JPMorgan

Letter of Comment No: 78
File Reference: 1082-194R
Date Received: 5/28/99

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May 24, 1999

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

Dear Tim:

Re: File Reference: 194-B,
Consolidated Financial Statements: Purpose and Policy

We welcome the opportunity to provide our comments on the revised Exposure Draft, *Consolidated Financial Statements: Purpose and Policy* ("ED"). We understand the Board's goal is to create a comprehensive consolidation standard that would apply to all types of entities and would combine all of the related authoritative literature that exists today. However, as we indicated in our responses to the Board's August 1994 Preliminary Views on Consolidation Policy and the 1995 ED, overall, we believe that the existing consolidation framework is well understood and has provided accurate and meaningful financial statements. We do not see a need to overhaul the entire current framework unless it is proven that the new framework provides more meaningful financial statements. We do not think this has been achieved in the revised ED. As described further in our letter, because of concerns with the subjectivity of the proposed standard, our objection to three of the four rebuttable presumptions of control, and the lack of clarifying guidance on special purpose entities ("SPEs"), we do not support issuance of this ED as a final standard at this time. We are concerned that application of the ED in its current form can lead to misleading financial statements and inconsistencies in reported information. Instead, we recommend that the Board should not replace the guidance in SFAS No. 94, *Consolidation of All Majority-Owned Subsidiaries* and ARB No. 51, *Consolidated Financial Statements*, but should focus on providing additional guidance where it is needed, such as SPEs and joint ventures. We have also participated in the process of preparing industry comments on the ED which reiterate many of our concerns.

We believe the level of subjectivity involved in determining whether an entity has "effective control" of another will limit the usefulness of the proposed statement. We do not believe that the examples provided, or that may be provided in the future, can compensate for the overall subjectivity inherent in the proposed statement. This will lead to lengthy deliberation on how to interpret control with the likely outcome being inconsistent application of the standard. The Board must resolve these issues before a final standard is issued. If the ED is issued in its current form, we expect that the Board will have to spend a great deal of time addressing implementation issues. While we understand there will always be issues to resolve after issuance of a new standard, we urge the Board to consider constituents' concerns before

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issuance of the final standard to avoid extensive revisiting of the standard at the same time we are supposed to be applying its rules.

We are especially concerned with trying to apply the ED's subjective notion of effective control to SPE transactions. One of the Board's goals of the consolidation project was to clarify consolidation issues related to special-purpose entities. The difficulty encountered by companies in applying the notion of effective control to consolidation of SPE's was one of the significant causes for the delay in issuing this standard. We do not believe the ED fulfills the Board's goal of providing sufficient clarity or specific guidance on these issues. Further, the examples provided with respect to SPEs were not reflective of SPEs that are used in the financial services industry so they were not particularly helpful. Contrary to the view expressed by the Board in paragraph 242, we believe the Board should provide a consolidation framework that is specifically crafted for SPE transactions.

Further, we understand that the Board wishes to resolve issues pertaining to the policy issues before it concludes on procedures to implement the new guidance. We do not think this is appropriate since the policy changes will lead to procedural issues. For example, under the ED's proposed guidance, a 1% general partner of a limited partnership will have to consolidate 100% of the limited partnership assets with a 99% "minority interest." Obviously, the proposed statement will overhaul the concept of minority interest yet there is no guidance on its replacement. We are aware that the Board is addressing related procedural issues in other projects, but the timing of those conclusions is unlikely to coincide with application of this statement.

The remainder of this letter provides detailed comments supporting our views and recommendations related to the ED and is organized as follows: (1) the impact of the ED on SPEs, (2) the purpose of consolidated financial statements, and (3) the proposed scope of the ED. The last section includes our responses to specific questions raised by the Board.

