American Council of Life Insurance

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Letter of Comment No: 145
File Reference: 1082-154
Date Received: 2/5/96

January 29, 1996

Mr. Timothy S. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
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**Proposed Statement of Financial Accounting Standards, "Consolidated Financial Statements: Policy and Procedures" (File Reference No. 154-D)**

Dear Mr. Lucas:

The Committee on Generally Accepted Accounting Principles of the American Council of Life Insurance (Council) appreciates the opportunity to comment on the Exposure Draft referenced above. The Council is the principal trade association for life insurance companies, and its 580 members represent, in the aggregate, approximately 90 percent of the assets of all domestic life insurers.

## CONSOLIDATION POLICY

### *Control of an Entity - Assessing the Existence of Control*

#### *Ownership of a Large Minority Voting Interest*

We do not believe that control alone is a sufficient and appropriate condition for requiring consolidation. Replacing an objective, verifiable ownership test that generally requires more than a 50 percent voting interest, with a subjective evaluation of the facts and circumstances would increase, rather than decrease, diversity of practice. While we most likely could support consolidation of less-than-fifty-percent-owned entities when control clearly is present, the presumption of control at "*approximately 40 percent*," as suggested in paragraph 14(a) of the ED, appears to be an arbitrary benchmark. In the absence of any conceptual basis for proposing "*approximately 40 percent*" ownership as the presumptive threshold for consolidation, we recommend that control continue to be presumed only in the presence of "*legal control*" - that is, majority ownership - and an "*assertive approach*" be applied when there exists a large minority

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voting interest. We believe that approach will charge management with the responsibility for making the appropriate assessments about the ability to control through large minority ownership positions and, where appropriate, will result in consolidation of less than majority-owned controlled entities without compromising the conceptual integrity of the Board's document. Simply lowering the consolidation threshold to "*approximately 40 percent*" will result in lowering the structure of transactions to the 39.9 percent level to overcome the presumption of control.

*Sole General Partnership Interest in a Limited Partnership*

We object to the consolidation of a limited partnership by a general partner having only a small equity interest. We share the view expressed by one Board member in paragraph 142 of the ED that the powers of a 1 percent general partner in a limited partnership investment arrangement may be identical to those of a mutual fund manager who specifically is excluded from the proposed consolidation requirements.

Use of the equity method of accounting by a general partner having a de-minimus equity interest in a limited partnership has been accepted accounting practice for many years, and we do not believe that users of financial statements have pressed for change. Although we are aware that the Board studied "*real*" situations in which less than majority owned controlled entities currently are not consolidated in practice and believe we could support consolidation in some of those "*examples*," the ED's premise that control alone is sufficient to require consolidation surely could result in a company consolidating an entity in which it has only a one percent interest. We believe the resulting "*gross-up*" in the financial statements for the assets, liabilities, revenues, expenses, gains and losses relating to the 99 percent "*non-controlling*" interests is inappropriate as it would seem to result in reducing rather than increasing the usefulness of the affected financial statements.

*Application of the Proposed Consolidation Policy Standard to Specific Circumstances*

Although the power to control, the level of ownership interest, and the flow of benefits oftentimes are interdependent, there exist business structures that disconnect those relative relationships. In those situations, as suggested in the alternative views expressed by one Board member in paragraph 143 of the ED, we believe the absence of a "*level of benefits test*" leaves constituents with insufficient guidance to appropriately assess the consolidation issue. For example, it is unclear whether the proposed criteria for consolidation are intended to capture a 35-percent owned entity (below the presumptive threshold for effective control) when a related arrangement or instrument provides a level of benefits (i.e., net cash flows) disproportionately higher than those represented by the minority equity interest. Similarly, although paragraph 172 of the ED distinguishes a lender's ability to "*influence*" from a parent's ability to "*control*," it is unclear how to evaluate the relative aggregate power of a minority shareholder who also has extended significant credit to an entity. Such relationships particularly are prevalent in real estate transactions and are complicated further, in terms of interpreting the ED's proposals for determining the existence of control, by debt and equity holdings residing both in different legal

entities within the consolidated group and in separate reporting entities subject to GAAP and SEC requirements.

Although not explicitly identified in paragraphs 160-172 of the ED under "*relationships that generally do not result in control of an entity*," insurance company Separate Accounts should be excluded from the proposed requirements for consolidation. As Board members are well aware, fee income is earned from the management of assets held in the Separate Accounts, however, the investment risks and rewards generally are transferred to the policyholders. Accordingly, we recommend that the Board clarify in the final statement that Separate Accounts are analogous to fund mangers and mutual funds explicitly identified in paragraph 162 of the ED.

