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Mr. Timothy J. Lucas
Director of Research and Technical Activities
Financial Accounting Standards Board
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Dear Mr. Lucas:

Morgan Stanley Dean Witter & Co. appreciates the opportunity to respond to the Exposure Draft, "Consolidated Financial Statements: Purpose and Policy."

We agree that when one entity "controls" another entity (a parent/subsidiary relationship), the financial statements of the subsidiary should be consolidated with those of the parent. However, we do not agree that there is a broad spectrum of presumptions of control. We believe that control should be presumed only when an entity has a majority equity interest (the voting shares outstanding) in another entity. Although we recognize that based on individual facts and circumstances control may also be present where there is less than a majority equity interest, these should be infrequent, and control should not be presumed. A presumption, although it may be rebutted, is by its nature biased in favor of consolidation. An entity should not be placed in the position of rebutting an assumed pattern of behavior where it does not believe it exercises control, it has taken no affirmative action to acquire control, it exhibits no indication of having effective control, and it could exercise control only with the acquiescence of others. Until an entity has taken action to establish control by acquiring a majority equity interest, not simply its ability to do so, no presumption should be made about its ability to exercise control.

We also agree with the focus of the Alternative View expressed in paragraphs 248 -256 of the Draft and ask the Board to reconsider those views in its final deliberations.

The Definition and Application of Control

We agree, in theory, that control involves (1) non-shared decision making ability to guide the on-going activities of another entity and (2) the ability to use that power for the benefit of the controlling entity. However, we also recognize that the application of a standard based on a notion of control is subjective and thus will present operational issues. As is clear from the examples in the Draft, strong counterarguments about the presence or absence of control can be made in virtually all cases. In addition, although not addressed directly in the examples, we are concerned that absent a clear objective control standard, assessments of control may result in more than one entity believing that they have control over another entity. The Board should satisfy itself that the final standard is sufficiently objective so that the probability of multiple controlling entities being identified is remote. Therefore, we encourage the Board to continue to actively field test application examples that will also reflect changes in the proposal before a final standard is issued.

Application in Multi-tiered Consolidations

The Draft is not clear as to whether an entity to which the consolidation standard would not apply (i.e., an "exempt" entity per paragraph 5 of the Draft) that is a subsidiary of an entity to which the consolidation standard would apply continues to be an exempt entity when it is included in the consolidated financial statements of its parent.

Example

Company A is a financial services firm that is not exempt under paragraph 5 of the Draft. Company A controls Company B, an investment company that is exempt under paragraph 5. Company B has a 60% voting interest in Company C; it controls C but reports its investment in C at fair value in accordance with the AICPA Audit and Accounting Guide, "Audits of Investment Companies." When B reports its separate financial statements it does not consolidate C. However, when B is consolidated with A, must B then also consolidate C or should C continue to be unconsolidated and reported at fair value?

We believe that an exemption under paragraph 5 for a member of a consolidated group should apply to any level of consolidation that includes the exempt entity. Thus, when B is consolidated with A, its investment in C continues to be reported at fair value, not on a consolidated basis. This appears to be the logical application of the exemption in multi-tiered consolidations. It avoids inconsistent reporting at different levels of the consolidated group. Also, we see no reason to adjust required fair value reporting solely for consolidation purposes.

Our conclusion is consistent with EITF 85-12 wherein a consensus was reached that a specialized industry accounting practice at a subsidiary level should be retained in consolidation. We believe that EITF 85-12 should either survive as GAAP guidance or its consensus should be incorporated into the final consolidation standard. While this is a consolidation procedure issue and not technically within the scope of the Draft, it does raise a significant implementation issue which should be clarified in the final standard.

Also, with respect to the application of paragraph 5, the Draft cites defined benefit pension plans and investment companies *as examples* of entities that would be exempt. We believe that the final standard should provide more definitive guidance as to what kinds of specific entities the Board considers to be exempt, or more specifically what kinds of reporting characteristics an entity should satisfy.

Presumptions of Control

Following are our comments on the four specific presumptions of control cited in the Draft. We believe that A, with clarifying wording, represents the only circumstance where a presumption of control can be supported, while B, C and D cannot be supported as presumptions and should not be identified as such in the final standard.

A) Has a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of the members of its governing body

We recommend that this presumption be reworded as follows; "As a result of owning a majority equity interest (the voting shares outstanding), has a majority voting interest in the election of the corporation's governing body." While ownership of less than a majority of the voting shares may sometimes allow an investor to control a majority of the governing body, whether control is present in such a case must be assessed based on the individual facts and circumstances. The same with the right to appoint a majority; if that right emanates from circumstances other than ownership of a majority voting interest, the presence of control must be assessed based on individual facts and circumstances.

B) Has a large minority voting interest in the election of a corporation's governing body and no other party or organized group of parties has a significant voting interest

At best, a large minority voting interest may influence an entity, but, in our opinion, rarely if ever would it be able to exercise the *non-shared* control required by the Draft. While the 50% formula described in footnote 2 of page 7 of the Draft is appealing, it fails to recognize that absent an absolute voting majority, a minority interest can effect control only with the acquiescence of the remaining voting interests, and only so long as the large minority holder's actions do not run counter to their interests. We view this as shared control; the minority holder would always be inhibited in the free exercise of control to the exclusion of the other shareholders knowing that actions which run counter to the interests of other shareholders could lead to the loss of effective control. Even in the case of very widely dispersed shareholdings, shareholders could quickly be marshalled as an effective voting block by other shareholders, such as investment companies, who themselves may hold only a de minimus interest but who have the ability and means to take action against the large minority holder.