Impact on SPEs

There are several major unknown variables relating to the guidance on the consolidation of SPEs that significantly impair our ability to provide a comprehensive view of the potential impact of this Statement on SPE transactions. In particular:

- It is unclear how the guidance in this ED impacts or interacts with the SFAS No. 125, *Accounting for Transfers and Servicing of Assets and Extinguishments of Liabilities* ("SFAS 125") as ultimately amended, and related EITF Issues including EITF Issue No. 96-20, *Impact of FASB Statement No. 125 on Consolidation of Special-Purpose Entities*.
- It is unclear how this ED will impact other SPE related literature, including EITF Topic No. D-14, *Transactions involving Special-Purpose Entities*, EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in leasing Transactions*, EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities*.
- It is unclear how the ED will impact the SEC's previously expressed views on consolidation of SPEs, i.e., the 3% substantive equity requirement.

Much progress has been made in the process to amend SFAS 125 to clarify guidance on qualifying SPEs. These efforts have produced a workable framework for deciding if an SPE is a qualifying SPE. We continue to support this framework and do not believe this ED should impact it.

Further guidance is needed for consolidation of non-qualifying SPEs as we do not believe the definition of control in the proposed ED provides a workable framework. The limitations on SPEs and typical restrictions on any one party's ability to use the assets make it very difficult, if not impossible, to apply the ED's concept of control as the sole determinant for consolidation of SPEs. As the FASB expressed in its comment letter on the International Standards Committee's Standing Interpretations Committee Draft Interpretation D-12, *Consolidation of Special Purpose Entities*, "often, many, if not most of the limits that are imposed on the activities of an SPE are specifically designed to protect the interests of two or more parties and ensure *that no single party can control the activities of the SPE"* (emphasis added). At a minimum, we believe that the standards section should provide an explicit, broad statement that there will be situations where control of the entity, and its resulting benefits, will be shared to the extent that no one party has exclusionary control and, therefore, no one party must consolidate the entity. Such a positive assertion in the standard may help avoid unnecessary debates between corporations and their auditors or other parties about the need to always identify an "owner" of an entity.

Further, we believe the Board should look to the SFAS 125 financial-components framework in determining what information is useful for the financial statement users with respect to SPE securitization transactions. The SFAS 125 financial-components approach was designed to be consistent with the way participants in the financial markets deal with financial assets[1], including the combination and separation of components of those assets via structured transactions. If entities are forced to consolidate certain SPEs under this ED, the financial statements would inappropriately ignore the effect of the securitization process and will result in an overstatement of assets that the entity can use as if they were its own. The specific procedures involved in establishing a bankruptcy-remote SPE are to justify derecognition of the assets, so we believe consolidation of the assets would be misleading and would be a step backwards from the progress made in SFAS 125.

Purpose of Consolidated Financial Statements
The lack of a majority financial interest before consolidation is required is a drastic change from previous consolidation standards. Application of the ED will require consolidation of entities that have never been considered "subsidiaries" and the Board has provided very little information on why they believe the specific proposed changes will improve reported information. We are troubled that many of the proposed changes, which result in merely grossing up the financial statements, will confuse readers of financial statements. For example, under the proposal, many 1% general partners may be forced to consolidate 100% of

[1] Paragraph 107, SFAS 125

an entity with a 99% "minority interest." This will gross-up the balance sheet and income statement and will mislead users into thinking there are significantly more assets available to generate cash for the "parent's" operations. The same overstatement can occur if entities are forced to consolidate when the assets cannot be used by the parent but are held only for the benefit of outside investors or if the use of the assets is limited by the governing documents of the entity. It is critical for the Board to address these issues. Contrary to the Board's conclusion to eliminate the need for a consolidation policy disclosure, entities may have to significantly expand disclosures to explain the effect of consolidated entities where consolidation does not reflect the reality of the relationship with the entity.