*Temporary Control*

As noted in paragraph 88 of the ED, the Board decided to retain the temporary control exception to consolidation, as currently allowed both by ARB 51 and Statement 94, even though some Board members found no compelling conceptual reasons for that exception to exist. Although we support retention of the temporary control exception to consolidation, we believe that, in certain situations, the proposed one-year disposition window will burden the financial statements with information not central to the reporting entity's ongoing operations - an argument not to be confused with the nonhomogeneity exception already removed from consolidation practice by Statement 94.

For example, a creditor in a troubled debt restructuring might receive a majority voting equity interest in an entity in full satisfaction of existing debt instruments, accompanied by proportionate representation on the board of directors to facilitate implementation of the work out plan. Although the creditor thus becomes the controlling party, we do not believe that consolidation is meaningful in such a situation. The intent of the creditor is to recover its "*loan*" from the operations and ultimate disposal of its now "*unintentional subsidiary*;" in fact, insurance regulations otherwise would prohibit such investments but impose no specific time requirements for their disposal. Work out plans typically demonstrate management's intention to exit the operations in a 3-5 year period. Accordingly, we believe that the proposed definition of "*temporary control*" should include the situation described in this paragraph. As an analogous example, the Board most recently concluded that longer than a one-year horizon generally is needed for disposing of assets identified as "*held for disposal*" under FASB Statement 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of.

In addition to significant equity positions received in loan restructuring situations, it is our understanding that the Board's proposal also might bring into consolidation merchant banking portfolios not consolidated under current practice of most investment banking operations. Although the investment banking entity clearly might be the controlling entity, we do not believe that consolidation would be meaningful for those equity positions because they are intended to be held for investment purposes and ultimately disposed of for profit rather than integrated into the

operations as a subsidiary of the investment bank. Consequently, we share the view described in paragraph 96 of the ED and recommend that the Board consider broadening its proposed definition of "*temporary control*" to distinguish investments from subsidiaries.

## CONSOLIDATION PROCEDURES

### *Elimination of Intercompany Transaction and Balances*

Paragraph 21 of the ED requires that any gain or loss for difference in the carrying amounts of the issuer and acquirer of intercompany investments in debt securities be attributed entirely to the issuer and allocated between the controlling and noncontrolling interest based on their proportionate interest in the issues. However, we question whether the board intends that accounting procedures be followed when intercompany investments in debt securities exist between two subsidiaries, each having a noncontrolling interest. For example, if a 60 percent owned and controlled subsidiary purchased, at a discount, from a third-party a debt security issued by an 80 percent owned and controlled subsidiary of the same parent entity, we believe that intercompany transaction should be reflected by allocating 40 percent of a gain in consolidation to the noncontrolling interest of the purchasing entity. We believe that accounting is more representationally faithful of the economics of the transaction.

### *Changes in a Parent's Ownership Interest in a Subsidiary*

The Board concluded in paragraph 9 of the ED that "*once a subsidiary is consolidated, it shall continue to be consolidated until the parent's control ceases to exist.*" As illustrated in Example 1 of Appendix B of the ED, it is made clear when an entity loses "*legal*" control of a subsidiary - that is, the right to cast a majority of the eligible votes - consolidation must be maintained absent evidence to overcome the presumption of "*effective*" control. However, we believe that except in the most simplistic circumstances in which the parent's ownership is reduce below 50+ percent (such as the alternatives presented in Example 1), the presumptive approach might continue consolidation of entities when such practice is inappropriate and defer recognition of gain or loss.

For example, the process of nominating and electing directors might not take place until a reporting period subsequent to closing the transaction producing the change in the parent's ownership interest. Even then, a number of shareholders might not view the nomination of board members to be a substantial issue. Not casting a vote should not be presumed to be an indication of an inability to vote. The shareholders who do not vote on this issue might have very strong views on other issues on which they would vote. For example, certain shareholders might not cast a vote until they disagree with the board. Other shareholders might vote only on significant issues such as a change in control. Thus, the former parent might appear to have control but in fact, it exists only as long as enough other shareholders support (or do not take exception to) the decisions made by it. We do not believe that this type of so called "control" without legal authority should result in continued consolidation.

## *Conforming Accounting Policies and Fiscal Periods*

### *Conforming Accounting Policies*

Paragraph 31 of the ED would require subsidiaries using specialized industry accounting practices to conform those policies to those of the "*reporting entity*" when preparing consolidated financial statements. Although the Board's objectives for imposing that requirement are not immediately obvious from the ED, it appears to be directed at eliminating in consolidation the ability to select from acceptable accounting methods available as a result of the legal structure and form "chosen" for the operations of specialized industries. While we do not dispute the merits of achieving comparability for specialized industries included in consolidated financial statements, we disagree with the Board's approach to this issue. We believe that specialized industry accounting practices were developed and have been supported in practice because they are believed to be the appropriate standards for those specific business operations irrespective of their legal form (i.e., branches, divisions, separate legal entities, etc.). Therefore, we believe that there should be a requirement to retain specialized industry accounting practices in consolidation.