C) 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

The ability to achieve control is not actual control, and consolidation is appropriate only when, or if, the right is exercised and actual control is achieved. The fact that the holder of a right has not exercised a right which would give it control is significant. If the presumption of control is valid, and the ability to control is always exploited, one should never see an unexercised right to achieve control which is beneficial to the holder (i.e., the benefit exceeds its expected cost). Yet, as the Alternative View notes, there may be many reasons why the holder of the right has not, can not, or may never exercise its right. For example: financing might be required to exercise the right; there might be strategic business or regulatory concerns, or significant dissident shareholders might attempt to oppose control. Thus, we do not agree that control should be presumed by the *ability to obtain* control.

D) Is a sole 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

We do not believe that it is appropriate to presume that a sole general partner controls the partnership, even in the face of widely dispersed limited partner interests. A general partner will often have a nominal economic interest (perhaps as little as 1%), with little or no ability to benefit unilaterally without considering the interests of the limited partners. We share the Alternative View that the general partner is usually more of a manager whose powers are delegated by the limited partners. Very often the role of the general partner is principally to qualify the limited partnership, but without the general partner having significant economic interest or risk. The argument that sole general partner interests should be consolidated because of the general partner's unlimited liability for the obligations of the partnership is not compelling because the general partner's risk can be limited. For example, financing for a project may be non-recourse, or the general partner's capitalization may implicitly limit what it has put at risk of loss.

Consolidated financial statements should present relevant information. However, the presumption of control by a sole general partner will often result in consolidated information which is distorted, confusing and probably less useful than if consolidation were not applied. For example, a sole general partner with a 1% interest (not an uncommon structure) would be required to inflate its financial statements and then establish what might very well be a material minority interest offset. To our knowledge, there is no frame of reference by which users of financial information can adequately assess performance in such a case, or indeed whenever any disproportionately large minority interest is present.

Merchant Banking Activities

Merchant banking is an investment management activity entered into for the purpose of producing significant rates of return through the subsequent sale of the investment. Under current accounting as prescribed by the AICPA Audit and Accounting Guide, "Brokers and Dealers in Securities," merchant banking investments must be reported at fair value even where there is a controlling equity interest. The accounting requirement is the same as that for investment companies. However, unlike investment companies, merchant banking activities are offered no specific exemption in the Draft and thus they would be subject to the consolidation criteria where control of an investee is present. We believe that merchant banking activities should be specifically exempted from consolidation requirements. Merchant banking activities are subject to specific investment criteria with on-going management oversight for conformity to those investment criteria. Merchant banking is almost always a discrete, readily identifiable activity carried out through a separate subsidiary with a fairly limited number of investments at any one time.

Consolidation of controlled merchant banking investees is not the accepted industry practice because control is recognized to be temporary (see our general comments below with respect to Temporary Control). Consolidation will frequently change the composition of the consolidated group both as to specific investees and industry mix. Since the core business of the merchant bank is investment management, we do not believe that it is useful to users of financial information to see consolidated financial statements with myriad unrelated assets in an ever-changing environment, with material minority interests, subject to numerous specialized industry accounting practices, where performance evaluation is not enhanced by the added information provided by consolidation. Also, we do not believe that it is meaningful for consolidation to create the appearance of business segmentation where management has made no long-term commitment and where separate investments are not necessarily managed as a common operating unit.

We believe that the appropriate accounting for merchant banking investments should continue to be fair value reporting for all such investments. We do not believe that moving away from fair value reporting to historical-cost based consolidated reporting is an improvement in reporting.

Temporary Control

We agree that where control over another entity is temporary, the controlled entity should not be consolidated because comparative consolidated information would not be meaningful. However, the proposed requirement that an investment can be considered temporary only if there is a commitment or obligation to relinquish control within twelve months is much too restrictive. We do not believe that an arbitrary timeframe should be imposed. Also, the intent to relinquish control should be sufficient to avoid consolidation even if there is no current commitment or obligation to do so and the timing is not yet precisely determinable. The reporting entity should be allowed to demonstrate its intent by reference to management actions and its historic operating and investment practices.

Qualifying Special Purpose Entities (QSPEs)

While the scope of the Draft includes SPEs, there is no specific reference in the Draft to QSPEs, as defined in FAS 125 and ancillary authoritative literature such as EITF Topics. Nor is there any cross-reference to the FAS 125 amendment project where QSPE consolidation issues are being addressed. It is our understanding from recent deliberations that the Board intends to include consolidation guidance for QSPEs in the proposed amendment of FAS 125. Therefore, the consolidation standard should include language to indicate that consolidation guidance for SPEs which are QSPEs under FAS 125 (as amended) is to be governed by FAS 125 (as amended). Specific wording is necessary to make clear the Board's intent and to avoid conflict between the two standards. If the consolidation standard is to be issued before the final FAS 125 amendment, then QSPEs should be specifically excluded from the scope of the consolidation standard, noting that until, or unless, an amendment of FAS 125 is issued, current FAS 125 and related authoritative literature should continue to guide QSPE consolidation.

Transition

The Board notes in its basis for conclusions that it does not believe that the standard will add significantly to the number of entities that would have to be consolidated. However, even if that is true, for many entities the process of assessing control will be a major undertaking. Thus, we support application in the initial year only for year-end or annual reporting periods. A calendar-year entity would first be required to present year-end or annual financial statements in accordance with the standard at December 31, 2000, with restated financial statements for comparative year-end or annual prior periods. Beginning with the first interim reporting period of the second year after adoption (the quarter ended March 31, 2001 for a calendar-year company), interim financial statements in accordance with the standard would be required, together with restated interim financial statements for prior comparative periods.

We appreciate the opportunity to comment on this proposal. We would be pleased to discuss our comments with the Board or the staff.

Sincerely,

Joanne Pace

Joanne Pace
Chief Accounting Officer