Further, we believe the section on the purpose of consolidated financial statements should include a discussion of the impact of what management views as its "single reporting entity." If management does not consider an entity's assets as "economic resources or assets...that are central to the existence and operations of [the] entity[2], this is evidence that this information may not be relevant to the shareholders, creditors, or other financial statement users. The Board has already highlighted the importance of management's view of an entity in SFAS 131, *Disclosures about Segments of an Enterprise and Related Information,* which states "general-purpose financial statements include selected segment information reported using a management approach, i.e., *based on the way that management organizes the segments within the enterprise for making operating decisions and assessing performance"* (emphasis added).

Scope

The proposed statement does not apply to financial statements of reporting entities that in accordance with generally accepted accounting principles carry substantially all of their assets, including investments in controlled entities, at fair value. Entities explicitly excluded include defined benefit pension plans, mutual funds, and other investment companies that apply the provisions of the AICPA Audit and Accounting Guide, *Audits of Investment Companies* ("Audit Guide").

We are concerned that the investment company exclusion will be narrowly interpreted as applying only to investment companies that are defined in the Audit Guide. Further, we note that AcSEC currently has a project on its agenda to clarify the scope of the Audit Guide, which further clouds how to interpret this exclusion. Therefore, we believe it is inappropriate to use the Audit Guide's definition as an absolute criterion for excluding an investment company from the ED's scope. Instead, if the nature of an entity is that of an investment company and it is following the accounting guidance of the Audit Guide, it should be eligible for an exclusion from applying the provisions of this ED. We believe it is reasonable to allow companies to apply judgment as to whether the spirit of an entity is an investment company. Further, in addition to completely distorting the consolidated financial statements, the cost of tracking whether underlying assets in investment companies are "controlled," which could change every period, would be an undertaking that entities are currently not equipped to handle.

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[2] Paragraph 205, Consolidations ED

Further, we weren't clear why the exclusion would be limited to entities that record substantially all of its assets at fair value through income. We believe this should be modified to incorporate entities that may record some of their assets at fair value through comprehensive income.

In addition, it is unclear how the fair value project will impact the applicability of this ED. We expect that certain entities that may be consolidated under this ED could fall under a fair value model and would no longer have to apply this ED, and it is not clear if there would be a significant benefit in applying this ED for a short period of time. We recommend that the Board provide its views on this issue.

Comments on Issues Raised by the Board

Our comments on specific questions raised by the Board are as follows:

***Issue 1*: Definition of Control**

We believe the definition of control should explicitly address that control must encompass the ability to use the entity's assets, similar to how this part of the definition was presented in the October 1995 ED. For example, "control of an entity is a parent's nonshared decision-making ability that enables it to direct the policies and management that guide the ongoing activities of its subsidiary, which must include the power to direct the use of the assets of another entity in essentially the same ways the controlling entity can use its own assets." This notion of control is consistent with the underlying concepts of the SFAS 125 financial-statements approach that focuses on control over assets. We understand that some respondents had concerns that focusing on an entity's "individual assets" could lead to misunderstandings and unintended consequences, but we believe that the concerns expressed have been addressed by the Board's discussion on protective rights and should not cause significant implementation issues.

Similar to our response to the 1995 ED, we do not believe consolidation should be required unless the "parent" has a majority of the voting shares or has the ability to use its "control" to derive significant benefits from the entity. Not all control is equal, and we have serious concerns that this distinction is not adequately addressed in the ED. It does not appear appropriate for an entity to consolidate another entity when all it can gain from its "control" is a return that reflects a minimal portion of the entity's revenues. If an entity were deemed to control an entity under the ED, but has no significant economic interest, the controlled entity's assets, liabilities, revenues, and expenses would lack relevance because the entity would not be able to derive any significant benefits from them. The Board has not provided any insights on why they believe this improves reported information.

We note that the concept of control requiring a "significant financial interest" can be found in the recent consensus reached in EITF Issue No. 97-2, "*Application of FAS 94 and APB 16 to Physician Practice Management Entities and Certain Other Management Entities with Similar Circumstances and Arrangements*. One of the conditions for a physician practice management (PPM) companies "controlling financial interest" in a medical entity is a *significant financial interest* that must provide the PPM with the rights to share in income from current operating results and a portion of sale or liquidation proceeds so that the amounts collectively derived constitute a *significant* portion of the total change in fair value.

