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Executive Vice President and General Counsel Legal & Regulatory Policy Letter of Comment No: 24A File Reference: 1082-154

Date Received:

American Stock Exchange

January 17, 1996

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

Dear Mr. Lucas:

Attached is the American Stock Exchange's comment letter to the Financial Accounting Standards Board Exposure Draft, Consolidated Financial Statements: Policy and Procedures.

I would also like to confirm that the Exchange does desire to speak at the public hearings to be held on February 20 and 21, 1996. I will make the presentation for the Exchange. My phone and fax numbers are indicated above.

Very truly yours,



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January 17, 1996

American Stock Exchange

Mr. Timothy S. Lucas
Director, 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 Mr. Lucas:

In the exposure draft titled "Consol idated Financial Statements: Policy and Procedures" (the "Exposure Draft"), the Financial Accounting Standards Board ("Board" or "FASB") solicits comment on a series of proposals that "would establish standards that specify when entities should be included in consolidated financial statements and how consolidated financial statements should be prepared." ¹ Corporations that regularly engage in acquisitions or other parent-subsidiary transactions would be affected by the proposals, which would significantly alter their financial reporting.

The American Stock Exchange ("Exchange" or "Amex") appreciates the opportunity to comment on the proposals, and respectfully opposes them. We believe the proposals would result in significant changes to financial reporting that are not necessary, are unlikely to address issues over which the Board has expressed concern, may result in less useful financial reporting and would likely impede the Exchange's ability to analyze financial statements of potential and existing listed companies.

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¹ Exposure Draft Summary.

The American Stock Exchange

The Exchange is a national securities exchange registered with the Securities and Exchange Commission, and one of the three primary securities markets in the United States.

As a self-regulatory organization under the Securities Exchange Act of 1934 ("Exchange Act"), the Amex has special rulemaking, oversight and enforcement responsibilities.² In fulfillment of its statutory requirements, the Exchange has adopted a variety of financial listing guidelines, a number of which relate to a company's pre-tax income and shareholder's equity.³ Similarly, the Exchange has adopted continued listing guidelines which are based upon an issuer's reported income and equity.⁴ Primary market listing standards are at the cornerstone of the integrity of the public marketplace, which is also reliant upon the fundamental premise that the conduct of a fair and orderly market requires every listed company to make available to the public the information necessary for informed investing. These policies seek to enhance the efficiency of the markets, to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts and practices and to protect investors and the public interest by ensuring prompt public dissemination of material information.

The Exchange relies upon companies' financial statements in its listing decisions. Companies that apply for listing on the Exchange must include in their application materials their latest annual and interim financial statements,⁵ which are integral to Exchange determinations regarding initial and continued listing.

⁵ See Section 211 of the Amex Company Guide. <u>See also</u> Section 12 under the Exchange Act (registration requirements for securities).



² <u>See</u> Exchange Act § 6, 17, 19 and the regulations thereunder.

³ See Part I of the Amex Company Guide.

⁴ See Part X of the Amex Company Guide.

Furthermore, as a condition of their listing companies must furnish shareholders with annual reports and release quarterly sales and earnings information.⁶ Administration of these provisions is a fundamental Exchange function, requiring significant staff time and resources. It represents an important device in maintaining the integrity of the U.S. securities markets.

As discussed below, the Exchange believes that several aspects of the Exposure Draft could impede the Exchange's ability to analyze its listed companies as well as companies seeking an Exchange listing. Moreover, the Exchange and members of the public may not receive an accurate depiction of the financial condition of listed companies in which they have or may wish to invest. This in turn could compromise the integrity of the U.S. securities marketplace and the capital-raising process. Our specific comments follow.

Consolidation Policy

The proposal emphasizes effective rather than legal control as the standard in determining whether consolidation of financial statements is required in a parent-subsidiary relationship. The Exposure Draft states that a number of comments received from the Discussion Memorandum and the Preliminary View document support the view that control <u>and</u> a majority or significant ownership interest is the appropriate criteria for consolidation. We support this latter view.

We believe that the existence of both control and significant ownership justifies combining the assets, liabilities, revenues, expenses, gains and losses of the subsidiary on a line-by-line basis with those of the parent in consolidated financial statements. We disagree with the premise in the Exposure Draft that all entities over which a controlling entity has effective control should be consolidated. Several of

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⁶ For a detailed description of these requirements, see §§610-624 of the Amex Company Guide.

the factors cited by the Board to assess the existence of effective control in paragraph 14 of the Exposure Draft are subjective. The ability to "dominate the process of nominating [board members]," the lack of any "other party or organized group of parties ha[ving] a significant interest," and the ability to obtain legal control "without assuming risks in excess of the expected benefits from the conversion [into a majority voting interest]" may be too indeterminate to provide workable guidelines as to when effective control exists.

