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January 22, 1996

Mr. Timothy Lucas  
 Director of Research and Technical Activities  
 Financial Accounting Standards Board  
 File Reference 154-D  
 401 Merritt 7  
 Norwalk, CT 06856-5116

Dear Tim:

On behalf of our members, the American Bankers Association (ABA) appreciates the opportunity to submit its comments on the Exposure Draft entitled Consolidated Financial Statements: Policy and Procedures (Consolidation ED). The ABA is the only national trade and professional association serving the entire banking community, from small community banks to large bank holding companies. ABA members represent approximately 90 percent of the commercial banking industry's total assets, and about 94 percent of ABA members are community banks with assets less than \$500 million.

In attempting to define control for purposes of determining when to consolidate assets and liabilities at the parent company level, the Consolidation ED proposes a definition of effective control that would misrepresent certain financial transactions and the financial condition of bank holding companies. The primary impetus for the Consolidation ED was to address AICPA questions on consolidation policy for subsidiaries that are controlled by means other than majority ownership by supplementing the notion of control in FASB Statement No. 94: Consolidation of All Majority-Owned Subsidiaries (FASB 94). However, in doing so, the criteria for determining consolidation policy has been made less clear, and the resulting financial statements may be less informative to financial statement users. We do not believe that the existing standard for consolidation based on ownership of a majority voting interest needs to be superseded. In our view, relying solely on the proposed criteria to assess existence of effective control (in paragraph 14 and Appendix B), in cases where an entity holds either a majority or minority voting interest, would mischaracterize a consolidated entity, and, therefore, would not fulfill the Board's statement (in paragraph 54) that the purpose of consolidated financial statements is to:

...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 (paragraph 7)".

We believe that consolidation ought to occur when an entity has the legal right to control the use of individual assets and liabilities as if they were its own and has a majority ownership interest in the associated cash flows. Paragraph 10 defines control as the "power to use or direct the use of the individual assets of another entity in essentially the same ways as the controlling entity can use its own assets" (emphasis added). Control of another entity is also evidenced by the parent being able to regulate access to a subsidiary's assets by noncontrolling shareholders, creditors, and others (paragraph 11). The legal right to control individual assets and liabilities as if they were an entity's own is the precursor to having a majority ownership interest in the associated cash flows, and the purpose of consolidated financial statements is to accurately report these facts (as stated in paragraph 7). We believe that the current framework for consolidation embraces these concepts and provides meaningful financial statements. The proposed definition of effective control does not embody these concepts and will make consolidated financial statements less valuable informational tools.

#### Definition of Control and Impact on Financial Instruments

The balance of this letter focuses on instances where the financial reporting for certain types of transactions would suffer if the proposed criteria for identifying effective control supersedes existing consolidation policy. The proposed definition of effective control (outlined in parts of paragraph 14 and Appendix B of the Consolidation ED) fails to improve the relevance and representational faithfulness of consolidated financial statements because entities would have to consolidate the assets and liabilities that underlie certain financial transactions even if they do not have legal control over the majority of benefits from those transactions. Banks could be particularly affected in their activities as sponsors of securitizations, managers of special purpose funding corporations, underwriters of convertible debt, or lenders in troubled debt restructurings.

#### Paragraphs 14a and b

These paragraphs would be difficult to implement because there is subjectivity in determining whether a "party or organized group of parties" has a significant enough interest to usurp the control of a large minority voting interest (paragraph 14a) or whether an entity has demonstrated an ability to dominate board elections (paragraph 14b). Under the proposed paragraphs, it is not unrealistic to expect that there would be difficulty in determining which of two entities with a large minority voting interest in a subsidiary (such as 40% and 35%) should consolidate the assets and liabilities of a single subsidiary. The deficiencies in these proposed criteria would be exacerbated if a large

creditor maintains rights to a significant amount of equity and voting interest (such as 30%) through a convertible debt instrument. Existing consolidation policy already provides a consistent and appropriate answer that no one controls the assets and liabilities of the subsidiary, and we see no reason to supersede it with the proposed definition of effective control in the Consolidation ED.