Requiring the use of specialized accounting practices in consolidation also would address our concern that the Board's proposal would introduce noncomparability in accounting in consolidation for the same operations depending on the accounting practices of the parent company. For example, we believe that under the Board's proposal, the same broker-dealer operations would be subject to different accounting requirements in consolidation depending on whether its parent company was a broker-dealer or a manufacturing entity. It is our interpretation that implementation of the requirements of paragraph 31 of the ED virtually would eliminate the use in consolidation of specialized industry accounting practices except in rare circumstances in which the parent company operates in the same specialized industries. We believe that result will confuse users of financial statements to the extent specialized industry practices used in preparing separate financial statements of public subsidiaries produce results different from practices used to account for those operations in the consolidated financial statements and to the extent segment disclosures might apply a basis of accounting different from that used in the consolidated financial statements.

If the Board feels compelled to retain the proposed requirements, we believe that there is a significant need for implementation guidance. As currently drafted, we have been unable to locate in the ED a definition of the"reporting entity" or guidance for determining its identity. We believe that absent such definition or more specific guidance, it is unclear what accounting policies should flow to the consolidated financial statements. For example, some companies operate under the structure of a holding company not entitled to any specific specialized industry practices. Under current practice, the specialized accounting policies of each subsidiary of the holding company, i.e., insurance, investment company, and broker-dealer - survive to the consolidated financial statements. Under the proposed standard, it is unclear whether the holding company is the reporting entity or whether one of its primary business operations somehow must be identified as

the primary reporting entity. If the Board's intent is for the holding company to be the reporting entity, it is unclear how to implement the proposal to conform accounting policies -- that is, must all specialized industry accounting practices be reversed in consolidation or may the holding company in consolidation adopt the specialized industry practices of one or more of its subsidiaries in the absence of specialized accounting practices of its own.

While we believe further clarification by the Board is needed on the issue of conforming accounting practices, we strongly urge the Board to reconsider its position. Specialized industry accounting practices are no less relevant in consolidated financial statements than in the stand alone financial statements of those operations and we do not believe that position is inconsistent in any way with the underlying concept advanced in the ED of a single economic entity. Furthermore, we believe that the ED is proposing to change a long-standing generally accepted accounting practice which few perceive a need to change and which would result in less meaningful financial statements.

*Conforming Fiscal Periods*

The ED proposes to eliminate the guidance in ARB 51 allowing a difference in consolidated financial statements of up to three-months between a subsidiary's fiscal period and that of its parents, provided that there is adequate disclosure of the effect of material intervening events. In paragraph 133 of the ED, the Board states its belief that since issuance of ARB 51 in 1959 "*improvements in telecommunications and management information systems and techniques make that accommodation no longer necessary.*" While we share the belief that tremendous strides have been made in the communication of financial information, it also is clear the proposed standard would require consolidation of many entities not consolidated under existing practice.

For example, the proposed standard would require consolidation of many types of entities such as investment partnerships, now accounted for under the equity method and for which the three-month lag period currently is applied because of the unavailability of more up-to-date financial data. Although the ED presumes a sole general partner with de-minimus equity interest controls a limited partnership for purpose of preparing consolidated financial statements, we believe that it is unrealistic as a practical matter to presume that the general partner can control the timeliness of financial information received from the limited partnership. Perhaps that point should lead the Board to reconsider whether those "*investments*" should be consolidated under its current notion of control.

Elimination of the three-month lag period is another example in the ED of a proposed change to a long-standing generally accepted accounting practice which few perceive a need to change and we are unaware of any significant problems in this area. While we urge the Board to reconsider its position of the issue of conforming fiscal periods, we at least recommend that the Board consider some transition provisions that allow for time to "*educate*" newly-consolidated subsidiaries of their reporting requirements. Alternatively, we recommend that the Board consider amending the disclosure only requirements of paragraph 4 of ARB to require recognition in consolidated

financial statements of the effect of material intervening events that occur during the three-month lag period.

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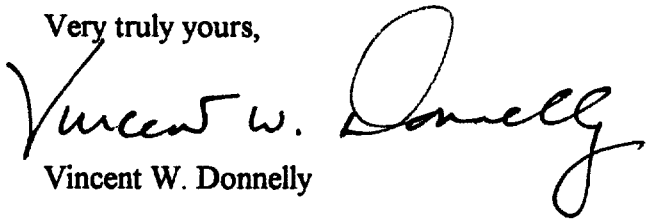
We would be pleased to discuss our comments with you, other members of the FASB staff, and Board members.

Very truly yours,



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