

First Union Corporation

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James H. Hatch

Senior Vice President and
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Letter of Comment No: 70**File Reference:** 1082-194R**Date Received:** 5/27/99

May 24, 1999

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

**Re: File Reference 194-B, Proposed Statement of Financial Accounting Standards,
*Consolidated Financial Statements: Purpose and Policy***

Dear Mr. Lucas:

First Union Corporation is pleased to have the opportunity to comment on the Proposed Statement of Financial Accounting Standards, *Consolidated Financial Statements: Purpose and Policy* (the "Exposure Draft"). First Union is the nation's sixth largest bank holding company with total assets in excess of \$220 billion. We routinely enter into a variety of transactions that involve consolidation issues, particularly transactions with entities set up specifically for the purpose of entering into one or a series of similar transactions, and we believe that it is important for the FASB to address these types of consolidation issues.

However, while we support the FASB's efforts to improve financial reporting as it relates to consolidation policy, we do not believe that the Exposure Draft achieves this objective. Instead, we believe that the accounting model for consolidation in the Exposure Draft is a digression from the current model, which can be objectively and consistently applied, to an approach that would be highly subjective and therefore subject to inconsistent application and the need for constant interpretation.

Our specific comments on the provisions of the Exposure Draft are outlined below.

Definition of Control

The definition of *control* in the Exposure Draft is based on the concept of effective control along with presumptions of control where the practical application of these presumptions is so unclear that it must be demonstrated through examples. The control criteria move away from the current objective and verifiable criteria to a vague and subjective definition. In order for accounting

literature to be meaningful and consistently applied, there must be objective and verifiable criteria. We believe that the subjective conceptual framework in the Exposure Draft will lead to inconsistent application of the definition of control resulting in financial statements that are not transparent and significant reliance on the EITF and/or the SEC to resolve interpretation issues. The current accounting model for consolidation where a parent consolidates all subsidiaries in which it owns either directly or indirectly more than 50 percent is a clear and verifiable framework that should be retained.

The following two examples illustrate the flaws in the application of the control-based model in the Exposure Draft:

1. Under the Exposure Draft, Company A which owns 35 percent of the voting stock of Company B is considered to control that entity if 69 percent or fewer shares were voted during recent shareholder votes, but is not considered to control the entity if 71 percent or more shares were voted. Voter apathy or a lack of substantive issues to inspire significant shareholder participation should have no impact on the determination of whether one entity controls, and therefore consolidates for financial statement purposes, an entity in which it has a minority investment.
2. The Exposure Draft also includes the presumption that a sole general partner, regardless of their ownership interest, controls the partnership and therefore should consolidate the entity. This presumption, in many situations, would result in a general partner consolidating significant assets and liabilities even though their residual interest in the partnership may be just one percent of the net assets that remain upon liquidation of the partnership. We believe that a general partner should only consolidate a partnership when they have a substantial residual interest in the entity.

Furthermore, the presumption that control generally rests with the general partner in a limited partnership implies that the limited partner will never be required to consolidate the partnership regardless of their ownership percentage. We find it disturbing that this guidance allows for non-consolidation by an entity that may have a controlling financial interest simply because the ownership is in the form of limited partnership interests. Also, it is important to note that the legal rights of a general partner vary by legal jurisdiction and the terms of the partnership agreement. The characteristics of a "typical" partnership are often modified such that the rights of a limited partner are more like those of an investor in a joint venture.

In both of the examples cited above, the consolidated financial statements may include a substantial amount of assets and liabilities resulting from the consolidation of a minority-owned company or partnership. The parent company has no current control of the assets of the second entity, but as the result of a significant minority ownership, is required to consolidate the second entity.

While these issues could affect us as a preparer of consolidated financial statements, they also affect us as a user of current and prospective borrowers' financial statements. In the two cases cited above, the only way to derive meaningful information about the creditworthiness of the borrower is to back out ("deconsolidate") the assets and liabilities of the subsidiaries in order to effectively analyze the borrower's financial condition.

Consolidation Procedures

While we support the FASB's decision to defer the consolidation procedures part of the project, certain aspects of applying the policies require procedural guidance. For example, Company A consolidates Company B because Company A owns convertible debt issued by Company B that, if converted, would cause Company A to have presumed control of Company B. The Exposure Draft provides no guidance with respect to the treatment of the convertible debt. Issues that immediately present themselves in this example include debt conversion assumptions and "intercompany" interest elimination.