Further, we noted inconsistency between some of the discussion in the ED and the ED's definition of control. The Board has concluded that there should be *no required level of benefits* for consolidation. However, in paragraph 243 the Board considered whether SPEs should be consolidated for reasons other than control, i.e., if an entity receives all or a majority of the "benefits" or a "residual interest." Based on our reading of this paragraph, the Board seemed to present a bias towards the conclusion that the party that receives a residual interest will likely be deemed to have control after a careful assessment of the facts. Does this mean that an entity that does *not* have the nonshared decision making ability to direct the use of another entity's assets can somehow meet the definition of control based on its benefits alone? The Board needs to address this inconsistency as its existence will increase the difficulties in applying an already subjective framework.

***Issue 2*: Are the rebuttable presumptions appropriate and workable?**
Similar to the concerns expressed by the Board member with the Alternative View, with the exception of rebuttable presumption (a), we do not believe that these presumptions provide compelling evidence that point toward control. These presumptions can lead to a conclusion that an entity controls another entity when, in fact, control does not exist. This result is in direct contradiction of the Board's stated purpose of financial statements, and would diminish the representational faithfulness and usefulness of the information provided by those financial statements.

(b) *An entity has a large minority voting interest in the election of a corporation's governing body and no other party or organized group has a significant voting interest.*

We do not believe it is operational to require entities to determine whether a less than majority interest may or may not result in the investor "controlling" the election of a corporation's governing body. Ownership of voting stock in a corporation provides clear legal evidence of control and we do not believe further guidance in this area is necessary. Unless an investor owns greater than 50% of a corporation's majority interest, it does not have *exclusionary* control over the investee. All other shareholders can decide to vote against that party.

Further, it is not practical to require an entity to track (1) the dispersion of ownership of other shares and (2) a tally of the number of investees that participate in Board elections. We believe application of this criterion would be non-operational and can lead to "volatility" in consolidating entities since the facts that points to or against consolidation are *not within control* of a minority interest holder and can change every year. Absent other compelling facts that a minority holder has control, i.e., agreements with other shareholders that they will vote in line with that party, we believe this rebuttable presumption will lead to incorrect consolidated financial statements.

(c) *The entity has a unilateral ability to (1) obtain a majority voting interest in the election of a corporation's governing body or (2) obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost.*

While the acquisition of such convertible securities, options, or warrants may be a *precursor* to obtaining control, we do not believe these conditions present compelling evidence that the entity has *current* control. Therefore, in these situations we believe consolidation is inappropriate. Until those parties actually exercise the rights provided in the instrument held (i.e., convertible securities, options, warrants, etc.) they do not have control. Further, control based on a *probable* action is inconsistent with SFAS 125 guidance that concludes that "probable behavior is not equivalent to a contractual right" and effective control over an asset is not maintained merely because a transferee *may* agree at a later date to return transferred assets to the transferor.[3]

Further, we believe that these provisions can be subject to abuse. For example, a greater than 50% owner of voting shares, would normally be required to consolidate under the rebuttable presumption in (a). However, if the investor wanted to avoid consolidation, it could enter into such agreements with an entity that is indifferent to consolidation issues. Would the current >50% owner "de-consolidate" due to the mere existence of these arrangements? We do not think that would be appropriate. As noted above, we believe that >50% ownership is legal evidence of control and that consolidation should be presumed unless other parties *currently* impair that ability. Again, absent further evidence that these situations provide current control to the holder of the convertible securities and that they eliminate the control of the entity with legal control, i.e., >50% ownership, we believe application of this rebuttable presumption will lead to incorrect and misleading financial statements.

(d) The entity is the only general partner in a limited partnership and no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner.

