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Financial Accounting Standards Board
401 Merrit 7
P.O. Box 5116
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Re: Exposure Draft on Consolidated Financial Statements: Policy and Procedures
File Reference No. 154-D

Dear Mr. Lucas:

The Chase Manhattan Corporation and Chemical Banking Corporation (collectively the "Corporations"), in anticipation of their merger, are writing a joint response letter commenting on the Financial Accounting Standards Board's (the "Board's") Exposure Draft on Consolidated Financial Statements (the "ED").

The ED would supersede, among other pronouncements, FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* ("SFAS 94"), which provides guidance regarding consolidation. SFAS 94 requires consolidation when there is a controlling financial interest, for which the usual condition is ownership of a majority voting interest. This existing standard is conceptually sound, is easily applied, and should remain the foundation for accounting guidance on consolidation matters.

While the Corporations, in principle, welcome the Board's attempt to clarify when control exists, clearly the Board's attempt has generated more issues and ambiguities than currently exist in practice. As a general statement, the ED discusses vague and ambiguous concepts and fails to provide workable practical implementation guidance. Given this inherent weakness in the ED, it is difficult to assess its impact. For that reason, we do not support its issuance as a final standard.

A prime example of this is the overlap between circumstances that the Board has identified as leading to a presumption of control versus those circumstances that may be indicators of control. Paragraph 152 discusses presumptions of control and states that "effective control of a corporation is usually evidenced by a present ability to elect or appoint a majority of the members of its governing board without the legal right to do so." However, paragraph 158.a.

lists as an indicator of control “an ability to cast a majority of the votes usually cast in an election of directors.” The Corporations question how it could be possible for a particular circumstance to be considered both an indicator and presumption of control. Most financial statement preparers will also have difficulty determining the difference between presumptions and indicators.

The Board should clarify its statement of when control is presumed to exist and provide relevant guidance on how the ED would be implemented prior to issuing a final Statement of Financial Standards. In the interest of due process, the Board should allow financial statement preparers additional time to respond to any revisions by the Board. The only reasonable means of doing this would be for the Board to issue a revised exposure draft documenting its updated and clarified thoughts.

Categories of Control

Consolidation should be required whenever one entity has legal control over another entity through an unconditional right that is enforceable at law. This conclusion is obvious when the controlling entity owns a majority of shares in a corporation that issues only a single class of stock having rights to elect or appoint a majority of the governing board. However, when control is deemed to exist through effective control, it becomes more difficult to determine at what point the ability to influence another entity becomes “control.” In practice, each situation is different and the level of control must be assessed based on the individual facts and circumstances. Situations in which an entity owns less than a majority of the voting rights but, nevertheless, actually controls the other entity are rare.

Presumptions of Effective Control

The Board has provided examples in paragraph 14 of the ED of circumstances that represent presumptions of control. Because the circumstances provided as presumptions will automatically lead to a control/consolidation conclusion absent evidence to the contrary, it is essential that the circumstances be noncontroversial and nonrebuttable. The circumstances provided as presumptions do not pass these necessary tests.

In addition, the presumptions may lead to results that are contrary to the Board’s stated intention when the decision was made to add this project to its agenda; namely to respond to questions raised by some constituents on previous accounting pronouncements. As the ED is written, it is likely to produce a great outcry for additional guidance. Another objective of the Board was to eliminate inconsistent practices. The presumptions are written so broadly that a significant amount of judgment will be required to determine whether a presumption of control has been met and whether enough evidence to the contrary exists to overcome that presumption. In practice, when that level of judgment is required, it is unlikely that similar entities in similar situations will reach the same conclusion. Therefore, diversity in practice will likely increase.

Further, the circumstances leading to a presumption of control are written in such a manner that they will lead to inconsistency in financial statement presentation for reporting entities over

different periods. This result occurs because the presumptions are fixated on one-time events as opposed to a long-term evaluation of the relationship between a “controlling” and “controlled” entity. A direct result will be that an entity that does not currently consolidate another entity may be required to consolidate it in a future period and then not consolidate it in subsequent periods. The following examples illustrate the problems of fixating consolidation evaluations on one-time events.

One of the presumptions of control proposed in the ED is when one party owns a large minority voting interest (approximately 40 percent) where no other party or organized group of parties has a significant interest. This presumption relies on the assumption that such an entity will be able to control the individual assets of the “controlled” entity and direct the use of those assets, since there is no other party or an organized group of parties with a large interest. However, the inherent flaw with this presumption is that it ignores the fact that control in such a situation becomes self-policing and self-correcting. For instance, if a party with a large minority interest attempts to exercise control of the “controlled” entity by directing the use of the entity’s assets to disproportionately benefit the “controlling” entity, then the natural consequence will be for the other approximately 60 percent of voting interests to band together to foil the “controlling” entity’s attempts. As such, control in such a scenario becomes an enigma; as soon as the “controlling” entity tries to exercise control, its attempt will not only fail, but may well backfire against it.