This lack of procedural guidance is very likely to result in diverse accounting practices and incomparable financial reporting. In addition, some of the basic financial ratios and financial measures upon which financial analysts and others rely (e.g., debt to equity, interest coverage and EBITDA) would be rendered meaningless in certain situations.

We recommend that the FASB address in this standard the key procedural issues that arise from the consolidation policies.

Special Purpose Entities

The Exposure Draft does not provide meaningful guidance for assessing when an entity controls a special purpose entity (SPE) that it sponsors and/or administers. Once again, the Exposure Draft relies on broad concepts and examples to develop accounting guidance. This is an area where clear and meaningful accounting guidance would significantly improve financial reporting. Currently, entities that sponsor and/or administer an SPE determine whether the SPE should be consolidated based on the accounting guidance provided by various EITF Issues, Appendix Topic D-14 and industry practice. This mix of accounting guidance and related interpretations allows entities to enter into very similar transactions from an economic perspective and yet have different accounting results due to nonsubstantive differences in the terms or structure of the respective transactions.

A proposed accounting standard that provides guidance for consolidations, but does not meaningfully address the issues relating to SPEs falls well short of the intended purpose of improving financial reporting.

Investment Companies

Investment companies that apply the provisions of the AICPA Audit Guide, *Audits of Investment Companies*, (the "Audit Guide") are excluded from the scope of the Exposure Draft. We surmise

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that the rationale for this exclusion is the fiduciary responsibilities and governance required under the Investment Company Act of 1940 (the "1940 Act"). However, the Audit Guide covers many types of investment companies including limited partnerships, investment partnerships, off-shore funds, management investment companies, life insurance companies, many of which are not subject to the 1940 Act.

We believe that the scope exclusion in the Exposure Draft should apply only to investment companies registered under the 1940 Act (including small business investment and business development companies) and investment companies which would qualify under the 1940 Act, except that the number of shareholders is limited and that their securities are not publicly traded.

Impact on Other Accounting Literature

The Exposure Draft, if finalized, will have a significant impact on other existing accounting literature, particularly certain EITF Issues. Without a clear understanding of how a new standard would affect other existing accounting literature, we are unable to provide complete comments with regard to the Exposure Draft. We believe that the FASB should take no more action on this Exposure Draft until it has completed an assessment of the impact on existing accounting literature and the full scope of the proposed changes are made available for comment. For example, will the consensus of EITF Issue No. 90-15, *Impact on Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*, which for certain transactions requires that an equity investor have a minimum of a three percent equity investment in order for it to be considered substantive, be superceded?

Use of Test Cases

It is our understanding that the FASB has solicited feedback from a group of volunteer companies on the application of the provisions of the Exposure Draft to seven case studies. We strongly encourage the FASB to carefully consider the results of this field test in terms of whether the definition of control and the presumptions of control can be consistently applied.

Effective Date and Transition

The new standard would be effective January 1, 2000, for companies whose fiscal year follows the calendar year. We believe that the proposed effective date will not allow adequate time for companies to evaluate existing ownership interests, address consolidation procedure issues and, if necessary, amend or modify existing transactions in order for them to comply with the new guidance. Therefore, we believe that the final standard should be effective for annual periods no earlier than those beginning after December 15, 2000.

In summary, we recommend that the FASB discontinue their efforts to develop new guidance for consolidated financial statements, and instead, focus efforts on developing meaningful guidance

Mr. Timothy S. Lucas

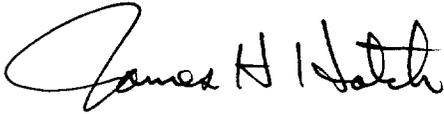
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addressing the accounting and consolidation issues related to special purpose entities. We believe that the current accounting model, which has worked well in practice for many years, should not be discarded in favor of an alternative that appears to be unworkable in practice, subjective in nature and likely to cause inconsistent and unreliable financial reporting.

We would be pleased to discuss these issues in more detail with the FASB or the staff, at your convenience. I can be reached at 704-374-6101.

Sincerely,

A handwritten signature in black ink, appearing to read "James H. Hatch". The signature is written in a cursive style with a large initial "J" and "H".

James H. Hatch

Senior Vice President and Corporate Controller

cc: Robert T. Atwood, Executive Vice President and Chief Financial Officer
B. Lynn Rogers, Director of Accounting Policy