The ability to control the assets of an entity and the ability to profit from the use of those assets are different. By requiring consolidation where a parent company has in fact only a minority ownership in the other entity, the relationship between the assets a company reports and the assets from which a company can profit is distorted.

Consolidation Procedures

The adoption of the Exposure Draft would likely burden regulators and investors with the task of deciphering confusing and often inconsistent financial reports. In making important initial and continued listing decisions, Exchange staff must analyze carefully issuers' financial statements. The proposals would make this task more difficult in several ways, and the ability of financial reports to inform regulators and investors of the economic impact that a complex transaction has on a company's financial health would be impaired. We agree with the majority of respondents to the Discussion Memorandum that the Board should retain the parent

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⁷ Exposure Draft ¶ 14(b).

⁸ Exposure Draft ¶ 14(a).

⁹ Exposure Draft ¶ 14(c) and (e).

company approach rather than adopting the economic unit approach for accounting for acquisitions of equity investments in a subsidiary.¹⁰

As noted above, the Exchange has adopted original and continued listing guidelines which are based in part upon a company's shareholders' equity.

Consistent with current accounting practice, the Exchange staff does not consider minority interest when evaluating listing eligibility. However, under the new proposals, companies which today fall short of our equity guideline might appear to be fully qualified to list. Moreover, increasing the net worth of the parent company by including minority interest within equity may not provide shareholders of the parent with an accurate depiction of the ownership of the parent's assets.

The provisions in paragraph 29 of the Exposure Draft, "Changes in a Parent's Ownership Interest in a Subsidiary", are particularly troubling to us. In conformity with this paragraph, a parent company selling a minority interest in its subsidiary's shares (i.e., retaining a controlling interest) would be precluded from recognizing a gain or loss upon the sale. However, if a similarly situated parent company were to sell a majority interest in its subsidiary's shares (i.e., retaining only a minority interest), it would recognize a gain or loss. We believe that the accounting treatment in each case should be the same, as it is under present application of GAAP, since in both cases the parent company's shareholders are affected in the same way. The parent's shareholders would likely regard the ownership interest in the subsidiary's shares as an asset of the parent. Thus, upon the sale of the asset, the parent company should recognize a gain or loss regardless of whether it retains a controlling interest.

Furthermore, this aspect of the proposal can distort the results of a parent company which sells a subsidiary in a "two-step" transaction. Consider the following example: Co. Y is a wholly-owned subsidiary of Co. X and its assets are

¹⁰ Exposure Draft ¶ 111.



carried on Co. X's financial statements at \$100 million. Co. X determines to sell Co. Y for \$80 million. If done in one transaction, Co. X would have to report a \$20 million loss on the sale. However, under the Exposure Draft Co. X could avoid reporting 49 percent of this by selling a 49 percent minority interest in one transaction and the remaining 51 percent in a subsequent transaction. Because the Exposure Draft does not treat the sale of a minority stake as the sale of an asset, the company could charge the loss on the sale of 49 percent directly to equity, and avoid reporting a loss of \$9.8 million.

A parent company could also utilize a two-step transaction to recognize a gain from the sale of a subsidiary even though the parent sold the subsidiary's shares at less than what it originally paid for the subsidiary in total. Under the proposal, once a company establishes a controlling position in a subsidiary, it is precluded from recognizing goodwill on subsequent steps in acquiring all or part of the minority interest. Instead, the parent would reflect such subsequent investments as charges to its equity. As a result, a parent could avoid reporting up to 49 percent of a subsidiary's goodwill merely by structuring the acquisition in two steps. As shown below, this creates the possibility that an accounting gain would be recognized even if the subsidiary were later sold at an economic loss.

Consider the example where a parent acquired the first 51 percent of the subsidiary for \$10 million, and the second 49 percent for \$10 million. Assume further that the fair value of the subsidiary's net assets are \$8 million at the time of the acquisition and remain constant. No goodwill is recorded on this second transaction, and the \$10 million purchase price for the 49 percent would decrease shareholders' equity. After the acquisition, the parent's net assets related to the subsidiary would be \$13.92 million (\$8 million of tangible assets plus goodwill of \$5.92 million). If the subsidiary is then immediately sold for \$15 million, the parent company would show a profit of \$1.08 million. We believe that a typical financial



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statement user would expect the net result of these transactions to be a loss of \$5 million, and would be misled by the proposed treatment. Current accounting treatment would more accurately reflect the economic reality of the transaction.

In sum, the Exchange respectfully opposes adoption of the consolidation policies and procedures in the Exposure Draft. The Exchange believes that, if adopted, the proposals would produce financial statements that distort a company's perceived economic status, which in turn could adversely affect the securities marketplace.

The Exchange appreciates the opportunity to comment on these important proposals. If you have any questions, please feel free to contact me at (212) 306-1400 or Michael Emen at (212) 306-1482.

Very truly yours,