Another presumption of control presented in paragraph 14 is based on an ability to dominate the process of nominating candidates for another entity’s governing board as evidenced by the casting of a majority of the votes in a recent election of board members. As above, such a situation is self-policing and self-correcting. For example, if an entity that casts its 26 percent stake in an election where only 50 percent of eligible votes are cast, attempts to benefit in a disproportionate manner by exercising control of the individual assets of the “controlled” entity, then the other 74 percent of eligible voters are certain to band together to foil the entity’s attempt. It is safe to assume that another election will be called, and a larger turnout of eligible voters will result in displacement of the previously chosen board.

In terms of financial statement presentation, the entity with a 26 percent stake will go from not consolidating the entity, to consolidating the entity, and then back to not consolidating the entity. Surely financial statement users will not benefit by having such volatility introduced into financial statements.

Another example of a presumption of control presented by the Board is when a party has the unilateral ability to obtain a majority voting interest in the future through ownership of securities or other rights that may be converted into a majority voting interest at that entity’s option. A key problem with this presumption is that it is inconsistent with current accounting concepts. Financial statements are based on current or past events. For instance, the statement of income and the statement of cash flows cover transactions that have occurred in the period of and ending on the final day of that period; the balance sheet is presented as of that point in time date. It is inconsistent for control to be based upon control that **could** exist in the future, as opposed to control that exists as of a given date.

In general, the ambiguities created by fixating control conclusions on one-time events (without analyzing the situational issues), such as focusing on the results of given elections or the abilities of parties to persuade and influence voting patterns of other stockholders, will lead to confusion. Such confusion will create situations that contradict the Board's statement in paragraph 10 of the ED that control of an entity is an exclusionary power such that if A controls B, no other entity can control B. By way of example, if A owns 40 percent of B, and C owns 25 percent of B, but can influence stockholders owning another 18 percent, which entity should be deemed to be in control of B? It appears to be the Board's intent that A and C either both consolidate B, or that they confer and come to an agreement as to which of them should consolidate B. This would require an evaluation of their current ownership interests, their holdings of convertible interests, their expectations of voter turnout, and their evaluations of their relative ability to persuade other stockholders. This will also lead to practice inconsistencies.

The most troubling presumption of effective control for the Corporations is paragraph 14.d. that appears to be directed at special-purpose entities ("SPEs"). This paragraph indicates that an entity that has no voting stock or member voting rights and has provisions in its charter, bylaws, or trust instrument that (1) cannot be changed by entities other than its creator (sponsor) and (2) limit the entity, including the powers of its board of directors or trustees, to activities that the creating entity can schedule (or can initiate) to provide substantially all future net cash inflows or other future economic benefits to its creator is presumed to be controlled by the creator. While we do not believe this is the Board's intent, this presumption could result in an unintended change in current accounting for certain securitization structures that currently are not consolidated.

The flaws in the above presumption are most evident when compared to the Board's related Exposure Draft, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (the "Transfers ED"), which specifically points readers to the ED on Consolidated Financial Statements for guidance on the application of the new requirements to transfers of assets to SPEs. If the Board examines the Transfers ED, it will see that the presumption in paragraph 14.d. of the ED on Consolidated Financial Statements can not be easily applied to structures currently used by financial institutions. For example, a common practice for banks and other financial institutions is to sell assets to a securitization SPE (typically a trust) and build into the structure a cushion to absorb potential losses such that the securities will receive an acceptable credit rating. In such cases, the transferor retains minimal risk, if any. The investors look to the assets of the trust and not the transferor in their credit risk evaluation. An example of such a transaction is a credit card securitization. From reading the Board's Transfers ED, one would conclude that the Board has evaluated the structures used by the marketplace and concluded that the underlying assets are truly sold and should be removed from the transferor's balance sheet since control is deemed to have been transferred. The Corporations agree with that conclusion. However, the ED on Consolidated Financial Statements generates significant ambiguity as to whether the intent is for such securitized assets to be consolidated by the transferor. The contradiction inherent in these conclusions, although both based on an analysis of control, is a direct result of the confusion created by the ED on Consolidated Financial Statements. The Board needs to review the types of SPEs used in current practice and conduct

public meetings with industry participants to understand why transfers of assets that qualify for sales treatment should also qualify to be excluded from the transferor's balance sheet.

The impact to financial institutions and the economy of changing accounting principles without fully analyzing the effects of the change could be severe. For instance, the process of securitizing assets has increased liquidity in many vital sectors. The Board must consider the enormous impact that consolidation of securitization structures like credit card and mortgage SPEs would have on liquidity in these important markets.

Furthermore, the term "sponsor," undefined as it is, compounds the confusion in application of the ED. In a typical securitization, there are a number of participants including transferor(s) of assets, investment banking advisors, liquidity and credit support providers, other administrative service providers, equity investors, and debt holders. It is unclear which of these the Board considers to be the sponsor. Moreover, even if clearly defined, the use of the term "sponsor" raises a conceptual problem to the extent it does not sufficiently recognize the often material rights and interests of such other participants.