#### Paragraph 14c

We are concerned about the impact of paragraph 14c on convertible debt holders because it might result in a holder of convertible debt having to consolidate the assets and liabilities of the debtor onto its balance sheet in cases where the creditor has not yet exercised its legal rights to exert control over the debtor. If this assessment is correct, paragraph 14c would misrepresent the financial condition of the debtor and creditor to financial statement users. Convertible debt gives the creditor the option to convert the obligation into an equity ownership position, but conversion is typically dependent on the operating performance and financial condition of the debtor. The creditor has not assumed the unilateral ability to obtain a majority, or large minority, voting interest until it converts the debt into equity. Paragraph 153 of the Consolidation ED concurs that current control might not exist if conversion rights require other future events, but this point needs to be made clearer in paragraph 14c.

Until the conversion, the debtor retains control over its assets. The creditor cannot obtain access to the debtor's assets, and the debtor can use them to retire, restructure, or refinance its debt. Convertible debt should be treated the same as a secured loan, and the underlying collateral should not be consolidated into the creditor's balance sheet. It would be misleading to consolidate the assets and liabilities of the debtor onto the creditor's balance sheet prior to this conversion, because the resources and obligations remain with the debtor, and noncontrolling debtors and current shareholders, until the creditor has legal control over the debtor. Not until the creditor converts the debt into equity does the creditor have the ability to obtain and regulate access to probable future economic benefits from the debtor's assets, thereby failing the definition of an asset that is cited in paragraphs 59 and 146 of the Consolidation ED [paragraphs 25-31 of Financial Concept Statement No. 6: Elements of Financial Statements].

#### Paragraph 14d

ABA's primary area of concern with respect to the proposed definition of effective control and its consolidation consequences is whether assets that are securitized through a special purpose entity, such as a trust, would have to be consolidated back into the sponsor's balance sheet. We believe that asset securitizations that qualify for derecognition in the Exposure Draft, Accounting for Transfers of Assets and Extinguishments of Liabilities, should not be consolidated into the sponsor's balance sheet. However, the Consolidation ED provides conflicting guidance in the body of the

proposed standard and Appendix B on whether sponsors of asset securitizations have control over the transferred assets and, therefore, should consolidate the securitized assets.

For the most part, it appears that paragraph 14d would not require consolidation of typical asset securitization activities because they are facilitated through special-purpose trusts, which give legal rights to control of the underlying assets and liabilities to the investors rather than the sponsor. Special-purpose trusts are structured to isolate the assets from the sponsor to insure that the financial condition of the sponsor does not impact the cash flows from the securitized assets. Restrictions on the sponsor include the inability of the sponsor to get the receivables back, collecting cash flows through lock-boxes, establishing accounts in the name of trustees, and giving trustees the right to replace the servicer. The sponsor has no control over the investor's interest in the trust, and the investor is free to pledge or sell its certificates in the trust without sponsor consent. The sponsor cannot change the initial purpose of the trust without the investor's consent and cannot select the specific receivables that are transferred to the trust. The sponsor has no control over the assets that are transferred into the trust nor the corresponding cash inflows from those assets, unless it maintains a subordinate position to the senior interests of the investor. In these cases, the investor receives a much larger share of future cash flows from the securitized receivables.

However, paragraph 154 of Appendix B states that special-purpose entities limited by their creating instruments may indicate that sponsors have effective control, and, therefore, consolidation by the sponsor would be required. Paragraph 157 further explains that the circumstances in paragraph 154 would leave little doubt about the sponsor's ability to control the assets in another entity and that control is presumed to exist without evidence to the contrary. The legal structure of special-purpose entities are strictly limited by the sponsor for the benefit of the investor, and the investor retains the essential legal rights of control over its investment, the underlying assets, and a priority position on the associated cash inflows. Therefore, the sponsor should not consolidate the special-purpose entity into its balance sheet. Appendix B of the Consolidation ED should be clarified so that securitizations that give the investor legal control over its interest and the activities of the special-purpose entity does not require the sponsor to consolidate the special-purpose entity.

