JPMorgan

January 16, 1996

Letter of Comment No: 102
File Reference: 1082-154
Date Received: 1/18/96

David H. Sidwell
Managing Director
and Controller

Morgan Guaranty
Trust Company of
New York

60 Wall Street
New York NY
10260-0060

Tel: 212 648-9095

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

Exposure Draft, *Consolidated Financial Statements: Policy and Procedures*
File Reference No. 154-D

Dear Mr. Lucas:

We welcome the opportunity to provide our comments on the Exposure Draft, *Consolidated Financial Statements: Policy and Procedures* ("ED"). Our comments on both aspects of the ED are summarized below.

Consolidation Policy

As noted in our response to the Board's August 1994 Preliminary Views on Consolidation Policy, we believe that the long-standing practice of consolidation based on control of a majority voting interest has been widely accepted and helpful to the financial statement user community. Consequently, we do not believe there is a need to replace the existing consolidation policy framework completely. Rather, we would recommend additional guidance, within the current framework, to resolve significant questions raised about consolidation policy, particularly with respect to nonstock entities and special purpose entities. We are concerned that the practical effect of the ED will be the replacement of the simple and operational model that we have today with an ambiguous and highly subjective approach that can only lead to inconsistent reporting by entities in similar circumstances. We disagree that the ED improves the "completeness and thus relevance and reliability of information provided by consolidated financial statements." Therefore, we do not support the finalization of this standard.

In our view, the ED's exclusive focus on control as the basis for consolidation is flawed and does not improve the usefulness of financial reporting. We continue to believe both control and level of ownership of residual interests ("beneficial interest"), two separate and necessary conditions, should be considered when evaluating whether an entity should be included in another entity's consolidated financial statements. Ownership of a majority of the beneficial interest enables the parent to enforce and realize the benefits of its investment in the subsidiary. It is this ability, in addition to controlling the entity's policies, budgets and personnel, that justifies consolidation.

A subsidiary of
J.P. Morgan & Co.
Incorporated

We are especially concerned about the ED's presumptive approach to effective control and related consolidation consequences. Whereas legal control is tested, enforceable at law, and subject to corroboration, we believe that effective control is untested, not legally enforceable, and difficult to assess, requiring numerous judgments. Consequently, we do not believe that the concept of effective control is operational, and think it will be insufficient to ensure the ED's consistent application across entities in similar circumstances. The ED's extensive implementation guidance on effective control lends support to this view.

In addition, we have noted inconsistencies between the ED and FASB's Exposure Draft, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("Transfers ED"). Under the requirements of the Transfers ED, a transferor has surrendered control over financial assets, and therefore can account for the transfer as a sale, if the assets are "put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy." FASB acknowledges that judgments about legal issues will be required in order to determine if this criterion has been met. Legal issues have also been important to users of the financial statements in evaluating consolidation matters as evidenced by the current framework. In our view, the recognition standard under effective control is inconsistent with the derecognition standard in the Transfers ED, since the recognition standard has no standing at law and is also less precise than the current framework. It is imperative that the Board synchronize the guidance between the ED and the Transfers ED before issuing final Statements.

We also note that the Transfers ED discusses transactions with "qualifying special purpose entities" and refers preparers to the ED for further consolidation guidance; however, there is no guidance in the ED for qualifying special purpose entities. We also believe the guidance in the Transfers ED is internally inconsistent in that paragraph 9 of that document states that a transfer to a qualifying SPE indicates that control has passed from the transferor to the qualifying SPE, while paragraph 23b. states that the transferor may still retain control of the qualifying SPE. We do not believe it is possible to give up and retain control at the same time. The FASB should correct this contradiction by removing the last two sentences in paragraph 23b. of the Transfers ED, and clarify this issue in the ED. In addition, we found the examples involving special purpose entities in Appendix B of the ED of limited utility.