As indicated above, the presumptions of control listed in paragraph 14 of the ED are so broadly written that the Board will need to provide significant additional guidance to ensure consistent application among financial statement preparers. Therefore, while the presumptions of control may be appropriate "indicators" of control, they contain too many rebuttable flaws to be considered "presumptions" of control. It is the Corporations' view that the only practical presumption of control is the ownership of a majority voting interest.

Scope

Paragraph 4 of the ED exempts from the scope of the ED entities that in accordance with generally accepted accounting principles carry substantially all of their assets, including investments in controlled entities, and liabilities at fair value with changes in value reported in a statement of net income or financial performance. The Board has settled on fair value as the litmus test, given its concern with using an imprecisely defined term like "investment companies." The ED states in paragraph 98 that allowing an exemption from the ED for such entities "deals with the similar operating environment and financial reporting by pension plans, mutual funds, and similar investment companies in an evenhanded way."

This paragraph 4 exemption does not promote evenhanded treatment between similar entities. Entities with operating environments and intent in conducting business akin to those that carry substantially all of their assets and liabilities at fair value may not meet the Board's litmus test. The intent and *raison d'être* of these entities is to make investments in other companies with the intent of profiting from increases in value of such investments. Some of these entities may not qualify for the exemption because readily determinable fair values may not be available. Evenhanded treatment is not promoted unless the Board modifies the scope of the exemption to include such entities for which the *intent* of doing business is to realize an appreciation in the value of their investments, and that carry at fair value the assets for which a readily determinable fair value is available.

For instance, if a venture capital entity invests, at whatever level, in a consumer distribution business, a manufacturing company, and a restaurant, then its objectives are to realize a sufficient return on its investments. To require the venture capital entity to consolidate its three investments as if it managed the consumer distribution business, manufacturing company, and restaurant would not serve the needs of users of the venture capital entity's financial statements. What is relevant, is how well the venture capital entity is performing in terms of earning a return on its investments. Surely, muddying the waters with such irrelevant information would contradict the Board's stated objective in paragraph 49 of improving the completeness and, thus, relevance and reliability of financial statements.

The Corporations concur with the position taken by respondents to the Board's Preliminary Views, *Consolidation Policy*, as stated in paragraph 96 of the ED, that consolidated financial statements would not provide meaningful information about these companies because they invest in nonhomogeneous businesses and intend to profit from the ultimate disposal of the investment rather than from its operations. This logic should not be disregarded by the Board.

Conforming Accounting Policies

The ED requires that the accounting policies of a subsidiary operating in a specialized industry, which requires generally accepted accounting principles that differ from those of its parent, conform its accounting policies to those of its parent when presenting consolidated financial statements. This changed requirement is not appropriate. Specialized accounting for certain industries exists for a reason; the specialized accounting better represents the financial position and results of operations of an entity operating in that industry.

It appears illogical to require entities to reverse, through the consolidation process, the effects of accounting principles that have been promulgated by various accounting setting bodies as being more appropriate in the circumstances for a particular industry. The fact should not be ignored that different accounting was needed for a specialized industry in order to provide more relevant and reliable information.

An example of the issues created by requiring conformity is that a broker-dealer subsidiary of a bank holding company would no longer be able to use specialized industry accounting when consolidated with its parent. As such, a consolidated broker-dealer would be subject to different accounting than applies to a broker-dealer that is not a subsidiary of a banking organization. This would be inconsistent with the Board's stated aim of having consistent accounting for similar events, transactions or entities.

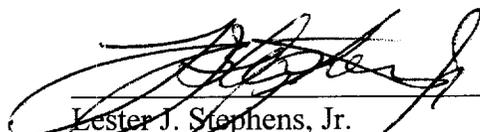
Alternatives

The Corporations concur with the views of the dissenting Board member that control alone is not sufficient to warrant consolidation. However, rather than focusing on the benefits of ownership, as that Board member does, consolidation should be based on the overall risks acquired or retained by the controlling entity. Thus, consolidation of an entity would be required when a

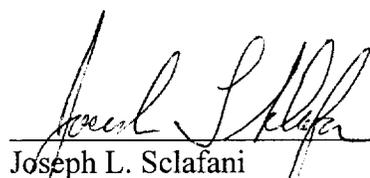
large stockholder has more than 50 percent of the risks of loss of the controlled entity. Risks as opposed to rewards are the most compelling evidence of control when coupled with a large equity holding. A large stockholder will be reluctant to assume the majority of the risk of another entity unless it has the ability in one form or another to control that entity.

The Corporations appreciate the opportunity to submit its views on the ED and are available to participate further in any discussions regarding the impact of proposed changes in consolidations guidance.

Very truly yours,



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