% corporate shareholder do not control, the LLC and the corporation would be consolidated. The general partnership, however, would not. It is unclear how not consolidating the general partnership in this situation leads to a more meaningful financial statement presentation.

Furthermore, TIC members believe that the proposed Statement should be expanded to include additional guidance and examples to assist in applying it to partnerships, joint ventures and limited liability companies.

## **Not-for-Profit Organizations**

TIC members note that the proposed Statement's discussion and examples relating to not-for-profit organizations is somewhat limited. In order to improve the utility of the proposed Statement, TIC recommends that it be expanded to include a more comprehensive discussion and additional examples of not-for-profit organizations. One example could address whether control exists when:

- The boards of two not-for-profit organizations are elected by “different” memberships (although the membership base does overlap),
- One board is more active than the other and may have at least one board member that sits on both boards, and
- One management team runs the two not-for-profit organizations.

## **Combined Financial Statements**

Paragraph 233 explains why the Board decided not to include combined financial statements within the scope of the proposed Statement. Since this area affects a significant number of closely-held corporations, TIC members urge the Board to address the nature, form and content of combined financial statements.

## **Examples**

TIC members commend the Board for the inclusion of examples and other implementation guidance to assist in applying the proposed Statement. TIC suggests that example 6 be expanded to explain why control is not considered to be temporary since the board members serve for one-year terms. Further, Appendix A could be improved by including examples to illustrate:

- An affiliation structure where Company A owns 100% of Company B and 20% of Company C; Company B owns 40% of Company C; and unrelated third parties own the remaining shares of Company C. The illustration should discuss which Company – A, B, or both – controls and should consolidate Company C.
- The situation described in paragraph 19 regarding corporations created without a governing board or with a governing board that has limited authority.
- A situation where convertible securities could dilute a large minority voting interest.

We appreciate the opportunity to present these comments on behalf of PCPS member firms. TIC also appreciates the opportunity to have had one of its members participate in the consolidations case study group. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

James A. Koepke, Chair  
PCPS Technical Issues Committee

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cc: PCPS Executive and Technical Issues Committees  
Elizabeth Fender (for AcSEC)