We further recommend the ED include definitive consolidation guidance for special purpose entities other than "qualifying special purpose entities." Based on our experience, we would recommend the Board consider the interaction of each of the following factors when formulating consolidation guidance for special purpose entities ("SPE):

- Source of the SPE's assets -- where the SPE's structuror is not the owner/originator of the assets, consolidation of the SPE should not be required.
- Owner of SPE -- substantive equity (3%) in the SPE provides a consolidation safe harbor for the structuror. Where the SPE issues certificates which represent undivided beneficial interests in the underlying assets of the SPE, the owners of the certificates would be deemed the owners of the SPE. Whereas, when notes (i.e., debt) are issued by the SPE, the noteholders are viewed as secured creditors and other factors must be considered to determine the appropriateness of consolidation.
- Control of SPE -- where substantive equity exists, it is presumed that the equity owner controls the SPE. To the extent substantive equity does not exist, other factors, similar to those outlined in the ED as indicators of effective control, must be considered to determine who controls the SPE.
- Risks and rewards associated with the assets of the SPE -- The recipient of a majority of the risks and rewards would generally be presumed to be the owner of the SPE. The extent and profitability of services provided by the structuror to the SPE does not affect the consolidation treatment.

Consolidation Procedures

We strongly disagree with the ED's requirement to conform the accounting policies of subsidiaries operating in specialized industries to the policies of the parent. In our view, industry specific GAAP developed by the AICPA's Accounting Standards Executive Committee is responsive to the needs of financial statement users. We question whether those same accounting rules are no longer appropriate when a subsidiary is consolidated into its parent. To require industry specific accounting practices to be reversed in consolidation to achieve consistency within the reporting entity seems inconsistent with the presumption that consolidated financial statements are more meaningful than separate statements.

Our additional comments are provided in the Attachment to this letter. We would be pleased to discuss this letter and Attachment with you at your convenience.

Sincerely,

Attachment

ATTACHMENT

Consolidation Policy

Control of an Entity

In evaluating whether an entity should be included in another entity's consolidated financial statements, we believe that both control and level of ownership of residual interests ("beneficial interest"), two separate and necessary conditions, should be considered. We support the alternative view expressed by one Board member in paragraphs 139-144 of the ED. Specifically, we believe "that assets and liabilities of a controlled entity should be consolidated only in situations where the ultimate net cash inflow or outflow from those assets and liabilities inure substantially for the benefit of, or detriment to, investors in the parent." For situations where an entity has control of another entity but does not have a majority beneficial interest in that entity, in our view, the investment is better presented on either an equity or cost basis as prescribed in APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. In addition, we believe that a similar conceptual framework could be applied to questions related to investments in nonstock entities.

Consolidation Procedures

Conforming Accounting Policies

We strongly disagree with the ED's requirement to conform the accounting policies of subsidiaries operating in specialized industries to the policies of the parent. In our view, industry specific generally accepted accounting principles developed by the AICPA's Accounting Standards Executive Committee provide a more meaningful presentation of information to the financial statement user community, and we do not see the benefit of undoing this progress by conforming principles in consolidation. We do not believe the mere mechanics of consolidation serves as justification for reversing industry specific practices, which have been developed to provide the most accurate reflection of specialized subsidiary activity.

During our evaluation of this section, we considered the following questions for a holding company with banking, insurance and brokerage subsidiaries which accounts for similar transactions following industry specific GAAP:

- Which subsidiary's policies should be conformed in consolidation (e.g., broker-dealers are specifically excluded form the scope of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*)?
- What constitutes generally accepted accounting principles for this holding company?

We believe that faithful representation of the financial condition and results of operations of specialized industry subsidiaries is achieved by the application of specialized industry accounting, and that application of banking practices to a brokerage or insurance subsidiary, or vice versa, fails to achieve such results. We refer the Board to the consensus reached in EITF Issue No. 85-12, *Retention of Specialized Accounting for Investments in Consolidation*, as support for the current practice.

Reporting Noncontrolling Interest in Financial Statements

We concur with the Board's conclusion that noncontrolling interests do not meet the conceptual definition of a liability. Furthermore, we do not believe that noncontrolling interests are viewed by users of the financial statements as equity. Including noncontrolling interests in the equity section would distort a very important element of the financial statements and reduce its meaningfulness to financial statement users. On a related point, we do not see the benefit of the Board's proposal to allocate net income between controlling and noncontrolling interests. This presentation could lead to confusion. As an alternative to guidance contained in the ED, we would recommend that the Board codify the current presentation of these amounts in the financial statements.