We are also concerned that conflicting statements about the indicators of control might be misinterpreted by preparers of financial statements and their auditors and would result in banks being required to consolidate the assets and liabilities of special-purpose funding corporations that they manage for other entities. For a fee, banks organize special-purpose funding corporations with investors to finance the purchase of corporate loans on the open market at competitive rates. Paragraph 158f states that a relationship between two or more entities formed to hold assets that generates income for either or both entities is an indicator that effective control is present. However, we believe that paragraph 14d would not require consolidation of the special-purpose funding corporation because the voting stock, voting rights, and assets are held by the investors,

and the investors outline the operating procedures for management of the corporation. Furthermore, the loans are purchased on the open market, not from the bank managing the corporation, and the majority ownership interest in cash flows rests with the investor. Even though banks may have a management role in the special-purpose funding corporations, we believe that the relationship does not exhibit the characteristics of control as discussed in paragraph 161. We recommend that the Consolidation ED be amended to clarify that an entity would not be required to consolidate a special-purpose funding corporation that it manages or sponsors as a conduit for business and generating fee income.

#### Paragraph 14c

Paragraph 14c states that the unilateral ability to dissolve an entity and assume control of its individual assets is evidence that effective control exists. We are concerned that this criterion could prematurely cause creditors to consolidate the assets and liabilities of debtors whose own equity is the collateral for loans that are subject to troubled debt restructurings. The arguments against consolidation in this situation are the same as those for convertible debt, as outlined in our comments on paragraph 14c. Even though there is a higher than normal risk of non-performance in these lending transactions, the creditor has not assumed control over the debtor and its assets until it has legally affirmed its contractual rights to the collateral. The ability to act upon a bank's security interest in collateral is typically predicated on performance measurements as stated in the loan documentation. Until the creditor has converted its security interest into actual ownership, the debtor has legal control over its assets and the obligation to fulfill its liabilities. We recommend that paragraph 14c be clarified so that only unconditional conversion rights that are not predicated on future and uncertain events be part of the criteria to assess effective control, as outlined in paragraph 153.

#### Temporary Control

We disagree with setting a time limit on the obligation of a parent to relinquish control of a new subsidiary as an exemption for consolidation. A one year time limit on the obligation to relinquish control is arbitrary and would create operational difficulties for bank holding companies that have controlling equity positions in other companies through their troubled debt restructurings or venture capital investments. Section 4(c)(2) of the Bank Holding Company Act, as implemented in Regulation Y at Section 225.22(c)(1), states that equity received in lieu of debt previously contracted must be liquidated within two years, unless the holding company receives annual extensions from the Federal Reserve Board for up to three additional years (total five year period). Bank holding companies may also obtain up to a 100% interest in Small Business Investment Companies (SBICs), but the SBIC may not exercise control over any company in its portfolio unless it is shown that temporary control, of not more than eight years, is necessary for the protection of its investment [13 CFR 107.801(c)-(d)]. Even though

bank holding company regulations limit the term of equity positions in commercial companies, the proposed one year time limit would cause banks to consolidate the assets and liabilities of a new subsidiary that it is obligated to relinquish. We believe that a legal obligation to relinquish control, no matter what the time period, should be a sufficient exemption from consolidating newly acquired subsidiaries.

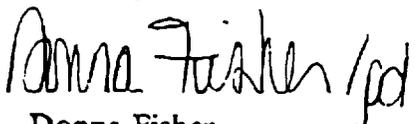
### Reporting Noncontrolling Interest in Subsidiaries

We believe that paragraph 22 would be misleading to financial statements users because it would require the noncontrolling interest in subsidiaries controlled by the parent to be reported in the equity section of the parent's consolidated financial statements. This could be misinterpreted as the noncontrolling entity having an equity interest in the parent company, when they only have an interest in the subsidiary of the parent company. We recommend that noncontrolling interests continue to be reported in the parent company's consolidated balance sheet as a separate item between the liabilities and equity sections.

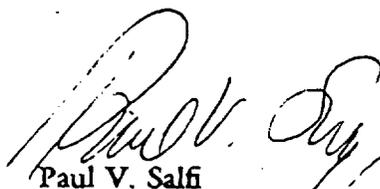
### Effective Date

If the current consolidation policy standard is superseded by the proposed criteria for effective control in the Consolidation ED, the effective date should be postponed until fiscal years beginning after December 15, 1997. It will be time consuming for entities to adapt their reporting systems and restate prior periods under the proposed criteria for determining effective control. We encourage the FASB to reconsider whether the existing standards for consolidation need to be replaced. Any definition of effective control should include both the legal right to control assets and liabilities as if they were an entity's own and having a majority ownership interest in the associated cash flows.

Sincerely,



Donna Fisher  
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Paul V. Salfi  
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