As previously noted, we believe application of this rule and the resulting grossed up financial statements will diminish the usefulness of reported information. The general partner will typically have a nominal, i.e., 1% interest, and the proposed consolidation with a 99% "minority interest" will confuse financial statement users. The limited partners are the parties that get the majority of the benefits from those assets and it would be misleading to record them on the general partner's balance sheet as if they were its own. The general partner cannot use the fund's assets for any purpose other than to benefit the investors in the fund and is restricted from using the assets to satisfy its general corporate purposes or obligations. In our view, the financial statements should only reflect amounts that are indicative of the rights

[3] Question 50, *A Guide to Implementation of Statement 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, Questions and Answers, Second Edition.

and obligations of a general partner, i.e., revenues relating to its interest and general partner expenses.

Further, in many of these arrangements the general partner is not acting in any different capacity than an investment manager of a mutual fund and the Board has concluded that an investment manager does not control a mutual fund. As stated in paragraph 70, "a fund manager cannot use the assets of the fund to do any of those things for the purpose of increasing its fees or other benefit and limiting its losses from the activities of the fund." This is equally applicable to general partners that act as managers of private funds. While there may not be the same regulatory restrictions imposed on private funds, they are nonetheless restricted by the agreements negotiated with the outside investors. We do not believe that completely different financial statements for a mutual fund manager or a private equity fund manager are justified merely due to the different form of the "managed" entity. Unless there is compelling evidence that the general partner is receiving a majority of the benefits from these structures, we do not agree that consolidation is appropriate.

We think that paragraph 217 overstates the importance of the general partner's assumption of the limited partners liabilities. The general partner is not managing the assets to limit the liabilities, since typically the liabilities of the partnership are not material. The assets are managed for the benefit of the investors in accordance with the guidelines of the limited partner agreements. Of course, if the general partner is negligent it may be exposed to litigation, but in the typical course of business the general partner's do not view their assumption of the partnerships liabilities as the primary incentive for managing the assets.

We disagree with the guidance in paragraph 63 and 65 that the number of limited partners should be considered in deciding whether the rights of the limited partners override the presumption that the general partner must consolidate. If the limited partners have the legal right to organize and remove the general partner, the fact that this effort may be more difficult when there are more limited partners does not negate that right. The presence of these rights, in and of themselves, provide sufficient evidence that the general partner does not have exclusionary control over the limited partnership. Further, in the age of information technology, if the limited partners are motivated, they can organize to effect the removal of the general partner.

***Issue 3*: Transition and Effective Date**

The current proposed time frame between issuance of the final standard and its effective date is unacceptable for a standard that could have such a broad and significant impact. Based on historical experience, until a standard is issued as *final,* its provisions are always subject to change, and typically do, as a result of due process and further deliberations. While entities may begin to consider and explore the ramifications of the proposed statement, it is unreasonable to expect that they will change their current accounting or begin renegotiating debt covenant agreements or start to exit activities, if necessary, until the standard is finalized and the final impact has been agreed upon by the public accountants. The accounting community needs sufficient time to reach this point.

Further, we believe the Board has grossly understated the potential impact to business activities and relationships and other impacts, i.e., the impact on regulatory ratios, that would need to be addressed if certain entities become "subsidiaries" under this ED. Therefore, we recommend an effective date for fiscal years beginning after December 15, 2000, without restatement. We do not believe restatement should be required because we do not think the benefits of providing this information outweigh the costs of compiling previous years' financial statements. Further, as many of these entities would not have previously been considered "subsidiaries," relevant information necessary for complete financial statements may be difficult, if not impossible, to obtain.

Further, a January 1, 2001 effective date (for preparers of calendar year end financial statements) is consistent with the tentative effective date of the SFAS 125 amendment. Since the FAS 125 amendment includes guidance on qualifying SPEs, we believe there should be one effective date for all "new" consolidation standards for SPEs.

In the event that the final standard is issued for implementation on January 1, 2000, we do not support application to interim periods in the year of adoption.

We would be happy to discuss any of our comments at your convenience.

Sincerely yours,

David